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**Delaware Supreme Court Clarifies the Import of
Directors' "Good Faith" Obligations and
the Requirements for Establishing Director "Oversight" Liability**

In an important *en banc* opinion issued November 6, 2006, the Delaware Supreme Court provided important guidance to directors and corporate practitioners on the application of "good faith" concepts to director conduct and the standards for imposing *Caremark* "oversight" liability on directors. In *Stone v. Ritter*, No. 93, 2006 (Del. Nov. 6, 2006) (Holland, J), the Delaware Supreme Court affirmed the Court of Chancery's dismissal of a derivative action for failure adequately to plead demand futility under Chancery Rule 23.1. The complaint alleged a *Caremark* claim, asserting that "the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention." The Supreme Court concluded that the Court of Chancery correctly applied the *Caremark* standard and the necessary conditions set forth in *In re Walt Disney Co. Deriv. Litig.*, 906 A. 2d 27 (Del. 2006), for assessing director oversight liability.

The Supreme Court reviewed the progression of oversight liability doctrine from *Graham v. Allis-Chalmers Mfg. Co.*, 188 A. 2d 125 (Del. 1963), to *In re Caremark Int'l Deriv. Litig.*, 698 A. 2d 959 (Del. Ch. 1996), to *In re Walt Disney Co. Deriv. Litig.* In *Graham*, the Delaware Supreme Court affirmed the dismissal of a derivative action seeking to impose liability on directors for failure to prevent anti-trust violations by employees. There was no claim that the directors knew of the misconduct. The claim was that the directors *should have known*. The Supreme Court held 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." 188 A. 2d at 130.

In *Caremark*, the Court of Chancery narrowly construed *Graham* in the procedural context of a motion to approve the settlement of a derivative action asserting a failure of oversight claim, explaining that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." 698 A. 2d at 970. Chancellor Allen articulated the following standard of director liability where the directors are unaware of the employee misconduct:

Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* or in this case... 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; emphasis supplied).

The Supreme Court carefully noted that *Caremark's* oversight liability standard depended in significant part on the directors' lack of good faith. Continuing the progression, in the *Disney* case, the Supreme Court gave examples of conduct that would amount to a lack of good faith:

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient. (906 A.2d at 67).

The Supreme Court explained that the third example describes and is consistent with the lack of good faith conduct that *Caremark* held was a necessary element of director oversight liability and that the Court of Chancery had applied the correct standard in analyzing whether demand was excused.

Importantly, the Court explained "a doctrinal issue that is critical to understanding fiduciary liability under *Caremark*." The Court stated that its description of lack of good faith as a necessary condition to liability was deliberate and intended to signal that a mere failure to act in good faith, in and of itself, does not result in direct imposition of fiduciary liability. Good faith is a "subsidiary element" of the duty of loyalty and not a separate, independent duty. The Court reasoned that, since a showing of bad faith conduct is essential to establish director oversight liability [and avoid the immunity of 8 *Del. C.* 102(b)(7)], the fiduciary duty violated by that conduct is the duty of loyalty.

The Supreme Court observed that the foregoing view of a failure to act in good faith results in two additional doctrinal consequences. First, the Court reiterated that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty." A failure to act in good faith may result in liability, but only indirectly. Second, the Court announced that "the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary interest." The duty of loyalty also encompasses those cases where the directors fail to act in good faith.

Concluding the analysis, the Supreme Court held that *Caremark* articulates the necessary conditions for director oversight liability: "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling

themselves from being informed of risks or problems requiring their attention." In either event, no liability will attach unless plaintiffs can show that "the directors *knew* that they were not discharging their fiduciary obligations." (emphasis supplied). Where the directors fail to act in the face of a known obligation to act, their conduct constitutes a breach of the duty of of loyalty by failing to discharge that fiduciary obligation in good faith.

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