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Chapter 16

Corporate Governance and The Role of The Board of Directors in Corporate Compliance

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Synopsis

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PART I: OVERVIEW

§ 16.01 Introduction

Directors are charged with managing the affairs of a corporation. Directors typically delegate to corporate officers the day to day management of the corporation. *See In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 761 n.490 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). While often divorced from the day to day operations, directors' oversight responsibility dictates that they have in place systems and controls to monitor the corporation's compliance with applicable laws, rules, and regulations. This oversight responsibility is imposed by a variety of laws, regulations, and private guidelines. While historically the province of state law, federal law and regulations are playing an ever-increasing role in director responsibilities, as are private entities, such as the stock exchanges and rating agencies. The consequences for breaching these obligations can mean liability for the corporation and personal financial liability for the director. This chapter will explore the sources and the parameters of this oversight responsibility.

§ 16.02 Summary of Fiduciary Duties

Directors owe a triad of fiduciary duties to the corporation and its shareholders: a duty of care, a duty of loyalty, and a duty of good faith. As a general proposition the duties of care, loyalty, and good faith that govern a director's conduct can be described as follows:

Duty of Care: The duty of care imposes the obligation of informed decision making. "The fiduciary duty of care requires that directors of a Delaware corporation 'use that amount of care which ordinarily careful and prudent [individuals] would use in similar circumstances,' and 'consider all material information reasonably available' in making business decisions, and that the deficiencies in the directors' process are actionable only if the directors' actions are grossly negligent." *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005) (citation omitted), *aff'd*, 906 A.2d 27 (Del. 2006); *see also* N.Y. Bus. Corp. § 717 (a)(1)–(3) ("A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by: (1) one or more officers or employees of the corporation . . . (2) counsel, public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or (3) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the certificate of incorporation or the bylaws, as to matters within its designated authority, which committee the director believes to merit confidence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted . . . ."); Model Bus. Corp. Act § 8.30(b) ("The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.").

Duty of Loyalty: "[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, [or] officer . . . and not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993); *see also Foley v. D'Agostino*, 21 A.D.2d 60, 66–67 (1st Dep't 1964) (" 'Officers and directors of a corporation owe [to it] their undivided and unqualified loyalty . . . . They should never be permitted to profit personally at the expense of the corporation. Nor must they allow their private interests to conflict with the corporate interests. These are elementary rules of equity and business morality . . . .' " (citation omitted)). The classic example of a transaction where the duty of loyalty is implicated is when an officer or director engages in a transaction with the corporation. *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). The duty of loyalty is also implicated in other circumstances where the director or officer at issue does not receive a financial benefit, including instances developed more fully below where a director consciously disregards his duties of oversight. *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006).

Good Faith: The duty of good faith is a " 'subsidiary element[,]' *i.e.*, a condition, 'of the fundamental duty of loyalty.' " *Id.* at 370 (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)) (alteration in original). Unlike a more traditional breach of duty of loyalty claim where a director puts his own interests ahead of the corporation, the duty of good faith encompasses those circumstances where the director fails to act in the corporation's best interests, but not necessarily for personal gain. The classic example is where "directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities," *e.g.*, utterly failing to implement a compliance system or consciously failing to monitor its operations. *Id.*; *see also* Model Bus. Corp. Act § 8.31 cmt. at 8-233 (2013 Revision) ("[I]t has been stated that a lack of good faith is presented where a board 'lacked an actual intention to advance corporate welfare' . . . [']or is known to constitute a violation of applicable positive law.' " (quoting *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049 (Del. Ch. 1996)). Conversely, the Delaware Supreme Court has identified at least two types of conduct that would constitute bad faith: (1) subjective bad faith, *i.e.*, "fiduciary conduct motivated by an actual intent to do harm"; and (2) "intentional dereliction of duty, a conscious disregard for one's responsibilities." *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64, 66 (Del. 2006).

Business Judgment Rule: No discussion of the duties of directors would be complete without reference to the business judgment rule—a "presum[ption] that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." *Walt Disney*, 906 A.2d at 52; *see also* Model Bus. Corp. Act § 8.31 cmt. at 8-232 (2013 Revision) ("[The business judgment rule] . . . presumes that, absent self-dealing or other breach of the duty of loyalty, directors' decision-making satisfies the applicable legal requirements."). The business judgment rule reflects courts' deference to business decisions made by independent directors in good faith and on an informed basis. The focus in such an inquiry is the process employed, as opposed to the substance of the decision reached by the board. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009); *cf. Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994, 1002 (1979). "Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith." *Walt Disney*, 906 A.2d at 52. Once the presumption is rebutted, "the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders." *Id.*; *see also Wolf v. Rand*, 258 A.D.2d 401, 685 N.Y.S.2d 708, 711 (1999) ("[S]ince the business judgment rule does not protect corporate officials who engage in fraud or self-dealing . . . or corporate fiduciaries when they make decisions affected by inherent conflict of interest, the burden shifts to defendants to prove the fairness of the challenged acts[.]").

Strategic Point: In certain circumstances that are not the subject of this chapter, specific applications of these duties are called for, such as under the corporate opportunity doctrine, *Broz v. Cellular Info. Sys.*, 673 A.2d 148, 155 (Del. 1996) (providing "guidelines to be considered by a reviewing court" when determining "whether or not a director has appropriated for himself something that in fairness should belong to the corporation" (internal quotation marks omitted)), the so-called *Unocal* standard, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (addressing the standard to be applied where a board adopts defensive measures to defeat a hostile takeover) or the *Revlon* principles, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (addressing the standard to be applied where a sale or break-up of a company becomes inevitable).

The focus of this chapter will be on the duties of loyalty and good faith as they relate to the officers' and directors' obligation to ensure the corporation has in place systems and controls to monitor the corporation's compliance with applicable laws, rules, and regulations.

PART II: RELEVANT AUTHORITIES

§ 16.03 Introduction

The directors' and officers' oversight responsibility is imposed by a variety of laws, regulations, and guidelines. Historically directors' and officers' duties were dictated largely by state law. However, federal law and regulations are playing an ever-increasing role in director responsibilities, as are private sources, such as the stock exchanges and rating agencies.

§ 16.04 State Law

The law of the state of incorporation typically governs the duties, responsibilities, and obligations of directors of corporations. *See McDermott, Inc. v. Lewis*, 531 A.2d 206, 215 (Del. 1987) ("The traditional conflicts rule developed by courts has been that internal corporate relationships are governed by the laws of the forum of incorporation."). Delaware law, because of its well-developed body of law regarding corporations and the duties of officers and directors, is often looked to for guidance by courts outside of Delaware.

- Del. Code Ann. tit. 8, § 141(a): "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."
- N.Y. Bus. Corp. § 701: "[T]he business of a corporation shall be managed under the direction of its board of directors . . . ."
- Model Bus. Corp. Act § 8.01(b): "All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . . ."

Core Cases:

- *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996): "[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."
- *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006): "*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."

§ 16.05 Federal Law

While traditionally the province of state law, federal law is increasingly encroaching on corporate governance duties and obligations.

- Sarbanes-Oxley Act of 2002, § 301, 15 U.S.C. § 78j-1(m): mandating certain functions for audit committees of boards of directors, including requiring that an audit committee establish procedures for the receipt, retention and treatment of complaints regarding accounting and internal audit controls, as well as procedures for employees to submit confidential and anonymous submissions concerning questionable accounting and auditing matters.
- Sarbanes-Oxley Act of 2002, § 404, 15 U.S.C. § 7262(a): directing the SEC to prescribe rules requiring companies to "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting," as well as assess and annually attest to "the effectiveness of the internal control structure and procedures of the issuer for financial reporting."
- Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78j-3: outlining requirements for independent compensation committees.
- Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7264: directing the SEC to prescribe rules requiring companies "to disclose whether or not" the company "has adopted a code of ethics," meaning "such standards as are reasonably necessary to promote," among other things, "compliance with applicable governmental rules and regulations."
- Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(e)(6): subjecting investment advisers to liability for a failure to supervise.
- Standard Instructions for Filing Forms Under the Securities Act of 1993 and the Securities Act of 1934, 17 C.F.R. § 229.407(h): requiring the disclosure in a proxy statement of "the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure."
- U.S. Sentencing Guidelines Manual §§ 8B2.1, 8C2.5(f) (2015): an effective compliance and ethics program designed to detect and prevent criminal misconduct may reduce a corporation's culpability score for the purposes of determining fines and penalties.
- U.S. Sentencing Guidelines Manual § 8C2.5(f)(3)(C) & cmt. (2015): Corporations may be given sentencing credit for an effective compliance and ethics program even though high-level personnel were involved in the offense if "(i) the individual or individuals with operational responsibility for the compliance and ethics program . . . have direct reporting obligations to the governing authority or an appropriate subgroup thereof (*e.g.*, an audit committee of the

board of directors); (ii) the compliance and ethics program detected the offense before discovery outside the organization or before such discovery was reasonably likely; (iii) the organization promptly reported the offense to appropriate governmental authorities; and (iv) no individual with operational responsibility for the compliance and ethics program participated in, condoned, or was willfully ignorant of the offense."

- United States Attorneys' Manual, Principles of Federal Prosecution of Business, §§ 9-28.300, 9-28.800, http://www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations: "In evaluating compliance programs [in connection with an investigation or a determination of whether to pursue or accept a plea from a corporation], prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestionably ratifying officers' recommendations; . . . and have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law." (citing *In re Caremark*, 698 A.2d at 969–970).
- Securities and Exchange Commission ("SEC") Division of Enforcement, Enforcement Manual, § 6.1.2, http://www.sec.gov/divisions/enforce/enforcementmanual.pdf: The SEC "considers in determining whether, and to what extent, it grants leniency" whether the company engaged in "[s]elf-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top."
- Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78n-1: say-on-pay provision providing shareholders a non-binding vote on executive compensation.
- Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78j-4: instituting additional three-year clawback against former and current executive officers upon the company's accounting restatement.

§ 16.06 Other Authority

There are additional sources of obligations imposed on officers and directors of public companies.

- NYSE Listed Company Manual § 303A.10: "Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers."
- NYSE Listed Company Manual § 303A.07(b)(i)(A): "The audit committee must have a written charter that addresses: (i) the committee's purpose—which, at minimum, must be to: (A) assist board oversight of (1) the integrity

of the listed company's financial statements, (2) the listed company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the listed company's internal audit function and independent auditors . . . ."

- NASDAQ Listing R. 5610: "Each Company shall adopt a code of conduct applicable to all directors, officers and employees, which shall be publicly available. A code of conduct satisfying this rule must comply with the definition of a 'code of ethics,' set out in Section 406(c) of the Sarbanes-Oxley Act of 2002 . . . and any regulations promulgated thereunder by the Commisison. . . . In addition, the code must provide for an enforcement mechanism."
- FINRA Rules R. 3130(b): "Each member shall have its chief executive officer(s) (or equivalent officer(s)) certify annually . . . that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations, and that the chief executive officer(s) has conducted one or more meetings with the chief compliance officer(s) in the preceding 12 months to discuss such processes."
- Rating agency corporate governance assessments, which include a review of audit committee and risk oversight.

PART III: ANALYSIS

§ 16.07 Duty To Monitor

[1] *Caremark*

Directors and the boards on which they serve have an obligation to ensure that the company has information and reporting systems in place to monitor compliance with applicable laws. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996). The duty to monitor is also referred to as the duty to supervise or the duty of oversight.

The Delaware Court of Chancery, in *Caremark*, was the first court to articulate and expand upon a director's and board's duty of oversight. In that case, as part of its business, Caremark International, Inc. ("Caremark"), a health service provider, entered into agreements and contracts with doctors, for example, in exchange for services or counsel. These agreements were regulated by law, principally because of the prohibition against allowing a company like Caremark from paying remuneration to induce doctors to refer Medicare and Medicaid patients to Caremark. *Id.* at 961–962. But because physicians that had contracted with Caremark had also been issuing such referrals, federal and state agencies began investigating the company. *Id.* at 962. Eventually, the company was indicted and pled guilty to mail fraud, in part, as a result of significant payments made to a doctor to induce him to distribute a drug marketed by Caremark. *Id.* at 964–65. Shortly thereafter, several shareholder derivative complaints were filed against the company alleging that the Caremark directors had breached their fiduciary duty by failing to oversee Caremark employees or institute remedial action, and that such failure had resulted in the government investigations, and the penalties and exposure faced by the company. *Id.* at 964. Subsequently, the parties reached a settlement and moved the court for approval.

In connection with its review of the settlement, the court was required to evaluate the strength of the derivative plaintiff's claims, including the allegation that the directors had failed to monitor Caremark's operations, *i.e.*, liability premised on "unconsidered inaction," not a board decision. The court explained that the duty to monitor requires the board "[to] assur[e itself] 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." *Id.* at 970.

The court then established the standard for determining liability for a board's failure to monitor the company or its business, officers, or employees: "[O]nly 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—will establish the lack of good faith that is a necessary condition to liability." *Id.* at 971. The court recognized that this test was a high standard but reasoned that such a demanding threshold was necessary to continue to encourage board service. *Id.*

[2] *Stone*

In *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the Delaware Supreme Court approved of the oversight liability standard articulated in *Caremark* and clarified how the important concepts of good faith and the duty of loyalty relate to *Caremark* claims. *Id.* at 369–70. The court held 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." *Id.* at 370. In both cases liability is predicated on "a showing that the directors knew that they were not discharging their fiduciary obligations." *Id.*

In *Stone*, the court clarified that *Caremark* or "oversight" liability is characterized by a lack of good faith. The court further explained that the "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty." *Stone*, 911 A.2d at 370. Thus, a failure to act in good faith indirectly subjects a director to liability:

> The purpose of [this] formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" *i.e.*, a condition, "of the fundamental duty of loyalty." It follows that because a showing of bad faith conduct . . . is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

Id. at 369–70 (second alteration in original) (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

The court reiterated that a *Caremark* violation requires a lack of good faith on behalf of the director or officer. Thus, it summarized the prime examples of conduct recognized by the Delaware courts that could establish such bad faith:

- "[W]here the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation";
- "[W]here the fiduciary acts with the intent to violate applicable positive law"; or
- "[W]here the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."

Id. at 369. The last instance represents the lack of good faith necessary to subject a director to liability for a failure to supervise under *Caremark*. *Id.*

[3] The Model Business Corporation Act

The duty to monitor is included within the oversight responsibilities listed by the Model Business Corporation Act ("MBCA") for boards of public companies. Model Bus. Corp. Act § 8.01(c). Those responsibilities include attention to

> (1) business performance and plans; (2) major risks to which the corporation is or

> may be exposed; (3) the performance and compensation of senior officers; (4) policies and practices to foster the corporation's compliance with law and ethical conduct; (5) preparation of the corporation's financial statements; (6) the effectiveness of the corporation's internal controls; (7) arrangements for providing adequate and timely information to directors; (8) the composition of the board and its committees, taking into account the important role of independent directors.

Id. The MBCA's Official Comment, citing *Caremark*, explains that "subsection (c)(7) reflects that the board of directors should devote attention to whether the corporation has information and reporting systems in place to provide directors with appropriate information in a timely manner in order to permit them to discharge their responsibilities." *Id.* § 8.01 cmt. at 8-5-6 (2013 Revision).

In addition to detailing particular areas which should be monitored by the boards of public companies, the MBCA provides that directors may be liable to the company or its shareholders if they fail to comply with their *Caremark*-type duty:

> (a) A director shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as a director, unless the party asserting liability in a proceeding establishes that:
>
> . . .
>
> (2) the challenged conduct consisted or was the result of:
>
> . . .
>
> (iv) a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefore[.]

Id. § 8.31.

§ 16.08 Conduct Breaching the Duty To Monitor

As discussed further below, Delaware courts applying *Caremark* have found that plaintiffs adequately alleged breaches of the duty to monitor where egregious behavior by directors evidenced their knowledge of inadequate internal controls. In addition, they have found breaches alleged where directors failed to adequately monitor a Delaware corporation's foreign operations. Moreover, a Delaware court applying *Caremark* held directors liable after trial for breach of the duty to monitor where no internal controls or monitoring systems were in place at all.

[1] Egregious Behavior

In *American International Group v. Greenberg*, 965 A.2d 763 (Del. Ch. 2009), the court found that stockholder plaintiffs' allegations that directors had engaged in significant wrongdoing, such that their activity resembled a "criminal organization," adequately stated a *Caremark* theory of failure to monitor because the directors' involvement in the wrongdoing demonstrated that they knew the company's internal controls were inadequate and could easily be bypassed.

In that case, the purported scheme alleged in the complaint included: misstating the company's financial performance to deceive investors, *e.g.*, "staged" reinsurance transactions to dress up the balance sheet and the use of "secret offshore subsidiaries" to hide losses; engaging in various "schemes" to avoid taxes, such as falsely claiming that workers' compensation policies were other types of insurance; conspiring with others to rig markets and competitive auctions; and selling its experience in "balance sheet manipulation." *Id.* at 775. The defendants argued, however, that the complaint was not properly pled in that the alleged facts did not show their involvement in the alleged schemes. The court disagreed, finding that the complaint set out sufficient facts to survive a motion to dismiss and to demonstrate that the defendants would have been involved in, monitored, or supervised the transactions at issue because of their positions within the company and their financial experience. *Id.* at 797–99.

The court found that the alleged "pervasive misconduct" had "permeated AIG's way of doing business." *Id* at 777. "The Complaint fairly supports the assertion that AIG's Inner Circle led a—and I use this term with knowledge of its strength—criminal organization." *Id.* at 799. The court acknowledged that "[a] cosmic wrong may have been done to the Inner Circle Defendants, whose members were victimized by a large number of lower level employees who, despite good faith efforts at oversight and the use of internal controls by the Inner Circle Defendants, were able to avoid detection and engage in widespread financial fraud." *Id.* at 777. However, at the motion to dismiss stage of the proceedings, "the pleading of direct involvement by . . . the Inner Circle Defendants in many of the specific alleged wrongs gives rise to a fair inference that the defendants knew that AIG's internal controls and compliance efforts were inadequate." *Id.* at 777. Therefore the court declined defendants' motion to dismiss the complaint, finding that plaintiffs had stated a breach of loyalty claim against the defendants for "knowingly tolerating inadequate internal controls and knowingly failing to monitor their subordinates' compliance with legal duties." *Id.* at 799.

Strategic Point: The court in the AIG case analyzed the complaint under the traditional and plaintiff-friendly pleading standard of Fed. R. Civ. P. 12 (b)(6), rather than the more difficult particularized pleading standard of Fed. R. Civ. P. 23.1 because of the procedural posture of the case. *Am. Int'l Group*, 965 A.2d at 778. The AIG board had created a special litigation committee to determine what action the corporation should take with respect to the derivative complaint, and vested full authority in the special committee, including whether to pursue the claims set out in the derivative complaint or whether to have them dismissed. Following its investigation, the special committee decided to "remain neutral" with respect to the relevant defendants. Therefore, any demand on the board would have been futile and was excused. As such, defendants' motion to dismiss was evaluated under Fed. R. Civ. P. 12(b)(6). *Compare* Del. Ct. Ch. R. 12(b)(6), *with* Fed. R. Civ. P. 23.1(a).

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[2] Failure to Adequately Monitor Foreign Operations

In three cases involving Delaware corporations with operations in China—*In re Puda Coal, Inc. Stockholders Litig.*, C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013) (Transcript), *Rich ex rel. Fuqi Int'l, Inc. v. Yu Kwai Chong*, 66 A.3d 963 (Del. Ch. 2013), *reargument den.*, 2013 Del. Ch. LEXIS 165 (July 2, 2013), and *In re China Agritech*, Inc., 2013 Del. Ch. LEXIS 132 (May 21, 2013)—the Court of Chancery refused to dismiss *Caremark* claims against directors of Delaware corporations who, if the facts were as alleged, failed to adequately monitor operations in China. In these cases, the courts emphasized that directors of a Delaware corporation have duties of oversight with respect to the corporation's foreign operations.

In *Puda Coal*, the Court of Chancery elaborated on directors' oversight duties in companies with foreign operations. There, the court refused to dismiss a breach of fiduciary duty claim against independent directors of a Delaware corporation where "the entire asset base of the company was sold out from under the independent directors nearly two years before they discovered it." C.A. No. 6476-CS, at 19. To make matters worse, the directors were not even the ones to discover what had happened. *Id.* When they were alerted to what had happened, rather than "cause the company to sue" or otherwise remedy the situation, "they simply quit." *Id.* at 23. In these circumstances, the court declined to dismiss the breach of fiduciary duty claim. The court concluded that "the magnitude of what happened[,] . . . the length of time it went undiscovered, [and] the repetitive filing of statements saying that the company owned assets [it] didn't" gave "rise to a *Caremark* claim." *Id.* at 19. In so concluding, the court elaborated on the oversight duties of directors of a Delaware corporation with assets and operations in China, explaining that as a director, in order to meet the obligation of good faith, you "better have your physical body in China an awful lot . . . [and] have in place a system of controls to make sure that you know that [the corporation] actually own[s] the assets." *Id.* at 17–18. Additionally, you "better have the language skills to navigate the environment in which the company is operating." *Id.* at 18.

In *Rich v. Chong*, the court found that a plaintiff had pled facts sufficient for the court "to reasonably infer that the [defendant] directors" of a Delaware corporation that held stock in a Chinese jewelry company as its sole asset "knew that [the company's] internal controls were deficient, yet failed to act." 66 A.3d at 966. Based on the alleged facts, the compliance system appeared "woefully inadequate." *Id.* at 982. For example, the inadequate inventory controls were "particularly troubling" because the company was "a jewelry company, specializing in precious metals and gemstones which are valuable and easily stolen." *Id.* at 983. Though the company had an audit committee, "there [did] not seem to have been any regulation of the company's operations *in China*." *Id.* at 983. Additionally, the board allegedly ignored numerous "red flags" that should have led the board to improve internal controls, including an earnings restatement, acknowledgment of "the likelihood of material weaknesses in [the company's] internal controls," and a letter from NASDAQ warning of possible delisting due to deficient reporting. *Id.* at 983–84. The court found it reasonable "to infer that the directors knew that the internal controls were inadequate and failed to act in the face of a known duty." *Id.* at 984. Reinforcing "the inference that the internal control were . . . grossly inadequate," was the fact that $130 million was transferred out of the company "without the directors knowing about it for over a year." *Id.* The court explained that "[e]ither the directors knew about the cash transfers and were complicit, or they had zero controls in place and did not know about them. If the directors had even the barest framework of appropriate controls in place, they would have prevented the cash transfers." *Id.*

In *China Agritech*, the court concluded that the shareholders' factual allegations supported a "reasonable inference" that the members of the company's audit committee had acted in bad faith by consciously disregarding their duties of oversight. 2013 Del. Ch. LEXIS 132, at *56. In particular, the alleged facts showed that the audit committee failed to meet, and there was "no documentary evidence" that it had ever met. *Id.* at *52–53. The company's outside auditor resigned and sent a letter under a provision indicating that the auditor believed an illegal act had occurred and the company had not taken appropriate remedial action. *Id.* at *53. Additionally, "[d]iscrepancies in the Company's public filings with governmental agencies reinforce[d] the inference of an Audit Committee that existed in name only." *Id.* at *54. In particular, the company's public filings in China reported losses while the company's public filings in the Unites States for the same periods reported profits. *Id.* at *54–55. The court distinguished this complaint from "the parade of hastily filed *Caremark* complaints that Delaware courts have dismissed," explaining that "like those rare *Caremark* complaints that prior decisions have found adequate, the Complaint supports these allegations with references to books and records . . . and with inferences that this Court can reasonably draw from the *absence* of books and records that the company could be expected to produce." *Id.* at *58.

[3] No Internal Controls or Monitoring Systems

In *ATR-KIM ENG Financial Corp. v. Araneta*, No. 489-N, 2006 Del. Ch. LEXIS 215 (Dec. 21, 2006), two executives were held liable following a full trial for *Caremark* violations even though there was no allegation that they participated in, approved of, or profited from wrongdoing. The court found that their lack of knowledge of the wrongdoing was not an excuse but, in essence, a confession of their failure to comply with their oversight duties.

There, a minority shareholder brought an action against three directors for breaches of their fiduciary duties. The allegations against the first director were "clear-cut claims of self-dealing by a controlling shareholder and director" who had transferred the company's most valuable asset to his family without consideration. But as to the remaining directors, the complaint did not allege that they participated in, approved of, or directly profited from the illicit conduct. Therefore the issue before the court was whether the remaining directors had breached their duties of loyalty by failing to monitor the brazen wrongdoing by the first director.

It was clear to the court that the remaining directors had, in fact, breached their *Caremark* duties. For instance, no reporting system had ever been instituted and internal controls had never even been contemplated. *Id.* at *73. Further, no board meetings had been held and the remaining directors had conceded that they were entirely deferential to the dominating director, who had looted the company. *Id.* at *73–76. In fact, the court explained that their admission of inaction in response to the dominating, looting director's actions amounted to an admission of the violation of their fiduciary duty to monitor, and thus found them jointly liable for the first director's conduct. *Id.* at *75–77.

The court explained: "Under Delaware law, it is fundamental that a director cannot act loyally towards the corporation unless she tries—*i.e.*, makes a genuine, good faith effort—to do her job as a director. One cannot accept the important role of director in a Delaware corporation and thereafter consciously avoid any attempt to carry out one's duties." *Id.* at *71.

§ 16.09 No Violation of the Duty To Monitor

Equally as important as the cases above, which illustrate facts supporting *Caremark* claims, are cases in which courts have rejected different *Caremark* theories of director liability. The three cases below illustrate types of scenarios where the courts have not imposed liability. One court rejected an attempt to extend the Caremark theory to a failure to monitor business risk, as opposed to a failure to monitor wrongdoing or illegal conduct, and another court found that a monitoring system's failure to detect fraud generally will not be a predicate for liability. Additionally, one court refused to extend the duty of oversight to encompass a duty to monitor the private affairs of the company's CEO.

[1] Business Risk

In *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), the court rejected the plaintiffs' attempt to impose liability on directors for a failure to monitor business risks, specifically the purported failure to monitor the bank's exposure to the subprime mortgage market. In *Citigroup*, the court expressed hostility to the attempt to extend *Caremark* obligations to liability predicated on the purported failure to monitor business risks: "While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different." *Id* at 131. The bank, the court noted, was in the business of balancing risk and return. *Id.* Courts are not. "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." *Id.*

The court noted that taking plaintiffs' theory—that defendants should be liable for their failure to foresee the extent of the problems in the sub-prime mortgage market—to its logical conclusion would mean that defendants could be found similarly liable for their failure to predict the problem and profit from it. *Id.* at 131 n.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 directors should have seen because of certain red (or green?) flags?" *Id.*

While the court did not rule out the possibility that under some set of facts directors could possibly be held liable for their failure to monitor a company's business risk, *id.*

at 125–26, "[o]versight 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." *Id.* at 131.

While the plaintiffs cast their claims as a failure of the duty to monitor the risk of Citigroup's exposure to the sub-prime mortgage market, the court found that the plaintiffs' claims were more accurately characterized as an attack on "business decisions that, in hindsight, turned out poorly for the Company." *Id.* at 124. "To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions." *Id.* at 126. In fact, the court noted that the "essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return." *Id.* Application of *Caremark* obligations to this decision process would invite the very type of "judicial second guessing" that the business judgment rule is designed to prevent. *Id.* at 126, 131.

The court ultimately dismissed the *Caremark* claims, finding that the derivative plaintiffs had "failed to state a *Caremark* claim sufficient to excuse demand based on a theory that the directors did not fulfill their oversight obligations by failing to monitor the business risk of the company." *Id.* at 128. The court cited a number of factors in support of its decision. For instance, the plaintiffs did not dispute that Citigroup had a number of procedures and controls in place to monitor and evaluate risk. *Id.* at 127. The plaintiffs nevertheless argued that "red flags" should have alerted the directors of the pending losses Citigroup would face. *Id.* at 127–28. But the court rejected this argument, finding that the "red flags" were merely signs of the deteriorating economic condition, rather than evidence that would support a finding of liability, *i.e.*, red flags that demonstrated that the directors had been aware of wrongdoing at Citigroup or that they were consciously disregarding their duties owed to Citigroup. *Id.* at 128.

[2] Well-Functioning Monitoring Systems with No Knowledge of Wrongdoing

In *David B. Shaev Profit Sharing Account v. Armstrong*, 2006 Del. Ch. LEXIS 33 (Feb. 13, 2006), 2006 Del. Ch. LEXIS 33 (Feb. 13, 2006), *aff'd*, 911 A.2d 802 (Del. 2006), the Delaware Court of Chancery held that directors could not be held liable under *Caremark* on a "bald allegation that directors bear liability where a concededly well-constituted oversight mechanism, having received no specific indications of misconduct, failed to discover fraud." *Id.* at *15–16. In *Shaev*, the derivative plaintiff filed a complaint, attempting to hold Citigroup directors liable in connection with Citigroup's transactions related to Enron and WorldCom. The plaintiff acknowledged that the directors had no knowledge of the alleged fraud and that the company had oversight mechanisms in place. *Id.* at *17–18. The plaintiff maintained, however, that "only a board violating its fiduciary duties could possibly have remained ignorant of Citigroup's allegedly corrupt relationships with Enron and WorldCom." *Id.* at *17. The court rejected the premise, holding that "these allegations are precisely the type of conclusory statements that do not constitute a *Caremark* claim." *Id.* at *18. The court reasoned that there were no allegations regarding inadequate controls or red flags that had alerted the board to potential misconduct. *Id.*

The *Shaev* decision and the case of *Guttman v. Huang*, 823 A.2d 492, 506–07 (Del. Ch. 2003) each dismissed a *Caremark* claim, and in so doing, the decisions are instructive in that they set out examples of the type of conduct that could be found to be a predicate for a *Caremark* claim:

- Lack of "an audit committee or other important supervisory structures" (*Shaev*, 2006 Del. Ch. LEXIS 33, at *16);
- The failure of the company's audit committee to meet (*Id.* at *17);
- The existence of "an audit committee [that] met only sporadically and devoted patently inadequate time to its work" (*Guttman*, 823 A.2d at 507);
- The board or audit committee ignored or failed to investigate notice of serious improprieties or misconduct (*Id.*; *Shaev*, 2006 Del. Ch. LEXIS 33, at *17), or;
- The board or audit committee learned of irregularities and encouraged their continuation (*Guttman*, 823 A.2d at 507).

[3] Personal Affairs

In *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 972 (Del. Ch. 2003), the Delaware Court of Chancery found that "the defendant directors had no duty to monitor [Martha] Stewart's personal actions." In *Beam*, a derivative action was filed against various directors of Martha Stewart Living Omnimedia, Inc. based, in part, on their alleged failure to monitor Martha Stewart's personal, financial, and legal affairs. *Id.* at 970–71. These allegations stemmed from Martha Stewart's alleged trading of stock of ImClome Systems, Inc. on inside information. *Id.* at 968. The court dismissed plaintiff's claim as an unreasonable extension of the board's oversight responsibilities. *See id.* at 971–72.

Judicial Perspective—Correct Demand Futility Standard for *Caremark* Claims: On a motion to dismiss a derivative complaint on the grounds that a plaintiff has failed to adequately plead that the required pre-suit demand on the board would be futile, the court will analyze plaintiff's demand futility allegations under Rule 23.1 which requires that such allegations be specified with particularity. *See, e.g.*, Del. Ct. Ch. R. 23.1(a). Where the underlying allegations relate to a challenged transaction or a business decision—*i.e.*, board action, the *Aronson* test is applied: "[The] plaintiffs must provide particularized factual allegations that raise a reasonable doubt that '(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.' " *In re Citigroup*, 964 A.2d at 120 (quoting *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000), and *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (second alteration in original)). But where the shareholder has objected to board inaction, as is the case with *Caremark* claims, the *Rales* test governs: "[The complaint] must allege particularized facts that '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.'" *Id.* (quoting *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993)).

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§ 16.10 Exculpation Provision May Be Inapplicable to Breach of Loyalty Claim

[1] Delaware

When discussing director liability, the Delaware courts often reference whether or not a corporation has adopted a "section 102(b)(7) provision." Under title 8, section 102(b)(7) of the Delaware Code, which governs the provisions of a corporation's articles of incorporation, a corporation may adopt:

> [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; [or] (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law[.]

Del. Code Ann. tit. 8, § 102(b)(7). This is an important provision as it "can exculpate directors from monetary liability for a breach of the duty of care." *Stone*, 911 A.2d at 367. Put another way, if a corporation has adopted this provision in its articles of incorporation, directors will not be subject to liability if they were involved in a board decision that was not well-informed, a result of an inadequate process, or grossly negligent.

Strategic Point: It is important to note that directors will not be protected by a section 102(b)(7) provision for breaches of the duty to monitor, as these violations are a breach of a director's duty of loyalty and necessarily involve a failure to act in good faith. *See, e.g.*, *In re Citigroup*, 964 A.2d at 125 ("[O]ne can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith."); *Guttman*, 823 A.2d at 506 ("Functionally, *Caremark* . . . matches the liability landscape for most corporate directors, who are insulated from monetary damage awards by exculpatory charter provisions.").

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[2] The Model Business Corporation Act

The MBCA provision exculpating directors under certain circumstances, provides that a corporation's articles of incorporation may contain:

> a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; . . . or (D) an intentional violation of criminal law.

Model Bus. Corp. Act § 2.02(b)(4).

The MBCA provision precludes exculpation of liability for conduct that would constitute "intentional infliction of harm" or "intentional violation of criminal law." *Id.*; *see also id.* § 2.02 cmt. at 2–35 (2013 Revision). In contrast, Delaware precludes exculpation of liability for conduct that constitutes a "breach of the director's duty of loyalty" or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." Del. Code Ann. tit. 8, § 102(b)(7)(i)-(ii). The drafters of the MBCA suggest that requiring that directors be held liable for "intentional" conduct is more precise, because it is directed at a board member with actual knowledge to harm the corporation, rather than a director that acted "knowingly," which necessitates a general, not specific, intent. Model Bus. Corp. Act § 2.02cmt. at 2–20 (2013 Revision).

§ 16.11 Board Assessment and Checklist

Given the diverse nature of companies, the markets they operate in and the products they sell, as well as the complex nature of the oversight obligations, a one-size-fits-all checklist is impossible. The following, which is based on the U.S. Sentencing Guidelines Manual § 8B2.1 (2015), is offered as a guide, rather than a minimal standard or complete prescription for compliance.

1) Does the company have standards and procedures in place to prevent and detect illegal conduct, such as a compliance and ethics program?

2) Has the Board of Directors assigned a committee, such as the Audit Committee, to oversee the implementation and effectiveness of the compliance and ethics program?

3) Is a specific company employee "delegated day-to-day operational responsibility for the compliance and ethics program"?

4) Does that person report periodically to senior management and a committee of the Board of Directors (*e.g.*, Audit Committee) on the effectiveness of the compliance and ethics program?

5) Does that person have adequate resources, authority and access to senior management and a committee of the Board of Directors (*e.g.*, Audit Committee)?

6) Does the company "take reasonable steps to communicate periodically" the standards and procedures of the compliance and ethics program within the organization, such as through training or dissemination of the program's standards and procedures?

7) Does the company take reasonable steps to ensure that the "compliance and ethics program is followed," such as monitoring and auditing for illegal activity?

8) Does the company periodically evaluate the effectiveness of the compliance and ethics program?

9) Does the company have and publicize a mechanism for employees to anonymously and confidentially report illegal conduct?

10) Does the company periodically assess the risk of illegal activity, and modify the program to address any changed risk assessment?

PART IV: PRACTICE RESOURCES

§ 16.12 Analytical Material

Holly J. Gregory and Rebecca C. Grapsas, *Corporate Governance Guidelines for Board Practices and Procedures*, Chapter 6 in Corporate Governance: Law and Practice, (Amy Goodman and Steven M. Haas Gen Ed., 2015).