Delaware Affirms High Standard In Director Suits

By Paul J. Martinek

Any fears that the Delaware Supreme Court might be backing off its traditional protection of corporate directors were categorically put to rest recently by a decision reinforcing the high standard that must be met to sue directors for failing to exercise sufficient oversight.

According to experts, the ruling in the case—*Stone v. Ritter*—is likely to have implications for litigation over stock option backdating, as well as other types of shareholder and derivative litigation. And some say the court's conclusions will not necessarily warm the hearts of governance advocates.

Jill Fisch, a business law professor at Fordham University, says there has been speculation about whether the Delaware court, "in light of things like Enron, are really going to hold directors' feet to the fire. This decision says they're not."

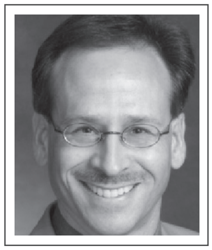
Fisch

Mary Ann Jorgenson, a partner with the law firm Squire Sanders & Dempsey, calls the Stone ruling a "good and pragmatic decision" that has made clear that Delaware is sticking by a principle the Chancery Court had articulated many years ago (but never formally adopted by the Supreme Court) that directors are not liable unless "there is a sustained or systematic failure of the board to exercise oversight."

Not only must directors not be doing something they should be doing, Jorgensen says, but "they've got to know that they're not doing it: They have to have knowledge that they're supposed to be doing something and consciously are not doing it."

Bank Hit With $50M Fine

The Stone case involved AmSouth Bancorp., a regional bank in the southeast United States that had been hit with $50 million in fines and civil penalties due to its alleged failure to meet reporting obligations under the Bank Secrecy Act and anti-money laundering rules. The bank found itself in trouble due to the actions of customers who participated in a Ponzi scheme over a two-year period.



"[Although the decision] doesn't change what people should be doing, directors can take comfort that if they put a system in place and make sure they're monitoring it and not looking away, they won't be blamed—or shouldn't be blamed—for acting in bad faith by not being perfect."

— Mark Olinsky,
Corporate Attorney,
Sills Cummis Epstein & Gross

Two shareholders of AmSouth brought suit on behalf of the corporation against the directors for their failure to prevent the violations. The suit didn't claim that any of the directors actually knew of the conduct of bank employees that resulted in the liability, but instead alleged that they should have known about it.

A Chancery Court judge dismissed the suit and the Delaware Supreme Court affirmed, for the first time expressly adopting the reasoning of a Chancery Court decision from the 1996 case *In re Caremark International Inc. Derivative Litigation*.

As in *Caremark*, the plaintiffs in the AmSouth case were trying to hold directors liable for negligent oversight, not conscious neglect.

In response, the Supreme Court cited two conditions necessary to hold the directors liable: that the directors "utterly failed" to implement any reporting or information system or controls; or, if the directors had implemented those systems, "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention," the court wrote. "In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."

The plaintiffs were seeking "to equate a bad outcome with bad faith," the court concluded. "In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions 'to assure a reasonable information and reporting system exists' and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome."

'Rogue' Employees

Mark Olinsky, a corporate litigator with the law firm Sills Cummis Epstein & Gross, says the "overall headline" from the AmSouth ruling is: "Good News for Corporate Directors."

Although the decision "doesn't change what people should be doing, directors can take comfort that if they put a system in place and make sure they're monitoring it and not looking away, they won't be blamed—or shouldn't be blamed—for acting in bad faith by not being perfect," Olinsky says.

Peter Ladig, of the Bayard law firm, agrees that the decision in Stone "doesn't ultimately change any advice lawyers would be giving to directors. There's an obligation to monitor what's going on and you have to have an adequate reporting system. Once you have that in place, you can't put your head in the sand if you find something has gone wrong."

But Ladig says the Delaware court seems to be making clear that, "even in the post-Enron, post-WorldCom world, they don't see anything wrong with the way Delaware monitors and enforces fiduciary duties."

Separate Duty Of 'Good Faith'

In addition to embracing the Caremark standard for liability, the court that decided the AmSouth case also clarified an issue from a case that left open the question of whether Delaware law imposes an independent duty of "good faith" on corporate directors, in addition to the traditional duties of care and loyalty, when it was decided earlier this year.

In *Stone v. Webster*, which involved Walt Disney, the court emphatically said no such separate duty of good faith exists; rather, it is part of the duty of loyalty.

Lawrence Hamermesh, a law professor at Widener Law School, says that while this aspect of the decision is mostly interesting to academics, it means that "lawyers defending directors, and directors themselves, have one less thing to worry about."

The court essentially issued a rebuke to commentators who read the Disney decision as creating an additional independent duty for directors, according to John Stigi, a partner with the law firm Sheppard Mullin Richter & Hampton. "In some respects it doesn't matter, but to the extent that a plaintiff could come up with a theory under which the director was acting in bad faith—but did not breach the duty of care or loyalty—Stone says there's no claim."

Ladig says it's also significant that the court placed the duty of good faith under the duty of loyalty. Historically, he says, a director could not violate the duty of loyalty unless he or she had some financial interest in the transaction. "Now, for the first time, the court has recognized that you can."

Placing the duty of good faith under the duty of loyalty may mean that some kinds of lawsuits may not be dismissed so easily, according to Ladig. But, he adds, "It's still the hardest claim to make in Delaware corporate law."

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EXCERPT

Below is an excerpt from a Nov. 8, 2006, legal bulletin from the law firm Gibson, Dunn & Crutcher reviewing the *Stone v. Ritter* case. To see a complete text of the bulletin plus related coverage, please visit www.complianceweek.com and enter **Print Reference Code: 010708**.

In a significant decision issued on November 6, 2006, the Delaware Supreme Court ruled on the standard to be applied under Delaware law when assessing the personal liability of corporate directors for failing to adequately oversee the corporation. In an era of option backdating scandals, the Supreme Court's clear and timely statement on the standard for assessing directors' oversight responsibilities strongly suggests that a similar (if not identical) standard will be applied to claims of director liability for failing to exercise proper oversight in awarding backdated options. Also of interest, the Supreme Court attempted to resolve the confusion around whether there is a separate fiduciary duty of good faith under Delaware law in addition to the fiduciary duties of care and loyalty.

These issues came before the Court in a case involving AmSouth Bancorp. In AmSouth, the Delaware Supreme Court affirmed the Court of Chancery's decision to apply the so-called *Caremark* standard for assessing a director's potential personal liability for failing to act in good faith in discharging his or her oversight responsibilities. As the standard is described by the Supreme Court, directors can be held liable based on alleged failures to satisfy their oversight responsibility only if:

(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 case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.

Before applying the Caremark standard to the facts, the Supreme Court noted that because most of the decisions that a corporation makes (through its human agents) are not the subject of director attention, "a claim that directors are 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."

In AmSouth, the company was subjected to $50 million in fines and civil penalties for allegedly failing to fulfill its disclosure and reporting obligations under the Bank Secrecy Act and anti-money laundering rules with respect to activities of certain bank customers that were engaged in a "Ponzi" scheme that took place over the course of nearly two years. Nonetheless, because AmSouth had systems in place meant to deter and detect such suspicious activity, the Supreme Court declined plaintiffs' invitation "to equate a bad outcome with bad faith," and concluded that the Court of Chancery was correct in dismissing plaintiffs' claims.

While the standard adopted by AmSouth to judge directorial oversight liability will most likely be invoked in the near future in the context of stock option backdating, its lessons are more universal. Although good faith exercise of oversight responsibility may not invariably prevent corporation employees from violating criminal laws, or from causing the corporation to incur significant liability, directors should take a significant amount of comfort in knowing that Delaware law imposes a heavy burden on plaintiffs seeking to impose personal liability on corporate directors in such circumstances. As AmSouth dictates, "in the absence of red flags, good faith in the context of oversight must be measured by the directors' actions to assure a reasonable information and reporting system exists and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome."

Source: Gibson, Dunn & Crutcher.