in a large sample had, by 1990, passed charter provisions eliminating liability to the full extent permitted by the statute.[14] Professor Roberta Romano provides an astute analysis of the explosion of D&O liability premia in the mid-1980s (occasioned in part by Delaware case law) and the consequent popularity of liability-limiting statutes in state legislatures. Among other interesting points, Romano reports that insurance companies did not lower premia in response to the passage of §102(b)(7) and that the plaintiffs' bar did not oppose the new legislation.[15] Does this suggest that §102(b)(7) is ineffective? If so, it is news to institutional investors, who generally support charter amendments waiving directorial liability, presumably because, as sophisticated investors, they understand that their self-interest lies in encouraging risk taking by directors.

QUESTIONS

1. Does Delaware's director liability statute raise issues different from those raised by the latitude Delaware firms enjoy to purchase personal liability insurance for their directors and officers? See DGCL §145(g). Could DGCL §102(b)(7) be viewed as simply allowing firms to "self-insure" directors against personal liability arising from gross negligence?

2. Is there reason to distrust a charter amendment, duly approved by shareholders, that eliminates director liability for gross negligence? Why might fully informed investors vote for such an amendment if it were not in their own interests? If the fact of informed shareholder approval of such a liability waiver might be consistent either with the advancement of shareholder economic interests or with a collective action disability of some sort, what might be an empirical methodology to estimate which interpretation of such approval is more likely correct?

3. Statutes such as DGCL §102(b)(7) can be viewed as a device for screening out some or all shareholder suits based on duty-of-care allegations. Is there reason to believe that such actions might be systematically less likely to increase shareholder welfare than duty of loyalty (i.e., conflict of interest) suits? Why? What alternatives, besides the approach used in §102(b)(7), might be worth considering for screening out some shareholder suits? Consider §1701.59, Ohio General Corporation Law (2006).

7.5 The Board's Duty to Monitor: Losses "Caused" by Board Passivity

So far, we have discussed the possible liability of directors for failing to take reasonable care in making business decisions that lead to financial losses. We

14. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 Emory L.J. 1155, 1160-1161 (1990).

15. Id.

now turn to the related question: What is the scope of director liability for losses that arise, not from business decisions, but rather from causes that the board might arguably have deflected but did not? The business judgment rule protects boards' *decisions.* In fact, however, the relatively few cases that actually impose liability on directors for breach of the duty of care are not cases in which a decision proved disastrously wrong, but cases, like the Enron collapse of 2001, in which directors simply failed to do anything under circumstances in which it is later determined that a reasonably alert person would have taken action.[16]

Directors' incentives are far less likely to be distorted by liability imposed for passive violations of the standard of care than for liability imposed for erroneous decisions. We should not be surprised that actual liability is more likely to arise from a failure to supervise or detect fraud than from an erroneous business decision. Nevertheless, given the disjunction between the scale of operations of many public corporations and the scale of the personal wealth of typical individual directors, the risk of liability for inactivity may still deter talented persons from serving on corporate boards. Despite this danger, the astonishingly rapid collapse of the Enron Corporation in 2001 suggested to many observers that boards may generally be too easily manipulated by company officers. As a corrective, some of these observers believe that the sharp prod of potential liability ought to be more in evidence. But liability for losses in these huge enterprises is a crude ex post method to force appropriate attention. Losses in the Enron case were in the many tens of billions of dollars. Liability for the smallest percentage of this loss would financially destroy corporate directors and would make board service to others desperately unappealing. How then are incentives for director attention to be created that do not deter service? We can, at least, say it cannot be done scientifically.

In this section, we review four cases dealing with directors who are charged with breaching their fiduciary duties by not sufficiently monitoring the corporation and thus by not preventing a loss that the corporation incurred. The seminal case in this field is *Caremark*. However, we begin with some precursors to it that laid the foundation, in part, for its development. We then discuss *Caremark* and examine where its progeny are taking the so-called "duty to monitor."

7.5.1 Prologue to *Caremark*

FRANCIS v. UNITED JERSEY BANK
432 A.2d 814 (N.J. 1981)

[Pritchard & Baird, Inc. was a reinsurance broker that arranged contracts between insurance companies that wrote large policies and other companies

16. Recall that the earliest case we find is the 1742 decision of *The Charitable Company v. Sutton*, noted above, in which the board was charged with failing to uncover a fraud. See also the often-cited U.S. Supreme Court case of *Briggs v. Spaulding*, 141 U.S. 132 (1891).

in order to share the risks of those policies thereby avoiding the possibility of a catastrophic loss for any one of them. In this industry, the company that sells insurance to the client pays a portion of the premium to the reinsurance broker, who deducts its commission and forwards the balance to the reinsuring company. The broker thus handles large amounts of money as a fiduciary for its clients.

By 1975, the corporation was bankrupt. This action was brought by the trustees in bankruptcy against Mrs. Pritchard and the bank as administrator of her husband's estate. As to Mrs. Pritchard, the principal claim was that she had been negligent in the conduct of her duties as a director of the corporation. She died during the pendency of the proceedings, and her executrix was substituted as defendant.]

THE FALL OF THE HOUSE OF PRITCHARD[17]

In the mid-1940s, Charles Pritchard, Sr., and George Baird founded one of the first domestic brokerages in the nascent American reinsurance industry. Under the leadership of Charles Pritchard, Sr., Pritchard & Baird became one of America's largest and most prestigious reinsurance intermediaries. After Baird retired in 1964, the Pritchards became the firm's sole shareholders, senior officers, and directors. In 1968, the Pritchard sons, Charles, Jr., and William, assumed sole responsibility for the management of the family firm due to the failing health of their father. Though they were well educated and raised in the family business, Charles, Jr., and William were cut from an altogether different cloth than their father. Where he was moderate, they were greedy; where he was conservative, they were risk-takers; and where he appears to have had integrity, they were unscrupulous.

For several years, the younger Pritchards financed their extravagant lifestyles by misappropriating more than $10 million held in trust by their reinsurance company. But eventually the brothers were discovered, forced into personal bankruptcy, and escaped lengthy prison sentences by a hair's breadth. Shortly thereafter, trustees — including Mr. Francis, the plaintiff in the civil case — were appointed to gather and administer the assets of the various estates. In April 1976, the bankruptcy court directed the trustees for Pritchard & Baird to bring suit against members of the Pritchard family to recover the more than $10 million of client funds misappropriated under the guise of "shareholder loans." Claims were initially filed against all three directors of the company, but the Pritchard brothers were dismissed from the case after being adjudicated bankrupt, leaving their mother — Lillian Pritchard, the only solvent director of Pritchard & Baird — as the main defendant in the case.

The trial court held that if Mrs. Pritchard "had paid the slightest attention to the affairs of the corporation, she would have known what was happening." Consequently, Mrs. Pritchard was found negligent, since "[h]ad she performed her duties with due care, she would readily have discovered

17. This account comes from Reinier Kraakman & Jay Kesten, *The Story of Francis v. United Jersey Bank: When a Good Story Makes Bad Law*, Corporate Law Stories (2010). Citations to the trial court opinion and other sources are provided there.

the wrongdoing . . . and she could easily have taken effective steps to stop the wrongdoing." The court rejected the argument that Mrs. Pritchard should be absolved of liability because she was "a simple housewife . . . old and grief-stricken at the loss of her husband" (Charles, Sr., had died in 1973) who merely "served as a director as an accommodation to her husband and sons." Indeed, in an interesting rhetorical twist, Judge Stanton opined that accepting this argument would insult the "fundamental dignity and equality of women." Based on these findings, the trial court held Mrs. Pritchard liable for the more than $10 million of "loans" improperly paid to members of the Pritchard family at the direction of Charlie and Bill between 1970 and 1975. The decision was affirmed by a three-judge panel of the Appellate Division, and the New Jersey Supreme Court granted certification on the question of Mrs. Pritchard's liability as a director.

POLLOCK, J.:

The "loans" were reflected on financial statements that were prepared annually as of January 31, the end of the corporate fiscal year. Although an outside certified public accountant prepared the 1970 financial statement, the corporation prepared only internal financial statements from 1971-1975. In all instances, the statements were simple documents, consisting of three or four 8½ × 11 inch sheets. . . .

	Working Capital Deficit	*Shareholders' Loans*	*Net Brokerage Income*
70	$ 389,022	$ 508,941	$ 807,229
71	NOT AVAILABLE	NOT AVAILABLE	NOT AVAILABLE
72	$ 1,684,298	$ 1,825,911	$1,546,263
73	$ 3,506,460	$ 3,700,542	$1,736,349
74	$ 6,939,007	$ 7,080,629	$ 876,182
75	$10,176,419	$10,298,039	$ 551,598

The statements of financial condition from 1970 forward demonstrated: Mrs. Pritchard was not active in the business of Pritchard & Baird and knew virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr. would "take the shirt off my back," Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation. . . .

After her husband died in December 1973, Mrs. Pritchard became incapacitated and was bedridden for a six-month period. She became listless at this time and started to drink rather heavily. Her physical condition deteriorated, and in 1978 she died. The trial court rejected testimony seeking to exonerate her because she "was old, was grief-stricken at the loss of her husband, sometimes consumed too much alcohol and was psychologically overborne by her sons." . . . That court found that she was competent to act and that the reason Mrs. Pritchard never knew what her sons "were doing was because she never made the slightest effort to discharge any of her responsibilities as a director of Pritchard & Baird." 162 N.J. Super. at 372. . . .

III

Individual liability of a corporate director for acts of the corporation is a prickly problem. Generally directors are accorded broad immunity and are not insurers of corporate activities. The problem is particularly nettlesome when a third party asserts that a director, because of nonfeasance, is liable for losses caused by acts of insiders, who in this case were officers, directors and shareholders. Determination of the liability of Mrs. Pritchard requires findings that she had a duty to the clients of Pritchard & Baird, that she breached that duty and that her breach was a proximate cause of their losses. . . .

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. . . . Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act." . . .

Directors are under a continuing obligation to keep informed about the activities of the corporation. . . . Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. Accordingly, a director is well advised to attend board meetings regularly. Indeed, a director who is absent from a board meeting is presumed to concur in action taken on a corporate matter, unless he files a "dissent with the secretary of the corporation within a reasonable time after learning of such action." N.J.S.A. 14A:6-13 (Supp. 1981-1982). . . .

While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements. In some circumstances, directors may be charged with assuring that bookkeeping methods conform to industry custom and usage. The extent of review, as well as the nature and frequency of financial statements, depends not only on the customs of the industry, but also on the nature of the corporation and the business in which it is engaged. Financial statements of some small corporations may be prepared internally and only on an annual basis; in a large publicly held corporation, the statements may be produced monthly or at some other regular interval. Adequate financial review normally would be more informal in a private corporation than in a publicly held corporation.

Of some relevance in this case is the circumstance that the financial records disclose the "shareholders' loans." Generally directors are immune from liability if, in good faith, they rely upon the opinion of counsel for the corporation or upon written reports setting forth financial data concerning the corporation and prepared by an independent public accountant or certified public accountant or firm of such accountants or upon financial statements, books of account or reports of the corporation represented to them to be correct by the president, the officer of the corporation having charge of its books of account, or the person presiding at a meeting of the board.

The review of financial statements, however, may give rise to a duty to inquire further into matters revealed by those statements. . . . Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign. . . .

[In this case, Mrs. Pritchard] should have realized [from those statements] that, as of January 31, 1970, her sons were withdrawing substantial trust funds under the guise of "Shareholders' Loans." The financial statements for each fiscal year commencing with that of January 31, 1970, disclosed that the working capital deficits and the "loans" were escalating in tandem. Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. . . .

Nonetheless, the negligence of Mrs. Pritchard does not result in liability unless it is a proximate cause of the loss. . . .

Cases involving nonfeasance present a much more difficult causation question than those in which the director has committed an affirmative act of negligence leading to the loss. Analysis in cases of negligent omissions calls for determination of the reasonable steps a director should have taken and whether that course of action would have averted the loss.

Usually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action. . . . Conversely, a director who votes for or concurs in certain actions may be "liable to the corporation for the benefit of its creditors or shareholders, to the extent of any injuries suffered by such persons, respectively, as a result of any such action." N.J.S.A. 14A:6-12 (Supp. 1981-1982). A director who is present at a board meeting is presumed to concur in corporate action taken at the meeting unless his dissent is entered in the minutes of the meeting or filed promptly after adjournment. N.J.S.A. 14:6-13. In many, if not most, instances an objecting director whose dissent is noted in accordance with N.J.S.A. 14:6-13 would be absolved after attempting to persuade fellow directors to follow a different course of action. . . .

In this case, the scope of Mrs. Pritchard's duties was determined by the precarious financial condition of Pritchard & Baird, its fiduciary relationship to its clients and the implied trust in which it held their funds. Thus viewed, the scope of her duties encompassed all reasonable action to stop the continuing conversion. Her duties extended beyond mere objection and resignation to reasonable attempts to prevent the misappropriation of the trust funds. . . .

A leading case discussing causation where the director's liability is predicated upon a negligent failure to act is *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924). In that case the court exonerated a figurehead director who served for eight months on a board that held one meeting after his election, a meeting he was forced to miss because of the death of his mother. Writing for the court, Judge Learned Hand distinguished a director who fails to prevent general mismanagement from one such as Mrs. Pritchard who failed to stop an illegal "loan":

> When the corporate funds have been illegally lent, it is a fair inference that a protest would have stopped the loan, and that the director's neglect caused the loss. But when a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful, or how much in dollars he could have saved? (*Id.* at 616-617) . . .

. . . The wrongdoing of her sons, although the immediate cause of [Pritchard & Baird's] loss, should not excuse Mrs. Pritchard from her negligence which also was a substantial factor contributing to the loss. . . . Her sons knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect. Her neglect of duty contributed to the climate of corruption; her failure to act contributed to the continuation of that corruption. . . .

Analysis . . . is especially difficult . . . where the allegation is that nonfeasance of a director is a proximate cause of damage to a third party. . . . Nonetheless, where it is reasonable to conclude that the failure to act would produce a particular result and that result has followed, causation may be inferred. We conclude that even if Mrs. Pritchard's mere objection had not stopped the depredations of her sons, her consultation with an attorney and the threat of suit would have deterred them. That conclusion flows as a matter of common sense and logic from the record. Whether in other situations a director has a duty to do more than protest and resign is best left to case-by-case determinations. In this case, we are satisfied that there was a duty to do more than object and resign. Consequently, we find that Mrs. Pritchard's negligence was a proximate cause of the misappropriations.

To conclude, by virtue of her office, Mrs. Pritchard had the power to prevent the losses sustained by the clients of Pritchard & Baird. With power comes responsibility. She had a duty to deter the depredation of the other insiders, her sons. She breached that duty and caused plaintiffs to sustain damages.

The judgment of the Appellate Division is affirmed.

NOTE

Although an odd case in some respects, *Francis* reflects the majority view that there is a minimum objective standard of care for directors — that directors cannot abandon their office but must make a good-faith attempt to do a proper job. The case law is divided on whether the minimum standard is the same for all directors or whether sophisticated directors (e.g., lawyers and investment bankers) ought to be held to a higher standard. The law is clear that all directors must satisfy the same legal standard of care, but the determination of liability is a director-by-director determination. A court may conclude that a reasonable engineer or investment banker serving on a board should have acted in certain circumstances while a reasonable person without that training and experience may not have done so. See *In Re Emerging Communications Inc. Shareholders Litigation*, C.A. No. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004) (investment banker held liable for complicity in controller's breach of loyalty in buyout, while other directors with less knowledge found not liable).

QUESTIONS

1. What would have been the result if Mrs. Pritchard had spotted her sons' activities; if they had responded: "Don't worry, Mama. We were stealing, but we'll stop now and establish a segregated fund for our clients' moneys"; and if her sons had continued to steal as before but pacified their mother with a false financial statement?

2. Courts are reluctant to impose a duty on directors who suspect wrongful activity to do more than protest and resign. Should corporate law impose something tough, such as a whistle-blowing duty (i.e., to go to prosecutors or disclose to shareholders)?

In general, boards of public companies have a particular obligation to monitor their firm's financial performance, the integrity of its financial reporting, its compliance with the law, its management compensation, and its succession planning. Because of the large scale of modern public corporations, the board must monitor largely through reports from others, whether outside auditors, other professionals, or corporate officers. The board authorizes only the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, etc. The lesser decisions that are made by officers and employees within the interior of the organization can, however, vitally affect the welfare of the corporation. Recent business history has graphically demonstrated that the failure of appropriate controls can result in extraordinary losses to even very large public companies. Even before the Enron and WorldCom scandals, large losses following monitoring failures resulted in the displacement of senior management and much of the board of Salomon, Inc.;[18] the replacement of senior management of Kidder, Peabody;[19] and extensive financial loss and reputational injury to Prudential Insurance arising from misrepresentations in connection with the sale of limited partnership interests.[20] Financial disasters of this sort raise this

18. See, e.g., *Rotten at the Core*, The Economist, Aug. 17, 1991, at 69-70; Mike McNamee et al., *The Judgment of Salomon: An Anticlimax*, Bus. Week, June 1, 1992, at 106.

19. See Terence P. Pare, *Jack Welch's Nightmare on Wall Street*, Fortune, Sept. 5, 1994, at 40-48.

20. Michael Schroeder & Leah N. Spiro, *Is George Ball's Luck Running Out?*, Bus. Week, Nov. 8, 1993, at 74-76.

question: What is the board's responsibility to assure that the corporation functions within the law to achieve its purposes?

GRAHAM v. ALLIS-CHALMERS MANUFACTURING CO.

188 A.2d 125 (Del. 1963)

WOLCOTT, J.:

This is a derivative action on behalf of Allis-Chalmers against its directors and four of its non-director employees. The complaint is based upon indictments of Allis-Chalmers and the four non-director employees named as defendants herein who, with the corporation, entered pleas of guilty to the indictments. The indictments, eight in number, charged violations of the Federal anti-trust laws. The suit seeks to recover damages which Allis-Chalmers is claimed to have suffered by reason of these violations. . . .

[T]he hearing and depositions produced no evidence that any director had any actual knowledge of the anti-trust activity, or had actual knowledge of any facts which should have put them on notice that anti-trust activity was being carried on by some of their company's employees. The plaintiffs, appellants here, thereupon shifted the theory of the case to the proposition that the directors are liable as a matter of law by reason of their failure to take action designed to learn of and prevent anti-trust activity on the part of any employees of Allis-Chalmers.

By this appeal the plaintiffs seek to have us reverse the Vice Chancellor's ruling of non-liability of the defendant directors upon this theory. . . .

Allis-Chalmers is a manufacturer of a variety of electrical equipment. It employs in excess of 31,000 people, has a total of 24 plants, 145 sales offices, 5000 dealers and distributors, and its sales volume is in excess of $500,000,000 annually. The operations of the company are conducted by two groups, each of which is under the direction of a senior vice president. One of these groups is the Industries Group under the direction of Singleton, director defendant. This group is divided into five divisions. One of these, the Power Equipment Division, produced the products, the sale of which involved the anti-trust activities referred to in the indictments. The Power Equipment Division, presided over by McMullen, non-director defendant, contains ten departments, each of which is presided over by a manager or general manager.

The operating policy of Allis-Chalmers is to decentralize by the delegation of authority to the lowest possible management level capable of fulfilling the delegated responsibility. Thus, prices of products are ordinarily set by the particular department manager, except that if the product being priced is large and special, the department manager might confer with the general manager of the division. Products of a standard character involving repetitive manufacturing processes are sold out of a price list which is established by a price leader for the electrical equipment industry as a whole.

Annually, the Board of Directors reviews group and departmental profit goal budgets. On occasion, the Board considers general questions concerning price levels, but because of the complexity of the company's operations the Board does not participate in decisions fixing the prices of specific products.

The Board of Directors of fourteen members, four of whom are officers, meets once a month, October excepted, and considers a previously prepared agenda for the meeting. Supplied to the Directors at the meetings are financial and operating data relating to all phases of the company's activities. The Board meetings are customarily of several hours duration in which all the Directors participate actively. Apparently, the Board considers and decides matters concerning the general business policy of the company. By reason of the extent and complexity of the company's operations, it is not practicable for the Board to consider in detail specific problems of the various divisions.

The indictments to which Allis-Chalmers and the four non-director defendants pled guilty charge that the company and individual non-director defendants, commencing in 1956, conspired with other manufacturers and their employees to fix prices and to rig bids to private electric utilities and governmental agencies in violation of the anti-trust laws of the United States. None of the director defendants in this cause were named as defendants in the indictments. Indeed, the Federal Government acknowledged that it had uncovered no probative evidence which could lead to the conviction of the defendant directors.

The first actual knowledge the directors had of anti-trust violations by some of the company's employees was in the summer of 1959 from newspaper stories that the TVA proposed an investigation of identical bids. Singleton, in charge of the Industries Group of the company, investigated but unearthed nothing. Thereafter, in November of 1959, some of the company's employees were subpoenaed before the Grand Jury. Further investigation by the company's Legal Division gave reason to suspect the illegal activity and all of the subpoenaed employees were instructed to tell the whole truth.

Thereafter, on February 8, 1960, at the direction of the Board, a policy statement relating to anti-trust problems was issued, and the Legal Division commenced a series of meetings with all employees of the company in possible areas of anti-trust activity. The purpose and effect of these steps was to eliminate any possibility of further and future violations of the antitrust laws.

As we have pointed out, there is no evidence in the record that the defendant directors had actual knowledge of the illegal anti-trust actions of the company's employees. Plaintiffs, however, point to two FTC decrees of 1937 as warning to the directors that anti-trust activity by the company's employees had taken place in the past. It is argued that they were thus put on notice of their duty to ferret out such activity and to take active steps to insure that it would not be repeated.

The decrees in question were consent decrees entered in 1937 against Allis-Chalmers and nine others enjoining agreements to fix uniform prices on condensers and turbine generators. The decrees recited that they were consented to for the sole purpose of avoiding the trouble and expense of the proceeding. . . .

The director defendants and now officers of the company either were employed in very subordinate capacities or had no connection with the company in 1937. At the time, copies of the decrees were circulated to the heads of concerned departments and were explained to the Managers Committee.

In 1943, Singleton, officer and director defendant, first learned of the decrees upon becoming Assistant Manager of the Steam Turbine Department, and consulted the company's General Counsel as to them. He investigated his department and learned the decrees were being complied with and, in any event, he concluded that the company had not in the first place been guilty of the practice enjoined.

Stevenson, officer and director defendant, first learned of the decrees in 1951 in a conversation with Singleton about their respective areas of the company's operations. He satisfied himself that the company was not then and in fact had not been guilty of quoting uniform prices. . . .

Scholl, officer and director defendant, learned of the decrees in 1956 in a discussion with Singleton on matters affecting the Industries Group. He was informed that no similar problem was then in existence in the company. . . .

Under the circumstances, we think knowledge by three of the directors that in 1937 the company had consented to the entry of decrees enjoining it from doing something they had satisfied themselves it had never done, did not put the Board on notice of the possibility of future illegal price fixing. . . .

Plaintiffs are thus forced to rely solely upon the legal proposition advanced by them that directors of a corporation, as a matter of law, are liable for losses suffered by their corporations by reason of their gross inattention to the common law duty of actively supervising and managing the corporate affairs. . . .

The precise charge made against these director defendants is that, even though they had no knowledge of any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end. However, the *Briggs* case expressly rejects such an idea. On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.

The duties of the Allis-Chalmers Directors were fixed by the nature of the enterprise which employed in excess of 30,000 persons, and extended over a large geographical area. By force of necessity, the company's Directors could not know personally all the company's employees. The very magnitude of the enterprise required them to confine their control to the broad policy decisions. That they did this is clear from the record. . . .

In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.

Plaintiffs say these steps should have been taken long before, even in the absence of suspicion, but we think not, for we know of no rule of law which requires a corporate director to assume, with no justification whatsoever, that all corporate employees are incipient law violators who, but for a tight check-rein, will give free vent to their unlawful propensities.

We therefore affirm the Vice Chancellor's ruling. . . .

QUESTIONS

1. There is evidence that the exceptionally decentralized operating policy of Allis-Chalmers was accompanied by enormous pressure on the company's semiautonomous units to show steadily growing profits. If this was the management style approved by the Allis-Chalmers board, should there be any implications for the board's duty of care?

2. What function would imposing liability for breach of the duty of care serve in *Allis-Chalmers*? When might it be in the narrow economic interests of shareholders, and when might it not be in the interests of shareholders?

3. To the extent that one is tempted to impose liability on the board for purposes of enforcing the antitrust laws, what alternative enforcement strategies might be available? What about increasing penalties against the company itself?

7.5.2 *Caremark* and the Beginning of a New Era?

Delaware jurisprudence on the Board's duty to monitor took its next big step with the watershed *Caremark* decision. Before discussing it, however, some background is useful in understanding the environment in which *Caremark* was decided.

Over many years, the United States has begun to sometimes treat lapses from statutory or administratively mandated standards of business conduct as criminal matters.[21] Federal statutory law has been a powerful engine of this movement. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),[22] for example, opens up potential civil and criminal liabilities for both corporations and "persons in charge," who may be officers or low-level employees.[23] The Resource Conservation and Recovery Act (RCRA) imposes criminal liability on "any person" who knowingly transports hazardous waste to an unpermitted facility or treats, stores, or disposes of any

21. E.g., Flom, *U.S. Prosecutors Take a Tough Line*, Fin. Times, Oct. 31, 1991, at 21.
22. 42 U.S.C.A. §§9601 et seq.
23. E.g., *United States v. Mexico Seed & Feed Co.*, 764 F. Supp. 565, *rev'd in part*, 980 F.2d 473 (8th Cir. 1992).

hazardous waste without a permit.[24] Similarly, the Clean Water Act[25] and the Clean Air Act include criminal penalties applicable to any "person" including "any responsible corporate officer"[26] who violates those Acts. Environmental laws are simply one category of substantive federal regulation in which the criminal law is deployed to promote corporate compliance with regulation. The Occupational Safety and Health Act (OSHA);[27] the Food, Drug, and Cosmetics Act;[28] the antitrust acts; the Foreign Corrupt Practices Act (FCPA);[29] and the acts regulating federally chartered or insured depository institutions[30] and securities markets,[31] all authorize substantial civil or criminal fines against corporations and their officers or employees.

In 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission[32] adopted the Organizational Sentencing Guidelines, which set forth a uniform sentencing structure for organizations convicted of federal criminal violations and provided for penalties that generally exceed those previously imposed on corporations.[33] The Guidelines offer powerful incentives for firms to put compliance programs in place, to report violations of law promptly, and to make voluntary remediation efforts. Under the Guidelines, a convicted organization that has satisfied these conditions will receive a much lower fine. For example, the Guidelines will reduce the base fine of a fully compliant firm by up to 95 percent, while they quadruple the base fine of firms with the highest culpability rating.[34] Thus, with a base fine of say $150 million, the culpability score could cause a variation in a fine from $7.5 million to $600 million for the same offense, depending on the circumstances.[35]

The importance of compliance programs grew even more after the 2003 Department of Justice memorandum entitled "Principles of Federal Prosecution of Business Organizations" (a.k.a. the "Thompson Memo," after then-Deputy Attorney General Larry Thompson) directed U.S. Attorneys to consider the depth and quality of a company's compliance program in connection with charging decisions. This and later memoranda were incorporated into the U.S. Attorneys' Manual which further ensconced the role of

24. 42 U.S.C. §6928(d), (e).

25. 33 U.S.C. §§1319(c), 1362(5), 1321(b)(5) (specifically including "any responsible corporate officer").

26. 42 U.S.C. §§7602(e), 7413(c)(6).

27. 21 U.S.C. §333.

28. 21 U.S.C.A. §§301 et seq.

29. 15 U.S.C. §§78m et seq.

30. E.g., Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-429, 104 Stat. 931 (1990).

31. E.g., Securities Enforcement Remedies and Penny Stock Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

32. See Sentencing Reform Act of 1984, Pub. L. No. 98-473, tit. II, ch. II, 98 Stat. 1987 (1984) (codified as amended in scattered sections of 18 and 28 U.S.C.).

33. See United States Sentencing Commission, Guidelines Manual, Ch. 8 (2018), available at: https://www.ussc.gov/sites/default/files/pdf/guidelines-manual/2018/GLMFull.pdf.

34. Id. §8C2.4-2.6.

35. The base fine is the higher of (1) an amount from an offense level table (currently capped at $150 million), (2) "the pecuniary gain to the organization," or (3) "the pecuniary loss from the offense caused by the organization to the extent the loss was caused intentionally, knowingly, or recklessly." Id. §8C2.4. Departures from the Guidelines are discussed in §8C4.

compliance programs in influencing the exercise of prosecutorial discretion.[36] Thus appropriate compliance programs might not only lead to lower sanctions, but also lower charges and a lower likelihood of facing prosecution in the first place.[37]

Designing corporate compliance programs has developed into a new, fast-growing, and highly remunerative legal subspecialty. The enormous potential fines at stake today make it less likely than it was in 1963 that a court construing the duties of corporate directors would pass over a board's failure to implement a legal compliance program as blithely as was done in *Allis-Chalmers.*

IN RE CAREMARK INTERNATIONAL INC. DERIVATIVE LITIGATION

698 A.2d 959 (Del. Ch. 1996)

ALLEN, C.:

Pending is a motion pursuant to Chancery Rule 23.1 to approve as fair and reasonable a proposed settlement of a consolidated derivative action on behalf of Caremark International, Inc. ("Caremark"). The suit involves claims that the members of Caremark's board of directors (the "Board") breached their fiduciary duty of care to Caremark in connection with alleged violations by Caremark employees of federal and state laws and regulations applicable to health care providers. As a result of the alleged violations, Caremark was subject to an extensive four year investigation. . . . In 1994 Caremark was charged in an indictment with multiple felonies. It thereafter entered into a number of agreements with the Department of Justice and others. Those agreements included a plea agreement in which Caremark pleaded guilty to a single felony of mail fraud and agreed to pay civil and criminal fines. Subsequently, Caremark agreed to make reimbursements to various private and public parties. In all, the payments that Caremark has been required to make total approximately $250 million.

This suit was filed in 1994, purporting to seek on behalf of the company recovery of these losses from the individual defendants who constitute the

36. See §9-28.000, *Principles of Federal Prosecution of Business Organizations*, U.S. Attorneys' Manual, Department of Justice.

37. The U.S. Supreme Court struck down the federal sentencing guidelines for *individuals* as violating a criminal defendant's Sixth Amendment right to a jury trial. See *United States v. Booker*, 543 U.S. 220 (2005). What this does to the legal status of the sentencing guidelines for *organizations* is murkier because the extent to which the Sixth Amendment applies to corporate defendants isn't clear. Nonetheless, the focus on compliance programs in the U.S. Attorneys' Manual and in plea bargains and settlements underscores the continuing and growing importance of compliance programs. See Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U. Chi. L. Rev. 323 (2017); Timothy L. Dickinson & Vikramaditya S. Khanna, *The Corporate Monitor: The New Corporate Czar?*, 105 Mich. L. Rev. 1713 (2007).

Board of Directors of Caremark.[1] The parties now propose that it be settled and, after notice to Caremark shareholders, a hearing on the fairness of the proposal was held on August 16, 1996.

A motion of this type requires the court to assess the strengths and weaknesses of the claims asserted in light of the discovery record and to evaluate the fairness and adequacy of the consideration offered to the corporation in exchange for the release of all claims made or arising from the facts alleged. . . .

Legally, evaluation of the central claim made entails consideration of the legal standard governing a board of directors' obligation to supervise or monitor corporate performance. For the reasons set forth below I conclude, in light of the discovery record, that there is a very low probability that it would be determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise. . . .

I. BACKGROUND

. . . I regard the following facts . . . as material. Caremark . . . was created in November 1992. . . . The business practices that created the problem predated the spin-off. During the relevant period Caremark was involved in two main health care business segments, providing patient care and managed care services. . . .

A substantial part of the revenues generated by Caremark's businesses is derived from third party payments, insurers, and Medicare and Medicaid reimbursement programs. The latter source of payments is subject to the terms of the Anti-Referral Payments Law ("ARPL") which prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. From its inception, Caremark entered into a variety of agreements with hospitals, physicians, and health care providers for advice and services, as well as distribution agreements with drug manufacturers, as had its predecessor prior to 1992. Specifically, Caremark did have a practice of entering into contracts for services (e.g., consultation agreements and research grants) with physicians at least some of whom prescribed or recommended services or products that Caremark provided to Medicare recipients and other patients. Such contracts were not prohibited by the ARPL but they obviously raised a possibility of unlawful "kickbacks."

As early as 1989, Caremark's predecessor issued an internal "Guide to Contractual Relationships" ("Guide") to govern its employees in entering into contracts with physicians and hospitals. . . . Each version of the Guide stated as Caremark's and its predecessor's policy that no payments would be made in exchange for or to induce patient referrals. But what one might deem a prohibited quid pro quo was not always clear. Due to a scarcity of court decisions interpreting the ARPL, however, Caremark repeatedly publicly stated that there was uncertainty concerning Caremark's interpretation of the law. . . .

1. Thirteen of the Directors have been members of the Board since November 30, 1992. Nancy Brinker joined the Board in October 1993.

In August 1991, the HHS [Health and Human Services] Office of the Inspector General ("OIG") initiated an investigation of Caremark's predecessor. Caremark's predecessor was served with a subpoena requiring the production of documents, including contracts between Caremark's predecessor and physicians (Quality Service Agreements ("QSAs")). Under the QSAs, Caremark's predecessor appears to have paid physicians' fees for monitoring patients under Caremark's predecessor's care, including Medicare and Medicaid recipients. Sometimes apparently those monitoring patients were referring physicians, which raised ARPL concerns. . . .

The first action taken by management, as a result of the initiation of the OIG investigation, was an announcement that as of October 1, 1991, Caremark's predecessor would no longer pay management fees to physicians for services to Medicare and Medicaid patients. . . .

During this period, Caremark's Board took several additional steps . . . to assure compliance with company policies concerning the ARPL and the contractual forms in the Guide. In April 1992, Caremark published a fourth revised version of its Guide apparently designed to assure that its agreements either complied with the ARPL and regulations or excluded Medicare and Medicaid patients altogether. In addition, in September 1992, Caremark instituted a policy requiring its regional officers, Zone Presidents, to approve each contractual relationship entered into by Caremark with a physician.

Although there is evidence that inside and outside counsel had advised Caremark's directors that their contracts were in accord with the law, Caremark recognized that some uncertainty respecting the correct interpretation of the law existed. . . .

Throughout the period of the government investigations, Caremark had an internal audit plan designed to assure compliance with business and ethics policies. In addition, Caremark employed Price Waterhouse as its outside auditor. On February 8, 1993, the Ethics Committee of Caremark's Board received and reviewed an outside auditors report by Price Waterhouse which concluded that there were no material weaknesses in Caremark's control structure. Despite the positive findings of Price Waterhouse, however, on April 20, 1993, the Audit & Ethics Committee adopted a new internal audit charter requiring a comprehensive review of compliance policies and the compilation of an employee ethics handbook concerning such policies.

The Board appears to have been informed about this project and other efforts to assure compliance with the law. For example, Caremark's management reported to the Board that Caremark's sales force was receiving an ongoing education regarding the ARPL and the proper use of Caremark's form contracts which had been approved by in-house counsel. On July 27, 1993, the new ethics manual, expressly prohibiting payments in exchange for referrals and requiring employees to report all illegal conduct to a toll free confidential ethics hotline, was approved and allegedly disseminated.[5]

5. Prior to the distribution of the new ethics manual, on March 12, 1993, Caremark's president had sent a letter to all senior, district, and branch managers restating Caremark's policies that no physician be paid for referrals, that the standard contract forms in the Guide were not to be modified, and that deviation from such policies would result in the immediate termination of employment.

The record suggests that Caremark continued these policies in subsequent years, causing employees to be given revised versions of the ethics manual and requiring them to participate in training sessions concerning compliance with the law. . . .

On August 4, 1994, a federal grand jury in Minnesota issued a 47-page indictment charging Caremark, two of its officers (not the firm's chief officer), an individual who had been a sales employee of Genentech, Inc., and David R. Brown, a physician practicing in Minneapolis, with violating the ARPL over a lengthy period. According to the indictment, over $1.1 million had been paid to Brown to induce him to distribute Protropin, a human growth hormone drug marketed by Caremark. . . .

In reaction to the Minnesota Indictment . . . [m]anagement reiterated the grounds for its view that the contracts were in compliance with law.

Subsequently, five stockholder derivative actions were filed in this court and consolidated into this action. . . .

On September 21, 1994, a federal grand jury in Columbus, Ohio issued another indictment alleging that an Ohio physician had defrauded the Medicare program by requesting and receiving $134,600 in exchange for referrals of patients whose medical costs were in part reimbursed by Medicare in violation of the ARPL. . . . Caremark was the health care provider who allegedly made such payments. . . .

II. LEGAL PRINCIPLES . . .

The complaint charges the director defendants with breach of their duty of attention or care in connection with the on-going operation of the corporation's business. The claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance. The complaint thus does not charge . . . loyalty-type problems. . . .

1. *Potential liability for directorial decisions:* Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." . . . What should be understood . . . is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. . . .
2. *Liability for failure to monitor:* The second class of cases in which director liability for inattention is theoretically possible entail circumstances in which a loss eventuates not from a decision, but from unconsidered inaction. Most of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention. . . . As the facts of this case graphically demonstrate, ordinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation. . . . [They] raise the question, what is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?

Modernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations. In 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission adopted Organizational Sentencing Guidelines which impact importantly on the prospective effect these criminal sanctions might have on business corporations. The Guidelines set forth a uniform sentencing structure for organizations to be sentenced for violation of federal criminal statutes and provide for penalties that equal or often massively exceed those previously imposed on corporations. The Guidelines offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.

In 1963, the Delaware Supreme Court in *Graham v. Allis-Chalmers Mfg. Co.*, addressed the question of potential liability of board members for losses experienced by the corporation as a result of the corporation having violated the anti-trust laws of the United States. There was no claim in that case that the directors knew about the behavior of subordinate employees of the corporation that had resulted in the liability. Rather, as in this case, the claim asserted was that the directors ought to have known of it. . . . The Delaware Supreme Court concluded that, under the facts as they appeared, there was no basis to find that the directors had breached a duty to be informed of the ongoing operations of the firm. . . .

How does one generalize this holding today? Can it be said today, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that corporate information gathering and reporting systems exists which represents a good faith attempt to provide senior management and the Board with information respecting . . . compliance with applicable statutes and regulations? I certainly do not believe so. . . .

[I]n recent years the Delaware Supreme Court has made it clear — especially in its jurisprudence concerning takeovers . . . — the seriousness with which the corporation law views the role of the corporate board. Secondly, I note the elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under [DGCL] Section 141. . . . Thirdly, I note the potential impact of the federal organizational sentencing guidelines on any business organization. Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers.

[I]t would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations. . . . But it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility. . . .

III. ANALYSIS OF THIRD AMENDED COMPLAINT AND SETTLEMENT

A. The Claims

On balance, . . . I conclude that this settlement is fair and reasonable. In light of the fact that the Caremark Board already has a functioning committee charged with overseeing corporate compliance, the changes in corporate practice that are presented as consideration for the settlement do not impress one as very significant. Nonetheless, that consideration appears fully adequate to support dismissal of the derivative claims of director fault asserted, because those claims find no substantial evidentiary support in the record and quite likely were susceptible to a motion to dismiss in all events. . . .

2. *Failure to monitor:* Since it does appear that the Board was to some extent unaware of the activities that led to liability, I turn to a consideration of the other potential avenue to director liability that the pleadings take: director inattention or "negligence." Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . 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. . . .

Here the record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function. To the contrary, . . . the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts. If the directors did not know the specifics of the activities that led to the indictments, they cannot be faulted. . . .

NOTES FOLLOWING CAREMARK

Since *Caremark*, there have been significant legislative and judicial developments. For instance, §404 of the Sarbanes-Oxley Act of 2002 ("SOX" or "Sarbox") requires that the CEO and the CFO of firms with securities regulated under the Securities Exchange Act of 1934 periodically certify that they have disclosed to the company's independent auditor all deficiencies in the design or operation, or any material weakness, of the firm's internal controls for financial reporting. This requirement has generated considerable discussion and controversy. Critics have complained that §404 compliance costs have far exceeded predictions, are irrationally high, and have pushed many companies, particularly smaller companies, out of the public markets.[38] Proponents, on the other hand, argue that §404 forces companies to take a hard look at their control systems, which has long-term benefits that they suppose outweigh the costs. Since 2002, among companies with more than $1 billion in market capitalization, 2 percent have disclosed material weaknesses under §404.[39]

In the event that a firm's internal controls fail to prevent a loss and the CEO *did not* identify any weakness in the control system to the auditors, cases such as *Kamin v. American Express Co.* (above) indicate that state law imposes little risk of directorial liability—unless, under *Caremark*, the board's failure to prevent a loss resulted from a systematic failure to attempt to control potential liabilities. Does §404 of Sarbanes-Oxley change that prediction in any way? What are the arguments, pro and con?

Confirming this point, in 2006, the Delaware Supreme Court in *Stone v. Ritter* endorsed and clarified the *Caremark* standard, stating that: "We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." 911 A.2d 362 (Del. 2006).

Another subtle but important point about *Stone* is that it treats violations of the two-prong test above as duty-of-loyalty breaches in the form of not acting in good faith. We address the duty of good faith in more detail in the context of executive compensation in Chapter 9, but here note it because framing *Caremark* obligations in these terms means that such claims cannot be blocked by waivers under §102(b)(7). Further, this makes *Caremark* claims somewhat easier to satisfy for directors because it requires just that the board have some system in place and not consciously fail to oversee it.

7.5.3 *Caremark*'s Progeny

The *Caremark* standard, as clarified in *Stone v. Ritter*, was put to the test in the following Delaware Supreme Court case. The particular issue

38. See Ehud Kamar, Pinar Karaca-Mandic & Eric L. Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, 25 J. L. Econ. & Org'n 107 (2009); Craig Doidge, G. Andrew Karolyi & Rene M. Stulz, *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices Over Time*. 91 J. Fin. Econ. 253 (2009).

39. Christine Dunn, *Effective Controls, Clean Opinions Rule the Roost*. Compliance Week (June 2, 2006). One study finds that companies disclosing weaknesses under §404 suffer a 2 percent market-adjusted decline in their stock price on average. See Messod Daniel Beneish et al., *Internal Control Weaknesses and Information Uncertainty*, 83 The Acc. Rev. 665 (2008).

before the court was whether demand was excused, a doctrine we examine in Chapter 10. However, the court's determination on this procedural question was guided by its assessment of the viability of the plaintiffs' substantive claims under *Caremark* and *Stone*.

MARCHAND v. BARNHILL
212 A.3d 805 (Del. 2019)

STRINE, C.J.:

Blue Bell Creameries USA, Inc., one of the country's largest ice cream manufacturers, suffered a listeria outbreak in early 2015, causing 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. . . . Three people died as a result of the listeria outbreak . . . [and] stockholders also suffered losses. . . .

Based on these unfortunate events, a stockholder brought a derivative suit against . . . Paul Kruse, the President and CEO, and Greg Bridges, the Vice President of Operations [that they] . . . breached their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of Blue Bell's food-making operations, and that the directors breached their duty of loyalty under *Caremark*.[1]

The defendants moved to dismiss the complaint for failure to plead demand futility. . . .

As to the *Caremark* claim, the Court of Chancery held that the plaintiff did not plead any facts to support "his contention that the [Blue Bell] Board 'utterly' failed to adopt or implement any reporting and compliance systems." Although the plaintiff argued that Blue Bell's board had no supervisory structure in place to oversee "health, safety and sanitation controls and compliance," the Court of Chancery reasoned that "[w]hat Plaintiff really attempts to challenge is not the existence of monitoring and reporting controls, but [their effectiveness] in particular instances," and "[t]his is not a valid theory under . . . *Caremark*."

In this opinion, we reverse . . . [and] hold that the complaint alleges particularized facts that support a reasonable inference that the Blue Bell board failed to implement any system to monitor Blue Bell's food safety performance or compliance. Under *Caremark* and this Court's opinion in *Stone* v. *Ritter*, directors have a duty "to exercise oversight" and to monitor the corporation's operational viability, legal compliance, and financial performance. A board's "utter failure to attempt to assure a reasonable information and reporting system exists" is an act of bad faith in breach of the duty of loyalty.

As a monoline company that makes a single product — ice cream — Blue Bell can only thrive if its consumers enjoyed its products and were confident that its products were safe to eat. That is, one of Blue Bell's central compliance issues is food safety. Despite this fact, the complaint alleges that Blue Bell's board had no committee overseeing food safety, no full board-level

1. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch.1996) (Allen, C.).

process to address food safety issues, and no protocol by which the board was expected to be advised of food safety reports and developments. Consistent with this dearth of any board-level effort at monitoring, the complaint pleads particular facts supporting an inference that during a crucial period when yellow and red flags about food safety were presented to management, there was no equivalent reporting to the board and the board was not presented with any material information about food safety. Thus, the complaint alleges specific facts that create a reasonable inference that the directors consciously failed "to attempt to assure a reasonable information and reporting system exist[ed]."

I. Background

A. Blue Bell's History and Operating Environment [and] History

Founded in 1907 in Brenham, Texas, Blue Bell Creameries USA, Inc. ("Blue Bell"), a Delaware corporation, produces and distributes ice cream under the Blue Bell banner. . . .

As a U.S. food manufacturer, Blue Bell operates in a heavily regulated industry. . . . Blue Bell is "required to comply with regulations and establish controls to monitor for, avoid and remediate contamination and conditions that expose the Company and its products to the risk of contamination."

Specifically, [Food and Drug Administration (FDA)] regulations require food manufacturers to conduct operations "with adequate sanitation principles" and, in line with that obligation, "must prepare . . . and implement a written food safety plan." As part of a manufacturer's food safety plan, the manufacturer must include processes for conducting a hazard analysis that identifies possible food safety hazards, identifies and implements preventative controls to limit potential food hazards, implements process controls, implements sanitation controls, and monitors these preventative controls. Appropriate corporate officials must monitor these preventative controls.

Not only is Blue Bell subject to federal regulations, but it must also adhere to various state regulations. At the time of the listeria outbreak, Blue Bell operated in three states, and each had issued rules and regulations regarding the proper handling and production of food to ensure food safety. . . .

B. The Caremark Claim

. . . Although *Caremark* claims are difficult to plead and ultimately to prove out, we nonetheless disagree with the Court of Chancery's decision to dismiss the plaintiff's claim against the Blue Bell board.

Under *Caremark* and *Stone* v. *Ritter*, a director must make a good faith effort to oversee the company's operations. Failing to make that good faith effort breaches the duty of loyalty and can expose a director to liability. In other words, for a plaintiff to prevail on *Caremark* claim, the plaintiff must show that a fiduciary acted in bad faith—"the state of mind traditionally used to define the mindset of a disloyal director."

Bad faith is established, under *Caremark*, when "the directors [completely] fail[] to implement any reporting or information system or controls[,] or . . . having implemented such a system or controls, consciously fail[] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it.

As with any other disinterested business judgment, directors have great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources. But Caremark does have a bottom-line requirement that is important: the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting. . . .

For that reason, our focus here is on the key issue of whether the plaintiff has pled facts from which we can infer that Blue Bell's board made no effort to put in place a board-level compliance system. That is, we are not examining the effectiveness of a board-level compliance and reporting system after the fact. Rather, we are focusing on whether the complaint pleads facts supporting a reasonable inference that the board did not undertake good faith efforts to put a board-level system of monitoring and reporting in place. . . .

Here, . . . the complaint fairly alleges that before the listeria outbreak engulfed the company:

- no board committee that addressed food safety existed;
- no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports existed;
- no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks existed;
- during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board; the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and
- the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues.

And the complaint goes on to allege that after the listeria outbreak, the FDA discovered a number of systematic deficiencies in all of Blue Bell's plants . . . that might have been rectified had any reasonable reporting system that required management to relay food safety information to the board on an ongoing basis been in place.

In sum, the complaint supports an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell. Although

Caremark is a tough standard for plaintiffs to meet, the plaintiff has met it here. When a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation, then that supports an inference that the board has not made the good faith effort that *Caremark* requires.

In defending this case, the directors largely point out that by law Blue Bell had to meet FDA and state regulatory requirements for food safety, and that the company had in place certain manuals for employees regarding safety practices and commissioned audits from time to time. In the same vein, the directors emphasize that the government regularly inspected Blue Bell's facilities, and Blue Bell management got the results.

But the fact that Blue Bell nominally complied with FDA regulations does not imply that the board implemented a system to monitor food safety at the board level. . . . At best, Blue Bell's compliance with these requirements shows only that management was following, in a nominal way, certain standard requirements of state and federal law. It does not rationally suggest that the board implemented a reporting system to monitor food safety or Blue Bell's operational performance. . . .

In decisions dismissing *Caremark* claims, the plaintiffs usually lose because they must concede the existence of board-level systems of monitoring and oversight such as a relevant committee, a regular protocol requiring board-level reports about the relevant risks, or the board's use of third-party monitors, auditors, or consultants. . . . Here, the Blue Bell directors just argue that because Blue Bell management, in its discretion, discussed general operations with the board, a *Caremark* claim is not stated. But if that were the case, then *Caremark* would be a chimera. At every board meeting of any company, it is likely that management will touch on some operational issue. Although *Caremark* may not require as much as some commentators wish,[115] it does require that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks. In Blue Bell's case, food safety was . . . critical. The complaint pled facts supporting a fair inference that no board-level system of monitoring or reporting on food safety existed.

If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty. Where, as here, a plaintiff has . . . plead facts supporting a fair inference that no reasonable compliance system and protocols were established as to the obviously most central consumer safety and legal compliance issue facing the company, that the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company exposed

115. *See, e.g.*, John Armour et al., *Board Compliance*, 104 Minn. L. Rev. (forthcoming 2020) (manuscript at 47); John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. Legal Analysis 35, 46 (2014); Hillary A. Sale, *Monitoring* Caremark's *Good Faith*, 32 Del. J. Corp. L. 719, 753 (2007).

consumers to listeria-infected ice cream, resulting in the death and injury of company customers, the plaintiff has met his onerous pleading burden and is entitled to discovery to prove out his claim. . . .

NOTES AND QUESTIONS ON MARCHAND

Marchand heralds an era of greater scrutiny compared to earlier cases where Delaware courts tended to limit the application of *Caremark*. Two recent Chancery Court cases — decided on the heels of *Marchand* — build upon its holdings. *In Re Clovis Oncology, Inc. Derivative Litigation*, C.A. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019) involved a case where a biotechnology company, Clovis Oncology, lost substantial value when it was revealed that the Food and Drug Administration (FDA) refused to grant approval to the firm's "mission critical" drug due to problems with the firm following well-established protocols related to clinical trials. Shareholders brought suit claiming a *Caremark* violation for failure to follow these protocols among other things. Although the board had oversight systems in place, the Chancery Court held that the plaintiffs had pled with sufficient particularity that the board ignored multiple red flags about management's reporting of clinical trials and "consciously failed to monitor or oversee its operations." The Court cited *Marchand* and noted that the firm must engage in greater oversight "when a monoline company operates in a highly regulated industry."

In *Hughes v. Hu*, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020), Kandi Technologies failed to rectify known problems relating to its financial reporting and internal controls leading to a financial restatement. Shareholders brought suit against the audit committee members and some top executives for *Caremark* violations. V. C. Laster held that the plaintiffs pled with sufficient particularity that the audit committee "met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation." Further, "the board never established its own reasonable system of monitoring and reporting, choosing instead to rely entirely on management." Simply put, the directors failed "to make a good faith effort — *i.e.*, try — to put in place a reasonable board-level system of monitoring and reporting."

1. Does the focus on "red flags" and reliance on management in these cases suggest that *Allis-Chalmers* is no longer good law? When can boards now rely on management representations?

2. In *Marchand* and *In Re Clovis*, the court stresses the highly regulated nature of the industries in which the firms conduct business and that each firm had "mission critical" products subject to that regulation. How does this change judicial analysis? What additional factors matter more in these situations?

3. In the *In Re Clovis* decision, the court noted there is a distinction between monitoring for business risks and legal risks. Earlier case law — *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A. 2d 106 (Del. Ch. 2009) — also seems to press on this point. There plaintiffs brought a

Caremark claim for the very large losses suffered by Citigroup from the subprime mortgage crisis. The court blocked the claim and noted that:

> While it may be tempting to say that directors have the same duties to monitor and oversee business risk [as legal risk], imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investments and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.[40]

As a policy matter, does it make sense to draw a distinction between establishing a control system to detect employee misconduct and establishing a control system to evaluate business risk properly? Which category would seem to be more within a board's expertise? And which category would shareolders be more concerned about?

4. These cases were decided after the Department of Justice issued its guidance on evaluating compliance programs (see discussion *infra* Section 7.5.4). Should the Department of Justice's guidance influence Delaware in interpreting *Caremark* (as perhaps federal policy influenced *Caremark* itself)? Do these cases suggest that it already has?

7.5.4 *Caremark* Duties and Federal Enforcement

Although *Caremark* duties appear motivated in part by the development of the federal organizational sentencing guidelines and the important role of compliance programs therein, that does not mean federal enforcement and Delaware corporate law are quite the same. There are some important differences. First, a poor monitoring system under Delaware law enhances the risk of ***directorial civil*** liability while it enhances *corporate criminal* liability under federal law. Second, it is easier to satisfy Delaware's standard for monitoring than the federal one. Under *Caremark*, even the version seen in *Marchand*, it will usually be quite difficult to impose liability on directors because the presence of any compliance system and some attempt to monitor and oversee it by the board are together likely to absolve directors of liability. This is not the case under federal enforcement. Such protean compliance programs are not generally considered "reasonably effective compliance programs" under the organizational sentencing guidelines. Further, as

40. *In re Citigroup Inc.*, at 131. As the court says in footnote 78, "If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?" Id.

noted earlier, such lackluster programs would increase the likelihood of the U.S. Department of Justice pursuing a criminal case against a corporation. Indeed, assessments about the effectiveness of a firm's compliance efforts may influence the details of any resolution — whether a deferred prosecution agreement might be given, would an independent monitor be appointed, and a host of other matters.[41]

In light of its importance, a critical question is what amounts to a "reasonably effective compliance program." That is the $64,000 question, or more accurately the multi-billion-dollar question given the size of the compliance industry. Although countless consultants, law firms, and academics have their views on this question, the Department of Justice remained relatively silent until recently when it issued its first policy statements on evaluating compliance programs. This was then updated in June 2020.[42]

The Department of Justice eschews any rigid formula for evaluating compliance efforts and prefers more individualized assessments that take into account a number of factors such as the firm's size, regulatory landscape, industry, and other relevant matters. The key features of the current approach center around three questions: (a) is the corporation's compliance program well designed, (b) is it adequately resourced and empowered to function effectively, and (c) does it work in practice? Although this may appear quite skeletal, the policy statements provide a bit more flesh to tease out some important elements. In particular, they note that a culture of compliance is critical, and this should manifest itself not just sporadically but in the day-to-day operations of the firm. Prosecutors should examine whether compliance and business are at loggerheads or do they try to work together. Moreover, "cookie cutter" compliance efforts are not as impressive as those more customized to a firm's specific context. Indeed, effective compliance is a process, not an end result — good compliance programs continuously learn from experience and try to improve. This will usually involve ongoing risk assessments and training within the firm as well as attempts to learn from the experiences of other similarly situated firms. The Department of Justice further encourages firms to rely on data and data analytics (and removing impediments to them) in making their decisions about compliance and internal controls and that both top and middle management be actively involved and committed to compliance. This level of seriousness should apply not just to the firm's employees but also to third parties utilized by the firm.[43]

41. See Arlen & Kahan, *supra* note 37; Brandon L. Garrett, Structural Reform Prosecution, 93 Va. L. Rev. 853 (2007); Dickinson and & Khanna, *supra* note 37.

42. See Evaluation of Corporate Compliance Programs (updated June 2020), U.S. Department of Justice, Criminal Division, available at: https://www.justice.gov/criminal-fraud/page/file/937501/download.

43. This is particularly important with the rise of supply chain structured businesses. In addition, in an interesting section of the Update, the Department of Justice notes that one part of the overall assessment of a firm's compliance efforts may include whether firms "track access [by its employees] to various policies and procedures to understand what policies are attracting more attention from relevant employees."

7.6 "Knowing" Violations of Law

In *Caremark*, the court says that directors have a duty to take reasonable steps to see that the corporation has in place an information and control structure designed to offer reasonable assurance that the corporation is in compliance with the law. But does that mean every aspect of our public policy should be deployed to this end? Specifically, in addition to the incentives provided in the federal Organizational Sentencing Guidelines above, should corporate law also command obedience to positive law? When we ask this question, are we necessarily asking whether shareholders should be able to sue directors to recover any loss the corporation may suffer (as in *Caremark*) by reason of a knowing violation of the law? Are there issues present in such a question in addition to whether we want augmented enforcement?

MILLER v. AT&T

507 F.2d 759 (3d Cir. 1974)

Seitz, C.J.:

Plaintiffs, stockholders in American Telephone and Telegraph Company ("AT&T"), brought a stockholders' derivative action . . . against AT&T and all but one of its directors. The suit centered upon the failure of AT&T to collect an outstanding debt of some $1.5 million owed to the company by the Democratic National Committee ("DNC") for communications services provided by AT&T during the 1968 Democratic national convention. Federal diversity jurisdiction was invoked under 28 U.S.C. §1332.

Plaintiffs' complaint alleged that "neither the officers or directors of AT&T have taken any action to recover the amount owed" from on or about August 20, 1968, when the debt was incurred, until May 31, 1972, the date plaintiffs' amended complaint was filed. The failure to collect was alleged to have involved a breach of the defendant directors' duty to exercise diligence in handling the affairs of the corporation, to have resulted in affording a preference to the DNC in collection procedures in violation of §202(a) of the Communications Act of 1934, . . . and to have amounted to AT&T's making a "contribution" to the DNC in violation of a federal prohibition on corporate campaign spending, 18 U.S.C. §610 (1970). . . .

The pertinent law on the question of the defendant directors' fiduciary duties in this diversity action is that of New York, the state of AT&T's incorporation. . . . The sound business judgment rule, the basis of the district court's dismissal of plaintiffs' complaint, expresses the unanimous decision of American courts to eschew intervention in corporate decision-making if the judgment of directors and officers is uninfluenced by personal considerations and is exercised in good faith. . . .

Had plaintiffs' complaint alleged only failure to pursue a corporate claim, application of the sound business judgment rule would support the district court's ruling that a shareholder could not attack the directors' decision. . . . Where, however, the decision not to collect a debt owed the corporation is itself alleged to have been an illegal act, different rules apply. When New York law regarding such acts by directors is considered in conjunction with the underlying purposes of the particular statute involved here, we are convinced that the business judgment rule cannot insulate the defendant directors from liability if they did in fact breach 18 U.S.C. §610, as plaintiffs have charged.

Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909), illustrates the proposition that even though committed to benefit the corporation, illegal acts may amount to a breach of fiduciary duty in New York. In *Roth*, the managing director of an amusement park company had allegedly used corporate funds to purchase the silence of persons who threatened to complain about unlawful Sunday operation of the park. Recovery from the defendant director was sustained on the ground that the money was an illegal payment. . . .

The plaintiffs' complaint in the instant case alleges a similar "waste" of $1.5 million through an illegal campaign contribution. . . .

The alleged violation of the federal prohibition against corporate political contributions not only involves the corporation in criminal activity but similarly contravenes a policy of Congress clearly enunciated in 18 U.S.C. §610. That statute and its predecessor reflect congressional efforts: (1) to destroy the influence of corporations over elections through financial contributions and (2) to check the practice of using corporate funds to benefit political parties without the consent of the stockholders. . . .

The fact that shareholders are within the class for whose protection the statute was enacted gives force to the argument that the alleged breach of that statute should give rise to a cause of action in those shareholders to force the return to the corporation of illegally contributed funds. Since political contributions by corporations can be checked and shareholder control over the political use of general corporate funds is effectuated only if directors are restrained from causing the corporation to violate the statute, such a violation seems a particularly appropriate basis for finding breach of the defendant directors' fiduciary duty to the corporation. Under such circumstances, the directors cannot be insulated from liability on the ground that the contribution was made in the exercise of sound business judgment.

Since plaintiffs have alleged actual damage to the corporation from the transaction in the form of the loss of a $1.5 million increment to AT&T's treasury, we conclude that the complaint does state a claim upon which relief can be granted sufficient to withstand a motion to dismiss.

II

We have accepted plaintiffs' allegation of a violation of 18 U.S.C. §610 as a shorthand designation of the elements necessary to establish a breach of that statute. . . . That such a designation is sufficient for pleading purposes does not, however, relieve plaintiffs of their ultimate obligation to prove the elements of the statutory violation as part of their proof of breach of fiduciary duty. At the appropriate time, plaintiffs will be required to produce evidence sufficient to establish three distinct elements comprising a violation of 18 U.S.C. §610: that AT&T (1) made a contribution of money or anything of value to the DNC (2) in connection with a federal election (3) for the purpose of influencing the outcome of that election. . . . The order of the district court will be reversed and the case remanded for further proceedings consistent with this opinion.

PROBLEM

Knowing violations of law are conceptually distinct from the duty-of-care topics that are addressed in the prior sections of this chapter. To see why, consider a board that deliberates with the utmost care to authorize an action that they know to be illegal. As the *Miller* court tells us, the business judgment rule will not immunize their decision from judicial scrutiny.[44] For this reason, the duty to obey the law can be seen as a judge-created positive overlay on the overall fiduciary duty structure. This imposition seems unproblematic in the case of definite violations of the law, but what about the far more common situation where the legal advice is "some likelihood" or "substantial risk" of violating the law? Could it be the case that corporate law prevents directors from taking *any* risk of violating the law? Or is a balance-of-the-probabilities test required, in which the directors have to know only that it is more likely than not lawful? If an action has some probability of being in violation of a binding regulation, but legal opinion is not that it is more likely than not illegal, how should a board decide? To make the question concrete, consider the following problem:

The board of Acme, Inc. is asked to approve the use of Grade II fuel instead of Grade I fuel in operating a large plant. The board is told that using the lower grade of fuel will cause the company to run an 85 percent risk that the plant will exceed Clean Air Act standards at least once a month, and the best estimate is that it will cause this to happen on average 3.5 times per month. If such a violation were detected and prosecuted, a fine could be levied that would be no more than $10,000 for each violation. Using the lower grade fuel would save more than $80,000 per month at current prices. While this decision would not ordinarily require board action, in this case senior management brings the question to the board because it does involve a possible violation of government regulations.

1. Consider that you are the general counsel of the company. What would you tell the board about its fiduciary duty to the corporation, and what would you say about the corporation's obligation to obey the law and the directors' obligation to cause it to do so?

44. See also *Metro Communications Corp. BVI v. Advanced Mobilecomm Technologies, Inc.*, 854 A.2d 121, 131 (Del. Ch. 2004) ("Under Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity.").