Examining Chancery's Recent Openness To Caremark Claims

By **Gail Weinstein, Philip Richter and Steven Epstein** (May 1, 2023)



Gail Weinstein



Philip Richter



Steven Epstein

In Ontario Provincial Council of Carpenters' Pension Trust Fund v. Walton, the Delaware Court of Chancery on April 12, at the pleading stage of litigation, rejected the dismissal of Caremark claims brought against Walmart Inc.'s officers and directors in connection with the company's role in the national opioid epidemic.

The decision is a narrow one in that the court, at this early stage of the litigation, addressed only the issue of whether the claims were timely made. The decision is important, however, because it's another in a recent trend of rulings indicating increased judicial receptivity to Caremark claims at the early pleading stage of litigation, thus providing plaintiffs with more leverage to negotiate an early settlement of such claims.

In most cases, the court nonetheless has continued ultimately to dismiss Caremark claims at the pleading stage, even in the context of arguably egregious factual situations. Thus, it is still very difficult for a plaintiff to succeed on such claims, primarily due to the requirements that they demonstrate bad faith by the defendants (that their alleged failure to meet their oversight obligations was knowing and intentional) and show demand futility (that the board itself was incapable of making an independent judgment as to whether to bring the derivative claims on behalf of the corporation).

It remains to be seen whether, in further pleading stage proceedings in Walton, the court will dismiss the case on grounds other than timeliness.[1]

We note that the court's commentary in this preliminary decision appears to emphasize the possible inadequacy of Walmart's compliance efforts. In other recent cases, including 2021's In re: Boeing Co. Derivative Litigation and January's In re: McDonald's Corp. Stockholder Derivative Litigation, the Delaware Chancery Court dismissed Caremark claims at the pleading stage on the basis that the board had taken steps — even if arguably weak or untimely steps — to address the company's problem once the board knew about it.

In Walton, however, the court's commentary stresses that while the board took some steps to address the company's compliance problem, it did not provide the infrastructure necessary for the company actually to achieve compliance.

The decision is also notable for establishing, in a ruling of first impression, that the so-called separate accrual approach applies to determine when a so-called Information Systems claim under Caremark accrued. Utilizing this approach increases the likelihood that a Caremark claim will not be time-barred.

The court further indicated that because Caremark claims implicate the duty of loyalty, in many cases equitable tolling would apply and render timely even claims otherwise accrued outside the actionable period.

Finally, the decision is important in underscoring the Chancery Court's recent trend of drawing pleading stage inferences against defendants on the basis that the company's minutes of meetings provide no substantive information about relevant discussions that took place. These rulings underscore the court's trend of increased receptivity to Caremark claims generally.

Background

In 2016 and 2017, numerous lawsuits were brought against Walmart, with claims that in connection with its dispensing opioids from, and distributing opioids to, its pharmacies, the company was not complying with its obligations under the federal Controlled Substances Act.

These litigations were later consolidated into multidistrict litigation — which Walmart settled in November 2022, agreeing to pay $3.1 billion to various state, local and tribal governments.

In March 2020, a ProPublica article detailing Walmart's involvement in the national opioid crisis revealed that in 2011, the company had entered into an undisclosed settlement agreement with its primary regulator, the U.S. Drug Enforcement Administration, and that the company may not have complied with the terms of the DEA settlement, which had expired in 2015.

Following a books and records investigation, the plaintiffs brought suit claiming that Walmart's directors and officers had breached their fiduciary duties of oversight under Caremark by having knowingly caused the company to fail to comply with (1) its legal obligations relating to the dispensing and distribution of opioids, and (2) the terms of the DEA settlement.

The defendants argued that the claims were not timely made — i.e., a laches defense. Vice Chancellor J. Travis Laster held that the claims were not untimely made and rejected dismissal on that basis.

Separate Accrual Approach

The separate accrual approach, according to the Walton ruling, considers "each day that the defendants' ongoing course of conduct continues [as] constitut[ing] a separate violation for purposes of claim accrual" — and thus makes it less likely that claims will be time-barred than would be the case under the alternative so-called discrete act method of determining claim accrual.

The court determined that the actionable period started on May 4, 2020, which was the date the plaintiffs began to exert diligent efforts to obtain books and records relating to the opioid issues. The court measured back three years from the lookback date, on the basis that, for fiduciary breach claims, the statute of limitations is three years.

The court then looked to whether "any of the ongoing conduct that [gave] rise to the claim occurred during the actionable period." If so, the claim would be timely, and if not, the court must determine whether any asserted tolling doctrines apply.

Timeliness of Claims

The court readily concluded that the claims relating to noncompliance with regulatory

obligations were timely, but the analysis relating to the DEA settlement terms was more complex.

The DEA settlement had expired on March 11, 2015, so any violations of that agreement ceased on that date. Thus, there was no overlap between the alleged wrongdoing relating to the DEA settlement and the actionable period, and the claims would be untimely unless tolling applied.

Under the doctrine of equitable tolling, a court, based on notions of fairness and equity, has discretion to extend a deadline when a litigant was prevented from complying with the deadline through no fault of its own.

In this case, the court held that the pleading stage record supported an inference that the DEA settlement was not disclosed by the company and that there had been no information publicly available about it until the March 2020 ProPublica article detailing Walmart's role in the opioid epidemic.

The court found that equitable tolling would apply in these circumstances because the defendants were fiduciaries, and, as stockholders, the plaintiffs had been "entitled to rely on the presumption that their fiduciaries were acting loyally." The court added that it could become clear at a later stage in the case that the plaintiffs had been on inquiry notice as of an earlier date — and, if so, the claims would then be held not to have been timely.

Identifying Central Compliance Risks Implicating Caremark Duties

The court explained that beyond obvious central compliance risks, such as food safety for an ice cream company, ambiguity may arise because risks evolve over time — like cybersecurity, which would not previously have been a central compliance risk, but now might be — and because, with officers and directors having a finite amount of time and attention, they must make judgments about what risks to monitor.

Vice Chancellor Laster stated that the "business judgment rule protects the decisions that officers and directors make about how and where to devote their time and resources." Indeed, he added, "outside of what intuitively registers as a central compliance risk, a plaintiff will have difficulty rebutting the business judgment rule when officers or directors have used a rational process to identify risks and made a good faith decision about the level of monitoring resources to deploy."

At the same time, the court wrote, "it may be difficult for a court not to draw a pleading-stage inference that an issue could qualify as a central compliance risk" if a company has "an enterprise risk management system and has identified [the] risk as central," "has a mission statement or set of policies that call out [the] issue as a priority for the company" or has "touted the importance of and its proficiency in [the] particular area."

Impact of Redacted Minutes

The unredacted portions of the minutes that Walmart produced identified that a relevant topic had been discussed, but indicated nothing about the substance of the discussion.

In each case, the court stated that "without any other substantive text to draw on," the plaintiffs were entitled at the pleading stage to the inference that the discussion favored the plaintiffs' case — for example, where the topic was the status of the company's compliance projects, the court inferred that the discussion reflected that poor progress had been made.

Negative View of the Company's Compliance Efforts

The court acknowledged that Walmart took some steps to meet its compliance obligations, and the decision recites numerous instances of reports to Walmart's board about the status of compliance efforts.

However, the court's narrative emphasizes the limitations and behind-schedule nature of the company's efforts. For example:

Budget

While Walmart established policies and procedures to enable compliance with the DEA settlement, the budget provided was $11 million, although the team responsible for creating and implementing the compliance program had estimated that it would require $40 million.

Database capacity

While Walmart's ability to track and report suspicious prescriptions depended on an expansion of the company's database capacity, Walmart had purchased only a limited amount of database capacity.

Timetable

While a January 2012 report from management to the board — nine months into the term of the DEA settlement — detailed a new plan to comply with the settlement, it projected compliance by January 2017, nearly two years after the settlement would expire.

No Status Report

While a May 2014 management report outlined the status of compliance efforts, including various successes, the report did not mention at all the settlement or the status of efforts to comply with it, although only 10 months remained before its term would expire.

Profit Focus

While, three years into the four-year term of the DEA settlement, Walmart announced a new anti-diversion compliance program, the new system only monitored for theft and loss of controlled substances within the company, without addressing other aspects of its anti-diversion obligations — and the court wrote that "Walmart notably took a step to meet a compliance obligation that helped its bottom line, while not taking steps that didn't."

Also, in response to a pharmacist's inquiry about compliance matters, Walmart's compliance director responded that, as the DEA settlement would be expiring soon, management's time would be better spent on "driving sales and patient awareness," a statement that, in the court's view, "openly prioritized profits ('[d]riving sales') over compliance."

Practice Points

A board and management should establish a rational process for determining what the central compliance risks facing the company are, establish and implement a monitoring and information reporting system to provide oversight of these risks and maintain a record — such as in meeting minutes — of the risk identification, monitoring and oversight efforts.

Most critically, boards — supported by management, the audit committee, the company's outside auditors and legal counsel — should stay focused on, and be apprised of key developments with respect to, issues and risks that are central to the business. A board and management should, in their statements and in substance, make effective management of key compliance risks a corporate priority and integrate risk management considerations into the company's corporate strategies and decision making generally.

Here are detailed practice points on Caremark-related best practices:

Create the required infrastructure.

A board and management should provide the resources and take other actions necessary to enable the company's personnel to implement its compliance plans and policies.

Walton underscores that simply establishing plans and policies to achieve legal compliance and reporting on compliance efforts to the board may not alone satisfy Caremark duties if the budget provided for compliance, and other infrastructure needed for successful implementation of the compliance programs, were obviously insufficient to achieve compliance.

Identify key risks.

Boards and management should keep in mind that the court may look to the company's own disclosure as to what the company's key risks or priorities are when determining whether a given risk qualifies as a critical compliance risk for Caremark purposes.

Any identification of specific issues as critical risks or corporate priorities should be carefully considered. In addition, a company touting its special proficiency in an area may be interpreted as indicating a critical compliance risk implicating Caremark duties.

The court provided as an example that McDonald's slogan that it provides "America's best first job" supports an inference that the company viewed protecting employees as a critical compliance risk to which Caremark oversight duties applied.

Do not prioritize profits at the expense of compliance.

A board and management should avoid statements that may be interpreted as prioritizing profits over legal compliance.

Focus on preparing corporate minutes.

Corporate minutes are the first — and a key — source of evidence that the court will look to when claims are made against directors.

Contrary to advice commonly given in the past, the court's recent trend of decisions indicates that minutes should include substantive information rather than merely identifying what topics were discussed. Minutes stating only that a topic was discussed may provide the basis for an inference by the court, at the pleading stage of litigation, that the substance of the discussion supports the plaintiffs' claims. Minutes that are silent with respect to a topic may provide a basis for the court to infer, at the pleading stage, that the topic was not discussed.

We recommend that not only the substance of a discussion should be reflected in the minutes, but also, the follow-up that the company took and the actions actually taken with respect to the issue should be reflected in new or supplemental minutes as well.

Gail Weinstein is senior counsel, and Philip Richter and Steven Epstein are partners and co-heads of the M&A team, at Fried Frank Harris Shriver & Jacobson LLP.

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[1] On April 26, 2023, the court rejected dismissal of the case on demand futility grounds and found that the plaintiffs pled valid Caremark claims. The case now will be scheduled to proceed to trial.