Caremark Update: Delaware Court of Chancery Dismisses Two 'Oversight' Derivative Actions Arising From Government Investigations

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The Delaware Court of Chancery recently issued two opinions — *Richardson v. Clark (MoneyGram)*[1] and *Fisher v. Sanborn* (*LendingClub*)[2] — that dismissed stockholder derivative claims for breach of directors' oversight duties (so-called *Caremark* claims).

Caremark claims comprise a two-part test. The first part asks whether the board "completely failed" to implement board-level reporting or control systems. The second part asks whether, once such a system is in place, the board failed to properly monitor it. In several recent opinions, derivative claims alleging the failure of directors to effectively exercise their oversight duties in connection with government investigations or litigation have survived motions to dismiss.[3] In contrast to those cases, in both *MoneyGram* and *LendingClub*, the Delaware Court of Chancery applied *Caremark*'s long-standing requirements to plead particularized facts showing bad faith and dismissed the claims. In both cases, the Court of Chancery held, despite the companies' alleged past and current regulatory compliance issues and significant governmental litigation, that the plaintiffs failed to plead particularized facts demonstrating that a majority of the board faced a substantial likelihood of liability.

MoneyGram

MoneyGram is a money transfer company that operates in a business environment that the court described as an "attractive vehicle[]" for money laundering and in which implementing effective controls to prevent wrongdoing is difficult. Federal prosecutors alleged in 2012 that MoneyGram violated anti-money laundering laws and aided and abetted wire fraud. MoneyGram entered into a deferred prosecution agreement (DPA) that obliged the company to dedicate $100 million for restitution to injured customers and to take specific remedial actions over the next five years. MoneyGram established a compliance committee and took steps to comply with its obligations under the DPA. When those efforts failed, to avoid prosecution, the company agreed to pay $125 million more in restitution and to extend the DPA through 2021.

The plaintiff in the 2020 case asserted *Caremark* claims against MoneyGram's directors and officers and alleged that demand upon the board was excused because a majority of the directors faced a "substantial likelihood of liability" in the lawsuit. The court noted that the facts pleaded showed that the board "ignored warnings from its DPA-imposed monitor" about compliance failures, responded to government mandates with "insufficient speed and skill," and "did a poor job applying its discretion to act" in attempting to comply with the DPA.

However, the court held that the plaintiff failed to plead particularized facts showing "bad faith" oversight. The court found that, although the board failed to ensure compliance with the DPA, "bad oversight" — "feckless oversight and lack of vigor … wistless[ness] or [being] overly reliant on management" — is not bad faith oversight, even over a long period of time. Thus, a "failed attempt" to comply with a DPA, or an "unsuccessful program" that results in additional financial restitution and extended remedial obligations,

[1] 2020 WL 7861335 (Del. Ch. Dec. 31, 2020).

[2] 2021 WL 1197577 (Del. Ch. Mar. 30, 2021).

[3] *See, e.g., Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *In re Clovis Oncology Derivative Litigation*, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

does not alone support a *Caremark* claim. To hold otherwise and penalize unsuccessful attempts to comply with regulators would create "a perverse incentive," the court determined.

LendingClub

LendingClub operates an online lending marketplace that connects borrowers with investors. In 2016, the Federal Trade Commission (FTC) sent LendingClub a civil investigative demand regarding potential deceptive and unfair trade practices with consumers. The FTC filed suit against the company two years later. Based on the pending FTC complaint, the plaintiff in the 2021 case filed a derivative action alleging that the board (i) utterly failed to implement a board-level monitoring system, (ii) consciously disregarded its duty to oversee compliance with consumer protection laws, and (iii) knowingly made false and misleading statements.

The Court of Chancery dismissed each argument. First, the court found that the complaint conceded that the board had established a functioning Risk Committee, which received updates on consumer complaints and was aware of the FTC investigation, receiving detailed reports about it and routinely discussing them. The court compared the facts at issue with those in the recent *Marchand* case before the Delaware Supreme Court, where the court found that the board of an ice cream company had failed to implement a system to monitor food safety. By contrast, the facts alleged against the LendingClub board could not state a claim that the board "utterly failed," *i.e.*, "made no good faith effort to 'try,'" to monitor compliance with consumer protection laws. Thus, the facts alleged did "not come close to the allegations" in *Marchand*.

Second, the Court of Chancery concluded that the plaintiff failed to adequately plead the requisite "red flag" that was ignored in order to state a claim based on failure of oversight. The court stated that "[t]he issuance of a subpoena or the launch of a regulatory investigation does not 'necessarily demonstrate that a corporation's directors knew or should have known that the corporation was violating the law.'" The court explained that had there been "'strong factual allegations of board knowledge of ongoing legal violations in the wake of federal government enforcement proceedings,'" then the presence of an investigation "would take on more significance." However, the court found "no particularized factual allegations indicating that the FTC warned LendingClub it was violating the law" and credited an internal communication noting that the company was "surprised" to receive a complaint from the FTC.

Third, the Court of Chancery held that LendingClub's public disclosures concerning the FTC investigation did not demonstrate bad faith. For the same reasons that the plaintiff failed to plead particularized facts that the directors knew the company was violating the law, there were likewise no facts from which the court could reasonably infer that the "directors deliberately lied to investors about the FTC investigation."

Takeaways

- The exacting standard to plead a *Caremark* claim has not changed, and particularized facts evidencing bad faith require showing that a board either utterly failed to implement a board-level monitoring system or that it was alerted to "red flags" of misconduct and consciously disregarded its duty to address them.
- The decisions in both *MoneyGram* and *LendingClub* reiterated that the mere presence of government investigations — whether ongoing or following actual findings of wrongdoing — is insufficient to sustain a *Caremark* claim.
- *Caremark* claims are rooted in a company's governance protocols: Maintaining a record of directors' engagement in oversight and compliance, especially regarding revenue drivers and operations that carry risks of misconduct, remains a critical tool in defending against *Caremark* claims.
- Directors should maintain regular contact with company compliance officials and counsel to ensure that appropriate governance protocols are in place and functioning effectively.

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Special thanks to **Stephen F. Arcano** and **Peter Luneau**.

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