CORPORATE LITIGATION:

DIRECTOR OVERSIGHT DUTY CLAIMS

JOSEPH M. MCLAUGHLIN AND SHANNON K. MCGOVERN*

SIMPSON THACHER & BARTLETT LLP

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The Delaware Supreme Court's decision last year in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), reversing the dismissal of a so-called *Caremark* claim challenging a board of directors' performance of its duty to oversee company operations, attracted significant commentary because courts traditionally characterized the *Caremark* claim as possibly the most difficult in corporation law to plead and prove. Directors and their advisers scrutinized *Marchand* to assess whether it signaled a change in how Delaware courts will evaluate *Caremark* claims, or whether it only reinforced *Caremark* in the context of stark factual allegations. While *Marchand* made clear that failure of oversight claims are no "chimera," it left open important questions, including defining the "mission critical" compliance risks that a board must oversee and monitor. A year later, a meaningful number of Delaware Court of Chancery decisions have interpreted *Marchand*, with mixed results for directors. As derivative plaintiffs continue to seek to expand what constitutes mission critical corporate risk, these decisions provide practical guidance on how courts will: (i) identify the key compliance risks a company's business presents, and (ii) evaluate whether a particular company has implemented reasonable board-level monitoring and reporting procedures.

Background

The *Caremark* claim has modest beginnings. In a decision approving a settlement of stockholder derivative actions alleging that director failures to monitor employee violations of law exposed Caremark International to fines and damages, then-Chancellor Allen opined that directors have a duty to attempt in good faith to ensure that "information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance." *In re Caremark International Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996). As developed in subsequent case law, the standard for pleading a *Caremark* claim is well-known. *Caremark* claims can take two forms: directors breach their duty of oversight when they (i) utterly fail to implement any reporting or information system or controls, or (ii) "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 A.3d at 821. The standard is designed to protect directors acting in good faith to monitor the company's operations for legal compliance risk: a plaintiff cannot prevail on a *Caremark* claim unless it can show that directors acted in bad faith, i.e., disloyally. Courts have therefore repeatedly called the claim possibly the most difficult in corporation law to plead and prove.

Joseph M. McLaughlin *is a Partner and* **Shannon K. McGovern** *is an Associate at Simpson Thacher & Bartlett LLP.*

The "utterly failed" part of the *Caremark* standard looks not at the adequacy of the internal controls of the company; only whether any reporting or information system or controls existed at all. For the "conscious failure to monitor" part of the standard, a stockholder plaintiff has two avenues. First, it can allege that the directors knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies. Second, a plaintiff can plead that the directors had clear notice of serious irregularities or illegality and deliberately ignored them. The usual way to allege such notice is to allege facts demonstrating that management alerted the board to evidence of illegality—the proverbial "red flag."

Like most *Caremark* decisions, *Marchand* addressed a motion to dismiss a derivative complaint under Chancery Court Rule 23.1 for failure to make pre-suit demand on the board to bring the claim and failure to plead demand futility. An established way to allege demand futility is to plead particularized facts showing that a majority of the board that would consider a demand faces a substantial likelihood of liability on the claim, e.g., a *Caremark* claim. A stockholder of Blue Bell Creameries brought a *Caremark* claim against the board after a listeria outbreak caused the death of three consumers, prompted recall of all its products, shut down production at all of its plants, and led to the lay-off of over a third of its workforce. Pre-filing, the shareholder obtained corporate books and records, including board minutes and presentation materials which enabled the plaintiff to allege with considerable specificity that over a period of several years regulators had found numerous compliance failures including multiple positive listeria tests. Despite management's awareness of growing compliance failures and the presence of listeria, neither topic was mentioned in any board meeting minutes. The Court of Chancery dismissed the complaint, because the stockholder did not challenge "the existence of monitoring and reporting controls, but the effectiveness of monitoring and reporting controls."

The Delaware Supreme Court unanimously reversed. Although emphasizing that such claims are "difficult to plead and ultimately prove out," the court held that *Caremark* imposes a "bottom-line requirement" that directors must at least "make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting," and that the complaint supported "an inference that no system of board-level compliance monitoring and reporting existed." The court noted that in cases dismissing oversight claims "plaintiffs usually lose because they must concede the existence of board-level systems of monitoring and oversight such as a relevant committee, a regular protocol requiring board-level reports about the relevant risks, or the board's use of third-party monitors, auditors, or consultants." What distinguished *Marchand* were allegations that before the listeria outbreak overwhelmed the company: (i) it had no board committee focused on food safety; (ii) no regular processes or protocols required management to update the board on food safety issues; (iii) there was no regular schedule for the board to consider key safety food risks; (iv) in the lead-up to the listeria outbreak, during a period in which the court found there were red and yellow food safety flags being raised with management, the board minutes made no mention of such concerns (at a time the board received favorable information about food safety); and (v) board minutes did not indicate any regular discussion of food safety. The court acknowledged that the board received presentations from management about general operations, but ruled that *Caremark* requires more. In order to avoid liability there must be "a reasonable system of monitoring and reporting about the corporation's central compliance risks," and in the case of a food company product safety plainly was "essential and mission critical," or stated differently, "the obviously most central consumer safety and legal compliance issue facing the company."

Post-'Marchand' Caselaw

Marchand's introduction of the concept of "mission critical" compliance risk may be its most significant clarification of *Caremark*'s analytical framework. A survey of recent decisions is useful to identify the shared characteristics of rulings dismissing or sustaining *Caremark* claims. Pleading a *Caremark* claim remains a difficult feat. *Rojas v. Ellison*, 2019 WL 3408812 (Del. Ch. July 29, 2019), reconfirmed the difficulty of alleging failure-of-oversight claims when a board-level reporting system is in place. The *Rojas* plaintiff asserted *Caremark* claims regarding J.C. Penney's alleged non-compliance with improved price comparison advertising

policies and practices which the company promised to implement as part of a $50 million California consumer class action settlement relating to sales of private branded and exclusive branded products. According to plaintiff, J.C. Penney's board failed to ensure that the company abided by the terms of the class settlement, leading to further private and regulatory civil litigation over its pricing practices (beyond the private branded context) beginning three months after court approval of the class settlement. The plaintiff, however, failed to allege facts sufficient to support claims under either *Caremark* standard, as (1) the complaint conceded that the board's audit committee oversaw legal and regulatory compliance and received updates on the class action litigation, including its settlement (so that plaintiff could not allege that the board "utterly failed" to have a system in place), and (2) plaintiff had not alleged that the board consciously failed to monitor the company's pricing compliance through these mechanisms. With respect to the second prong, the court reasoned that the existence and amount of the consumer class action settlement was not a "red flag" indicating non-compliance with the new policies beyond the private branded context, so that plaintiff's allegations about the settlement failed to suggest that the directors knew or should have known that J.C. Penney was engaged in ongoing violations of law.

Reinforcing that operational failures and the failure to connect reasonably similar dots, standing alone, will not sustain a claim, the court in *In re MetLife Inc. Derivative Litigation*, 2020 WL 4746635 (Del. Ch. Aug. 17, 2020), dismissed *Caremark* claims against MetLife's board based on problems reported by MetLife in 2017 regarding the payment of group annuity benefits. MetLife determined that its efforts to contact individuals who might be eligible for retirement benefits under a product known as a group annuity contract were inadequate, leading the company to reverse a release of reserves associated with a subset of group annuitants who did not respond to the Company's outreach, resulting in a $510 million charge. Plaintiff's theory was that the directors breached their oversight duties by knowingly failing (i) to introduce into MetLife's pension risk transfer business remedial measures prescribed in a 2012 regulatory settlement for MetLife's life insurance business, a different business line, and (ii) to establish and monitor a reasonable system and controls to ensure the identification of unresponsive and missing group annuitants.

As to the first *Caremark* standard, the court determined that "[i]t is clear from the Complaint that MetLife had an extensive network of internal controls," so the "failure to implement" a monitoring system argument failed. Regarding the "conscious failure to monitor" standard, the court ruled that the Complaint failed to allege any facts indicating that the board was presented with and ignored "red flags" indicating illegal conduct. The court acknowledged that life insurance and pension risk annuities are "analogous" lines of core business within MetLife. It also agreed that an allegation that a prudent person would conclude that enhanced and updated contact procedures in one line of business would be useful in another is plausible.

"But the failure to recognize that use of the enhanced and updated contact procedures in one way in one line of business made it wise to use it differently in another, and the failure to modernize other administrative contact procedures, even if those failures imply unwise or imprudent management, does not thereby also imply bad faith." Plaintiffs also placed great weight on MetLife's Codes of Conduct and its committee charters to argue that based on their oversight responsibilities various directors should have known or should have reported to the full Board about the potential extension of the problems identified in the regulatory action to other business lines. "But an allegation that the underlying cause of a corporate trauma falls within the delegated authority of a board committee does not support an inference that the directors on that committee knew of and consciously disregarded the problem."

The court's treatment of a second purported "red flag"—an allegation that one year before MetLife disclosed the annuitant identification problem, MetLife's Chief Auditor presented the audit committee with an internal auditor's report noting control weaknesses in several areas, including contacting annuitants—shows that "failure to undertake immediate remediation of a reported defect, even where immediate action would be wise, is not evidence of bad faith unless it implies a need to act so clear that to ignore it implies a conscious disregard of duty." The audit committee allegedly did not follow up, and there was no indication that the Report was brought to the attention of the board. Around the same time as the internal report, the U.S. Department of Labor opened

an investigation into annuitants reporting that pensions were going unpaid, and MetLife responded to the investigation by creating a "Pilot Program" for its pension risk transfer business, which demonstrated the insufficiency of the existing notification system and proposed new methods to identify annuitants. Rejecting the assertion that these developments were red flags that were obvious to the board, the court responded that the issue was "not whether the [board] could have saved the company from embarrassment, fines and securities litigation had the board been informed of weaknesses at the time of the [internal report], and taken prompt action," but instead whether the directors acted in conscious disregard of their duties. "A failure to undertake immediate remediation of a reported defect, even where immediate action would be wise," the court concluded, "is not evidence of bad faith unless it implies a need to act so clear that to ignore it implies a conscious disregard of duty." Accordingly, the directors did not face a substantial likelihood of liability and plaintiffs' failure to make a demand on the board was fatal to the *Caremark* claims.

Fastening onto the concept of "mission critical corporate risk, several post-*Marchand* decisions applying the pro-plaintiff motion to dismiss standards have sustained *Caremark* claims, most readily in the face of clear illegality at a highly regulated monoline company. In *In re Clovis Oncology, Inc. Derivative Litigation*, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019), the Court of Chancery held that a complaint stated a claim under *Caremark*'s "conscious failure to monitor" standard by alleging with particularity that the board of a biopharmaceutical firm (Clovis) board consciously ignored red flags that "revealed a mission critical failure to comply" with a medically-standard protocol for evaluating an experimental cancer drug's efficacy and associated FDA regulations. Like Blue Bell, Clovis was a "monoline [single product] company operat[ing] in a highly regulated industry." The drug at issue was "intrinsically critical to the company's business operation," and the board was "laser-focused" on its efficacy, which defined its success in the clinical trial. The court observed that as the clinical trial progressed, the board knew that neither investors nor the FDA would accept clinical conclusions unless they were confirmed and reproducible. Despite reports received by the board (including management presentations) indicating that the drug's efficacy was being calculated based on unconfirmed responses, "the board did nothing" and allowed the company to mislead the market regarding the drug's efficacy. While "*Caremark* does not demand omniscience," the court stated, each director must be a "careful observer … whose gaze is fixed on the company's mission critical regulatory issues" and plaintiffs adequately pled that Clovis' directors consciously ignored a series of red flags that the clinical trial was failing.

In *Teamsters Local 443 Health Services & Insurance Plan v. Chou*, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020), the court denied a motion to dismiss *Caremark* claims asserted against the board of AmerisourceBergen Corp. (ABC), a pharmaceutical sourcing and distributing company, determining that plaintiff stockholders alleged a substantial likelihood of liability on claims that the directors in bad faith breached their duty to oversee company operations. An indirect wholly-owned subsidiary of ABC named Oncology Supply Pharmacy Services (pharmacy) was in the business of buying single-dose sterile vials of oncology drugs, placing those drugs into syringes, and selling the syringes for injection into cancer patients. As acquired by pharmacy, these single-dose vials had been intentionally overfilled by the manufacturer to account for human error in filling syringes and to permit the medical provider to discharge a small amount before injection to avoid air bubbles, but still have a full dose. Instead of discarding the overfill, which was not intended for patient use, pharmacy illegally pooled the overfill and used it to fill and sell additional syringes. Discovery of pharmacy's illegal activities led to significant corporate criminal and civil penalties. Stockholders filed derivative claims against ABC's board, alleging that the directors consciously failed to implement and monitor compliance policies and systems and that their failure to exercise their oversight responsibilities led to the penalties. The court agreed that a majority of the board faced a substantial likelihood of liability because the plaintiffs adequately pled that the board consciously ignored red flags rising to the level of bad faith.

Again focusing on the importance of identifying "mission critical compliance risk," the court concluded that "though ABC is a relatively more complex corporation than either Blue Bell Creameries or Clovis, that does not mean the concept of mission critical compliance risk is inapplicable here." As a "manufacturer, distributor, and packager of pharmaceutical drugs," the court noted, ABC operates in a highly regulated industry. Citing *Clovis*,

the court reiterated that "'when a company operates in an environment where externally imposed regulations govern its "mission critical" operations, the board's oversight function must be more rigorously exercised.'" Because regulations governing drug health and safety were at issue, ABC's board needed to actively exercise its oversight duties in order to discharge its duties in good faith. The court held that "[c]alling attention to the hiring of law firms to review alleged illegality, without more, is insufficient to refute well-pled allegations that the Board failed to address mission critical compliance risks."

Focusing on the "conscious failure to monitor" standard, the court ruled that the complaint adequately alleged that the directors ignored several red flags. For example, the complaint alleged that the audit committee ignored a 2007 independent report identifying numerous compliance failures, including ABC's failure to integrate pharmacy and its direct parent entity into ABC's compliance and reporting function, delegating oversight responsibilities to officers and directors of various ABC subsidiaries. Further, the complaint adequately alleged that after the former COO of pharmacy's parent filed a qui tam action in 2010 alleging that the Pre-Filled Syringe Program was an "overfill laundering scheme," ABC's directors, having signed a 10-K disclosing the suit, in bad faith ignored the concerns by failing to take action regarding the operation of the Pre-Filled Syringe Program. It bears emphasis that in *Chou*—as in numerous other post-*Marchand* cases—the court rejected defense arguments that vague and "nearly entirely redacted" board and audit committee minutes will negate plaintiffs' allegations that the board consciously ignored notice it had received of wrongdoing. The court determined that plaintiffs adequately pled that a DOJ subpoena served on ABC constituted another red flag, because although ABC disclosed in a 10-K that it was cooperating with the DOJ, "the plaintiff is entitled to the inference that the Board never discussed the subpoena due to its absence from the Board's minutes." Under "the plaintiff-friendly standard at this pleading stage," the court concluded that "plaintiffs have adequately pled that the Board was aware of the Pre-Filled Syringe Program's contravention of mission critical drug health and safety regulations, and that the board failed to act in response."

Hughes v. Hu, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020), differs from *Marchand and Clovis* because it did not involve a monoline company subject to mission critical regulations yet the court nevertheless held that allegations of several "chronic deficiencies" supported a reasonable inference that the directors failed to provide meaningful oversight of the company's financial statements and system of financial controls, which culminated in restatement of three years' financial statements. The court concluded that the complaint alleged facts supporting "an inference that the company's audit committee met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation." The court rejected the argument that merely having "the trappings of oversight, including an [a]udit [c]ommittee, a Chief Financial Officer, an internal audit department, a code of ethics, and an independent auditor," insulated the directors from exposure where the audit committee's "pattern of behavior indicates that they followed management blindly, even after management had demonstrated an inability to report accurately about related-party transactions." The court also pointed to documents produced by the company in response to a books and records demand showing that the audit committee typically met only once per year and never for more than an hour, despite awareness of serious accounting and financial reporting deficiencies that the company publicly disclosed and resolved to remediate. It also accepted a pleading stage inference of conscious failure to monitor arising from the audit committee's deferring to management on replacing the company's outside auditor and not "engag[ing] in independent oversight of this important role," and the committee acting by written consent on important matters such as approving related party transactions.

Conclusion

Caremark rests on a presumption that directors are afforded broad discretion to create context-and industry-specific approaches to risk management tailored to their companies' businesses and resources. Absent the rarest of cases where a board has "utterly failed" to implement any reporting system, to plead the claim a plaintiff must allege particularized facts demonstrating that the board was alerted to evidence of illegality—the proverbial "red

flag"—yet acted in bad faith by consciously ignoring the problem. The fact-dependent nature of the *Caremark* analysis is evident in the varying post-*Marchand* outcomes.

It is clear that, as *Marchand* signaled, Delaware courts will more readily permit a *Caremark* claim to proceed when the company conducts its "essential and mission critical" operations under obligations imposed by external regulation or law, yet fails to implement compliance systems, or fails to monitor existing compliance systems, and compliance lapses result in regulatory or legal violations with attendant monetary loss. Boards and their advisers should be attentive to the possibility that what qualifies as "mission critical" may evolve or expand as the way business is conducted changes. Data security, privacy, and response to the pandemic may be areas of compliance risk that for many companies are now vital to operations. Last week, Google's parent company announced a derivative settlement which, if approved, will entail a $310 million commitment to diversity, equity and inclusion efforts to resolve derivative claims alleging employment discrimination and data privacy problems which allegedly cost the company hundreds of millions of dollars in exit packages to executives and exposed it to litigation and a loss of federal contracts over alleged workplace violations. In addition, the call by some for a widening conception of corporate purpose through environmental, social (including gender and race discrimination) and governance (ESG) criteria has led many businesses to reconsider the role of business in society. The Business Roundtable's issuance last year of a "Statement on the purpose of a corporation" signed by nearly 200 CEOs who pledged to lead their companies for the benefit of all stakeholders—customers, employees, suppliers, communities and stockholders—may be asserted by *Caremark* claimants as elevating additional matters for these companies to "mission critical" status.

The board should review allocations of risk oversight at least annually, ensuring that critical risks are assigned to a committee with appropriate competency and resources. Notice to the board of wrongdoing or lack of controls will be viewed cumulatively in order to assess potential bad faith. The board therefore should "kick the tires" on the company's public disclosures (e.g., the proxy, Annual Report) about corporate risks. The board should consult with legal advisers and understand any significant changes to disclosures (e.g., supplements to risk factors, updates to the MD&A, and withdrawals or changes to earnings guidance). If oversight of a critical risk has been delegated to a board committee, the committee's charter should reflect that responsibility in language clarifying that the committee's role is oversight of management, and not suggesting that the committee's role is to ensure compliance.

Recent case law also underscores the important role of board and committee minutes and management presentations in assessing corporate consideration of risk. Before bringing suit, careful stockholders will obtain relevant minutes and board presentations through a books and records demand and pore over these materials to try to build a case of inadequate attention or responsiveness to a risk. Several recent decisions pointed to the fact that board minutes provided no indication that the board tried to inform itself of a compliance risk intrinsically critical to operations, or that the available record supported an inference that directors turned a blind eye to red flags regarding a critical compliance matter, permitting a reasonable inference on a motion to dismiss that the board did not make the good faith effort required by *Caremark*. While there is no blueprint for drafting minutes, *Marchand* signals that when directors seek dismissal of a *Caremark* claim, abbreviated minutes that cryptically describe board discussions on critical risks may not be sufficient to show that the board performed its oversight duties in good faith. Minutes should not be meeting transcripts, but *Marchand* suggests that when it comes to board consideration of key risks, minutes should contain sufficient detail to demonstrate that the board received reports about matters of concern and took action to respond as appropriate. Vague references to board deliberations about unspecific "operational matters," as in *Marchand*, may receive little to no judicial consideration.
