Directors beware: Ignorance can mean bucks, not bliss

Oversight duty is critical in matters of document retention and destruction

The board of directors of a corporation is charged with managing its business and affairs. In carrying out this role, directors owe fiduciary duties to the corporation and its shareholders. When directors are sued by shareholders, chances are that the claims are for breaches of those fiduciary duties.

The nature and extent of a director's fiduciary duties are defined by the laws of the state of incorporation. Most public companies, and many private ones, are incorporated under Delaware law, even if they are headquartered elsewhere.

Fiduciary duties under Delaware law include the well-defined duties of loyalty, care, and candor. They also include the less well-defined duty of oversight and duty to act in good faith. Yet, directors who ignore the duties of oversight and good faith may pay a high price. A breach of these duties can significantly increase a director's risk of personal liability.

In Stone v. Ritter, 911 A.2d 362 (Del. 2006), Delaware's highest court recently shed new light on the duties of oversight and good faith.

Director oversight liability

In Stone v. Ritter, the Delaware Supreme Court adopted, for the first time, the standard for director oversight liability announced 10 years ago in the landmark Delaware Court of Chancery decision in re Caremark Inc. v. Derens, Litig. No. 6688 A.2d 959 (Del. Ch. 1990). The Caremark opinion articulated the obligation of directors to actively monitor corporate performance, famously stating that "It is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."

The Stone v. Ritter Court agreed with Caremark that director oversight liability may be found (a) when directors fail to implement any reporting or information system or controls, or (b) when directors fail to monitor or oversee the operation of reporting or information systems or controls that have been implemented. The Court then looked to the standard of good faith announced in the recent re Walt Disney opinion, 906 A.2d 27 (Del. 2006), tying oversight liability to conscious disregard of oversight obligations: "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."

The relevance and timeliness of the discussion of director oversight liability in Stone v. Ritter are underscored by the December 1, 2006 enactment of widely-anticipated amendments to the Federal Rules of Civil Procedure governing electronic discovery. As discussed more thoroughly in our previous article "New Federal Rules Address Destruction of Electronic Documents," Technology Times, December 2006, the newly enacted rules provide some protection for deletion or destruction of electronic information through the "routine, good faith operation of an electronic information system."

Preserving electronic information

The consequences to the corporation of failure to preserve documents have been much-discussed, particularly in the wake of Enron and the demise of Arthur Anderson. Less discussed, as yet, are the potential consequences to directors who fail to implement and ensure the integrity of corporate document retention policies. Given the sustained and ever-increasing attention focused on the treatment of electronic information, one implication of Stone v. Ritter for directors is that their fiduciary obligations may include ensuring that corporate document retention policies are both in place and designed to preserve electronic information in compliance with accounting, reporting, regulatory, and other applicable standards.

Conscientious directors should exercise their duty of oversight, and seek advice from competent counsel if necessary, to ensure that their corporation has implemented and is enforcing document retention and destruction policies that address the proper preservation and destruction of electronic information.

Ignorance in this case is not bliss. Noncompliance can devastate the corporation—and potentially lead to personal liability for its managers.

The content of this article is not intended as legal advice. The views expressed are those of the authors and not Fish & Richardson P.C. The article was co-written by Cathy L. Reese (cathyfjr.com), counsel at Fish & Richardson's Delaware office and head of the firm's Corporate and Chancery Litigation practice, and Kyle Wagner Compton (kwc@fr.com), an associate at Fish & Richardson's Delaware office and former law clerk to Vice Chancellor Stone of the Delaware Court of Chancery. To learn more, call 302-652-5070 or visit www.fr.com.

Crystal ball

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- Understanding not only customers' wants and needs but also goals and objectives around their jobs and activities — wants and needs will yield incremental changes, while goals and objectives lead to research-through ideas

- Customer observation and inquiry in context of their product usage environments in addition to central interviewing

- Research among typical customers, non-customers and "lead users" — those who are well ahead of market trends and have needs that go far beyond those of the average user

A variety of qualitative and quantitative research methods

For example, one of the clients I work with closely, Adobe (provider of Acrobat, Photoshop, etc.), has adopted just such a multi-faceted new product development research program. At any one time you might find them engaged in:

- Ethnographic studies to identify new opportunities
- Customer site visits to understand pain points and workflow
- Focus groups or in-depth interviews among lead and non-customers to develop product concepts
- Web surveys to determine market potential
- Discrete choice modeling to optimize product and line lines

And, Adobe does this for each of their product lines. Imagine the opportunities you could uncover simply by engaging your customers and taking a multi-faceted approach — it's almost like looking into your very own crystal ball. You may, though, need to take a flashlight into the alley to find it.}

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