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Alert | Delaware Corporate Law

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Delaware Court of Chancery Determines that Corporate Officers Owe Duty of Oversight: Practical Considerations

The Delaware Court of Chancery, resolving an open question of Delaware law, recently held that corporate officers owe a fiduciary duty of oversight similar to that of corporate directors under the *Caremark* line of cases.[1] This represents an important development in Delaware law with potentially far-reaching implications for Delaware entities and their fiduciaries.

Assessment of Officers' Fiduciary Duties under Delaware Law

The allegations in the plaintiff's complaint, which Vice Chancellor J. Travis Laster was required to accept as true at the motion to dismiss stage of the case, reflected an extreme set of circumstances related to alleged conduct by a former head of human resources and allegations relating to corporate culture. Based on those allegations and inferences, the Court denied a motion to dismiss claims for breach of fiduciary duty against the officer-defendant.

In reaching its decision, the Court stated that, when an officer engages in acts of serious misconduct, it is reasonable to infer that the same officer consciously ignored red flags about similar acts of misconduct by others. The Court further inferred from the complaint's allegations that such an officer can play a role in creating a problematic corporate culture. Although the officer was disciplined and joined in company responses to misconduct, the Court found that for purposes of a motion to dismiss, the company's

[1] C.A. No. 2021-0324-JTL (Del. Ch. Jan. 26, 2023).

response may not have been adequate or that the company may have ignored red flags, because that officer was subsequently terminated for cause after another incident of similar misconduct. As a result, the motion to dismiss was denied with respect to the claims related to allegations both before, and after, the initial disciplinary measures.

The Court explained the legal view that officers' fiduciary duties include oversight obligations, by tracking through the background of fiduciary oversight obligations, emphasizing that, as independent fiduciaries who must report to the board, manage daily operations, and exercise discretion, officers are a critical part of the structure mandated by Delaware law for management of the corporation. The Court concluded that the imposition of a duty of oversight for officers was consistent with the rationale of the *Caremark* line of cases. The Court further explained that officers' duty of oversight—as with directors' oversight obligation—entails obligations to establish a monitoring system and respond to red flags, and liability for failure to fulfill this obligation is subject to a bad faith standard. This decision noted, however, that the context-driven application of the duty of oversight will result in different obligations for directors and officers, as well as for officers with different roles, responsibilities, and authority—suggesting the duty of oversight for officers would be confined to their sphere of responsibility. The Court also noted that, as a policy matter, the decision would likely not lead to a flood of new claims, in part because such a claim is derivative, so all of the protections associated with derivative claims will apply.

Considerations from Corporate, Compliance, Regulatory, Securities, Employment, Insurance, and Litigation Perspectives

This decision was made at the motion to dismiss stage, when the Court must accept all of the complaint's allegations as true. The holding may be challenged on appeal and further refined by future Delaware case law. Nevertheless, this case represents a significant development in Delaware law and suggests consideration of a number of issues from corporate, litigation and other legal perspectives.

- ***Identification of officers and oversight obligations***. An important question arising from this decision, especially for large organizations, is how widely will officer oversight obligations apply (or, put another way, which employees will be treated as "officers" under Delaware law for this purpose). Previous Delaware case law addressing indemnification of officers has suggested that large corporations, which have a large number of employees with officer-sounding titles (e.g., "vice president"), may have employees who are deemed to be officers far beyond a small handful of C-suite executives. Applying that broad definition of "officer" would lead to many employees having oversight obligations. Although all corporate fiduciaries owe the same fiduciary duties, including the obligation to oversee company operations, this decision explains that those duties could apply in different ways to different officers, depending on their level and their areas of responsibility. Thus, the areas of responsibility of senior and junior officers should be carefully and clearly documented. Further case law may explain the parameters of officers' oversight obligations, but it is possible that there may be significant differences in the oversight obligations of senior and junior officers.
- ***Officer oversight at large institutions vs. small VC-backed companies***. This decision may have different implications for companies and their officers, depending on the size of the company. For instance, companies like banks and financial institutions with hundreds of "vice-presidents" may wish to carefully balance the desire to broadly provide indemnification rights while limiting the imposition of oversight obligations of employees who may be treated as officers. On the other hand, early- and growth-stage companies, such as leanly staffed, venture capital-backed companies, may want to give greater thought to reporting structures and awareness of oversight obligations, in light of the fact that employees at such companies often operate with autonomy in numerous roles (which may constitute management irrespective of their titles).

- ***Identifying and monitoring mission critical operations***. Over the past few years, Delaware case law around oversight has focused on the discharge of oversight obligations in the context of "mission critical" operations at companies in heavily regulated industries. This point may be salient when determining the extent of efforts required of senior and junior officers involved in "mission critical" operations in exercising their oversight obligations.
- ***Compliance, conduct, and training programs***. Companies and their counsel and advisors should review the design of their compliance programs and codes of conduct with the officers' duty of oversight in mind—especially the monitoring and reporting procedures and roles of compliance officers. Considering the possibility that performance of a wide group of officer employees may now come into sharper focus, independent audits of the compliance function and training for senior and junior officer functions should also take this development into account. This is particularly important for companies operating in heavily regulated industries, for employees dealing with mission critical operations, for companies in regulated spaces, particularly those that have been subject of previous oversight case law (e.g., anti-money laundering rules, Foreign Corrupt Practices Act, etc.), and for publicly traded companies, which are subject to SEC reporting obligations and are required to ensure compliance with federal securities laws prohibiting insider trading and other misuses of material, nonpublic information. Chief compliance officers (CCOs, and employees performing that role) should also understand this Delaware corporate law development in tandem with developments in federal law enforcement's focus on compliance, such as potential CCO certifications about the design and implementation of compliance programs in connection with criminal resolutions reached with the U.S. Department of Justice.
- ***Corporate recordkeeping and books and records demands***. This decision reinforces the importance of maintaining records related to oversight activities on board- and officer-levels. Officers and corporate recordkeepers may want to revisit past practices to ensure that formal corporate documentation adequately reflects officers' performance of their oversight obligations. Companies should also be thoughtful about how to appropriately respond to books and records demands, such as those seeking corporate records related to potential wrongdoing that regularly follow announcement of a company settlement or other negative developments.
- ***Insurance and indemnification***. Although this case suggests potential new grounds for litigation and liability, its ultimate impact on directors and officers (D&O) insurance and corporate indemnification obligations is less clear and remains to be determined. The Court explained that oversight claims against officers may, like similar claims against directors, be a rare phenomenon. If that proves to be true, the market for D&O insurance may not be fundamentally altered, but attention should be paid to the company's Side A coverage and limits (covering non-indemnified and non-indemnifiable loss suffered by the officer) and new policy terms and exclusions that may follow in the wake of this case. We must wait to see how litigation explores the possibilities of this theory of liability, and how employment practices liability insurance (EPLI) and other D&O coverages or pricing may be affected.
- ***Officer exculpation***. It is also worth noting that officer exculpation for liability from direct claims under recently amended Section 102(b)(7) of the Delaware General Corporation Law generally may not apply to duty of oversight claims, because the Court's decision expressly stated that a successful oversight claim would require a showing of bad faith, which is not subject to exculpation. In addition, depending on the company's organizational structure and relevant corporate documents, the scope of the officers who can be exculpated under the new Delaware statute may be far narrower than the employees who are viewed as "officers" who have a duty of oversight under Delaware law.

- ***Application to entities other than traditional Delaware corporations***. Many jurisdictions look to Delaware for guidance regarding corporate law, and it may be advisable for corporate officers and their advisors in those jurisdictions to take note of this Delaware decision. Other jurisdictions (e.g., Ohio and Nevada), however, have diverged from Delaware corporate law and fiduciary duties in relevant ways, such as the determination not to recognize oversight obligations as part of corporate fiduciary duties. In those jurisdictions, this Delaware decision may not directly impact the application of fiduciary duties or potential officer liability. However, if the company's code of conduct or other governance documents require officers to be vigilant for and to report wrongdoing, then the concept of an oversight obligation may still be applicable and cases defining that duty may hold some relevance. Likewise, entities, such as limited liability companies (which are permitted to establish bespoke duties for managers and officers that modify most traditional corporate fiduciary duties) or public benefit corporations (PBCs) (which require balancing of fiduciary duties among stockholder pecuniary interests, the PBC's public benefit, and affected communities), may need to consider oversight obligations and the potential of resulting liability.

We will continue to monitor the implications of this decision, any appeal of its determinations, and further developments regarding officers' fiduciary duties, including the duty of oversight.

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