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Insights from the Delaware courts on board oversight of compliance programs

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Since the Delaware Chancery Court's decision in the *Caremark*[1] case in 1996, it has been understood that boards of directors owe a fiduciary duty to oversee an organization's compliance monitoring and reporting systems. Or, to use the court's language in that case, boards cannot "satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning...the corporation's compliance with law...."

Since *Caremark*, it has also been clear that holding directors personally liable for misconduct at an organization (for failure to exercise their duty to be reasonably informed) is quite difficult. Indeed, according to the Delaware courts, it is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[2]

This high bar for liability has resulted in a large number of dismissed cases over the intervening years. However, in 2019, in two different cases, Delaware courts refused to dismiss plaintiffs' *Caremark* claims on summary judgment, allowing the cases to proceed. Although the courts gave no indication that their decisions were intended to modify existing law, the decisions do further expand on *Caremark* in a way that is important for compliance and ethics professionals to be aware of. Robust and engaged board oversight of compliance systems is necessary to afford a compliance program the level of independence and authority that is required for effectiveness, and these cases offer a rare (from the Delaware courts, at least) opportunity for organizations to revisit the topic of board oversight of compliance. In this article, we will review both of the recent cases with that in mind. But first, a little background on Delaware law in this area.

Caremark and *Stone v. Ritter*

In *Caremark*, the plaintiff shareholders had sought to hold the company's directors liable for the damages resulting from violations of certain federal and state laws governing healthcare fraud. The complaint alleged that the directors had (through their failure of oversight) allowed misconduct to occur, which exposed the organization to liability, and thereby violated a duty to monitor the company's compliance with legal requirements. The *Caremark* case established that directors have a duty to "be reasonably informed concerning the corporation," including assuring themselves that there are systems in place to permit the board to oversee the company's compliance with law. In other words, boards must make some effort to ensure that they are being kept appropriately apprised of a company's compliance.

However, *Caremark* and subsequent cases also made clear that—while director liability is possible—it presents a high bar for success. The *Caremark* court described it thus: "Only 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 exists will establish the lack of good faith that is a necessary condition to liability."[3]

Ten years after *Caremark*, in the 2006 case of *Stone v. Ritter*,[4] the Delaware Supreme Court affirmed the Chancery Court's *Caremark* holding, stating that directors may be held liable for misconduct that occurs on their watch if they either completely failed to implement a reporting or information system or controls 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."[5] The court further held that, in a case such as *Stone*, where information failed to reach the board because of ineffective internal controls, but information systems had been established and the directors neither knew nor should have known of the violations of law, there had been no violation of the duty of good faith.

Marchand v. Barnhill

In 2019—13 years after *Stone v. Ritter*—the Delaware courts decided two cases in which they reiterate their holdings in that case, but also find that the plaintiffs have managed to plead a case that meets the very high bar established in *Caremark.* The first case, *Marchand v. Barnhill,*[6] which was decided by the Delaware Supreme Court in June of 2019, concerned a listeria outbreak at an ice cream plant. The listeria outbreak at Blue Bell Creameries resulted in the tragic deaths of three people, caused the company to recall all of its products, and required a lay-off of over a third of Blue Bell's workforce. The outbreak also resulted in financial loss to shareholders, who then filed suit against two officers of the corporation and against Blue Bell's directors, alleging that the directors had breached their duty of loyalty under *Caremark.*

The trial court dismissed the *Caremark* claims, finding that plaintiffs had alleged not that there were no board-level monitoring and reporting controls, but that the monitoring and reporting controls were ineffective in particular instances, which "is not a valid theory" under *Caremark.* The Delaware Supreme Court reversed, holding that the complaint could support a reasonable inference that "the Blue Bell board failed to implement any system to monitor Blue Bell's food safety performance or compliance," thus permitting the suit to continue.

Interestingly, the court focused its analysis not on general compliance oversight systems, but instead on compliance oversight of the company's most significant risk area given its line of business: food safety. "[O]ne of Blue Bell's central compliance issues is food safety. Despite this fact, the complaint alleges that Blue Bell's board had no committee overseeing food safety, no full board-level process to address food safety issues, and no protocol by which the board was expected to be advised of food safety reports and developments." In other words, the board did not have compliance systems in place for a particular risk area that is critical to the company. Because of the lack of board-level oversight in this risk area, the court concluded that "the complaint alleges specific facts that create a reasonable inference that the directors consciously failed 'to attempt to assure a reasonable information and reporting system exist[ed].'" Although the court recognized that, consistent with the business judgment rule, directors have enormous discretion in the design and approach of their monitoring systems, *Caremark* nonetheless has "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."

Marchand thus highlights the importance of engaged board oversight of the design and implementation of compliance systems in critical compliance areas, in addition to a general system of compliance monitoring and reporting. This would seem, in turn, to necessitate both an understanding of critical compliance areas (and hence a risk assessment) and appropriate systems in light of—or, in other words, tailored to—those areas. These conclusions are consistent with recent government guidance on compliance and ethics programs, such as that found in the Department of Justice's April 2019 memorandum titled *Evaluation of Corporate Compliance Programs*[7] and the Antitrust Division's July 2019 memorandum titled *Evaluation of Corporate Compliance Programs in Criminal Antitrust Investigations*.[8] For further reading, also see Jeff Kaplan's "Summer compliance reading for boards of directors," on the *Conflicts of Interest Blog*.[9]

In addition, the court in *Marchand* focused on the allegation that there was *no* board-level discussion about the testing done by Blue Bell that identified listeria contamination in certain plants, despite management knowledge of the issue. The court's focus on the failure of these red flags to make it to the board reiterates the importance of ensuring that escalation protocols for informing the board of serious issues on a timely (which in some cases will mean immediate) basis are established and used at organizations.

Clovis Oncology

The second case was decided by the Delaware Chancery Court on October 1, 2019. *In re Clovis Oncology, Inc. Derivative Litigation* concerns a biopharmaceutical company, which had a promising drug called Rociletinib, designed for the treatment of lung cancer. Clovis had no approved products and no sales revenue, so the clinical trials and U.S. Food and Drug Administration (FDA) approval of Rociletinib were critical to the company's existence. In *Clovis*, plaintiffs alleged that the company failed to comply with FDA-required testing protocols and regulations, and that the board consciously ignored warnings and refused to act despite information indicating that the required protocols were not being followed.

Focusing on the board's alleged failure to monitor established systems in the face of red flags, the court stated that, "when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised." Because "protocols and related FDA regulations" governing the company's clinical trial were "mission critical regulatory issues" for the company's "mission critical product," the court was satisfied that the plaintiffs had met the *Caremark* pleading requirements.

The *Clovis* decision thus highlights the importance of a board's establishing systems to ensure that it will be made aware of serious issues when they arise, and of the board's otherwise making efforts to be aware of and respond to issues that arise, in particular when the concerns relate to risks or issues that are critical to an organization's viability. In other words, similar to the decision in *Marchand*, the court in *Clovis* focused on the board's oversight of compliance systems in high-risk areas for the company and on the board's awareness of and response to specific compliance concerns.

Lessons to take away

The decisions in *Marchand* and *Clovis* present an important opportunity for organizations to revisit their board's oversight of compliance systems, in particular in high-risk and highly regulated areas; their protocols for escalating serious issues to the board; and their methods of keeping the board apprised of the company's response to serious concerns. The Delaware courts do not present compliance professionals with this opportunity often, so we would be well advised to take advantage of it.

About the author

Rebecca Walker is a member of the Editorial Advisory Board of *CEP Magazine* and is the author of *Conflicts of Interest in Business and the Professions: Law and Compliance.*

Takeaways

- Strong board oversight of compliance programs is important to ensure that a program has the necessary independence and authority to be effective.
- In *Caremark*, the court held that only sustained/systematic board failures to assure the existence of compliance and reporting systems results in board liability for corporate misconduct.
- The two recent decisions of Delaware courts present compliance professionals with an important opportunity to revisit their board's oversight of compliance programs.
- The *Marchand* case highlights the importance of board oversight of the design and implementation of compliance systems in high-risk, critical compliance areas.
- The *Clovis* decision highlights the importance of a board establishing systems to ensure that it will be made aware of serious issues when they arise.

1 In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch.1996).
2 Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 372 (Del. 2006).
3 In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch.1996).
4 Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).
5 Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006).
6 Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
7 U.S. Dep't of Justice, Criminal Div., *Evaluation of Corporate Compliance Programs* (Updated April 2019), http://bit.ly/2Z2Dp8R.
8 U.S. Dep't of Justice, Antitrust Div., *Evaluation of Corporate Compliance Programs in Criminal Antitrust Investigations* (July 2019), http://bit.ly/33l1gDS.
9 Jeff Kaplan, "Summer compliance reading for boards of directors," *Conflict of Interest Blog*, July 15,

2019, http://bit.ly/2XYZaaB.