



message from partner in charge

It is my pleasure to introduce Pepper Hamilton LLP's Wilmington Office Newsletter. Our clients and friends often ask Pepper attorneys for advice and education on subjects of interest. This newsletter, and its future editions, will not only focus on timely topics relevant to our clients' business needs, but also will discuss industry challenges, changes and innovations – and of course, the many legal issues that arise from such changes.

Our first newsletter focuses on obligations of directors and changes in our Wilmington office. More information about these topics can be found on Pepper's Web site, www.pepperlaw.com.

I hope that you enjoy the Wilmington Office Newsletter and welcome your suggestions for topics to include in future editions. As always, if you have any questions about any of the information contained in this newsletter, just give us a call and we'll do our best to help.

Enjoy!

David B. Stratton
302.777.6566
strattond@pepperlaw.com

in this issue

- 3 **Hertzberg and Stratton Become Co-Chairs of Pepper Hamilton's Corporate Restructuring and Bankruptcy Practice**
- 3 **Peppercast: High Cost Loans to Military Personnel**
- 4 **Edmond D. Johnson Joins Pepper Hamilton's Wilmington Office as a Partner**

Delaware Supreme Court Upholds *Caremark* Standard For Director Oversight Liability; Clarifies Duty of Good Faith

In its decision earlier this month in *Stone v. Ritter*, the Delaware Supreme Court reaffirmed the standard for assessing obligations of directors to oversee the conduct of corporations. Additionally, for the second time in five months, the Court offered guidance regarding a board's obligation to discharge its directorial duties in good faith.

The appeal arose from the dismissal of a derivative complaint alleging that the directors of AmSouth Bancorporation had failed in good faith to implement policies and procedures that would have ensured compliance with reporting requirements under federal banking laws and regulations. The derivative plaintiffs alleged that if such monitoring and oversight procedures had existed, AmSouth would have avoided \$50 million in fines and penalties resulting from the failure by AmSouth employees to file certain Suspicious Activity Reports, as required by a federal statute and regulations, in connection with a Ponzi scheme.

In upholding the dismissal of the complaint, the Supreme Court held that a KPMG forensic report demonstrated that AmSouth had dedicated considerable resources to ensure compliance with reporting requirements. The Court concluded that the KPMG report showed not only that the directors "discharged their oversight responsibility to establish an information and reporting system," but also that "the system was designed to permit the directors to periodically monitor AmSouth's compliance" with federal law.

As a result, the Court held that the claim for oversight liability failed under the *Caremark* standard established by the Court of Chancery in 1996. Quoting *Caremark*, the Court held that “the lack of good faith that is a necessary condition to liability” can be established “only [by] a sustained or systematic failure of the board to exercise oversight - such as an utter failure to attempt to assure a reasonable information and reporting system exists.”

It appears that directorial liability for lack of good faith under *Caremark* may be found only in rare circumstances, such as a failure to establish any reporting or information system or controls, or, if such a system or controls exist, a conscious absence of any monitoring or oversight of the system. *Caremark*, therefore, dissuades acts or omissions by a board that preclude the board from obtaining meaningful information about risks or problems requiring its attention.

The Court also offered guidance “critical to understanding fiduciary liability under *Caremark*.” The Court explained that oversight liability amounts to a breach of the duty of good faith. The failure to exercise good faith does not in and of itself create liability. Instead, “[t]he failure to act in good faith may result in liability because the requirement to act in good faith ‘is a subsidiary element,’ i.e., a condition ‘of the fundamental duty of loyalty.’ ” “It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.”

The Court explained that two principles can be derived from its holding. First, although the duty of good faith may be characterized as one of three sets of fiduciary duties, along with the duties of care and loyalty, “the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.” Second, the duty of loyalty is not limited to cases involving conflicts of interest on the part of directors; it also includes instances in which the fiduciary “fails to act in good faith.”

The Delaware Supreme Court has placed additional focus on a significant area of the law that had until recently not been well developed.

By addressing the concept of good faith for a second time within just a few months after having done so in the *Disney* decision, the Delaware Supreme Court has placed additional focus on an area of the law that had until recently not been well developed. It is potentially a significant issue, because complaints about lack of oversight are categorized as claims for breaches of the duties of loyalty and good faith, and under section 102(b)(7) of the Delaware General Corporation Law, charter provisions are not permitted to immunize directors from personal liability for breaches of the duty of loyalty or for conduct that is not in good faith. That might suggest that an increasing number of derivative claims will assert that directors did not adequately discharge their duties of oversight. Cutting against that possibility, however, is the high standard that the derivative plaintiff must meet to prevail. The Supreme Court quoted a passage from *Caremark*, in which the Court of Chancery stated that a *Caremark* claim remains “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win judgment.”

Authors:

Phillip T. Mellet
302.777.6523
melletp@pepperlaw.com

M. Duncan Grant
302.777.6544
grantm@pepperlaw.com

Hertzberg and Stratton Become Co-Chairs of Pepper Hamilton's Corporate Restructuring and Bankruptcy Practice

Pepper Hamilton LLP announced that partners **Robert S. Hertzberg** and **David B. Stratton** will co-chair the firm's Corporate Restructuring and Bankruptcy Practice Group.

Mr. Hertzberg, a partner in Pepper's Detroit office and a fellow of the American College of Bankruptcy, has been practicing almost exclusively in the bankruptcy and restructuring field for more than 25 years, representing secured lenders, debtors, debtors-in-possession, trustees, creditors and creditors' committees. Mr. Hertzberg will spend a portion of his time in Pepper's newly expanded New York office, and lead the expansion of the Corporate Restructuring and Bankruptcy Practice there.

Mr. Stratton is the managing partner of the firm's Wilmington office. He also is a member of the firm's Executive Committee. Mr. Stratton has more than 28 years of experience in representing debtors, creditors' committees, secured creditors and individual creditors and parties in interest, both as lead counsel and as co-counsel in bankruptcy courts in the District of Delaware, the District of Maryland, the Southern District of New York and in other bankruptcy courts in

the United States. He has been recognized as one of the leading bankruptcy practitioners in Delaware in the 2004, 2005 and 2006 editions of *Chambers USA America's Leading Lawyers*.

Pepper's Corporate Restructuring and Bankruptcy Practice Group handles a full range of debtor/creditor matters, regardless of the complexity, location, industry or market sector involved. Members of the group, drawing on their own experience and the assistance of Pepper's other practitioners, address many complex subjects necessary to the successful resolution of bankruptcy and reorganization matters, including environmental, collective bargaining, transportation, leveraged buyout, toxic tort, pension, intellectual property, health care, financial institution, mortgage banking, real estate, construction/surety, insurance and tax issues. Pepper is one of the few national firms with a significant bankruptcy practice in Wilmington, Delaware, often a forum of choice for bankruptcy filings of national significance.



Peppercast: High Cost Loans to Military Personnel

President Bush recently signed into law an amendment to the Miscellaneous Prohibitions and Penalties chapter of the General Military Law which prohibits creditors from entering into payday loan and title loan agreements with active duty service members.

Listen to a short podcast with Wilmington's Rick Eckman and Albert Manwaring. Rick chairs Pepper's Financial Services Practice Group and Albert is a Pepper partner and lieutenant colonel in the Judge Advocate General Corps of the U.S. Army Reserves. This podcast discusses the host of issues this amendment raises and why it is very troubling for the entire consumer credit industry.

Listen today at www.pepperpodcasts.com

Edmond D. Johnson Joins Wilmington Office as Partner

Focuses on Complex Commercial and Corporate Litigation, Including Patent Litigation

Edmond D. (Ted) Johnson, an experienced lawyer concentrating in complex commercial and corporate litigation, including patent litigation, has joined the firm as a partner resident in the Wilmington office.

“Ted is a great addition to the firm and our commercial litigation practice group,” said David B. Stratton, the partner in charge of the Wilmington office. “He is a highly experienced litigator, with substantial first-chair experience in the Chancery Court and the federal courts in Delaware. In addition, his patent litigation experience will bolster our Delaware intellectual property practice. We’re very pleased that he has chosen to join us.”

Mr. Johnson’s practice includes patent infringement, trade secret, class action and derivative action cases. His intellectual property litigation experience includes matters involving semi-conductors, computer systems, software and pharmaceuticals.

Additionally, Mr. Johnson has litigated matters involving significant technology issues, including the operation and characteristics of jet aircraft engines and large diesel engines used in ships and locomotives. He also has experience litigating business valuations and business accounting issues, including audit failures.

“Wilmington has become a destination for intellectual property litigation,” said Mr. Johnson. “My experience in this area and my years of experience handling matters before the Chancery Court are nice complements to Pepper’s already strong litigation practice in Delaware. I’m happy to be a part of and help build Pepper’s litigation practice here.”

Mr. Johnson joins Pepper from The Bayard Firm in Wilmington, where he had practiced and been a director since 1996. Before joining Bayard, he was a partner with Morris, Nichols, Arsht & Tunnel LLP in Wilmington.

He is a graduate of Harvard University (B.A. 1965), where he majored in math and chemistry, and he received his law degree from the University of Florida College of Law (J.D. 1983).

Pepper Hamilton LLP

Attorneys at Law

The material in this publication is based on laws, court decisions, administrative rulings and congressional materials, and should not be construed as legal advice or legal opinions on specific facts.

www.pepperlaw.com

Berwyn | Boston | Detroit | Harrisburg | New York | Orange County
Philadelphia | Pittsburgh | Princeton | Washington, D.C. | Wilmington

© 2007 Pepper Hamilton LLP. All Rights Reserved.

ATTORNEY ADVERTISING