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Caremark & its "Red Flag" Progeny

Recently, two (2) excellent law review Articles have been written on the impact of the seminal case of In re Caremark International, Inc. Derivative Litigation ("Caremark") 698 A.2nd 959 (Del Ch. 1996). The key issue in the *Caremark* case was basically determining how a company should be "directed" by its directors? In the Article entitled "Caremark at the Quarter-Century Watershed: Modern Day Compliance Realities Frame Corporate Investors Duty of Good Faith Oversight," the authors look back at the 25 years of legal history on this seminal case. The second Article entitled "Caremark and ESG, Perfect Together. A Practical Approach to Implementing Integrated, Efficient, and Effective Caremark and EESG Strategy" focuses on how this case can impact the present and future debate on corporate governance for years to come.

In the ABA 2020-2021 Article entitled "Caremark at the Quarter-Century Watershed: Modern Day Compliance Realities Frame Corporate Investors Duty of Good Faith Oversight" (Vol. 76, Issue 1) by N. Veasey and R. Holland, the co-authors point out in the abstract regarding the *Caremark* case that the court held, regarding the Board of Directors duties that:

> The proper exercise of good faith requires that "[a] director's obligation includes a duty to assure that a corporation's information and reporting system . . . exists, and that the failure to do so under some circumstances may . . . render a director liable for losses caused by non-compliance with applicable legal standards. [But] . . . only a sustained or systematic failure of the board to exercise oversight - such as utter failure to attempt to assume a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability.

So how has this "good faith" standard evolved in the past 25 years? The Article goes on to state that its progeny has found directors personally liable when so-called "red flags" have been ignored along the way. So what does an effective oversight and monitoring program look like to avoid "red flags? In *Caremark*, the Plaintiff had argued that the directors had failed their fiduciary duty of care and loyalty to the company by violating the Anti-Referral Payments Law ("ARPL") in the form of a "kickback" to the referring health care providers. Ultimately the case was settled, and Caremark paid $98.5 million to private insurers for past damages. In addition, Caremark agreed to restructure its governance structure by adding board-level compliance and ethics committees (including two non-management directors, and arranging certain times to meet each year. Factually, it was a "failure of the board to act" type liability claim. Legally, the court held that:

> A directors obligation includes a duty to attempt in good faith to assure that a corporation's information and reporting

> system, which the board concluded is adequate, exists, and that the failure to do so under same circumstances may, in theory at least, render a director liable . . . [Only] a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is [emphasis added] necessary to liability. Such a test of liability – lack of good faith . . . is quite high . . . [but] . . . it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.

The authors summarize the *Caremark* case by simply stating that a board of directors must conceive, design, and monitor a compliance system in "good faith." Over the past 25 years, the legal system has tried to sort out what *Caremark* should mean in various fact patterns. Is the duty set forth in *Caremark* a new fiduciary duty (i.e., triad)? Is the duty simply a duty that is a pre-requisite to the duty of loyalty? Does the "good faith" duty replace the duty of care (which can be exculpated)? Does the duty of good faith require proof of intentional bad faith to assert a violation of same? How should a company comply with this new construct? Although the authors cite multiple cases, I will highlight only a few for discussion purposes.

In the case of In re Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006), regarding the termination of Michael Ovitz as its President, the Delaware Supreme Court held that his 130 Million dollar severance package be viewed in light of the "duty to act in good faith" which is qualitatively different from the duty of care. The authors summarize the *Disney* case by listing intentional conduct guidelines that could show bad faith, namely, where a fiduciary,

"(1) intentionally acts with a purpose not consistent with best interest of corporation,

(2) intentionally acts to violate applicable positive law; and

(3) intentionally fails to act in the face of a known duty to act."

So does this line of inquiry solve the duty of care problem, or just shift it to further due diligence by the court?

In various cases that followed, the authors recite a consistent pattern of numerous red flags by the defendant corporation in which the court allows the case to proceed (or when the case was dismissed if not shown), where the corporation had in fact, implemented and monitored compliance systems, but they were grossly inadequate.

In Stone v. Ritter, 911 A.2d 362 (Del. 2006), the Court made it clear "that a failure to act in good faith is not conduct that results . . . in the direct imposition of fiduciary liability." The reason is because the failure to act in good faith is a "subsidiary element" (i.e., a condition) of the fundamental duty of loyalty. So proof of bad faith is a

prerequisite subset of a violation of the duty of loyalty. But how do you prove it? The author argues that courts look for "red flags." The *Stone* case clarified *Caremark* by placing the condition (i.e., not duty) of good faith squarely under the fiduciary duty of loyalty. Because a director can be personally liable, this acts as an incentive for companies to seek and approve directors with the proper expertise. So what are the limitations? The primary limit to the "red flag" liability model has been the business judgment rule. (see below)

In Marchand v. Barnhill, 212 A.3d 805 (Del. Ch. 2019), the court stated that the Plaintiff failed to act in good faith because it ignored several red flags of a serious listeria outbreak in the company plant, and then failed to do anything about it over time. The Court held that there were no protocols for management to deliver reports to directors, no board committee, and no process for board level discussions regarding same. As such, the court held that the combination of all the above factors constitute bad faith, as representing the "mindset of a disloyal director."

Finally, in the case of In re Clovis Oncology, Inc. Derivative Litigation 2019 WC 4850188 (Del. 2019), the court addressed the red flags of a failure to monitor an oversight system, even though the company had in fact implemented a compliance system. So the second condition of the *Caremark* case was cited as dispositive, and the defendant was held liable because the company failed to "monitor" its compliance systems.

So what are some recommendations for directors from this ABA Article? They are as follows:

(1) The Board needs to own the oversight and monitoring of risk and compliance systems of the company (e.g., compliance committee, CCOs as well as GCs, etc.).

(2) "Red flags" are key indicators that a court will look at to determine whether the board of directors took their duties seriously.

(3) Board of directors meetings need to be structured to allow for robust discussion on all compliance systems, not just financial systems as done in the past.

(4) Documentation by the board of directors as to what they did, why, and their follow up, is critical to show compliance with a directors duty of care (e.g., The corporate minute book needs to be updated and accurate.).

Summarizing the above, the authors conclude that "the enduring legacy of *Caremark* is that an independent director violates her fiduciary duties of oversight only if she breaches the duty of loyalty by failing to discharge those oversight responsibilities in good faith." So the obvious follow up question is what would be a good way to implement same?

The second essay was published in May 2020. It was written by Leo Strine, Kirby Smith and Reilly Steel and entitled: "Caremark and ESG, Perfect Together. A Practical Approach to Implementing Integrated, Efficient, and Effective Caremark and EESG

Strategy" [Discussion Paper No. 1037; July 2020, Harvard Law School]. In said essay, the co-authors argue that the key to *Caremark*, and its progeny of cases, is the board's duty to comply with the *Caremark* criteria in good faith to create and monitor compliance systems. How? By "situating EESG (i.e., employee, environmental, social, and governance factors) within the board's existing fiduciary duties," a company can be both efficient and effective. So how could this work?

First, let's identify the nexus between the *Caremark* case and EESG. According to Strine, creating sustainable profits by using EESG constructs is just the next level up, so to speak, of a director's fiduciary duty of care and loyalty. So instead of adding an ESSG to *Caremark* compliance requirements, where directors may push back with the proverbial "enough is enough," the authors state they are not proposing to substantially modify a director's fiduciary duties. Instead, they propose to make the necessary changes procedurally. Their essay proceeds in 3 parts, namely:

<u>First</u>, a company has to act lawfully per their charter, so EESG is simply a principal in the furtherance of the conduct that promotes lawful business by lawful means.

<u>Second</u>, the proposed EESG construct can easily fit into an existing corporate structure at the board of directors' committee level.

<u>Third</u>, the authors offer some practical advice to merge EESG programs into company management systems. If done properly, the author argues, it fulfills the business requirement of being both "effective and efficient."

So how did we get here today? The authors trace the history of the problem from the shareholder primacy ideology over the past 50 years (i.e., from Milton Friedman to "Reagonomics") to the financial inequality and economic insecurity that we have today. Collectively, it has raised the question of the so-called efficiency of "free market" deregulation. The solution, they proffer, is stakeholder centric companies that focus on long-term value, by addressing their whole ecosystem. As we know, the U.S. taxpayers rescued the financial industry in 2008. Such corporate misjudgment, coupled with the lack of build up of corporate reserve accounts (instead many corporations did large stock buy-backs and dividends), could create a financial crunch in future hard times. By treating stakeholders as an "end in themselves," this creates a more sustainable behavior in a broader ecosystem. It also ties into the enlightened self-interest culture of reputational branding, that too often companies have failed in the past decade, in their shareholder primacy quest, to turn a large profit (think Enron). The first principle of corporate law is that corporations may only conduct "lawful business by lawful means." To conduct a business lawfully, the authors quote the *Caremark* case, to reiterate the purpose of good governance, which is ". . . to reach informed judgments concerning both corporate compliance with the law, and good business performance."

In furtherance of case law leaning towards more articulated corporate compliance, corporations have attempted to address same with more ramped up independent audit committees and compensation committees. So the "trend" is such that the more the regulators and the courts clarify compliance standards, the more corporations need to ramp up their board of director committees to deal with same. To solve the differences

between profit hungry, short-term investors, and greater risk management legislation in view of all the scandals, shareholders have stepped up their direct and derivative litigation to reframe companies as a stakeholder-centric, sustainable, long-term association. This tension creates a situation, according to the authors, where EESG can play a major role. To these authors, the "stockholder wealth maximization principle is not just legally erroneous, but [it's also] socially harmful."

So again, the question is, how can a corporation implement same? The good news is that the authors believe there is significant overlap with other corporate compliance systems already in place. They believe that the most important foundational question corporate directors and managers need to ask to be an effective fiduciary is, "how does the corporation make money"? Why? The answer will drive the type of compliance measures needed to address both EESG and *Caremark* compliance requirements. Once they determine that, they need to set up your corporate committees accordingly. In the past, companies have not placed enough value on these committees, but to the authors, they are the *sine qua non* of moving forward effectively and efficiently in the new stakeholder economy. Directors need to "own" their companies compliance systems, and creating core committees to address same is a good start.

So what is perhaps a good snapshot of this more robust compliance structure? Perhaps, as the authors state, "management and the board should be prepared to explain to its <u>stakeholders</u> . . . why it selected the standards it did, and how they will help the company best comply with the law, and be a good corporate citizen." By doing so, it will also help the board of directors identify what expertise it needs to monitor the system for *Caremark* purposes. Simply put, just having an audit committee and compliance committee is not sufficient. Once the committees are set up, the reporting alignment of an "officer–to–board" level system must be carefully structured to optimize same in a "functionally sensible way." Ultimately, cross-checking of management data by each committee creates a synergy for a broader view of how the company operates to make all governance and management function better.

The days of the audit committee being the "kitchen sink" compliance mechanism for corporate risk management and compliance matters may be waning. Corporate governance issues are too complex and too broad to be squeezed into one committee. Besides, as the authors state, "much of the basic task of quality EESG reporting is likely already being done by businesses if they are following the basic precept of conducting lawful business by lawful means. The paper concludes by stating that "the justification by a set of strong committees well populated with relevant expertise . . . sets up the whole board to function much better than loading too much in to the audit committee (the traditional approach). With careful thought, corporate leaders can position their companies to better identify and address known and emerging risks; adopt goals for responsible corporate behavior toward workers, other stakeholders, and society; and establish standards and policies designed to promote and measure the attainment of both EESG goals and legal compliance." Such a positive sum solution is hard to disagree with, especially with such a well-defined roadmap to do so. Real solutions require real structural change to how companies operate in order to be both efficient and effective.

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