Delaware Courts Examine *Caremark* After *Marchand* and *Clovis*

Contributors

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In 2019, the Delaware Supreme Court issued *Marchand v. Barnhill*,[1] which was soon followed by the Court of Chancery's opinion in *In re Clovis Oncology Derivative Litigation*.[2] Both rulings sustained derivative claims for breach of directors' oversight duties (so-called "*Caremark*" claims) at the motion to dismiss stage, marking the first times Delaware courts allowed such claims to survive the pleadings stage in more than two decades. The Court of Chancery has since issued several additional opinions addressing *Caremark* claims, including several granting motions to dismiss.

Caremark Claims Sustained

Kandi Technologies[3]

In 2014, Kandi Technologies Group publicly announced the existence of material weaknesses in its financial reporting and oversight system, including a lack of oversight by the audit committee and lack of internal controls for related-party transactions. The company pledged to remediate these issues. However, in March 2017, the company disclosed that the prior three years of financial statements needed to be restated, and disclosed that it lacked sufficient expertise relating to GAAP requirements and SEC disclosure regulations and sufficient expertise to ensure the accurate accounting of taxes, as well as the completeness of the disclosure of financial statements. Stockholders initiated federal securities litigation, and the federal district court granted a motion to dismiss.

Stockholder plaintiffs also brought a *Caremark* claim in the Delaware Court of Chancery. On a motion to dismiss, Vice Chancellor J. Travis Laster sustained the *Caremark* claim, stating that

> "the complaint alleges facts that support 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 … . [T]he Company suffered from pervasive problems with its internal controls, which the Company acknowledged in March 2014 and pledged to correct. Yet after making that commitment, the Audit Committee continued to meet only when prompted by the requirements of the federal securities laws. When it did meet, its meetings were short and regularly overlooked important issues."[4]

Thus, the court concluded that the plaintiff adequately pled a claim under *Caremark*'s first prong, *i.e.*, that the board conceivably failed to establish a "reasonable system of monitoring and reporting."[5] Notably, the court observed that "[t]he Company could have produced documents in response to the plaintiff's Section 220 demand that would have rebutted [the] inference" that the audit committee "failed to provide meaningful oversight," and that "[t]he absence of those documents is telling because it is more reasonable to infer that

[1] 911 A.2d 362 (Del. 2006).

[2] 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

[3] *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020).

[4] 2020 WL 1987029, at *14.

[5] 2020 WL 1987029, at *16.

exculpatory documents would be provided than ... that such documents existed and yet were inexplicably withheld."[6]

AmerisourceBergen Corporation[7]

In 2001, AmerisourceBergen Corporation (ABC) acquired Medical Initiatives, Inc. d/b/a Oncology Supply Pharmacy Services (Pharmacy). From 2001 to 2014, Pharmacy's business was to buy single-dose sterile vials of oncology drugs, put those into syringes and sell the syringes for injection into a cancer patient's body (the Pre-Filled Syringe Program). Those vials were intentionally overfilled to account for human error in filling syringes and to permit medical providers to discharge a small amount before administering. Instead of discarding the unused overfill, however, Pharmacy "pooled" the overfill in an unsterile manner in order to fill, and sell, more syringes. A number of syringes contained "floaters" (*i.e.*, particulates visible to the naked eye), and the "clean room" in which syringes were prepared was found to have unsafe levels of contaminants. Pharmacy's parent company, Specialty (an ABC subsidiary), closed the Pre-Filled Syringe Program in 2014. In September 2017, the U.S. Department of Justice launched an investigation into the Pre-Filled Syringe Program. Specialty admitted wrongdoing in connection with its "pooling" practices and other related practices, and in November 2017, ABC reached a civil settlement with the U.S. Attorney's Office for the Eastern District of New York for $625 million.

In October 2019, ABC stockholders filed suit in the Court of Chancery, alleging, among other things, that the majority of ABC's directors and certain of its officers breached their fiduciary duties by failing to implement compliance policies and systems and failing to exercise their oversight responsibilities.[8] In August 2020, the Court of Chancery denied the defendants' motion to dismiss. In its decision, the court focused on the plaintiffs' allegations as they related to *Caremark*'s second prong and reviewed a series of red flags alleged by plaintiffs. In particular, the court held that the director defendants were aware of three "red flags" but failed to take appropriate action. Those red flags were (i) a report prepared by outside counsel that showed that Specialty had "substantial gaps" in its "mission critical compliance mechanisms"; (ii) a *qui tam* suit by Specialty's chief operating officer, which alleged details concerning Pharmacy's problematic use of the overfill; and (iii) a subpoena served by the DOJ on Specialty.[9] According to the court, it could draw a reasonable inference of board knowledge because each of these red flags was either disclosed directly to the director defendants or was referenced in ABC's SEC filings. The court also held that plaintiffs sufficiently alleged a *Caremark* claim against the officer defendants, stating that the director defendants "could not bring their business judgment to bear on a demand to prosecute" claims against the officers because "such litigation would implicate their own wrongdoing."[10]

Caremark Claims Dismissed

GoPro[11]

In early 2016, GoPro had planned to roll out two new products — the Karma drone and the latest iteration of its wearable HERO camera. GoPro provided positive revenue guidance for 2016 based on projected sales for both. Once both products were finally launched, the company faced production ramp-up issues, inventory shortages and ultimately a product recall of the drone. As a result, the board adjusted the company's

[6] 2020 WL 1987029, at *16.

[7] *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou*, C.A. No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020).

[8] 2020 WL 5028065, at *14.

[9] 2020 WL 5028065, at *19-24.

[10] 2020 WL 5028065, at *26.

[11] *In re GoPro, Inc. Stockholder Derivative Litig.*, Consol. C.A. No. 2018-0784-JRS 2020, WL 2036602 (Del. Ch. April 28, 2020).

revenue guidance downward and, even so, missed its updated revenue guidance. As a result, the company's stock price declined 12%. Multiple federal securities class actions were filed and survived motions to dismiss. Stockholders also filed derivative actions in the Court of Chancery, alleging that the board wrongfully allowed management to continue to disclose overly optimistic revenue projections.

While plaintiffs claimed that they did not intend to allege a *Caremark* claim, Vice Chancellor Joseph R. Slights noted that "it is difficult to ignore the allegations in the Complaint that walk and talk like *Caremark*," and thus, addressed the "*Caremark*-like allegations" and found they did not state a claim.[12] First, the court found that the board members had no duty to access the company's inventory software and extrapolate on their own that the company had incurable inventory shortages. "Taking a self-guided tour through an ERP system to check inventory levels for a product that would comprise only 10% of the Company's revenue is not the sort of 'oversight' *Caremark* contemplates."[13] Similarly, the court noted that a few YouTube videos showing the drone's battery defect "cannot be considered 'red flags' that were 'waived' in front of the Board. Even if they *were* red flags, the Board met to discuss 'proposed recall plans' just eleven days after the first video was posted. A *Caremark* claim cannot be squared with an allegation the Board *responded* to red flags."[14]

With respect to revenue guidance, the court found that management was "regularly advising the Board that, notwithstanding production difficulties, GoPro was on track to meet its inventory projections and hit its revenue guidance."[15] The court held that "[c]onsidering the *presumption* of directorial good faith, as well as the Board's statutory right to rely on management's reports, the Karma Production Forecast renders unreasonable any inference that the Board *knew* GoPro was headed for a significant revenue miss."[16] In doing so, the court distinguished between the conclusion in the California securities action that certain defendants knew that the inventory was insufficient. The court noted that it was entitled to consider Section 220 documents that were incorporated by reference into the complaint, which the California plaintiffs did not have access to. Moreover, the claims before the California court all pertained to GoPro officers, but in Delaware "the relevant inquiry is whether Plaintiffs have well plead a majority of the *Demand Board* acted with scienter."[17]

TrueCar[18]

TrueCar's stock price fell over 35% after it announced third quarter losses and lowered its guidance because sales generated by USAA, its most important affinity partner, were down 5% from the prior year as a result of a website redesign. A federal securities action followed on the heels of the announcement and stock drop. The district court in the securities action denied defendants' motion to dismiss, and the parties subsequently settled. Stockholders then brought derivative claims against the TrueCar board, including *Caremark* claims.

The Court of Chancery noted that the plaintiffs attempted to plead a "prong two" *Caremark* claim (*i.e.*, that the board ignored significant red flags). Plaintiffs claimed that the red flags consisted of the fact that a prior USAA website change to the location and prominence of links to TrueCar's website led to substantial loss of traffic from USAA; there were numerous board presentations identifying the USAA relationship as "fragile"; board presentations identified "USAA underperformance" as a top risk; and board presentations projected a declining USAA growth rate.

[12] 2020 WL 2036602, at *11.

[13] 2020 WL 2036602, at *13.

[14] 2020 WL 2036602, at *13.

[15] 2020 WL 2036602, at *2.

[16] 2020 WL 2036602, at *14.

[17] 2020 WL 2036602, at *14, n.170.

[18] *In re TrueCar, Inc. Stockholder Derivative Litig.*, Consol. C.A. No. 2019-0672-AGB, 2020 WL 5816761 (Del. Ch. Sept. 30, 2020).

Chancellor Andre G. Bouchard held that "[t]hese allegations are woefully insufficient to support a reasonable inference that the 'directors were conscious of the fact that they were not doing their jobs, and that they ignored red flags indicating misconduct.'"[19] Specifically, the court held that "vague references to a 'fragile' relationship and 'USAA underperformance' in Board presentations fail to demonstrate with particularity that the directors were made aware of USAA's website redesign, much less that they knew that the redesign would have a material adverse impact on TrueCar's financial performance."[20] Moreover, the fact that the board was made aware of prior website changes "demonstrates that the Company's monitoring systems kept the Board apprised of important developments concerning its relationship with USAA."[21] Thus, the court dismissed the *Caremark* claim.

Esperion Therapeutics[22]

In August 2015, Esperion Therapeutics was in the midst of seeking FDA approval of a new cholesterol drug that was critical to the company's future as a going concern. After Esperion executives attended an End-of-Phase II meeting with the FDA, the company issued a press release summarizing guidance it had received from the FDA. The press release contained "some very good news," including that Esperion would not need to complete a time-consuming "long-term safety study."[23] Shortly thereafter, Esperion's president and CEO made similar statements that were "generally received as positive news."[24] Weeks later, Esperion released another press release, this time summarizing the FDA's meeting minutes. "One analyst noted the FDA minutes were 'worse than consensus expected, and even inexplicably inconsistent with'" statements in the prior press release and conference call.[25] Esperion's stock suffered a near 50% decline following this news. The following year, Esperion received more troubling news from the FDA, causing the stock price to drop by over 40%.[26]

In 2016, stockholders brought a federal securities class action litigation and survived a motion to dismiss. This was followed by a parallel derivative action in the Court of Chancery in which the plaintiff asserted *Caremark* claims, relying on *Caremark*'s second prong. The Court of Chancery granted the defendants' motion to dismiss, noting at the outset that "[u]nlike federal securities actions, however, plaintiffs filing derivative suits in Delaware must adequately plead demand futility to survive dismissal" and "Plaintiff has failed to carry this heightened pleading burden."[27] In rejecting the plaintiff's arguments, the court held that the complaint "failed to plead any facts that would offer a conceivable explanation of *why* any of the Directors, let alone the Outside Directors, would intentionally lie to the market knowing full well the official FDA minutes would contradict their statements in a matter of weeks."[28] The court also rejected the plaintiff's attempt to invoke the "core operations" doctrine, stating that plaintiffs "must plead other particularized facts that support an inference of director knowledge before the core operations doctrine may be invoked to enhance that inference."[29]

[19] 2020 WL 5816761, at *20 (citation omitted).

[20] 2020 WL 5816761, at *20.

[21] 2020 WL 5816761, at *20.

[22] *Owens v. Mayleben*, C.A. No. 12985-VCS, 2020 WL 748023 (Del. Ch. Feb. 13, 2020).

[23] 2020 WL 748023, at *4-5.

[24] 2020 WL 748023, at *5.

[25] 2020 WL 748023, at *5.

[26] 2020 WL 748023, at *5.

[27] 2020 WL 748023, at *1, *6.

[28] 2020 WL 748023, at *8.

[29] 2020 WL 748023, at *8.

Takeaways

- *Marchand* and *Clovis* did not change the approach to reviewing *Caremark* claims but instead involved extremely case- and fact-specific inquiries and findings based on the allegations in the complaints.
- The court will carefully evaluate books and records (or lack thereof) that have been incorporated into the complaint, for whether they support the allegations in the complaint.
- The fact that related federal securities claims have survived a motion to dismiss does not necessarily mean that there is an underlying *Caremark* claim. In *TrueCar*, *GoPro* and *Esperion*, the court dismissed *Caremark* claims even though federal securities claims based on the same facts had survived motions to dismiss.
- After *Marchand*, *Caremark* claims have been on rise, and the increased focus is a good reason for companies and boards to consult with outside counsel to ensure they have adequate controls in place for oversight liability purposes.

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