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Recommended Citation

Arlen, Jennifer, "The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor" (2008). *New York University Law and Economics Working Papers*. Paper 160.

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CHAPTER 11

The Story of *Allis-Chalmers*, *Caremark*, and *Stone*: Directors' Evolving Duty to Monitor

Jennifer Arlen*

This chapter explores the evolution in Delaware's approach to director oversight of legal compliance. It is a story of how changes in federal criminal law induced Delaware to reform its approach to directors' oversight duties. It also is the story of the struggle between the Delaware Chancery Court and the Delaware Supreme Court over how broad to make directors' oversight duties and liability.

Directors have the ultimate duty to manage the firm, but questions remain about which obligations this duty imposes on directors. Historically, Delaware permitted directors to exercise oversight indirectly through their power to hire and fire corporate officers, as well as through their ability to veto major corporate transactions.¹ Yet Delaware also expected directors to assert direct oversight when officers have a direct financial interest. Over time, Delaware recognized that director oversight also is needed in other circumstances. Delaware's challenge has been to delineate the scope of directors' oversight duties and also the standard of review to govern judicial review of claims that directors breached their oversight duties.

Delaware's view of director oversight evolved through a series of derivative suits over whether directors have a duty to oversee their firm's compliance with criminal laws. Legal compliance is a natural candidate for director oversight. First, compliance oversight is ancillary to directors' duty to monitor officers because effective compliance programs enable directors to obtain information from deep within the firm. Second, outside director oversight of legal compliance is important because officers cannot be relied upon to act in the firm's interests. Officers face a constant threat of losing their livelihood if the firm does not meet its performance targets – a threat that may tempt them to allow the firm to violate profit-constraining criminal laws if unable to meet performance goals

* I would like to thank William T. Allen, Stephen Bainbridge, Samuel Buell, Robert Lee Hotz, William Klein, Marcel Kahan, Mark Ramseyer, and Vice Chancellor Leo Strine, Jr. for helpful comments, Daniel Priest for excellent research assistance, and the D'Agostino/Greenberg Fund of the New York University School of Law for financial support.

¹ See *Grimes v. Donald*, 1995 Del. Ch. LEXIS 3 (Del. Ch. 1995) (the board meets “its management responsibilities by appropriately appointing and monitoring corporate officers and exercising informed business judgment with respect to corporate goals and performance”), *aff'd on other grounds*, 637 A.2d 1207 (Del. 1996).

through legal means.² By contrast, outside directors are less dependent on short-term firm profits and thus are better able to eschew profitable criminal activities in order to protect the firm's long-term welfare.

Delaware first addressed the issue of whether directors should be subject to an affirmative duty to oversee legal compliance absent any notice of wrongdoing more than forty years ago in *Graham v. Allis-Chalmers Manufacturing Company*.³ *Allis-Chalmers* reached the Delaware Supreme Court at a time when Delaware allowed directors to grant considerable autonomy to officers. Moreover, at the time, Delaware had little reason to exhort directors to oversee legal compliance because federal criminal law was relatively narrow in its reach and imposed small fines. Accordingly, the Supreme Court in *Allis-Chalmers* rejected plaintiffs' claim that the Allis-Chalmers directors always must ensure that the firm has an effective compliance program, holding instead that directors are not liable for losses arising from corporate illegality unless they ignored clear signs of wrongdoing.⁴

Thirty-three years passed before Delaware reconsidered this issue, during which time three important developments occurred. First, the Delaware Supreme Court imposed on directors a more active oversight duty when the firm is being sold because officers face conflicting interests when their jobs are threatened.⁵ Second, corporate legal compliance became a vital issue as a result of both the expansion of federal criminal liability and the dramatic increase in corporate sanctions (especially for firms without an effective compliance program). Third, the business community was rocked by a series of corporate scandals which revealed that directors (including outside directors) would not unilaterally assume responsibility over legal compliance unless legally required to do so, in large part because they disliked challenging senior officers and did not want to be

² See Cindy R. Alexander & Mark A. Cohen, *New Evidence on the Origins of Corporate Crime*, 17 *Managerial & Decision Econ.* 421 (1996) (providing empirical evidence that crime is an agency cost); see also Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691 (1992) (discussing securities fraud as an agency cost); cf. Pamela Bucy, *et al.*, *Why Do They Do It? The Motives, Mores and Character of White Collar Criminals*, 82 *St. John's L. Rev.* 401 (2008) (white collar criminals commit crimes both to save/enhance their jobs and because they convince themselves that the conduct is not wrongful).

³ 188 A.2d 125 (Del. 1963).

⁴ *Id.*

⁵ *E.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

responsible for blocking profitable, but legally suspect, activities.⁶ These developments suggested that Delaware should reconsider its approach to director oversight of legal compliance.

In 1996, Delaware heeded the call for change, but change did not come in the usual way – through a Delaware Supreme Court decision ruling on an on-going legal dispute. Instead, Chancellor William T. Allen, of the Delaware Chancery Court, took it upon himself to reform Delaware law. Moreover, he did so by seizing upon a simple request to approve a settlement as an opportunity to issue a far-reaching opinion on both the scope of directors’ duties to monitor and the standard of review that should govern their liability for failure to do so. The resulting opinion, *In re Caremark International Inc. Derivative Litigation*,⁷ transformed Delaware law.

Chancellor Allen had two goals in mind when he issued *Caremark*. First, he wanted to induce directors to play a more active oversight role, especially over corporate legal compliance. Second, he wanted to ensure that directors remained free to exercise their own judgment about how best to satisfy this duty, free from court oversight of whether their decisions were objectively reasonable. Specifically, Chancellor Allen wanted to resist the Delaware Supreme Court’s tendency to allow courts to assess whether directors’ actions were (grossly) objectively unreasonable, as they had in *Smith v. Van Gorkom*.⁸

To achieve these twin goals, Chancellor Allen articulated a standard of conduct which expanded directors’ oversight duties but adopted a standard of review that constrained courts’ authority to hold directors liable for poor compliance decisions.⁹ Chancellor Allen ruled that directors have a fiduciary duty to adopt and oversee a compliance program even in the absence of any notice of actual wrongdoing – in effect rejecting the Delaware Supreme Court’s holding in *Allis-Chalmers*. Turning to the standard of review, however, Chancellor Allen held that courts could not impose liability on directors for failure to monitor

⁶ One can think of these as “soft agency costs.” Of course, some directors also obtain an immediate financial benefit from the additional profits produced by illegal activities, which may produce “hard agency costs.”

⁷ 698 A.2d 959 (Del. Ch. 1996).

⁸ *Van Gorkom*, 488 A.2d at 858; see William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 *Bus. Lawyer* 1287, 1299-1301 (2001) (criticizing *Van Gorkom* for holding that gross negligence review permits the imposition of liability for actions that were (grossly) objectively unreasonable, even if the directors acted rationally and in subjective good faith).

⁹ See Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *Fordham L. Rev.* 437 (1993)(discussing the distinction).

compliance unless the directors acted in bad faith.¹⁰ To further insulate directors from liability, Chancellor Allen defined bad faith to require inaction amounting to a sustained or systematic failure of the board to exercise reasonable oversight.¹¹ Chancellor Allen recognized that this standard of review largely eliminated any serious threat of director liability. Yet he concluded that *Caremark* nevertheless would induce greater oversight over legal compliance because he believed that directors would comply with a clearly articulated legal duty even if not threatened with liability.¹²

The question arises: Was *Caremark* successful? The answer depends on whether the decision is measured against Chancellor Allen's own goals or against federal authorities' goal of ensuring corporate compliance.

Caremark succeeded in achieving Chancellor Allen's twin goals of expanding directors' oversight duties while simultaneously circumscribing courts' authority to review the reasonableness of directors' actions. Indeed, Chancellor Allen's victory was fully realized in 2006, when, in *Stone v. Ritter*,¹³ the Delaware Supreme Court held that directors have a duty to monitor corporate compliance efforts, contrary to its prior holding in *Allis-Chalmers*. Moreover, and perhaps more important, the Delaware Supreme Court accepted Chancellor Allen's view that directors should only be liable for failure to monitor legal compliance if they act in bad faith, defined as a systematic and sustained failure to address compliance. Indeed, the *Stone* court went further and located directors' "good faith" duty under the duty of loyalty, thereby emphasizing that bad faith entails a conscious or knowing failure to serve the firm, and not an inadvertent failure to exercise reasonable oversight.¹⁴

Caremark did not succeed, however, in inducing directors to exercise the level of active oversight over legal compliance that federal authorities want. *Caremark*'s oversight duty was not sufficiently specific to induce outside directors to actively oversee compliance program design and internal investigations. Moreover, *Caremark*'s effectiveness was further undermined by directors' conflicts of interest and lack of financial expertise. Finally, *Caremark*'s narrow bad faith standard largely eliminated any incentive effects arising from the

¹⁰ While *Caremark* had a 102(b)(7) provision in its charter, which eliminated liability for lack of due care but not for bad faith, Allen's discussion of liability in *Caremark* is written broadly as a general statement of director liability.

¹¹ *Caremark*, 698 A.2d at 971.

¹² Conversation with Professor (then Chancellor) William T. Allen, New York, New York (May 14, 2008).

¹³ *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006) (en banc).

¹⁴ *Stone*, 911 A.2d at 362.

threat of liability,¹⁵ but Delaware could not expand director liability without running afoul of its commitment not to regulate internal business judgments.¹⁶ The limitations of Delaware's approach became apparent at the turn of the century when the country again was rocked by corporate scandals. In response, Congress and the national exchanges injected themselves into corporate governance regulation through a variety of compliance-related mandates, thereby ending Delaware's unchallenged authority to regulate corporate governance issues relating to legal compliance and introducing a more rule-based approach to corporate governance.

I. Prelude to Caremark

On a general level, the story of *Caremark* is the story of Delaware's evolving view of the appropriate role of directors. More specifically, it is the story of how dramatic changes in federal criminal law and practice transformed the question of corporate compliance with federal criminal laws into a corporate governance issue warranting serious attention by the Delaware courts.

A. Graham v. Allis-Chalmers

The Delaware Supreme Court first addressed directors' duties to adopt a compliance program in 1963 in *Allis-Chalmers*.¹⁷ *Allis-Chalmers* was a derivative action against the directors of Allis-Chalmers and four non-director employees. Allis-Chalmers and the four non-director employees had pled guilty to violating the federal anti-trust laws by price-fixing and bid rigging. Plaintiffs sought to recover the damages Allis-Chalmers suffered as a result of these violations.

The derivative action focused on the potential liability of the defendant directors who were not directly involved in the crimes.¹⁸ Of particular importance, plaintiffs' complaint included the claim that the directors had a duty (that they breached) to implement measures designed to prevent anti-trust violations. Plaintiffs offered two alternative justifications for this duty. Plaintiffs first argued that the Allis-Chalmers directors had such a duty because two prior FTC consent

¹⁵ See *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003) ("A *Caremark* claim is a difficult one to prove... [requiring a] showing that the directors were conscious of the fact that they were not doing their jobs.")

¹⁶ When faced with a conflict between its oversight function and protecting directors' authority over business decisions, the Delaware Courts generally favor the latter. See Stephen Bainbridge, *et al.*, *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 570 (2008).

¹⁷ *Allis-Chalmers*, 188 A.2d at 125.

¹⁸ The decision focused on the claims against the defendant directors since the non-director defendants were never served with process and never appeared in the case. *Id.* at 127.

decrees provided them notice that the firm's employees were at risk of violating the anti-trust laws. Later, plaintiffs amended their complaint to add the claim that all directors have a duty to adopt measures designed to deter wrongdoing, even when they have no notice that crime might occur.

The Chancery Court dismissed the complaint. The Delaware Supreme Court affirmed, rejecting plaintiffs' claims that the directors had a duty to monitor. The Delaware Supreme Court agreed that the directors would have had a duty to act *if* the consent decrees provided them with notice of criminal wrongdoing.¹⁹ The court nevertheless dismissed the claim on the grounds that the FTC consent decrees did not in fact put the board on notice that employees might commit anti-trust crimes. Almost all of the directors were unaware of the decrees, having joined the board long after they were imposed. The three inside directors who did know about them had concluded that the firm was complying with the decrees and, moreover, had not been guilty of the enjoined practice in the first place. Finally, the firm had not admitted guilt in the consent decrees.²⁰

The court then turned to plaintiffs' more ambitious claim: that the directors' duty to actively supervise and manage corporate affairs includes a duty to adopt a compliance program designed to bring wrongdoing to directors' attention, even when the directors have no reason to suspect that wrongdoing is occurring. The Delaware Supreme Court rejected this claim out of hand, holding that directors do not have a duty to implement a compliance program, but instead can "rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."²¹

B. Placing Allis-Chalmers in Context

The Delaware Supreme Court's holding in *Allis-Chalmers* reflects the narrower conception of directors' duties which prevailed at the time. But the

¹⁹ The court also held that defendants did not otherwise have notice of any criminal activity. Plaintiffs were unable to establish that the directors knew about the price-fixing because the Allis-Chalmers board was not in charge of setting prices; pricing decisions were made at the department level. Moreover, plaintiffs offered no evidence that the board received internally-validated evidence of suspected criminal activity until after the Grand Jury investigation, when the Legal Division, in response to the inquiry, conducted an investigation and found evidence of suspected wrongdoing. The court found that the board's response to this information satisfied its duty of care because the board acted to eliminate any existing and future anti-trust violations by instructing subpoenaed employees to cooperate with federal authorities, issuing a policy statement about the anti-trust problems and causing the Legal Division to commence a series of employee meetings on anti-trust compliance. *Id.*

²⁰ *Id.* at 129-30.

²¹ *Id.* at 130-31. But see Stanton Wheeler, *et al.*, *White Collar Crimes and Criminals*, 25 Am. Crim. L. Rev. 331 (1988) ("The commission of wrongs through fraud ... is as old as human society.").

holding also reflects the fact that, at the time, directors had little reason to focus on compliance because firms derived little, if any, expected benefit from expenditures on legal compliance. Indeed, firms could be harmed by their compliance programs.

There were three reasons for this. First, the probability of a criminal violation was low because there were few criminal laws applicable to businesses. Second, the cost to firms of a conviction was negligible because corporations were subject to the same fines as individuals, and these sanctions were low since they were set with individuals in mind.²² Thus, sixty percent of the fines imposed on corporations were less than \$10,000, while the average fine was \$45,790.²³ Third, federal criminal law did not provide any direct incentive for firms to adopt a compliance program, and indeed discouraged it. Corporations were strictly vicariously liable for crimes committed by employees in the course of employment; corporate adoption of a compliance program neither protected the firm from a criminal conviction nor entitled it to a lower sanction.²⁴ Indeed, a firm could be harmed by a compliance program if it produced evidence which could be used to convict the corporation.²⁵

C. Transformation of Federal Corporate Criminal Law

By the mid-1990s, federal corporate criminal law and practice had changed dramatically. Corporations now could benefit significantly from a compliance program, both indirectly, if it deterred crime, and directly, through its effect on the penalty imposed should a crime occur.

Corporations benefited more from deterring crime because both the risk and the potential cost of a violation had dramatically increased since the 1960s.

²² 10 William Meade Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* § 4946 (2007). If penalty for the crime was limited to death or imprisonment, the corporation could not be indicted for the crime. *Id.*

²³ Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988–1990*, 71 B.U. L. Rev. 247, 254–256 (1991). One reason corporate fines were so low is that federal law imposed the same penalties on corporations and natural persons until the mid-1980s.

²⁴ *See* New York Central & Hudson River R.R. Co. v. United States, 212 U.S. 481, 29 S. Ct. 304, 53 L.Ed. 613 (1909) (establishing corporate criminal liability through the doctrine of respondeat superior); *see, e.g.*, United States v. Hilton Hotels Corp., 467 F.2d 1000, *cert. denied* 409 U.S. 1125, 93 S. Ct. 938, 35 L. Ed.2d 256 (1973) (a corporation can be criminally liable for an employee's crime committed within the scope of employment even when done against corporate orders).

²⁵ Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. Legal Stud. 833 (1994); *see* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. Rev. 687 (1997).

Federal criminal law expanded dramatically as a result of criminalized regulations governing the environment,²⁶ consumer and employee safety,²⁷ and business practices.²⁸ Many of these regulations both prevented firms from taking otherwise profitable actions and contained imprecise standards governing the boundary between legal and illegal conduct. This increased the value of measures to ensure that the firm complied with the law.²⁹

Moreover, corporations now faced dramatically higher sanctions as a result of statutes which specified high criminal penalties on corporate criminals.³⁰ The 1991 Organizational Sentencing Guidelines³¹ also increased both expected criminal fines and expected non-fine sanctions (such as restitution or remediation) imposed on convicted corporations. As a result, by 1996, publicly-held corporations convicted of federal crimes paid average fines of \$19 million and average total sanctions (including public and private civil) of more than \$49

²⁶ See generally Otto G. Obermaier and Robert G. Morvillo, *White Collar Crime: Businesses and Regulatory Offenses* 14-3 (2008). These statutes included the Clean Air Amendments of 1970, § 113(c), 42 USC §§ 7401-7671q, § 7413(c) (2000) (criminal penalties); Federal Water Pollution Control Act of 1972 (Clean Water Act), *codified as amended* at 33 USC §§ 1251-1387, § 1319(c) (2000 & Supp. 2005) (criminal penalties); the Federal Environmental Pesticide Control Act of 1972, 7 U.S.C. § 136, 136(j) (2000), (criminal provisions); Toxic Substances Control Act of 1976, 15 U.S.C. §§ 2601-29, § 2615(b) (2000 & Supp. 2005) (criminal provisions); and the Resource Conservation and Recovery Act of 1976, 42 U.S.C. §§ 6901-6992k, § 6928(d) (2000) (criminal provisions). In the 1980s, Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. §§ 9601-75, § 9603 (2000) (criminal provisions).

²⁷ E.g., Occupational Safety and Health Act of 1970, 29 U.S.C. §§ 651-78, § 666 (2000) (criminal provisions); the Consumer Product Safety Act, 15 U.S.C. §§ 2051-85, § 2068 (2000) (criminal provisions).

²⁸ E.g., Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78m(b)(2), 78dd-1, 78dd-2, 78ff (2000) (criminal provisions); Bank Secrecy Act of 1970, 12 U.S.C.S. §§ 1829b, 1951-59, 31 U.S.C. 5311-5332, 12 U.S.C.S. § 1956-57, 31 U.S.C.S. §§ 5322, 5332, (Lexis 2008) (criminal penalties); Money Laundering Control Act of 1986, 18 U.S.C. §§ 1956, 1957 (2000).

²⁹ See Stanton Wheeler, *Trends and Problems in the Sociological Study of Crime*, 23 Soc. Probs. 525, 528 (1976) (white collar crime will grow in importance with the growth of the regulatory state).

³⁰ Criminal Fine Enforcement Act of 1984, Pub. L. No. 98-596, 98 Stat. 3134; Criminal Fines Improvement Act of 1987, Pub. L. No. 100-185, 101 Stat. 1279.

³¹ U.S. Sentencing Commission, *Guidelines Manual* Ch. 8 (2007). In 2005, the Sentencing Guidelines became advisory, and not mandatory. See *U.S. v. Booker*, 543 U.S. 220 (1995). They remain influential, however.

million (1996 dollars). One firm was hit with a \$340 million fine; another paid total sanctions of \$646 million.³²

Finally, federal sentencing law changed to give firms a strong reason to adopt effective compliance programs. The Organizational Sentencing Guidelines reduced the criminal fine of any convicted corporation with an effective compliance program. Later, the Department of Justice adopted a policy of not prosecuting corporations that had a good compliance program, reported detected wrongdoing and cooperated with federal authorities in bringing any individual wrongdoers to justice.³³

II. Caremark

The dramatic change in federal criminal law heightened the benefits to corporations of adopting an effective compliance program capable of deterring crime and reducing the firm's liability for any crimes that do occur. This presented the Delaware courts with a challenge: Should they reverse *Allis-Chalmers* and require directors to play a more direct role in overseeing corporate compliance? If so, what standard should govern directors' liability?

The Delaware court's answer to these questions came from an unexpected source in equally unusual circumstances. A Delaware Chancery Court judge, William T. Allen, took it upon himself to reform Delaware's law on directors' duty to monitor. Moreover, he assumed this responsibility even though neither of the parties to the dispute asked him to do so. They had simply asked him to approve the settlement of a derivative suit filed against Caremark International. The resulting opinion forever changed Delaware law.

A. Factual Background

Caremark International, a health care corporation incorporated in Delaware, was a dominant player in the alternative-site health-care service business – a business which included home infusion therapy³⁴ and growth-hormone therapy.³⁵ The home infusion business was created by changes in

³² Cindy R. Alexander, Jennifer H. Arlen & Mark A. Cohen, *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 42 J. Law & Econ. 393, 410 (1999).

³³ See generally Jennifer Arlen, *Corporate Criminal Liability*, in *Leadership and Governance from the Inside Out* (Jeffrey Sonnenfeld & Robert Gandossey, eds., 2004).

³⁴ Home infusion provides intravenous medication or nutrition at home.

³⁵ *Caremark*, 698 A.2d at 961.

Medicare reimbursement rules in 1977.³⁶ The industry grew rapidly and by 1987 was a \$10 billion business. Caremark entered the market in 1979 as Home Health Care of America.³⁷ In 1985, the firm changed its name to Caremark. By this point, it ran 33 home-care centers across the country.³⁸ Two years later, Caremark owned 70 health-care outlets; its revenues jumped to approximate \$250 million, almost double the year before.³⁹ That year, Caremark was purchased by Baxter International for around \$500 million.⁴⁰ Between 1990 and 1991, home infusion-related Medicare reimbursement rose 213%, attracting the attention of federal and state authorities.⁴¹ Caremark flourished, its sales having nearly doubled in the four years since the deal with Baxter.⁴²

Caremark had a regular practice of making financial payments to physicians who referred patients to it for home infusion therapy. In 1991, federal authorities commenced a criminal investigation into whether these payments constituted illegal “kickbacks” to doctors for referring patients to Caremark,⁴³ in violation of a federal anti-kickback law that makes it a felony for health-care providers to make payments to physicians either to induce or in return for referring Medicare and Medicaid patients to health care providers.⁴⁴ Caremark acknowledged that it paid weekly fees of \$12 to \$150 per patient to doctors who

³⁶ Bruce Locklin, *Competition Does not Cut Costs or Profits in Home-IV Business*, *The Record*, Mar. 14, 1993, at a14.

³⁷ See 54 Jay P. Pederson, ed., *International Directory of Company Histories* 42 (2003). Caremark went through various changes in ownership during the period of time described in these facts. For simplicity it is referred to Caremark throughout.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ Julia Flynn Siler, *The Case Against Baxter International*, *Bus. Wk.*, Oct. 7, 1991, at 106.

⁴¹ See Patricia Moore, *Prescription for Growth; For Caremark, Diversity is Healthy Move*, *Chi. Sun-Times*, Nov. 21, 1993, at 1.

⁴² Pederson, *supra* note 37, at 43.

⁴³ See *Medical Supply Kickbacks Investigated*, *S.F. Chron.*, Sep. 10, 1991, at A5.

⁴⁴ See 42 U.S.C. § 1320(b)(2) (2008) (“Whoever knowingly and willfully offers or pays any remuneration (including any kickback, bribe, or rebate) directly or indirectly, overtly or covertly, in cash or in kind to any person to induce such person— to refer an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under a Federal health care program. . . shall be guilty of a felony”). Prohibited payments included those made to induce someone “to purchase, lease, order, or arrange for or recommend purchasing, leasing, or ordering any good, facility, service, or item for which payment may be made in whole or in part under a Federal health care program.” *Id.*

referred patients to Caremark, but claimed that the fees were not kickbacks, but instead were payments for monitoring patients' treatment by reviewing medications and lab results.⁴⁵ Although regulations had recently been announced creating narrow safe harbors for certain types of financial relationships with doctors,⁴⁶ Caremark's payments apparently did not fall within the safe harbors.⁴⁷ The legality of payments falling outside the safe harbors depended on whether they were intended in return for or in order to induce referrals.⁴⁸ Caremark (still part of Baxter International) responded to the investigation by announcing that it would terminate all physician payments pertaining to Medicare and Medicaid customers; it did not admit wrongdoing.⁴⁹

In 1992, Baxter spun Caremark off as a publicly held corporation.⁵⁰ All but one of the directors involved in the subsequent derivative suit became Caremark directors at this time. The criminal investigations expanded with the intervention of the Department of Justice and additional federal and state agencies.⁵¹ Caremark responded by revising its internal guide governing contracts with physicians. It also instituted a policy requiring regional officer approval of all contracts with physicians. It maintained its position that its existing arrangements were legal, although it openly acknowledged in its annual report that its view might not withstand legal challenge.⁵²

In 1993, federal officials announced a criminal investigation into the financial arrangements arising out of "Caremark Minnesota" -- a home infusion therapy joint-venture co-owned by Caremark and a physician-owned non-profit

⁴⁵ Thomas M. Burton, *Baxter Faces Probe of Fees Paid to Doctors*, Wall St. J., Sept. 9, 1991, at A3. Shortly prior to this probe, the Caremark unit of Baxter and Sandoz Pharmaceuticals announced that they had agreed to pay \$21 million to settle a 33-state lawsuit accusing the firms of having an illegal tie in involving schizophrenia treatment. Milt Freudenheim, *Sandoz and Caremark in Suit Settlement*, N.Y. Times, Sept. 4, 1992.

⁴⁶ 42 C.F.R. § 1001.952 (2008).

⁴⁷ Burton, *supra* note 45.

⁴⁸ See Locklin, *supra* note 36, at a14. As early as 1989, Caremark (Baxter) issued an internal "Guide to Contractual Relationships," which stated that payments should not be made to induce or reward referrals. *Caremark*, 698 A.2d at 962. Caremark took the position that these payments were not payments for referrals; thus they did not violate its Guide.

⁴⁹ Burton, *supra* note 45.

⁵⁰ See Ron Stodghill II, *A Mea Culpa – And a Comeback? After Its Guilty Plea, Caremark Plans a New Path*, Bus. Wk., Jul. 3, 1995, at 33.

⁵¹ *Caremark*, 698 A.2d at 962.

⁵² *Id.* at 963.

corporation. Under this joint venture, the doctors referred patients to Caremark Minnesota for home tube-feeding. The physician-owned corporation received almost one-fifth of the earnings from Caremark's entire Minnesota operation,⁵³ which amounted to about \$1.5 million per year.⁵⁴ The physicians claimed that their profit-sharing arrangement was not an illegal payment for referrals, but instead was in return for the doctors providing Caremark with "model" managed-care procedures and technology to be used in the home infusion setting. A newspaper found that the purportedly "model" procedures were ordinary and that the payments pre-dated development of the procedures, raising the question of whether the payments were disguised kickbacks. Auditors concluded that the arrangements were legally defensible, but warned that a court or federal agency could take a different view.⁵⁵

In February of that year, Price Waterhouse presented a report to the Ethics Committee of Caremark's Board which concluded that there were no material weaknesses in Caremark's control structure. That spring, the committee nevertheless adopted a new internal audit charter requiring a comprehensive review of compliance policies and the drafting of a new employee handbook. Caremark claims that it also started requiring home-office approval for all payments to physicians by branch offices under existing agreements.⁵⁶

The firm continued to expand. By 1994, it was the largest home infusion company. The federal investigation also expanded and intensified.⁵⁷ In August, a federal grand jury in Minneapolis indicted Caremark, three of its executives, and an executive at Genentech for alleged kickback violations based on payments totaling \$1.1 million made by Caremark to Dr. David Brown between 1986 and 1993. These payments were allegedly intended to induce Brown to prescribe Protropin to his juvenile patients.⁵⁸ Protropin, which was made by Genentech and distributed by Caremark,⁵⁹ is a genetically engineered human growth hormone,

⁵³ See Joe Rigert, *Hasselmo Seeks Audit of Doctors' Ties to Firm // 'U' Probe to Look at Home-Care Firm*, Star-Trib. Newspaper Twin Cities Mpls.-St. Paul, Nov. 4, 1993, at 1A.

⁵⁴ Thomas M. Burton, *Probe Focuses on Transactions in Minnesota – Federal Investigators Look Into Alleged Kickbacks at University Hospital*, Wall St. J., Oct. 18, 1993, at B4.

⁵⁵ See Gregor W. Pinney, *'U' Medical School Audit Finds No Proof of Doctors Accepting Kickbacks*, Star-Trib. Newspaper, Feb. 23, 1995 at 4B.

⁵⁶ *Caremark*, 698 A.2d at 963.

⁵⁷ See *Key Dates*, Chi. Sun-Times, Sep. 27, 1994, at 49.

⁵⁸ John Burns, *Caremark Faces Kickback Charges*, Modern Healthcare, Aug. 08, 1994, at 4.

⁵⁹ See Ralph T. King Jr., *FDA Widens Marketing Probe of Genentech – Flagship Heart Drug TPA is Added to an Inquiry that Includes Protropin*, Wall St. J., Nov. 10, 1994, at A3;

costing about \$30,000 per year.⁶⁰ Dr. Brown was one of the largest prescribers of Protoprin. According to the indictment, Caremark's payments to Dr. Brown initially took the form of a revenue-sharing arrangement. Later, the payments took the form of consulting fees and "research grants," yet allegedly Dr. Brown neither performed significant additional consulting functions nor produced research papers or results. Caremark's management met with the board and explained why they believed Caremark's contracts were legal.⁶¹ Caremark denied any wrongdoing.

The last quarter of 1994 brought more bad news.⁶² In August, the Office of the Inspector General of the Department of Health and Human Services announced a "Special Fraud Alert," warning health-care providers and patients about practices representing potential industry-wide violations of anti-kickback statutes, citing "research grant" arrangements as one of the three major types of scheme.⁶³ In September, a federal grand jury in Ohio indicted another doctor, Dr. Neufeld, for receiving \$134,600 in kickbacks from Caremark. Caremark's payments to Dr. Neufeld, who did refer patients to Caremark, took the form of consulting fees and compensation; Caremark also allegedly paid the salaries of his nurses and supplied him with equipment.⁶⁴ Then, federal investigators announced that they were investigating a joint venture between Caremark and Dr. Bruce

Kathleen Day, *Kickbacks Alleged in Sale of Children's Growth Drug*, Wash. Post, Aug. 5, 1994, at A1.

⁶⁰ This was not the first controversy involving Caremark's aggressive marketing of Protoprin. Prior to 1994, Caremark helped finance height screenings at schools to identify potential patients. They publicly agreed to stop in 1994 amid concerns that children without medical problems were receiving hormones. See *Concerns Agree to Halt Push of Hormones*, N.Y. Times, Oct. 7, 1994, at A23.

⁶¹ *Caremark*, 698 A.2d at 964.

⁶² Caremark faced other legal problems as well. In 1994, the criminal investigation expanded to examine whether Caremark submitted false and inflated bills to Medicaid, Blue Cross and other insurers. See Thomas M. Burton, *Caremark Probe Widens to Cover Billing Practices – Medicaid May Have Paid False and Inflated Bills for Home Health Care*, Wall St. J., Nov. 17, 1994, at A3. The Federal Trade Commission also launched an investigation, asking drug companies to provide information on their relationships with Caremark. See Milt Freudenheim, *F.T.C. Seeks Data on Caremark Alliances*, N.Y. Times, Nov. 24, 1994, at D4.

⁶³ See *Publication of OIG Special Fraud Alerts*, 59 Fed. Reg. 65372, 65376 (Dec. 19, 1994) (describing a 'research grant' program in which physicians were given substantial payments for de minimis recordkeeping tasks. The physician administered the drug manufacturer's product to the patient and made brief notes, sometimes a single word, about the treatment outcome. Upon completion of a limited number of such 'studies,' the physician received payment from the manufacturer").

⁶⁴ Thomas M. Burton, *Doctor is Charged with Kickbacks from Caremark*, Wall St. J., Sept. 22, 1994, at B7.

Margulis. Dr. Margulis, who allegedly operated as a salesman for Caremark giving Caremark greater access to physicians, made over \$2 million from his arrangement with Caremark. Allegedly, Dr. Margulis often offered doctors payments of up to \$100,000 for referring patients to his joint venture with Caremark. Caremark did not pay the doctors directly. Instead, the doctors were paid by a company owned by Margulis, which was then reimbursed by Caremark. Caremark defended all payments as reflecting legitimate patient services, but some Caremark employees said that the doctors were paid only if they referred a patient and regularly did little or no work beyond the referral. Margulis denied all wrongdoing, saying he relied on advice from Caremark's lawyers.⁶⁵ Caremark announced that it was terminating all financial relationships with physicians in its home infusion, hemophilia, and growth hormone businesses as of January 1, 1995. It also terminated its research grant program.⁶⁶

In 1995, Caremark moved to put its legal troubles behind it. It sold its home infusion business.⁶⁷ It then reached a landmark settlement of all criminal and civil investigations involving federal and state authorities. Under the terms of the agreement, Caremark pled guilty to two counts of mail fraud (one each in Minnesota and Ohio) and agreed to pay approximately \$161 million to federal authorities, including \$29 million in criminal fines; \$81.75 million in civil restitution, damages and penalties based on kickbacks and fraud in its home infusion, oncology, hemophilia and human growth hormone businesses; \$3.5 million in civil penalties for violations of the Controlled Substances Act; and a \$2 million donation.⁶⁸ Caremark also agreed to make payments of about \$45 million to the states.⁶⁹ It also agreed to cooperate with the ongoing federal investigation

⁶⁵ See Thomas M. Burton, *Fee for Service: Caremark Faces Heat for Paying Doctors Who Sent it Patients – Physician-Salesman Enlisted Fellow M.D.'s, Raising Fortunes All Around – Years of Treatment for Lyme*, Wall St. J., Nov. 11, 1994, at A1. Investigators also examined another doctor who generated sales for Caremark of over \$2 million in one year by allegedly providing excessive medical treatment. He placed hundreds of people on antibiotics (provided by Caremark), saying they were needed to detect Lyme disease, even though there were only three recorded cases of the disease in the state in two years and it was not accepted practice to use antibiotics to diagnose Lyme disease. *See id.*

⁶⁶ *See Caremark*, 698 A.2d at 965.

⁶⁷ See Charlotte Snow, *Coram, Caremark Settle Legal Fight*, Modern Healthcare, Jul. 7, 1997, at 24.

⁶⁸ *United States v. Caremark, Inc.*, No. Cr. 4-94-95, 1995 WL 422157 (D. Minn. June 15, 1995); *Press Release*, U.S. Dep't of Justice, *Caremark to Pay \$161 Million in Fraud and Kickback Cases* (June 16, 1995) (available at http://www.usdoj.gov/opa/pr/Pre_96/June95/342.txt.html); *see Caremark*, 698 A.2d at note 10.

⁶⁹ See Lisa Scott, *Caremark to Plead Guilty in Fraud Case; Feds End Hill-Rom Antitrust Probe*, Modern Healthcare, Jun. 19, 1995, at 6.

and to abide by the terms of a 22-page Corporate Integrity Agreement (“CIA”)⁷⁰ which imposed a variety of compliance obligations on the firm for five years.⁷¹ In return, the United States agreed not to prosecute Caremark, or otherwise proceed against it, for a list of potential criminal offenses related to Caremark’s relevant lines of business.⁷²

The settlement did not end Caremark’s legal troubles. The company was sued by private insurers and eventually paid \$66 million to settle these claims. It was sued by Coram Healthcare, the purchaser of Caremark’s home infusion division; this suit resulted in a substantial payment.⁷³ When all was said and done, Caremark’s total required payments (to federal, state, and private authorities) totaled approximately \$250 million.⁷⁴

Caremark’s agreement expressly did not protect individuals or other entities who might be implicated in its activities. Some of them were convicted; others were not. Specifically, while the three Caremark executives indicted along with Caremark escaped liability,⁷⁵ the government obtained guilty pleas from several entities involved with Caremark and also Dr. Neufeld.⁷⁶ As for Dr. Brown, he was convicted of receiving kickbacks in return for prescribing Protropin,⁷⁷ but this conviction was overturned and he was granted a new trial because jurors

⁷⁰ See *Caremark*, 1995 WL 422157, at *11 n.20.

⁷¹ Among other things, the CIA required Caremark to develop procedures designed to prevent reoccurrence of the specific violations that HHS believed occurred, reaching well beyond the problem at issue in the indictment. Caremark also agreed to conduct instructional meetings for officers and employees with responsibilities for matters implicated in the investigations; to investigate any evidence of misconduct and take appropriate corrective action; and to prepare an annual report on compliance measures and the status of any ongoing investigations. See Office of Inspector Gen., U.S. Dep’t of Health and Human Servs., Corporate Integrity Agreement 7, 8, 11-15, 18 (Jun. 16, 1995) (on file with author).

⁷² See *Caremark*, 1995 WL 422157, at *5-6.

⁷³ See *Caremark Fraud Case Ended for \$66 Million*, Plain Dealer, Mar. 20, 1996, at 3D.

⁷⁴ *Caremark*, 698 A.2d at 960-61.

⁷⁵ Thomas M. Burton, *Aides at Caremark, Genentech Cleared by U.S. Judge in Medical Kickback Case*, Wall St. J., Oct. 4, 1995, at B12.

⁷⁶ See Kelly Shriver, *New Action in Caremark Cases*, Modern Healthcare, Jan. 22, 1996, at 8; Robert Ruth, *Physician Must Serve 3 Months, Pay \$5000*, Columbus Dispatch, May 4, 2000, at 6C.

⁷⁷ *Doctor is Found Guilty of Receiving Kickbacks*, Wall St. J., Oct. 20, 1995, at A4.

learned through news accounts about Caremark's guilty plea and the fines it paid.⁷⁸

B. The Litigation

The initial shareholder derivative suit against Caremark's board of directors was filed on August 5, 1994, within 24 hours of Caremark's indictment.⁷⁹ Four similar complaints were consolidated into one action on September 14.⁸⁰ The litigation proceeded as evidence about the scope of the investigation was coming out.

Plaintiffs filed an original complaint followed by multiple amended complaints, as the evolving criminal investigation provided additional evidence of potential criminal wrongdoing by the firm. In their original complaint, plaintiffs claimed that the directors breached their duty of care, resulting in a waste of corporate assets, because they knew of the federal investigations and yet did not intervene to stop the firm's criminal activity.⁸¹ The plaintiff's amended complaint asserted that the directors were liable under *Graham v. Allis-Chalmers Manufacturing Co.* for knowingly and recklessly failing to act to prevent illegal payments to physicians in the face of obvious danger signs of employee wrongdoing.⁸² Plaintiffs did not affirmatively request that Delaware reverse *Allis-Chalmers*.

Defendants (repeatedly) moved to dismiss the complaint on the grounds that demand is required;⁸³ later they argued that plaintiffs' claim should be dismissed for failure to state a cause of action because Caremark's certificate of incorporation contains a 102(b)(7) provision, protecting directors from liability for breach of the duty of care.⁸⁴ Plaintiffs countered that demand was excused and that their claim that directors knowingly and recklessly failed to act was predicated on bad faith, and thus fell outside the limitations of the 102(b)(7)

⁷⁸ *Physician Convicted in the Caremark Case is Granted a New Trial*, Wall St. J., Jan. 15, 1996, at B3; see *U.S. v Brown*, 108 F.3d 863 (8th Cir. 1997) (affirming order for a new trial).

⁷⁹ See Defendant's Opening Brief in Support of Their Motion to Dismiss at 1, *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (Cons. C.A. No. 13670).

⁸⁰ See *id.*

⁸¹ See *id.* at 9.

⁸² See Plaintiff's Brief in Opposition to Defendants' Motion to Dismiss at 22, *In re Caremark*, 698 A.2d 959 (Cons. C.A. No. 13670).

⁸³ See Defendants' Opening Brief in Support of Their Motion to Dismiss Plaintiff's Second Amended Complaint at 1, *In re Caremark*, 698 A.2d 959 (Cons. C.A. No. 13670).

⁸⁴ See *id.* at 19.

charter provision.⁸⁵ Defendants countered that plaintiffs could not establish that they acted knowingly because during this period no one was convicted of any crimes; the directors did not have notice of *illegal* conduct, only conduct that could *possibly* be illegal.⁸⁶

C. Chancellor Allen's Decision to Intervene

Before the suit reached trial, Caremark agreed to settle the derivative action, entering into these negotiations at the same time that it commenced negotiations to settle the federal criminal charges. The resulting settlement provided plaintiffs limited benefits. The directors were not required to pay any damages. Instead, the settlement simply required the board to adopt changes designed to promote compliance. Plaintiffs' counsel sought \$1,025,000 in attorney's fees and reimbursable expenses, of which \$710,000 represented payment for hours worked and \$53,000 covered out-of-pocket expenses.⁸⁷

As required by Delaware law, the parties filed a motion with Chancellor Allen to approve the settlement as being "fair and reasonable." Courts responding to settlement motions are required to evaluate the merits of the claims, but generally do not produce a written opinion – much less a path-breaking one. Chancellor Allen, however, used the invitation to assess the merits of the case to write a far-reaching opinion on the scope of directors' duty to monitor for legal compliance and the standard of review that should govern director liability.

Years later, Chancellor Allen explained that he used the opportunity presented by *Caremark* to write a broad opinion on directors' duty to monitor because directors had become overly passive, lulled into complacency by both Delaware's strong business judgment rule and a business norm favoring directorial non-interference with the CEO.⁸⁸ Chancellor Allen believed that *Allis-Chalmers* had exacerbated the problem. *Allis-Chalmers*'s holding that liability only attached to directors who had (and ignored) evidence of wrong-doing protected directors who remained completely ignorant, while threatening those who tried to

⁸⁵ See Plaintiff's Brief in Opposition to Defendants' Motion to Dismiss at 33, *In re Caremark*, 698 A.2d 959 (Cons. C.A. No. 13670).

⁸⁶ See Defendants' Reply Brief in Support of Their Motion to Dismiss the Third Amended Complaint at 1, 5-6, *In re Caremark*, 698 A.2d 959 (Cons. C.A. No. 13670).

⁸⁷ *Caremark*, 698 A.2d at 966, 972.

⁸⁸ Conversation with Professor (then Chancellor) William T. Allen, N.Y., N.Y., May 14, 2008. The *Caremark* settlement also invited legal scrutiny because it implicated another issue that troubled the Delaware courts: derivative suit settlements which provided higher benefits for plaintiffs' counsel than for the shareholder plaintiffs. Indeed, Chancellor Allen used his oversight authority to reduce plaintiffs' counsel's fee from the requested \$1,025,000 to \$869,000. 698 A.2d at 972.

monitor with liability should they not respond effectively to any evidence of wrongdoing. Chancellor Allen also believed that *Allis-Chalmers* was inconsistent with the line of Delaware cases holding that directors have a duty to exercise independent and informed oversight over the firm. Directors' oversight of information and reporting systems designed to inform them about potential violations of the law seemed consonant with that duty. *Caremark* presented Chancellor Allen with an opportunity to require directors to oversee legal, thereby bringing Delaware law governing this duty in line with Delaware's overall approach to board oversight.⁸⁹

Chancellor Allen also viewed *Caremark* as an opportunity to establish that liability for breach of directors' monitoring duties should be limited to knowing and not inadvertent neglect.⁹⁰ Chancellor Allen felt heightened concern about the standard of review because the Delaware Supreme Court had repeatedly articulated the view that judges can impose liability on directors whose conduct is objectively (grossly) unreasonable, even if the directors acted in subjective good faith.⁹¹ Chancellor Allen believed that objective reasonableness review was contrary to central policies of the business judgment rule and would cause directors to be excessively risk averse and spend too much money on oversight.⁹² Although publicly-held firm directors generally were insulated from due care liability by 102(b)(7), they could be liable for a failure to act in "good faith." Chancellor Allen wanted to ensure that the good faith standard of review was delineated to restrict liability to instances of conscious or deliberate director neglect.⁹³

⁸⁹ *Id.*

⁹⁰ Conversation with Professor (then Chancellor) William T. Allen, N.Y., N.Y., May 14, 2008.

⁹¹ *E.g.*, *Smith v. Van Gorkom*, 488 A.2d at 858.

⁹² Moreover, Chancellor Allen believed that shareholders had elected the directors, not the Delaware judiciary, to assess the reasonableness of corporate actions. As Chancellor Allen explained in *Caremark*:

"Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to fully satisfy the duty of attention. If the shareholders [feel]... entitled to some other quality of judgment than the director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors."

698 A.2d at 968; accord Leo E. Strine, Jr., *Derivative Impact: Some Early Reflections on the Corporate Law Implications of the Enron Debacle*, 57 *Bus. Lawyer* 1371, 1375 (2002).

⁹³ Reasonableness review of directors' compliance decisions would be particularly troublesome because judges could not avoid making substantive business judgments since compliance program design and oversight involves trade-offs between centralized oversight and decentralized action affecting the fundamental structure and operation of the firm.

Accordingly, Chancellor Allen sought to use *Caremark* to expand directors' oversight duties beyond the limits of the Delaware Supreme Court's opinion in *Allis-Chalmers* while establishing a standard of review more narrow than the Delaware Supreme Court had adopted in due care cases such as *Van Gorkom*.

D. The Decision

Chancellor Allen addressed the first goal by ruling, contrary to *Allis-Chalmers*, that all directors (even those who do not have reason to suspect wrongdoing) have a fiduciary duty to adopt an information and reporting system that is reasonably designed to provide "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."⁹⁴ To ground his conclusion in Delaware Supreme Court precedent, Chancellor Allen treated this duty as the natural extension of directors' duty to exercise good-faith, informed oversight over the firm, concluding that directors cannot meet this duty unless they ensure that they can obtain information from within the firm about the firm's activities and legal compliance. Chancellor Allen also based the need for legal change on the recently-adopted U.S. Sentencing Guidelines, which subjected firms without effective compliance programs to substantially greater penalties for criminal convictions.⁹⁵

Chancellor Allen addressed the second goal by explicitly articulating a narrow standard of review to govern director liability for failure to oversee compliance. Chancellor Allen specifically rejected gross negligence as the standard to determine liability for failure to monitor because gross-negligence liability would permit courts to second-guess directors' business decisions, ruling instead that directors could only be liable for failure to monitor if they acted in bad faith. Moreover, Chancellor Allen placed a high hurdle before plaintiffs seeking to show bad faith, requiring them to show that the directors' inaction amounted to a "sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure that a reasonable information and reporting system exists." In effect, bad faith required evidence that director neglect resulted from a bad motive; a grossly unreasonable failure to act would not be enough.⁹⁶

⁹⁴ *Caremark*, 698 A.2d at 970.

⁹⁵ *Id.*

⁹⁶ *Id.* at 970-71. To be precise, Chancellor Allen ruled that claims that directors failed to act would be governed by a bad faith standard. By contrast, claims that directors adopted an inadequate compliance program would be governed by the business judgment rule, which would permit liability for gross negligence in firms without a 102(b)(7) charter provision. By contrast, Chancellor Allen explicitly ruled that directors were not subject to gross negligence liability for

Chancellor Allen recognized that this liability rule was too narrow to induce most recalcitrant directors to change their behavior. Yet he believed that *Caremark* nevertheless would change directors' behavior through its simple statement that directors have a duty to oversee legal compliance. Chancellor Allen believed that *Caremark's* standard of conduct could change behavior, notwithstanding its narrow standard of review, because he felt that directors generally want to satisfy their legal duties. He felt that directors' current passivity largely resulted from a business norm that directors should assume a limited role and avoid challenging management. Chancellor Allen believed that *Caremark's* clear imposition on directors of a duty to monitor legal compliance would alter directors' behavior through its moral suasion and associated impact on directors' norms.⁹⁷

Chancellor Allen recognized that some directors might not be so well-intentioned and might neglect their oversight duties for more nefarious, self-serving reasons. These directors would not be swayed purely by the moral force of *Caremark's* statement of their duties. Chancellor Allen concluded that *Caremark* would reach these directors through its threat to impose personal liability on directors who neglected their oversight duties in bad faith.⁹⁸

E. The Dismissal of Plaintiffs' Complaint

The importance of the distinction between subjective bad faith and objective reasonableness is apparent in Chancellor Allen's analysis of the merits of the claim against *Caremark's* directors. Chancellor Allen concluded that the plaintiffs probably could not prevail against the directors because the directors' inaction fell far short of the kind of sustained inattention required for bad faith.⁹⁹ Chancellor Allen reached this conclusion because the board regularly revised the compliance manual, made an effort to become aware of the relevant facts, and did not consciously permit a known violation to continue because the firm

pure inaction because there is no process for courts to review. He thus restricted liability to bad faith. *Id.*; Email exchange with William T. Allen (July 27, 2008); compare with Bainbridge, *et al.*, *supra* note 16, at 597, 599 (asserting that *Caremark*, as a duty of care case, allows courts to impose gross negligence liability for board inaction).

⁹⁷ For an insightful discussion of the norm-providing function of Delaware law, see Edward Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 *UCLA L. Rev.* 1009 (1997).

⁹⁸ Conversation with Professor (then-Chancellor) William T. Allen, N.Y., N.Y., May 14, 2008.

⁹⁹ Chancellor Allen might well have rejected the settlement had he concluded that the plaintiffs' had a strong case on the merits because the settlement provided little real benefit to the plaintiffs. The settlement did not require defendants to pay any financial compensation; only the attorneys received any money.

consistently asserted that conduct was legal.¹⁰⁰ This was sufficient to negate bad faith, even though the Caremark directors, having been elected to a firm subject to criminal investigation, apparently took no direct action to evaluate directly the firm's legal compliance. There is no evidence that they either conducted a legal audit of the firm's contracts with physicians, even though these were being challenged, or obtained independent legal advice about the validity of management's interpretation of the law. Such actions might have been desirable – perhaps even reasonable – under the circumstances. Yet the directors' failure to take such steps did not establish bad faith, given their general conscious (albeit non-aggressive) attention to compliance.

III. Stone v. Ritter

Caremark's largely advisory ruling on the duty to monitor remained the leading exposition of Delaware law for over ten years. Then in 2006, the Delaware Supreme Court decided *Stone v. Ritter*.¹⁰¹ *Stone* involved a claim that the directors of AmSouth Corporation had breached their *Caremark* duties by failing to ensure that the firm adopted a reasonable compliance and reporting system to ensure compliance with the federal Bank Secrecy Act.

In *Stone*, the Delaware Supreme Court affirmed *Caremark's* statement that directors owe a duty to act in good faith to ensure existence of a compliance program. It also affirmed Chancellor Allen's ruling that directors could only be liable if they acted in bad faith. Moreover, the court accepted Chancellor Allen's view that plaintiffs would have to show that the directors either "utterly failed to implement any reporting or information system or controls" or "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 order to establish bad faith. In either case, plaintiffs must show that "the directors knew that they were not discharging their fiduciary obligations."¹⁰²

The court emphasized the distinction between "bad faith" and gross negligence by dismissing plaintiff's complaint for failure to show that the directors were subject to a potential threat of personal liability sufficient to excuse demand under *Rales v. Blasband*,¹⁰³ even though the court agreed with the Chancery Court that "it is beyond question" that the firm's internal controls were "inadequate." Inadequate internal controls were not sufficient because, even if the

¹⁰⁰ *Caremark*, 698 A.2d at 971-72.

¹⁰¹ *Stone*, 911 A.2d at 362.

¹⁰² *Id.* at 370.

¹⁰³ 634 A.2d 927 (Del. 1993).

directors' actions fell short of reasonable care, the directors had not systematically ignored compliance and indeed devoted substantial resources to it as well as ongoing oversight.

Moreover, the Delaware Supreme Court further secured Chancellor Allen's victory over the scope of liability by holding that bad-faith liability falls under the duty of loyalty. In so doing, the court both established that good faith was not a distinct fiduciary duty and clarified that liability can only be imposed on directors who knew they were not discharging their fiduciary obligations.¹⁰⁴

IV. Implications of Caremark

Caremark is important because it substantially expanded directors' oversight role through its ruling that directors have a duty to ensure that their firms have a compliance program and to monitor the firm's investigation of suspicious activities. In so doing, it represents a substantial advance over *Allis-Chalmers*. Moreover, and perhaps more important, it represents a victory for the view that Delaware judges should not review the reasonableness of directors' decisions. Instead, non-conflicted directors should be liable only if they act in subjective bad faith.

Caremark's approach to the duty to monitor – with its clear duty to monitor and its narrow liability rule – appears to be a good solution to the challenge facing Chancellor Allen: How to use fiduciary-duty liability to induce greater attention to compliance without inviting excessive court interference with business decisions.

Nevertheless, it is important to recognize that this solution did not induce adequately active director oversight of legal compliance. First, while *Caremark* asserts that directors have a duty to oversee legal compliance, the duty is not sufficiently specific to induce active director oversight of investigations by directors reluctant to challenge management.¹⁰⁵ Moreover, the bad faith liability standard is too easily avoided to provide substantial deterrent effect. Finally, *Caremark's* duty was not able to induce active and effective director oversight. Norm-shifting requires that directors both be independent of management pressures to be passive and have the expertise needed to oversee management. These conditions often were not met in the 1990s, as became apparent in the wake of Enron and WorldCom. *Caremark* thus could not induce adequate director

¹⁰⁴ 911 A.2d at 370. For a critique of the *Stone* court's decision to incorporate good faith into the duty of loyalty see, e.g., Bainbridge, et al., *supra* note 16, at 585-588.

¹⁰⁵ By contrast, federal authorities often require convicted firms to adopt compliance programs meeting specific and detailed requirements. See, e.g., *Caremark's* Corporate Integrity Agreement, Office of Inspector Gen., U.S. Dep't of Health and Human Servs. at 11-13 (Jun. 16, 1995) (on file with author).

oversight without additional measures designed to increase board independence, director expertise, and managements' support for compliance. Congress and the securities exchanges consequently intervened to regulate corporate compliance, in effect abandoning their historic acceptance of state court authority over corporate governance matters.¹⁰⁶

V. Conclusion

Most people are, by and large, law abiding. So are most publicly held firms. Yet this lawfulness is not automatic. The omnipresent pressure to boost earnings creates temptation for officers and employees to skirt or violate the numerous federal criminal laws constraining firms' profits.

Firms are more likely to comply with the law when subject to oversight from people whose welfare is less dependent on short-term firm profits, such as outside directors. To ensure that their firms abide by the laws, directors must assume direct responsibility—and active oversight—over corporate compliance. This includes intervention to adopt an effective compliance program as well as a willingness to assume direct authority over investigations of potential wrongdoing. This task is a difficult one for directors because adherence to the law often requires that they intervene to push managers to forego otherwise profitable business activities and incur the costs of otherwise unnecessary oversight. This oversight role is particularly difficult when the reach of the federal criminal law is unclear. Directors need additional encouragement to assume this role.

Chancellor Allen's ruling in *Caremark* was an important and creative effort to provide directors with both the encouragement and the financial incentive to assume active oversight over legal compliance. It was a substantial improvement over Delaware's traditional approach to the problem. Nevertheless, *Caremark*, in its effort to address the problem of excessive court interference, in

¹⁰⁶ The major congressional response was the Sarbanes-Oxley Act of 2002. See Sarbanes-Oxley Act of 2002, §§ 301 (audit committee independence and authority), 302 (corporate responsibility for financial reports), 401-09 (financial disclosures), Pub. L. 107-204, 116 Stat. 745 (codified in various sections of 15, 18 and 28 U.S.C.); see 17 C.F.R. § 240.13a-15 (2008); 17 C.F.R. § 229.308T (2008). In addition, the New York Stock Exchange and NASDAQ's adoption of rules requiring, among other things, that (1) all listed firms have a majority of independent directors (with independence defined more strictly than under Sarbanes-Oxley), (2) non-management directors periodically meet without management present, (3) that all listed companies have a nominating/governance committee, an audit committee and compensation committee composed entirely of independent directors and (4) that companies maintain an internal audit function, disclose corporate governance guidelines, and annually certify to the NYSE that they are not aware of any violations of its standards. See *NASD and NYSE Rulemaking: Relating to Corporate Governance*, Exchange Act Release No. 34-48745, (Nov. 4, 2003), 68 Fed. Reg. 64154, 64157-59, 64161-64 (Nov. 12, 2003); N.Y. Stock Exchange, *Final NYSE Corporate Governance Rules* (Nov. 4, 2003), available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>; NASD, *NASDAQ Corporate Governance Summary of Rule Changes* (Nov. 2003), available at <http://www.nasdaq.com/about/CorpGovSummary.pdf>.

effect removed much of the bite of the liability that it created. *Caremark's* bad-faith liability is so narrow that it is unlikely that a well-advised board of directors will run afoul of it, whether or not it monitors effectively.

Caremark's effectiveness thus depends heavily on its moral suasion. *Caremark's* norm-shifting is most effective against directors burdened by soft, not hard, agency costs, and thus its effectiveness has been heightened by recent changes increasing the authority, independence, and expertise of outside directors. Yet two other factors are needed. Delaware must clearly establish that outside directors should exert independent oversight of the firm's analysis of what conduct is illegal. Equally important, federal authorities must clarify the line between legal and illegal conduct because outside directors cannot effectively challenge management's decisions unless they can be confident the conduct is illegal. Director oversight cannot be as effective when the law is unclear because outside directors cannot help but be reluctant to assume responsibility for forcing the firm to forgo profitable actions which *may*, but also may not, be illegal.

Indeed, there is perhaps no better illustration of how hard it is to induce corporate compliance than the recent history of the Caremark Corporation itself. Notwithstanding the huge penalties imposed on it in 1995, the Delaware court's imposition of an oversight duty on its directors, and the post-2001 reforms, Caremark (now operating as CVS Caremark) again found itself the subject of legal challenges. In February 2008, Caremark agreed to pay \$38.5 million to 28 states to settle a lawsuit arising out of an alleged program to induce patients to switch drugs so that Caremark could profit from manufacturer rebates.¹⁰⁷ The next month, it reached a settlement requiring a total payment of \$37.5 million settlement with the Department of Justice and several state Attorneys General arising from alleged over-billing for an antacid drug.¹⁰⁸ The settlement included a fresh Corporate Integrity Agreement with the Office of the Inspector General of the Department of Health and Human Services.¹⁰⁹ The challenge of ensuring corporate compliance continues.

¹⁰⁷ *CVS Caremark Settlement Includes Missouri*, Kansas City Bus. J., Feb. 18, 2008.

¹⁰⁸ See Ameet Sachdev, *CVS Settles Medicaid Overbilling Charges*, Chi. Tribune, Mar. 19, 2008, at 1.

¹⁰⁹ See Ashley M. Heher, *CVS Caremark Agrees to Settle Multistate Medicaid Fraud Claims*, Legal Intelligencer, Mar. 20, 2008, at 4. The new agreement can be found at http://www.usdoj.gov/usao/iln/pr/chicago/2008/pr0318_01a.pdf.