

CLIENT ALERT

Delaware Supreme Court Decision in *Marchand* Potentially Impacts *Caremark* Standard

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Last week, the Delaware Supreme Court issued an important decision in *Marchand v. Barnhill*,¹ reversing the dismissal of a shareholder derivative action against the directors and officers of Blue Bell Creameries USA, Inc., a large ice cream manufacturer. The Delaware Supreme Court's decision in *Marchand* potentially alters the landscape for *Caremark* claims² and serves as a cautionary tale for boards seeking to monitor key risks facing the company.

Background

In early 2015, Blue Bell suffered a high-profile *listeria* outbreak after 10 people in four states were hospitalized from eating tainted ice cream. Tragically, three people died as a result of the outbreak. The resulting crisis forced Blue Bell to recall all of its products (over eight million gallons of ice cream), shut down production of its plants for several months, and lay off over a third of its workforce. In the aftermath, Blue Bell faced a severe liquidity crisis that forced it to accept a dilutive private equity investment.

A shareholder of Blue Bell brought a derivative suit in the Court of Chancery against two key executives, Paul Kruse, the President and CEO, and Greg Bridges, the Vice President of Operations, and the Blue Bell directors alleging breaches of

¹ 2019 WL 2509617 (Del. June 18, 2019).

² *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (Allen, C.). Under *Caremark*, directors have a duty "to exercise oversight" by monitoring the corporation's operational viability, legal compliance, and financial performance. These types of oversight claims (which are known as "*Caremark*" claims) have generally been very difficult to establish against directors.

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fiduciary duty. The theory of the complaint was that the executives knowingly disregarded contamination risks and failed to oversee the safety of the Company's operations, and the directors breached their duty of loyalty under *Caremark*. No demand was made on the Blue Bell board before initiating the action.

On September 27, 2018, Vice Chancellor Joseph R. Slight III issued a lengthy decision granting the motion to dismiss for failure to plead demand futility.³ As to the claims against management, the Vice Chancellor found that the complaint had failed to raise a reasonable doubt as to the impartiality of a majority of the Blue Bell board coming up one director short of the required eight votes. As to the *Caremark* claims, the Vice Chancellor found that plaintiff had sought to challenge the *effectiveness*, rather than the *existence*, of the directors' monitoring and reporting controls, a theory of liability rejected by *Caremark* and its progeny.

The Supreme Court Decision

Exercising *de novo* review, the Delaware Supreme Court reversed both of the lower court's holdings. Tracing the history of Blue Bell as a monoline company making a single product (ice cream) and operating in a heavily regulated industry, the Court emphasized that the primary compliance risk facing the Company was food safety, and yet "no system of board-level compliance monitoring and reporting existed at Blue Bell" regarding food safety matters.⁴

The Supreme Court's independence review focused on W.J. Rankin, Blue Bell's former CFO. The complaint alleged close and long-standing ties between Rankin and the Kruse family: principal among them was that Rankin started at Blue Bell as Ed Kruse's (father to Paul Kruse) administrative assistant, and with the support of the Kruse family, rose over the course of his 28-year career to become CFO and director. Despite some evidence of independent conduct by Rankin as a director, the Supreme Court found that Rankin was beholden to Paul Kruse, writing that "deep and long-standing friendships are meaningful to human beings and that any realistic consideration of the question of independence must give weight to these important relationships and their natural effect on the ability of the parties to act impartially toward each other."⁵

Next, while recognizing that *Caremark* claims are difficult to plead and even harder to prove, the Supreme Court concluded that the Blue Bell board made no "good faith" effort to oversee the Company's operations on food safety matters, the critical compliance issue facing the Company. The key allegations credited by the Court included that prior to the outbreak:

- Blue Bell had no board committee focused on food safety.

³ *Marchand v. Barnhill*, 2018 WL 4657159 (Del. Ch. Sept. 27, 2018).

⁴ 2019 WL 2509617, at *13.

⁵ 2019 WL 5509617, at *11.

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- No processes or protocols existed for elevating food safety concerns to the board.
- No regular schedule existed for presenting food safety issues to the board.
- Prior to the outbreak, “yellow” and “red” flags of potential contamination existed at the level of management that were never escalated to the board.
- The Blue Bell board was given a one-sided picture of food safety by management.
- Board minutes reflected no regular discussion of food safety issues.

Emphasizing that boards retain significant business judgment in structuring reporting and control systems, the Supreme Court nevertheless parted ways with the Court of Chancery and concluded that these allegations supported a reasonable inference that “the board did not undertake good faith efforts to put a board-level system of monitoring and reporting in place.”⁶ The lack of board-level attention to food safety was particularly striking to the Supreme Court given that food safety was a “compliance issue intrinsically critical to the company’s business operation.”⁷

Conclusion

Whether *Marchand* (due to its unusual allegations) represents a one-off decision or an invitation for future *Caremark* litigation in Delaware courts remains to be seen.

The Court’s emphasis on board-level oversight on the specific topic of food safety—as opposed to the more general question of whether reporting systems and controls existed in the first place—is novel and represents a departure from prior cases. At the very least, *Marchand* teaches that boards will be expected to exercise formalized and regularized oversight on the most significant risks facing the company. Just how far Delaware courts are willing to go beyond that in scrutinizing the nature and effectiveness of those policies is left open by the decision.

Following *Marchand*, public company directors should identify key risks facing the company and ensure that the board is devoting substantial and focused attention on mitigating those risks through the form of devoted board committees, formalized board-level policies requiring escalation, and periodic and scheduled reporting to the entire board.

⁶ 2019 WL 5509617, at *13.

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