Caremark 2.0 Lends Shareholders Agency Against Polluters

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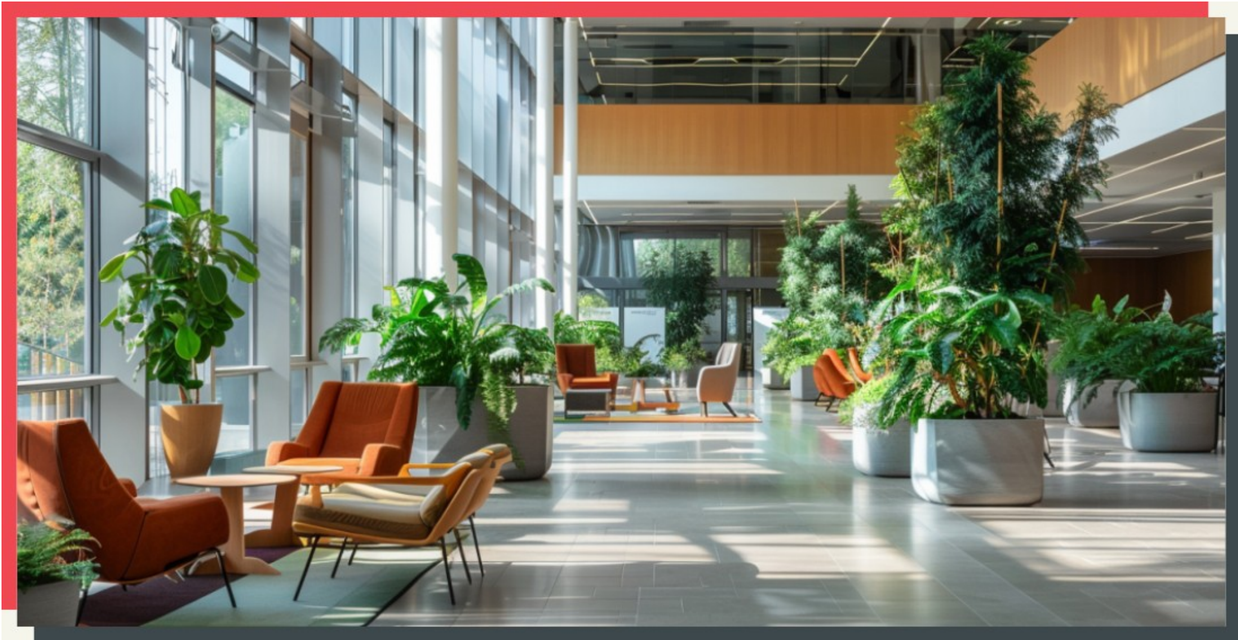

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Over the past couple of decades, the central aims of environmental law, broadly defined, have shifted, with increasing focus on the climate crisis. Ambitions have so far outpaced action in the U.S., as climate legislation has proven exceedingly difficult to enact.

Meanwhile, the vast suite of environmental laws passed during the height of the movement in the 1970s — those addressing issues like air and water pollution and the cleanup and disposal of hazardous waste — continue to powerfully shape the behavior of regulated entities, namely large corporate polluters.

Accordingly, as scholars and shareholders have recently sought to use plaintiff-friendly developments in corporate and regulatory law to hold emitters liable for climate harms, less attention has been paid to how these legal changes may affect traditional environmental liability.

While corporate climate and environmental exposure touches many legal regimes, there has been particular interest in the intersection of the Caremark duty of oversight with regulations like the U.S. Securities and Exchange Commission's proposed climate disclosure rules.

The Caremark doctrine, which requires corporate fiduciaries to adequately manage serious legal risks to their companies and was long a difficult theory on which to succeed, has been liberalized in a series of cases that makes liability far more plausible.

This evolution has created opportunity for shareholders to deter failures to oversee environmental risks arising from traditional regulatory violations, like toxic spills and air pollution.

As is explored below, these illegal acts, which often involve key company operations and attract enormous penalties, are prime candidates for this newly invigorated Caremark liability.

Caremark: Classic and 2.0

Established in the Delaware Chancery Court's 1996 In re: Caremark International Inc. Derivative Litigation,[1] and refined in the Delaware Supreme Court's 2006 Stone v. Ritter decision,[2] the Caremark duty of oversight is a subset of the duty of loyalty that requires corporate directors and officers[3] to monitor important company activities that could create legal exposure.

Extended to officers in 2023 in the McDonald's shareholder litigation, the duty can be breached in two ways:

- Prong 1: Boards or officers fail to oversee key company activities by maintaining no control structure, generally taking the form of reporting systems; or
- Prong 2: Boards or officers implement that structure but it is inadequately monitored.

Though long regarded as nearly unwinnable — the late Chancellor William T. Allen, who wrote the Caremark opinion, memorably dubbed it "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" — several Caremark claims have recently survived motions to dismiss.

Beginning with the watershed 2019 Marchand v. Barnhill[4] case, the Delaware Court of Chancery has revitalized Caremark claims, creating what some have called Caremark 2.0.

This recent line of derivative cases stands for the proposition that, while difficult, Caremark claims may proceed where boards or officers ignore or inadequately address red flags in so-called mission critical areas of corporate operations.

Marchand itself provides an instructive example. There, shareholders brought a Caremark claim against the board of a company whose operations consisted solely of manufacturing ice cream. The claim was brought after a listeria outbreak tied to a company factory led to three deaths.

The court denied the motion to dismiss because despite the extensive safety regulations to which the company was subject, plaintiffs adequately showed that the board failed to audit safety concerns at all, a clear Prong 1 breach.

Similarly, the 2020 Inter-Marketing Group USA Inc. v. Armstrong[5] decision concerned a pipeline belonging to a company whose "primary operational emphasis [was] on pipeline integrity and maintenance," which ruptured, causing a disastrous oil spill that cost $257 million to clean up and led to "fines, a federal securities lawsuit, lost revenue, reputational harm, a decline in stock market price, and criminal convictions."

Shareholders brought a derivative suit against the company's directors, claiming they breached their Caremark duties. The court, citing Marchand, allowed the claim to proceed because although the board did have an audit committee, it "never discussed pipeline integrity" and therefore there was "no system of board-level compliance monitoring and reporting."[6]

Last year, the Chancery continued to fine-tune and at times expand the rapidly developing doctrine.

In the April 26, 2023, Ontario Provincial Council of Carpenters' Pension Trust Fund v. Walton[7] decision, the court refused to dismiss a Caremark claim involving violations of federal drug law because the plaintiffs sufficiently showed that although the board had control systems in place, Walmart Inc. directors had knowingly disregarded noncompliance with essential regulations, a Prong 2 breach.

The court held that "a corporate fiduciary cannot … make a business judgment to cause or allow the corporation to break the law."[8]

On the other hand, in the Dec. 14, 2023, Segway Inc. v. Cai decision,[9] the court held that "mission critical" means just that. The court refused to extend Caremark liability to cases involving "everyday business problems," finding that "[l]iability can only attach in the rare case where fiduciaries knowingly disregard [their] oversight obligation and trauma ensues."

The court dismissed the claim because the plaintiff did not show the company president "consciously failed to act after learning about evidence of illegality — the proverbial 'red flag' within her areas of responsibility."[10] The case confirms that even Caremark 2.0 claims can only succeed where material legal violations are overlooked.[11]

It is clear from Walton, Segway and other cases[12] decided since Marchand that Caremark liability is likeliest to attach where fiduciaries either ignore or approve breaches of key regulatory controls that seriously damage their company.

There is an ongoing debate about whether significant business risks, in addition to legal violations, may trigger Caremark, but this article is focused on the relatively settled point that liability can and often does follow illegal acts. The considerable legal exposure companies face from environmental regulation fits neatly into this framework.

Environmental Violations

Many have argued that the corporate operations that contribute to and will be impacted by climate change are precisely the sort of mission critical activities contemplated by Marchand.

After all, fossil fuel, natural resource, and industrial companies, and even certain asset managers place greenhouse gas-emitting infrastructure at the core of their businesses. However, less clear is what legal responsibilities such companies owe because of these operations, given the nascent state of American climate law.

Traditional environmental risks, on the other hand, have received far less Caremark attention despite often implicating just as critical, if not the same, company operations. Much of the same infrastructure that contributes to climate change is also responsible for air and water pollution, and there are innumerable operations that pose no obvious climate risk but do threaten the environment in a more traditional fashion.

And, crucially, these harms are heavily regulated by a vast network of state and federal laws. These two components, mission criticality and intense regulatory scrutiny, combined with the sizable financial penalties that often follow these violations, make environmental risks an obvious potential source of Caremark liability.

A recent Clean Air Act violation settlement provides a telling case study. This past December, the U.S. Department of Justice fined Cummins Inc. a record $1.675 billion for installing so-called defeat devices in truck engines in clear violation of the Clean Air Act.

The company will also have to spend over $300 million to remedy its wrongdoing.[[13]This case clearly raises the specter of Caremark liability.

While Cummins' board does include audit and environment or health committees, allaying Prong 1, the fiduciaries' failure to prevent this patently illegal activity could constitute a breach of Prong 2.

In addition to Walton and Cai, which explicitly allow for liability where material legal violations are ignored, another case in the Marchand line, the 2020 Teamsters Local 443 Health Services & Insurance Plan v. Chou decision,[14] is on point.

There, the Chancery denied the motion to dismiss because the plaintiff sufficiently alleged that the board knew the company's products were in "contravention of mission critical drug health and safety regulations [] and … failed to act in response," a breach of Prong 2.[15]

In the case of Cummins, either the board was unaware of the illegality, which could amount to a failure to monitor red flags, or it was aware and failed to take necessary action — or, perhaps, even approved the bad acts — which could demonstrate inadequate monitoring and a clear breach of fiduciary duties under Walton and Chou.

Either way, liability may attach. Multiple shareholder suits have been filed against Cummins.[16] So far, these claims have focused on the breaches of federal securities laws allegedly occasioned by the company's misstatements to investors.

However, a Caremark claim is very likely also available, given the above discussion and the fact that Caremark duties have been found to apply to Indiana corporations, like Cummins.[17]

And the Cummins situation is by no means an isolated one — far from it. Also in December 2023, a Washington state jury entered an $857 million verdict against Monsanto for torts related to PCB toxicity.[18]

Indeed, since 2000, companies in the U.S. have faced $130 billion in environmental penalties.[19] That entire sum represents corporate actions in violation of either state or federal environmental laws.

Undoubtedly, a large percentage of that illegal activity could trigger Caremark, stemming from, as it does, mission critical operations of environmentally exposed companies that constitute material legal violations.

As in Walton, Chou, and potentially Cummins, each instance of corporate trauma occasioned by one of these fines was plausibly either ignored or approved by fiduciaries. It seems that wherever a substantial penalty is leveled for illegal corporate misconduct, which evidently happens frequently in the environmental space, Caremark may have a role to play.

Upshot

Caremark claims can act as a serious deterrent to corporate environmental lawbreaking and empower shareholders to hold boards accountable for fiduciary breaches.

Given how well traditional environmental risks fit into the Marchand framework as clarified by Walton and Cai, shareholders in companies with significant exposure to environmental regulation should keep this powerful tool in mind when they seek to correct fiduciaries' misbehavior.

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[1] In re Caremark Int'l Inc. Deriv. Litig. , 698 A.2d 959 (Del. Ch. 1996).

[2] Stone v. Ritter , 911 A.2d 362 (2006)

[3] In In re McDonald's Corp. S'holder Derivative Litig. , 289 A.3d 343 (Del. Ch. 2023).

[4] Marchand v. Barnhill , 212 A.3d 805 (Del. 2019).

[5] Inter-Mktg. Grp. USA Inc. on Behalf of Plains All Am. Pipeline L.P. v. Armstrong , No. CV 2017-0030-TMR, 2020 WL 756965 (Del. Ch. Jan. 31, 2020).

[6] Id.

[7] Ontario Provincial Council of Carpenters' Pension Tr. Fund v. Walton , No. 2021-0827-JTL, 2023 WL 3093500 (Del. Ch. Apr. 26, 2023).

[8] Id. at *34

[9] C.A. No. 2022-1110-LWW (Del. Ch. Dec. 14, 2023).

[10] Id.

[11] Id.

[12] See, e.g., In re Boeing Co. Derivative Litig. , No. CV 2019-0907-MTZ, 2021 WL 4059934, at *24 (Del. Ch. Sept. 7, 2021) and In re Clovis Oncology, Inc. Derivative Litigation, C.A. No. 2017-0222-JRS, BL-248 (Aug. 10, 2021).

[13] United States and California Announce Diesel Engine Manufacturer Cummins Inc. Agrees to Pay a Record $1.675 Billion Civil Penalty in Vehicle Test Cheating Settlement, U.S. Dep't of Just., https://www.justice.gov/opa/pr/united-states-and-california-announce-diesel-engine-manufacturer-cummins-inc-agrees-pay.

[14] Teamsters Local 443 Health Services & Insurance Plan v. Chou , 2020 Del. Ch. LEXIS 274, at *69 (Del. Ch. Aug. 24, 2020).

[15] Id.

[16] Alex Brown, Cummins faces shareholder, customer lawsuits after $2B settlement, Inside Indiana Business (Feb. 19, 2024), https://www.insideindianabusiness.com/articles/cummins-faces-shareholder-and-customer-lawsuits-after-2b-settlement.

[17] In re ITT Derivative Litig. v. ITT Corp. , 923 N.E.2d 664, 669 (Ind. 2010).

[18] Jesus Jimenéz, Monsanto Should Pay $857 Million in PCB Case, Jury Finds, N.Y. Times (Dec. 18, 2023), https://www.nytimes.com/2023/12/18/business/monsanto-bayer-verdict-washington.html.

[19] Violation Tracker, Good Jobs First, https://violationtracker.goodjobsfirst.org/summary?offense_group_sum=environment-related+offenses.

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