BRACEWELL

INSIGHTS

Second Circuit Reinforces High Pleading Burden for Director Duty of Oversight Claims

February 18, 2014

To listen to the podcast, please click ***here***.

In *Welch v. Havenstein*, No. 13-2648-cv, 2014 WL 322055 (2d Cir. Jan. 30, 2014) (summary order), *aff'g In re SAIC Inc. Derivative Litigation*, 948 F. Supp. 2d 366 (S.D.N.Y. 2013), the United States Court of Appeals for the Second Circuit affirmed the District Court's dismissal on the pleadings of claims that the directors of SAIC, Inc. ("SAIC") breached their fiduciary duties by ignoring warnings of criminal misconduct in connection with a major project for the City of New York. The decision reinforces the high bar under Delaware law for pleading "duty of oversight" claims premised on director *in*action in the face of alleged "red flags."

Background

In 2001, SAIC entered into a $63 million contract with the City of New York to develop CityTime, a workforce management system that was intended for use by several city agencies. *In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d at 371. The project quickly ballooned in cost, and by 2010 the city had paid SAIC more than $600 million for the project. *Id.* Several articles in local and niche publications brought attention to the dramatic cost overruns and questioned whether city officials were properly challenging the high fees charged by SAIC. *Id.* at 373. New York City Mayor Michael Bloomberg announced that the City Comptroller would audit the CityTime agreement, which had been amended eight times over several years to reflect extensions to the project, and City Councilman Joseph Addabbo, Jr. held a hearing to review the cost overruns from the CityTime project. *Id.* at 373-74. CityTime was not the only SAIC enterprise to fall under scrutiny. During the 1990s and 2000s, more than a dozen SAIC projects were criticized in the media or even the subject of criminal charges for overbilling, fraud, and other forms of misconduct. *Id.* at 374-75.

In December 2010, the U.S. Attorney's office brought the first criminal charges arising out of the CityTime project, alleging wrongdoing on the part of four government consultants. *Id.* at 372. Two months later, the U.S. Attorney's office added Gerard Denault, Vice President and Operations Manager of SAIC, as a defendant. *Id.* Around the same time, Carl Bell, an SAIC employee who had served as a developing engineer for CityTime, pleaded guilty to defrauding both the city and SAIC. *Id.* In March 2012, SAIC entered into a deferred prosecution agreement with the U.S. Attorney, pursuant to which the company agreed to disgorge profits that it earned from the scheme and issued a Statement of Responsibility that admitted to "managerial failures" and "illegal conduct" in connection with CityTime. *Id.* at 373. Notably, the Statement of Responsibility disclosed that a whistleblower had filed an ethics complaint regarding the scheme in 2005, but stated that the complaint was not brought to the attention of SAIC's board of directors. *Id.* U.S. Attorney Preet Bharara characterized the corruption on the CityTime

project as "epic in duration, magnitude and scope." *Id.*

In early-2012, four shareholder derivative suits were filed against SAIC related to the CityTime project. The suits were eventually consolidated into one action in the U.S. District Court for the Southern District of New York (Oetken, J.). In the consolidated complaint, the plaintiffs alleged that the Board of Directors of SAIC was "on actual or constructive notice of significant wrongdoing in relation to [CityTime], but nonetheless consciously ignored or perpetuated that wrongdoing." *Id.* at 370. In particular, the plaintiffs claimed that SAIC's directors were put on notice of potential wrongdoing by, among other things, articles in the press, proven instances of impropriety in contracts similar to the CityTime contract, and the magnitude and duration of the CityTime engagement. *Id.* at 382-91. The plaintiffs also alleged a handful of other claims arising from the company's behavior over the past decade relating to CityTime. *Id.* The SAIC Directors and SAIC itself as a nominal defendant filed motions to dismiss the consolidated complaint. *Id.*

The District Court Decision

The District Court's opinion focused on the threshold question whether the plaintiffs had adequately pleaded demand futility – *i.e.*, that a demand on SAIC's board of directors to bring this action would have been futile. The requirement of pleading demand futility is rooted in the bedrock principle of corporate governance that the decision whether to bring suit in the company's name ordinarily is within the providence of the board of directors. *Id.* at 375. Thus, where no prior demand has been made on the board of directors, Fed. R. Civ. P. 23.1 requires that a shareholder plaintiff plead particularized allegations that demonstrate that a demand on the board of directors would have been futile. Delaware law governed this question because SAIC is a Delaware corporation. *Id.* at 376.

A. Applicable Legal Standards

The parties disagreed over the appropriate standard for determining demand futility. Under Delaware law, when an affirmative decision by a board of directors is challenged, demand futility is analyzed under the test established by *Aronson v. Lewis,* which permits a finding of demand futility if there is a reasonable doubt regarding (1) whether the directors are disinterested and independent, *or* (2) whether the challenged decision was a "valid exercise of business judgment." *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). On the other hand, when a complaint challenges something other than "a particular business decision made by the board as a whole" – such as board *in*action – demand futility is analyzed under the test established by *Rales v. Blasband*, 634 A.2d. 927 (Del. 1993), which permits a finding of demand futility only where the allegations raise a reasonable doubt regarding whether a majority of the board was disinterested or independent. *Id.* at 934. Under both the *Aronson* and *Rales* tests, allegations of board interestedness based on the threat of personal liability only are sufficient if they rise to the level of establishing that a majority of the directors face a "substantial likelihood of liability." *Aronson*, 473 A.2d at 815.

Defendants argued that the plaintiffs' claims arose out of the SAIC Directors' failure to act, rather than a particular decision of the board, thereby mandating analysis under *Rales*. The defendants further argued that because the plaintiffs' claims arose out of director *in*action, the plaintiffs were required to plead that the SAIC Directors faced a substantial likelihood of liability under the high standard for oversight liability first articulated by the Delaware Court of Chancery in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (1996). In *Caremark*, the Delaware Court of Chancery, noting that the theory of oversight liability is "possibly the

most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," *id.* at 967, held that "only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability." *Id.* at 971. In the wake of *Caremark*, Delaware courts consistently have held that allegations rising to the level of bad faith are a prerequisite to oversight liability. In particular, where oversight liability is predicated on the presence of so-called "red flags," plaintiffs must plead particularized allegations that demonstrate "a conscious disregard for their duties." *Stone ex rel AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

In an apparent effort to avoid the high bar for oversight liability set by *Caremark* and its progeny, the plaintiffs attempted to "collapse the choice between *Aronson* (designed for board action) and *Rales* (designed for board inaction) into the question whether a Board majority is interested because it faces a substantial likelihood of liability due to its conscious decision to remain inactive." *In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d at 379. In essence, the plaintiffs contended that the SAIC board's apparent inaction should be treated as a form of board action because the board was "on notice" of the company's misconduct in connection with the CityTime project. Thus, according to plaintiffs, the allegations of the complaint did not implicate *Caremark*; rather, the allegations established that the board made a conscious decision to remain inactive, which constitutes a breach of the duties of loyalty and good faith. *Id.* at 378. Plaintiffs conceded at oral argument that if "the case is a *Caremark* case, it should be dismissed." *Id*. The District Court acknowledged that "the question of when behavior that some perceive as inaction should be understood to constitute a legally significant form of action does not, in general, lend itself to easy resolution[,]" *id.* at 379, yet ultimately concluded that the plaintiffs' allegations rested on a theory of oversight liability which Delaware courts have consistently analyzed under *Rales* – not *Aronson*. *Id.* at 382.

B. Analysis

With those principles in mind, the District Court turned to the facts at hand. The plaintiffs relied on a number of red flags that they contended put the SAIC Directors on actual or constructive notice of the company's wrongdoing in connection with the CityTime project, including: (i) statements in SAIC's Statement of Responsibility in connection with its deferred prosecution agreement with the U.S. Attorney's office; (ii) that CityTime was a "core operation" of SAIC; (iii) the "magnitude and duration" of the CityTime project; (iv) wrongdoing in relation to other government contracts, including several criminal charges and settlements; and (v) numerous publications criticizing SAIC for the cost overruns associated with CityTime. As discussed below, the District Court held that these alleged red flags were insufficient – independently and collectively – to plead a substantial likelihood of liability on the part of a majority of SAIC's board of directors.

The Statement of Responsibility. The District Court rejected the plaintiffs' contention that the company's "stunning admissions" in the Statement of Responsibility proved that the board "knew or should have known of the CityTime overbilling scheme." *Id.* at 383. The District Court emphasized that, on close examination, all of the company's purported "admissions" addressed corporate and managerial responsibility for SAIC's actions, but did not provide any basis to infer actual or constructive knowledge on the part of any of the directors. *Id.*

Core operations. As an initial matter, the District Court noted that the core operations doctrine was a relic of securities law that had seen its vitality significantly diminished, if not eliminated, by superseding legislation and case law. *Id.* at 384. Putting that aside, the District Court

concluded that the plaintiffs' "core operations" argument failed because (i) the allegations of the complaint fell far short of suggesting that the SAIC Directors had "direct access" to information about CityTime, and (ii) the complaint's allegations even failed to demonstrate that the CityTime project qualified as a "core operation" of SAIC. *Id.* at 384-85. As the District Court noted, the CityTime contract was merely one of over 10,000 active contracts for the company around that time. *Id.* at 385.

Magnitude and duration. While the District Court recognized that the magnitude and duration of the underlying misconduct may be probative of whether directors had actual or constructive knowledge of wrongdoing, it emphasized that these two factors, standing alone, typically are insufficient to satisfy the heightened pleading requirement of Rule 23.1. *Id.* at 387.

Other frauds. The District Court summarily rejected the contention that misconduct in connection with other, unrelated contracts somehow was sufficient to put the SAIC Directors on notice of the company's wrongdoing in connection with the CityTime project. *Id.* The District Court cited numerous Delaware decisions that have rejected the contention that "knowledge of wrongdoing in other transactions should have put the Board on a heightened state of alert[]" as a matter of law. *Id.*

News articles. The District Court rejected the plaintiffs' contention that public reports in publications such as *CityLimits* and *IEEE Spectrum Risk Factor* create the "reasonable inference" that SAIC Directors were aware of the wrongdoing described in those reports. *Id.* at 385. While it recognized that there may be exceptional circumstances where news coverage is so pervasive that no director could credibly claim to have missed it, the District Court concluded that the allegations here fell far short of that high mark. *Id.* at 386. The District Court reasoned that "[i]t would turn *Caremark* on its head to impose on directors an obligation to review every national (and local) blog, newspaper, Twitter feed, and televised news program for evidence of potential illegality in their corporate operations." *Id.* at 385-86.

After concluding that the red flags each were independently inadequate, the District Court addressed plaintiffs' argument that the alleged red flags collectively put the SAIC Directors on notice of wrongdoing. The District Court distinguished three federal court decisions – notably, two of which were from the Southern District of New York – where aggregated red flags were held to be sufficient notice of wrongdoing. *Id.* at 387-91 (distinguishing *In re Abbott Laboratories Derivative Plaintiffs Litigation*, 325 F.3d 795, 802 (7th Cir. 2003), *In re Pfizer Shareholder Derivative Litigation*, 722 F. Supp. 2d 453, 458 (S.D.N.Y. 2010), and *In re Vecco Instruments, Inc. Securities Litigation*, 434 F. Supp. 2d 267, 273 (S.D.N.Y. 2006)). The District Court pointed to allegations in each of those cases that identified *with particularity* the circumstances under which the directors had been alerted to "direct signals of wrongdoing." *Id.* at 389. In contrast, the District Court reasoned that the complaint in this matter was devoid of any particularized allegations that established why the alleged red flags were "direct signals of wrongdoing" or how the directors would have been aware of the alleged red flags at all. *Id.* at 390-91. Thus, the District Court concluded that, even when taken together, "the allegations did not support an inference of actual or constructive knowledge on the part of the Board, such that the failure to act qualified as a form of bad faith action." *Id.* at 391.

Accordingly, the District Court granted the defendants' motion to dismiss the complaint. The District Court, moreover, took the unusual step of denying the plaintiffs' request for leave to amend the complaint, emphasizing that the plaintiffs had failed to provide the District Court

with "any suggestion of what changes such amendment would reflect." *Id.* at 392.

The Second Circuit Affirmance

On January 30, 2014, the U.S. Court of Appeals for the Second Circuit affirmed the District Court's decision in a summary opinion. Judges Kearse, Pooler, and Raggi agreed with the District Court's conclusion that because "the complaint makes no particularized allegation that the board took action to approve the fraudulent conduct," it was properly subjected to scrutiny under the *Caremark* rubric. *Welch*, 2014 WL 322055, at *1. Noting the plaintiffs' concessions at both the trial and appellate level that the claims should be dismissed if they implicated *Caremark*, the panel agreed with the District Court that the plaintiffs' "so-called 'red flags' did not expose the director defendants to the substantial likelihood of liability that would excuse demand." *Id.*

Takeways

This decision serves to further illustrate the extraordinarily high burden on plaintiffs that seek to assert claims resting on a theory of oversight liability under Delaware law. As this decision amply illustrates, the exacting standard set by *Caremark* and its progeny renders oversight claims highly susceptible to dismissal on the pleadings. It therefore is hardly surprising that the plaintiffs in this case went to great lengths in an attempt to sidestep *Caremark*. Despite the existence of a fraudulent scheme that the U.S. Attorney described as "epic in duration, magnitude and scope," and other indications that the company's directors knew or certainly should have known of the existence of the scheme, the District Court nevertheless concluded that the allegations of the complaint were insufficient to satisfy the plaintiffs' burden of pleading that a majority of the company's board of directors faced a substantial likelihood of liability. In so holding, the District Court rejected numerous generalized red flags that the plaintiffs contended established in the aggregate that the vast fraudulent scheme executed by SAIC management should have been obvious to any prudent director acting in good faith. While this decision does little to draw a line in the sand, it solidifies that *Caremark* is the prevailing standard for claims arising out of board inaction, and illustrates that plaintiffs will be hard-pressed to evade *Caremark*'s high bar in the absence of particularized allegations that establish a direct link between the directors' knowledge and the alleged red flags.