Blogs
January 31, 2024
Delaware Chancery Confirms High Standard to Plead Caremark Claims Against Officers

Last year, the Delaware Court of Chancery confirmed that corporate officers—not just directors—have a fiduciary duty of oversight in *In re McDonald's Corp. S'holder Deriv. Litig*., 289 A.3rd 343 (Del. Ch. 2023). In *Segway Inc. v. Cai, C.A.* No 2022-1110-LWW (Del. Ch. 2023)—a decision that should give some comfort to corporate officers—the court clarified that a duty of oversight claim against a corporate officer must satisfy the same high pleading standards as an oversight claim against a corporate director in order to survive a motion to dismiss.

Segway sued its former president, Judy Cai, alleging that she breached her duty of oversight. Cai served as Segway's vice president of finance after the company's 2015 acquisition by a subsidiary of Ninebot (Beijing) Tech Co. Ltd. and was appointed president in 2018. During her tenure, Cai allegedly oversaw the company's finance department, had complete responsibility for Segway's tax matters, was aware of the company's accounts receivable, and remained involved in compiling and reviewing financial information for Ninebot's management. The company changed its business model after the acquisition but did not prosper, losing customers and revenue, and shrinking its operations. Cai's employment was ultimately terminated in 2020. Subsequently, Segway allegedly discovered discrepancies in the recording of its accounts receivable.

Segway asserted that Cai breached her fiduciary duty of oversight by ignoring issues with certain Segway customers that caused Segway's accounts receivable to increase which negatively affected the company's profitability, and by failing to take any action to address those issues or inform the company's board of directors about them. In the lawsuit, Segway sought money damages and an accounting for the uncollected accounts receivable.

In dismissing Segway's complaint, the court explained that a breach of the duty of oversight is a breach of the duty of good faith, which is a subsidiary element of an officer's fiduciary duty of loyalty. The conditions for oversight liability were articulated in the seminal *Caremark* case (*In re Caremark Int'l. Deriv. Litig*., 698 A. 2d 959 (Del. Ch. 1996)), and restated by the Delaware Supreme Court in *Stone v. Ritter*, (911 A. 2d 362, 370 (Del.

2006)) as follows: "bad faith can be established when fiduciaries (a) 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." Here, Segway's allegations were insufficient to plead a claim of bad faith under either prong of *Caremark.*

In the court's view, Segway appeared to believe that the court's earlier *McDonald's* decision had established "a lower standard for [pleading] oversight claims brought against officers" than against directors, an assertion that the court firmly rejected. In reaching its conclusion, the court made several points that will be helpful for officers facing Caremark duty of oversight claims:

1. **A corporate officer's duty of oversight only extends to that officer's areas of responsibility, except under "extreme" circumstances.** Corporate officers do not, generally, face oversight liability for corporate inaction or activities that are outside their purview. Here, Cai's duties allegedly included oversight of the company's finances.

2. **To be liable for an oversight breach, an officer must have "consciously failed to act after learning about evidence of illegality—the proverbial 'red flag.'"** This is the second prong of *Caremark*, which applies if the company has a relevant reporting system but fails to monitor it. Here, Segway did not allege any wrongdoing in connection with the company's accounts receivable—for example, that Cai "overlooked accounting improprieties, fraudulent business practices, or other material legal violations."

3. ***Caremark* liability arises from an officer's actions in bad faith.** The court was clear that an officer's oversight liability cannot be based solely on confronting "everyday business problems," "failure to predict the future," or failure "to properly evaluate business risk." Instead, facts demonstrating bad faith must be alleged.

4. **Negative outcomes alone do not establish oversight liability.** The court noted that"[o]fficers' management of day-to-day matters does not make them guarantors of negative outcomes from imperfect business decisions." Rather, to plead a breach of oversight claim against an officer, a plaintiff must show, at a minimum, "that the officer failed to make a good faith effort to monitor central compliance risks within her remit that pose potential harm to the company or others".

In short, the court reaffirmed that "a *Caremark* claim is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,'" whether the defendant is a corporate officer or a director.

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