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Corporate Law Issues from a National Perspective: An Essay on a Director's Duty of Oversight – Caremark *and* Marchand*

By Gerard V. Mantese

"I Assure You, I am Spiritually and Emotionally and Ethically and Morally in Favor of Whoever Wins."-- Stewie, Director of the Waystar Royco Board of Directors, expressing his philosophy on conflicting positions of directors in the television series, *Succession*.

Succession, the award-winning television series, has riveted millions of viewers as it depicts the intrigue and conflict among the board of directors, the founder, and his extended family members over the fate of the company. Intergenerational disputes among shareholders or LLC members often involve bruising conflict over entity control, fortunes, fame, and long-simmering emotions. This conflict frequently places great stress on the decision making of directors.

In fact, the U.S. is about to witness the greatest transfer of wealth in its history, as older generations are expected to transfer $61 trillion to their heirs between 2018 and 2042.[1] Part of this wealth transfer will undoubtedly include interests in profitable, closely held companies. This transition of power may, in turn, create conflict among the shareholders and differing views at the board level on the direction and management of the company. Will new owners, many of whom will elect themselves as directors and officers, understand their duties as directors and officers? But whether a director is newly elected or has served for decades, the director must understand these duties.

Directors are the architects of corporate policy. They set goals, determine direction of the company, hire and fire officers, and ultimately control the fate of the company. They wield great power in corporations. This article generally explores the specific duty of a director under Delaware caselaw to conduct oversight of the company's executives, the proper workings of the company, and the company's compliance with the law.

Fiduciary Duties of Directors

MCL 450.1541a

The fiduciary duties of directors in Michigan are set forth both in statutes and by caselaw. While interestingly not using the words "fiduciary duties," MCL 450.1541a, in pertinent part, sets forth fiduciary duties of directors and officers as follows:

> (1) A director or officer shall discharge his or her duties as a director or officer including his or her duties as a member of a committee in the following manner:
> (a) In good faith.
> (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances.
> (c) In a manner he or she reasonably believes to be in the best interests of the corporation.[2]

Caselaw

Just last year, the Michigan Supreme Court held that the Legislature "did not abrogate directors' common-law fiduciary duties owed to the shareholders of a corporation" when the Legislature codified directors' duties to the corporation in MCL 450.1541a. *Murphy v Inman*, 509 Mich 132, 157, 983 NW2d 354 (2022). Under the common-law, directors of a corporation have fiduciary duties of good faith, loyalty, transparency, and due care to the shareholders. *See, e.g.*, *Murphy*, 509 Mich at 147 (citing *Thomas v Satfield Co*, 363 Mich 111, 118, 108 NW2d 907 (1961)); *Murphy*, 509 Mich at 148 (citing *Reed v Pitkin*, 231 Mich 621, 204 NW 750 (1925)); and *Lumber Village, Inc v Siegler*, 135 Mich App 685, 695, 355 NW2d 654 (1984).[3]

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Directors also have a duty to manage the corporation so "as to produce to each stockholder the best possible return for his investment." *Thompson v Walker*, 253 Mich 126, 134-35, 234 NW 144 (1931).

Like many other states, Michigan often looks to Delaware for guidance on matters of corporate and LLC law. *See, e.g.*, *Murphy*, 509 Mich at 149, fn 33 ("Delaware is commonly understood to be the leading state on matters of corporate law …"). Therefore, this article examines Delaware law[4] on an interesting and still-developing issue of corporate law dealing with the oversight duties of a director to monitor the operations of a company. This duty of oversight may be considered a component of the duty of due care.

A "*Caremark*" Claim Premised on a Duty of Oversight

In re Caremark Int'l Inc v Derivative Litig, 698 A2d 959 (Del Ch 1996), is a leading case dealing with corporate governance. *Caremark* involved a derivative suit against the directors alleging they breached fiduciary duties by failing to exercise the duty to oversee the actions of executives. Caremark International was indicted for, and pled guilty to, mail fraud arising out of, among other things, improper referral payments made to physicians and others to induce them to distribute drugs that Caremark marketed. Caremark paid fines and reimbursements of more than $250 million.

The plaintiffs in *Caremark* filed a derivative action against the board, alleging that it failed to have in place an information and reporting system that was "in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations," as to the possibly illegal referral relationships with physicians and others who might recommend their medications. *Caremark*, 698 A2d at 970.

The court stated that "such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high." *Id.* at 971. Although the court found that the case against Caremark's board of directors for failure to monitor was weak, it approved the settlement as fair because the board agreed to make modest but systemic changes to its monitoring mechanisms. *Caremark* came to be known as a leading case in this area. Yet, it has never been applied in any reported Michigan appellate decision.

Marchand v Barnhill

More recently, a *Caremark* claim was addressed in *Marchand v Barnhill*, 212 A3d 805 (Del 2019). In *Marchand*, the Delaware Supreme Court permitted litigation to proceed against the directors of an ice cream manufacturer on a theory of failure of oversight. In 2015, a widespread listeria outbreak occurred in which three people died. The outbreak led the company to recall all of its products, shut down production at its plants, and lay off one-third of its workforce. The company's shareholders suffered major losses and the company suffered a liquidity crisis, which required it to accept a dilutive private equity investment.

In assessing the duty of oversight, the Delaware Supreme Court noted that as the company made only a single product, ice cream, it could only thrive if its products were safe to eat. Yet, the complaint alleged that there was no evidence of any system of information flow to the board about either the hygiene of its plants or correction of the issues that arose with listeria and that the board did not have a protocol or board meetings established specifically devoted to food safety compliance. The court held that bad faith is established under *Caremark*, when "the directors completely fail to implement … or having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Marchand*, 212 A3d at 821. The court concluded, "under *Caremark*, a director may be held liable if she acts in bad faith in the sense that she made no good faith effort to ensure that the company had in place any 'system of controls.'" *Id.* at 822. There, the court stated: "As to the *Caremark* claim, we hold that the complaint alleges particularized facts that support a reasonable inference that the Blue Bell board failed to implement any system to monitor Blue Bell's food safety performance or compliance." *Id*. at 809.

Under *Marchand*, then, boards are not required to know everything, nor are they required to prevent all misfortune from befalling the company. But they *are* required to exercise reasonable diligence and good faith in putting in place a system whereby they receive a reasonable amount of information about company operations, including wheth-

No Michigan state court appellate decision has yet applied *Caremark* or *Marchand*. Whether Michigan will follow this line of cases to enunciate a duty of oversight on the part of directors remains to be seen.

er the company is complying with the law and observing reasonable safety protocols.

Michigan Law

No Michigan state court appellate decision has yet applied *Caremark* or *Marchand*. Whether Michigan will follow this line of cases to enunciate a duty of oversight on the part of directors remains to be seen. One can argue, however, that such a duty is already implicit in the fiduciary duty of due care and good faith, which directors already have.

In any event, to the extent that a company is engaged in illegal conduct, Michigan's oppression statutes may also offer an avenue for redress. For example, MCL 450.1489 provides a shareholder with a cause of action against directors, or those in control of the corporation, for conduct that is "illegal, fraudulent, or willfully unfair and oppressive to the corporation or to the shareholder." *See also* MCL 450.4515, for analogous language applicable to LLCs.[5]

Conclusion

The contours of the duty of oversight, as stated by *Caremark* and *Marchand*, are not yet crystallized. While Michigan has yet to specifically deal with these concepts, they may be understood as related to directors' duties of due care and good faith. Although the law in Michigan regarding the duty to monitor or investigate is not yet clarified, directors would be well advised to act as if it is.[6] With this in mind, I leave you with this haiku.

Ignorance is bliss.
But for directors, not this.
Can be dangerous.

NOTES

1. *The Wall Street Journal*, July 2, 2021.

2. The balance of this statute sets forth safe harbors for directors and officers in exercising their fiduciary duties.

3. *See also* Gerard V. Mantese, *The Fiduciary Duty – Et Tu, Brute?* Mich B J 52 (Sept 2020). (https://mantese-law.com/wp-content/uploads/2021/03/The-Fiduciary-Duty-Gerard-Mantese-MI-Bar-Journal-September-2020.pdf).

4. It should be noted that New York also recognizes a duty of oversight. *See, e.g., Kravitz v Tavlarios*, No 20-2579-cv (2nd Cir Nov 18, 2021).

5. A leading case on MCL 450.1489 is *Franks v Franks*, No 13-809-CBB (St Joseph County 2023), with G. Mantese and I. Williamson as co-lead counsel for plaintiffs. After an 11-day Zoom bench trial, the circuit court found that "the management team and Board acted in bad faith to withhold payment of dividends." The court ordered four of the individual defendants and the company to pay damages to plaintiffs in the form of a dividend totaling $2.1 million, including interest. The court also ordered the appointment of an independent outside director to the board. Prior to trial, the case generated *Franks v Franks*, 330 Mich App 69, 944 NW2d 388 (2019), where the Court of Appeals held that oppression requires a showing of intentional conduct and that the board of directors may not avail themselves of the business judgment rule defense where oppression is shown.

6. Note that such claims might be covered by directors' and officers' insurance. *See* MCL 450.1561, discussing when a corporation may indemnify directors and officers.

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