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Caremark Duties Ascribed To General Counsel, Other Officers

By Michael W. Peregrine, McDermott Will & Emery LLP

In a decision of potentially jarring significance, the U.S. Bankruptcy Court has recently interpreted Delaware law as imposing *Caremark* obligations on corporate officers, specifically including the general counsel.^[1] The court also suggested that the general counsel may, in certain situations, have some responsibility for corporate waste committed by other officers even though he/she had not personally benefited from the (alleged) waste. (The matter of actual liability was not before the court.) Despite the egregious facts involved, the Bankruptcy Court's close evaluation of fiduciary duty principles and the general deference given Delaware law suggest that the *Miller* decision may receive broad attention, if not also application. As such, it is a development that should be the subject of careful consideration by the board, in conjunction with its non-director officers, for its implication on (a) corporate compliance oversight, and (b) the role, authority, and board support of the general counsel.

1. Underlying Facts

The *Miller* decision arose from a 13-count fiduciary duty-based complaint filed by the bankruptcy trustee against the directors, and senior officers (including the general counsel), of World Health Alternative, Inc., a Florida corporation that provided healthcare staffing services on a nationwide basis to hospitals and other healthcare facilities.^[2] Like many other corporations in recent years, World Health enjoyed a burst of spectacular financial success over a short period of time (2003-2005), only to collapse under the collective weight of aggressive financial transactions, heavy debt, and allegedly fraudulent transactions and tax filings. By 2006 over \$20 million in previously undetected debt was identified by management, and World Health filed for Chapter 11 protection under the federal bankruptcy laws (the case was subsequently converted to a Chapter 7 proceeding).

The bankruptcy trustee's complaint included allegations of corporate waste, breach of fiduciary duty, and negligent misrepresentation (e.g., filing false and misleading financial statements) on behalf of the World Health officers, among other allegations. Many of these allegations were based on alleged conduct involving the chartering of expensive flights, leasing luxury automobiles, and granting large bonuses to certain officers and directors while the corporation was experiencing significant financial stress. The basis for the trustee's fiduciary duty claim was that the general counsel breached his duty of care by failing to implement an adequate monitoring system and/or failing to utilize such system to prevent corporate wrongdoing (citing *Caremark*).

The specific issue at hand arose from the general counsel's motion to dismiss the complaint.^[3] The general counsel's basic argument was that the board's compliance oversight duties, as articulated in the seminal *Caremark* decision, do not apply to non-director officers (like this general counsel) and other employees.^[4] Accordingly, the fiduciary duty claim should have been dismissed. Although the court noted that Florida law (the law of the state of incorporation) should govern the breach of fiduciary allegation, it deferred to the relevance of Delaware law because "Florida courts have relied upon Delaware corporate law to establish their own corporate doctrines."^[5]

2. Review: The Duty of Oversight

The director's duty to oversee the corporate compliance program is articulated (*in dicta*) in the *Caremark* decision. There, the Delaware Chancery Court concluded that a director's obligation includes a duty to attempt in good faith to assure that (1) a corporate information and reporting system, which the board concludes is adequate, exists, and (2) this system is sufficient to assure that appropriate information regarding organizational compliance with applicable laws will come to the board in a timely manner and in the ordinary course.^[6] The level of detail that is adequate for such an information and reporting system is a matter for the board's business judgment.^[7] The *Caremark* court did, however, acknowledge that no rationally designed information and reporting system could be expected to remove the possibility that the organization will violate applicable laws or otherwise fail to identify corporate acts potentially inconsistent with law.^[8] Significantly, the *Caremark* court observed that a director's failure to reasonably oversee the implementation of such a

system/compliance plan could under certain circumstances (and in theory) expose the directors to breach of duty of care exposure.[\[9\]](#)

In late 2006, the Delaware Supreme Court affirmed the *Caremark* standard as the basis for assessing director oversight liability, in its *Stone v. Ritter* decision.[\[10\]](#) In the *Stone* decision, the court applied a useful “gloss” from its then recent *Disney* decision[\[11\]](#) on the relationship between “good faith” and the exercise of oversight responsibility, and confirmed the “high bar” for establishing director culpability.[\[12\]](#)

3. The *Miller* Court’s Decision.

The *Miller* court reached two conclusions of particular compliance oversight-related relevance to non-director officers, including but not limited to the general counsel.

First, the court concluded that Delaware law, as implicated in *Caremark* and other decisions, intends to apply liability for failure of the duty of oversight equally to corporate officers, as it does to corporate directors. It based its conclusion on an interpretation of Delaware and Florida law that both officers and directors owe fiduciary duties to the corporation. The issue of whether the general counsel actually breached those duties was not addressed by the court.

Second, the court suggested that the general counsel could have exposure for “aiding and abetting” corporate waste allegedly committed by other corporate officers, in part on the basis of certain Sarbanes-Oxley principles. The general counsel had argued for dismissal of the “waste” and “aiding and abetting” claims in part on the basis that he (a) was not a financial officer and thus had limited knowledge of the allegedly wasteful expenditures; and (b) did not personally benefit from, nor actively engage in, the allegedly wasteful expenditures. However, the court concluded that the bankruptcy trustee’s waste-based complaint set forth allegations sufficient to support the claim and to overcome the motion to dismiss, given the applicable pleading standard. These allegations included the supposed failure of the general counsel to implement proper financial checks and balances, including those relating to the accuracy of corporate financial representations and failing to properly report such misrepresentations that the general counsel knew, or should have known, were false. In this regard, the court referenced the obligations of Section 307 of the Sarbanes-Oxley Act relating to counsel’s obligations to examine the truthfulness of corporate filings with the Securities and Exchange Commission and to report corporate/employee misconduct “up the ladder” to the highest corporate authorities.

4. Analysis

Miller v. McDonald is a significant decision, which is likely to have a unique combination of positive (from the perspective of overall corporate compliance initiatives) and negative (placing further, and arguably unwarranted, burden on the general counsel) implications.

It is without question a harsh decision based upon allegations of egregious breaches of fiduciary duties. Yet, it is only a decision in regards to a motion to dismiss the complaint. Portions thereof may be susceptible to reversal should they be appealed. Furthermore, the actual fiduciary liability of the general counsel remains to be established.

Nevertheless, the decision is worthy of close attention by the broadest possible range of corporate leadership for the following reasons, among others:

The decision provides a useful review of the *Caremark* obligation and the cases which have applied it.

- Delaware cases are worthy of note by nonprofit corporations generally, because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware courts, the strength of its judiciary (including a specialized court, the chancery court, that has jurisdiction over cases arising under its corporate laws), and the fact that it has a unified corporation code applicable to for-profit and nonprofit corporations alike. Furthermore, Delaware decisions often address alleged violations of fiduciary duty that closely resemble those duties owed by directors of nonprofit corporations. Accordingly, rulings of Delaware courts on issues of director conduct can be particularly informative to nonprofit organizations—and those who regulate them—even where those organizations are not governed by Delaware law.
- The fundamental conclusion—that non-director corporate officers have *Caremark* and other fiduciary duties—appears fairly grounded in Delaware (and Florida) law.

- The arguments applied by the bankruptcy trustee are likely the same that would be applied by a state attorney general in a civil breach of fiduciary claim under similar circumstances.
- At its core, the case speaks to the critical value attributed to organizational commitment to corporate compliance, i.e., the potential that effective compliance systems possess to safeguard against wrongdoing by corporate officers, employees or agents. The board should respond to this decision with a renewed interest in providing effective compliance plan oversight.
- The court's refusal to dismiss the corporate waste/"aiding and abetting" allegations underscore the need for corporate leadership to be increasingly sensitive to the significant burdens being placed upon general counsel by legislation, regulation, and judicial decisions. This is critical.

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For these and other reasons, *Miller v. McDonald* should be regarded as having noteworthy corporate compliance implications and thus should be shared with the executive leadership, the board, and its audit and compliance committees.

[1] *Miller v. McDonald*, 2008 WL 1002035 (Bkrcty.D.Del. Apr. 9, 2008) (henceforth, "Miller").

[2] It is interesting to note that *Miller*, like *Caremark*, involves the conduct of directors of a healthcare corporation.

[3] Pursuant to Section 12(b)(6) of the Federal Rules of Civil Procedure.

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

[5] *Miller*, *supra*, at 1012.

[6] *Caremark*, *supra*, at p. 970.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] 2006 Del. LEXIS 597, Nov. 6, 2006 (henceforth, "Stone").

[11] *In re Walt Disney Co. Deriv. Litigation*, 906 A. 2d 27 (Del. 2006).

[12] For further discussion of the *Caremark* and *Stone* decisions, see Michael W. Peregrine, "New Guidance to Governing Board on Compliance Plan Oversight," American Health Lawyers Association Corporate Governance Task Force Executive Summary, January 2007.