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Failure-of-Oversight Claims Against Directors

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Editor's note: John F. Savarese is a partner in the Litigation Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton firm memorandum by Mr. Savarese, Emil A. Kleinhaus, C. Lee Wilson, and Noah B. Yavitz. This post is part of the Delaware law series; links to other posts in the series are available here.

Last week, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of purported shareholder derivative claims alleging that directors of JPMorgan Chase, a Delaware corporation, failed to institute internal controls sufficient to detect Bernard Madoff's Ponzi scheme. *Central Laborers v. Dimon*, No. 14-4516 (2d Cir. Jan. 6, 2016) (summary order). The decision represents a forceful application of Delaware law holding that, when directors are protected by standard exculpation provisions in the corporate charter, they will not be liable for alleged oversight failures absent a particularized showing of bad-faith misconduct.

The shareholder plaintiffs in *Central Laborers* attempted to sue JPMorgan's directors based on a so-called Caremark theory. In *Caremark*, the Delaware Court of Chancery held that, when directors of a Delaware corporation are exculpated from liability for breach of the duty of care, they may nonetheless be held liable on a breach of loyalty theory for a bad-faith failure to implement and oversee the corporation's information systems and controls. The Court of Chancery, however, described this theory at the time as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." Thereafter, in *Stone v. Ritter*, the Delaware Supreme Court held that a *Caremark* claim can be sustained only where the directors "knew that they were not discharging their fiduciary obligations," and that such a showing can only be made where "(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."

In *Central Laborers*, the shareholder plaintiffs argued that they had asserted a valid Caremark claim based on allegations that, at the time of Madoff's fraud, the bank's anti-money laundering controls were not "reasonable" or "adequate." The Second Circuit rejected this argument as inconsistent with Delaware's *Stone* decision, which held that a *Caremark* claim requires proof that directors "utterly failed to implement any reporting or information system." The Court explained that the "plain language" of the Stone decision "could not be any clearer—'any' simply does not mean 'reasonable.'" The Court also emphasized that *Caremark* itself spoke in terms of a "failure to attempt" to implement controls, consistent with its holding that "bad faith" is required to impose liability.

The *Central Laborers* decision is important because it reaffirms that, in New York as in Delaware, courts will faithfully enforce the protections that Delaware law provides to directors who act in

good faith, including the protections afforded by exculpation provisions. The decision also makes clear that Caremark claims against directors require allegations of conscious misconduct, and cannot be predicated on after-the-fact challenges to the “reasonableness” of a corporation’s controls.