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Client Alert

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Delaware Court Dismisses Director Oversight Claims But Allows Other Stockholders to File Suit

A recent Delaware case reiterates the difficulty facing plaintiffs in bringing derivative claims that seek to hold directors liable for breach of their duty of oversight. The Delaware Court of Chancery found that the plaintiffs failed to allege sufficiently that the directors knowingly disregarded significant risks to the company or utterly failed to implement a reasonable system of internal controls and reporting. As a result, the case was dismissed. Because the court found that the plaintiffs had not adequately represented the company, however, the court ruled that other stockholders would not be precluded from bringing suit and litigating the same issues. Thus, the opinion confirms the high pleading threshold to bring director oversight claims, but it may also lead to situations in which corporations must defend substantially identical actions.

Background

South v. Baker, C.A. No. 7294-VCL, mem. op. (Del. Ch. Sept. 25, 2012), involved a derivative suit alleging that the directors of Hecla Mining Company had breached their duty of oversight. The suit was brought after the company had three mining accidents occur within the span of a year, some of which resulted in employee deaths and injuries. The company also was cited by the U.S. Mine Safety and Health Administration for various safety violations. Within weeks after those citations were announced, stockholders filed several securities fraud and derivative suits.

The Delaware plaintiffs alleged that the company's board of directors, including the members of its Health, Safety, Environmental & Technical Committee, had breached their duty of oversight. These claims are often referred to as *Caremark* claims, in reference to the Court of Chancery's landmark decision in *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). Since that decision, the Delaware Supreme Court and several lower court opinions have held that such liability must be predicated on an absence of good faith. This, in turn, requires the plaintiff to show that the directors "knowingly caus[ed] or consciously permitt[ed] the corporation to violate positive law, or … fail[ed] utterly to attempt to establish a reporting system or other oversight mechanism to monitor the corporation's legal compliance."

Because *South v. Baker* was a derivative suit, the plaintiffs were also required to show that making a pre-suit demand on the board of directors would be futile. To show demand futility, the plaintiffs had to plead "particularized factual allegations [that] create a reasonable doubt that … the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." Because *Caremark* claims, by their nature, do not challenge a particular board action or decision, the plaintiffs had to plead that the directors faced "a substantial likelihood of personal liability" due to the mining accidents. As the court explained, "[w]ithout a connection to the board, a corporate trauma will not lead to director liability. Without a substantial threat of director liability, a court has no reason to doubt the board's ability to address the corporate trauma and evaluate a related demand."

The Court's Analysis of the *Caremark* Claims

The court first found that the plaintiffs failed to show that the board of directors had made any decision or taken any action that resulted in the mine accidents. Thus, there was no basis to infer that the directors made a conscious decision to "violate positive law."

Next, the court found that the plaintiffs failed to allege sufficiently that the board of directors consciously disregarded safety problems at the mine. The court stated that "the complaint nowhere alleges anything that the directors were told about the incidents, what the Board's response was, or even that the incidents were connected in any way." The court also held that "an allegation that the underlying cause of a corporate trauma falls within the delegated authority of a board committee does not support an inference that the directors on that committee knew of and consciously disregarded the problem." Moreover, the court rejected the plaintiffs' argument that "three mining accidents in a year" could support a "reasonable inference" of board involvement and bad faith, particularly where the incidents appeared to be unrelated.

Finally, the court held that the plaintiffs failed to allege a sustained or systematic failure of the board to exercise oversight, which would be necessary to support an inference of bad faith. To the contrary, the court noted that the company had a board committee charged with overseeing safety issues. As a result of the foregoing, the court concluded that the plaintiffs failed to show that the directors faced a substantial risk of liability that would excuse making a demand on the board.

Effect of Dismissal on Other Suits

The court dismissed the plaintiffs' complaint with prejudice, but only to the named plaintiffs in the Delaware action. It found that the plaintiffs rushed to file their complaint without first trying to inspect the company's books and records to bolster their pleadings. The court concluded that, "[r]ather than acting in the best interests of the corporation, the [plaintiffs] filed hastily because doing so served the interests of their attorneys," thereby rendering the plaintiffs inadequate derivative plaintiffs.

Because the court found that the plaintiffs were inadequate representatives, however, it ruled that the dismissal would not have a preclusive effect on other stockholders. Thus, other stockholders could inspect the company's books and records and bring derivative complaints alleging *Caremark* claims relating to the same subject matter. In explaining its decision, the court expressed concern that "if a different stockholder carefully investigated the events at the Lucky Friday mine, uncovered a meritorious claim, and wished to pursue it, the potential combination of a broad preclusion rule together with all-too-predicable results of the [current plaintiffs'] litigation strategy could bar the diligent stockholder from suing."

Implications

Caremark claims continue to be among the most difficult theories on which shareholders can seek to recover from directors. Among other reasons, the plaintiffs are forced to show that the directors acted in bad faith and in a systemic fashion. As the Delaware Supreme Court held in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), liability predicated on a *Caremark* claim requires that the directors must have (i) "utterly failed to implement any reporting or information system or controls" or (ii) "having implemented such a system or controls, consciously failed to monitor or oversee its operations." In either case, furthermore, the directors must have known that they were not discharging their fiduciary duties. This high standard has led to the dismissal of most *Caremark* claims in Delaware. It is much easier for plaintiffs instead to focus on challenging a particular transaction or specific board action.

South serves as another warning to plaintiffs' counsel to inspect a corporation's books and records under Section 220 of the Delaware General Corporation Law before filing a derivative suit. For that reason, books and records inspections should be taken seriously by corporations since they are often precursors to litigation.

South also provides a roadmap for framing director oversight claims:

- First, a plaintiff can try to plead facts and circumstances to show that the directors had actual knowledge that they were not discharging their fiduciary duties — a conscious violation of "positive law."
- Second, a plaintiff can try to show that the board consciously failed to act after learning about a potential illegality — "the proverbial red flag." "A board that fails to act in the face of such information," the court wrote, "makes a decision, and the decision not to act is just as much of a decision as a decision to act."
- Third, a plaintiff can show that the board is dominated or controlled by key members of management who have engaged in improper conduct. The court observed that the conditions to succeeding on this theory are "quite high" and, in order to prove bad faith, require a showing of a "sustained or systematic failure" to exercise oversight, such as an "utter failure" to assure a reasonable information and reporting system exists.

Importantly, *South* took a very realistic view of complex businesses. Boards of directors are charged with overseeing a corporation, but they do not actively manage a corporation's operations. For this reason, the court refused to infer that the directors had engaged in knowing indifference simply because three mining accidents happened within a year. "In a large corporation engaged in a dangerous business," the court explained, "three incidents could readily happen in a single year because of decisions made and actions taken sufficiently deep in the organization for the board not to have been involved."

The decision should also give comfort to board committees. Nothing in the opinion suggests that the members of the company's safety committee had acted in bad faith or should be held to a higher standard of care. Rather, the court rejected the notion that the directors had consciously disregarded a risk just because an incident fell within the scope of that committee's charter. In fact, the court noted that the existence of a committee devoted to health and safety matters, and composed of the board's most knowledgeable directors on the issue, evidenced the board's efforts to establish a reasonable reporting and oversight system. Other corporations may take note of this in reviewing their existing committee structures.

From a litigation perspective, there will be mixed reactions to *South*. On the one hand, *South* may lead to additional, and potentially wasteful, litigation in which stockholders get more than one bite at the apple.[1] This means that a corporation may have to expend its resources in defending a hastily filed complaint and still have to litigate the same issues in a subsequent suit. On the other hand, the Delaware court used its authority to police plaintiffs' counsel, who often are accused of pursuing fee awards and jockeying for lead counsel positions rather than serving the interests of the applicable derivative plaintiff or stockholder class. Seen this way, *South* is among several recent opinions in which the Court of Chancery has been highly critical of the manner in which plaintiffs' lawyers pursue fiduciary duty litigation. In addition, by rewarding better complaints, *South* further undermines the perceived race to file suits by plaintiffs' lawyers.

[1] The Court of Chancery reached a similar conclusion in *La. Mun. Police Empls.' Ret. Sys. v. Pyott*, 46 A.3d 313 (Del. Ch. 2012), in which it permitted a plaintiff to proceed with a derivative complaint after a federal court had dismissed a similar action for failure to establish demand futility.

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