JUNE 25, 2019

The *Caremark* Chimera: Can Directors Be Liable When The Red Flag Is Hidden From Them?

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Speed Read

On June 18, 2019, in *Marchand v. Barnhill*, the Delaware Supreme Court revived a stockholder derivative lawsuit against the directors of ice-cream manufacturer Blue Bell Creameries USA, Inc. The suit alleged breaches of the directors' fiduciary duty to oversee and monitor the corporation's operations, following an early-2015 *listeria* outbreak at its manufacturing plants that resulted in three deaths, a product recall, an operational shutdown, and a liquidity crisis. The board was alleged to be completely unaware of prior "red flags" on food safety compliance because management had failed to bring any of these matters to its attention. In overturning the Court of Chancery's dismissal of the claims, the Supreme Court concluded that the plaintiffs had met the standard to avoid dismissal by pleading facts supporting a reasonable inference that the Blue Bell directors had acted with bad faith, despite the management team's alleged shortfalls as to information flow, because no board-level system whatsoever was in place to monitor and report on food safety. While the result of a full trial remains to be seen, this decision serves as a cautionary tale for any board of directors operating in a regulated industry, and suggests careful thought should be given to procedures for ensuring information flow to the board on key areas of operational risk.

Oversight – *i.e.*, ensuring management is properly managing a corporation's business and affairs – is one of the principal functions of directors in a Delaware corporation. Liability for breaches of this duty need to meet a very high standard, "possibly the most difficult theory in corporation law" to prove.[1] These so-called *Caremark* claims require "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."[2] Directors are not liable simply because a corporate trauma has occurred on their watch, or because the reporting systems failed or were ineffective. Plaintiffs have to show that the directors acted in bad faith – that "they were conscious of the fact that they were not doing their jobs" or that they ignored the red flags waved in front of them.[3]

On June 18, 2019, in *Marchand v. Barnhill*, the Delaware Supreme Court revived a *Caremark* claim against the board of directors of Blue Bell Creameries USA, Inc. that had been dismissed by the Delaware Court of Chancery. The decision hinged on the Supreme Court's view that, under the particular facts, the Blue Bell directors had acted in bad faith by not more proactively taking specific and targeted actions to set up a "system of controls" to alert it to food safety compliance issues – an "essential and mission critical" area for the single-product company.

From 2009 through 2013, various state and federal regulators identified to management various food safety compliance failures at Blue Bell's manufacturing facilities. In 2013 and 2014, management received reports of positive *listeria* tests at those facilities. According to the plaintiff's allegations, the board of directors never received any information about these food safety issues generally or *listeria* specifically. Only after *listeria* spread to Blue Bell's products in February 2015 and resulted in three consumer deaths did the board discuss the issue for the first time. The contamination forced Blue Bell to shutter its facilities, triggering a liquidity crisis that led to a dilutive investment from a private equity firm.

Plaintiff brought claims derivatively against the Blue Bell directors for allegedly breaching their duty of loyalty under *Caremark* by failing to institute a system of controls and reporting concerning food safety.[4] The Court of Chancery dismissed plaintiff's claims, in part, for failing to plead facts sufficient to support a reasonable inference that the directors acted with bad faith under *Caremark*.[5]

On appeal, the Delaware Supreme Court disagreed and revived the claim. Although the Court continued to recognize that a *Caremark* claim is difficult to plead (and prove) and will fail if it merely alleges that board-level compliance and reporting systems were not effective, "*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 reporting." With respect to Blue Bell, the Court found that there was no specific system of controls in place whatsoever "ensuring that the only product it makes—ice cream—is safe to eat." The Court specifically emphasized that Blue Bell's board of directors had

- no standing board committee monitoring food safety issues;
- no regular process established where a portion of the board's meetings were dedicated to discussion of food safety issues; and
- no protocol requiring, or any expectation that, management would deliver food-safety compliance reports to the board on a "consistent and mandatory" basis.

The Court viewed the absence of any specific report or discussion about food safety or *listeria* in the Blue Bell board's minutes from its meetings as supporting a conclusion that the board had not made a good faith effort to monitor compliance. For example, the Court juxtaposed positive *listeria* test results in April 2014 with minutes from an April 2014 board meeting that did not reflect any discussion of *listeria* but only stated that "plant operations were discussed briefly." The Court found these references in the minutes to be insufficient to support a reasonable inference that the board had an expectation of significant compliance issues being brought to its attention. Compounding this issue, the Court also noted that, after learning of an outbreak of "life-threatening bacteria" and two years of not being informed of yellow and red flags, Blue Bell's board left the response to management without holding more frequent emergency meetings or otherwise forcing management to provide more frequent updates on the crisis response efforts.

TAKEAWAYS FOR BOARD MEMBERS

This decision may be a case of "bad facts making bad law" in light of the tragic consequences that resulted from Blue Bell's *listeria* contamination. Nonetheless, it highlights some important lessons for the board of any company that can help directors understand and discharge their duties, particularly in regulated industries where compliance problems can have serious consequences. Most directors, by necessity, rely heavily on management for information flow as well as operational expertise. After *Marchand*, without a sufficient record of board deliberation and involvement on critical compliance issues, even directors relying on management in good faith may be at risk of being subject to a *Caremark* claim that cannot be readily dismissed at the motion to dismiss stage.

Some key takeaways for board members to consider are as follows.

- **Consider what risks are "essential and mission critical."** The Court placed great weight on the fact that Blue Bell was a single-product company, and that the one product was subject to critical food-safety testing and standards. More complex, multiproduct companies may not be in a position to identify one specific risk as easily as a monoline company, but identifying categories of mission-critical risks may nonetheless be useful.

- **Consider what protocols and procedures are in place to ensure information flow to the board**.

  - **Standing Committee**. In its decision, the Court cited the absence of a standing food safety compliance committee of the board of directors as a negative fact. In our view, a standing committee may not be the right answer for all companies given the extra infrastructure and administrative burden, but a clear line of responsibility for these matters may help clarify expectations on management.

  - **Consider Board Expertise**. Boards may wish to consider whether they have members with adequate background to assess compliance concerns in mission-critical areas and, if not, whether engaging consultants or specialists would assist the board in better understanding any risks and their potential consequences.

  - **Regular Agenda Items**. Consider whether mission-critical compliance risks should be a specific agenda item in regular periodic reporting by management on the business. Often, the board receives presentations directly from executives responsible for a specific function (*e.g.*, head of IT presenting on cybersecurity), and this may be appropriate from compliance executives on a periodic basis.

  - **Establishing Procedures/Setting Expectations for Management**. Consider whether any other procedures are appropriate for a given company to be put in place in order to ensure that significant concerns with respect to the identified mission-critical risks are communicated on a timely basis to the board. For example, companies could consider including in their corporate governance guidelines statements as to the expectations and responsibilities of management in bringing compliance issues to the attention of the board. Boards may wish to set an expectation for management to report on potential issues in a way that is memorialized and can readily be demonstrated in a court proceeding. This may be particularly relevant in heavily regulated industries where there will always be a written record of compliance tests at the operational level.

- **Assess specificity of board minutes.** The Court focused heavily on the lack of specific detail in the board's minutes, noting that the minutes did not reflect any discussion about food safety or *listeria*. For example, the Court juxtaposed positive *listeria* test results in April 2014 with minutes from an April 2014 board meeting that did not reflect any discussion of *listeria* but only that "plant operations were discussed briefly." Boards may wish to consider ensuring that their minutes explicitly refer to mission-critical compliance areas when discussed, or that explicit references are contained in board materials referenced in or attached to the minutes.

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[1] *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006).

[2] *In re Caremark Int'l Inc. Derivative Litigation*, A.2d 959,971 (Del. Ch. 1996).

[3] *Guttman v. Huang*, 823 A.2d 492, 506-507 (Del. Ch. 2003).

[4] The plaintiffs also brought claims derivatively against two Blue Bell executives for allegedly breaching their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of Blue Bell's operations, which claims are beyond the scope of this Client Alert.

[5] The Court of Chancery also held that the plaintiffs had not met the demand futility standard because it had not sufficiently shown reasonable doubt that a majority of the board's votes impartially or objectively could consider a demand to bring suit against Blue Bell executives. The Supreme Court reversed this decision as well.

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