Client Alert

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Further Developments in Delaware's Duty of Director Oversight

Earlier this month, the Delaware Court of Chancery denied a defendant-board's motion to dismiss, allowing plaintiffs to move forward with a derivative suit claiming that the board failed its duty of oversight.[1] These sorts of claims, known as *Caremark* claims, are difficult to plead and prove.[2] *In re Clovis Oncology, Inc. Derivative Litigation*, however, helps solidify new precedent that when a "company is operating in the midst of 'mission critical' regulatory compliance risk," the *Caremark* pleading standard may not offer as much protection for directors as previously thought.[3] The court's opinion in *Clovis* adds an important caveat to the established sentiment that a *Caremark* claim "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[4]

Clovis, an upstart biopharmaceutical company, was developing a drug to treat lung cancer, which showed early promise and attracted significant investor attention. When the Clovis board later revealed that the drug was not performing well enough to obtain FDA approval, Clovis's stock price immediately dropped 70 percent, erasing more than $1 billion in market capitalization. Clovis's stockholders then brought a suit alleging, among other things, that the board members breached their fiduciary duties by failing to oversee the clinical trials.

Defendants moved to dismiss this claim, asserting that plaintiffs failed to reach the very high *Caremark* standard because they did not plead particularized facts that either "the directors completely fail[ed] to implement any reporting or information system or controls, or … having implemented such a system or controls, consciously fail[ed] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." The court acknowledged that the Clovis board had put in place oversight protocols that *Caremark* duties require. The court sustained plaintiffs' claims, however, based on allegations that the board failed in the second duty—to actually monitor the company—by ignoring "red flags" that Clovis was not adhering to clinical protocols and continuing to use skewed results to deceive both regulators and the stockholders themselves.

The court did not have to look far for precedent: earlier this year, the Delaware Supreme Court sustained plaintiffs' claims in *Marchand v. Barnhill*, stating that the duty to monitor involves engaged board-level oversight on "mission-critical" issues. In *Marchand*, the board of Blue Bell Creameries failed to properly oversee food safety regulation compliance, resulting in several consumer deaths caused by listeria-tainted ice cream. Just as food safety was the "most central safety and legal compliance facing the company" in *Marchand*, clinical trial protocols were intrinsically critical to Clovis. Because the courts saw compliance as a key risk, both boards had to face scrutiny for their actions in cases that may not have moved forward under traditional *Caremark* standards.

[1] *In re Clovis Oncology, Inc. Derivative Litig.*, C.A. No. 2017-02220JRS (Del. Ch. Oct. 1, 2019).
[2] *See generally In re Caremark Int'l Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996); *see also Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) ("A *Caremark* claim is a difficult one to prove.").
[3] *See Clovis*, C.A. No. 2017-02220JRS at 35 (Del. Ch. Oct. 1, 2019) (quoting *Marchand v. Barnhill*, 212 A.3d 805, 824 (Del. 2019)).
[4] *Stone v. Ritter*, 911 A.2d 362, 372 (Del. 2006) (internal quotation marks omitted).

The quick succession of *Marchand* and *Clovis* underscores the importance of a board's oversight function, especially when operating in a highly regulated industry. The court observed that Delaware has been "more inclined to find *Caremark* oversight liability … when the company operates in the midst of obligations imposed upon it by positive law yet fails to implement compliance systems, or fails to monitor existing compliance systems, such that a violation of law, and resulting liability, occurs." Having oversight committees and protocols in place may not be enough to protect board members from liability if the compliance issue is of critical importance to the company—a board should take steps to vigilantly monitor and oversee the company to ensure that it is responding to "red flags."

The combination of *Marchand* and *Clovis* may cause concern that courts will uphold stockholder claims against directors whenever there is a catastrophic event involving a foreseeable risk. This is unlikely, however, to be the case.[5] *Marchand* focused on well-pled allegations of a complete absence of any system of board-level controls over the most significant risk facing that company—food safety. *Clovis* is further distinguishable because the ruling was based on allegations—which may be refuted at trial—that the board had actual knowledge that the company was not complying with an established clinical protocol and associated FDA regulations.[6]

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[5] *In re Massey Energy Co. Derivative & Class Action Litig.*, 2011 Del. Ch. LEXIS 83, at *83 (May 31, 2011) ("The *Caremark* liability standard is a high one, and requires proof that a director acted inconsistent with his fiduciary duties and, most importantly, that the director *knew* he was so acting").
[6] *Cf. La. Mun. Police Emples. Ret. Sys. v. Pyott*, 46 A.3d 313, 323 (Del. Ch. 2012) (finding that a plaintiff stated a claim for breach of the duty of loyalty where directors allegedly "consciously approved a business plan predicated on violating [federal law]"), *rev'd on other grounds*, 74 A.3d 612 (Del. 2013).