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Failure of Oversight Claims Bar Still High

BY GREGORY A. MARKEL,
RONIT SETTON AND AMANDA L. KOSOWSKY

SINCE MOST LARGE COMPANIES are incorporated in Delaware, that state's law applies to most derivative claims filed on behalf of corporations, including those filed in federal and state court outside Delaware. Several recent decisions by Delaware courts have important implications for derivative cases involving claims that the board of directors breached its oversight duties.

In *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court held that a claim against the directors of a Delaware corporation for failure of oversight requires a showing of bad faith conduct.

The Delaware Chancery Court subsequently addressed the standard for pleading bad faith in dismissing breach of fiduciary duty claims against Citigroup Inc.'s board of directors in a shareholder derivative action concerning the directors' alleged failure to monitor Citigroup's business risk arising from Citigroup's involvement in the subprime mortgage market.

The court stated that a plaintiff must allege "with particularity that a director knowingly violated a fiduciary duty or failed to act in violation of a known duty to act, demonstrating a conscious disregard for her duties." *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009) (*Citigroup (Delaware)*) (emphasis in original).

This article focuses on *Stone*, *Citigroup (Delaware)* and other decisions interpreting the bad faith requirement under Delaware law. These decisions confirm that Delaware law imposes a stringent standard for director liability in derivative actions asserting failures of oversight.

Because derivative claims belong to the corporation, a shareholder must either demand that the board of directors commence the litigation that

the shareholder seeks to pursue, or file a complaint that alleges with particularity why demand is excused as futile. See Federal Rule of Civil Procedure 23.1(b) (3); Del. Ch. Ct. R. 23.1.

Where a plaintiff asserts claims based on the absence of board action, such as a failure of oversight, the requirement to make demand is excused only if the complaint pleads with particularity that a majority of the directors at the time the lawsuit is filed are interested in the subject matter of the action such that they are incapable of exercising independent and disinterested judgment in the best interest of the company in responding to the demand.

Particularized facts demonstrating that directors face a substantial likelihood of personal liability with respect to the claims alleged may establish director interest. See *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

Failure of Oversight Claims

Delaware courts have stated that a failure of oversight claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *Stone*, 911 A.2d at 372 (quoting *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)).

In *Stone*, the Delaware Supreme Court held that director oversight liability requires a showing that the directors failed to discharge their fiduciary duties in good faith. *Stone*, 911 A.2d at 370. The court adopted the stringent standard for director oversight liability articulated by the Delaware Chancery Court in *Caremark* and made clear that a showing of bad faith is a necessary condition to liability:

"[O]nly 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." *Stone*, 911 A.2d at 364 (quoting *Caremark*, 698 A.2d at 971).

Put another way, liability is premised "on a showing that the directors were conscious of the fact that they were not doing their jobs." *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) (citing *Caremark*).

The *Stone* court recognized that "[s]uch a test of liability...is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such

directors." *Id.* at 372 (citing *Caremark*, 698 A.2d at 971) (emphasis in original).

Bad faith conduct is "fiduciary conduct motivated by an actual intent to do harm," or an "intentional dereliction of duty, a conscious disregard for one's responsibilities." *In re the Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64, 66 (Del. 2006).

Examples of such conduct include "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." *Id.* at 67. This standard is rarely met.

High Standard, Rarely Met

In *Stone*, the company paid a total of \$50 million in fines and civil penalties to resolve government and regulatory investigations relating to its employees' failure to file certain reports required to be filed when they suspect that a transaction involves funds derived from illegal activities. The *Stone* court affirmed the dismissal of the derivative action for failure to plead demand futility.

It found that the fact that the corporation was exposed to government investigations and fines because of employee misconduct did not demonstrate the directors' bad faith. The court reasoned that "the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both...." 911 A.2d at 373.

In *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008), the Delaware Supreme Court similarly held that plaintiffs must allege particularized facts that, if proven, "would show that a majority of the directors knowingly engaged in 'fraudulent' or 'illegal' conduct or breached 'in bad faith' the covenant of good faith and fair dealing" in order to excuse demand where a company's shareholders have adopted an exculpatory provision under 8 Del. Code Ann. tit. 8, §102(b) (7) (2000).

The Delaware Code authorizes shareholders to adopt such a provision, which exempts directors from liability for breaches of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty. The vast majority of Delaware corporations have a provision that provides for exculpation to the extent provided for by §102(b) (7). *Disney*, 907 A.2d at 752.

GREGORY A. MARKEL is the chairman of Cadwalader, Wickersham & Taft's litigation department, RONIT SETTON is a partner in the department, and AMANDA L. KOSOWSKY is special counsel. GILLIAN GROARKE, an associate, assisted in the preparation of this article.

In *Wood*, the court held that “[w]here...directors are exculpated from liability except for claims based on ‘fraudulent,’ ‘illegal’ or ‘bad faith’ conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter, i.e., that they had ‘actual or constructive knowledge’ that their conduct was legally improper.” 953 A.2d at 141.

The *Wood* court affirmed the dismissal of the action because the complaint did not adequately allege that the directors knew the conduct at issue was wrongful or consciously failed to discharge their fiduciary responsibilities. Id. at 142-44; see also *In re MIPS Techs. Inc. Derivative Litig.*, No. C-06-06699 RMW, 2008 WL 3823726, at *6 (N.D. Cal. Aug. 13, 2008) (“[t]he Delaware Supreme Court...has set a high bar for director oversight liability. When directors are immunized by a section 102(b)(7) provision in the certificate of incorporation, a showing of bad faith conduct is essential to establish director oversight liability.” (citation omitted)); *In re Extreme Networks Inc. S’holder Derivative Litig.*, 573 F. Supp. 2d 1228, 1239 (N.D. Cal. 2008) (plaintiffs failed to plead a non-exculpated claim against the directors such that demand was excused where the alleged facts were not sufficient to demonstrate actual or constructive knowledge).

The ‘Citigroup’ Ruling

Following *Stone* and *Wood*, in *Citigroup (Delaware)*, the Delaware Chancery Court determined that bad faith may be pled by “particularized facts that show that a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business.” *Citigroup*, 964 A.2d at 125 (emphasis in original).

Noting that Citigroup’s shareholders had adopted a §102(b)(7) director exculpatory provision, the court held that the complaint failed to allege a director oversight claim sufficient to excuse demand. See id. at 124.

It also determined that plaintiffs’ assertions that “red flags,” including market deterioration, could or should have put the directors on notice of business risks posed by Citigroup’s involvement in the subprime-related mortgage market did not adequately allege that the directors were aware of wrongdoing at Citigroup or consciously disregarded “a duty to somehow prevent Citigroup from suffering losses.” Id. at 126-28. The court reached this conclusion despite the fact that Citigroup had suffered “staggering” losses. Id. at 131.

The *Citigroup (Delaware)* court also stated that “[e]valuating director action under the bad faith standard is a contextual and fact specific inquiry and what a director knows and understands is, of course, relevant to such an inquiry.” Id. at 128 n.63. Although it noted that “[d]irectors of a committee charged with oversight of a company’s risk have additional responsibilities to monitor such risk, ... such responsibility does not change the standard of director liability under *Caremark* and its progeny, which requires a showing of bad faith.” Id.

The court determined that the complaint lacked allegations “specify[ing] how the board’s oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them.” Id. Rather, the court determined, plaintiffs were seeking to “hold

the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly.” Id. at 124.

The court concluded by stating that “we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law.” Id. at 139.

The *Citigroup* decision confirms the stringent standard for pleading a shareholder derivative claim based on a failure to monitor business risk and thus provides important precedent for other derivative actions stemming from the current credit crisis.

Recent Dismissals

Relying on *Citigroup (Delaware)*, *Stone* and *Wood*, other courts have recently dismissed failure of oversight claims on the ground that demand was not excused where the allegations failed to demonstrate the directors’ bad faith.

The U.S. District Court for the Southern District of New York dismissed a derivative action based on Goldman Sachs’s involvement in the market for auction rate securities because the complaint did not allege particularized facts showing that the directors consciously disregarded their duties or otherwise “acted with bad faith based on their potentially improper evaluation of the risk that threatened the [auction rate securities] market and the resulting losses suffered by the company and investors.” *Louisiana Mun. Police Employees Ret. Sys. v. Blankfein*, No. 08 Civ. 7605 (LBS), 2009 WL 1422868, at **5, 8 (S.D.N.Y. May 19, 2009), reconsid. denied, 2009 WL 2191243 (S.D.N.Y. July 20, 2009).

Delaware courts have set a high bar for shareholder derivative plaintiffs asserting director oversight claims, requiring them to **demonstrate** the directors’ **bad faith**.

Similarly, in *Playford v. Lowder*, 635 F. Supp. 2d 1303, 1309 (M.D. Ala. 2009), the court dismissed the complaint because plaintiffs did not allege “particularized facts suggesting the directors knew they were failing to discharge their oversight duties or that they consciously disregarded such duties.”

Other courts applying the bad faith standard have reached similar conclusions. *In re Verifone Holdings Inc. S’holder Derivative Litig.*, No. C 07-06347 MHP, 2009 WL 1458233, at **7-8 (N.D. Cal. May 26, 2009) (complaint failed to allege particularized facts that the directors “knew about the accounting deficiencies and acted accordingly in bad faith”); *King v. Baldino*, No. Civ. A. 08-54GMSMPT, 2009 WL 2750470, at *12 (D. Del. Aug. 26, 2009) (plaintiff’s attempt “to equate a bad outcome with bad faith” did not meet the requirement for failure of oversight claims that particularized facts must be pled demonstrating that the board members were aware of the wrongdoing and consciously failed to act in light of that knowledge).

In a derivative action recently brought against Citigroup in the Southern District of New York, plaintiffs alleged that demand was futile because the directors faced a substantial likelihood of liability for failure of oversight. *In re Citigroup Inc. S’holder Derivative Litig.*, 07 Civ. 9841, 2009 WL 2610746 (S.D.N.Y. Aug. 25, 2009) (*Citigroup (New York)*).

The court recognized that “to show that the directors face a substantial likelihood of liability for ‘allowing’ Citigroup to invest in subprime mortgages, the complaint must contain ‘particularized factual allegations demonstrating bad faith by the director defendants.’” Id. at *6. Relying on the standard set forth in *Stone* and the Delaware Chancery’s Court’s decision in *Citigroup (Delaware)*, 964 A.2d 106, the Southern District of New York rejected plaintiffs’ contention that the board had acted in bad faith because it “failed to act on evidence of approaching catastrophe.” 2009 WL 2610746 at *6.

Instead, it concluded that plaintiffs’ allegations at most evidenced that the directors made bad business decisions. Id. (granting the motion to dismiss for failure to plead demand futility); see *Louisiana Mun. Police Employees Ret. System v. Pandit*, No. 08 Civ. 3789 (LTS)(RLE), 2009 WL 2902587, at *8 (S.D.N.Y. Sept. 10, 2009) (plaintiff’s allegations of director oversight failure were insufficient because they were “entirely devoid of particulars indicative of bad faith in connection with the allegedly improper inaction”).

A Motion to Dismiss Denied

In contrast to the forgoing decisions, the Delaware Chancery Court recently denied a motion to dismiss failure to monitor claims against certain directors of AIG who were also senior managers, finding that the complaint stated a claim against them that was not covered by AIG’s §102(b)(7) provision. See *American Int’l Group Inc., Consol. Derivative Litig.*, 965 A.2d 763 (Del. Ch. 2009).

Unlike the other cases cited in this article, the court analyzed the complaint under the “plaintiff-friendly lens required by Rule 12(b)(6),” id. at 776, rather than the particularized pleading standard of Rule 23.1, because demand futility was not at issue. In fact, AIG had joined the suit as a plaintiff following an investigation by a special litigation committee appointed by the board.

The court held that the factual allegations in the complaint were sufficient to support an inference that AIG executives knew of and approved much of the wrongdoing. The court determined that the complaint adequately alleged the directors’ involvement in “pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG” and conscious failure to discharge their fiduciary duties. Id. at 776-78.

The court also stated that the complaint supported the assertion that top AIG officials were leading a “criminal organization” and that the extent of the alleged wrongdoing was “extraordinary.” Id. at 799.

Citigroup (Delaware), *Stone* and *Wood* confirm that Delaware sets a high bar for shareholder derivative plaintiffs asserting director oversight claims, requiring them to demonstrate the directors’ bad faith. The knowledge and intent of directors is a central issue that must be proved in actions alleging such claims.