

**Board oversight of a compliance program**  
**The Implications of *Stone v. Ritter***

By Rebecca Walker

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In 1996, Delaware's Court of Chancery sent ripples across both the compliance and corporate law communities when it stated that a director's duty of good faith includes a duty to attempt to assure that a corporate information and reporting system exists, and that failure to do so may, under some circumstances, render a director liable for losses caused by the illegal conduct of employees.<sup>1</sup> Late last year, ten years after that Chancery Court decision, the Delaware Supreme Court applied and clarified the *Caremark* language in the case of *Stone v. Ritter*.<sup>2</sup>

While the standard articulated in *Caremark* was *dicta*, and while that case certainly did not include the strongest possible language regarding a director's oversight duties, it did create a much keener awareness of the importance of board oversight of a company's compliance program, both within the compliance community and among government regulators and legislators. Its impact on compliance legal guidance and best practices has been

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quite substantial, and the court's decision in *Stone* therefore takes on additional meaning for the compliance community.

*Stone* was a derivative action brought by shareholders on behalf of AmSouth Bancorporation against 15 present and former directors. The plaintiffs alleged that the bank's directors had failed to ensure the existence of a reasonable federal Bank Secrecy Act and anti-money laundering compliance and reporting system, which allegedly resulted in violations of laws and consequent fines and penalties against the bank for \$50 million. The Chancery Court of Delaware dismissed the action, and Delaware's Supreme Court affirmed the Chancery Court's dismissal. In the course of its opinion, the Supreme Court addressed the question of the extent of a director's duty to ensure monitoring and reporting systems and otherwise oversee a company's compliance program.

### **The Caremark Decision**

To understand the importance of the court's decision in *Stone*, it is helpful to have some background information regarding the law of fiduciary duties in Delaware and the predecessor *Caremark* case. In *Caremark*, the plaintiff shareholders had sought to hold the defendant directors liable for the damages resulting from Caremark employees' alleged violations of various federal and state laws governing healthcare fraud. Caremark had

been under investigation by the United States Department of Health and Human Services and the Department of Justice (DoJ), as well as various states, and had entered into a number of agreements with DoJ and others that required the company to make payments of approximately \$250 million to settle the allegations against it. The complaint in that case thus charged that the directors had--through their failure of oversight--allowed misconduct to occur, which exposed the organization to liability, and, thereby, violated a duty to monitor the performance and compliance of the corporation.

In *Caremark*, the Delaware Chancery Court stated that it would be a mistake to conclude that corporate boards can

“satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.”

In other words, without some effort to ensure that they are being kept appropriately apprised of a company's compliance, boards have failed to satisfy their duty to be reasonably informed about the corporation.

The *Caremark* decision sought to limit an earlier decision of Delaware's Supreme Court, *Graham v. Allis-Chalmers Mfg.*

*Co.*,<sup>3</sup> which had held that directors may be found personally liable for wrongdoing at the corporation only if they deliberately or inattentively ignore obvious warning signs. The *Caremark* court said that the *Graham* standard makes less sense in today's legal and regulatory environment, given the disastrous impact that legal and regulatory violations can have on an organization.<sup>4</sup>

The court in *Caremark* specifically mentioned the United States Sentencing Guidelines as a factor to be considered in determining the appropriate level of board oversight of a company's compliance systems. The court stated that the Guidelines offer powerful incentives for companies to implement compliance programs, and went on to state that "any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers."<sup>5</sup>

#### **After *Caremark*: Legal Guidance Regarding Board Oversight**

Since the Chancery Court's 1996 decision in the *Caremark* case, there have been a number of significant pronouncements by various government bodies that have built on the logic of that

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decision, further highlighting the importance of board oversight of a company's compliance program. An important example is the McNulty Memorandum – the Justice Department memorandum instructing prosecutors as to the factors that they should consider in determining whether to indict a corporation for the purported criminal conduct of its employees (the McNulty Memo revised the earlier the Thompson Memo). In the Thompson Memo, the Justice Department instructed prosecutors to consider (among other factors) the existence and adequacy of a corporation's compliance program when determining whether to charge a corporation. The Thompson Memo also provided guidance on how to assess a compliance program's adequacy.

The McNulty Memo provides that, when assessing the adequacy of a company's compliance efforts, prosecutors should consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct, such as whether directors exercise independent review over proposed corporate actions, whether directors are provided with information sufficient to enable the exercise of independent judgment, and whether directors have established an information and reporting system reasonably designed to provide management and the board of directors with timely and accurate information

regarding the corporation's compliance with the law.<sup>6</sup> (This last factor uses the same language that the court used in *Caremark* and cited the *Caremark* decision.)

References to director involvement in certain aspects of a company's compliance efforts also appear in the Sarbanes-Oxley Act of 2002 and the stock exchange regulations promulgated after the Sarbanes-Oxley Act. For example, pursuant to section 301 of Sarbanes-Oxley, the Securities and Exchange Commission, in April 2003, adopted a rule directing the national securities exchanges and associations to prohibit the listing of securities of any company where the audit committee of the company has not established procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.<sup>7</sup> This legislative requirement for board oversight builds directly on the logic of *Caremark*, with its focus on a board's implementation of monitoring procedures to ensure that the board will be informed in the event of misconduct. Indeed, in this area of compliance, the audit committee now has more than mere oversight responsibility;

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it must actively engage in establishing compliance procedures relating to the reporting financial misconduct by employees and others.

In 2003, both the New York Stock Exchange and NASDAQ established rules that require listed companies to adopt and disclose codes of business conduct and ethics applicable not only to officers and employees, but also to directors.<sup>8</sup> The rules also require that any waivers of the code for directors and executive officers be made only by the board of directors or a board committee and that all waivers be promptly disclosed to shareholders.<sup>9</sup> These rules thus require corporations to adopt a code of conduct – the backbone of most companies’ compliance programs – that will govern directors. They also require that directors be responsible for deciding whether to waive the code for other directors and for executive officers – thus requiring director involvement in the implementation of the compliance program. The New York Stock Exchange also requires the charters of audit committees to specify that it is the committee’s responsibility to assist the board in its oversight of the company’s compliance with laws and regulations.<sup>10</sup>

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The 2004 revisions to the U.S. Sentencing Guidelines for Organizations also emphasized the role of directors in overseeing a company's compliance program. The 1991 iteration of the Guidelines' definition of an "effective" compliance program made no specific mention of a director's role in the design and implementation of the program, but the 2004 version contains requirements regarding both board oversight and board training. Specifically, the Guidelines now require that, in order to have an effective compliance and ethics program, the board must be knowledgeable about the content and operation of the compliance and ethics program and exercise reasonable oversight with respect to its implementation and effectiveness.<sup>11</sup> The Guidelines also require organizations to communicate their standards and procedures to directors by conducting effective training programs and otherwise disseminating information that is appropriate to the director's roles and responsibilities.<sup>12</sup>

Numerous other government regulations have followed on the heels of the corporate debacles that occurred in the first part of this decade concerning the importance of board oversight of compliance programs since *Caremark* was decided – many of which, like the Sentencing Guidelines' revised the definition of an effective compliance and ethics program,. By the time the

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Delaware Supreme Court decided *Stone v. Ritter*, near the end of 2006, corporate governance standards and practices had undergone tremendous change; boards of directors were subject to increased scrutiny; and the general expectations regarding boards' roles in overseeing compliance programs were significantly greater than they had been in 1996.

### **The Duty of Good Faith**

The Supreme Court in *Stone* reiterated much of what the Chancery Court had said in the *Caremark* decision ten years earlier. *Stone* also followed and built on the much-heralded decision of the Delaware Supreme Court in the case of *In re Walt Disney Co. Deriv. Litig.*,<sup>13</sup> which was decided earlier in 2006. In that case, Delaware's Supreme Court addressed the question of when directors can be held liable for *not* acting when they have a purported duty to do so (as opposed to liability for an action or specific conduct that violates a director's duties to the corporation). The court in *Disney* stated that directors have a duty of good faith, separate from their duties of loyalty and care, and identified three types of conduct that would establish a director's failure to act in good faith:

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other

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than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.<sup>14</sup>

The *Stone* court stated that it was the intentional failure to act in the face of a known duty to act that was the type of bad faith at issue in the *Caremark*, *Disney*, and *Stone* cases.<sup>15</sup> The court also explained that the duty of good faith at issue in *Caremark* and *Stone* (i.e., purported failure to establish or oversee compliance systems) is a subset of the duty of loyalty.<sup>16</sup> This is particularly important language because, unlike claims that directors have violated their duty of care, corporations cannot limit or eliminate directors' liability for violating their duty of loyalty.

The *Stone* court held that *Caremark* articulates the necessary conditions for holding directors liable for a failure of oversight. Directors may be held liable if they either completely failed to implement a reporting or information system or controls or, "having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring

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their attention.”<sup>17</sup> The court held that, in a case such as *Stone*, where information failed to reach the board because of ineffective internal controls, but information systems had been established and the directors neither knew nor should have known of the violations of law, there has been no violation of the duty of good faith.<sup>18</sup> The court also reiterated what the *Caremark* court had stated ten years earlier: that the plaintiffs’ theory of liability in *Stone* – attempting to hold directors liable for the misconduct of employees in the organization – is possibly “the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”<sup>19</sup>

### **Analysis of the Compliance Program**

Notwithstanding the high threshold for liability set by the *Stone* (and *Caremark*) courts, the court in *Stone* nonetheless spent a good deal of time discussing the specific compliance systems that had been established by AmSouth’s board to assist in its oversight of the company’s Bank Secrecy Act compliance and reporting systems, including:

- (1) Appointing an officer of the company to have responsibility for Bank Secrecy Act and anti-money laundering matters, including employee training,

- general communications, regulatory reporting, and presenting anti-money laundering policy and program changes to the board and management;
- (2) Establishing a compliance department, headed by a compliance officer and comprised of nineteen professionals, including a compliance manager and a compliance reporting manager;
  - (3) Establishing a corporate security department with responsibility for detecting and reporting suspicious fraudulent activity; and
  - (4) Establishing a “Suspicious Activity Oversight Committee,” with a directive to “oversee the policy, procedure, and process issues affecting corporate security and the Bank Secrecy Act and anti-money laundering compliance programs, to ensure that an effective program exists at AmSouth to deter, detect, and report money laundering, suspicious activity and other fraudulent activity.”<sup>20</sup>

The court emphasized that the AmSouth board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for monitoring compliance, and exercised oversight by relying on periodic reports

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from them.<sup>21</sup> After listing the above compliance oversight activities by the board, the court concluded that, “although there ultimately may have been failures by employees to report deficiencies to the Board, there is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.”<sup>22</sup> In other words, the court found no basis for liability after a lengthy summary of the various compliance activities undertaken by the directors in that case.

### **The Significance of *Stone***

The *Stone* decision effectively converts the *dicta* that appeared in *Caremark* regarding potential liability of directors into a holding that directors may be liable for the damages resulting from legal violations committed by employees of a corporation, if directors fail to implement a reporting or information system or controls or fail to monitor such systems. The court also places this duty of directors squarely within the duty of loyalty.

The *Stone* case also provides an interesting view of those factors that a court will look to in determining whether board oversight of a company’s compliance systems is adequate to withstand challenge. The court focused primarily on the structure

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of oversight of the compliance systems at the bank (e.g., the position of compliance officer and the role of the oversight committee of the board), but also discussed the staff designated to implement the program, training and policies, and monitoring systems. This gives boards some helpful insights regarding some of the issues that they may wish to oversee in compliance programs.

Interestingly, the court in *Stone* recognized the necessary limitations on both director oversight and – by implication – compliance programs more broadly, when it stated that “directors’ good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both, as occurred in *Graham*, *Caremark* and this very case.”<sup>23</sup> The Chancery Court had made a similar observation in *Caremark*, when it stated that “no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation’s compliance with the law.”<sup>24</sup> (While both courts’ observations seem fairly obvious, they include a truth that sometimes escapes the recognition of

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prosecutors and regulators.) This judicial recognition of the inherent limitations in any compliance program – no matter how effectively implemented – may prove helpful to corporations seeking to defend their good faith compliance efforts following violations of law.

### **What Constitutes Appropriate Board Oversight?**

Many corporations have, for some years now, kept their audit committees apprised when the corporation receives allegations of suspected misconduct and the company's responses to those allegations. Communication of this type of information continues to be very important. It is this type of information that the *Caremark* and *Stone* cases focused on, and that is the subject of the Sarbanes-Oxley provision discussed above. Boards may also wish to consider expanding the type of information that they receive regarding a company's compliance activities. For example, beyond receiving information regarding reports of suspected misconduct, boards may also wish to consider meeting with the compliance officer periodically to inquire about:

1. Information regarding how the company's reporting system is structured, the company's investigation policies for and otherwise responding to suspected misconduct, and

- employees' perceptions of the reporting system, including questions regarding fear of retaliation;
2. How the compliance program is structured, including whether it has the appropriate level of resources and authority to be effective and whether the compliance officer has sufficient authority effectively to implement the program;
  3. How the company conducts law and compliance-related risk assessments, and the methods developed by the company to prioritize and address risks identified;
  4. Significant modifications to the company's compliance policies, including its code of business conduct;
  5. Periodic review of the types of compliance training that employees and others are required to complete, and any modifications to those training requirements;
  6. How the company audits for implementation of the compliance program and for substantive legal violations, especially in high-risk areas; and
  7. The perception of employees regarding the culture of compliance at the corporation, including the level of fear of retaliation for reporting suspected misconduct and whether

employees believe that management is committed to compliance.

Compliance oversight activities need not be conducted by the full board. Many companies have delegated this responsibility to the audit committee, a compliance committee, or another appropriate committee of the board.<sup>25</sup> However, even when delegated to a committee, it may nonetheless be appropriate for the full board to periodically receive information regarding implementation of the compliance program. As directors spend more time overseeing companies' compliance efforts, their level of sophistication regarding how compliance programs work will undoubtedly increase. Boards will ask more probing questions regarding program effectiveness and will more effectively use the compliance program as a monitoring device.

## **Conclusion**

Corporate governance and corporate compliance practices have undergone enormous change in a relatively short period of time, and best practices are continually developing. The level of scrutiny, not only of a board's affirmative decision-making, but also a board's monitoring--or failing to monitor--the activities of a corporation has increased. The challenge for boards and

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compliance officers is to view the increased scrutiny and enhanced standards, not merely as a host of new legal requirements, but also as an opportunity to review and enhance their corporate governance and compliance practices. Best practices will help satisfy the growing expectations of regulators, shareholders and others; create valuable methods of communicating information to boards and management; and prevent and detect legal violations within corporations. The *Stone* decision is yet another step in the development of that all-important space where governance meets compliance, both reinforcing the importance of board oversight and providing insight into how a court will review a board's oversight of a corporation's compliance program.

*The views expressed by the author herein do not necessarily represent the views of Kaplan and Walker, LLP.*

<sup>1</sup> *In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996).

<sup>1</sup> *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

<sup>1</sup> *Graham v. Allis-Chalmers Mfg. Co.*, 231 Del. Ch. 78, 188 A.2d 125 (Del. 1963).

<sup>1</sup> *In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 969-70 (Del. Ch. 1996).

<sup>1</sup> *Id.* at 970.

<sup>1</sup> United States Department of Justice, *Memorandum Regarding Principles of Federal Prosecution of Business Organizations* at 4 (Dec. 2006), available at [http://www.usdoj.gov/dag/speech/2006/mcnulty\\_memo.pdf](http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf).

<sup>1</sup> Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220; 34-47654, 17 C.F.R. §§ 228, 229, 240, 249 & 274 (April 25, 2003).

<sup>1</sup> NYSE Rule 303A.10; Nasdaq Rule 4350(n).

<sup>1</sup> *Id.*

<sup>1</sup> NYSE Rule 303A.07(c)(i)(A).

<sup>1</sup> United States Sentencing Guidelines Manual § 8B2.1(b)(2)(A).

<sup>1</sup> United States Sentencing Guidelines Manual § 8B2.1(b)(4).  
*In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del.2006).

<sup>1</sup> *Id.* at 67.

<sup>1</sup> *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006).

<sup>1</sup> *Id.* at 369-70.

<sup>1</sup> *Id.* at 370.

<sup>1</sup> *Id.* at 370-71.

<sup>1</sup> *Id.* at 372.

<sup>1</sup> *Id.* at 371.

<sup>1</sup> *Id.* at 372-73.

<sup>1</sup> *Id.* at 372.

*Id.* at 373.

<sup>1</sup> *In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996).

As noted above, New York Stock Rules require the audit committee charter to specify that it is the audit committee's responsibility to assist the board in its oversight of the company's compliance with laws and regulations. NYSE Rule 303A.07(c)(i)(A).