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Delaware Court Again Finds Bad Faith Adequately Pled Against Directors

Court of Chancery Sustains Bad Faith Claim Alleging That the Board Ignored "Red Flags" Revealing Pharma Company's Published Clinical Trial Data Flouted Governing Industry Protocols

In a decision issued earlier this week in *In re Clovis Oncology, Inc. Derivative Litigation*, No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019), the Delaware Court of Chancery declined to dismiss a stockholder derivative lawsuit against the members of the board of directors and one officer of Clovis, an early stage biopharmaceutical firm focused on cancer treatments. The lawsuit arose out of the failure of a once promising lung cancer treatment Rocilentinib ("Roci"), which Clovis withdrew from FDA consideration in 2016 after disappointing clinical trials. When Clovis announced those adverse clinical results, which were substantially less favorable than previous public reports, and the withdrawal of its FDA application, Clovis' stock price cratered, erasing the vast majority of its market capitalization. The Court of Chancery, applying the "duty to monitor" doctrine that was recently expanded upon by the Delaware Supreme Court in *Marchand* v. *Barnhill*, 212 A.2d 805 (Del. 2019), held that the facts pled, even if arguably in conflict with internal Clovis documents, adequately alleged the requisite bad faith by the members of the Clovis board. As has become common, Plaintiffs did so by using board records obtained in a Section 220 books and records demand to show facts deemed sufficient to support their contention that the Board was aware that the Company had been reporting publicly, including in recent convertible note and equity offering documents, favorable interim clinical trial results for Roci that did not comport with the governing clinical trial protocols. The Court of Chancery found these facts sufficient to allege a conscious failure on the part of the Board members to monitor or oversee Clovis' operations, and thus declined to dismiss a claim that the directors breached their duty of loyalty, potentially exposing directors to non-exculpated (and potentially not indemnifiable) monetary damages.

The *Clovis* decision is the second recent Delaware decision holding a duty of loyalty claim adequately pled against the members of a board after the company experienced a highly publicized corporate trauma tied to compliance shortfalls in technical scientific matters. In both *Clovis* and *Marchand*, the courts found a so-called "duty to monitor" claim adequately pled because the plaintiff had established *either* (i) "the directors completely fail[ed] to implement any reporting or information system or controls," or (ii) "having implemented such a system or controls, consciously fail[ed] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[1] *Marchand* addressed the first prong, finding that that "food safety was essential and mission critical" to that company's business, and thus bad faith was adequately pled following a *listeria* outbreak by alleging "that no board-level system of monitoring or reporting on food safety existed."

Clovis addressed the second prong of Delaware duty to monitor jurisprudence, concluding that, while the Clovis board had established a robust board-level compliance system with respect to clinical trials, the Board consciously failed in its duty to monitor that compliance system because the board members "did understand (or should have understood) that Clovis was reporting [clinical trial] results incorrectly." Noting that "[t]he Board was comprised of experts" in the biopharma field, and echoing the views from *Marchand* that a "board's oversight function must be rigorously exercised" with respect to "'mission critical' operations," the Court of Chancery ruled that plaintiffs alleged adequately bad faith on the part of the Board members. Citing Board presentations that described Roci's clinical trial results in a manner that did not comply with industry protocols that plaintiffs alleged were unequivocal, the court found that plaintiffs "have well-pled that the Board consciously ignored red flags that revealed a mission critical failure to comply with the [clinical trial] protocol and associated FDA regulations."

Although sustaining the claims, the court noted that "Plaintiffs' causation case will be challenging," because the "corporate trauma" here was a stock drop that was the subject of typical federal securities law class action claims that the company settled in 2017. Notably, documents filed in the class action state that the 2017 settlement exhausted "the entirety of Clovis' available director and officer insurance."

This decision, while only on a motion to dismiss, reiterates the risk of fiduciary duty litigation in the wake of a corporate trauma tied to employee misconduct or compliance shortfalls. The *Marchand* and *Clovis* decisions confirm the need for boards of directors to review carefully their board processes and procedures to ensure that adequate compliance systems and protocols are in place, particularly with respect to important or otherwise highly regulated aspects of the business. Equally important, boards should ensure appropriate and documented procedures exist for monitoring and supervising reporting systems and risks that are—or may in hindsight be deemed—"mission critical" to the company.

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[1] *Marchand*, 212 A.3d at 821 (internal quotation omitted); *see* SULLIVAN & CROMWELL LLP, *Delaware Supreme Court Reverses Dismissal of Bad Faith Claim Against Directors* (June 20, 2019).

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