NDI Executive Exchange

NATIONAL DIRECTORS INSTITUTE

Recent DE Decisions Increase Board/Company Exposure for Failure to Manage Risks

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Panelists

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Setting the Stage: Increased Scrutiny of Risk Management

- Prior *Caremark* standard:
  - ***"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 . . . liability"***
- This protective standard is fast eroding:
  - Shift to "inadequate risk disclosure" theories of liability. *See, e.g.*, VW emission standards, Equifax data breach, Wells Fargo account openings, etc. brought as securities class actions rather than solely as derivative actions
  - Important new DE decisions:
    - *Marchand v. Barnhill (Del. 2019)*: ***directors "must make a good faith effort to implement an oversight system and then monitor it"***
    - *Clovis Oncology (Del. Ch. Oct. 1, 2019):* ***directors "[w]ith hands on their ears to muffle the alarms" must face trial for oversight failures"***

Increased Scrutiny of Risk Management

- ***Marchand* Facts:**
  - Blue Bell Creameries suffered deadly listeria outbreak; 3 consumers died. For years regulators had warned management about health safety risks. Management did not share with board these warnings or reports of increasing risk of listeria issues until initial listeria-related limited recall. Even then, Board called no emergency meetings, and left resolution to management. Listeria outbreak then spread, triggering full recall and resulting in 3 deaths and layoffs of one-third of work force. To stay afloat, new financing obtained, but under negative terms.
  - *Held:* Board failed to affirmatively "ask the right questions" to ensure they were aware of the company's key risks and the compliance plan to address those risks
    - No board committee to monitor food safety. No board time devoted to food safety compliance.
    - No proactive identification of mission-critical risks, and mitigation plan.
  - ***Case also remanded to trial court to address director independence issue.*** Allegations regarding relationships as well as economic ties (worked at Blue Bell for decades and owed entire career to CEO) were sufficient to raise a question as to director's interest and thus support a claim of demand futility.

Increased Scrutiny of Risk Management

- ***Marchand* takeaways:**
  - Boards should assume they have an *affirmative duty* to "ask the right questions." Those questions include:
    - What are the critical risks facing our company, considering our industry, our scope of operations, and our mix of products?
    - What key metrics do we need to hear from management on, in order to know these risks are being addressed?
  - Director independence should be continually and carefully scrutinized
    - Independence should be particularly scrutinized when there is an identifiable risk that the validity of a particular decision being taken by the board may be challenged.
    - *Marchand* illustrates that scrutiny should be constant, since it may affect the validity of board *inaction* as well.

Increased Scrutiny of Risk Management

- ***Clovis Oncology facts:***
- Clovis had no products on the market but had one especially promising cancer treatment drug (called "Roci") undergoing a clinical trial; the court called Roci the company's "mission-critical product"
- Despite early success in clinical trials, later trial data revealed problems with the result that Roci was unlikely to gain FDA approval
- A shareholders' derivative suit alleged that Clovis directors had breached their fiduciary duty by failing to oversee the integrity of Roci clinical trials and then allowed management to mislead the regulators and the public about the drug's efficacy
- On motion to dismiss, ***HELD, for the plaintiffs, because the Clovis board "ignored red flags*** that [management] was not adhering to the clinical trial protocols, thereby placing FDA approval of the drug in jeopardy"; and then the Clovis board allowed management to deceive regulators
- Clovis, like Blue Bell in *Marchand*, was a monoline company operating in a highly regulated industry, making it especially important for the board to establish and monitor a viable management oversight system
- In Clovis, unlike *Marchand*, the board did have a committee charged with oversight of FDA compliance and related matters, so lack of a reporting system was not the problem
- ***The problem was that the board failed to monitor the output of the reporting and controls systems that had been established***

Takeaways

- Duty of oversight is alive and well.
- Board must implement a reporting and controls system and monitor its functioning.
- Oversight is especially important for mission-critical product launched into heavily-regulated industry.
- Industry expertise is valuable to the board, but may increase oversight expectations.
- Board should catalogue key risks and make sure management reporting system produces actionable board-level information about each one.
- Board should document the existence and functioning of the reporting and control systems.

DOJ Sends a Warning: Make Sure Compliance Programs are Implemented Effectively

April 2019 Memo: Evaluation of Corporate Compliance Programs

When evaluating corporate compliance, prosecutors will consider whether those responsible for compliance have been empowered through sufficient authority, resources and staff, and autonomy (*e.g.*, access to BOD or audit committee)

https://www.justice.gov/criminal-fraud/page/file/937501/download

Evaluation of Corporate Compliance Programs

DOJ April 2019

- What compliance expertise is available to the board?
  - Executive sessions held with compliance leaders?
  - Types of information examined by the board?
  - Types of issues reported to the board?
    - How were they addressed?

DOCUMENT! DOCUMENT! DOCUMENT!

Thank you!

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