Accelerate ESG Alert

Akin Gump
STRAUSS HAUER & FELD LLP

‘Mission Critical’—Revisiting the Board’s Oversight Role After In re: Boeing Co.

May 17, 2022

Recent rulings in the United States and overseas, coupled with the Securities and Exchange Commission’s (SEC) recently proposed disclosure rules covering climate-risk disclosures, underscore the attention boards of directors and management must continue to pay to climate change and its potential impact on business operations and the risks faced by companies across all sectors of the economy. Obviously, the energy industry is acutely attuned to these issues and last year’s decision in *In re: Boeing Co. Derivative Litigation* (discussed in detail below) only serves as the most recent reminder of the potential exposures (including personal liability) companies, boards of directors and management may face when they fail to consider these issues seriously.

May 26, 2021, marked the first time that a court imposed a bright-line emissions reduction requirement on a private corporation unrelated to an independent statutory or regulatory mandate. The District Court of The Hague ruled that Royal Dutch Shell must uphold a duty of care owed to Dutch citizens to reduce its carbon dioxide (CO_2) emissions. The District Court of The Hague grounded the obligation in the “unwritten standard of care” enshrined in Dutch tort law that dictated “what may be expected of [Shell] . . . with respect to Dutch residents.” In its decision the District Court of The Hague considered a number of factors, including Shell’s and other actors’ contributions to and responsibilities for climate change, human rights concerns, climate science, regulatory pathways to address climate change and feasibility. The District Court of The Hague criticized Shell’s existing policy for merely monitoring developments, for being intangible and undefined, and for allowing other parties to take the lead in addressing climate change. Ultimately the District Court of The Hague ordered Shell to enact a new policy to address climate change.

Shell has made clear that it intends to appeal the decision, yet regardless of any precedential value the decision adds further pressure on companies to proactively implement policies that align with the Paris Agreement targets and basic human rights to a clean and healthy environment, and not just react to government-imposed laws and policies. In the United States, the decision will continue to attract significant attention in the oil and gas and other energy-intensive sectors, as well as in the financial industry. It also may cause companies promoting corporate sustainability to take a closer look at how they set environmental targets and substantiate their claims.

Contact Information

If you have any questions concerning this alert, please contact:

Kerry E. Berchem
Partner
kberchem@akingump.com
New York
+1 212.872.1095

John Goodgame
Partner
jgoodgame@akingump.com
Houston
+1 713.220.8144

Cynthia M. Mabry
cmabry@akingump.com
Partner
Houston
+1 713.220.8130

Grace K. Seidl
Associate
gseidl@akingump.com
Houston
+1 713.250.2268

Charles E. Smith
Consultant
cesmith@akingump.com
+1 212.836.2247

While it is unlikely that United States courts will follow the reasoning set forth by the District Court of The Hague, in part due to the conservative majorities on the United States Supreme Court and in the federal judiciary, the focus on a corporation's duty of care calls to mind a line of Delaware cases that address boards of directors duty to oversee risk and safety, which are highlighted below. Similar to the *Shell* case, this line of cases presents an avenue for activists to bring litigation related to climate risks.

In a derivative case against directors of The Boeing Co., the Delaware Court of Chancery allowed *Caremark*[1] claims against The Boeing Co. directors to survive a motion to dismiss—confirming that the plaintiffs satisfactorily alleged that Boeing's board breached its duty of oversight by failing to establish and oversee compliance procedures related to the company's "mission critical" airplane safety risks. This article further provides background on the *Caremark* line of cases and an overview of the Delaware Court of Chancery's ruling in *Boeing*[2] on September 7, 2021.

Caremark and Director Liability

Delaware corporations may include provisions in their certificate of incorporation that exculpate their directors from monetary liability for any breach of the fiduciary duty of care.[3] However, breaches of the fiduciary duty of loyalty and bad faith conduct cannot be exculpated. If a plaintiff asserts a claim for breach of the duty of care against a director or directors where such an exculpation provision exists, that claim would be subject to dismissal at the early stages of the case.

In *Caremark*, the Delaware Court of Chancery stated that when directors of a Delaware corporation are exculpated from liability for breach of the duty of care or attention, they may nonetheless be held liable on a breach of loyalty theory if such directors have (1) utterly failed to implement any reporting system or controls and (2) consciously failed to monitor such a system. Both prongs of this *Caremark* test require that the directors have had knowledge that they were not discharging their fiduciary obligations. At the time, the court characterized this theory of liability as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

In *Caremark*, the court reviewed a proposed settlement of shareholder derivative claims that arose from the company's guilty plea and payment of criminal and civil penalties for violations of state and federal health care fraud laws. The court focused on the plaintiffs' claim that "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." The court established a high bar for such a claim, stating "only a sustained or systematic failure of the board to exercise oversight such as an utter failure to attempt to assure a reasonable information and reporting system exists will establish the lack of good faith that is a necessary condition to liability."

As a result of *Caremark*, the board, among its other fiduciary obligations, must undertake a duty of oversight to make a good faith effort to put into place a reasonable board-level system of monitoring and reporting.

Decisions Since *Caremark*

In *Marchand*,[4] plaintiffs' alleged breach of fiduciary duty claims against the board of directors of a company survived a motion to dismiss. The Delaware Supreme Court

© 2022 Akin Gump Strauss Hauer & Feld LLP

concluded that the plaintiff had adequately pled a *Caremark* claim that directors had acted in bad faith and breached their duty of loyalty by failing to have a board-level compliance monitoring and reporting system related to food safety. The court, focusing on regulatory risks, held that board oversight of such risks must be "rigorously exercised" when dealing with "mission critical" risks.

Plaintiffs in *Marchand* alleged that the board in question did not have a board committee to oversee food safety, nor did it have any protocol for advising the board of food safety reports. Plaintiffs also alleged there was no evidence in board's minutes or schedules of any regular discussion of food safety issues. Notably, the court acknowledged such company's nominal compliance with Food and Drug Administration (FDA) requirements for food safety but stated this only showed the management's compliance with the law rather than the board implementing a system to monitor food safety risks. As a result, the *Marchand* decision provides that the directors' lack of attentiveness to key risks in their oversight role may rise to the level of "bad faith indifference" required for a *Caremark* claim.

Subsequently, in *Clovis Oncology*,[5] the Delaware Court of Chancery again allowed the plaintiffs' *Caremark* claim to survive a motion to dismiss. While developing a lung cancer treatment, the company overstated the effectiveness of the treatment and did not comply with the rules for reporting test results set by the FDA. Unlike in *Marchand*, the Clovis board's "Nominating and Corporate Governance Committee was 'specifically charged' with 'provid[ing] general compliance oversight . . . with respect to . . . Federal health care program requirements and FDA requirements.'" As a result, the court stated that it was unlikely the plaintiffs would be able to prove that "the Board had no 'reporting or information system or controls.'" Instead, the court relied on the second prong of the *Caremark* test in which a company "implemented an oversight system but the board failed to 'monitor it.'" The court pointed to allegations that the board knew the requirements for reporting the treatment results and knew that management was reporting inaccurate results, but did nothing to address the problem. Based on these allegations, the court denied the motion to dismiss finding that plaintiffs had successfully plead "that the Board consciously ignored red flags that revealed a mission critical failure to comply with [federal health care protocols] and associated FDA regulations." *The Clovis Oncology* decision highlights the importance of not only having in place a system for board oversight, but also for the board to actively use and monitor that system.

Boeing Decision

The Delaware Court of Chancery most recently permitted claims against the Boeing board to survive a motion to dismiss, in a case that some commentators believe has further expanded potential board oversight liability. In the *Boeing* case, shareholders filed a suit against the board following two crashes of the company's 737 MAX aircrafts. In denying the board's motion to dismiss, the court concluded that the pleaded facts showed a board that had "failed to establish a reporting system" for airplane safety. Further, the court stated that the first crash "was a red flag . . . that the Board should have heeded but instead ignored," and "the Board was aware or should have been aware that its response to the [first crash] fell short."

The court pointed to safety being "essential and mission critical" to Boeing's business. Allegedly, there was no board committee assigned the specific task of overseeing airplane safety. Boeing's audit committee was responsible for overseeing legal and

© 2022 Akin Gump Strauss Hauer & Feld LLP

regulatory compliance but it is alleged to have “primarily focused on financial risks.” The committee charter did not mention safety as part of the committee mandate. Board minutes included in the complaint showed that airplane safety was not addressed as part of the board’s yearly updates on compliance, nor was airplane safety regularly on the agenda at board meetings. Instead of direct board oversight, the company had a Safety Review Board run by employees. The complaint further alleged that the board did not have any way to receive internal reports or complaints about safety nor did management report to the board on safety issues.

The court recognized that plaintiffs’ pleading burden was onerous, but found that they had made sufficient allegations to survive the motion to dismiss and were entitled to pursue discovery to prove their claims.

Conclusion and Recommendations

Caremark claims likely remain one of the most difficult theories for plaintiffs to use to establish director liability in Delaware and the decisions that have followed do not affect that conclusion. Nevertheless, some commentators believe that decisions subsequent to *Caremark*, including *Boeing* and other recent cases, demonstrate that it has become increasingly easier to for plaintiffs to survive the motion to dismiss stage with *Caremark* claims, where the court must assume the plaintiff’s allegations are true and draw all reasonable inferences in favor of the plaintiff.

Still, as economic and social consequences of climate change have become increasingly hot topics, and as public figures, regulators and equity holders seek accountability from corporations, we expect climate-focused litigation to continue to increase. Climate-related *Caremark* claims are one way plaintiffs could attempt to take action in response to perceived inaction by boards in addressing climate-related risks.

As a result, boards should consider taking proactive steps to reduce the risk of similar claims, including reviewing the composition and culture of the board, as well as the areas where the board provides direct oversight. We recommend that boards include members with industry knowledge or experience, as well as members who can demonstrate objectivity. Too many interrelationships between board members, for example, can make objective opinions harder to obtain. We also recommend that boards cultivate an environment where potential problems can be freely discussed and where constructive criticism is appreciated. Disagreement among directors on governance issues does not, in and of itself, establish a conflict or undermine impartiality; rather, it can enhance the overall oversight provided by the board as different viewpoints are considered. Finally, we recommend that boards review their areas of direct oversight and consider whether additional committees should be formed (or whether additional oversight responsibility should be added to existing committees) to cover any areas—including climate-related areas—that may be argued to be “essential and mission critical” in later litigation.

Additionally, boards can potentially limit the likelihood of facing a suit by adopting practices such as:

- Reviewing their public facing documents, such as board committees and charters, and evaluating whether committee mandates and reviews should be expanded to cover key risks, including climate change.
- Ensuring the board structure reflects the industry and its specific needs and risks.

- Reviewing safety issues regularly. If there is not one already in place, the board should consider creating a committee specifically tasked with this oversight. Alternatively, if a board determines that a stand-alone committee is unnecessary in light of particular facts or circumstances, then it should ensure that another committee (e.g., an audit committee) regularly receives reports from management covering these risks.
- Assessing its protocols for an environmental or personal safety issue occurring. The board should know how it will be notified and how it will follow up with management to resolve the situation and prevent a reoccurrence of the issue.
- Ensuring board and committee minutes memorialize the efforts that are being undertaken with respect to overseeing issues and demonstrate that the board and/or committees are regularly engaged in oversight and compliance programs.
- Discussing worst case scenarios frequently. By periodically hypothesizing problems and proposing potential solutions, boards can improve their ability to react quickly and effectively in the event an actual issue arises.
- Enforcing accountability whenever problems arise. When a board appears to punish wrongdoing and hold people accountable, it inspires trust and faith in the board, making it less likely for shareholders to file suit.

While *Caremark* claims might seem like an obvious course of action to address climate-risks, they are not likely to be the most successful avenue for tackling climate change. *Caremark* claims only allow for companies to recover funds themselves. They would not result in companies paying for any climate risks. As a result, when a board has taken action to insulate itself from challenges related to its oversight, the threat of *Caremark* claims is likely low.

[1] In *re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[2] In *re* the Boeing Co. Derivative Litig., No. 2019-0907 (Del. Ch. Sept 7, 2021).

[3] Delaware General Corporation Law §102(b)(7).

[4] *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).

[5] In *re* Clovis Oncology, Inc. Derivative Litig., No. CV 2017-0222-JRS, 2019 WL 4850188, (Del. Ch. Oct. 1, 2019).

akingump.com

© 2022 Akin Gump Strauss Hauer & Feld LLP