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Director Independence and Oversight Obligation in *Marchand v. Barnhill*

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Editor's Note: **Peter Atkins** and **Paul Lockwood** are partners at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on their Skadden memorandum and is part of the **Delaware law series**; links to other posts in the series are available **here**.

On June 18, 2019, in *Marchand v. Barnhill*, the Delaware Supreme Court, in an opinion written by Chief Justice Leo E. Strine, Jr. on behalf of a unanimous court, issued a decision reversing the Court of Chancery's dismissal of a stockholder derivative suit alleging *Caremark* claims [1]—that the board failed to provide adequate oversight of a key risk area and thus breached its duty of loyalty. The case arose out of a listeria outbreak in ice cream made by Blue Bell Creameries USA Inc. that sickened many consumers, caused three deaths and resulted in a total product recall.

Key Determinations

The key Delaware Supreme Court determinations, both fact-driven, were:

- **Independence.** The Supreme Court held that one director, viewed by the Court of Chancery as independent, was not independent based on the allegations in the complaint. 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.
- **Oversight.** For purposes of denying a motion to dismiss by the company, the facts alleged by the plaintiffs were 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.

Key Reminders

Marchand does not signal any change in Delaware law. But it is a clear reminder that:

- The facts relating to director independence (and disinterestedness) should be continually and carefully scrutinized in light of current legal trends and common sense assessments, especially when there is an identifiable risk that the validity of a particular decision being taken by the board may be challenged. The Delaware courts have shown a willingness to consider personal relationships as well as economic ties in evaluating independence, so these connections must be vetted as well.
- To demonstrate their good faith efforts to implement and monitor a risk oversight system, boards need to focus on (a) their companies having in place—and continually monitoring, updating (as necessary) and periodically reporting to the board about—systems reasonably designed to identify, monitor and mitigate material risks to their companies, and (b) not ignoring information that comes to the attention of the board. The board should also take care to document its compliance efforts in minutes and other meeting materials.

Summary of the Court's (Heavily Fact-Driven) Analysis

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 a duty 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: (a) the directors must have utterly failed to implement any reporting or information system or controls; or (b) having implemented appropriate compliance controls, the directors consciously failed to monitor or oversee the operation of that system.

In *Marchand*, 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." The Supreme Court noted that testing reports received by management had identified listeria contamination in certain Blue Bell plants, but the board meeting minutes reflected "no board-level discussion" of these negative reports. 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." The court was particularly concerned that reports containing "what could be considered red, or at least yellow, flags" were not disclosed to the board. As Chief Justice 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."

The Supreme Court also reversed the trial court's dismissal of the complaint for failure to make a pre-suit demand on the board. Because the Court of Chancery had concluded the board was independent by one vote, the Supreme Court focused its analysis on one director who had previously worked for Blue Bell. The Supreme Court held that the complaint adequately pleaded that he could not impartially decide whether to sue members of the Kruse family—who founded Blue Bell—because they had been instrumental in this director's career success, which included 28 years at the company, becoming chief financial officer and being elected a director. The Kruse family also had led a campaign that resulted in over $450,000 being donated to a local college, which resulted in the naming of a building after the director. The Supreme Court disagreed with the Court of Chancery's conclusion that the director's support for separating the CEO and board chair positions—which the CEO, who was a member of the Kruse family, opposed—indicated that the director would not be influenced by these other circumstances when it came to deciding whether to sue the CEO. The court concluded: "[o]n a cold complaint, these facts support a reasonable inference that there are very warm and thick personal ties of respect, loyalty, and affection between [the director] and the Kruse family" to support a pleading-stage inference that the director could not have impartially decided whether to sue the CEO. Accordingly, a pre-suit demand was not required.

Endnotes

[1] *In re Caremark International Inc. Derivative Litigation,* 698 A.2d 959 (Del. Ch. 1996).
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[2] 911 A.2d 362 (Del. 2006).
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