

**DELAWARE SUPREME COURT ADDRESSES DIRECTOR OVERSIGHT LIABILITY,
CLARIFIES THE OBLIGATION TO ACT IN GOOD FAITH**

The Delaware Supreme Court recently approved the *Caremark* standard for director oversight liability, and brought some clarity to whether there is a stand-alone fiduciary duty of "good faith." *Stone v. Ritter*, C.A. No. 1570-N, 2006 WL 3169168 (Del. Nov. 6, 2006).

In *Stone*, stockholders of AmSouth Bancorporation appealed the Court of Chancery's dismissal of a derivative complaint alleging that directors failed to exercise oversight over conduct that resulted in \$50 million in penalties for violations of the Bank Secrecy Act and various anti-money-laundering regulations. The stockholders' allegations principally arose from the failure by certain bank employees to file Suspicious Activity Reports as required by the applicable state and federal regulations.

The Supreme Court affirmed the Court of Chancery's dismissal of the complaint, relying on a report prepared by KPMG that reviewed AmSouth's compliance with the regulations at issue. The Court found that the KPMG report, which had been incorporated by reference in the complaint (and, interestingly, made available to the stockholders as a result of a "books and records" demand made prior to filing the lawsuit), refuted the stockholders' claim that the board did not exercise any oversight. In so holding, the Court stated that "*Caremark* articulates the necessary conditions for assessing director oversight liability." *Id.* at *1.

As construed by the Supreme Court in *Stone*, the *Caremark* standard for director oversight liability requires that "(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." *Id.* at *6. In approving and applying this standard, the Court explained:

The phraseology used [by the Court of Chancery] in *Caremark* and that we employ here—describing the lack of good faith as a "necessary condition to liability"—is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[.]" *i.e.*, a condition, "of the fundamental duty of loyalty." It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

Id. at *6 (footnotes and citations omitted).

The Court then stated that two consequences flow from its adoption of the *Caremark* standard. First, "although good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of

care and loyalty." Second, "the fiduciary 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." *Id.* at *6. The Court concluded its discussion of the interplay between good faith and the *Caremark* standard, stating "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id.*

It is obviously helpful to have the definitive guidance of the Delaware Supreme Court that "good faith" is *not* a separate fiduciary duty. However, directors will nonetheless need to be mindful of the requirement of "good faith" behavior because the Court linked the absence of good faith to the duty of loyalty. Directors cannot be exculpated under a limitation on liability provision adopted under Section 102(b)(7) for breaches of the duty of loyalty.

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