1998

The Corporate Director's Duty of Oversight

Mark J. Loewenstein
University of Colorado Law School

Citation Information

Mark J. Loewenstein, *The Corporate Director's Duty of Oversight*, Colo. Law., May 1998, at 33, available at
.

The Corporate Director's Duty of Oversight

by Mark J. Loewenstein

Corporate directors' fiduciary duties include duties of care and loyalty. The duty of care is twofold, as directors must exercise care in both overseeing the corporation's business as well as in making specific business decisions. While the duty of oversight has received less attention than the duty of care in making business decisions,[1] a recent Delaware case has made the duty of oversight a timely topic of consideration.

This article discusses two leading Delaware cases and other authorities on the duty of oversight. It also reviews Colorado case law.

The Duty of Oversight

From Graham *to* Caremark

Since 1963, the leading Delaware Supreme Court case on the duty of oversight has been *Graham v. Allis-Chalmers Mfg. Co.*[2] *Graham* was a shareholder's derivative action based on antitrust violations by lower-level managers' price fixing. This antitrust violation took place without the knowledge or acquiescence of the Allis-Chalmers' directors or senior officers. However, the plaintiff's derivative action theorized that if the board had exercised a proper level of supervision, it would have discovered this unlawful conduct before it harmed the corporation.

The plaintiff's theory of the case did not persuade the Delaware Supreme Court, which affirmed the Vice Chancellor's dismissal of the action against the director-defendants. The court rejected the argument that directors had an obligation to implement a "system of watchfulness" with this observation:

> [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 reason to suspect exists.[3]

Commentators have characterized the Delaware court's pronouncement in *Graham* as a "red flag" test—unless the directors see one they can assume that all is well.

The comforting "red flag" test, however, may no longer be a reliable standard of law. In the thirty-five years since *Graham* was decided, several developments have undermined the precedent, indicating that directors must be more proactive in discharging their duty of oversight. These developments were highlighted in *In re Caremark International Inc. Derivative Litigation*,[4] an opinion written by Chancellor Allen of the Delaware Court of Chancery. While a Chancery opinion is typically of lesser precedential value than a Supreme Court opinion, the age of the *Graham* decision, Chancellor Allen's prominence, and the force of his opinion all suggest otherwise.

Like *Graham*, *Caremark* was a derivative action that followed disclosure of corporate misconduct. In the case of Caremark, the disclosures revealed that the company had violated the federal Anti-Referral Payments Law, which prohibits health care providers from paying kickbacks to physicians and others for referring Medicare and Medicaid patients. Caremark had violated this law, and it cost the company $250,000,000 to settle criminal and civil suits. The shareholders sued the directors on a negligence theory to recover the corporate losses.

The suit was settled, and Chancellor Allen had before him the parties' settlement agreement for his approval. Under the settlement, Caremark agreed to amend its bylaws to add committees and procedures designed to avoid a repeat of the conduct that resulted in the violations. Chancellor Allen found the settlement fair to the shareholders and agreed to the dismissal. However, he also used the opportunity to define the directors' duty of oversight, which duty was the basis of the plaintiff's complaint.

In *Caremark*, Chancellor Allen opined that the Delaware Supreme Court, if faced with the issue, would no longer endorse the red flag test.[5] Rather, the opinion observed, in the years since the Supreme Court decided *Graham*, it had recognized the increased importance of the board of directors. Citing *Smith v. Van Gorkom*[6] and *Paramount v. QVC*,[7] the opinion said that Delaware's jurisprudence makes clear the "seriousness with which the corporation law views the role of the corporate board."[8]

The opinion in *Caremark* noted two other factors that weaken the *Graham* precedent. First, under the Delaware corporate code, as in the Colorado Business Corporation Act, the directors are charged

---

Column Ed.: David P. Steigerwald of Sparks Dix, P.C., in Colorado Springs—(719) 475-0097

This newsletter is prepared by the Business Law Section of the CBA to apprise members of the Bar of current information concerning substantive law. This month's article was written by Mark J. Loewenstein, Boulder, a Professor of Law at the University of Colorado School of Law, (303) 492-8048.

with the obligation of monitoring the corporate business,[9] and this obligation requires "relevant and timely information."[10] Second, the federal sentencing guidelines have enhanced penalties for corporate violators and provided opportunities for reduced sanctions if certain oversight mechanisms are in place. Both of these factors suggest a proactive role for the board. Thus, the opinion concluded, if a corporation violates the law, the directors may be found responsible, even absent knowledge or grounds for suspicion. According to *Caremark*, this would be true unless the board can demonstrate that "information and reporting systems exist that are reasonably designed to provide the board with 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 business performance."[11]

With this principle in mind, the opinion then considered the plaintiff's burden when alleging a lack of oversight. Plaintiffs must show that the directors demonstrated a "sustained or systematic failure" to exercise oversight,[12] through, for instance, "an utter failure [on the board's part] to attempt to assure that a reasonable information and reporting system exists."[13]

Other Sources

Caremark is not the sole source that suggests a heightened duty of oversight for corporate directors. The ABA Corporate Directors Guidebook, the ALI Corporate Governance Project, and the Business Roundtable's "Statement of Position on the Role of Corporate Governance and American Competitiveness" all suggest that directors must be proactive in assuring that their company is in compliance with the law. For instance, the Guidebook provides:

> A director should be satisfied that an effective system is in place for periodic and timely reporting to the board on . . . compliance with law and corporate policies. . . .[14]

There are similar pronouncements in the other sources.

Colorado Precedents

The Holland *Case*

Colorado courts have not directly decided any oversight cases raising the kinds of issues present in *Graham* and *Caremark*, and what scant Colorado precedent that does exist is somewhat difficult to characterize. The "leading" Colorado case on director responsibility, *Holland v. American Founders Life Insurance Co.*,[15] illustrates this uncertainty.

> "*Caremark* suggests that directors must act to assure that corporate policies are being faithfully discharged and that the corporation is complying with the law."

Holland involved a suit by a corporation against one of its directors in which the corporation alleged a breach of fiduciary duty. As there was no question of loyalty involved, the alleged breach related to the duty of care. The director in question, Holland, apparently was an unwitting participant to a scheme devised by Hudson, a fellow director and the president of American Founders. Hudson agreed to issue American Founders stock to several people in exchange for shares of another corporation, Texas Adams. The American Founders stock was issued to the subscribers without the approval of the American Founders board. Unfortunately, the Texas Adams' shares received in the exchange were apparently worthless. Holland's role, however, was apparently limited to signing the American Founders' certificate as secretary of the corporation.

The trial court found Holland liable, but the Colorado Supreme Court reversed, holding that "a director and officer of a business corporation is liable for his own misconduct and not for the wrongful conduct of other directors or officers unless he joined with them in perpetrating the wrong."[16] Read broadly, this statement suggests that the Colorado court would not follow the *Caremark* precedent, because *Caremark* holds that under certain circumstances a director may be liable for the misconduct of others, even if the director did not know of the wrongdoing. The defendant-director in *Holland* must have known that the stock issuance was unauthorized by the board and therefore improper, if not illegal.

Two points about *Holland* are worth noting. First, the defendant Holland was not accused of failing to discharge his fiduciary duty of oversight as a director of American Founders. The claim appears to be that he should not have signed the stock certificates as secretary of the company without board authorization. In this regard, it is important to note that suit was brought against only Holland and Hudson. If the claim were one of failure of oversight, the remaining six directors would probably have been named as defendants as well. Second, *Holland* was decided three years before *Graham*, so even if *Holland* were characterized as an oversight case, the continued validity of the holding must be questioned in light of the factors cited in *Caremark*.

The Christy *Case*

Another case construing Colorado law, *Christy v. Cambron*,[17] was decided by the Tenth Circuit Court of Appeals. Like the *Holland* decision, which it cites, *Christy* fails to shed much light on the oversight obligation. *Christy* involved, among other things, a claim by a group of investors that their business failed due to the poor management of the defendant. The report of the case states that the defendant was charged with breaching "his fiduciary duties as an incorporator under Colorado law."[18] Clearly, though, the defendant's role was greater than that of a mere incorporator, as he established the business as well as incorporated it. The jury awarded damages to the plaintiffs, but the trial court granted the defendant's motion for a judgment notwithstanding the verdict. On appeal, the Court of Appeals affirmed.

As to the plaintiff's claim against the defendant for breach of fiduciary duty, the appellate court simply cited *Holland* to the effect that directors (and, the court added, promoters) are liable only for losses "caused by their bad faith or willful and intentional departure from duty, their fraudulent breaches of trust, their gross or willful negligence, or their *ultra vires* acts."[19] The court did not explain the application of this principle to the facts of the case, thus implying that the defendant's conduct must not have been egregious. *Christy* may be characterized as a decision-making case rather than an oversight case, as the defendant was not charged with failing to discover wrongdoing by others.

Financial Institutions

The *Holland* court made a point of distinguishing business corporations from banks: "The directors of a business corporation *other than a bank* are not held responsible for mere errors of judgment or for want of prudence short of clear and gross negligence."[20] The clear implication of this statement is that directors of a bank (or, presumably, a similar financial institution) are liable for mere negligence. The leading case on the liability of directors of a Colorado financial institution appears to be *Resolution Trust Corp. v. Heiserman*,[21] a decision by the U.S. District Court for the District of Colorado.

Heiserman involved, among other things, a claim by the RTC that the directors of Capitol Federal Savings and Loan Association of Denver were negligent. The report of the case did not point to a single decision or series of decisions that the directors made in a negligent fashion. Had it done so, the case might be characterized as a challenge to the process that the directors used in making decisions, a classic duty of care claim. Instead, the claim seems to be broader—that the directors somehow breached their duty to properly oversee the activities of the institution. As to this claim, the court held that directors were liable for their mere negligence.

The District Court justified this decision primarily on the basis of the Colorado Corporate Code, which applied to this financial institution and provided in pertinent part that:

> A director shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use in similar circumstances.[22]

This language, the court concluded, is language of common law negligence.

This statutory section, however, does not distinguish between the directors of a business corporation and a financial institution, and *Holland* had already held that directors are not liable for their mere negligence. The District Court recognized this problem and had basically two answers: first, the Colorado Supreme Court (in *Holland*) had indicated that bank directors are held to a higher standard; and second, the District Court was only deciding the standard of care for directors of a financial institution, period.[23]

The *Heiserman* case is not helpful precedence on the oversight duty, in financial institutions or business corporations. Concepts of negligence do not translate very well when considering the oversight function. The *Heiserman* court, unlike the *Caremark* court, gives no hint as to what a director must do to discharge his or her duty of oversight, so it is impossible to say what constitutes a negligent breach of that duty. If *Caremark* is an accurate statement of the law, directors are responsible for implementing compliance law and policy systems for officers and employees. If those systems fail, the directors have done their part and bear no responsibility for the resulting losses.[24] Is the situation different for banks—that is, are bank directors liable even if, acting in good faith and in a manner they reasonably believe to be in the best interests of the corporation, the system they devise fails? *Heiserman* does not resolve this question.

Alternatively, *Heiserman* might be characterized as a case in which the directors failed in their decision-making by, for instance, exercising bad judgment in approving certain loans. Here, too, the language of negligence does not serve well, because the only rational way to judge the directors' decision-making is to reference the *process* they employed. The appropriate questions to ask are whether the directors exercised care in informing themselves prior to making the decision, whether they acted in good faith, and whether they acted in a manner that they believed was in the best interests of the corporation. That series of questions cannot be simply characterized as a single question of whether the directors acted negligently.

Conclusion

To discharge their duty of oversight, directors cannot sit back and assume that all is well. The *Caremark* case from Delaware, as well as other authorities, suggests that directors must act to assure that corporate policies are being faithfully discharged and that the corporation is complying with the law. Colorado law is less than clear on this subject. What precedent that does exist might be read otherwise, but such a reading may be incorrect. A recent federal district court case, involving a failed savings and loan, suggests that directors of a financial institution have a higher duty of oversight. In any event, until the Colorado Supreme Court rules on the question, some doubt will remain. The prudent course, however, would follow the guidance provided by the *Caremark* case.

NOTES

1. *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), a leading Delaware case on the duty of care in making business judgments. This case spawned a plethora of com-

mentary. For a particularly thoughtful article, *see* Eisenberg, "The Director's Duty of Care in Negotiated Dispositions," 51 *U. Miami L. Rev.* 579 (1997).

2. 188 A.2d 125 (Del. 1963).
3. *Id.* at 130.
4. 698 A.2d 959 (Del. Ch. 1996).
5. *Id.* at 970.
6. 488 A.2d 858 (Del. 1985).
7. 637 A.2d 34 (Del. 1994).
8. *Caremark, supra,* note 4 at 970.
9. CRS § 7-108-101(2).
10. *Caremark, supra,* note 4 at 970.
11. *Id.*
12. *Id.* at 971.
13. *Id.*
14. "Corporate Director's Guidebook—1994 Edition," 49 *Bus. Lawyer* 1247, 1250 (1994).
15. 376 P.2d 162 (Colo. 1962).
16. *Id.* at 166.
17. 710 F.2d 669 (10th Cir. 1983).
18. *Id.* at 670.
19. *Id.* at 672, quoting from *Holland, supra,* note 15 at 165.
20. *Id.* [*Emphasis added.*]
21. 839 F.Supp. 1457 (D.Colo. 1993).
22. CRS § 7-5-101(2). The corporate code has since been amended and recodified. The new section, which is substantially the same as the provision cited by the court, is found at § 7-108-401.
23. *Heiserman, supra,* note 21 at 1464.
24. *Caremark, supra,* note 4 at 970.

Criminal Defense Bar Names Olom Award Recipient

The Colorado Criminal Defense Bar ("CCDB") recently named Boulder attorney Michael Enwall as the recipient of the 1998 Jonathan Olom Award. He will be honored at dinner on May 9 at the Adam's Mark Hotel in Denver. The Olom Award, the CCDB's highest honor, recognizes an attorney each year for "outstanding service on behalf of the accused without regard for personal gain." Tickets for the Olom Dinner are available through the CCDB by calling (303) 758-2454 in Denver.