

# Board Oversight Liability Three Years after *Marchand* What Has Changed? What Still May Change?

CLE Materials to Accompany March 23, 2022  
Weinberg Center For Corporate Governance  
Prepared by Rolin Bissell, Panel Moderator

# Roundtable Information and How To Use These CLE Materials

# Roundtable Overview

In the three years following the Delaware Supreme Court's decision in *Marchand v. Barnhill*, 212 A.3d 805 (2019), the Delaware Court of Chancery has considered several motions to dismiss in high-profile cases alleging that a public company board of directors had failed to exercise oversight duties, dismissing some cases and allowing other cases to go forward.

Do these decisions represent an expansion of oversight liability and a change in a director's standard of conduct, a shift in pleading standards, or both? Relatedly, what are stockholder plaintiffs focusing on in bringing oversight claims and what are board counselors advising directors about the board's path forward following an unsuccessful motion to dismiss?

# Roundtable Participants and How to Use These CLE Materials

## Roundtable Participants:

- **Rolin Bissell**, Partner, Young Conaway Stargatt & Taylor, LLP (Moderator)
- **Joel Friedlander**, Partner, Friedlander & Gorris, P.A.
- **Meredith Kotler**, Partner, Freshfields Brukhaus Deringer
- **Blake Rohrbacher**, Director, Richards Layton & Finger

## How to use these CLE Materials:

These materials provide historical background and detail concerning the developments the panelists will be discussing for those who want to learn more.

# A Brief History of the Evolution of Oversight Claims

# What are Oversight Claims?

- Director liability for breach of fiduciary duty for oversight failures—the failure to implement internal control systems or the failure to monitor and ignoring red flags.
- Typically arise when the company faces liability for failure to comply with regulation or law through government criminal charges, regulatory action or civil lawsuits.
- Derivative claims through which a stockholder sues directors to recover the company's losses on behalf of the company.

# Landmark Oversight Cases Before *Marchand*: *Allis Chalmers*

## ***Graham v. Allis Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963)**

- Derivative claim to recover company's losses arising from the company's liability for illegal price fixing.
- There was no claim that the Allis Chalmers directors knew of the employees' conduct that resulted in the company's liability. Rather, the plaintiffs claimed that the Allis Chalmers directors should have known of the illegal conduct by the company's employees.
- Court held that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”

# Landmark Oversight Claims Before *Marchand*: *Allis Chalmers* (Cont.)

## ***Graham v. Allis Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963)**

- Limited board's oversight obligations to situations where red flags were waving in board's face. *Id.* at 130.
- In dicta, indicated board had affirmative duty to assure itself in good faith that the company have a system of internal controls to monitor for illegal activities. *Id.*



# Landmark Oversight Claims Before *Marchand-Caremark*-Procedural Posture

## ***In re Caremark*, 698 A.2d 959 (Del. Ch. 1996).**

- Caremark paid approximately \$250 million in fines and penalties and entered into plea agreement with US DOJ in connection with violation of healthcare laws and regulations.
- Stockholders bring derivative claims seek on behalf of the company for recovery of these losses from the board of directors of Caremark.
- In connection with a motion to approve a settlement between the directors and the company, the court assesses the risk of liability the directors faced to determine whether settlement is fair.

# Landmark Oversight Claims Before *Marchand Caremark*. Holding on Oversight Liability

“Legally, evaluation of the central claim made entails consideration of the legal standard governing a board of directors' obligation to supervise or monitor corporate performance. For the reasons set forth below I conclude, in light of the discovery record, that there is a very low probability that it would be determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise. Indeed the record tends to show an active consideration by Caremark management and its Board of the Caremark structures and programs that ultimately led to the company's indictment and to the large financial losses incurred in the settlement of those claims. It does not tend to show knowing or intentional violation of law. Neither the fact that the Board, although advised by lawyers and accountants, did not accurately predict the severe consequences to the company that would ultimately follow from the deployment by the company of the strategies and practices that ultimately led to this liability, nor the scale of the liability, gives rise to an inference of breach of any duty imposed by corporation law upon the directors of Caremark.”

*In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 961 (Del. Ch. 1996)

# Landmark Oversight Claims Before *Marchand Caremark*: The Two Prong Test

- **Prong one:** “*utterly failed* to implement any reporting or information system or controls...”
- **Prong two:** “or...having implemented such a system or controls, *consciously failed* to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”
- **Scienter required:** “In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”
- **Opinion Questions:** the ongoing viability of certain readings of *Allis Chalmers*.

# Landmark Oversight Claims Before *Marchand Stone v. Ritter*, 911 A.3d 362 (Del. 2006)

- Company (AmSouth Bancorporation) paid \$50 million in penalties to resolve claims relating to failure to comply with banking regulations.
- Delaware Supreme Court affirms Court of Chancery's decision to dismiss holding that "We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."
- Supreme Court holds that the Court of Chancery's application of *Caremark* analysis to dismiss complaint was correct.

# 1996 through 2018—*Caremark* “Toothless”?

- *Caremark* claims “among the hardest [for plaintiffs to plead successfully.” *Okla. Firefighters Pension & Ret. Sys v. Citigroup Inc.*, 2015 WL 1884453, at \*5 (Del. Ch. April, 2015).
- *Caremark* duty is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win judgment.” *Caremark*, 698 A.2d at 967.
- See Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 709, 756 (2019)(“Despite widespread corporate illegality, there are few modern cases in which shareholders have successfully held directors liable for breaking the law.”).

# But Did *Caremark* Cause Greater Board Attention to Oversight Obligations?

- Langevoort, *Caremark and Compliance: A Twenty Year Lookback*, 90 Temple L. Rev. 727-742 (2018).
- Hill, *Caremark as Soft Law*, 90 Temple L. Rev. 681-697(2018).

*Caremark's* Teeth Grow in?  
*Marchand v. Barnhill*, 212 A.3d  
805 (Del. 2019)

# *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019)

The Delaware Supreme Court reversed the Court of Chancery's dismissal of *Caremark* claims against directors of an ice cream company (Blue Bell Creameries USA, Inc.) finding that the complaint alleged facts supporting a reasonable inference that the board "failed to implement any system to monitor [the company's] food safety performance or compliance." 212 A.3d at 809.



# *Marchand* Key Ruling One: “Mission Critical” Risks

*Caremark* “require[s] that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation’s central compliance risks. In Blue Bell’s case, food safety was essential and mission critical. The complaint pled facts supporting a fair inference that no board-level system of monitoring or reporting on food safety existed.”

*Marchand*, 212 A.3d at 824.

# *Marchand* Key Ruling Two: Pleading “Utter Failure”

“Where, as here, a plaintiff has followed our admonishment to seek out relevant books and records and then uses those books and records to plead facts supporting a fair inference that no reasonable compliance system and protocols were established as to the obviously most central consumer safety and legal compliance issue facing the company, that the board’s lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company exposed consumers to *listeria*-infected ice cream, resulting in the death and injury of company customers, the plaintiff has met his onerous pleading burden and is entitled to discovery to prove out his claim.”

*Marchand*, 212 A.3d at 824.

# What *Marchand* Changed (Arguably)

- Pleading standard
  - Court insists pleading standard has not changed.
  - But number of *Caremark* claims surviving motion to dismiss increases.
- Standard of conduct
  - “utter failure” under *Caremark* versus “more rigorously exercised” under *Marchand*—has *Caremark*’s scienter requirement (i.e., “directors knew that they were not discharging their fiduciary obligations”) been relaxed to something closer to gross negligence?
  - Heightened duty when overseeing “mission critical” risks versus other risks— which risks are mission critical is sometimes more apparent in hindsight.

# Oversight Claims Post-*Marchand*

# Post *Marchand*—Motion to Dismiss Denied

- *In re Clovis Oncology Derivative Litigation*, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).
- *Inter-Marketing Group USA, Inc. v. Armstrong*, C.A. No. 2017-0030-TMR, 2020 WL 756965 (Del. Ch. Jan. 31, 2020).
- *Hughes v. Hu*, 2020 WL 1987029, at \*15 (Del. Ch. Apr. 27, 2020).
- *Teamsters Local 443 Health Services & Insurance Plan v. Chou, et. al.*, 2020 WL 5028065, at \*1 (Del. Ch. Aug. 24, 2020).
- *In re Boeing Co. Derivative Litig.*, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021).

# Post-*Marchand*—Motion to Dismiss Granted

- *In re GoPro, Inc. Stockholder Derivative Litig.*, 2020 WL 2036602 (Del. Ch. Apr. 28, 2020).
- *Owens v. Mayleben*, 2020 WL 748023 (Del. Ch. Feb. 13, 2020).
- *In re LendingClub Corp. Derivative Litig.*, 2019 WL 5678578 (Del. Ch. Oct. 31, 2019).
- *Rojas v. Ellison*, 2019 WL 3408812 (Del. Ch. July 29, 2019).
- *Firemen's Ret. Sys. of St. Louis on behalf of Marriott Int'l, Inc. v. Sorenson*, 2021 WL 4593777, at \*11 (Del. Ch. Oct. 5, 2021).

# *Clovis*—Post Motion Procedural History SLC Formed, Motion to Terminate, then Settlement

- Company formed a Special Litigation Committee.
- Court granted motion to stay litigation pending SLC completing its investigation.
- After completing its investigation, SLC filed motion to terminate litigation as not in the Company's interest.
- Parties reach settlement while motion still *sub judice*.
- Settlement hearing scheduled for May 4, 2022

# *Amerisource (Chou)*—Post Motion Procedural History—SLC Formed

- Company formed a Special Litigation Committee.
- Parties agreed to stay litigation pending SLC completing its investigation.
- After completing its investigation, SLC filed motion to terminate litigation as not in the Company's interest in September 2021.
- Motion still *sub judice* with Plaintiff taking discovery of SLC.



# Post Motion Procedural History-- Cases Being Litigated

## ***(Armstrong)Plains All American Pipeline, L.P.***

- Derivative plaintiff is prosecuting case.
- The parties are engaged in discovery.

## • ***Hughes v. Hu***

- Derivative plaintiff is prosecuting case.
- The parties are engaged in discovery.

# *Boeing*—Post Motion Procedural History

## Quick Settlement

- No SLC formed.
- Parties entered into settlement agreement for \$237.5 on November 5, 2021.
- Court approved settlement on February 23, 2022.

# *Marchand*—Post Motion Procedural History

## SLC Formed

- Additional independent directors appointed and SLC formed.
- Court granted motion to stay litigation pending SLC completing its investigation.
- SLC investigation delayed by criminal proceedings by U.S Department of Justice against two of Blue Bell's former officers and directors.

# Unanswered Questions *Post-Marchand*

# Still Scant Guidance on How *Marchand* Will Be Applied on a Developed Evidentiary Record

- No decisions analyzing oversight claims on a motion to dismiss by a Special litigation Committee
- No decisions analyzing oversight claims following a trial on the merits.
- Remarks at *Boeing* settlement hearing suggest that oversight claims remain hard to win.

# Unanswered Questions Post-*Marchand*: Trial of a *Caremark* Claim

- How *Marchand* will be applied after a full trial on the merits.
  - *Marchand* was decided on a motion to dismiss, a plaintiff-friendly standard under which the court must accept the plaintiff's well-plead allegations as true.
  - At trial, plaintiff bears the burden of proof and must prove its claims by a preponderance of the evidence.
- Proof of a *Caremark* claims remains difficult.
  - Plaintiff must prove “the directors knew that they were not discharging their fiduciary obligations”; this requires more than showing “gross negligence” requires a showing of scienter, willfulness or some type of bad intent.
  - “Utter failure” or “consciously failed to monitor” difficult to show.

# Unanswered Questions Post-*Marchand*: SLC Decision to Terminate a *Caremark* Claim

- In determining whether it is in the Company's interest to pursue a *Caremark* claim, an SLC can consider a wide range of factors that go beyond what the court considers in a motion to dismiss including (but not limited to):
  - The difficulty of showing directors acted in bad faith.
  - The difficulty of proving that a breach of oversight duties caused any damages to the company.
  - Procedural problems with claim, including statute of limitations.
  - Cost to the company, including advancement and indemnification of directors.
  - Distraction litigation of the claim may cause to management, board and company personnel.

# Unanswered Questions Post-*Marchand*: SLC Decision to Terminate a *Caremark* Claim

- Court review SLC decision to dismiss claim under the *Zapata* standard. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).
  - The court evaluates whether:
    - the committee was independent,
    - acted in good faith,
    - and had a reasonable basis for its conclusions.
  - The court then applies its own independent business judgment to determine whether dismissal is in the best interest of the corporation.
- Post *Marchand*, the courts have yet to rule on an SLC's motion to dismiss a *Caremark* claim under the *Zapata* standard.



# Early Settlement—Considerations For Plaintiff

- SLC process can lead to dismissal of claim.
- SLC process can be lengthy due to need to coordinate with parallel proceedings, especially regulatory and criminal proceedings that will take precedence.
- Proving bad faith of individual directors difficult and no history of successfully tried *Caremark* claims.

# Early Settlement—Considerations For Defendants

- SLC process can be difficult to set up and run.
  - Sufficient number of independent directors/appointing additional independent directors.
  - Time consuming for SLC directors and expensive for Company.
- SLC process can be lengthy due to need to coordinate with parallel proceedings and may work against getting issue behind the Company and “moving on.”
- Settlement can be funded with insurance; finding of bad faith at trial may lead to director liability that is unexculpated and may not be covered under D&O policies.

# Questions?



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