

## Three Lessons From Three Years of Post-'Marchand' Caselaw

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Just over three years ago, the Delaware Supreme Court held in *Marchand v. Barnhill* that the failure to maintain an internal monitoring system that could have prevented a deadly listeria outbreak gave rise to an actionable oversight claim against the board of directors under *In re Caremark International Inc. Derivative Litigation*. Although the Delaware Supreme Court has famously stated that *Caremark* claims are "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," *Marchand* seemed to invite deeper inquiry into oversight claims, as the Delaware courts, in four of the ensuing nine opinions addressing *Caremark* claims, denied the defendants' motion to dismiss. This article offers a high-level snapshot of the current state of *Caremark* jurisprudence by highlighting three key takeaways from the 21 published trial court opinions addressing motions to dismiss *Caremark* claims issued post-*Marchand*.

First, *Caremark* claims remain difficult to plead. As mentioned above, four *Caremark* complaints survived motions to dismiss between June 2019 (when *Marchand* was issued) and August 2020: *In re Clovis Oncology Derivative Litigation*, *Inter-Marketing Group USA v. Armstrong*, *Hughes v. Hu*, and *Teamsters Local 443 Health Services & Insurance Plan v. Chou*. But of the 12 *Caremark* opinions that followed that initial flurry, only one—*In re the Boeing Company Derivative Litigation*—sustained an oversight claim. Put differently, *Caremark* claims' rate of success dipped from about 44% in the first 14 months post-*Marchand* to about 8% in the two years that followed. This trend, however, is not necessarily evidence of a doctrinal shift because one (potentially significant) cause of the dip could be an increased focus on policies and procedures surrounding risk post-*Marchand*. Thus, boards should remain closely focused on overseeing business and regulatory risks.

Second, *Caremark* claims premised on failure to oversee a business risk—as opposed to a violation of positive law—will usually fail. For example, the Court of Chancery in *Construction Industry Laborers Pension Fund v. Bingle* dismissed a *Caremark* claim premised on a software company's failure to prevent a cybersecurity breach—a business risk that manifested despite no unlawful conduct by the company—reasoning in part that "historically," only omissions "in connection with the corporation's violation of positive law" have given rise to *Caremark* claims. The Court of Chancery repeated this observation in *Clovis* and *Firemen's Retirement System of St. Louis v. Sorenson*, the latter of which went further in stating that "Delaware courts have not broadened a board's *Caremark* duties to include monitoring risk in the context of business decisions." In fact, all five post-*Marchand* plaintiff victories involved a regulatory infraction of some sort: *Clovis* involved the violation of FDA testing protocols, *Inter-Marketing* involved criminal charges arising from an oil pipeline leak, *Hughes* involved an earnings restatement and related federal securities fraud actions, *Chou* involved criminal charges arising from the sale of contaminated cancer drugs, and *Boeing* involved airplane safety regulations.

The *Bingle* court explained why alleged lawbreaking is often a necessary ingredient of *Caremark* claims: *Caremark* plaintiffs must plead that board misconduct caused the harm in question, and business risks, which can have complex, multivariate causes deriving from agents outside the company (like the Russian hackers in *Bingle* itself), are categorically harder to tie to a failure of the board's oversight. Violations of law, by contrast, must derive from intra-corporate conduct and are thus often easier to connect to the board's oversight obligations. Thus, directors facing *Caremark* liability premised on a business risk or adverse (but legal) outcomes can and should invoke *Bingle's*

causation precept as a defense. Examples of adverse (but legal) outcomes might include a drug failing the FDA approvals process despite following FDA testing protocols (e.g., *In re Geron Corporation Stockholder Derivative Litigation*), violating an industry standard (e.g., *Sorenson*, which addressed cybersecurity industry standards), failing to follow SEC interpretive guidance (e.g., *Bingle*, which addressed SEC guidance on cybersecurity), disregarding warnings issued by government agencies and private companies (also alleged in *Bingle* with respect to cybersecurity), the fact of a regulatory investigation or a mere risk of violating positive law (e.g., *Sorenson* and *Fisher v. Sanborn*), and a settlement for illegal conduct in which the corporation does not admit guilt or fault (e.g., *Rojas v. Ellison*).

Third and relatedly, a number of cases illustrate that *Marchand's* primary doctrinal impact was to clarify that when a *Caremark* claim is premised on a "mission-critical" regulatory risk, it is easier to infer the element of bad faith as a practical matter. Put differently, a failure to monitor regulatory risks that obviously pose an existential threat to the enterprise is more likely to be deemed by a reviewing court, at the motion to dismiss stage, to involve bad faith. In *Marchand*, the Supreme Court held that a board's failure to monitor "a compliance issue intrinsically critical to the company's business operation ... supports an inference" of bad faith and several cases sustaining *Caremark* claims since *Marchand* have followed the same general playbook. For example, in *Clovis*, the Court of Chancery inferred that director-defendants knew about (and thus consciously disregarded) the regulations in question (FDA testing protocols) due to how important those regulations were to the success or failure of the fledgling, monoline company they helmed. Similarly, in *Boeing*, the Court of Chancery inferred scienter from the board's alleged failure to establish a monitoring system for airplane safety under facts deemed "remarkably similar" to those giving rise to the *Marchand* inference of bad faith, which the court deemed "dispositive." Conversely, the Court of Chancery has declined to infer scienter where the risk that manifested was not "mission critical." For example, in *Pettry v. Smith*, the court reasoned that the lack of a mission critical regulatory risk meant that "the court would not draw an inference of bad faith from the breadth and severity of the alleged illegal conduct alone; the plaintiff must plead additional facts that allow an inference the board acted in bad faith."

Pettry's logic—that failure to monitor conspicuous and important risks intuitively supports an inference of bad faith—gives rise to a second structural defense to *Caremark* claims premised on business risks: only violations of positive law (not business risks) are conspicuous enough to support an inference of bad faith. This logic informed the outcome in *Bingle*, where the court declined to infer scienter despite an alleged failure to monitor a mission-critical business risk (cybersecurity for an online service provider). There, the court assessed whether defendants violated positive law in a subsection of the opinion devoted to whether plaintiffs had adequately pleaded bad faith and declined to infer scienter in part because no lawbreaking occurred. But although *Caremark* liability is less likely for business risks than regulatory ones, boards should remain keenly focused on monitoring business risks to discharge their duty of loyalty and avoid oversight issues.

Like many developments in the Delaware courts, *Marchand* underwent (and is still amidst) an exploratory phase during which trial courts are elucidating its contours through the iterative common law process. Corporate managers should continue to monitor both legal developments in this area and the risks *Caremark* counsels them to address while the law continues to evolve.

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