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Delaware Update: Confidentiality of Corporate Records, Board of Directors Oversight, Shareholder Derivative Claims

Analyzing Recent Cases and the Impact on Corporate Practice

WEDNESDAY, APRIL 8, 2020

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Delaware Update:

Confidentiality of Corporate Records, Board of Directors Oversight, and Shareholder Derivative Claims

Overview of Recent Cases Decided by Delaware Supreme Court and Delaware Court of Chancery

Salzberg, et al. v. Sciabacucchi, C.A. No. 346,2019 (Mar. 18, 2020)

- In an *en banc* decision, the Delaware Supreme Court reversed a Delaware Court of Chancery decision that had invalidated forum selection provisions in the corporate charters of three different companies.
- The provisions required a stockholder-plaintiff to file any claims under the Securities Act of 1933 in federal district court.
- The Supreme Court's opinion thus presumptively allows corporations to limit the "difficulties presented by multi-forum litigation of Securities Act claims" through federal forum provisions.
- Such provisions have been implemented in response to increasing practice of plaintiffs filing 1933 Act claims in state courts to avoid defendant-friendly provisions in the PSLRA that apply only in federal court.
- Because case involved facial challenge to such provisions, door remains open for as-applied challenges.
- Supreme Court commented, in dicta, that provisions requiring arbitration of internal corporate claims would violate 8 *Del. C.* § 115.

Inspections of Books and Records

Inspections of Corporate Books and Records
8 *Del. C.* § 220

- Statutory requirements under Section 220
  - Form and manner
    - "Under oath"
    - Evidence of stock ownership
    - Power of Attorney
    - Service of Demand
    - Response to Demand
  - Parents and subsidiaries
  - Proper purpose
    - A "purpose reasonably related to such person's interest as a stockholder"
  - Director vs. stockholder

Inspections of Corporate Books and Records
8 *Del. C.* § 220

- Prerequisites beyond the statute
  - Defining "proper purpose"
  - Credible basis requirement
  - Scope of documents for production
  - Burdens of proof
  - Conditions on inspection

Inspection Rights Relating to Delaware Alternative Entities

- Delaware Limited Liability Company Act
  - 6 *Del. C.* § 18-305
- Delaware Revised Uniform Limited Partnership Act
  - 6 *Del. C.* § 17-305
- Delaware Revised Uniform Partnership Act
  - 6 *Del. C.* § 15-403
- Delaware Statutory Trusts Act
  - 12 *Del. C.* § 3819

Lebanon County Empls.' Ret. Fund v. AmerisourceBergen Corp., 2020 WL 132752 (Del. Ch.)
(Laster, V.C.)

- Plaintiff was a stockholder of AmerisourceBergen Corp., a distributor of, *inter alia*, pharmaceutical and health care products.
- The Company was the subject of congressional investigations, multiple subpoenas, and nationwide litigation relating to the Company's distribution of opioids.
- Plaintiff sought books and records to investigate alleged wrongdoing.

Lebanon County Empls.' Ret. Fund v. AmerisourceBergen Corp., 2020 WL 132752 (Del. Ch.)
(Laster, V.C.)

- The Company opposed the inspection on several grounds, including that:
  1. The stockholders had not presented credible evidence of wrongdoing.
  2. The stockholders sought to investigate claims that were time-barred.
  3. Section 102(b)(7) precluded the inspection.
  4. The requested inspection was overly broad.

Lebanon County Empls.' Ret. Fund v. AmerisourceBergen Corp., 2020 WL 132752 (Del. Ch.) (Laster, V.C.)

- The Court granted inspection of certain books and records.
- Existence of several governmental investigations and lawsuits provided a "credible basis" to suspect possible corporate wrongdoing.
- The Court also held that Plaintiffs were not required to state what they intended to do with the requested information.
- The Court further noted that Plaintiffs were not required to present evidence of "actionable wrongdoing" to access the Company's books and records.
- The Court added that neither the Company's exculpatory charter provision, a possible laches defense nor that certain claims may fall within the statute of limitations period barred Plaintiffs' demand.

Lebanon County Empls.' Ret. Fund v. AmerisourceBergen Corp., 2020 WL 132752 (Del. Ch.)
(Laster, V.C.)

- Takeaways:
  - Is a purpose-plus-an-end needed?
  - What effect does a Section 102(b)(7) provision have on an inspection demand?

Lebanon County Empls.' Ret. Fund v. AmerisourceBergen Corp., 2020 WL 132752 (Del. Ch.) (Laster, V.C.)

- Because the production order was not a final judgment giving rise to an appeal as a matter of right, the Company sought to appeal on an interlocutory basis.
- On February 12, 2020, the Court of Chancery certified the interlocutory appeal.
- On March 5, 2020, the Delaware Supreme Court accepted the Company's interlocutory appeal.
- Appeal briefing scheduled to begin later this month.

The *Rales* Test

The *Rales* Test

- When a majority of directors at the time of the challenged conduct have been replaced, the demand futility test articulated in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), applies.
- The *Rales* test considers "whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations."
- The plaintiff satisfies the demand futility pleading requirements under *Rales* if his or her allegations "create a reasonable doubt that ... the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

The *Rales* Test

- First, the court must consider whether any directors were interested.
  - A director is interested if, in this instance, she would face a substantial likelihood of personal liability for the conduct alleged in the complaint.
  - Merely being named as a defendant is not sufficient.

The *Rales* Test

- Second, if any directors were interested, the court considers whether any other directors were not independent of an interested director.
  - Independence turns on whether "the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."

The *Rales* Test

- After tallying the results, if a majority of the board in place when the complaint was filed was disinterested and independent, the stockholder must first make a demand on the board before pursuing litigation on the corporation's behalf.

Caremark and the Duty of Oversight

Developments Regarding Directors' *Caremark* Duty to Monitor Where Comprehensive Laws Govern the Company's Mission Critical Operations

Gardner Davis
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Caremark Duty to Monitor

- Under *Caremark*, a director must make good faith effort to oversee the company's operations.

- Corporate law requires the board to exercise good faith judgment that the company's information and reporting system is adequate to assure that appropriate information will come to the director's attention in a timely manner as a matter of ordinary operations, so that the board may satisfy its oversight responsibility. The approaches the boards take to monitor the company's affairs will vary because of the different risks and circumstances that face each business.

- *In re Caremark Int'l Inc. Derivative Litig.,* 698 A.2d 959 (Del. Ch. 1996)

Caremark Duty to Monitor

- *Caremark* articulates two categories of oversight claims: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Caremark Duty to Monitor

- In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. As

- For a plaintiff to prevail on a *Caremark* claim, the plaintiff must show that a fiduciary acted in bad faith—the state of mind traditionally used to define the mindset of a disloyal director.

Caremark Duty to Monitor

- Historically, claims against directors for breach of the duty to monitor were believed to be among the most difficult legal theories upon which a shareholder plaintiff might hope to win a judgment. Where the shareholder's claim of director liability for corporate loss is predicated upon ignorance of liability creating activities within the organization, only a sustained or systemic failure of the board to exercise oversight was believed sufficient for the suit to proceed to trial.

Marchand v. Barnhill, 212 A.3d 805 (Del. 2019)

- *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), the Supreme Court considered derivative claims against Blue Bell Creameries following a listeria outbreak, which caused three deaths and a costly shut-down of the Company's manufacturing plants.

Marchand v. Barnhill, 212 A.3d 805 (Del. 2019)

- The *Marchand* plaintiff claimed that Blue Bell failed to implement any reporting system for food safety compliance and, therefore, breached its duty of loyalty under *Caremark*.

- The Supreme Court reversed the dismissal of plaintiff's derivative suit, holding that when a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation, then that supports an inference that the board has not made the good faith effort that the first prong of *Caremark* requires.

Marchand v. Barnhill, 212 A.3d 805 (Del. 2019)

- The Supreme Court highlighted plaintiff's allegations that Blue Bell's board conducted no "regular discussion of food safety issues"; there was "no regular process or protocols that required management to keep the board apprised of food safety compliance practices"; the board received and apparently ignored "reports that contained what could be considered red, or at least yellow, flags"; the board was given only "certain favorable information about food safety"; and "no board committee that addressed food safety existed."

Marchand v. Barnhill, 212 A.3d 805 (Del. 2019)

- Based on the allegations, the Supreme Court concluded the plaintiff adequately pled that "no reasonable compliance system and protocols were established as to the obviously most central consumer safety and legal compliance issue facing the company [and] that the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years." Thus, the plaintiff's claims survived the motion to dismiss stage.

In re Clovis Oncology, Inc. Derivative Litigation, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019)

- Clovis Oncology was a start-up biopharmaceutical company focusing on acquiring, developing, and commercializing drugs for cancer treatment. In order to obtain FDA approval, these new drugs, such as the Clovis drug, must prove their efficacy and safety in clinical trials that are conducted under strict standards, known as the clinical trial protocol. If the drug sponsor fails to adhere to the protocol, the FDA will not approve the drug for market.
- In the *Clovis* case, the board received reports indicating Clovis was improperly conducting the trials and failing to adhere to the clinical trial protocol. Notwithstanding these revelations, the Clovis board did not act to correct the situation.

In re Clovis Oncology, Inc. Derivative Litigation, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019)

- In *Clovis*, Vice Chancellor Joseph R. Slights III suggested that Delaware courts are more inclined to find *Caremark* oversight liability at the board level when a company operates in the midst of obligations imposed upon it by positive laws yet fails to implement compliance systems, or fails to monitor existing compliance systems, such that a violation of law and resulting liability occurs.

Steps to Take in Light of Decisions

- In light of *Marchand* and *Clovis*, boards and their counsel are well advised to re-examine the corporate information reporting systems and whether they are reasonably designed to provide the board with timely, accurate information sufficient to allow the board to reach informed judgments concerning the corporation's compliance with laws and business performance.

Steps to Take in Light of Decisions

- Boards and their counsel should specifically examine the company's primary risk areas and the measures in place to oversee and monitor the corporation's risk management.

Steps to Take in Light of Decisions

- Two board-level procedural safeguards noted with approval by the Delaware Supreme Court in *Marchand* are to appoint a committee to regularly monitor these risks and to establish a regular schedule, such as quarterly or bi-annually, for the full board to examine and discuss these risk areas.

Steps to Take in Light of Decisions

- Corporate secretaries should endeavor to provide board agendas and minutes that clearly document the board's risk management and legal compliance oversight efforts in order to defend in the event a shareholder claims a failure to monitor.

Application of *Marchand*

- In addition to *Clovis*, a number of other Court of Chancery decisions have applied *Marchand*.
  - *Rojas v. Ellison*
  - *In re LendingClub*
  - *Inter-Marketing Group USA, Inc. v. Armstrong*
  - *Owens v. Mayleben*

Rojas v. Ellison, 2019 WL 3408812 (Del. Ch. July 29, 2019) (Bouchard, C.)

- Plaintiff, a stockholder of J.C. Penney, Co., filed a complaint alleging the Board had failed to oversee the Company's compliance with California laws governing price-comparison advertising.
- The Court rejected Plaintiff's "faint-hearted" argument that the Board "utterly failed" to establish reporting system under *Caremark*'s first prong
  - Described "utterly" as a "linguistically extreme formulation"
  - Distinguished from *Marchand* – could not be said there was no "good faith effort to try."
- The Court also rejected Plaintiff's primary argument, which focused on *Caremark*'s second prong. This theory, that the Board consciously disregarded "red flags," requires:
  - (1) that the directors knew or should have known that the corporation was violating the law,
  - (2) that the directors acted in bad faith by failing to prevent or remedy those violations, and
  - (3) that such failure resulted in damage to the corporation.

Rojas v. Ellison, 2019 WL 3408812 (Del. Ch. July 29, 2019) (Bouchard, C.) (cont.)

- Plaintiff alleged that, even after entering into a settlement in a class action in California, the Company continued to violate price-comparison laws.
- The Court rejected Plaintiff's claim that the settlement constituted a consciously-disregarded "red flag."
- No particularized facts from which it reasonably could be inferred that the settlement put the directors on notice of any ongoing violations of law.
- Indeed, the settlement had expressly acknowledged that the Company was not then violating any laws, and the Company committed to implement a program to ensure continued compliance.

In re LendingClub Corp. Derivative Litig., 2019 WL 5678578 (Oct. 31, 2019) (McCormick, V.C.)

- Plaintiff was stockholder of LendingClub Corp., an online platform facilitating loans.
- An internal investigation revealed potential issues relating to the sale of loans, related party transactions, and accounting practices.
- LendingClub self-reported to the SEC, which led to an SEC investigation.
- Plaintiffs brought suit under *Caremark*, asserting that the Board failed to: (i) implement appropriate internal controls regarding LendingClub's operations and compliance, and (ii) monitor LendingClub's operations and regulatory compliance.

In re LendingClub Corp. Derivative Litig., 2019 WL 5678578 (Oct. 31, 2019) (McCormick, V.C.) (cont.)

- The Court applied the *Rales* test.
- Regarding the first category of *Caremark*, the Court found that Plaintiffs failed to plead facts concerning LendingClub's alleged failure to implement internal controls that would support a finding that the Board utterly failed to implement such controls.
- Regarding the second category of *Caremark*, the Court found that Plaintiffs failed to demonstrate that the Board consciously failed to monitor LendingClub's operations or otherwise acted in bad faith.
- *Marchand* was "readily distinguishable" -- Unlike in *Marchand*, where there was no system of board-level monitoring, LendingClub had an audit committee, a risk committee, and an independent auditor.
- Accordingly, demand was not excused.

McElrath v. Kalanick, 2020 WL 131371 (Del. Jan. 13, 2020) (Seitz, C.J.)

- Plaintiff, a stockholder of Uber Technologies, Inc., brought a derivative lawsuit regarding acquisition of Ottomotto LLC ("Otto").
- Plaintiff claimed that the directors ignored certain thefts of intellectual property and failed to investigate pre-closing diligence that would have revealed problems with the transaction.
- Defendants moved to dismiss under Rule 23.1.
- The Court of Chancery applied the *Rales* test and held that a majority of the Uber Board could have fairly considered a demand.

McElrath v. Kalanick, 2020 WL 131371 (Del. Jan. 13, 2020) (Seitz, C.J.) (cont.)

- On appeal, Plaintiff argued that 5 of the 11 directors on the Board when the complaint was filed were interested because they faced a substantial likelihood of liability.
  - Interestedness of one director not disputed.
  - As to others, allegations that the directors should have been better informed were insufficient. Due care violations by the Uber directors were exculpated by Uber's charter.
- Plaintiff also argued that 6 of 11 directors were not independent of the allegedly interested directors.
  - At least one of the challenged directors was found to be independent because the appointment of a director by an allegedly interested director insufficient to infer a relationship of a "bias-producing nature."
- Therefore, a majority of the Uber Board was disinterested and independent to consider a demand
- Accordingly, the Court affirmed the Delaware Court of Chancery's decision to dismiss the complaint.

Inter-Marketing Group USA, Inc. v. Armstrong, 2019 WL 417849 (Del. Ch. Jan. 31, 2019) (Montgomery-Reeves, V.C.)

- Plaintiff was a unitholder of Plains All American Pipeline, L.P., a master limited partnership owning thousands of miles of pipelines.
- In 2015, a pipeline ruptured and spilled 3,400 barrels of oil into an environmentally sensitive part of the west coast.
- Revenue fell nearly 40%. Stock price dropped nearly 40%. Total cleanup effort cost $257 million.
- The Court analyzed demand futility under *Rales*.
- First, the Court rejected Plaintiff's argument that the directors were interested because their actions created a substantial likelihood of personal liability.
    - The partnership agreement eliminated common law fiduciary duties
    - No allegations demonstrating breach of contractual standard.
- The Court also rejected Plaintiff's argument that a majority of directors lacked independence.
    - Plaintiff contested the independence of only 7 of the 10 directors.
    - The Court held membership on a committee responsible for challenged decisions does not call into question impartiality.
    - The Court rejected "cognitive bias" argument.
- While the Court dismissed the complaint under Chancery Rule 23.1, it granted leave to amend.

Inter-Marketing Group USA, Inc. v. Armstrong, 2020 WL 756965 (Del. Ch. Jan. 31, 2020) (Montgomery-Reeves, Justice (sitting by designation))

- Exactly one year later, the Court decided a motion to dismiss the amended complaint.
- The amended complaint did not rely on Section 220 documents. Instead, it used trial testimony of CEO and Board Chairman.
- In applying the *Rales* test, the Court looked at whether General Partner faced a substantial likelihood of liability for breaching its contractual duties.
- While recognizing that the case concerned a master limited partnership, the Court (and the parties) analyzed liability through the lens of *Caremark*.
- Citing to *Marchand*, the Court rejected General Partner's claim that existence of an audit committee and the Board's review of reports was sufficient for oversight purposes.
- Nothing in the complaint or documents incorporated by reference showed that the audit committee actually conducted a pipeline integrity review or that the activity-level reports received by the Board addressed pipeline integrity.

Owens v. Mayleben, 2020 WL 748023 (Del. Ch. Feb. 13, 2020) (Slights, V.C.)

- Plaintiff, a stockholder of Esperion Therapeutics, brought derivative litigation claiming that the Company made false and misleading comments regarding an FDA End-of-Phase II Meeting.
- The Company disclosed in a press release that the FDA had advised that the Company's product candidate could follow a "fast track[ed]" regulatory approval process going forward. This process, described by the Company as "clear regulatory path forward," would allow for limited marketing without a lengthy trial.
- The FDA's summary of the meeting differed.
- Plaintiff alleged that the Board knew that the FDA advised the Company on August meeting that a longer regulatory approval process might be necessary.

Owens v. Mayleben, 2020 WL 748023 (Del. Ch. Feb. 13, 2020) (Slights, V.C.) (cont.)

- The Court found that the documents referenced in the complaint did not demonstrate that the Board knew the Company's statements were false or misleading.
- The Court also found that a majority of the Board was independent.

Post-*Marchand*

- **Has The *Caremark* Standard Changed?**
- **What Is A "Heavily Regulated" Industry?**

Cases on the Horizon

Cases on the Horizon for the Delaware Judiciary

- Increased likelihood of broken-deal litigation in the COVID-19 Era
- A number of broken-deal cases have landed in the Court of Chancery in the past year
  - *In re Anthem-Cigna Merger Litigation*, 2017-0114-JTL (Laster, V.C.)
    - Currently in post-trial briefing
  - *Vintage Rodeo Parent, LLC v. Rent-A-Center, Inc.*, C.A. No. 2018-0927-SG (Del. Ch. Mar. 14, 2019) (Glasscock, V.C.)
  - *Genuine Parts Co. v. Essendant Inc.,* C.A. No. 2018-0730-JRS (Del. Ch. Sept. 9, 2019) (Slights, V.C.)
  - *Channel Medsystems, Inc. v. Boston Scientific Corp.*, C.A. No. 2018-0673-AGB (Del. Ch. Dec. 18, 2019) (Bouchard, C.)

Thank You

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