BOARD DUTIES

Blue Bell Meltdown Serves Up a Double Dip of Danger for Directors

By James A. Deeken

A recent combination of two interesting cases arising from the same underlying fact pattern—*Marchand v. Barnhill*[1] and *Discover Property & Casualty Insurance et al v. Blue Bell Creameries USA, Inc.*[2]—highlight the need for corporate directors to understand not only their duties but the scope of insurance coverage that applies, or in some cases does not apply, to those duties.

Perhaps there is no greater nightmare for a corporate director than to be held liable for a duty they didn't know about in a situation where neither indemnification nor insurance applies. The situation may seem unreal to some, but recent case law underscores that liability nightmares for directors are not isolated to dreams.

Bell Blue Creameries USA, Inc., one of the most established and longest serving, manufacturers and distributors of ice cream, had an outbreak of listeria in 2015 at its facilities that resulted in three deaths and led to a large-scale recall of Blue Bell products. The situation resulted in an alleged decrease in value for pre-existing stockholders. A stockholder brought a derivative claim on behalf of the company against its directors and certain of its officers seeking recourse for the liabilities incurred by the company as a result of the listeria crisis.[3]

The concept that a director can be personally liable for a mishap at a corporation for which they serve as a director may seem to contravene the understanding of corporate law that most directors have and operate under in the performance of their services. Most director liability is thought of in the context of the "business judgment rule," a long-standing principle of corporate law that generally provides a court will not second guess a properly informed business decision made by a director in good faith absent certain excepted circumstances described below.

While directors generally take comfort from the business judgment rule, less commonly understood is that the business judgment only applies to the exercise of a director's duty of care and not the exercise of a director's duty of loyalty or a director's duty to act in good faith. Perhaps even less commonly understood are the pitfalls that accompany the duty of loyalty and duty to act in good faith.

Basic Director Delaware Law Duties[4]

The following is a brief overview of some of the elements of Delaware fiduciary law as applied to members of a Delaware corporation's board of directors to help frame the issues presented by the Blue Bell scenario. An exhaustive and complete analysis of such duties would merit a separate law review article in and of itself. Under Delaware law, directors owe fiduciary duties to the corporation and its shareholders.[5] A director's fiduciary duties include both a duty of care and a duty of loyalty,[6] with an overall obligation to act in good faith.

The duty of care requires a director to be informed about the affairs of the corporation and all material information reasonably available before making a business decision.[7] Directors must then act with requisite care[8] and use the care that ordinarily careful and prudent people would use in similar circumstances after considering all information reasonable

James A. Deeken *is a law partner at Akin Gump Strauss Hauer & Feld LLP and an adjunct lecturer at SMU's Dedman School of Law.*

available.[9] Under the duty of care, directors in some cases rely on reports and information provided by the corporation's officers, legal counsel, public accountants, investment bankers, and other individuals on matters pertaining to the corporation.

Directors' decisions pursuant to the duty of care generally are subject to the business judgment rule. Under the business judgment rule, a court generally will give deference to the board and will not substitute its own judgment for that of the board, even if a decision turned out to be unwise, so long as the directors acted on an informed basis, in good faith, and in the rational belief that the decision made was in the best interests of the corporation and its stockholders.[10] Delaware law presumes that "in making a business the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the company."[11]

Those presumptions can be rebutted if a plaintiff shows that the directors breached their fiduciary duty of care (by acting with gross negligence) or of loyalty or acted in bad faith,[12] otherwise acted in an uninformed manner,[13] or abdicated its functions,[14] or failed to act[15] or were not disinterested.[16]

The duty of loyalty requires directors to refrain from self-dealing and to act in good faith.[17] A director's own financial or other self-interest may not take precedence over the interests of the corporation and its stockholders when making decisions on behalf of the corporation.[18] The director must also refrain from any conduct that would injure the corporation and its stockholders or deprive the corporation of profit or advantage.[19]

Closely related to the duty of loyalty, is the duty of a corporate director to act in good faith.[20] The duty to act in good faith requires that a director avoid "subjective bad faith," conduct motivated by an actual intent to harm to the corporation.[21] However, a director can also breach its obligation to act in good by consciously disregarding a duty at act.[22] In the words of one Delaware Chancery Court opinion:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.[23]

Why Good Faith Poses Accented Personal Liability Risks for Directors

The absence of the business judgment in the context of the duty of loyalty may be enough of a danger for a director. However, the absence of a potential indemnity for a claim involving the breach of loyalty combined, with the absence of the business judgment rule has a real potential for a director to be bare of traditional liability protections.

Section 145(b) of the Delaware General Corporation Law provides that a corporation has the power to indemnity a person who is party to an action brought in the name of the corporation "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation." The restriction makes it difficult for a director to prevail for indemnity when they are adjudicated to be liable for a breach of the duty of loyalty, as a breach of the duty of loyalty is usually determined to arise from a director acting in bad faith or in manner they did not reasonably believe to be in the best interest of the corporation.[24]

Caremark and the Delaware Duty of Loyalty/Good Faith Liability Trap

Breaching the duty of loyalty or obligation to act in good faith may sound like something that would require some intentional conscious wrongdoing doing on the part of a director. *In re Caremark Int'l Inc. Derivative Litig.*[25] arguably tells a different story. In *Caremark*, the Chancery Court determined that directors can be deemed to have acted in breach of their duty of loyalty if they did not in good faith make efforts to implement a monitoring and reporting system for a corporation.

The *Caremark* standard was elaborated on by the Delaware Supreme Court in *Stone v. Ritter*,[26] as explained by the court:

> We hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) 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. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[27]

What is interesting is that *Caremark*, as amplified by *Stone*, the Delaware Supreme Court seems to be combining the duty of loyalty with the duty of a director to act in good faith.

Blue Bell's First Dip

In *Marchand*, the Delaware Supreme Court noted the Court of Chancery originally had dismissed plaintiff's claims on the grounds, that among other things, that it viewed the plaintiff complaint as having alleged not the absence of monitoring and reporting controls but instead challenging the effectiveness of monitoring and reporting controls. The court disagreed and stated that the complaint had plead particularized facts to support a reasonable inference that the board had failed to implement any system to monitor the company's food safety performance or compliance.

In the reasoning of the court, directors have a duty to exercise oversight and to monitor a corporation's operational viability, legal compliance and financial performance and a board's utter failure to attempt to assure a reasonable information and reporting system exists constitutes an act of bad faith in breach of the duty of loyalty. Along these lines, the court explained that the complaint alleged facts, among other things, that there was no board level effort at monitoring and thus supported an inference that the directors consciously failed to attempt to assure that a reasonable information and reporting system existed.

The court went to lengths to point out that board minutes reflected no discussion of health and safety issues at the company had arisen on inspections in the years prior to the listeria outbreak and that the matter was not discussed until the outbreak. The court also noted that the pleadings alleged that there was no board committee charged with monitoring food safety, no portion of the board meetings were devoted to food safety compliance and the lack of a protocol for management delivering compliance reports or summaries to the board on a consistent and mandatory basis.

The court noted that the rationale for the Chancery Court's dismissal was the existence of sanitation manuals and procedures with board reporting on the company's operations. In analyzing the Chancery Court's dismissal, the Court noted that directors must not only make a good faith effort to implement an oversight system but to monitor it as well.

Although the court noted that defendants claimed that the company had in place systems to comply with applicable safety laws, the Court emphasized that these were not board level reporting items. The court was also not convinced with an argument that the Board was briefed on operational issues at the company level. The court instead highlighted that there was alleged to be no monitoring with respect to food health and safety specifically.[28]

The Contours of *Marchand*

Marchand does not arguably change or modify *Caremark* but at the very least it accents how a board needs to make sure that it has procedures for monitoring areas that pose risks for a corporation. *Marchand* and *Caremark* when read together leave several unanswered questions that directors may find discomforting.

For example, assume there is a corporation that engages in the provision of healthcare services and one of the greatest risks is assumed quite rationally to be the quality of healthcare that it provides. So, if the board puts in place some system for monitoring risks related to that. Are they home free under *Caremark*?

Assume a year later the corporation has a cyber security issue and personal information of patients is compromised resulting in patient litigation against the corporation. Assume the board had no mechanism in place for monitoring cyber security risks. Are the directors liable under *Caremark*? Could they argue that cyber security was not thought to be one of the main risks?

The potential issue for directors is what constitutes a material risk for a corporation is sometimes judged in retrospect with hindsight bias. Should a nervous director try to think of every conceivable risk and demand system for monitoring it? Would that even be good enough to ward off any risk of *Caremark* dangers? Will there always be some risk that somebody did not think of?

Is it sufficient to have a monitoring system for the main risk or does *Caremark* require monitoring systems for multiple risks. The Chancery Court in *Marchand*[29] seemed to focus on the fact that there was a general system in place for monitoring operational aspects. The Delaware Supreme Court however went to great lengths to point out that even though there was a system for monitoring operational aspects there was not a system in place for monitoring food safety which was the main risk to the company.[30] Does the board monitoring duty stop at the main risk, or does it continue on to other material risks? Also, unanswered is a situation in which there may be disagreement about the main risks faced by a company. For *Marchand* it seemed easy, at least in the opinion of the Court, to identify the main risk. Other corporations may have a more muddled picture of the main risk that they face.

The landscape that corporations operate under is one of increasing regulation and liability, not one of lessening regulation and liability. That, coupled with an enhanced focus on Environmental, Social, and Governance (ESG), increases both the volume and magnitude of risks that any given corporation could face. Under *Caremark/Marchand* are directors being de facto supervisory compliance officers?

Another important import of *Marchand* is that even if there is a system in place to monitor a danger that alone will not be sufficient to ward off liability. Even if in *Marchand* had the plaintiff not alleged the lack of a monitoring system for food health and safety issues, it is not clear that the defendants would have prevailed on summary judgment. Even if there is a monitoring system in place, plaintiffs are free to allege that the system although implemented was not properly monitored by a board.

Thus, even if a board can think of every risk that might later be alleged to be material and put in and implemented a system for monitoring risks, the board would still conceivably be at risk for a claim that it did not actively monitor the reporting. Again, the risk of hind sight bias could create a fair amount of second guessing on the point. So, if a board did have a cyber security risk monitoring system in place and monitored it every quarter, could a plaintiff allege in hindsight if an issue arises that it should have been monitored every month? Some of the dicta in *Marchand* about the discretion the board has along these lines might suggest not, but the result is less than clear.

Would anyone ever allege a breach of *Caremark* duties? Unfortunately, yes. If a plaintiff alleges misconduct on the part of a board, it does them perhaps very little good if indemnification, the business judgment rule, and exclusion from liabilities under the corporation's certificate of incorporation apply. Thus, even though the pleading standards are harder, plaintiffs in some cases have more of an incentive to file breach of duty of loyalty claims than breach of care claims.

For a director what is particularly alarming about the *Caremark/Marchand* line of cases is that they arguably obscure the dividing line between the duty of care and the duty of loyalty. In *Marchand* for example, there was no allegation that the directors received some sort of improper personal benefit or were subject to a conflict of interest transaction. The lack of those allegations is significant.

It might be tempting to argue, from a policy standpoint, that absent any sort of improper benefit or interested director transaction, a board should be able to determine in its business judgment what types of monitoring systems, if any, for certain dangers are appropriate. However, *Caremark* and *Marchand* could be viewed as importing over an element of the duty of care, where the business judgment rule generally applies and where indemnification may be available, to the duty of loyalty where the business judgment rule is absent and where corporate indemnification is not generally available. The result is a potential gaping hole in personal liability protection for directors even in situations where there was not an improper personal benefit or conflicted interest.

At this point, assume a director throws up his hands and says "Fine. I will rely upon insurance." There are a number of issues with insurance often cause it not to be a rain proof umbrella. Those can, among other things, include the nature of claims made policies, limits, conditions, deductibles and exclusions that are beyond the scope of this particular article. However, the Blue Bell litigation highlights the importance of not just having insurance but of having the right type of insurance for the right type of liability.

Blue Bell's Second Dip

In *Discover*, a federal district court and the US Fifth Circuit Court of Appeals addressed a dispute between Bell Blue and defendants in the *Marchand* litigation on one hand and insurers on the other hand.

The court began with a history of the facts giving rise to the Marchand litigation and a summary of the claims thereunder, noting in particular that the claims alleged a breach of the duty of loyalty for willfully failing to manage the company and institute a system of controls and reporting. The court noted that during the periods in question that Blue Bell and related entities were covered by several commercial general liability, or CGL, insurance policies issued at various times by the applicable insurance companies. These policies covered not only the Blue Bell entities but also officers and directors "with respect to their duties" as officers and directors of the Blue Bell entities. Specifically, the policies covered occurrences (generally defined as accidents) resulting in bodily injury or property damage.

The Blue Bell entities gave notice of claims to the insurers related to the Marchand litigation, which prompted the insurers to file suit contesting coverage.

The court explained that at least under Texas law the duty of insurer to defend and provide an indemnity is covered exclusively by the complaint itself and policy, that is, if the complaint does not allege a claim that is covered by the policy, then there will be no duty to defend and provide indemnity.

The insurers argued that because the defendants were alleged to breached their fiduciary duties, that they were not acting "with respect to" those duties and thus are not insureds under the applicable policies. The district court, relying in part on US Eight Circuit Court of Appeals precedent and US Ninth Circuit Court of Appeals precedent reasoned that a GCL policy, such as the one at issue, would only cover officer and directors when they acted in accordance with their duties and not in breach of duties owed by them to the insured entity.[31]

The court also went to great length to put out that the cases cited by the defendants were ones that addressed directors' and officers' liability policies that were designed to cover individuals such as the officers and directors in the present case and not GCL policies like the one at issue. It is interesting to note that the court arguable read "with respect to duties" to mean "in accordance with duties," which may have not synced with the way someone might have read and understood the policy as applying, absent guidance of the case law cited by the court.

The Fifth Circuit disagreed and determined that the directors and officers were acting with respect to their duties since the actions taken by them were not alleged to be outside of the scope of managing the applicable business.

The Fifth Circuit however reasoned that coverage was not applicable for independent reasons. The policy covered "accidents" and the court viewed matters arising from a breach of fiduciary duty as not accidental in nature. The court further pointed out that the defendants' insurance claims related to financial matters instead of ones related to bodily injury within the meaning of the policies.

The most important take away for directors is not merely to ask whether a company has insurance covering directors when agreeing to serve on a corporate board but whether the company effectively has the right type of insurance. In this case, the reliance on a CGL policy may have been mis-placed but a director and officer liability policy, depending on its specific wording, might have provided the desired coverage. One note of caution though is that director and officer liability policies can often contain exceptions from coverage for breaches of the duty of loyalty or bad faith, which could create a hole in insurance coverage for *Caremark* liabilities.

Secondly, the case serves as a reminder that coverage under policies ties to the exact wording of those policies, and at times, the wording may be applied by a court in a manner that is not necessarily intuitive. The lingering question then is whether a director should not only ask what type of insurance is provided but perhaps ask whether the board has had an insurance coverage lawyer review the applicable policy or policies.

Finally, Blue Bell was a private company as opposed to a publicly traded company. The case serves as an additional reminder that director and officer liability exist not just in the context of public companies but in the context of private companies as well.

Notes

1. Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
2. Discover Property & Casualty Insurance et al v. Blue Bell Creameries USA, Inc., 73 F.4th 332 (5th Cir. 2023).
3. *Marchand*, 212 A.3d at 807.
4. The summaries of law contained herein are for educational and informational purposes, they do not contain the legal detail necessary for legal advice, and are not tailored for the specific relevant facts of any situation, and thus, should not be construed as legal advice.
5. McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).
6. *McMullin*, 765 A.2d at 917.
7. *Smith*, 488 A.2d at 872; In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005) (noting that the business judgment rule does not apply if directors make an "unintelligent or unadvised judgment"), *aff'd* 906 A.2d 27 (Del. 2006); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); McMullin at 922 (noting that the business judgement rule can be rebutted if directors failed to exercise due care in informing themselves prior to making a decision).
8. *Aronson*, 473 A.2d at 812.
9. *Walt Disney*, 907 A.2d at 749; *Aronson*, 473 A.2d at 812 (noting that once being informed, directors must act with requisite care).
10. *Smith*, 488 A.2d at 873 (*citing* Aronson at 812); *Walt Disney*, 906 A.2d at 52 (requiring an informed basis, good faith and honest belief that the action was in the bests interests of the relevant corporation).
11. *Aronson*, 473 A.2d at 812.
12. *Walt Disney*, 907 A.2d at 747; *Smith*, 488 A.2d at 872 (We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.)

13. *Smith*, 488 A.2d at 872.
14. *Aronson*, 473A.2d at 813.
15. *Id*.
16. *McMullin*, 765 A2d. at 923.
17. *Walt Disney*, 907 A.2d at 751.
18. *Id*. at 751.
19. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987).
20. In re Caremark Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996); Nagy v. Bistricer, 770 A.2d 43, 48, n. 2 (Del. Ch. 2000).
21. *Walt Disney*, 907 A.2d at 752.
22. *Id*. at 755.
23. *Id*. The Delaware Supreme Court explained that there are three categories of bad faith: (i) subjective bad faith when motivated with an actual intent to do harm; (ii) conduct resulting from gross negligence without malevolent intent; and (iii) intentional dereliction of duty, a conscious disregard of one's responsibilities. *Walt Disney*, 906 A.2d at 26-30.
24. Likewise, Section 102(b)(7) of the Delaware General Corporation law allows a corporation to exculpate directors from monetary damages for a breach of the duty of care, but not for acts or omissions not in good faith. *See also Disney*, 906 A.2d at 28-29.
25. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
26. Stone v. Ritter, 911 A.2d 362 (Del. 2006).
27. *Stone*, 911 A.2d at 370.
28. *Marchand* seems to be in line with a number of recent Delaware court cases that have been determined favorably for plaintiffs. *See* In re Boeing Co. Derivative Litig., 2021 WL 4059934 (Del. Ch. 2021); In Re Clovis Oncology, Inc. Derivative Litigation, 2019 WL 4850188 (Del. Ch. 2019); Hughes v. Hu, 2020 WL 1987029 (Del. Ch. 2020); Teamsters Local 443 Health Services & Insurance Plan v. Chou, 2020 WL 5028065 (Del. Ch. 2020). *Compare* Firemen's Retirement System of St. Louis v. Sorenson (Marriott), 2021 WL 4953777 (Del. Ch. 2021) and In City of Detroit Police and Fire Retirement System *ex rel* NiSource Inc. v. Hamrock dismissing *Caremark* claims.
29. *Marchand*, 2018 WL 4657159 (Del. Ch. 2018).
30. "the obviously most central consumer safety and legal compliance issue facing the company..." *Marchand*, 212 A.3d at 805.
31. Discover Property & Casualty Insurance et al v. Blue Bell Creameries USA, Inc. et al, 622 F.3d. Supp. 349 (W.D. Tex. 2022).