Professional Perspective

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Director's Duty of Oversight and Covid-19: Part 1

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Claims designed to hold directors personally liable for failure to oversee company operations—so-called *Caremark* claims—have been routinely dismissed, earning the description "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006). Yet, Delaware courts have increasingly denied motions to dismiss *Caremark* claims, prompting some to question whether the standard for pleading such claims has relaxed, and whether a once-reliable protection for directors has eroded.

The Covid-19 global pandemic brings renewed focus on this question, as it raises unique challenges and presents novel risks that may have serious implications for both the financial health of the company and the physical health of the company's employees. Safely and effectively reopening physical workspaces, adjusting operations to the new economic and public health realities, and planning for the possibility of future virus-driven slow-downs and shutdowns are all issues necessitating board-level scrutiny.

Relatedly, strong reporting systems and internal controls are more important now than ever, and will likely become the subject of intense scrutiny and, potentially, second-guessing with the benefit of hindsight.

This article explores these developments in duty-of-oversight case law through the lens of the unique challenges posed by the Covid-19 pandemic, and, together with a second article, offers practical guidance to directors to help assess their oversight capabilities and obligations to implement and monitor adequate reporting systems and controls. The goal is not just to provide a guide to successfully navigating the risk of a *Caremark* claim, but also to use the duty of oversight as a starting point for directors to think about the novel challenges they face due to Covid-19.

No Material Change or Relaxation of *Caremark* Standard

In its seminal decision, *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Court of Chancery held that directors cannot satisfy their obligation—inherent in the duty of care—to be reasonably informed "without assuring themselves that information reporting systems exist in the company that are reasonably designed to provide the board and senior management with timely, accurate information sufficient to permit informed judgments" on compliance matters.

The *Caremark* court clarified that the test for director liability under this theory was demanding, stating that "only a sustained or systematic failure of the Board to exercise oversight—such as an utter failure to attempt to ensure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." That standard was later refined in *Stone v. Ritter*, where the Delaware Supreme Court added a state-of-mind requirement placing the burden on the plaintiff to prove that the director-defendants "consciously" failed to monitor company operations.

Notwithstanding a few high-profile successes by plaintiffs over the last few years, the *Caremark* standard remains a formidable obstacle for plaintiffs seeking to hold directors personally liable for failure to oversee company operations. Indeed, Delaware courts continue to recognize that *Caremark* claims are difficult to plead and ultimately prove out. *See, e.g.*, *Marchand v. Barnhill*, 212 A.2d 805, 820 (Del. 2019).

This is precisely why it is notable that courts have allowed such claims to proceed in three cases over the past year, leading some to question whether the high bar for imposing liability on directors has been lowered. Yet, these cases involved highly unusual fact patterns, where directors allegedly ignored clear red flags or failed to implement a meaningful system of internal controls, resulting in public safety risks and existential threats to the company.

A close examination of these cases demonstrates that survival of these cases past a motion to dismiss suggests less of a shift in judicial application of the *Caremark* standard, but rather a set of cases where oversight failures were extreme, and well-supported by documentary evidence detailed in the complaints.

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Marchand v. Barnhill

Marchand v. Barnhill, 212 A.2d 805 (Del. 2019), stems from a 2015 listeria outbreak involving Blue Bell Creameries, one of largest ice cream manufacturers in the U.S. The outbreak resulted in three deaths, forcing the company to recall all its products, shut down production at all its plants, and lay off over a third of its workforce. Consequently, Blue Bell suffered a liquidity crisis that forced it to accept an unfavorable private equity investment. Targeting the first *Caremark* prong, the derivative plaintiff alleged that Blue Bell's board had no committee overseeing food safety, no full board-level process to address food safety issues, and no protocol by which the board was expected to be advised of food safety reports and developments.

The Delaware Supreme Court recognized the high bar *Caremark* established, but explained that "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort–i.e., try–to put in place a reasonable board-level system of monitoring and reporting." Because the court found that the complaint supported a reasonable inference that Blue Bell failed to implement any such system, it held that the plaintiff met his onerous pleading burden under the *Caremark* standard.

In re Clovis Oncology, Inc.

In re Clovis Oncology, Inc. Derivative Litigation, No. CV 2017-0222-JRS, 2019 BL 373697 (Del. Ch. Oct. 1, 2019) concerns director oversight of the development of a cancer treatment drug candidate called Rociletinib (Roci). The clinical trial for Roci incorporated RECIST, a well-known and accepted protocol for new drug applications. Targeting the second *Caremark* prong, the derivative plaintiffs alleged that the board ignored red flags that the company was not adhering to the RECIST protocol, in violation of FDA regulations, and allowed the company to deceive regulators and the market regarding the drug's efficacy.

The court opined that the first *Caremark* prong would be difficult to satisfy because the plaintiffs acknowledged that the board implemented an information and reporting system concerning compliance oversight. However, in denying the defendants' motion to dismiss, the court held that the complaint supported a reasonable inference that the board knew management was incorrectly reporting responses but did nothing to address this fundamental departure from RECIST protocol.

Hughes v. Xiaoming Hu

Hughes v. Xiaoming Hu concerns director oversight of the internal controls and accounting processes of Kandi Technologies, Inc., a publicly-traded corporation that struggled persistently with its financial reporting and internal controls. No. CV 2019-0112-JTL, 2020 BL 155470 (Del. Ch. Apr. 27, 2020). As the court observed, the company publicly announced in 2014 the existence of material weaknesses in its financial reporting and oversight system, including a lack of oversight by the board's audit committee. Although the company pledged to remediate these problems, it disclosed in 2017 that its financial statements from the preceding three years needed to be restated.

The court determined that the plaintiff alleged facts sufficient to support an inference that the board's audit committee met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to these irregularities. Accordingly, the court held that the directors "face a substantial likelihood of liability under *Caremark* for breaching their duty of loyalty by failing to act in good faith to maintain a board-level system for monitoring the company's financial reporting" and denied the defendants' motion to dismiss the plaintiff's *Caremark* claim.

In each of these cases, the court examined the traditional *Caremark* standard and determined that the plaintiffs had presented detailed factual allegations giving rise to a reasonable inference that the board either utterly 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.

More recent decisions lend further support to the notion that these cases did not–and should not–usher in a new era of director oversight liability. For example, one day after *Marchand* was decided, the Delaware Court of Chancery issued a decision in *In re GoPro, Inc. Stockholder Derivative Litigation* applying the traditional *Caremark* standard and emphasizing the difficulty in pleading facts that would allow the court to reasonably infer that directors consciously failed to monitor company operations. No. CV 2018-0784-JRS, 2020 BL 157466, at *12.

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Other courts have dismissed *Caremark* claims where the plaintiffs expressly acknowledged the existence of board-level monitoring and oversight systems and failed to establish that the company's directors consciously ignored—or were even aware of—alleged red flags concerning company operations.

For example, in *Kravitz v. Tavlarios*, No. 19 CIV. 8438 (NRB), 2020 BL 254142 (S.D.N.Y. July 8, 2020), a case involving a former executive who allegedly defrauded the company for $300 million, the plaintiff conceded that the board maintained an audit committee and retained an outside firm to audit its financial statements and internal controls, and, as to the second *Caremark* prong, failed to allege any "conscious inaction."

Likewise, earlier this month, the Delaware Court of Chancery issued a decision in *In re MetLife Inc. Derivative Litigation*, No. CV 2019-0452-SG, 2020 BL 310978 (Del. Ch. Aug. 17, 2020), applying the traditional *Caremark* standard and dismissing *Caremark* claims where the plaintiffs failed to "offer specific factual allegations from which [the court could] reasonably infer that the Board was aware of red flags and ignored them in bad faith."

Collectively, these decisions demonstrate that courts have—and will continue to—apply the traditional *Caremark* standard when adjudicating claims alleging that directors have breached their duty of loyalty by failing to adequately oversee company operations.

Practical Implications for Directors During Covid-19

While *Marchand* and its progeny have not meaningfully changed the standard for duty of oversight claims, they reaffirm that directors invite liability if they fail to make a good-faith effort to oversee company operations by implementing and monitoring adequate reporting systems and controls.

The Covid-19 pandemic has rapidly reshaped company risk profiles and subjected directors to heightened scrutiny of their actions. Directors should be mindful about how their roles may be scrutinized in the context of Covid-19 and exercise their oversight in this environment more rigorously to ensure they meet the good-faith effort required by *Caremark*.

As workplaces begin to reopen their doors, companies throughout the world have been faced with juggling business risks as well as health and safety risks posed by reopening. Health and safety systems must be tailored to address Covid-19-specific concerns upon reopening, and boards and senior management must actively monitor the systems once implemented so they are aware of risks or problems requiring their attention.

Such systems must comply with applicable government requirements and guidelines, including those concerning workplace ventilation, health screening, physical distancing, and enhanced cleaning. They must also be able to respond quickly and efficiently to limit any outbreaks among employees or linked to persons visiting company sites.

Enterprising plaintiffs' lawyers will focus on any disparate efforts made by companies in developing or implementing these protocols and will particularly focus on companies that violate regulatory requirements or fall below industry standards. For that reason, such reopening efforts must be compared against complex and evolving patchwork of federal, state, and local Covid-19 regulations, as well as parallel actions taken by industry peers.

As production increases with reopening, companies should be consider risks associated with the company's physical location where employees interact with other employees and customers, as well as risks associated with the safety of the company's products that reach consumers—which, of course, requires strict adherence to all Covid-19 protocols and concomitant monitoring by the board. This is especially critical if the company, like Blue Bell in *Marchand*, is substantially dependent on a single product and its primary compliance issue is ensuring the safety of that product.

Additionally, Covid-19 may continue to cause significant financial and operational disruptions. Many companies will need to take steps to understand and address the company's near-term liquidity needs and current debt structures. To that end, as discussed more fully in the second article, companies may need to enhance their reporting systems to stay abreast of Covid-19-related developments, and to allow the board and management to monitor the pandemic's impact on the company's operations and liquidity.

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