

“Mission Critical” Board Oversight

Boeing decision suggests importance of board oversight over critical risks and operations in *Caremark* claims

On September 7, 2021, a Delaware court largely denied The Boeing Company’s (“Boeing”) motion to dismiss a stockholder derivative suit against Boeing directors in connection with two crashes of Boeing’s 737 MAX airplane in October 2018 and March 2019. In *In re The Boeing Company Derivative Litigation*, No. 2019-0907-MTZ (Del. Ch. Sept. 7, 2021), the plaintiffs alleged, among other things, that Boeing’s board of directors had breached its fiduciary duty of oversight under the standards established in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) and *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019) by failing to establish an adequate reporting system for airplane safety and “turning a blind eye to a red flag representing airplane safety problems”. Though noting that *Caremark* claims are “possibly the most difficult theory in corporate law upon which a plaintiff might hope to win a judgment,” Vice Chancellor Zurn of the Delaware Court of Chancery (the “Court”), denied the defendants’ motion to dismiss on the basis that the plaintiffs had adequately pled facts to support the claim that the directors had breached their duty of oversight.

BACKGROUND

In October 2018 and March 2019, two separate Boeing 737 MAX airplanes crashed, resulting in a tragic loss of life and significant financial and reputational losses for Boeing. Investigations later revealed a number of critical flaws in the 737 MAX’s design that contributed to the crashes, including a single sensor that was known to be highly vulnerable to false readings and failure. Investigations also revealed that issues with the 737 MAX’s new software was insufficiently disclosed to regulators and inadequately explained to pilots.

The case before the Court was a stockholder derivative suit in which plaintiffs asserted, among other things, that Boeing’s board of directors breached their fiduciary duties based on the standards set forth in *Caremark* by failing to implement and monitor an adequate airplane safety oversight system. Defendants moved to dismiss for failure to adequately plead the claim.

To survive defendants’ motion to dismiss, the Court observed that plaintiffs must allege particularized facts showing one of the two necessary conditions for director oversight liability articulated in *Caremark*, either that:

- (1) “directors utterly failed to implement any reporting or information systems or controls” or
- (2) “having implemented such a system or controls, [the directors] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”

The Court also emphasized that the *Caremark* standard requires “a showing of bad faith [as] a necessary condition” to a director’s breach of fiduciary duty and thus to survive a motion to dismiss the plaintiffs must

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plead facts supporting a finding of scienter, and that the “director[s] acted inconsistent[ly] with [their] fiduciary duties,’ but also, ‘most importantly, that the director[s] knew [they] were so acting.’” The Court found that the *Boeing* plaintiffs adequately pled such facts.

Importantly, the Court noted that the critical nature of airplane safety triggered more rigorous director oversight than might have otherwise been required for a company without consumer-facing products that could cause “material suffering, even short of death, among customers, or to the public at large.” The Court noted that airplane safety “was essential and mission critical to Boeing’s business” and found that it was comparable to food safety in *Marchand* where the Delaware Supreme Court concluded that the board’s oversight function “must be more rigorously exercised” over “mission critical aspects of a company’s business such as the safety of its products that are widely distributed and used by consumers.” As in *Marchand*, the Court found that: (i) no Boeing board committee had been charged with direct responsibility to monitor airplane safety; (ii) the board did not formally address or monitor airplane safety, or regularly discuss airplane safety or quality control issues until after the second crash; (iii) the board had no process or protocols in place requiring Boeing’s management to regularly apprise it of airplane safety issues; and (iv) the board left compliance with critical safety mandates to management’s discretion rather than implementing and overseeing a more structured compliance system.

The Court also found that the plaintiffs adequately pled facts to support a finding that the board had breached their fiduciary duty with scienter, stating that “the board knew of evidence of corporate misconduct – the proverbial red flag – yet acted in bad faith by consciously disregarding its duty to address that misconduct.” The Court highlighted a number of examples cited by the plaintiffs, including that the board did not ask management for any information about the 2018 crash after it occurred, and when management finally did report to the board over a week later, the board “passively accepted” without question management’s assertion that the 737 MAX was safe. The Court stated that the board subsequently misinformed the public about its safety monitoring process, with the lead director of the board telling the press that the board met within 24-hours of the 2018 crash and determined, after conducting a safety investigation, that the 737 MAX did not need to be grounded. The Court concluded that by passively accepting management’s view that the 737 MAX was safe, the board treated the crash as “an ‘anomaly,’ a public relations problem, and a litigation risk, rather than investigating the safety of the aircraft and the adequacy of the certification process.”

OUR VIEW

Boeing reiterates that directors should be actively engaged in overseeing every aspect of a company’s business that is core – or “mission critical” – to the company; for consumer-facing products that could cause “material suffering, even short of death, among customers, or to the public at large,” this oversight requirement is much stricter and should include the implementation and rigorous monitoring of a safety oversight system. Furthermore, *Boeing* (i) suggests that instead of relying solely on company management, boards of such companies must establish safety reporting systems and other protocols that are not only activated when a critical risk emerges, but should also provide continuous oversight on key safety challenges and operations (e.g., establishing a board committee to oversee a particular risk or operation) and (ii) demonstrates the importance of preparing detailed and complete board meeting agendas, minutes and materials in connection with risk-related matters to expressly document the board’s active engagement on, and oversight over, risk management systems.

We welcome the opportunity to discuss any questions you might have regarding this case.

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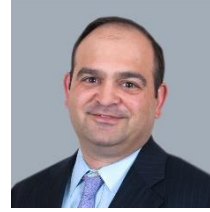
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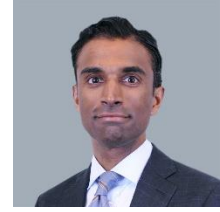
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