FEBRUARY 23, 2024 • 7 MIN READ

Caremark's exacting pleading standard applies equally to directors and officers, Delaware Chancery confirms

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The Delaware Chancery Court recently confirmed in *Segway Inc v. Cai*[1] that to survive a motion to dismiss, a duty of oversight claim must satisfy the same exacting pleading standard irrespective of whether the defendant is a director or officer of the company.

What you need to know

- **Heightened pleading under *Caremark* for directors applies equally to officers.** The Court expressly rejected *Segway's* implicit argument that an oversight duty claim against an officer would be simpler to plead than one against a director. Although the Court recently established in *McDonald's* that officers' oversight duties under *Caremark* are "context-specific" and generally limited to matters within the scope of the officer's corporate responsibilities (with rare exceptions), the *Caremark* pleading standard remains the same. Indeed, a successful claim still requires pleading that the officer acted in bad faith and breached their duty of loyalty.

- **Bad faith is a prerequisite to an oversight claim.** Although Segway claimed Cai had "consciously disregarded" financial discrepancies in her reporting to the company, the Court held there were no allegations from which it could reasonably infer she acted in bad faith. "Classic business decisions", "everyday business problems", "failure to predict the future", or failure "to properly evaluate business risk" are distinct from legal compliance and cannot alone support an oversight duty claim. Put differently, mismanagement of general business risks cannot rise to the level of conduct evidencing a knowing disregard of the risk of a specific corporate injury. Rather, "[a]t a minimum, a plaintiff pursuing an oversight claim against an officer would need to demonstrate 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".

- **Continuing import of proverbial "red flags" in the *Caremark* analysis.** The Court reasoned that although Segway alleged Cai "conscious[ly] disregard[ed]" financial discrepancies, it failed to adequately plead under *Caremark's* second prong that Cai "consciously failed to act after learning about evidence of illegality—the proverbial 'red flag'". Grievances flowing from allegations of "generic financial matters are far from the sort of red flags that could give rise to Caremark liability if deliberately ignored". The Court relied on two recent Chancery decisions similarly holding that "general risks" regarding non-compliance were not "red flags" of a "specific corporate trauma" supporting a *Caremark* claim.

- **Bad outcomes do not equal liability.** The Court explained that an officer's oversight of "day-to-day matters does not make them guarantors of negative outcomes from imperfect business decisions". Nor are oversight duties designed to subject fiduciaries to personal liability for failure to predict the future or properly evaluate business risk"—the *Caremark* doctrine is not a tool to hold fiduciaries liable for "everyday business problems".

Background

In April 2015, Ninebot (Beijing) Tech Co., Ltd. acquired personal transportation device maker Segway, but the companies continued to operate separately. Segway maintained its own board, officers, and accounting and finance systems after the acquisition. Judy Cai became Segway's vice president of finance in 2015, overseeing its daily operations. Cai then became Segway's president in 2018 but continued to function as its in-house accountant, compiling and reviewing financial information for Ninebot.

Segway's sales and customer base declined post-acquisition. It began focusing on Ninebot products and started downsizing its operations. By 2020, Segway had closed its headquarters and laid off most employees. After Cai's employment terminated in November 2020, Ninebot allegedly uncovered a significant discrepancy in its accounts receivable. Ninebot could not reconcile the discrepancy, and Cai declined its requests for assistance.

The litigation

Segway filed a single-count complaint against Cai alleging a breach of her fiduciary duty on December 2, 2022. Cai moved to dismiss, and Segway amended the complaint. The amended complaint likewise contained a breach of fiduciary duty claim—specifically, Cai's oversight obligations, in reliance on the seminal *Caremark*[2] case and its progeny, which had articulated the conditions for oversight liability.

Segway alleged Cai knew or should have known about potential issues involving certain Segway customers causing its accounts receivable to rise. It further claimed Cai breached her fiduciary duty as an officer by ignoring issues impacting its profitability and failing to otherwise alert the board or take remedial action. Cai moved to dismiss for failure to state a claim.

Motion to dismiss

In analyzing Segway's *Caremark* claim, Vice Chancellor Lori Will explained that oversight duties arise from the duty of good faith, which is subsumed within the duty of loyalty. Oversight liability, as articulated in *Caremark* and restated by *Stone v. Ritter*[3], can be established where fiduciaries (1) "utterly fail to implement any reporting or information system or controls", or (2) "having implemented such a system or controls, consciously fail to monitor or oversee its operations", which disables them "from being informed of risks or problems requiring their attention"[4].

Segway argued it met the *Caremark* standard by relying on the Court's recent decision in *McDonald's*[5], which extended to officers, for the first time, *Caremark's* oversight duties. In *McDonald's*, the vice chancellor observed that officers of Delaware corporations owe context-specific oversight duties comparable to those of directors but emphasized that the duty of oversight extended only to matters within their province, with limited exceptions.

Although Cai, as president of Segway, owed fiduciary duties to the company and its stockholders, whether she breached those duties, giving rise to a claim under either prong of the *Caremark* test, was unclear. The Court began by applying the *McDonald's* framework, which requires that any alleged oversight violation must fall within Cai's remit. The Court summarized Cai's alleged job duties and allegations concerning her lack of oversight but found no potential wrongdoing, and certainly none within her purview. Because "generic financial matters are far from the sort of red flags that could give rise to Caremark liability if deliberately ignored"[6], and because the complaint lacked any indicia of bad faith on Cai's part, the Court granted Cai's motion to dismiss on December 14, 2023.

In dismissing the action, the Court cautioned that oversight duties should not subject fiduciaries to personal liability for failure to accurately predict the future or evaluate business risk. Nor should the *Caremark* doctrine be used as a tool to hold fiduciaries liable for routine business problems. Rather, it is intended to address "the extraordinary case where fiduciaries' 'utter failure' to implement an effective compliance system or 'conscious disregard' of the law gives rise to a corporate trauma". The Court also addressed Segway's misapprehension that an oversight claim against an officer is easier to plead than one against a director. It reiterated that "a *Caremark* claim is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment'. At a minimum, a plaintiff pursuing an oversight claim against an officer would need to demonstrate 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"[7].

FOOTNOTES

To discuss these issues, please contact the author(s).

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