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# The Delaware Supreme Court's Blue Bell Creameries Decision: Lessons on Risk Oversight and Independence from *Marchand v. Barnhill*

By Stewart M. Landefeld, Evelyn C. Sroufe, Sean C. Knowles, and June Wang

In its June 2019 *Marchand v. Barnhill*<sup>1</sup> opinion, the Delaware Supreme Court provided guidance for directors (and their advisors) in two key areas—compliance and independence. In *Marchand*, the Delaware Supreme Court reversed the Chancery Court's dismissal of a stockholder derivative complaint. The complaint had alleged a breach of the duty of loyalty under *Caremark* by two key executives and the directors of Blue Bell Creameries USA Inc., an ice cream producer.

The Chancery Court had previously dismissed the complaint for failure to plead demand futility, that is, for failure to make a pre-litigation demand on the board of directors. As author of the opinion, Chief Justice Strine expressed the Delaware Supreme Court's view that to avoid liability under *Caremark*, boards must demonstrate that they have instituted and supervised a board-level process to oversee and monitor a system of compliance that addresses the company's mission-critical risks. The *Marchand* decision also states the Delaware Supreme Court's view that the standard for independence of a director who is considering a stockholder demand to initiate litigation against company insiders may be higher than the degree of independence required for less significant board decisions.

**Background.** Because the Delaware Supreme Court was reviewing a decision on a motion to dismiss, it accepted as true the allegations in the derivative complaint. Those unproven allegations tell the story of Blue Bell, a 90-year-old

ice cream producer and distributor long run by the family of Chief Executive Officer and Chairman Paul Kruse. The U.S. Food and Drug Administration (FDA) and state food safety agencies heavily regulated Blue Bell as a food producer. As described in the allegations, FDA regulations mandated standards for manufacturing food products in sanitary facilities free of contamination.

CEO Kruse and his cousin and fellow executive, Greg Bridges, were alleged to be responsible for the operation of Blue Bell's ice cream production plants in Texas, Oklahoma, and Alabama. According to the complaint, from 2009 to 2014, they failed adequately to address indications of contaminated or unsanitary Blue Bell facilities, including those in reports by FDA and state food safety inspectors, as well as positive test results for *listeria*—a pathogenic bacterium that causes listeriosis, a serious infection—from a third-party laboratory. The complaint alleged that the board had made no effort to implement a system by which it would be routinely advised of food safety issues and, therefore, was not informed of the growing *listeria* problems.<sup>2</sup>

By early 2015, *listeria* had spread to Blue Bell products in the marketplace, and Blue Bell announced a limited recall. The board then discussed the *listeria* issues, yet it left the handling of those issues and the product recall to management, allegedly providing no board oversight. Ultimately, many people were sickened by the company's products, and three died. Other results of the *listeria* outbreak included a recall of all of the company's products, the shutdown of Blue Bell's production plants, the termination of one-third of the company's workforce, and a dilutive stock issuance to raise capital necessary in the wake of these developments.<sup>3</sup>

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The plaintiff stockholder brought a derivative action alleging that the Blue Bell directors breached their duty of loyalty by failing to provide adequate oversight of food safety, a central compliance issue for Blue Bell as a producer of ice cream. The lawsuit also alleged that executives Kruse and Bridges breached their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of Blue Bell's food-making operations.<sup>4</sup>

**The Caremark Standard.** *Caremark* and later decisions established that boards have a duty of oversight that is grounded in their duty of loyalty.<sup>5</sup> Under *Caremark*, a board must make a good faith attempt to ensure that the corporation has a risk and compliance reporting system that is sufficiently robust to bring key risk and compliance matters to the board's attention in time for the board to take appropriate actions.<sup>6</sup>

The hurdle to establishing director liability for an oversight failure under *Caremark* is a high one, essentially requiring a showing of bad faith.<sup>7</sup> In order to prevail on such a claim, a plaintiff must establish either that there was an "utter failure to attempt to assure a reasonable information and reporting system exists" or, if such a system exists, that the board consciously failed to monitor or oversee its operations.<sup>8</sup> In *Marchand*, Chief Justice Strine described the "bottom-line requirement" under *Caremark*: "the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting."<sup>9</sup>

**The Delaware Supreme Court Opinion.** In reaching its decision, the Delaware Supreme Court considered both the loyalty claim under *Caremark* and the independence of one director.

**Oversight.** Chief Justice Strine first emphasized that Blue Bell's central regulatory compliance issue was "ensuring that the only product it makes—ice cream—is safe to eat."<sup>10</sup> The court considered the plaintiff's allegations, based on plaintiff's examination of Blue Bell's books and records prior to filing the lawsuit, including allegations that the Blue Bell board lacked any:

- Board committee overseeing food safety;
- Process or protocol by which management would advise the board of food safety compliance practices, risks, or reports;
- Schedule for the board to consider key food safety risks on a regular basis;
- Evidence that the board received important negative food safety reports provided to management that ran counter to favorable food safety information management shared with the board; or
- Regular discussions of food safety issues, at least as reflected in the company's board minutes.<sup>11</sup>

Finding that these unproven allegations supported "an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell" and that the board had "not made the good faith effort that *Caremark* requires," the Delaware Supreme Court reversed the Chancery Court's dismissal of the *Caremark* claim.<sup>12</sup>

**Independence.** Based on the allegations in the derivative complaint, the Delaware Supreme Court also disagreed with the Chancery Court's conclusion that one director, a former Blue Bell executive and Chief Financial Officer, was independent for purposes of considering a claim against management members of the Kruse family.

The Chancery Court, having found this director independent and therefore the Blue Bell board to be majority-independent, had held that the plaintiff was required to make a pre-suit demand on the board. The director in question, W. J. Rankin, was alleged to have been hired and mentored by Ed Kruse, Blue Bell CEO Paul Kruse's father. After starting as Ed Kruse's administrative assistant, Rankin was eventually promoted to CFO before retiring in 2014 after 28 years at the company.<sup>13</sup> The Kruse family had also "spearheaded charitable efforts" in connection with a campaign that raised over

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\$450,000 to name a building at a local college after Rankin.<sup>14</sup>

Taking these well-pled allegations from the complaint as true and drawing all reasonable inferences in the plaintiff's favor, the court concluded that it was reasonable to infer that there existed "very warm and thick personal ties of respect, loyalty, and affection between Rankin and the Kruse family," which created a reasonable doubt that director Rankin could have impartially decided whether to sue Paul Kruse and his subordinate, Greg Bridges.<sup>15</sup> The court concluded that it was reasonable to infer that Rankin owed his successful career as a businessperson "in large measure" to the opportunities and mentoring given to him by Ed Kruse and other members of the Kruse family.<sup>16</sup>

Although the Chancery Court observed that the allegation concerning the \$450,000 donation to the local college did not include any specifics as to who donated how much or make any attempt to characterize the materiality of the gesture to Rankin and was therefore unlikely to satisfy the applicable particularity requirements to plead demand futility,<sup>17</sup> the court concluded that this allegation supported a reasonable inference that Rankin could not be impartial in considering a pre-litigation demand.<sup>18</sup>

The court was not persuaded by defendants' argument that director Rankin had demonstrated independence by voting differently from CEO Paul Kruse on a proposal to separate the CEO and Chairman positions, a fact that was a significant factor in the Chancery Court's conclusion that Rankin was independent.<sup>19</sup> Chief Justice Strine wrote that the decision to sue a corporate officer was "materially different and more important" than the governance decision about the CEO and Chairman roles and that "the nature of the decision must be considered in determining whether a director is independent."<sup>20</sup> Concluding that the complaint raised a reasonable doubt about Rankin's independence, the court reversed the Chancery Court's dismissal for failure to plead demand futility as to the claim against management.<sup>21</sup>

**Oversight Lessons for Boards.** Although the *Marchand* decision does not break new ground in Delaware, the court's telling of the Blue Bell story, as penned by Chief Justice Strine and based on the unproven facts alleged in the complaint, describes compliance failures in the company's core risk area of safe food production. The Delaware Supreme Court enumerated several failures at Blue Bell with respect to food safety, which, it wrote, supported an inference that there was no system of board-level compliance monitoring in place. A review of the Delaware Supreme Court's assessment of Blue Bell's alleged failures suggests the following practices that a board and its advisors might consider in designing a reasonable compliance oversight program:

- **Identify mission-critical risks.** As part of the board's oversight responsibility, ensure that the board and management agree on, and identify, the company's key business risks. A regular strategic planning process involving the board and management that looks critically at industry and company risks can help to identify risks that are mission-critical. Board retreats, outside of the flow of routine board matters, can provide an environment conducive to stepping back and reviewing and refreshing mission-critical risks with a fresh perspective.
- **Implement a board-level reporting system to monitor critical risks.** To comply with the duty of loyalty, directors should make a good faith effort to implement a robust system to inform the board about the company's material risks and ensure that the monitoring system remains effective. The board should ensure that regular processes or protocols require management to apprise the board of mission-critical compliance practices, risks, and both favorable and unfavorable compliance reports on a regular schedule: quarterly, biannually, or at least annually. Under *Caremark*, the board must not just establish a risk oversight and compliance system but must try, on some appropriate schedule, to ensure that the system remains effective.

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- **Review the way in which board committees oversee key risks.** Corporate boards generally allocate the oversight of key risks among the audit and other standing committees. The alleged absence of a board-level committee to oversee food safety risks and compliance was a factor in the Delaware Supreme Court's decision in *Marchand* to reverse the dismissal of the *Caremark* claims against the Blue Bell directors.

A board, particularly in a regulated industry, could periodically consider whether a standing board committee to monitor the corporation's key business risks—similar to patient safety committees for health-care providers or financial risk committees for banks—would assist in the oversight of such risks. Alternatively, as is often the case, the review of key risks can be appropriately—and explicitly—delegated to an existing board committee by specifically including this responsibility in the committee's charter.

- **Engage in robust board and committee discussion concerning compliance issues.** Once the board has been made aware of risks and compliance issues, directors should actively listen to a recitation of these issues, ask probing questions of management, and engage in the robust inquiry that is a hallmark of the board's duty of care. Such diligence includes engaging experts where necessary to fully understand the risks presented and the potential solutions to problems.
- **Contemporaneously document reporting and board discussion in appropriate minutes.** In *Marchand*, allegations that the board minutes did not reflect either discussion of or reports on food safety supported an inference that the board had not made a good faith effort to implement and oversee a board-level food safety reporting system. Delaware cases have long established that contemporaneously drafted board meeting minutes are the best evidence of what occurred (or did not occur) at a board meeting. Although board minutes should not constitute a transcript of the

meeting, the minutes should generally devote more discussion to matters of greater importance, and should include enough detail to establish that the board is discharging its oversight responsibility. The minutes could include, for example:

- o Agendas for board and committee meetings that include review of key compliance risks;
- o Highlights of the key topics that arose in discussion; and
- o Questions asked by directors (usually without attribution) and how those questions were addressed.

## Independence Lessons for Boards

**Higher-stakes decisions require a higher level of independence.** Whenever a decision by the board may be questioned or challenged, the board should carefully test the independence or impartiality of directors who would be making that decision. The *Marchand* decision shows that Delaware courts will demand a higher standard of independence for directors considering whether to sue members of management than the standard required for less sensitive decisions, such as those under stock exchange listing standards in connection with the nomination of directors. Other high-stakes decisions that may require a higher bar for director independence could include the approval of related party transactions or decisions involving a change of corporate control.

Such an independence review is highly fact-specific. In *Marchand*, the court considered the previous long-term employment of the director at the family-controlled company and the family's support in securing the director's name for a building at the local college as facts supporting the director's lack of independence with respect to

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the decision whether to sue management members of the family. Although director Rankin had previously voted against the family-member CEO's position on a corporate governance matter, the Delaware Supreme Court did not find that prior action determinative with respect to the director's independence for purposes of whether to sue the CEO.

## Conclusion

The *Marchand* decision's articulation of the board's duty of oversight, together with its application of oversight principles to the facts presented, provide important guidance to boards in navigating the *Caremark* standard and their core fiduciary duties of care and loyalty.

## Notes

1. 212 A.3d 805 (Del. 2019).
2. *See generally id.* at 809–13.
3. *See generally id.* at 813–15. Unless stated otherwise, all recitations of factual events that relate to Blue Bell

Creameries are allegations of facts from the complaint, as described by the Delaware Supreme Court, and this article does not necessarily represent the view of Perkins Coie LLP or any of its clients.

4. *Id.* at 815–17.
5. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996); *see also Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369–70 (Del 2006).
6. *Caremark*, 698 A.2d at 970.
7. *Marchand v. Barnhill*, 212 A.3d 805, 809 (Del. 2019).
8. *Stone*, 911 A.2d at 370–72.
9. *Marchand*, 212 A.3d at 821.
10. *Id.* at 822.
11. *Id.*
12. *Id.* at 822, 824.
13. *See generally id.* at 808–09.
14. *Marchand*, 212 A.3d at 816.
15. *Id.* at 819.
16. *Id.* at 818–19.
17. *Id.* at 816.
18. *Id.* at 818–20.
19. *Marchand*, 212 A.3d at 819.
20. *Id.*
21. *Id.* at 820.