Avoiding Duty of Oversight and Fiduciary Duty Breach Claims

Key Takeaways for In-House Counsel Advising Corporate Directors and Officers

AVOIDING DUTY OF OVERSIGHT AND FIDUCIARY DUTY BREACH CLAIMS

Table of Contents

Background of Duty of Oversight Claims **2**

Overview of Recent Case **4**

How Directors and Officers May Avoid Oversight Claims **5**

Takeaways for Directors. **6**

Takeaways for Officers **10**

The Business Judgment Rule **12**

Conclusion. **14**

About Seyfarth's Securities & Fiduciary Duty Litigation Practice **16**

Meet The Authors **17**

Background of Duty of Oversight Claims

Oversight claims, which historically have most often been brought against a company's directors and much less frequently against officers, are subject to the principles outlined in the 2019 *Marchand* case where the opinion is from a unanimous *en banc* panel of the Delaware Supreme Court. For additional information on the *Marchand* decision, see *A Director's Duty of Oversight after Marchand in "Caremark" Case*, Harvard Law School Forum on Corporate Governance (Jan. 23, 2022).

After Marchand, oversight claims are often commenced alleging one of two theories:

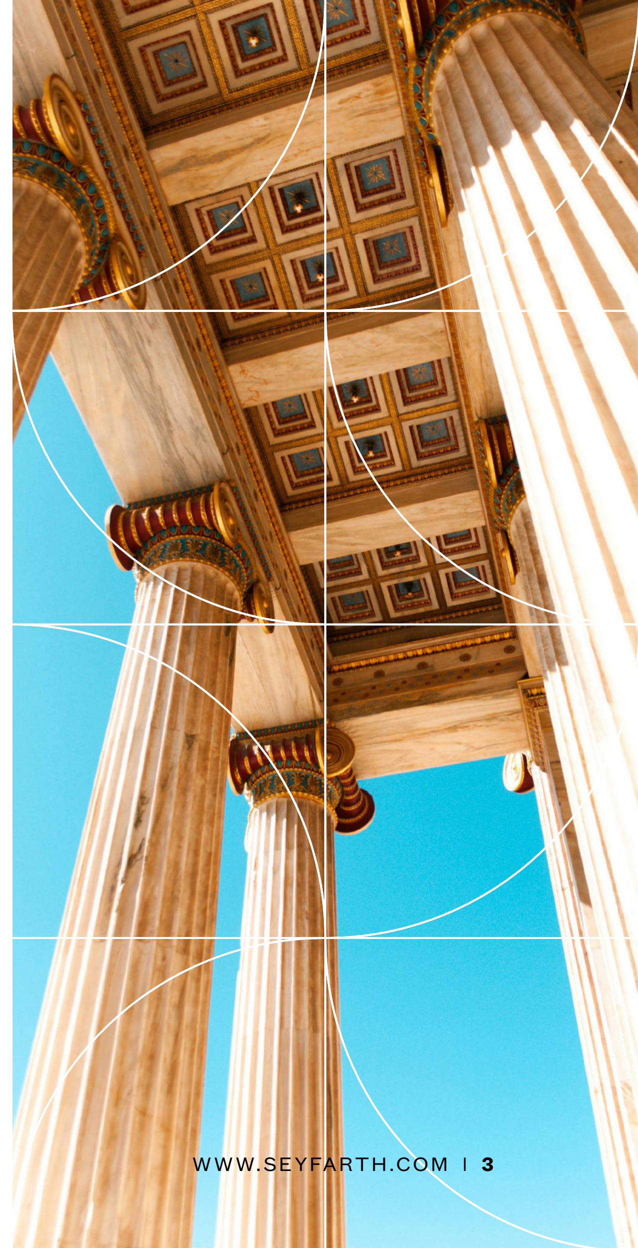
(a) **failure to implement** a reasonably thorough system of information flow to the board and reasonable internal controls; or

(b) having implemented a reasonable system of information flow, that the directors or officers **consciously failed to monitor or oversee** the issues or risks identified by the information.

A plaintiff setting forth an oversight claim must do more than simply allege with hindsight that the oversight system was deficient in some respect. Rather, a plaintiff must allege either a failure to implement a reasonable oversight system or, if a reasonable oversight system is in place, a conscious or bad faith failure to respond to information provided by such system.

For many years *oversight* claims were frequently dismissed even when illegal or harmful company activities escaped detection because the board had not established an adequate system of receiving information.

In its 2019 *Marchand* decision, the Delaware Supreme Court, sitting *en banc*, unanimously reversed the dismissal of an oversight claim, finding that the complaint had adequately alleged that an ice cream company subsidiary had "failed to implement any system to monitor the company's food safety performance or compliance" following a listeria outbreak. *Marchand*, and several subsequent cases in Delaware, showed that despite the still steep requirements to plead an oversight claim, such a claim may be allowed to go forward particularly when it involves an issue or risk which is important to the business of the firm.

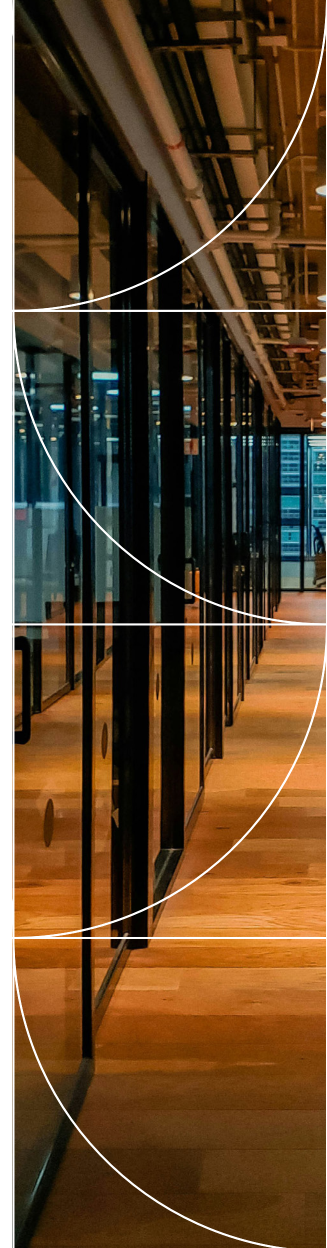


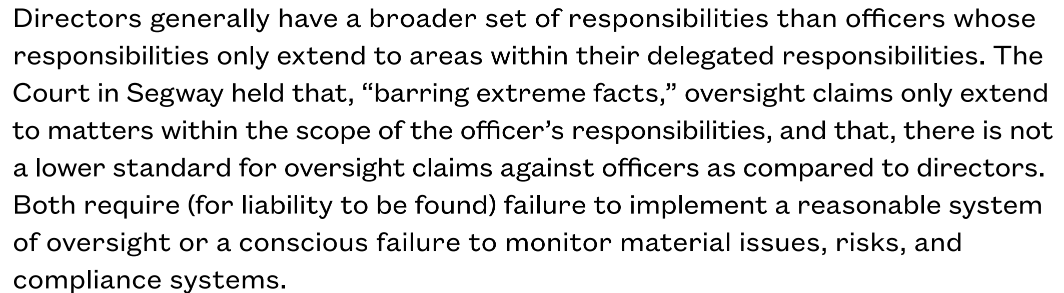
Overview of a Case Against an Officer

On December 14, 2023, Vice Chancellor Will of the Delaware Chancery Court dismissed a complaint brought by Segway, Inc. ("Segway"), alleging that a former officer had breached her duty of oversight. *Segway* is notable in that Vice Chancellor Will took the opportunity to emphasize that what is required to meet the pleading standard to state an oversight claim against officers is not materially different from what is required to state a claim against board members, but is quite different from what many lawyers believed pre-*Segway*.

Segway involved an action by Segway itself against its former President, Judy Cai, alleging that Cai had breached her fiduciary duty of oversight by "continuously ignoring" complaints from Segway's customers which had caused Segway's accounts receivable to "continuously rise," (rather than be paid) and failing to report these issues to Segway's board.

In a short opinion dismissing the case, the Court expressed surprise at Segway's attempt to fashion allegations related to failure to predict a business trend as oversight claims. Importantly, the *Segway* Court soundly rejected the plaintiff's theory that recent caselaw allowing oversight claims to proceed against company officers had also created a lower oversight pleading standard as to officers. Vice Chancellor Will called such a theory a distressing reading of our law." The *Segway* Court explained that recent caselaw "observed that officers of Delaware corporations duties of oversight comparable to those of directors on issues for which they had responsibility.





Directors generally have a broader set of responsibilities than officers whose responsibilities only extend to areas within their delegated responsibilities. The Court in Segway held that, “barring extreme facts,” oversight claims only extend to matters within the scope of the officer’s responsibilities, and that, there is not a lower standard for oversight claims against officers as compared to directors. Both require (for liability to be found) failure to implement a reasonable system of oversight or a conscious failure to monitor material issues, risks, and compliance systems.

How Directors & Officers May Avoid Oversight Claims

Segway made clear when an officer was at risk for oversight claims and as a result companies should:

1. Ensure that they have adequate D&O insurance to protect both directors and relevant senior officers against potential claims they may face.
2. Both directors and officers should with care pay attention to monitoring information in ways described above, to help, avoid oversight risks.

The following pages provide some policies that should help both directors and officers in *avoiding oversight* liability.

Takeaways for Directors

Directors should ensure that compliance systems are in place that they in good faith believe are reasonable and are monitored through regular reports to the entire board or a special committee, especially for any "mission: critical" issues or material risks relating to the company's business.

Action items directors can initiate to reduce their risk of an oversight claim include:

1. Identify and Monitor Critical Issues and Significant Risks
2. Implement Oversight Measures
3. Assess Board Composition and Qualifications
4. Delegate Authority to Committees
5. Consider When to Engage Experts
6. Build Reporting Structures
7. Consider Stakeholders' Interests
8. Obtain Guidance of Lawyers
9. Create and Monitor Internal Controls

1. **Identify and Monitor Critical Issues and Significant Risks.** Directors and officers should identify the most significant issues and risks relating to the company's business. Any such issues or risks should be carefully monitored by or on behalf of the board, its members, and by officers who are responsible within the scope of their authority. Oversight claims which have survived the pleading stage to date, most often involve some failure such as a failure to implement a reasonable method for transmitting information to the board on major issues and risks or monitor an issue or risk important to the company's success.

   Examples of "mission critical" issues and risks include:

   - product safety as seen in *Marchand* (food safety).
   - cybersecurity which one Court, while dismissing an oversight claim, acknowledged could be "an area of consequential risk that spans many modern business sectors."

   Other significant issues and risks will be business-specific, such as trial outcomes for a company's only drug product as seen in *Clovis*.

2. **Implement Oversight Measures.** Board members should continue on an ongoing basis to keep themselves informed on issues of significance or high risk to the company, including through receiving both regularly scheduled updates and by implementing reporting protocols for timely updates on major incidents or new risks.

3. **Assess Board Composition and Qualifications.** The board should periodically evaluate its composition and the corporate structure and the charter of the company to determine whether there is sufficient experience, expertise, and diversity on the board, an absence of conflicts of interest, and that there is no domination by a conflicted controlling person. The duty of loyalty requires that directors always keep the best interests of the corporation as their primary goal when assessing courses of action.

4. **Delegate Authority to Committees.** The board should determine whether there are topics or issues it should reasonably delegate to a special committee, to another committee of the board, or management. In making these determinations, the board should consider the expertise of any likely candidate or candidates for receiving the delegation from the board and make sure of the absence of any conflict of interest and the absence of any domination by a controlling party over the candidate.

   Other factors to consider in selecting committee members include:

   - the ability to devote sufficient time to board matters;
   - experience as a board or committee member, which is often helpful;
   - expertise on an issue, which while not necessary is useful; and,
   - importantly, having good, reasoned judgment which is a prime desired characteristic when searching for a good board or committee member.

5. **Consider When to Engage Experts.** The board where helpful can and should assign inside experts or engage third parties and external advisors to give guidance and advice to help address critical issues and risks. Before doing so, the board and officers should consider the materiality of the issue, the cost, the expertise of the person or entity, the the time required to monitor the number of issues and risks being considered, and the possibility that information relating to risks might get outside the company.

6. **Build Reporting Structures.** To comply with its duty of oversight, the board must arrange for an adequate flow of information to itself. In doing so, the board must carefully consider what information it needs to properly oversee risks and mission critical business issues that the company faces, as well as how it will receive that information in time to make it useful in the board's decision-making process.

7. **Consider Stakeholders' Interests.** The board should make sure it understands significant company policies and procedures and understands how management is communicating to the corporation's shareholders and other stakeholders. Board members should keep in mind the corporate purpose adopted by the company. The board should also consider the interests and treatment of other stakeholders such as employees, investors, customers, business partners, suppliers, the community, the environment, diversity, and other factors.

8. **Obtain Guidance of Lawyers.** When serious issues arise, the board and sometimes officers should take steps to see that inside and/or outside counsel are helping to evaluate the litigation risk and advising on steps to take to avoid being sued.

9. **Create and Monitor Internal Controls.** The board should ensure that an adequate system of internal controls exists or should promptly create such a system of controls.

   It should also see to it that there is sufficient internal monitoring of compliance with:

   a) company policies

   b) government laws; and

   c) regulations in its business area.

   The board should perform assessments of internal controls and regularly get the report of an expert on such controls and understand how the expert rates the company's performance and how it compares with industry standards.

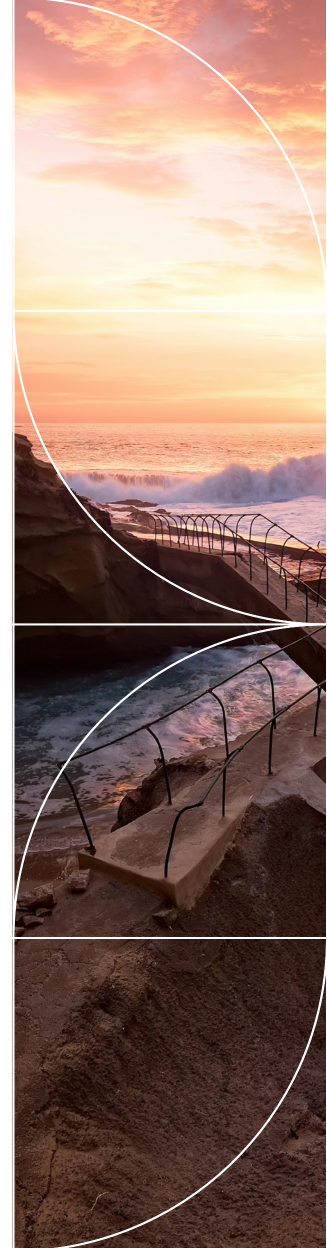
Takeaways for Officers

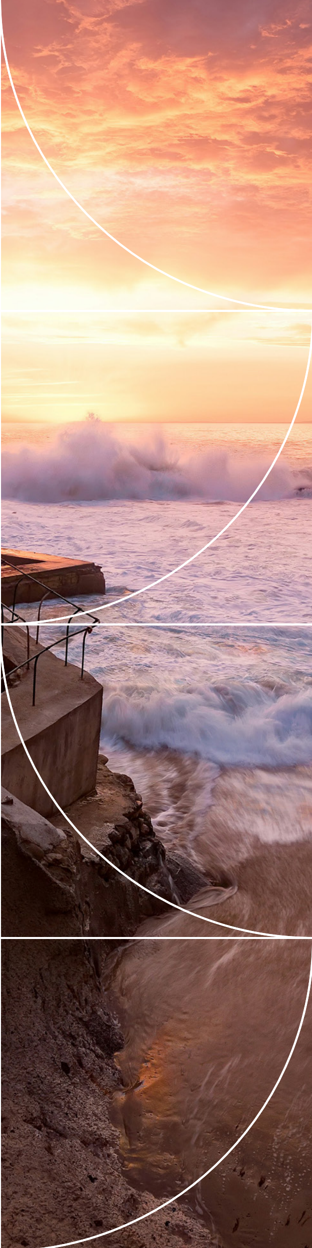
Officers should see to it that they are complying with the fiduciary duty of care and loyalty in always putting the company's interests ahead of their own. Officers should evaluate regularly whether the staff they work with have adequate expertise for their duties.

Fiduciary duties of officers of a corporation are similar to those of the board but the breadth and scope of the obligations are often less wide and, in some cases, less stringent than those that apply to the board. Officers are expected to carry out the duties entailed in their employment and areas of responsibility properly assigned or delegated to them.

Action items that officers can take to mitigate the risk of an oversight claim include:

1. Identify Business Risks Within their Scope of Authority
2. Get Regular Reports on Material Issues and Risks
3. Consider with Legal Advice What Records Should be Kept of Oversight and Compliance Issues





Officers are generally most at risk concerning oversight claims by failing to monitor issues and risks in those areas which are within the officer's scope of authority. Officers (including senior officers) should ensure that they are well-apprised of the risks that the company faces within the scope of their duties and have systems in place to monitor information concerning such issues and risks. Some action items that officers can take to mitigate the risk of an oversight claim include:

1. **Identify Business Risks Within their Scope of Authority.** Officers should identify "mission critical" issues and risks within their scope of responsibility and implement procedures for reporting any significant ones. Officers should also ensure proper controls are in place to help identify any significant problems within their scope of authority.

2. **Get Regular Reports on Material Issues and Risks.** Just as directors should have systems in place to regularly receive reports concerning material issues and risks, so too should officers see to that they are appropriately informed.

3. **Consider with Legal Advice What Records Should be Kept of Oversight and Compliance Issues.** Just as with directors, officers should have a system in place to address important issues and risks and actively monitor and utilize that system. This can include, where pros and cons are carefully considered, memorializing the subject of certain meetings that report on such items as well as memorializing in written reports made to a CEO. We also recommend an attorney review any officer's reports to the board to help avoid unhelpful or inaccurate memorialization.

The Business Judgment Rule

Beyond oversight, officers and directors are vital contributors, executing all duties with diligence and loyalty to the corporation.

Self-dealing and letting personal interests outweigh the interests of the corporation will expose officers to liability for breach of the duty of loyalty. Recently, more cases have been filed as derivative claims against individual officers who allegedly failed to carry out their duties of care and loyalty to the corporation's interests.

The business judgment rule is a legal presumption that protects corporate directors and officers who are independent and have no personal interest in the outcome of specific board issues or actions, and who, while reasonably informed, act in good faith and with an honest belief that they are acting with the lawful and legitimate interests of the corporation and shareholders in mind. Directors and officers who comply with the Business Judgment Rule standards are very often protected from liability for breaches of fiduciary duty relating to such issues or actions.

Courts, which are ill-equipped to make business judgments on how corporations should be run or managed on a day-to-day basis, will generally afford great deference to board actions taken by independent directors who are reasonably informed on the issue in question and act in good faith pursuant to the fiduciary duties of care, loyalty, and oversight.

The business judgment rule is a presumption that may be rebutted by evidence that the directors breached a fiduciary duty by engaging in self-dealing, making decisions tainted by conflicts of interests, or acting fraudulently, dishonestly, or in bad faith, or failing to act with reasonable diligence in informing herself of relevant facts and circumstances. In such instances, courts will likely analyze challenged conduct by using the "entire fairness standard" under which the board carries the burden of demonstrating that the process and outcome of the transaction at issue are fair to company shareholders. To preserve review under the more favorable business judgment rule in situations where a conflict of interest has arisen, boards are encouraged to adopt certain safeguards, including:

1. establishing a special committee of independent and disinterested directors authorized to take actions on the transaction without input from the potentially conflicted parties;
2. where applicable, obtaining a fairness opinion on the transaction from an independent financial advisor; and
3. where applicable, consider trying to vote to achieve a vote of a majority of the non-conflicted shareholders to approve the transaction.

Conclusion

Recent Chancery Court decisions have made clear that oversight claims may be brought against directors and officers but most often where such officers and directors are alleged to have failed to implement a reasonable oversight system or, acting consciously and in bad faith, failed to respond to reported issues or risks. By taking certain steps outlined above, officers and directors can reduce the risks of such litigation.

About Seyfarth's Securities & Fiduciary Duty Litigation Practice

Elevating corporate governance expertise, our legal team specializes in advising and representing in-house counsel on strategies to guide corporate directors and officers in steering clear of duty of oversight and fiduciary duty claims. With a focused, cost-effective approach, we not only mitigate risks but also safeguard financial interests, providing robust defense against securities, financial, derivative, and governance disputes. Recognized as premier trial advocates, we excel in handling intricate securities class actions, shareholder lawsuits, derivative claims, and regulatory investigations.

For more information on Securities & Fiduciary Duty Litigation Practice, visit **www.seyfarth.com**.

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