Blogs

Delaware courts have been leaders in articulating the oversight duties of corporate directors, most famously in *In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959 (Del. Ch. 1996). The court, in *Caremark*, held that directors breach their duty of oversight when they do either or both of the following:

- Fail to make a good-faith effort to establish information systems reasonably designed to provide them with the information needed to perform their duties as directors.
- Have such a system, but consciously fail to monitor it, and ignore information regarding risks to the corporation.

In recent rulings, Delaware courts have appeared more willing to permit claims against directors asserting breaches of the duty of oversight to proceed beyond a motion to dismiss, especially when the failure of oversight is in an area fundamental to the corporation's business, such as product safety.

Now, the Delaware Chancery Court has clarified for the first time that *non-director* officers have a duty of oversight akin to that of corporate directors. The January decision has raised alarms that corporate officers may be subject to new claims that they somehow breached this duty. But both officers and directors should be aware that the court's opinion also articulates important limitations on any such claims.

Corporate officers concerned about being subjected to additional liability resulting from the January decision should bear the following issues in mind:

1. **An officer's duty is the same as a director's**. All corporate officers have the same duties of care and loyalty as corporate directors. The duty of oversight requires them, in addition, to establish systems reasonably designed to provide them with the information they need to do their jobs, to monitor and continually adjust those systems, to address any problems of which they become aware, and to report to other management and the board on any risks to the corporation they discover through those processes.

2. **An officer's scope of responsibility matters, but so does observing others' wrongdoing**. In general, an officer should not be responsible for oversight of activities outside that officer's area of responsibility. If the officer has a broad remit—such as an executive officer in charge of global sales—then the scope of their oversight responsibilities will be similarly broad. But if the officer's responsibilities are narrowed geographically or by subject matter, the officer's oversight obligations will be appropriately limited.

   Nevertheless, if an officer should observe wrongdoing by another officer in an area outside the first officer's realm of responsibility, that officer may have a duty to report the behavior to other management or the board as part of their general duty of loyalty, which requires an officer to act in good faith and in the best interests of the corporation.

3. **Bad faith must be involved**. In the January decision, the court found that, to breach the duty of oversight, an officer must act in bad faith. Because the duty of good faith is part of an officer's duty of loyalty, acting in bad faith is tantamount to disloyalty.

   To be liable, the court concluded: "The officer must *consciously* fail to make a good faith effort to establish information systems, or the officer must *consciously* ignore red flags." *(Emphasis added.)* In particular, the court concluded that a plaintiff must allege that the officer's failure to act "was sufficiently sustained, systematic, or striking to constitute action in bad faith." This is a high threshold for plaintiffs to overcome and protects corporate officers who may have acted negligently, but in good faith.

4. **Oversight breach claims are derivative claims**. Any oversight claims against corporate officers are derivative; that is, they belong to the corporation and may only be asserted by the board of directors. Shareholders may assert such claims on behalf of the corporation only if they can prove that a demand upon the board to bring suit would be futile (for example, if the board itself is conflicted) or if a refusal by the board to bring the suit is otherwise wrongful.

   It may be more difficult for a plaintiff to successfully plead that a board is conflicted for demand futility purposes for claims against an officer than for claims against the directors themselves. This, again, is protective of corporate officers who believe they have acted—and who the board believes have acted—in good faith.

5. **Neither indemnification nor exculpation are available because claims are derivative.** Corporate officers typically have some form of indemnification from liability for actions taken in their capacity as

officers, either via the corporation's bylaws or via individual indemnification agreements or both. In addition, Delaware recently amended its laws to allow corporations to exculpate officers for breaches of their duty of care through adoption of a charter provision.

Under the laws of most states, however, corporations are not permitted to indemnify officers (and in Delaware's case, to indemnify *or* to exculpate officers) from derivative claims asserted in suits brought in the name of the corporation. In general, corporations may only indemnify for an officer's expenses incurred in such suits, which expenses are subject to repayment if the officer is found liable to the corporation. Thus, since oversight claims are always derivative, they are not indemnifiable.

6. **D&O policies should be checked for coverage**. Nearly all corporations have some form of D&O liability insurance that covers both the expenses of litigation and any resulting judgements, within the policy limits. In general, corporations are permitted to maintain insurance for directors, officers, or other agents, regardless of whether the corporation has the power to indemnify such a person under the indemnification statutes.

Delaware has interpreted its corporate law broadly to protect directors and officers covered by D&O insurance. These policies should be examined to determine their application in the case of a claim that an officer or officers breached their duty of oversight.

7. **Sound recordkeeping practices are the first line of defense**. Corporate officers best protect themselves from liability by acting in accordance with their duties of care and loyalty and by complying with their duty of oversight. But if a claim is made against them that they breached their oversight duties, they must still defend against it.

Because most such litigation begins with a request to review the corporation's books and records, a first line of defense is the preparation of accurate minutes of board and committee meetings that establish the following:

- Relevant oversight systems were in place.
- The officers were actively involved in developing those systems to insure that relevant operational information came to their attention and, to the extent necessary, to the attention of the board.
- Responsible officers took appropriate action when risks to the corporation came to their attention through the monitoring process, and were, if necessary, brought to the attention of the board.

Presentations to senior management or the board should be retained along with the minutes to establish the regularity and detail of such reporting up from the relevant monitoring systems. Since such claims may involve employment practices, human resources records should also be carefully prepared and preserved.

By keeping in mind the points made above, directors and officers can place the January decision in perspective and take the steps necessary to protect against unwarranted claims.

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