INVESTMENT COMPANY INSTITUTE

MEMO# 31870

July 26, 2019

Delaware Supreme Court Upholds Suit Against Directors That Failed to Monitor Corporation's Central Compliance Risks

[31870]

July 26, 2019 TO: ICI Members
Investment Company Directors
Chief Compliance Officer Committee
Chief Risk Officer Committee SUBJECTS: Compliance
Risk Oversight RE: Delaware Supreme Court Upholds Suit Against Directors That Failed to Monitor Corporation's Central Compliance Risks

The Delaware Supreme Court recently issued an opinion that sheds light on a board's duty of loyalty to shareholders under Delaware law. While this case involved an ice cream manufacturer, and not an asset management firm, the court's holding may be of interest to our members and their boards. The relevant facts of this case, and the court's holding are briefly described below.[1]

Background of the Case

This case involves Blue Bell Creameries, USA, which is one of the largest US ice cream manufacturers, and its board. As an ice cream manufacturer, "one of Blue Bell's central compliance issues is food safety."[2] Notwithstanding this, the plaintiff's complaint alleges that Blue Bell's board neglected to oversee or monitor the food safety of Blue Bell's ice cream because:

- It had no committee overseeing food safety;
- There was no full board-level process to address safety;
- It had no process to be informed of food safety reports and developments; and
- Although management was aware of food safety concerns raised by inspectors of the Food and Drug Administration (FDA) and others, there was no process for ensuring that this information was reported to the board.

The plaintiffs' complaint also alleged that, when food inspectors began to raise serious concerns about the firm's food safety, Blue Bell's management "turned a blind eye to red and yellow flags that were waved in front of it by regulators and its own tests, and the board – by failing to implement any system to monitor the company's food safety compliance programs – was unaware of any problems until it was too late.[3] As a result this conduct, the plaintiffs alleged that Blue Bell's directors failed to attempt to assure that a reasonable information and reporting system relating to the firm's food safety existed.

In its defense, the board argued that Blue Bell operates in a heavily regulated environment and that FDA rules require the firm to prepare and implement a written food safety plan. Such plans must: (1) include processes for conducting a hazard analysis that identifies possible food safety hazards; (2) identify and implement preventative controls to limit potential food hazards; (3) implement process and sanitation controls; and (4) monitor such preventative controls. The FDA further requires appropriate corporate officials to monitor such preventive controls. In addition to these federal regulations, Blue Bell was required to comply with the food safety regulations in the three states in which the firm operated plants. According to the board, these regulatory requirements fulfilled Blue Bell's food safety requirements notwithstanding the above failures of the board.

In support of their claims against Blue Bell's directors for their lack of attention to food safety concerns, the plaintiffs' complaint details how Blue Bell began to have food safety concerns starting in 2009, when state food inspectors "found troubling compliance failures at Blue Bell's facilities."[4] These concerns continued and, in 2013, the firm had five positive tests for listeria.[5] While the firm's senior management was aware that Blue Bell's products were contaminated with listeria for the next three years, it neglected to pass information about any food safety concerns, including the numerous positive tests for listeria, onto the board. As stated in the Decision, "[d]espite management's knowledge of the growing problem, the complaint alleges that this information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem."[6] As late as February 19, 2015, two years after the first evidence of listeria, the board was still unaware of the food safety concerns at the Blue Bell plants. In late February 2015, Blue Bell initiated a limited recall of its products. Two days later, the firm's board met and was informed that the firm was working with state health inspectors regarding the recall. According to the Decision, "[d]espite two years of evidence that *listeria* was a growing problem for Blue Bell, this is the first time the board discussed the issue."[7] Moreover, "[i]nstead of holding more frequent emergency board meetings to receive constant updates on the troubling fact that life-threatening bacteria was found in its products, Blue Bell's board left the company's response to management."[8]

In March 2015, as Blue Bell's problems with listeria continued to grow, the firm was forced to recall more product. That month, the board's response to this news was to adopt a resolution expressing support for the firm's CEO, management, and employees and encouraging them to ensure that the firm was distributing a wholesome and good tasting product. The problems worsened and, the next month the firm instituted a recall of all of its products. Also, around this time, three of five adults sickened by the firm's tainted products died. As the FDA continued its inspections of the company's three manufacturing plant, each of which had major safety deficiencies, the Centers for Disease Controls and Prevention (CDC) investigated the outbreak and deaths.

The Court's Legal Analysis

The Decision first discusses the lower court's consideration of the plaintiffs' compliant. It noted that the lower court, the Court of Chancery, rejected the plaintiffs' claim that Blue Bell's directors breached their duty of loyalty because the plaintiffs failed to demonstrate, as required by *In re Caremark Int'l Inc. Derivative Litig*,[9] that the board failed to "'institute a system of controls and reporting' regarding food safety."[10] In reaching this decision, the lower court noted that the Blue Bell had implemented the monitoring and reporting systems required under federal and state law; the firm was subject to ongoing third-party monitoring of its food safety; and senior management of Blue Bell provided regular reports to the board regarding Blue Bell's "operations." Based on this holding, the lower court dismissed the case and the plaintiffs appealed to Delaware's Supreme Court.

The Supreme Court began its analysis by noting that, under the *Caremark* case, "a director must make a good faith effort to oversee the company's operations" and "[f]ailing to make that good faith effort breaches the duty of loyalty and can expose a director to liability." The Decision continues:

> Bad faith is established, under *Caremark,* 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 information of risks or problems requiring their attention.' In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it.
>
> As with any other disinterested business judgment, directors have great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources. 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 reporting.[11]

According to the Court, *Caremark* does not require the Court to assess the *effectiveness* of the firm's board-level compliance and reporting system. Instead, its role was to assess whether the complaint supported a reasonable inference regarding whether the board *undertook* a good faith effort to put such a system in place. The Court found that Blue Bell's board failed to satisfy the *Caremark* standard because the firm:

- Had no board committee that addressed food safety, even though food safety was "one of Blue Bell's central compliance issues" and the company could "only thrive if its consumers enjoyed its products and were confident that its products were safe to eat;"[12]
- Had no regular process or protocols that required management to keep the board apprised of any food safety compliance practices, risks, or reports;
- Had no schedule for the board to consider on a regular basis any key food safety risks; and
- Did not have evidence that the board was informed of the reports the firm's senior management had received about the serious concerns with listeria in Blue Bell's products.

The Court also found that, while the board was provided favorable information about food safety, it was not provided any unfavorable information when it began to surface. As summarized by the Court, "the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues." While Blue Bell argued that it satisfied its legal duty by the firm complying with FDA regulations, the Court did not find this persuasive on the issue of whether "the *board* implemented a system to monitor food safety *at the board level.*"[13]

According to the Court, the *Caremark* decision requires "that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about a corporation's central compliance risks."[14] For Blue Bell, even though "food safety was essential and mission critical," the firm's board failed to put in place a system of board-level compliance monitoring and reporting. The Court, therefor, overruled the lower court's dismissal of the case and remanded the case for a determination of whether the board's failure constituted a breach of the board's duty of loyalty.

Tamara K. Salmon
Associate General Counsel

endnotes

[1] *See Marchand v. Barnhill*, No. 522 2018 (Del. June 19, 2019) (the "Decision"), which is available at: https://courts.delaware.gov/Opinions/Download.aspx?id=291200. This summary of the case focuses on the court's consideration of a board's duty of loyalty under Delaware law. It does not discuss the procedural issues the Court considered relating to demand futility, which was also on appeal to the Court. Demand futility excuses shareholders from filing suit against a company unless they first demand that the company's board bring such suit on behalf of all shareholders. Under state corporate law, including Delaware's law, this requirement may be avoided if the plaintiff can demonstrate that asking the board to bring the suit would be futile because the board is not sufficiently independent of the company to determine whether to bring such a suit. In this case, because the plaintiffs claimed demand futility, this determination was also on appeal. The Supreme Court agreed that the plaintiffs could bring the suit without first making a demand on the board because such demand would have been futile.

[2] Decision at p. 5.

[3] Decision at pp. 8-9.

[4] Decision at p. 5.

[5] Listeria is a food borne illness that, as demonstrated by this case, can kill.

[6] Decision at p. 12.

[7] Decision at pp. 14-15.

[8] Decision at p. 15.

[9] 698 A.2d 959 (Dec. Ch. 1996).

[10] Decision at pp. 21-22.

[11] Decision at pp. 30-31. Internal footnotes omitted.

[12] Decision a p. 5.

[13] Decision at p. 34. Emphasis in original.

[14] Decision at p. 36.
