Delaware Supreme Court Reinforces Director Oversight Obligation

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> See page 4 for takeaways

On June 18, 2019, in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), the Delaware Supreme Court issued an important decision reaffirming the obligation that directors of Delaware corporations make good faith efforts to implement and monitor a risk oversight system. In *Marchand*, the Supreme Court reversed the Court of Chancery's dismissal of a stockholder derivative suit seeking damages pursuant to alleged *Caremark* claims, which are difficult to plead and prove.[1] Specifically, the Supreme Court held that, at the pleading stage, the plaintiffs had alleged facts sufficient to satisfy the high *Caremark* standard for establishing that a board breached its duty of loyalty by failing to make a good faith effort to oversee a material risk area, thus demonstrating bad faith.

The decision in *Marchand* is already impacting several cases pending in the Court of Chancery.

Summary of Supreme Court's *Caremark* Analysis in *Marchand*

In *Marchand*, the plaintiffs asserted a claim against the directors for lack of oversight under the standards developed in *Caremark* and *Stone ex rel. AmSouth Bancorporation v. Ritter*,[2] which recognize an obligation to attempt in good faith to assure that a corporate information and reporting system exists, such that appropriate information will come to the board's attention in a timely manner. The elements for director liability on an oversight claim are well settled: (i) the directors must have utterly failed to implement any reporting or information system or controls; or (ii) having implemented appropriate compliance controls, the directors consciously failed to monitor or oversee the operation of that system.

The case arose out of a listeria outbreak from ice cream made by Blue Bell Creamery USA Inc. that sickened many consumers, caused three deaths and resulted in a total product recall. The Delaware Supreme Court held that the complaint stated a claim for lack of board oversight because the Blue Bell board allegedly failed to implement any system to monitor Blue Bell's food safety performance or compliance. The Supreme Court explained that "[a]s with any other disinterested business judgment, directors have great discretion to design context- and industry-specific approaches," but "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort — *i.e.*, try — to put in place a reasonable board-level system of monitoring and compliance."[3] The Supreme Court noted that testing reports received by management had identified listeria contamination in certain of Blue Bell's plants, but the board meeting minutes reflected "no board-level discussion" of these negative reports.[4] The Supreme Court indicated 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*."[5] Additionally, the court rejected the directors' argument that because Blue Bell management discussed general operations with the board, a *Caremark* claim was not stated. In doing so, the Supreme Court explained "if that were the case, then *Caremark* would be a chimera," because "[a]t every board

[1] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (*Caremark*).

[2] 911 A.2d 362 (Del. 2006).

[3] 212 A.3d at 821.

[4] *Id.* at 812.

[5] *Id.* at 823 (emphasis in original).

meeting of any company, it is likely that management will touch on some operational issue."[6] According to the opinion, despite management's knowledge of the problem, "this information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem" regarding "what has to be one of the most central issues at the company: whether it is ensuring that the only product it makes — ice cream — is safe to eat."[7] The court was particularly concerned that reports containing "what could be considered red, or at least yellow, flags" were not disclosed to the board.[8] As Chief Justice Leo E. Strine observed: "If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty."[9]

[6] *Id.* at 824.

[7] *Id.* at 812, 822.

[8] *Id.*

[9] *Id.* at 824. Another notable aspect of the Supreme Court's *Marchand* decision involved the reversal of the Court of Chancery's dismissal of the action for failure to make a presuit demand on the board. Specifically, the Supreme Court held that the complaint adequately pled that a director — previously viewed by the Court of Chancery as independent — could not impartially consider a demand due to his alleged "warm and thick personal ties of respect, loyalty, and affection between [the director] and the [company's founding family]," including business relationships allegedly facilitated by the family over many years. As a result, the court found that a majority of the board was not independent and disinterested for purposes of the board's consideration of a stockholder demand to file a lawsuit against directors and officers. This aspect of the *Marchand* decision is also having an immediate impact on recent Chancery decisions. *See, e.g.*, *In re BGC Partners, Inc. Derivative Litigation*, Consol. C.A. 2019-0722-ABG (Del. Ch. Sept. 30, 2019) (TRANSCRIPT) (relying in part on *Marchand*, finding three of four directors on a special committee were not independent because, in part, they were among the alleged controller's "go-to" choices for board appointments on companies he controlled, they received substantial compensation from their service on those boards, and they had significant social ties to the controller).

Caremark Decisions Post-*Marchand*

The *Marchand* opinion had an almost immediate ripple effect in a number of cases pending in the Court of Chancery, although two of these cases focused their analysis on the second prong of *Caremark*, which requires directors to monitor and oversee reporting systems already in place.

In *Rojas v. Ellison*, 2019 WL 3408812 (Del. Ch. July 29, 2019), the Court of Chancery refused to find that the allegations stated a *Caremark* claim. A stockholder of J.C. Penney Company asserted that the company's directors breached their fiduciary duty of loyalty by consciously disregarding their responsibility to oversee the company's compliance with California laws governing price-comparison advertising.[10] The complaint alleged that the board failed to ensure that the company abided by the terms of its settlement in a class action (the *Spann* action) related to claims of false reference pricing.[11] The independence of J.C. Penney's directors was "unquestioned;" instead, the plaintiff argued that a majority of the board faced a substantial likelihood of liability with respect to the alleged oversight claims.[12]

Referencing the Supreme Court's guidance in *Marchand*, the court found that the complaint and documents incorporated therein indicated that the company had a board-level reporting system in place at the time of the *Spann* action to monitor compliance with laws and regulations.[13] The court acknowledged that the audit committee of the board was charged with regulatory compliance, and that both the audit committee and the board reviewed the memorandum of settlement in the *Spann* action. As a result, the court held "it cannot be said that J.C. Penney's directors 'utterly

[10] 2019 WL 3408812, at *1.

[11] *Id.* at *1, *3.

[12] *Id.*

[13] *Id.* at *9.

failed to implement any reporting or information system or controls' relevant to complying with price-comparison advertising laws or, in the more recent words of *Marchand*, that they made no good faith effort to 'try.'"[14]

The court held that the plaintiff's allegations similarly failed to support an inference that the directors consciously failed to monitor or oversee the company's operations. The plaintiff argued that "settlements and warnings" constitute red flags to demonstrate directors knew or should have known of violations of the law, but the court concluded that "[w]hen such events become a 'red flag' depends on the circumstances."[15] The court held that plaintiff did not allege "particularized *facts* from which it reasonably can be inferred that the *Spann* settlement put the directors on notice of any ongoing violations of law."[16] The court observed that, to the contrary, when the *Spann* action was discussed with the board, it was in terms of a settlement to resolve the class action without any admission of liability and with an express acknowledgement that the company was not then violating any laws.[17] Further, when the settlement was approved, the company represented to the court that it implemented a new price-comparison advertising policy in response to the *Spann* action, created a pricing governance committee, instituted regular training sessions, and created a new director of pricing compliance position to monitor and ensure compliance with the new pricing policy.[18] As a result, the court held that the plaintiff failed to allege facts from which the court could infer that any of the directors consciously allowed the company to violate any price-comparison advertising laws to demonstrate bad faith, and dismissed the complaint with prejudice.[19]

More recently, in *In re Clovis Oncology, Inc. Derivative Litigation*, Consol. C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019) (TRANSCRIPT), the Court of Chancery upheld *Caremark* claims that the director defendants breached their fiduciary duties by failing to oversee a clinical trial of a drug under development and allowing the company to mislead the market regarding the drug's efficacy. Clovis, a biopharmaceutical firm, develops and commercializes cancer treatments, and was in the process of developing its first drug, Roci, to hit the market.

As a company with no products on the market and no sales revenue, Clovis relied heavily on investor capital for its operations, and the company's prospects were dependent upon the success and FDA approval of one of the company's developmental drugs.[20] As a result, the court observed that, in the company's "race for FDA approval" against a competing drug, the board was "hyper-focused" on Roci's development and clinical trial.[21] The plaintiffs alleged that the defendants spent hours at board meetings discussing the drug and its progress, and that the board was "laser-focused" on the drug's response rate, which was the criteria that defined its success in the clinical trial.[22] The court observed that as the trial progressed, the board knew that neither investors nor the FDA would accept unconfirmed responses.[23] Yet, despite reports received by the board (including management presentations) indicating that Roci's response rate was being calculated based on unconfirmed responses, "the Board did nothing."[24] The court observed that the board "relied heavily on the market's positive reaction" to the publicly reported response rate "to make its case for further investment in the Company."[25] Despite the drug's trial results, Clovis' public statements

[14] *Id.*
[15] *Id.* at *11.
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.* at *14.

[20] C.A. No. 2017-0222-JRS, Tr. at 10.
[21] *Id.*
[22] *Id.* at 11-13.
[23] *Id.* at 13.
[24] *Id.* at 14-15.
[25] *Id.* at 16.

"remained upbeat," and "[w]ith hands on their ears to muffle the alarms," the defendants signed the company's annual report reaffirming the inflated reports that relied upon unconfirmed responses.[26] Not only did the company fail to properly report response rates, but the board was advised that Roci had serious, undisclosed side effects and that there were clinical trial violations due to management reports on protocol deviations and the drug's side effects, and notice letters from the FDA.[27]

The court found that the plaintiffs alleged particularized facts to support reasonable inferences that the board knew the drug's testing protocol required "confirmed" responses, both industry practice and FDA guidance required reporting of "confirmed" responses, and management was incorrectly reporting responses. The court held that "[a]s *Marchand* makes clear, when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised."[28] Acknowledging that "even in this context, *Caremark* does not demand omniscience," the court found that given the degree to which Clovis relied upon the response rate when raising capital and the defendants' personal backgrounds in the industry, "it is reasonable to infer the Board would have understood the concept and would have appreciated the distinction between confirmed and unconfirmed responses."[29]

[26] *Id.* at 16-17.
[27] *Id.* at 22-24.
[28] *Id.* at 36.
[29] *Id.* at 36, 40.

Takeaways

Although *Marchand* does not signal any change in Delaware law, it reaffirms the obligation on directors to demonstrate their good faith efforts to implement and monitor a risk oversight system. To do so, directors should focus on (i) their companies having in place, continually monitoring and updating (as necessary), and periodically reporting to the board about, systems reasonably designed to identify, monitor and mitigate material risks to their companies; and (ii) acknowledging information that comes to the board's attention. Boards also should take care to document their compliance efforts in minutes and other meeting materials.

The recent decisions highlight the importance of director oversight when a company operates in an environment subject to external regulations that govern its "mission critical" operations, noting that in such circumstances, director oversight "must be more rigorously exercised." This suggests that the courts might be inclined to more aggressively monitor directors' *Caremark* efforts at the pleading stage in those circumstances.

The recent guidance from the Delaware courts suggests that effective board-level monitoring and compliance procedures may include a board committee that addresses (i) risk and compliance, (ii) regular processes and protocols that require management to keep the board apprised of compliance and risks, (iii) regularly scheduled board meetings to consider key risks (iv) and protocols for disclosing to the board adverse information received by management. The guidance further highlights the importance of a board-level response to violations of positive law or adverse reports received by the board.