jayk7/Moment/Getty Images

Board Oversight of Compliance Risk

In her regular column on corporate governance issues, Holly Gregory discusses recent developments in the Delaware courts regarding the board's oversight of compliance risk.

HOLLY J. GREGORY
PARTNER
SIDLEY AUSTIN LLP

Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory, and listing rule requirements, and governance best practice.

Since the Delaware Court of Chancery's landmark 1996 decision in *In re Caremark International Inc. Derivative Litigation*, shareholder plaintiffs have sought to hold directors liable for a variety of corporate missteps on the basis that the directors failed to fulfill their compliance oversight role (see *Box, Key Caremark Cases*). *Caremark* claims are among the most difficult on which to establish director liability. Until recently, they typically have been dismissed at the pleading stage for failure to state a claim.

However, in two recent decisions, the Delaware courts clarified the circumstances in which these claims can move beyond the pleading stage to discovery and potentially to a trial on the merits. These cases confirm the serious nature of directors' obligations to oversee legal and regulatory compliance and the litigation risks associated with a failure to evidence in corporate records that directors are attending to important compliance issues.

To assist boards in understanding when directors may be liable for a failure to oversee the company's compliance and risk systems and controls, and how to provide the necessary oversight, this article discusses:

- General principles of board oversight of compliance risk.
- Recent Delaware cases where claims for failure of compliance oversight survived dismissal.
- Practical guidance for boards and their advisors to protect against these claims.

BOARD OVERSIGHT OF COMPLIANCE RISK

The board is charged under Delaware law with managing and directing the company's affairs, and has an obligation to provide direction and oversight to the CEO and senior management team to whom the board has delegated authority for the day-to-day operations of the company. The board may rely on others to whom authority has been delegated, as long as it is reasonable to do so. Ongoing assessment of whether this reliance is reasonable lies at the heart of board oversight and extends to ensuring that information and reporting systems are in place to provide the board with the information it needs to monitor the compliance of the company's operations with applicable laws, rules, and regulations.

When corporate employees are found to have participated in fraud or other serious misconduct, shareholders may seek to hold directors liable for a breach of fiduciary duty premised on the board's failure to provide adequate oversight and implement related information and reporting systems and controls. A failure of oversight suggests an absence of good faith and is considered a breach of directors' fiduciary duty of loyalty, which cannot be exculpated under Delaware law. (While a Delaware company can eliminate its directors' personal monetary liability for a breach of the duty of care by including an exculpation provision in the certificate of incorporation, it cannot do so for a breach of the duty of loyalty.) Moreover, Delaware companies cannot indemnify directors or officers who have not acted in good faith.

Therefore, this claim is one of the few remaining avenues to seek monetary damages from directors personally, absent a conflict of interest situation. Plaintiffs asserting a claim for failure of oversight under Delaware law must allege with particularity facts demonstrating that the directors failed to implement any information and reporting systems and controls or, having implemented the systems and controls, consciously failed to pay attention to them, effectively disabling themselves from being informed of risks or issues that arose.

Search Fiduciary Duties of the Board of Directors for more on the board's oversight role.

RECENT DELAWARE CASES WHERE *CAREMARK* CLAIMS SURVIVED MOTIONS TO DISMISS

Twice in 2019, Delaware courts rejected motions to dismiss claims of failure of compliance oversight, providing guidance about the circumstances in which these claims are sufficiently alleged to proceed to discovery and potentially to trial.

Marchand v. Barnhill involved a listeria outbreak in ice cream manufactured by Blue Bell Creameries USA, Inc., which resulted in three customer deaths. After a total product recall, plant shutdowns, layoffs, and resolution of a resulting liquidity crisis through a dilutive private equity investment, a shareholder filed a derivative lawsuit alleging that Blue Bell's directors had failed to make a good faith effort to implement and monitor an oversight system for food safety, which was a key area of risk to the business.

The Delaware Chancery Court granted the defendant's motion to dismiss, and the plaintiff appealed to the Delaware Supreme Court, which reversed after finding that the allegations supported a reasonable inference that the directors failed to implement any system to monitor Blue Bell's food safety performance or compliance. The court noted that food safety is a central compliance issue for Blue Bell. As a manufacturer of a single product, its business is reliant on consumers trusting that its ice cream is safe to eat. The Delaware Supreme Court noted the plaintiff's allegations that:

- Blue Bell lacked:
  - a board committee to oversee food safety;
  - a full board-level process to address food safety issues; and
  - a protocol for advising the board of food safety reports and developments.
- Despite management's awareness of increasing yellow and red flags relating to food safety, there was no evidence of any process to report food safety information to the board.

Accordingly, the court concluded that it appeared that no system of board-level compliance monitoring and reporting existed at Blue Bell, implying that the board had not made a good faith effort to exercise oversight. As a result, the court allowed the plaintiff's *Caremark* claim to proceed. (212 A.3d 805 (Del. 2019).)

Search Delaware Supreme Court Reverses Chancery Court in Marchand v. Barnhill, Finds Reasonable Doubt of Director Independence and Possible Caremark Claim for more on this decision.

In *In re Clovis Oncology, Inc. Derivative Litigation*, the Delaware Chancery Court cited *Marchand*'s explanation of *Caremark* guidance that the board's oversight responsibility includes good faith efforts both to ensure that a compliance system is implemented, and to monitor the system once implemented. The court also emphasized that the board's responsibilities must be exercised and assessed in relation to the level of risk presented, stating that *Marchand* "underscores the importance of the board's oversight function when the company is operating in the midst of 'mission critical' regulatory compliance risk." In a mission critical environment, "the board's oversight function must be more rigorously exercised." However, while *Marchand* focused on the first prong of the *Caremark* test (failure to implement any compliance system), *Clovis* focused on the second prong of the *Caremark* test (failure to monitor the compliance system's operation).

Clovis involved a biotechnology company with a drug in development for the treatment of a type of lung cancer.

Key *Caremark* Cases

CAREMARK

Caremark involved review of a settlement of shareholder derivative claims that were premised on the company's guilty plea to mail fraud charges and payment of significant criminal and civil fines for violations of federal and state health care laws. The plaintiff had alleged that the directors failed to supervise adequately the conduct of employees several layers down in the company, which the court described as an allegation of "unconsidered inaction." The court noted that decisions by employees can impact a company's reputation and well-being, and that criminal penalties and the Federal Sentencing Guidelines for Organizations provide "powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts."

Search Criminal and Civil Liability for Corporations, Officers, and Directors for more on the Federal Sentencing Guidelines for Organizations.

The court emphasized that directors have an affirmative duty to assure 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 both the corporation's compliance with law and its business performance." The level of detail for any such system is a matter of business judgment, but failure to have an information and reporting system may "render a director liable for losses caused by non-compliance with applicable legal standards." (698 A.2d 959 (Del. Ch. 1996).)

STONE v. RITTER

In *Stone v. Ritter*, the Delaware Supreme Court emphasized the high standard to bring a claim against directors for failure of compliance oversight. Following a civil settlement related to company employees' failure to file reports required by federal anti-money laundering laws, shareholders alleged that the board had failed to exercise oversight responsibilities, even though the company had both an anti-money laundering compliance program in place and procedures to regularly monitor compliance. Given this alleged failure, the plaintiffs asserted that the demand requirement, which gives the board the opportunity to assert the claim on behalf of the company, should be waived as futile.

The Delaware Supreme Court held that *Caremark* provides a two-prong test for director oversight liability. Directors face potential liability for either:

- Complete failure to implement any compliance system, including information and reporting systems.
- Having implemented a compliance system, failure to monitor the operation of that compliance system.

The Delaware Supreme Court ultimately affirmed the Delaware Chancery Court's dismissal of the case, holding that the directors' actions in light of the compliance program were not likely to establish the lack of good faith necessary to excuse demand. Quoting *Caremark*, the court emphasized that "[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation ... 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." (911 A.2d 362 (Del. 2006).)

IN RE CITIGROUP INC. SHAREHOLDER DERIVATIVE LITIGATION

The Delaware Chancery Court considered *Citigroup*, which distinguished between oversight of compliance risk and oversight of business risk, to be a "twist" on *Caremark*-style claims. The *Citigroup* plaintiffs alleged that the board failed to monitor the bank's risk profile, including its exposure to subprime loans. The court found that the challenged actions were properly evaluated subject to the business judgment rule, "even if ... framed under a *Caremark* theory." As evaluated under the business judgment rule, which is designed to prevent "judicial second guessing" of business decisions, the directors would not face liability without a finding of bad faith, which could not be demonstrated.

The court stated that "[t]here are significant differences between failing to oversee [in order to limit or prevent] employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk." Further, "[w]hile it may be tempting to say that directors have the same duties to monitor and oversee business risk [as with fraud and criminal conduct], imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different." (964 A.2d 106 (Del. Ch. 2009).)

SUBSEQUENT CASES

Subsequent cases have highlighted that the failure to monitor compliance with the law, including regulatory mandates, is more likely to give rise to oversight liability under *Caremark*. It is more difficult to plead and prove *Caremark* liability based on a failure to monitor and prevent harm flowing from business risks arising in the ordinary course of operations (see *Okla. Firefighters Pension & Ret. Sys. v. Corbat*, 2017 WL 6452240 (Del. Ch. Dec. 18, 2017); *Reiter ex rel. Capital One Fin. Corp. v. Fairbank*, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016); *In re Facebook, Inc. Sec. 220 Litig.*, 2019 WL 2320842 (Del. Ch. May 31, 2019)).

The likelihood of the drug receiving Food and Drug Administration (FDA) approval depended on the success of the drug trials, which under established protocols were to be reported based on confirmed clinical responses. The FDA took issue with the degree to which the company strictly followed the protocols.

Unlike the board in *Marchand*, the board in *Clovis* had an established reporting system in which the board reviewed and discussed detailed information regarding the status of the drug's clinical trial. Despite the actual results during the clinical trial, Clovis publicly reported inflated success rates and omitted any discussion of side effects. During this time, the board was periodically informed of the actual results and that management was inaccurately calculating and publicly disclosing the inaccurate metrics. When the actual results were accurately disclosed, the company's share price declined significantly, and the FDA ultimately declined to approve the drug.

Shareholders filed a derivative lawsuit against the directors, alleging among other things a failure to oversee the clinical trials. The court denied the defendants' motion to dismiss the duty of oversight claim. Because the board had oversight and reporting systems in place relevant to the clinical trials, the court held that the plaintiffs had not established the board's failure to implement these systems. However, the court found that the plaintiffs had stated a claim for the board's failure to monitor the oversight systems by alleging with particularity that the board consciously ignored multiple red flag warnings that management was inaccurately reporting the drug trial results. (2019 WL 4850188 (Del. Ch. Oct. 1, 2019).)

Clovis reminds boards that having a compliance program, including information and reporting systems, in place is necessary, but insufficient. The board must attend to the information and reporting systems to monitor mission critical compliance risks.

Search Clovis: Delaware Chancery Court Allows Caremark Claim to Proceed for Failure to Monitor for more on this decision.

PRACTICAL GUIDANCE

The duty of oversight is central to directors' fiduciary duties and requires that directors make a good faith effort to ensure that an oversight system has been implemented and then to monitor it.

While *Marchand* and *Clovis* do not change Delaware law, they highlight that on the right set of factual allegations *Caremark* claims may be allowed to proceed. Specifically, if board meeting minutes provide no indication that the board has made an effort to inform itself of a compliance issue "intrinsically critical to the company's business operation" (*Marchand*, 212 A.3d at 822), or the available record indicates that directors ignored red flags regarding a mission critical compliance matter, a court may reasonably infer that the board has not met the good faith effort required by *Caremark*. *Marchand* and *Clovis* reinforce the potential for director liability under *Caremark*, and boards therefore should continue to focus on oversight of key areas.

Boards of companies that operate in heavily regulated industries or depend on a sole product line are especially on notice after *Marchand* and *Clovis* that diligence is expected of boards regarding oversight of compliance risks. However, the guidance from these cases applies to all companies. Therefore, a board seeking to fulfill its oversight duties should consider:

Clovis reminds boards that having a compliance program, including information and reporting systems, in place is necessary, but insufficient. The board must attend to the information and reporting systems to monitor mission critical compliance risks.

- **Key compliance risks.** The board should understand the key compliance risks, including any mission critical compliance risks, facing the company.
- **Compliance culture, programs, and systems.** The board should understand, and the board or an appropriate committee should oversee, the compliance culture, programs, and systems (the policies, controls, and procedures) that management has put in place to identify, manage, and mitigate risks, as well as respond to risk incidents that arise. The duty of oversight is discharged in large measure by ensuring that the company has implemented appropriate compliance programs and systems (including information and reporting systems) designed in relation to the risk profile of the company, including mission critical compliance risks.
- **Information and reporting systems.** The board should ensure that an appropriate information and reporting system is in place to keep management and the board abreast of compliance issues. The board (or delegated committee) should ensure that the company's information and reporting systems contemplate the key compliance risks it faces, and these systems should be reasonably designed to provide the board with timely, accurate information sufficient to allow it to reach informed judgments concerning the company's

compliance with laws and oversight of risk. The board (and any delegated committee) should set clear expectations with management about the circumstances in which compliance issues should result in a board or committee report. In addition, the board (or delegated committee as appropriate) should hear, on a regular basis, from the senior executives with overall responsibility for the most significant risk areas and, if there is an issue in a significant risk area, should ensure that management has an appropriate plan for addressing the risk and regularly updates the board or committee regarding that plan.

- **Oversight delegation.** The board should consider from time to time whether it has adequately apportioned responsibility for risk oversight, including oversight of compliance risk, between the board and its various committees. A committee with appropriate competency and resources should oversee mission critical risks.
- **Competency.** The board should ensure that it has access not only to appropriate information, but also to appropriate expertise to monitor key risks and assess management's efforts to mitigate those risks. This requires consideration of management's competencies, experts' availability, and the board's own expertise. (For more information, search Board Evaluation Processes and Related Disclosures and Board Composition, Diversity, and Refreshment (2018) on Practical Law.)
- **Annual review of compliance programs and systems.** At least once per year (and more frequently if issues arise) the board or delegated committee should review the compliance programs and systems that are in place and ensure that they are performing and aligned with the standards set forth in the Federal Sentencing Guidelines for Organizations, Department of Justice guidelines, and other influential resources that provide guidance regarding board oversight of compliance risk and compliance program effectiveness. This review should also consider:
  - alignment of the compliance programs and systems with the key compliance risks facing the company, which evolve over time as the company's business and compliance environment change;
  - the effectiveness of reporting hotlines and whistleblower mechanisms; and
  - whether changes are appropriate, based on compliance issues that arise.
- **Agendas, minutes, and exhibits.** In *Marchand* and *Clovis*, the board records (board meeting agendas and minutes) failed to evidence that directors were attending to the mission critical compliance risks. The absence of references in the board records to compliance discussions related to the specific risks at issue allowed the courts to assume that such activity was not occurring. Generally, board and committee meeting agendas, minutes, and exhibits should reflect discussions on compliance issues, such as with respect to ongoing oversight, periodic reviews as well as more in-depth reviews, and special situations that arise. Counsel should review minutes and other materials to ensure proper identification of privileged information.
- **Disclosure.** Public company boards should oversee risk-related disclosures and disclosure controls and procedures.

A commonsense risk oversight approach should not focus unduly on technical issues. It should address issues related to policies and processes, including efforts to educate employees and ensure compliance, and the appropriate deployment of corporate resources.

- **Fiduciary duty standards.** The general counsel or outside counsel should review fiduciary duty standards with the board periodically (once every one or two years). This discussion should include a review of the board's compliance oversight responsibilities, as well as a discussion of any significant compliance risks.
- **Common sense.** Directors should apply the same commonsense approach to compliance risks that they apply to other risks. A commonsense risk oversight approach should not focus unduly on technical issues. It should address issues related to policies and processes, including efforts to educate employees and ensure compliance, and the appropriate deployment of corporate resources.

Search Corporate Compliance and Ethics Toolkit for resources to assist companies in designing compliance programs.

Search Advantages of Implementing a Legal Compliance Program and Developing a Legal Compliance Program for information on the benefits of developing, implementing, and maintaining a legal compliance program.

PL

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.