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Delaware Supreme Court Issues Guidance on Board Oversight Responsibilities

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A director's duty to make a good faith effort to oversee the operations and management of a Delaware company is well-established. In a recent case, *Marchand v. Barnhill* (available at: https://courts.delaware.gov/Opinions/Download.aspx?id=291200), the Delaware Supreme Court provided guidance to boards of directors on how to minimize potential liability for failure to comply with their oversight obligations (known as *Caremark* claims).

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Background

Blue Bell Creameries USA, Inc. manufactures a single category of product offerings — ice cream and related confections. As a food manufacturer, Blue Bell is in a highly regulated industry and is subject to oversight by the U.S. Food and Drug Administration and various state authorities.

In early 2015, Blue Bell suffered a listeria outbreak at several of its manufacturing plants. This outbreak spread across Blue Bell's products, resulting in the death of three of its customers. As a result of the outbreak, the company was required to recall all of its products, shut down production at its three manufacturing facilities, and lay off more than a third of its workforce.

The outbreak followed years of reported problems at Blue Bell's manufacturing facilities. From 2009 through 2014, the FDA and state regulators identified numerous food safety violations across Blue Bell's plants in Texas, Alabama and Oklahoma. Although the company's management was informed of reports of a growing listeria presence in Blue Bell's facilities, minutes of board meetings during that time do not reflect any report or discussion of health concerns associated with the company's products.

Following the outbreak, a stockholder brought a derivative suit against two key executives and Blue Bell's board, alleging breaches of their fiduciary duties, including their duty to oversee the company's operations.

Court's Analysis

To sufficiently plead a *Caremark* claim, a complaint must allege that directors "completely fail[ed] to implement any reporting or information system or controls, or, having implemented such a system or controls, consciously fail[ed] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."

The Delaware Court of Chancery dismissed the *Marchand* complaint, but the Supreme Court reversed, ruling that the complaint sufficiently pleaded a *Caremark* claim that the board failed to oversee the company's operations. Specifically, the Supreme Court concluded that the complaint had alleged that:

- The board had no committee responsible for monitoring food safety.
- The board had no process that required management to keep the board apprised of food safety issues.
- The board had no schedule to consider food safety risks on a routine basis, and board minutes did not reflect any regular discussion of food safety issues.
- During the period leading up to the outbreak, as the company's safety problems mounted, management failed to report red or yellow flags about food safety to the board.
- Management presented the board with only favorable information about food safety, but not the full picture of the company's growing safety problems.

Evaluating all of those factors, the Supreme Court concluded that the complaint pleaded an inference that no system of board-level compliance monitoring and reporting existed at the company. The Supreme Court found this lack of monitoring particularly egregious in Blue Bell's case because the board's alleged failure concerned "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."

The Supreme Court concluded that the complaint sufficiently alleged that the Blue Bell board failed to make a good faith effort to oversee the company's operations (a component of the directors' duty of care), and that this failure, if proven, could breach the directors' duty of loyalty and expose them to liability. The Supreme Court remanded to the Court of Chancery for further proceedings.

Takeaways

Marchand provides guidance for companies and their boards as to how they should design board-level oversight systems. It also leaves an important open question that will likely result in future litigation: What are the critical compliance risks that a board must oversee?

First, *Marchand* reiterates the importance of board-level information reporting systems. For matters of great importance to the company, a management-level compliance system likely will no longer be sufficient. Rather, the board has an obligation to keep itself informed of the performance of these systems. Boards should consider requiring that the effectiveness and results of these systems be regularly reported by management, and directors should push management on the hard questions and not necessarily accept representations at face value.

Second, when management reports to the board on compliance functions, that reporting should be accompanied by appropriate supporting documentation, whether in board packets or in meeting presentations. Board minutes should also reflect, with appropriate detail, the extent of the information the board received and considered. For example, it is not sufficient, as in *Marchand*, to include vague references to the board's consideration of "operational issues." Sufficient documentation should be included to demonstrate that a compliance reporting system exists and is monitored by the board.

Third, it is important that boards include, among their members, directors who have sufficient industry experience to understand and explain the reports presented by management, particularly information that could constitute a red or yellow flag, as described in *Marchand*. While management failed to report such concerning information in that case, ensuring that the board is sufficiently knowledgeable to understand and act on this information is inherently necessary for directors to fulfill their fiduciary obligations. Directors need to ask the appropriate follow-up questions and provide guidance, where necessary, about any additional concerns regarding any proposed management response or future actions.

One crucial, unanswered question after *Marchand* is what compliance risks are "essential" or "mission critical" to a company. While it would not be reasonable to expect a board to receive reports on each compliance violation or concern — no matter how small — boards should closely consider what compliance issues are of central importance to their companies. In *Marchand*, the company's exclusive focus on manufacturing ice cream made food safety an obviously critical compliance risk. But each company will have to evaluate its own essential compliance areas based on its operational scope. By casting a wider net and taking a more proactive, hands-on role in compliance matters, directors can reduce the likelihood of being subject to allegations that they failed to meet their oversight obligations.