Delaware Supreme Court Announces Standard for Director Liability In Oversight Cases: ‘Conscious Disregard’ of Fiduciary Duty of Loyalty

BY MELISSA C. BROWN

As the courts of Delaware go, so go most other U.S. jurisdictions applying corporate law. Thus the Delaware Supreme Court’s recent decision in Stone v. Ritter, 911 A.2d 362 (Del. 2006), is destined to become the dominant standard for analyzing the potential liability of directors in so-called “oversight” cases, in which plaintiffs attempt to hold corporate directors personally liable for failing to monitor or properly oversee corporate activities. Under Stone, plaintiffs seeking to hold corporate directors personally liable in such cases now must show that directors’ behavior rose to the level of a conscious disregard for the good-faith exercise of their fiduciary duty of loyalty.

Stone expressly adopts the standard articulated ten years earlier by Chancellor William T. Allen in In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996) when he observed that “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.” It also clarifies the Delaware high court’s view of the doctrinal foundation of the duties of care, loyalty, and good faith in oversight cases—an area that the Court has conceded is “not a well-developed area of our corporate fiduciary law.” In re The Walt Disney Co. Deriv. Litig., 906 A.2d 27, 63 (Del. 2006).

The Road to Stone: Foundations in Graham and Caremark. Delaware law has long been clear in its protection of directors’ business judgments: the law presumes that in making such decisions, directors act on an informed basis, in good faith, and in the honest belief that the actions taken are in the best interests of the company. But the business judgment rule addresses actions taken; the standard (and the philosophical foundation) for finding liability in oversight actions has been murkier.

The Delaware high court’s commentary in Stone brings a clearer standard to analysis of liability in oversight cases. Stone traces the evolution of this standard to Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963), a shareholder derivative action attempting to hold directors personally liable for failing to prevent losses as a result of employees’ violations of federal antitrust laws. Plaintiffs in Graham argued that board members should have known about the violations and had a duty to prevent the losses. The Court disagreed,

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holding (in famously colorful language) that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.” Graham at 130.

Graham established what is not required of directors in oversight cases, but it left open the flip side of the question: absent any conflicts, self-dealing, or suspect motivation suggesting bad faith, what legal standard should govern directors’ affirmative obligations to supervise or monitor corporate activities?

This is the question discussed—but not determined—in Chancellor Allen’s 1996 Caremark decision. Caremark was before the Chancery Court on the parties’ jointly proposed settlement, thus it did not decide the issue of director liability. However, evaluation of the fairness of the settlement required consideration of the plaintiffs’ central allegation: that Caremark directors had breached their duty of care by not preventing huge losses based on the corporation’s alleged violations of law.

The Caremark case was sparked by criminal investigations and indictments that ultimately cost the company approximately $250 million, paid to various public and private parties for violations of the federal Anti-Referral Payments Law and state laws prohibiting payments to induce referrals of Medicare or Medicaid patients. In five stockholder derivative actions consolidated before the Chancery Court, plaintiffs alleged that board members breached their fiduciary duty of care by failing to prevent the company’s losses.

Pointing to the rule of Graham, Chancellor Allen concluded that in general, corporate officers and directors should not be held liable for assuming that corporate employees are acting honestly and with integrity. But he cautioned against a too-narrow reading of Graham, believing that it would be a mistake to conclude that boards could fulfill their duties without assuring themselves that adequate information and reporting systems existed:

I am of the view that a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

Caremark at 970.

Affirmatively stated, boards may satisfy their obligation to be reasonably informed by making certain that the company has information and reporting systems that are designed to provide timely, accurate information sufficient to allow management and the board to reach informed judgments concerning the corporation’s compliance with law and its business performance. Only “a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.” Id. at 971.

Stone Defines the Doctrinal Framework of Fiduciary Duties Under Delaware Law. Stone expressly adopts the “sustained or systematic failure” standard articulated in Caremark, as well as endorsing Chancellor Allen’s warning against reading Graham too broadly. But Stone also provided the Court an opportunity to expand on doctrinal distinctions it sees as crucial to understanding the duties of care, loyalty, and good faith. The plaintiffs in Caremark alleged that Caremark directors had breached their duty of care in failing to monitor the corporation’s activities. In Stone, the Court makes it clear that a failure to act in the face of a known duty to act is not a breach of the duty of care. Instead, it is a breach of the fiduciary duty of loyalty “by failing to discharge that fiduciary obligation in good faith.” Stone at 370. The requirement to act in good faith is a subsidiary element of the fundamental duty of loyalty. Id. (citing Guttmann v. Huang, 823 A.2d 492 (Del. Ch. 2003)). Though this may seem to be a distinction without much practical difference, the Court illustrates critical doctrinal consequences of the clarification.

Facts in Stone. The derivative action in Stone was brought by shareholders of AmSouth Bancorporation after the company paid $50 million in fines and penalties in connection with a Ponzi scheme run by an attorney and an investment advisor who defrauded investors by promising rosy returns on investments supposedly for construction of medical clinics overseas. The two men, who had no connection to AmSouth, set up custodial trust accounts related to their fraudulent scheme in an AmSouth branch bank. The scheme was discovered when investors failed to receive monthly interest payments, and the perpetrators ultimately pled guilty to federal money-laundering charges. Though the bank was not part of the fraudulent scheme, AmSouth was investigated by the United States Attorney’s Office and bank regulators, who found that in spite of suspicions on the part of one or more employees, the bank had failed to file Suspicious Activity Reports (“SARs”) as required by the Bank Secrecy Act and anti-money-laundering regulations.

AmSouth entered into a Deferred Prosecution Agreement with the government, agreeing to pay a $40 million fine. Notably, the Statement of Facts in the agreement did not ascribe any blame to the board or any individual director. In a separate action, the Federal Reserve and the U.S. Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) assessed a $10 million civil penalty against AmSouth for inadequate anti-money-laundering programs and failure to file the required SARs. FinCEN’s written Assessment of Civil Money Penalty stated that AmSouth’s compliance program “lacked adequate board and management oversight” and that the reporting system for compliance activities was “materially deficient.” Stone at 366.

The derivative plaintiffs sued fifteen present and former directors of AmSouth on the theory that the board failed to establish information and reporting systems that would have revealed the behavior and prevented the $50 million in losses. Calling it a “classic Caremark case,” the Chancery Court dismissed the complaint under Chancery Rule 23.1(b) on its finding that plaintiffs did not adequately plead that a pre-suit de-

2 Del. Ct. Ch. R. 23.1 governs shareholder derivative lawsuits and requires that plaintiffs plead with particularity “the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiffs’ failure to obtain the action or for not making the effort.”
Stone in a Nutshell:
1. Directors may be found personally liable for failure to oversee or monitor corporate activities and performance when:
   (a) the directors utterly failed to implement any reporting or information system or controls, or
   (b) having implemented such a system or controls, [they] consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

2. Imposition of liability requires a showing that directors knew that they were not discharging their fiduciary obligations.

3. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that duty in good faith.

Stone at 370.

Affirmative Duty of Board Members
To assure, in the director’s good faith judgment, that the corporation’s information and reporting system is, in concept and design, adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.

mand on AmSouth’s board would have been futile. Stone at 364.

The standard for determining demand futility in oversight cases is stated in Rules v. Blasband, 634 A.2d 927, 934 (Del. 1993): the court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” Plaintiffs argued that demand in Stone would have been futile because the directors would face a substantial likelihood of liability due to their failures to exercise oversight, thus they would not be able to exercise independent and disinterested judgment in evaluating the allegations in the derivative complaint.

On appeal, plaintiffs conceded that there were no red flags to alert the board to any violations of the law or banking regulations and that directors did not know, nor was there reason they should have known, of the lapses in reporting the suspicious accounts. Instead, plaintiffs based their appeal on the argument that directors knew that they were not discharging their fiduciary duties.

Doctrinal Consequences of Distinctions Between Directors’ Duty of Care and Duty of Loyalty. The Delaware high court upheld the Chancery Court’s dismissal of the complaint, agreeing that the Caremark standard had been properly applied. However, the Court pointed out that understanding the doctrinal distinctions—and the consequences thereof—between the duty of care and the duty of loyalty is “critical to understanding fiduciary
duty under Caremark as we construe that case.” Stone at 369.

Courts and commentators alike often refer to directors’ fiduciary duties as a triad of the duties of care, loyalty, and good faith, without drawing precise distinctions among them. But only violations of the duties of care or the duty of loyalty can result in liability, according to Stone. The requirement that directors act in good faith is a subsidiary element to the duty of loyalty, since a director cannot act loyally unless she holds a good faith belief that her actions are in the corporation’s best interest. A showing of bad faith is a necessary condition for establishing director liability in oversight cases, and if bad faith is found in the context of an oversight case it constitutes a failure to act in good faith in the performance of the duty of loyalty. The liability arises from the breach of the duty of loyalty, not the bad faith per se.

This distinction is relevant not only to understanding Caremark but also Disney. In fact, Stone and Disney together are welcome clarifications of the Court’s view of directors’ fiduciary duties. While Disney provides important guidance to understanding the duty of good faith (and the consequences of bad faith), Stone provides guidance as to the standard of conduct expected of directors and the standard by which potential liability will be assessed.

In Disney the Court observed that though the duty to act in good faith has become increasingly important, it has remained “relatively uncharted.” Disney at 63. Reported decisions often fail to distinguish the duty to act in good faith from the duties of care and loyalty, the Court wrote, but “in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line-drawing,” negligent or even grossly negligent conduct, without more, does not constitute a breach of the duty to act in good faith. Disney at 65. Conduct that is the subject of due care may overlap with conduct requiring good faith, “but from a legal standpoint those duties are and must remain quite distinct.” Id.

The consequences resulting from that distinction can be significant, even determinative of director independence and disinterestedness under Chancery Rule 23.1, because the potential liability of directors under the Delaware statutory scheme hinges on which fiduciary duty is implicated. The Delaware legislature has applied the distinction to director indemnification in two contexts. First is § 102(b)(7), which authorizes Delaware corporations to exculpate directors (thus protecting them against personal liability) by including a specific provision in the certificate of incorporation. This section contains exceptions for actions or omissions not in good faith, thus demonstrating the legislature’s intent to protect against breaches of the duty of care while expressly excluding any protection for actions that constitute breaches of the duty of loyalty. The second legislative protection distinguishing gross negli-

3 Disney involved the notoriously generous severance package awarded to departing executive Michael Ovitz after less than two years with the corporation. Derivative plaintiffs sought to hold directors liable on a failure-to-monitor theory, but the Chancery Court dismissed their complaint, finding no breach of the duty of care and no bad faith. On appeal plaintiff urged the Court to treat directors’ failure to be properly informed as a failure to act with due care.

4 8 Del. C. § 102(b)(7).
gence from lack of good faith is Delaware’s indemnification statute, 8 Del. C. § 145,\footnote{8 Del. C. § 145(a), (b).} which allows corporations to indemnify directors who act “in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation,” but not those who act in bad faith. Thus, though the Delaware legislature has provided for indemnification of directors actions breaching the duty of care, it has specifically excluded protection for acts done in bad faith, which breach the duty of loyalty.

Plaintiffs in Stone sought to “equate a bad outcome with bad faith.” Stone at 373. Now, however, in oversight cases plaintiffs will have to do more to establish directors’ personal liability. They will have to show that directors demonstrated a conscious disregard for their responsibilities, such that they breach the duty of loyalty by failing to exercise that duty in good faith.