Presented at the International Conference to Commemorate the Fortieth Anniversary of the Korean Commercial Code

Seoul, September 2002

THE DIRECTOR'S DUTY OF OVERSIGHT – PRE-ENRON; POST-ENRON

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1. The Post-Enron Environment.

The revelation of massive accounting irregularities at Enron, which began to come to light last October, has ushered in a new wave of concern over the accountability of large publicly-traded corporations in the U.S. It was soon followed by stories of significant misconduct at Global Crossing, Tyco International, Adelphia Communications, WorldCom and others. As a result, the subject of corporate governance presently occupies a place at the forefront of U.S. public attention that it has not enjoyed for 25 years.

From Main Street to the White House, Enron has touched a nerve. Most of the public condemnation has been reserved for the insiders. Kenneth Lay, Jeffrey Skilling and Andrew Fastow of Enron; John Rigas of Adelphia; and Bernard Ebbers of WorldCom have all received extensive front-page coverage in the U.S. and worldwide media over the last few months. But substantial criticism has also been directed at the boards of these companies, including the outside directors, for allowing the false accounting and other misconduct to occur and go undetected.

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Probably the most dramatic attacks have been reserved for the outside directors of Enron. The AFL-CIO, the umbrella group for U.S. labor unions, launched a campaign urging other companies on whose boards these individuals also served not to re-nominate them. This resulted in at least four of Enron's former outside directors stepping down from board seats at California Water Service Group, Harvard University, Invesco Funds and Motorola.

What about the potential legal liability of these outside directors for the losses incurred by their corporations? In the U.S. this issue is governed by what has come to be known as the director's "oversight function." It is a branch of the larger duty of care. Most of the focus on the director's duty of care in recent decades has concerned specific decisions or actions by the board that turn out poorly, and the availability of the business judgment rule to protect the directors from personal liability for the resulting losses. The duty of oversight, which in contrast deals with the board's *failure to take action*, has received less attention and is, as a result, less well developed.

This paper explores the director's duty of oversight – how it had evolved prior to Enron, the reforms that Enron has triggered, and what we may expect in the future. One distinctive feature of corporate governance in the U.S. is that the responsibility for making law is shared by many institutions – some better equipped to respond quickly than others. To date, Congress, the Securities & Exchange Commission and the New York Stock Exchange have each initiated corporate governance reforms in the wake of Enron. We have yet to hear, however, from the institutions with the primary responsibility for writing corporate law – the legislatures and courts of the various states, notably Delaware. In the final analysis, they will have principal responsibility for spelling out the content of the director's duty of oversight in the post-Enron world.

2. What's in a Duty?

Because this paper is about a particular "duty" it is important to acknowledge from the outset the ambiguity that sometimes attaches to that term, especially when applied to the director of a U.S. corporation. Lawyers typically think of duty in terms of legal obligation. Legal consequences attend the failure to perform a duty. Often, those caused injury by a breach of duty will have a remedy against the breaching party. Everyday parlance exhibits a broader conception of duty, however. *Webster's Dictionary* defines it as "something that one is expected or required to do by moral or legal obligation." When employees describe their job duties they usually set their standards higher than the minimum necessary to avoid personal liability.

With corporate directors in particular there is often a considerable gap between their "duty" in the sense of that which they are supposed to do and their "duty" in the sense of that for which they will incur liability if they fail to do. The reason is obvious. Any significant adverse development might cost the corporation and its shareholders millions or billions of dollars. If the directors' personal assets are at stake whenever a court might determine that they could have avoided that loss by acting more diligently, few persons would agree to serve as board members or to lead the corporation in any but the safest and most conservative of pursuits.

Only relatively recently, however, has this gap between what the director is supposed to do and the grounds for personal liability received formal recognition in the statutes. The initial signs were easy to miss.[1] The first step to gain widespread attention was to immunize directors who breached their duty of care from liability

[1] In 1974, when the ABA's Committee on Corporate amended the Model Business Corporation Act to include a general statement of the director's standard of conduct, it also included a sentence stating that a director whose conduct meets the standard incurs no liability. Even though the focus of the amendment was the director's standard of conduct rather than standard of liability, there arose the possible negative inference that failing to meet the standard was grounds for liability. *See* R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct and Liability: The Model Business Corporation Act Liability*, 56 BUS. LAW. 35, 39-47 (2000). This negative inference was not completely eliminated until the 1998 amendments to the Act, described in the text that follows.

for monetary damages. Although proposed by commentators for some time,[2] this approach did not receive statutory endorsement until Delaware enacted section 102(b)(7) of its General Corporation Law in 1986. That section permits the shareholders to amend the corporation's charter to protect the directors from liability for conduct not involving breach of the duty of loyalty, lack of good faith, or similar kinds of misconduct. Note, though, that instead of identifying which breaches of care should be grounds for liability, this approach simply lumps together all such breaches and makes them eligible candidates for immunity. More nuanced approaches began to emerge from the scholarly literature and even the case law, which addressed the difference between legal duties and good corporate practice[3] or between standards of conduct and standards of review.[4] This latter approach ultimately found its statutory home in the 1998 amendments to the Model Business Corporation Act. Section 8.30 sets forth the director's standard of conduct, section 8.31 the standard of liability.

Without question, the vocabulary of corporate law needs to be sharper about exactly what it intends when referring to the director's duty. Is it the standard of conduct, the standard of review, the standard of liability, or something else? To achieve that clarity, this paper employs a different scheme of categorization – one based on obligation, expectation and aspiration. "Obligation" refers to those acts that are grounds for personal liability if not performed. "Expectation" refers to other

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[2] *See, e.g.*, Alfred F. Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 912-15.

[3] Brehm v. Eisner, 746 A.2d 244, 255-56 (Del. 2000) (*citing* also E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 699-700 (1998)).

[4] The leading article is Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993). *See also* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1295-99 (2001).

acts within the general consensus as to what directors are supposed to do, even though the failure to perform them does not result in personal liability. "Aspiration" refers to acts that directors ideally should perform, although it is generally acknowledged that many, perhaps most, directors typically fail to.

I prefer these categories to ones based on standards for two reasons. First, the terminology seems better calculated to remind us that the process of assigning particular acts to particular categories is a dynamic one. Over time, what were once aspirations may become expectations, what were once expectations may become obligations, and perhaps the reverse. Thus, our examination of the duty of oversight needs to be sensitive to these trends. Second, it recognizes that personal liability is not the only sanction worth considering. For many directors, the consequences of disregarding an expectation may be almost as strong a deterrent as those for disregarding an obligation.

To understand this last point, it is important to appreciate the layers of protection dampening the likelihood, under U.S. law and practice, that a breach of care claim will actually result in dollars out of the director's pocket. Consider first the procedure by which such a claim gets enforced. Because the claim belongs to the corporation, the typical mechanism is a shareholder derivative suit on the corporation's behalf. If the allegations involve solely a breach of care, the plaintiff will have to make a demand on the corporation's board of directors before bringing suit.[5] If the board then decides that the suit is not in the corporation's best interests,

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[5] While such a demand may be excused as futile under some circumstances, the futility exception will generally not be available in a pure duty of care case. In Delaware, for example, demand will not be excused unless the plaintiff's allegations create a reasonable doubt that "(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984). Under the Model Business Corporation Act, in contrast, demand is always required. MODEL BUSINESS CORP. ACT § 7.41 (1990).

that decision will ordinarily be upheld.[6] Assume, though, that the suit proceeds. The director still has three lines of protection. First, we have seen that Delaware, along with virtually all of the other states, allows the corporate charter to immunize the director from liability for money damages when ordinary or even gross negligence is the only breach of duty at issue. Second, corporate law permits the corporation to indemnify its directors for liability and attorneys fees so long as they acted in good faith and in a manner they reasonably believed to be in, or at least not opposed to, the best interests of the corporation.[7] There are understandable limitations, however, when the liability at issue is on the corporation's own behalf. The corporation is generally foreclosed from turning around and reimbursing its directors for any amount which they have been adjudged liable to the corporation or paid in settlement of a claim on its behalf. Thus, in derivative suits, indemnification is typically limited to the directors' attorneys fees.[8] Nonetheless, the directors will usually not end up paying the judgment or settlement from their own funds. Major corporations usually carry Directors & Officers Liability Insurance, which covers even some items for which indemnification is impermissible, such as liability to the corporation for breach of care.[9]

Conversely, even though expectations (as opposed to obligations) carry not even the nominal risk of personal liability, they are not to be taken lightly. Directors of major U.S., corporations are invariably ambitious and high-profile individuals, for whom reputation and stature are particularly important. Being part of a board that is criticized in the media or by public officials as "asleep at the switch" and

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[6] In Delaware, the board's decision is protected by the business judgment rule. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981). Under the Model Act, the decision will be upheld if it is in good faith and based on a reasonable inquiry. MODEL BUSINESS CORP. ACT § 7.44(a) (1990).

[7] DEL. GEN. CORP. L. § 145(b); MODEL BUSINESS CORP. ACT § 8.51(a) (1994).

[8] *See* DEL. GEN. CORP. L. § 145(b); MODEL BUSINESS CORP. ACT § 8.51(d)(1) (1994).

[9] *See* DEL. GEN. CORP. L. § 145(g); MODEL BUSINESS CORP. ACT § 8.57 (1984).

responsible for substantial losses to shareholders is hardly beneficial to either the director's ego or future career opportunities.

What all this suggests is that the critical event in changing the behavior of corporate directors may not be when the action at issue ceases to be an expectation and becomes an obligation, but instead the shift from aspiration to expectation. We will be mindful of this distinction as we now turn to the details of the director's oversight duties. Yet it raises a methodological problem. Unlike obligations, which can be derived from the formal legal authorities – cases, statutes, regulations and the like – identifying and specifying the state of expectations at any particular time is more elusive. Thus, the discussion that follows frequently calls on the secondary literature to help trace how expectations concerning the duty of oversight have evolved over time.

3. The Allis-Chalmers Case.

One important reason why the contours of the directors' oversight obligation remain clouded is that the Delaware Supreme Court has not addressed the issue since 1963, in the case of *Graham v. Allis-Chalmers Manufacturing Co*.[10] Allis-Chalmers was an electrical equipment manufacturer involved in a conspiracy with others in the industry to fix prices and rig bids in sales to private electric utilities and governmental agencies. The company and four of its employees (none directors) pled guilty to criminal violations of the antitrust laws.

The *Graham* case was a shareholders derivative action brought to recover damages from the Allis-Chalmers directors for losses caused by the violations. The plaintiffs were unable to produce evidence that any of the directors had actual knowledge of the illegal activity or of facts that should have put them on notice of its existence. As a result, the plaintiff's case came down to the proposition that the

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[10] 188 A.2d 125 (Del. 1963).

directors should by liable as a matter of law for failing to take action designed to learn of and prevent antitrust violations by the company's employees.

The court squarely rejected this argument. Its reasoning is nicely summarized in the following paragraph from the opinion:

> The precise charge made against these director defendants is that, even though they had no knowledge of any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end. . . . On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent 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.[11]

Under what circumstances would a corporate director become liable for losses caused by neglect of duty? The court offered the following observation: "If [the director] has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him."[12] But finding none of these situations presented by the record before it, the court upheld judgment for the defendants. In closing, it added "we know of no rule of law which requires a corporate director to assume, with no justification whatsoever, that all corporate

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[11] *Id.* at 130.

[12] *Id.*

employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities."[13]

4. Corporate Governance and the Evolution of the Oversight Function, 1970-1995.

Following the *Allis-Chalmers* case, the director's duty of oversight did not receive substantial attention again until the early 1970s, when two events caught the spotlight and led to the term "corporate governance" as a subject of national discussion and debate in the U.S. The first was the fall-out from the demise of the Penn Central railroad. In an investigation into charges of management misconduct and improper accounting before the collapse, the SEC issued a report strongly criticizing the passivity of the railroad's outside directors and their lack of information.[14] The other was the discovery of a pattern of questionable foreign payments, kickbacks and political contributions by some of the largest corporations in the U.S., including Lockheed Aircraft, Mattel and Gulf Oil. Typically, these payments came from "off the books" slush funds, with the corporation's board of directors having no awareness of either the funds or the payments.

For corporate law, these events focused substantial attention on the role and function of the board of directors. Observers of the modern business corporation had long noted that the job of managing the corporation had, as a practical matter, passed from the board of directors to the senior management. Yet the formal legal model continued to cast the board in the management role. Thus, the first step in revamping the board's function was hardly controversial. In 1974, Delaware amended its statute to provide that the business and affairs of the corporation "shall

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[13] *Id.* at 130-31.

[14] *See* THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY: STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS (1972).

be managed by *or under the direction of* a board of directors."[15] Amendments to the Model Act that same year drove home the point even more forcefully: "All corporate powers shall be exercised by *or under authority of*, and the business and affairs of a corporation shall be managed *under the direction of*, a board of directors."[16]

With the board now officially removed from the role of management, the obvious question was what role it should realistically be expected to play instead. The answer that emerged from scholars of corporate law in the mid-1970s was "monitoring," that is, monitoring the conduct and performance of those entrusted with management – the Chief Executive Officer and other senior executives.[17] This concept of the board as monitor began to find mainstream acceptance, albeit slowly in some quarters. In gauging the "expectations" dimension of the director's role, the work of the American Bar Association's Committee on Corporate Laws is a noteworthy guide. An appointed group of practitioners, academics and judges all specializing in corporate law, the Committee is responsible for not only the Model Business Corporation Act but also various ad hoc policy statements and guidelines on matters of corporate law. Among these is the *Corporate Director's Guidebook*, first circulated in 1976 and approved in 1978. In it one can sense the Committee cautiously coming to grips with the model of the monitoring board. Referring to the 1974 amendment to section 35 of the Model Act described above, the *Guidebook* language as ultimately approved described the director's responsibilities in the following terms:

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[15] DEL. GEN. CORP. L. § 141(a).

[16] MODEL BUSINESS CORP. ACT § 35 ¶1 (1974) (revised 1984).

[17] *See, e.g.*, Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CAL. L. REV. 375, 398-402 (1975); Noyes E. Leech & Robert H. Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1803-06 (1976); Elliott J. Weiss & Donald E. Schwartz, *Using Disclosure to Activate the Board of Directors*, 41 LAW & CONTEMP. PROBS. 63, 69-80 (Summer 1977).

The phrase "managed under the direction of" was inserted in the Act in 1974 to replace the phrase "managed by" and to emphasize the responsibility placed upon the individual corporate director, together with his fellow directors, to

-- review and confirm basic corporate objectives

-- select competent senior executives and monitor personnel policies and procedures with a view to assuring that the enterprise is provided with other competent managers in the future

-- review the performance of the senior managers thus selected and monitor the performance of the enterprise[18]

In the original version, the last bullet point had been worded more broadly: "monitor both the performance of the managers thus selected and the enterprise."[19]

At least for the large publicly-held corporation, if not for corporations generally, the monitoring concept carried with it three important implications for the composition and performance of the board of directors. First, a significant number of the directors (ideally a majority) should be outsiders, independent from the CEO and other members of management.[20] Second, the board should have an audit committee, to select the outside auditor and review its work; a compensation committee, to determine the compensation of the senior executives; and a nominating committee, to nominate candidates for election as director. All of the

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[18] *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1606-07 (1978).

[19] *Corporate Director's Guidebook*, 32 BUS. LAW. 5, 20 (1976).

[20] *See, e.g.*, AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE & STRUCTURE: RESTATEMENT & RECOMMENDATIONS § 3.03(a) (Tent. Draft No. 1, 1982); *Corporate Director's Guidebook*, *supra* note 18, at 1624-25; *Statement of the Business Roundtable – The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083, 2108 (1978). (Because our purpose is to trace the thinking about the director's oversight function over time, citations are to the versions of the work in effect during the period under discussion, rather than to the version now in effect.)

members of the audit and compensation committees and at least a majority of the members of the nominating committee should be outsiders.[21] Given the prior revelations of slush funds and improper payments, the audit committee, and the corporation's accounting function generally, were singled out for special attention. In 1977, the New York Stock Exchange required every listed company to have an audit committee made up entirely of independent directors. That same year Congress enacted the Foreign Corrupt Practices Act requiring every 1934 Act reporting company to (1) keep books and records that accurately and fairly reflect corporate transactions and (2) devise and maintain a system of internal corporation accounting controls sufficient to assure that transactions are executed in accordance with management's authorization and properly recorded, and that assets are accessible only in accordance with management's authorization.[22]

The final implication – and most important for our purposes – was the acknowledgement that in light of the recent examples of illegal conduct by some leading corporations, directors should take a more pro-active approach to law compliance than contemplated by the court in the *Allis-Chalmers* case. For example, the Business Roundtable, a group of the largest and most influential corporations in the U.S., recognized in 1978:

> Directors and top management cannot be guarantors of the lawful conduct of every employee or manager in a large organization – particularly in view of the fact that legal and regulatory requirements currently imposed on corporations are so numerous, so wide-ranging, so obscure and complex. On the other hand, some recent lapses in corporate behavior have emphasized the need for policies and implementing procedures on corporate law compliance. These policies

[21] *See, e.g.*, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 20, §§ 3.05-3.07; *Corporate Director's Guidebook*, *supra* note 18, at 1625-27; Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 35 BUS. LAW. 1335 (1980); *Statement of the Business Roundtable*, *supra* note 20, at 2109-10.

[22] Securities Exchange Act of 1934 § 13(b)(2).

> and procedures should be designed to promote such compliance on a sustained and systematic basis by all levels of operating management.
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> Certain requirements are of major importance from both business and public points of view. Examples of these are antitrust compliance and the provisions of the federal securities laws calling for timely disclosure. It is appropriate in these cases for the board to assure itself that there are policy directives and compliance procedures designed to prevent breaches of the law.

Take as a second example the following observations in a 1980 article co-authored by E. Norman Veasey, then a leading corporate practitioner and now the Chief Justice of Delaware:

> [A] comparison of the results of *Graham* and our hypothetical exposes not a philosophical difference between Delaware courts and the Business Roundtable; rather, it shows a natural development in the role of an "ordinary prudent director" since 1963, the year in which *Graham* was decided.

The footnote to this passage states:

> Naturally, compliance with the law has been a proper concern of management since the birth of the corporation. However, the *institutionalization* of a system designed to assure legal compliance, suggested by the Business Roundtable, is a recent response to the last decade's explosion of complex and wide-ranging regulations affecting corporate life. Since *Graham*, we have seen tremendous growth of antitrust law, antidiscrimination requirements, environmental law, energy law as well as the development of more extensive internal regulation, *e.g.*, the Foreign Corrupt Practices Act, ERISA and NYSE and SEC regulations concerning the creation of audit committees. The

installation of legal compliance systems is, therefore, a new director function which will experience further development in the future.[23]

In summary, we can say that as of 1980 – and the end of the first wave of attention to corporate governance in the U.S. – the idea that directors of large, publicly-traded corporations had the responsibility to see that a system was in place to assure corporate compliance with certain fundamental laws was moving from the area of aspiration to that of expectation. What if any of this reached the level of an obligation remained, in light of *Graham v. Allis-Chalmers*, a real question. This is where matters essentially remained until the mid-1990s. When the *Corporate Director's Guidebook* was revised in 1994, it contained, like its predecessor, a section on the director's duty of care. Under the sub-heading "Inquiry," the text stated only that: "A director should make inquiry when alerted by the circumstances."[24]

5. The Caremark Case

The 1996 *Caremark* case[25] involved judicial approval of the settlement of a shareholders derivative suit. Caremark was in the health care business, providing patient care and managed care services. As a result of a U.S. government investigation into whether Caremark had violated Medicare and Medicaid laws by paying kickbacks to referring physicians, the corporation pled guilty to mail fraud and agreed to pay criminal and civil penalties and reimburse various parties in amounts totaling $250 million. The derivative suit sought to recover from Caremark's directors for breaching their duty of care by allowing the violations to occur. Deciding to approve the settlement, Chancellor Allen concluded that had the

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[23] E. Norman Veasey & William E. Manning, *Codified Standard – Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care and Delaware Law*, 35 BUS. LAW. 919, 930 & n.53 (1980).

[24] *Corporate Director's Guidebook – 1994 Edition*, 49 BUS. LAW. 1243, 1254 (1994).

[25] *In re* Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

suit proceeded to judgment, there was very little probability that the Caremark directors would be found to have breached their duty to appropriately monitor and supervise the corporate enterprise.

In reaching this conclusion, the Chancellor reviewed at some length the director's duty to monitor corporate operations. Observing how the legal landscape had changed since the *Allis-Chalmers* case, he noted the increasing tendency of the federal government to use criminal sanctions to assure corporate compliance with various environmental, financial, employee and product safety regulations. He also described how the U.S. Sentencing Commission's uniform guidelines had strengthened the penalties for corporate criminal violations but had at the same time created powerful incentives for corporations to have in place compliance programs to detect violations themselves and take voluntary remedial action. As to the specific holding in *Allis-Chalmers* and its continuing vitality, the Chancellor asked:

> Can it be said today that, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that a corporate information gathering and reporting systems exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations?[26]

Doubting that such a broad generalization would have been accepted by the Delaware Supreme Court even in 1963, he stated it would not be accepted today. It would be a mistake, the Chancellor reasoned, to conclude on the basis of *Allis-Chalmers* that directors can discharge their obligation to be reasonably informed about 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

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[26] *Id.* at 969.

concerning both the corporation's compliance with law and its business performance."[27]

Accordingly, he concluded that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[28] But is this "duty" in the obligation sense or in the expectation sense? Apparently the latter, for the Chancellor's subsequent analysis reveals his view that personal liability should be imposed only when the director lacks good faith:

> [I]n my opinion 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.[29]

Thus, as seen by Chancellor Allen, the predicate for liability in a duty of oversight case looks more like recklessness than gross negligence, the standard set by the Delaware Supreme Court for duty of care cases generally.[30] The 1998 amendments to the Model Business Corporation Act echo the Chancellor's view that the director's lack of oversight must be "sustained" to be actionable. One of the enumerated grounds for liability under section 8.31 is:

> (iv) a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made)

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[27] *Id.* at 970.

[28] *Id.*

[29] *Id.* at 971.

[30] *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

> appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor;[31]

According to the commentary, "[w]hile the facts will be outcome-determinative, deficient conduct involving a sustained failure to exercise oversight – where found actionable – has typically been characterized by the courts in terms of abdication and continued neglect of a director's duty of attention, not a brief distraction or temporary interruption."[32] It is noteworthy that the one case cited in this section of the comment is *Francis v. United Jersey Bank*,[33] in which the director completely ignored her responsibilities, never attending board meetings or making any effort to familiarize herself with the corporation's business and financial condition.

As to expectations, on the other hand, *Caremark* had helped to clearly weave into the fabric of mainstream U.S. corporate law the idea that the director's duty of care included the responsibility to assure that an effective compliance system was in place. Again, we can use the *Corporate Director's Guidebook* (revised once more in 2001) as our gauge. The subsection on "Inquiry" under the duty of care now reads:

> Directors should make inquiry into potential problems or issues when alerted by circumstances or events which indicate that board attention is appropriate: for example, when information provided on an important matter appears materially inaccurate or inadequate or there is reason to question the veracity of management. When directors see "red flags" indicating that the corporation is or may be experiencing significant problems in a particular area of business, or may be engaging in unlawful conduct, they should make further inquiry until they are reasonably satisfied that management is dealing with the situation appropriately. *Directors should also periodically*

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[31] MODEL BUSINESS CORP. ACT § 8.31(a)(2)(iv) (1998).

[32] *Id.* official comment 1.*f*.

[33] 432 A.2d 814 (N.J. 1981).

satisfy themselves that corporate compliance programs are reasonably effective to help attain compliance with laws and corporate policies and procedures.[34]

6. Enforcement of the Oversight Obligation.

When it comes to the director's duty of oversight, the distinction between expectations and obligations may be more important than for other aspects of the duty of care. We saw in Section 2 that four factors reduce the practical likelihood that a pure breach of care claim would ultimately result in monetary liability to the director. Claims that meet *Caremark's* rigorous test of the oversight obligation, however, may often be able to overcome many of these layers of protection.

Consider first the requirement of a demand on the board of directors before a shareholders derivative suit may be commenced. The Delaware Supreme Court has repeatedly noted: "Where there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application."[35] The traditional test for excusing demand, set forth in *Aronson v. Lewis* discussed above, therefore does not apply. This does not mean, though, that the demand requirement is eliminated. As the court noted in *Rales v. Blasband*, the leading Delaware case on this issue:

> [W]here directors are sued derivatively because they have failed to do something (such as a failure to oversee subordinates), demand should not be excused automatically in the absence of allegations demonstrating why the board is incapable of considering a demand. Indeed, requiring demand in such circumstances is consistent with the board's managerial prerogatives because it permits the board to have

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[34] *Corporate Director's Guidebook, Third Edition*, 56 BUS. LAW. 1571, 1583 (2001) (emphasis added).

[35] Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993).

the opportunity to take action where it has not previously considered doing so.[36]

The appropriate test in these cases is "whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. Thus, a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[37]

In applying this test to duty of oversight cases, courts have evaluated "reasonable doubt" on the basis of the risk of personal liability facing the directors. When the potential for their own liability is not a "mere threat" but a "substantial likelihood," a reasonable doubt exists whether the directors can exercise independent and disinterested business judgment in responding to claims brought against them.[38] And in assessing the director's potential liability for this purpose, it is necessary to take into account any immunity created pursuant to section 102(b)(7) or its counterparts in other states.[39] Thus, the first two of the four layers of protection will tend to stand or fall together. The principal difference, of course, is that to overcome the demand requirement the plaintiff need only establish a reasonable doubt, while overcoming the second requires success on the merits.

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[36] *Id.* at 934 n.9.

[37] *Id.* at 934.

[38] McCall v. Scott, 239 F.3d 808, 816-17, *amended in part by* 250 F.3d 997 (6th Cir. 2001); Rales v. Blasband, 634 A.2d at 936; Baxter Int'l, Inc. Shareholders Litigation, 654 A.2d 1268, 1269 (Del. Ch. 1995).

[39] McCall v. Scott, 250 F.3d at 999-1001; Baxter Int'l, Inc. Shareholders Litigation, 654 A.2d at 1270 (Del. Ch. 1995).

Two federal courts of appeals have recently applied this line of reasoning to permit duty of oversight cases to proceed without a prior demand on the board.[40] The first, *McCall v. Scott*,[41] involved the directors of Columbia/HCA Healthcare Corp. and their alleged responsibility for federal investigations into health care fraud at Columbia's hospitals and other facilities. The district court had held that demand was required, apparently reasoning that *Caremark* applies only to intentional harm to the corporation. Reversing, the court of appeals observed that gross negligence suffices to state a claim under *Caremark* but not to overcome the immunity created by section 102(b)(7).[42] The court concluded, however, that the plaintiffs' allegations established "a conscious disregard of known risks" on the part of the directors, which brought the claims within the statute's exception for "omissions not in good faith."[43] In reaching this conclusion, the court stressed the prior experience of a number of the directors as either directors or managers of health care organizations that had

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[40] Demand has likewise been excused by a federal district court in *In re* Oxford Health Plans, Inc., 192 F.R.D. 111, 117 (S.D.N.Y. 2000). Another recent case, *Lewis v. Beall* (Cal. Super. Ct., Orange Cty. Jan. 18, 2001), represents the first duty-of-oversight case to proceed to judgment following *Caremark*. The court found the directors of Rockwell International Corp. not liable for the fines and costs resulting from charges that the company illegally stored and disposed of hazardous waste. It is reasonable to assume that this suit, as well, was allowed to proceed in the absence of a pre-suit demand. *See also* Ash v. McCall, 2000 WL 1370341, at *15-*16 (Del. Ch. Sept. 15, 2000) (dismissing oversight claim without prejudice for failure to make demand, with leave to amend). On the other hand, for examples of oversight cases requiring demand, *see* Salsitz v. Nasser, 208 F.R.D. 589, 599 (E.D. Mich. 2002); Baxter Int'l, Inc. Shareholders Litigation, 654 A.2d 1268 (Del. Ch. 1995); Wilson v. Tully, 676 N.Y.S.2d 531 (App. Div. 1998).

[41] 239 F.3d 808, 816-17, *amended in part by* 250 F.3d 997 (6th Cir. 2001).

[42] 250 F.3d at 999-1000. The opinion had originally said only that "something less than intentional conduct" may state a claim under *Caremark*, 239 F.3d at 818 – a position that seems more consistent with the language of *Caremark* itself. *See supra* text accompanying note 30.

[43] 250 F.3d at 1001.

been acquired by Columbia. Given that experience, their failure to respond to the various facts alleged to have come to their attention created a substantial likelihood of liability for intentional or reckless breach of the duty of care.[44]

The second case is *In re Abbott Laboratories Derivative Shareholders Litigation*.[45] The plaintiffs argued that the Abbott directors breached their duty of oversight by failing to correct compliance problems with the FDA over a six-year period that included four warning letters and reports in the national press, and ultimately resulted in imposition of the highest civil penalty in FDA history. The court's approach differed from that in *McCall*. The court accepted the plaintiffs' allegations that "the facts indicate the directors purposefully took no action."[46] As a result, it treated the case as one of affirmative board action, governed by *Aronson v. Lewis*, rather than board inaction, governed by *Rales v. Blasband*.[47] Under the *Aronson* analysis, the court concluded that the allegations in the complaint established that the board had been grossly negligent in failing to inform itself of all material information. Consequently, its actions fell outside the protections of the business judgment rule, and demand should be excused as futile. The case was decided on June 6, 2002. On August 2, the opinion was withdrawn, with the statement that a revised opinion will be issued at a later date.

Whatever the ultimate outcome in *Abbott Laboratories*, the court's approach suggests a fundamental question. Do directors face a greater practical risk of personal liability in a duty of oversight case than in other duty of care contexts because, due to the absence of a specific board decision, the business judgment rule

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[44] 239 F.3d at 819-24.

[45] 2002 WL 1225183 (June 6, 2002), *opinion withdrawn*, 299 F.3d 898 (7th Cir. 2002). The case was nominally decided under Illinois law. But the court held that the Illinois courts would follow Delaware, so the opinion relies on the Delaware case law.

[46] 2002 WL 1225183, at *7.

[47] The court went on to note that its result would have been the same, even if it had applied the *Rales* test. *Id.* n.3.

is unavailable? In one sense yes. To be sure, the court in *Abbott Laboratories* negated the business judgment rule for a different reason – the board's failure to adequately inform itself. But what if the board had fully informed itself and still decided to defy the FDA? It is one thing if the illegality is clearcut. There is a body of thinking that the deliberate decision to disobey the law is beyond the board's permissible exercise of business judgment.[48] When, however, the legality is legitimately open to debate, the directors should be protected if they decide to take on the FDA but ultimately lose. If instead, the directors simply do nothing for a sustained period and the company's practices are ultimately adjudged illegal, *Caremark* indicates they may well be liable for the resulting loss.

7. Push Versus Pull.

Before examining some of the recent corporate governance reforms in the U.S. and where they might lead, let us develop a basic analytical framework. If we envision the oversight function as the process of assuring the complete flow of information from the corporate employee in direct possession of that information all the way upstream to the board of directors, we can see the possible approaches as follows: Corporate law could put the burden on the directors to "pull" the information upstream from the employees; it could put the burden on the employee to "push" the information upstream to the board; or it could employ some combination of the two.

Traditionally, imposing pull-type obligations on the board has faced four obstacles. First, outside directors of large publicly-traded companies invariably have

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[48] *See, e.g.*, Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS §§ 2.01(b)(1) & comment *g*, 4.01(a) ¶1 comment *d* (1992). I have elsewhere questioned this view. *See* Kenneth B. Davis, Jr., *The Discretion of Corporate Management to Do Good at the Expense of Shareholder Gain – A Survey of, and Commentary on, the U.S. Corporate Law*, 13 CAN.-U.S. L.J. 7, 49-56 (1988).

demanding, high profile careers of their own. They lack the time to serve as ongoing investigators of what might be happening at the corporation. Second, directors typically lack the specialized expertise or experience necessary to detect or unravel accounting fraud or the violation of complicated regulatory requirements. Corporate law has generally demanded that they bring to the table only "the basic director attributes of common sense, practical wisdom, and informed judgment."[49] Third, the office of director carries with it only the power to function together with one's fellow directors, at a meeting, as a board or a committee of the board. Directors have no authority as individuals to initiate their own investigations into the inner-workings of the company. While the board might establish a committee to look into a specific problem, the practice to date in the U.S. has not been to form permanent board committees to police for management misconduct. Finally, the historic culture in the U.S. has been for directors to advise and counsel the CEO and other senior executives, when called upon, and not to aggressively question or challenge management in the absence of a crisis.

This last obstacle has been significantly dissipated by the attention to corporate governance over the last 25 years, although it has not disappeared altogether. Likewise, the first obstacle is not as strong as it once was. Directorships are today viewed less as honorariums and more as significant professional commitments, and directors are compensated accordingly. Otherwise, however, the traditional obstacles to effective *direct* oversight by board members persist. Some might argue that the law should impose upon them a pull-type duty of investigation nonetheless, as an incentive for directors to modify their traditional behavior. It is noteworthy, though, that in the one case where the law does impose a direct, personal obligation on each director to conduct an investigation into the corporation's affairs – that is, in connection with the filing of a registration statement for an offering of securities[50] – standard practice in the U.S. is for directors to delegate most of the due diligence work to the issuer's outside counsel

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[49] MODEL BUSINESS CORP. ACT § 8.30(b) Official Comment 3 (1998).

[50] *See* Securities Act of 1933 § 11(b)(3)(A).

and accountants. State corporation statutes specifically entitle the directors to rely on information, opinions and reports provided by the corporation's officers, employees, lawyers, accountants and consultants.[51]

The foregoing helps to explain why, as a practical matter, the pull-type duties of directors in the U.S. have evolved to focus on two basic components. First, they stress indirect information-gathering through intermediaries such as outside auditors and counsel, rather than direct information-gathering by the directors themselves. This is illustrated by *Caremark's* emphasis on the director's duty to assure that adequate information and reporting systems are in place as well as the reason efforts to make board audit committees more effective. Second, spared direct responsibility for information gathering, the directors should concentrate their personal involvement on evaluating and responding to the information that comes their way, and deciding when to ask for more or to dig deeper. This suggests a basic convergence between the two fundamental threads of the director's duty of care – that is, the rules governing inaction and those governing action. Both *Graham v. Allis-Chalmers* and *Smith v. Van Gorkom* tailor the obligational component of the director's duty of care to a few specific situations when it is reasonable to expect directors to ask tough questions and inform themselves of what is really happening.

Here again, though, the more important distinction may be between aspirations and expectations than between expectations and obligations. Asking tough questions of the CEO may run afoul of the traditional culture of the boardroom. The task is facilitated when everyone agrees that it is what good directors are supposed to do, whether or not they face personal liability if they fail to. The problem is that traditional legal institutions (legislatures, courts and regulatory agencies) intent on changing the behavior of directors will often find that, given the tools available, it is far more expedient to impose new obligations than new expectations.

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[51] *See, e.g.*, DEL. GEN. CORP. L. § 141(e); MODEL BUSINESS CORP. ACT § 8.30(e) (1998).

Push-type duties are different. While potentially available to deal with outright fraud, they are likely to have little marginal impact. Is the employee engaged in that fraud likely to act differently because now under an additional obligation to disclose it? Where they do work well is in the gray areas. Employees concerned about what they are being asked to do or how a particular transaction is being handled will be much more likely to reveal those concerns when under an obligation or expectation to do so. Certainly, this is in part due to traditional notions of deterrence; the employee wants to avoid the consequences that follow from violating the obligation or expectation. But again, overcoming corporate culture is often just as importance. The existence of a clear obligation or expectation makes it easier for the employee to voice his or her concerns without being branded as disloyal.

Pure push-type obligations apply only when imposed on the person with most direct access to the information. When imposed on those higher upstream, the push necessarily embodies an element of pull, since the person must gather the information from others. The recent requirement that corporate CEOs and CFOs certify financial statements supplies an example. CEOs and CFOs quickly developed the practice of obtaining "sub-certifications" from those involved in preparing the reports that they knew of no reason why the information does not meet the standards for attestation.

8. Post-Enron Reforms.

The recent round of corporate governance reforms was actually underway before the demise of Enron. Since Enron, of course, there has been a race to get fresh reforms into law.

A good starting point for our discussion is the 1999 *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of*

Corporate Audit Committees.[52] The committee's overarching objective was to better involve the audit committee in improving the "quality" of corporate financial reporting. This was in response to a growing concern that publicly traded companies were "managing" their reported earnings to meet the expectations of securities analysts. Several of the committees' recommendations touched on matters of corporate governance: (1) The recommendations sought to enhance the independence of the audit committee by requiring at least three directors to be members, all of whom must be independent, and by adopting a more rigorous test for who is independent. (2) Each member of the audit committee must be "financially literate." (As we have seen, corporate law traditionally has not insisted that a director meet any special qualifications or have any particular expertise.) (3) The audit committee should adopt a formal written charter, which must specify that the outside auditor is ultimately accountable to the audit committee, and that the committee has the ultimate authority to select, evaluate and replace the outside auditor. (4) The outside auditor should discuss with the audit committee its views of the quality, not just the acceptability, of the company's accounting principles, including their degree of aggressiveness or conservatism. One of the goals of the recommendations was to "encourage the outside auditors and the internal auditors to speak freely, regularly and on a confidential basis with the audit committee." This is a good example of the use of push-type obligations to change the corporate culture, as discussed in the preceding section.[53]

The SEC adopted many of the committee's recommendations in late 1999.[54] One area of particular concern was the potential for enhanced personal liability that might result from the new audit committee report required as a part of the company's annual disclosure to its shareholders. As originally recommended, the report was to include statements whether (1) the audit committee had reviewed the

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[52] The report is reprinted at 54 BUS. LAW. 1067 (1999).

[53] 54 BUS. LAW. at 1085.

[54] Securities Exchange Act Release No. 42266 (Dec. 22, 1999).

financial statements and discussed various matters with both management and the outside auditor (but no disclosure of the details of those deliberations was required) and (2) based on those discussions the audit committee believes that the financial statements are fairly presented in accordance with generally accepted accounting principles (GAAP). As to the first of these statements, the SEC rejected the concerns over enhanced reliability. Citing *Caremark*, it reasoned that by conducting the discussions referred to in the statement, the committee would better inform itself and thereby actually reduce its risk of liability. Liability concerns did lead the SEC to trim back the second statement significantly, however. It had originally proposed addressing those concerns by reducing the required statement to whether anything had come to the audit committee's attention that caused it to believe that the financial statements contained false or misleading statements. When that too failed to assuage the concerns, the SEC agreed to require only a statement whether the audit committee recommended the financial statements to the full board.

The two most important sets of corporate governance reforms following Enron have been (1) the New York Stock Exchange's proposed revisions to its listing standards as a result of the June 2002 report of its Corporate Accountability and Listing Standards Committee and (2) the Sarbanes-Oxley Act of 2002, enacted on July 30.

The New York Stock Exchange proposals address the full board as well as the audit committee. As to the full board, they require that (1) a majority of the corporation's directors must be independent; (2) the corporation must have a nominating committee and a compensation committee consisting entirely of independent directors; (3) for a director to be deemed independent, the board must determine that he or she has no material relationship with the corporation, and he or she may not have been an employee of the corporation or its outside auditor for five years; and (4) the non-management directors must meet without management present in regular executive sessions. As to the audit committee, the proposals (1) add to the test for independence the requirement that director's fees are the only compensation that the audit committee member may receive from the corporation, (2) grant the audit committee sole authority to hire and fire the independent auditor and to approve any significant non-audit relationships between it and the corporation, and (3) set forth detailed requirements for what the audit committee's written charter must address. Even before Enron, the Exchange's listing standards had required that at least one member of the audit committee have "accounting or related financial management expertise" and that all members be financially literate.

Sarbanes-Oxley requires that (1) the audit committee be directly responsible for the appointment, compensation and oversight of the outside auditor and (2) the outside auditor report directly to the audit committee. Only independent directors may be members of the audit committee. In addition, the audit committee must establish procedures for receiving complaints about the corporation's accounting and auditing functions and confidential submissions from employees about questionable accounting matters. And it must have the authority and funding to engage independent counsel and other advisers. Finally, the SEC is directed to adopt rules requiring corporations to disclose whether the membership of their audit committees includes at least one "financial expert."

The question posed by all these reforms – particularly those requiring some level of financial expertise or knowledge – is whether they enhance the duty of oversight for those directors serving as members of the audit committee. This will likely be the case in two modest ways, at least as to the expectational component of the duty if not the obligational. First, although corporate law has not held directors to any minimum level of expertise, it has at the same time recognized that "the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care."[55] Second, the various reforms will almost certainly enhance the lines of communication between the audit committee and the corporation's outside auditor, management and internal auditor. As a result, more information is likely to finds its way into the hands of the audit committee, and the directors on that committee will be expected to respond to it. It is important to keep in mind, however, that none of

[55] MODEL BUSINESS CORP. ACT § 8.30(b) Official Comment 3 (1998).

this undermines the committee members' statutory right, under state law,[56] to continue to rely on the information provided by management, the outside and internal auditors and others, so long as they do so in good faith. Most of the reforms are traceable to the work of the 1999 Blue Ribbon Committee, which observed both that "[t]he committee's job is clearly one of oversight and monitoring, and in carrying out this job it acts in reliance on senior financial management and the outside auditors" and that it "appreciates the impracticability of having the audit committee do more than rely upon information it receives, questions and assesses . . . ."[57]

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[56] *See supra* note 51.

[57] 54 BUS. LAW. at 1071, 1087. *See also* Release No., *supra* note 54, at nn. 56-57.