Del. Dispatch: Director Caremark Claims Need Extreme Facts

By **Gail Weinstein, Philip Richter and Steven Epstein** (August 12, 2024)



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This article is part of a monthly column that delves into the most significant corporate law cases emerging from Delaware and offers practice points arising from recent court decisions. In this installment, we examine the Delaware Court of Chancery's recent decision in Bricklayers Pension Fund of Western Pennsylvania v. Brinkley.

In Bricklayers Pension Fund of Western Pennsylvania v. Brinkley, the Delaware Court of Chancery, at the pleading stage of litigation, dismissed so-called Caremark claims against the directors of Centene Corp., whose primary business was administering Medicaid plans for various states. On July 12, the court held that it was not reasonably conceivable — the standard for dismissal of claims at the pleading stage — that the directors had, in bad faith, failed to oversee the company's compliance with Medicaid laws and regulations.

Key Points

The court found that Centene's board did not breach its Caremark duties, although it deferred to management to deal with the company's serious, long-standing compliance problems.

In certain previous Caremark cases — such as 2022's City of Detroit Police & Fire Retirement System v. Hamrock (NiSource Inc.), 2019's In re: LendingClub Corp., and 2020's Richardson v. Clark (MoneyGram International Inc.) — the court has stressed that Caremark requires board-level oversight of compliance risks, and that reliance on management alone to deal with critical compliance risks and problems is insufficient.

Brinkley, however, indicates that the extent to which a board's reliance on management may be sufficient for the fulfillment of Caremark duties depends on the context.

Here, the court found it reasonable to infer, from the facts the plaintiff alleged, that Centene's board knew what steps management was taking to address the problems. The court also found that the overall context was not so "extreme" that the board was unreasonable in accepting management's assurances that the problems "were being handled."

The court did not draw negative inferences from silence in board and committee meeting minutes as to whether there had been a discussion of compliance issues.

In prior Caremark decisions — such as 2023's Ontario Provincial Council of Carpenters' Pension Trust v. Walton (Walmart Inc.) — as well as decisions in other contexts, the Court of Chancery has sometimes inferred, from minutes that did not specifically mention discussion of an issue, that there had been no such discussions.

In this case, however, the Court of Chancery concluded that, notwithstanding silence in the minutes as to the discussion of compliance issues, if the court accepted — as the plaintiff urged — that the alleged facts supported an inference that management likely had reported compliance problems to the board, then the court also would infer that management likely reported the steps being taken in response to the compliance problems — even though the topic was not mentioned in board minutes.

The decision reaffirms that, generally, directors will not face Caremark liability unless the factual context is extreme.

In this case, Centene had a compliance reporting system in place, and the system appeared to be functioning at least to some extent. Also, we would note, while the regulatory noncompliance was ongoing over many years and resulted in significant financial losses, and reputational damage, to Centene, there was not — as has been present in most Caremark cases where the court has found potential liability — loss of life or direct threat to human health.

The court stated that the plaintiff "ha[d] not painted the extreme picture present" in cases where it has found potential Caremark liability.

The court indicated a high bar for a finding of the required element of bad faith for Caremark liability.

The court found that, even if the plaintiff's alleged facts supported reasonable inferences that the board had known about, and failed to respond to, Centene's compliance problems, no facts were alleged that supported an inference that the board failed to respond in bad faith.

The board accepted management's statements that the compliance risks and issues "were being handled" — it "did not make a conscious decision to violate the law," the court stated.

The court stressed the need to resist hindsight bias in ruling on Caremark claims.

The court emphasized that the fact that illegal behavior occurred at a company does not mean that the company's internal controls must have been deficient, nor that the board must have known as much. "[A] bad outcome, without more, does not equate to bad faith," the court wrote.

Background

Centene, a healthcare company that administers Medicaid plans for states, had 2021 revenue of $126 billion and earnings from operations of almost $1.8 billion.

Centene had faced numerous regulatory compliance issues over many years. Among these was an illegal scheme, of which the board was unaware for years, that had been devised by four of Centene's officers to increase their incentive pay through false billings for Medicaid reimbursements.

Under the scheme, in 2017, the officers each received additional incentive compensation ranging from $890,000 to more than $3.9 million. When the board ultimately became aware of the scheme, Centene agreed to settlements with 12 states for a total of almost $750 million, was discussing settlements with another nine states, and set aside a $1.2 billion

reserve for settlements relating to the scheme.

Other regulatory issues Centene faced included governmental investigations, subpoenas and litigation as part of a general public backlash against so-called spread pricing by Medicaid management companies — which was not illegal, but was disfavored as it was nontransparent — as well as governmental concerns about pharmacy benefit management pricing, which led to a particular focus on Centene's PBM operations.

The plaintiff, after conducting a books and records investigation under Section 220 of the Delaware General Corporation Law, brought suit, claiming that the board had breached its Caremark duties by not adequately overseeing the risks associated with the officers' unlawful scheme, and that the officers engaged in the scheme had been unjustly enriched.

The court (1) dismissed the Caremark claims against the directors, finding that they had not acted in bad faith; and (2) dismissed the unjust enrichment claims against the officers, as demand on the board to bring the claims was not excused because, given the dismissal of claims against the board, it was capable of impartially considering whether to bring the claims against the officers.

Discussion

Caremark claims require a reasonable inference of bad faith.

Oversight duties arise from the duty of good faith, which is a subsidiary element of the duty of loyalty. Accordingly, to plead a viable claim for breach of the duty of oversight, a plaintiff must allege facts sufficient to support a reasonable inference that the fiduciary acted in bad faith.

Under Caremark, bad faith can be established when fiduciaries: (1) utterly fail to implement any reporting or information system or controls (a so-called information claim); or (2) having implemented such a system or controls, consciously fail to monitor or oversee its operations, which disables them from being informed of risks or problems requiring their attention (a so-called red-flags claim).

The court rejected the plaintiff's claim that Centene effectively had no reporting system controls in place, and that the board knew as much.

The plaintiff asserted that, given all of the noncompliance problems over many years, Centene's internal reporting system and controls were not effective, and that the board knew this and "turned a blind eye" to the problems with its systems.

The plaintiff argued, (1) that it could be reasonably inferred from management's quarterly updates to the board's compliance committee that the committee was aware of Centene's compliance deficiencies; and (2) that it could be reasonably inferred from the committee's reports to the board at each of the board's quarterly meetings that the committee had reported the compliance deficiencies to the full board.

The court stated that, if these inferences were accepted, it would be inferable also that the committee had, in addition, informed the board at those times of the actions management was taking to address the deficiencies. "And so even accepting Plaintiff's requested inference[s], … [t]his falls far short of a showing that the directors 'turned a blind eye' to problems with its reporting systems or knew that Centene effectively had no controls in place," the court wrote.

The court rejected the plaintiff's assertion that the board and its committees acted in bad faith by not discussing Centene's Medicaid compliance problems.

The plaintiff argued that the absence of such discussions could be inferred from the fact that board and committee minutes did not mention any such discussions. The court acknowledged that, in certain other Caremark cases, it has inferred that a board turned a blind eye to regulatory compliance based on the absence in meeting minutes of references to regulatory compliance discussions.

In those cases, however, the court emphasized here, the absence of references in the minutes was only one of many factors the court found supported an inference that a board had not overseen regulatory compliance risks. The court stated that, even assuming it is reasonable to infer neither the board nor its committees discussed Medicaid compliance for more than a year, "this alone is not enough for the Court to conclude a board of directors acted in bad faith."

Centene had an information system in place with respect to Medicaid compliance.

The court noted that while Centene had three committees — the compliance committee, audit committee, and government and regulatory affairs committee — responsible for overseeing Medicaid compliance, the record showed that two of the committees "did real work and reported to the full Board."

It also found that management was required to report quarterly to the compliance committee on the company's annual health plan compliance assessment; management conducted an annual internal audit, which covered Medicaid compliance, and reported to the board on a quarterly basis; and the full board regularly received enterprise risk management reports, which identified key risks, with many of those presentations specifically discussing risks pertaining to the company's Medicaid pharmacy benefit management operations.

The court rejected the plaintiff's claim that the board had ignored red flags of compliance problems.

The plaintiff claimed that the board ignored the red flags presented by Centene's receiving increasing regulatory scrutiny, state investigations and threatened litigation over compliance issues.

While such developments, without more, typically are not considered by the court to be red flags of imminent corporate trauma such that Caremark liability would be implicated, the plaintiff argued that these developments at Centene were red flags "because they were presented in the context of notice that Centene's compliance assessment and monitoring functions were not functioning."

The court stated that it would "assume that adding knowledge of a known faulty compliance system to knowledge of investigations, a subpoena, and regulatory scrutiny would put the Board on notice that Centene was heading for major corporate trauma" — but it emphasized that, even if so, the plaintiff had not supported "the essential conclusion that the Board ignored that information in bad faith."

The board's reliance on management's assurances reflected a lack of bad faith.

To establish the requisite inference of bad faith, the court stated, a plaintiff would have to plead that directors knew from red flags that a "corporate trauma was coming and nevertheless forged ahead for reasons unrelated to the best interests of the corporation."

Here, by contrast, "the Board accepted management's statements that both the compliance issues and the regulatory risks were being handled. The Board did not make a conscious decision to violate the law," the court wrote.

Practice Points

Caremark Compliance

Under Caremark, boards need not ensure regulatory compliance or the avoidance of corporate harm, but they must in good faith seek to establish a reasonable oversight system and then monitor it reasonably, particularly with respect to the company's key risks.

Regulatory Compliance

Boards should pay particular attention to ensuring the company's compliance with applicable laws and regulations relating to key risks. Violation of positive law clearly heightens the risk of Caremark liability.

At the same time, however, we note that Brinkley follows a number of recent cases — including NiSource, LendingClub and MoneyGram — in which the court has dismissed Caremark claims at the pleading stage notwithstanding that the company had an extensive history of regulatory noncompliance.

Successful defenses in these cases — that supported a lack of bad faith by directors — included that the board was not aware of the regulatory noncompliance; the noncompliance was not sufficiently related to the corporate trauma that occurred; the noncompliance occurred at a different subsidiary of the company; the board had taken steps to remediate the noncompliance; and, now, in Brinkley, that the board reasonably relied on management's assurances that it was handling the issues.

Reliance on Management

To what extent a board itself should be actively involved in dealing with regulatory noncompliance issues, rather than solely relying on management to deal with the issues, will depend on the context. The clearer and more extreme the noncompliance, and the more significant the potential harms therefrom, the more the board should be involved.

For example, in 2021's In re: Boeing Company Derivative Litigation, where the Court of Chancery faulted the board for simply relying on management's assurances that serious airline safety problems were being dealt with, multiple deaths had resulted from two airplanes having fallen from the sky. And, in Marchand v. Barnhill, where the Delaware Supreme Court in 2019 faulted the board for relying on management's assurances, numerous customers eating the company's ice cream had fallen ill following repeated, widespread listeria contaminations at the company's plants.

In Brinkley, by contrast, the board was aware of governmental investigations, subpoenas and litigation relating to alleged regulatory noncompliance — but it was not necessarily clear

to the board that Centene had been noncompliant. In addition, the harm was financial injury to Centene, without any direct impact on human life, health or safety.

In all events, however, as Brinkley highlights, management should not only inform the board of significant compliance risks and problems, but also should specify any potential noncompliance by the company and the steps management is taking to address the issues.

Tips for Boards

On an ongoing basis, boards generally should:

- Identify the key risks facing the company and delegate responsibility for oversight of these risks to specific board committees;

- Establish effective management of key risks as a corporate priority;

- Consider setting a regular schedule for reporting from management on key risks and be proactive in seeking out additional reports when appropriate;

- Seek to ensure that the board is informed about how management is dealing with the company's critical risks and problems;

- Consider whether the steps management is taking to address compliance problems are appropriate; and

- Create a record, such as in board minutes, of the board's risk monitoring and oversight efforts.

Tips for Management

Management generally should:

- Establish regular processes and protocols to keep the board apprised of key regulatory compliance and other practices, risks, reports, and developments;

- Not hide from the board or underplay wrongdoing by the company underlying such developments;

- Inform the board when it learns of red flags — or "yellow flags" — about key risks, including, for example, complaints or reports from regulators or whistleblowers;

- Include the board in the company's whistleblower process;

- Tailor risk management strategies to the company's specific circumstances and risk profile;

- Inform the board of the practices of other companies in its industry or peer companies, with respect to oversight of mission-critical risks; and

- Integrate risk management considerations into the company's corporate strategies and decision making generally.

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