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# A NEW DIRECTION FOR SHAREHOLDER ENVIRONMENTAL ACTIVISM: THE AFTERMATH OF CAREMARK

GEOFFREY CHRISTOPHER RAPP\*

Traditionally, shareholders seeking to encourage more environmentally-friendly corporate governance have pursued one of two strategies.<sup>1</sup> First, some shareholders have sought to nominate environmentally-sensitive directors to corporate boards.<sup>2</sup> Second, shareholders have initiated shareholder resolutions regarding environmental practices.<sup>3</sup> In some limited sense, these efforts have had positive results, raising environmental awareness in the corporate governance community.<sup>4</sup> However, from a purely tactical legal perspective, they have faced severe impediments. Existing corporate law disfavors insurgent board candidates in director elections; and even where successfully elected, an environmentally-friendly director may be unable to alter corporate policy due to board structures preventing wholesale change in a single election cycle (such as staggered boards) or fiduciary obligations which bar directors from serving special interests exclusively.<sup>5</sup> Similarly, shareholder resolutions concerning environmental protection are often excludable from a corporation's definitive proxy solicitation as ordinary business or

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<sup>1</sup> There are, of course, other connections between environmental protection and the corporate law. See, e.g., Robert H. Feller, *Environmental Disclosure and the Securities Laws*, 22 B.C. ENVTL AFF. L. REV. 225 (1995) (discussing requirements to disclose environmental information under the securities laws); Richard M. Schwartz & Donna Mussio, *Environmental Disclosure Requirements Under the Federal Securities Laws*, in CONDUCTING DUE DILIGENCE 2003, at 457 (PLI Corporate Law & Practice, Course Handbook Series No. B-1368, 2003).

<sup>2</sup> See *infra* Part I.A.

<sup>3</sup> See *infra* Part I.B.

<sup>4</sup> Investor pressure may have helped spur or shame the corporate governance community into pursuing increased self-regulation. See Mitchell F. Crusto, *Endangered Green Reports: "Cumulative Materiality" in Corporate Environmental Disclosure After Sarbanes-Oxley*, 42 HARV. J. ON LEGIS. 483, 492 (2005).

<sup>5</sup> See *infra* Part I.A.; Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 856-61 (2005) [hereinafter Bebchuk, *The Case for Increasing Shareholder Power*].

beyond the power of the corporation to effectuate under applicable SEC rules.<sup>6</sup> Even where a shareholder resolution is included in a corporation's proxy solicitation, or where a resolution's proponents bear the cost of financing a proxy campaign on their own, such resolutions are rarely adopted and may have limited practical effect.<sup>7</sup>

This Essay attempts to flesh out an alternative strategy for environmental activists based on the Delaware Chancery Court's decision in *In re Caremark International Inc. Derivative Litigation*.<sup>8</sup> *Caremark* may have breathed new life into the fiduciary duty of care by declaring persistent failures to establish compliance and oversight systems to prevent illegal activities to be a breach of directors' business judgment so as to give rise to liability to shareholders (and make available other forms of relief, such as injunctions).<sup>9</sup> While *Caremark* was a case dealing with healthcare billing and accounting fraud,<sup>10</sup> its application in the environmental context seems clear. This Essay will detail the legal burdens, benefits, and strategies available to environmental activists in a post-*Caremark* setting.

Part I explores the tactical limitations facing traditional shareholder environmental activism efforts. Part II discusses the *Caremark* case. Part III sets forth the likely applications of *Caremark* in the environmental arena.

## I. TRADITIONAL TOOLS OF SHAREHOLDER ENVIRONMENTAL ACTIVISM

This section discusses the limitations of the most common tools for what this Essay will call "shareholder environmental activism." While this Essay will treat such activism as a single phenomenon, there are of course differences between various environmentally-conscious shareholder campaigns. Some shareholder activists may target specific environmental practices of their firms. Others may aim at achieving the more amorphous concept of "green management."<sup>11</sup> Some activism may be

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<sup>6</sup> See *infra* notes 25-26 and accompanying text.

<sup>7</sup> See *infra* notes 27-37 and accompanying text.

<sup>8</sup> *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> "Green management" is a term that has been used both broadly and to denote more specific business practices in literature on the environmental behavior of corporations. See Joseph F. DiMento & Francesco Bertolini, *Green Management and the Regulatory Process*:

globally directed, while other activism may be targeted towards specific local environmental concerns.

A. *Environmentally-Friendly Directors*

One approach for environmentally-conscious shareholders is to seek to nominate and elect to corporate boards directors who are likely to favor sound environmental practices. Shareholders may nominate directors in three ways: at an annual meeting; through recommendation to the corporation's nominating committee; and through a proxy battle.<sup>12</sup> Such an effort faces the same uphill battle as does any insurgency campaign aimed at replacing directors on a corporate board for the sake of changing corporate business practices. Nomination of directors at shareholder meetings is unlikely to succeed given that many shareholders vote by proxy prior to an annual meeting, making it unlikely for a candidate nominated at a meeting to obtain the necessary votes.<sup>13</sup> Recommendation to a corporation's nominating committee is also unlikely to be effective, because corporations are under no obligation to consider shareholder nominations or to give any explanation for their refusal to nominate a recommended individual.<sup>14</sup>

Nor is a direct proxy challenge likely to succeed. Insurgents are at a huge disadvantage when compared to incumbent directors because they will be unlikely to get their nominees on the company's definitive proxy solicitation statement.<sup>15</sup> Absent that, insurgents will be forced to finance the costs of a proxy campaign on their own (something that very few shareholder groups will be able to, or are interested in doing).<sup>16</sup> While there has been recent action in this area, including high-level

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*For Mother Earth, Market Share, and Modern Rule*, 9 TRANSNAT'L LAW. 121 (1996). It may include: "(1) a commitment to research and development to create innovative technologies and processes . . . ; (2) innovations aimed at reducing environmental impacts in the firm's relationships with its dependents and subsidiaries; and (3) development of products which are environmentally friendly . . ." *Id.* at 124.

<sup>12</sup> See Lewis J. Sundquist III, Comment, *Proposal to Allow Shareholder Nomination of Corporate Directors: Overreaction in Times of Corporate Scandal*, 30 WM. MITCHELL L. REV. 1471, 1475 (2004).

<sup>13</sup> *Id.* at 1476-77.

<sup>14</sup> *Id.* at 1477.

<sup>15</sup> *Id.* at 1471 & n.2.

<sup>16</sup> *Id.* at 1479 ("The cost of undertaking such an endeavor can be quite high."). Such costs can easily exceed \$1 million for a large company. *Id.* at 1479 n.70.

proposals to increase shareholder access to the corporation's definitive proxy, the fate of such proposals remains in doubt.<sup>17</sup>

The harsh reality for the activist shareholder is that, absent reform, the corporate election process does not provide significant power to shareholders. As Lucian Bebchuk writes:

[U]nder current arrangements, shareholders seeking to exercise their theoretical power to replace directors face substantial impediments. Challengers do not have the access to the corporate ballot and to the corporation's proxy machinery that incumbents enjoy. Unlike incumbents, who have their campaign costs fully borne by the company, challengers have to bear their campaign costs themselves—even though they will share the benefits from improved corporate governance with their fellow shareholders. . . . In a study of such challenges during the seven-year period 1996-2002, I found that, among thousands of public companies, there were on average only eleven such challenges a year, with less than two a year for firms with market capitalization exceeding \$200 million.<sup>18</sup>

While institutional investors might be able to overcome some of these impediments and encourage greater environmental consciousness in the corporate community,<sup>19</sup> it is not at all clear that institutional investors will generally have an incentive to do so.<sup>20</sup>

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<sup>17</sup> *Id.* at 1472. In 2003, the SEC listed various alternatives to “increase shareholder involvement in the nomination and election of directors,” including a proposal that would allow shareholders access to the corporation's definitive proxy statement. *Id.* at 1480. However, the SEC envisioned access only following certain triggering events, such as a large number of abstentions in a previous director election or the failure of a corporation to act on a shareholder proposal after it received a majority of shareholder votes. *Id.* at 1481. Other potential triggers might include criminal indictments of corporate officers or a sanctioning of the company. *Id.* at 1482. However, the proposed rule was never finalized, and appears to be dead. See Posting of Christine to The Conglomerate, [http://www.theconglomerate.org/2005/02/shareholder\\_acc\\_1.html](http://www.theconglomerate.org/2005/02/shareholder_acc_1.html) (Feb. 8, 2005, 09:07 EST).

<sup>18</sup> Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 5, at 856 (citation omitted).

<sup>19</sup> See Cynthia A. Williams & John M. Conley, *Is There an Emerging Fiduciary Duty to Consider Human Rights?*, 74 U. CIN. L. REV. 75, 94-98 (2005) (noting that “institutional investors, a critical class of shareholders, are increasingly requiring . . . consideration” of social and environmental concerns).

<sup>20</sup> See Benjamin J. Richardson, *Enlisting Institutional Investors in Environmental Regulation: Some Comparative and Theoretical Perspectives*, 28 N.C. J. INT'L L. & COM. REG. 247, 291-93 (2002).

### B. *Shareholder Resolutions*

Environmentally-conscious shareholders may also attempt to secure adoption of resolutions committing the firm to environmentally sensitive practices.<sup>21</sup> During a single year, for example, environmental issues were part of shareholder resolutions at fifty-six companies in seventeen industries.<sup>22</sup> Such proposals “range from general calls for companies to adopt environmental values to specific demands for environmental compliance.”<sup>23</sup> Such proposals have had mixed results,<sup>24</sup> with many being found to be excludable from a corporation’s definitive proxy statement under the federal securities laws.<sup>25</sup> Typically, companies will argue that such proposals are vague, have been substantially implemented, are beyond the power of the company to effectuate, are insignificantly related to the company’s business, or are related to ordinary business operations of the company.<sup>26</sup> Even those proposals found not excludable have rarely carried the necessary votes to secure adoption.<sup>27</sup>

One of the most well-known examples of environmentally-based shareholder proposals is the Coalition for Environmentally Responsible Economies (“CERES”) Principles (formerly known as the Valdez principles).<sup>28</sup> These principles “call on corporations to, inter alia, reduce waste matter and provide for its safe treatment, market safe products

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<sup>21</sup> See Elizabeth Glass Geltman & Andrew E. Skroback, *Environmental Activism and the Ethical Investor*, 22 J. CORP. L. 465, 476 (1997) (“Increasingly, however, investors have used shareholder resolutions and other internal procedures to bring pressure on corporate management to consider investor favored policies when making business decisions.”).

<sup>22</sup> *Id.* at 477.

<sup>23</sup> Crusto, *supra* note 4, at 492.

<sup>24</sup> *Id.* at 492.

<sup>25</sup> Section 14 of the Securities Exchange Act of 1934 and SEC Rule 14a-8 promulgated thereunder govern whether shareholder proposals must be included in a corporation’s definitive proxy statement. Geltman & Skroback, *supra* note 21, at 483. In specified circumstances, a company may exclude a shareholder proposal and any statement supporting the proposal from its proxy. *Id.* at 486.

<sup>26</sup> For a discussion of the various grounds for exclusion under SEC Rule 14a-8, see *id.* at 486-90.

<sup>27</sup> Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 55 (2003) (stating that “resolutions that focus on social or special interest issues uniformly fail”). However, there are signs that some companies may be altering their strategy towards environmental resolutions. During the recent proxy season, two major companies actually supported shareholder resolutions concerning the environment. See Williams & Conley, *supra* note 19, at 97.

<sup>28</sup> See Schwartz & Mussio, *supra* note 1, at 501.

and services, and provide redress for environmental damage.<sup>29</sup> The main focus of the CERES principles is disclosure.<sup>30</sup> The Valdez or CERES principles “were placed on the agenda by shareholders of many Fortune 500 companies,” including American Express, Atlantic Richfields, Union Pacific, and Exxon.<sup>31</sup> As shareholder proposals, the principles have generally withstood corporate efforts to exclude them from the definitive corporate proxy statements.<sup>32</sup> Some sixty companies had signed on to the CERES Principles by 2005.<sup>33</sup>

Other environmental shareholder proposals, however, have not fared so well. The so-called “Pure Profit Reports” proposals—proposals that were part of an organized shareholder campaign in connection with the World Resources Institute’s March 2000 report, *Pure Profit: The Financial Implications of Environmental Performance*<sup>34</sup>—were successfully excluded by corporations from their proxy materials under: (1) Rule 14a-8(i)(3) and 14a-8(i)(6), for being vague, indefinite, and misleading; (2) Rule 14a-8(i)(7), for dealing with a matter relating to the company’s ordinary business operations; and (3) Rule 14a-8(i)(10), for having been substantially implemented.<sup>35</sup>

Even where they are not excluded, shareholder environmental proposals rarely win full shareholder approval.<sup>36</sup> In part, this happens because “[e]ven if a shareholder proposal is included, a registrant may include in its proxy materials a statement explaining its opposition to the proposal.”<sup>37</sup>

Although some have suggested liberalizing shareholder proposal rules as a way of increasing corporate environmental protection,<sup>38</sup> that might be an effective but inefficient approach. Liberalizing shareholder

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<sup>29</sup> *United Paperworkers Int’l Union v. Int’l Paper Co.*, 985 F.2d 1190, 1193 (2d Cir. 1993).

<sup>30</sup> Geltman & Skroback, *supra* note 21, at 499.

<sup>31</sup> *Id.* at 477.

<sup>32</sup> See *United Paperworkers*, 985 F.2d 1190; Schwartz & Mussio, *supra* note 1, at 501; Geltman & Skroback, *supra* note 21, at 491.

<sup>33</sup> See Crusto, *supra* note 4, at 492.

<sup>34</sup> ROBERT REPETTO & DUNCAN AUSTIN, WORLD RES. INST., *PURE PROFIT: THE FINANCIAL IMPLICATIONS OF ENVIRONMENTAL PERFORMANCE* (2000), available at <http://pdf.wri.org/pureprofit.pdf>.

<sup>35</sup> See Schwartz & Mussio, *supra* note 1, at 501-02 (citing Mead Corp., SEC No-Action Letter, 2001 SEC No-Act LEXIS 181 (Jan. 31, 2001); Potlatch Corp., SEC No-Action Letter, 2001 SEC No-Act LEXIS 216 (Feb. 13, 2001); Willamette Indus., SEC No-Action Letter, 2001 SEC No-Act LEXIS 439 (Mar. 20, 2001)).

<sup>36</sup> See Crusto, *supra* note 4, at 492.

<sup>37</sup> See Geltman & Skroback, *supra* note 21, at 491.

<sup>38</sup> See Richardson, *supra* note 20, at 319 (“[G]overnments could liberalize the formal channels currently available for shareholders to intervene in corporate governance processes, such as . . . the shareholder proposal under securities regulations.”).

proposals could potentially expose corporations to greater “crank” proposals and bog down boards with more shareholder-initiated resolutions.<sup>39</sup>

## II. THE CAREMARK DECISION

### A. *The Decision*

Chancellor William T. Allen—now a professor of corporate law at NYU—delivered his decision in *In re Caremark International, Inc. Derivative Litigation*,<sup>40</sup> in 1996. In many ways, *Caremark* is testimony both to Chancellor Allen’s individual reputation and confidence on the bench and to the institutional power of the Delaware Chancery, insofar as it was a decision in which a lower court judge effectively—in mere dicta—overruled a twenty-year-old precedent from the state’s highest court.<sup>41</sup>

The decision itself flowed from a fairness hearing on a settlement of a derivative suit against Caremark International, Inc., a pharmaceutical services company operating over 60,000 retail pharmacies in the United States<sup>42</sup> and providing “a variety of ‘alternative’ services, including growth-hormone treatments and HIV/AIDs-related treatments, at

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<sup>39</sup> See Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 5, at 879.

It might . . . be argued . . . that granting shareholders the power to intervene would result in the initiation of many proposals that would have little chance of being adopted but that would impose costs on companies and their shareholders. According to this view, many shareholders might bring proposals that are unlikely to obtain majority support because they are farfetched, ill-considered, or motivated by considerations other than shareholder wealth. Although these proposals would ultimately be defeated, dealing with them would be costly: shareholders would be burdened by the need to vote against the proposals, and management would have to devote time, attention and company resources to campaign against them.

*Id.* at 879 (citation omitted). Professor Bebchuk, however, believes that a properly designed shareholder proposal regime would help keep costs associated with “nuisance proposals” to an “acceptable minimum.” *Id.* at 879.

<sup>40</sup> *Caremark*, 698 A.2d at 959-72.

<sup>41</sup> H. Lowell Brown, *The Corporate Director’s Compliance Oversight Responsibility in the Post-Caremark Era*, 26 DEL. J. CORP. L. 1, 144 (2001) (“The chancellor’s suggestion that directors have an affirmative duty to see that the corporation has an effective compliance program in place . . . is a direct challenge to the very restrictive view of the director’s responsibility to oversee employee conduct expressed in the *Graham* case.”).

<sup>42</sup> Caremark Inc., Company Overview, <http://www.caremark.com> (follow “About Caremark” hyperlink; then follow “Company Overview” hyperlink) (last visited Dec. 1, 2006).



hospitals and managed care facilities.<sup>43</sup> Caremark was charged with various violations of the Medicare anti-kickback law and indicted in 1994 for multiple felonies.<sup>44</sup> A plea agreement led to civil and criminal fines; in total, the company paid some \$250 million in fines and reimbursement.<sup>45</sup> A class-action derivative suit claiming that the board of directors breached its fiduciary duties of care by failing to detect and deter illegal kickbacks by company employees<sup>46</sup> followed the plea agreement.<sup>47</sup> Because Caremark was a Delaware corporation (even though it was headquartered in the Chicago suburbs), that suit was filed in the Delaware Chancery Court.<sup>48</sup>

After some limited discovery, the derivative suit settled.<sup>49</sup> The terms of the settlement involved no payment to shareholders.<sup>50</sup> Instead, the company agreed to create a new "Compliance and Ethics Committee,"<sup>51</sup> to refrain from breaching the law in the future, and to remove any employees from positions in which their primary task was to pay kickbacks or bribes.<sup>52</sup> Caremark and the plaintiffs petitioned for approval of the class-action settlement pursuant to Delaware Chancery Rule 23.1.<sup>53</sup> Chancellor Allen's task was to determine the fairness of the settlement to the corporation.<sup>54</sup> That required some analysis of the merits of the class-action case.<sup>55</sup> If the action was particularly strong, then a settlement that involved no payment to shareholders, and no payment by the allegedly negligent directors, would seem inadequate.

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<sup>43</sup> David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1851 (2001). Caremark was originally a division of Baxter International, but was spun off in 1992. *Id.* at 1851 n.158. See also Brown, *supra* note 41, at 17.

<sup>44</sup> *Caremark*, 698 A.2d at 960.

<sup>45</sup> *Id.* at 961.

<sup>46</sup> See *id.* at 962 (describing the kickbacks and other illegal acts occurring at Caremark).

<sup>47</sup> *Id.* at 964.

<sup>48</sup> *Id.* at 959, 961.

<sup>49</sup> *Id.* at 965. The initial version of the settlement involved directors giving up some of their stock options; that aspect of the agreement was dropped. *Id.* at 965 n.13.

<sup>50</sup> *Id.* at 965 n.13.

<sup>51</sup> *Id.* at 966.

<sup>52</sup> *Id.*

<sup>53</sup> DEL. CH. CT. R. 23.1, available at <http://courts.delaware.gov/Rules/?chancery.rules.pdf>.

<sup>54</sup> *Caremark*, 698 A.2d at 961.

<sup>55</sup> *Id.*

The complaint itself alleged a breach of the duty of care.<sup>56</sup> Directors, sitting on the board and statutorily authorized to manage a corporation's day-to-day affairs, have a duty to perform their role with the care, skill and diligence a reasonable person would employ under similar circumstances in like position.<sup>57</sup> Prior to the *Caremark* decision, however, the duty of care was not viewed as having a whole lot of teeth.<sup>58</sup> Delaware corporate law authorizes the adoption by corporations of so-called "exculpatory clauses,"<sup>59</sup> which, along with indemnification provisions<sup>60</sup> and Director and Officer insurance policies<sup>61</sup> make it unlikely that a director will be forced to pay for fiduciary breaches. Moreover, directors are protected against duty of care liability by the so-called "business judgment rule" an abstention principle under which courts will refrain from second-guessing reasonably informed decisions that are the product of a reasonable investigation and suitable procedures and that have a rational basis.<sup>62</sup>

While the failure to monitor corporate agents might theoretically lead to liability,<sup>63</sup> the Delaware Supreme Court cast severe doubt on the viability of such suits with its 1963 decision in *Graham v. Allis-Chalmers Mfg. Co.*<sup>64</sup> The court found no breach of the duty of care on the part of a board that had failed to act to put in place a monitoring system to detect

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<sup>56</sup> *Id.* at 960. Corporate scholars and judges generally divide duty-of-care cases into "misfeasance" claims (challenging a board's decision or decision-making process), and "non-feasance" claims (challenging a board's failure to take action). *See, e.g.,* Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1445 (1998).

<sup>57</sup> Guth v. Loft, 5 A.2d 503, 510 (Del. Ch. 1939); MODEL BUS. CORP. ACT § 8.30(b) (2003).

<sup>58</sup> *See* Williams & Conley, *supra* note 19, at 88. Professors Williams and Conley note that:

[Some scholars] suggest that the duty of care generally has been eliminated as an enforceable duty of corporate law as a result of the combination of: the business judgment rule, which precludes personal liability for officers and directors taking reasonable care in making business decisions; indemnification, which authorizes or requires the company to reimburse officers and directors for most forms of personal liability; exculpation clauses, which companies adopt in their articles of incorporation to eliminate a cause of action for breach of the duty of care; and directors and officers (D&O) insurance, which effectively shifts the financial risk of malfeasance to an insurance company.

*Id.* at 89.

<sup>59</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

<sup>60</sup> *Id.* § 145(f).

<sup>61</sup> *Id.* § 145(g).

<sup>62</sup> *See generally* Stephen A. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

<sup>63</sup> *Caremark*, 698 A.2d at 968.

<sup>64</sup> 188 A.2d 125 (1963).

price fixing violations by corporate agents: “[A]bsent *cause for suspicion* there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”<sup>65</sup>

*Caremark* effectively overruled *Allis-Chalmers* for the modern era,<sup>66</sup> although it did so in dicta and recognized that a suit based on failure to monitor was “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”<sup>67</sup> Chancellor Allen noted three factors favoring his decision: (1) “the seriousness with which the corporation law views the role of the corporate board;”<sup>68</sup> (2) “the 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;”<sup>69</sup> and (3) “the potential impact of the federal organizational sentencing guidelines on any business organization.”<sup>70</sup> Only the last explanation merited further discussion: “Any 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.”<sup>71</sup>

Therefore, a board has an obligation to assure itself that the corporation has “information and reporting systems . . . 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 cor-

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<sup>65</sup> *Id.* at 130 (emphasis added). Ironically, even though the court’s ruling in the case was that no fiduciary breach had occurred, the *Allis-Chalmers* scandals helped prompt American corporations in particular to adopt the type of corporate monitoring systems that the court held were not required by fiduciary law. See Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 278-80 (2004).

<sup>66</sup> Discussing *Allis-Chalmers*, Chancellor Allen asked, “How does one generalize this holding today? Can it be said today that, absent some ground giving rise to suspicion . . . that corporate directors have no duty to assure that . . . information gathering and reporting systems exist . . . ?” *Caremark*, 698 A.2d at 969. Such a broad interpretation, the Chancellor predicted, would not be accepted by the Delaware Supreme Court in 1996. *Id.* at 969-70.

<sup>67</sup> *Id.* at 967.

<sup>68</sup> *Id.* at 970.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

poration's compliance with law and its business performance."<sup>72</sup> While the exact mechanics of such systems are left to the board's business judgment, the board must use 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, so that it may satisfy its responsibility."<sup>73</sup>

Given this articulation of a board's oversight duties, Chancellor Allen provided that a duty-of-care plaintiff:

[W]ould have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of . . . .<sup>74</sup>

The Chancellor added that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exi[s]ts—will establish the lack of good faith that is a necessary condition to liability."<sup>75</sup>

Turning to the facts of the case itself, Chancellor Allen concluded that the settlement was fair and reasonable in light of the fact that there was little evidence that the board knew of ongoing illegal kickbacks<sup>76</sup> and no evidence of a sustained and systematic failure to exercise oversight.<sup>77</sup> Therefore, even though the Chancellor characterized the settlement as providing "very modest benefits," he concluded that it was fair.<sup>78</sup> The flaws in the plaintiffs' case meant that a better result was unlikely were the case to proceed to trial.<sup>79</sup>

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<sup>72</sup> *Id.* Chancellor Allen did not explore some of the other reasons why failure to put in place a monitoring system to detect and deter criminal acts would be unreasonable. For instance, government contractors (including Caremark, which dealt extensively with Medicaid and Medicare) who face criminal sanction may lose their eligibility for future government work. See Brown, *supra* note 41, at 26.

<sup>73</sup> *Caremark*, 698 A.2d at 970.

<sup>74</sup> *Id.* at 971.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 972.

<sup>79</sup> See *id.*

The actual result of the case—that the settlement was upheld as fair—is far less important than Chancellor Allen’s articulation of the standards of potential board liability for inattention or lack of oversight. As one set of commentators noted: “While unconsidered inaction, in theory, can render a director liable, no Caremark directors were found personally liable. *Caremark* enhanced a director’s risk of liability by opening the door to increased scrutiny and reinforcement of the duty to monitor.”<sup>80</sup>

### B. *Aftermath*

The *Caremark* decision has influenced other courts’ understanding of the duty of care under Delaware law, even though it is not a case from the state’s highest court.<sup>81</sup> Subsequent Delaware Chancery decisions (by other Chancellors) have described *Caremark* claims as difficult to prove,<sup>82</sup> but the decision has not been repudiated by another judge.<sup>83</sup> The United States Court of Appeals for the Sixth Circuit read *Caremark* as allowing for claims involving breach of the duty of care arguing “something less than intentional conduct.”<sup>84</sup>

Initially, some observers have speculated that “a definitive statement regarding a director’s liability [in *Caremark*-type situations] must

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<sup>80</sup> See Kimberly D. Baker & Arissa M. Peterson, *Post-Caremark Implications for Health Care Organization Boards of Directors*, 3 SEATTLE J. FOR SOC. JUST. 387, 392 (2004).

<sup>81</sup> See, e.g., *In re Abbott Lab. Derivative S’holders Litig.*, 325 F.3d 795, 805-06, 808 (7th Cir. 2003). “Delaware law states that director liability may arise for the breach of the duty to exercise appropriate attention to potentially illegal corporate activities from ‘an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.’” *Id.* at 808 (quoting *Caremark*, 698 A.2d at 967). See also *McCall v. Scott*, 239 F.3d 808, 817 (6th Cir. 2001); *Stanziale v. Nachtomi*, 330 B.R. 56, 64-65 (Bankr. D. Del. 2004), *aff’d in part, rev’d in part sub nom.* *Stanziale v. Nachtomi (In re Tower Air, Inc.)*, 416 F.3d 229 (3d Cir. 2005).

<sup>82</sup> See, e.g., *Saito v. McCall*, NO. Crv. A. 17132-NC, 2004 WL 3029876, at \*6 (Del. Ch. Dec. 20, 2004); *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003). The *Guttman* decision, interestingly, viewed *Caremark* as a duty of loyalty case:

Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations’ compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith.

*Id.* at 506.

<sup>83</sup> *Id.* at 508 n.39 (“[A]s I understand it, the well-thought out *Caremark* decision accurately reflects our law, strikes a sensible policy balance in this difficult area, and I adhere to it.”).

<sup>84</sup> *McCall*, 239 F.3d at 817.

await a decision of the Supreme Court of Delaware,<sup>85</sup> although the Delaware court gave no indication that it was inspired to reject Chancellor Allen's *Caremark* intuition.<sup>86</sup> In a case published while this Essay was in the final stages of the editorial process, on November 6, 2006, the Delaware Supreme Court expressly endorsed the *Caremark* position. In *Stone v. Ritter*, the court "h[e]ld that *Caremark* articulates the necessary conditions for assessing director oversight liability."<sup>87</sup>

### C. *Vitality*

Central to Chancellor Allen's decision in *Caremark* overturning *Allis-Chalmers* was the effect of the Federal Sentencing Guidelines on the "reasonableness" of corporate policy towards compliance and detection of criminal activities.<sup>88</sup> Since *Caremark*, of course, the Supreme Court of the United States issued its opinion in *United States v. Booker*<sup>89</sup> striking down the Federal Sentencing Guidelines as a mandatory system of sentencing.<sup>90</sup> It is certainly worth asking whether the Delaware Supreme Court would adopt *Caremark* given the evisceration of one of the legal foundations of that decision.

While the issue is certainly an open one, *Booker* probably does not affect the soundness of *Caremark*. The leading appellate court decisions post-*Booker* have indicated that while the sentencing guidelines are now no longer mandatory, they are directive.<sup>91</sup> For example, in 2006, the Eighth Circuit affirmed a sentence of life in prison that was within the Guidelines in *United States v. Denton*,<sup>92</sup> but remanded for further explanation a decision to impose a below-Guideline ten year sentence in *United States v. Feemster*.<sup>93</sup> In the words of Ohio State University Professor Douglas Berman, the Guidelines "remain the gold standard for reasonableness review."<sup>94</sup> Thus, even though it is possible that a judge

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<sup>85</sup> See Brown, *supra* note 41, at 6.

<sup>86</sup> *Id.* at 16 ("*Caremark* . . . represents a departure from precedent . . . [H]owever, [the Chancellor's analysis] is in accordance with the main themes of corporate governance over the past twenty years.").

<sup>87</sup> *Stone v. Ritter*, 2006 WL 3169168 at \*1 (Del. Nov. 6, 2006).

<sup>88</sup> *Caremark*, 698 A.2d at 969.

<sup>89</sup> 543 U.S. 220 (2005).

<sup>90</sup> *Id.*

<sup>91</sup> See *United States v. Denton*, 434 F.3d 1104, 1113 (8th Cir. 2006).

<sup>92</sup> *Id.* at 1113.

<sup>93</sup> 435 F.3d 881 (8th Cir. 2006).

<sup>94</sup> Douglas A. Berman, Sentencing Law and Policy, [http://sentencing.typepad.com/sentencing\\_law\\_and\\_policy/2006/01/eighth\\_circuit\\_\\_1.html](http://sentencing.typepad.com/sentencing_law_and_policy/2006/01/eighth_circuit__1.html) (Jan. 24, 2006, 12:03 EST).

would not impose enhancement or reject mitigation based on a corporation's failure to implement the kind of monitoring called for in *Caremark*, that judge would likely need to explain his departure in order to have his sentence upheld on review. This means that generally, absent compelling reasons which they feel comfortable putting on record, judges are likely to avoid sentences which do not fall within the Guidelines. To the extent that *Caremark* was good law in the first place, *Booker* changes little. It would still be unreasonable to ignore the impact of the Sentencing Guidelines on the reasonableness of a corporation's decision whether or not to have a compliance policy.

Moreover, there are other benefits associated with compliance programs. Compliance programs, by avoiding or reducing the possibility of illegal activity, can help preserve the valuable reputation of a firm.<sup>95</sup>

### III. RAMIFICATIONS AND ROADMAP OF *CAREMARK* LITIGATION FOR ENVIRONMENTAL ACTIVISTS

A fairly clear implication of *Caremark* is that the decision likely requires firms to put in place a reasonable system for detecting environmental non-compliance and lawbreaking. While other authors have addressed the broader impact of *Caremark* on non-shareholder concerns,<sup>96</sup> this section focuses on the impact of *Caremark* on environmentally conscious stakeholders.

In his *Caremark* opinion, Chancellor Allen explicitly suggested that the ruling required the implementation of environmental compliance systems: the ruling calls for an assurance of "corporate compliance with external legal requirements, including *environmental* . . . as well as

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<sup>95</sup> See Williams & Conley, *supra* note 19, at 93 ("The risks to business reputation from credible allegations of human rights abuses create incentives for companies and directors to consider these issues seriously, irrespective of whether an ultimate finding of liability is likely.").

<sup>96</sup> See, e.g., *id.* at 87-88.

As set out in . . . *Caremark* . . . part of the directors' fiduciary duty of care is a duty to provide oversight with respect to law compliance—a duty to have systems in place to reduce liability risks from illegal activities by employees. . . . [H]uman rights violations are part of the liability risks that directors need to consider, at least to the extent of ensuring that the company has established appropriate information and reporting systems to assess risks of human rights violations, as well as policies to address conditions that may give rise to such risks.

*Id.* (citation omitted).

assorted other health and safety regulations."<sup>97</sup> While *Caremark* is not an "environmental factual case," its "basic principle . . . is instrumental" in understanding corporate liability "in the environmental arena."<sup>98</sup>

Putting in place "information systems that assure that instances of noncompliance are communicated to high level management"<sup>99</sup> can help reduce a corporation's exposure to criminal sanctions. Examples of such programs have appeared in the case law.<sup>100</sup>

Professor Lucia Ann Silecchia writes:

In the 1990s, with criminal enforcement of American environmental statutes becoming more widespread, and the consequences of violations potentially more severe, the creation of effective environmental compliance programs has rapidly become a priority for the regulated community. In previous years, creation of such programs could have been viewed merely as a responsible option to assist corporations in achieving or maintaining reputations as good corporate citizens . . . . More recently, the possession of a compliance plan became a desirable way of reducing expensive civil and administrative penalties for the violation of environmental statutes. However, when the 1990's ushered in increased criminal prosecution of environmental violators, the stakes were raised significantly and the motives for creating environmental compliance plans changed.<sup>101</sup>

"The number of federal criminal environmental prosecutions substantially increased in 1980s."<sup>102</sup> While teachers of white collar crime have

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<sup>97</sup> *Caremark*, 698 A.2d at 969 (emphasis added).

<sup>98</sup> Mathias H. Heck, Jr. & Rhonda R. Mims, *The Corporate Officer: To Pay or Not to Pay?*, THE PROSECUTOR, July-Aug. 1998, at 24, 24.

<sup>99</sup> DiMento & Bertolini, *supra* note 11, at 146.

<sup>100</sup> See, e.g., *United States v. Royal Caribbean Cruises, LTD*, 11 F.Supp. 2d 1358 (S.D. Fla. 1998); *United States v. Palm Beach Cruises, S.A.*, 206 B.R. 634 (S.D. Fla. 1996); Charles A. De Monaco, *Criminal Enforcement of Environmental Laws: Changes to Environmental Compliance Through the Security and Antiterrorism Prism*, SH050 ALI-ABA 83 (ALI-ABA Continuing Legal Education Course of Study, 2003) [hereinafter De Monaco, *Changes to Environmental Compliance*] (citing *United States ex rel. Pearl Shipping Corp. & Anax Int'l Agencies, Inc.*, No. CR-98-000384 MHP (N.D. Cal., Sept. 1999)).

<sup>101</sup> Lucia Ann Silecchia, *Ounces of Prevention and Pounds of Cure: Developing Sound Policies for Environmental Compliance Programs*, 7 FORDHAM ENVTL. L.J. 583, 583-87 (1996).

<sup>102</sup> *Id.* at 587 (quoting Carol E. Dinkins, *Criminal Enforcement of Environmental Regulations: The Genesis of Environmental Enforcement Through Criminal Sanction*, in



been known to complain about the lack of published opinions in the area,<sup>103</sup> published opinions are not in short supply because of an absence of criminal actions,<sup>104</sup> but rather because most accused corporations seek plea agreements and implement extensive self-remediation.<sup>105</sup>

The Federal Organizational Sentencing Guidelines themselves, of course, provide for a reduction in fines for organizations that have implemented compliance programs generally.<sup>106</sup> A three point reduction will flow from having in place an "effective compliance and ethics program" as defined in the Guidelines.<sup>107</sup> The Guidelines provide an example of a necessary environmental compliance system: "If an organization handles toxic substances, it must have established standards and procedures designed to ensure that those substances are properly handled at all times."<sup>108</sup> Where there has been no compliance system in place, the Guidelines mandate probation for organizations with more than fifty employees.<sup>109</sup> Businesses may be forced to bear the costs of hiring a specially appointed probation officer to monitor their behavior during the probationary period.<sup>110</sup>

In addition to these formal benefits, the existence of compliance plans may lead environmental enforcement authorities to pursue civil or administrative actions rather than criminal prosecutions.<sup>111</sup> Significant discretion exists in environmental cases—both at the Environmental Pro

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ENVIRONMENTAL CRIMINAL LIABILITY: AVOIDING AND DEFENDING ENFORCEMENT ACTIONS 1, 5 (Donald A. Carr et al. eds. 1995)).

<sup>103</sup> Kathleen F. Brickey, *The Rhetoric of Environmental Crime: Culpability, Discretion, and Structural Reform*, 84 IOWA L. REV. 115, 135-37 (1998).

<sup>104</sup> *Id.*

<sup>105</sup> See generally Silecchia, *supra* note 101.

<sup>106</sup> U.S. SENTENCING COMM., GUIDELINES MANUAL § 8C2.5(f), at 496-97 (Nov. 1, 2006) [hereinafter U.S.S.G. MANUAL].

<sup>107</sup> *Id.* "Effective Compliance and Ethics Program" is defined in the Guidelines at section 8B2.1(a). *Id.* § 8B2.1(a), at 482.

<sup>108</sup> De Monaco, *Changes to Environmental Compliance*, *supra* note 100, at \*98 (quoting the Federal Sentencing Guidelines, which are codified at 18 U.S.C.A. Appx.).

<sup>109</sup> U.S.S.G. MANUAL, *supra* note 106, § 8D1.1(a), at 511-12.

<sup>110</sup> See, e.g., Settlement Agreement at 8-12, *United States v. Roger Williams Med. Ctr.*, No. 06-02, [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/files/roger\\_williams\\_deferred\\_sentence\\_agreement.pdf](http://lawprofessors.typepad.com/whitecollarcrime_blog/files/roger_williams_deferred_sentence_agreement.pdf). In this settlement, which likely mirrors the sentences imposed by the courts, the defendant hospital was ordered to pay the costs of a monitor for a two year tenure. *Id.*

<sup>111</sup> Silecchia, *supra* note 101, at 597.

tection Agency (“EPA”) referral stage<sup>112</sup> and at the Department of Justice (“DOJ”) stage<sup>113</sup>—making it possible to influence regulators to stave off criminal punishment.<sup>114</sup> Some local prosecutors also explicitly consider compliance programs in deciding whether or not to pursue criminal charges against environmental offenders.<sup>115</sup>

The sentencing benefits of an environmental compliance program will become even more clear if the Proposed Sentencing Guidelines for Organizations Convicted of Environmental Offenses<sup>116</sup> are ever adopted. The Proposed Sentencing Guidelines for Organizations Convicted of an Environmental Offenses (authored by an Advisory Group in 1993 but apparently never implemented) reward putting in place a compliance program.<sup>117</sup> Under the Proposed Sentencing Guidelines, an organization that fails to put in place a “program or other organized effort to achieve and maintain compliance with environmental requirements, or . . . had such a program in form only and had substantially failed to implement such a program. . . .” would be subject to a four-level increase.<sup>118</sup> At the same time, the existence of an appropriate environmental compliance program would lead to a three- to eight-level reduction in sentencing score.<sup>119</sup>

The potential exposure to a *Caremark*-style claim creates a powerful incentive for corporations to develop and implement environmental compliance programs. Injunctive relief may even be available to plaintiff-

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<sup>112</sup> *Id.* at 598-602; Charles A. De Monaco, *Pollution and Corporate Compliance Programs: Civil and Criminal Minefield or Corporate Savior*, SG014-ALI-ABA 143, 158-160 (ALI-ABA Continuing Legal Education Course of Study, 2001) [hereinafter De Monaco, *Pollution and Corporate Compliance Programs*].

<sup>113</sup> Silecchia, *supra* note 101, at 604-06; De Monaco, *Pollution and Corporate Compliance Programs*, *supra* note 112, at 158-160.

<sup>114</sup> See Silecchia, *supra* note 101, at 598.

<sup>115</sup> See, e.g., Heck & Mims, *supra* note 98, at 27-28 (noting that the Montgomery County, Ohio, Prosecutor’s Office considers the existence of a “meaningful and effective internal compliance program” in deciding “whether to charge a person with an environmental crime”).

<sup>116</sup> U. S. SENTENCING COMM’N, REPORT FROM ADVISORY GROUP ON ENVIRONMENTAL SANCTIONS (1993), available at <http://www.ussc.gov/publicat/ENVIRON.PDF>.

<sup>117</sup> Silecchia, *supra* note 101, at 594. For a general overview of the Proposed Environmental Guidelines, see Jeffrey M. Rosin, *New Chapter 9: An Analysis of the Proposed Sentencing Guidelines for Organizational Environmental Offenders and the Historic Evolution of a Compliance Nightmare*, 3 N.Y.U. ENVTL. L.J. 559 (1995).

<sup>118</sup> See REPORT FROM ADVISORY GROUP ON ENVIRONMENTAL SANCTIONS, *supra* note 116, at 16 (setting forth § 9.C1.1(f) of the Proposed Sentencing Guidelines).

<sup>119</sup> *Id.* at 17 (setting forth § 9C1.2(a) of the Proposed Sentencing Guidelines).

shareholders, calling upon corporations to implement such proposals.<sup>120</sup> However, it is worth asking whether the implementation of a compliance plan actually has any effect on harmful environmental practices.<sup>121</sup> Compliance plans do not focus on positive environmental outcomes, but rather on “means of managing compliance.”<sup>122</sup> Even the most ingenious of monitoring systems might not overcome the practical limitations associated with assessing a corporation’s environmental compliance at a particular moment.<sup>123</sup> Compliance methods may be “inherently limited in what they can do, making the modest expectations associated with positive aspirational controls sensible but increasing the likelihood of disappointed expectations associated with the more ambitious efforts of negative preventive controls.”<sup>124</sup> Moreover, the emphasis on compliance encourages companies to achieve minimum legal requirements, rather than expand environmentally conscious practices beyond what the law requires.<sup>125</sup> At least some critics of *Caremark* have suggested that the decision requires only minimal action on the part of board members seeking to satisfy their duty of care.<sup>126</sup>

How do you prove a sustained and systematic failure to exercise oversight? An example of a successful *Caremark* claim can be found in the Seventh Circuit’s decision in *In re Abbott Labs.*, a case that arose after the company engaged in a pattern of non-compliance with FDA

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<sup>120</sup> See Cheryl L. Wade, *Racial Discrimination and the Relationship Between the Directorial Duty of Care and Corporate Disclosure*, 63 U. PITT. L. REV. 389, 407 (2002) (“*Caremark* demonstrates the value of injunctive relief that may help to avoid shareholder losses that derive from corporate liability for noncompliance with legal obligations.”).

<sup>121</sup> See Silecchia, *supra* note 101, at 594.

<sup>122</sup> *Id.* at 615.

<sup>123</sup> See David Monsma & John Buckley, *Non-Financial Corporate Performance: The Material Edges of Social and Environmental Disclosure*, 11 U. BALT. J. ENVTL. L. 151, 151-52 (2004) (“Generally speaking, there is no single management or monitoring system that comprehensively assures full compliance with all legal requirements on a *continuous*, uninterrupted basis.”).

<sup>124</sup> Cunningham, *supra* note 65, at 269.

<sup>125</sup> Silecchia, *supra* note 101, at 624-28 (“[T]he end to which all three of these plans strive is full legal compliance, but little else.”).

<sup>126</sup> See Stephen F. Funk, Commentary, *In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 DEL. J. CORP. L. 311, 321-22 (1997) (“The true import of the *Caremark* decision is that directors need only take minimal steps to satisfy the demands of the duty to monitor and are at a low risk of personal liability, because their ‘business judgment’ in implementing a particular reporting system is given substantial protection.”).

regulation in connection with the manufacture of medical diagnostic kits.<sup>127</sup> There, the court noted an

extensive paper trail . . . concerning the violations . . . [which] support[ed] a reasonable assumption that there was a ‘sustained and systematic failure of the board to exercise oversight,’ in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith.<sup>128</sup>

Other clues can be found in cases rejecting claims patterned after *Caremark*. For instance, in a case involving financial irregularities, the Delaware Chancery Court noted a plaintiff’s failure to plead that the company lacked an “audit committee,” or “had an audit committee that met only sporadically and devoted patently inadequate time to its work” when it dismissed the plaintiff-shareholders’ complaint.<sup>129</sup>

*Caremark*-style environmental derivative suits are more relevant in some contexts than others. Because they must target oversight and compliance systems, such suits have relatively little to say about pollution reduction or prevention.<sup>130</sup> While *Caremark*-style claims might help reduce incidences of illicit dumping, they are unlikely to convince companies not to engage in conduct that results in the destruction of natural environments through more gradual development and industrialization.

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<sup>127</sup> *In re Abbott Lab. Derivative S’holders Litig.*, 325 F.3d 795, 795 (7th Cir. 2003).

<sup>128</sup> *Id.* at 809.

<sup>129</sup> *Guttman v. Huang*, 823 A.2d 492, 507 (Del. Ch. 2003).

<sup>130</sup> See Silecchia, *supra* note 101, at 621 (“[C]ompliance policies do not focus at all on pollution prevention or any other proof of environmental improvement.”).