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Critical Legal Issues: WORKING PAPER SERIES

FEDERALIZING FIDUCIARY DUTIES THROUGH SHAREHOLDER LAWSUITS: THREE REASONS FOR COURT SCRUTINY

By

William G. Lawlor
Michael L. Kichline
Michael J. Newman
Dechert LLP

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ABOUT THE AUTHORS

William G. Lawlor is a partner in the Corporate & Securities Department of Dechert LLP, where he represents clients in securities, corporate governance and mergers and acquisition matters. He is a graduate of the University of Pennsylvania (B.A., 1977) and Stanford Law School (J.D., 1980).

Michael L. Kichline is a partner in the Litigation Department of Dechert LLP, where he represents clients in securities, derivative, corporate governance and mergers and acquisition matters. He is a graduate of Temple University (B.A., magna cum laude, 1988) and Temple University School of Law (J.D., magna cum laude, 1991, member of the Moot Court Honor Society).

Michael J. Newman is an associate in the Litigation Department of Dechert LLP, where he focuses on white collar and securities litigation matters. He is a graduate of the University of Pennsylvania (B.A., cum laude, 2002) and Columbia Law School (J.D., 2006).

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William G. Lawlor
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Dechert LLP

INTRODUCTION

This WORKING PAPER examines a phenomenon in corporate litigation that has largely escaped close study: the proliferation of "*Caremark* claims" – that is, derivative cases based on a corporate director's fiduciary duty to monitor – grounded in corporate penalties and fines, whether assessed or anticipated, resulting from a corporation's violation of federal law. Since the *Caremark* decision itself, courts have accepted the fundamental premise that state law fiduciary duty claims may be based on corporate violations of federal criminal law. This position has spawned a proliferation of lawsuits against directors for duty to monitor (also called duty of oversight) breaches following the imposition of significant corporate fines or penalties.[1] It is common for

[1]Such lawsuits are part of a growing trend of using litigation as a blunt tool to try to reform corporate conduct, of a piece with the recent increase in claims brought against corporations for alleged violations of the Alien Tort Statute, a centuries-old law that allows non-U.S. nationals to file lawsuits in federal courts for certain claimed violations of international law. *See*, *e.g.*, Jonathan Drimmer, "Think Globally, Sue Locally," WALL ST. J. (June 19, 2010) *available at* http://online.wsj.com/article/SB10001424052748704002104575291101685354766.html (last viewed 6/29/2010).

plaintiffs to sue directors based on nothing more than the mere allegation that their corporation is being *investigated* for possible violations of a federal statute or regulation. Whether based on an actual criminal penalty or the mere announcement of an investigation or indictment, "federalized *Caremark* claims" deserve closer scrutiny for three reasons.

First, the propriety of conflating state civil liability for breach of fiduciary duty with federal criminal statutes is, at best, questionable. Importing federal liability into the board room serves only to subvert Congressional intent and raises potential preemption issues. Even where there are similarities, however shallow, between a federal statute and *Caremark* duties – as with the Foreign Corrupt Practices Act (FCPA) – a conflation of state and federal liability is not appropriate.

Second, the calculation of harm to corporations in federalized *Caremark* claims has escaped thorough analysis, allowing potential manipulation by the plaintiffs' bar. This is especially so where plaintiffs allege damages based on the mere announcement of an investigation, with no substantiation of the alleged underlying criminal conduct and no penalty or fine yet imposed. And, even where a criminal penalty is imposed, the alleged criminal conduct may, in certain circumstances, create a net economic benefit for the corporation – again raising the question of whether the corporation has, on balance, actually been harmed.

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Finally, federalized *Caremark* claims raise practical issues and undermine the goals of Delaware corporate law. Claims based *solely* on the announcement of federal investigations or indictments – with no substantiation of the alleged illegal acts – are meritless from a legal perspective. Such meritless claims allow plaintiffs to abuse the litigation process, as they may bring an initial lawsuit upon announcement of a federal investigation and, if unsuccessful, another lawsuit upon announcement of a settlement with the government. This abusive litigation undermines important protections for directors provided by Delaware corporate law.

Given the myriad problems presented by federalized *Caremark* claims, we suggest that courts be vigilant to ensure that such claims do not become vehicles for abusive litigation and violations of legislative intent.[2]

I. *CAREMARK* AND THE DUTY OF LOYALTY

Derivative actions provide shareholders a means to protect a corporation's interests when the corporation is injured by breaches of fiduciary duty by directors and/or officers. Delaware courts have long held that corporate directors owe to their corporations and shareholders a triad of fiduciary duties: due care, good faith, and loyalty.[3] To fulfill his fiduciary duty

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[2]Many, though not all, of these arguments likewise apply to the conflation of *Caremark* and alleged corporate breaches of state law. Because of the particularly troublesome preemption issues raised by the conflation of *Caremark* claims and federal statutes, this paper focuses on federal statutes.

[3]*See, e.g., Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) ("The directors of Delaware corporations stand in a fiduciary relationship not only to the stockholders but also to the corporations upon whose boards they serve. The director's fiduciary duty to both the

of care, a director must make decisions on behalf of the corporation with all material information reasonably available to him and, having been so informed, must then act with care in discharging his duties.[4] To fulfill the duty of good faith, a director must not intentionally disregard his duties to the company and its stockholders.[5] To fulfill his duty of loyalty, a director must act so that "the best interest of the corporation and its shareholders takes precedence over any interest" of his own.[6]

The quintessential duty of loyalty case involves a director who puts his own interest above the corporation's by, for example, embezzling funds or appropriating a corporate opportunity. An example of such a case is *Guth v. Loft*, one of the first cases in which the Delaware Supreme Court considered the fiduciary duty of loyalty, and one that has been cited well over a thousand times.[7] In *Guth*, the president of a company that dealt in soda and candy took personal advantage of an opportunity to purchase the Pepsi-Cola trademark and formula rather than passing it along to his employer. Holding that

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corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.").

[4]*See Aronson v. Lewis*, 473 A.2d 805, 812-13 (Del. 1984); *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) ("[A] director's duty to exercise an informed business judgment is in the nature of a duty of care.").

[5]*See, e.g.*, *Nagy v. Bistricer*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000).

[6]*Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993). Delaware courts have noted that the duty of good faith is part and parcel of the duty of loyalty. *See Emerald Partners v. Berlin*, 2001 Del. Ch. LEXIS 20, *87-88 (Del. Ch. Feb. 7, 2001).

[7]*Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

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"corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests," the Delaware Supreme Court held that the president "had no right to appropriate the opportunity to himself" and, therefore, had breached his fiduciary duty to his corporation.[8]

In recent decades, however, derivative actions involving the duty of loyalty have moved well beyond the type of allegations made in cases like *Guth*. The Delaware courts have established that among the fiduciary duties owed by directors of Delaware corporations is the duty of oversight. A claim based on the duty of oversight is known as a *Caremark* claim, which, as the Delaware Chancery Court has acknowledged, is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[9]

In *Caremark*, the Delaware Chancery Court explained that that a failure-to-monitor claim arises in two contexts: (1) liability that "follow[s] from a board decision that results in a loss because that decision was ill advised or 'negligent'"; or (2) liability "from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."[10] The first category of liability is protected by the business judgment rule. As long as a director makes a "good faith effort to be informed and

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[8]*Id*. at 515.

[9]*In re Caremark*, 698 A.2d 959, 967 (Del. Ch. 1996).

[10]*Id*.

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exercise judgment," he has met his duty of care and is protected from liability.[11] The second type of liability discussed in *Caremark* is a board's failure to monitor the corporation, resulting in "a loss [that] eventuates not from a decision but from unconsidered inaction."[12] The *Caremark* court held that directors have a duty to ensure 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."[13] Additionally, "absent grounds to suspect deception," a director or an officer cannot be charged with wrongdoing for "assuming the integrity of employees and the honesty of their dealings on the company's behalf."[14]

In 2006, in *Stone v. Ritter*, the Delaware Supreme Court analyzed the *Caremark* standard for the first time, affirming the doctrine and framing it as part of the fiduciary duty of loyalty: "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."[15] In *Stone*, the Chancery Court had

[11]*Id.* at 968.

[12]*Id.*

[13]*Id.* at 670.

[14]*Id.* at 969.

[15]*Stone v. Ritter*, 911 A.2d 362, 270 (Del. 2006). By categorizing *Caremark* liability as a breach of the duty of loyalty, the Delaware Supreme Court took that liability outside of the

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dismissed a derivative complaint for failure to make a demand on the Board, noting that the *Stone* plaintiffs failed to plead "any facts showing that the board ever was aware that [the company's] internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed."[16] The Delaware Supreme Court affirmed the Chancery Court's decision, noting that plaintiffs could not merely "equate a bad outcome with bad faith" to show director oversight liability.[17]

II. FEDERALIZED *CAREMARK* CLAIMS

Federalized *Caremark* claims, a subset of *Caremark* claims, push the scope of the duty of loyalty even further from the *Guth*-type claims. Such cases have been based on a wide variety of federal laws, ranging from banking laws to the Federal Food, Drug and Cosmetic Act. We provide a few illustrative cases below.

In *Stone*, the plaintiff accused the directors of AmSouth, a bank, of "breaching their fiduciary duties by failing to institute sufficient internal controls to guard against violations of the Bank Secrecy Act and anti-money

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protections of exculpation clauses under § 102(b)(7), which only allows corporations to exculpate (and thus legally shield) directors for the breaches of the fiduciary duty of care.

[16] *Stone v. Ritter*, C.A. No. 1570-N , 2006 Del. Ch. LEXIS 20, at *7 (Del. Ch. 2006) (Letter Opinion). Delaware Chancery Court Rule 23.1 places similar burdens on derivative plaintiffs as Federal Rule of Civil Procedure 23.1. A derivative plaintiff must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Del. Ch. Ct. R. 23.1(a).

[17] *Stone*, 911 A.2d at 372.

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laundering regulations."[18] The case arose out of AmSouth's federal liability for allowing customers to use AmSouth accounts to run a Ponzi scheme. In other words, the plaintiff alleged that the directors should be held liable for failing to correct a situation in which lower-level employees allowed customers to use the bank in a way that caused the corporation to violate federal law. As noted, the plaintiff did not succeed.

In *In re Intel Corp. Derivative Litig.*, the plaintiff alleged that the directors breached their duty to monitor because the company had allegedly dominated the microprocessor market through unfair anti-competitive and monopolistic behavior. As evidence, the plaintiff pointed to numerous ongoing investigations into Intel's trade practices around the world. The case was dismissed.[19]

In *Midwestern Teamsters Pension Trust Fund v. Deaton, et al.*, which will be discussed below, the plaintiff attempted to hold the directors of Baker Hughes liable for breaching their fiduciary duties because the company had

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[18] *Stone*, 2006 Del. Ch. LEXIS 20, at *1. As the Delaware Supreme Court summarized: "In 2004, AmSouth and AmSouth Bank paid $40 million in fines and $10 million in civil penalties to resolve government and regulatory investigations pertaining principally to the failure by bank employees to file 'Suspicious Activity Reports' ('SARs'), as required by the federal Bank Secrecy Act ('BSA') and various anti-money-laundering ('AML') regulations. Those investigations were conducted by the United States Attorney's Office for the Southern District of Mississippi ('USAO'), the Federal Reserve, FinCEN and the Alabama Banking Department." *Stone*, 911 A.2d at 365.

[19] *In re Intel Corp. Derivative Litig.*, 621 F. Supp. 2d 165 (D. Del. 2009).

breached the FCPA in various parts of the world. The plaintiff was not successful.[20]

And in *King v. Baldino*, which also will be discussed in greater detail below, the plaintiff alleged that the directors of a pharmaceutical company should be liable under *Caremark* because the company pled guilty to a misdemeanor violation of the Federal Food, Drug and Cosmetic Act, paid a large fine, and agreed to enter into a corporate integrity agreement with the Department of Health and Human Services Office of the Inspector General.[21] This argument did not succeed.

The list goes on and on. Although each of these *Caremark* claims was based on different laws, they all share common problems. We address these problems below.

III. IS FEDERALIZING *CAREMARK* APPROPRIATE?

The first and most important question is whether federalized *Caremark* claims are ever appropriate. A federalized *Caremark* claim creates a collision between two distinct legal regimes: state and federal law. Under the United States Constitution, Congress has the power to pass laws, including criminal statutes, which fall within its enumerated powers. Simultaneously, under the internal affairs doctrine, states have the power to regulate the corporations that

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[20] *Midwestern Teamsters Pension Trust Fund v. Deaton*, Civ. A. No. H-08-1809, 2009 U.S. Dist. LEXIS 50521, *23 (S.D. Tex. May 7, 2009).

[21] *King v. Baldino*, 648 F. Supp. 2d 609 (D. Del. 2009).

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are incorporated in their states.[22] Within this state power to regulate is the power to establish the fiduciary duties for corporate directors. Federalized *Caremark* claims attempt to conflate these distinct structures. We believe this conflation is inappropriate, especially because the state claim is aimed at the corporate directors, whereas the federal claim is directed at the company itself.

Besides provoking a collision between two distinct bodies of law, federalized *Caremark* claims also slight Congressional intent. When Congress passes a law that involves criminal or civil liability, the final terms of that statute and the scope of its liability are carefully crafted, often after long debate and negotiation among competing legislators, lobbyists, and other interested parties. In particular, statutes that regulate corporate behavior constitute a carefully calibrated balance between under-deterrence and over-deterrence, as unnecessarily onerous penalties might over-deter, thus discouraging economic growth and causing other inefficiencies. If plaintiffs are allowed to supplement federal laws with state law-based civil liability directed at a corporation's directors, solely on the ground that the corporation violated a federal statute, then the fine balance struck by Congress in creating these statutes would be disrupted.

Finally, federalized *Caremark* claims present potential preemption issues. The Supreme Court has explained that the traditional principles of

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[22]*VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1112 (Del. 2005) ("The internal affairs doctrine is a long-standing choice of law principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs – the state of incorporation.")

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implied federal preemption provide that: "Pre-emptive intent may . . . be inferred if the scope of the statute indicates that Congress intended federal law to occupy the legislative field, or if there is an actual conflict between state and federal law."[23] The carefully constructed statutes establishing federal crimes – whether related to healthcare, antitrust, or securities fraud – are specifically designed to address social ills falling within the enumerated powers of Congress. In other words, Congress may intend to occupy the field when creating federal criminal liability for these wrongs. To the extent that *Caremark* claims intrude on these liability schemes, are *Caremark* claims that are grounded in federal law preempted by federal statute?

The Foreign Corrupt Practices Act is an illuminating lens through which to consider the propriety of federalized *Caremark* claims. The FCPA, which criminalizes the bribery of foreign officials, has an internal controls provision that facially mirrors certain aspects of the directors' duty to monitor. Plaintiffs who have brought FCPA-based *Caremark* claims have attempted to exploit this similarity – but to no avail. A close look at the differences between Delaware's duty to monitor and the federal scheme for regulating bribery of foreign officials illustrates why it is inappropriate to federalize *Caremark* claims.

The FCPA gives the DOJ and the SEC shared responsibility to deter and punish the bribery of foreign officials. The statute has two substantive parts: (1) an anti-bribery provision, which makes it illegal to bribe a foreign official

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[23] *Altria Group, Inc. v. Good*, 129 S. Ct. 538, 543 (2008).

for the purpose of obtaining or retaining business;[24] and (2) an accounting provision, which imposes accounting, recordkeeping, and internal controls requirements on issuers.[25] The FCPA, particularly its accounting provisions, appears to overlap with the contours of *Caremark* claims in some respects. Corporations are required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that" transactions are correctly executed and recorded; that assets are protected from unauthorized access; and that records are routinely checked.[26] This statutory language somewhat mirrors the Delaware Supreme Court's holding that *Caremark* liability may result from "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists."[27] Nevertheless, these facial similarities between the FCPA's internal controls violations on the one hand, and *Caremark* liability on the other, are merely that – superficial.

Derivative claims, including *Caremark* claims, target the individuals who oversee the corporation – that is, directors and officers. The FCPA, on the other hand, targets corporations in their entirety, imposing liability for the whole by virtue of the actions of the few. FCPA liability is possible in many instances in which there was no breach of fiduciary duty by any director. For

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[24]*See* 15 U.S.C. § 78dd-2.

[25]*See* 15 U.S.C. § 78m.

[26]15 U.S.C. § 78m(b)(5).

[27]*Stone*, 911 A.2d at 372.

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example, imagine that Corporation X, a large multinational corporation, has a qualified and active board of directors with an audit committee and a risk committee, as well as an internal audit mechanism. Now imagine that, despite these systems, a low-level employee of a rogue unit of Corporation X routinely engages in bribery in Southeast Asia and successfully covers his tracks such that the records appear legitimate. As a result, none of the directors are presented with any "red flags" of suspicious conduct. Under these circumstances, the actions of Corporation X's rogue unit would violate the FCPA, and the failure of Corporation X's internal controls to uncover the misconduct would likewise give rise to additional FCPA liability. But when the directors (a) set up a system of internal controls; (b) legitimately believed that the internal controls functioned well; and (c) never saw any "red flags" of suspicious conduct, subjecting them to liability under *Caremark* would subvert fundamental principles of Delaware law, as described in detail in Section V below. As the Delaware Court of Chancery has noted, "'red flags' are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer."[28]

The recent derivative complaint against the officers and directors of Baker Hughes exemplifies the approach of trying, and failing, to equate

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[28]*In re Citigroup*, Cons. Civ. A. No. 19827, 2003 Del. Ch. LEXIS 61 *8 (Del. Ch. June 5, 2003).

violations of the FCPA with *Caremark* liability.[29] Baker Hughes is an international corporation specializing in oil and natural gas products and services. In April 2007, it entered into a deferred prosecution agreement with the government and paid $44 million to settle FCPA charges brought by the SEC and the U.S. Attorney's Office (USAO) in the Southern District of Texas to resolve allegations that it had violated the FCPA in Khazakhstan, Angola and Nigeria.[30] By January 2009, shareholders filed a derivative complaint against the company's officers and directors in federal district court alleging that the FCPA investigation and settlement were proof that "Defendants failed to implement policies and controls to ensure the Company's compliance with the FCPA" and that "[t]his failure, especially in the face of Defendants' knowledge of ongoing FCPA violations at Baker Hughes and its past problems with FCPA compliance, represents a knowing breach of fiduciary duty that has exposed the Company to significant harm."[31] Thus, the plaintiffs based their derivative complaint in large part on the allegation that Baker Hughes lacked internal controls, a deficiency allegedly caused by the Board's lack of oversight.

The court rejected the plaintiffs' attempt to equate FCPA liability with

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[29]Complaint, *Midwestern Teamsters Pension Trust Fund v. Deaton, et al.* (Civ. A. No. H-08-1809) (June 6, 2008) (Docket No. 1) (Baker Hughes Complaint).

[30]"SEC Charges Baker Hughes With Foreign Bribery and With Violating 2001 Commission Cease-and-Desist Order" SEC Press Release (Apr. 26, 2007), *available at* http://www.sec.gov/news/press/2007/2007-77.htm. Baker Hughes had previously received a Cease and Desist Order from the SEC relating to alleged FCPA violations in the 1990s.

[31]Baker Hughes Complaint at ¶10.

Caremark liability.[32] Citing *Stone v. Ritter*, the magistrate judge noted that "Plaintiffs must allege particularized facts which demonstrate that the directors 'knew that they were not discharging their fiduciary obligations' and that they failed to act 'in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities'" to overcome a motion to dismiss.[33] After carefully analyzing the company's actions subsequent to receiving the Cease and Desist Order, the magistrate judge held that "[f]rom the undisputed facts, it appears that a number of the violations complained of occurred *despite* clear company policies and procedures."[34]

As the *Baker Hughes* decision makes clear, the difference in focus between the FCPA and *Caremark* illustrates why the two different types of liability are not easy bedfellows. It also provides further reasons why attempting to base *state* law liability on violations of *federal* law is inappropriate. If FCPA liability is expanded to encompass directors who did not engage in improper conduct through state law claims, the FCPA would reach much further than Congress, the DOJ, or the SEC ever intended.[35]

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[32]*See Midwestern Teamsters Pension Trust Fund v. Deaton*, Civ. A. No. H-08-1809, 2009 U.S. Dist. LEXIS 50521 (S.D. Tex. May 7, 2009) (Baker Hughes). This recommendation was accepted fully by the district court.

[33]*Id.* at *23.

[34]*Id.* at *30.

[35]The DOJ and SEC are fully capable of pursuing senior executives if they actually engaged in wrongdoing. For example, during its investigation of KBR and Halliburton, a former chairman and CEO of KBR came within the crosshairs of the DOJ. That individual,

IV. ARE CORPORATIONS THAT VIOLATE FEDERAL LAW HARMED?

Federalized Caremark claims also raise interesting, and largely unexamined, issues regarding economic harm. When corporations are accused of committing federal crimes, those crimes typically are committed by employees seeking to advance the company's interests and bolster the bottom line. For example, the FCPA violations committed by Baker Hughes were presumably committed in order to bring valuable contracts to the company, not from a generous employee's desire to subsidize the lifestyle of foreign officials.

If the illegal conduct in question actually *benefits* the corporation, it is curious that a lawsuit grounded in that illegal conduct would allege *harm* to the corporation. This would be all the more true if the claim's sole basis was an announced investigation or indictment – in other words, on unsubstantiated claims by the federal government. In such circumstances, the allegation that the corporation actually suffered harm would be doubly specious because (1) if the illegal conduct did, in fact, occur, it may have been to the benefit of the corporation; and (2) the corporation would not yet have faced any financial penalties as a consequence to the alleged misconduct. But, even assuming a derivative plaintiff waits until after an investigation ends in a fine or penalty, the corporation may not have been harmed unless the penalties overcame the profits the illicit conduct created. For example, if Corporation X breaks the law

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Albert "Jack" Stanley, pled guilty to a two-count criminal information charging him with conspiracy to violate the FCPA and conspiracy to commit mail and wire fraud.

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and makes a profit of $10 million in doing so, how is the corporation harmed unless the criminal fine which Corporation X pays meets or exceeds $10 million? At the very least, this question merits scrutiny.

V. DO FEDERALIZED *CAREMARK* CLAIMS UNDERMINE DELAWARE LAW?

Finally, federalized *Caremark* claims present practical problems that undermine Delaware corporate law and create opportunities for corporations to be harassed into settling meritless suits.

Delaware corporate law has established important policies that are undermined by plaintiffs' attempts to import federal statutes into the board room. The corporate law of Delaware is constructed on a careful foundation of shareholders' rights and corporate flexibility in making executive decisions.[36] To ensure that qualified directors are willing to serve on boards, Delaware law sets high bars for establishing director liability and allows corporations to exculpate their directors for breaches of the fiduciary duty of care so long as there is no showing of bad faith.[37] For example, good-faith corporate decisions are generally protected by the business judgment rule, which was enacted to protect directors from liability when a legitimate corporate decision

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[36]*See* 8 Del. C. § 141.

[37]*See* 8 Del. C. § 102(b)(7). Indeed, Delaware courts have noted that "a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors." *In re Caremark*, 698 A.2d at 971.

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unfortunately results in harm to the company.[38] Allowing plaintiffs to sue directors on the basis of a corporate violation of federal law, especially where that violation has not yet been substantiated by a court of law or a guilty plea, undercuts this important goal and decreases the chance that qualified individuals will serve on corporate boards.

Moreover, federalized *Caremark* claims based on nothing more than unsubstantiated allegations of violations of federal law simply do not state a claim on which relief can be granted. As discussed above, a derivative claim must show that the corporation has been injured by the actions of the defendants. A claim based on unconfirmed misconduct that has not resulted in damage fails to meet this requirement and such a claim cannot stand.

Allowing plaintiffs to bring such meritless claims has significant, adverse consequences. When a corporation finds itself the target of a federal investigation, it must devote substantial amounts of time and energy resolving that investigation. A meritless derivative complaint ought not distract the focus of the corporation's board, management, and legal counsel. Additionally, to the extent a government agency alleges violation of federal law, that agency should have the latitude to investigate its charges without the interference of a plaintiff seeking discovery to support its action. Finally, a plaintiff who brings a premature, meritless claim is granted multiple bites at the litigation apple:

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[38] *Gantler v. Stephens*, 965 A.2d 695, 705 - 06 (Del. 2009) ("[T]he business judgment standard . . . is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

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first in a lawsuit preceding a penalty or settlement, and then after the corporation reaches such a settlement (assuming there actually was a violation of corporate law), it can file anew.

These practical problems recently surfaced in a series of cases involving Cephalon, a pharmaceutical company that had to defend against two federalized *Caremark*-based derivative complaints grounded in the same underlying conduct.[39] Cephalon, a growing, international pharmaceutical company, falls under the oversight of the Food and Drug Administration (FDA), which heavily regulates the manner in which pharmaceutical companies market their products and which may impose large fines on a corporation if its employees do not abide by these regulations.[40] In September 2004, the U.S. Attorney's Office in Philadelphia subpoenaed Cephalon seeking information on promotional activities of Cephalon's workforce as they related to the off-label prescribing of certain Cephalon products by physicians.[41] In January 2007, before the investigation was resolved, a derivative plaintiff filed a complaint against Cephalon's directors, alleging, among other things, that they breached

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[39]The authors' law firm, Dechert LLP, represented Cephalon in connection with this litigation.

[40]The Food and Drug Administration Modernization Act of 1997, 21 U.S.C. § 360aaa, *et seq.*, authorizes a manufacturer to disseminate "written information concerning the safety, effectiveness, or benefit of a use not described in the approved labeling of a drug or device." For example, this law requires that manufacturers may only provide "authorized information" in the form of unabridged peer-reviewed articles or qualified reference publications.

[41]In addition to the subpoena, Cephalon received a voluntary request for information from the Office of the Connecticut Attorney General; an information-requesting letter from the Chairman of the House Committee Oversight and Government Reform; and a civil demand from the Office of the Massachusetts Attorney General.

their fiduciary duty of oversight.[42] The complaint was based largely on a *Wall Street Journal* article reporting on investigations of Cephalon's marketing practices by the FDA, the U.S. Attorney, and the Office of the Attorney General of Connecticut.[43] At the time of the complaint, however, the allegations of illegal marketing practices were *unconfirmed*, as the investigations had not yet been resolved. After the defendants answered and filed a motion for judgment on the pleadings, the plaintiffs voluntarily dismissed their action.[44]

The year after the first case was voluntarily dismissed, Cephalon announced that it had reached an agreement-in-principal with the USAO to settle all federal and related state Medicaid claims for $425 million. Cephalon also agreed that the corporation would plead guilty to one federal misdemeanor violation of the Federal Food, Drug and Cosmetic Act and would enter into a corporate integrity agreement with the DHHS OIG.[45] Notably, no officer or director of Cephalon was charged with any wrongdoing. Nevertheless, a shareholder brought a second derivative complaint alleging a federalized *Caremark* claim shortly after the proposed settlement became public.

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[42]Complaint, *Krattenmaker v. Baldino, et al.*, Civ. A. No. 07-CV-101 (E.D. PA Jan. 7, 2007) (Docket No. 1).

[43]*Id.* at ¶30.

[44]Stipulation of Dismissal Without Prejudice, *Krattenmaker v. Baldino, et al.*, Civ. A. No. 07-CV-101 (Apr. 12, 2007) (Docket No. 15).

[45]*King*, 648 F. Supp. 2d at 614.

Pointing to the investigations and the proposed settlement, the plaintiff alleged that the directors breached their fiduciary duty claims by failing to exercise "reasonable and prudent supervision over the management, policies, practices, controls and financial affairs of Cephalon."[46] The court dismissed the case, noting that the "plaintiff does not allege particularized facts which demonstrate what information and reporting systems exist at Cephalon, much less that there is an utter failure to attempt to assure reasonable information and reporting system exists."[47] The court accordingly held that "the complaint fails to demonstrate an utter failure to implement any reporting or information system or controls."[48] The court also disregarded the plaintiff's assertion that "red flags" should have alerted the directors to problems at Cephalon, specifically rejecting the assertion that the settlement itself constituted proof of a *Caremark* violation. Noting that Cephalon "cooperat[ed] with each investigation or inquiry by providing documents and other information [and] entered into a corporate integrity agreement with the Office of Inspector General of the U.S. Department of Health and Human Services as part of its settlement of the investigation by the Philadelphia USAO," the court held that "the Board did not ignore those red flags."[49] The court applied the Delaware Supreme Court's maxim that a plaintiff cannot succeed by seeking "to equate a

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[46]*King v. Baldino* Complaint (filed Jan. 25, 2008).

[47]*King*, 648 F. Supp. 2d at 621-22.

[48]*Id.* at 622.

[49]*Id.* at 626.

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bad outcome with bad faith"[50] and held that "the plaintiff fail[ed] to plead particularized facts demonstrating that the Board was aware of the actions of the alleged 'principal wrongdoers' and consciously failed to act in light of that knowledge."[51]

Although Cephalon's directors were eventually vindicated, their experiences highlight the practical problems with federalized *Caremark* claims. Because derivative plaintiff brought two rounds of complaints, Cephalon and its directors were forced to expend resources and energy toward defending two meritless suits. Such harassment undermines the delicate balance established by Delaware law and decreases the likelihood that qualified individuals will become directors of public corporations.

CONCLUSION

Directors of public corporations have fiduciary duties to their companies. They must not steal from their corporations. They must not usurp opportunities that could have benefited their corporations. And they must not blithely ignore when others are harming the corporation before their eyes. Indeed, this last duty is the backbone of Delaware's duty to monitor: directors not only have a duty to refrain from harming the company themselves, but also to take steps to prevent others from harming it. For this reason, directors must ensure that their companies have oversight and reporting structures in place,

[50]*Stone*, 911 A.2d at 373.

[51]*King*, 648 F. Supp. 2d at 626.

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and they cannot ignore "red flags" indicating misconduct.

Despite the importance of holding directors to an appropriate standard of conduct and giving corporations and their shareholders a legal remedy when those standards are not met, basing duty to monitor claims on corporate violations of federal law takes these claims too far. When examined closely, federalized *Caremark* claims are problematic on a number of levels. Such claims undermine Congressional schemes and raise potentially unconstitutional collisions of federal and state law. Moreover, it is unclear that plaintiffs in federalized *Caremark* claims can actually show economic harm to the corporation. Finally, these claims present practical problems: they are often untimely and without merit, and they give plaintiffs the opportunity to harass corporations and their leadership by filing multiple rounds of lawsuits on the same underlying conduct. Such abusive conduct clearly undermines Delaware corporate law's goal of protecting directors from harassment. Therefore, courts should continue to carefully scrutinize federalized *Caremark* claims, staying vigilant to avoid the potential for abuse inherent in these suits.

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