



Caremark (1996)

- * **Directors have a duty to exercise oversight over the corporation**
 - And over management
- * **Must ensure existence of information and reporting systems that are reasonably designed to provide the *board* with timely and accurate information relevant to the company's compliance with the law and its business performance**
- * **Must exercise due care in responding to evidence of potential misconduct**
 - Cannot knowingly allow firm to violate the law

Caremark Liability: Bad Faith

Prong 1
the directors completely fail to implement any reporting or information system or controls

Prong 2
Board consciously failed to monitor or oversee reporting or information system, or failed to respond appropriately to evidence of legal violation

and board inaction was a proximate cause of harm to firm.

Stone v Ritter (Dela. S. Ct 2006)

Court approves Caremark standard for determining liability for failure to oversee legal risk

Board Liable if:

- Prong 1:** Directors utterly failed to implement any reporting or information system or controls, or
- Prong 2:** Directors implements a system but then consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention.
 - Liabile under prong 2 if get evidence of misconduct and consciously fail to act.

Need Bad Faith: conscious disregard for duties

Initially Caremark Little Threat

Stone v Ritter (Dela. S. Ct. 2006)

FinCEN: AmSouth compliance program “lacked adequate board and management oversight” and that “reporting to management for purposes of monitoring and oversight of compliance was materially deficient”

Dela. Board Not Liable: No Utter Neglect

AmSouth had a compliance program
CCO Reported to Audit Committee and Board
Board responded to evidence misconduct

Sea Change H

Caremark complaints all dismissed

Exception: public companies whose audit committees did not meet for three years.

But then came Marchand & now Boeing

Important change:

General compliance program and vague oversight over compliance not enough

Company with vital regulatory/compliance risks (e.g., safety of products) just ensure genuine board oversight of those risks

Liable if fails to establish procedures (prong 1) or to exercise oversight (prong 2)

Marchand

- **Blue Bell creameries suffered listeria outbreak in 2015. 3 people died.**
- **SH brought a derivative action**
- **Caremark claims against board for failure to establish system to ensure board had information needed about food safety**
 - Food safety: regulatory and business risk
- **Trial Ct dismisses because Blue Bell had a compliance program**
 - CCO reported to audit and the board

Dela. S. Ct.

When a specific legal/regulatory risk is vital to the health of the firm—as good safety is here—board must

- 1) Establish system to ensure that it gets information about food safety
- 2) Exercise oversight over that system and respond to potential issues

Board cannot satisfy its duties by delegating to management

Board's breaches

No board committee explicitly responsible for food safety

Management not required to give the board

- a) Regular report on food safety
Reports on operational issues ≠ food safety
- b) Immediate notice of red/yellow flags about food safety

Management did not in fact report to board on these issues

Upon notice of problem, board inactive

Left the response to management

Scienter

H

Scienter: intentional neglect

Marchand: court infers scienter from

- 1) Lack any board committee focused on safety
- 2) No regular process/protocols requirement management to report to board on safety
- 3) No regular schedule for board to address safety
- 4) Lack board minutes where safety discussed
- 5) No evidence red/yellow flags disclosed to board
- 6) No evidence management conveyed safety information to the board

Boeing (Ch Ct Sept 7, 2021)

Oct. 2018 737 Max manufactured by Boeing Crashed (Lion Air)

Second 737 Max crashed in March 2019

Problem: 737 Max was a redesign. Boeing added a software system to bring the nose down

MCAS software prone to activate inappropriately
Boeing misled FDA=> FDA not require needed pilot training

Board no committee explicitly charged with overseeing safety

Board passive after crash; defers to management

Dela. Ch. Ct.: Caremark Prong 1

Board of a company operating in shadow of mission critical regulatory/compliance risk:

- 1) Must establish a system to ensure that it gets information about that specific risk
Here airplane safety
- 2) Must ensure that it actually gets the information
- 3) Must respond appropriately to yellow/red flags

Prong 1 failures

1. No Board Committee with Direct Responsibility for Airplane Safety

- Audit committee charter not mention safety
- Audit committee not regularly address safety
- CCO report to audit not discuss safety

2. Board as whole not Oversee Safety

- No Board Meeting Time Set Aside for Safety
- Management not required to regularly report on safety
- No board procedures for oversight of investigation

3. Internal Reporting System not designed to enable employees/Whistleblowers to reach the board

Scienter

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**Plus: after crash 2 directors email that should discuss safety to show their commitment
Publicly tout safety steps never took**

Prong 2 failures

After learning about first crash, Boeing board consciously disregarding its duty to address safety risk

- 1) Board not request information from management
Board accepted CEO assertion MCAS was safe
- 2) Not seek request information after WSJ reported potential problems with MCAS
Accepted management's claims without question
- 3) Full board not discuss crash for months
Earlier Board call to discuss 1st crash was optional
Board focused on production not safety

Implications

Threat of Liability

Shareholder allowed to proceed to trial in Marchand and Boeing. Settlement likely given existing facts

Disclosure Directors' Communications

In Facebook and Amerisource Bergen shareholder leveraged Caremark claims to obtain court order requiring firm to disclose management and *directors'* emails relating to commission/oversight of the alleged misconduct

Facebook: Privacy Violations (Cambridge Analytica)

Amerisource Bergen: Illegal marketing/sales opioids

Take away Message (Prong 1)

1) Board cannot allow firm to pursue business plan that would violate the law

2) Board must determine company's material regulatory/compliance/safety risks

A board committee given responsible for these risks

Committee must have (and devote) adequate time

Minutes should show they did discuss it

CCO or CRO must report on those risks

3) Full board must be informed

Committee must report to the board on those risks

Management must be required to report to board

Internal reporting system should enable reports to board

4) Board must set aside time to discuss these vital risks

Take Away Message (Prong 2)

1) Management must be required to inform about yellow/red flags about legal violations

2) Board should obtain information about potential material violations

Needs raw information on issue

Can't defer to management's conclusion all is well

3) Board should actively oversee firm's response

Meet promptly/allocate adequate time

Obtain independent expert advice (not just CEO)

4) Minutes should document board's actions