

# Court Explains Directors' Fiduciary Duty of Oversight

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Capital One Financial Corp. was subpoenaed in 2015 by the New York District Attorney regarding its anti-money laundering practices. Although the company ultimately settled without admitting liability, Capital One said that it had failed to adopt and implement a compliance program that adequately covered various money laundering programs due to an inadequate system of internal controls and ineffective independent testing.

Michael Reiter, a shareholder of Capital One, subsequently sued the company's 10 board members, arguing that the settlement was evidence of the board's failure to fulfill its fiduciary duty of oversight.

The case that subsequently unfolded in the Delaware Court of Chancery, *Reiter v. Fairbank*, provides a practical lesson that outlines a director's duties of oversight and defines the conditions under which a plaintiff can successfully prevail.

The Capital One board sought to dismiss the complaint based on Chancery Court Rule 23.1, which presumes that directors are faithful to their fiduciary duties. This rule also provides that a plaintiff must overcome that presumption by making a pre-suit demand that adequately asserts reasonable doubt as to the independence of the board and that

the plaintiff's demand would expose a majority of the board of directors to a substantial likelihood of personal liability. The threat of personal liability alone is insufficient. The conduct alleged in the complaint must be "so egregious on its face" that the board could not have exercised its business judgment in responding to a stockholder demand to pursue those claims. The Capital One board reasoned that Reiter did not overcome this presumption prior to filing his lawsuit. Reiter countered that making a formal legal claim on the board prior to filing suit would have been futile as all 10 members of the board would have faced personal liability.

In its decision in the 2012 case *In re Bank of America Corp.*, the Delaware Supreme Court explained that to impose personal liability on a director for failure of oversight, one must show that the director knew that he or she was not discharging his or her fiduciary obligations. A key component of such a claim requires a plaintiff to assert a sufficient connection between the "corporate trauma" and the inaction of the board. To establish such a connection, the plaintiff must plead that the board knew of evidence of corporate misconduct—the proverbial "red flag"—yet acted in bad faith by consciously disregarding its duty to address that misconduct.

In *Reiter v. Fairbank*, the Delaware Court of Chancery reasoned that there was no key event or document that constituted a red flag to the board. At most, there were a number of yellow flags that the board adequately addressed.

The court also reasoned that even though the directors received regular reports regarding compliance problems, those reports did not notify them that management either refused to act or displayed indifference toward complying with the money laundering statutes and regulations.

Moreover, the court explained that the facts did not warrant an inference that Capital One's management embraced a strategy to pursue profits by employing illegal means, much less that its directors were knowingly complicit in such a strategy. The court stated that there is "a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties."

The court concluded that Reiter failed to establish that a majority of Capital One's 10-member board acted in such an egregious manner that they would face a substantial likelihood of liability for breaching their fiduciary duty of loyalty so as to disqualify them from applying disinterested and independent consideration to a stockholder demand.