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Delaware Supreme Court Reaffirms the *Caremark* Standard and Clarifies Duty of Good Faith in the Wake of *Disney*

On November 6, 2006, the Delaware Supreme Court reaffirmed the deferential standard for director oversight liability set forth by the Court of Chancery a decade ago in *In re Caremark International Derivative Litigation*. The court held that imposition of liability requires a clear showing that the directors either knew they were not discharging their fiduciary obligations or showed a conscious disregard for their responsibilities. Perhaps most importantly, the Supreme Court also took the opportunity to clarify the role of the “duty of good faith” most recently articulated in its *In re Walt Disney Co. Derivative Litigation* decision. In so doing, it made clear that the duty of good faith does not stand as a separate duty, but rather is encompassed under the traditional rubric of the duty of loyalty.

Background and Key Holdings

In 2004, AmSouth and its wholly-owned subsidiary, AmSouth Bank, paid \$40 million in fines and \$10 million in civil penalties to resolve government and regulatory investigations related to the failure of bank employees to file “Suspicious Activity Reports” (SARs), as required by the federal Bank Secrecy Act and various anti-money-laundering regulations. No fines or penalties were imposed on AmSouth’s directors, and no other regulatory action was taken against them.

Plaintiffs William and Sandra Stone, AmSouth shareholders, filed a derivative action against fifteen present and former directors of AmSouth, alleging the directors were liable for the \$50 million in fines and penalties levied by federal regulators. They did not make a pre-suit demand, but instead asserted demand was futile. The Court of Chancery dismissed the complaint for failure to adequately plead that such a demand would have been futile. Plaintiffs appealed.

Pleading Requirements to Show Demand Futility

For the plaintiffs to show that demand was futile and therefore their failure to make such a demand was excused, they would have to show through the particularized factual allegations in the complaint that there was a “reasonable doubt” at the time the complaint was filed that “the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” The plaintiffs attempted to show the directors could not be disinterested or independent by asserting that the defendant directors “face[d] a substantial likelihood of liability.” However, according to section 102(b)(7) of AmSouth’s certificate of incorporation, directors faced the potential for monetary liability only if they

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engaged in conduct that was not in good faith or breached the duty of loyalty. Breaching the duty of care, alone, would not lead to monetary liability. Therefore, the plaintiffs had to assert facts sufficient to show that the AmSouth directors' conduct rose above the level of gross negligence and either was not in good faith or breached the duty of loyalty.

Board Oversight

The plaintiffs acknowledged the AmSouth directors neither knew nor should have known that violations of the law were occurring. However, the plaintiffs argued that demand was futile because the directors 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 defendants argued that these assertions were contradicted by the derivative complaint itself and by several documents incorporated therein by reference.

The complaint referred to an independent report prepared by KPMG that reviewed AmSouth's compliance efforts. According to the court, this report reflected that AmSouth's Board dedicated considerable resources to various compliance programs and "put into place numerous procedures and systems to attempt to ensure compliance." These included: (1) a compliance officer who was responsible for employee training, keeping up to date on compliance issues, and reporting to the Board; (2) a compliance department led by the compliance officer and employing nineteen other professionals; (3) a corporate security department responsible for the detection and reporting of suspicious activity; and (4) a "Suspicious Activity Oversight Committee" that actively oversaw the compliance programs and deterred, detected, and reported "money laundering, suspicious activity and other fraudulent activity."

However, the court also noted that the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) found in its investigations of AmSouth that "AmSouth's [compliance] program lacked adequate board and management oversight," and that "reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient." AmSouth neither admitted nor denied FinCEN's determinations.

Delaware Supreme Court Decision

The Supreme Court upheld the Court of Chancery decision dismissing the complaint for failure to properly allege demand futility. The court held the plaintiffs failed to create a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in responding to a demand, because the plaintiffs did not plead the existence of any "red flags" that would have warned the board of problems. In addition, the KPMG report, which listed several steps the board took to ensure regulatory compliance before the investigations began, belied plaintiffs' claims that the board never took those steps. Because the plaintiffs

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had not shown the directors either knew or should have known that violations of the law were occurring, nor had they shown the directors “utterly failed to implement any reporting or information system or controls,” they could not show that the directors’ conduct rose to the level of bad faith or a breach of the duty of loyalty, and therefore, could not excuse their failure to make a pre-suit demand on the board.

In its opinion, the court also reaffirmed and elaborated on the *Caremark* legal standard for director oversight liability, and clarified the parameters of the “duty of good faith” recently addressed in *Disney*.

[Caremark, Disney, Stone and the Evolving Good Faith Standard for Director Oversight Liability](#)

As followers of Delaware compliance decisions know, the *Caremark* court held that where a plaintiff claims director liability for corporate loss predicated upon the director’s ignorance of the liability-creating activities within the corporation, “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.”

The Delaware Supreme Court later elaborated on this standard in *In re Walt Disney Co. Derivative Litigation*, holding that “a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence).” The *Disney* court articulated three examples of conduct that would establish a failure to act in good faith: (1) “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation,” (2) “where the fiduciary acts with the intent to violate applicable positive law,” or (3) “where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” This final example describes, and is consistent with, the lack of good faith conduct that the *Caremark* court held was a necessary condition for director oversight liability.

Finally, in *Stone*, the court stated it would not find liability without a clear showing that the directors knew they were not discharging their fiduciary obligations. Thus the two necessary conditions predicate for director oversight liability are: “(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.”

[Good Faith and the Duties of Loyalty and Care](#)

In reaffirming *Caremark*, importantly the court also took the opportunity to clarify the legal framework under which issues of good faith should be considered in the wake of *Disney*. As

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followers of *Disney* will recall, the Supreme Court left open the issue of whether the “duty of good faith” could be considered a third “duty,” separate from and equal to the duties of care and loyalty. The *Stone* court quickly put that question to rest. The court clarified that, although failure to act in good faith “requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (*i.e.*, gross negligence),” good faith “is a *subsidiary* element, *i.e.*, a condition, of the fundamental duty of loyalty” (emphasis added). Indeed, the court stated that “a failure to act in good faith is not conduct that results, *ipso facto* in the direct imposition of fiduciary liability.” Thus, only breach of the duties of care or loyalty may result in direct liability; failure to act in good faith may also result in liability, but only indirectly, through a breach of the duty of loyalty. As a consequence of this new interpretation, now liability for breach of “the duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.”

Legal Implications

Stone poses two main legal implications. First, a derivative complaint may not proceed against directors except in the rare case that a plaintiff can make a clear showing at the pleading stage that the directors knew they were not discharging their fiduciary obligations. This occurs in one of two instances: either “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system of controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.” Thus, in the absence of “red flags,” the sole relevant inquiry is whether the directors acted “to assure a reasonable information and reporting system exists.” As the court acknowledged, a claim that a director is subject to personal liability for employee failures is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”

Second, the court reaffirmed that, unless plaintiffs in a derivative lawsuit can show, using the rubric above, that the directors failed to act in good faith and therefore were not disinterested (because they could be subject to personal liability), plaintiffs will have failed to show they are excused from making a demand on the board, and their complaint will be dismissed for failure to plead demand futility with particularity. A “hindsight” showing, that corporate employees engaged in bad acts causing corporate loss, does not necessarily indicate the board failed to exercise oversight and, is not, without additional evidence that the board knew or should have known of these bad acts, enough to meet the high pleading requirement for demand futility.

Practical Lessons

The *Stone* decision, combined with the recent *Disney* decision, suggests a continued trend by the Delaware Supreme Court toward deference in favor of outside directors in the absence of

specific red flags. Directors who implement reasonable information systems and continue to monitor such systems can help to insulate themselves from liability. As we have iterated in the past, such practices include:

- reading all the materials given to them by management;
- reviewing public disclosures, filings, and releases;
- reading analysts' reports;
- if necessary, asking management for additional information in order to have a better understanding of the company's business and the risks it faces; and
- ensuring that the board's audit committee communicates on a regular and periodic basis with the company's outside auditors outside the presence of company management.

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