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DIRECTOR OVERSIGHT AND MONITORING: THE STANDARD OF CARE AND THE STANDARD OF LIABILITY POST-ENRON

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I. INTRODUCTION

The summer of 2005 saw the third anniversary of the passage of the Sarbanes Oxley Act of 2002 ("Sarbanes-Oxley").[1] Characterized by some as "the most sweeping federal regulation of public corporations since the federal securities laws were enacted some seventy years ago,"[2] Sarbanes-Oxley has both supporters and critics in diverse arenas: the business community, state and federal legislative bodies, the judiciary, academia, and of course, the media and the public-at-large. The discussion about Sarbanes-Oxley usually concerns (1) the extent to which Sarbanes-Oxley federalizes corporate governance structure in the United States, (2) civil and criminal penalties under Sarbanes-Oxley, (3) whether standards-based or rules-based regulation is preferable, (4) what steps corporate officers and directors must take to comply with the mandates of Sarbanes-Oxley, (5) the provisions dealing with attorney ethics and responsibilities and potential conflicts with state rules of attorney conduct, (6) whistle blowing provisions, (7) the cost of compliance with Sarbanes-Oxley, and last but not least (8) the impact of Sarbanes-Oxley on state fiduciary duty law. Those who have concluded that Sarbanes-Oxley has merit still express the concern that the biggest impact of Sarbanes-Oxley would be an increase in the cost of compliance with federal securities laws and listing standards, and that ten years from now the reality might be that Sarbanes-Oxley actually will have had minimal impact on the type of corporate fraud that was the catalyst for the legislation.[3]

Recently, attorneys and executives from the business community have agreed that Sarbanes-Oxley "set the right tone following the scandals at WorldCom Inc. and Enron Corp., both through force of law and the message it sent."[4] However, conclusions about the merits of Sarbanes-Oxley could

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.A.) [hereinafter *Sarbanes-Oxley*].

2. Alfred P. Carlton, Jr., *Lessons from Enron: A Symposium on Corporate Governance*, 54 MERCER L. REV. 731, 732 (2003).

3. J. Brent Wilkins, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 341, 353-54 (2005).

4. Richard Hill, *Accounting Reform Business Panel Tells House Committee Sarbanes-Oxley Effecting Positive Changes*, 36 SEC. REG. & L. REP. (BNA) NO. 30, 1368 (2004) [hereinafter Hill].

require the even more thorough analysis presented in this article, which discusses the standard of director conduct implied by the legislation, raises questions about the long-term impact of the legislation, and suggests answers as well as the possible implications of both "the force of law" and "the message sent" to corporate directors and officers in the context of attempts to oversee corporate business performance, all for the sake of assuring compliance with the laws and restoring investor confidence in public corporations and the financial markets.[5] Also, this article joins the rapidly growing body of information that presents and summarizes various provisions of Sarbanes-Oxley, stock exchange listing standards, and Public Company Accounting Oversight Board ("PCAOB") rules, and discusses the impact of the legislation, standards and rules.[6] It proposes that the rules governing the responsibilities of board committees may establish a new and higher standard of behavior for the operations of boards of directors, and, in turn, for all others responsible for corporate operations. Further, the new rules may have a direct and indirect influence on the test for liability in state court for breach of the directors' duty to monitor and oversee the corporation's business performance and compliance with law.

Prominent scholars and judges have written that in enacting Sarbanes-Oxley, the legislature did not intend to change directors' fiduciary obligations under state law, and that nothing was explicitly written into Sarbanes-Oxley to modify the state court test for liability for wrongful board conduct.[7] That may be factually accurate; nonetheless certain Sarbanes-Oxley provisions appear to set a new standard of board conduct. Further,

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5. *Id.*

6. Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1149-50 (2004)[hereinafter Johnson & Sides]. *See, e.g.*, Jeffrey M. Lipshaw, *Sarbanes-Oxley, Jurisprudence, Game Theory, Insurance and Kant: Toward a Moral theory of Good Governance*, 50 WAYNE L. REV. 1083, 1086-87 (2005); Elizabeth A. Weeks, *Gauging the Cost of Loopholes: Health Care Pricing and Medicare Regulation in the Post-Enron Era*, 40 WAKE FOREST L. REV. 1215, 1218-19 (2005); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1574-75 (2005); Joseph A. Castelluccio III, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429, 453-62 (2005); Lyman P.Q. Johnson, *The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective*, 47 S. TEX. L. REV. 27, 29-30 (2005); Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381, 382-84 (2005). On January 28, 2006, a Westlaw search revealed 1625 citations to articles referencing Sarbanes-Oxley and fiduciaries or audit committee and seventy-five citations with Sarbanes-Oxley and director, fiduciary, or audit committee in the title.

7. *See* Johnson & Sides, *supra* note 6, at 1150-51.

some speculate that the legislation sends a message to state courts to scrutinize more closely directors' conduct for potential breaches of due care.[8]

This article proposes that Sarbanes-Oxley redefines the concept of due care in a manner which mandates the content of reasonable directors' attention to the operation of the corporation. Further, this article proposes that Sarbanes-Oxley implicitly modifies state court standards of review from a lenient standard that gives great deference to directors' business judgment to a stricter standard that allows courts to more closely scrutinize directors' conduct in overseeing and monitoring the corporation. When courts scrutinize directors' behavior more closely than in the past, issues of whether the directors took reasonable steps to properly inform themselves are given less deference to the judgment of the board.[9] Thus this article does not propose that Sarbanes-Oxley represents a *de jure* change in the standard of review, but rather that Sarbanes-Oxley represents a *de facto* shift from a very lenient judicial review of the process the board followed to become properly informed about corporate operations, to more judicial scrutiny into that process.

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8. *See* E. Norman Veasey and Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1419-20 (2005). Fiduciary standards are not explicitly defined in Sarbanes-Oxley.

> [I]t is arguable—but not settled—that board conduct may be measured not only by the evolving expectations of directors in the context of Delaware common law fiduciary duty, but also by other standards. The Sarbanes-Oxley Act, the Rules of the Securities and Exchange Commission (SEC), and the listing requirements of self regulatory organizations (SROs) such as the New York Stock Exchange (NYSE) may become relevant in state courts. Even though there is no express private right of action in the federal legislation or the SRO requirements, when and if these reforms are presented in a Delaware court as governing a board's conduct, adherence to these reforms may be relevant. Thus, adherence to these requirements would be advisable as a best practice, whether or not expressly required as a matter of state fiduciary duty law. Chancellor Chandler and Vice Chancellor Strine have, in fact, written an article suggesting, in part, that state courts, particularly Delaware courts, may be seeing Sarbanes-Oxley and other '2002 Reforms' issues.

Id. at 1419-20. *See also* William B. Chandler III and Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 956, 981-88 (2003).

9. Sean A. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 8 (2005).

Section II of this article briefly discusses the evolution of directors' fiduciary duties. It defines the contours of the specific fiduciary duties implicated by the role of the board as overseers of the corporation, as opposed to policy and decision-makers. Section III describes the standard of conduct and the tests for director liability in the oversight and monitoring context under case law and state statute in more detail. It examines recent trends in the standard of director behavior towards a higher standard of care. Much of the standard derives from *Caremark International Inc. Derivative Litigation* ("*Caremark*").[10] Section IV identifies provisions in Sarbanes-Oxley that implicitly define the standard of director attention to corporate operations. It also examines rules promulgated by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB") under Sarbanes-Oxley. It argues that these rules perhaps unintentionally and quite indirectly establish a new and higher standard of behavior for corporate directors. Section V discusses changes in industry standards and case law following the Enron debacle and the enactment of Sarbanes-Oxley. Section VI compares the test for liability outlined in *Caremark* and the test for liability implied by Sarbanes-Oxley and recent state court decisions.

II. THE STANDARD OF CARE IN THE OVERSIGHT AND MONITORING CONTEXT

The common law that determines trustee behavior provides the framework for the fiduciary duties and responsibilities expected to be fulfilled by members of boards of directors.[11] The standards set for boards of directors, as policymakers and overseers, have evolved over time along with the corporate practices they are to oversee and monitor. State statute proscribes the role of the board and generally establishes the structure of corporate governance.[12] Case law provides guidance as to whether or not the directors have met the standards.[13]

Divergent board responsibilities influence the stated and unstated rules set for the fiduciary duties of a board of directors. The board may function as a corporation overseer, or it may operate as a policy and decision maker.[14] Whatever the case may be, within the past decade significant legislative actions – Sarbanes-Oxley, the SEC regulations, and the PCAOB rules and standards, for examples, have joined the public demands for change.

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10. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
11. *See* Manice v. Powell, 94 N.E. 634, 637 (1911) ("The relation of the directors to the stockholders is essentially that of trustee and *cestui que trust*.").
12. *See* Johnson & Sides, *supra* note 6, at 1192-93.
13. *See id.* at 1193.
14. *See* Principles of Corporate Governance 5 (Nov. 2005), *available at* http://www.businessroundtable.org/taskForces/index.aspx (last visited March 3, 2006).

Directors' Fiduciary Duties Defined Generally

The obligations and the role of the board of directors originate from state statute that defines the governance structure of the corporation.[15] Directors' specific fiduciary obligations stem from their statutory roles and obligations in the corporate governance structure,[16] and are defined in detail by courts in the context of the boards' role in managing or overseeing the management of the corporation.[17] The duty of care and the duty of loyalty have been described as the traditional fiduciary duties owed by directors to the corporation.[18] Courts and legislatures have stated that directors must also

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15. *See, e.g.*, MODEL BUS. CORP. ACT § 8.01(b) (2005). Requirements for and Duties of Board of Directors:

> 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 managed by or under the direction, and subject to the oversight, of its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32 [of the Revised Model Business Corporation Act].

Id. The official comments to section 8.01(b) further explain

> [t]he phrase 'by or under the direction, and subject to the oversight, of,' encompasses the varying functions of boards of directors of different corporations. In some closely held corporations, the board of directors may be involved in the day-to-day business and affairs and it may be reasonable to describe management as being 'by' the board of directors. But in many other corporations, the business and affairs are managed 'under the direction, and subject to the oversight, of' the board of directors, since operational management is delegated to executive officers and other professional managers.

Id. at 8-5 – 8-6.

16. MODEL BUS. CORP. ACT §§ 8.30 (a)-(b) (2005) ("Standards of Conduct for Directors"). Many states have adopted the Model Business Corporation Act, which sets forth a standard of care. *Id.* at xix. The standard itself comes from legally binding, nonlegislative sources, such as case law and NYSE and NASDAQ listing standards, and corporate best practices which are non-binding and aspirational in nature. *See* Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000). The comments to the MBCA state that what is reasonable is to be defined in the state courts on a case by case basis. MODEL BUS. CORP. ACT § 8.30, cmt.

17. Henry R. Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973-75 (1994) [hereinafter Horsey].

18. William F. Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624, 628 (1983). *See also* William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate*

carry out their corporate obligations in good faith, but what remained to be determined is whether or not the duty of good faith is subsumed within the duty of care,[19] or loyalty,[20] or both,[21] or whether or not the duty of good faith is a fiduciary duty separate and distinct from the traditional duties of care and loyalty.[22] However, the tendency today is to allocate to the corporate directors the triad of fiduciary duties—care, loyalty and good faith.[23]

The characteristics of directorship "duties" are determined by the corporate context. Court decisions are determined on a case-by-case review and with consideration of the unique structure of a particular corporation.[24] Case-by-case review has led to the creation of subsidiary duties as courts

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Law, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 315 (Klaus J. Hopt et al. eds., Clarendon Press, Oxford 1998).

19. McCall v. Scott, 250 F.3d 997, 1000 (6th Cir. 2001). The Sixth Circuit Court of Appeals, en banc, described an intentional or reckless breach of the duty of good care as more properly a claim of breach of the duty of good faith, and as such not precluded by Delaware's corporation statute section 102(b)(7).

> Plaintiff's claims of 'reckless or intentional breach of the duty of care' do not fit easily into the terminology of Delaware corporate law . . . . Allegations of intentional or reckless director misconduct are more commonly characterized as either a breach of the duty of loyalty or a breach of the duty of good faith.

Id.

20. Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The issue in this case is not whether Mercury's directors breached their duty of disclosure. It is whether they breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the company."). *See also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475-76 n.41 and 42 (Del. Ch. 2000) (Vice Chancellor Strine opines that the fiduciary duty of good faith is a "subsidiary requirement" that more logically arises from the traditional duty of loyalty, based on language in Barkan v. Amsted Industries, Inc., 567 A.2d 1279, 1286 (Del. 1989), that equates due diligence to the duty of care and good faith to the duty of loyalty.).

21. John F. Olson and Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, 59 BUS. LAW. 421, 438 (2004) (stating that the duties of care and loyalty give rise to the obligation to act in good faith).

22. *Malone*, 722 A.2d at 10 ("[D]irectors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty."). *See also* Emerging Commc'ns, Inc. S'holders Litig., No. 16415, 2004 WL 1305745, at*38 (Del. Ch. June 4, 2004).

23. *Malone*, 722 A.2d at 10 (citing *Cede & Co.*, 634 A.2d at 361). In the much-awaited decision on appeal in Walt Disney Co. Derivative Litig., No. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005), evidence exists that good faith should be treated as a separate and distinct fiduciary duty, at least in Delaware. *See, e.g., Disney*, 2005 WL 2056651 at *31, *35-*37.

24. Horsey, *supra* note 17, at 973.

define the parameters of proper director behavior.[25] For example, the duty of care gives rise to the duty to monitor and to exercise oversight,[26] the duty to remain informed about the corporation,[27] the duty to regularly review financial statements and devote attention to board duties[28] and the duty to inquire into corporate affairs.[29] Further, the duty of loyalty gives rise to the duty not to usurp corporate opportunities,[30] the duty not to engage in improper self-dealing transactions with the corporation,[31] and the duty not to transfer control of corporate assets to a third-party who may loot those assets.[32] And the duties of care and loyalty give rise to the duty to properly disclose material information about the company.[33] These subsidiary duties often overlap.[34] Although directors are always expected to discharge their obligations in accordance with their fiduciary duties and in the best interests of the corporation, the standard of conduct to which directors are to aspire traditionally has been defined by legally binding case law and statute and by non-binding standards of business best practice.[35]

Contours of the Oversight and Monitoring Duties

The terminology used to describe the directors' fiduciary duties, the nature of those fiduciary duties, and the standard of conduct to which directors must aspire depend to a large degree on the type of director conduct at issue. Directors are afforded a presumption that their conduct is actuated by "a bona fide regard for the interests of the corporation whose affairs the stockholders have committed to their charge."[36] When the facts and circum-

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25. Francis v. United Jersey Bank, 432 A.2d 814, 821 (N.J. 1981).
26. *Id.* at 822. *But see* Beam v. Stewart, 833 A.2d 961, 971 n.16 (Del. Ch. 2003) (stating that the duty to monitor stems from the duties of care and loyalty).
27. *Francis*, 432 A.2d at 822. *See* MODEL BUS. CORP. ACT § 8.30(a), cmt. 1.
28. *Francis*, 432 A.2d at 822.
29. *Id.*
30. Northeast Harbor Golf Club v. Harris, 661 A.2d 1146, 1148-49 (Me. 1995).
31. Cookies Food Prod's. Inc. v. Lakes Warehouse, 430 N.W.2d 447, 452 (Iowa 1988).
32. Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387 (N.Y. Ct. App. 1979).
33. Horsey, *supra* note 17, at 973. The duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty and good faith.
34. Lisa M. Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 ST. JOHN'S L. REV. 953, 955 (2002) [hereinafter Fairfax].
35. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).
36. Robinson v. Pittsburgh Oil Refining Corp., 126 A. 46, 48 (Del. Ch. 1924). The presumption has earned the rubric "the business judgment rule." *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). In *Aronson* the court stated:

> [T]he business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section

stances involve directors' attention to the operation of the company, directors are found to have a duty to monitor and oversee the corporation.[37] The duty to monitor and oversee the corporation may arise in two distinct factual situations involving directors' attention to the operation and management of the corporation.[38] The first factual scenario involves board decision-making in a transactional context. Underlying the detailed articulation of the standard of behavior in this context, as in all others, is the normative principle that directors must discharge their responsibilities as reasonably prudent directors would in like circumstances, in good faith, and in the best interests of the corporation. More specifically, directors are expected to employ a reasonable decision-making process, ie., one that was "either deliberately considered in good faith or [that] was otherwise rational,"[39] and to act in the good faith pursuit of corporate, not personal, interests.

The second factual scenario in which the duty to monitor is implicated involves circumstances "in which a loss eventuates not from a decision, but from unconsidered inaction."[40] Here, too, directors are expected to act as reasonably prudent governing or oversight entities who would, in good faith, attempt to advance corporate interests. Since the standard of conduct governing director and officer behavior is defined on a case-by-case basis, the specific details of the standard of board behavior in this context differ from the standard of care articulated in the decision-making context.

III. CASE LAW AND INDUSTRY STANDARDS PRE-SARBANES-OXLEY

While state statutes generally specify that directors are obligated to oversee the affairs of the corporation, they do not specifically address *how* directors are to carry out their oversight function. For example, the MBCA, which is adopted by a majority of states and forms the basis of much of state statutory corporations law, does specify in comment two to section 8.30(b) that "[t]he phrase 'devoting attention,' in the context of the oversight function, refers to concern with the corporation's information and reporting systems and not to proactive inquiry searching out system inadequacies or non-

> 141(a) . . . . It is a presumption 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.

Id.

37. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 961 (Del. Ch. 1996).
38. *Id.* at 967
39. *Id.*
40. *Id.* at 968.

compliance."[41] Comment two further specifies that "the standard of care associated with the oversight function involves gaining assurances from management and advisers that systems believed appropriate have been established coupled with ongoing monitoring of the systems in place, such as those concerned with legal compliance or internal controls—followed up with a proactive response when alerted to the need for inquiry."[42] However, the comments to the MBCA also note that the drafters did not attempt to establish a bright-line rule to define the standard of care.[43] Moreover, the drafters did not attempt to formulate a test to determine whether or not the standard is breached.[44] Instead, the drafters intended for each state's courts to determine both the standard of care and the test for directors' liability.

State courts do provide greater specificity when defining the behaviors expected of corporate directors. Recent state court cases suggest that the duty to monitor the corporation and to exercise appropriate attention requires that directors and officers have access to and use timely information about the corporation's business performance and compliance with legal requirements.[45] The question that arises in response to plaintiff's claims that directors breached their oversight duty by inaction when they knew, or should have known, that action was required is what responsibility do corporate directors have to ensure that the appropriate systems indeed have been established and are providing timely, material information about the corporation's business performance and compliance with legal requirements.

Graham *and* Caremark

In 1963 the Delaware Supreme Court addressed this question in its opinion in *Graham v. Allis-Chalmers Manufacturing Company.*[46] Plaintiffs brought a derivative action against Allis-Chalmers directors for failure to prevent antitrust violations by corporate employees.[47] Allis-Chalmers had entered into consent decrees with the Federal Trade Commission in 1937 to

41. MODEL BUS. CORP. ACT § 8.30(b), cmt. 2 (2005). Twenty-nine states have adopted the MBCA in whole or in part and a significant number of additional states' corporate codes are based on the MBCA. MODEL BUS. CORP. ACT (2005), xix.
42. MODEL BUS. CORP. ACT § 8.30(b), cmt. 2 (2005).
43. *Id.* A third interpretation, subsequently rejected in *Caremark*, is that boards needn't put information and reporting systems in place if information would be communicated to the board despite the absence of such systems. *See* Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 373 (discussing the application of *Caremark* in Abbott Labs. Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2003)).
44. MODEL BUS. CORP. ACT § 8.30(b) (2005), cmt. 2.
45. *Caremark*, 698 A.2d at 970.
46. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963).
47. *Id.* at 127.

avoid the expense of litigating possible antitrust violations.[48] The director defendants were neither directors nor senior officers of Allis-Chalmers in 1937.[49] However, certain of the director defendants learned of the consent decrees as early as 1943.[50] These directors, after conducting a limited investigation, and after consulting with legal counsel, concluded that the company had never been involved in antitrust violations.[51] As late as 1956, the directors believed that no antitrust violations existed at the company.[52]

In 1959, certain Allis-Chalmers employees were subpoenaed before a grand jury regarding possible antitrust violations commencing in 1956.[53] The board became aware of the possible antitrust violations in 1959 and began its own investigations in 1960.[54] The plaintiffs claimed that the directors had actual knowledge or in the alternative, constructive knowledge, of the alleged antitrust violations because Federal Trade Commission consent decrees should have put the directors on notice of those violations as early as 1937, when Allis-Chalmers entered into those consent decrees to avoid litigation.[55] Further, the plaintiffs argued that if the defendants had no actual knowledge of antitrust violations in the company, the 1937 consent decrees put the directors on notice that they should take steps to learn about antitrust violations in the company and prevent future antitrust violations from occurring.[56]

The Delaware Supreme Court's opinion is notable for several reasons. First, the court based its conclusions on the specific facts and circumstances of the case—even though the directors knew of the 1937 consent decrees and thus had notice of possible illegal activity in 1937, such notice was not sufficient notice of future illegal activity in 1956.[57] Second, the court found that if the directors had actual or imputed knowledge that something was amiss, then they may be liable for breach of fiduciary duty.[58] Third, the court found that without notice of possible illegal activity, the directors had no duty to put into place "a system of watchfulness, which would have brought such misconduct to [the board's] attention in ample time

48. *Id.* at 129.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.* at 128.
54. *Id.* at 128-29.
55. *Id.* at 127.
56. *Id.* at 129.
57. *Id.* at 130.
58. *Id.*

to have brought it to an end . . . [and] no duty . . . to . . . ferret out wrongdoing which [the board had] no reason to suspect exists."[59]

There are two conflicting interpretations of *Graham*. One interpretation is that corporate directors have a duty to inquire when put on notice of corporate wrongdoing within their own organizations.[60] Several modern decisions fall in line with this holding, which imposes liability for a breach of the duty to monitor only when the directors had actual or constructive notice of potential wrongdoing within their own organizations.[61] The broader interpretation is that absent red flags within the corporation that might alert the directors to the need for information gathering and reporting systems regarding the corporation's compliance with law, directors needn't put in place such information systems.[62] This second interpretation was rejected in 1996 by the Delaware Chancery Court in *Caremark.*

Caremark was decided on a motion to settle a derivative lawsuit brought against the members of Caremark International Inc.'s board of directors. The plaintiffs claimed that the Caremark directors should have known that certain officers and employees of Caremark were involved in violations of the Anti-Referral Payments Law ("ARPL") that prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. The plaintiffs claimed that the directors breached their fiduciary duty of attention because "the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[63]

Caremark's legal counsel was uncertain about whether Caremark's consulting agreements and research grants to physicians who recommended Caremark products and services to Medicare and other patients violated the ARPL.[64] Nonetheless, Caremark's board instituted various measures to en-

59. *Id.*
60. *Id.*
61. Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 809 (7th Cir. 2003); McCall v. Scott, 239 F.3d 808, 818 (6th Cir. 2001); Baxter Int'l, 654 A .2d 1268, 1270-71 (Del. Ch. 1995); Illinois Valley Acceptance Corp., 531 F. Supp. 737, 741 (C.D. Ill. 1982). *But see* Joy v. North, 692 F.2d 880, 896-897 (2d Cir. 1982), superseded by statute on other grounds; CONN. GEN. STAT. § 33-724; Cheff v. Mathes, 199 A.2d 548, 556 (Del. 1964); and Brane v. Roth, 590 N.E.2d 587, 591-92 (Ind. Ct. App. 1992) (directors became aware of the corporation's losses after the fact but were held liable for failure to monitor).
62. *Graham,* 188 A.2d at 130 ("[A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.").
63. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).
64. *Id.* at 962.

sure that Caremark employees followed ethical and business practices concerning the ARPL and designed to comply with the ARPL.[65] However, government investigations led to allegations that two Caremark officers, an employee of another corporation, and a physician had entered into a consulting agreement under which the physician had performed none of the services, yet was allowed to keep the fees he had received from Caremark, and that the same physician "had been providing patient referrals to Caremark valued at $6.55 for each $1 of research money they received."[66] A second indictment "allege[d] that an Ohio physician had defrauded the Medicare program by requesting and receiving $134,600 in exchange for referrals of patients whose medical costs were in part reimbursed by Medicare in violation of the ARPL."[67] The derivative lawsuits followed, and Caremark entered into settlement agreements with federal and state government entities.[68]

In evaluating whether to approve the proposed settlement agreement in the shareholder derivative lawsuits, the court evaluated whether the settlement agreement was fair and reasonable in light of further steps Caremark agreed to take to ensure compliance with the ARPL and in light of the strength of the shareholders' breach of due care claims against the directors.[69] In evaluating the strength of the due care claims, the Chancery Court narrowly interpreted the *Graham* case "as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."[70] The court went on to say that

> it would, in my opinion, be a mistake to conclude that our Supreme Court's statement in *Graham* concerning "espionage" means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[71]

65. These measures included distributing personnel and policy manuals and training employees. *Id.* at 963.
66. *Id.* at 964 n.6.
67. *Id.*
68. *Id.* at 965.
69. *Id.* at 960, 968, 970.
70. *Id.* at 969.
71. *Id.* at 970.

The court further explained that the level of detail of the system is a question of business judgment; no "rationally designed" system, however detailed, would ensure the integrity of employees or guarantee that a corporation would not violate laws or regulations. Thus, *Caremark* identified a duty for directors to put internal controls in place to reach informed judgments regarding a business's compliance with law and regarding business performance.

Should directors become aware of red flags, generated by the internal controls or otherwise, directors have a duty to heed the red flags and take some action.[72] However, in the absence of red flags known to the board, "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 a necessary condition to liability."[73] Despite the fact that Caremark's incentive systems encouraged kickback payments, the court found "no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function."[74] The court appeared to believe that the directors established reasonable information and reporting systems in good faith, and that the fault lay with the lack of integrity of the indicted employees, and not with Caremark's board. Thus, after *Graham* and *Caremark*, the contours of the directors' duty to exercise appropriate attention include a duty to put in place "reasonable" information and reporting systems, and to inquire when directors become aware of red flags generated by those systems or by other means.[75]

Since the intent of a *Caremark* claim is to redress harm to the corporation, harm allegedly resulting from misconduct by its directors, such a claim may be brought before a court as a derivative lawsuit.[76] Decisions subsequent to the *Caremark* decision have added to the contours of a *Caremark* claim, by refining the test to determine if demand is excused in a *Caremark* derivative action and by discussing the test for liability. A derivative action is properly brought before a court where "the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litiga-

72. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 192 (Del. 1963). *See also Caremark*, 698 A.2d at 970.
73. *Caremark*, 698 A.2d at 971.
74. *Id.*
75. Salsitz v. Nasser, 208 F.R.D. 589, 592 (E.D. Mich. 2002); Citigroup Inc. S'holders Litig., No. 19827, 2003 WL 21384599, at * 2 (Del. Ch. June 5, 2003).
76. Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) (quoting Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)).

tion."[77] The test for whether demand is excused in the context of a derivative *Caremark* claim is stated in *Rales v. Blasband*.[78]

Under the *Rales* test, demand is excused if the plaintiff can show "the existence of a reasonable doubt that as of the time that the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[79] One court stated that facts showing that demand is excused might involve a plaintiff presenting facts leading to an inference that the board knew or might have been aware of red flags and took no action to respond to them.[80] There-

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77. *Id.* at 932.

78. *Id.* (citing Levine v. Smith, 591 A.2d 194, 200 (Del. 1991)). The basic test for whether demand is excused because it would be futile for the plaintiff in the action to make demand on the board is articulated in *Aronson v. Lewis*. *Id.* The *Aronson* test applies only in the decision-making context. *Id.* at 933-34. The test does not apply in the context of a derivative *Caremark* claim because plaintiffs' claims are based on the "absence of board action." *Rales*, 634 A.2d at 933. *See also* Rattner v. Bidzos, No. 19700, 2003 WL 22284323, at *8 (Del. Ch. Oct. 7, 2003), Ash v. McCall, No. 17132, 2000 WL 1370341, at *10 (Del. Ch. Sept. 15, 2000) and McCall v. Scott, 239 F.3d 808, 816 (6th Cir. 2001), *amended by, reh'g denied, rehearing en banc denied*, 250 F.3d 997 (6th Cir. 2001) (holding that the duty of care claims sounded in

> allegations of nonfeasance by the Board (i.e., 'intentional ignorance of,' or 'willful blindness to' the 'red flags' that were signs of potentially fraudulent practices) and challenge[d] the Board's failure to take action or investigate under the circumstances. The claims do not allege a conscious Board decision to refrain from acting).

But see Abbott Labs Derivative S'holders Litig., 325 F. 3d 795, 806 (7th Cir. 2003) (applying the second prong of the *Aronson* test and the board's inaction was indicative of a conscious decision to refrain from acting. Therefore the Rales test was inapplicable).

79. White v. Panic, 793 A.2d 356, 371 (Del. Ch. 2000) (citing Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)). *See also* McCall v. Scott, 250 F.3d 997, 1000 n.1 (6th Cir. 2001), *reh'g denied*, 239 F. 3d 808 (6th Cir. 2001).

80. Ash v. McCall, No. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000), at *15. *See also* Guttman v. Huang, 823 A.2d 492, 507 n.36 (Del. Ch. 2003) (quoting *Ash*:

> Their conclusory complaint is empty of the kind of fact pleading that is critical to a *Caremark* claim, such as contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.)

fore, the plaintiff would argue, the board would be unlikely to pursue a lawsuit to remedy the issues raised by the red flags. In this circumstance, the likelihood of substantial liability for the directors might be high; such a showing would demonstrate that the board could not have properly exercised disinterested business judgment in responding to the demand.[81]

Thus, the same facts that give rise to a colorable *Caremark* claim also may satisfy the *Rales* test for demand excusal. However, such cases are few and far between. For example, in *Saito v. McCall*,[82] the court found that the plaintiff presented—"barely"[83]—a colorable *Caremark* claim based on McKesson HBOC's board's failure to remedy unlawful accounting practices at HBOC of which the board should have known.[84] The court also found that the demand was excused because the audit committee likely was aware of the accounting irregularities, and members of such a committee "acting in good faith, would have openly communicated with each other concerning the accounting problems . . . [previously] disclosed and would have shared the information with the entire McKesson HBOC board."[85] Plaintiffs demonstrated that the entire board should have known about the accounting irregularities and that demand on the board to address these issues would directly call into question the good faith of McKesson HBOC's audit committee. The substantial likelihood of liability that the members of the McKesson HBOC audit committee "faced for a breach of their duty of good faith

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Id.

81. *See* Ratner v. Bidzos, No. 19700, 2003 WL 22284323 at *9 (Del. Ch. Oct. 7, 2003) (quoting Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1995) (citations omitted)). In fact, such a showing might indicate the lack of good faith necessary to overcome a provision in a corporation's charter relieving directors of liability for lack of due care.

82. Saito v. McCall, No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004).

83. *Id.* at *6.

84. *Id.* One may argue that the court mischaracterizes the claim as a *Caremark* claim, because the directors knew or should have known of red flags. However it is unclear whether systems in place, that the board was obliged to ensure functioned properly, failed to function properly to alert the McKesson HBOC board (the systems were unreasonable, raising a *Caremark* claim), or whether the systems functioned properly to alert the board who chose to ignore red flags (a *Graham* issue). The distinction makes little practical difference in substance. In either case, the plaintiff's argument is that the board failed to take action, thus implicating *Caremark*, not *Graham*. At the very least, the board knew or should have known about red flags, whether the systems functioned properly or not. If the systems did not function properly, still the board had enough information to be alert to the need to inquire further.

85. *Id.* at *7 n.71.

disabled the entire McKesson HBOC board from mustering an independent and disinterested majority."[86]

In other cases, the plaintiffs' suits at least survived a motion to dismiss for failure to make demand, although at this stage the court did not reach the merits of the underlying claim that the directors' breached their duty to monitor.[87] These cases may be properly characterized as embodying *Graham* claims, since the breach of duty arose not from a lack of information gathering and reporting systems, and internal controls, but from the failure to take appropriate action in the face of obvious signals of wrongdoing in the corporation.[88] The holdings in these cases "were based on either actual knowledge or conscious disregard of wrongdoing in the corporation, and on the existence of several obvious red flags."[89] Also, in these cases, the direc-

86. *Id.* at *7 n. 71. Six members of the full board were on the audit committee; three of these members served on the audit committees of the premerger companies. *Id.* at *3. Suppose however that the audit committee comprised a small minority of the full board. In that case, the company may have mustered the disinterested vote required. Or, suppose the three members of the audit committee were new to McKesson HBOC. Demand might have been excused, even though the audit committee's actions lacked good faith.

87. Eric Landau, Shawn Harpen, and Kristel A. Massey, *Revisiting Caremark and a Director's Duty to Monitor: The Chancery Court's Wake-up Call to Directors*, 1418 PLI/CORP 37, *50 [hereinafter Landau].

88. *Id.* at *52. Note that the court in *Abbott* takes the opposite view and characterizes the claim as a *Caremark* claim, in that the directors failure to take action in the face of obvious red flags rose to the level of a sustained and systematic failure to exercise oversight. Thus, according to the 7th Circuit Court of Appeals, failure to implement internal controls is just one way to breach the duty of care under *Caremark*. Willful inaction in the face of red flags rises to the level of a "'sustained and systematic failure of the board to exercise oversight.'" Abbott Labs. Derivative S'holders Litig, 325 F.3d 795, 809 (7th Cir. 2003).

89. Landau, *supra* note 87, at *52. *See, e.g.*, McCall v. Scott, 239 F.3d 808, 816 (6th Cir. 2001). The plaintiffs contended that the Board's Audit Committee received information from the company's internal audit staff that indicated the existence of red flags. *Id.* at 820. The Sixth Circuit Court of Appeals agreed with the trial court that there was little likelihood of liability based on failure to assure that reasonable internal controls existed. *Id.* at 820 n.11. In *Benjamin v. Kim*, the director defendant had received notice of several serious red flags from the sole shareholder and co-CEO of the company, such as the company being unable to meet its payroll and that accounts receivables were "trickling in." Benjamin v. Kim, No. 95 Civ. 9597 (LMM), 1999 WL 249706, at *8, (S.D. N.Y. April 28, 1999). The director had failed to inquire or take any other action in response to those red flags. *Id.* Thus "plaintiffs . . . submitted sufficient evidence that Silva was made aware of problems at GMR that should have prompted him to investigate, or that he was so negligent in his efforts to become informed about the affairs of GMR that his actions constituted a total failure to exercise reasonable oversight." *Id.* at *14. In *Abbott Labs*, the plaintiffs did not allege an inadequate reporting system. *Abbott Labs*, 325 F.3d at 795, 802. Instead, the complaint alleged a failure by the directors to take

tors took no action in response to the red flags. However, the courts predicated liability on the test stated in *Caremark*, and found that failure to take action in the face of red flags amounted to "a sustained or systematic failure of the board to exercise oversight."[90]

If it is difficult for plaintiffs to prevail on a claim that the board failed to implement reasonable information gathering systems to provide timely and accurate information to the board,[91] it would be even more difficult to survive a motion to dismiss for failure to make demand, because courts are reluctant to find liability for failure to respond to red flags of which the board should have known if monitoring systems are in place. Many *Caremark* claims have been dismissed at the pleading stage because plaintiffs failed to meet the test in *Rales* and demonstrate that the demand on the board was excused.[92]

On one hand, *Graham* and *Caremark*, along with the line of cases discussed above, indicate that although having an information reporting system in place might weigh against liability,[93] directors cannot ignore red flags generated by internal control systems if those red flags are numerous, serious, directly in front of the directors, and indicative of a corporate-wide problem. On the other hand, courts have been reluctant to hold directors liable for failure to respond to red flags if internal monitoring and control systems are in place, but those systems did not reveal the existence of red flags to the board.[94]

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action in light of the red flags generated by internal controls and external sources. *Id.*

90. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).

91. *Id.* at 967.

92. Landau, *supra* note 87, at *46.

93. *The Caremark Case and Directors' Duty to Establish Compliance Programs*, PLIREF-CORPLEG § 16:4, at *16-10 (citing Dean Starkman, *Compliance Ruling May Shield Directors*, WALL ST. J., Dec. 24, 1996, at B5).

94. *Saito v. McCall* may represent a trend towards holding directors liable even though systems are in place. Saito v. McCall, No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004). *Also see supra* note 82 and accompanying text. The defendant claimed that knowledge of red flags could not be imputed to the full McKesson HBOC board because four of the original six HBOC directors were outside directors not on the HBOC audit committee. *Id.* at *7 n.68. Only one HBOC audit committee member was on the full McKesson HBOC board (this board member was also on the audit committee of the McKesson HBOC board). *Id.* at 3. The court declined to accept that "head in the sand" argument because at least three HBOC audit committee members and HBOC's Chief Executive Officer knew of HBOC's accounting irregularities. *Id.* at *7 n.68. The court drew a reasonable inference (from the court's point of view) that the information was communicated to the HBOC board members who later served on the McKesson HBOC board. *Id.*

One question that arises is whether having information gathering and reporting systems in place that comply with industry standards and practices, relieves a director from the duty to inquire into the type, reliability, accuracy and usefulness of the information gathered and reported by the systems, absent obvious and numerous red flags. While under *Caremark*, liability will stem from not having any "reasonable" information gathering and reporting systems in place,[95] it seems under subsequent cases that only particularly egregious inattention to the output of information gathering and reporting systems, or an utter failure to inquire as to the meaning of the output of those systems, will lead to liability.[96] In other words, the existence of red flags, if they are known to the board, indicates that the systems were reasonably designed and helps protect the board from liability. But under *Caremark*, the fact that red flags exist, unbeknownst to the board, but known to other senior managers within the corporate organization, in and of itself, has little bearing on whether the board met its duty to plan or oversee the design of internal controls that were "reasonably" created to provide timely information to the board.[97]

The board of directors has a duty to inquire not only when red flags are present,[98] but also when approving major corporate transactions and when approving specific corporate documents.[99] However, there is no duty under *Caremark* to inquire into ordinary course of business matters such as the effectiveness of internal controls at an operational level, when reasonable information and reporting systems are in place, and when directors are not put on notice of noncompliance with laws and problems with business per-

95. Pereira v. Cogan, 294 B.R. 449, 530 (Bankr. S.D.N.Y. 2003).
96. *See supra* note 81 and 83 and accompanying text.
97. *See* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1203 (2003). The author of this article strongly criticized the *Caremark* decision's holding that Caremark's internal controls were reasonably designed:

> Chancellor Allen gave a great deal of lip service to Delaware's standards of supervision and the extent to which they were met by Caremark's cosmetic policies in a case in which it was obvious, to the even marginally sophisticated observer, that Caremark's compensation system and management structure were set up in every way possible to create incentives for employees to disregard the Anti-Referral Payment Law and defraud the Medicare program [citation omitted].

Id.
98. *See* Fairfax, *supra* note 34, at 972-73. The Securities and Exchange Commission has also noted a duty to inquire. *Id.* at 972-73.
99. *See id.* at 973-74. Furthermore, there is a Securities Act requirement. *Id.*

formance.[100] An inquiry into the effectiveness of operational internal controls might uncover the red flags that are known to others within the corporation, but that are unknown to the directors. However, directors may have assumed that "in ordinary course business matters . . . they could rely on the recommendations of senior management or a board . . . committee without further diligence."[101] Such an assumption is fully supported by state statute and the *Caremark* decision.

State statutes permit directors to rely on officers or employees of the corporation and on the information, statements and opinions provided by those officers or employees.[102] While directors can rely in good faith on board committees, other corporate managers, and reports to affirm the effectiveness of internal controls, such reliance is not unlimited. For example, directors may not rely blindly.[103] Reliance must be reasonable and in good faith.[104] Hence, blind reliance may be unreasonable and, depending on how egregious the behavior, may amount to a reckless lapse in meeting the standard of care. An egregious lapse in meeting the standard of care even may rise to the level of a breach of the duty of good faith.[105] "In the typical

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100. Lois F. Herzeca and Angelique Mamby, *Evolving Standards for Director Reliance*, THE M&A LAWYER, February 2004, at 18 [hereinafter Herzeca & Mamby].
101. *Id.*
102. MODEL BUS. CORP. ACT § 8.30 (c), (d) and (e), Del. Code. Ann. tit. 8, § 141(e) (2003).
103. Herzeca & Mamby, *supra* note 100, at 18.
104. *Id.*
105. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967-68 (Del. Ch. 1996). *See also* R. FRANKLIN BALOTTI AND JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, § 4.29 at 4-116 to 4-116.1 (3d ed. Supp. 2000). In relation to the standard of care,

> [w]hether the statute would protect a director against reckless acts [in breach of the duty of care] is not altogether clear. To the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith and thus could not be liability exempted under the new statute. On the other hand, to the extent that the conduct alleged to be reckless is predicated solely on allegations of sustained inattention to the duty it is arguable whether such conduct is "grossly negligent," but not conduct amounting to bad faith.

Id. Columbia's board's inaction in *McCall v. Scott* (in the face of anomalies in the audit reports, federal lawsuits and investigations into illegal Medicare and fraudulent billing practices, all of which suggested wide-spread and systematic fraud), amounted to "a substantial likelihood of director liability for intentional or reckless breach of the duty of care," sufficient to survive a motion to dismiss for failure to make presuit demand on the board. McCall v. Scott, 239 F.3d 808, 824 (6th Cir.

Caremark case, '[i]n order to hold the directors liable, [a] plaintiff will have to demonstrate that they were grossly negligent in failing to supervise these subordinates.'"[106] Blind reliance may qualify.

Reliance is not in good faith if there were red flags known to some board members.[107] In several cases, directors followed established procedures that called for reliance on the recommendations of board committees and management. However, reliance was not reasonable; each case held that the board of directors should have inquired into the factual support for the recommendations.[108]

One commentator has suggested that

> even in the absence of warning signs, directors should not accept a management or committee recommendation without inquiry into: (1) the process used to arrive at the recommendation (including whether outside experts were engaged); (2) the factual basis for the recommendation; (3) the analytical framework applied; and (4) the risks of, or counterarguments to, the recommendation.[109]

Under this view, a recommendation regarding the effectiveness of internal controls should be subject to a higher level of scrutiny than seems to be required under current case law, because directors would make inquiry even in the absence of red flags. Failure to do so would be unreasonable and lacking in good faith.

However, the *Caremark* standard is not without strong and supportive policy rationales. One rationale for the more lenient standard is that there are an "'infinite number of useful things that a board of directors might reasonably [do] or look into in a given time period.'"[110] Therefore, "'the

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2001). Such a claim would be dismissed for failure to make presuit demand, or alternatively, failure to state a claim under the corporation's exculpatory provisions, if the directors' reckless conduct amounted to gross negligence but did not amount to a breach of the duty of good faith.

106. Rattner v. Bidzos, No. 19700, 2003 WL 22284323, at *12 (Del. Ch. Oct. 7, 2003) (quoting Seminaris v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995)).

107. Smith v. Van Gorkom, 488 A.2d 858, 875 (Del. 1985); Saito v. McCall, No. 17132-NC, 2004 WL 3029876, at *7 (Del. Ch. Dec. 20, 2004); Pereira v. Cogan, 294 B.R. 449, 536 (S.D.N.Y. 2003).

108. *See* Herzeca & Mamby, *supra* note 100, at 18.

109. *Id.*

110. Stephen A. Radin, *Year 2000 Bank Director Liability Issues: State Law Breach of Fiduciary Duty and Mismanagement Claims*, *in* YEAR 2000 LIABILITY PREVENTION & LITIGATION MANUAL (vol. 1) *at* http://www.weil.com/wgm/Cbyline.nsf/0/bd2a95f10865e4cd85256817000502f79?OpenDocument (quoting Bayless

number that will not [be] done by the most qualified, best-run, and most diligent board in the world will always be far greater than the number that were done.'"[111] A further rationale is that "'a retrospective indictment' of directors for failing to consider a specific issue may be 'hollow, because it can be as easily designed to hurl against the best-performing board as against the worst.'"[112] Nonetheless, a criticism of *Caremark* is instructive. Scholars opine that Caremark's directors knew that Caremark's internal controls created an environment of "don't ask, don't tell," where abuses were likely to occur and such abuses were unlikely to be reported. Thus, directors would never be aware of red flags, although knowing that illegal conduct was likely to exist.[113] "Absent a system that encourages employees to expose inappropriate conduct, [internal controls] will never achieve their full potential to deter wrongdoing."[114]

The Role of Industry Standards

Although corporate best practices are non-binding, they have become increasingly influential in setting norms for corporate conduct.[115] The

Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1485 (1984)).

111. *Id.*

112. *Id.*

113. *See* Fairfax, *supra* note 34, at 969-70.

114. Ronald Berenbeim, *How Effective Are Corporate Codes in Combating Corruption?*, INTERNATIONAL ANTI-CORRUPTION CONFERENCE (IACC) (1999), available *at* http://www.transparency. org/iacc/9th_iacc/papers/day2/ws3/d2ws3_rberenbeim.html (discussing corporate codes and other measures to set company-wide, uniform standards of business conduct, i.e.,"[c]orporate codes are the prevalent company instrument world-wide for establishing uniform business conduct standards").

115. *See id.* Indeed, a particular company's code of best practices may become the de facto standard on a worldwide basis, due in part to the globalization of markets. For example,

> [t]here is little doubt that the global financial, product, and service markets have blurred the distinction between public and private sector rule making. In this new power equation, trans-national businesses (as they now like to be called) have enormous leverage . . . . [T]hey are an ideal network and site for the implementation of global standards. To note just one example of the hard logic of this view, is there any doubt that Wal-Mart's policies on buyer acceptance of vendor gifts is a more widely accepted and easily enforced behavioural (sic) norm than almost any kind of public sector rule making initiative?

Id.

Delaware Chancery Court in *Graham* and *Caremark* provided little guidance on the level of detail of the information systems, other than to say that the level of detail must be reasonable and is left to the business judgment of the directors. Reasonable corporate conduct is defined not only by reference to the conduct of a particular corporate actor, but also by industry standards and practices, such as those stated by the Business Roundtable and the Committee of Sponsoring Organizations of the Treadway Commission. These standards define "reasonableness" by reference to the type, reliability, accuracy and usefulness of the information gathered and reported by the systems. When the Business Roundtable recognized a need for corporations to implement compliance systems, the Chief Justice of the Delaware Supreme Court opined that "the expected role of a director has grown to include the installation of legal compliance systems."[116]

The factors used by the court to determine whether there was a "sustained and systematic failure" of the board to exercise oversight are similar to the factors set forth in the Federal Sentencing Guidelines and used by the United States Department of Justice and the United States Attorney General's office to determine if a corporation should be prosecuted.[117] These guidelines influence corporate best practices that in turn influence how the courts define the standard of director conduct.[118]

IV. STANDARDS OF CARE UNDER SARBANES-OXLEY AND RELATED RULES

Commentators have summarized the provisions in Sarbanes-Oxley in greater and lesser detail.[119] The following, recently authored general overview of Sarbanes-Oxley is concise yet comprehensive:

116. E. Norman Veasey & William E. Manning, *Codified Standard – Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 929-30 (1980).
117. Abbott Laboratories Derivative Shareholders Litig., 325 F.3d 795, 809-10 (7th Cir. 2001); McCall v. Scott, 239 F.3d 808, 814 (6th Cir. 2001). *See* Sentencing Reform Act of 1984, 18 U.S.C.A. §§ 3551-3556; U.S. Sentencing Guidelines Manual § 8C2.5(f) (2001).
118. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969 (Del. Ch. 1996) (discussing the Sentencing Guidelines and how the guidelines would influence a reasonable director and the design of reasonable information systems).
119. Hill, *supra* note 4, at 1368.

> Among other provisions, the legislation toughened penalties for accounting fraud, established a five-person independent board to oversee the accounting industry, prohibited non-audit services to audit clients in most cases, mandated auditor rotation, and established employment restrictions on accountants who go to work for their former audit clients. Further, the law required company officials to certify periodic reports, subject to civil and criminal penal-

> Sarbanes-Oxley includes six main initiatives: creating the Public Company Accounting Oversight Board, a private, non-profit corporation that is overseen by the SEC to "oversee the audit of public companies that are subject to the securities laws"; enhancing the independence of public company auditors; regulating corporate governance and responsibility; enhancing financial disclosure; regulating securities analyst conflicts of interest; and adding several new substantive crimes under the securities laws and enhancing penalties for violations of the securities and other laws. In addition, Sarbanes-Oxley provided for additional funding of the SEC and enhancement of the SEC's regulatory authority; commissioned several studies that required reports back to Congress, and contained an editorial comment on corporate tax returns.[120]

Several provisions in Sarbanes-Oxley, and the SEC and self-regulatory organization ("SRO") rules promulgated thereunder, deal directly with or will influence the scope of directors' fiduciary duties, including audit committee composition[121] and board composition,[122] nominating[123]/corporate governance committee composition and duties, oversight of public accountants by the audit committee of the board of directors[124] and the functions and role of the audit committee with respect to independent audits of the corporation's financial controls and internal controls,[125] and forfeiture of certain

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> ties; made it a crime for issuers to interfere with audits; prohibited corporate loans to company executives; and required enhanced financial disclosures. It also bolstered the budget of the SEC and made it a crime to retaliate against corporate whistleblowers.

Id.

120. Johnson & Sides, *supra* note 6, at 1154.

121. Sarbanes-Oxley § 301 (codified at 15 U.S.C.A. § 78j-1 (West Supp. 2002)) (amending the Securities Exchange Act of 1934, § 10A(m)(3)). This provision specifies that an issuer's audit committee is required to oversee the public accounting firms employed to prepare the issuer's audit reports.

122. New York Stock Exchange, Inc., Listed Company Manual § 303A(1)-(2) (2003), http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html (last visited March 3, 2006) [hereinafter NYSE Manual]. The requirement that a majority of the board be independent, and the list of factors that the NYSE will use to determine if a director is independent, are entirely new requirements. *See* Johnson & Sides, *supra* note 6, at 1159 n.48.

123. *See* NYSE Manual, *supra* note 122, at § 303A(4).

124. Sarbanes-Oxley § 301(m)(3)(A) (codified at 15 U.S.C.A § 78j-1 (West Supp. 2002)).

125. *See infra* notes 168-174 and accompanying text.

bonuses and profits on restatements.[126] Other provisions deal directly with or will influence the scope of officers' fiduciary duties, such as the officer certification provision[127] and the provision requiring a code of ethics for senior financial officers[128] and senior executive officers.[129] This article will focus on the provisions that are likely to have a direct impact or to have the most influence on directors' oversight and monitoring of the corporation, including the provisions relating to management's assessment of internal controls.

The consensus is that Sarbanes-Oxley is indicative of at least a trend towards a higher standard of care.[130] It may even be that it sets an entirely new standard or raises the bar, so to speak, for corporate directors in the exercise of their oversight function. Some of the impact is direct as in section 301, which requires that corporations' internal controls include a formal mechanism for channeling complaints and other reports of wrongdoing in connection with "all questionable practices," including questionable financial and accounting practices, to the board's audit committee.[131] Moreover, rules adopted by the SEC under section 406 require that boards adopt a code of ethical conduct. One may argue that a self-defined code of conduct should be adopted as the legal standard of conduct for that particular board because a court may look to the corporation's conduct for a model of business practice.

Other sections may have an indirect impact on the standard of care, particularly sections 301 and its directive to the SEC that delegated rulemaking authority under Rule 10A-3 to the NYSE and NASD with respect to audit committee charters, 404[132] and 302(a),[133] each of which deals directly with director and officer oversight of internal controls.

Furthermore, rules promulgated by the SEC and listing standards and sanctions promulgated by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") deal directly with the monitoring and oversight function of the board.[134] Finally, rules promul-

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126. Sarbanes-Oxley § 302(a)(4) (codified at 15 U.S.C.A § 7243 (West Supp. 2002)).
127. *Id.* § 302(a) (codified at 15 U.S.C.A. § 7241).
128. *Id.* § 406 (codified at 15 U.S.C.A. § 7264).
129. *Id.* § 407 (codified at 15 U.S.C.A. § 7265).
130. *See* Johnson & Sides, *supra* note 6, at 1178.
131. Sarbanes-Oxley § 301 (codified at 15 U.S.C.A. § 78j-1(h)(4)); Standards Relating to Listed Company Audit Committees, Release No. 33-8820, § II(C) (Apr. 9, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm (last visited Mar. 17, 2006)[hereinafter Audit Committee Release].
132. Sarbanes-Oxley § 404 (codified at 15 U.S.C.A. § 7262 (West Supp. 2002)).
133. *Id.* § 302(a) (codified at 15 U.S.C.A. § 7241).
134. *See, e.g.*, *supra* notes 122-130 and accompanying text.

gated by the Public Company Accounting Oversight Board ("PCAOB"), approved by the SEC and tarteting public accounting firms may impact directors' standard of care.[135]

Section 301 and Internal Complaint Systems

The Securities Exchange Act of 1934, section 10A(m)(4), as added by Sarbanes-Oxley Section 301, as codified at 15 U.S.C. section 78j-1, and Securities Exchange Act Rule 10A-b(3) requires that the audit committee of the board of directors "shall establish procedures for—(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."[136] One goal of the provision is "to alert the audit committee to potential problems before they have serious consequences."[137]

This provision appears to impact directors' standard of care in at least two ways. First, the provision gives explicit guidance that internal controls must include a mechanism for employees to provide feedback on not only the inputs and outputs of the system, but on the effectiveness of the system itself. Whereas the "level of detail" of such a feedback procedure would be within the business judgment of the board, the fact that such a procedure must exist is no longer within the board's discretion. Second, to the extent that complaints are made known to the audit committee through an information gathering and reporting system, the provision appears to require that the board itself must investigate the complaints. Such a requirement is not new; as discussed in the previous section, directors must investigate known "red flags." However, no longer would such investigation come from the bottom-up, through ranks of management that "may not have the appropriate incentives to self-report all questionable practices,"[138] instead the investigation would come from the top-down.[139] In its investigation, directors may still rely on management. However, the fact that a top down investigation is required suggests that directors may face a more stringent duty to make inquiries to ensure that reliance is reasonable. For example, one such inquiry might be to investigate why the issue was not brought to the board's

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135. *See infra* notes 168-176 and accompanying text.
136. Sarbanes-Oxley § 301 (codified at 15 U.S.C.A. 78j-1(m)(4) (West Supp. 2002)).
137. Audit Committee Release, *supra* note 131, at § II(C).
138. *Id. See also* Johnson & Sides, *supra* note 6, at n.38.
139. Johnson & Sides, *supra* note 6, at n.38.

attention through management itself, which would lead to assessment of a substantive aspect of the internal controls.[140]

Furthermore, this rule contradicts and probably overrides the rule in *Graham* because (1) it is federal law occupying the field, and (2) it requires that companies put in place internal controls specifically designed to assess the company's compliance with laws, rules and regulations.[141] One goal of such a system would be to ferret out information regarding illegal activity.[142] A reasonable director would put such a system in place, so as to comply with federal law and to limit exposing the corporation to liability under Sarbanes-Oxley.

Section 301 and Committee Charters

Section 301 of Sarbanes-Oxley also requires that the SEC direct the "national securities exchanges and the national securities associations . . . [to] propose[] rules or rule amendments complying with the requirements of Exchange Act Rule 10A-3."[143] In complying with the SEC rule, both the NYSE and the NASD adopted rules requiring that each public company adopt a written audit committee charter.[144] The NYSE and the NASD rules are similar. NYSE rules require that the audit committee's written charter addresses the committee's obligations, which include, at a minimum and in addition to oversight of the independent auditors and the internal audit function, "assisting board oversight of the integrity of the company's financial statements and the company's compliance with legal and regulatory requirements."[145] Furthermore, the audit committee must meet regularly with the full board of directors to discuss "any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and in-

140. If management didn't make the red flag known when it should have done so, and fraud or bad faith is not an issue, then what procedure or control should be in place to ensure that management doesn't fail to bring the matter to the board's attention?

141. Fairfax, *supra* note 34, at 968-69.

142. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963); Fairfax, *supra* note 34, at 969.

143. Audit Committee Release, *supra* note 131, at "DATES."

144. NYSE Manual, *supra* 123, at §303A(7)(c); The NASDAQ Stock Market, Inc. Corporate Governance Rules 4200, 4200A, 4350, 4350A and 4360 and Associated Interpretive Material, *available at* http://www.nasdaq.com/about/corporate-governance.pdf (last visited Mar. 17, 2006), 11, 12 and 14. Both require that audit committees have a charter that at a minimum addresses "the duties and responsibilities . . . set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act."

145. NYSE Manual, *supra* note 123, at § 303A(7)(c)(i)-(ii).

dependence of the company's independent auditors, or the performance of the internal audit function."[146]

Thus, at a minimum the audit committee's self-defined standard of conduct must include ensuring that mechanisms exist to receive complaints relating to accounting, internal accounting controls or auditing matters.[147] Moreover, it is the audit committee's responsibility to ensure that such information about "red flags" is communicated to the full board of directors. Whereas the requirement that the board be made aware of red flags was announced in *Caremark*, the assignment of responsibility for the task was only recently enunciated in the SRO listing rules promulgated under Sarbanes-Oxley.

The NYSE also requires that a board's nominating/corporate governance committee have a written charter that addresses "the committee's purpose and responsibilities—which, at minimum, must be to . . . oversee the evaluation of the board and management . . . ."[148] Thus, the nominating/corporate governance committee's self-defined standard of conduct would include oversight of management and of the board of directors. While the audit committee, and for the NYSE-listed companies, the nominating/governance committee, have specific (self-created) governance responsibilities, the board as a whole is not relieved of its monitoring and oversight duties.[149] Instead, Sarbanes-Oxley mandates that boards self-evaluate and communicate directly with those within the organization who

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146. *Id.* at § 303A(7)(c)(iii)(H).

147. E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 448 (Spring 2003) (determining that in certain areas, the listing requirements have supplanted state common law). Chief Justice Veasey cites to Edward D. Herlihy et al., *A Practical Guide for Directors in Responding to the Current Business Climate*, in the New Disclosure and Corporate Governance Regime, at 865 (PLI Corp. Law and Practice Courts, Handbook Series No. BO-OIVY, 2002).

> Especially in the current environment, audit committees will be expected to exercise a level of heightened care in monitoring the integrity of the financial statements of the company, the independent auditor's qualifications and independence, the performance of both the company's internal audit function and its independent auditors and the compliance by the company with legal and regulatory requirements.

Id.

148. NYSE Manual, *supra* note 123, at § 303A(4)(b)(i).

149. *See* NYSE Manual, *supra* note 123, at § 303A(7)(c)(i)(A) and Johnson & Sides, *supra* note 6, at 1217-18. *See also* Sarbanes-Oxley §§ 301 and 205 (codified at 15 U.S.C.A. §§ 78j-1 and 78c(a) (defining responsibilities of the board of directors)).

know of red flags but might be otherwise unwilling to come forward. This standard of conduct approaches the standard suggested by some commentators,[150] and is higher than the standard set forth in *Graham* and *Caremark*.

Section 302(a) and Officer Certification

Sarbanes-Oxley section 302(a) requires that the SEC promulgate rules requiring the chief executive officer (CEO) and the chief financial officer (CFO), or persons performing similar functions, to certify, based on the officers' knowledge, that the financial statements and other financial information in the annual and quarterly reports "fairly present[s] in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report."[151] The materiality standard "mirrors the existing statutory disclosure standards for 'material' accuracy and completeness of information contained in reports."[152] It is the SEC's belief that Congress intended the certification

> to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.[153]
>
> [A] 'fair presentation' . . . encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations, and cash flows.[154]

In addition, the CEO and CFO must certify that they

> (A) are responsible for establishing and maintaining internal controls;

150. *See supra* note 149 and accompanying text.
151. 15 U.S.C.A. § 7241 (West Supp. 2002).
152. Certification of Disclosure in Companies' Quarterly and Annual Reports, 17 C.F.R. §§ 228, 229, 232, 240, 249, 270 and 274 (2002), *available at* http://www.sec.gov /rules/final/33-8124.htm (last visited Mar. 17, 2006), § II(B)(3) [hereinafter Disclosure Release].
153. *Id.*
154. *Id.*

> (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
>
> (C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
>
> (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.[155]

In adopting rules under Sarbanes-Oxley §302(a), the SEC distinguished between "internal financial controls and procedures" and "internal disclosure controls and procedures."[156] The term "disclosure controls and procedures" is meant to embody "controls and procedures addressing the quality and timeliness of disclosure."[157] Such controls and procedures include "controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported . . . ."[158] Such reports include material information about the issuer's business,[159] financial information about business segments and material risk factors,[160] information about executive compensation,[161] as well as financial statements.[162] Thus "disclosure controls and procedures" broadly include not only financial controls and procedures, but internal controls designed to provide the board information needed to effectively carry out its monitoring and oversight function.

The distinction is designed to effectuate "Congress' intent to have senior officers certify that required material non-financial information, as well as financial information, is included in an issuer's quarterly and annual reports." [163] Furthermore, it will be difficult for senior officers to argue that material information was not made known to them, absent fraud, once such officers have certified that the information systems and operational proce-

155. 15 U.S.C.A. § 7241(a)(4) (West Supp. 2002).
156. Disclosure Release, *supra* note 152, at § II(A).
157. *Id.* at § II(B)(3).
158. *Id.* at § II(A).
159. 17 C.F.R. § 229.101(a)(1) (2002).
160. *Id.* § 229.101(c) (2002).
161. *Id.* § 229.402 (2002).
162. *Id.* §§ 210.3-01 (2005) and 17 C.F.R. § 229.302 (2002).
163. Disclosure Release, *supra* note 152, at § II(B)(3).

dures are sufficient to disclose material financial and nonfinancial information to senior management.[164]

Moreover, the signing officers must certify that they have disclosed to the audit committee "all significant deficiencies in the design or operation of internal controls . . . [and] any fraud that involves management or other employees who have a significant role in the issuer's internal controls . . ."[165] and that the signing officers have disclosed any significant changes in internal controls, including those changes made to correct significant deficiencies and material weaknesses.[166] Here, the term "internal controls" relates to internal controls regarding financial reporting.[167]

Under existing state law, the board may have delegated the task of oversight and monitoring of internal controls entirely to the CEO and CFO, who likely would have delegated further down the chain of command. The rule effects a change in existing state law because it requires that the CEO and the CFO report directly to the audit committee of the board on effectiveness of internal financial and disclosure controls,[168] an issue that formerly was within the board's power to delegate entirely to the CEO and CFO, absent red flags.

Section 404 and Management Report on Internal Controls

Section 404 requires that the SEC promulgate rules requiring that each annual report required by the Securities Exchange Act contain

> an internal control report which shall (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.[169]

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164. *Id.*
165. 15 U.S.C.A. § 7241(a)(5) (West Supp. 2002).
166. *Id.* § 7241(a)(6).
167. *See* Disclosure Release, *supra* note 152, at § II(A). *See also* Securities Exchange Act of 1934 § 13(b)(2) (codified at 15 U.S.C.A. § 78m(b)(2) (West Supp. 2002)), Securities Exchange Act Rules 13b2-1 and 12b2-2 (codified at 17 C.F.R §§ 240.13b2-1 (West Supp. 2002) and 240.12b2-2 (West Supp. 2002)), promulgated under § 13(b)(2), for rules related to internal financial controls.
168. Stephen Bainbridge, *The Creeping Federalization of Corporate Law*, REG. 26, 29 (Spring 2003).
169. 15 U.S.C.A. § 7262(a)-(b) (West Supp. 2002).

Furthermore, section 404 requires that the issuer's auditor "attest to, and report on, the assessment made by the management of the issuer."[170]

The rules promulgated under Sarbanes-Oxley section 404 by the SEC define the term "internal controls" for purposes of its rules under section 404 to mean "internal controls over financial reporting."[171] Internal control over financial reporting is defined as a process

> to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements . . . and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect of the financial statements.[172]

This process is "effected by the registrant's board of directors."[173] The CEO and CFO, or persons performing similar functions, are responsible for "designing, establishing, maintaining, reviewing and evaluating the issuer's disclosure controls and procedures."[174] The issuer must also report whether

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170. *Id.*
171. Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 17 C.F.R. §§ 210, 228, 229, 240, 249, 270 and 274, *available at* http://www.sec.gov/rules/final/33-8238.htm (last visited Mar. 17, 2006), § II(A)(3) [hereinafter 33-8238 Release].
172. *Id.*
173. *Id.*
174. *Id.* Under Sarbanes-Oxley § 302's certification requirement, the CEO and CFO are responsible for the establishment, design and maintenance of the corporation's internal financial controls. Moreover, the Section 404 Release defines the term 'disclosure controls and procedures:'

there were "significant changes in . . . internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses."[175]

One commentator noted that the requirement that management analyze the sufficiency of its internal controls may implicitly create a duty for the CEO and CFO "to go beyond [their internal monitoring procedures] and obtain some independent verification of the structure's validity."[176] Section 404(b) explicitly requires independent verification of the effectiveness of

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> (e) For purposes of this section, the term disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C.A. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Exchange Act Rule 13a-15(e), 17 C.F.R. 240.13a-15(e) (2005). *See also* Johnson and Sides, *supra* note 6, at 1183-84 (noting that "[a]n important contribution of the new rules was to define the term 'internal control over financial reporting' for purposes of Section 404 compliance . . . . The [33-8238] Release spends a good deal of time on this definition, as it has been the subject of much writing in the accounting literature over the years." [footnote omitted]).

175. 33-8238 Release, *supra* note 171, at § II(F)(1). The release provides additional guidance regarding disclosures related to internal controls:

> [t]he terms 'material weakness' and 'significant deficiency' both represent deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a 'material weakness' constituting a greater deficiency than a 'significant deficiency'. Because of this relationship, it is our judgment that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.

Id. at § II(B)(3)(c) n.73. *See also* Regulation S-K Item 307.

176. Fairfax, *supra* note 34, at 976.

internal financial controls. The Public Company Accounting Board (PCAOB) was charged with promulgating standards for attestation engagements that are the subject of Section 404(b). The standards deal with auditors' review of internal controls for financial reporting, and specifically not with controls dealing with general compliance with laws other than those dealing with the preparation of financial statements.[177] However, effectively functioning internal disclosure controls and procedures are necessary to have effectively functioning internal financial controls. In other words, procedures designed to identify business risk factors should be able to identify if a weakness in internal financial controls may be a material weakness. That weakness in financial controls should be addressed in order to have an effectively functioning internal control system. Again the CEO and CFO must report directly to the board that has overall responsibility for resolving the issues.

Codes of Ethical Conduct

Section 406 requires that the SEC promulgate rules requiring that each annual report required by the Securities Exchange Act disclose whether the issuer has adopted a code of ethical conduct for senior financial officers, and if not, why not.[178] In addition, the issuer must disclose in its Form 8-K

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177. The issue of whether the auditors would attest to controls involving areas not dealing with financial reporting was raised by comment letters and addressed by the SEC in its release:

> [i]n addition, many commenters [sic] indicated that even the more limited definition related to financial reporting that we proposed will impose substantial reporting and cost burdens on companies. Finally, independent accountants traditionally have not been responsible for reviewing and testing, or attesting to an assessment by management of, internal controls that are outside the boundary of financial reporting.

33-8238 Release, *supra* note 171, at § II(A)(2). The SEC adopted the view that attestation engagements primarily would focus on controls involving areas dealing with financial reporting, stating:

> Our definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements.

33-8238 Release, *supra* note 171, at § II(A)(3).

178. Sarbanes-Oxley § 406 (codified at 15 U.S.C.A. § 7264 (West Supp. 2002)).

report of material changes with respect to the issuer, when there is any change in or waiver of the ethics code.[179] The code must contain standards to promote the ethical handling of conflicts of interest, "full, fair, accurate, timely and understandable disclosure" in the issuer's periodic reports, and "compliance with applicable governmental rules and regulations."[180]

The rules prescribed by the SEC are broader than the statutory requirements.[181] For example, the rules mandate that the company disclose whether the issuer has adopted an ethics code for its CEO that require "[f]ull, fair, accurate, timely and understandable disclosure" in reports and documents filed with or submitted to the SEC and in other public communications, and that requires a mechanism to report code violations that specifies who is accountable to ensure code compliance.[182]

Rules adopted by the NYSE and NASD are even more extensive than those prescribed under Sarbanes-Oxley and adopted by the SEC.[183] Under the SRO rules, issuers must adopt and disclose a code of conduct for directors, officers and employees, including such standards as comply with the code of ethical conduct standards defined in Sarbanes-Oxley.[184] NASDAQ's guidance on its rule requiring a code of ethical conduct states that the purpose of the rule is "to demonstrate to investors that the board and management of NASDAQ issuers have carefully considered the requirement of ethical dealing and have put in place a system to ensure that they become aware of and take prompt action against any questionable behavior."[185] Thus at the very least a board must adopt a code of ethical conduct, after carefully considering the code including its standard of conduct, or risk delisting.[186]

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179. 15 U.S.C. § 7264(a)-(b) (2005).
180. 15 U.S.C. § 7264(c) (2005).
181. Johnson & Sides, *supra* note 6, at 1155. *See also* Disclosures Required by §§ 406, 407 of the Sarbanes-Oxley Act of 2002, § II(B)(2)(a), *available at* http://www.sec.gov/ rules/final/33-8177.htm (last visited May 11, 2006).
182. *Id.* at § II(B)(2)(c).
183. New York Stock Exchange, Final NYSE Corporate Governance Rules, § 303A(10) (2003), *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf (last visited Mar. 17, 2006). A proposed rule change (SR-NASD-2002-139) would amend NASD Rule 4350(n) to require listed companies to adopt a code of conduct for all directors, officers, and employees. *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. to Amend NASD Rule 4350 to Require Listed Companies to Adopt a Code of Conduct for All Directors, Officers, and Employees, Release No. 34-48125, 68 Fed. Reg. 41, 194 (July 10, 2003) [hereinafter 34-48125 Release].
184. *Id.* Johnson & Sides, *supra* note 6, at 1188-89.
185. 34-48125 Release, *supra* note 183, at 41, 194.
186. Craig Ehrlich, *Is Business Ethics Necessary*, 4 DEPAUL BUS. & COM. L.J. 55, 59 n.20 (2005) ("Companies traded on the NYSE must adopt a code of business

V. CASE LAW AND INDUSTRY STANDARDS POST SARBANES-OXLEY

Change in Industry Standards Post Sarbanes-Oxley

Numerous changes in industry and board conduct have followed the passage of Sarbanes-Oxley. Corporations increasingly have adopted codes of ethics for employees, officers and directors.[187] Similarly, corporations are undertaking review of internal controls to ensure that they provide quality information to management.[188] They are also seeking advice on how Sarbanes-Oxley may affect transactional matters, such as mergers and acquisitions. These steps may be seen as going beyond the statutory and regulatory requirements. As mentioned above, since standards of conduct evolve in part based on evolving industry standards, these steps may be seen as defining the standard of conduct across industries.

Cases Post Sarbanes-Oxley

Recent literature suggests that private plaintiff lawsuits alleging violations of the provisions of Sarbanes-Oxley will be brought in state courts and decided based on state law articulations of the standard of care.[189] Although no state court cases have addressed specific allegations of a breach of due care in oversight and monitoring as articulated in Sarbanes-Oxley or related rules and regulations,[190] or that a violation of the express provisions of Sarbanes-Oxley amounts to a breach of due care,[191] many believe it is simply a matter of time. Therefore, it is instructive to review recent due care

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conduct addressing conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection of company assets, compliance with law and the reporting of illegal or unethical behavior."). Such a code may be used as a shield (by directors) or as a sword (by plaintiffs).

187. Ethics Resource Center, *National Business Ethics Survey* 3 (Oct. 12, 2005), *available at* http://www.ethics.org/nbes/nbes2005/2005summary.pdf (last visited Mar. 17, 2006).

188. *See* Dwayne Jorgensen, "Sarbanes-Oxley Section 404: The Tip of the Compliance Iceberg", 1-3 (2004), *available at* http://www.sec.gov/news/press/4-497/dejorgensen5378.pdf (last visited May 8, 2006) (noting that some corporations are undertaking a broad, strategic review while others are focused on narrow compliance with Sarbanes-Oxley section 404).

189. *See* Veasey, *supra* note 147, at 448.

190. HealthSouth Corp. S'holder's Litig., 845 A.2d 1096 (Del. Ch. 2003) (finding that defendant Scrushy was not remiss in his oversight duty, and that the accounting fraud happened in spite of his best efforts to enforce proper accounting standards). Also, Scrushy was recently acquitted in a federal, criminal action. U.S. v. Scrushy, No. CR-03-BE-0530-S, 2003 WL 23698952 (N.D.Ala. 2003). The SEC civil enforcement action against Scrushy is ongoing.

191. *HealthSouth* 845 A.2d at 1105-10 (ruling rescinding CEO's payment of corporate loan with overpriced stock and the plaintiffs alleged unjust enrichment, not breach of fiduciary duty).

cases to discern trends that may be influenced by or at least consistent with standards of conduct enunciated in Sarbanes-Oxley and the related rules.

Two recent decisions focused on the directors' duty to make inquiry in the context of CEO compensation, which is often considered to be an ordinary course of business matter subject to the discretion of the board.[192] Both were decided before the approval of the final NASD rules concerning independent director oversight of officer compensation decisions, but both are instructive in their focus on action that prior to Sarbanes-Oxley might have been an ordinary business decision delegated to senior officers, but now might be viewed as board action requiring greater care on the part of the board. It is arguable that the discussion surrounding the adoption of the rules influenced each court's decision-making.[193]

In *Pereira v. Cogan*, the Southern District Court of New York, applying Delaware law in a proceeding brought by a Chapter 7 trustee against the corporate debtor's former directors and senior officers, held that the board breached its duty of care in approving the former CEO's compensation package and breached their duty of loyalty in failing to establish procedures to monitor loans to the CEO and others. The board of directors was found not to have reasonably relied on a conclusory report of the compensation committee with respect to setting the salary of the CEO. In this case the Board ratified the CEO's compensation on the recommendation of the compensation committee. The court found that the Board ratified the CEO's compensation without knowing what the compensation was or how that compensation level compared to similarly situated executives.[194] Similarly the compensation committee had never met, did not seek the advice of outside consultants, and presented little more than an "*ipse dixit*" to the board.[195] Citing to *Caremark* and *Graham*, the court held that the directors' grave inattention to the CEO's loans and failure to do anything except renew

192. *See* Herzeca & Mamby, *supra* note 100. *See also* Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997).
193. *See* Veasey, *supra* note 147, at 448.

> [O]ne can see that Sarbanes-Oxley and the proposed NYSE/NASDAQ listing requirements have supplanted state internal affairs common law in some areas, such as mandating the specific composition and duties of the audit committee and the auditors. [citations omitted]. But in other areas, they may have enhanced the expectations of minimal director conduct. One example is in the prescription for the duties of the independent nominating/corporate governance committee of the board.

Id.
194. Pereira v. Cogan, 294 B.R. 449, 528-29 (S.D.N.Y. 2003).
195. *Id.* at 529.

the compensation contract was a breach of their duties of care and of loyalty.[196]

Similarly, in the *Walt Disney Company Derivative Litigation*,[197] plaintiffs alleged that the directors breached their fiduciary duty of care by approving the compensation arrangement that Disney's CEO made with Disney's former president without review and with only minimal discussion of the employment agreement by the compensation committee and the full board. In addition, the agreement was not reviewed by outside consultants.

The court held that the plaintiffs' complaint was sufficiently well-pleaded to withstand a motion to dismiss for failure to make demand on the board and a motion to dismiss for failure to state a claim on which relief can be granted. In doing so, the court stated that the facts

> if true, [did] more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of *material importance* to their corporation [emphasis added.] Instead, the facts alleged . . . suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision.[198]

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196. *Id.* at 532. The Delaware Chancery Court suggests that directors who fail to act may violate their duty of loyalty. *Id.* In such a case, a court may apply a strict standard of review:

> In light of the discussion above, however, the Defendants also may be held to the higher entire fairness standard if their inaction was a result of a breach of any of the fiduciary duties discussed above. Otherwise, a Board could avoid the higher judicial scrutiny of the entire fairness standard merely by ignoring or not addressing any potentially harmful transactions. Such is not good corporate governance and should not be encouraged by the law. Thus, the actions in which the Board took no action will be individually discussed.

Id.

The business judgment rule protects lawful action, not unlawful action. The defendants' inattentiveness was a breach of their fiduciary duty, therefore the business judgment rule did not apply.

197. The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

198. *Id.* at 289.

The court held that the complaint sufficiently alleged "a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests . . ." and denied the directors' motion to dismiss.[199]

At trial, the Delaware Chancery Court held that the Disney directors did not breach their duties of care and good faith. The decision is instructive because in the past, courts seldom questioned—let alone considered overturning—a compensation decision.[200] In *Disney*, as in *Periera*, the board followed established procedures, relying on the compensation committee which delegated decision making regarding compensation to senior officers. This conduct was quite ordinary and matter of course for compensation decisions. While it is true that *Periera* also involved conflicts of interest and loyalty issues, and in *Disney* the senior executive's level of compensation was quite large in comparison to what it appeared he brought to the table, the fact that the cases proceeded suggests a willingness for courts to hold directors to a higher standard of conduct.

Recent literature casts the denial of the Disney directors' motion to dismiss in a negative light.[201] One commentator suggested that the directors were simply making a business decision, that they believed they had adequate information to rely on the CEO for finalizing the terms of the president's employment agreement, and that they believed their reliance was reasonable.[202] The facts alleged support an inference that the directors were negligent or even grossly negligent—perhaps their actions were "stupid," "foolish," "egregious" or "irrational"—equally as well as the facts support an inference of knowing disregard of their responsibilities.[203] Alternatively, if the facts raise a duty to monitor and oversee issue, there were no allegations that there was a "sustained and systematic failure [of the board] to exercise oversight."[204]

Most agree that the *Disney* opinion shows "a shift in judicial attitude in the wake of the corporate scandals of recent years."[205] The court faulted the directors for not "insisting on having all reasonably available relevant

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199. *Id.*
200. *See* MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 648-650 (9th ed., 2005).
201. *See* Harold G. Levison, *Ruling Threatens Retrenchment of Business Judgment Rule: New Jersey Courts Must Be Prepared to Reject the Delaware Chancery Court's Ill-Advised Application of Aronson*, 174 N.J.L.J. 100 (2003)[hereinafter Levison].
202. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), *superceded by statute,* Delaware General Corporation Law § 102(b)(7).
203. Levison, *supra* note 201.
204. Caremark Intern. Inc. Derivative Litig., 698 A.2d. 959, 971 (Del. Ch. 1996).
205. Bart Schwartz, *Directors' Actions Come Under Intensified Scrutiny*, N.Y.L.J. July 24, 2000, col. 1.

information . . . asking probing questions; and deliberating the costs and benefits of the proposed actions to the corporation and its stockholders."[206] While these actions may have surely spelled liability in the past in the context of major corporate transactions such as mergers and acquisitions, in today's climate these actions *may* spell liability in the context of ordinary business decisions, although these actions would likely not be required under *Caremark*, as there were little to no red flags in *Disney*.[207] Either way, *Disney* and *Pereira* appear to signal a sea change in judicial attitudes towards the standard of behavior underlying the duty to inquire, to monitor and to oversee.

A number of state court cases were dismissed at the pleading stage for failure to make demand on the board. In these cases, plaintiffs alleged that directors breached their fiduciary duty to oversee accounting practices and prevent accounting irregularities,[208] and for failure to prevent involvement in the corporate scandals.[209] These cases were dismissed because the complaint did not plead with sufficient particularity exactly what internal controls were in place and exactly what the audit committee knew or did not know.[210]

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206. *Id. See* Herzeca & Mamby, *supra* note 100 (noting that "[t]here is increasing pressure from regulators, the courts and institutional shareholders on outside directors to engage management more fully").
207. At trial in the Delaware Chancery Court, the Disney directors were found not to have acted in bad faith and at most to be ordinarily negligent. However, the Chancery Court faulted the Disney directors for less than desired corporate governance, even though it held that their inattention did not constitute conduct in bad faith in a legal sense. The Walt Disney Co. Derivative Litig., No. 15452, 2005 WL 2056651, at *39 (Del. Ch. Aug. 9, 2005). Regardless, a compensation decision for a senior executive may call for more inquiry from the board after Disney.
208. *See, e.g.*, Guttman v. Huang, 823 A.2d 492, 506-07 (Del. Ch. 2003); Rattner v. Bidzos, No. 19700, 2003 WL 22284323, at *1 (Del. Ch. Oct. 7, 2003) (stating that "[I]ndividual Defendants breached their fiduciary duty of care by inadequately maintaining accounting controls and utilizing improper accounting and audit practices").
209. *See, e.g.*, Citigroup Inc. S'holders Litig., No. 19827, 2003 WL 21384599, at *1 (Del. Ch. Jun. 5, 2003) (finding a breach of fiduciary duty for approving Enron transactions and for "sustained and systematic failure" to oversee subsidiaries involved in Enron's activities).
210. *See, e.g.*, *Rattner*, 2003 WL 22284323. The *Rattner* court stated:

> Here, once again, it is instructive to review not what facts the Amended Complaint alleges, but what facts the Amended Complaint fails to allege, with particularity. [footnotes omitted] The Amended Complaint sets forth vast tracts of quoted materials from public sources, detailing wrongdoings in the form of alleged misstatements. The Amended Complaint also summarizes numerous

Another state case arose from the Martha Stewart federal insider trading action. The case involved the "novel claim" that the Board failed to adequately oversee Stewart in her conduct of her personal legal and financial affairs. The court dismissed the claim holding that the duty to monitor did not extend that far.[211]

There has been a great deal of federal enforcement action in the wake of the corporate scandals.[212] The SEC has committed to undertake enforcement actions against directors who fail to oversee and monitor corporate activities.[213] In a reversal of the trend towards state fiduciary duties being influenced by federal law, one such case involves federal law claims that an outside director violated Securities Exchange Act section 10(b) and Rule 10b-5 "by signing a number of false financial statements and, as an outside director with fiduciary responsibilities, by ignoring clear warning signs that financial improprieties were ongoing at the company and by failing to ensure that the company's public filings were accurate."[214] The complaint alleges that the director ignored a number of red flags (a breach of fiduciary duties under *Caremark*), and that although the director was not directly involved in

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> SEC rules and regulations, and FASB and GAAP standards. However, conspicuously absent from any of the Amended Complaint's allegations are particularized facts regarding the Company's internal financial controls during the Relevant Period, notably the actions and practices of VeriSign's audit committee. The Amended Complaint also is similarly wanting of any facts regarding the Board's involvement in the preparation of the financial statements and the release of financial information to the market.

Id. at *12.

211. Beam v. Stewart, 833 A.2d 961, 971 (Del. Ch. 2003). In relation to the novel claim the *Stewart* court stated:

> Plaintiff's allegation, however, that the Board has a duty to monitor the personal affairs of an officer or director is quite novel. That the Company is 'closely identified' with Stewart is conceded, but it does not necessarily follow that the Board is required to monitor, much less control, the way Stewart handles her *personal* financial and legal affairs.

Id.

212. *See* Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221 (2004) (discussing Department of Justice enforcement); Ralph Ferrara, *Corporate Governance Opinion: Warning Shot: Corporate secretaries and general counsel beware: the SEC is taking aim at "reckless" directors*, CORP. COUNS., April 2004, 90 (discussing SEC enforcement).

213. Ferrara, *supra* note 212, at 90. *See also* Brickey, *supra* note 212.

214. SEC v. Brian Adley, Securities and Exchange Commission Litigation Release No. 18104 (April 24, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18104.htm (last visited Mar. 17, 2006).

the frauds, he acted with the necessary scienter to fulfill the requirements of a violation of the antifraud provision. Although the federal securities laws do not provide a statutory basis for holding directors liable for a breach of oversight duties,[215] cases holding that such behavior violates federal law may set a clear federal standard of conduct for directors—indeed such law may preempt the state common law of fiduciary duty.[216]

VI. STANDARDS OF LIABILITY IN THE OVERSIGHT AND MONITORING CONTEXT

Although Sarbanes-Oxley appears to require a higher standard of director behavior than previously existed under state case law, the legislation does not define a test to determine whether directors have breached their duty of care.[217] This section addresses whether Sarbanes-Oxley implies any particular liability test. It begins by discussing the state law test for liability. It then addresses whether Sarbanes-Oxley suggests a new test for liability.

The standard of conduct and the test for liability for failure to act as a reasonably prudent director diverge in corporate law.

> Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation, and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.[218]

State law defines the test for liability due to failure to monitor. Directors must act as reasonably prudent directors would under similar circum-

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215. John F.X. Peloso & Ben A. Indek, *Outside Directors and Red Flags*, 2/19/2004 N.Y.L.J. 3, Vol. 231 (col. 1) (discussing WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392 (S.D.N.Y. 2003), and Enron Corp. Securities, Derivative & "ERISA Litigation," 258 F. Supp. 2d 576 (S.D. Tex. 2003), both in which the court dismissed section 10(b) claims for failure to adequately plead scienter).

216. *See generally* Veasey, *supra* note 147 and accompanying text. The *Chancellor* case perhaps signals a new emphasis by the SEC on actions against directors who fall "asleep at the switch." *SEC to Target Directors in Fraud Cases, Cutler Says*, BLOOMBERG Aug. 20, 2003. However, as of November, 2005, this author has been unable to find any other cases based on the same or similar causes of action brought against outside directors in federal court.

217. Perhaps legislators intended claims that directors breached Sarbanes-Oxley duties to be brought in state court, and for state law standards of review to govern such claims. *See generally* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393 (2005).

218. Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

stances. However, the doctrine known as the "business judgment rule" may come into play in evaluating whether director conduct breached the duty of care. The business judgment rule, which is more of a doctrine than a test for liability, gives great deference to director decision-making by limiting judicial review, more or less, to the procedure that the directors followed when they made their decision. Under the business judgment rule, courts examine whether the directors acted in an informed manner, e.g., gathered the appropriate information given the context of the decision, engaged in suitable deliberations, and consulted with the appropriate outside parties and consultants. Therefore, the test for liability for director decision-making is not whether they acted as reasonably prudent directors, but whether they were grossly negligent in effectuating a decision-making process. In effect, courts applying the business judgment doctrine will give little to no review of the substance of the decision, so long as the decision-making process was reasonable. However, there is an alternate side to the application of the business judgment rule in the decision-making context. In some cases, courts have held in effect that the decision itself was so irrational, it could not have been the product of a reasonable decision-making process.[219]

The business judgment rule applies in the context of director decision-making and in the absence of conflict of interest issues. When the context of the decision-making involves a conflict of interest, then both the substance of the decision and the process the board followed to come to a decision are reviewed to ascertain whether the board acted fairly. In the absence of a decision, a different test for liability applies. For example, the liability test enunciated in *Caremark* applies when the claim is that the board failed to monitor a corporation's compliance with applicable laws and to take corrective action when it should have acted.

The Test for Liability in Caremark

In *Caremark*, the court stated that

> In order to show that the Caremark directors breached their duty of care by failing adequately to control Caremark's employees, plaintiffs would have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation . . . .[220]

219. Brane v. Roth, 590 N.E.2d 587, 592 (Ind. Ct. App. 1992).
220. Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).

Since it appeared that the directors did not know of the alleged violations of federal and state laws, the court analyzed director liability for failure to monitor.[221] The court stated,

> Generally, where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—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. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.[222]

Despite the Chancery court's careful attempt to state the alternative facts that a plaintiff must show, and that court's quite clear demarcation of the "test of liability" by use of that exact phrase, recent literature and court opinions grapple with the precise level of director culpability that must be shown by the plaintiff.[223]

One problem in interpreting the court's opinion lies with the court's analysis of the test under the business judgment rule. According to the *Caremark* court

> whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests.[224]

While Delaware decisions state that directors may be liable for grossly negligent decision-making processes, it does not necessarily follow that directors are only liable if the directors were grossly negligent in their decision-

221. *Id.*
222. *Id.*
223. *Id.* at 972.
224. *Id.* at 967.

making process.[225] Part of the analysis of whether the directors were grossly negligent in their decision-making process should be to determine if there is some connection between the decision making process and the outcome of the process. Thus, in theory a plaintiff could demonstrate that the substance of the decision was so irrational a court should infer that the decision-making process was therefore procedurally flawed.[226]

Moreover, the court in *Caremark* recognized that the business judgment doctrine should not apply to *Caremark* claims—the business judgment doctrine applies to shield directors from unwise decisions. *Caremark* claims are based on the directors' failure to make a decision. Therefore, a more significant area of debate may be that the court uses, nay emphasizes, the term "good faith" throughout the opinion, while eschewing any reference to gross negligence in its discussion of liability for failure to monitor.[227] It appears to some that the *Caremark* court articulates a test that requires a showing of an egregious, not grossly negligent, breach of the duty to monitor that rises to the level of a breach of the duty of good faith. In other words, the liability arises from a breach of the duty of care that rises to the level of a breach of the duty to act in good faith in the best interests of the corporation, not from a "mere" breach of the duty of care.

One court explained the issue is to balance the requirement that the board authorize significant transactions and corporate acts (and thus does not authorize the majority of business decisions, which are ordinary business decisions) with the fact that "ordinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals."[228] Thus, under *Caremark*, director liability should follow only if directors exhibit a pattern of overreliance on systems without ascertaining the effectiveness of those systems or if directors fail to put systems in place.[229] This author believes such overreliance need not amount to bad faith to qualify as a breach of due care (although labeling such conduct as bad faith conduct would avoid application of any exculpatory charter provisions and expose directors to personal liability).

The concept of a duty of good faith as a separate and distinct director fiduciary duty is a relatively recent phenomenon gaining acceptance in the courts. The contours of the duty of good faith, as a fiduciary duty not subsumed within the duty of loyalty or the duty of care, are still evolving.

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225. *Id.*
226. Brane v. Roth, 590 N.E.2d 587, 592 (Ind. Ct. App. 1992).
227. *Caremark*, 698 A.2d at 972.
228. *Id.* at 968.
229. McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001) (quoting *Caremark*, 698 A.2d at 971).

One justice recently noted that there is a separate duty of good faith, based on statutory construction:[230] "Reckless, disingenuous, irresponsible or irrational conduct . . . could implicate concepts of good faith. If the board's decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred."[231]

To some, based on the *Caremark* court's language that a board must make a "good faith" attempt to put "reasonable" information systems in place, it appears that the court is describing good faith as an aspect of the duty of care. Under this articulation of the test for liability, "a sustained or systematic failure to exercise oversight" is extreme gross negligence amounting to bad faith. Two recent cases, *Disney* and *Abbott*, appear to affirm this view.[232]

To others, it appears that the *Caremark* court states a higher test for liability than gross negligence, e.g. recklessness, because Delaware cases suggest that directors could be grossly negligent while still acting in good faith.[233] Whether the standard in *Caremark* is "good faith" or "gross negligence"[234] is an important subject of debate because while grossly negligent departures fall within the safe harbor of exculpatory charter provisions, potentially relieving directors of liability for breaches of due care, reckless conduct and other breaches of the duty of good faith do not.

Another significant area, that is not well elaborated in the literature, is whether the director failure that leads to liability is the utter failure to attempt to assure that an information and reporting system exists, or the utter failure to attempt to assure that a "reasonable" information and reporting system exists. Perhaps the reason for the dearth of discussion on this point is that the *Caremark* court states that what is "reasonable" is a matter of business judgment of the board. Here one assumes that what is "reasonable" would be evaluated under the business judgment test articulated in prior case law, although it could be evaluated under the somewhat different standard

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230. Veasey, *supra* note 147, at 447.
231. *Id.* (citing Gagliardi v. Trifoods Int'l, 683 A.2d 1049, 1051-52 (Del. Ch. 1996)).
232. The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); Abbott Labs. Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2003). Both cases involved "gross inattention, severe enough for a court to conclude that the directors acted in bad faith." Bernard Black et al., *Outside Director Liability* 10 (Stan. L. Sch.: John M. Olin Program in Law and Econ., Working Paper No. 250), *available at* http://papers.ssrn.com/abstract=382422 (last visited Mar. 17, 2006).
233. Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985), *superceded by statute*, Delaware General Corporation Law § 102(b)(7).
234. Rattner v. Bidzos, 2003 Del. Ch. LEXIS 103, at *43-44 (Del. Ch. Sept. 30, 2003) (quoting Seminaris v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995)).

articulated in *Caremark*. But since one instance of failing to assure that a reasonable information and reporting system exists likely would not render directors liable under *Caremark*, both parts of the test—the extent of the failure and the reasonableness of the system—should be evaluated.

While the exact articulation of the test for liability is important for purposes of determining whether a derivative suit will survive a motion to dismiss for failure to allege a cause of action outside of an exculpatory provision's safe harbor, or whether the suit will survive a motion to dismiss for failure to state a claim, perhaps it is more important to determine whether conduct that once did not lead to liability will now lead to liability in the new regulatory environment.

The Test for Liability Post-Sarbanes-Oxley

Commentators have suggested several reasons why private plaintiffs will bring state court claims against directors for breach of duties defined in Sarbanes-Oxley.[235] First, there is no forum for adjudication of shareholder complaints specified in Sarbanes-Oxley—there is no private right of action in federal court.[236] Second, the federal law remedy for violating certain provisions includes forfeiture of profits, jail time, and fines, but it is unlikely that shareholders would benefit from restitution. Third, the remedy for violation of the listing standards promulgated under Sarbanes-Oxley is delisting[237] or suspending trading, neither of which is a satisfactory remedy from the point of view of the stockholder.[238] Thus, plaintiffs may attempt to bring state court actions for breach of the fiduciary standards defined by Sarbanes-Oxley. State courts may respond to these attempts by asserting that the sole remedy for violations of the standards defined in Sarbanes-Oxley is provided in Sarbanes-Oxley.

State courts may be hard-pressed, however, to ignore a plaintiff's argument that directors breached their fiduciary duties by not complying with the requirements of Sarbanes-Oxley and the listing requirements, and

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235. This idea is not new. *See, e.g.*, John F. Olson, *How to Really Make Audit Committees More Effective*, 54 BUS. LAW 1097, 1101-02 (May 1999). Olson discusses listing standards proposed by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, chaired by Ira Millstein and John Whitehead and states "[the new listing standards] may well become key elements in litigation that challenges directors on the point of whether the corporate audit committee has functioned adequately as part of the company's system of internal controls." *Id.* at 1102.

236. A court may imply a private right of action, as is implied under 10b-5.

237. Audit Committee Release, *supra* note 131, at § II(F)(5).

238. William B. Chandler & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 983 (2003).

by thus exposing the corporation to delisting.[239] As Chancellors Strine and Chandler recently opined, "[t]here will be some legitimate pressure on state courts to respond with a measure of receptivity to these arguments."[240]

Although many warning notes are struck by judges, practitioners, and academics in recent literature, views diverge as to the likelihood of increased liability for breaches of due care in state court. Judges and academics imply that increased liability *may* follow; practitioners opine that increased liability *will* follow. One practitioner wrote recently that "[n]umerous reports and communications required to flow to audit committees and independent directors will not only increase the knowledge of these independent directors, but also increase their liability under state corporate laws."[241] On the other hand, the Chief Justice of the Delaware Supreme Court recently cautioned counsel to "advise the directors of that possible exposure and encourage the utmost in good faith behavior."[242]

One rationale for the divergence of views is that Congress did not explicitly intend to change the state court tests for liability for breach of due care. Congress did not articulate a test for liability for failure to implement reasonable internal controls in Sarbanes-Oxley, nor is such a test articulated in the rules and regulations stemming from the statute.[243] Directors may face increased liability for two reasons: (1) behavior that would not have led to liability before Sarbanes-Oxley now does not meet the minimal level of director conduct (Sarbanes-Oxley rules set a floor for "reasonable" standards), or (2) courts may apply a more strict test for liability, such that behavior that was once considered merely negligent is now considered grossly negligent, or behavior that was considered grossly negligent now meets the standard of recklessness.

For example, plaintiffs could argue that "the utter failure to follow the minimum expectations . . . [of the act, regulations, SRO and PCAOB requirements dealing with internal controls] . . . raise[s] a good faith issue" under the test articulated in *Caremark*.[244] Under this argument, the requirements of Sarbanes-Oxley and related regulations articulate the *minimum* standards for a reasonable information system. A sustained and systematic failure to meet the minimum requirements of the rules and regulations may

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239. *Id.* at 986.
240. *Id.* at 987.
241. John P. Beavers, *Sarbanes Does Not Change a Director's Right of Reliance on Officers and Accountants*, December 2002, http://www.counselfor.com/Publicationsarticles/639.asp (last visited Mar. 17, 2006).
242. Veasey, *supra* note 147, at 446-47.
243. While judges and academics may be more aware that the likelihood of liability will flow from whether or not courts follow Congress' implied intent, practitioners caution their clients as if courts *will* follow Congress' intent.
244. Veasey, *supra* note 147, at 446.

be linked to lack of knowledge of "liability creating activities" within the corporation.[245] One recent article noted that liability for failure to meet the requirements of Sarbanes-Oxley would in effect treat the requirements of the rules as a floor and change the test for liability to negligence. This author respectfully disagrees with that position. A court could still weigh other factors, such as whether an individual committed fraud in order to hide the red flags. And it should do so because no system of internal controls "will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law."[246]

As another example, instead of requiring plaintiffs to demonstrate that directors should have known about red flags that were known to the senior executives of a subsidiary, a court may require directors to prove that they sought explanations from the chief accounting officer, the auditors, and the chief financial officer. Directors acting in good faith would have inquired.

It is difficult for plaintiffs to prove that directors "should have known that violations of law were occurring" and that their lack of knowledge stemmed from "a sustained or systematic failure of the board to exercise oversight"; in other words, the directors utterly failed to attempt to ensure that a "reasonable" information and reporting system exist[ed] . . . ." It is harder to prove that had directors attempted in good faith to exercise oversight supported by a reasonable information and reporting system, directors would have been aware of red flags, than it is to prove that directors were aware of red flags but took no steps to correct the identified problems. Plaintiffs may be left in the undesirable position of attacking the reasonableness of the information and reporting system, a determination that under the business judgment doctrine is most often left within the discretion of the board as well as the good faith of the board.

Plaintiffs may have two interrelated lines of attack: one, whether testing was reasonably designed to conclude that the information and reporting systems were operating effectively, and two, whether the information and reporting systems were indeed reasonably designed and operated. Sarbanes-Oxley and the rules promulgated under that statute give additional guidance on the nature of a reasonable information and reporting system and the required testing to determine if the "reasonable information and reporting system" is operating effectively. The management's report regarding the

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245. *See* Saito v. McCall, No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004).

246. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

company's internal controls over financial reporting must address not only the design of the systems, but also their operating effectiveness. Internal controls over financial reporting that are operating effectively must (under Section 404 and the SEC rules) identify significant and material weaknesses. While the level of detail of the system is within the board's discretion, the level of detail must be sufficient to identify "significant deficiencies" and "material weaknesses." Similarly, although the design of the procedures used to test the operating effectiveness of the internal controls is within the discretion of the board, the testing procedures must be sufficient to identify any "material weaknesses" in the systems themselves. However, part of the testing procedure will usually include actual testing of the controls, not just inquiry. If such systems are operating effectively, then the systems are "reasonably designed" to provide information to the board. Thus reasonably designed systems may bolster a plaintiff's argument that the directors should have known of unlawful activity. Failure to heed the red flags (of which the board should have known) may demonstrate bad faith on the part of the board.[247] There is no exculpation for acts or omissions involving a knowing violation of law.[248]

Narrowing the gap between desired behavior and liability creating behavior accords more closely with congressional intent. Recent cases and literature reveal a possible trend in this direction. Moreover, a broader reading accords more closely with congressional intent to reinvigorate investor confidence in financial markets.[249]

VII. CONCLUSION

"For many companies, the new rules on internal control reports will represent the most significant single requirement associated with the Sarbanes-Oxley Act. The establishment and maintenance of internal control over financial reporting has always been an important responsibility of management."[250]

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247. *See generally* Saito v. McCall, No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004).
248. *Cf.* DEL. CODE ANN. TIT. 8, § 102(b)(7)(ii) (2001).
249. Larry Catá Backer, *The Duty to Monitor: Emerging Obligations of Outside Lawyers and Auditors to Detect and Report Corporate Wrongdoing Beyond the Federal Securities Laws*, 77 ST. JOHN'S L. REV. 919, 934 (2003).
250. Johnson and Sides, *supra* note 6, at 1185 (citing William H. Donaldson, Chairman of the U.S. Securities and Exchange Commission., Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002, Before the Senate Committee on Banking, Housing and Urban Affairs 19-20 (September 9, 2003)), *available at* http://banking.senate.gov/_files /wmdndsn.pdf (last visited May 8, 2006).

Some argue that legislation can never mandate good corporate behavior.[251] This author believes that while Sarbanes-Oxley is just one tool that may be used to influence corporate behavior, it may yet prove to be one of the right tools that is appropriate for the job. Although a determination of director due care "is highly particularized and generalizations are of little help in that task,"[252] it is useful to use Sarbanes-Oxley as a measure of director liability for conduct that falls significantly short of its standards.

In the nearly four years since the passage of the Sarbanes-Oxley Act of 2002, the names Enron, WorldCom, Adelphia, and Qwest have become symbols for the financial scandals that shook the business community at the turn of the century. The legacy of the scandals, and the legislation that was passed in their wake, may fade into history in a mere decade, just as Teapot Dome and Tulipmania are barely known to this year's class of entering law students, or as other high-profile cases such as the McDonald's hot coffee case pass into popular myth. However, the actions of the courts and other enforcement and regulatory bodies may after all result in the significant, lasting, positive elimination of corporate climate elements that inspired and supported the scandalous behaviors. Perhaps the recent corporate tragedies will foster the future inculcation into the corporate culture standards conducive to more circumspect corporate behavior.

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251. *See* Matthew J. Barrett, *Enron and Andersen: What Went Wrong and Why Similar Audit Failures Could Happen Again*, *in* NANCY B. RAPOPORT & BALA G. DHARAN, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (2004).

252. Citron v. Steego Corp., Civ. A. No. 10171, 1988 WL 94738, at *10 (Del. Ch. Sept. 9, 1988); *see also* Periera v. Cogan, 294 B.R. 449, 529 (Bankr. S.D.N.Y. 2003).