THE CORPORATE DIRECTOR'S COMPLIANCE OVERSIGHT RESPONSIBILITY IN THE POST CAREMARK ERA

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ABSTRACT

For corporations operating in regulated industries, compliance with the applicable laws is essential. Violation of these laws may materially affect the corporation's financial standing and may result in foreclosure of the corporation's ability to continue its operations. Thus, the avoidance of a regulatory crisis may be as significant to the corporation's long-term well-being as is strategic planning and product innovation.

The holding of the Delaware Court of Chancery in In re Caremark International, Inc., Derivative Litigation,¹ that directors may be liable for losses resulting from the corporation's failure to comply with applicable legal standards has fueled discussion of the board's role in ensuring compliance. This article discusses the board's compliance oversight responsibility in light of pronouncements by the Securities and Exchange Commission (SEC), the American Law Institute, and the American Bar Association, as well as the commentary of corporate governance scholars and other precedent. Steps for implementing a compliance program that will satisfy the board's oversight responsibility are also suggested.

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¹698 A.2d 959 (Del. Ch. 1996).

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I. INTRODUCTION

In the typical American corporation, business is managed under the direction of the corporation's board of directors. The degree of the board's involvement in the day-to-day management of the business is determined, to a great extent, by the size and complexity of the corporation. In practice, however, most directors, at least those who come from outside the corporation, cannot devote the substantive attention necessary to directly manage the business of the corporation. As a result, managers manage the

3See Del. Code Ann. tit. 8, § 141(a) (1999) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); see also American Bar Association Section of Business Law, Model Business Corporation Act § 8.01(b) (1999) [hereinafter MBCA] ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation . . . .").

3As Bayless Manning has observed:
   Many of today's corporations are not only large, they have usually become highly diversified in their business operations — even those that are not conglomerates. They often operate on a worldwide basis, and their products and services have in many cases become highly technical. This diversification and complexity of operations have been overlaid upon the ordinary problems of all businesses: accounting control, personnel succession, labor relations, financial vitality, competition, governmental regulations, profitability, product development, marketing, and the like.

Bayless Manning, The Business Judgment Rule and the Director's Duty of Attention: Time for Reality, 39 Bus. Law. 1477, 1481 (1984). Lester Pollock has similarly observed that: [i]n my experience, each effective corporate board beats to the sound of a different drummer. It is as and should be a function, among other things, of the nature of the business, its complexity, the personality and experience of the board and management, the size of the enterprise, and geographical dispersion of its assets. Each corporation has or should have a pattern of board conduct tailored to its needs; basic enough to cover fundamentals, innovative enough to get to the heart of a particular company, to assure that the board is involved, that the board has information, that the board is exercising its oversight responsibility, that the board has access to management or internal auditors or outside auditors or advisers in order to monitor and audit the activities of the company and its management.


4Dean Manning also notes in this regard that:
   [t]he outside directors of a corporation are part-time people with respect to the amount of working time that is allocated to the affairs of the company. The most recent survey (1982) shows that the average director of a publicly held company devotes a total of about 123 hours per year to his board and committee work,
business of the corporation, while the board's role is limited to providing

including travel. That averages less than 3 hours a week or about 1.5 working days a month.

Manning, supra note 3, at 1481 (citing Korn Ferry International Board of Directors, Tenth Annual Study, Feb. 1983, at 1). As a result, the paradigm of the corporation as being managed by the directors as representatives of the shareholders has been altered to correspond more closely with reality. Thus, Professor Melvin Eisenberg has commented that:

[i]n fifteen or twenty years ago, the received model of the corporation contemplated that the board of directors managed the corporation's business and made business policy; the officers acted as agents of the board and executed its decisions; and the shareholders elected the board and decided major corporate actions. It is now well understood that the received model did not reflect business reality. Many boards meet no more than six times a year, and few meet more than twelve times a year. Board meetings usually last only a few hours, time spent preparing for meetings is roughly comparable to time spent in meetings, and committee time is unlikely to exceed board time. By reason of time constraints alone, therefore, the typical board could not possibly "manage" the business of a large publicly held corporation in the normal sense of that term. Such businesses are far too complex to be managed by persons who put in the equivalent of at most ten or fifteen working days a year.

Melvin A. Eisenberg, The Duty of Care of Corporate Directors and Officers, 51 U. PITT. L. REV. 945, 949 (1990) [hereinafter Eisenberg, Duty of Care]. Professor Eisenberg made the same point recently in his article, Corporate Governance: The Board of Directors and Internal Control, 19 CARDOZO L. REV. 237, 237 (1997). See also John F. Olson, How to Really Make Audit Committees More Effective, 54 BUS. LAW. 1097, 1106 (1999), stating:

Directors are not and should not try to be full-time corporate managers. Except in times of crisis, they should provide oversight and counsel to the managers of the corporation but they are not responsible for the day-to-day work of management or for the setting of the company's strategic course.

Id.

2While, in part, this is due to constraints on the director's time, it can also be due to the director's lack of detailed information concerning the operation of the business, access to which is in the control of management. As Professor Eisenberg has noted:

In a complex organization concerned with complex choices, policy cannot be developed on a part-time basis. Furthermore, although an opportunity to consider relevant information is obviously essential to meaningful decisionmaking, the amount, quality, and structure of the information that reaches the board is largely within the control of the corporation's executives. In short, it is the executives, and not the board, who normally manage the business and set business policy.

Eisenberg, Duty of Care, supra note 4, at 950 (citations omitted). Thus, in their treatise, Edward Brodsky and Patricia Adamski observed:

The legal model of the structure of the corporation is premised upon the shareholders' election of the board of directors, who are expected to generally manage the business of the corporation, make policy, and select officers, who will carry out the policies formulated by the board. In line with this model of management structure, state corporation laws commonly provide that the business of the corporation shall be managed "by or under" the direction of the board of directors.

In reality, the actual day-to-day management of the corporation is performed by officers and not by the board of directors. Outside directors are subject to constraints of time and lack of detailed information and cannot be
oversight of the corporation's affairs.\textsuperscript{6}

For corporations operating in regulated industries, particularly those with a governmental body as its primary or sole customer, compliance with the laws and rules applicable to the corporation's business is essential. Violation of these laws and rules may materially affect the corporation's financial standing, may result in foreclosure of the corporation's ability to continue its operations.\textsuperscript{7} Thus, the avoidance of a regulatory crisis may be as significant to the corporation's long-term well-being as is strategic planning and product innovation.

Therefore, should the corporation's directors be responsible for ensuring that the laws and regulations regarding the corporation's business are obeyed? Interestingly, there does not appear to be consensus on the board's responsibility in this regard. While there is general agreement that compliance with the law and good corporate citizenship are praiseworthy goals, they are often viewed as aspirational rather than imperative.

The suggestion by the Delaware Court of Chancery in the Caremark\textsuperscript{8} case that directors may be liable for losses resulting from the corporation's failure to comply with applicable legal standards\textsuperscript{9} has fueled the discussion of the board's role in ensuring compliance. Although a definitive statement regarding a director's liability must await a decision of the Supreme Court of Delaware, the Chancellor's views in this regard finds substantial support. As a result, directors would be well advised to attend to the corporation's compliance efforts, even in the absence of a definitive statement of the board's responsibility.

\vspace{1em}

\textsuperscript{6}See generally American Bar Association, Section of Business Law, Corporate Director's Guidebook, 49 BUS. LAW. 1243, 1249 (1994) (advising that the principal responsibility of a corporate director is to promote the best interests of the corporation). Indeed, commentators have suggested that the boards of medium and large size corporations may not consistently fulfill that role. See Lawrence E. Mitchell, A Critical Look at Corporate Governance, 45 VAND. L. REV. 1263, 1273 (1992) (citations omitted) ("It is the law of American corporations that the corporation's business is to be managed by, or at least under the direction of, its board of directors. It is now a platitude that the reality is different, at least in the case of large and medium-size corporations. In reality, management manages and the board rarely acts in even a supervisory capacity.").

\textsuperscript{7}For example, as discussed infra Part IV, a corporation that has been found to have violated the law may be debarred from contracting with the United States government for up to three years. For a company that does not have other sources of revenue, debarment may effectively put it out of business.

\textsuperscript{8}In re Caremark Int'l, Inc., Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

\textsuperscript{9}See id. at 970.
This article will discuss the contours of the board's compliance oversight responsibility, as well as steps that should be taken to meet that responsibility. Part II reviews the Chancellor's opinion in Caremark in the light of other precedent. Part III considers the board's oversight responsibility as viewed by the Securities and Exchange Commission, the American Law Institute's Corporate Governance Project and the American Bar Association's Section of Business Law. Part IV discusses what the Chancellor in Caremark referred to as the "powerful incentives" for compliance, as well as the consequences of noncompliance. Part V proposes steps for implementing a compliance program that will satisfy the board's oversight responsibility. Finally, Part VI offers several concluding observations.

II. THE CAREMARK LITIGATION

A. Backdrop: The Director's Duty of Care

By virtue of their office, directors of corporations are deemed to owe duties as fiduciaries to the corporation and its shareholders.10 In accordance

10See, e.g., Harvey Gelb, Director Due Care Liability: An Assessment of the New Statutes, 61 TEMPLE L. REV. 13, 13-14 (1988) ("In the traditional corporate model the board of directors, which is elected by the shareholders, is given the ultimate power to manage the corporation. With this grant of power there comes responsibility, and directors are viewed as fiduciaries with certain duties to their corporations."). As the New York Court of Appeals explained:

Because the power to manage the affairs of a corporation is vested in the directors and majority shareholders, they are cast in the fiduciary role of "guardians of the corporate welfare." In this position of trust, they have an obligation to all shareholders to adhere to fiduciary standards of conduct and to exercise their responsibilities in good faith when undertaking any corporate action... Actions that may accord with statutory requirements are still subject to the limitation that such conduct may not be for the aggrandizement or undue advantage of the fiduciary to the exclusion or detriment of the stockholders.

The fiduciary must treat all shareholders, majority and minority, fairly. Moreover, all corporate responsibilities must be discharged in good faith and with "conscientious fairness, morality and honesty in purpose." Also imposed are the obligations of candor and of good and prudent management of the corporation. When a breach of fiduciary duty occurs, that action will be considered unlawful and the aggrieved shareholder may be entitled to equitable relief.

Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 25-26 (N.Y. 1984) (citations omitted). Characterization of the director's duties to the corporation and shareholders as fiduciary duties has been criticized. In formulating the MBCA, the Committee on Corporate Laws of the ABA Section of Business Law eschewed the use of the term fiduciary. As the committee explained, the MBCA "does not use the term 'fiduciary' in the standard for directors' conduct, because that term could be confused with the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation." 2 ABA Committee on Corporate Laws
with one of these duties, the duty of care, a director is required, at all times, to act in good faith and in a manner the director believes to be in the best interest of the corporation.11 In discharging this duty, the director is charged,

of the Section of Business Law, Model Bus. Corp. Act Ann. § 8.30 commentary at § 8-168 (1998/99 Supp.). Norman Veasey (now Chief Justice of Delaware) and William Manning are also of the view that trust principles concerning the duties of fiduciaries are inapposite to the obligations of directors. As Veasey and Manning note in regard to the avoidance of the term "fiduciary" in the MBCA:

This deemphasis (if not outright rejection) of the term "fiduciary" as an analytical tool in examining a director's conduct should help curb a form of judicial inquiry which is "at best pointless, and at worst misleading." Having proclaimed directors to be of the genus "fiduciary", courts have displayed considerable difficulty in identifying the proper species: agent, trustee, or some hybrid.

Moreover, trust law seems particularly inapposite to situations in which no self-dealing or other act of bad faith is alleged. The risks assumed by the stockholder and the _cestui que trust_ and the duties performed respectively for them by directors and trustees differ. It follows that courts should measure differently the performance of corporate directors and trustees. While both classes of "beneficiaries" are entitled to "an undivided and unselfish loyalty . . . ["] the stockholder, in return for his expectation of greater profit, accepts the risk that a director's judgments, honestly formed but not vindicated by subsequent events, may result in financial loss.

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, 925 (1980). Nevertheless, courts continue to be drawn to regard directors as fiduciaries. A former Vice-Chancellor of Delaware, William T. Quillen, has noted in this regard, "The reason why the directors' business decision is not absolutely respected is simple. Directors are fiduciaries. It is true that the risk taking responsibility of a business corporate director is materially different from the asset preserving responsibility of a personal trustee. But the fiduciary concept is so strong that the trust analogy continues to exact judicial tribute." William T. Quillen, _Trans Union, Business Judgment, and Neutral Principles_, 10 DEL. J. CORP. L. 465, 491 (1985).

11Section 8.30(a) of the MBCA sets forth the director's duty of care as follows: "A director shall discharge his duties as a director, including his duties as a member of a committee. 1. In good faith; and 2. in a manner he reasonably believes to be in the best interests of the corporation." MBCA, _supra_ note 10, § 8.30(a).

The second principal fiduciary duty of a director is the "duty of loyalty." The ABA Section of Business Law _Corporate Director's Guidebook_ notes that

[I]t is the duty of loyalty requires directors to exercise their powers in the interests of the corporation and not in the directors' own interest or in the interest of another person (including a family member) or organization. Simply put, directors should not use their corporate position to make a personal profit or gain or for other personal advantage. In themselves, conflicts of interest are not inherently improper. It is the manner in which an interested director and the board deal with a conflict that determines the propriety of the transaction and of the director's conduct.

_Corporate Director's Guidebook, supra_ note 6, at 1254-55. As explained by Professor Eisenberg:

When a director or officer acts in a manner in which his self interest is involved, the standard of conduct is that he must act or deal fairly. Like the standard that governs disinterested decision making, the standard of fair dealing has both a substantive and a procedural aspect. These two different aspects are sharply presented in cases involving self-interested transactions between director or officer and the corporation. In such cases, the substantive aspect of fair dealing requires
at a minimum, with exercising due care in being informed of the facts and law relating to a corporate decision, and with exercising due care to ensure that board decisions are made as the result of reasonable deliberation.12

that the terms of the transaction must be fair—meaning, essentially, that the terms the corporation gives or gets should be the terms it would have given or gotten if it had dealt on the market—and that the transaction must be in the corporation's best interests. The procedural aspect of fair dealing requires that the transaction and its terms must be arrived at through a fair process. For example, the director or officer must make full disclosure concerning the transaction and must explain the implications of the transaction if he is in a position to realize those implications and the persons representing the corporation are not.


12See Charles Hansen, The All Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary, 41 Bus. Law 1237, 1241 ("[U]nder corporate law, the standard of due care is met if two tests are satisfied: (i) due care must be used in 'ascertaining relevant facts and law before making the decision,' and (ii) the decision must be made after reasonable deliberation."). In their treatise, Brodsky and Adamski further elaborate:
The duty of care requires that directors and officers act with good faith and on an informed basis in making a business decision. Thus, to satisfy the duty of care, directors must make an informed business judgment; that is, they must inform themselves "of all material information reasonably available to them." The directors' decision "must be made on the basis of reasonable diligence in gathering and considering material information."

Brodsky & Adamski, supra note 5, § 2.08. Professor Eisenberg has suggested that the director's duty of care includes other duties as well, such as the duty to monitor and the duty to inquire:
The application of this standard of conduct to the functions of directors results in several distinct duties. Directors must reasonably monitor or oversee the conduct of the corporation's business to evaluate whether the business is being properly managed, primarily by regularly evaluating the corporation's principal senior executives and ensuring that appropriate information systems are in place. This is known as the duty to monitor. Directors must follow up reasonably on information, acquired through monitoring systems or otherwise, that should raise cause for concern. This is known as the duty of inquiry. Directors must make reasonable decisions on matters that the board is obliged or chooses to act upon. Finally, directors must employ a reasonable decision-making process to make decisions.

Eisenberg, supra note 11, at 440. Professor Eisenberg has also characterized these four duties (i.e., the duty to monitor, the duty of inquiry, the duty to employ reasonable decision-making, and the duty to make reasonable decisions) as comprising the corporate directors "moral obligation to exercise care." Eisenberg, Duty of Care, supra note 4, at 948. Thus, the Corporate Director's Guidebook counsels that compliance with the director's duty of care includes: (1) regular attendance and participation in board and committee meetings; (2) placement of important matters on the agenda; (3) review of significant information in advance of the board or committee meeting; (4) reliance on information from others whom the director considers to be reliable, such as the authorized committees of the board; and (5) further inquiry "when alerted by the circumstances." Corporate Director's Guidebook, supra note 6, at 1253-54. Nevertheless, former Securities and Exchange Commission (SEC) Chairman Ray Garrett cautioned that although contributions to the clarity of due care as a concept can be made, the concept "cannot be reduced to a rule of mathematical precision
Courts are particularly unsuited to, and therefore are reluctant to, evaluate, after-the-fact, whether a business decision resulted from a breach of the duty of care, or was a proper decision that simply turned out badly. As a result, the duty of care has been said to be linked to and constrained by the business judgment rule. Without doing more harm than good. Address Before the Securities Regulation Institute, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) \[79,623 (1974).

Thus, Professor Eisenberg has observed, in the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A decision maker faced with uncertainty must make a judgment concerning the relevant probability distribution and must act on that judgment. If the decision maker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail, the decision maker has not made a bad decision, because in any normal probability distribution some outcomes will inevitably fall on the unlucky tail.

Eisenberg, supra note 11, at 444.

Charles Hansen has observed that:
The duty of care, as applied by the courts to a director's decisions, is intimately linked to, and constrained by, the business judgment rule, a doctrine limiting the liability of a director in the good faith pursuit of his duties. Under that rule, so long as a director acts in good faith and with due care in the process of decision making, the director will not be found liable even though the decision itself was not one that would have been made by an ordinarily prudent person. Therefore, because application of the business judgment rule prevents the imposition of liability, and the care element of the rule is solely process, the duty of care in the decision making context is process due care alone.

The duty of care is solely meant to proscribe incompetent performance. Many corporate decisions will be carefully researched but not be profitable. These types of unprofitable decisions do not create liability. Corporate law recognizes the paramount importance of encouraging informed risk-taking by officers and directors. If corporate executives demonstrate that an unprofitable decision was preceded by a prudent consideration of the relevant facts, they are protected from liability by the business judgment rule. This rule generally insulates directors and officers from liability for decisions that are lawful, informed, rational, and made without conflicts of interest.

Id. Nevertheless, several commentators have pointed out that courts continue to review the substance of the business decision either on the basis of reasonable prudence (because the director is a fiduciary) or on the basis of good faith (because the business judgment rule only applies to those directorial decisions made in good faith). Thus, as former Delaware Vice-Chancellor Quillen has observed, "[T]here can be no question that for years the courts have in fact reviewed directors' business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries." Quillen, supra note 10, at 492. In a similar vein, Professor Eisenberg has noted that courts review decisions on the basis of rationality because an irrational decision would reflect bad faith on the part of the
Despite the longevity of the business judgment rule,\textsuperscript{15} the precise contours and boundaries of the rule remain elusive.\textsuperscript{16} Nevertheless, the business judgment rule operates as a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and with the honest belief that the action taken was in the best interests

directors:

Even courts that seem to use the term "good faith" in a relatively subjective way nevertheless almost always review the quality of decisions under the guise of a rule that the irrationality of a decision show bad faith. Courts have adopted an objective element because a subjective-good-faith standard would depart too far from the general principles of law that apply to private individuals. Serious problems would arise if even an irrational business decision was protected solely because it was made in subjective good faith.

Eisenberg, supra note 11, at 442. Norman Veasey (now Chief Justice of Delaware) and Julie Seitz have made a similar observation that the irrationality of a business decision will be viewed as evidencing a lack of good faith, at least in cases involving contests for control or termination of derivative suits. See E. Norman Veasey & Julie M.S. Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case, an the ALI Project — A Strange Porridge, 63 Tex. L. Rev. 1483, 1485-86 (1985), stating:

A decision that is either patently frivolous, capricious, or one which "no person of ordinary sound business judgment would believe" to be rational would not be in good faith or grounded on a rational business purpose and would be an "abuse of discretion." In cases other than those involving contests for control or termination of derivative suits, however, courts normally will avoid reviewing the "reasonableness" of the directors' action.

\textit{Id.} (citations omitted).

\textsuperscript{15}It has been suggested that the business judgment rule had its origins in 1829 in the case of Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829) in which it was stated:

[The occurrence of difficulties . . . which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us, to suppose the possession, and require the exercise [sic] of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions . . . . The test of responsibility therefore should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by shewing that the error of the [director] is of so gross a kind, that a man of common sense, and ordinary attention, would not have fallen into it.

\textit{Id.} at 77-78.

\textsuperscript{16}It has been observed that

[the continuing fascination of corporation law mavens with the business judgment rule and their passion for universal agreement on its true meaning is now approaching the devotion of spelunkers, New York Times crossword puzzlers and, until recently, would-be solvers of Fermat's Last Theorem. Fortunately for these enthusiasts, there is more material than ever for them to chew on.

of the corporation. In essence, the rule shields decisions by directors that are made in good faith, so long as there is a rational business purpose. As a result, the business judgment rule is viewed as a presumption, a doctrine of judicial restraint, and a substantive rule.

For example, as the Delaware Supreme Court stated in *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971), "A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment." Norman Veasey has described the business judgment rule as providing a "safe harbor" for directorial decision making:

When directors decide routine matters such as the declaration of dividends, one normally has little problem with the application of the business judgment rule. When they undertake more extraordinary transactions (such as selling a large asset) the business judgment rule ordinarily will provide a safe harbor, given good faith, absence of a disabling conflict, and due care.


The formulation of the business judgment rule in *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), has been construed as suggesting a "rational business purpose test" under which "the business judgment rule is satisfied and a decision of disinterested directors will not be disturbed if it can be attributed to any rational business purpose." Veasey & Seitz, *supra* note 14, at 1485.

See, e.g., Veasey & Seitz, *supra* note 14, at 1487 (stating that "[t]he business judgment rule is a presumption that protects directors from personal liability in damages, usually in shareholder derivative suits").

For an example, see Dennis J. Block et al., *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 3-4 (4th ed. 1993), stating:

*Should* the directors be sued by shareholders because of their decision, the court will examine the decision only to the extent necessary to verify the presence of a business decision, disinterestedness and independence, due care, good faith, and the absence of an abuse of discretion. If these elements are present—and they are assumed to be present—and the case does not involve fraud, illegality, ultra vires conduct or waste, then the court will not second guess the merits of the decision. The business judgment rule is thus a tool of judicial review rather than a standard of conduct, and applies both in actions seeking to impose liability for money damages upon directors for their decisions and in actions seeking injunctive relief against particular board actions.

*Id.* As one commentator has said:

From a systemic perspective, the rule is an institutional defense for the judiciary against invitations to venture into unfamiliar areas. Judges "really are not equipped by training and experience to make business judgments because such judgments are intuitive, geared to risk-taking and often reliant on shifting competitive and market criteria." In this sense, the rule is an integral part of judicial review in a society based on free enterprise, and helps to assure that the nation's businesses are not run from courtrooms.


The Delaware Supreme Court has stated:

The [Business Judgment] rule operates as both a procedural guide for litigants and a substantive rule of law. As a rule of evidence, it creates "a presumption that in making a business decision, the directors of a corporation acted on an informed
The protections of the business judgment rule, however, are invoked only when a decision of the board of directors is under attack. Thus, the business judgment rule provides no shelter from claims arising from the alleged breach of the duty of care, which do not involve directorial decision making, as when the directors are charged with having failed to exercise proper oversight.

22See, e.g., Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) ("In business judgment rule cases, an essential element is the fact that there has been a business decision made by a disinterested and independent corporate decisionmaker."); Smith v. Van Gorkom, 488 A.2d 858, 872 n.12 (Del. 1985) (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 n.12 (Del. Ch. 1971)); Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) ("[T]he business judgment rule operates only in the context of director action . . . . [I]t has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."); In re J.P. Stevens & Co., Inc. Shareholder Litig., 542 A.2d 770, 780 n.3 (Del. Ch. 1988) ("[A] conscious decision to act or to refrain from action is a necessary factor for the invocation of the [business judgment rule] . . . ."); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) ("Application of the rule of necessity depends upon a showing that informed directors did, in fact, make a business judgment authorizing the transaction under review.").

23Chief Justice Veasey of the Delaware Supreme Court has commented that "[s]trictly speaking, the business judgment rule applies only to business decisions and does not apply in an oversight context. But there are judgment aspects to mechanisms directors decide to set up to monitor management, and it is the judgment of the directors on which the investors are relying." E. Norman Veasey, An Economic Rationale for Judicial Decisionmaking in Corporate Law, 53 BUS. LAW. 681, 690 (1998). In this regard, it has been noted, as well, that "[t]he inapplicability of the business judgment rule is perhaps one of the most critical features of a director oversight claim. The essence of a director oversight claim is that the directors failed to detect or deter some wrongdoing on the part of management or other members of the board. These claims are ordinarily portrayed as a violation of a director's duty of care . . . ." James L. Griffith, Jr., Director Oversight Liability: Twenty First Century Standards and Legislative Controls on Liability, 20 DEL. J. CORP. L. 653, 656 (1995).
In addition to their decision-making function, directors have an obligation to see that the corporation's affairs are properly managed.\textsuperscript{24} The board's responsibility in this regard involves a variety of functions,\textsuperscript{25} including active monitoring through the installation of an internal control structure,\textsuperscript{26} and oversight of the corporation's policies and procedures.

\textsuperscript{24}As Veasey and Seitz note: Decision making is only one of two principal functions of directors. The other is "oversight." Directors must be able, as a practical matter, to delegate functions except those that are nondelegable by statute or otherwise. Although there is no precise definition of "oversight," it is clear that directors have a duty, in carrying out the statutorily mandated duty of directing the management of the corporation, to see that the officers of the corporation are properly managing its business and affairs.

Veasey & Seitz, supra note 14, at 1501.

\textsuperscript{25}For example, the Corporate Director's Guidebook identifies the following functions of the board as part of its oversight responsibility:

- approving fundamental operating, financial, and other corporate plans, strategies and objectives; evaluating the performance of the corporation and its senior management and taking appropriate action, including removal, when warranted;
- selecting, regularly evaluating, and fixing the compensation of senior executives; requiring, approving, and implementing senior executive succession plans;
- adopting policies of corporate conduct, including compliance with applicable laws and regulations, and maintenance of accounting, financial and other controls;
- reviewing the process of providing appropriate financial and operational information to decisionmakers (including board members); and evaluating the overall effectiveness of the board.

Corporate Director's Guidebook, supra note 6, at 1249.

\textsuperscript{26}Thus, for example, Professor Eisenberg has commented that "the modern authorities point in the direction of requiring active monitoring as a component of a director's due care. Active monitoring, in turn, requires the installation of an internal control structure that is appropriate for the particular corporation." Eisenberg, Corporate Governance, supra note 4, at 260. As Professor Eisenberg has explained elsewhere:

The first of these [specific duties that comprise the legal duty of care] is the duty of directors to reasonably monitor or oversee the conduct of the corporation's business, and, as a corollary, to take reasonable steps to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques. Typically, the duty to monitor is satisfied not, or not primarily, by direct observation, but by installing or reviewing the adequacy of procedures or techniques by which salient information concerning the conduct of a corporation's business will flow to the board, or to reliable executives or third-party professionals acting on the corporation's behalf and subject to the ultimate responsibility of the board.

Eisenberg, Duty of Care, supra note 4, at 951-52. Dean Manning has made a similar observation: [N]o board can deny the existence of a built-in paramount responsibility with regard to what may be called the organic or structural integrity of the company. This organic integrity is essentially made up of two elements. A company must have a functioning management in place and operating at all times. A board can itself see that this is done. And a company must have an internal information system in place that is generally suitable for an enterprise of the company's character to keep the management informed about what is going on and particularly to provide the accounting data on which to base financial statements.
regarding compliance with the law.\textsuperscript{27} However, whether a director is individually liable for losses resulting from a failure to oversee and monitor the corporation's activities has not been settled.\textsuperscript{28} Indeed, Delaware precedent is to the effect that a director's obligation to inquire into the conduct of the corporation's officers and employees arises only when there are "specific indicia suggesting misconduct," i.e., red flags.\textsuperscript{29}

The board cannot design, install, operate or monitor the operation of such systems; but the board can press for the installation and call for periodic assurances that they are in place. As to these two organic elements of the enterprise, the directors may not wait for the management to bring issues to their attention. The responsibility of the board in these two key regards is inherent and ongoing; it is up to the board to take the initiative to keep itself informed about them and to take such periodic action as its business judgment dictates.

Manning, supra note 3, at 1484.

\textsuperscript{27}Professor Edward Lawler has observed, [A]s the ultimate oversight body, the board must be sure that the company has adequate information, control, and audit systems in place to tell it and senior management whether the company is meeting its business objectives. And it is also the board’s responsibility to ensure that the company complies with the legal and ethical standards imposed by law and by the company’s own statement of values.

Edward E. Lawler, \textit{Appraising Boardroom Performance}, HARVARD BUS. REV., Jan./Feb. 1998, at 139. Thus, it was the view of the Business Roundtable twenty years ago that:

directors and top management cannot be the 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 and procedures should be designed to promote such compliance on a sustained and systematic basis by all levels of operating management.


\textsuperscript{29}See, e.g., Veasey & Seitz, supra note 14, at 1503-04. There is a belief that "recommended corporate practice" involves some monitoring or supervision, at least to ensure compliance with the law. If the expected role of a director has grown to include the installation of mechanisms to ensure compliance with laws, good counselling suggests that it be done. Nevertheless, despite advances in recommended corporate practices, heightened sensitivity, better supervision, and advanced technology, it does not follow that failure to install a surveillance system results in liability.

\textsuperscript{28}Thus, in \textit{Graham v. Allis-Chalmers Manufacturing Co.}, 188 A.2d 125 (Del. 1963), the Delaware Supreme Court held that the directors of Allis-Chalmers were not liable for losses due to violations of the federal antitrust laws of which they had no actual knowledge. As the court explained,

[D]irectors 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
The suggestion in Caremark, that a director could face personal liability for the board's failure to take steps to assure the corporation's compliance with the law, represents a departure from precedent. The Chancellor's analysis of a director's responsibility to fulfill a monitoring role, consistent with the duty of care, however, is in accordance with the main themes of corporate governance over the past twenty years.

B. The Investigation of Caremark International, Inc.

Caremark was a health care provider engaged in both patient and managed care services. Caremark's patient care business and alternative site services composed the majority of its revenue. The remainder of Caremark's business came from managed care, which included prescription drug programs and multi-specialty group practices.

Caremark realized significant revenues from third party payments, including payments from insurers and Medicare/Medicaid reimbursements. Medicare/Medicaid reimbursements were subject to a prohibition against payments by health care providers to induce the referral of Medicare/Medicaid patients.

As a matter of practice, Caremark had advice and service agreements with various hospitals, physicians and other health care providers, and distribution agreements with various drug manufacturers. Although these agreements were not specifically prohibited under the Medicare/Medicaid programs, the fact that these health care providers and drug manufacturers

reason to suspect exists.

Id. at 130. The Delaware of Chancery rejected a similar claim of director liability in In re Baxter Intl, Inc. Shareholders Litig., 654 A.2d 1268 (Del. 1995). There, it was contended that the directors had breached their duty of care by failing to prevent the corporation's employees from engaging in a scheme to systematically overcharge the U.S. Veterans Administration for medical supplies, that resulted in the suspension of the company from contracting with the government. Holding that the derivative plaintiff had not met the burden of pleading with particularity why demand should be excused, the Vice Chancellor applied the Graham standard, noting, "Plaintiff has not pled with particularity that the directors ignored obvious danger signs of employee wrongdoing. Rather, plaintiff's claim is premised on a presumption that employee wrongdoing would not occur if directors performed their duty properly. Plaintiff's position is inconsistent with Graham." Id. at 1270-71. In contrast, in Boeing Co. v. Shrontz, No. 11,273, 1992 Del. Ch. LEXIS 84 (Del. Ch. Apr. 20, 1992), reprinted in 18 Del. J. Corp. L. 225 (1993), a motion to dismiss the complaint was denied because the derivative plaintiffs had alleged instances of wrongful conduct resulting in fines and sanctions against Boeing of which they contended the board members had knowledge.

31Caremark, 698 A.2d at 961.
32Id. at 961-62.
33Id.
34Id. at 962.
35Caremark, 698 A.2d at 962.
prescribed or recommended Caremark's services to Medicare/Medicaid recipients may have created a risk of prohibited referral fees and kickbacks.°

Caremark's practices, that began with Caremark's predecessor, Baxter International, Inc., came under investigation by the Inspector General of the Department of Health and Human Services (HHS/IG) in 1991. In March 1992, the U.S. Department of Justice joined the HHS/IG investigation, expanding the investigation to include Caremark's billing practices, possibly involving unnecessary treatment, improper waiver of patient co-payment obligations, and inadequate record keeping at Caremark operated pharmacies.

On August 4, 1994, a federal grand jury in Minnesota returned a lengthy indictment charging Caremark, two of its officers, and an employee of Genentech, with having made payments in excess of $1.1 million between 1986 and 1993 to a Minneapolis physician, to induce the physician to distribute a growth hormone distributed by Caremark. These payments were in the guise of "consulting agreements" and "research grants" for which the physician performed no services.

One month later, a federal grand jury sitting in Ohio returned a second indictment alleging that an Ohio physician received $134,000 in exchange for referring Medicare patients to Caremark. It was further alleged that Caremark had provided the physician with free office equipment and the services of a registered nurse to work in his office.

C. Settlement of the Criminal Charges and Related Civil Claims

In May 1995, Caremark entered into negotiations with the U.S. Department of Justice, the Department of Health and Human Services, the U.S. Veterans Administration, the U.S. Federal Employee Health Benefits Program, the Civilian Health and Medical Program of the Uniformed Services, and various state regulatory authorities, with a view toward settling, on a global basis, the pending and threatened criminal and regulatory proceedings. On June 15, 1995, Caremark's board of directors

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36 Id.
37 Id. Caremark was spun-off from Baxter International in 1992 and a separate publicly-owned company was formed. Id. at 961.
38 Id. at 962 n.2.
39 See Caremark, 698 A.2d at 963-64.
40 See id. at 964 (quoting the indictment).
41 See id.
42 See id.
43 See Caremark, 698 A.2d at 965.
approved a settlement agreement.\textsuperscript{44} Under the agreement, Caremark entered a guilty plea to one count of mail fraud,\textsuperscript{45} and a subsidiary entered a guilty plea to two counts of mail fraud.\textsuperscript{46} Caremark agreed to pay $29 million in various criminal fines, $3.5 million for violations of the Controlled Substances Act,\textsuperscript{47} $129.1 million in civil claims arising from Caremark's payment practices, and a $2 million donation to an AIDS research grant program.\textsuperscript{48}

In exchange for the agreements, the federal and state proceedings were concluded and Caremark was allowed to continue participating in Medicare/Medicaid funded programs.\textsuperscript{49} Additionally, there were no senior officers or directors charged individually with wrongdoing.\textsuperscript{50} In December 1995, after the consummation of the agreement with the government entities, Caremark learned that several private insurance companies intended to make claims against Caremark based on the same practices that were the subject of the government's investigations.\textsuperscript{51} On March 18, 1996, following intensive negotiations with the private insurers, the Caremark board approved a $98.5 million settlement of the claims.\textsuperscript{52}

\section*{D. The Shareholder Derivative Actions}

In the meantime, based on events revealed in the two criminal indictments, as well as in various newspaper reports, five shareholder derivative actions were filed in the Delaware Chancery Court.\textsuperscript{53} The derivative actions alleged that Caremark's directors had breached their duty of care by failing to adequately supervise Caremark's employees.\textsuperscript{54} The shareholders further claimed that Caremark's directors failed to institute

\begin{footnotes}
\footnote{See id.}
\footnote{See id.}
\footnote{Id. at 965 n.10.}
\footnote{See generally 21 U.S.C. \S 841 (1994).}
\footnote{See Caremark, 698 A.2d at 965 n.10.}
\footnote{See id. As discussed infra, Caremark would have been subject to debarment from participation in Medicare/Medicaid programs by virtue of its criminal conviction. See 42 U.S.C. \S 1320a-7 (1994 & Supp. IV 1999). See Caremark, 698 A.2d at 965. Indeed, in the criminal proceedings in Ohio, the "United States stipulated that no senior executive of Caremark participated in, condoned or was willfully ignorant of the wrongdoing . . . ." Id. (emphasis in original).}
\footnote{See id. at 966.}
\footnote{See id.}
\footnote{See id. at 964.}
\footnote{See Caremark, 698 A.2d at 964.}
\end{footnotes}
corrective measures, and, as a result of these failures, Caremark had been exposed to significant liability.\textsuperscript{55}

After seeking dismissal of the complaints, Caremark entered into settlement negotiations with the plaintiffs in May 1995,\textsuperscript{56} which concluded in June with a memorandum of understanding and settlement agreement.\textsuperscript{57}

E. Review of the Settlement Agreement by Chancellor Allen

The Agreement settling the derivative actions came before Chancellor William T. Allen for approval under the legal standard: "fair and reasonable in the light of all relevant factors."\textsuperscript{58} Chancellor Allen noted that the essence of the complaint was that the Caremark directors had breached their duty of

\textsuperscript{55}See id.

\textsuperscript{56}See id. at 965.

\textsuperscript{57}See id. at 965-66. The Chancellor summarized the terms of the settlement as follows:

1. That Caremark, undertakes that it and its employees, and agents not pay any form of compensation to a third party in exchange for the referral of a patient to a Caremark facility or service or the prescription of drugs marketed or distributed by Caremark for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program;

2. That Caremark, undertakes for itself and its employees, and agents not to pay to or split fees with physicians, joint ventures, any business combination in which Caremark maintains a direct financial interest, or other health care providers with whom Caremark has a financial relationship or interest, in exchange for the referral of a patient to a Caremark facility or service or the prescription of drugs marketed or distributed by Caremark for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program;

3. That the full Board shall discuss all relevant material changes in government health care regulations and their effect on relationships with health care providers on a semi-annual basis;

4. That Caremark's officers will remove all personnel from health care facilities or hospitals who have been placed in such facility for the purpose of providing remuneration in exchange for a patient referral for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program;

5. That every patient will receive written disclosure of any financial relationship between Caremark and the health care professional or provider who made the referral;

6. That the Board will establish a Compliance and Ethics Committee of four directors, two of which will be non-management directors, to meet at least four times a year to effectuate these policies and monitor business segment compliance with the ARPL, and to report to the Board semi-annually concerning compliance by each business segment; and

7. That corporate officers responsible for business segments shall serve as compliance officers who must report semi-annually to the Compliance and Ethics Committee, and with the assistance of outside counsel, review existing contracts and get advanced approval of any new contract forms.

\textit{Id.} at 966.

\textsuperscript{58}See Caremark, 698 A.2d at 966.
care, stating: "[T]he 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." In reaching the conclusion that the proposed settlement was fair and reasonable, Chancellor Allen reviewed what he considered to be the two controlling legal contexts where director liability for inattention could arise: liability for a decision that was ill-advised or negligent, and liability for failure to monitor the activities of the corporation.

1. An Ill-Advised or Negligent Decision

In the first context, "liability may be said to follow from a board decision that results in a loss because that decision was ill-advised or 'negligent.'" Chancellor Allen observed, however, that such claims are "subject to review under the director-protective business judgment rule, assuming the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational." Chancellor Allen also observed that judicial review of directorial decisions focuses on the process leading to the decision, rather than the

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59Id. at 967. Chancellor Allen characterized the plaintiffs' theory of liability as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win judgment." Id. at 967-69.

60See id. at 967-69.

61Id. at 967. Chancellor Allen questioned the suitability of the negligence standard to a review of board attentiveness. The Chancellor suggested that imposing liability on the basis of what an "average" or "ordinary" person would consider "prudent" and "sensible" or "rational" could cause an inappropriate restriction of a director's judgment concerning the amount of risk the enterprise should assume in its investments. See id. at 967 n.16. Professor Elliott Weiss made a similar observation concerning the reluctance of courts generally to impose liability due to several factors: Courts are reluctant to subject directors — particularly outside directors — to due care liability. A number of factors explain this reluctance. First, courts realize that no person is obligated to serve as a corporate director, especially an outside director. If corporate law threatened directors who failed to perform at the level of the law's aspirations with liability, "no men (or women) of sense would take the office ...." Second, shareholders, as equity investors, can be viewed as having assumed the risk that managers will make some bad judgments resulting in business losses. Third, fact finders viewing situations retrospectively too often may be inclined to determine that a bad result was due to bad judgment rather than bad luck. Finally, the threat of liability may lead directors or managers to avoid potentially profitable but risky business opportunities or to focus on safeguarding corporate resources. Elliott J. Weiss, Economic Analysis, Corporate Law, and the ALI Corporate Governance Project, 70 CORNELL L. REV. 1, 14 (1984) (alteration in original).

62Caremark, 698 A.2d at 967 (citing Aronson v. Lewis, 473 A.2d 805 (Del. 1984)).
substance of the decision itself.\textsuperscript{63} Accordingly, a belief that a board decision was substantively wrong, stupid, egregious, or irrational will not result in 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."\textsuperscript{64}

Chancellor Allen cautioned that to do otherwise, or to evaluate the substance of a good faith 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."\textsuperscript{65} For that reason, "the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions."\textsuperscript{66}

In order to be considered to have acted in good faith, and thus to benefit from the presumption of the business judgment rule, the director's

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  \item \textsuperscript{63}Id. Professor Hansen is also of the view that the due care standard applies only to the process employed by the board in reaching the decision and not to the substance of the decision itself. Hansen, supra note 14, at 1357.
  
  It is now clear, as a result of later decision, that the holding in Van Gorkom on the duty of care in corporate decision making relates solely to process . . . . In other words, a director can make a decision that would not have been made by the ordinarily prudent person and escape liability if appropriate process was followed. Thus there is no such thing as liability for a negligent substantive decision.
  
  \textit{Id.}
  
  [T]he due care standard in corporate law is applied to the decision making process and not to its result. Even though a decision made or a result reached is not that of the hypothetical ordinarily prudent person, no liability will attach as long as the decision-making process meets the standard.

  Hansen, supra note 12, at 1241.

  \textsuperscript{64}Caremark, 698 A.2d at 967.

  \textsuperscript{65}Id. As Veasey had earlier remarked:

  [T]he rationale of the business judgment rule was rooted in the concept that, in managing or overseeing the management of a business, directors must have wide discretion to delegate, to take risks, and not be second-guessed by courts (at least insofar as their exposure to liability for damages is concerned).

  E. Norman Veasey, Book Review, \textit{The Business Judgment Rule: Fiduciary Duties of Corporate Directors}, 15 DEL. J. CORP. L. 573, 576 (1990). See also discussion supra note 13 (explaining the rationale for judicial deference to corporate directors' business decisions). Veasey and Manning ascribe the tendency of judges to substitute their judgment for that of the directors to vagueness of the ordinary prudence standard:

  \begin{quote}
  Since our "excellent, but odious" friend — the ordinarily prudent person — never takes the stand to enlighten judges or juries, the standard of care that exalts his presence actually encourages a substitution of the court's judgment for that of the defendant director. Thus, the restraints, if any, imposed upon this judgmental substitution play the most significant role in determining the outcome of a given case.
  \end{quote}

  Veasey & Manning, supra note 10, at 931.

  \textsuperscript{66}Caremark, 698 A.2d at 967-68.
\end{itemize}
decision must have been an informed one.\textsuperscript{67} The most common grounds for

\textsuperscript{67}See Hansen Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 276 (2d Cir. 1986) (citing Auerbach v. Bennett, 419 N.Y.S.2d 920, 927 (N.Y. 1979)), stating:

The proper exercise of due care by a director in informing himself of material information and in overseeing the outside advice on which he might properly rely is, of necessity, a pre-condition to performing his ultimate duty of acting in good faith to protect the best interests of the corporation.

See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 (Del. 1993) (finding breach of duty of care when decision to merge was made with no knowledge of the transaction or fair valuation); Aronson, 473 A.2d at 812 ("[T]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."). Thus, the Delaware Supreme Court has said, "[U]nder the business judgment rule there is no protection for directors who have made an 'unintelligent or unadvised judgment.'" Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Mitchell v. Highland-Western Glass, 167 A. 831, 833 (Del. Ch. 1933)). In this connection, former SEC Division of Enforcement Director (now U.S. District Judge) Stanley Sporkin commented that:

\begin{quote}
the business judgment rule provides that directors can rely on their best professional judgment when filling the duties of their office. But what is the key to the business judgment rule? First, the directors must be acting in good faith. But even under the good faith standard, they must make the requisite investigation and inquiry. Otherwise they cannot really be acting in good faith.
\end{quote}

Stanley Sporkin, \textit{SEC Enforcement and the Corporate Board Room}, 61 N.C.L. REV. 455, 456-57 (1983). Thus, the \textit{Corporate Director's Guidebook} counsels that:

[a] director is entitled to rely on reports, opinions, information, and statements (including financial statements and other financial data) presented by (i) the corporation's officers or employees whom the director reasonably believes to be reliable and competent in the matters presented, (ii) legal counsel, public accountants, or other persons as to matters that the director reasonably believes to be within their professional or expert competence, and (iii) duly authorized committees of the board on which the director does not serve, unless in any such cases the director has knowledge that would make such reliance unwarranted. However, a director relying on others has a responsibility to keep informed of the efforts of those to whom the word has been delegated. The extent of this review function will vary depending upon the nature and importance of the matter in question.

\textit{Corporate Director's Guidebook}, supra note 6, at 1253-54. Commenting on changes in the MBCA, the Committee on Corporate Laws of the ABA Section on Business Law has noted, as well, that:

\begin{quote}
unless the circumstances would permit a reasonable director to conclude that he or she is already sufficiently informed, the standard of care requires every director to take steps to become informed about the background facts and circumstances before taking action on the matter at hand. The process typically involves review of written materials provided before or at the meeting and attention to participation in the deliberations leading up to a vote. It can involve consideration of information and data generated by persons other than legal counsel, public accountants, etc., retained by the corporation, . . . . [R]eview of industry studies or research articles prepared by unrelated parties could be very useful. It can also involve direct communications, outside of the boardroom, with members of management or other directors. There is no way for "becoming informed" and both the method and the measure — "how to" and "how much" — are matters of reasonable judgment for the directors to exercise.
\end{quote}

Committee on Corporate Laws, \textit{Changes in the Model Business Corporation Act — Amendments}
liability in director negligence cases has been the abdication of the director's role through inattention and uninvolvelement. As Chancellor Allen pointed out, a director's unsuitability for the position is not grounds for liability, so long as "a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention."  


See Hansen, supra note 14, at 1359. Indeed, Charles Hansen has said that abdication or prolonged failure to exercise oversight have been the only grounds for director liability in nondecision making cases.

Even in a nondecision making context, however, the required due care standard is less stringent than that which "an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." While it is true that this so-called traditional language often appears in the cases, a careful examination of the facts and holdings based thereon yields a different result. Using such an analysis, it would appear that directors were found liable in the nondecision making context only upon an express abdication of responsibility or upon obvious and prolonged failure to exercise oversight or supervision.

Id. Thus, in the seminal case of Bowerman v. Hamner, 250 U.S. 504 (1919), a director of a failed bank was found liable for negligent management of the bank's affairs based on evidence that he never attended a meeting of the directors, never reviewed a statement of the bank's financial condition, never examined the bank's books and records, and did not otherwise inform himself of the loan transactions that resulted in the bank's failure. In sum, as the Supreme Court noted, "[H]e deliberately avoided acquiring knowledge of [the bank's] affairs and wholly abdicated the duty of supervision and control which rested upon him as a director." Id. at 510-11. Similar dereliction has resulted in director liability in a variety of other cases. See, e.g., Sandberg v. Virginia Bankshares, Inc., 891 F.2d 1112 (4th Cir. 1989), rev'd on other grounds, 501 U.S. 1083 (1991). In cases other than director abdication, the standard for director liability is less clear, however, as Dean Manning has observed:

Although courts regularly declare that the director who is not careful is not entitled to the protection of the business judgment rule, courts have been extremely reluctant to decide retrospectively that personal liability should be imposed on a director for failure to perform his duties with sufficient care. It is universally agreed that an outside director who simply ignores directorial responsibilities, does not attend meetings, and fails to do necessary homework runs a substantial risk that if something goes wrong, the business judgment rule will not be available as a defense. It is also agreed that an outside director is not expected to devote his or her entire working time and energies to performing the functions of the director. Between these extremes, however, the criteria are murky.


Caremark, 698 A.2d at 968. In this connection, Chancellor Allen stated:

Judge Learned Hand made the point rather better than can I. In speaking of the passive director defendant Mr. Andrews in Barnes v. Andrews, Judge Hand said:

True, he was not very suited by experience for the job he had undertaken, but I cannot hold him on that account. After all it is the same corporation that chose him that now seeks to charge him.... Directors are not specialists like lawyers or doctors.... They are the general advisors of the business and if they faithfully give such ability as they have to their charge,
2. Director Liability for Failure to Monitor

The Chancellor's discussion of the second context in which director liability can result — that is, where a "loss eventuates not from a decision but, from unconsidered inaction"\textsuperscript{70} — has been more provocative. It was in this connection that Chancellor Allen suggested that directors could be liable. For failure to comply with applicable legal standards that results in economic loss.\textsuperscript{71}

Chancellor Allen noted that the board's attention is normally devoted only to the most significant corporate matters, for example, the appointment and compensation of the CEO, changes in the capital structure, and mergers.\textsuperscript{72} As exemplified by Caremark's experience, however, actions taken by officers and employees outside of the board's normal purview can have

\textit{id. (quoting Barnes v. Andrews, 268 F. 614, 618 (S.D.N.Y. 1924)).} Although Judge Hand found that Andrews, as director, had failed to adequately inform himself of the condition of the business, Judge Hand declined to impose liability because, the action being in tort, plaintiffs had failed to prove that Andrews' inattention had caused the business to fail. \textit{id. at 616.} However, as the Delaware Supreme Court made clear in Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 370 (Del. 1993), that because \textit{Barnes} was a tort action it does not control claims for breach of fiduciary duty, such as the duty of care.

\textsuperscript{70}Caremark, 698 A.2d at 968.

\textsuperscript{71}Chancellor Allen's suggestion that directors may be liable in the event of corporate illegality has engendered a broad range of comment. \textit{See, e.g.,} Steven N. Berk, \textit{Do Right and Do Well with Internal Compliance}, CORP. COUNSEL MAG. 98 (June 1997); Edward Brodsky, \textit{Director's Liability — The Importance of Compliance Procedures}, DERIVATIVES LITIG. REP. 11 (Mar. 1997); Kathryn A. Finerty, \textit{The Duty of Care After Caremark}, 15 ACCA DOCKET 54 (Nov./Dec. 1997); Harvey L. Pitt et al., \textit{Director Duties to Uncover and Respond to Management Misconduct}, INSIGHTS 5 (June 1997).

\textsuperscript{72}Caremark, 698 A.2d at 968. As Chancellor Allen observed:

Most of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention. Legally, the board itself will be required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEO, etc. As the facts of this case graphically demonstrate, ordinary business decisions that are made by officers and employees deeper in the interior of the organization can, however, vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals.

\textit{id.} The vicarious liability of corporations for the criminal acts of its employees and agents has been the law in the United States for the better part of a century following the Supreme Court's decision in \textit{New York Central \\& Hudson River Railroad Co. v. United States}, 212 U.S. 481 (1909). \textit{See generally} Kathleen F. Brickey, \textit{Corporate Criminal Accountability: A Brief History and Observation}, 60 WASH. U.L.Q. 393 (1982) (surveying the history of regulating institutions).
significant adverse effects on the corporation's well-being and ability to conduct its business. The consequences to Caremark and other companies of such actions led the Chancellor to consider the board's responsibility to monitor the corporation's compliance with law.

The issue of the board's responsibility for assuring the corporation's legal compliance takes on a special importance because of what the Chancellor viewed as "an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements." The effect of this increased criminalization of corporate conduct has been magnified by the Sentencing Guidelines for Organizations, where penalties are imposed on corporations convicted of crimes "that equal or often massively exceed those previously imposed on corporations." For those reasons, the Chancellor found that the sentencing guidelines offered powerful incentives for corporations to implement effective compliance programs.

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73Caremark, 698 A.2d at 968.
74Id. at 968-69. As Chancellor Allen wrote: If this case did not prove the point itself, recent business history would. Recall for example the displacement of senior management and much of the board of Solomon, Inc.; the replacement of senior management of Kidder, Peabody following the discovery of large trading losses resulting from phantom trades by a highly compensated trader; or the extensive financial loss and reputational injury suffered by Prudential Insurance as a result its junior officers' misrepresentations in connection with the distribution of limited partnership interests. Financial and organizational disasters such as these raise the question, what is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?

Caremark, 698 A.2d at 968-69.
75Caremark, 698 A.2d at 969. As Chancellor Allen stated: Modernly this question [of the board's responsibility to assure compliance] has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations.

Id.
77Caremark, 698 A.2d at 969.
78Id. Thus, the Chancellor observed: In 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission adopted Organizational Sentencing Guidelines which impact importantly on the prospective effect these criminal sanctions might have on business corporations. The Guidelines set forth a uniform sentencing structure for organizations to be sentenced for violation of federal criminal statutes and provide for penalties that equal or often massively exceed those previously imposed on corporations. The Guidelines offer powerful incentives for corporations today to have in place compliance programs to detect violations of
Although not commented upon by Chancellor Allen, the criminal conviction of a company doing business with the government may have consequences more severe than the penalties imposed under the guidelines. In general, companies believed to have engaged in serious criminal conduct are not considered to be suitable to contract with the government for goods or services. As a provider of health care to patients covered by Medicare/Medicaid, Caremark's indictment and subsequent convictions for mail fraud could have resulted in its suspension and debarment from participation in the Medicare/Medicaid programs. Similar restrictions also apply to other government contractors. Under federal regulations, a contractor may be suspended from receiving contracts pending the institution of legal proceedings if there is "adequate evidence" that the contractor has engaged in a criminal action. An indictment is deemed to satisfy this criteria upon conviction. A contractor may be debarred from being awarded a government contract for three years. For many contractors, debarment is tantamount to a corporate death sentence. Thus, for companies like Caremark, a compliance program that may prevent criminal conduct or may at least mitigate the effects of that conduct in the eyes of the procurement law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.

Id. Delaware Chief Justice Veasey appears to agree, although he points out that director liability is another matter.

[T]he guidelines alone should be sufficient incentive for a board to have a law-compliance system as a matter of good corporate practice. I hasten to add, however, that liability issues may be another matter... As a matter of good corporate practice, I think it would be unwise for a board to adopt an ostrich attitude and do nothing in this area.

Veasey, supra note 23, at 692.

79Under the Medicare and Medicaid Patients and Program Protection Act of 1987, 42 U.S.C. § 1320a-7 (1994), and the implementing regulations, 42 C.F.R. § 1001.1 (1999), conviction of crime may result in either a mandatory or permissive exclusion from the program for up to five years. Chancellor Allen noted that the settlement agreement entered into with the government allowed Caremark to continue to participate in the Medicare/Medicaid programs. Caremark, 698 A.2d at 965.


integrity officials, may mean the difference between continuation in business or financial ruin.

In Graham, however, the Delaware Supreme Court appeared to have ruled that there was no general obligation on the part of directors to monitor the corporation's compliance with law, and, absent some cause for suspicion, the directors had no obligation, under their duty of care, "to ferret out wrongdoing which they have no reason to suspect exists." Although Graham involved a claim that the board failed to monitor antitrust compliance, notwithstanding that the corporation was subject to two antitrust consent decrees and was therefore liable for losses suffered by the corporation as a result of violations of the antitrust laws, Chancellor Allen questioned the breadth of the Graham holding and its applicability to the Caremark facts. Instead, Chancellor Allen interpreted the Graham holding to allow the board to rely on the honesty and integrity of the corporation's officers and employees, unless there are grounds to suspect otherwise.

In any event, Chancellor Allen was of the view that an interpretation of Graham that "a corporate board had no responsibility to assure that appropriate information and reporting systems are established by management," would not be accepted by today's Delaware Supreme Court.

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82 According to 48 C.F.R. § 9.402(a) (1997), government contracts will only be awarded to responsible contractors.

83 Using what Chancellor Allen described as "notably colorful terms," Caremark, 698 A.2d at 969, the Delaware Supreme Court said in Graham that "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." Graham, 188 A.2d at 130.

84 Caremark, 698 A.2d at 969. Chancellor Allen was of the view that Graham did not limit the board's responsibility to be informed of, among other things, the corporation's compliance with applicable laws:

Can it be said today that, absent some ground giving rise to suspicion of violations of law, that corporate directors have no duty to assure that a corporate information gathering and reporting system 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? I certainly do not believe so. I doubt that such a broad generalization of the Graham holding would have been accepted by the Supreme Court in 1963.

Id.

85 Caremark, 698 A.2d at 969. As Chancellor Allen stated:

The [Graham] case can be more narrowly interpreted 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.

Id.

86 Caremark, 698 A.2d at 969-70. Chancellor Allen noted three developments in Delaware law as leading him to this conclusion. The first was "the seriousness with which the corporation law views the role the corporate board" as reflected in the line of cases from Smith v. Van Gorkom, 488
Indeed, Chancellor Allen opined that it would be a mistake to conclude otherwise.\(^8^7\)

A.2d 858 (Del. 1985) through Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1993). Second, Chancellor Allen noted, "[T]he elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law." *Caremark*, 698 A.2d at 970. Third, Chancellor Allen noted that in view of the "potential impact" of the federal sentencing guidelines on corporations convicted of criminal conduct, "[a]ny rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers." *Id.*

\(^8^7\) *Caremark*, 698 A.2d at 970. Thus, Chancellor Allen observed with respect to the proper reading of *Graham* that:

[i]t 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.

*Id.* The views of Chief Justice Veasey of the Delaware Supreme Court appear to be in accord with Chancellor Allen on this point. Although making it clear that he was not commenting on the continued vitality of *Graham* or on Chancellor Allen's opinion in that regard, Chief Justice Veasey observed that:

the oversight responsibility is a dynamic one. That is not to say that *Graham* would or would not be decided the same way today on its particular facts. No doubt, however, some of the language in *Graham* would be edited as we now look at it through a prism of what is now thirty-four years of experience. Today, as the Chancellor noted, the federal sentencing guidelines give a corporation credit, in a criminal proceeding, for "an effective program to prevent and detect violations of law" and that the program should be "reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct." These Guidelines alone should be sufficient incentive for a board to have a law compliance system as a matter of good corporate practice.

E. Norman Veasey, *The Director and the Dynamic Corporation Law with Special Emphasis on Oversight and Disclosure*, prepared for delivery as the keynote address to the 17th Annual Ray Garrett, Jr. Corporate and Securities Law Institute, Chicago, Illinois, Apr. 24, 1997, at 11. Justice Veasey expressed these same views in Veasey, *supra* note 23, at 691. Additionally, several commentators have suggested that *Graham* should not be interpreted as relieving the board of its responsibility to implement and oversee corporate compliance programs. William Kennedy has said, for example, that:

[w]e do not suggest that a prudent board of directors or an experienced corporate lawyer, in advising the board, would place uncritical reliance on *Allis-Chalmers* in the specific antitrust context. If the company has a history of serious antitrust violations, or if there is a specific basis for current concern, it may well be appropriate for corporate management to establish a compliance program, and for a board to review the program and to require periodic reports as to its operation. Compliance reports may also be appropriate in other sensitive areas.

William F. Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624, 640 (1984). Professor James Cox has also observed that the changes in the perception of directors from "super-managers" to monitors, together with the modern practice of employing legal compliance programs, have recast the *Graham* decision:
Chancellor Allen emphasized that in order for the board to successfully avail itself of the business judgment rule in this respect, the directors must "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." Therefore, the board would satisfy its responsibility to be reasonably informed about the corporation. Accordingly, it was the Chancellor's conclusion that a director is obliged to take appropriate action, under the circumstances, to assure that the corporation has an adequate information and reporting system in place, and that a director's failure to do so could result in liability for losses resulting from the corporation's noncompliance with applicable legal standards. We must await further elucidation by the Delaware Supreme Court in order to determine if Chancellor Allen was correct in his assessment of potential director liability.

3. Analysis of the Claims

Applying the previously mentioned controlling legal principles to the derivative plaintiff's claims, Chancellor Allen concluded that the settlement was "fair and reasonable." The Chancellor noted that in order to prevail on a claim that the directors breached their duty of care by failing to control the corporation's employees, four elements must be shown: "(1) that the director knew or (2) should have known that violations of law were occurring and,

Graham's reasoning is understandable in the context of an era when directors were perceived as "super-managers" rather than monitors of those who manage. In contrast to the atmosphere in which the court decided Graham, a solid perception now prevails that the role of directors is to monitor management's stewardship. A corollary of this perception is the well-received practice among public corporations of designing, installing, and enforcing legal-compliance systems such as those for which the plaintiff in Graham argued. Because the content of the law is informed and legitimized by prevailing practices, there is ample reason to believe that Allis-Chalmers' board today would be pressed to justify the absence of any compliance procedures. James D. Cox, The ALL, Institutionalization and Disclosure: The Quest for the Outside Director's Spine, 61 GEO. WASH. L. REV. 1233, 1256-57 (1993) (emphasis in original).

See Caremark, 698 A.2d at 970.

See id.
The Chancellor also noted that no corporate information and reporting system could ensure compliance with law, and that the design of such a system was a matter of business judgment. Caremark, 698 A.2d at 970. With respect to director liability, Chancellor Allen commented further that "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause, since, for reasons that I take to be obvious, it could never be assumed that an adequate information system would be a system that would prevent all losses." Id. at 970 n.27.

Caremark, 698 A.2d at 970.
in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in losses.\[^{91}\] The Chancellor concluded that the record in the case did not support such a showing.\[^{92}\]

First, Chancellor Allen found that the record did not support a finding that the board of directors had actual knowledge of the violations of law. The board was aware that Caremark had financial arrangements with health care professionals who had prescribed treatments that Caremark provided. The board was also aware that payments for these treatments were made by government agencies that prohibited referral payments.\[^{93}\] Nevertheless, the board had been advised by both in-house and outside counsel that although the law prohibiting referral payments was unclear, in their opinion, Caremark's contracts with the health care professionals were legal and Caremark had disclosed this uncertainty, as well as the government's investigation, in its 1992 annual report.\[^{94}\] Chancellor Allen considered the board's reliance on counsel's opinion to have been reasonable, and therefore,

\[^{91}\]Id. at 971. Citing Cede & Co. v. Technicolor, Inc., 636 A.2d 956 (Del. 1994), the Chancellor noted, with respect to the fourth element, that causation may also be thought of as an affirmative defense. Caremark, 698 A.2d at 971. In Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993), the Delaware Supreme Court held that proof of resultant loss was not required in a duty of care claim to overcome the presumption of correctness under the business judgment rule. Id. at 371. The court also noted, however, that shifting the burden of proof on to the directors (by rebutting the business judgment rule) did not thereby establish director liability. See id. Instead, the court appeared to suggest that proof of resultant loss, either affirmatively or defensively, would be part of an adjudication on the merits. As the court explained:

To inject a requirement of proof of injury into the [business judgment] rule's formulation for burden shifting purposes is to lose sight of the underlying purpose of the rule. Burden shifting does not create per se liability on the part of the directors; rather, it is a procedure by which Delaware courts of equity determine under what standard of review director liability is to be judged. To require proof on injury as a component of the proof necessary to rebut the business judgment presumption would be to convert the burden shifting process from a threshold determination of the appropriate standard of review to a dispositive adjudication on the merits.

Id.

\[^{92}\]Caremark, 698 A.2d at 971.

\[^{93}\]See id. As early as 1989, Caremark's predecessor had issued a "Guide to Contractual Relationships" stating that payments would not be made to health care professionals in exchange for patient referrals. This guide was reviewed and updated regularly by Caremark's lawyers. Following the promulgation of so-called "safe harbor regulations" by the U.S. Department of Health and Human Services in July 1991, both the guide and the company's standard-form agreements were revised to conform to the regulations. In April 1992, after the government's investigation had begun, the guide was again revised to ensure that Caremark's contractual arrangements either complied with the prohibitions against referral payments or excluded Medicare/Medicaid patients altogether. See id. at 962.

\[^{94}\]See id. at 963.
there was no issue of the board knowingly causing the corporation to violate a criminal statute.95

Next, Chancellor Allen found that the record did not support a finding of breach of duty resulting from a failure to monitor the activities of the corporation. Although "the board was to some extent unaware of the activities that led to liability," in the Chancellor's view, "only a sustained or systematic failure of the board to exercise oversight [would establish] the lack of good faith that is a necessary condition to liability."96 Chancellor Allen cited as an example of such a sustained or systematic failure to exercise oversight, "an utter failure to attempt to assure a reasonable information and reporting system exists."97 On the record before him, the Chancellor found that "the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts."98

The Caremark decision was the product of Chancellor Allen's view of the role of directors, particularly the corporation's outside directors, as active monitors of corporate management who, by virtue of their office, assume responsibility for the company's performance.99 The Chancellor's views in that regard, as well as his view that legal compliance is within the director's oversight responsibility under the director's duty of care, also finds

95See id. at 971.
96Caremark, 698 A.2d at 971.
97Id.
98Id. Chancellor Allen had earlier noted that Caremark had already had an internal audit plan during the period of the government's investigation that had been focused on compliance with the company's business and ethics policies. Caremark's outside auditors had reviewed Caremark's control structure and had found no material weaknesses. The independent auditors had also informed the board's Audit and Ethics Committee that the auditors were not aware of any irregularities or illegal acts in relation to the government's investigation. The Audit and Ethics Committee nevertheless adopted a new audit charter that required a comprehensive review of compliance policies and the compilation of an employee ethics handbook. In addition, employees received training concerning the prohibition against referral payments and the proper use of the company's standard form contracts. New policies were also adopted requiring headquarters approval of disbursements under contracts with health care professionals and requiring branch managers to certify compliance with the ethics program. Id. at 963.
99For example, in his address at the Ray Garrett, Jr. Corporate and Securities Law Institute in 1992, Chancellor Allen observed that:
[6]Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.
substantial agreement and support in the corporate governance thinking of the Securities and Exchange Commission, the American Law Institute, and the American Bar Association.


Corporate reform has been a recurring theme throughout the twentieth century. In the early decades of the century, the reform movement arose from the perceived increase in corporate concentration and resulted in the "trust busting" legislation of the Theodore Roosevelt and Taft administrations. Interest in corporate reform was rekindled by the Great Depression. In response to the perception of the failure of the business system, the Franklin Roosevelt administration enacted sweeping regulatory legislation as part of the "New Deal." The current corporate governance movement arose, in large part, as a reaction to the revelations of illegal corporate campaign contributions by U.S. corporations during the 1970s and the subsequent inquiries by the Securities and Exchange Commission's Division of Enforcement. Unlike

102 See id. As Professor Schwartz observed:
No one explanation can suffice for the revived interest in basic corporate reform in the 1930s, except that most of the different strands of thought were Depression-related. That is, many believed that the business system had failed and that corporations needed fundamental changes. Berle and Means ... pointed to the separation of ownership from control, placing a worrisome amount of power in the hands of managers who were not effectively accountable for its exercise. More important than the philosophical musings, many changes resulted from this concentrated effort, accomplished through a patchwork of regulatory statutes.

Id. at 547-48.
their earlier incarnations, however, the current reform efforts have focused on the process with which the corporation is managed, rather than on controlling corporate behavior through substantive law reform.\(^\text{104}\)

The Securities and Exchange Commission has been a significant force in the corporate governance movement. Beginning with its inquiry into questionable corporate payments in the mid-1970s, and in subsequent reports, public statements and enforcement proceedings, the SEC spearheaded the re-evaluation of the way that publicly held corporations are managed.

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The "ferment" in corporate law appears to have been precipitated in large part by several developments in the mid-1970's. One was the general re-examination of our institutions that followed in the wake of Watergate. An element of Watergate was the revelation that some of our largest corporations had been engaged in widespread violation of domestic law, and some others had paid bribes to persons at the highest levels of foreign governments and thereby recklessly endangered our national security by putting at risk the political stability of our closest allies. In the short term, these disclosures led to the Foreign Corrupt Practices Act of 1977. In the long term, they needlessly shook the public's confidence in one of the pillars of legitimacy of the American corporate system — the premise ... that placing control of the factors of production and distribution in the hands of privately appointed managers maximizes our national wealth without entailing substantial nonfinancial costs.

Id. Furthermore, see Bryan F. Smith, Corporate Governance: A Director's View, 37 U. MIAMI L. REV. 273, 276 (1983), noting:

The growing importance of such public issues as pollution and the environment, consumerism, and civil rights in the late 1960's and early 1970's led to the enactment of hundreds of new regulatory restraints on business enterprises. The revelations of Watergate and instances of corporate bribery and corruption represented to many a breakdown of effective control in certain elements of American business.

Id.\(^\text{104}\)

See Schwartz, supra note 101, at 549. As former SEC Commissioner A.A. Sommer has observed:

In the mid-seventies, as a consequence of numerous corporate failures, the disclosure that many American companies made questionable and often illegal payments abroad and illegal campaign contributions at home, and the upsurge in contested corporate takeovers, there developed a renewed interest in corporate governance: the rights of shareholders, the duties of directors and management, the institutionalization of practices like the audit committee — generally, how corporations governed themselves.

A. The Securities and Exchange Commission

1. The Accounting and Controls Provisions of the Foreign Corrupt Practices Act

Corporate management, as well as the adequacy of internal controls, came under intense public, regulatory, and legislative scrutiny following the uncovering of financial abuses by some of America's leading corporations by the Watergate special prosecutor. The SEC followed up on the revelations of overseas "slush funds," used by U.S. corporations to make illegal campaign contributions in the U.S. and corrupt payments to foreign officials, by undertaking its own broad-ranging investigation.

The SEC's division of enforcement brought actions against a variety of companies, including: Ashland Oil, Inc.; Gulf Oil Corporation; Phillips Petroleum Company; Northrop Corporation; Braniff Airways, Inc.; General Tire and Rubber Company; Lockheed Aircraft Corporation; and United Brands Company. Enforcement actions were also brought against a number of other companies.

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The SEC also instituted a program in which companies conducted their own internal investigations of "questionable payments" and voluntarily reported the results of their investigations to the SEC. This "voluntary disclosure program" resulted in reports of sensitive or questionable payments by over 400 companies.

The SEC reported the findings of its questionable payments inquiry to Congress in 1976. Based on the information received from the SEC, Committees in both the House and the Senate conducted hearings in 1976 and 1977. The portrait of the conduct of U.S. companies that emerged was not flattering.

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116See Abuses of Corporate Power: Hearings Before the Subcomm. on Priorities and Econ. in Gov't of the Joint Econ. Comm., 94th Cong. 16-18 (1979) (testimony of Roderick M. Hill, Chairman of the SEC); see also Daniel L. Goelzer, The Accounting Provisions of the Foreign Corrupt Practices Act-The Federalization of Corporate Record Keeping and Internal Control, 5 J. Corp. L. 1, 6-9 (1979) (describing the SEC's voluntary disclosure program); John Sweeny, The SEC Interpretive and Enforcement Program Under the FCPA, 9 SYRACUSE J. INT'L. & COM. 273, 275 (1982) (explaining that the SEC's voluntary disclosure program gave corporations the option of voluntary disclosures that avoided court filings, in exchange for making a generic report that would not disclose details of bribery payments); Wallace Timmeny, An Overview of the FCPA, 9 SYRACUSE J. INT'L. & COM. 235, 236-37 (1982) (explaining the historical development of Foreign Corrupt Practices Act (FCPA) disclosure and record keeping requirements); Note, supra note 105, at 1851-52 (stating that voluntary disclosure meant corporations could avoid litigation).

117See Timmeny, supra note 116, at 237.

118See generally SEC. AND EXCH. COMM'N, 94TH Cong., 2D SESS., REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (Comm. print 1976) [hereinafter May 12 Report].


120Thus, for example, Theodore Levine and Edward Herlihy characterized the revelation as follows:

Throughout much of history, corruption has been no stranger to money dealings between businessmen, politicians, and others. The trail of Watergate, however, has led to revelations of foreign and domestic bribes, kickbacks, political payoffs, and other questionable financial transactions involving U.S. and foreign corporations to an unprecedented extent and degree. These transactions have been facilitated by elaborate methods of concealment, including the falsification of records and the structuring of fictitious transactions, which are generally lumped under the rubric "management fraud."
The Foreign Corrupt Practices Act of 1977 (FCPA)\textsuperscript{121} was the product of these discoveries.\textsuperscript{122} The FCPA is perhaps best known for the anti-bribery

The complexity and variety of the cases involving management fraud have perplexed observers. On a daily basis, new revelations of corporate misconduct, at home and abroad, are made. Although there is no distinct model or prototype, several factors typically are present, including the involvement of corporate management, the falsification of corporate books and records, the accumulation of secret pools of corporate funds or the diversion of funds from the corporate entity, and the illegality of the conduct involved.

\textbf{Edward Herlihy} & Theodore Levine, \textit{Corporate Crisis: The Overseas Payment Problem}, 8 LAW & POL’Y Int’l Bus. 547, 547-48 (1976). Professor John C. Coffee made a similar observation: Improper payment stories first began to trickle out from the swamp of Watergate when the Special Prosecutor’s Office discovered a sizable number of American corporations had made illegal political contributions during the 1972 presidential campaign. This freshest quickly swelled to a steady stream with the subsequent investigation initiated by the SEC to determine whether the absence of disclosure surrounding these payments had violated the federal securities laws. The floodstage was reached, however, only after the revelation of an unrelated and unsuspected scandal: "Bananagate." The dramatic exposure of United Brands misconduct occurred after the suicide of its prominent chief executive officer, Eli Black, whose death followed the commencement of an SEC investigation into a $1.25 million payment, authorized by Black, to the President of Honduras, apparently to avoid the imposition of a confiscatory export duty on bananas. "Bananagate" shifted the focus of both SEC and popular attention from illegal domestic political contributions to the broader issues arising out of foreign and commercial bribery. It thus set the stage for the unfolding of the incredible saga of Lockheed Corporation and its worldwide efforts to bribe senior ministers of friendly foreign governments. Other notable instances of such payments, such as those of Gulf in South Korea, Exxon in Italy, and Northrop and Grumman in the Middle East, have been described in detail elsewhere, and in the aggregate suggest a level of corporate hubris and unchecked ambition reminiscent of Commodore Vanderbilt and the nineteenth century robber barons.


\textsuperscript{122}As former Secretary Chairman Harold M. Williams explained: [D]uring the mid-1970's the existence of a pattern of questionable payments to foreign government officers by prominent American corporations became public knowledge. These disclosures — often, in bold headlines — shook faith and trust in the integrity of the corporate sector. This reaction became part of a rising tide
provisions which prohibit the payment, directly or indirectly, of money or "anything of value" to officials of a foreign government or political party, with corrupt intent, in order to obtain or retain business.\textsuperscript{123}

In addition to the anti-bribery provisions, the FCPA established, for the first time under federal law, record keeping and accounting requirements\textsuperscript{124} for publicly traded companies registered with the SEC pursuant to the Securities and Exchange Act of 1934.\textsuperscript{125} Under these provisions, "issuers"\textsuperscript{126} are first required to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."\textsuperscript{127} Second, issuers are required to have in place internal controls that provide "reasonable assurances" that:

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with

of public skepticism and served further to undermine the traditional American consensus that business conducts itself and reasonably pursues its own economic interests in a manner consistent with the standards and expectations of the larger society. In this climate, Congress felt compelled to act. And, after nearly three years of hearings and debate, the Foreign Corrupt Practices Act became law. The Accounting Provisions of the Foreign Corrupt Practices Act: An Analysis, supra note 120, at 83,934.


\textsuperscript{126}The FCPA's accounting provisions apply to "e[very] issuer which has a class of securities registered pursuant to [15 U.S.C.] section 78f and every issuer which is required to file reports pursuant to [15 U.S.C.] section 78o(d) . . . ." 15 U.S.C. § 78m(b)(2) (1994). An "issuer" is defined in the Securities Exchange Act as:


\textsuperscript{127}Id. § 78m(b)(2)(A).
generally accepted accounting principals or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.\(^\text{123}\)

The accounting and controls provisions of the FCPA, which were adopted largely at the insistence of the SEC,\(^\text{129}\) represented a significant expansion

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\(^{123}\text{Id. § 78m(b)(2)(B). As former SEC Chairman Harold M. Williams commented, "In essence, these objectives are that assets be safeguarded from unauthorized use, that corporate transactions conform to managerial authorizations, and that records be accurate." Remarks Before the American Institute of Certified Public Accountants, Foreign Corrupt Practices Act of 1977, Release No. 34-17500, 46 Fed. Reg. 11,544, 11,545 (Feb. 9, 1981). See also SEC v. World-Wide Coin Inv. Ltd., 567 F. Supp. 724, 750-51 (N.D. Ga. 1983) (explaining that the financial controls provisions serve to implement significant internal governance requirements).}\)

\(^{129}\text{In its Report on Questionable and Illegal Corporate Payments and Practices, the SEC stated that:}\)

[i]The almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is a proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to the shareholders do not omit or misrepresent material facts. Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors. Accordingly, the primary thrust of our actions has been to restore the efficacy of the system of corporate accountability and to encourage the boards of directors to exercise their authority to deal with the issue.

May 12 Report, supra note 118, at (a). A former deputy director of the SEC's Division of Enforcement has said that:

[i]n the early days when we were drafting some of the complaints in the first cases, the seeds were planted for the FCPA as we now know it. For example, the first thing we did when we drafted our complaints in these cases was to seek an injunction against the falsification of books and records. At that time there was no requirement that companies maintain accurate books and records, but we sought injunctions against false entries. That was the seed for section 13(b)(2)(a) of the Exchange Act.

Timmeny, supra note 116, at 236. The Commission's May 12 Report proposed legislation containing the accounting and controls provisions later adopted by Congress. See May 12 Report, supra note 118, at 63-64. Testifying in support of the SEC's proposal, SEC Chairman Roderick M. Hills stated that:

[o]ur enforcement actions filed to date have, generally speaking, been based on alleged transactions that involved payments of large amounts of money which
of the federal government's authority to regulate the internal governance of corporations, which are subject to the SEC's regulatory jurisdiction.

were caused to be inaccurately stated on the companies' books and records by top corporate officers. Thus, they were concealed from the companies' boards of directors and often its auditors. The ancillary relief obtained in most of these actions has had an effect on the "governance of the corporations" by requiring that the boards of directors be provided with adequate information so that appropriate action can be taken to protect the interests of public investors. In my view, an effective system of corporate accountability requires that facts pertaining to illegal payments not be concealed from a corporation's independent accountants or its board of directors. This is a key point. Nothing else in the system will work unless the books and records are kept in good faith.

Abuses of Corporate Power: Hearings Before the Subcomm. on Priorities and Econ. in Gov't of the Joint Econ. Comm., 94th Cong. 18 (1976).

Chairman Hills also noted the Commission's efforts toward greater accountability on the part of corporate management which would also be furthered by the proposed legislation. See Foreign Payments Disclosure: Hearings on H.R. 15481 and S. 3664 and H.R. 13870 and H.R. 13953 Before the Subcomm. on Consumer Protection and Fin. of the Comm. on Interstate and Foreign Commerce, 94th Cong. 18 (1976). In like fashion, Harold M. Williams, who succeeded Hills as SEC Chairman, subsequently testified that "[t]he Commission does not believe . . . that prohibitions against bribery are the full answer. In our view, the long-term solution requires a fundamental strengthening of the record keeping, auditing, and internal control systems which are the foundation of any modern, multinational corporation." Unlawful Corporate Payments Act of 1977: Hearings on H.R. 3815 and H.R. 1602 Before the Subcomm. on Consumer Protection and Fin. of the Comm. on Interstate and Foreign Commerce, 95th Cong. 197 (1977).

As the court noted in World-Wide Coin Invs.: The accounting provisions of the FCPA will undoubtedly affect the governance and accountability mechanisms of most major and minor corporations, the work of their independent auditors, and the role of the Securities and Exchange Commission. The maintenance of financial records and internal accounting controls are major every-day activities of every registered and/or reporting company. The FCPA also has important implications for the SEC, since the incorporation of the accounting provisions into the federal securities laws confers on the SEC new rulemaking and enforcement authority over the control and record-keeping mechanisms of its registrants. . . . The consequence of adding these substantive requirements governing accounting control to the federal securities laws will significantly augment the degree of federal involvement in the internal management of public corporations.

World-Wide Coin Invs., 567 F. Supp. at 747. See also Barbara Crutchfield George & Mary Jane Dundas, Responsibilities of Domestic Corporate Management Under the Foreign Corrupt Practices Act, 31 SYRACUSE L. REV. 865, 880 a.79 (1980). The accounting standards provisions of the FCPA regulate the everyday operations of a publicly-held corporation. Notwithstanding its other powers, the SEC has never had authority to regulate the internal operations of American corporations. This power has now been given to the SEC through Sections 13(b)(2)(A) and 13(b)(2)(B) of the 1934 Act.

Id.; Goelzer, supra note 116, at 5.

Broadly speaking the Foreign Corrupt Practices Act reflects a congressional determination that the scope of federal securities laws and the Commission's authority should be expanded beyond the traditional ambit of disclosure requirements. Accordingly, the Commission's General Counsel, Ralph C. Ferrara, has noted that the scope and impact of accounting provisions may be analogous
Thus, the FCPA is said to have heralded "a new era" in federal regulation.\footnote{See George & Dundas, supra note 130, at 866-67 ("The internal accounting provisions of the FCPA have changed the mandate of the Securities and Exchange Commission (SEC) by giving that agency the means for regulating the internal management of domestic corporations. Thus, the FCPA heralds a new era."); George J. Siedel, Corporate Governance under the Foreign Corrupt Practices Act, 21 Q. Rev. Econ. & Bus. 43, 44 (1981) ("[T]he accounting provisions were referred to as the most significant intrusion into corporate affairs since the 1930's when federal securities legislation was originally enacted.").}

It is important to note in this regard that a violation of the FCPA's accounting and control provisions does not necessarily involve corrupt payments overseas.\footnote{Former SEC Chairman John S. R. Shad testified that [a]s the legislative history of the Foreign Corrupt Practices Act makes clear, the accounting provisions were enacted in part to facilitate the disclosure provisions of the federal securities laws and in part to provide for greater accountability of corporate assets. They were not intended exclusively to curb foreign bribery. Statement of John S.R. Shad, SEC Chairman, Joint Hearing on S. 708 Before the Subcomm. of Sec. and the Subcomm. on Int'l Fin. and Monetary Policy of the Senate Comm. on Banking, Hous. and Urban Affairs, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,882, at 84,343 (June 24, 1981). Application of the accounting and controls provisions to cases which do not involve foreign bribery has been criticized. See John W. Bagby, Comment, Enforcement of Accounting Standards in the Foreign Corrupt Practices Act, 21 Am. Bus. L.J. 213, 231-32 (1983) ("[T]he SEC has used FCPA accounting provisions in a manner which is arguably inconsistent with the legislative purpose of preventing foreign corrupt payments. This clearly provides the strongest argument for the removal of the record keeping requirements from the FCPA.").} In fact, corporations which conduct no overseas business may nevertheless be liable for accounting and controls violations.\footnote{Professor Kathleen F. Brickey has observed in this connection: Even though the record keeping and accounting control provisions are intended to work in tandem with the foreign bribery provisions to deter corporate bribery, liability for violating the accounting provisions is not contingent upon the establishment of a nexus between the inadequacy of the recording system and maintenance of off-book accounts to finance unlawful foreign payments. For while Congress hoped that the combined effect of the antibribery provisions and...}
As a result, the accounting and controls provisions are regarded as rules of general applicability, adopted for the protection of all investors.  

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the accounting provisions would be deterrence, the structure of the statute does not inextricably intertwine liability under each. Indeed, the record keeping and accounting requirements . . . apply to domestic corporations that conduct no business abroad and conduct no business with foreign entities here in the United States.

KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY § 9.20, at 279 (2d ed. 1984). See also Bialkin, supra note 130, at 625.

[T]he provisions having to do with books and records and internal controls are not at all limited with respect to foreign corrupt payments. They apply in a plenary manner to the activities of the subject issuers, nor is it necessary to relate those provisions to any act involving a foreign corrupt payment.

Id. Hubert Lenczowski, Questionable Payments By Foreign Subsidiaries: The Extraterritorial Jurisdictional Effect of the Foreign Corrupt Practices Act, 3 HASTINGS INT'L & COMP. L. REV. 151, 159 (1979) (quoting Stabler, SEC's New Weapon: Foreign Bribery Act Imposes Tough Rules on the Bookkeeping of All Public Firms, WALL ST. J., July 28, 1978, at 30, col. 1) ("Under the new Foreign Corrupt Practices Act, it is becoming clear, you don't have to be either operating in foreign lands or corrupt to be in trouble."). Steven M. Morgan, In Search of An International Solution to Bribery: The Impact of the Foreign Corrupt Practices Act of 1977 on Corporate Behavior, 12 VAND. J. TRANSNAT'L L. 359, 369 (1979) ("It is a significant development that issuers are now required to implement a system of internal accounting controls — it must be remembered that this provision applies regardless of whether or not the company operates overseas. Even without engaging in bribery, a company must be careful to comply.").


The accounting provisions embody many of the suggestions recommended by the SEC and submitted to the Senate Committee on Banking, Housing and Urban Affairs in its 1976 Report on questionable foreign payments. It is important to note, however, that the accounting provisions of the Act are not limited to payments to foreign officials. A failure to maintain accurate books and records will be violative of the Act, even though foreign payments are not involved. Hence this section of the Act is applicable to wholly domestic business activities.

Id.

135 See World-Wide Coin Inv., 567 F. Supp. at 746:

The FCPA was enacted on the principle that accurate record keeping is an essential ingredient in promoting management responsibility and is an affirmative requirement for publicly held American corporations to strengthen the accuracy of corporate books and records, which are the "bedrock elements of our system of corporate disclosure and accountability."

A motivating factor in the enactment of the FCPA was a desire to protect the investor, as was the purpose behind the enactment of the Securities Acts.

Id. The legislative history supports this view:

The establishment and maintenance of a system of internal controls is an important management obligation. A fundamental aspect of management's stewardship responsibility is to provide shareholders with reasonable assurances that the business is adequately controlled. Additionally, management has a responsibility to furnish shareholders and potential investors with reliable financial information on a timely basis. An adequate system of internal accounting controls is necessary to management's discharge of these obligations.

The SEC described the accounting and financial controls provisions of the FCPA as "inherent obligations of the stewardship of a public corporation," which would have to be met even in the absence of a statutory requirement. The responsibility for compliance with these provisions resides with the board of directors.

Compliance with the accounting and controls provisions requires the establishment of a control environment. A control environment has been defined as:

The tone of the organization, the foundation for all other components [of internal control], providing discipline and structure; factors include the integrity, ethical values and

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Cong., 1st Sess. 8 (1977). The SEC has interpreted the accounting and controls provisions to be of general applicability. As former SEC Chairman Harold M. Williams stated, "The primary thrust of the Act's accounting provisions, in short, was to require those public companies which lacked effective internal controls or tolerated unreliable record keeping to comply with the standards of their better managed peers. That is the context in which these provisions should be construed." Remarks Before the American Institute of Certified Public Accountants, supra note 128, at 11,546. As the SEC elsewhere explained:

[The maintenance of accurate books and records by reporting companies is one of the foundations of the system of corporate disclosure embodied in the Securities Exchange Act. In this regard, the disclosure requirements of the Securities Exchange Act are based on the premise that "No investor ... can safely buy or sell securities ... without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells."


The Accounting Provisions of the Foreign Corrupt Practices Act: An Analysis, supra note 120, at 83,935. As Chairman Williams further explained, "The standards embodied in the Act's accounting provisions are, in effect, the cardinal principles of managing a business enterprise. Among the members of the business community, few would dispute that acceptable management cannot be achieved absent such records and controls." Id.

For example, Professor Gerald R. Ferrera has said that:

[The effect of the Act is to place compliance responsibility on the board of directors. It is the corporate board that must judge the sufficiency of the internal accounting controls or face potential civil and criminal liability. The board must not only establish internal accounting controls but delegate their implementation. A periodic review should be made by the audit committee to insure compliance.

When possible violations are detected, remedial action must be taken.

Gerald D. Ferrera, Corporate Board Responsibility Under the Foreign Corrupt Practices Act of 1977, 18 AM. BUS. L.J. 259, 266 (1980). Professors George and Dundas have similarly stated that "[u]nder the accounting standards provisions of the FCPA, the current responsibility of the board of directors is to develop, implement, and review the corporate internal accounting controls systems and to establish an effective compliance program." George & Dundas, supra note 130, at 888-89.

See, e.g., Albert L. Beswick, Corporate Compliance with the FCPA, 9 SYRACUSE INT'L & COM. 301, 301 (1982) ("The only reliable way to make sure of compliance is to create what the Securities and Exchange Commission (SEC) enforcement staff and others have called a control atmosphere within the corporation.").
competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors

The SEC has stressed the importance of the board of directors establishing "a strong control environment" and overseeing the procedures for evaluating internal controls. 140

Thus, the FCPA accounting and financial controls provisions extended the SEC's regulatory authority into what had previously been considered corporate governance matters within the province of the corporations themselves. The SEC's experience in enforcement actions against companies that made improper payments, and its experience in the voluntary disclosure program, where companies had self-reported instances of questionable payments, led the SEC to conclude that the corporation's board of directors was the element of the corporation's governance structure best suited to ensure compliance with the FCPA's requirements.

The same events which gave rise to the SEC's advocacy of these corporate governance provisions in the FCPA also led the Commission's staff to undertake its own wide-ranging inquiry into the efficacy of the corporate governance of publicly held companies. This, in turn, brought forth additional observations and recommendations concerning the


140 In the text accompanying a proposed rule requiring a statement by management on internal control, the SEC stated that "[t]he role of the board of directors in overseeing the establishment and maintenance of a strong control environment, and in overseeing the procedures for evaluating a system of internal accounting control, is particularly important." Statement of Management on Internal Accounting Control, 44 Fed. Reg. 26702, 26705 (1979) (to be codified at 17 C.F.R. pts. 211, 229, 240, 249). Former SEC Chairman Williams reiterated this view in his speech to the American Institute of Certified Public Accountants:

This concept [of internal control] is not a mandate for board—or even most senior management—involvement in the minute of recording and accounting for every transaction which the company may make. But it does mean that both management and the board have important roles to play in monitoring and evaluating the adequacy of the company's records and controls systems. ... In the last analysis, the key to an adequate "control environment" is an approach on the part of the board and top management which makes clear what is expected, and that conformity to these expectations will be rewarded while breaches will be punished.

compliance responsibilities of directors.

2. The Corporate Governance Proceeding

In reaction to the events of the 1970s, the SEC undertook a sweeping review of its rules regarding corporate governance. The study, which became known as the "Corporate Governance Proceeding" began in April 1977, with hearings held in Washington, D.C., New York City, Los Angeles, and Chicago. Written comments were received from over 300 individuals and organizations. On the basis of this information, as well as information in the SEC's own files, on September 4, 1980, the SEC's Division of Corporation Finance issued its Staff Report on Corporate Accountability. The report examined corporate governance from the perspectives of shareholder participation, institutional investors, the board of directors, and regulatory authorities.

The staff found that there was a generally held view that the board of directors was "the center of efforts to enhance corporate accountability." In this regard, the staff also noted that "there was almost universal agreement that a strong, independent board of directors is a key to effective corporate accountability." The staff also offered a number of observations as to how

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141See Staff Report on Corporate Accountability, supra note 103, at 7-8.
142Id. at 5-14.
143See id. chs. 1-4.
144See id. ch. 5.
145See Staff Report on Corporate Accountability, supra note 103, ch. 6.
146See id. chs. 8-9.
147Id. at 579. As the staff stated, "With an increased number of truly independent directors and an effectively functioning committee system, an institutionalized process for holding management accountable will be created." Id.
148Id. at 54. The staff also noted that "companies are beginning to acknowledge what the commentators in the corporate governance hearing, as well as others who have studied the question, have said — that the board of directors has a crucial role to play in the corporate accountability process and that to perform this role members of the board must be able to exercise independent judgment." Id. at 436. For example, with respect to the role of independent directors, in particular, one commentator has observed that

[c]ommon stockholders are the corporation's residual claimants. Yet, as we have seen, common stockholders are the corporate constituency perhaps least able to monitor management behavior meaningfully. Accordingly, corporate law steps in to provide alternative monitoring mechanisms. Chief among them is the board of directors, especially the independent directors. To be sure, as outsiders, the independent directors have neither the time nor the information necessary to be involved in the minutiae of day-to-day firm management. What they can do, however, is monitor senior managers and replace those whose performance is subpar.

the needed strength and independence of the board could be achieved.149

The board's role in corporate governance is to provide advice and
counsel to the Chief Executive Officer,150 to monitor corporate
performance,151 to ensure that the corporation has policies and procedures in
place that are designed to assure system-wide compliance with legal
requirements,152 and to formulate policy and long-term objectives.153 One
way in which the staff concluded that the board could discharge this function
with the requisite independence was to structure the board with a "critical
mass" of directors who were not aligned with management.154 Although it
was recognized that this "critical mass" could vary, the staff concluded that
at least a majority of the members of the board should be independent of
management.155

The staff noted, however, that "[n]either the composition nor structure
of a board of directors can ensure that it will act as an effective
accountability mechanism."156 Furthermore, the staff observed that the
development of committees of the board made it "more likely that an
appropriate environment for the governance of publicly owned corporations
will be produced."157 In this regard, the staff discussed at length the
importance of the audit committee to ensuring proper oversight and
management accountability.

149STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 54-62.

150The staff commented that "[t]raditionally, a major function of the board of directors has
been to provide advice and counsel to the corporation's chief executive officer." STAFF REPORT ON
CORPORATE ACCOUNTABILITY, supra note 103, at 548. However, "the advice and counsel function
is a passive one and is not essential to the corporation's enterprise." Id. at 549.

151See id. at 549-52.

152The staff noted that the Business Roundtable had expressed the view that "boards of
directors should ensure that policies and procedures are in place which are designed to promote such
compliance on a sustained and system-wide basis by all levels of management." Id. at 555.

153In large, publicly held corporations, policy making is typically a management function
rather than a board function. STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at
556-57. Commentators had suggested, however, that the board must be involved in policy making
and strategic planning as part of its measurement of management performance, its consideration of
the commitment of corporate resources, and its oversight role. See id. at 557-58.

154It was observed that "directors from outside the corporation are 'windows to the world'
through which the public can see what is happening in publicly-held corporations and through which
corporations can better see and understand the expectations of society." Id. at 437. With regard to
the composition of the board, "[t]he importance of an independent board of directors with a critical
mass of outsiders — generally at least a majority of non-management directors — has been
recognized by most companies today." Id. at 468.

155Id. at 581.

156Id. at 470.

157Id. The staff cited an earlier SEC release in which the Commission had stated that
"development of stronger committee systems will enable boards of directors to better serve
(July 18, 1978)).
The SEC has long advocated the establishment of audit committees to co-exist with the boards of publicly held corporations, subject to SEC jurisdiction. Indeed, it has been suggested that the true interest of the SEC in adopting the accounting and financial controls provisions of the FCPA was to establish independent audit committees. Although the federal securities laws, particularly the accounting controls provisions of the FCPA, provided a statutory basis for such a rule, no rule requiring audit

159Professor Schwartz has observed that "[t]he creation of audit committees was central to the SEC objective to influence the control system." Schwartz, supra note 101, at 571. In correspondence with William Batten, Chairman of the New York Stock Exchange, SEC Chairman Roderick Hills noted that "the Commission has for many years advocated that publicly held companies create audit committees, composed of independent directors, to work with outside auditors." Letter from Roderick M. Hills to William Batten, dated May 11, 1976, reprinted in May 12 Report, supra note 118, Exhibit D. Chairman Hills cited, as an example, the SEC's investigation of McKesson-Robbins in 1940 in which "the Commission urged the formation of audit committees, composed of non-officer directors, to participate in arranging corporate audits." Id. Chairman Hills also noted that:

In 1972, the Commission endorsed the establishment of audit committees composed of outside directors for all publicly-held companies to provide more effective communications between independent accountants and outside directors, and thereby to safeguard further the integrity of corporate financial statements on which public investors rely. In 1974, in amending its rules to require disclosure in proxy statements of the existence or absence of audit committees, the Commission reiterated its support.

Id. Establishment of an audit committee was also suggested as being "necessary to demonstrate reasonable efforts in the effective implementation of a control system." Goelzer, supra note 116, at 45.

160See Morgan, supra note 134, at 378 ("Ralph Ferrara, Executive Assistant to SEC Chairman Harold Williams, has indicated that the SEC's real interest in the FCPA is to see reporting companies establish independent audit committees and improve their internal accounting controls.").

161In 1978, SEC Chairman Harold L. Williams requested an opinion concerning the SEC's authority to adopt rules requiring the establishment of audit committees comprised of independent directors. See Memorandum of the SEC General Counsel, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,535, at 80,176 (Mar. 22, 1978). In response, SEC General Counsel Harvey L. Pitt prepared a memorandum in which he set forth five alternative grounds for such rulemaking authority. See id. at 80,178. Among those grounds was the then-recently enacted accounting and financial controls provisions of the FCPA. See id. Although the establishment of an audit committee was not itself an element of a system of internal accounting controls, Pitt observed, nevertheless, that:

[t]he Commission could, however, determine that the establishment of an independent audit committee, charged with communicating with the issuer's outside auditors, is a "necessary or appropriate" means of implementing the requirement that the internal control system described in section 13(b)(2)(B) is in place and operating in the manner intended.

Id. at 80,181. Further, noting the requirement that auditors report material weaknesses in internal controls to senior management and the audit committee (if one exists), Pitt suggested that:

the Commission might well conclude that the opportunity of reporting defects in internal controls to an independent audit committee would significantly enhance the probability that appropriate corrective action will be taken and thus would promote compliance with the internal control requirements of the new legislation.
committees was promulgated. Instead, the SEC prevailed on the New York Stock Exchange to adopt an audit committee requirement for listed companies. Nevertheless, the staff continued to advocate the effectiveness and necessity for audit committees in their report.

The staff noted that there was general agreement among the commentators in the Corporate Governance Proceeding that "three committees — auditing, nominating, and compensation — [were] important ingredients to effective oversight . . . [and] monitoring." Of those committees, the audit committee was "the most established and clearly defined of all board committees."

The staff described the audit committee as "the group within the board primarily responsible for ensuring that the company's accounts and financial statements are audited properly by an independent accounting firm," and the report outlined the audit committee's principal functions. The first of these

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This approach would appear to harmonize with the Commission's general philosophy of relying, to the extent possible, on self regulatory or other private sector mechanisms to encourage compliance with the federal securities laws. *Id.* at 80,182.

As the Commission explained in its Notice of Proposed Rules, to implement the accounting and financial controls requirements it had recommended in the May 12 Report:

The second prong of the Commission's suggested attack on the problem of questionable and illegal corporate payments involved strengthening the independence and vitality of corporate boards of directors by requiring that companies maintain audit committees comprised of independent directors and by encouraging the separation of the functions of independent corporate counsel and director. In the May 12 Report, the Commission proposed that, at least initially, these principles could best be implemented by amendment to the listing requirements of the New York Stock Exchange and the rules of the other self-regulatory organizations, rather than by direct commission action. Notice of Proposed Rule Change, Securities Exchange Act Release No. 13,185, SEC Docket 1514 (1977). Thus, on May 11, 1976, SEC Chairman Hills wrote to the Chairman of the New York Stock Exchange, William Batten, soliciting the Exchange's views on whether the Exchange's listing requirements should be amended to require the establishment of audit committees composed of outside directors. Letter from Roderick M. Hills, *supra* note 158. In reply, on August 3, 1976, NYSE Chairman provided the SEC with a draft proposal for audit committees. On September 3, 1976, the audit committee proposal was submitted for comment to the chief executive officers of all domestic corporations listed on the NYSE. *See Foreign Corrupt Practices Act - Oversight Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Fin. of the Comm. on Energy and Commerce, 97th Cong. 32-47 (1982).* Thereafter, the NYSE adopted the proposed amendment and on March 9, 1977, the SEC approved the NYSE rule change. *See Memorandum of the SEC General Counsel, *supra* note 160, at 80,177. This process was described by Professor Schwartz as "regulation by raised eyebrow." Schwartz, *supra* note 101, at 571.

*162* STAFF REPORT ON CORPORATE ACCOUNTABILITY, *supra* note 103, at 477.

*163* *Id.* at 486.

functions was the recommendation or approval of an independent auditor of the corporation. In this connection, the staff noted that the audit committee "has an important role to play in assuring the independence of the accounting firm" by defining the services to be performed, as well as determining compensation.

The second of the principal functions identified by the staff was to review the scope of the audit plan. This activity was considered to be of particular importance because "it is at this stage that the audit committee assures itself that the audit will be adequate and that it will meet the needs of the board as well as those of management." The third function is to review the results of, and report the annual audit, and the auditor's management letter. The staff noted that it is during this review that the committee would become aware of any "differences of opinion between the independent accountants and management." The staff also noted that commentators in the proceeding suggested that the audit committee should review the quality and adequacy of the corporation's internal accounting and finance departments.

Review of the "adequacy of internal controls" has become an important function of the audit committee since the enactment of the FCPA. The staff also observed that the FCPA's "emphasis on internal

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165 Staff Report on Corporate Accountability, supra note 103, at 496. Professor Eisenberg has also commented on the importance of the audit committee's role in this regard: Objective reporting on executives' financial results cannot be assured in an institutional structure that combines power of selection among competing accounting principles by the very executives whose activities are being accounted for, wide discretion in the executives in making that selection, and auditing of executives' financial performance by persons whom the executives hire and can fire. To achieve an objective flow of information on the financial results achieved by the executives, the accountant must be truly independent of the executives. Toward that end, publicly held corporations should be required to have an audit committee composed of directors who have no significant relationships to the senior executives. This committee should be vested with the power to select and dismiss the independent accountant (or recommend its selection and dismissal), set the terms of its engagement, and generally oversee the independent auditing process.

Eisenberg, supra note 103, at 208.

166 Id. at 499.

167 See id. at 499.

168 See id. at 500.

169 See id. at 500.

170 Staff Report on Corporate Accountability, supra note 103, at 500.

171 Id. at 501.

172 Id. at 502.
controls" has placed "an even greater burden on companies without audit committees."\textsuperscript{173}

The Staff Report emphasized the SEC's view that to ensure adequate independence, the audit committee should be composed of directors who are not affiliated with management.\textsuperscript{174} The staff also warned, rather ominously, that corporations choosing not to institute audit committees of independent directors should carefully assess the downside of such a decision.\textsuperscript{175} The staff cited several commentators suggesting that the absence of an audit committee "may become a consideration in weighing whether or not the directors . . . have met the standard of care,"\textsuperscript{176} or at the very least was a decision that warranted an explanation to both shareholders and investors.\textsuperscript{177} Although the staff did not feel that a rule requiring audit committees was necessary, they recommended that the Commission "continue to monitor the trend of establishment of audit committees and strive to obtain such committees in appropriate enforcement cases."\textsuperscript{178}

\textsuperscript{173}Id. at 490 n.201.

\textsuperscript{174}STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 492, 494.

\textsuperscript{175}The Staff Report states:
The audit committee today has become so well established that any company which has chosen not to establish such a committee, composed solely of directors independent of management, should weigh carefully the costs of such a decision in terms of liability and loss of control against the reasons, if any, for not establishing an audit committee. STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 583.

\textsuperscript{176}Committee on Corporate Laws of the ABA Section of Business Law report, The Overview of the Board of Directors, 35 BUS. LAW. 1335, 1352-53 (1980). "Given its increasingly widespread use, the absence of an audit committee may become a consideration in weighing whether or not the directors of a publicly held corporation have met the standard of care set forth in many state corporation laws." STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 491 (citation omitted).

\textsuperscript{177}See STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 489-90.

\textsuperscript{178}Id. at 583. For example, in SEC v. Killearn Properties, Inc., [1997-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,256, at 92,693 (Jan. 5, 1978), a consent order of permanent injunction required that the majority of the board of directors would be "outside directors" who, within five years, had not been:

i. employed by Killearn or any of its subsidiaries, affiliates, parents, officers or directors;
ii. under the control of Killearn or any of its subsidiaries, affiliates, parents, officers or directors;
iii. an officer, director, trustee or partner or a person controlled by any person owning or having a controlling interest in Killearn, or any affiliate or subsidiary of Killearn;
iv. the direct or indirect owner of more than 2% of any class of equity securities of Killearn or any of its affiliates or subsidiaries or parents, or the direct or indirect owner of more than 5% of any class of equity securities of, or otherwise controls any corporation, any partnership, limited partnership joint venture or any other business venture involving
Finally, the staff was of the view that "adequate relevant information about the company" was "crucial to the ability of the board of directors to perform its functions, particularly its monitoring function." The staff recognized that assuring the provision of adequate information "remains one of the most critical and difficult problems which boards of directors are facing today," and noted that the use of board committees "is one way boards are attempting to ensure that board members are adequately informed." The staff observed that "[i]t is extremely important that the information system makes all relevant information, both good and bad, available to management and the board." The audit committee's communication with both the internal auditors and the independent accountants "is particularly important in ensuring that adverse information gets to the board."

Thus, the principal themes underlying Chancellor Allen's decision in Caremark resonate with the corporate governance initiatives of the SEC in the 1970s. The accounting and financial controls requirements of the FCPA were specifically directed toward establishing requirements to assure the integrity and adequacy of the corporation's financial reporting systems and control of assets. As interpreted by the staff of the SEC's Division of Corporate Finance, the ultimate responsibility for ensuring that adequate systems were in place to satisfy these requirements lay with the corporation's board of directors acting, in the first instance, through an audit committee composed of directors who were independent of the corporation's

Killeam.

Id. at 92,694. Additionally, Killeam was required to maintain an audit committee of the board of which at least three members had to be outside directors. The audit committee was to: (1) review the engagement of the independent accountants; (2) review the policies and procedures respecting internal auditing, accounting, and financial controls with the independent accountants and the chief financial officer; (3) review with the independent accountants the results of their audit including significant transactions, adjustments, changes in accounting principles, the accountants' perceptions of the company's accounting and financial personnel, and any recommendations for improving financial controls; (4) periodically review company codes of conduct and inquire into any deviations from the codes; (5) meet with the company's financial staff twice a year concerning the scope of internal accounting and auditing procedures, and the implementation of recommendations made by the independent accountants; (6) recommend to the board whether the independent accountants should be retained or discharged; (7) direct and supervise the investigation of "any matter brought to its attention within the scope of its duties;" (8) review press releases and public statements concerning the disclosure or projection of financial conditions; (9) review dealings between the company and its officers and directors; and (10) approve settlement or disposition of claims against past or present officers, directors, employees or controlling persons. See id. at 92,695.

179STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 559.
180Id. at 560.
181Id. at 562-63.
182Id. at 564.
183STAFF REPORT ON CORPORATE ACCOUNTABILITY, supra note 103, at 565.
management. These are themes that the SEC continues to elucidate in its actions to enforce the provisions of the federal securities laws.

3. Corporate Governance in the Context of SEC Enforcement Actions

Beginning in the early 1970s with the investigation of the collapse of the Penn Central Company, the SEC has used its authority to issue reports of investigation (under Section 21(a) of the Securities Exchange Act of 1934), to express its views on the obligations of board members, and in times of financial crisis or when confronted with fraudulent conduct on the part of management, to act independently and to be adequately informed. These investigations have often revealed the issuance of false or misleading public statements, or the filing of inaccurate reports with the SEC. In those circumstances, the SEC has also emphasized the obligation of directors to be informed concerning the company's operations, and to ensure that any statements made by the company are accurate and complete.

a. Penn Central Company

Stanley Sporkin, Director of the SEC's Division of Enforcement, referred to the SEC's 1972 investigation into the failure of the Penn Central Company as a "turning point" in the SEC's policy toward the duties of

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184 The SEC continues to be actively interested in this area. Recently, in response to the SEC's growing concern as to the adequacy of oversight and accountability with regard to corporate financial reporting, the SEC encouraged the New York Stock Exchange and the National Association of Securities Dealers to review the corporate financial reporting process and in particular the role of the audit committee of the board in ensuring the accuracy and completeness of corporate financial reports. See Ira M. Millstein, Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 Bus. Law. 1057, 1057-58 (1999). A "Blue Ribbon" committee was formed in October 1998 to conduct the review, which became known as the Millstein/Whitehead Committee after its co-chairmen Ira M. Millstein and John C. Whitehead. See id. The report of the Millstein/Whitehead Committee urged boards of directors "to understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight to be, as the law requires, a fiduciary for those who invest in the corporation." Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999), reprinted (without appendices) in 54 Bus. Law. 1067, 1070 (1999) [hereinafter Millstein/Whitehead Report]. Thus, the Millstein/Whitehead Report noted, "The measure of the board . . . is not simply whether it fulfills its 'legal' requirements but, more importantly, the board's attitude and how it puts into practice its awareness and understanding of its responsibilities." Id. With respect to the role of the audit committee in the overall corporate governance scheme, the Millstein/Whitehead Report emphasized the primacy of the board and the audit committee in overseeing financial reporting by the corporation. Id. at 1071.

business honesty that seriously and directly affects the present responsibility of a government contractor or subcontractor.  

A contractor may be suspended (i.e., temporarily disqualified) from competing for government contracts, pending completion of an investigation or legal proceedings. Cause for suspension is essentially the same conduct evidencing a lack of integrity for purposes of debarment. An indictment arising from the enumerated conduct constitutes "adequate evidence" of a cause for suspension. Unless legal proceedings are initiated, the period of suspension is not to exceed eighteen months. If legal proceedings are commenced within that period, however, the suspension remains in effect until the proceedings are terminated.

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461 The FAR provides in this regard that a contractor may be debarred for, among other reasons, conviction of or a civil judgment for:

1. Commission of fraud or a criminal offense in connection with —
   (i) Obtaining;
   (ii) Attempting to obtain; or
   (iii) Performing a public contract or subcontract.
2. Violation of Federal or State antitrust statutes relating to the submission of offers;
3. Commission of embezzlement, theft, forgery, bribery, falsification or destruction of records, making false statements, tax evasion, or receiving stolen property;
4. Intentionally affixing a label bearing a "Made in America" inscription (or any inscription having the same meaning) to a product sold in or shipped to the United States, when the product was not made in the United States; or
5. Commission of any other offense indicating a lack of business integrity or business honesty that seriously and directly affects the present responsibility of a Government contractor or subcontractor.

462 A "suspension" is an "action taken by a suspending official . . . to disqualify a contractor temporarily from Government contracting and Government-approved subcontracting." Id. § 9.403.

463 As stated in the FAR, "Suspension is a serious action to be imposed on the basis of adequate evidence, pending the completion of investigation or legal proceedings, when it has been determined that immediate action is necessary to protect the Government's interest." Id. § 9.407-1(b)(1). The contractor facing suspension is entitled to "fundamental fairness" where the suspension may extend for a significant period. As was stated in Home Bros. v. Laird, 463 F.2d 1268, 1271 (D.C. Cir. 1972):

We think an action that "suspends" a contractor and contemplates that he may dangle in suspension for a period of one year or more, is such as to require the Government to insure fundamental fairness to the contractor whose economic life may depend on his ability to bid on government contracts. That fairness requires that the bidder be given specific notice as to at least some charges alleged against him, and be given, in the usual case, an opportunity to rebut those charges.


465 Id. § 9.407-2(b).

466 Id. § 9.407-4(b).

467 See id. § 9.407-4(e).