What Is Oversight? Del. Courts Continue to Provide Clarification Post-*"Marchand"*

Marchand v. Barnhill seemingly breathed new life into the viability of *Caremark* claims in Delaware.

By Sara Thompson

Delaware Business Court Insider

December 11, 2019

Delaware courts have long described claims against a board of directors of a Delaware corporation for breach of its duty of oversight (*Caremark* claims) as involving the most difficult theories in corporate law upon which a plaintiff can prevail—requiring a plaintiff to demonstrate that the board "utterly failed" to adopt controls and systems for reporting "mission critical" legal and business risks to the board or, having established such a system, failed to effectively monitor it. Nonetheless, in *Marchand v. Barnhill*, (Del. June 18, 2019), the Delaware Supreme Court, reversing the Delaware Court of Chancery's dismissal of *Caremark* claims, found that the board of directors of Blue Bell Creameries USA, a "monoline" company that produced and sold only ice cream, failed to establish systems and controls for reporting on food safety, which the court viewed as a "mission critical" risk for that business. *Marchand* seemingly breathed new life into the viability of *Caremark* claims in Delaware.

Not long thereafter, the Court of Chancery, in *In re Clovis Oncology Derivative Litigation*, (Del. Ch. Oct. 1, 2019), declined to dismiss *Caremark* claims, finding plaintiffs adequately alleged that Clovis Oncology's board failed to act upon certain "red flags" raised during the company's clinical trial for FDA approval of its key developmental-stage drug. These opinions have reinvigorated the discussion surrounding the nature and scope of directors' duty of oversight.

The most recent entry in the *Caremark* line of cases, *In re LendingClub Derivative Litigation*, (Del. Ch. Oct. 31, 2019), provides additional gloss on the continuing discussion. In *LendingClub*, the court dismissed allegations that the board of directors of LendingClub, a company that operates an online platform that facilitates loans, breached its fiduciary duties by failing to implement internal controls to prevent the issuance of false and misleading statements; investing in a company in which Renauld Laplanche, LendingClub's CEO and chairman of the board, and John Mack, a member of the board, were heavily invested; permitting LendingClub to sell nonconforming near-prime loans to an institutional investor; and failing to monitor LendingClub's wholly owned subsidiary, LC Advisors, risk management and compliance with federal laws.

In April 2016, the board's audit committee learned that, between March and April 2016, LendingClub sold to an institutional investor over $22 million in near-prime loans that did not meet the investor's instructions concerning loan characteristics. Promptly thereafter, the board created a subcommittee, which hired independent counsel and a forensic auditor, to investigate the sales. In further response, LendingClub repurchased the loans at par value, resold them at par to another investor, and secured the termination of three senior managers involved.

The subcommittee's investigation uncovered additional problems. The board learned that prior to LendingClub's $10 million investment in Cirrix Capital, neither Laplanche nor Mack had disclosed his personal investments in Cirrix. Promptly thereafter, Laplanche was asked to resign. The investigation also revealed that LC Advisors made certain valuation adjustments that were inconsistent with generally accepted accounting principles. Though

LendingClub had an established supervisory committee to monitor LC Advisors—the investment policy committee—LendingClub, upon discovery of these events, abolished such committee and established a governing board to supervise LC Advisors; in addition, LendingClub took additional remedial actions with respect to the limited partners and funds adversely impacted by the improper adjustments. The board promptly self-reported the misconduct to the SEC.

Rejecting each of the four claims, the court provided useful guidance regarding what constitutes sufficient exercise of the duty of oversight. The court rejected the plaintiffs' first claim that the board utterly failed to implement and maintain adequate internal controls, finding that the board had an audit committee that met monthly. The court similarly rejected the plaintiffs' second claim regarding LendingClub's investments in companies affiliated with its executive officers, finding that the board had a risk committee, membership of which overlapped with the audit committee, and, through their diligence, such committee members adequately evaluated the investment. Moreover, the court found that the plaintiffs provided no facts suggesting that such members knew or should have known about Laplanche's or Mack's investments, which were neither disclosed nor listed on their director questionnaires. The court emphasized that upon discovery, the audit committee resolved that all LendingClub-Cirrix transactions be disclosed as related-party transactions in LendingClub's quarterly financial statements, and the board ratified the investment as such.

Rejecting the plaintiffs' third claim regarding the sale of nonconforming loans, the court noted that at the time of such loans, LendingClub "maintained an effective information security program" that established policies and procedures to safeguard borrower and investor information. The program involved incident response reports and continuous monitoring and review, and, the court found, deficiencies in such program did not equate with an utter failure of oversight. The court again seemingly credited the board for its prompt remedial efforts. Finally, the court rejected the plaintiffs' fourth claim regarding the board's monitoring of risk and compliance at a key subsidiary, finding that the investment policy committee had been created to oversee LC Advisors' operations. The court emphasized that upon learning of the problems at LC Advisors, the board abolished the committee and established a new governing board comprised of a majority of independent members to supervise LC Advisors' exercise of its fiduciary duties. Accordingly, the facts "demonstrate[d] that the board implemented an oversight system and, when the Board first learned that it was not working, created a new one."

Noting that *LendingClub* was "readily distinguishable from *Marchand*," the court emphasized, among other things, the existence and functioning of the risk and audit committee and the investment policy committee, and the subsequent establishment of the governing board. *LendingClub* therefore provides an example of the means through which a board may ensure that systems and controls for reporting on legal and business risks are in place and that remedial efforts are taken in response to "red flags." The *LendingClub* court emphasized that LendingClub had well-functioning committees tasked with monitoring the alleged issues and took proactive steps to address problems as they arose.

Accordingly, while *Marchand* and *Clovis* may have signaled that properly pleaded *Caremark* claims alleging that a board failed to either adopt systems or controls for risk reporting or properly oversee such systems might survive a motion to dismiss, *LendingClub* confirms that, where a company can show that it has board-level systems and controls for monitoring risks and proactively addresses problems as they arise, claims based on a failure of the duty of oversight remain among the most difficult in corporate law to plead and prove.

Sara Thompson *is an associate of Richards, Layton & Finger. She focuses her practice on transactional matters involving Delaware corporations, including mergers and acquisitions, corporate governance and corporate finance.*