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Parsing Boeing Decision In Light Of ESG, Caremark Trends

By **Helene Banks and Elizabeth Sweeny** (October 25, 2021, 6:10 PM EDT)

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In the last two years, it seems all eyes in the boardroom have been focused on environmental, social and governance issues.

Within this growing ESG portfolio, many boards have focused their attention on environmental and social issues by being more intentional on diversity matters, considering term limits, adding environmental expertise, and requiring various ESG presentations from executives and management.

A series of cases in the Delaware courts concerning the Caremark standard is likely to reorient the attention of boards and refocus directors on core governance matters and how they monitor environmental and social risks.

The recent cases in which plaintiffs are alleging a breach of the board's fiduciary duty of oversight that have been allowed to proceed demonstrate the risk to boards of exposure to protracted legal processes and personal liability for the misdeeds of their companies.

In fact, the two trends — the rise of ESG and the increase in Caremark cases — may be related. While correlation does not prove causation, ESG's focus on stakeholder capitalism may be a contributing factor in opening the door for greater scrutiny of claims under the Caremark standard.

If so, more Caremark cases may be forthcoming.

Boards would be well served to understand these cases and take recommended steps to ensure they do not suffer similar fate.

The most recent Caremark case, September's In re: The Boeing Co. Derivative Litigation decision, arose out of two fatal crashes of the Boeing 737 Max airplane.

In the wake of the crashes, which killed everyone onboard, Boeing's shareholders brought a derivative action against the company's board, claiming directors failed to oversee a mission-critical aspect of their business and thus breached their fiduciary duty to shareholders.

The Delaware Court of Chancery allowed the breach of fiduciary duty claims to proceed, measuring them against the Caremark standard.

When setting the Caremark standard of the 1996 In re: Caremark International Inc. Derivative Litigation decision, the court noted that succeeding under the Caremark theory is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[1]

Yet since 2019, at least five cases have met the standard, strongly suggesting that directors would be well-advised to revisit their own core governance structures to ensure their companies and boards are properly protected.

In Caremark, the Delaware courts set a stringent standard, requiring a plaintiff to prove that either:

- The directors completely 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.

The Caremark court carefully distinguished its ruling from the business judgment rule, where a board decision made in good faith turns out to have been a bad decision in hindsight. Instead, the Caremark court explained that "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."[2] The court concluded that such a test is "quite high."

In Boeing, the court concluded that:

- The directors failed to have adequate safety reporting systems in place; and
- Once the board did learn of potential safety issues following the first crash in October 2018, it disregarded its duty in bad faith.[3]

Indeed, the Boeing court found the board completely failed to implement a reporting system. The board lacked a committee devoted to airplane safety, provided for no regular review of safety risks related to airplanes, and never created a board-level reporting mechanism for safety concerns from management.[4]

Instead, the duty to manage risks fell to the audit committee. However, the audit committee's compliance and risk management charter did not include a review of airplane safety.[5]

Rather, the committee focused on financial risk and nominal compliance with regulatory requirements.[6] The failure by the board to ensure that safety concerns were escalated to them and overreliance on management for safety updates led the court to conclude that the plaintiffs could move forward under the first prong of Caremark.

The plaintiffs also successfully established that the board's failure to act following the first crash amounted to a conscious failure to oversee operations despite their awareness of a safety concern.[7]

After the first crash, the board did not request any information about the safety of the 737 Max and passively accepted management's assertions that the plane was safe, ignoring safety red flags suggesting that it was not.[8]

The court determined that the board was aware or should have been aware that its response to the 737 Max's safety "fell short."[9] After the second crash, the board minutes finally reflected that the board devoted substantial time to address the causes of the two crashes. The board established board-level safety reporting and a dedicated safety committee, essentially admitting to its own shortcomings.[10]

The other Caremark cases illustrate additional ways by which a board may fail in its duties. In the Delaware Supreme Court's 2019 decision in Marchand v. Barnhill, the first Caremark claim to survive a motion to dismiss, the plaintiffs alleged that the board of Blue Bell Creameries USA Inc. completely failed to establish a reporting system regarding the safety of the one product that the company produced: ice cream.

The case was brought after a listeria outbreak caused the deaths of several customers.[11] In Marchand, the Delaware Supreme Court emphasized that nominally complying with U.S. Food and Drug Administration regulations and regular management reporting fails to amount to oversight sufficient to satisfy the board's fiduciary duties.[12]

Rather, Caremark requires that "to satisfy their duty of loyalty, directors must make good faith effort to implement an oversight system and then monitor it."[13]

In the next case, the 2019 In re: Clovis Oncology Inc. Derivative Litigation decision, the plaintiffs claimed the board failed to oversee the clinical trial of its flagship drug Roci and also allowed management to mislead regulators and the market.[14]

The claim was supported by the fact that the board's lack of oversight put the drug's FDA approval at risk.[15] Unlike in Marchand and Boeing, in Clovis, the board had been receiving regular updates about the situation but failed to recognize the inconsistent data used to mislead regulators.

In the January 2020 decision in Inter-marketing Group Inc. USA v. Armstrong, the plaintiff alleged the board of Plains All American Pipeline failed to oversee the integrity of the pipeline resulting in a spill in an environmentally sensitive area.[16]

Finally, in the April 2020 decision in Hughes v. Hu, the Delaware corporation based in China admittedly struggled to maintain internal controls and adequate financial reporting.

The court allowed the claim under Caremark based on the board's failure to establish a system of monitoring and reporting, its apparent deference to management, and the audit committee's failure to review and investigate red flags raised by auditors.[17]

The Caremark cases make clear that any company — well-established or upstart, large or small — can run aground on basic boardroom governance issues. Together with the heightened pressure on companies to incorporate ESG into all aspects of their operations, these issues provide ample caution to directors to rethink their governance processes and practices. Board members must:

- Be sure their procedures not only have the indicia of oversight in place for important matters, but also are demonstrating their attention to safety issues and other critical governance matters by ensuring adherence to industry protocols and regulatory mandates;

- Discuss critical safety and impactful matters at board meetings, seeking reports and information from management on key areas that could expose the company and its stakeholders to risk;

- Deliberate on strategic planning implications of impactful matters; and, importantly,

- Document all actions in charters, agendas, minutes and board decks to be in the best position possible to show the board has satisfied its fiduciary duties.

Even as straightforward as this checklist seems, it is clear that these basic steps can be challenging for even the most sophisticated company, perhaps especially in the face of new areas of concern to a growing group of stakeholders.

As such, at periodic intervals, boards should require internal and external reviews of their board structure, periodic reporting and committee charters to ensure they meet the checklist above and other best practices, including as a result of recent Caremark cases and evolving ESG matters.

Further, boards should reexamine their internal whistleblower mechanisms, such as hotlines, to ensure any concerns reach the board level.

Finally, boards should require from management regular, periodic reports that examine stakeholder issues, including ESG concerns, mission-critical areas of focus and core governance issues.

The run of Caremark cases that have been allowed to proceed in recent years offers a fair and timely warning to directors: Do not forget that ESG matters also include baseline corporate governance matters.

Wise directors will see the current focus on ESG as an excellent opportunity to take a step back and reexamine their foundational board governance structures and processes to better protect their companies, their shareholders and themselves.

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[1] In re Caremark Int'l Deriv. Litig., 698 A.2d 959 at 987 (Del. Ch. 1996).

[2] Id. at 970-971

[3] In re Boeing Deriv. Litig., 2021 WL 4059934, at 68 (Del. Ch. Sept. 7, 2021).

[4] In re Boeing at 5-7.

[5] Id. at 3-4.

[6] Id. at 6. Marchand established that nominal compliance with regulations is insufficient to establish that the board provided oversight on a mission-critical factor of its business. Marchand v. Barnhill, 212 A.3d 805, 823-24 (Del. 2019).

[7] Id. at 33.

[8] Id. at 34.

[9] Id.

[10] Id. at 18, 19.

[11] Marchand at 810.

[12] Id. at 823-24.

[13] Caremark at 970.

[14] In re Clovis Oncology, Inc. Deriv. Litig., 2019 WL 4850188, at 12 (Del. Ch. Oct. 1, 2019).

[15] Id.

[16] Inter-marketing Group USA, Inc., v. Armstrong, 2020 WL 756965 at 3 (Del. Ch. Jan. 31, 2020).

[17] Hughes v. Xioming Hu, 2020 WL 1987029 at 5 (Del. Ch. Apr. 27 2020).