ARTICLES

CAREMARK'S BEHAVIORAL LEGACY

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ABSTRACT

Caremark *is undoubtedly one of the most important decisions in corporate governance and compliance. The opinion's articulation of the standards for holding board members liable for failing to properly monitor the corporation is said to have transformed Delaware law. Exactly why that is, however, carries some mystery. The opinion, composed largely of dicta, held very little from a legal standpoint. Moreover, by coupling lofty prescriptions with a standard of review that ensured no director would actually be found liable, the opinion was destined to fall short of its goal to remake board oversight of compliance. Yet, when the opinion is analyzed through a behavioral lens, which this Symposium Article undertakes on the opinion's twenty-first anniversary, the mystery of* Caremark *becomes clearer—everything from its outsized impact to its underwhelming legacy. This analysis also highlights the opportunities that behavioral compliance strategies hold for creating truly effective efforts to lessen unethical and illegal acts in business. In the end, this may be* Caremark*'s true legacy, one that allows its lofty aspirations to take effect in a meaningful and lasting way.*

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INTRODUCTION

In re Caremark International Inc. Derivative Litigation[1] has always been somewhat of a mystery to me. If you are not familiar with *Caremark*, few cases loom larger in the realm of corporate governance.[2] The reason is that the opinion's articulation of the standards for holding board members liable for failing to properly monitor the corporation "transformed Delaware law" by significantly expanding the responsibilities of corporate directors.[3] Penned by legendary Delaware Chancery Court judge William T. Allen, *Caremark* is considered by some to be "the seminal modern case on directors' liability for failure to act."[4]

The case's impact on corporate compliance, what is at the core of corporate governance,[5] may be even greater. Many, including me, have acknowledged *Caremark*'s substantial role in expanding the compliance function in most companies.[6] By opening the door to director liability, particularly for companies failing to operationalize the Organizational Sentencing Guidelines' "effective compliance" provisions,[7] *Caremark* fueled a new era of corporate oversight and regulatory compliance at a time when it was sorely needed.[8]

But here is the mystery: despite its impact, the *Caremark* opinion did not

1. 698 A.2d 959 (Del. Ch. 1996).

2. *See, e.g.*, Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719, 719–20 (2007) (stating that the *Caremark* opinion "is destined to be one of the most prominent Delaware opinions of all time").

3. Jennifer Arlen, *The Story of* Allis-Chalmers*,* Caremark*, and* Stone*: Directors' Evolving Duty to Monitor*, *in* CORPORATE LAW STORIES 323, 325 (J. Mark Ramseyer ed., 2009).

4. DAVID EPSTEIN ET AL., BUSINESS STRUCTURES 224 (3d ed. 2010).

5. *See* Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2077 (2016) (explaining the new relationship between corporate governance and compliance).

6. *See, e.g.*, Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?*, 34 J. CORP. L. 679, 690 (2009) (discussing the impact of *Caremark* on the increase in compliance efforts); Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1215, 1229 (2017) [hereinafter Haugh, *Criminalization*] (arguing that *Caremark* acted as a catalyst for the era of compliance dominated by the U.S. Sentencing Guidelines, which have had the single largest impact on how companies approach their compliance function); Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 713–14 (2002) (discussing the impact of *Caremark* on the increase in compliance efforts). *But see* Mercer Bullard, Caremark*'s Irrelevance*, 10 BERKELEY BUS. L.J. 15, 16 (2013) (arguing that there are stronger determinants of compliance systems than potential *Caremark* liability).

7. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a)–(b) (U.S. SENTENCING COMM'N 2016).

8. Haugh, *Criminalization*, *supra* note 6, at 1228–29.

actually hold much from a legal perspective. And it certainly did not require directors to revamp their companies' corporate compliance programs. Chancellor Allen did not find the Caremark board liable for failing to stop the kickbacks at the heart of the criminal investigation of the company and the ensuing derivative litigation.[9] Nor did he find that the company's directors violated any actual duties.[10] In fact, Chancellor Allen explicitly stated at the opinion's outset that nothing even gave rise to an inference of a breach of any duty.[11] Moreover, it was not until ten years later that the Delaware Supreme Court expressly endorsed the "*Caremark* claim" it had created.[12] But even then it was clear that such a claim would be "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[13]

So how is it that an opinion without a substantive holding on the issue of corporate compliance, and one that offers an impossibly high bar shielding directors from liability for failing to implement an effective compliance program, remade how American companies actually *do* compliance? A simple answer may be through the power of judicial personality and the liberal use of dicta. But that does not fully explain why *Caremark* ushered in a new era of compliance, one that we still feel the effects of today.[14] While numerous legal and business academics and practitioners have commented on *Caremark*'s impact, few have looked at the question of why it has had an impact at all.[15]

In this Article, which comes on the heels of the *Caremark* opinion's twenty-first anniversary, I would like to explore the "why" of its impact through a

9. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971–72 (Del. Ch. 1996); *see also* Arlen, *supra* note 3, at 342–43.

10. *Caremark*, 698 A.2d at 967. This includes violations of the duty of care by failing to provide proper monitoring, oversight, or action to curb employee wrongdoing, the focus of the opinion. *See* Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 973–75 (2009) [hereinafter Bainbridge, *Enterprise*].

11. *Caremark*, 698 A.2d at 961.

12. Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) (holding that "*Caremark* articulate[d] the necessary conditions predicate for director oversight liability" but seating the obligation in the duty of loyalty, as opposed to the duty of care); *see also* Paul E. McGreal, *Corporate Compliance Survey*, 64 BUS. LAW. 253, 272 (2008) (explaining that since the decision, Chancellor Allen's pronouncements had "morphed" into a recognized cause of action in state and federal courts).

13. *Stone*, 911 A.2d at 372.

14. *See* Arlen, *supra* note 3, at 325 (relating Chancellor Allen's goals in writing the opinion based on first-hand interviews with the judge); Bainbridge, *Enterprise*, *supra* note 10, at 973 (describing Chancellor Allen's dicta as "a mini-treatise on the oversight responsibilities of boards of directors").

15. Two notable works hint at this analysis without addressing it directly. *See* Arlen, *supra* note 3, at 345–46 (suggesting *Caremark*'s effectiveness "depends heavily on its moral suasion"); Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 967 (2009) (stating that "lawyers and compliance providers responded to *Caremark* by expanding the level of services available to" directors). Only Donald C. Langevoort directly identified the issue. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 78 n.17 (stating that the "threat" of director liability is not severe, but "the *perception* of a threat increased considerably" after *Caremark* (citing Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 819–20 (2001) [hereinafter Langevoort, *Human Nature*])).

behavioral lens.[16] Drawing from the fields of behavioral economics and behavioral ethics, I suggest that there are a few key reasons why *Caremark*'s impact was so great despite its meager holding. After providing some background behavioral theory, I will explain how the opinion triggered powerful cognitive reactions in corporate directors driven by loss aversion and the overestimation of unlikely events. These behavioral phenomena help explain the significant influence of an opinion that just as easily could have been ignored by corporate America.

While that may be interesting in its own right, it more importantly offers a framework to consider *Caremark*'s legacy as to corporate compliance—one that is far-reaching, yet decidedly mixed. *Caremark*'s legacy, which has seen sustained criticism, stems from the opinion's discordant strands, which offer lofty intentions aimed at remaking board oversight of compliance coupled with a review mechanism that ultimately encourages compliance failures.[17] Although it may be too much to say, as others have, that *Caremark* has been "an empty triumph of form over substance," I accept as true that aspects of the opinion have undermined corporate compliance.[18] By doing so, I am free to explore what I see as the more interesting question: why have these shortcomings persisted? Again, I draw on behavioral concepts—those of framing effects and the status quo bias—for the answer. Given the harms caused by unethical and illegal acts in business, it is critical to understand any limitations to compliance efficacy that the opinion may be fostering.

Fortunately, these limitations need not persist forever. The same behavioral insights explaining *Caremark*'s outsized impact and underwhelming legacy can also provide an opportunity, possibly even a blueprint, for companies committed to achieving truly effective corporate compliance. By employing cutting edge behavioral compliance strategies, which focus primarily on assessing and mitigating behavioral risk, companies can take advantage of, rather than fall prey to, the powerful cognitive preconditions we all possess. Increasing ethical decisionmaking within the firm, even in small increments, will reduce employee wrongdoing and foster self-sustaining ethical cultures, the ultimate goal Chancellor Allen advanced more than twenty years ago.[19] Unraveling the mystery of *Caremark*, then, allows us to understand where corporate compliance came from, why it has developed as it has, and what its future may hold.[20]

16. In advancing these arguments, I am mindful of pronouncements made by Abraham H. Maslow and others, such as: "I suppose it is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail." ABRAHAM H. MASLOW, THE PSYCHOLOGY OF SCIENCE: A RECONNAISSANCE 15–16 (1966) (critiquing behaviorism in the field of psychology). While I do not see behavioral economics and behavioral ethics as the only "hammer" through which to deconstruct the *Caremark* case, or corporate compliance more generally, I do see it as a useful tool. It is, of course, only one of many in the legal analyst's toolkit.

17. *See* Charles M. Elson & Christopher J. Gyves, In re Caremark*: Good Intentions, Unintended Consequences*, 39 WAKE FOREST L. REV. 691, 691–92 (2004).

18. *Id.* at 692.

19. Arlen, *supra* note 3, at 325.

20. This Article draws inspiration from Ed Rock's seminal article on Delaware law. Edward B.

I. *CAREMARK*'S IMPACT ON CORPORATE COMPLIANCE

Much has been written on the *Caremark* opinion and its impact on corporate governance and compliance.[21] I will not add to that here, except to provide enough context for the critical point to come: the reason the case has had such a profound effect on compliance has more to do with what was in the heads of corporate directors than in the head of a Delaware Chancery Court judge.

A. The Caremark *Opinion*

The story of *Caremark* begins before *Caremark*. Until Chancellor Allen wrote his legendary opinion, the rule under Delaware law was that directors had no affirmative duty to oversee legal compliance at the corporation absent clear signs of employee wrongdoing.[22] This was established in *Graham v. Allis-Chalmers Manufacturing Co.*[23] In *Graham*, the Delaware Supreme Court rejected shareholder derivative claims against the Allis-Chalmers board for failing to install a compliance program to catch criminal price fixing by company executives.[24] The court found that the board was not on notice of the possibility of antitrust violations despite the company entering into two prior consent decrees with the Federal Trade Commission.[25] More broadly, the court found that "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."[26] *Graham* therefore held that there was no duty placed on corporate directors to preemptively install and monitor a corporate compliance program.[27] That straightforward holding stood for over thirty years.

Until *Caremark*. The background of the case can be quickly summarized. Caremark International was a healthcare company specializing in alternative-site care.[28] After a lengthy investigation by the Department of Justice, the company

Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1010 (1997) (addressing the "central mystery" of Delaware corporate law).

21. *See, e.g.*, Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008) [hereinafter Bainbridge et al., *Convergence*]; Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717 (2009).

22. Arlen, *supra* note 3, at 328–29.

23. 188 A.2d 125 (Del. 1963).

24. *Graham*, 188 A.2d at 129–30; *see also* Bainbridge et al., *Convergence*, *supra* note 21, at 576 (explaining why the Delaware Supreme Court dismissed the plaintiff's claim in *Graham*).

25. *Graham*, 188 A.2d at 129–30.

26. *Id.* at 130.

27. *Id.* (rejecting the plaintiff's claims that the board should have "put into effect a system of watchfulness"). As Professor Stephen Bainbridge and his co-authors point out, there are easily justified reasons, most specifically based on cost-benefit analysis, for limiting director liability to cases in which a prior violation was known. Bainbridge et al., *Convergence*, *supra* note 21, at 578. Professor Jennifer Arlen argues that the holding is a reflection of corporate attitudes at the time, i.e., compliance warranted little attention because it offered scant benefits—there were few criminal laws applicable to business and low fines in the event of liability. Arlen, *supra* note 3, at 329–30.

28. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 961 (Del. Ch. 1996). Alternative-

and two of its executives—but none of its board members—were indicted for paying illegal kickbacks to doctors for patient referrals.[29] Numerous shareholder derivative suits were filed alleging that Caremark's directors breached their duty of care by failing to supervise the offending executives, thereby exposing the company to criminal and civil liability.[30] The suits sought to recover damages from the individual board members.[31] Caremark eventually reached a settlement with the DOJ and a host of federal agencies; the company would plead guilty and pay approximately $250 million in civil penalties, but would be allowed to continue participating in federal programs.[32] An announcement of the settlement of the derivative claims soon followed, but it required Delaware Chancery Court approval before it could be finalized.[33] Chancellor Allen had the task of simply approving or disapproving the settlement.

We now know, of course, that he did much more than that. Based on interviews conducted by Professor Jennifer Arlen, it is clear that Chancellor Allen seized the opportunity created by the Chancery Court's settlement procedures to write a broad opinion addressing director oversight liability.[34] This was an opportunity he had long been awaiting; he believed that directors had "become overly passive, lulled into complacency by both Delaware's strong business judgment rule and a business norm favoring directorial non-interference with the CEO."[35] By Chancellor Allen's own rendering, he "took it upon himself to reform Delaware's law on directors' duty to monitor."[36]

To do so, however, he would have to deal with *Graham*. This created a problem because he had no authority to overturn a Delaware Supreme Court opinion. Instead, Chancellor Allen employed the extensive use of dicta to "author a mini-treatise" on oversight liability.[37] While he could not explicitly overrule *Graham*, he could sidestep it by "replac[ing] [its] relaxed approach" to director oversight with one that created a fiduciary obligation to ensure that a "legal compliance mechanism existed within the organization."[38] Chancellor

site care includes home intravenous therapies, HIV/AIDS care, women's health programs, and hemophilia care. *Id*.

29. Milt Freudenheim, *Company News; Caremark Is Indicted in Kickbacks*, N.Y. TIMES (Aug. 5, 1994), http://www.nytimes.com/1994/08/05/business/company-news-caremark-is-indicted-in-kickbacks.html?mcubz=3 [perma: http://perma.cc/SS73-JCUL]. The company was charged with violating the federal Anti-Referral Payments Law, which made it illegal for health providers to pay referral fees to doctors but allowed consulting payments and research grants. Bainbridge et al., *Convergence*, *supra* note 21, at 579.

30. *Caremark*, 698 A.2d at 964.

31. *Id.* at 961.

32. *Id.* at 960, 965. The most important of which were Medicare and Medicaid. *Id.* at 965.

33. *Id.* at 966; Bainbridge et al., *Convergence*, *supra* note 21, at 579–80.

34. Arlen, *supra* note 3, at 339 n.88 (citing conversations with Chancellor Allen in May 2008).

35. *Id.* at 339. A full reading of Arlen's article is essential in understanding the context underlying the *Caremark* opinion.

36. *Id.* at 331 ("Moreover, he assumed this responsibility even though neither of the parties to the dispute asked him to do so.").

37. Bainbridge, *Enterprise*, *supra* note 10, at 973.

38. Elson & Gyves, *supra* note 17, at 699.

Allen explained this newly formulated obligation as follows:

> [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 non-compliance with applicable legal standards.[39]

Thus, *Graham* notwithstanding, directors would be obligated to ensure their company instituted an adequate compliance program regardless of prior knowledge of employee wrongdoing.[40] Indeed, Chancellor Allen suggested that any rational board member attempting to fulfill his or her governance responsibilities in good faith must do so.[41] The opinion drew special attention to complying with the Organizational Sentencing Guidelines (Guidelines), which had been introduced five years prior and had set forth the importance of an effective corporate compliance program.[42]

Despite the "lofty, aspirational standard" *Caremark* set for board oversight of compliance, Chancellor Allen was more pragmatic when it came to allowing enforcement of that standard through derivative litigation.[43] He stated that

> where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* or in this case, in my opinion only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.[44]

He went on to say what was likely already clear—that "[s]uch a test of liability . . . is quite high."[45] Because Chancellor Allen found no evidence that the Caremark directors failed in their oversight duties—indeed, he believed the company's information systems represented a "good faith attempt to be informed" and the plaintiffs' claims were "extremely weak"—he approved the settlement.[46]

But the actual holding of the opinion was beside the point. Through his

39. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (footnote omitted).

40. Elson & Gyves, *supra* note 17, at 700.

41. *Id.* Chancellor Allen situated this obligation of good faith within the duty of care. *Caremark*, 698 A.2d at 971. For a more complete discussion of the ramifications of the duty of care on corporate governance and fiduciary law, see Sale, *supra* note 2, at 721–30, which explains how *Stone* reoriented the good faith conduct obligation of fiduciaries within the duty of loyalty.

42. *Caremark*, 698 A.2d at 969 (referencing the Guidelines' "powerful incentives for corporations . . . to have in place compliance programs to detect violations of law"); *see also* U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (U.S. SENTENCING COMM'N 1991) (reducing a company's culpability score if it maintained an effective compliance program).

43. *See* Elson & Gyves, *supra* note 17, at 700–01 (noting *Caremark*'s "[l]ofty aspirations, but minimal expectations").

44. *Caremark*, 698 A.2d at 971.

45. *Id.*

46. *Id.* at 971–72.

"doctrinally innovative" approach, Chancellor Allen had effectively overruled *Graham*.[47] When read together, the two passages set off above drastically expanded directors' oversight liability, while at the same time establishing a narrow legal mechanism to review directors' actions, both in contravention of longstanding Delaware Supreme Court precedent.[48] But, not until a decade later in *Stone v. Ritter*[49] did Delaware's highest court affirmatively endorse *Caremark*'s rationale.[50] Even then, however, the court made clear just how difficult it would be to hold directors liable under a *Caremark* claim.[51] Plaintiffs would have to show that "directors knew that they were not discharging their fiduciary obligations," which was close to a legal impossibility when directors were not involved in any underlying illegality.[52]

B. Caremark*'s Impact on Corporate Compliance*

So what was the effect of *Caremark*, an opinion filled almost entirely with dicta, drafted to "readily sidestep seemingly inconvenient" precedent?[53] At least as to corporate compliance, the effect was just as Chancellor Allen had hoped—immediate and far-reaching. Without revealing too much of the analysis to come, what *Caremark* did was to increase the perceived risk that companies, and their directors, would be found liable for failing to institute corporate compliance programs. This perception superheated the burgeoning compliance movement.

To be sure, the Organizational Sentencing Guidelines, which were promulgated in 1991 and then amended in 2004, had already begun increasing compliance efforts by U.S. companies.[54] The Guidelines codified the minimum criteria necessary for companies to have an "effective" compliance program and offered reductions in fines for convicted companies if such a program was in place at the time of the violation.[55] Companies now had specific guidance from a

47. Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 48 (2015).

48. Arlen, *supra* note 3, at 340–41.

49. 911 A.2d 362 (Del. 1996).

50. *Stone*, 911 A.2d at 362; Arlen, *supra* note 3, at 342–43. Many legal academics who are interested in *Caremark* focus on where its duty of oversight was and should be situated within a corporation. If directors' failure to gather and report relevant information is a breach of the duty of good faith, as Chancellor Allen suggests it is, should that be a standalone duty, or does it fall under a larger duty of care? *Stone* answered that question, albeit unexpectedly, by situating good faith under the duty of loyalty. *See* Claire A. Hill & Brett H. McDonnell, Essay, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1777 (2007). While this debate is interesting, it is not the focus here.

51. *See Stone*, 911 A.2d at 369 (holding that liability occurs "where the fiduciary intentionally acts with a purpose other 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" (quoting *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006))).

52. *Id.* at 370.

53. Cheffins, *supra* note 47, at 48.

54. *See* Haugh, *Criminalization*, *supra* note 6, at 1128.

55. Although the original version of the Guidelines vaguely stated that effective compliance was

government agency as to what they could do to mitigate the expansive liability inherent in a respondeat superior legal regime.[56] But more important than penalty reductions, the Guidelines changed companies' view of corporate compliance—it was no longer just industry or regulation specific, but was now "a broad issue for organizations generally worthy of substantial attention."[57] By following the Guidelines' criteria, companies could lessen legal and regulatory risk across all business segments and as to all potential employee violations.[58]

Caremark fueled the compliance increase by suggesting that directors may be violating their oversight duties if they fail to adopt compliance programs consistent with the Guidelines. In theory, every company—and every director—was now on the hook for implementing a Guidelines-based compliance program. Even though the language of the opinion made the potential for liability exceedingly low, *Caremark* "helped keep corporate compliance programs on corporate boards' agendas."[59]

Industry groups, lawyers, and compliance providers responded to this newly

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key to reducing organizational culpability, later amendments set forth the "hallmarks" of an effective compliance and ethics program. *See* Philip A. Wellner, Note, *Effective Compliance Programs and Corporate Criminal Prosecutions*, 27 CARDOZO L. REV. 497, 500–02, 505 (2005). Effective compliance is judged on the following criteria:

1. Standards and procedures to prevent and detect criminal conduct
2. Responsibility at all levels of the program, together with adequate program resources and authority for its managers
3. Due diligence in hiring and assigning personnel to positions with substantial authority
4. Communicating standards and procedures, including a specific requirement for training at all levels
5. Monitoring, auditing, and non-retaliatory internal guidance/reporting systems, including periodic evaluation of program effectiveness
6. Promotion and enforcement of compliance and ethical conduct, and
7. Taking reasonable steps to respond appropriately and prevent further misconduct upon detecting a violation.

See U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(b) (U.S. SENTENCING COMM'N 2004); *see also* Wellner, *supra*, at 500–01 n.11.

56. *See* Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1570–74 (1990) (discussing the history of corporate criminal liability based on the doctrine of respondeat superior).

57. Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 AM. BUS. L.J. 203, 212 (2016); *see also* Ford & Hess, *supra* note 6, at 690 (suggesting that the Organizational Guidelines "pushed compliance programs out of the defense industry, beyond limited issues such as antitrust and the FCPA, and into the mainstream").

58. *See* Haugh, *Criminalization*, *supra* note 6, at 1228–29.

59. David Hess, *Ethical Infrastructure and Evidence-Based Corporate Compliance and Ethics Programs: Policy Implications from the Empirical Evidence*, 12 N.Y.U. J.L. & BUS. 317, 329 (2016). *Caremark* also kept corporate compliance on the regulators' agendas. In 1999, the DOJ issued its first internal memorandum memorializing its best practices regarding corporate prosecutions. This document, and its many successors, is distributed to all U.S. Attorney's Offices and incorporated into the U.S. Attorney's Manual. *See* Baer, *supra* note 15, at 968–72 (discussing the Holder and other memoranda and their impact on corporate compliance); *see also* Bullard, *supra* note 6, at 16–17 (arguing threat of agency enforcement actions impacted the design and operation of corporate compliance programs much more than *Caremark* opinion).

understood risk. The National Association of Corporate Directors (NACD), which supports directors in their corporate governance and compliance efforts, was established partially in response to *Caremark*.[60] Compliance practitioners, some already providing corporate governance and audit services to major companies, expanded their offerings to help create effective compliance programs.[61] "The result was dramatic, ... a substantial increase in the size and scope of corporate compliance activities and ultimately the creation of vast compliance bureaucracies within the organization."[62]

The numbers bear this out. A survey of almost 300 companies conducted in 1996, the year the *Caremark* opinion was issued, found that the vast majority spent $500,000 or less on compliance annually.[63] Today, things are quite different. A 2011 study found that multinational companies spent on average approximately $3.5 million a year on compliance-related activities, a fivefold increase.[64] Another study found that for companies with more than $1 billion in revenue, total compliance costs now equal that of 190 full-time employees.[65] Siemens A.G. reportedly spent more than $1 billion solely related to the government's inquiry into the company's payment of foreign bribes.[66] Much of the increasing compliance budget goes to staff, who are hired to oversee the growing compliance landscape. For example, JPMorgan has hired 8,000 compliance and control personnel since the financial crisis;[67] HSBC added

60. Elson & Gyves, *supra* note 17, at 702–03 (describing NACD's Best Practices Counsel, which was created to help boards prevent fraud and illegal acts by employees); *About NACD*, NAT'L ASS'N CORP. DIRS., http://www.nacdonline.org/AboutUs/?navItemNumber=556 [perma: http://perma.cc/63N7-PCF7] (last visited May 20, 2018).

61. *See* Baer, *supra* note 15, at 967 (citing Rebecca Walker, *Board Oversight of a Corporate Compliance Program: The Implications of* Stone v. Ritter, 1661 PLI/CORP. 67, 69 (2008)); Elson & Gyves, *supra* note 16, at 701.

62. Elson & Gyves, *supra* note 17, at 701; *see also* Cheffins, *supra* note 47, at 47 ("Practitioners in turn relied on Chancellor Allen's judgment to urge boards of public companies to upgrade substantially existing internal reporting and compliance programs. A sizable increase in the size and scope of reporting and compliance systems reputedly followed." (footnote omitted)).

63. JED S. RAKOFF & JONATHAN S. SACK, FEDERAL CORPORATE SENTENCING: COMPLIANCE AND MITIGATION § 5.01[2] (1st ed. Supp. 2012). A third of the companies were on the *Fortune 500* list. *Id.*

64. When adjusted for inflation. *See* PONEMON INST., THE TRUE COST OF COMPLIANCE: A BENCHMARK STUDY OF MULTINATIONAL ORGANIZATIONS 7 fig.3 (2011), http://www.ponemon.org/local/upload/file/True_Cost_of_Compliance_Report_copy.pdf [perma: http://perma.cc/2NX3-S3V2].

65. RICHARD M. STEINBERG, OPENPAGES, THE HIGH COST OF NON-COMPLIANCE: REAPING THE REWARDS OF AN EFFECTIVE COMPLIANCE PROGRAM 3 (2010), http://www.securityexecutivecouncil.com/common/download.html?PROD=238 [perma: http://perma.cc/H4CW-EB8F]. Other studies have found the costs associated with compliance to be almost $10,000 per employee. *See* Robert Bird & Stephen Park, *An Efficient Investment-Risk Model of Compliance*, COLUM. L. SCH.: CLS BLUE SKY BLOG (Nov. 30, 2016), http://clsbluesky.law.columbia.edu/2016/11/30/an-efficient-investment-risk-model-of-corporate-compliance/ [perma: http://perma.cc/R4S5-JM97].

66. Peter J. Henning, *The Mounting Costs of Internal Investigations*, N.Y. TIMES: DEALBOOK (Mar. 5, 2012, 11:07 AM), http://dealbook.nytimes.com/2012/03/05/the-mounting-costs-of-internal-investigations/?_r=0 [perma: http://perma.cc/5WBH-9EGE].

67. Anthony Effinger, *The Rise of the Compliance Guru—And Banker Ire*, BLOOMBERG MARKETS (June 25, 2015, 6:00 AM), http://www.bloomberg.com/news/features/2015-06-

1,600.[68] Some large companies in highly regulated industries hire "hundreds, even thousands, of compliance officers at a time."[69] The compliance industry *Caremark* helped create is now a $30 billion industry and growing.[70]

C. *The Behavioral Reasons Why* Caremark *Remade Corporate Compliance*

While *Caremark*'s impact on corporate compliance is apparent, the question remains as to why. Both the "largely advisory" nature of the opinion[71] and the extremely narrow path it allowed for derivative liability meant that "[r]ational directors ha[d] little reason to fear."[72] In fact, considering the actual holding of the case, corporate boards should have given it no more than a passing read, and maybe even ignored it altogether.[73] This is the mystery of *Caremark*—why was it not simply ignored?

While there are undoubtedly a number of reasons, I would like to offer an explanation grounded in behavioral science, specifically the concepts of loss aversion and the overestimation of unlikely events. But to fully understand how these phenomena led to *Caremark*'s impact, it is necessary to start with what is at the heart of much of behavioral economics and behavioral ethics research: the groundbreaking work of behavioral psychologists Daniel Kahneman and Amos Tversky.

Kahneman and Tversky, whose collaboration ran some forty years, found that individuals possess both intuitive and reasoning cognitive processes.[74] The intuitive, or "System 1," process is "fast, automatic, effortless, associative, and often emotionally charged."[75] Because it operates by associative memory, it is "governed by habit, and [is] therefore difficult to control or modify."[76] This system of thinking, sometimes called the "Automatic System," may not seem like thinking at all.[77] That is because a lot happens through System 1 all at once. The mind offers associations rapidly, one idea being evoked after another, all linked

25/compliance-is-now-calling-the-shots-and-bankers-are-bristling [perma: http://perma.cc/FQQ8-LDAQ].

68. Gregory J. Millman & Samuel Rubenfeld, *Compliance Officer: Dream Career?*, WALL ST. J. (Jan. 15, 2014, 8:13 PM), http://www.wsj.com/articles/SB10001424052702303330204579250722114538750 [perma: http://perma.cc/C4HH-HATT].

69. Griffith, *supra* note 5, at 2077.

70. *See* Effinger, *supra* note 67; Dov Seidman, *Why Companies Shouldn't 'Do' Compliance*, FORBES (May 4, 2012, 11:30 AM), http://www.forbes.com/sites/dovseidman/2012/05/04/why-ceos-shouldnt-do-compliance/ [perma: http://perma.cc/4EHT-ZPGN].

71. Arlen, *supra* note 3, at 21.

72. Bullard, *supra* note 6, at 26.

73. *See* Griffith, *supra* note 5, at 2111, n.166 ("In retrospect, *Caremark* probably never deserved the attention it received . . . .").

74. Daniel Kahneman, *Maps of Bounded Rationality: Psychology for Behavioral Economics*, 93 AM. ECON. REV. 1449, 1451 (2003) [hereinafter Kahneman, *Bounded Rationality*].

75. *Id.*

76. *Id.*

77. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 19 (2008).

effortlessly.[78]

In contrast, the reasoning, or "System 2," process operates much more slowly and carefully.[79] It is "serial, effortful, and deliberately controlled," subject to logic and rules.[80] System 2 thinking, also referred to as the "Reflective System," is engaged when we use thought in an organized manner—for example, when we solve a complex math problem, write a paragraph, or contemplate pros and cons of a tough decision.[81] Not surprisingly, System 2 thinking requires significantly more cognitive load than System 1.[82] In fact, a person using his System 2 process at "full tilt" can only do so for a very short time.[83] The effort is worth it, of course, because System 2 is how we thoughtfully deal with new tasks when there are no easy associations to make.[84] It is the type of thinking that gives us the "experience of agency, autonomy, and volition."[85] The features of each thinking system are shown in Table 1.[86]

TABLE 1: DUAL MODES OF THINKING

System 1—Automatic Thinking	System 2—Reflective Thinking
Associative	Deductive
Effortless	Effortful
Uncontrolled	Controlled
Fast	Slow
Emotional	Rule-Following
Subconscious	Self-Aware
Low cognitive load	High cognitive load

This is not to say that System 2 is better than its counterpart; both modes of thinking have a role to play. Because System 1 thinking is effortless and efficient, it is suitable for making the vast majority of our routine daily decisions. But for

78. DANIEL KAHNEMAN, THINKING, FAST AND SLOW 52 (2011) [hereinafter KAHNEMAN, THINKING]. Kahneman suggests that the capabilities of System 1 include "innate skills that we share with other animals," such as to perceive the world we live in, recognize objects, orient our attention, avoid losses, and fear things that may hurt us. *Id.* at 21–22.

79. *See* Cass R. Sunstein, *Do People Like Nudges?*, 68 ADMIN. L. REV. 177, 205 (2016).

80. Kahneman, *Bounded Rationality*, *supra* note 74, at 1451.

81. *See* THALER & SUNSTEIN, *supra* note 77, at 19–20.

82. *See* Sunstein, *supra* note 79, at 205.

83. KAHNEMAN, THINKING, *supra* note 78, at 31. If this sounds surprising, try the Add-1 game: at a steady rhythm, flip over a card with a four-digit number on it, and then state the number in which each of the four digits is increased by 1 (5294 would become 6305). As Kahneman's studies show, this brings participants to the limits of the cognitive abilities within a few seconds and "[f]ew people can cope with more than four digits." *Id.* at 31–32.

84. *Id.* at 36–37.

85. Pelle Guldborg Hansen & Andreas Maaløe Jespersen, *Nudge and the Manipulation of Choice: A Framework for the Responsible Use of the Nudge Approach to Behaviour Change in Public Policy*, 4 EUR. J. RISK REG. 3, 13 (2013).

86. *See id.* at 13 tbl.4.1.

more important decisions System 2 thinking is required to ensure a thoughtful, and likely more accurate, outcome. The problem is that because of the greater cognitive load required to employ System 2, it is often supplanted by the less effortful System 1. While we ideally want System 2 to operate as a watchful monitor, kicking in when important mental tasks arise, the reality is that System 1 is dominant and pervasive—the unconscious system controls a majority of human decisionmaking.[87]

One of the major insights that comes from dual system thinking theory is that reference is critical to decisionmaking. Because System 1 operates very quickly through association, we often evaluate choices based on change, not on objective values.[88] Although this is counter to traditional notions of rational decisionmaking, especially those advanced by classical economic theory, change is what matters when making decisions.[89] And changes are tied to reference points.[90] Additionally, if evaluations occur based on referential change, the distance an outcome seems from a reference point matters greatly. Put another way, we have "diminished sensitivity" when evaluating potential outcomes as they move away from a reference.[91] Kahneman and Tversky labeled these ideas "prospect theory," and they help explain how we make uncertain decisions, or those "under risk."[92]

One of prospect theory's main tenets is loss aversion. Loss aversion is the tendency of people to value losses more heavily than gains of the same magnitude.[93] In more direct terms, "[p]eople hate losses."[94] We tend to feel twice

87. Kahneman, *Bounded Rationality*, *supra* note 74, at 1467. Jonathon Haidt has used the image of a person riding on an elephant to explain the relationship between System 1 and 2 thinking. The rider is System 2, which tries to steer the more powerful System 1 elephant under him, often unsuccessfully. *See* JONATHAN HAIDT, THE HAPPINESS HYPOTHESIS: FINDING MODERN TRUTH IN ANCIENT WISDOM 16–17 (2006).

88. *See* KAHNEMAN, THINKING, *supra* note 78, at 281–82.

89. *See* RICHARD H. THALER, MISBEHAVING: THE MAKING OF BEHAVIORAL ECONOMICS 30–31 (2015). As Thaler puts it, changes are what "make us happy or miserable." He uses the following example to illustrate the point: If you are in an office building with well-functioning temperature control, you probably feel like your office is "room temperature." But if you leave your office to go to a conference room, how will you react? If it is the same temperature as your office, you will not give it a thought; you only notice if its "room temperature" is hot or cold relative to your office. *Id.*

90. Kahneman also referred to evaluation against a neutral reference point as an "adaptation level." KAHNEMAN, THINKING, *supra* note 78, at 282.

91. *Id.*

92. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 307 (1979); *see also* Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV. 1115, 1117, 1118 n.21 (2003). According to prospect theory, people make decisions under risk in four ways: (1) they evaluate decision options relative to a reference point, usually the status quo; (2) their risk preferences tend to reverse when facing decision outcomes with low-probability gains and losses; (3) they tend to value losses more heavily than gains of the same magnitude; and (4) they tend to overvalue certainty. Guthrie, *supra*, at 1118–19. Prospect theory has had such a profound impact on law and economics because it calls into question expected utility theory, which, up until Kahneman and Tversky, served as the "generally accepted . . . normative model of rational choice and widely applied as a descriptive model of economic behavior." Kahneman & Tversky, *supra*, at 263 (citation omitted).

93. Kahneman & Tversky, *supra* note 92, at 279. Or, as Kahneman puts it, when directly

as miserable losing something as gaining the same thing would make us happy.[95] Because we are always judging against a reference point, the negative change hurts more than a corresponding positive change feels good.[96] Kahneman suggests that this asymmetry has an evolutionary explanation: organisms that treat threats more urgently than opportunities have a better chance of survival.[97]

The concept of loss aversion has important consequences for all types of decisionmaking. Consider the gambling game experiment, in which participants are asked whether they will gamble on a coin toss. If the coin lands on tails, they lose $100; if it lands on heads, they win $150.[98] An objective analysis suggests that everyone should play the game because the expected value of the gamble is positive—the player stands to gain more than lose. But it turns out that most people will not play unless the potential gain is higher. They want a payoff closer to $200—nearly double what they might lose—before they will agree to flip the coin.[99]

This tendency does not make a lot of sense based on rational decisionmaking, but it makes perfect sense when incorporating dual system thinking and reference points. What is happening is that the participants are evaluating the gamble according to reference-based potential changes in wealth. As Kahneman puts it, "The rejection of this gamble is an act of System 2, but the critical inputs are emotional responses that are generated by System 1. For most people, the fear of losing $100 is more intense than the hope of gaining $150."[100] Moreover, as the prospective loss amounts are altered, say from $100 to $2,000, people's loss aversion increases. That would track what many of us would expect, but this does not—the increase is nonlinear. The nonlinearity occurs because of the "diminish[ed] sensitivity" that comes when evaluating potential outcomes as they move away from a reference point.[101] Figure 1 shows a graph of the psychological value of gains and losses, which is central to prospect theory and loss aversion.[102]

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compared against each other, "losses loom larger than gains." KAHNEMAN, THINKING, *supra* note 78, at 282.

94. THALER & SUNSTEIN, *supra* note 77, at 33.

95. *Id.*; Chip Heath et al., *Goals as Reference Points*, 38 COGNITIVE PSYCHOL. 79, 87 (1999).

96. THALER, *supra* note 89, at 31; *see also* Colin F. Camerer & Howard Kunreuther, *Decision Processes for Low Probability Events: Policy Implications*, 8 J. POL'Y ANALYSIS & MGMT. 565, 574 (1989).

97. KAHNEMAN, THINKING, *supra* note 78, at 282. They have a better chance at more than mere survival, but rather fecundity, or survival to procreate. *Id.*

98. *Id.* at 283.

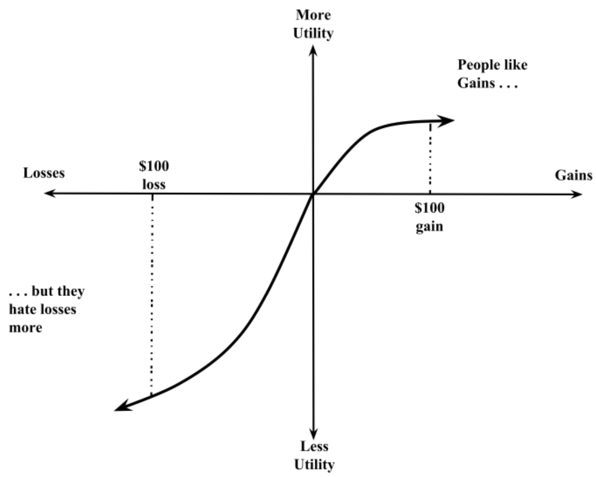
99. *Id.* at 294; *see also* THALER & SUNSTEIN, *supra* note 77, at 34.

100. KAHNEMAN, THINKING, *supra* note 78, at 284.

101. *Id.* at 282–84.

102. THALER, *supra* note 89, at 31, 31 fig.3. Note that the graph is S-shaped, which shows that outcomes better than the reference point (the center of the graph) are seen as gains; outcomes below the reference point are losses. The graph's shape also shows that there is diminished sensitivity to gains and losses as the outcome moves away from the reference point (utility increases or decreases at a slower rate). Finally, the slope of the graph changes abruptly at the reference point, showing that responses to losses are stronger than to corresponding gains. KAHNEMAN, THINKING, *supra* note 78, at

FIGURE 1



With that background, it becomes much clearer why *Caremark* has had such an impact on corporate America. As explained above, the opinion held very little. Given the procedural posture of the case and Chancellor Allen's expansive use of dicta, *Caremark* did not overrule *Graham*, which for over thirty years had imposed no liability on directors for failing to institute preemptive corporate compliance. At best, *Caremark* signaled that the Delaware courts' view of director oversight liability might be evolving; but that was far from certain, and in any event, that did not happen until ten years later in *Stone*.[103] Even then, the bar remained so high that "an outside director ha[d] more chance of being hit by lightning than being found liable" for a *Caremark* claim.[104]

Yet directors made aware of the *Caremark* opinion (likely by corporate counsel, more on that below) were not judging the probabilities of liability to them or their companies in a purely objective manner. Once liability is even on the table as a possibility, deciding whether to institute a compliance program that would guard against it becomes like the gambling game, a game subject to prospect theory and the effects of loss aversion. And what behavoiral theory tells us is that directors would feel potential losses from derivative liability much more than corresponding gains.[105] So, any scenario by which the company may

282–83.

103. Arlen, *supra* note 3, at 21–23.

104. Hill & McDonnell, *supra* note 50, at 1772 n.15 (commenting specifically on director liability after the Delaware legislature enacted Section 102(b)(7) which allows corporations to alter their certificates of incorporation to waive personal liability of directors for fiduciary duty violations); *see also* DEL. CODE. ANN. tit. 8, § 102(b)(7) (West 2018). Even Chancellor Allen stated that "in light of the discovery record . . . there [was] a very low probability that it would [have] be[en] determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise." *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 961 (Del. Ch. 1996).

105. *See* KAHNEMAN, THINKING, *supra* note 78, at 284.

have to pay money to an outsider would sting more than gaining it otherwise through normal business practices would feel good.[106] This includes a loss paid to a plaintiff pursuant to a *Caremark* claim.[107]

Of course, that aversion to loss would be even more pronounced for corporate directors. After all, a director's decision of whether to implement or enhance a compliance program concerns not just liability for the company, but personal liability.[108] Yet the costs of operating the program are borne only by the company. By way of example, companies at the time of *Caremark* were typically spending $500,000 or less per year on compliance.[109] But the plaintiffs in the *Caremark* case alleged that the board's oversight failures caused the company to incur losses of roughly $275 million.[110] That would be individual personal liability for the thirteen board members of over $20 million each.[111]

While director and officer indemnity agreements and insurance would limit actual liability,[112] any potential personal loss amount is significant from a behavioral standpoint.[113] That feeling is particularly true for nonwealthy directors who face a much lower wealth reference point.[114] Moreover, even if financial loss is not likely for directors, there remains the loss of reputation, time, and control—all of which prolonged derivative litigation brings.[115] Thus, directors facing the threat of personal loss can easily make the decision to revamp a compliance program so it conforms to the Guidelines, even if unnecessary from a legal standpoint to protect the corporation.[116]

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106. THALER, *supra* note 89, at 34.

107. One could argue that the additional cost of creating a more robust compliance program is also a loss subject to prospect theory. While that is true, the costs of non-compliance are much higher. One report estimated the average cost to firms of compliance failures to be $9.4 million—almost three times yearly compliance costs. PONEMON INST., *supra* note 64, at 2. Moreover, it is likely that losses sustained by the company in a lawsuit would loom larger than similar losses spent by the company internally.

108. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (discussing the standard under which to find a director personally liable).

109. RAKOFF & SACK, *supra* note 63, § 5.01[2].

110. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 964 n.8 (Del. Ch. 1996).

111. *See id.* at 961 n.1.

112. *See* Daniel Hemel & Dorothy Shapiro Lund, *It May Not Matter What the Weinstein Company Knew*, ATLANTIC (Oct. 14, 2017), http://www.theatlantic.com/business/archive/2017/10/harvey-weinstein-company-legal-consequences/542838/ [perma: http://perma.cc/P2EL-28EP] ("[It is] standard practice for Delaware companies to indemnify directors against negligence liability, and directors and officers usually have their own insurance that protects from exposure for other types of claims.").

113. *See* THALER, *supra* note 89, at 31.

114. *See id.* (demonstrating that peoples' perception to a loss of their status quo is quite acute).

115. *See* Langevoort, *Human Nature*, *supra* note 15, at 823 ("[W]hat drives director responsiveness to legal interventions is not so much the threat of an adverse judgment as the threat of being subjected to prolonged litigation."); *see also, e.g.*, Hemel & Lund, *supra* note 112 (arguing that the financial impact of a judgment on wealthy directors may be minimal, "though the reputational consequences could be severe").

116. Langevoort discusses this phenomenon in the context of fear. *See* Langevoort, *Human Nature*, *supra* note 15, at 823.

There is another aspect of loss aversion that helps explain *Caremark*'s impact. Boards considering whether to institute or substantially increase the scope of their compliance programs would have sought the advice of their legal team. Any general or outside counsel, especially those advising large companies, would have been knowledgeable about the precedential force of dicta (or the lack thereof) and the practical limits of liability as set forth in the *Caremark* opinion. Accordingly, corporate lawyers at the time should have steered directors toward an optimal decision based on objective legal analysis, thus countering the potential effects of loss aversion.[117] But that does not seem to have happened.

Professor Donald Langevoort suggests that corporate lawyers may themselves have been subject to loss aversion. Langevoort argues that lawyers may actually "reinforce an inflated view of legal risk," thereby increasing loss aversion in directors.[118] The mechanism by which this happens is intriguing. According to Langevoort, lawyers face an "asymmetric reputational dilemma" if their advice turns out to be incorrect, which leads them to systematically overemphasize the possibility of loss.[119]

> If the [lawyer's] advice is overprecautionary, so that all the client's losses are largely in the form of foregone opportunities, there is little likelihood of sanction. But if the advice is more aggressive, so that the client is sued and faces liability, the [lawyer's] reputational impact can be severe, even if there was a rational, calculated risk. This leads to a natural bias toward overstatement of risks to clients.[120]

This is another way of describing loss aversion—how it is reinforced for directors, but also how it is operating on their counsel. By overstating the legal risk the *Caremark* opinion posed, and advocating for (or at least acquiescing to) more compliance measures, a corporate attorney may have been guarding against his or her own loss of reputation. Overprecaution "pays" more than objective legal advice because the attorney's potential loss looms larger than a concomitant gain. Langevoort calls this the "[l]awyer's [b]ias," and he questions whether corporate counsel might be "habitually amplify[ing] what may be muted and ambiguous signals from courts, legislatures, and administrative agencies."[121] If one accepts the characterization of the *Caremark* holding as "muted" and its impact on compliance as "amplif[ied],"[122] the narrative Langevoort offers is compelling.

Loss aversion has been called "the single most powerful tool" of behavioral economics, and it does much of the work in explaining *Caremark*'s impact on

117. *See id.* at 823–24.

118. *Id.*

119. *Id.* at 824.

120. *Id.* Langevoort offers an additional behavioral-driven concern that "there is often both a pecuniary and a status-based reason to be dramatic: The more perceptible the legal risk, the more the lawyer's services are needed and the more important role she will play in the events." *Id.*

121. *Id.* at 823–24.

122. *Id.* at 824.

compliance.[123] But there is a second, related phenomenon at play—the overestimation of low-probability events. Because this also flows from prospect theory, we need to consider a bit more of Kahneman and Tversky's research before turning to its application.

The ideas underlying the overestimation of low-probability events can be understood by returning to Figure 1.[124] As gains and losses get farther away from the reference point at the center of the graph, the judged value of those gains or losses increases at a slower rate.[125] The graph shows our diminishing sensitivity to changes in value as it moves away from a reference.[126] The concept is another core tenet of prospect theory, and it explains why we tend to overweight low probability events. If we are asked to determine the probability of an unknown outcome, we have two obvious reference points: certainty and impossibility.[127] As we near one of these two points, we become more sensitive to change (the curve gets steeper)—for example, a change from zero to one percent is seen as more significant than a change from thirty-two to thirty-three percent, because the change makes the impossible possible versus being just another nominal increase.[128]

Accordingly, when asked to consider probabilities, people tend to overweight events that are unlikely to happen—those events that fall closer to the "impossibility" reference point.[129] This outlook might seem counterintuitive, but it makes sense in light of dual-system thinking at the core of prospect theory. Because impossibility is a stronger reference under System 1 thinking, it exerts a stronger pull than it otherwise should. This overweighting is made worse when the unlikely event being considered is vivid or has happened recently. We may "know" an event has a low probability of occurring through our System 2 thinking, but System 1's associative process makes sure the event has a disproportionate impact upon us, causing us to misjudge the probability of its occurrence.[130]

123. THALER, *supra* note 89, at 34; *see also* Andrei Shleifer, *Psychologists at the Gate: A Review of Daniel Kahneman's* Thinking, Fast and Slow, 50 J. ECON. LITERATURE 1080, 1087 (2012) (book review).

124. See *supra* note 102 and accompanying text for an explanation of Figure 1.

125. KAHNEMAN, THINKING, *supra* note 78, at 283; THALER, *supra* note 89, at 31. In Figure 1, notice that the rise or slope of the curve tapers off as it moves away from the reference point. See *supra* note 98 and accompanying text for an explanation of Figure 1.

126. KAHNEMAN, THINKING, *supra* note 78, at 283.

127. Zach Burns et al., *Overweighting of Small Probabilities*, *in* WILEY ENCYCLOPEDIA OF OPERATIONS RESEARCH AND MANAGEMENT SCIENCE 1, 1 (James J. Cochran ed., 2010).

128. *Id.* at 5. In prospect theory, the value of each outcome is multiplied by a decision weight, which is "inferred from choices between prospects." Kahneman & Tversky, *supra* note 92, at 280. Algebraically, the decision weights of "both $\pi(.01) - \pi(0)$ and $\pi(1) - \pi(.99)$ are larger than $\pi(.33) - \pi(.32)$." Burns et al., *supra* note 127, at 5.

129. Of course, that also means we tend to believe things are more certain than they are. While this seems to be incongruous with the overweighting of low probability events, it makes sense if one focuses on the impact of the two reference points. Burns et al., *supra* note 127, at 5.

130. KAHNEMAN, THINKING, *supra* note 78, at 323 ("Overweighting of unlikely outcomes is rooted in System 1 features . . . . Emotion and vividness influence fluency, availability, and judgments

The overweighting of low-probability events has been shown in numerous studies. For example, when asked, most people prefer a definite prize of a one-week tour of England over a fifty percent chance at winning an objectively better three-week tour of England, France, and Italy.[131] That outcome would seem to make sense given the probabilities—a sure thing versus a fifty-fifty chance of winning something better. Yet, when the same people are asked whether they would prefer a five percent chance to win the three-week tour or a ten percent chance at the one-week tour, they choose the three-week tour—the better trip, but the one with a lower probability of actually winning.[132] They become more risk seeking when faced with a low-probability event. In other words, they are overweighting the probability of attaining the better outcome.[133] This reasoning is likely exacerbated by the automatic thinking system, which conjures up a host of vivid images of a wonderful three-week European vacation, crowding out a thoughtful evaluation of the objective probabilities of winning it compared to what is now seen as a "lesser" one-week trip in England.[134]

The overweighting of low-probability events was almost assuredly operating in regard to *Caremark*'s impact on compliance. Everything points to the risk of personal directorial liability being exceedingly low. The legal improbability of a successful *Caremark* claim has been discussed, but the same is true for derivative litigation more generally. According to the "seminal empirical study" of shareholder derivative suits, such litigation is rare.[135] Only nineteen percent of the companies in the study's sample experienced a shareholder suit.[136] And the frequency of litigation averaged out to just one shareholder suit every forty-eight years.[137] When there is litigation, the plaintiffs typically lose, both at trial and through settlement—only half the settled suits end in recovery for the plaintiffs, averaging just $6 million.[138] Nonmonetary relief is usually "inconsequential in

of probability—and thus account for our excessive response to the few rare events that we do not ignore.").

131. Guthrie, *supra* note 92, at 1119; Kahneman & Tversky, *supra* note 92, at 280.

132. Guthrie, *supra* note 92, at 1119.

133. *Id.* at 1124.

134. *See* Shleifer, *supra* note 123, at 1087. The same mechanisms are at work when people attach excessive weights to "highly unlikely but extreme events: they pay too much for lottery tickets, overpay for flight insurance at the airport, or fret about accidents at nuclear power plants." *Id.* Affect-rich events—those that are dramatic, fear-inducing, or catastrophic—are likely to be overweighed to a larger extent than rare events that are affect-poor in nature. Burns et al., *supra* note 127, at 6. *But see* Christoph Ungemach et al., *Are Probabilities Overweighted or Underweighted when Rare Outcomes Are Experienced (Rarely)?*, 20 PSYCHOL. SCI. 473, 473 (2009) (finding underweighting of low-probability events based on paired choices).

135. Stephen Bainbridge, *Is There a Case for Abolishing Derivative Litigation?*, PROFESSORBAINBRIDGE.COM (Oct. 3, 2017, 7:07 AM), http://www.professorbainbridge.com/professorbainbridgecom/2017/10/is-there-a-case-for-abolishing-derivative-litigation.html [perma: http://perma.cc/F9HG-BV4W] [hereinafter Bainbridge, *Abolishing*] (citing Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991)).

136. Romano, *supra* note 135, at 59.

137. *Id.*

138. Bainbridge, *Abolishing*, *supra* note 135.

nature."[139]

The same low probabilities are true for the type of governmental intervention in companies that give rise to a *Caremark* claim. In the ten years between *Caremark* and *Stone*, there were 2,365 federal criminal convictions of organizations under the Guidelines.[140] That is an average of just 215 convictions per year.[141] In addition, the DOJ granted approximately sixty-two deferred and nonprosecution agreements, which are also dependent on the Guidelines' application, to corporate offenders during that same time, an average of six per year.[142] That is a total of just 221 dispositions per year. While dispositions do not equal interventions, even assuming triple the number, a *Caremark*-like intervention is an extremely low-probability event for individual companies.[143] Behavioral theory tells us, however, that such a low probability is exactly why directors would systematically overweight the chances of a federal intervention occurring.

Moreover, this tendency to overweight was likely influenced by the events of the day. The promulgation of the Guidelines in 1991, the *Caremark* opinion in 1996, and a series of high-profile corporate scandals in the early 2000s made the probability of government intervention, and follow-on private lawsuits, seem greater than it otherwise was. Some of the most well-known corporate scandals—Enron, WorldCom, Tyco, and HealthSouth—occurred within a very compressed timeframe.[144] Although the public is less surprised by this level of

139. *Id.*

140. *See Sourcebook Archives*, U.S. SENT'G COMMISSION, http://www.ussc.gov/research/sourcebook/archive [perma: http://perma.cc/J4TP-TVYY] (providing for the period from 1996 to 2006). Data collected by the Transactional Records Access Clearinghouse (TRAC) shows slightly different yearly numbers, but the average is almost the same. *See* TRAC, *Justice Department Data Reveal 29 Percent Drop in Criminal Prosecutions of Corporations*, TRAC REP. (Oct. 13, 2015), http://trac.syr.edu/tracreports/crim/406/ [perma: http://perma.cc/ZHW9-KPZT] (displaying average of 216 corporate convictions per year from 1996 to 2006).

141. *See Sourcebook Archives*, *supra* note 140.

142. *2017 Mid-Year Update on Corporate Non-Prosecution Agreements (NPAs) and Deferred Prosecution Agreements (DPAs)*, GIBSON DUNN (July 11, 2017), http://www.gibsondunn.com/publications/Pages/2017-Mid-Year-Update-Corporate-NPA-and-DPA.aspx [perma: http://perma.cc/SDQ8-5GSA]. Gibson Dunn only has records going back until 2000. *See id.* However, the use of DPAs and NPAs was exceedingly rare prior to 2000. From 2000 to 2002, only seven DPAs and NPAs were granted, an average of a little more than two per year. Thus, the number of additional agreements from 1996 until 2000 is likely to be negligible. This is consistent with reports that the DOJ devised the wider use of DPAs and NPAs for corporate crime only after the Enron and Author Anderson prosecutions in 2002. *See* BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS 55 (2014).

143. Although we do not know how many investigations there were of corporations around that time, we do have a sense of how many criminal referrals were made. Between 2010 and 2014, approximately 10,000 referrals were made to the DOJ from numerous agencies. *See* TRAC, *supra* note 140. Almost the same number of referrals were made between 2004 and 2008. *See id.* Assuming the averages were the same between 1996 and 2006, approximately 2,000 referrals were filed per year (many of which would not have risen to the level of even an investigation), which is an exceedingly small number when compared to the more than 5 million corporations and 2 million partnerships in the U.S. around the same time. *See id.*

144. *Our Take on the 10 Biggest Frauds in Recent U.S. History*, FORBES,

corporate wrongdoing today, let us recall just how big these scandals were at the time. When it collapsed, Enron was valued at approximately $70 billion and employed upwards of 20,000 people;[145] WorldCom was valued at $107 billion and was the United States' second largest long-distance telephone company.[146] By the end of 2002, the two had become the first- and second-largest bankruptcies in U.S. history.[147] These scandals were the primary drivers behind the Sarbanes-Oxley Act becoming law and helped to usher in a new era of corporate compliance.[148]

This was the environment in which directors were judging the probability of their companies' liability—and their own—under *Caremark*, an environment that seemed particularly hostile to corporate wrongdoing and inactive boards. That there were so many vivid and available negative events likely amplified the overweighting of the probability of their own liability.[149] Couple this with the loss aversion operating on directors and the mystery of *Caremark*'s impact begins to make sense. While corporate directors maybe should have ignored the opinion and the false risk it created, that would have been almost impossible—requiring directors to ignore the powerful behavioral mechanisms operating on their decisionmaking.

II. *CAREMARK*'S LEGACY AS TO CORPORATE COMPLIANCE

The preceding Section offers a behavioral explanation for *Caremark*'s impact on corporate compliance. While that may be of some interest, it more importantly offers a framework through which to consider the character of that impact—the opinion's legacy as to compliance. On that score, the results are mixed. Without wading too far into the debate, I will assume that the central critique levied against the *Caremark* opinion has validity; that is, by coupling "lofty intentions" with a difficult-to-meet liability standard,[150] Chancellor Allen rewarded the creation of "paper program[s]" that were aimed more at protecting directors than eliminating corporate wrongdoing.[151] Accepting the critique as

http://www.forbes.com/pictures/ghde45fli/our-take-on-the-10-bigge/#5e81a1e37e50 [perma: http://perma.cc/Z8TF-G2J9] (last visited May 20, 2018).

145. *The Enron Scandal by the Numbers*, USA TODAY, http://usatoday30.usatoday.com/money/energy/2002-01-22-enron-numbers.htm [perma: http://perma.cc/9ZF4-NDPA] (last updated Jan. 21, 2002, 10:47 PM); *The Fall of Enron*, NPR, http://www.npr.org/news/specials/enron/ [perma: http://perma.cc/HV98-D3SZ] (last visited May 20, 2018).

146. Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES (July 22, 2002), http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html [perma: http://perma.cc/FL89-WK5J].

147. *See id.*

148. Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 357–59 (2003).

149. *See* Burns et al., *supra* note 127, at 2–3 (describing the "availability heuristic," one of the three causes of overestimation of unlikely events).

150. Elson & Gyves, *supra* note 17, at 691–92.

151. Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 941 (2017) [hereinafter Langevoort, *Cultures*] (stating that the "commentary of the time" suggested skepticism of

valid allows for the exploration of what I see as the more interesting question: why have these conditions persisted, thereby limiting compliance effectiveness and tainting *Caremark*'s legacy? Again, while there are certainly numerous answers, I will offer two resting on behavioral science: the status quo bias and framing effects.

A. Caremark*'s Mixed Corporate Compliance Legacy*

Before turning to the behavioral explanations, it is helpful to clarify the main critique levied against the *Caremark* opinion.[152] Professor Charles Elson and attorney Christopher Gyves offer it most directly. They contend that Chancellor Allen's dual-track approach—providing an aspirational standard governing directors' roles in monitoring and compliance, but allowing liability to attach only if there are sustained and systemic failures—caused "a doctrinal and practical dilemma" for corporate directors.[153] In essence, boards were confused regarding their obligations; *Caremark* told them they had to do more regarding compliance, but not exactly what or how much.[154] Without clear guidance, directors defaulted to concerns about their own personal liability, and "the goal became liability avoidance rather than the prevention of corporate misconduct."[155] As a result, compliance increased in size and scope, but its focus was to create a record that would insulate against liability in the event of judicial review.[156] Although Chancellor Allen may have been correct that "directors generally want to satisfy their legal duties,"[157] Elson and Gyves's analysis suggests that directors have found very narrow ways in which to do so.[158]

If the motivation for creating additional compliance functions in a

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compliance program quality).

152. Here, I am talking about the critiques related to the long-term effects of the opinion on corporate compliance practices, not doctrinal critiques related to business and fiduciary law. See *supra* note 50 for an explanation of where *Caremark* analyses tend to focus.

153. Elson & Gyves, *supra* note 17, at 700–01.

154. *Id.* The Guidelines, which *Caremark* specifically mentioned, are not of particular help here because they do not define precisely what is an effective compliance program. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a)–(b) (U.S. SENTENCING COMM'N 1991) (providing only minimal standards for promoting an organizational culture that encourages ethical conduct). Various government agencies have provided additional guidance. *See, e.g.*, U.S. DEP'T OF JUSTICE CRIMINAL DIV. FRAUD SECTION, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS (2017), http://www.justice.gov/criminal-fraud/page/file/937501/download [perma: http://perma.cc/SUK8-GFD2]; U.S. SEC. & EXCH. COMM'N, EXCH. ACT RELEASE NO. 44969, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 AND COMMISSION STATEMENT ON THE RELATIONSHIP OF COOPERATION TO AGENCY ENFORCEMENT DECISIONS (Oct. 23, 2001), http://www.sec.gov/litigation/investreport/34-44969.htm [perma: http://perma.cc/YYG7-ETSZ]. But the main source of guidance comes from compliance providers. *See* Baer, *supra* note 15, at 993 ("[B]y declining to define effectiveness in detail, the government's open-ended compliance mandate creates the need for a private compliance industry that performs both gap-filling and signaling functions for putative corporate defendants.").

155. *See* Elson & Gyves, *supra* note 17, at 701.

156. *Id.*

157. Arlen, *supra* note 3, at 20.

158. *See* Elson & Gyves, *supra* note 17, at 701–02.

corporation is primarily aimed at limiting director liability, the impact of compliance on employee behavior becomes a secondary concern. This leads to a host of problematic outcomes. One is that boards become passive once they achieve the desired level of liability avoidance.[159] They cease compliance innovation, increasing the risk that their company will fail to detect employee wrongdoing.[160] Elson and Gyves suggest this passivity is to blame for some corporate scandals in which companies had robust compliance programs that were simply no good in practice.[161] A related, albeit more cynical, concern is that boards will view compliance programs as a type of insurance purchased to shift liability from the company and its senior executives onto lower-level employees.[162] Boards will only purchase the minimum amount of insurance necessary to avoid liability, which also limits compliance effectiveness.[163] Such approaches "encourage the adoption of paper programs" that are aimed at procedurally limiting liability but are unconcerned with actually preventing compliance failures.[164]

These critiques have some empirical support. For example, Professor Kimberly Krawiec argues that "a growing body of evidence indicates that internal compliance structures do not deter prohibited conduct within firms."[165] After reviewing studies regarding the efficacy of codes of conduct, Guidelines-based compliance programs, and diversity training, she finds little support for their inclusion as a central feature of negotiated governance.[166] This leads her to suggest that compliance programs may only serve as "window-dressing" to maintain market legitimacy and reduce legal liability.[167] As Elson and Gyves might put it, the compliance approach fostered by *Caremark* is "an empty triumph of form over substance."[168]

Even assuming all of this is true, however, it does not fully explain *Caremark*'s mixed legacy. Although the opinion may have initially fostered a compliance approach myopically focused on limiting director liability, it is

159. *See id.* at 702.

160. *See id.*

161. *Id.* (mentioning specifically Enron, Tyco, WorldCom, and Adelphia, all of which had compliance systems).

162. *See* William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1402–03 (1999).

163. David Hess, *Ethical Infrastructures and Evidence-Based Corporate Compliance and Ethics Programs: Policy Implications from the Empirical Evidence*, 12 N.Y.U. J. L & BUS. 317, 333–34 (2016).

164. *Id.* at 334.

165. Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 491 (2003) [hereinafter Krawiec, *Cosmetic Compliance*]; *see also* Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571, 572, 591–97 (2005) [hereinafter Krawiec, *Organizational Misconduct*].

166. *See* Krawiec, *Cosmetic Compliance*, *supra* note 165, at 510–15, 542.

167. *Id.* at 491. *But see* Baer, *supra* note 15, at 996–97 (questioning the assumptions on which Krawiec bases her arguments); Langevoort, *Cultures*, *supra* note 151, at 941 (suggesting practitioners believe compliance efforts decrease wrongdoing, but the "data to know for sure one way or the other [are] lacking").

168. Elson & Gyves, *supra* note 17, at 692.

unclear why that would still be the case. Our understanding of compliance and its benefits has evolved quite a bit in the past twenty years. For example, we know that companies with positive ethical cultures—those whose employees perceive the company as having integrity—are more successful.[169] Those companies have greater productivity and profitability, better industry relations, and attract a higher level of prospective job applicants.[170] We also know that the way to create positive culture is not strictly through the command-and-control compliance approach suggested by the Guidelines.[171] In fact, an exclusively criminal law-driven approach is most likely counterproductive, potentially undermining compliance goals and the "insurance" directors believe they have purchased.[172] Yet these approaches persist, weakening compliance effectiveness and *Caremark*'s legacy.

Maybe the reason for this is as simple as incentives. It could be that there are no real incentives for directors to consider and apply new compliance approaches, even if more effective, because they are insulated from personal liability either way by a paper program.[173] Why authorize the company to expend more resources when doing so does not benefit the directors personally and may actually hurt them by harming profitability? But this argument fails to adequately address the competing incentives created by the economic gains that result from ethics and compliance initiatives. If the research is correct that building an ethical culture, which would be a substantive compliance improvement, begets financial gain, then rational directors would attempt to foster such an ethical culture, either by redesigning compliance programs or layering innovative culture-building initiatives over traditional Guidelines-based measures. This would preserve the liability avoidance function discussed above

169. Luigi Guiso, Paola Sapienza & Luigi Zingales, The Value of Corporate Culture 3 (Sept. 2013) (unpublished manuscript), http://www.law.northwestern.edu/research-faculty/searlecenter/events/roundtable/documents/Sapienza_Corporate_Culture.pdf [perma: http://perma.cc/B7K7-T59H].

170. *Id.* ("These effects are also economically relevant: a one standard deviation increase in integrity is associated with a 0.19 standard deviation increase in Tobin's Q, [and] a 0.09 standard deviation increase in profitability . . . ."); *see also* LINDA KLEBE TREVIÑO & KATHERINE A. NELSON, MANAGING BUSINESS ETHICS: STRAIGHT TALK ABOUT HOW TO DO IT RIGHT (5th ed. 2011) (providing a book-length examination of the evidence showing that good ethics is good business); Marc Orlitzky & John D. Benjamin, *Corporate Social Performance and Firm Risk: A Meta-Analytic Review*, 40 BUS. & SOC'Y 369, 388 (2001) (integrative empirical study supporting the argument that firms with higher levels of social responsibility, which includes corporate culture, have lower levels of financial risk).

171. *See, e.g.*, Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV., Mar.–Apr. 1994, at 106, 106 (discussing rules-based compliance grounded in deterrence theory and its limitations); Linda Klebe Treviño et al., *Managing Ethics and Legal Compliance: What Works and What Hurts*, CAL. MGMT. REV., Winter 1999, at 131, 135 (explaining the first large-scale study testing and finding support for Paine's hypothesis); Tom Tyler et al., *The Ethical Commitment to Compliance: Building Value-Based Cultures*, CAL. MGMT. REV., Winter 2008, at 31, 33 (demonstrating that procedural fairness is critical in promoting employee commitment and compliance); *see also* Langevoort, *Cultures*, *supra* note 151, at 944–49 (providing an extensive analysis of cultures of compliance and non-compliance).

172. *See* Haugh, *Criminalization*, *supra* note 6, at 1266–67.

173. *See* Elson & Gyves, *supra* note 17, at 692.

while also increasing firm performance, all of which benefits directors, especially those with an equity stake in the company.[174]

B. The Behavioral Reasons for Caremark*'s Limited Legacy*

If it is not traditional incentives, or if that does not fully explain *Caremark*'s underwhelming legacy, perhaps behavioral science can provide insight. One concept that would seem to apply is the status quo bias—the common tendency people have to stick with their current situation rather than change it.[175] Essentially, we allow inertia to determine our decisions.[176]

Much of the status quo bias comes from the now familiar concept of loss aversion.[177] Because existing structures and definitions define our reference points, any changes to them are felt primarily as losses.[178] The asymmetry of feelings around those losses—that they weigh more than comparable gains—means we tend to view change negatively.[179] This creates a "powerful conservative force" that favors minimal change in many aspects of our lives.[180]

There is also a strong System 1 component to the status quo bias. Sometimes called the "yeah, whatever heuristic," we tend to let inertia rule our decisionmaking because it takes effort to effect change.[181] That effort often requires System 2 thinking, which is easily taxed, so we let System 1 operate mindlessly.[182] This means we have difficulty altering the status quo, especially when there are clear defaults available.[183]

There are many examples of people falling prey to the status quo bias, but one of the best is 401(k) enrollments. It turns out that enrolling in a 401(k) plan is an obstacle for many Americans; roughly thirty percent of eligible employees do not enroll and therefore do not save as much as they could for retirement.[184]

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174. *See id.* at 702–03 (discussing NACD's proposal, issued shortly after *Caremark*, that suggested using broad-based equity ownership throughout the organization as a compliance measure). Not to mention, the additional gains that would come from further reducing the costs of compliance failures are substantial. *See* PONEMON INST., *supra* note 64, at 2. For example, Wells Fargo has reported that its fake accounts scandal, a compliance failure if there ever was one, has already cost the company $1 billion in litigation costs alone, and the total is likely to rise to $3.3 billion. Sue Reisinger, *Wells Fargo Picks New Compliance Officer from Barclays amid $1 Billion in Litigation Costs*, CORP. COUNSEL, http://www.law.com/corpcounsel/sites/corpcounsel/2017/10/16/101617wellsfargo/?slreturn=20180321015710 [perma: http://perma.cc/35PM-EFLZ] (last updated Oct. 19, 2017, 11:59 AM).

175. THALER & SUNSTEIN, *supra* note 77, at 34.

176. *Id.*

177. *See id.*

178. KAHNEMAN, THINKING, *supra* note 78, 304.

179. *Id.*

180. *Id.* at 305. Thaler links the status quo bias caused by loss aversion directly to the endowment effect, which is the tendency of people to overvalue items simply because they are in their possession. THALER, *supra* note 89, at 154. This causes people to want to "stick with what they have," even if it would be objectively better for them to change. *Id.*

181. THALER & SUNSTEIN, *supra* note 77, at 35.

182. *See* Sunstein, *supra* note 79, at 205–06.

183. THALER & SUNSTEIN, *supra* note 77, at 35.

184. *Id.* at 103, 106–07. Eligible employees fail to enroll or delay enrolling for a host of reasons,

Studies conducted by behavioral economists found that by simply changing the default enrollment provisions of 401(k) plans from "opt in," in which employees have to fill out forms and make investment choices to begin saving, to "opt out," in which employees are automatically enrolled but can elect to stop saving, enrollment rates increased to ninety-eight percent.[185]

This small change had such a dramatic effect because the vast majority of employees use their System 1 thinking when confronted with the enrollment decision. They react to the prospect of opting in, which requires significant thought about future retirement needs and complex investments, by ignoring the decision or delaying it. Even those that may have considered enrolling are faced with the prospect of "losing" the money they had earned to a savings plan. Switching to an opt-out enrollment regime—flipping the default—structured the choice in a way that overcame loss aversion by using the inertia caused by System 1 thinking. Now, the automatic system actually helps employees save; in fact, a System 2 override would now be required to *not* save for retirement.[186]

A second, related behavioral concept is framing. By now, framing is a relatively well-understood idea—that how we describe things impacts their perceived value.[187] But framing of risks is what really interests behavioral economists, and according to the research, when people must decide whether to accept an uncertain prospect—one with risk—they are heavily influenced by the frame in which that decision is made.[188] Framing a decision as one that may cause loss means it will be chosen less than if the same decision was framed as causing a type of gain, as keeping something, or as just a routine cost.[189]

A good example of this is described in Professors Richard Thaler and Cass Sunstein's book, *Nudge: Improving Decisions About Health, Wealth, and Happiness*. If you were suffering from a serious health condition and trying to determine whether you would agree to a treatment, your doctor might say, "Of one hundred patients who have this condition, ninety are alive in five years."[190] That would make you feel pretty good about the odds, and you would likely move forward with the treatment.[191] But, if the doctor said, "Of one hundred patients who have this condition, ten are dead after five years," you likely would

although contributing offers significant tax benefits and matching employer funds. *Id.*

185. *Id.* at 109.

186. *See id.* at 34–35.

187. The most readily understood type of framing is called "attribute framing," which is when a product or option is described using a positive or negative attribute label. *See* Chris Janiszewski et al., *Different Scales for Different Frames: The Role of Subjective Scales and Experience in Explaining Attribute-Framing Effects*, 30 J. CONSUMER RES. 311, 312 (2003). As an example, an advertiser might describe ground beef as comprising twenty-five percent fat or as being seventy-five percent lean; consumers prefer the latter. *Id.* (citing Irwin P. Levin & Gary J. Gaeth, *How Consumers Are Affected by the Framing of Attribute Information Before and After Consuming the Product*, 15 J. CONSUMER RES. 385 (1988)).

188. *See* KAHNEMAN, THINKING, *supra* note 78, 364.

189. *See id.* at 364–66.

190. *See* THALER & SUNSTEIN, *supra* note 77, at 36–37 (describing framing effects and providing numerous examples).

191. *See id.* at 36.

not.[192] It is the same objective information, so a rational decisionmaker should not be influenced differently. Yet you are because framing the decision around death creates a negative reference, which the automatic system judges the decision against.[193]

The status quo bias and framing effects seem to be operating in the compliance sphere, and they may explain the persistence of compliance practices that have tarnished *Caremark*'s legacy. Imagine you are a director of a large company that was "shocked" into instituting or remaking your compliance program a number of years ago based on Chancellor Allen's opinion.[194] But because of *Caremark*'s failure to provide specifics regarding your compliance oversight obligations, you have defaulted to a "check the box" compliance program that will shield you from liability but will not significantly eliminate wrongdoing in the company. And, in fact, there has been a steady drip of compliance failures over the years, costing your company millions of dollars in internal investigations, monitorships, and civil settlements, not to mention losses in productivity and employee morale.[195] All the while, some of your industry competitors have had meaningful ethics and compliance programs and are seeing higher profitability, more engaged employees, and maybe increasing market share. So why has your company not evolved on compliance? Why have you not pushed for change?

The answer is that every move from the status quo, even ones that will result in positive long-term gain, goes against our natural cognitive tendencies. It takes a significant amount of planning and execution to revamp a legacy compliance program. That is a decidedly System 2 process.[196] Yet System 1 is dominant, and it does not handle those types of decisions well. It prefers the default, and here the default is not so bad for the decisionmaker because she has insulated herself from the loss of personal liability.[197] Indeed, advocating for change if other board members do not agree could cause a reputational loss.[198] In a situation like this, where the switching costs are high and the default creates problems that might only be realized in the future, it is exceedingly difficult for a "mindless chooser" to seek out and effect change.[199]

192. *See id.*

193. *Id.* Kahneman puts this more directly: "Choices are not reality-bound because System 1 is not reality-bound." KAHNEMAN, THINKING, *supra* note 78, at 364. This nonrationality applies to the experts too. Even doctors are more likely to recommend a treatment when told that ninety patients will live versus ten will die. *See* THALER & SUNSTEIN, *supra* note 77, at 36; *see also* Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 457 (1981) (demonstrating effects on decisionmaking based on framing of acts, contingencies, and outcomes).

194. Arlen, *supra* note 3, at 23–24.

195. Guiso, Sapienza & Zingales, *supra* note 169, at 3.

196. KAHNEMAN, THINKING, *supra* note 78, at 36–37.

197. *See* THALER & SUNSTEIN, *supra* note 77, at 36.

198. *See* Langevoort, *Human Nature*, *supra* note 15, at 823.

199. THALER & SUNSTEIN, *supra* note 77, at 35. This also implicates the behavioral concept of discounting the future, which is the tendency to view consequences that will occur tomorrow as more compelling that those that will occur a year from now. Rooted in prospect theory, discounting the

This problem is made worse if the director was involved in the original creation of the compliance program. Any discussion of a change to the program is now a negotiation between the creators and the innovators.[200] But the creators have a more compelling psychological stake in the outcome because they are predisposed to see change as loss.[201] Their reference point is the status quo, and altering it is a "painful concession[]" demanded of them.[202] They are now in a loss frame even though changes to the compliance program would make the company economically better off in the long term. While it may seem silly for individuals to view changes in programs or systems as losses, almost anything that we own, create, or view as ours, even for a short time, causes an "endowment effect" that is powerful and sometimes difficult to overcome.[203]

Unfortunately, despite its lofty intentions, *Caremark*'s mixed legacy was in many ways cemented from the start. By creating an approach to compliance that rewarded form over substance, the opinion set the default. The status quo bias and loss framing then acted as the "gravitational force" making it difficult for even well-intentioned boards to change their compliance approach.[204]

III. HOW COMPANIES CAN REIMAGINE CORPORATE COMPLIANCE

Admittedly, the above discussion paints a somewhat dire picture for corporate compliance. It appears that *Caremark*'s approach has led boards to widely adopt compliance programs yet structure them in a way that destines their lack of effectiveness. To make matters worse, our cognitive predispositions tend to reinforce that ineffectiveness because our dominant mode of decisionmaking operates "by habit, and [is] therefore difficult to control or modify."[205] In other words, we have a fundamental problem in compliance that may be difficult to fix because it is rooted in how directors—those tasked with overseeing compliance efforts—think.

Although the problems facing compliance are real, they are not insurmountable. In fact, the very cognitive processes that have limited compliance effectiveness can be used to remake it. By focusing on behavioral compliance strategies, the use of behavioral insights to enhance ethicality in organizations, we can harness our understanding of decisionmaking to improve corporate governance and compliance—focusing less on traditional command-and-control tools suggested by the Guidelines and more on affecting the

future "partly explains the decaying urban infrastructure, the U.S. budget deficit, the collapse of fisheries, global warming, and environmental destruction." David M. Messick & Max H. Bazerman, *Ethical Leadership and the Psychology of Decision Making*, SLOAN MGMT. REV., Winter 1996, at 9, 11.

200. *See* KAHNEMAN, THINKING, *supra* note 78, at 304–05 (describing loss aversion and the bias in favor of the status quo it creates as "an ever-present feature of negotiations").

201. *Id.*

202. *Id.*

203. *See* THALER, *supra* note 89, at 154 (discussing the endowment effect and its relation to loss aversion).

204. KAHNEMAN, THINKING, *supra* note 78, at 305.

205. Kahneman, *Bounded Rationality*, *supra* note 74, at 1451.

behavior of board members, managers, and employees. Below, I offer a few straightforward and cost-effective steps that companies can take to begin this process. While none of these steps alone will entirely change director decisionmaking or remake a company's compliance regime, collectively they offer a path to reimagining compliance in the spirit of *Caremark*.

A. *Educating as to Behavioral Compliance*

The first step is to raise awareness of both the cognitive pitfalls and opportunities inherent in corporate compliance. Although dual-system thinking, prospect theory, loss aversion, and other aspects of behavioral psychology have been known for decades, the application of the behavioral sciences to corporate governance and compliance is in its infancy.[206]

Partly this is due to the well-known divide between academia and business.[207] Even ideas from behavioral economics, which have obvious implications for all aspects of business, have not been widely adopted by corporate America.[208] The issue, I think, is primarily one of lack of understanding. Most decisionmakers within companies, and certainly at the director level, simply have not been exposed in any real way to behavioral science and how it can explain decisionmaking under risk. This is especially true in the compliance space, which has been dominated by lawyers, usually former regulators, with a relatively narrow legal focus.[209] Although lack of understanding of behavioral science is changing as behavioral tools become more mainstream, directors and senior executives overseeing compliance are unlikely to possess this expertise.[210]

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206. As a distinct field of study, behavioral ethics, which is a subset of business ethics, has been around less than a generation. *See* Marshall Schminke & Manuela Priesemuth, *Behavioral Business Ethics: Taking Context Seriously*, *in* BEHAVIORAL BUSINESS ETHICS: SHAPING AN EMERGING FIELD 47, 72 (David De Cremer & Ann E. Tenbrunsel eds., 2012). Behavioral economics has a longer history, but its application to compliance has been considered for an equally short time. *See* Yuval Feldman, *Behavioral Ethics Meets Behavioral Law and Economics*, *in* THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW 213, 213 (Eyal Zamir & Doron Teichman eds., 2014).

207. *See, e.g.*, Mark Thoma, *A Great Divide Holds Back the Relevance of Economists*, REUTERS (July 26, 2011), http://blogs.reuters.com/great-debate/2011/07/26/a-great-divide-holds-back-the-relevance-of-economists/ [perma: http://perma.cc/9RAA-UG8J].

208. Michael Blanding, *The Business of Behavioral Economics*, FORBES (Aug. 11, 2014, 1:26 PM), http://www.forbes.com/sites/hbsworkingknowledge/2014/08/11/the-business-of-behavioral-economics/#3408d7175a6e [perma: http://perma.cc/TUP8-JZN3] (reporting that relatively few companies have attempted to use behavioral economics to try to change their employees' behavior).

209. *See* Haugh, *Criminalization*, *supra* note 6, at 1247 (discussing compliance professionals, many of whom are former regulators, "fall[ing] back on their training and expertise as lawyers and investigators, treating compliance as a problem that can be solved with the familiar tools of the criminal law"); Effinger, *supra* note 67 (reporting that a chief compliance and ethics officer said, "Most of us tend to be auditors or attorneys").

210. The profile of behavioral economics and its application to public policy was greatly enhanced with Richard Thaler's recent receipt of the Nobel Prize in Economic Sciences. *See* Gemma Tetlow, *Richard Thaler Wins Nobel Prize in Economics*, FIN. TIMES (Oct. 9, 2017), http://www.ft.com/content/aa08d810-acd8-11e7-aab9-abaa44b1e130 [perma: http://perma.cc/2Z3D-YN6D].

Companies, then, should start by educating themselves. The best way to do that is to hire a behavioral specialist or develop one in-house to stay abreast of the various behavioral insights from divergent fields—behavioral ethics, behavioral economics, moral psychology, criminology, and so forth. All these disciplines approach the topic of organizational decisionmaking and compliance in slightly different ways, which are not always compatible.[211] A company's behavioral specialist should be able to organize, interpret, and distribute the various insights to the entire organization, educating its members on key takeaways from current research. For the compliance team and human resources staff, this likely entails deep dives into the latest empirical studies.[212] For board members and senior executives, a less labor-intensive approach is to read a curated list of popular books on decisionmaking and dishonesty authored by serious researchers.[213] Lower-level employees might benefit most from roundtable discussions of behavioral case studies specific to their work.[214] Regardless of how the information is delivered, a company's behavioral specialist should create a "behavioral compliance curriculum" that gives all members of an organization insight into their decisionmaking process.[215] This curriculum serves as the backbone of a behaviorally cognizant compliance program by awakening System 2 thinking about how decisionmaking occurs.

B. Employing Behavioral Compliance Best Practices

At the same time, a behavioral specialist should be more than just a resource for education. The real power of behavioral science is not in its theory, but in its application. To create a compliance program that takes advantage of behavioral insights instead of falling prey to them, companies must adopt behavioral compliance best practices. These practices should be targeted at the behavioral "obstacles" that prevent wanted behaviors.[216] The key here is to start small and measure results. Once a behavioral compliance practice demonstrates a positive impact, it can be measured and refined, and then expanded if warranted.[217]

211. *See* Todd Haugh, *Nudging Corporate Compliance*, 54 AM. BUS. L.J. 683, 709–10 (2017) (identifying the different focus of behavioral economics and behavioral ethics and the implications for corporate compliance); Feldman, *supra* note 206, at 213, 222.

212. *See, e.g.*, David De Cremer & Ann E. Tenbrunsel, *On Understanding the Need for a Behavioral Business Ethics Approach*, *in* BEHAVIORAL BUSINESS ETHICS: SHAPING AN EMERGING FIELD, *supra* note 206, at 3, 3–10.

213. *See, e.g.*, DAN ARIELY, THE (HONEST) TRUTH ABOUT DISHONESTY: HOW WE LIE TO EVERYONE–ESPECIALLY OURSELVES (2012); FRANCESCA GINO, SIDETRACKED: WHY OUR DECISIONS GET DERAILED, AND HOW WE CAN STICK TO THE PLAN (2013); KAHNEMAN, THINKING, *supra* note 78; THALER, *supra* note 89; THALER & SUNSTEIN, *supra* note 77.

214. *See, e.g.*, EUGENE SOLTES, HARVARD BUS. SCH., CASE NO. 110-045, A LETTER FROM PRISON (2009).

215. Timothy J. Lindon, *Crediting the Behavioral Approach*, N.Y.U.: COMPLIANCE & ENFORCEMENT (July 20, 2016), http://wp.nyu.edu/compliance_enforcement/2016/07/20/crediting-the-behavioral-approach/ [perma: http://perma.cc/PNX7-XC27].

216. THALER & SUNSTEIN, *supra* note 77, at 11–12.

217. This process is not foolproof; understanding and calibrating precise behavioral impacts is

For directors, a number of approaches are available. Because System 1-driven loss aversion is at the root of many of the cognitive processes limiting effective compliance, the design of any behavioral compliance practice must account for it.[218] One of the most frequently applied behavioral devices used to do so is a "precommitment device"—a commitment, often made publically, to take a future action that may prove difficult when the time comes.[219] Thaler's "Save More Tomorrow" program illustrates the concept:

> The program gives employees the option of precommitting to a gradual increase in their savings rate in the future, each time they get a raise. The program also avoids the perception of loss that would be felt with a reduction in disposable income, because consumers commit to saving future increases in income. People's inertia makes it more likely that they stick with the program, because they have to opt out to leave.[220]

This same idea can be used to ensure directors implement robust compliance programs. Companies might adopt procedures that automatically trigger compliance program budget increases or the adoption of new compliance tools. Because the triggers happen automatically, say on a yearly or biyearly cycle, the resulting actions are seen as sunk costs and not new losses, which creates less aversion and takes advantage of the Automatic System instead of being hindered by it.[221] If adopting rules triggering automatic spending increases proves too much for boards, scheduling regular reviews of the company's compliance initiatives may suffice. The longer the period to which directors commit the better, as the reviews will begin to be seen as normal rather than in a "change" frame.[222] Long-term precommitment devices also help new board members become habituated to compliance reviews and spending. Now everyone is a creator and an innovator, sharing equally in the process of continuous improvement.[223]

Another behavioral best practice aimed at directors is ethical priming. Behavioral ethics research shows that priming, or introducing certain stimuli, can impact legal and ethical decisionmaking.[224] For example, one study showed that

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notoriously difficult, and quantifying the benefits of any new compliance approach is similarly challenging.

218. See *supra* Part II.B for a discussion of System 1 driven loss aversion.

219. W. FRED VAN RAAIJ, UNDERSTANDING CONSUMER FINANCIAL BEHAVIOR: MONEY MANAGEMENT IN AN AGE OF FINANCIAL ILLITERACY 234–36 (2016); *cf.* Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow™: Using Behavioral Economics to Increase Employee Savings*, 112 J. POL. ECON. S164, S169 (2004) (discussing automatic enrollment in employee savings plans).

220. *Precommitment*, BEHAVIORALECONOMICS.COM, http://www.behavioraleconomics.com/mini-encyclopedia-of-be/precommitment/ [perma: http://perma.cc/UX27-JBAW](last visited May 20, 2018).

221. Thaler & Benartzi, *supra* note 219, at S170. In some ways, directors are using the "sunk cost effect," another behavioral economics concept, to their benefit. *See* Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORG. BEHAV. & HUM. DECISION PROCESSES 124 (1985).

222. THALER & SUNSTEIN, *supra* note 77, at 36.

223. *See* KAHNEMAN, THINKING, *supra* note 78, at 304.

224. *See* John Tsalikis, *The Effects of Priming on Business Ethical Perceptions: A Comparison Between Two Cultures*, 131 J. BUS. ETHICS 567, 567–68 (2015).

negative priming for rudeness caused respondents to become less ethically sensitive when making decisions.[225] An opposite approach could be taken with directors when they are scheduled to make decisions related to compliance. By considering positive company values or ethical acts at the outset of the meeting, directors would be positively primed to make ethical and compliance-advancing decisions.[226] This could be effectuated by having directors read the company's value statement or relate founding principles. This is the idea behind displaying the corporate mission statement at the office entrance; everyone entering the company is primed to do the right thing despite inherent cognitive obstacles to the contrary.[227]

These same behavioral concepts can be incorporated into the best practices of the compliance program itself. One of the simplest ways behavioral insights can be harnessed to increase compliance is to ask employees to sign an ethics-focused certification before they engage in behavior that has historically created compliance risk, such as filling out an expense report or transferring client funds. Studies show that reminding employees of morality just before they act—a priming tool—significantly reduces dishonesty.[228] This is likely the case because it creates a morality frame around the task, in which System 2 is engaged prior to there being an opportunity to rationalize an unethical act.[229] Such "just-in-time" compliance measures range in cost and sophistication—everything from a signature on a printed form to a buzz from a wearable device—but they have shown measurable results for organizations as diverse as Bank of America and the IRS.[230]

Another simple behavioral compliance best practice is to create risk-specific task checklists for employees. This sounds easy enough, but the vast majority of companies either do not do it, or they do it incorrectly. Most companies train their employees on complex legal risk as part of their compliance program.[231] And then they expect employees, everyone from executives to those in the field,

225. *Id.*

226. THALER & SUNSTEIN, *supra* note 77, at 69–71.

227. *See* Interview by Michael Useem & Adam Grant with Alex Gorsky, Chief Exec. Officer, Johnson & Johnson, in Philadelphia, Pa. (Jan. 9, 2014), http://knowledge.wharton.upenn.edu/article/alex-gorsky-leadership-moments-jj [perma: http://perma.cc/2B3W-CDXG]. Johnson & Johnson's credo, which is etched in stone in the lobby of the corporate headquarters, boils down to the following: "We're here on earth to serve people who need our products, great community, great employment setting and then we work for shareholders as well." *Id.*

228. ARIELY, *supra* note 213, at 39–53 (explaining the impact of asking participants to recall moral standards before engaging in certain behaviors).

229. Feldman, *supra* note 206, at 16.

230. ARIELY, *supra* note 213, at 47–53 (discussing the results of an experiment with an IRS tax form that improved the agency's collection rates); Timothy L. Fort et al., *The Angel on Your Shoulder: Prompting Employees to Do the Right Thing Through the Use of Wearables*, 14 NW. J. TECH. & INTELL. PROP. 139, 146 (2016) (discussing a Bank of America program that monitored employees by wearable sensors and found that social employees were more productive).

231. Haugh, *Criminalization*, *supra* note 6, at 1222. This is principally accomplished through the drafting of formal codes of conduct, corporate policies, and organizational procedures, which employees are then trained on so that the policies can be applied to their day-to-day work.

to recall the laws, regulations, and internal rules governing that risk and apply them at the right time.[232] That may work for training lawyers, but not for most others because it "pushes all of the 'transfer' work to the employee," and transfer is the critical step in the application of learned knowledge.[233] Instead, to ensure employees properly perform tasks with compliance risk, companies "need to frame [their] training around those specific, risky job tasks."[234]

For example, a start-up compliance provider called Broadcat has created a series of checklists that are task specific and direct employee action. One titled "Going Overseas on a Business Trip?" contains check boxes for things such as getting company preapprovals for gift giving and entertainment, packing a safe laptop and securing files, and carrying an ethics helpline phone number.[235] Although the checklist is simple and easy to understand (which best allows System 1 review and retention), it contains a sophisticated precommitment device for avoiding paying a bribe.[236] By committing to the company's antibribery provisions, and then being reminded of them while undertaking the task of overseas travel, employees are less likely to engage in risk-creating behavior.

A more broadly applicable behavioral best practice is for companies to encourage employee storytelling. While this might sound like a trite recommendation for a sophisticated company, storytelling in its many forms is essential to corporate compliance. Stories of ethical employee behavior told by high-level managers educate employees as to applicable laws and regulations in a way that makes the abstract concrete and accessible, which allows System 1 recall.[237] More importantly, stories of ethical dilemmas the company faced and triumphed over reinforce positive corporate values. Research shows that compliance messaging is most effective when it conveys that positive behaviors are "widely performed and roundly approved" within an organization.[238] This type of messaging falls under the behavioral concept of descriptive social norming, which is the practice of providing people with information about how others around them behave.[239] It turns out that peer behavior induces people to act similarly, likely because it creates a strong reference point such that acting

232. RICARDO PELLAFONE, BROADCAT, KEEPING COMPLIANCE SIMPLE 8–9 (2016), http://www.thebroadcat.com/downloads [perma: http://perma.cc/VHN4-NBEW].

233. *Id.* at 9.

234. *Id.* at 11.

235. *Id.* at 13–14.

236. *See id.*

237. *See* Scott Killingsworth, *Modeling the Message: Communicating Compliance Through Organizational Values and Culture*, 25 GEO. J. LEG. ETHICS 961, 983 (2012).

238. Robert B. Cialdini et al., *Managing Social Norms for Persuasive Impact*, 1 SOC. INFLUENCE 3, 13 (2006).

239. A descriptive norm describes what individuals think that other people typically do, e.g., "Most people actually do litter." Alan S. Gerber & Todd Rogers, *Descriptive Social Norms and Motivation to Vote: Everybody's Voting and so Should You*, 71 J. POL. 178, 180 (2009). When primed with this information, individuals tend to follow norm-consistent behavior. *See id.* (citing various sources).

contrary would create a perceived reputational loss.[240]

BestBuy has used this approach by hosting a public website where its Chief Ethics Officer related emerging ethical dilemmas within the company. The web posts discussed how certain employees considered ethics and compliance issues, sought advice from superiors and coworkers, and ultimately resolved the issue—both positively and negatively.[241] Similarly, Parsons Corporation, an international engineering and construction firm, publishes "Ethics Challenges" on its internal website.[242] The company solicits employee votes on how an ethics hypothetical should be resolved, publishes the narrative comments anonymously, and then follows up with a detailed analysis by the company's ethics committee.[243] The challenges serve to unite employees around the values of the company as applied to real life scenarios.[244]

More immersive uses of storytelling are also available to companies. For example, as part of its new employee compliance training, Nordstrom eschews the use of an overly detailed handbook explaining its customer service rules and protocols.[245] Instead, new employees are told elaborate stories about the "lengths fellow employees have gone to in order to wow clientele."[246] And during nonstore hours, managers read customer comments over the intercom so that all employees can hear of coworkers' accomplishments.[247] Barry-Wehmiller, a global capital equipment and engineering consulting company, goes even further. It created a communication skills training class as part of its larger leadership training curriculum. Open to all employees, the class focuses on improving interpersonal communication skills with a focus on effective listening and storytelling.[248] According to Bob Chapman, Barry-Wehmiller's CEO, the core idea of the class is disclosure; the company believes that "real people telling real stories creates real learning" about the company's employee-centered value system.[249] Even the senior managers acting as the professors are trained to share

240. *See* Hunt Allcott, *Social Norms and Energy Conservation*, 95 J. PUB. ECON. 1082, 1092–93 (2011) (finding that simply sending letters to homeowners regarding their neighbors' energy saving efforts, "a treatment that has no effect on relative prices," significantly affected energy use). Descriptive norming may also combat the "claim of relative normality" rationalization, which would help justify unethical behavior in the minds of employees who compare their acts to the bad acts of others. *See* Haugh, *Criminalization*, *supra* note 6, at 1258.

241. Killingsworth, *supra* note 237, at 983.

242. *Id.*

243. *Id.*

244. *See also* Joycelyn M. Pollock & Ronald F. Becker, *Law Enforcement Ethics: Using Officers' Dilemmas as a Teaching Tool*, 6 J. CRIM. JUST. ED. 1, 3-4 (1995) (explaining series of story-telling-focused exercises authors used to train police officers regarding ethical decisionmaking).

245. Patrick M. Lencioni, *Make Your Values Mean Something*, HARV. BUS. REV., July 2002, at 5, 9.

246. *Id.*

247. *Id.*

248. BOB CHAPMAN & RAJ SISODIA, EVERYBODY MATTERS: THE EXTRAORDINARY POWER OF CARING FOR YOUR PEOPLE LIKE FAMILY 213–23 (2015).

249. *Id.* at 222.

their personal stories.[250] The company credits its success to these efforts.[251]

C. Reconsidering Incentives

Behavioral science research tells us that even seemingly inconsequential factors can greatly influence decisionmaking. This is certainly true regarding corporate compliance. Studies show that the most effective compliance comes from intrinsic employee motivation—building a culture in which all members of the organization want to act ethically because it is the right thing to do for the company, not because it satisfies a regulation or because conduct is being monitored.[252] Building intrinsic motivation is less about money and more about creating a feeling of shared value. When directors and managers' "tone at the top" communicates high levels of trust to employees, those employees feel intrinsic motivation.[253] It turns out that praise and expressions of gratitude motivate more than money, and social group interactions likely motivate individual behavior more than almost anything.[254] Although many directors have difficulty conceptualizing nonmonetary incentives—after all, it goes against the status quo—this shift in thinking is critical for reimagining compliance programs.

So instead of defaulting to monetary rewards, companies need to think creatively about incentives that encourage ethical employee conduct. For example, Boeing prominently profiled a marketing manager in its company newsletter who immediately alerted the legal department when she received an inadvertently delivered packet containing a competitor's proprietary information.[255] Lockheed Martin instituted an annual Chairman's Award, which

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250. *Id.*

251. Ambar Bajaj & Scott S. Smith, *Bob Chapman's Barry-Wehmiller Packages the Works*, INVESTOR'S BUS. DAILY (July 31, 2015), http://www.investors.com/news/management/leaders-and-success/robert-chapman-runs-barry-wehmiller-packaging-giant/ [perma: http://perma.cc/DH6H-HTAH] (growing to $2 billion in sales and offering a 15.6% compound annual return for investors). Barry-Wehmiller has also been named by *Inc. Magazine* as one of the "25 Most Audacious Companies" for its culture. *Id.*

252. *See, e.g.*, Paine, *supra* note 171, at 107 (arguing that compliance is most effective when it ceases to be a constraint and becomes "the governing ethos of an organization," fostering legitimacy organization-wide).

253. Johann Graf Lambsdorff, *Preventing Corruption by Promoting Trust—Insights from Behavioral Science* 11 (Universität Passau, Working Paper No. V-69-15, 2015), http://www.researchgate.net/publication/286441815_Preventing_Corruption_by_Promoting_Trust_-_Insights_from_Behavioral_Science [perma: http://perma.cc/6QRS-TEMD]; Adam Grant & Jitendra Singh, *The Problem with Financial Incentives—And What to Do About It*, KNOWLEDGE@WHARTON (Mar. 30, 2011), http://knowledge.wharton.upenn.edu/article/the-problem-with-financial-incentives-and-what-to-do-about-it/ [perma: http://perma.cc/9L2Q-KRLQ].

254. Cialdini, *supra* note 238, at 4; Adam M. Grant & Francesca Gino, *A Little Thanks Goes a Long Way: Explaining Why Gratitude Expressions Motivate Prosocial Behavior*, 98 J. PERSONALITY & SOC. PSYCHOL. 946, 953 (2010).

255. *See* JOSEPH E. MURPHY, SOC'Y OF CORP. COMPLIANCE & ETHICS, USING INCENTIVES IN YOUR COMPLIANCE AND ETHICS PROGRAM 29 (2011), http://www.corporatecompliance.org/Portals/1/PDF/Resources/IncentivesCEProgram-Murphy.pdf [perma: http://perma.cc/C7YL-5WTR]. A glowing personal letter to the employee from the CEO soon followed. *Id.*

is given to employees who exemplify the company's ethical standards.[256] The company also has a competition that awards the best short film promoting ethics in the workplace. The winners receive public recognition and their film becomes part of the company's ethics training video series.[257]

Using the example of Barry-Wehmiller again, each of the company's ten business units recognizes an employee with a "Guiding Principles of Leadership" award.[258] The award, given yearly, acknowledges employees whose actions embody the tenets of the company's culture. What is unique about the accolade is that it is peer nominated and nonmonetary. Instead, in an elaborate ceremony attended by the winner's family, fellow employees express their sentiments as to why the award was bestowed.[259] While the employee is given a unique vehicle to drive for a week as part of the award, it is the peer recognition that resonates.[260]

More formal ethics-focused incentives include considering ethical leadership in performance reviews, compensation, and promotion decisions. While companies must be mindful of unintended behavioral consequences—namely reframing of ethics as an economic proposition—thoughtful use of incentives can structuralize ethics and compliance within an organization and signal to the entire company its importance.

CONCLUSION

The *Caremark* opinion is undoubtedly "[o]ne of the most important court decisions in th[e] area" of corporate governance and compliance.[261] Yet exactly why that is carries some mystery, because the opinion held very little that required directorial action as to compliance. By coupling lofty prescriptions with a standard of review that ensured no director would be found liable, Chancellor Allen destined the opinion to fall short of its goal of remaking board oversight of compliance. That said, *Caremark* offers much when viewed from a behavioral lens. Not only can some of the mystery of its outsized impact and underwhelming legacy be understood, but it highlights the opportunities of behavioral compliance—a set of compliance strategies, rooted in behavioral science, that hold real promise for creating effective efforts to lessen unethical and illegal acts in business. In the end, this may be *Caremark*'s true legacy. By fostering a compliance movement, even an imperfect one, the opinion set in motion a chain of events that may achieve its "lofty aspirations" after all.[262]

256. *Id.* at 30.

257. *Id.*

258. *Shine a Light on Good Leadership*, BARRY-WEHMILLER, http://www.barrywehmiller.com/our-culture/recognition-celebration [perma: http://perma.cc/AGH4-VF9R] (last visited May 20, 2018).

259. *Id.*

260. *Id.*

261. MARTIN T. BIEGELMAN, BUILDING A WORLD-CLASS COMPLIANCE PROGRAM: BEST PRACTICES AND STRATEGIES FOR SUCCESS 72 (2008).

262. *Id.* at 75.