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COLUMN: BANKING ON CORPORATE

Oversight and hindsight

Recent Delaware Court of Chancery decisions indicate corporate directors should mind their recordkeeping and responses to avoid liability

IT'S A YEAR for hindsight, it now being 2020. It's not just the new year that makes one think of hindsight. I recall, though it may just have been an old joke that I repurposed, being asked by friends what superpower I would like to have if we were to team up and responding that I'd like the power of hindsight. When asked how that could possibly help, my predictable response was, "Now that I think about it, it probably won't."

Still another reminder of hindsight is the question of corporate directors' responsibilities (and liabilities), which often raise questions that are doubtlessly complex and only in retrospect seem apparent.

Directors are, of course, not expected or generally well positioned to monitor the day-to-day business operations for which they're ultimately responsible. Rather, directors have a responsibility for oversight. Recent cases out of Delaware have renewed focus on the meaning and requirements of directors' duty of care in oversight. Cases touching on this issue are often described as *Caremark* claims, based on the Delaware Court of Chancery's seminal decision I*n re Caremark International Inc.*

This decision has been often described as imposing a high bar to director liability for oversight issues, requiring either profound failure to implement suitable systems and controls to facilitate oversight or that, having implemented systems, they were simply unused or issues identified by the systems were ignored.

Put differently, having referred to hindsight and oversight, in cases involving failure of foresight, the standard often adopted was one that required serious offence to one's sense of smell.

Nevertheless, a couple of recent Delaware *Caremark* cases have survived motions to dismiss. *Marchand v. Barnhill* related to a listeria outbreak at an ice cream manufacturing facility that resulted in a product recall, a production shutdown, layoffs and, tragically, three deaths. Although the Delaware Supreme Court acknowledged that the company had certain legally required food safety requirements in place, its nominal compliance with those requirements and lack of a meaningful monitoring system for the company's core risk area was highly problematic.

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Shortly afterward, the Delaware Court of Chancery permitted another *Caremark* claim to survive a motion to dismiss. In *In re Clovis Oncology, Inc.*, a biopharmaceutical firm implemented an industry-standard protocol for assessing drug efficacy, but it failed to apply that protocol in its reports to the regulators and the investing public. Although the firm had in place a board-level compliance system, the court concluded that the directors had ignored a series of red flags.

These two cases bear some similarities in that the defendants operated in highly regulated industries (where legal compliance is "mission critical") and failed to properly manage risks in their core products.

The two cases cited should not be interpreted as a sea change. Recently, in *In re LendingClub Corp.*, a series of *Caremark* claims brought against the board were dismissed. The litigation related to a series of material internal control problems at a lending institution (lending being another highly regulated industry). Despite the number and severity of the issues, which resulted in self-reporting to the SEC and material internal remediation steps, the Delaware Court of Chancery concluded that suitable internal controls had been implemented and monitored. Similarly, in *Rojas v. Ellison*, the court dismissed *Caremark* claims brought against the directors of J.C. Penney Company, Inc. in circumstances in which the board had a reporting system and properly considered and addressed a potential red flag issue.

From these cases concerning oversight, which evoke pangs of hindsight, there are bound to be some insights. The board's recordkeeping and response, for example, clearly matter. Detailed meeting minutes helped support the board's conduct in *LendingClub*, compared to the meeting minutes in *Marchand* that contained no references to food safety reports. Similarly, prompt self-reporting and remediation, as well as other indicia of good faith, are emphasized in decisions supporting the board.

With apparently increasing dynamism in commercial markets and the profound impacts of risks, cases where board decisions are second-guessed might be expected to increase, even in Canada. Looking ahead, one might predict a future comment that "in hindsight, we should have seen these cases coming in Canada, because there were a lot of red flags." CL

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