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Delaware Supreme Court Finds Directors May have Breached *Caremark* Duties by Failing to Oversee Compliance Risks; Rules Personal and Business Relationships Undermined Director's Independence

Recently in *Marchand* v. *Barnhill*, the Delaware Supreme Court, sitting *en banc*, reversed the Court of Chancery's dismissal of claims alleging that the directors of Blue Bell Creameries USA, Inc. acted in bad faith by failing to implement board-level oversight of compliance and reporting systems (so-called "*Caremark* claims") with regard to the company's food safety operations. The *Marchand* opinion, written by Chief Justice Strine, reiterates that complete delegation by a board of compliance functions to management may constitute a failure to implement and monitor an oversight system in breach of directors' duty of loyalty.

In the same opinion, the court also ruled that a director lacked independence due to "very warm and thick personal ties of respect, loyalty, and affection" between the director and the Chairman and CEO's family, continuing a trend of relatively recent cases where long-standing personal friendships have been found to raise director independence concerns.

Background

Blue Bell was one of the country's largest manufacturers of ice cream—the company's primary product. Following years of problematic food safety inspections at certain of its plants, a 2015 *listeria* outbreak caused the death of three people and resulted in the company's recalling all of its products, shutting down production at all of its plants and laying off a large portion of its workforce. The shutdown caused Blue Bell to suffer a liquidity crisis, leading the company to accept a dilutive private equity investment. The plaintiff, a Blue Bell stockholder, brought a *Caremark* claim against the board and also accused two of the company's officers (including the Chairman and CEO) of breaching their fiduciary duties of care and loyalty in allowing these food safety risks to have had such a consequential effect on the company's business. The Court of Chancery dismissed the *Caremark* claim against the board and also dismissed the claim against the officers, ruling that a majority of the board was independent and, therefore in this case, the plaintiff was required to make a so-called pre-suit "demand" asking the board to bring the lawsuit against the officers on behalf of the company.

Analysis

On appeal, the Delaware Supreme Court reversed the dismissal of the plaintiff's claims.

- *Plaintiff's* Caremark *claims survive a motion to dismiss because he adequately pled a reasonable inference that the board had taken no efforts to put in place a board-level compliance and reporting system.* Although acknowledging that *Caremark* claims are "difficult to plead and ultimately to prove out," the court reiterated that *Caremark's* "bottom-line requirement" 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." The court then ruled that the plaintiff's allegations supported a reasonable inference that no compliance system or protocols regarding food safety had been established by the board, despite food safety being "essential and mission critical" to a monoline food producer like Blue Bell. Those allegations included, among others, that the board's meeting minutes did not reference the topic, the board had not charged any committee with overseeing food safety, no board-level process to address food safety issues existed and the company had not adopted any protocol requiring management to deliver (nor did management deliver) key food safety reports and developments to the board on a consistent basis, despite several "yellow and red flags" that management knew about.

- *The plaintiff was not required to make a pre-suit demand on the board regarding his claims against the officers because a majority of the board lacked independence from the company's Chairman and CEO.* The Court of Chancery had ruled that seven directors—one director less than a majority—lacked independence from Blue Bell's Chairman and CEO, but the majority of the board would have been able to impartially consider a pre-suit demand to initiate litigation against the officers and, therefore, the plaintiff was required to make such a demand as to those claims. The Supreme Court reversed, noting that an eighth director's advancement in the company over the span of his 28-year career was due in large part to the CEO's father, as well as the fact that the CEO's family had led a campaign to raise $450,000 to have a building at a local university named after the director. The court concluded that these allegations supported an inference that the director "owes an important debt of gratitude and friendship to [the CEO's] family" and suggest a "deep and long-standing friendship[]." "[A]ny realistic consideration of independence must give weight to these important relationships and their natural effect on the ability of the parties to act impartially toward each other," the court reasoned. The fact that the director had voted against the CEO to separate the roles of Chairman and CEO did not undermine the court's conclusion that the director lacked independence to assess a demand, as the court reasoned that voting on an issue of corporate governance could be very different from a decision on whether or not to initiate litigation.

Takeaways

The *Marchand* decision illustrates the importance of establishing a reasonable system at the board level for monitoring and reporting regulatory and compliance issues because, while *Caremark* claims are difficult to sustain, the threshold is not insurmountable. In *Marchand*, it was the alleged absence of any such monitoring and reporting system *at the board level* that permitted the claim to survive and, in turn, created potential liability for the Blue Bell directors. Even though the management team was aware of "yellow and red flags," the alleged absence of any policy or protocol requiring management to inform the board of those issues supported an inference that the directors may have breached their duty of loyalty. The court acknowledged that directors have "great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources"—such as delegation to a relevant committee, a regular protocol requiring board-level reports about the relevant risks, or the use of third-party monitors, auditors or consultants—but held that complete abdication of the regulatory and compliance function to management is not acceptable. From a practical standpoint, the opinion also is a reminder of the importance of clearly documenting board-level discussions relating to these oversight and reporting regimes in the board's meeting minutes, as the absence of references to food safety discussions in the company's existing minutes supported an inference at the motion to dismiss stage of this litigation that no such discussions had occurred, whether or not that will ultimately be proven to be true.

Additionally, the opinion offers further guidance on the types of personal and professional relationships that will call into question a director's independence. As noted by the court, "deep and long-standing friendships," like the one at issue here, may cast doubt on a director's ability to act impartially.

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Matthew W. Abbott +1-212-373-3402 Email	Scott A. Barshay +1-212-373-3040 Email	Ariel J. Deckelbaum +1-212-373-3546 Email
Ross A. Fieldston +1-212-373-3075 Email	Andrew G. Gordon +1-212-373-3543 Email	Jaren Janghorbani +1-212-373-3211 Email
Jeffrey D. Marell +1-212-373-3105 Email	Robert B. Schumer +1-212-373-3097 Email	Taurie M. Zeitzer +1-212-373-3353 Email

Counsel Frances F. Mi, associate Jason S. Tyler and legal consultant Cara G. Fay contributed to this memorandum.

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