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■ DIRECTOR LIABILITY

In re LendingClub: Responding to Red Flags in the Wake of *Marchand*

A recent Delaware Chancery Court decision demonstrates that Caremark *claims for breach of the board's duty of oversight remain difficult to plead and prove. Nevertheless, the opinion provides guidance regarding the appropriate means of implementing systems of controls and responding to issues that come to the board's attention through those systems.*

By John Mark Zeberkiewicz and Robert B. Greco

Two recent opinions of the Delaware courts—the Delaware Supreme Court's opinion in *Marchand v. Barnhill*[1] and the Delaware Chancery Court's later opinion *In re Clovis Oncology Inc. Derivative Litigation*[2]—have placed an increased focus on the board's duty of oversight under *Caremark*.[3] Although claims under *Caremark* have been described as notoriously difficult to plead and prove,[4] the Court of Chancery recently has observed that such claims are "perhaps, not so chimerical as once thought."[5] Indeed, in *Clovis*, the Delaware Court of Chancery indicated that the duty of oversight under *Caremark* "must be more rigorously exercised," at least with respect to the "mission critical" operations of regulated companies.[6] Against this backdrop, however, the Court of Chancery's opinion in *In re LendingClub Corp. Derivative Litigation* serves to demonstrate that *Caremark* claims remain difficult to plead and prove, particularly where the board takes an active role in monitoring and addressing so-called red flags.[7] The *LendingClub* opinion provides substantial guidance to corporations and practitioners regarding appropriate means of implementing systems of controls and responding to issues that come to the board's attention through those systems.

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Background

LendingClub operates an online platform designed to facilitate third-party loans. It then purchases the loans and re-sells them to investors based on the loan characteristics specified by each investor. In March and April 2016, LendingClub sold $22 million in loans to an institutional investor that did not meet the investor's preferred characteristics. After the board was alerted to the non-conforming loans through whistleblowers, it initiated an internal investigation with the assistance of outside counsel and forensic auditors. The internal investigation uncovered other issues, including that two members of the board, one of whom was chairman and chief executive officer, failed to disclose their personal investments in Cirrix Capital L.P. prior to LendingClub's $10 million investment in Cirrix that initially was proposed by the chairman and CEO. The investigation further revealed that valuation adjustments made by one of LendingClub's wholly-owned subsidiaries, LC Advisors, LLC, were inconsistent with generally accepted accounting principles.

Promptly after uncovering these issues, LendingClub's board self-reported to the US Securities and Exchange Commission (SEC). While the SEC ultimately entered a cease-and-desist order, it also issued a press release praising LendingClub for self-reporting, cooperating and taking remedial actions. Part of the board's remedial efforts included securing the departure of the employees involved (including the CEO and CFO), separating the roles of CEO and Chairman, ratifying the Cirrix transactions, disclosing transactions between LendingClub and Cirrix on its financial statements and making public disclosure regarding the issues prompting the internal investigation and its results. In response to the public disclosures, a group of stockholders filed suit under *Caremark* asserting that LendingClub's board had not made a good faith effort to implement a system of controls or, alternatively, that it consciously failed to monitor LendingClub's operations, thereby disabling itself from being informed of "red flag" issues requiring its attention. The defendants moved to dismiss under Rule 23.1 for failure to plead demand futility.

Analysis

In assessing whether plaintiffs had sustained its pleading-stage burden, the Court evaluated, on a claim-by-claim basis, whether a substantial likelihood of liability impugned the board's impartiality. Plaintiffs' first cause of action alleged that the board breached its fiduciary duties in failing to implement internal controls, leading to the alleged false public disclosures, as well as with respect to the investment in Cirrix and the approval of the non-conforming loans. Plaintiffs' second cause of action alleged that the defendants breached their fiduciary duties by failing to monitor LC Advisors' compliance with federal law and oversee its risk management.

Plaintiffs' first claim invoked the first prong of *Caremark,* namely, that "the directors utterly failed to implement any reporting or information system or controls."[8] The Court noted that imposition of liability for this claim would require a showing that "the directors knew that they were not discharging their fiduciary obligations" and therefore acted in bad faith.[9] In this regard, the Court found plaintiffs' allegations insufficient, noting that they were devoid of the type of pleading required to prevail on the first prong of a *Caremark* claim such as allegations that the Company "lacked an audit committee" or "had an audit committee that met only sporadically and devoted patently inadequate time to its work."[10] The Court observed that the plaintiffs' complaint indicated that LendingClub had an Audit Committee—and that the Audit Committee met on a monthly basis. Moreover, the complaint contained no facts to the effect that there were no internal controls in place sufficient to sustain a finding that the Board would face a substantial risk of liability for failing to implement them, nor were there any facts suggesting a majority of the Board acted in bad faith.

Plaintiffs' second claim—that the directors breached their fiduciary duties by failing to prevent harm stemming from the Cirrix investment—invoked *Caremark*'s second prong. To prevail on this claim, the plaintiffs' were required to demonstrate that the directors, having implemented a system of controls, failed to monitor them, thus disabling themselves from addressing "red flag" issues. In this case, the plaintiffs attempted to argue that members of LendingClub's Risk Committee consciously disregarded their duties by approving the Cirrix investment without asking questions regarding its "propriety" or taking the time to learn whether the senior executives had interests in Cirrix.[11] As to the quality of the Risk Committee's deliberations, the Court noted that there was substantial overlap between the Risk Committee and the Audit Committee, and that the members of the Risk Committee, by virtue of their service on the Audit Committee, where the Cirrix investment was actively discussed, had indeed questioned the "propriety" of the investment.[12] In addition, the Court found there were no facts indicating that the Risk Committee knew or should have known of the senior executives' interests in Cirrix. Rather, those executives failed to disclose their interests, which were not listed on their director questionnaires. Moreover, after learning of the interests, the Audit Committee resolved to have all transactions between LendingClub and Cirrix disclosed as related-party transactions in LendingClub's quarterly financial statements—and it specifically ratified the transactions as related-party transactions. Thus, far from disregarding "red flags," the Audit Committee actually took affirmative steps to address and remediate issues that had come to its attention.

With respect to the claim challenging the non-conforming loans, plaintiffs could not show that the Board "utterly failed" to implement a system of controls regarding the integrity of loans, given that, as alleged in the complaint, LendingClub maintained an information security program and established policies to safeguard borrower and investor information; that the system may have had some deficiencies did not establish an "utter failure" to implement controls. Thus, the non-conforming loan claim, like the claim challenging the Cirrix investment, invoked the second prong of Caremark. The Court, however, found that the complaint itself contained information supporting the opposite of plaintiffs' claims. As the complaint noted, the Board took several remedial actions after the non-conforming loans were discovered, including procuring the resignation of the CEO, and separating the role of Chairman and CEO. The Board also established a sub-committee to investigate the matter, which in turn led to the discovery of the accounting issues at LC Advisors.

As to the claims involving LC Advisors, the plaintiffs again attempted to invoke the first prong of *Caremark*, asserting that the Board had failed to implement any controls by which it could oversee operations at LC Advisors. In rejecting plaintiffs' argument that the Board had utterly failed to implement controls to monitor LC Advisors, the Court noted that the Board had created an Investment Policy Committee specifically to monitor LC Advisors. Because the Board put this oversight mechanism in place, the fact that two of the three members of Investment Policy Committee turned out to be the senior executives who were subsequently involved with the non-conforming loans was inapposite. The Court also acknowledged that, after learning of the relevant facts, the Board abolished the Investment Policy Committee and installed a new governing board to supervise LC Advisors and to make regular reports to the Board.

Takeaways

The Court's opinion in *In re LendingClub* is an important reminder of the various means by which directors may satisfy their duty of oversight. First, the control and reporting systems that prevented plaintiffs from advancing claims premised on their absence or ineffectiveness serve as an example of the types of measures that may suffice under *Caremark*'s first prong. Most notably, the fact that LendingClub had specific committees focused on key areas of risk—and that those committees had met on a regular basis—was a key factor in the defendants' overcoming allegations that the Board had "utterly failed" to implement systems of controls.[13] As both the *LendingClub* and *Marchand* Courts observed:

> In decisions dismissing *Caremark* claims, the 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.[14]

As *LendingClub* further illustrates, director questionnaires (and other measures such as a related person policy) can be used to monitor board and management conflicts of interest. Accordingly, it remains difficult for plaintiffs to adequately plead *Caremark* claims, particularly where the board has shown that it has taken action to address risks and concerns.

Second, *LendingClub* highlights the critical importance of monitoring the systems of controls adopted by the board, ensuring that red flag issues are reported to the board and appropriately responding to any such red flags. The LendingClub Board's efforts in meeting to respond to reports on areas of risk, including its self-reporting, its procurement of executive departures and its governance changes, were all critical in fending off claims that it had failed to adequately oversee the business and respond to "red flag" issues. Far from representing a breach of the duty of oversight, the LendingClub Board's response was consistent with the basic principles that animated the original *Caremark* Court's development of the duty of oversight. In this regard, the *Caremark* Court stated that:

> [f]inancial and organizational disasters . . . raise the question, what is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?[15]

In answering this question, the Court looked to the 1991 revisions to the Sentencing Reform Act of 1984, which contained a "uniform sentencing structure for organizations to be sentenced for violation of federal criminal statutes" and, in the Court's view,

> offer[ed] powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.[16]

This is precisely what the LendingClub Board did. To this end, the *LendingClub* opinion serves as an important reminder that swift and decisive action with respect to red flag issues will provide a powerful defense to claims that the board failed in its duty of oversight.

Notes

1. Marchand v. Barnhill, 212 A.3d 805 (Del. 2019); *see generally* John Mark Zeberkiewicz & Robert B. Greco, "*Marchand v. Barnhill*: Addressing & Monitoring Corporate Risk," 33 *INSIGHTS* 7, 11 (July 2019).
2. In re Clovis Oncology Inc. Deriv. Litig., 2019 WL 4850188 (Del. Ch. Oct. 1, 2019); John Mark Zeberkiewicz & Robert B. Greco, "*In re Clovis*: Considering Caremark Claims after *Marchand*," 33 *Insights* 11, 36 (Nov. 2019).
3. In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).
4. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006) ("[A] claim that directors are subject to personal liability for employee failures is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.") (internal quotations omitted); South v. Baker, 62 A.3d 1, 25 (Del. Ch. 2012) ("*Caremark* claims are difficult to plead and harder to prove."); *Caremark*, 698 A.2d at 967 ("The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.").
5. *In re Oracle Corp. Deriv. Litig.*, 2019 WL 6522297, at *1, n.1 (Del. Ch. Dec. 4, 2019) (*citing* the holding in *Marchand*, where the Delaware Supreme Court reversed the dismissal of a duty of oversight claim, as an example of what was believed to be among the "rarae aves and chimeras" of corporate law).
6. *Clovis*, 2019 WL 4850188, at *13.

7. In re LendingClub Corp. Deriv. Litig., 2019 WL 5678578 (Del. Ch. Oct. 31, 2019).
8. *Id.* at *9 (*quoting Stone*, 911 A.2d at 370).
9. *Id.* (*quoting Stone*, 911 A.2d at 370).
10. *Id.* at *10 (*quoting* Guttman v. Huang, 823 A.2d 492, 507 (Del. Ch. 2003)).
11. *Id.* at *11.
12. *Id.*
13. *See id.* at *9 n.59 (finding the case "readily distinguishable from *Marchand*" because, among other things, in *Marchand* the "Court held that 'the complaint support[ed] an inference that no system of board-level compliance monitoring and reporting existed' at the company," but here, "the Complaint concedes the existence of the Risk Committee and the Audit Committee" and "similarly concedes the former existence of the Investment Policy Committee as the supervisory committee for LC Advisors") (*quoting Marchand*, 212 A.3d at 822).
14. *Id.* (*quoting Marchand*, 212 A.3d at 822).
15. *Caremark*, 698 A.2d at 968–969.
16. *Id.* at 969.

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