

Directors take heed

The Delaware Supreme Court has recently handed down a decision which could have a profound impact on the board members of many US companies. It indicates that failure to oversee intellectual assets may lead to personal liability

By **Cathy L Reese** and **Kyle Wagner Compton**

A recent decision by Delaware's Supreme Court lays the groundwork for corporate directors to be held personally liable for failing properly to manage their corporations' intellectual assets. Over the last decade, Delaware courts and the federal government (largely through the Sarbanes-Oxley legislation) have increasingly stressed that directors owe their corporations a duty to oversee corporate property and processes. This includes the duty to oversee the corporation's intellectual assets and to ensure that the corporation is taking necessary measures not to infringe on the intellectual property of others. This oversight duty remains with the board of directors and cannot simply be delegated to management (see R Sterne and T Chaplick, "Why Directors Must Take IP Responsibility," *IAM* issue 10, February/March 2005, pages 16-24).

Unlike most fiduciary breaches, breach of the duty of oversight results from director inaction—failing to monitor or take proper action. Breach of this oversight duty has until now been viewed as a breach of the director's fiduciary duty of care—not the fiduciary duties of loyalty or good faith. Because a breach of the duty of oversight was viewed as a duty of care violation, directors faced with an oversight claim have been protected by: (1) the business judgment presumption; (2) exculpatory provisions in the corporate charter that exempt directors from personal liability for duty of care breaches; and (3) ultimately, the corporation's indemnification policies, which paid the director's legal fees and damages, so long as the director did not breach the duties of loyalty

and good faith. Those protections may no longer be available to directors who breach their duty of oversight.

This article explores the Delaware Supreme Court's recent decision in *Stone v Ritter*, in which Delaware's highest court found that directors can be subject to "oversight liability" for (a) failing to implement any reporting or information system or controls that would avoid corporate liability and protect corporate assets; or (b) having implemented such a system or controls, consciously failing to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Additionally, the court found that such an oversight failure breached the directors' duty of loyalty—not the duty of care—meaning that directors cannot be shielded from oversight liability in the corporate charter and their fees and damages cannot be indemnified or paid by the corporation. In short, directors are more likely now than ever before to be held personally liable for money damages for breaching their duty of oversight of IP assets and risks—at a time when the value of IP assets and the magnitude of liability in IP litigation have never been greater, particularly for IP companies. This article concludes by discussing what directors can do to mitigate this new risk of liability.

The significance of a Delaware corporate decision

The state of Delaware is the corporate home of the majority of public companies in the US, as well as a significant number of private companies and alternative business entities, such as LPs and LLCs. This

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seemingly disproportionate attraction of corporate America to the country's second smallest state is no coincidence. It is rationally related to Delaware's historical specialisation in corporate law. For the better part of the last century, Delaware state law has taken a leading role in shaping American corporate governance standards. Delaware lawmakers have carefully crafted the state corporation law to balance the interests of corporate directors with the interests of shareholders, giving directors freedom to govern corporations and create value through the assumption of risk, while protecting investors from malfeasance and neglect.

Delaware state courts, most notably the Delaware Court of Chancery and the Delaware Supreme Court, are tasked with applying the state corporation law, and are primarily responsible for defining the duties that corporate fiduciaries—directors and officers owe the corporations and shareholders they serve. Moreover, the courts of other jurisdictions throughout the United States frequently look to decisions of Delaware courts as persuasive authority in defining the scope of corporate fiduciary duties and in resolving corporate governance disputes. In this regard, developments in Delaware corporate law are viewed as highly relevant, even to corporations that are not incorporated in Delaware.

Although corporate directors' fiduciary duties are most often implicated in the context of financial transactions, particularly mergers and acquisitions, Delaware corporate law provides valuable lessons for the management of intellectual property assets as well. In this article, we introduce the concept of fiduciary obligations incumbent on corporate officers and directors, and offer suggestions for discharge of those obligations through best practices and liability avoidance.

Directorial duties

As a basic premise, corporate directors are charged with managing the business and affairs of the corporation on whose board they serve. The tasks that are subsumed within this charge of managing business and affairs are wide-ranging and can vary in accordance with the nature of the business. In general, directors enjoy the power of, and bear the ultimate responsibility for, deciding what business objectives the corporation will pursue and how those objectives will be attained. Yet it is shareholders, not directors, who own the corporation. Thus, the directors are duty-bound to manage the corporation for the benefit of the shareholders.

In fulfilling their function of managing the corporation, directors are bound by certain fiduciary duties and it is the fulfilment of those duties by which directorial performance is measured. The principal fiduciary duties that directors and officers owe the corporation and its shareholders are the duty of care and the duty of loyalty.

The duty of care requires that directors properly inform themselves of all relevant information available to them prior to making business decisions. Directors satisfy this duty procedurally by ensuring that sufficient information is made available to permit them to act on an informed basis. The duty of care is most commonly implicated in the context of business transactions, in which directors are obligated to weigh all available information concerning the potential risks and benefits in reaching a decision to proceed or not to proceed. But the duty of care is not limited in application to directorial decision-making. Directors are also obligated to exercise due care in delegation of authority to management and supervision of managerial performance.

The duty of loyalty embodies the obligation of directors to actively protect the interests of and to refrain from conduct that would injure the corporation and its shareholders. The duty of loyalty is most often conceptualised as an obligation of the directors to avoid self-dealing. More recently, it has become clear that the duty is not limited to avoidance of self-interest—the duty of loyalty demands that directors not disregard or fail to act in the corporation's best interest.

Several subsidiary duties come within the scope of the overarching duties of care and loyalty, including the duty to disclose relevant information to shareholders and the duty of corporate oversight. While the duty of oversight has received comparatively little attention, a recent Delaware Supreme Court decision has brought new attention to that duty and has changed its nature in a way that should be of considerable interest to corporate directors, and may have particular relevance in the management of intellectual property assets.

While the substance of the duties of care and loyalty may appear somewhat nebulous and overlapping, the legal consequences of the distinction are significant. Recognising the need of corporations to attract talented and experienced individuals to board positions, the Delaware corporation law permits corporations to indemnify fiduciaries from personal liability for breaches of the fiduciary

Delaware facts and figures

More than 695,000 active business entities incorporated under Delaware law through 2005.

For 2005, there were over 134,000 new business entities formed in the state of Delaware:

34,377	corporations
87,630	LLCs
8,802	LPs/LLPs
3,200	statutory trusts

"In 2005, new domestic business formations in Delaware rose 19.5% versus 2004, the highest one-year growth rate on record.

"More than a half a million entities have their legal home in Delaware, including more than 50% of all US publicly-traded companies and 60% of the Fortune 500.

Stats taken from the State of Delaware, Division of Corporations webpage (www.state.de.us/corp)

duty of care. Additionally, many corporations include in their corporate charters and bylaws provisions permitted by corporate law that insulate directors and officers from personal liability for monetary damages resulting from breaches of the duty of care. However, corporations are explicitly not permitted to exculpate or indemnify fiduciaries for breaches of the duty of loyalty. Thus, directors found to have been disloyal to the corporation can be held personally liable for corporate losses attributable to their disloyalty.

The directorial duty of oversight

A 1996 opinion of the Delaware Court of Chancery, *In re Caremark*, provides what has been widely regarded as the Court's most influential discussion of directorial oversight liability. The case was brought as a shareholder derivative action seeking to impose personal liability on members of the board of directors of Caremark International, a company that provided patient healthcare and managed care services. Caremark came under investigation for violations of federal laws that prohibited kickback payments to healthcare providers in exchange for referrals of Medicare and Medicaid patients, and was indicted on numerous counts. Caremark entered into plea agreements with the Department of Justice and other agencies, ultimately paying civil and criminal fines and reimbursements totalling approximately US\$250 million. Although no Caremark director was indicted, the shareholder plaintiffs alleged that the directors breached their duty appropriately to monitor and supervise corporate operations, and that this breach resulted in substantial financial losses to the company.

Chancellor Allen, writing for the court, discussed the fiduciary obligation of corporate boards to be reasonably informed concerning the corporation, satisfaction of which required: "Assuring themselves that information and reporting systems exist in the organisation that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."

In Chancellor Allen's view, failure to implement appropriate reporting systems could provide a basis for director liability: "A director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system,

which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."

But oversight liability under *Caremark* is premised on a breach of the fiduciary duty of care, which Chancellor Allen characterised as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

The Delaware Supreme Court weighs in on oversight liability: *Stone v Ritter*

For 10 years, the teachings of *Caremark* were regarded as setting forth the correct standard for director oversight liability, but were never adopted by the Delaware Supreme Court. In November 2006, however, the Supreme Court revisited oversight liability in *Stone v Ritter*. Like *Caremark*, the case was brought in the Chancery Court, this time as a shareholder derivative action against the directors of AmSouth Bancorporation. AmSouth had been under investigation by the US Attorney's Office and other regulatory agencies for failure to comply with the federal Bank Secrecy Act, and eventually paid US\$50 million in fines and civil penalties to resolve those investigations. Although no regulatory action was taken against AmSouth's directors, the shareholder plaintiffs alleged that they failed to implement monitoring systems that would have alerted them to problems requiring their attention. The Chancery Court dismissed the complaint, which was described as a "classic *Caremark* claim."

On appeal, the Supreme Court affirmed the Chancery Court's dismissal, holding that *Caremark* correctly articulates necessary conditions for director oversight liability. Liability can arise when: (1) directors utterly fail to implement any reporting or information system or controls; or (2) having implemented such systems or controls, directors consciously fail to monitor or oversee their operation, and thus disable themselves from being informed of risks or problems.

But the *Stone v Ritter* opinion departs from *Caremark* in two significant respects: First, *Stone v Ritter* emphasises that oversight liability requires a showing that directors knew, in failing to implement or monitor reporting systems, that they were not discharging their fiduciary obligations.

Second, the Supreme Court clarified that such failure to act in the face of a known duty essentially a conscious disregard

of fiduciary responsibilities is not a breach of the duty of care, but a breach of the duty of loyalty.

Legal implications for oversight liability

What are the legal implications for directors of the Supreme Court's new ruling on oversight liability? The first implication is that oversight liability claims against directors remain difficult to prove. Delaware courts have long recognised the business reality that directors are often distantly removed from day-to-day corporate operations and accordingly have been reluctant to hold corporate fiduciaries directly accountable for acts and omissions of officers and their subordinates.

Noting that most corporate decisions are not the subject of director attention, *Stone v Ritter* reiterates the language of *Caremark*, stating that a claim against a director for actions of employees remains "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment". The court seems to be primarily interested in procedural compliance. In the same way that the duty of care is satisfied through a procedurally sound decision-making process, under *Stone v Ritter*, the duty of loyalty is satisfied through implementation of procedures sufficient to bring relevant information to the attention of the board. Further, the requirement of showing that directors knowingly failed to discharge their fiduciary duties creates an additional hurdle to establishing liability. The Supreme Court did not elaborate on how such knowing failure might be established.

The second implication, of which directors should be particularly wary, is the reclassification of failure to exercise oversight as a breach of the fiduciary duty of loyalty, rather than a breach of the fiduciary duty of care. As discussed above, Delaware law permits corporations to shield directors from monetary liability for breaches of the duty of care, but not breaches of the duty of loyalty. Consequently, under *Stone v Ritter*, directors face personal monetary liability if knowing failure to exercise reasonable oversight including failure to attempt to assure reasonable information or reporting systems exist is proved.

Practical implications for directorial oversight

The prospect of personal financial liability, for which indemnification by the corporation is not legally permissible, begs the question: what can directors do to avoid this? The first recommendation is not to panic. Although *Stone v Ritter* forecloses the availability of

indemnification for directors who breach their oversight duty, *Caremark*'s demanding "sustained or systemic failure" test for liability remains intact, while oversight liability remains difficult to establish. Tellingly, neither the *Caremark* court nor the *Stone v Ritter* court found evidence of such "sustained or systemic failure".

Nevertheless, even the remote possibility of personal liability, potentially for millions of dollars in damages, warrants an abundance of caution. The solution to avoiding oversight liability under *Stone v Ritter* is spelled out in the opinion itself: corporate boards should implement systems for collecting timely and accurate information concerning corporate performance and should monitor the information obtained. What is less clear from the *Stone v Ritter* opinion is which types of information a board must monitor. The types of information that could potentially be monitored are endless. Which types of information are directors duty-bound to monitor? Which types of problems are directors duty-bound to identify and redress?

The types of information that should be monitored may vary by industry. For example, companies in regulated industries, such as the healthcare provider in *Caremark* and the financial institution in *Stone v Ritter*, would do well to monitor regulatory compliance. As a general rule of thumb, directors would be well advised to focus their monitoring efforts in areas where the corporation bears an affirmative duty to investigate its actions, in which case it may be easier for a plaintiff to argue that a director knowingly failed to act. Directors should also pay special attention to areas where the corporation could potentially be held liable for massive or catastrophic damages—areas to which plaintiffs are naturally drawn.

For companies that specialise in technological innovation, one such area of focus is overseeing their intellectual property assets and risk, including the avoidance of patent infringement. Before companies launch new products or processes, or when they learn of patents relevant to their own technology, they have an affirmative duty to ensure that they do not infringe on others' patents. Liability for patent infringement, which could include injunctive relief that effectively puts the company out of business, can indeed be catastrophic. Further, failure to satisfy the duty of ensuring non-infringement once the company is on notice may result in liability for wilful infringement. In special cases where patent infringement is shown to be wilful, the infringer can be subject to

Significant US wilful patent infringement cases

24th January 2006

Applied Medical Resources v US Surgical

US\$64.5 million award against US Surgical for patent infringement and enhanced damages for wilfulness is affirmed on appeal

7th July 2006

Finisar v DirectTV

Jury award of US\$78.9 million against DirectTV for patent infringement increased to US\$116 million, including US\$25 million for wilfulness

10th October 2006

Power Integrations v Fairchild Semiconductor

Jury found wilful patent infringement by Fairchild and awarded Power Integrations US\$34 million. No decision has been reached concerning enhanced damages, but Fairchild could be ultimately liable for treble damages of US\$102 million.

20th December 2006

Visto v Seven Networks

US\$3.6 million award against Seven Networks for patent infringement doubled to US\$7.7 million for wilfulness.

treble the damages. Given the current prevalence of patent litigation, directors in relevant industries should consider implementing systems for monitoring institutional awareness of competing patents and routine procedures for investigating and ensuring that patents are not infringed, particularly when new products or processes are launched.

For companies that derive significant value from intellectual assets that are maintained as trade secrets, oversight should focus on monitoring the handling, accessibility and disclosure of secret information. Trade secret protection and attendant economic benefit can be irreparably lost if reasonable efforts to maintain the secrecy of the relevant information are not taken. Complicating matters somewhat is the nature of trade secrecy law itself, which is derived primarily from judicial opinions rather than a uniform body of federal law. Different standards may apply in different jurisdictions and monitoring should be informed by the applicable standards.

Compliance with financial disclosure obligations and accounting standards is a concern that spans all industries, and failed compliance, irrespective of industry, almost invariably leads to litigation. Of particular relevance to companies that sell or acquire intellectual assets is the Financial Accounting Standards Board's Statement of Financial Accounting Standard 141 (SFAS 141), which requires that intangible assets, such as patented technologies, be accounted for at fair value. Because the value of intangible assets is relevant in many contexts—such as financial reporting, insurance, licensing and collateralisation—it is important that values not be under- or overstated and that values be consistently stated. Directors should monitor accounting procedures to ensure that intangible assets are appropriately and consistently valued. (For a more thorough discussion of SFAS 141 and intellectual asset valuation, see Bryan Benoit and Kimberly Cauthorn, "Avoiding the Patent Storm," *IAM* issue 20, October/November 2006, pages 37-43.)

Finally, directors should consider implementing systems for oversight of document and electronic information control, retention and destruction. Even years after Enron and the demise of Arthur Andersen, the failure of corporations to preserve documents or electronic information remains an area of deep scrutiny and a concern for most companies. In innovative industries,

particularly for companies that are engaged in patenting, control of internal documents, such as laboratory notebooks, should already be a concern. When the innovative company is also subject to frequent litigation, exercise of oversight should also include document retention policies that prevent destruction of all documents that are potentially relevant as evidence when a lawsuit is threatened or seems likely. Failure to do so could result in sanctions for spoliation—destruction of evidence that have, in certain cases, included fines in the millions of dollars.

The continued seriousness with which courts view untoward document destruction was demonstrated by the 1st December 2006 enactment of amendments to the Federal Rules of Civil Procedure governing electronic discovery. The newly enacted rules, bearing a startling resemblance to the language of *Caremark*, provide protection for deletion or destruction of electronic information through the "routine, good faith operation of an electronic information system." Savvy directors should view this as nothing short of a wake-up call. Implementation and maintenance of corporate document retention and destruction policies, while always advisable, are now indispensable, and should be on every director's shortlist of agenda items. If not already in place, directors should ensure that a comprehensive policy is put in place. If already in place, directors should ensure that policies are current, particularly in that they address the deletion and destruction of electronic information, including email. In all cases, directors should ensure that current policies are properly implemented and monitored on an ongoing basis.

In sum, the Delaware Supreme Court's recent ruling in *Stone v Ritter* means that directors may be held personally liable potentially for millions of dollars in corporate losses for failing to institute and monitor systems that protect corporate assets or detect and prevent liability-creating behaviour within the corporation. And the corporation may be precluded from indemnifying or insulating directors against such liability for what is now considered a breach of their duty of loyalty to the company.

For corporations that possess IP assets or risk patent infringement claims, boards of directors should be particularly vigilant regarding their oversight duties and may consider creating a committee of the board charged with IP oversight to ensure compliance. ■

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Talking monkeys

What is it that makes otherwise intelligent people appear to be Neanderthals when it comes to IP?

One of the most successful entertainers of our time, Michael Crichton, is the author of *Jurassic Park* and 14 other best-selling novels. His latest, *Next*, deals with the destruction wrought by gene patents. Thirteen of his novels have been made into films, several of which he directed, and he is creator of one of the most successful series on television, *ER*. He is the only artist to have running simultaneously a number one film, novel and television series.

However, there is another, darker side to this Hollywood success story. Dr Crichton, a Harvard-trained MD who did post-doctoral work at the Salk Institute and has taught anthropology at Cambridge University, has been mixing IP fact with fiction.

In a recent op-ed piece in *The New York Times*, which I urge you all to all read (<http://www.nytimes.com/2007/02/13/opinion/13crichton.html?ex=1172552400&en=c09a391fb5085528&ei=5070>), he vents his spleen about the societal dangers of providing exclusivity for gene-related inventions. What he writes is clearly the product of a creative mind run amok; or, perhaps, he is seeking to encourage controversy in support of a personal agenda, namely book sales.

Pirates of the human genome

"Gene patents are now used to halt research, prevent medical testing and keep vital information from you and your doctor, Dr Crichton writes. "Gene patents slow the pace of medical advances on deadly diseases. And they raise costs exorbitantly; a test for breast cancer that could be done for \$1,000 now costs \$3,000.

He tells the reader that this is "because the holder of the gene patent can charge whatever he wants, and does. Couldn't somebody make a cheaper test? Sure, but the patent holder blocks any competitor's test. He owns the gene. Nobody else can test for it.

Apparently, this is all the fault of the USPTO: "This bizarre situation has come to pass because of a mistake by an underfinanced and understaffed government

agency. The United States Patent Office misinterpreted previous Supreme Court rulings and some years ago began to the surprise of everyone, including scientists decoding the genome to issue patents on genes.

But, according to Crichton it gets even worse: "In addition, a gene's owner can in some instances also own the mutations of that gene, and these mutations can be markers for disease. Today, more than 20 human pathogens are privately owned, including haemophilus influenza and Hepatitis C.

I blinked after reading the above statements and emailed a few people for a reality check. Gene-related inventions are and should be patentable; if the patents covering some of them were granted in error, the courts will invalidate them. If they are not, they are sure to inspire a lot of important research in adjacent areas.

This was the response about the editorial that I received from Bruce Lehman, former United States Commissioner of Patents and Trademarks: "I have read several of his novels, and while entertaining, they are hardly serious literature. I don't think he knows anything about patent law. You are correct that the patent does not cover the actual genes in the body there must be a utility to the patent. Certainly, using knowledge of a gene to develop a test for a disease is something that involves the kind of R&D that should be supported by the patent system. The testing procedure could be novel and non-obvious and, therefore, appropriately patentable. There seems to be a disturbing trend lately to think that it is immoral somehow to get paid for inventions that result from R&D in the health sciences. To the extent that patients cannot afford new treatments, that is not a patent issue but a safety net issue that needs to be addressed with remedies such as the new (US) Medicare Part D system.

Out of control

Irving Rappaport, former chief patent counsel at Apple, National Semiconductor and Medtronic, provides similar perspective: "I read Crichton's most recent book, *Next*, which deals with patents. I thought it was one of his poorer books. The story line has talking

monkeys and birds around which he weaves a fantastic, but highly unbelievable, tale about how gene research gets out of control and affects unrelated families across the country. He did go to medical school, about 40 years ago, and then became a writer. Someone must have put a bee under his bonnet about gene-related patents and he has gotten on a high horse to speak to the masses based on little experience in the patent field. His article shows the dangers of a layman talking about a field of which he knows nothing. He should stick to writing novels and TV shows, for which he has some ability. Maybe his latest book sales are down and he is looking for some free publicity to pump them up.

In response to Dr Crichton's op-ed, John F Duffy, a research professor at George Washington University Law School, said in a letter to the editor that "gene patents have the same affect as all patents: they temporarily increase prices to provide greater incentives for discovery. It would be no less true and no less hyperbolic to speculate that you, or someone you love, could die if genes became unpatentable because the necessary genetic research would not be done in time.

Copy and sell

A final sobering thought came from op-ed responder David P Lentini, a patent attorney in San Francisco: "Gene patents are vital to the biotechnology and pharmaceutical industries. Why would anyone risk the billions needed to transform basic science into lifesaving products if someone else could simply copy those products without risk? I doubt that Michael Crichton would let others copy and sell his novels and movies for no cost.

From my perspective, the greater threat to our well-being is less likely to come from gene patents than from entertainers, politicians, healthcare professionals, and the like, with a little knowledge and too much imagination. Dinosaurs 1, humans 0.

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