Simpson Thacher

Securities Law Alert

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July 2019

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–Legal 500

Third Circuit: Nonvoting Board Observers Affiliated With an Issuer's Placement Agent Are Not Subject to Liability Under Section 11 of the Securities Act of 1933

On July 23, 2019, the Third Circuit held that "a nonvoting board observer affiliated with an issuer's placement agent" is not subject to liability under Section 11 of the Securities Act of 1933 as a person who "'perform[s] similar functions'" to a "'director.'" *Obasi Inv. Ltd. v. Tibet Pharm., 2019 WL 3294888 (3d Cir. 2019) (Hardiman, J.)* (quoting 15 U.S.C. § 77k(a)(3)).

Background

Plaintiffs brought Section 11 claims against two nonvoting board observers who were chosen by the placement agent and named with their consent in a registration statement. The registration statement noted that although the board observers had no formal authority or responsibilities, "they may nevertheless significantly influence the outcome of matters submitted to the Board of Directors for approval." Plaintiffs contended that defendants were subject to Section 11 liability pursuant to 15 U.S.C. § 77k(a)(3), which provides that Section 11 claims may be brought against "every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner."

The district court found that there was "a genuine issue of material fact as to whether [the board observers] could be viewed as . . . people performing similar functions to a director." *Dartell v. Tibet Pharm.*, 2017 WL 1944106 (D.N.J. May 10, 2017). The district court noted that "[a]ccording to the description" in the registration statement, the "[b]oard [o]bservers could influence the entire board." The district court reasoned that the "[b]oard [o]bservers arguably had more influence than any individual board member, who could only cast a single vote." The district court subsequently certified the following question for an interlocutory appeal:

> Can Defendants be potentially liable under Section 11 of the Securities Act of 1933, each as a 'person performing similar functions' to a director, in light of Defendants' role as board observers who could (but did not necessarily have to) significantly influence the outcome of matters submitted to the board of directors for approval?

Obasi, 2019 WL 3294888.

Third Circuit Holds Nonvoting Board Members Affiliated With an Issuer's Placement Agent Do Not Perform "Similar Functions" to Directors as a Matter of Law

On appeal, the Third Circuit held that "deciding whether a person is a proper § 77k(a)(3) defendant . . . is a question of law for the court, not a question of fact for the jury." The court further held that the inquiry is limited to a review of "the description provided" in the registration statement of the person's role, and does not extend to extrinsic evidence concerning the person's actual functions. The Third Circuit found that holding otherwise "would excise the phrase 'named in the registration statement as' altogether and rewrite § 77k(a)(3) to say 'every person who, with his consent, is or is about to become a director [or] person performing similar functions." The court further reasoned that "the requirement of consent to be named . . . confirms that [the court's] inquiry stops at the text of the registration statement." The court noted that "[i]t is hard to see how this consent could be informed if a person's status (and potential liability) were speculative and mutable based on facts and events beyond the text of the registration statement."

Turning to the question of whether the nonvoting board members affiliated with the issuer's placement agent could face Section 11 liability pursuant to § 77k(a)(3), the Third Circuit held that defendants were not "performing similar functions" to directors based on the description of their role in the registration statement. The court emphasized that defendants "cannot vote for board action" and thus have no "ability to manage the company's affairs," which is the "directors' most basic power." The court also found it significant that defendants were "aligned with the placement agent" rather than the company. The court explained that defendants' "loyalties aren't with [the company's] shareholders—and loyalty to the shareholders is as vital to directorship as the power to manage." Finally, the court noted that defendants' "tenures are set to end automatically, with no opportunity [for shareholders] to vote them out." The court found that these "[t]hree features differentiate [defendants] from directors."

The Third Circuit deemed defendants' "influence" insufficient to render them similar to directors. The court observed that a well-regarded analyst "might also enjoy special access to the issuer's board and management," and may also have the "power to influence the issuer's board." The court explained that "no one would argue that [this] hypothetical analyst is any meaningful way 'similar' to a board member."

The Third Circuit also rejected plaintiffs' contention that "a broad construction" of § 77k(a)(3) "is necessary to hold wrongdoers accountable." The court noted that "Section 11 imposes near-strict liability for untruths and omissions made in a registration statement," as "a § 11 plaintiff need not allege scienter, reliance, or loss causation." The court explained that "[b]ecause § 11 is such strong medicine, . . . it applies only to limited and enumerated categories of defendants." The court pointed out that "Section 11 is but one part of an overlapping web of civil liability provisions," many of which could be used to seek redress against nonvoting board members appointed by the issuer's placement agent.

In a dissenting opinion, Judge Robert Cowen expressed his view that the majority had applied an unduly narrow definition of the term "similar," and failed to adhere to the Supreme Court's instruction that federal securities fraud laws "should be construed . . . flexibly to effectuate their remedial purposes." *Id.* (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983)). Judge Cowen opined that "a person may be named as performing similar functions to a director even if he or she does not possess the directors' formal power to direct and manage a corporation, and the responsibilities and duties that accompany those powers."

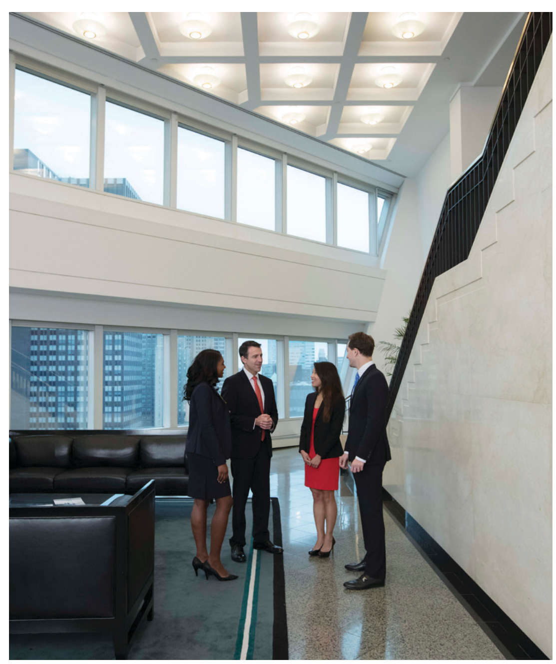
Third Circuit: Company's Comprehensive Disclosures Defeated an Inference of Scienter

On June 20, 2019, the Third Circuit affirmed dismissal of a securities fraud action alleging that a company "fraudulently lauded its financial health and misrepresented that its distributions were funded from the performance of the business." [*Fan v. StoneMor Partners*, 2019 WL 2529250 (3d Cir. 2019) (Restrepo, J.)](). The Third Circuit found that "for each category of alleged misstatements, [the company] disclosed sufficient information to render them immaterial." The court further held that the company's comprehensive disclosures belied any inference of scienter.

As to alleged misstatements concerning the company's financial health, the court found that the company "repeatedly disclosed the risks it faced in its business." For example, the company cautioned that its "substantial level of indebtedness could materially adversely affect its ability to generate sufficient cash for distribution to its unitholders, to fulfill its debt obligations and to operate its business." The court determined that these types of disclosures "alert[ed] reasonable investors" to the company's downside potential.

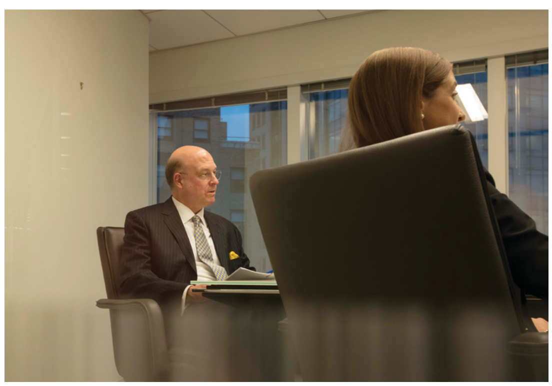
With respect to statements concerning the source of the company's distributions, the court noted that the company's Form 10-Ks defined "Available Cash as consisting of cash on hand at the end of that quarter, plus cash on hand from working capital borrowings made after the end of the quarter . . . less cash reserves." The court determined that a reasonable investor would have known from this definition that the company's "distributions were funded by more than just its operating revenue." The court also found it significant that the company included in its annual reports both "GAAP and non-GAAP financials side-by-side, which demonstrated the mathematical reality that [the company] was not able to fund its distributions primarily from its day-to-day operations because much of that cash was being held in state trusts and was unrecognized by GAAP." The court determined that these disclosures refuted plaintiffs' allegation that the company "fraudulently concealed the fact that its distributions were not funded primarily from the current operating revenue."

The court further found that the company's "disclosures do not demonstrate an intent to defraud—rather, they accurately show how [the company] leveraged its assets in order to maximize its distributions despite the state trust requirements" that limited its ability to recognize proceeds as revenue under GAAP. The court explained that although the company "may have been caught by the risk inherent in its business strategy, . . . those risks were disclosed" to investors and thus "the pleadings do not demonstrate scienter as the [Private Securities Litigation Reform Act] requires."



Southern District of New York: Second Circuit's Decision in *Singh v. Cigna* Does Not Stand for the Proposition That a Company Can Never Face Securities Fraud Liability for Statements in a Corporate Code of Conduct

On June 11, 2019, the Southern District of New York held that the Second Circuit's decision in *Singh v. Cigna Corporation*, 918 F.3d 57 (2d Cir. 2019), did not entitle defendants to judgment on the pleadings in a securities fraud action alleging misstatements in the company's Codes of Conduct and Ethics concerning its policies on sexual harassment and merit-based advancement.[1] [*In re Signet Jewelers Ltd. Sec. Litig.*, 2019 WL 2428529 (S.D.N.Y. 2019) (McMahon, J.)]. The court found that *Cigna* "did not announce a new legal rule . . . deeming an entire category of statements—those contained in a company's code of conduct—per se inactionable."



In *Cigna*, the Second Circuit determined that "general declarations about the importance of acting lawfully and with integrity" set forth in a company's Code of Ethics were "textbook example[s] of puffery." The Second Circuit explained that "general statements about reputation, integrity, and compliance with ethical norms are inactionable puffery, meaning that they are too general to cause a reasonable investor to rely on them."

The *Signet* court rejected defendants' contention that "*Cigna* wrought a sea change in the doctrine of puffery." The court found that "*Cigna* did not purport to change the well-established law regarding materiality," nor did it "rule . . . that all statements in codes of conduct qualify as puffery." The court observed that "the *Cigna* court expressly stated that context bears on materiality." The *Signet* court recognized that "[w]here a statement is located is one factor (of several) relevant to materiality; that was the law before *Cigna*, and it remains the law after it." However, the court reasoned that "it does not follow from *Cigna* that a securities fraud claim can *never* rest on statements contained in a public company's code of conduct."

The *Signet* court pointed out that in *Indiana Public Retirement System v. SAIC*, 818 F.3d 85 (2d Cir. 2016), the Second Circuit specifically "eschewed laying down a bright line rule . . . that would categorize all statements located in a company's code of conduct as immaterial puffery as a matter of law." *Signet,* 2019 WL 2428529. The *SAIC* court noted that "statements about a company's reputation for integrity or ethical conduct . . . may amount to more than puffery and may in some circumstances violate the securities laws." 818 F.3d 85. The *SAIC* court offered as examples "a company's specific statements that emphasize its reputation for integrity or ethical conduct as central to its financial condition or that are clearly designed to distinguish the company from other specified companies in the same industry."

The *Signet* court found that the facts alleged in the case before it "differ starkly from those alleged in *Cigna*." Unlike the "exceptionally vague and aspirational" statements the Second Circuit deemed inactionable in *Cigna*, the statements at issue in *Signet* specifically "touted how the company makes decisions based solely on merit, disciplines misconduct, and provides a safe and anonymous means for employees to report misconduct without retaliation." The court found these allegedly misleading statements were designed "to reassure the investing public that [the company] did not, in fact, have a toxic workplace" at a time when the company faced accusations of a culture of sexual harassment. The court held that these statements were actionable because a reasonable investor "would be concerned about how grave allegations concerning rampant sexual misconduct might affect her investment in [the company]."

1. Please click here to read our discussion of the Second Circuit's decision in *Cigna*.

Southern District of New York: A Company Has No Duty to Disclose Uncharged, Unadjudicated Wrongdoing Unless There Is a "Direct Nexus" Between the Alleged Wrongdoing and the Company's Statements

On July 12, 2019, the Southern District of New York dismissed a securities fraud action alleging that a multinational conglomerate "fraudulently failed to disclose [an] alleged bribery scheme." *Schiro v. Cemex, S.A.B. de C.V.*, 2019 WL 3066487 (S.D.N.Y. 2019) (Caproni, J.). The court underscored that "a company has a duty to disclose uncharged, unadjudicated wrongdoing" only if there is "a direct nexus between the alleged wrongdoing and the company's statements." The court further held that the scienter of the officers of one of the company's subsidiaries officers could not be imputed to the company because there were no allegations that the officers served as proxies for the company, or that the company "possessed some degree of control over, or awareness about, the fraud."

A Duty to Disclose Uncharged, Unadjudicated Wrongdoing Does Not Arise Merely Because a Criminal Conviction Would Adversely Impact the Company

The court explained that the duty to disclose uncharged, unadjudicated wrongdoing arises only if there is "a connection between the illegal conduct and the misleading statements beyond the simple fact that a criminal conviction would have an adverse impact upon the company's operations in general or the bottom line." For example, the court recognized that "[a] duty to disclose uncharged wrongdoing may . . . arise when a corporation puts the reasons for its success at issue, but fails to disclose that a material source of its success is the use of improper or illegal business practices."

The court held that statements "attribut[ing] the [c]ompany's growth to broad trends and corporate strengths, without pointing to any specific factors or sources of revenue," did not trigger a duty to disclose the alleged bribery scheme because the statements were "far too generic to be actionable under the securities laws." The court similarly found that statements concerning the company's Code of Ethics and its anti-bribery policies were "classic puffery." The court noted that "[m]any of the statements were preceded by explicitly aspirational language (*e.g.*, 'committed to'; 'tr[ies] to ensure'), thus unmistakably signaling that they were statements about goals, not statements of fact." The court also found inactionable statements concerning the company's internal controls because the company "did not state that the [c]ompany's internal controls were effective" but "only that management had *concluded* as much." The court also held that the company had no duty to disclose the alleged bribery payment in its financial statements because "a violation of federal securities laws cannot be premised upon a company's disclosure of accurate historical data."

The court did, however, find that the company's statements concerning litigation over rights to a Columbian plant triggered a duty to disclose the company's alleged payment of a bribe to acquire the plant's assets. The court determined that "[t]he alleged bribery scheme bears a direct nexus" to the company's statements concerning the litigation. The court reasoned that "in the mind of a reasonable investor, both the scheme and the proceeding could have raised serious doubts about" the legal enforceability of the company's rights to the plant's assets.

Plaintiffs' Allegations Were Insufficient to Impute the Scienter of the Subsidiary's Officers to the Company

The court held that plaintiffs did not adequately allege that the scienter of officers of the company's subsidiary should be imputed to the company. The court explained that "[t]he mere existence of a parent-subsidiary or affiliate relationship is not on its own sufficient to impute the scienter of the subsidiary to the parent or its affiliate." The court found that the subsidiary's officers "were not sufficiently senior within [the parent company] to serve as a proxy for the [c]ompany." Moreover, there were no allegations that the officers "participated in the overall management of the [c]ompany, reported directly to [the company's] senior managers, or otherwise served as proxies for the [c]ompany." The court found it significant that the subsidiary "comprises less than 6 percent of the total assets, and less than 13 percent of the total net sales" of the company. "Given the tiny share of [the company's] business that [the subsidiary] comprises," the court held that "the scienter of officers of [the subsidiary] cannot, without more, be fairly attributed to" the company.

Eastern District of New York: (1) Statements Concerning a Mutual Fund's Investment Goals Were Inactionable, But (2) Loss Causation Requirement Does Not Preclude Securities Act Claims Against Mutual Funds

On June 25, 2019, the Eastern District of New York dismissed with prejudice a securities fraud action alleging misrepresentations in a mutual fund's offering documents in violation of Sections 11 and 12(a)(2) of the Securities Act. *Emerson v. Mutual Fund Series Trust*, 2019 WL 2601664 (E.D.N.Y. 2019) (Spatt, J.). The court held plaintiffs failed to allege any material misstatements or omissions, and specifically found that statements concerning the fund's investment strategy were inactionable. However, the court rejected defendants' contention that plaintiffs could not satisfy the loss causation requirement for Securities Act claims because a mutual fund's misstatements or omissions do not directly affect the fund's net asset value ("NAV"). The court held that plaintiffs can rely on the "materialization of the risk" framework discussed in the Second Circuit's decision in *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), to demonstrate loss causation in Securities Act claims against mutual funds.

Statements Concerning the Fund's Investment Goals Were Inactionable

Plaintiffs alleged that "[d]efendants misrepresented the [f]und as a low-risk investment" by describing the fund's investment objectives as "capital appreciation and capital preservation in all market conditions" and characterizing the fund's investment strategy as "market neutral." Plaintiffs contended that these representations were misleading in view of "the [f]und's significant investment in naked call options, which rendered the [f]und susceptible to large losses in rapidly rising markets." The court found these statements inactionable "because they merely articulate the goals of the [f]und, rather than promise a particular investment strategy." The court observed that the fund's stated objectives were "to generate returns on investments while avoiding losses—the aspiration of nearly all mutual funds." The court reasoned that it could not "fathom how any mutual fund could escape liability if such vacuous pronouncements became actionable simply because the [f]und suffered losses against its best wishes."

A Reasonable Investor Considers the "Totality of the Disclosures" and Conducts Basic Mathematical Analyses of Financial Data

Plaintiffs also claimed that defendants misleadingly "conveyed that the [f]und did not write uncovered call options." The court found that the statements at issue were not misleading "when read in conjunction with the totality of the disclosures in the Offering Documents." The court noted that the offering documents were "replete with disclosures regarding the [f]und's investment in uncovered call options and the associated risks."

The court found it particularly significant that the fund "publish[ed] an itemized list of every single investment and option in the [f]und's portfolio" on a quarterly basis. The court concluded that "a reasonable investor would have determined that the [f]und did not cover its written options with purchased options by simply comparing the two numbers" in the itemized list. The court explained that "[p]laintiffs cannot allege the [f]und failed to disclose its investment in uncovered call options when it could have 'discovered' the truth purely through simple arithmetic." The court emphasized that "the Securities Act creates liability for *misleading* statements, not statements that an investor simply misunderstood." The court observed that the "disclosure requirements are not intended to attribute to investors a child-like simplicity. Rather, investors are presumed to have the ability to be able to digest varying reports and data."

The court found that disclosures concerning the fund's writing of uncovered call options put plaintiffs on inquiry notice of their alleged claims for purchases made more than one year before they brought suit. Plaintiffs argued that the accrual of their claims was delayed by defendants' reassurances concerning the fund's capital preservation and risk mitigation strategies. But the court explained that "an investor may not reasonably rely on words of comfort from management when there are direct contradictions between defendant's representations and the other materials available to plaintiffs regarding the possibility of fraud." The court also found meritless plaintiffs' argument that "determining whether a plaintiff had sufficient facts to place it on inquiry notice is often inappropriate for resolution on a motion to dismiss." The court noted that the Second Circuit has "stated that courts can readily resolve the issue of inquiry notice as a matter of law on a motion to dismiss . . . where the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of fraud can be gleaned from the complaint and papers . . . integral to the complaint."

Plaintiffs Cannot Assert a Securities Fraud Claim Based Solely on the Ineffectiveness of Risk Mitigation Strategies

With respect to plaintiffs' claims based on the fund's risk management-related statements, the court found "the [f]und's representations merely announced the goal of mitigating losses, rather than providing a guarantee that the [f]und would, in fact, avoid such losses." The court explained that "[n]o reasonable investor would consider such an abstract promise to mitigate losses, untethered from any specific form of hedging, material to their investment decision" in light of the fund's other disclosures. The court reasoned that plaintiffs "could perhaps allege a misrepresentation if the fund did not actually use" the risk management techniques it claimed to employ. But plaintiffs "cannot . . . recover simply because those methods failed to actually minimize losses to the [p]laintiffs' satisfaction."

Plaintiffs May Recover Losses in Mutual Fund Shares Under the Securities Act

The court then addressed the "economic reality" that "any decline in a mutual fund's NAV would result solely from changes in the value of the mutual fund's underlying investments, as opposed to any of the fund's statements or omissions." The court considered "what effect this economic reality has on a plaintiff's ability to recover for Securities Act violations by mutual funds that implicate the principle of loss causation."

In *In re State Street Bank and Trust Co. Fixed Income Funds Investment Litigation*, 774 F. Supp. 2d 584 (S.D.N.Y. 2011), the court dismissed Securities Act claims against a mutual fund for failure to plead loss causation. The court noted that Sections 11 and 12(a)(2) of the Securities Act "tie the recovery of a potential plaintiff to the value of a security." The *State Street* court found that plaintiffs' claims under Sections 11 and 12(a)(2) must be dismissed because "the NAV does not react to . . . any misstatements in the [f]und's prospectus" and thus "no connection between [an] alleged material misstatement and a diminution in the security's value ha[d] been or could be alleged."

The *Emerson* court was "unwilling to concur with *State Street*" because the *State Street* court "effectively found mutual funds categorically exempt from liability for misrepresentations under the Securities Act." 2019 WL 2601664. The court explained that "[i]f Congress intended such a sweeping loophole, it would have said so directly." The *Emerson* court determined that "the most coherent way to address loss causation in the context of mutual funds would be through the 'materialization of the [concealed] risk' framework discussed in *Lentell*." The court found that in the case before it, plaintiffs had adequately alleged "an at least plausible basis for defeating loss causation" by pleading that "the mutual fund issuer misrepresented the composition of the portfolio, concealing the fact that it had potentially unlimited exposure to rapid upward swings in the S&P 500." The court explained that it could not say that "the revelation of the [f]und's overinvestment in naked call options had no causal connection to decline in the [f]und's NAV."

Delaware Supreme Court: Reverses Dismissal of *Caremark* Claim Where the Directors Allegedly Made No Effort to Establish a Board-Level Monitoring and Reporting System

On June 19, 2019, the Delaware Supreme Court reversed dismissal of a derivative suit alleging that the directors of an ice cream manufacturing company "breached their duty of loyalty under *Caremark*" by failing to oversee the company's operations.[2] [*Marchand v. Barnhill*, 2019 WL 2509617 (Del. 2019) (Strine, C.J.) (*Marchand II*)]. The Supreme Court held that the plaintiff adequately pled a *Caremark* violation by alleging "particularized facts that support a reasonable inference that the [company's] board failed to implement any system to monitor [the company's] food safety performance or compliance." The court further found that the plaintiff adequately alleged demand futility with respect to breach of fiduciary duty claims against the company's officers.

Background

In early 2015, an outbreak of *listeria* "caus[ed] the company to recall all of its products, shut down production at all of its plants, and lay off over a third of its workforce." The *listeria* outbreak resulted in the death of three consumers of the company's ice cream products, and also precipitated a major liquidity crisis for the company.

One of the company's stockholders filed a books and records request pursuant to 8 *Del. C.* § 220 to investigate the board's oversight of the company's food safety practices. The stockholder subsequently brought a *Caremark* claim alleging that that the board "had no committee overseeing food safety" or "reporting system in place about food safety," and "did not discuss food safety at its regular board meetings." The plaintiff further alleged that the lack of a reporting system was evidenced by management's failure to report *listeria* issues to the directors until a crisis erupted, even though management allegedly had "two years of evidence that *listeria* was a growing problem for [the company]." The plaintiff also asserted breach of fiduciary duty claims against the company's CEO and one other officer. Defendants moved to dismiss the complaint.

The Chancery Court found that "there was a monitoring system in place" in view of the company's "compliance with FDA regulations, ongoing third-party monitoring for contamination, and consistent reporting

2. In *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Chancery Court stated that "where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."

by senior management to [the company's] board on operations." *Marchand II*, 2019 WL 2509617. The Chancery Court held that the plaintiff failed to state a *Caremark* claim because he was not challenging "the *existence* of monitoring and reporting controls, but the *effectiveness* of monitoring and reporting controls in particular instances." *Id.* (quoting *Marchand v. Barnhill*, 2018 WL 4657159 (Del. Ch. 2018) (emphasis in original)).

The Chancery Court also ruled that the plaintiff was one director short of alleging that a majority of the board could not impartially consider a demand with respect to breach of fiduciary duty claims against the company's CEO. The plaintiff alleged, *inter alia*, that the CEO's family had made donations totaling $450,000 to a university building named in honor of the dispositive director. The Chancery Court nevertheless found that the director was independent of the CEO and his family because the director had voted in favor of separating the CEO and Chairman positions—which the CEO strongly opposed. The plaintiff appealed.

Caremark Imposes a "Bottom-Line" Requirement of a Board-Level Oversight System

On appeal, the Supreme Court recognized that "*Caremark* is a tough standard for plaintiffs to meet" and imposes an "onerous pleading burden." The court noted that "directors have great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources" when establishing a board-level oversight system. The court also observed that Delaware "case law gives deference to boards and has dismissed *Caremark* cases even when illegal or harmful activities escaped detection" by the board's oversight system. However, the Supreme Court underscored that *Caremark* imposes a "bottom-line requirement" that directors must at least "try . . . to put in place a reasonable board-level system of monitoring and reporting."

The Supreme Court held that "the complaint supports an inference that no system of board-level compliance monitoring and reporting existed at [the company]." The court found the company's "nominal[ ]" compliance with FDA regulations insufficient to demonstrate "that the *board* implemented a system to monitor food safety *at the board level*." The court reasoned that "these types of regulatory requirements, although important, are not typically directed at the board." The court explained that the company's compliance with regulatory requirements "does not rationally suggest that the board implemented a reporting system to monitor food safety or [the company's] operational performance."

The Supreme Court further found that the directors could not avoid *Caremark* liability merely because "management regularly reported to them on 'operational issues.'" The court noted that "[a]t every board meeting of any company, it is likely that management will touch on some operational issue." The court reasoned that "*Caremark* would be a chimera" if the board's oversight responsibilities could be satisfied by management's discretionary discussions with the board concerning the company's general operations.

Director's Vote Against the CEO on a Corporate Governance Matter Did Not Establish the Director's Disinterestedness to Consider a Suit Against the CEO

The Supreme Court also found the Chancery Court erred in determining that one of the director's ties to the CEO's family "did not matter" because the director voted against the CEO on a corporate governance matter. The court explained that "the decision whether to sue someone is materially different and more important than the decision whether to part company with that person on a vote about corporate governance." The Supreme Court stated that the Chancery Court was "bound to accord the plaintiff the benefit of all reasonable inferences, and the pled facts fairly support the inference that [the director] owes an important debt of gratitude to the [CEO's] family for giving him his first job, nurturing his progress from an entry level position to a top manager and director, and honoring him by spearheading a campaign to name a building at an important community institution after him." The court explained that Delaware "law has recognized that deep and longstanding friendships are meaningful to human beings and that any realistic consideration of the question of independence must give weight to these important relationships and their natural effect on the ability of the parties to act impartially toward each other." The Supreme Court held that the plaintiff had adequately pled demand futility by alleging that a majority of the board could not impartially consider demand as to the claims against management, and reversed dismissal of these claims.

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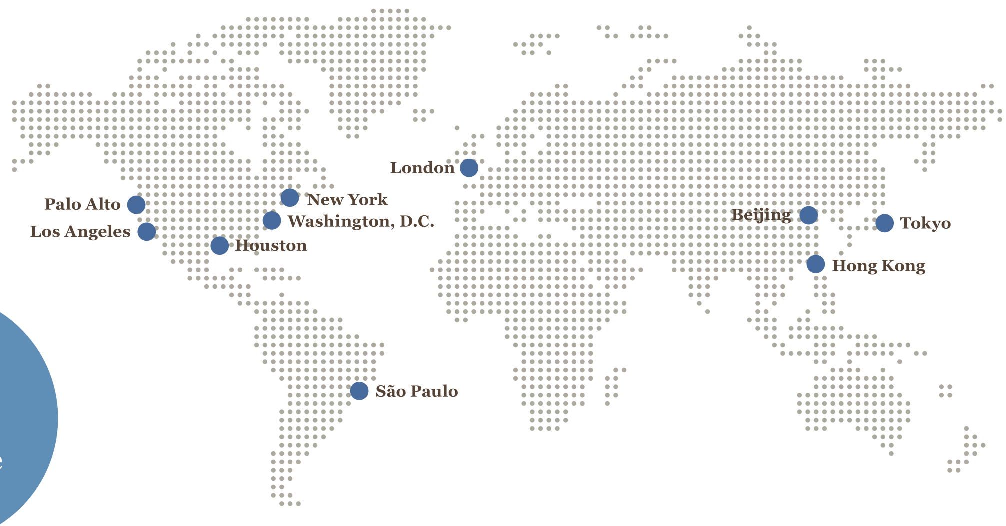

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