

The Duty of Directors and Officers to Respond to Red Flags

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The duty of oversight requires directors to (1) make a good faith effort to ensure that their corporations have proper reporting systems in place, and (2) take action to address red flags that indicate potential corporate wrongdoing. These oversight duties provide the basis for two corresponding forms of fiduciary duty claims, often called Caremark claims: (1) information systems claims and (2) red-flag claims. In a few recent decisions, the Delaware Court of Chancery has offered some further guidance regarding red-flag claims.

Red-flag claims assert that, even if necessary, reporting systems and controls were in place, the directors (and potentially officers) of the corporation failed to utilize or monitor those systems, and thereby failed to stay informed of (and thus failed to act on) problems requiring their attention. Red-flags claims generally require that a director's or officer's failure to remain informed and act on such information amount to bad faith because the inaction was (1) sufficiently sustained, (2) systematic, or (3) striking.

In some cases, a single striking red flag may support a red-flags claim. For example, the Delaware Court of Chancery recently noted that a manufacturer's failure to investigate problems resulting in a serious incident involving the product of the manufacturer was enough to support an inference of bad faith needed for a red-flags claim.^[1] Despite only one red flag being raised, the particularly graphic and devastating nature of the red flag was sufficient to support a red-flags claim, according to the court. As such, in circumstances where a single graphic or devastating red flag arises, boards and officers should take appropriate action to address the problem rather than treat it as an anomaly. But Delaware courts have also clarified that red flags do not need to relate to "mission critical risks."^[2] Rather, any red flag that has the potential to harm the corporation can give rise to a red-flags claim if not properly addressed by the corporation's board. While the failure to address "mission critical" and central compliance red flags are most likely to give rise to red-flag claims, directors should ensure that they maintain up-to-date records, not only regarding how they stay informed of risks to the corporation, but also how they respond to such risks when they arise.

And the duty to respond to red flags is not limited to directors. While the Delaware Supreme Court has not yet directly addressed the issue, a recent Delaware Court of Chancery decision expressly

extended the reach of red-flag claims to corporate officers because, like directors, officers play a crucial role in the operations of the business and “are optimally positioned to identify red flags and either address them or report” the issues.^[3] However, an officer’s scope of liability for such claims is generally limited to such officer’s area of authority.

Given these recent decisions, directors and officers (particularly of Delaware corporations) should ensure that they are exercising good faith and responding appropriately to red flags when they arise. Furthermore, given that red-flag claims generally require a finding that the director’s or officer’s failure to act rose to the level of bad faith, directors and officers should be mindful that a successful red-flags claim against them may not be covered by any Section 102(b)(7) exculpatory provisions that may be contained within the applicable corporation’s certificate of incorporation, even if such exculpatory provisions have been expanded as permitted by the August 2022 amendments to Section 102(b)(7).

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Footnotes

(1) In re Boeing Co. Derivative Litigation, C.A. No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch., Feb. 1, 2021)

(2) In re McDonald’s Corporation, C.A. No. 2021-0324-JTL, 2023 Del. Ch. LEXIS 278 (Del. Ch., March 1, 2023).

(3) In re McDonald’s Corporation, C.A. No. 2021-0324-JTL, 2023 Del. Ch. LEXIS 255 (Del. Ch., January 26, 2023).

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