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NOT EVERYONE IS SCREAMING FOR ICE CREAM: HOW *MARCHAND V. BARNHILL* IMPOSES A HEIGHTENED DUTY TO MONITOR

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I. INTRODUCTION

One of the most challenging questions in corporate law is determining the extent to which the board of directors must monitor the corporation.[1] To run a corporation properly, directors must uphold their fiduciary duties to both the corporation and its shareholders.[2] According to the Delaware Supreme Court, a board of directors must demonstrate good faith efforts to implement and monitor a system of oversight by having such a system in place, and to continually monitor and update that system.[3] Historically, plaintiffs have struggled to succeed in bringing claims against a board of directors based on a failure to monitor.[4] However, the 2019 case of *Marchand v. Barnhill*[5] has arguably created a new era, one in which plaintiffs can more easily succeed in bringing a failure to monitor claim. In *Marchand*, a shareholder of Blue Bell Creameries USA, Inc. brought a derivative suit against the board of directors following a listeria outbreak.[6] Unlike previous duty to monitor cases, the court held that

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1. Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y. L. SCH. L. REV. 717, 718 (2010) (stating that in corporate law, it is difficult to determine whether the board of directors has a duty to prevent harm to the corporation).

2. JOSEPH D. ZAMORE ET AL., 1 BUSINESS TORTS § 2.01 (rev. ed. 2020).

3. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

4. *See* Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019); *Stone*, 911 A.2d at 372; *In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996); Cydney Posner, *Delaware Supreme Court Allows* Caremark *Duty of Loyalty Claims Against Directors to Survive Dismissal Action*, COOLEY PUBCO (July 12, 2019), https://cooleypubco.com/2019/07/12/delaware-marchand-v-barnhill/.

5. *Marchand*, 212 A.3d at 805.

6. *Id.* at 805.

the plaintiffs succeeded in alleging facts that support a reasonable inference that the board failed their duty to monitor.[7] The decision in *Marchand* reinterprets the duty to monitor and creates a much stricter standard for highly regulated industries, such as food and drug companies.

This Comment examines the effects of *Marchand* and how Delaware courts will approach duty to monitor claims in the future. Part II considers the pre-*Marchand* framework of the board of directors' duty to monitor by examining the various standards developed by Delaware courts in the past. Part III discusses the facts of *Marchand* and examines the court's holding and its reasoning. Part IV argues that the court's decision in *Marchand* has made it easier for shareholder derivative suits to succeed in alleging claims based on the board's failure to monitor by examining the effects that *Marchand* has had on recent litigation. Lastly, Part V analyzes the public policy impact of *Marchand* for highly regulated industries and how to navigate the duty to monitor following *Marchand*, especially during the COVID-19 pandemic.

II. HISTORY OF THE DUTY TO MONITOR

Under corporate law, the board of directors is subject to the fiduciary duties of (1) care and (2) loyalty.[8] A board's duty of care requires directors to act in a manner that it reasonably believes to be in the best interest of the corporation.[9] A board may be held liable for breaching its duty of care if it were to make an uninformed, unadvised judgment that is not reasonably in the best interest of the corporation.[10] In comparison, the duty of loyalty requires the board to (1) protect the corporation's interests and (2) refrain from causing harm to the corporation.[11] Directors breach their duty of loyalty when they "fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities."[12] However, in the absence of a conflict of interest, the courts often apply a business

7. *Id.* at 824.

8. Peter A. Atkins et al., *Directors' Fiduciary Duties: Back to Delaware Law Basics*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 10, 2020), https://corpgov.law.harvard.edu/2020/03/10/directors-fiduciary-duties-back-to-delaware-law-basics/; ZAMORE ET AL., *supra* note 2.

9. Atkins, *supra* note 8; ZAMORE ET AL., *supra* note 2.

10. ZAMORE ET AL., *supra* note 2.

11. *See id.*

12. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

judgment rule, which presumes that the board of directors acted on an informed basis in good faith and in the best interest of the company.[13] Thus, courts have long refrained from holding directors liable for harmful consequences that do not involve wrongful or illegal acts.[14] Some scholars argue that by applying the business judgment rule, courts have encouraged directors to be unaware of aggressive risk-taking by officers.[15] In breaching their fiduciary duties, the directors could cause shareholders to suffer detrimental losses.[16]

While there is not a separate duty of good faith, some Delaware courts impute such a duty in cases where numerous red flags have arisen, finding a failure to monitor to be a breach of the fiduciary duty of loyalty.[17] To hold a director liable for failure to provide an adequate system of oversight, the directors must have "utterly failed to implement any 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."[18] The most important issue related to the duty to monitor is the standard of care that must be taken by the board to detect potential harm.[19] Imposing a strict standard could cause a board to become risk-averse and cause the company to overinvest in monitoring systems.[20] Additionally, the board could reject risky business decisions to prevent liability.[21] For this reason, past decisions from the Delaware courts have made it difficult, if not impossible, for plaintiffs to succeed in duty to monitor cases.[22]

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13. ZAMORE ET AL., *supra* note 2.

14. Pan, *supra* note 1, at 718; *see generally In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 125 (Del. Ch. 2009) (explaining that the purpose of the business judgment rule is "to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly").

15. Pan, *supra* note 1, at 718.

16. *Id.*

17. *See Stone*, 911 A.2d at 370.

18. *Id.*

19. *See* Pan, *supra* note 1, at 720.

20. Ronald J. Daniels, *Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance*, 24 CAN. BUS. L.J. 229, 233 (1995) (discussing how directors may "be induced to operate the company in an excessively risk averse fashion" to avoid liability); Pan, *supra* note 1, at 720.

21. *See* Daniels, *supra* note 20, at 234; Pan, *supra* note 1, at 720.

22. *In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996) (describing the duty to monitor claims as the "most difficult theory in corporation law upon which a plaintiff might hope to win a judgment"); *see also* Pan, *supra* note 1, at 720 (discussing how Delaware courts have

Over the past 60 years, Delaware courts have interpreted and expanded upon the standard required to succeed in bringing a failure to monitor claim.[23] The three seminal Delaware cases establishing the duty to monitor are *Graham v. Allis-Chalmers*,[24] *In re Caremark International*,[25] and *Stone v. Ritter*.[26] The landmark case was *Graham*, which held that directors are not liable for failing to enact a compliance program unless suspicious circumstances have been brought to its attention that make the board aware of illegal or wrongful activity.[27] Thirty-three years later, the court expanded on *Graham* through its decision in *Caremark*.[28] The opinion of Chancellor William Allen in *Caremark* remains the most comprehensive examination of the meaning of duty to monitor, leading these lawsuits to be referred to as "*Caremark* claims."[29] The *Caremark* decision required directors to be informed and vigilant, so that they may implement an information and reporting system even before the occurrence of red flags.[30] Only ten years later, in *Stone v. Ritter*, the court expanded on the decision in *Caremark*.[31] In *Stone*, Justice Holland stated that to recover in an oversight case, the plaintiff must show a lack of good faith on the part of the directors.[32] A more detailed examination of these three cases helps to understand the modern standard applied today.

A. Graham v. Allis-Chalmers

In 1963, *Graham* was the first case in Delaware to acknowledge a board's duty to oversee compliance and preclude corporate misconduct.[33] In *Graham*, the plaintiffs filed a derivative suit on

limited the scope of the duty to monitor due to "the chilling effect that the threat of legal liability may have on a board's business judgment").

23. *See, e.g.*, *Stone*, 911 A.2d at 362; Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 126 (Del. 1963); *In re Caremark Int'l*, 698 A.2d at 959.

24. 188 A.2d 125 (Del. 1963).

25. 698 A.2d 959 (Del. Ch. 1996).

26. 911 A.2d 362, 370 (Del. 2006).

27. *Graham*, 188 A.2d at 129.

28. *In re Caremark Int'l*, 698 A.2d at 959.

29. *See, e.g.*, Pan, *supra* note 1, at 722–23.

30. *See In re Caremark Int'l*, 698 A.2d at 970.

31. *Stone*, 911 A.2d at 362.

32. *Id.* at 372.

33. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 129 (Del. 1963); s*ee also* Paul E. McGreal, Caremark *in the Arc of Compliance History*, 90 TEMP. L. REV. 647, 651 (2018) (discussing how the "fiduciary duty to oversee legal compliance" was first addressed in *Graham*);

behalf of Allis-Chalmers against the company's directors for failing to stop employees from violating federal antitrust laws.[34] Allis-Chalmers was an electrical equipment manufacturer, whose company was divided into multiple divisions and departments within those divisions.[35] The company's business model was designed to decentralize the delegation of authority by giving responsibilities to the lowest management level capable of fulfilling the tasks.[36] For this reason, the department manager generally priced products, without the participation of the directors.[37] Instead, the board of directors would meet once a month to consider general financial and operating data.[38] During these meetings, the board would not consider specific issues related to the various divisions or the departments within those divisions.[39]

Multiple indictments charged Allis-Chalmers with violations of anti-trust laws by engaging with other manufacturers and employees to fix prices and interfere with bids to both private and governmental agencies.[40] While there was no evidence that the directors had actual knowledge of the illegal anti-trust activity, the plaintiffs claimed that prior decrees from the Federal Trade Commission in 1937 put the directors on notice of their duty to ensure that future anti-trust activity would not occur.[41] However, none of the directors currently employed by Allis-Chalmers were directors or officers in 1937.[42] Thus, the court held that the 1937 decrees did not put the directors on notice of the possibility of future anti-trust activity.[43]

The plaintiffs further argued that the directors were liable for the losses suffered by Allis-Chalmers based on their duty to actively supervise and manage the corporate affairs, and that they should have known of the employees' illegal conduct.[44] However, the court did not agree with this argument either, and held directors are bound to use

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Pan, *supra* note 1, at 21 (stating that *Graham* was the first case to recognize a board's duty to prevent corporate misconduct).

34. *Graham*, 188 A.2d at 127.
35. *Id.* at 128.
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.* at 129.
42. *Id.*
43. *Id.* at 129–30.
44. *Id.* at 130.

the same care that an ordinarily prudent individual would use in similar circumstances.[45] The court held that "failure to exercise proper control depends on the circumstances and facts of the particular case."[46] Further, the court stated that "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."[47] If the directors are suspicious of misconduct and fail to take action, they could be liable; however, in this case, the directors could not possibly have known all of the employees' misconduct based on the company's decentralized system of decision making.[48] Instead, the directors decided company policy based on summaries, reports, and corporate records.[49] The court holds that this system was proper and is distinct from cases in which directors recklessly rely on an obviously untrustworthy employee, negligently perform their duties, or ignore obvious signs of employee misconduct.[50] In those situations, the court held that the directors will be liable for the corporation's losses based on a neglect of duty, but none occurred here.[51] According to the court in *Graham*, this board acted promptly to end misconduct and prevent its recurrence, once it became aware of the employees' actions.[52] Thus, the court held that the individual directors were not liable merely because they were unaware of the fact that some employees of Allis-Chalmers violated anti-trust laws and caused the corporation losses.[53]

Following *Graham*, directors had no duty to install and operate an oversight system absent cause for suspicion.[54] In acknowledging the duty to monitor, the court in *Graham* made two distinct points. First, the court categorized the duty to monitor as falling within the board's duty of care.[55] The duty of care arises from a board's control over the management of a corporation and in *Graham*, the court specifically characterizes the board's duty to monitor as "those of

45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.* at 131.
54. *Id.* at 130–31.
55. *Id.* at 130.

control."[56] Second, the court defined the duty to monitor as a passive duty, in which boards were only liable if they ignored obvious red flags indicating wrongdoing.[57] In reaching this conclusion, the court gave boards very little incentive to monitor. Delaware courts continued to follow the standard created in *Graham* for the next thirty-three years, until the court expanded upon the duty to monitor in *Caremark*.

B. In re Caremark International

Chancellor William Allen's opinion in *In re Caremark International* provides one of the most expansive considerations of the duty to monitor.[58] Caremark International, Inc. ("Caremark") was a Delaware corporation, whose main revenue came from alternative site health care and managed care services, including growth hormone therapy, hemophilia therapy, and prescription drug programs.[59] A significant portion of Caremark's revenue was obtained from third-party payments and insurance programs, including both Medicare and Medicaid reimbursements.[60] Some of these payments were regulated by the Anti-Referral Payments Law (ARPL), which is enforced by the U.S. Department of Health & Human Services and the Department of Justice.[61] The ARPL prohibits health care providers from making any payments to encourage referrals of Medicare or Medicaid patients.[62] Despite the U.S. Department of Health & Human Services' attempt to clarify the scope of the ARPL, there was much uncertainty about the law due to a lack of court decisions interpreting the statute.[63] Caremark entered into contracts with various physicians and health care providers in exchange for services, who in turn recommended Caremark's services or products to patients.[64] However, to ensure that

56. *Id.*

57. *Id.*

58. *See, e.g.*, Pan, *supra* note 1, at 722–23 (referring to Chancellor William Allen's opinion in *In re* Caremark International as the "most complete exploration by a Delaware court of the meaning of the duty to monitor").

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

60. *Id.*

61. *Id.*; *see generally A Roadmap for New Physicians*, U.S. DEP'T OF HEALTH & HUM. SERVS., https://oig.hhs.gov/compliance/physician-education/intro.asp (last visited Apr. 11, 2021) (providing additional background on the Anti-Referral Payments Law and additional federal laws regarding Medicare/Medicaid referrals).

62. *In re Caremark Int'l*, 698 A.2d at 961–62.

63. *Id.* at 962.

64. *Id.*

Caremark was not violating the ARPL, Caremark followed an internal "Guide to Contractual Relationships" (the "Guide"), which was initially created by Caremark's predecessor in 1989, and was reviewed and updated by Caremark's lawyers annually.[65] Each version of the Guide established the policy that no payments would be made to physicians and hospitals in exchange for the physicians inducing patient referrals.[66]

Between 1991 and 1992, the Department of Health and Human Services and the Department of Justice launched an investigation into Caremark.[67] This investigation attempted to uncover the extent to which Caremark paid physicians for monitoring patients under their care and making patient referrals.[68] During this investigation, Caremark claimed that it attempted to increase supervision over branch operations and took additional steps to assure compliance with the ARPL.[69] As a result of this investigation, Caremark published revised versions of its Guide and designed an internal audit plan to enforce business and ethics policies.[70]

In August 1994, a Minnesota federal grand jury charged Caremark, two of its officers, a sales employee, and a physician with violating the ARPL.[71] The indictment alleged Caremark had paid the physician over $1.1 million to induce him to prescribe one of the company's human growth hormone drugs to his patients.[72] In response to this claim and the ongoing investigation, five separate stockholders filed derivative suits on behalf of Caremark against the board of directors.[73] These actions, which the court consolidated, alleged "that Caremark's directors breached their duty of care by failing adequately to supervise the conduct of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability."[74] Subsequently, in September of 1994, an Ohio federal

65. *Id.*
66. *Id.*
67. *Id.*; *see generally* Milt Freudenheim, *Caremark Is Indicted in Kickbacks*, N.Y. TIMES (Aug. 5, 1994), https://www.nytimes.com/1994/08/05/business/company-news-caremark-is-indicted-in-kickbacks.html (discussing the investigation of Caremark).
68. *In re Caremark Int'l*, 698 A.2d at 962; *see generally* Freudenheim, *supra* note 67 (discussing the investigation of Caremark).
69. *In re Caremark Int'l*, 698 A.2d at 963.
70. *Id.*
71. *Id.* at 963–64.
72. *Id.* at 964.
73. *Id.*
74. *Id.*

grand jury issued an additional indictment, claiming that an Ohio physician had received $134,600 in exchange for referrals of patients, in violation of the ARPL.[75] One month later, the shareholder derivative suit amended the complaint to include the Ohio indictment.[76]

In January 1995, Caremark terminated any remaining financial relationships with physicians related to Caremark's business of home infusion, hemophilia, and growth hormones.[77] A few months later, Caremark began settlement negotiations with the federal and state agencies that had been investigating Caremark's wrongdoing.[78] As a result of these negotiations, Caremark offered to make payments of approximately $250 million to both private and public parties.[79]

In 1996, the Court of Chancery of Delaware considered whether to approve a proposed settlement of a consolidated derivative action on behalf of Caremark.[80] However, in approving the settlement, Chancellor William Allen took the opportunity to examine the duty to monitor.[81] The shareholders claimed that Caremark's directors "allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[82] The court in *Caremark* expressed that this is the most difficult claim for a plaintiff to succeed upon.[83]

A director's liability for failure to monitor may arise from (1) a board decision that was "ill-advised or 'negligent'" or (2) "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."[84] When considering director liability, courts will apply the business judgment rule.[85] The business judgment rule holds that a director has not breached the duty to monitor if the board exercised a good faith effort

75. *Id.*
76. *Id.*
77. *Id.* at 965.
78. *Id.*
79. *Id.* at 960–61.
80. *Id.* at 966.
81. *Id.* at 967.
82. *Id.*
83. *Id.*
84. *Id.* (emphasis omitted).
85. *Id.* at 967–68.

to be informed and to exercise appropriate judgment.[86] According to the *Caremark* court, plaintiffs would have to show (1) the directors knew or should have known that violations of law were occurring; (2) the directors failed to make any good faith efforts to prevent or remedy the situation; and (3) such failure proximately resulted in financial losses to the corporation.[87] According to the court, a director could be held liable for losses caused by non-compliance with applicable legal standards if they fail to assure that adequate corporate information and reporting systems exist.[88]

In *Caremark*, Chancellor Allen recognized the benefits shareholders could receive from a heightened duty to monitor and took care to ensure that the scope of his opinion was not too broad.[89] The court made certain that the test of liability for directors—a lack of good faith—was quite high.[90] Directors would not be required to possess detailed information about every aspect of the corporation, as "such a requirement would simple [sic] be inconsistent with the scale and scope of efficient organization size in this technological age."[91] If directors were not aware of the specific activities that led to the corporation's losses, they could not be liable.[92]

Through the court's opinion, Chancellor William Allen created a stricter monitoring standard than was applied in *Graham*, by extending the board's liability to situations where they "should have known that violations of law were occurring."[93] This standard is broader than that of *Graham*, where directors were only liable for neglecting obvious red flags. In cases prior to *Caremark*, Delaware courts viewed the board as being uninvolved in the day-to-day operations of the corporation.[94] However, in *Caremark*, Chancellor Allen recognized that "ordinary business decisions that are made by officers and employees deeper in the interior of the organization can, however, vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals."[95] Thus, after *Caremark*,

86. *Id.* at 968.
87. *Id.* at 971.
88. *Id.* at 970.
89. *Id.* at 971.
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. Pan, *supra* note 1, at 726.
95. *In re Caremark Int'l*, 698 A.2d at 968.

Delaware courts created a stricter obligation on boards, by requiring directors "to act in good faith to assure the board was receiving sufficient information to oversee operations."[96] Despite this, it was still difficult for plaintiffs to succeed upon a *Caremark* claim, as the plaintiff still had to prove that the board failed to provide reasonable oversight in a continuous and systematic manner.[97] While the standard in *Caremark* gave much more insight than the previous case of *Graham*, there was still a lack of clarity around the board's duty to monitor, leading to the court's analysis in *Stone v. Ritter* ten years later.

C. Stone v. Ritter

In 2006, the Delaware Supreme Court was presented with the opportunity to reexamine *Caremark*'s duty to monitor standard.[98] In *Stone*, the plaintiffs brought a derivative complaint against the directors of AmSouth Bancorporation ("AmSouth").[99] AmSouth was a Delaware corporation, whose wholly-owned subsidiary, AmSouth Bank, operated commercial banking branches throughout the southeastern United States.[100] "In 2004, AmSouth and AmSouth Bank paid $40 million in fines and $10 million in civil penalties" in response to government and regulatory investigations, which concluded bank employees failed to file Suspicious Activity Reports ("SARs") required by federal anti-money-laundering regulations.[101] In October, the Federal Reserve and Alabama Banking Department required AmSouth to improve its Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) compliance program and to hire an independent consultant "to conduct a comprehensive review of the Bank's AML compliance program and make recommendations, as appropriate, for new policies and procedures to be implemented by the Bank."[102] Additionally, the Financial Crimes Enforcement Network ("FinCEN")

96. Michael Furey, *Del.* Caremark *Opinion Shows Shift in Deference to Boards*, LAW360 (July 23, 2020, 5:03 PM), https://www.law360.com/articles/1292332/del-caremark-opinion-shows-shift-in-deference-to-boards.

97. Pan, *supra* note 1, at 723.

98. Stone v. Ritter, 911 A.2d 362, 364 (Del. 2006).

99. *Id.* at 365.

100. *Id.*

101. *Id.*

102. *Id.* at 366.

found that AmSouth's compliance program "lacked adequate board and management oversight."[103]

The plaintiff shareholders filed a derivative suit, alleging a classic *Caremark* claim.[104] Plaintiffs specifically claimed that the directors "utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention."[105] Here, the court discussed how the failure to act in good faith may lead to liability, as it is a fundamental condition of the duty of loyalty.[106] The court applied the *Caremark* standard, and held that the necessary conditions for director oversight liability are that the board: (1) "utterly failed to implement any reporting or information system or controls" or (2) "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."[107] According to a report from an independent consultant, AmSouth's board had dedicated numerous resources to the BSA/AML compliance program and put multiple systems into place to ensure compliance with these regulations.[108] These systems established a reporting procedure and allowed directors to periodically monitor AmSouth's compliance with the necessary regulations.[109] Therefore, the court held that the plaintiffs failed to establish facts to satisfy the high burden of the *Caremark* standard.[110]

In *Stone*, the court redefined the duty to monitor as a failure of good faith, which they determined was a subsidiary element of the duty of loyalty.[111] This was inherently different than the court's opinion in *Graham* and *Caremark*, where both courts considered the duty to monitor to be part of the duty of care.[112] The standard from *Stone* created three challenges for plaintiffs: (1) plaintiffs must show

103. *Id.*
104. *Id.* at 364.
105. *Id.*
106. *Id.* at 369–70.
107. *Id.* at 370.
108. *Id.* at 371.
109. *Id.*
110. *Id.* at 373.
111. *Id.* at 370; Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1769–70 (2007); Pan, *supra* note 1, at 727.
112. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); *In re* Caremark Int'l, 698 A.2d 959, 971 (Del. Ch. 1996); Hill & McDonnell, *supra* note 111.

scienter by proving that the board acted with "conscious disregard for their responsibilities," (2) the board is responsible only for preventing wrong or illegal acts, and (3) the board cannot be held liable for failing to keep up with the outcomes of previous board decisions.[113] However, the most significant change was that post-*Stone*, oversight liability required an element of scienter, requiring plaintiffs to prove that directors not only breached their duty to monitor but did so knowingly.[114]

III. *MARCHAND V. BARNHILL*

These three Delaware court decisions have resulted in making it close to impossible for plaintiffs to succeed in finding boards liable for failure to monitor. However, in 2019, plaintiffs were given a ray of hope with the court's decision in *Marchand v. Barnhill*.[115] The issue in *Marchand* surrounded Blue Bell Creameries USA, Inc. ("Blue Bell"), a Delaware corporation and one of the largest manufacturers of ice cream in the nation.[116] Blue Bell operates in a heavily regulated food industry, which is primarily governed by the Food and Drug Administration (FDA).[117] Blue Bell must comply with all regulations and establish controls to monitor for and avoid contamination.[118] The FDA has strict guidelines, which require food manufacturers like Blue Bell to conduct operations with adequate sanitation principles and institute a written food safety plan, which includes a food hazard analysis and implements preventative controls.[119] In addition to federal regulations, Blue Bell must also adhere to various state regulations in each of the three states that it operates in—Texas, Oklahoma, and Alabama.[120]

Between 2009 and 2013, Blue Bell repeatedly failed to comply with the required regulations.[121] FDA inspections in Texas discovered leaking pipes, ripped and open containers of ingredients, and

113. *Stone*, 911 A.2d at 369, 370; Pan, *supra* note 1, at 719–20; Louis J. Bevilacqua, *Monitoring the Duty to Monitor*, N.Y. L.J. (Nov. 28, 2011).

114. *See* Bevilacqua, *supra* note 113 (stating that by adding an element of scienter, "*Stone* made it virtually impossible for plaintiffs to show that directors breached their duty").

115. 212 A.3d 805 (Del. 2019).

116. *Id.* at 807, 809.

117. *Id.* at 810.

118. *Id.*

119. *Id.*

120. *Id.* at 810–11.

121. *Id.* at 811–12.

employees failing to wear gloves or wash their hands, in violation of FDA standards.[122] Additionally, in 2010 and 2011 the Alabama Department of Health found equipment left on the floor, standing water, open lids, and unprotected measuring cups, in violation of Alabama regulations and FDA standards.[123] And, an inspection of the facility in Oklahoma further revealed a failure to manufacture foods under sanitary conditions and a failure to handle equipment in a way that protects against contamination, in violation of FDA standards.[124] In addition to the FDA's inspections, Blue Bell also conducted internal investigations of their Oklahoma facility.[125] According to the complaint, these internal examinations found "presumptively positive tests [of listeria] dating back to 2013."[126] Later, in 2014, a third-party laboratory found two positive reports of listeria in the Oklahoma facility.[127]

Despite management's knowledge of the listeria findings, the complaint alleges that the "information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem."[128] The board's meetings in early 2014 showed no discussion of the listeria reports or the findings of the FDA inspections, which is further evidence that the board did not know of the listeria reports.[129] Throughout the remainder of 2014, the Oklahoma facility continued positive findings of listeria.[130] Ironically, board minutes from the September 2014 meeting stated that recent third-party audits for sanitation issues "went well."[131]

The next year showed no improvements for Blue Bell.[132] Positive coliform levels were found in the Oklahoma facility during January 2015, and one month later, Blue Bell received notification of positive

122. *Id.* at 811.
123. *Id.*
124. *Id.*; *see generally* BLUE BELL CREAMERIES, LP, ESTABLISHMENT INSPECTION REPORT 2 (Mar. 28, 2012), https://www.fda.gov/files/about%20fda/published/Blue-Bell-Creameries--LP--Broken-Arrow--OK--EIR-dated-3-28-12.pdf (discussing the FDA's findings at the Oklahoma facility).
125. Marchand v. Barnhill, No. 2017-0586-JRS, 2018 Del. Ch. LEXIS 316, at *12–13 (Del. Ch. Sept. 27, 2018), *rev'd*, 212 A.3d 805 (Del. 2019).
126. *Id.* at *13.
127. *Id.*
128. *Marchand*, 212 A.3d at 812.
129. *Id.*
130. *Id.*
131. *Id.* at 812–13.
132. *Id.* at 813.

listeria tests at the Texas plant from the Texas Department of State Health Services.[133] Interestingly, the Blue Bell board of directors did not discuss any issues of listeria during their meeting on February 19, 2015.[134] However, four days later Blue Bell initiated a limited recall, likely in response to the findings by the Texas Department of State Health Services.[135] Two days later, on February 25, 2019, the board met and discussed how the FDA was working with the Texas health inspectors to investigate the recall.[136] This was the first time that the board's discussion of listeria was reported in the minutes, despite the overwhelming evidence that the contamination was occurring.[137] By March 13, 2015, the FDA, CDC, and Bluebell had all issued public recall notifications.[138] However, listeria cases continued to rise and resulted in the deaths of three adults from Kansas.[139] These overwhelming implications forced Blue Bell's chief executive officer, advertising and public relations manager, and vice president for sales and marketing to meet in April 2015.[140] During this meeting, the executives decided to expand the recall to all of Blue Bell's products and shut down all of its production operations.[141] In total, the listeria outbreak caused by Blue Bell's products infected ten people across four states: Arizona, Kansas, Oklahoma, and Texas.[142]

Following the full product recall, the FDA reinspected all three of the company's plants.[143] The investigation did not fare well for Blue Bell.[144] At the Texas facility, the FDA found a "'failure to manufacture

133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.* at 813–14.
137. *Id.*
138. U.S. Dep't of Just., Office of Pub. Affs., *Blue Bell Creameries Agrees to Plead Guilty and Pay $19.35 Million for Ice Cream Listeria Contamination—Former Company President Charged* (May 1, 2020), https://www.justice.gov/opa/pr/blue-bell-creameries-agrees-plead-guilty-and-pay-1935-million-ice-cream-listeria.
139. *Marchand*, 212 A.3d at 814; *Multistate Outbreak of Listeriosis Linked to Blue Bell Creameries Products (Final Update)*, CTR. FOR DISEASE CONTROL (June 10, 2015, 10:30 AM), https://www.cdc.gov/listeria/outbreaks/ice-cream-03-15/index.html.
140. Rachel Abrams & Hiroko Tabuchi, *For Blue Bell, a Drastic Move to Recall Ice Cream as Listeria Findings Rose*, N.Y. TIMES (Apr. 21, 2015), https://www.nytimes.com/2015/04/22/business/listeria-leads-to-major-ice-cream-recall.html.
141. *Marchand*, 212 A.3d at 814; Marchand v. Barnhill, No. 2017-0586-JRS, 2018 Del. Ch. LEXIS 316, at *16 (Del. Ch. Sept. 27, 2018), *rev'd*, 212 A.3d 805 (Del. 2019).
142. *Multistate Outbreak of Listeriosis Linked to Blue Bell Creameries Products*, *supra* note 139.
143. *Marchand*, 212 A.3d at 814.
144. *Id.*

foods under conditions and controls necessary to minimize the potential for growth of microorganisms,' inadequate cleaning and sanitizing procedures, 'failure to maintain buildings in repair sufficient to prevent food from coming adulterated,' and improper construction of the building that failed to prevent condensation from occurring."[145] In Oklahoma, the FDA found that listeria tests had been showing positive results for the past three years, and there was a failure to manufacture and package foods in a way to minimize the potential for contamination.[146] While the conditions of the Alabama plant were not as severe as Texas and Oklahoma, the FDA continued to find contamination and failure to perform necessary testing to identify possible food contamination.[147]

Following the company's recall and listeria outbreak, a Blue Bell shareholder requested the company's books and records.[148] The shareholder then filed a derivative suit, claiming that the board failed to inform itself of Blue Bell's food safety compliance and failed to respond appropriately to the growing food safety issues.[149] The complaint alleged multiple facts that are relevant to this issue: (1) there was no board committee in place that addressed food safety; (2) Blue Bell had no regular process or protocols that required management to notify the board or keep them apprised of food safety compliance practices, risks, or reports; (3) the board did not have a schedule to consider any key food safety risks existed; (4) board minutes show that management did not disclose any cautionary or red flags to the board leading up to the unfortunate deaths of three customers; (5) management reported favorable information about food safety to the board, but the board was not shown any unfavorable reports or FDA findings; and (6) the minutes from board meetings were lacking any suggestion that there was regular discussion of food safety issues.[150] The complaint also alleged that the issues the FDA found could have been cured if management had relayed the information to the board on an ongoing basis.[151] Initially, the Delaware Court of Chancery granted Blue Bell's motion to dismiss, holding that the plaintiff failed to plead

145. *Id.*
146. *Id.*
147. *Id.* at 815.
148. *Id.* at 815–16.
149. *Id.* at 816.
150. *Id.* at 822.
151. *Id.*

any facts to support "his contention that the [Blue Bell] Board 'utterly' failed to adopt or implement any reporting and compliance systems."[152] The Court of Chancery reasoned that the plaintiff did not challenge the existence of a monitoring system, "but the effectiveness of monitoring and reporting controls in particular instances," which is "not a valid theory under . . . *Caremark*."[153] The shareholder plaintiffs appealed, and in June 2019, the Supreme Court of Delaware issued its opinion and reversed the Court of Chancery's decision.[154]

The Supreme Court of Delaware applied the rule from *Caremark*, which requires a director to make a good faith effort to implement an oversight system and monitor it.[155] The court recognized that directors have the discretion to approach business and industry-specific approaches, but the directors must still meet the bottom-line requirement to make a good faith effort to implement a reasonable system of monitoring and reporting.[156] Prior case law has given great deference to a company's board of directors and made the *Caremark* claim standard difficult—if not impossible—to meet.[157] If the facts can show that the directors have "a relevant committee, a regular protocol requiring board-level reports about the relevant risks, or the board's use of third-party monitors, auditors, or consultants," it is unlikely that the court will hold in favor of the plaintiff.[158]

However, the court held that the plaintiff in *Marchand* did meet the difficult *Caremark* standard.[159] If 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 operation, then that supports an inference that the board has not made the good faith effort that *Caremark* requires."[160] In defense, the directors of Blue Bell emphasized the fact that manuals were in place discussing safety practices and third-party audits were

152. *Id.* at 808 (quoting Marchand v. Barnhill, No. 2017-0586-JRS, 2018 Del. Ch. LEXIS 316, at *41 (Del. Ch. Sept. 27, 2018), *rev'd*, 212 A.3d 805 (Del. 2019)).

153. *Marchand*, 212 A.3d at 821 (omission in original) (quoting *Marchand*, 2018 Del. Ch. LEXIS 316, at *41).

154. *Marchand*, 212 A.3d at 808.

155. *Id.* at 820–21.

156. *Id.* at 821.

157. *Id.*

158. *Id.* at 823.

159. *Id.* at 824.

160. *Id.* at 822.

commissioned occasionally.[161] However, the court stressed that simple compliance with FDA regulation and the fact that management received results of government inspections is not enough to meet the requirements to implement "a system to monitor food safety *at the board level*."[162] Blue Bell directors also emphasized that management communicated with them regularly regarding "operational issues."[163] Again, the court did not agree with this argument.[164] Food safety is essential to Blue Bell's operation, and the facts that the plaintiff pled support a fair inference that there was no system of food safety monitoring or reporting at the board-level.[165] Additionally, the court noted that "as a monoline company that makes a single product—ice cream—Blue Bell can only thrive if its consumers enjoyed its products and were confident that its products were safe to eat."[166] Here, the board's lack of efforts not only resulted in a lack of "compliance," but also resulted in the deaths and illness of Blue Bell's customers.[167] For this reason, the Supreme Court of Delaware reversed the Court of Chancery's decision to grant the defendant's motion to dismiss.[168] The Supreme Court found that the plaintiffs succeeded in alleging "particularized facts that support a reasonable inference that the Blue Bell board failed to implement any system to monitor Blue Bell's food safety performance or compliance."[169] Thus, the Supreme Court remanded the case for proceedings consistent with their opinion.[170]

IV. THE CURRENT DUTY TO MONITOR STANDARD

A. The Marchand *Standard*

Generally, it is quite difficult for a plaintiff to plead a *Caremark* claim and ultimately prove liability based on a board's failure to monitor.[171] According to Chief Justice Strine, writing in *Marchand*, a *Caremark* claim is "possibly the most difficult theory in corporation

161. *Id.* at 822–23.
162. *Id.* at 823.
163. *Id.*
164. *Id.* at 823–24.
165. *Id.* at 824.
166. *Id.* at 809.
167. *Id.* at 814.
168. *Id.* at 808.
169. *Id.* at 809.
170. *Id.* at 824.
171. *See, e.g.*, *id.*; *In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996); Posner, *supra* note 4.

law upon which a plaintiff might hope to win a judgment."[172] *Marchand* arguably lowers the heightened standard that plaintiffs previously had to plead under *Caremark* and *Stone*. In doing this, *Marchand* gives new life to duty to monitor claims.

Prior to *Marchand*, *Caremark* claims were typically dismissed in early pleading stages, even before discovery.[173] It was difficult for plaintiffs to reach the high standard required by *Caremark* and *Stone,* as they would have to prove that that the board utterly failed "to attempt to assure a reasonable information and reporting system exists."[174] *Marchand* expands on the court's previous interpretations and explains that compliance with regulations is not enough. In the *Marchand* opinion, Justice Strine clarifies that Blue Bell's compliance with applicable regulations "does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a *Caremark* claim."[175] The court's decision in *Marchand* warns directors to be proactive when creating a proper compliance program and conducting risk oversight.[176] For companies in the food industry, like Blue Bell, nominal compliance with FDA regulations is simply not enough.[177] Instead, after *Marchand*, companies may be more likely to face liability if they fail to "make a good faith effort to implement an oversight system and then monitor it."[178]

B. Post-Marchand *Litigation*

Following *Marchand*, the Delaware courts released two subsequent decisions allowing both *Caremark* claims to survive motions to dismiss.[179] By analyzing the *Caremark* claims that were brought post-*Marchand*, we can better understand what the current duty to monitor standard is. In Section IV.B.1, I will discuss the case

172. *In re Caremark Int'l*, 698 A.2d at 967.

173. Holly J. Gregory et al., *Board Oversight in Light of COVID-19 and Recent Delaware Decisions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 26, 2020), https://corpgov.law.harvard.edu/2020/05/26/board-oversight-in-light-of-covid-19-and-recent-delaware-decisions/.

174. *Id.*

175. *Marchand*, 212 A.3d at 823.

176. Posner, *supra* note 4.

177. *See id.*

178. *Marchand*, 212 A.3d at 821.

179. *See In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 Del. Ch. LEXIS 1293, at *38 (Del. Ch. Oct. 1, 2019); Hughes v. Hu, No. 2019-0112-JTL, 2020 Del. Ch. LEXIS 162, at *54 (Del. Ch. Apr. 27, 2020).

of *In re Clovis Oncology, Inc. Derivative Litigation*,[180] and its similarity to *Marchand*. In Section IV.B.2, I will discuss *Hughes v. Hu*,[181] and contrast how the duty to monitor standard may be applied differently depending on what industry the company is involved in and what regulations it must comply with.

1. *In re Clovis Oncology, Inc.*

Just a few months after *Marchand*, the Delaware Court of Chancery found a *Caremark* claim sufficient to survive a motion to dismiss in *In re Clovis Oncology, Inc*.[182] Clovis Oncology, Inc. ("Clovis") is a biopharmaceutical company, who was in the process of developing a lung cancer drug, Rociletinib ("Roci").[183] During this time, Clovis had no pharmaceutical products on the market, and Roci was the most promising among the drugs in development.[184] As part of the development process for Roci, Clovis conducted a clinical trial to test the safety and efficacy of the drug.[185] The clinical trial was supposed to be based on the protocol that Clovis had submitted to the FDA.[186] However, Clovis did not adhere to the protocol and included unconfirmed responses from trial participants, even though the FDA could only approve Roci based on confirmed responses.[187] By incorporating unconfirmed responses, the biopharmaceutical company miscalculated drug performance metrics and even failed to account for the drug's side effects.[188] In doing such, Clovis reported inflated success rates to the public.[189] Eventually, Clovis disclosed to the public that Roci was much less successful than was previously reported, which caused Clovis' stock to drop 70%.[190] Further, Clovis was forced to stop the clinical development of the drug in May 2016,

180. 2019 Del. Ch. LEXIS 1293.
181. 2020 Del. Ch. LEXIS 162.
182. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *4.
183. *Id.* at *2; *see generally* Adam Slutsky et al., Caremark *Round II: Beware Red Flags in Drug Development*, GOODWIN (Oct. 8, 2019), https://www.goodwinlaw.com/publications/2019/10/10_08-caremark-round-ii-beware-red-flags (discussing additional background regarding the drug, "Roci").
184. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *5.
185. *Id.* at *9.
186. *Id.* at *9–10.
187. *Id.* at *12.
188. *Id.* at *18–19.
189. *Id.* at *12.
190. *Id.* at *17.

following the FDA's refusal to approve it.[191] Clovis' failure to adhere to proper clinical trial protocol resulted in investigations by the FDA and the SEC, and a shareholder derivative lawsuit.[192]

In this derivative suit, the plaintiffs claimed that the board of directors for Clovis ignored red flags indicating the company was not adhering to FDA protocols in clinical trials for its new drug.[193] While the *Marchand* court found the board liable on the first prong of *Caremark*,[194] the court in *Clovis* held that the first prong of *Caremark* was satisfied based on the fact that the Clovis board had tasked its nominating and corporate governance committee with providing oversight of federal health care and FDA requirements.[195] Instead, the court found that the board was liable under the second prong of *Caremark* because they consciously failed to monitor the system of controls that they implemented.[196]

The court characterized Clovis as a company operating in a highly regulated industry, where compliance with protocols is critical.[197] The Clovis board failed to address the unconfirmed reports, even though they had enough experience in the pharmaceutical industry to understand the risks of violating FDA protocols and procedures.[198] Thus, the monetary and reputational harm to Clovis stems from the company's "mission critical failure" to comply with the protocol and related FDA regulations.[199] The court noted that *Caremark* liability is more likely to attach when the alleged oversight failure concerns

191. *Id.*

192. *Id.* at *21.

193. *Id.* at *22; *see generally* Stephanie C. Evans & Alan J. Wilson, *Another Reminder from Delaware About the Duty of Oversight*, WILMERHALE (Oct. 28, 2019), https://www.wilmerhale.com/sitecore/content/Shared-Data/Blogs/Focus-on-Audit-Committees-Accounting-and-the-Law/2019/10/28/20191028-Another-Reminder-from-Delaware-About-the-Duty-of-Oversight (providing additional background on the facts of *Clovis*).

194. Marchand v. Barnhill, 212 A.3d 805, 824 (Del. 2019). Following *Caremark*, courts have held that a plaintiff can show director liability on one of two prongs: (1) the directors failed to implement an adequate monitoring system or (2) having implemented a system, the board failed to properly monitor it. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006); *see* Evans & Wilson, *supra* note 193 (discussing how the plaintiffs in *Marchand* successfully pleaded facts that show Blue Bell failed to implement any monitoring system).

195. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *29.

196. *Id.* at *32.

197. *Id.* at *30–31.

198. *See id.* at *6–8; *see also* Gardner Davis & John Wolfel, *Delaware Court Permits* Caremark *Claim Against Clovis Oncology Board*, 34 WESTLAW J. DEL. CORP. (2019) (discussing how the board was "comprised of experienced biopharmaceutical executives, medical researchers[,] and health care-focused venture capitalists").

199. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *32.

"compliance with positive law,"[200] as opposed to the managing of business risk.[201] For these reasons, the court allowed the plaintiff's *Caremark* claim to survive a motion to dismiss.[202]

The most significant shift between the standard applied in *Caremark* and *Stone* and the standard applied in *Marchand* and *Clovis* is the judicial emphasis placed on board monitoring of businesses operating in highly regulated industries. While *Caremark* and *Stone* were focused on business decisions that harmed the company, the failure to adequately monitor food and drug industries could create significant harm to the general public.

Although Blue Bell Creameries operated in the food industry and Clovis operated in the pharmaceutical industry, the companies' business models were very similar. Both Blue Bell and Clovis operated with a monoline business model.[203] "As ice cream was to Blue Bell Creameries, Clovis' Rociletinib ('Roci') drug candidate to treat lung cancer was Clovis' mission critical product."[204] Although Roci was not the only drug that Clovis was developing, it was the only one that was "especially promising."[205] Additionally, both companies in *Marchand* and *Clovis* were regulated by the Food and Drug Administration, whose mission is to protect public health "by ensuring the safety, efficacy, and security of human and veterinary drugs, biological products, and medical devices; and by ensuring the safety of our nation's food supply, cosmetics, and products that emit radiation."[206] Although the line between food and pharmaceutical industries is sometimes blurred, there is one important factor that they

200. *Id.* at *27. When using the phrase "positive law," the Chancery Court of Delaware explains that this includes regulatory mandates. *Id.* The Court is likely using the phrase "positive law" to describe statutes and laws from regulatory authorities, such as the FDA and SEC. *See id.*

201. *Id.* at *27 (stating that "it is appropriate to distinguish the board's oversight of the company's management of business risk that is inherent in its business plan from the board's oversight of the company's compliance with positive law") (emphasis omitted); *see also* Davis & Wolfel, *supra* note 198 (discussing how the court in Clovis suggested that Delaware courts are more likely to find *Caremark* oversight liability if the company is regulated by positive laws).

202. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *32.

203. *See id.* at *3; Marchand v. Barnhill, 212 A.3d 805, 809 (Del. 2019); *see also* Evans & Wilson, *supra* note 193 (comparing Blue Bell's monoline business model to the model used by Clovis).

204. Evans & Wilson, *supra* note 193; *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *31.

205. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *2.

206. *What We Do*, FDA, https://www.fda.gov/about-fda/what-we-do (last updated Mar. 28, 2018).

have in common—a need for public safety.[207] Here, Clovis chose to disregard one of Roci's significant side effects, QT prolongation, which carries a risk of sudden cardiac death.[208] Thus, if Clovis had succeeded in distributing Roci, multiple consumers could have been put at risk for severe illness or even death.

When considering the oversight of food and drug companies, boards must be more risk-averse, as the public's health and safety are at risk. The *Clovis* court cites *Marchand* repeatedly, and states 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."[209] The court's opinion in *Clovis*, "signals that, post-*Marchand*, the Delaware courts, in assessing *Caremark* claims at the pleading stage, may hold boards operating in highly regulated industries to a somewhat elevated standard for monitoring and assessing compliance with mission-critical regulatory regimes."[210] For these reasons, *Marchand* and *Clovis* demonstrate a significant emphasis on the importance of the duty to monitor to protect public health and safety.

2. *Hughes v. Hu*

As of April 2020, another *Caremark* claim survived a motion to dismiss in the case of *Hughes v. Hu*.[211] *Hughes* involves a *Caremark* claim against the audit committee and several executives of Kandi Technologies Group, Inc. ("Kandi").[212] Kandi is a publicly-traded

207. Sometimes it can be difficult to differentiate between foods and drugs; for example, caffeine can be considered as both a food when found in caffeine drinks, or a drug when ingested in pill form. However, both food and drugs can cause significant harm, such as obesity, overdose, or even death. Matthew J. Edlund, *Is That a Food or a Drug?: What's Really Inside that Food You Just Ate?*, PSYCH. TODAY (May 5, 2011), https://www.psychologytoday.com/intl/blog/the-power-rest/201105/is-food-or-drug.

208. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *18–20; *see* Wesley T. O'Neal, et al., *Association Between QT-Interval Components and Sudden Cardiac Death*, CIRCULATION: ARRHYTHMIA & ELECTROPHYSIOLOGY (2017), https://www.ahajournals.org/doi/10.1161/CIRCEP.117.005485.

209. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293, at *28 (quoting Marchand v. Barnhill, 212 A.3d 805, 824 (Del. 2019) (stating "food safety was essential and mission critical")).

210. John Mark Zeberkiewicz & Robert B. Greco, In re Clovis*: Considering* Caremark *Claims After* Marchand, 33 INSIGHTS: CORP. & SEC. L. ADVISOR, Nov. 2019, at 36, 38.

211. *See* Hughes v. Hu, No. 2019-0112-JTL, 2020 Del. Ch. LEXIS 162, at *4 (Del. Ch. Apr. 27, 2020); Cydney Posner, *Another* Caremark *Claim Survives Dismissal*, COOLEY PUBCO (May 12, 2020), https://cooleypubco.com/2020/05/12/caremark-claim-survives-dismissal/.

212. *Hughes*, 2020 Del. Ch. LEXIS 162, at *1.

Delaware company based in China that sells parts for the manufacturing of electric vehicles.[213] Kandi had faced financial reporting issues in the past, dating back to 2010.[214] In particular, the company had numerous issues with properly reporting related-party transactions.[215] Although these material weaknesses were publicly announced in 2014, no remedial actions were taken.[216]

In March 2017, Kandi disclosed in its 10-K that three years of financial statements were to be restated and that it lacked sufficient expertise related to GAAP, SEC disclosure requirements, and effective financial controls.[217] Following this, plaintiff shareholders commenced litigation on Kandi's behalf, alleging the directors who comprised the audit committee failed to establish a board-level system of oversight, which led to the March 2017 restatement that caused the Company severe harm.[218] The complaint identified numerous issues including (1) internal audits were reported directly to the CEO, not to the audit committee; (2) the audit committee met only once a year for no more than an hour; (3) Kandi's outside auditor was sanctioned by the Public Company Accounting Oversight Board for improperly handling 2010, 2011, and 2012 audits; and (4) a lack of policies or procedures mentioned in the company's minutes.[219] While the company did have an audit committee and internal audit department, the *Hughes* court compared these directors to those in *Marchand*, who failed to make good faith efforts to reasonably monitor at the board-level.[220] The court even went as far as to say that the board's "pattern of behavior indicates that they followed management blindly, even after management had demonstrated an inability to report accurately about related-party transactions."[221] Thus, although Kandi had an audit committee, the Court of Chancery found that these directors

213. *Id.* at *5–6; Posner, *supra* note 211.

214. *Hughes*, 2020 Del. Ch. LEXIS 162, at *1; Posner, *supra* note 211.

215. *Hughes*, 2020 Del. Ch. LEXIS 162, at *1.

216. *Id.* at *1–2.

217. *Id.* at *2 (stating that the Company "lacked[] sufficient expertise relating to technical knowledge of US GAAP requirements and SEC disclosure regulations; [s]ufficient expertise to ensure the completeness of the disclosure of financial statements for equity investments; [s]ufficient expertise to ensure the proper disclosure of related-party transactions . . . [and s]ufficient expertise to ensure the accuracy of the accounting and reporting of income taxes and related disclosures").

218. *Id.* at *3.

219. *Id.* at *11, *20, *26, *49.

220. *Id.* at *47.

221. *Id.* at *48.

faced a substantial likelihood of liability under *Caremark*, and denied the defendant's motion to dismiss.[222]

It may be tempting to claim that *Hughes* follows the trend of *Marchand* and *In re Clovis*, but *Hughes* is significantly distinct.[223] The main distinction from *Marchand* and *In re Clovis* is that the misconduct in *Hughes* did not involve any public health or public interest issues.[224] Unlike Clovis and Blue Bell, Kandi did not operate a single-product business and was not in the food or pharmaceutical industries. Kandi's products were not of any issue in the case, which further distinguishes it from the previous cases. Instead, the issue here was that Kandi's board failed to properly monitor the company's financial reporting.

It can be argued that the facts of *Hughes* are more similar to the facts of *Stone*, in which the plaintiffs brought forth allegations based on the company's failure to comply with financial reporting regulations. Similar to the company in *Stone*, Kandi's actions were regulated by the SEC. Unlike the FDA, the SEC's mission is to "protect investors by vigorously enforcing the federal securities laws to hold wrongdoers accountable and deter future misconduct."[225] Therefore, the purpose of the SEC's regulations is starkly different from the public health concerns of the FDA, as the SEC is concerned about financial misconduct, not physical harm. Thus, while it could be argued that *Hughes* follows the trend of *Marchand* and *Clovis*, it is more likely that the "particularly egregious" actions of the audit committee allowed the *Caremark* claim to move past the pleading stages.[226]

Although *Hughes* does not follow the public interest trend of *Marchand* and *Clovis*, the case is significant because it shows how a board may be held liable even if they have an audit committee in place. While Kandi did have an audit committee in place, it only met when

222. *Id.* at *54; *see generally* Nicholas D. Mozal & David A. Seal, *Three Is Not a Trend: Another* Caremark *Claim Survives a Motion to Dismiss, but Does Not Reflect a Change in the Law*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 27, 2020), https://corpgov.law.harvard.edu/2020/05/27/three-is-not-a-trend-another-caremark-claim-survives-a-motion-to-dismiss-but-does-not-reflect-a-change-in-the-law/ (providing further background on the misconduct of the audit committee).

223. Mozal & Seal, *supra* note 222.

224. *Id.*; Furey, *supra* note 96.

225. *What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/about/what-we-do (last visited April 11, 2021).

226. Mozal & Seal, *supra* note 222.

federal securities law required it to meet, which was not often enough considering the material weaknesses in the company's internal controls.[227] The court also noted that the duration of the audit committee meetings was too short, and there was "no possible way that the Audit Committee could have fulfilled all of the responsibilities it was given under the Audit Committee Charter during a fifty-minute meeting."[228] Additionally, Kandi claimed that they had retained an independent, outside auditor; however, this auditor's sole client was Kandi, which put into question whether the auditor was truly independent.[229] Thus the court claimed that the audit committee was liable for Kandi's "pervasive problems with its internal controls" due to the committee meeting sporadically, not devoting adequate time to its work, and "consciously turned a blind eye to their continuation."[230] While the actions of the audit committee in *Hughes* are egregious and likely not analogous to a majority of audit committees, it is important for boards to be reminded of the significance of meeting regularly and effectively addressing irregularities to avoid liability.[231]

V. HOW TO NAVIGATE COMPLIANCE FOLLOWING *MARCHAND*

When navigating the duty to monitor, boards must consider not only case law but also federal regulations and current societal issues. The following part will consider these factors and address the necessary steps that boards should take moving forward to avoid liability. In Section V.A, I will consider how *Marchand* and subsequent litigation has impacted directors' assessment of their monitoring systems. Further, in Section V.B, I will examine the influence that federal guidance has on boards' duty to monitor. Lastly, in Section V.C, I will consider the significant impacts of COVID-19, and how the pandemic will affect the duty to monitor.

A. Impacts of Case Law on Boards' Next Steps

After *Marchand*, *Clovis*, and *Hughes*, companies are likely left questioning their compliance programs and wondering what a proper oversight system should consist of. Some corporate attorneys do not

227. *Hughes*, 2020 Del. Ch. LEXIS 162, at *48; Mozal & Seal, *supra* note 222.
228. *Hughes*, 2020 Del. Ch. LEXIS 162, at *16.
229. *Id.* at *45; Mozal & Seal, *supra* note 222.
230. *Hughes*, 2020 Del. Ch. LEXIS 162, at *41–42.
231. Mozal & Seal, *supra* note 222.

view *Marchand* as a shift in Delaware law, but instead, see the decision as a caution to directors to actively engage in proper oversight.[232] However, others fear that *Marchand* creates a significant shift in Delaware law, which could cause corporations to face increased costs and efforts to implement a proper oversight program.[233] By requiring a more stringent oversight system for corporations in highly regulated industries, the corporation will have to face the costs of both designing and implementing its compliance program.[234] However, it is imperative that courts impose the stricter *Marchand* standard when deciding whether plaintiffs can bring forth a *Caremark* claim to protect consumers' health and safety. While the costs of the compliance program may be high, these costs are minimal compared to the financial and reputational harm that a company may face, along with the negative health risks that its consumers may be impacted by.[235]

One of the significant lessons of *Marchand* is that corporate minutes and other forms of documentation should be created to reflect the board's oversight efforts.[236] These documents should reflect the company's reporting protocols, compliance with regulations, and any actions taken to overcome business risks.[237] In *Marchand*, the Delaware Supreme Court stated that when a plaintiff can establish a board has failed to take any efforts to make sure it is properly informed of compliance issues, then "that supports an inference that the board has not made the good faith effort that *Caremark* requires."[238] For this reason, boards should regularly review, on either a quarterly or semi-annual basis, the effectiveness of their compliance efforts through third-party audits.[239] Additionally, corporations must guarantee that any compliance program contains clear direction about maintaining and transferring any compliance responsibilities in the case of

232. *See* David A. Katz & Laura McIntosh, *Oversight and Compliance Reminder*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 1, 2019), https://corpgov.law.harvard.edu/2019/08/01/oversight-and-compliance-reminder/.

233. *See* Posner, *supra* note 4.

234. RICHARD W. BLACKBURN & JEFFREY J. BINDER, 3 SUCCESSFUL PARTNERING BETWEEN INSIDE AND OUTSIDE COUNSEL § 47:8 (rev. ed. 2020).

235. *See id.*

236. Katz & McIntosh, *supra* note 232.

237. *Id.*

238. Marchand v. Barnhill, 212 A.3d 805, 822 (Del. 2019).

239. *Evaluation of Corporate Compliance Programs*, U.S. DEP'T OF JUST. CRIM. DIV. (June 2020), https://www.justice.gov/criminal-fraud/page/file/937501/download; Katz & McIntosh, *supra* note 232.

employee turnover.[240] For example, if a corporation's vice president of human resources becomes the new chief financial officer, the corporation must take care to transfer any compliance responsibilities and ensure that the oversight system maintains continuity and consistency.[241]

To expand oversight efforts, boards can also utilize committees to review and keep records of the board's risk management.[242] While not required, audit committees and risk management committees could ensure that proper documentation is kept by consistently reviewing board minutes and materials.[243] However, the audit committee must have the proper expertise and devote adequate time to monitoring, so that they do not suffer the same fate as the directors in *Hughes*.[244] While there is no strict rule regarding proper expertise, courts will likely consider whether the committee has industry-related knowledge or previous experience, either through education or career choices, how long the committee members have been involved in the industry, and how they have handled risk management issues in the past.[245] Additionally, any documentation that is kept by committees, or the board itself, should be detailed and include specific language.[246] While privileged information should not be disclosed, these

240. BLACKBURN & BINDER, *supra* note 234.

241. *Id.*

242. Katz & McIntosh, *supra* note 232.

243. *Id.*

244. *See* Hughes v. Hu, No. 2019-0112-JTL, 2020 Del. Ch. LEXIS 162, at *2 (Del. Ch. Apr. 27, 2020) (stating that the Company "lacked[s]ufficient expertise relating to technical knowledge of US GAAP requirements and SEC disclosure regulations; [s]ufficient expertise to ensure the completeness of the disclosure of financial statements for equity investments; [s]ufficient expertise to ensure the proper disclosure of related-party transactions . . . [and s]ufficient expertise to ensure the accuracy of the accounting and reporting of income taxes and related disclosures").

245. *See In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 Del. Ch. LEXIS 1293, at *5–8 (Del. Ch. Oct. 1, 2019) (discussing the defendants' length of time on the board, experience in the relevant industry, prior careers, and history serving on other boards); *see also* Nicholas J. Price, *The Best Practices for Board Education*, DILIGENT INSIGHTS (June 27, 2018), https://insights.diligent.com/board-education/the-best-practices-for-board-education (discussing how board directors should seek out continuing education that will help them understand how to "leverage the corporation's potential, manage data and information, mitigate risks and protect the corporation's reputation").

246. *See* Katz & McIntosh, *supra* note 232 (stating vague, generalized language is not sufficient and lack of detail may be viewed as evidence that the board failed to make a good faith effort towards oversight); Mozal & Seal, *supra* note 222 (discussing how the absence of detailed minutes in *Hughes* led the Delaware Court of Chancery to deny the motion to dismiss).

documents should not be drafted so vaguely or generalized as to doubt the board's compliance.[247]

B. Federal Guidance on the Duty to Monitor

Historically, the duty to monitor has been governed by the 1991 U.S. Sentencing Guidelines, which created a legal incentive for corporations to develop and operate an effective compliance system.[248] Recently, federal law has been "trending strongly in the direction of a robust corporate compliance obligation in many disparate fields of regulation," including antitrust, financial services, and healthcare industries.[249] Prior to *Marchand*, the Department of Justice released a memorandum in April 2019 providing additional guidance on how to navigate corporate compliance.[250] This updated guidance provides factors that prosecutors should consider when determining whether to prosecute or penalize a corporation depending on the effectiveness of the corporation's compliance program at the time of the offense.[251] When considering a corporation's oversight system, prosecutors will consider whether the company has made sure that the compliance program is understood by company employees and whether the compliance program has been continuously improved through periodic testing and reviews.[252] The DOJ memorandum

247. *See* Katz & McIntosh, *supra* note 232 (discussing how documents should not contain vague, generalized information).

248. McGreal, *supra* note 33, at 647. In 2004, the Sentencing Guidelines were updated to address the role of directors with regard to corporate compliance. *Id.* at 669. The updated Guidelines noted that a strong commitment from the board and senior management is critical for the compliance program to succeed. *Id.* at 671. The U.S. Sentencing Guidelines created a foundation for federal corporate compliance and led the way for future federal involvement, perhaps influencing the DOJ's 2019 Memorandum. *See id.* at 677–79.

249. Donald C. Langevoort, Caremark *and Compliance: A Twenty-Year Lookback*, 90 TEMP. L. REV. 727, 728 (2018).

250. John Nassikas et al., *New DOJ Compliance Program Guide*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 10, 2019), https://corpgov.law.harvard.edu/2019/06/10/new-doj-compliance-program-guidance/; Katz & McIntosh, *supra* note 232; *Evaluation of Corporate Compliance Programs*, *supra* note 239.

251. Nassikas et al., *supra* note 250; *Evaluation of Corporate Compliance Programs*, *supra* note 239.

252. *Evaluation of Corporate Compliance Programs*, *supra* note 239 (stating that "prosecutors may reward efforts to promote improvement and sustainability"). In considering audits, the prosecutors will analyze how frequently the audits took place, whether they are internal or not, and whether the relevant audit findings are regularly reported to the board. *Id.* Prosecutors assess periodic testing by considering how the corporation tests and analyzes compliance data, and how the results are reported and tracked. *Id.* Additionally prosecutors are concerned with how the company updates its risk assessments and what steps it takes to determine the best policies and practices for the particular business model. *Id.*

suggests that prosecutors will further consider what types of issues have been reported to the board, how the board has addressed them, and whether documentation of board minutes can show that the board has acted diligently in fulfilling their duty to monitor.[253] Thus, the DOJ memorandum compliments the *Marchand* decision by emphasizing the importance of maintaining an adequate oversight and compliance program.[254]

C. Increased Liability from COVID-19

The risk of shareholder derivative litigation is especially heightened during the crisis of COVID-19.[255] Attorneys and scholars have already predicted an increase in *Caremark* claims as a result of the massive business disruption caused by the unprecedented health crisis.[256] The COVID-19 pandemic creates a unique circumstance, where companies are now being held to additional regulations that require social distancing and increased health and safety measures.[257] Similar to *Marchand* and *Clovis*, the failure to monitor compliance with positive law,[258] such as the COVID-19 regulations, makes it more likely for plaintiffs to succeed in bringing a *Caremark* claim.[259] While companies are additionally facing increased financial litigation in light of COVID-19, it will be more likely for a board to be held liable for failure to monitor if the corporation's actions create a public health risk, as was seen in *Marchand* and *Clovis*.[260] For example, if the directors of a travel or restaurant company decide to continue normal business operations despite social distancing regulations, its consumers would be placed at an increased risk to COVID-19 and the corporation could be found liable for failing to monitor critical conditions.[261] Additionally, boards may face liability for their failure

253. *Id.*

254. *See id.*

255. Scott Crofton et al., *How Boards Can Protect Against Covid-19-Related Shareholder Claims*, CORP. SECRETARY (May 15, 2020), https://www.corporatesecretary.com/articles/shareholders/32102/how-boards-can-protect-against-covid-19-related-shareholder-claims.

256. William Savitt et al., *Governance Litigation and the COVID-19 Pandemic*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 19, 2020), https://corpgov.law.harvard.edu/2020/04/19/governance-litigation-and-the-covid-19-pandemic/.

257. Crofton et al., *supra* note 255.

258. *See supra* text accompanying note 200.

259. *See* Crofton et al., *supra* note 255.

260. *See* Savitt et al., *supra* note 256.

261. *See* Lisa Nagele-Piazza, *Here's What Employers Need to Know About COVID-19 Liability Shields*, SOC'Y FOR HUM. RES. MGMNT. (Sept. 4, 2020), https://www.shrm.org/resourcesandtools

to properly prepare for the pandemic, which could include claims that the board failed to take steps to mitigate risks or take proper precautionary measures to prevent the spread of COVID-19 among employees or customers.[262] While businesses are advocating for legislation to protect themselves from COVID-19-related liability, very few states have created such protections and there remains no protection at the federal level.[263] These few state protections are extremely limited, and employers must still show that they acted in good faith to comply with federal, state, and local guidance.[264]

Additionally, it is important to note that a board's compliance with federal and state regulations is not enough.[265] When Blue Bell argued that it had complied with certain FDA and state regulations, the court in *Marchand* made sure to note that compliance with regulations does not imply that the board implemented an adequate monitoring system at the board-level.[266] The risks of COVID-19 are unique to each company's line of business.[267] As companies move forward and contemplate reopening, it is vital for boards to affirmatively investigate mission-critical compliance risks created by COVID-19.[268] Corporations should continue to take accurate and detailed board minutes, form COVID-19 committees, and consider the use of third-party advisors to supplement their compliance efforts.[269] COVID-19 presents multiple red-flag issues that corporations must address expeditiously to survive this pandemic and prevent any shareholder derivative suits in the future.

/legal-and-compliance/employment-law/pages/what-employers-need-to-know-about-covid-19-liability-shields.aspx.

262. Virginia Milstead, *Shareholder Derivative Suits Likely to Extend to COVID-19, Racial Equality*, SKADDEN (Sept. 30, 2020), https://www.skadden.com/insights/publications/2020/09/quarterly-insights/shareholder-derivative-suits.

263. Nagele-Piazza, *supra* note 261. In Georgia, recent legislation has created a "rebuttable presumption that the plaintiff assumed the risk of exposure, transmission, infection or potential exposure to COVID-19, unless the plaintiff is asserting certain claims involving gross negligence, willful misconduct[,] or reckless behavior." *Id.* Additionally, New Jersey's law only protects health care providers from COVID-19-related liability in order to remove any impediments to providing medical treatment. *Id.*

264. *See id.*

265. Crofton et al., *supra* note 255.

266. Marchand v. Barnhill, 212 A.3d 805, 823 (Del. 2019); Crofton et al., *supra* note 255.

267. Nicholas A. Gravante et al., Caremark *Precedent Should Inform Boards' COVID-19 Duties*, LEXOLOGY (June 4, 2020), https://www.lexology.com/library/detail.aspx?g=6ffca590-7598-4450-9f43-85a4d0736872.

268. *Id.*

269. Crofton et al., *supra* note 255.

The main goal of a compliance program is to create a system in which the board will receive all necessary information regarding significant business risks, thereby allowing the board to take appropriate action.[270] Risk management is a significant issue that corporations must learn how to navigate, especially in times where one small mistake can cause catastrophic harm not only to the company's business, but also to the public's health. The Supreme Court of Delaware has moved in the right direction with *Marchand*, and it is crucial for companies to strengthen their fiduciary duty to monitor, especially during these times.

VI. CONCLUSION

Since the decision of *Graham* in 1963, Delaware courts have come quite a long way in interpreting the duty to monitor. Instead of passively responding to red flags, directors must now take initiative to actively address and resolve critical risks that could harm the corporation.[271] While all companies must uphold their fiduciary duty to monitor, highly regulated industries are under heightened scrutiny. Corporations in the food, beverage, and pharmaceutical industries are at a higher risk of facing shareholder derivative suits based on their obligation to comply with federal and state regulations and protect public health.[272] Consumers rely on these companies to provide safe and healthy products, and if the board fails to properly monitor operations, it could cause their consumers to face significant health risks and their company to suffer a loss of business. *Hughes* also showed us that establishing an audit committee is not enough if that committee does not have the requisite knowledge and demonstrate reasonable efforts to manage risks.[273] *Marchand* has arguably created a new era for duty to monitor cases, one in which plaintiffs are more likely to succeed in holding directors liable for failure to monitor. While commentators fear that *Marchand* will create risk-averse businesses, the heightened liability is necessary to hold boards accountable for their actions.[274]

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270. Katz & McIntosh, *supra* note 232.

271. *Marchand*, 212 A.3d at 820–21.

272. *See id.*; *In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 Del. Ch. LEXIS 1293, at *2–4 (Del. Ch. Oct. 1, 2019).

273. Hughes v. Hu, No. 2019-0112-JTL, 2020 Del. Ch. LEXIS 162, at *40–41 (Del. Ch. Apr. 27, 2020).

274. *See* Daniels, *supra* note 20.

Moving forward, it is crucial for boards to establish risk management policies at the board-level. Especially during the current COVID-19 pandemic, it is now more important than ever for boards to stay vigilant and document their efforts in corporate books and records.[275] The recent guidance from *Marchand* will hopefully influence boards to take action and prevent future risks that could cost them the support of their shareholders and consumers. Overall, the *Marchand* decision has led the duty to monitor in the right direction and future *Caremark* claims involving public interest issues are likely to follow the same trend.

275. *See* Gravante et al., *supra* note 267.