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When Compliance Oversight Fails

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The scope and quality of management-to-board risk reporting should be a key Audit & Compliance Committee agenda item following a recent Delaware Supreme Court decision (*Marchand v. Barnhill*) of unusual relevance to health care providers and their governing boards.[1]

The essence of *Marchand* is that corporate directors may be exposed to breach of duty of loyalty claims under the *Caremark* doctrine when they take no action, with management or otherwise, to implement a reporting system by which they may exercise oversight of a key risk area (in this case, food safety). What exactly constitutes "no action" is at the core of the decision.

Marchand is consistent with suggestions that in circumstances involving egregious fact patterns implicating significant consumer (patient?) harm, courts may be more accepting of *Caremark*-based fiduciary duty claims than in the past.

The *Caremark* Obligation

The so-called *Caremark* standard obligates directors to "attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[2] The level of detail that is appropriate for such an information system is a matter of the board's business judgment.[3]

The *Caremark* standard has historically been applied to establish a very high burden for plaintiffs to satisfy in bringing breach of duty claims: e.g., "only a sustained or systematic failure of the Board to exercise oversight—such as an utter failure to attempt to ensure a reasonable information and reporting system exists"[4]

Notably, cases interpreting *Caremark* have emphasized that the mere presence of "red flags" of compliance problems alone won't be sufficient to demonstrate the necessary element of bad faith to prove a *Caremark* violation, in the absence of particular allegations that the defendants were aware of weaknesses in their oversight systems and failed to correct them.[5]

Case Background

The controversy arose from a listeria outbreak in ice cream made by Blue Bell Creameries USA Inc. that sickened many consumers, caused three deaths, and forced the company to recall all of its products, shut down production at all of its plants, and lay off over a third of its workforce. The underlying litigation was filed as a shareholder derivative action alleging *Caremark* violations; i.e., that the board breached its duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of Blue Bell's food-making operations.

The Delaware Chancery Court upheld the defendants' motion to dismiss, ruling that the plaintiff had not plead any facts to support "his contention that the [Blue Bell] Board 'utterly' failed to adopt or implement any reporting and compliance systems." The court reasoned that the Plaintiff was really attempting to challenge not the *existence* of monitoring and reporting controls, but their *effectiveness* in particular instances, which it did not find to be a valid theory under *Caremark*.

The Delaware Supreme Court overturned the Chancery Court's prior decision, concluding that the plaintiff pled allegations of bad faith by the directors sufficient to overcome a motion to dismiss under the *Caremark* doctrine. According to the Delaware Supreme Court, the complaint listed enough particularized facts to support a reasonable inference that no board-level system was in place at Blue Bell.

Critical Facts

Key to the Delaware Supreme Court's analysis was the Blue Bell board's apparent lack of awareness of a mounting series of compliance and food safety "yellow" and "red flags" that arose during a roughly two-year time period, before the listeria outbreak, of which management was well aware. In particular, the court interpreted the pleadings to the effect that before the time period in which the listeria outbreak engulfed the company:

- Blue Bell had no board committee charged with monitoring food safety;
- There was no schedule for the Blue Bell board to consider on a regular basis, such as quarterly of biannually, [whether] any key food safety risks existed;
- The Blue Bell board had no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports;
- Management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- The board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and
- The board minutes were devoid of any suggestion that there was any regular discussion of food safety issues.

Indeed, the first time the board discussed the listeria issue was six days after the company issued a limited recall.

The Court's Rationale

The Court of Chancery focused on Blue Bell's compliance with Food and Drug Administration regulations, ongoing third-party monitoring for contamination, and consistent reporting by senior management to the board on operational matters to conclude that the company had established a monitoring system.

The Delaware Supreme Court rejected those arguments, interpreting *Caremark* as requiring a board to make a good faith effort to put in place a reasonable system of monitoring and reporting *about the corporation's central compliance risks* [emphasis added]. "When a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business model, then that supports an inference that the board has not made the good faith effort that *Caremark* requires." It is not enough that management regularly reported to the board on general operational matters.

The Significance

Marchand can be viewed as significant for the following reasons, among others:

- Identifying the failure of the board to require a sufficient level of risk reporting from management as a breach of the board's *Caremark* obligations.
- Suggesting that in circumstances involving egregious fact patterns that implicate significant consumer harm, Delaware courts (like an increasing number of other jurisdictions) may be more accepting of *Caremark*-based fiduciary duty claims than in the past.

- Raising concerns about the collateral implications of a *Caremark* violation based upon the absence of a risk reporting mechanism (e.g., compliance plan effectiveness as interpreted by the Department of Justice).
- Drawing a distinction between management-to board-reporting on general operational issues, as opposed to specific risk and compliance issues, which distinction should prompt boards to revisit the scope, content, and frequency of risk reporting processes.

The Relevance to Health Care Providers

Marchand's substantial relevance to health care providers can be seen in the following ways:

- Food manufacturers and health care providers both operate in heavily regulated industries and have singular lines of business that implicate quality of care and safety concerns.
- *Caremark* is generally thought to apply broadly to boards, regardless of industry participation, form of organization, or tax status.
- The fundamental board level compliance concerns of the board of a food manufacturer (whether the product it makes is safe to eat) are similar to those of a health care provider (whether the care it makes available will improve or harm a patient's health).

Action Items

The question prompted by *Marchand* is not whether health care providers have compliance programs in place; most do, and with some element of sophistication. Rather, the question is whether the management-to-board level reporting adequately addresses the provider's central compliance risks.

Are directors comfortable that their organization's internal reporting protocols will inform the board in a timely manner of compliance issues intrinsically critical to the provider's business operation? Is there clarity between the board and management (and between the board and its key committees) on what information should be reported to it, and with what frequency?

The timing, scope, and quality of compliance and risk reporting is of particular significance given the limited time available in board and committee meetings to inform directors and committee members on critical risk developments. To further complicate matters, some CEOs—well intentioned or not—exercise substantial control on the information flow to the board and may be less than willing to share bad compliance or quality news.

Marchand also underscores the critical role that faithfully and skillfully prepared minutes can play in defending the conduct of the board of directors.

AUTHOR'S NOTE: The Delaware Supreme Court did not conclude that any individual breached his or her fiduciary duty; only that the plaintiff's complaint was sufficiently pled to overcome a motion to dismiss.

Endnotes:

[1] *Marchand v. Barnhill* (Del. June 19, 2019).

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

[3] *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 125-126 (Del. Ch. 2009).

[4] *Stone v. Ritter,* 911 A.2d 362, 372 (Del. 2006).

[5] *Marchand*, *supra* note 1.

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