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EXPERT ANALYSIS

When Internal Compliance Monitoring Stumbles, Directors And Officers May Face Risk

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In connection with the resolution of criminal or civil antitrust enforcement proceedings, the government frequently requires companies to institute rigorous antitrust compliance programs as a term of probation or a civil consent decree.

In these cases, the government either requires the appointment of an external antitrust compliance monitor or permits the company to appoint a monitor internally.

Issues relating to external compliance monitors made headlines when Apple complained about the monitor imposed on it after the company was found liable for e-books price-fixing.[1]

High-profile criminal antitrust cases — notably, the prosecutions of AU Optronics Corp.[2] and Bridgestone Corp.[3] — have also involved the imposition or potential imposition of external compliance monitors.

A recent decision from the U.S. District Court for the Western District of Washington involving Microsoft demonstrates that the allowance of internal compliance monitoring may not eliminate all of a company's headaches.

Indeed, the Microsoft case demonstrates that if internal compliance monitoring stumbles, a company's board of directors may be at risk for claims of breach of fiduciary duty and, in particular, breach of the duty of loyalty.

BACKGROUND: MICROSOFT VIOLATES WEB BROWSER COMMITMENTS

The ruling in *Barovic v. Ballmer*, No. C14-0540-JCC, 2014 WL 7011840 (W.D. Wash. Dec. 10, 2014), arose from Microsoft's efforts to address the European Commission's concern over the company's practice of "tying" its Web browser, Internet Explorer, to its ubiquitous Windows operating system.

To resolve a proceeding regarding the "tying" issue, Microsoft made certain "commitments" in 2009. Memorialized in a commission decision, the commitments were intended to eliminate Internet Explorer's status as the presumptive Windows browser.

Between March 2010 and December 2014, versions of Windows sold within the European Economic Area were required to include a "browser choice screen" that enabled users to select from a menu of popular browsers. Microsoft was also required to submit annual reports on its implementation of the commitments.

In late June 2012, the commission notified Microsoft that certain computers running the Windows 7 operating system were reportedly not displaying the choice screen. A series of exchanges between Microsoft and the commission ensued.

Microsoft quickly acknowledged that the browser choice screen was not displayed on computers sold with a particular Windows 7 "service pack" preinstalled. Within a month, it implemented a fix that provided the browser choice screen to affected users.

The commission subsequently determined that the failure involving the browser choice screen lasted roughly 14 months — from May 2011 until July 2012 — and affected about 15 million users.

Microsoft's failure to properly distribute the browser choice screen "was due to inadvertent technical and human errors," and the company "acted negligently" in breaching its commitments, the commission concluded.

The commission further concluded that "[g]iven its resources and know-how … Microsoft should have been able to avoid such errors and should have had better processes in place to ensure [compliance]."

Balancing Microsoft's prompt admission and subsequent remedial efforts against the seriousness of the breach of the previous commitment and the need for deterrence, the commission levied a fine of € 561 million, or about $732 million.[4]

MICROSOFT'S REJECTION OF PRE-SUIT DEMAND LETTERS

Shortly after the commission announced the fine, Microsoft received two pre-suit demand letters in March 2013. Each letter was written on behalf of an individual shareholder.

The letters, which were nearly identical, advised that the shareholders would commence derivative actions unless the company's board investigated the violation of the Web browser commitments and sued management for breach of fiduciary duty.

In response, Microsoft's board appointed a demand review committee of two independent directors to investigate and advise the board as to an appropriate response.

In January 2014 the board notified the shareholders that it was rejecting their demand. The rejection letter included a board resolution summarizing the committee's investigation, which was undertaken with the assistance of the firm Fenwick & West.

As itemized in the resolution, the investigation included a review of more than 10,000 documents as well as a report on the browser choice screen failure that another law firm had previously prepared on Microsoft's behalf.

The investigation also included "relevant interviews" — a category that would become a focus of the ensuing litigation.

In response to inquiries from the shareholders' counsel, Microsoft declined to specifically identify the interviewees but indicated they consisted of 36 current and former Microsoft board members and employees.

DERIVATIVE SUIT

In April 2014, the shareholders sued the company as promised. Their suits, later consolidated into a single derivative action, asserted what are commonly referred to as *Caremark* claims.[5]

Essentially, the plaintiffs alleged a failure to monitor — that is, they claimed Microsoft's board and management breached their fiduciary duties by failing to prevent the company from violating the commitments over an extended period.

As early as the pleading stage, the plaintiffs appeared to face an uphill struggle. As a legal and practical matter, a number of hurdles existed. A claim of inadequate oversight is, in *Caremark*'s oft-repeated phrase, "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[6]

It seemed implausible that, having resolved the European Commission's inquiry into the Web browser issue, Microsoft's board or management would condone, even tacitly, a flagrant violation of the company's binding commitments.

The commission itself characterized Microsoft's violation as the product of negligence and acknowledged both the company's acceptance of responsibility and its prompt remedial efforts.

The complaint did not raise a specter of self-dealing or conflict of interest, and the plaintiffs essentially conceded as much by making a pre-suit demand on the board.

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In response to that demand, the board followed what seemed like a prudent course. It appointed a demand review committee of disinterested directors to oversee a substantial investigation with the assistance of outside counsel.

Moreover, the board's decision to reject the shareholders' demand was presumptively entitled to the protections of the business-judgment rule.

Finally, Microsoft's charter included an exculpatory clause shielding its directors from claims for breach of the duty of care.

Nevertheless, the plaintiffs survived motions to dismiss filed by Microsoft and the defendant directors and officers.

THE *CAREMARK* STANDARD

In In re *Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Chancery Court issued a seminal opinion that spawned a series of decisions in Delaware and elsewhere. Specifically, the opinion and its progeny established that a corporation's board of directors has a legal duty to create a compliance program, and to make sure it works.

Caremark involved a shareholder derivative suit that accused company directors of breaching their fiduciary duty of care to the corporation in connection with employee violations of federal and state laws applicable to health care providers. Significantly, the suits did not allege that the directors were involved in the violations or were even aware of them.

Rather, the suits alleged the directors breached their duty of care "by failing adequately to supervise the conduct of Caremark employees or to institute corrective measures, thereby exposing Caremark to fines and liability."[7]

The corporation and shareholders reached a proposed settlement that was presented to the Delaware Chancery Court for approval.

The court concluded that, in light of the record before it (which essentially was a discovery record only), "there [was] a very low probability that it would be determined that the directors … breached any duty to appropriately monitor and supervise the enterprise."[8]

In reaching its conclusion, the court delineated the directors' obligation to implement an effective compliance program.

The court opined that a director's duties encompass the responsibility to ensure that a corporate reporting system exists so that appropriate information will come to the board's attention. It also said that if the board fails to put such a system in place, the directors may be liable for losses. The court explained:

> [I]t is important that the board exercise a good-faith judgment 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 so that it will satisfy its responsibility.
>
> Thus … a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by noncompliance with applicable legal standards.[9]

The Delaware Supreme Court adopted and endorsed *Caremark* in later shareholder derivative actions that accused directors of breaching their fiduciary duty of loyalty by failing to institute and supervise an effective compliance program.

In *Stone et al. v. Ritter et al.,* 911 A.2d 362 (Del. Nov. 6, 2006), the Delaware high court elaborated on the *Caremark* standard by articulating alternative theories of liability for a board of directors' failure of oversight:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) The directors utterly failed to implement any reporting or information system or controls, *or* (b) 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 their attention.[10]

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The court made it clear that directors cannot be held liable under either theory without a showing that they knew they were not discharging their fiduciary obligations.

APPLYING *CAREMARK* TO THE MICROSOFT CASE

In the *Barovic* case, the plaintiffs did not dispute that Microsoft "established oversight mechanisms and internal controls nominally dedicated to ensuring legal compliance, nor dispute that the elimination of the [browser choice screen required by the European Commission settlement] was most directly caused by technical error on the part of its engineering team."[11]

In the view of U.S. District Judge John Coughenour, however, the plaintiffs adequately alleged that the defendant directors consciously failed to monitor or oversee the company's internal control system.[12]

The court cited several alleged facts that it concluded were sufficient to state a claim for inadequate oversight:

- Microsoft was directly responsible for monitoring its own compliance with the European Commission settlement.
- The settlement obligated Microsoft to include a browser choice screen on its systems.
- The browser choice screen was missing from more than 15 million installations of Windows 7 in Europe.
- Microsoft had to be informed of the browser choice screen issue by the European Commission's antitrust chief.
- After the commission imposed a $732.2 million fine on Microsoft, the defendant officers and directors offered no explanation for why or how the technical errors went undetected.[13]

Judge Coughenour held that an inference that the board consciously failed to monitor or oversee the internal compliance obligations could be drawn from the fact that, over the course of a year and a half, at least 15 million installations of its product were missing a crucial element.

He felt that this inference was particularly appropriate because Microsoft had a legal duty to ensure that the browser choice screen was included in Windows sold in Europe and a legal duty under the settlement to verify that it was included. He also noted that the inclusion of the browser choice screen was entirely responsible for saving the company from an antitrust suit and massive fines and that the presence or absence of the browser choice screen was readily detectable, even to average consumers.

CONCLUSION

Conduct remedies relating to post-conviction judgments or post-settlement consent decrees have been controversial within the antitrust community. If such a remedy is the centerpiece of a probation order or consent decree and the corporation is permitted to self-monitor compliance, the lesson from the *Barovic* decision is the board of directors must ensure the company fulfills its obligation. If it does not, it faces the risk of a derivative claim for breach of its fiduciary duty.

NOTES

[1] *See* Nate Raymond & Joseph Ax, *Apple Loses Latest Bid to Block E-books Antitrust Monitor,* Reuters (Feb. 10, 2014), *available at* http://www.reuters.com/article/2014/02/10/us-apple-ebooks-idUSBREA191YP20140210).

[2] In September 2012, following the conviction of AU Optronics and its American subsidiary for conspiring to fix prices of LCD panels, a $500 million fine was imposed on the parent company. In addition, both entities were required as a condition of their three-year probationary sentences to adopt an antitrust compliance program and to hire an independent monitor to oversee program compliance. See Press Release, U.S. Dep't of Justice, Taiwan-Based AU Optronics Corp. Sentenced to Pay $500 Million Fine for Role in LCD Price-Fixing Conspiracy (Sept. 20, 2012), *available at* http://www.justice.gov/atr/public/press_releases/2012/287189.htm.

[3] In April 2014, under a plea agreement in which it admitted conspiring to fix prices of automotive anti-vibration rubber parts, Bridgestone agreed to pay a $425 million fine and serve a three-year term of probation that required it to report annually to the U.S. Probation Office regarding its antitrust

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compliance program. As part of the plea agreement (*available at* http://www.justice.gov/atr/cases/f305600/305636.pdf), the government reserved the right to recommend a court-appointed monitor if Bridgestone failed to make timely and complete reports concerning the program.

[4] These facts are drawn from the commission's decision June 3, 2013, which formally imposed a fine that had been publicly announced three months earlier. *See* http://ec.europa.eu/competition/antitrust/cases/dec_docs/39530/39530_3162_3.pdf.

[5] *See In re Caremark Int'l Derivative Litig.,* 698 A.2d 959 (Del. Ch. 1996).

[6] *Id.* at 967.

[7] *Id.* at 964.

[8] *Id.* at 961.

[9] *Id.* at 970.

[10] *Id.* (emphasis in original).

[11] 2014 WL 7011840 at *5.

[12] Judge Coughenour first addressed the threshold question of whether the board's rejection of the plaintiffs' pre-suit demand should be upheld under the business-judgment rule. He agreed with the plaintiffs that the failure of the demand review committee to interview any European Commission official was "sufficient grounds for calling into question the reasonableness and good-faith nature of the board's investigation." 2014 WL 7011840, at *4. For this proposition, the court relied on *City of Orlando Police Pension Fund v. Page,* 970 F. Supp. 2d 1022 (N.D. Ill. Sept. 26, 2013). In that case, which concerned a $500 million fine levied by the Justice Department based on the alleged failure to prevent Google's search engine from displaying unlawful ads for prescription medications manufactured abroad, the U.S. District Court for the Northern District of California opined that "any reasonable investigation [in response to pre-suit demand] should have included an interview of" the DOJ's lead investigator. Id. at 1032. Although the topic is beyond the scope of the present article, it bears noting that this aspect of Barovic and Page is problematic. As a matter of rule, prudence, ethics and professional disposition, prosecutors and regulators may have reason to resist requests for nonpublic information about investigations that are resolved through negotiated settlement. Likewise, in the wake of a settlement involving allegations of corporate wrongdoing, even the most independent demand review committee might question whether "interviewing" the lead investigator is in the company's best interest.

[13] 2014 WL 7011840 at *5.

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