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Delaware Court Dismisses Claims Against Directors for Failing to Investigate Past Misconduct

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Editor's note: Heather Benzmiller Sultanian is a Partner at Sidley Austin LLP. This post is based on her Sidley memorandum, and is part of the Delaware law series; links to other posts in the series are available here.

In a recent dismissal of all claims in Borsody v. Gibson, the Delaware Court of Chancery grappled with an unusual set of circumstances involving a former director who believed he had been wrongfully removed from a board and prevented from exercising his stock options. Having missed the window for asserting claims against the two officers who allegedly engaged in the wrongful scheme, he instead targeted two new directors who did not join the Board until after the scheme had already been completed.

Plaintiff Mark Borsody co-founded and chaired the Board of a medical device company, Nervive, Inc. The complaint alleged that, in late 2019, Borsody was denied contractually-owed stock options (which had been granted through a Stock Option Agreement) and ousted from the Board after he began to question the interim CEO's dealings with potential investors. Shortly thereafter, in October 2019, two new directors were appointed to the Board, one of whom had previously served as CEO of Nervive and allegedly felt "personal animus" toward Borsody. The following month, Borsody attempted to exercise his stock options, but Nervive refused to recognize the exercise — despite advice from Nervive's counsel that Borsody's claims to the stock options were legitimate.

A few months later, in January 2020, Borsody spoke to one of the new directors about the interim CEO's alleged misconduct, including the improper refusal to allow him to exercise his stock options. He then made a written demand on Nervive to execute the stock options, consistent with the Stock Option Agreement. The company refused.

In March 2021, Borsody filed suit in Ohio against Nervive and the officers who schemed to oust him. A few months later, the two new directors retroactively ratified and approved the interim CEO's refusal to honor Borsody's stock options.

In January 2023, Borsody filed suit again, this time against the two new directors. The suit was originally filed in Ohio, but the case was dismissed for lack of jurisdiction. Then, in December 2023, Borsody filed a similar suit in the Delaware Court of Chancery, alleging that the two new directors had breached their fiduciary duties to him by (1) failing to cause Nervive to recognize its contractual obligations to execute his stock options, and (2) neglecting to "investigate" and "redress" the officers' misconduct. He also claimed that the new directors had aided and abetted the interim CEO's breaches of fiduciary duties, fraud, and conspiracy.

The Court dismissed each claim. The Court first found that Borsody's breach of fiduciary duty claims were time-barred under the three-year statute of limitations because his claims accrued in late 2019, when he was ousted and denied the exercise of his stock options, and he had waited more than three years, until January 2023, to file suit. The Court rejected Borsody's argument that the statute of limitations was equitably tolled because he did not know the new directors were "involved in the plot" until January 2020, when he spoke with one of them about the alleged scheme. The Court found that Borsody was on notice of this claim by December 2019, even if he did not yet know what role the new directors played in Nervive's refusal to honor his stock options.

Next, the Court addressed Borsody's attempt to "plead around this timeliness problem" by recharacterizing the claims as based on the new directors' subsequent failure to remedy the past misconduct in two ways. First, as to Borsody's theory that the new directors breached their duties by continuing to not force Nervive to execute his stock options, the Court determined the claim was governed by a contract to which the directors were not parties and the fiduciary duty claim was, therefore, superfluous.

Second, as to Borsody's theory that the new directors breached their duties by neglecting to "investigate" and "redress" past misconduct, the Court determined that the allegations failed to state a claim. Under Nervive's Certificate of Incorporation, which insulated its directors from liability for breach of the duty of care pursuant to 8 Del. C. § 102(b)(7), Borsody was limited to pleading breach of the duty of loyalty. But his allegations did not show that the new directors were acting under a conflict of interest, were not truly independent from the Board, nor were acting in bad faith when they decided not to investigate the past misconduct. In particular, the Court was not convinced that the new directors' potential to obtain stock options in the future was material enough to create a conflict. And the "rote allegation" that one of the directors felt "personal animus" toward Borsody did not rise to the "extreme" level necessary to support an inference of bad faith.

The Court also dismissed Borsody's aiding and abetting claim, concluding that it was also time-barred and unsupported by any facts showing that the new directors knowingly participated in a breach of fiduciary duty. In addition, the Court determined that, because the new directors had already joined the Board when they allegedly participated in the interim CEO's misconduct, they were "co-fiduciaries" with the officer and thus could not "aid and abet" their co-fiduciaries' breaches as a matter of law.

The Delaware Court of Chancery's ruling sends the message that the Court, sitting in equity, will not tolerate creative ploys to revive otherwise time-barred claims or repackage contractual disputes as breaches of fiduciary duties. And, for a new director who learns of alleged misconduct at the company that predates his tenure on the Board, this ruling provides some comfort that aggrieved shareholders will need something more than a mere failure to “investigate” that past misconduct before prevailing on a fiduciary duty claim.