Harvard Law School Forum on Corporate Governance

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# Three Is Not A Trend: Another *Caremark* Claim Survives A Motion To Dismiss, But Does Not Reflect A Change In The Law

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**Editor's note:** Nicholas D. Mozal is counsel and David Seal is an associate at Potter Anderson & Corroon LLP. This post is based on their Potter Anderson memorandum and is part of the Delaware law series; links to other posts in the series are available here. Related research from the Program on Corporate Governance includes Monetary Liability for Breach of the Duty of Care? by Holger Spamann (discussed on the Forum here).

The Delaware Court of Chancery recently denied another motion to dismiss a *Caremark* claim in *Hughes v. Hu*. [1] Under *In re Caremark International Inc. Derivative Litigation*, [2] directors have a duty to exercise oversight and monitor a corporation's operational viability, legal compliance, and financial performance and reporting. *Hughes* is now the second decision, after *In re Clovis Oncology, Inc. Derivative Litigation*, [3] to allow a *Caremark* claim to proceed beyond the pleadings stage since the Delaware Supreme Court reversed the Court of Chancery's dismissal of a *Caremark* claim in *Marchand v. Barnhill*. [4] It would be a mistake, however, to read *Hughes* as an extension of those decisions and only in that context. Indeed, *Hughes* understandably does not even cite *Clovis*. The better reading is that *Hughes*, like the Court of Chancery's 2013 decisions in *Rich v. Yu Kwai Chong* [5] and *In re China Agritech, Inc. Shareholder Derivative Litigation*, [6] reflects the particular accounting and oversight difficulties witnessed in certain Chinese businesses that have gained access to the United States capital markets through a reverse merger. In short, the actions of the audit committee in *Hughes* are in no way analogous to how the vast majority of audit committees and their advisors operate to ensure a board fulfills its *Caremark* duties by exercising appropriate oversight. Nevertheless, *Hughes* reiterates the reasons why it is important for boards and committees to continue adhering to those best practices. In addition, *Hughes* addresses the importance of maintaining proper records and indicates how those records may be useful in responding to stockholder demands for books and records pursuant to 8 *Del. C.* § 220.

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[1] 20 WL 1987029, at *1 (Del. Ch. Apr. 27, 2020).

[2] 8 A.2d 959 (Del. Ch. 1996).

[3] 19 WL 4850188 (Del. Ch. Oct. 1, 2019); discussed on these pages https://corpgov.law.harvard.edu/2019/10/14/observations-on-clovis-oncology-inc-derivative-litigation/

[4] 2 A.3d 805 (Del. 2019); discussed on these pages https://corpgov.law.harvard.edu/2019/08/16/recent-application-of-caremark-oversight-liability/.

[5] A.3d 963 (Del. Ch. 2013).

[6] 13 WL 2181514, at *18 (Del. Ch. May 21, 2013).

## Background Facts

Kandi Technologies Group, Inc. ("Kandi" or the "Company") is a Delaware corporation based in China which sells parts for the manufacture of electric vehicles. In 2007, Kandi completed a reverse merger with a defunct, publicly listed Delaware entity. Kandi retained a supposedly independent, outside auditor, but that auditor had no other clients. In the course of its yearly audits from 2011 through 2016, that auditor identified a number of concerns with respect to certain related party transactions, including those involving the CEO's son and the personal bank accounts of officers and employees. The auditor either rebooked certain transactions and eliminated references to them from its audit trail, failed to report the transactions involving the CEO to the audit committee, or did not investigate the matters further.

In 2014, Kandi filed its 2013 10-K and stated therein that its "disclosure controls and procedures were not effective as of December 31, 2013, due to a material weakness." The Company announced a number of efforts to fix its deficiencies, including its intention to revise its audit committee charter and to subject all related-party transactions to review by its audit committee.

Despite those stated intentions, from May 2014 to August 2016 the audit committee met only five times, each time for an hour or less. Those meetings were usually for the audit committee to approve the Company's 10-K or 10-Q filings as required by federal law. The Company's board or audit committee often acted by written consent, after each audit committee meeting, to address matters under the audit committee's purview, such as matters involving related party transactions or decisions to retain or replace the Company's auditor.

In March 2017, the Company announced that its financial statements from 2014 through the third quarter of 2016 could not be relied upon and would be restated. The Company filed its 10-K for 2016 shortly thereafter, which disclosed that the Company lacked expertise regarding matters such as US GAAP and SEC disclosure requirements and the proper disclosure of related-party transactions.

In May 2017, plaintiff delivered a Section 220 demand to the Company and filed a Section 220 lawsuit, eventually obtaining documents after receiving Court guidance. The 220 production did not include a number of agreements, procedures, and policies that the audit committee supposedly reviewed or approved.

Thereafter, plaintiff filed a complaint, which named the three members of the audit committee, the Company's CEO/Chairman, and its three successive CFOs, as defendants. The Complaint asserted two counts: Count I asserted *Caremark* claims against all defendants, and Count II asserted an unjust enrichment claim against all defendants. The defendants moved to dismiss the claims for failing to adequately plead that a demand on the board was excused.

## The Court of Chancery's Ruling

In an opinion by Vice Chancellor Laster, the Court denied the motion to dismiss derivative claims brought on behalf of Kandi. In reaching its decision, the Court held that four defendants, constituting a majority of the board that would have had to consider a demand, faced a substantial risk of liability under *Caremark* with respect to claims asserting that they failed to exercise their oversight duties in good faith.

The Court emphasized that the audit committee only met when federal securities laws required it to meet, despite known material weaknesses in the Company's internal controls. The Court also focused on the short duration of the once-a-year audit committee meetings, believing there was "no possible way that the Audit Committee could have fulfilled all of the responsibilities it was given under the Audit Committee Charter." Further, the audit committee and board often had to act by written consent after audit committee meetings to address issues the audit committee was supposed to address at its meetings. The Court damningly concluded the audit committee "met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation" which led the Company to suffer "pervasive problems with its internal controls." The Company's acknowledgement and pledge to correct those shortcomings fell flat given how little work the audit committee appeared to do to fix the issues.

The Court rejected the Company's argument that plaintiff could not meet its burden under *Caremark* because it had an audit committee, audit department, code of ethics, and independent auditor and therefore plaintiff was pleading only that monitoring systems already in existence should have been more effective. The plaintiff's allegations supported an inference that the audit committee never implemented its own system for reporting and monitoring, instead choosing to rely upon management for decisions such as replacing its auditor and the appropriate policies for reviewing related party transactions, even though management had previously shown it did not accurately report related-party transactions. While an audit committee can rely upon the reports of management, it could not blindly defer to and totally rely upon management.

The Court also rejected the Company's argument that the director defendants were not subject to liability because the 2017 restatement resulted in no changes to Kandi's net income. That point had convinced the Southern District of New York to dismiss a federal securities lawsuit. But even if there was no harm to net income, the director defendants could still be liable for incidental damages, such as the costs of the restatement, reputational harm, and the costs of litigating lawsuits related to the restatement.

Finally, the Court noted that the books and records the Company produced to the plaintiff did not include exculpatory evidence demonstrating that the audit committee appropriately exercised oversight. The absence of the relevant agreements, policies, and detailed minutes or other document memorializing those efforts meant it was reasonable to infer no evidence existed that could rebut the complaint's well-plead allegations of a failure to establish reasonable systems of monitoring and reporting.

In light of the foregoing, the Court held that four directors (the three audit committee members and the CEO/Chairman) faced a substantial likelihood of liability under *Caremark*. The board thus lacked a disinterested and independent majority that could have considered a demand, rendering demand futile.

## Lessons and Implications

Although one could claim a trend because *Hughes* is the third decision in less than a year allowing *Caremark* claims to proceed beyond the pleadings, the particularly egregious facts in *Hughes* cautions against drawing such a conclusion. The conduct of Kandi's audit committee should immediately raise the eyebrows of readers who are even cursorily familiar with proper

operations of oversight and reporting systems. And since *Marchand*, the Court of Chancery has more often dismissed *Caremark* claims at the pleadings stage than let them pass, [7] and it is those decisions that analyze more familiar and common compliance, oversight, and reporting systems. The dismissals confirm *Marchand*'s statement that "the plaintiffs usually lose [*Caremark* claims] because they must concede the existence of board-level systems of monitoring and oversight such as a relevant committee, a regular protocol requiring board-level reports about the relevant risks, or the board's use of third-party monitors, auditors, or consultants," [8] which should reassure directors that proactive efforts to implement proper systems will defeat *Caremark* claims.

*Hughes* and *Clovis* are interesting to compare in so far as their discussions of books and records require harmonizing. In *Clovis*, the Court did not consider certain of the Company's books and records provided to the plaintiffs that the defendants believed undercut the complaint's allegations. Although the parties had agreed that any books and records provided to the plaintiffs would be incorporated by reference into the complaint, the Court stated that documents "hand selected by the company, cannot be offered to rewrite an otherwise well-pled complaint." The Court thus limited its analysis to the allegations of the complaint and did not rely upon documents identified by defendants that "might suggest the facts are otherwise." In *Hughes*, on the other hand, the Court noted the absence of exculpatory evidence in the 220 production, which the Company had agreed "either do not exist or had been withheld on privilege grounds." Those missing documents "would have rebutted" the reasonable inference the Court drew from the complaint's allegations "that the board never established its own reasonable system of monitoring and reporting." The Court in *Hughes* thus expressed a willingness to consider books and records that would rebut allegations in a *Caremark* complaint. The decisions can be read together to mean that defendants can use documents in a 220 production to fill the vacuum of inaction a plaintiff tries to create (*i.e.*, the board did not meet), but not to resolve competing interpretations of documents on more nuanced topics (*i.e.*, the board understood the seriousness of an alleged red flag). Be that as it may, *Hughes* reiterates the importance of boards and committees documenting their activities and maintaining those records. Corporations should thus make sure to include helpful documents in books and records productions if only to avoid the negative inferences drawn in *Hughes*, while acknowledging the ability to use them offensively by offering competing interpretations may be limited.

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[7] *See In re GoPro, Inc. S'holder Deriv. Litig.*, 2020 WL 2036602, at *11 (Del. Ch. Apr. 28, 2020); *Hubert Owens v. Tim M. Mayleben*, 2020 WL 748023, at *6 (Del. Ch. Feb. 13, 2020); *LendingClub Corp. Deriv. Litig.*, 2019 WL 5678578, at *9 n.59 (Del. Ch. Oct. 31, 2019); *Rojas v. Ellison*, 2019 WL 3408812 (Del. Ch. July 29, 2019).

[8] 2 A.3d at 823.