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CORPORATE GOVERNANCE FAILURES AND THE MANAGERIAL DUTY OF CARE

CHERYL L. WADE†

INTRODUCTION

Thanks to a plentiful supply of news reports and extensive coverage of congressional hearings concerning the Enron bankruptcy, Sherron Watkins has become a prominent character in the Enron saga. Watkins was Enron’s Vice-President of Corporate Development, working with Andrew Fastow, Enron’s former Chief Financial Officer (CFO) and Executive Vice-President.¹ It was not Watkins’ work as Vice-President that led her to prominence; rather, it was her role as Enron’s only whistleblower that thrust her into the spotlight. Watkins wrote a memorandum to Kenneth Lay, Enron’s former Chairman and Chief Executive Officer (CEO), stating that she was “incredibly nervous that [Enron would] implode in a wave of accounting scandals.”² It was her work with Fastow that led to Watkins’ suspicions regarding accounting fraud and her resulting “incredible nervousness” about Enron’s failure to comply with accounting and disclosure rules.³ Why was Watkins the only Enron manager who questioned what seemed to have been blatant improprieties in the way senior executives did business? Would the company’s public humiliation and vilification have been avoided if more Enron officers had notified the entire board (and not just Kenneth Lay) about suspected wrongdoing? I cannot answer the latter question. We will never know what would have happened if more Enron officers who were not involved in the wrongdoing that led to the company’s downfall had communicated with Lay and other board members about

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¹ PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON 155 (2002).
² Id. at 185.
³ Id. at 155.
problems within the company. I can attempt to answer the first question. Enron managers, other than Watkins, remained silent about the company’s problems in order to avoid professional suicide. Complaints from Enron’s executive vice-presidents and other managers about apparent improprieties would have been complaints about the boss. In fact, after writing her memorandum to Lay, Watkins was transferred to human resources.4 While Watkins was demoted, CEO Lay failed to respond to the concerns she expressed.

One of the questions explored in this Article is the potential role of corporate officers in revealing unlawful behavior within the firm. My focus is on officers who are not board members, and who are not themselves involved in conflicts or wrongdoing that may potentially harm the company—corporate officers such as Sherron Watkins. I examine the often-stated proposition that corporate officers owe a fiduciary duty of care.

One of the conclusions I make in this Article is that a greater emphasis on standards of care for both directors and officers is warranted, especially in the aftermath of the corporate governance failures that scandalized Enron, WorldCom, and other large publicly held companies. Reaction to judicial condemnation of directorial behavior by finding a breach of the board’s duty of care in Smith v. Van Gorkum5 illustrates the need to revitalize duty of care analysis. Delaware’s legislature responded to the Van Gorkum holding by enacting section 102(b)(7),6 which allows Delaware companies to limit or eliminate directorial liability for duty of care breaches in their certificates of incorporation. Other states have enacted similar legislation.7 Yet, even where a state statute limits liability, it would be hard to imagine that in Van Gorkum’s aftermath, a board would approve major corporate events and transactions, such as a merger, in the same way condemned by the Delaware Supreme Court—namely, after only a brief oral presentation concerning the event, and without having read materials documenting the event.

4 Id.
5 488 A.2d 858 (Del. 1985) (finding breach of fiduciary duty where board approved acceptance of tender offer only two hours after learning of the offer and without getting an appraisal or even reading the proposed offer).
Commentators have offered empirical evidence that the enactment of section 102(b)(7) not only reduced shareholder wealth in Delaware but also negatively impacted the market when firms announced that they would limit or eliminate directors' personal liability. Reduced or eliminated standards of care under section 102(b)(7) harm Delaware shareholders. The value of their firms decrease when standards of care are diminished or eliminated.

The Delaware Chancery Court in *In re Caremark International Inc. Derivative Litigation* provided guidance with respect to the type of directorial behavior that would breach the fiduciary duty of care. In *Caremark*, Chancellor Allen opined that where a board has acted in a grossly negligent manner or has failed to monitor corporate compliance with relevant federal or state law, there has been a duty of care breach. While *Caremark* is a settlement opinion with no precedential value, its significance may be found in Chancellor Allen's clarification of the directors' standard of care.

The standards set forth in *Van Gorkum* and *Caremark* have not proved particularly helpful in holding directors accountable for breaches due to liability limiting legislation such as Delaware's section 102(b)(7). Such statutes reflect the view that duty of care breaches should be difficult for plaintiffs to litigate so as not to diminish the willingness of directors to take risks that might otherwise enhance shareholder value. This is not to say the standards set forth in these cases are not significant. They are useful for articulating and clarifying a standard of care.

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8 See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 69 (1989). It is further asserted:

The significant decrease in the relative value of Delaware firms both around the enactment of Section 102(b)(7) and when they elect to adopt the provisions of the statute indicate that relaxed liability exposure for violations of the duty of care standard allowed by this act has reduced the wealth of the stockholders of Delaware firms. The results are consistent with the view that the new regime established by Section 102(b)(7) allows corporate managers wider latitude in managing their firms, which in turn increases the agency costs of the corporate form and reduces the value of the equity claims of these firms.

9698 A.2d 959 (Del. Ch. 1996).

that can be utilized by officers and directors. And although there is little threat of large verdicts, the potential for any duty of care litigation should serve as an incentive to boards to satisfy their duties. Furthermore, section 102(b)(7) does not preclude the possibility of injunctive relief\textsuperscript{11} and allows for limitation or elimination of liability for breaches by directors only—not managers’ breaches.\textsuperscript{12}

Much has been written about the directorial duty of care, including analyses that distinguish standards applicable to inside and outside directors.\textsuperscript{13} Much less has been written about the managerial duty of care. One of the questions examined in this Article is why courts, commentators, and plaintiffs’ lawyers fail to distinguish analyses of duty of care breaches in a way that focuses on the roles played by corporate actors.\textsuperscript{14} I conclude that courts and attorneys should distinguish analysis of the duty of care owed by corporate executives or managers from the duty of care owed by directors. I suggest an analytical approach that distinguishes the standard of care owed by officers from that owed by directors. Principles requiring reasonableness and rationality govern duty of care analysis for both directors and officers. The standard of care owed by officers and directors is the same, but the \textit{amount} of care owed by a company’s managers, dealing with day to day affairs, is unavoidably higher than the amount of care owed by a company’s outside directors, who have far less contact and involvement with the company. Thus far, courts have not distinguished between the care owed by boards and executives, leading to the conclusion that breaches of the duty of care could not be proven even in instances where


\textsuperscript{12} § 102(b)(7), (“A provision eliminating or limiting the personal liability of a director to the corporation . . . ”) (emphasis added).

\textsuperscript{13} “An outside director is generally defined as a director who is otherwise unaffiliated with and independent of the corporation.” Bradley & Schipani, \textit{supra} note 8, at 21.

\textsuperscript{14} In \textit{Van Gorkum}, for example, the defendant directors’ attorneys failed to separate arguments for outside and inside directors even after the judge asked whether it would be appropriate to do so. The court concluded that “since all of the defendant directors, outside as well as inside, take a unified position, we are required to treat all of the directors as one.” Donald E. Pease, \textit{Outside Directors: Their Importance to the Corporation and Protection from Liability}, 12 \textsc{Del. J. Corp. L.} 25 (1987).
Managerial slothfulness or inattentiveness was blatant and egregious.

Greater clarification regarding the duty of care owed by corporate directors and officers may create more corporate watchdogs and potential whistleblowers. It is important to clarify and articulate the duty of care owed by corporate officers, including the CEO, CFO, presidents, vice-presidents, and treasurers. The focus must include those who allow potential malfeasance to occur and persist without reporting, disclosing, or investigating it. This focus is imperative because corporate boards and attorneys cannot ensure corporate legal compliance on their own.

Corporate officers beyond the CEO and CFO must be aggressive in coming forward when they suspect wrongdoing. This increase in the number of corporate monitors is essential in preventing the types of corporate governance failures that led to corporate scandals at Enron and other companies. This is especially true in light of one of the corporate governance reforms requiring that a majority of a board be composed of independent directors. When most of a board's members are independent, it will be less likely to detect malfeasance because its members are not involved in the day-to-day matters of the company. Outside directors have less time for, and less information about, the company. Corporate presidents and vice-presidents who are in the corporate trenches are the ones best positioned to discover wrongdoing. Corporate executives already owe a duty of care without reforming any of the rules relating to corporate governance. That duty, however, must be clarified, revitalized, and emphasized to guide officers and to inspire the kind of conduct that will change corporate cultures and help to restore investor confidence.

In addition to suggesting a theoretical approach that distinguishes the managerial standard of care from the duty owed by directors, I offer a practical proposal that creates a relationship between board members and senior corporate officers who do not serve on the board. In order to satisfy their duty of care, managers should have available to them a method of communicating with outside directors concerning possible malfeasance that will not jeopardize their professional standing within the company. One way to accomplish this is for the board to establish a system of communication between its members
and officers who do not serve on the board. Obviously, managers should be able to communicate with independent directors in confidence. In order to explore the benefits of greater officer-director communication I also examine the problem of racial discrimination in the corporate setting.

The facts of the corporate governance debacles at Enron and other companies continue to unfold. The one thing that seemed apparent almost immediately was that Enron's board was not adequately informed about the company's business affairs. Corporate governance reformers should consider ways to establish a relationship between the board and corporate officers who are not serving as directors, and who are not involved in alleged malfeasance. Communication with such officers will result in a better-informed board.

One reason for the scant discussion in legal commentary, legislation, and case law of the managerial duty of care may be that fiduciary duty analysis in the corporate context was intended to protect shareholders from managers. It seems paradoxical to suggest, as I do in this Article, that managerial satisfaction of the duty of care may help protect the corporation and shareholders. I suggest that managers should be clear about the fiduciary duty of care they owe, and I suggest how to satisfy that duty even though fiduciary duty law is aimed at deterring potential managerial abuses that are made possible because of the separation between a company's owners and managers.

I. THE DUTY OF CARE

A. Background and Criticisms of the Corporate Law Duty of Care

The articulation of the standard of care owed by corporate directors and officers derives from tort law, which imposes a duty to behave as a reasonable and prudent person would in a given situation.\(^\text{15}\) In addition to requiring directors to exercise due care when making business decisions, directors owe a duty to monitor the corporation's business through a system of information-gathering designed to bring salient facts to the

board's attention.\textsuperscript{16} Included in the duty of care is a duty of inquiry triggered upon notice of potential problems.\textsuperscript{17}

There are several longstanding criticisms of the application of a duty of care in the corporate context. For example, the duty of care has been condemned for vagueness.\textsuperscript{18} It has also been observed that with the benefit of hindsight anyone can formulate an argument that a board's failure to satisfy its duty of care caused corporate losses.\textsuperscript{19} Commentators have asserted that imposition of a duty of care costs too much: companies must spend large sums of money compensating board members for increased time spent making decisions and monitoring the corporation and will also need to spend large sums of money on experts to advise the board about the duty of care.\textsuperscript{20} Another argument against recognition of a corporate law duty of care is the chilling effect that such an imposition has on the decisions and risk-taking that may potentially benefit shareholders.\textsuperscript{21} Finally, imposition of a duty of care has been criticized because it requires judicial determinations about whether the duty is breached by judges, who have no business expertise.\textsuperscript{22}

Since I conclude that a revitalized duty of care may help prevent corporate governance failures of the type that occurred at Enron and other companies, I will briefly address some of the longstanding criticisms of the duty of care. First, the standard is vague because it must be flexible enough for a variety of situations. For example, the standard must be applicable to both large and small companies. This flexibility is accomplished by language that looks to the reasonableness of a person in a similar position. Second, while it may be easy, with the benefit of hindsight, to allege duty of care breaches, a conclusion that the duty has been breached should be reached only in instances of grossly negligent or inattentive behavior; only egregious misconduct breaches the directorial duty of care. Moreover, the

\textsuperscript{16} Id. at 952, 955.
\textsuperscript{17} Id. at 956.
\textsuperscript{19} See Frankel, supra note 18, at 710–11; Kennedy, supra note 18, at 630–31.
\textsuperscript{20} See, e.g., Frankel, supra note 18, at 712–13.
\textsuperscript{21} See id. at 713.
\textsuperscript{22} See id. at 714–15.
standard of care is applied to the process of decision-making and not the result of the decision. Third, greater remuneration for directors, who in return will spend more time and pay more attention to corporate affairs, makes sense if costly mistakes that result from extreme inattention are prevented. Higher fees for directors may increase their willingness to monitor and inquire, possibly uncovering or preventing managerial abuses or fraud. Fourth, while directors will still take risks, with a revitalization of the duty of care, unconsidered risk-taking may be avoided. Fifth, courts do not need business expertise to recognize extreme inattention and negligence. This is the only kind of behavior that would breach the corporate duty of care.

B. Revitalizing the Duty of Care: A Theoretical Approach to the Fiduciary Duty of Care That Distinguishes Officers from Directors.

"[I]f one is inclined toward greater accountability for corporate management, the obligation to come forward and to suggest appropriate standards of conduct under the directors' duty of care becomes difficult to avoid." Revitalization and clarification of the duty of care may help corporate boards and managers avoid the types of corporate governance failures that led to the collapse of Enron and other large publicly-held companies. The Van Gorkum and Caremark opinions provide language that may help corporate boards satisfy a standard of care that would preclude the kind of extreme and egregious inattention that allowed corporate malfeasance to fester and destroy Enron, WorldCom, Adelphia, Tyco, and ImClone. The problem with current case law on the corporate duty of care is that it focuses on the directorial duty of care and almost completely ignores analysis and description of the officers' duty of care.

Case law and state codes are not consistent with respect to managerial liability for duty of care breaches. "It is reasonably

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well-settled that officers owe a duty of care to the corporation. It is less well settled that officers get the benefit of the business judgment rule. Under the ALI Principles, the rule applies to both directors and officers. Judicial precedents are divided, however. This means that in some jurisdictions, it may be difficult for shareholders to hold managers accountable for duty of care breaches because of the protection of the business judgment rule.

The content of the standard of care for corporate officers and directors is substantially the same. It is the amount of care that each owes under the standard that differs radically. The tort law duty of care requires that an actor with special skills and knowledge use them before being deemed to have satisfied the duty of care. This is one basis for distinguishing due care analysis owed by managers from that which is owed by directors. Corporate managers have knowledge and expertise concerning the corporation that outside directors will not have. Applying the approach taken under tort law would mean that managers who fail to use their special knowledge of the corporation breach their duty of care.

II. RACIAL DISCRIMINATION IN THE CORPORATE WORKPLACE

In this part, I focus on another type of corporate wrongdoing—racial discrimination. I compare the relatively mild public reaction to allegations of racial discrimination in the corporate workplace to the furor created by the Enron scandal. The September 11th attacks on the United States and the huge scandal surrounding the Enron bankruptcy threaten to inalterably eclipse discourse concerning this nation's enduring problem with racism. One of the goals of this Article is to continue the consideration of race matters by focusing on the relationship between corporate boards and managers, particularly managers who are not also directors, and who have engaged in no intentional wrongdoing.

26 Hills v. Sparks, 546 S.W.2d 473, 476 (Mo. Ct. App. 1977) (holding that an actor with special skills "is required to exercise the superior qualities that he has in a manner reasonable under the circumstances" (quoting RESTATEMENT (SECOND) OF TORTS § 289 (1965))); Fredericks v. Castora, 360 A.2d 696, 697–98 (Pa. Super. Ct. 1976) (suggesting that one who has special skills, such as a doctor, will be held to a higher standard of care).
Much has changed about the nature of racial relationships since the Civil Rights Movement of the 1960s. Lunch counters are integrated, and black and brown faces are seen in the fronts of buses. But more than four decades later, insidious racial inequities endure. The American workplace, governed by the managers of large publicly held corporations, is the locus of much of today’s racial injustice. Workplace discrimination in hiring, promotion, and pay, and the corporate governance processes that allow for continuing bias in employment relationships, should be the focus of civil and human rights work in this new millennium.

Why does workplace discrimination persist? The accounting practices and other alleged wrongdoing that led to the Enron collapse is illustrative. Obviously, Enron’s board should not have deferred to the financial decisions made by the managers they were supposed to monitor. Business Week reported that

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It shall be an unlawful employment practice for an employer . . . to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin.

Enron’s former chief executive “created and embodied the in-your-face Enron culture, where risk-taking, deal-making, and ‘thinking outside the box’ were richly rewarded, while controls appeared loose at best.” The Enron implosion offers lessons for the way the relationship between boards and managers should change. A system of communication between the board and managers who do not serve on the board and who are not involved in malfeasance may provide the board, especially outside directors, with the information they need to adequately monitor compliance with law. These observations are also relevant in considering other types of managerial malfeasance, including racial discrimination at companies such as Texaco and Coca-Cola.

The difference in public reaction to the Enron bankruptcy on the one hand, and the allegations of racial discrimination on the other hand, present a significant and meaningful dissimilarity. The public’s outrage in reaction to Enron is an interesting contrast to the much quieter reaction of the public to the details that led up to the filing of racial discrimination litigation against Texaco and Coca-Cola. Elected officials and the public demanded greater vigilance and examination of the accounting practices of companies other than Enron. “Even companies once considered above suspicion are being subjected to increasing scrutiny.” Significant changes in the law have occurred in the aftermath of the Enron and WorldCom debacles. The Sarbanes-Oxley Act of 2002 (the “Act”) is the first such change. The Securities and Exchange Commission (SEC) and various stock exchanges are expected to revise their rules.

There were no public calls for enhanced scrutiny of the equal opportunity employment practices of companies other than Texaco and Coca-Cola after the two class actions were settled. There was no demand for heightened vigilance of companies with few or, more often than not, no people of color in their ranks of senior executives or on boards of directors.

29 See ROBERTS & WHITE, supra note 27; Winter, supra note 27.
32 See, e.g., § 308(c)(2) (to be codified at 15 U.S.C. § 7246) (“The [S.E.C.] shall report its findings [regarding its enforcement actions over the last five years] . . . and shall use such findings to revise its rules and regulations as necessary.”).
A. The Role of Corporate Lawyers.

What is the role of corporate lawyers in helping boards and managers make decisions that diligently ensure compliance with law? External law that governs private corporate conduct is often open to conflicting interpretations. For example, while it is clear that Title VII prohibits workplace discrimination, discriminatory conduct is not easily recognized. Discrimination in the workplace may be unconscious, covert, or subtle and, therefore, difficult to detect. Corporate lawyers can help managers interpret the law in a way that ensures responsible behavior towards employees. This means that corporate lawyers will have to help change the way corporate boards operate when they make decisions and supervise the conduct of corporate officers. Lawyers must encourage corporate directors to avoid the psychological pitfalls of group decision-making that prevent the adequate monitoring of corporate compliance with the law.

Corporate lawyers can help directors and senior executives understand that in large companies unlawful or discriminatory conduct on the part of some employees may be inevitable. This should be easier to understand in the aftermath of Enron. The Enron debacle makes it more difficult to claim surprise about directorial and managerial wrongdoing. Lawyers can help corporate managers respond more appropriately to inevitable allegations of wrongdoing. Lawyers can help corporate managers protect the public image of their companies by encouraging them to make socially responsible choices that comply with applicable law.

The notion that corporate lawyers should guide corporate directors and managers toward ethically and socially responsible decision-making seems intuitively sensible, even if a bit idealistic. The important question, however, is whether corporate lawyers are able to move their clients toward social responsibility as a practical matter. Will clients listen? Investigations of the Enron crisis revealed that managers failed to follow advice of counsel. The quixotic nature attempts by corporate lawyers to inspire socially responsible corporate activity is also demonstrated by a 1995 wrongful discharge case brought by in-house counsel for GTE Products Corporation.33 One of the plaintiff’s claims was that he was constructively

discharged by GTE for having encouraged its management to “warn the public about safety risks associated with the use of certain GTE products, and his insistence that GTE comply with federal law governing the disposal of hazardous waste.” The plaintiff claimed that one GTE officer warned that the plaintiff “should stop being the ‘social conscience’ of the company.”

Section 307 of the Act requires a significant change in the relationship between corporate counsel and their clients. In a sense, the Act requires corporate lawyers to be the company’s social conscience and to report failures to comply with law.

Enhanced communication between directors and managers who are not on the board may prevent the kinds of corporate governance failures that led to the huge settlements of racial discrimination litigation paid in the 1990s. A system of communication between boards and officers who are not on the board, but who are likely to have pertinent information, may have prevented the type of board inattention that led to the failures at Enron, WorldCom, and other companies.

One concern that many have in Enron’s aftermath is whether any of the enacted or proposed changes in corporate governance will make a real difference in the way boards and managers conduct business. When companies are profitable in the future, will the extensive discourse about corporate social responsibility that has occurred recently be forgotten? What will inspire boards and managers to take seriously the notion of corporate social responsibility in the future?

In this Article, my primary focus is on compliance with law as a type of corporate social responsibility. Community activists can play a role that enhances socially responsible corporate behavior by publicizing and protesting against corporate conduct that harms employees or other constituencies. Traditional considerations of the impact of corporate activity on non-shareholder constituencies have focused on the decisions made by corporate officers and directors. It is possible to fashion a broader model for potential participants in, and contributors to,

34 Id. at 163.
35 Id. at 164.
36 Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245) (directing the SEC to promulgate “rules of professional responsibility for attorneys” that require corporate counsel to monitor corporate conduct and, where necessary, report misconduct to the board of directors).
efforts aimed at enhancing corporate social responsibility. This model would require an element of self-responsibility on the part of consumers who can make decisions about the products and services they purchase in a way that will make discriminatory behavior less than profit maximizing. Community activists can organize boycotts. Corporate lawyers can help directors and senior executives understand that in large companies, unlawful or discriminatory conduct on the part of some employees may be inevitable. Lawyers can help corporate managers respond more appropriately to inevitable allegations of wrongdoing.

Corporate lawyers who give their clients advice about how to pursue ethically and socially responsible paths must carefully choose the most appropriate strategies for advising managers who often resist this kind of guidance. Should socially responsible corporate conduct be the goal simply because the lawyer concludes that it is the right thing to do? Should lawyers tell their corporate clients to do good simply for its own sake? Or should they encourage corporate clients to do good for the financial good of their companies?

B. Duty of Care Breaches at Enron

Newspaper accounts of the report drafted by members of a special committee of the Enron board formed after the company's problems became public suggest that at least some managers may have engaged in criminal wrongdoing. The special committee chair, Bill Powers, Dean of the University of Texas School of Law, concluded that Enron's board of directors breached the fiduciary duty of care it owed to the company's shareholders. According to Powers:

There was a fundamental default of leadership and management. Leadership and management begin at the top, with the CEO, Ken Lay. In this company, leadership and management depended as well on the chief operating officer, Jeffrey Skilling. The board of directors failed in its duty to provide leadership and oversight.

38 See Katie Fairbank & Jim Landers, Lay Knew Enron Was Hiding Losses, DALLAS MORNING NEWS, Feb. 5, 2002, at 1A. According to Powers:

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Id.; see also "Yes Men" Make Up Boards That Miss Enron-Type Failings, U.S.A. TODAY, Feb. 21, 2002, at 16A.
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care owed by both directors and officers. The standard of care owed by officers and directors may be the same, but the amount of care owed by the company’s managers of day-to-day affairs should be unavoidably higher than the amount of care owed by a company’s outside directors with far less contact and involvement with the company.

Enron managers such as Andrew Fastow clearly breached fiduciary duties owed shareholders. Fastow breached the duty of loyalty because he had a material financial interest in the transactions between Enron and the investment partnerships he created and managed. 39 Other Enron employees who enriched themselves also breached fiduciary duties of loyalty. 40

What about the Enron managers who did not reap pecuniary benefits from Enron’s transactions with the suspect partnerships? They did not breach the fiduciary duty of loyalty, but they may have breached the fiduciary duty of care they owed shareholders. One Enron executive observed that Jeffrey Skilling “surrounded himself with ‘yes men.’” 41 It would be reasonable to argue that the “yes men,” if they were corporate officers, breached the duty of care by invariably saying yes instead of adequately investigating, monitoring, and ensuring compliance with law.

One cannot ignore the troubling relationship between Enron’s managers and its board. “The directors have maintained . . . that they were misled by some Enron executives and were never told about critical transactions.” 42 According to some newspaper accounts, transactions were hidden from the board. 43 At this point, the extent to which managers misled the board is unclear. There are clear allegations, however, that Kenneth Lay, the former Chair of Enron’s Board of Directors, was “disengaged and unfamiliar with many aspects of his own

40 Id.
41 Zellner, supra note 28, at 39.
company." If this characterization of Lay's tenure as Chairman of the Board is accurate, he has in fact breached the duty of care he owes shareholders.

The very culture at Enron risked the kinds of managerial breaches and possibly criminal conduct that occurred. One former Enron manager observed that "[t]he environment was ripe for abuse. . . . It was completely hands-off management. A situation like that requires tight controls. Instead, it was a runaway train." In fact, Enron's board did not hold the company's Risk Assessment and Control group accountable. This group, that was supposed to serve as an internal mechanism to manage risky corporate conduct, reported to Jeffrey Skilling, the executive who incited excessively risky conduct at Enron. Jeffrey Skilling "created and embodied the in-your-face Enron culture, where risk-taking, deal-making, and 'thinking outside the box' were richly rewarded, while controls appeared loose at best."

C. Duty of Care Breaches in Cases of Racial Discrimination

The inadequate monitoring of corporate compliance with law is a breach of the directorial and managerial duty of care owed to shareholders and is contrary to the shareholder primacy paradigm that is the fundamental tenet of state corporate law. In another article, I apply the language of the Delaware Chancery Court in In re Caremark International Inc. Derivative Litigation to the conduct of corporate managers at Texaco and Coca-Cola, two companies that paid large amounts to settle racial discrimination litigation in the 1990s. In Caremark, the court approved the settlement of a derivative suit. The suit was brought by shareholders alleging that the board and officers' failure to adequately monitor corporate employees resulted in

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45 See John A. Byrne, The Environment Was Ripe for Abuse, BUS. WK., Feb. 25, 2002, at 118.
46 Id.
47 Id.
48 Zellner, supra note 28, at 38.
49 See, e.g., Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (stating that a "corporation is organized and carried on primarily for the profit of stockholders").
50 698 A.2d 959 (Del. Ch. 1996).
51 See Wade, supra note 10, at 404–05.
violation of federal and state laws applicable to health care providers. The Caremark court described the type of directorial and managerial conduct that would breach the fiduciary duty of care owed to shareholders. The court advised that a board's "sustained or systematic failure" to monitor compliance with law would amount to a duty of care breach. The conduct described in Caremark is the kind of conduct that led to losses suffered by the shareholders of Texaco and Coca-Cola when the companies paid large amounts to settle. There was a sustained and systematic failure of the directors and managers of Texaco and Coca-Cola to investigate and monitor alleged racial discrimination.

Caremark is merely a settlement opinion and, therefore, has no precedential value. Yet, it offers potentially helpful guidance with respect to the kind of conduct that satisfies the fiduciary duty of care. A board's egregious failure to monitor employees' compliance with law that results in losses due to fines and penalties imposed upon the company, may make it possible for shareholders to recover those losses in a derivative action. It must be acknowledged, however, that a board has limited time and ability for oversight. "The board cannot design, install, operate, or monitor the operation of [internal information systems]; but the board can press for the installation [sic] and call for periodic assurances that they are in place."

Neither Texaco, nor Coca-Cola, nor any of the other companies that have recently paid large amounts to settle racial discrimination claims had installed a system to monitor compliance with anti-discrimination law before the litigation. While this observation offers some insight, it is also true that the number of things a board should do is almost infinite.

Any plaintiff's lawyer of even the most modest talent and imagination will always be able to find a subject matter X as to

53 Corporate officers at Texaco, for example, ignored Texaco employees who complained of racially discriminatory employment practices. This executive inaction, and directorial failure to exercise appropriate oversight, allowed the problem to fester. Eventually, the company paid over $175 million to settle a class action racial discrimination suit. See ROBERTS & WHITE, supra note 27, at 276.
54 Caremark, 698 A.2d at 960–61.
which he can denounce its directors, declaiming: "Surely any reasonable prudent person in these circumstances would have explored subject X, but this board sat back, did nothing, and did not even inquire into it."\(^{56}\)

The list of things to be monitored by boards is extensive, almost limitless. That is why board members deserve and receive the protection of the business judgment rule. The rule, however, was not intended to protect board members or senior executives in the face of blatant, ongoing corporate malfeasance.

Texaco shareholders did in fact file derivative litigation against Texaco's directors and managers alleging breach of fiduciary duties to oversee Texaco's compliance with federal and state law prohibiting discrimination. The derivative suit was settled, and the United States District Court for the Southern District of New York issued an opinion reducing the fee awarded plaintiffs' attorneys for the services they rendered in filing and negotiating a settlement of the derivative suit.\(^{57}\) The value of the plaintiffs' claim was one of the factors the court considered in determining that plaintiffs' attorneys' fees should be reduced by $400,000.\(^{58}\) The court concluded that:

\[\text{[A] rational director could well conclude that the absence of substantial assets on the part of the actual malefactors renders the claim against them not worth pursuing in behalf of the corporation, as a matter of business judgment. Also... the required showing of reckless indifference to support individual director liability for failure to catch the problem in time to avoid the substantial damage visited on the corporation [by the racial discrimination class action] presents a high threshold, which on the present record very likely could not have been met.}\(^{59}\)

The court's observations may indicate that plaintiffs neglected to include as defendants all of the officers of Texaco who heard complaints from employees of color but failed to take steps to address them. Clearly, Texaco's officers were recklessly indifferent to the complaints made by Texaco's employees of color. The court, however, spoke only to directorial scienter. Even if Texaco's board did not have a complete understanding of

\(^{56}\) Id. at 1485.


\(^{58}\) See id. at 591–92.

\(^{59}\) Id. at 585.
the complaints made by Texaco's minority employees, their managers certainly did. The court made no attempt to address the "reckless indifference" of Texaco's officers. Nor did the court distinguish between the level of care that should be exercised by inside, as opposed to outside, directors.

Even if Texaco's board had no reason to ask officers about racial discrimination, the boards of companies with few or no minorities among senior managers or executives may be recklessly indifferent to the possibility of litigation and large settlements if they fail to ask their officers the right questions in the aftermath of the large settlements paid by Texaco and Coca-Cola. In other words, the boards of large public companies should inquire about racial discrimination in order to avoid the negative publicity and huge settlements that plagued Texaco and Coca-Cola.

CONCLUSION

Corporate officers and managers have a duty of care similar to that owed by directors. Satisfaction of that duty, however, requires a greater amount of care because of managers' day-to-day involvement with the company. This greater involvement can only be an effective mechanism for ensuring responsible corporate behavior if there are also lines of communication between officers and directors. In particular, a board's independent directors must be available to receive managers' reports of misconduct. Such communication can create the oversight and involvement by the board necessary to ensure more ethical behavior by corporate actors.

60 Id. The court correctly noted that a board may decide not to pursue litigation against an individual because the costs outweigh the benefits of such litigation when the potential defendant has little money.