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DIRECTORS' AND OFFICERS' LIABILITY

ASSESSING *CAREMARK* CLAIMS FOR DIRECTOR OVERSIGHT LIABILITY

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In addition to their direct decision-making role concerning the most significant corporate acts and transactions, corporate directors have oversight responsibility to monitor the corporation's compliance with applicable laws and regulations. This monitoring function principally entails ensuring that the corporation designs and implements effective policies and procedures calculated to assure corporate compliance with the law. But what is the proper gauge of directors' liability if corporate agents engage in conduct that results in a corporate legal or regulatory violation? At what point does the failure to uncover wrongdoing become actionable? The answers to these questions are of particular importance because a breach of oversight responsibility entails a breach of the duty of loyalty through failure to discharge directorial duties in good faith, and exposure to monetary damage liability for such a breach cannot be eliminated by an exculpatory corporate charter provision. This column examines recent decisions, including two last month from the Delaware Supreme Court, which explicate the demanding liability standard for claims based on the failure of directors to exercise adequate oversight of the affairs of the company. The clear message is that the argument that an attentive, properly functioning board and its committees "should have been aware" of employee misconduct is no substitute for particularized facts showing sustained or systematic failure of the board to exercise oversight.

Caremark Claims

A *Caremark* claim derives its name from the 1996 Delaware Court of Chancery decision *In re Caremark Int'l Inc. Deriv. Litig.*,[1] which approved a proposed settlement of derivative claims against directors for alleged breaches of the duty of care and oversight in failing to prevent violations of state and federal law by Caremark employees, resulting in criminal investigations and indictments, fines, penalties and other costs to the company totaling over $250 million. The claim in *Caremark* was that the company's directors breached their duty of care by failing adequately to supervise the conduct of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability.

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Considering the duty of care claim, the court noted that director liability may arise from two contexts: (i) liability for ill-advised decisions made by the directors or (ii) liability for the directors' failure to monitor responsibly the actions of the corporation. The former basis for liability is subject to review under the business judgment rule, assuming the decision "was the product of a process that was either deliberately considered in good faith or was otherwise rational." Rejecting the notion that directors' duty to be reasonably informed concerning the corporation entails no responsibility to assure that management establishes appropriate information and reporting systems, Chancellor Allen held that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."

Section 141 of the Delaware General Corporation Law provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." Recognizing that in a corporation of any size most corporate decisions do not receive director attention, *Caremark* acknowledged that directors are not omniscient and therefore have no duty to possess detailed information about every nook and cranny at the company. Accordingly, absent specific allegation that directors knew, through the presence of "red flags," that violations of law were occurring at the company, "only a sustained or systematic failure of the board to exercise oversight - such as an utter failure to attempt to assure a reasonable information and reporting system exists" – can establish the lack of good faith needed to allege a claim based on ignorance of liability-creating conduct within the company. Thus it bears emphasis that *Caremark* involved review of director liability "predicated upon ignorance of liability creating activities," and an absence of factual allegations to suggest the directors "conscientiously permitted a known violation of law by the corporation to occur." In *Caremark*, the corporation had 7,000 employees at 90 branches, and a decentralized management structure. As a result of government investigations, the corporation had begun to centralize management oversight of the company's business practices. The *Caremark* court observed that the claim asserted in *Caremark* was only that the directors "ought to have known" of the violations, and that the law imposed no duty on directors "to ferret out wrongdoing which [the directors] have no reason to suspect exists," particularly where "there were no grounds for suspicion . . . and the directors were blamelessly unaware of the conduct leading to the corporate liability." The court concluded that where the claim is not based on "considered" board action, the proper focus of judicial review is on corporate governance and whether a corporate information gathering and reporting system exists. As the Court of Chancery stated in *In re Walt Disney Co. Derivative Litig.*,[2] plaintiffs must allege particularized facts showing that the defendant directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude."

Caremark did not address demand futility; it enunciated a liability standard for certain alleged breaches of the duty of care. The court described a director oversight liability claim as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" and noted that, even if the underlying harm to the corporation resulted from a criminal law violation, a *per se* breach of fiduciary duty does not arise. Virtually every court to address a *Caremark* claim has reemphasized the difficult task confronting a plaintiff seeking to allege such a claim, noting that a lesser standard might undermine the business judgment rule's and 8 Del. C. § 102(b)(7)'s utility in encouraging risk-taking and board service.

A stockholder has no right to bring a derivative suit unless he or she has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so, or where demand is excused as futile because a majority of the directors are incapable of making an impartial decision regarding the litigation. In examining demand futility on a *Caremark* claim, there usually is no specific challenged transaction to test against the business judgment rule, so courts review the complaint under the *Rales v. Blasband*[3] standard, which asks whether the particularized factual allegations of a derivative complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.

Most derivative suits essentially ask directors to authorize suit against themselves and thus act against their own personal interests. Delaware law has thoroughly explored this conundrum by focusing closely on each director's potential liability, and concluded that except in egregious circumstances, the "mere threat" of personal liability does not constitute a disabling interest for a director considering a derivative plaintiff's demand. But if a "substantial likelihood" of personal liability is shown as to a director, he or she may not impartially consider a demand.[4] The members of a board or a committee thereof who have general oversight responsibility of the activities underlying a derivative complaint (*e.g.*, establishing accounting controls and guarding against irregularities) are not automatically deemed "interested" so that they cannot disinterestedly consider a demand to bring a proposed claim.

Rather, there are two ways to establish the substantial likelihood of liability on an oversight liability claim required to excuse demand. First, plaintiffs seeking to allege a *Caremark* claim may plead that the directors failed to investigate misconduct despite specific "red flags," in disregard of their fiduciary duties. Alternatively, particularized allegations of directors' sustained and systematic failure to implement a reasonable information, reporting and compliance system can establish the lack of good faith that is a necessary condition to liability. In the context of accounting problems, for example, this may be shown through "such as contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."[5] The lapse must be so egregious, however, as to justify the conclusion that the directors knew they were not exercising their supervisory responsibilities.

Recent Case Law

Last month, in *Stone v. AmSouth Bancorporation*,[6] the Delaware Supreme Court reaffirmed the standard for director oversight liability enunciated in *Caremark*, and clarified that, properly understood, the doctrinal basis of such liability is the duty of loyalty, even if the claim may also involve lapses in care. The most significant practical effect of the ruling that a showing of bad faith conduct is essential to establish oversight liability is that an adequately alleged claim falls outside the monetary damages liability waiver afforded by an exculpatory charter provision. In *Stone*, shareholders filed a derivative complaint without making a pre-suit demand on the board, alleging demand futility under *Rales* based on the allegation that the defendant directors faced a substantial likelihood of oversight liability that rendered them unable to disinterestedly consider whether to pursue the claims asserted in the complaint. The derivative claim for oversight liability arose from the payment by AmSouth, which operated 600 commercial banking branches in six states, and a wholly-owned subsidiary paying $40 million in fines and $10 million in civil penalties to resolve government and regulatory investigations pertaining to the failure by bank employees to file “Suspicious Activity Reports” (“SARs”), as required by the federal Bank Secrecy Act and various anti-money-laundering regulations. AmSouth also entered into a Deferred Prosecution Agreement in which it agreed to, *inter alia*, the filing of a one-count Information in federal court charging AmSouth with failing to file SARs. In addition, the Federal Reserve and the Alabama Banking Department concurrently issued a Cease and Desist Order against AmSouth, requiring it to improve its Bank Secrecy Act and anti-money laundering programs. The Cease and Desist Order also required AmSouth to retain an independent consultant to conduct a comprehensive review of the company’s compliance programs and make recommendations for new policies and procedures, for which it retained KPMG.

Affirming the dismissal of the complaint for failure to allege demand futility, the Delaware Supreme Court traced the evolution of director oversight liability, and concluded that liability may be imposed only if: “(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.” Under either basis, the court emphasized, “imposition of liability requires a showing that the directors *knew* that they were not discharging their fiduciary obligations.” Applying this demanding standard, the court concluded that plaintiffs did not plead the existence of “red flags” showing that the board was aware that internal controls were inadequate. This left their claim to rise or fall with particularized allegations of sustained or systematic failure by directors to exercise reasonable oversight by ensuring that a reasonable – not waterproof – information and reporting system existed. The court looked no further than the report issued by KPMG, which plaintiffs incorporated into the complaint, and showed that the board “received and approved relevant polices and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them.” That the system obviously failed to detect certain serious misconduct did not, the court emphasized, demonstrate the conscious disregard of oversight duties necessary to impose liability.

The Delaware Supreme Court underscored its ruling in *Stone* ten days later by issuing a decision in *Shaev v. Armstrong*,[7] which applied *Stone* and adopted the "well-reasoned" Court of Chancery opinion in *Shaev*.[8] There, plaintiff alleged demand futility in connection with a putative derivative claim against 19 present or former directors of Citigroup, asserting a substantial likelihood of present director liability on a *Caremark* claim that the board lacked oversight procedures to become aware of (a) eight fraudulent structured finance transactions with Enron and (b) alleged misconduct by employees at Citigroup subsidiary Salomon Smith Barney regarding what plaintiff alleged were overly optimistic analyst research reports. Plaintiff conceded that the directors knew nothing about the challenged transactions and that Citigroup had extensive compliance systems in place, but nevertheless alleged that the board's failure to ferret out employee misconduct resulted in Citigroup's payment of significant settlements and regulatory fines.

Noting that "Delaware law requires only diligence, not heroism," the Court of Chancery dismissed the complaint because it failed to plead any particularized facts demonstrating that the board should have known that Citigroup's extensive oversight systems were inadequate to detect the alleged wrongdoing. "[T]he one thing that is emphatically not a *Caremark* claim," the court remarked, "is the bald allegation that directors bear liability where a concededly well-constituted oversight mechanism, having received no specific indications of misconduct, failed to discover fraud." The court emphasized that the sheer magnitude of financial loss resulting from employee misconduct is never, by itself, a sufficient basis on which to rest liability. "Boards are expected to erect mechanisms designed to bring misconduct to their attention, and to investigate in good faith when warnings appear." Absent a failing in one of these twin duties, no oversight liability may be imposed.

Conclusion

Delaware law rejects a *res ipsa loquitur* approach to director liability. Directors are not liable whenever - in hindsight - an oversight system fails to achieve perfection. Oversight liability is not determined by whether the directors a compliance or information system turned out to work effectively; rather, the proper analysis is whether the directors made a good faith attempt to create and maintain systems which, in the exercise of their business judgment, they believed were reasonable under the circumstances. A *Caremark* claim thus must allege with specificity either that no compliance system or other supervisory structure existed, or if one existed, how it worked, and more importantly, facts demonstrating that it was so deeply flawed as to amount to bad faith attributable to the board.

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1 698 A.2d 959 (Del. Ch. 1996).

[2] 825 A.2d 275, 289 (Del. Ch. 2003).

[3] 634 A.2d 927 (Del. 1993).

[4] *Rattner v. Bidzos*, 2003 WL 22284323, at *9 (Del. Ch. Oct. 7, 2003).

[5] *Guttman v. Huang*, 823 A.2d 492, 507 (Del. Ch. 2003).

[6] 2006 WL 3169168 (Del. Nov. 6, 2006).

[7] *Shaev v. Armstrong*, 2006 WL 3190507 (Del. Nov. 16, 2006).

[8] *Shaev v. Armstrong*, 2006 WL 391931 (Del. Ch. Feb. 13, 2006).