ESSAYS

CAREMARK AS SOFT LAW

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ABSTRACT

This Essay, included in Temple Law Review's symposium issue on Caremark, assesses the influence of “Caremark duties.” Under Caremark, directors have duties to monitor their corporations for wrongdoing. Caremark has been extremely influential; firms spend considerable amounts of time and money “complying” with what are now called Caremark duties. But liability for breach of Caremark duties is exceedingly unlikely, and, in almost all cases, is completely avoidable with only minimal effort, far less than is typically expended. This Essay considers how Caremark can be both influential and legally toothless—that is, how it operates as “soft law.” As soft law, Caremark can have a considerable penumbra beyond what law requires, encompassing other aspects of corporate good citizenship. I argue here that the Caremark penumbra, together with other forces promoting greater attention to societal interests, is bringing about a considerable convergence between profit maximization and corporate social responsibility, broadly construed.

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INTRODUCTION

What should a company’s compliance program encompass? In re Caremark International, Inc. Derivative Litigation (Caremark) establishes directors’ monitoring and oversight duties, functioning in tandem with other rules and regulations. But compliance programs go far beyond what is needed to avoid lawbreaking, and what directors do to “comply with” their Caremark duties goes far beyond what is needed to avoid liability, incorporating, among other things, concerns about reputation, both theirs and their company’s. Stated differently, Caremark has a considerable penumbra, much of which is “soft law,” law that influences behavior through forces other than instrumental ones. The Caremark penumbra is part of an increasing convergence of corporate profit maximization and corporate social responsibility, a development that I argue here is felicitous.

I. THE LIMITS OF CAREMARK

What should directors do to monitor their company? Directors’ monitoring duties were first defined in Caremark. But liability for breach of Caremark duties is exceedingly difficult to establish. Caremark claims are “among the hardest [for plaintiffs] to plead successfully.” Indeed, breach of the Caremark duty is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” To be liable, directors must have utterly failed to implement any reporting or information system or controls; or . . . having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.

Given that Caremark suits allege harms to the corporation, such suits would be derivative, properly brought by the corporation. Shareholder-plaintiffs, seeking to bring such a suit, thus have to first persuade the court that they should be excused from making demand on the board because demand would be “futile”—because the board would not have brought a suit even if the suit had merit. In this context, what is typically required is a showing that a majority of the board faces a substantial risk of liability for the breach of duty. Having no system of controls will yield liability, but having an imperfect or even apparently

1. 698 A.2d 959 (Del. Ch. 1996).
2. Caremark, 698 A.2d 959.
4. Caremark, 698 A.2d at 967.
6. Id. at 366–67.
7. Id. at 367.
inadequate system generally will not.\(^8\) Liability thus requires more than that the corporation had a bad outcome, such as having had to pay a large fine. The recent General Motors debacle, in which GM kept manufacturing cars with defective ignition switches for many years after some people at the company, including people in senior positions, had knowledge of the defect, and deaths resulted, did not yield Caremark liability for the directors.\(^9\) Even repeated fines for violations of statutes and regulations may not yield Caremark liability. As noted in a recent case,

> [T]he Plaintiffs . . . produced a ponderous omnibus of a complaint. It describes red flags placed before the directors, dating back to the financial crisis of a decade ago as well as more recently, in connection with activities of Citigroup and its subsidiaries that led to large fines levied against the bank. The Complaint makes it reasonably conceivable that the directors, despite these red flags, failed to take actions that may have avoided loss to the company. That is not the standard, however. To my mind, the allegations of the Complaint, if true, fail to demonstrate scienter. The Complaint does not make it reasonably conceivable that the directors acted in bad faith. Therefore, the Motion to Dismiss is granted.\(^10\)

II. PENUMBRAS IN CORPORATE LAW

Law students, hearing about the hurdles to Caremark liability, may give us (professors) a look that can be interpreted as “why are you wasting my time?” But, of course, the answer, not so satisfactory to students who like their law to be law-like (that is, to have a plausible chance of resulting in the imposition of liability), is that directors (and officers)\(^11\) take abiding by Caremark duties extremely seriously, as do their companies, notwithstanding how pale the specter of liability under Caremark is. Caremark, like some other doctrines in corporate law, has a considerable penumbra—“a surrounding or adjoining region in which something exists in a lesser degree.”\(^12\) What yields liability for a breach of duty is

\(^8\) See Caremark, 698 A.2d at 970 (“Obviously the level of detail that is appropriate for such an information system is a question of business judgment.”).


\(^11\) Caremark duties’ applicability to officers is very rarely addressed apart from rote recitations that fiduciary duties are owed by both directors and officers. E.g., In re Goldman Sachs Grp., Inc. S’holder Litig., No. 5215, 2011 WL 4826104, at *23 (Del. Ch. Oct. 12, 2011). The usual focus of Caremark cases is director conduct, paradigmatically that the directors did not do enough. A notable exception is In re World Health Alternatives, Inc., 385 B.R. 576, 591 (Bankr. D. Del. 2008), which stressed the applicability of Caremark duties to officers. See also Francis G.X. Pileggi et al., Court Imposes Caremark Fiduciary Duty on Corporate Officer, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 8, 2008), http://corpgov.law.harvard.edu/2008/05/08/court-imposes-caremark-fiduciary-duty-on-corporate-officer/ [perma: http://perma.cc/2NW5-AYGW].

a very small part of what the duty is considered to encompass or require. In other words, what directors and officers apparently think they should do to abide by their Caremark duties is much more than what they have to do to avoid liability.13

In many spheres, corporate law has a considerable penumbra.14 Forces that shape the penumbra include dicta in judicial opinions and other pronouncements by the judiciary in various contexts, both of which the Delaware judiciary is particularly known for; law firm memoranda to clients that tell those clients, including the companies’ directors and officers, what they should do, rather than telling them the minimum they must do to avoid liability; and pressure from various constituencies, sometimes from shareholders in the form of shareholder proposals, and sometimes from expressed or perceived customer and regulator sensitivities to certain conduct or messaging.15 The penumbra affects what companies do, and the effect is recursive, insofar as what companies do creates norms that come to be part of the penumbra.

III. THE CAREMARK PENUMBRA

Moving to Caremark more specifically, the increasing federal government involvement in pursuit of compliance issues such as Foreign Corrupt Practices Act violations, money laundering, and assistance in client tax evasion also contributes, as companies consider what the government might want to see and what might prompt it to be lenient should a violation be found. Insofar as the compliance endeavor is characterized as a “Caremark penumbra,” it is far broader than what might be expected if the endeavor were simply focused on avoiding liability under Caremark. Indeed, nobody would dispute that much of the force of Caremark is soft rather than hard. As noted above, very few cases give rise to liability. For instance, the directors of a company that (a) was fined in several countries for antitrust violations and (b) had entered into a settlement of another related case that it had won at the lower court but lost at the appeals level were not liable where

the Board consistently expressed—both verbally and through its actions—its view that its business practices were not violative of international antitrust laws and elected to address the relevant legal actions by focusing on educating industry participants and government officials as to why its practices were legal and by pursuing appeals.16

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13. Another notable example of a penumbra relates to the fiduciary duty of care. Directors would characterize themselves as having, and trying to abide by, the duty, notwithstanding the nearly-invariably-used option to exculpate them from monetary liability for breaches of the duty under the Delaware General Corporation Law, Del. Code Ann. tit. 8, § 102(b)(7) (West 2018), and the considerable deference director actions and omissions are accorded under the business judgment rule.

14. See Melvin Aron Eisenberg, Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner’s Dilemma, Sheep’s Clothing, Social Conduct, and Disclosure, 28 Stetson L. Rev. 1, 6 (1998).


Caremark cases are paradigmatically brought after a company has had to pay a fine, penalty, or settlement in connection with a charge brought, typically by a regulator (or sometimes by a private party). What should have been monitored for and, ideally, prevented was the allegedly illegal conduct. Even if the company has not admitted to behaving illegally, there is typically an accusation of illegality.17

There is, of course, a significant economy of scope in companies’ Caremark compliance programs, their attempts to avoid breaking the law, and their ability to demonstrate to regulators their efforts in both these regards. Thus, that a company’s compliance program is not only, or even not principally, about helping directors avoid Caremark liability is not surprising: what the company and its directors would do to avoid Caremark liability should also help them (and others within the company) avoid liability from other sources.

But what boards do to abide by their Caremark duties extends to activities or omissions that are not illegal. An example illustrates the point. A seller of securities is, by law, not allowed to lie about the securities’ quality to his buyer. A proper compliance program will, of course, train a company’s sellers not to lie. It will also attempt not to hire sellers who would lie, or fire those who have lied.

10872–VCMR, 2016 WL 4076369, at *12 (Del. Ch. 2016), aff’d mem., 158 A.3d 449 (Del. 2017). Among the few suits where plaintiffs might have prevailed is one involving a company at which twenty-nine miners died in an explosion. See In re Massey Energy Co. Derivative & Class Action Litig., C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011). The company’s CEO had “publicly stated that the idea that governmental safety regulators knew more about mine safety than he did was silly.” Id. at *19. The plaintiffs pled “that the independent directors of the Massey Board did not make a good faith effort to ensure that Massey complied with its legal obligations” and that the board failed to “respond to numerous red and yellow flags by aggressively correcting the management culture at Massey that allegedly put profits ahead of safety.” Id. Also, Caremark liability was possible where, “despite the general counsel’s warning, ‘the Board discussed and approved a series of annual strategic plans that contemplated expanding’” sales related to off-label drug use, where marketing the sales would be illegal. Melbourne Mun. Firefighters’ Pension, 2016 WL 4076369, at *11 (quoting La. Mun. Police Employees’ Ret. Sys. v. Pyott, 46 A.3d 313, 352 (Del. Ch. 2012), rev’d on collateral estoppel grounds, 74 A.3d 612 (Del. 2013)). In fact, the plaintiffs did not prevail in either of these cases, but not because their Caremark claims were weak. In re Massey Energy, 160 A.3d 484, 507–08 (Del. Ch. 2017) (explaining that although the plaintiffs pled a viable Caremark claim, a subsequent merger extinguished their standing); Melbourne Mun. Firefighters’ Pension, 2016 WL 4076369, at *13 (dismissing the complaint for failure to make demand or show that demand was excused).

17. Plaintiffs have argued that directors have a duty under Caremark to monitor for business risks. See, e.g., In re Goldman Sachs Grp., Inc. S’holder Litig., C.A. No. 5215–VCG, 2011 WL 4826104, at *22 (Del. Ch. Oct. 12, 2011). Courts considering the issue have largely, although not completely, rejected this possibility:

“Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk.” No reasonable inference can be made from the pleadings that the Director Defendants consciously disregarded their duty to be informed about business risk (assuming such a duty exists). On the contrary, the pleadings suggest that the Director Defendants kept themselves reasonably informed and fulfilled their duty of oversight in good faith. Good faith, not a good result, is what is required of the board.

Id. at *23 (footnotes omitted) (quoting In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009)). In any event, claims regarding lack of oversight of business risk generally relate to some sort of illegality. E.g., id. at *2.
But what about doing something short of lying? For instance, a seller might focus efforts to sell “dog” securities on nominally sophisticated buyers he knows are actually unsophisticated.\(^\text{18}\) The Financial Crisis Inquiry Commission, formed to provide a better understanding of the 2008 financial crisis, described this type of behavior:

Back in October [2006], Goldman Sachs traders had complained that they were being asked to “distribute junk that nobody was dumb enough to take first time around.” . . . In a December 28 email discussing a list of customers to target for the year, Goldman’s Fabrice Tourre, then a vice president on the structured product correlation trading desk [who is now best known for his role in the ABACUS transaction], said to “focus efforts” on “buy and hold rating-based buyers” rather than “sophisticated hedge funds” that “will be on the same side of the trade as we will.”\(^\text{19}\)

There are many other examples, including the following:

A former IKB credit officer, James Fairrie, told the Financial Times that the pressure from higher-ups to buy CDOs from Wall Street was intense. “If I delayed things more than 24 hours, someone else would have bought the deal,” he said.

Another CDO investor told the newspaper that IKB was known to be a patsy. “IKB had an army of Ph.D. types to look at CDO deals and analyse them,” he said. “But Wall Street knew that they didn’t get it. When you saw them turn up at conferences there was always a pack of bankers following them.”\(^\text{20}\)

Nobody would advocate for a compliance program that encouraged or even permitted this sort of “near the line” conduct on grounds that it was not illegal (and, of course, could be profitable!). Quite the contrary: such programs seek to install a robust compliance culture that respects the spirit as well as the letter of the law, and a robust risk culture that sensitisizes employees to the dangers of excessive risk-taking, as well as instituting processes by which employees throughout the company report compliance issues, and monitoring and continually improving the compliance process.

One objection to the argument thus far—that compliance with Caremark duties goes beyond what is necessary to avoid liability, either under Caremark itself or under the laws that Caremark suits allege were violated—should be acknowledged and addressed. The Caremark penumbra importantly includes

ethical concerns. Attention to such concerns is in fact encouraged by law—might such encouragement be properly viewed as a requirement? In this regard, the U.S. Sentencing Guidelines provide that the existence of an effective compliance and ethics program is a mitigating factor in determining the punishment that will be imposed on a company caught engaging in illegal behavior.\textsuperscript{21} Moreover, pursuant to a rule adopted under the Sarbanes-Oxley Act of 2002, public companies must disclose whether they have adopted a code of ethics that applies to the company’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and, if not, why not, and must report amendments to or waivers of the code.\textsuperscript{22} Finally, the NYSE and NASDAQ listing rules require companies to adopt codes of ethics covering their directors, officers, and employees.\textsuperscript{23}

Codes of ethics can be cosmetic—companies can ignore them or otherwise convey to their employees that they do not “mean it.” Enron, for instance, was known to have an exemplary ethics code.\textsuperscript{24} (Not to say that doing this is easy—regulators considering whether to be lenient when able to impose possible punishment after an offense will be looking for an “effective” program, which they should be able to distinguish from a purely cosmetic one.) Moreover, insofar as there is no “law” as to precisely what ethical codes should require and how they should be inculcated and applied, the specifics naturally become part of the broader compliance endeavor—the \textit{Caremark} penumbra.

IV. BEYOND LAW

Why is it unacceptable for companies to approach compliance narrowly and formally, as merely a means to avoid lawbreaking? Doing so might seem or even be profitable: such an approach might allow a company to collude with competitors to fix prices, bribe foreign governments to solicit business, or engage in a complex tax shelter similar to one that had been outlawed, if it computed that the expected payoff exceeded the expected cost. In making that computation, a company might consider its superior resources relative to the relevant regulator; its ability to avoid detection (because, for instance, potential whistleblowers or those who would do internal reporting have been threatened with firing, or the matter at issue is very complex and very well concealed); its influential contacts, including lobbyists; its willingness to use process to delay and to impose costs on the other side; and any arguments that support its legal position—even if made in bad faith. It might give careful advice to its employees: “Don’t get caught doing X,” or “Hint that the disclaimers in the securities disclosure are boilerplate, but don’t actually say so,” or “Sell to people who

\begin{footnotes}
\footnote{21. U.S. SENTENCING GUIDELINES MANUAL § 8B2.5(f) (U.S. SENTENCING COMM’N 2016).}
\footnote{22. 17 C.F.R. § 229.406 (2017).}
\footnote{23. See, e.g., NYSE, LISTED COMPANY MANUAL § 303A.10 (2018); NASDAQ, INC., NASDAQ STOCK MARKET RULES § 5610 (2018).}
\end{footnotes}
might be particularly unlikely to complain.” It might even conclude that having a diversified portfolio of illegal activity in different countries would constitute acceptable risk insofar as detection is country-by-country, and profits obtained from business obtained through bribes in countries A, B, and C would exceed the fines assessed in countries D and E. A company could assess potential reputational costs as acceptably low if it concluded that getting caught would be sufficiently unlikely or that if it was caught it could exaggerate its good faith belief in its legal position, blame “some bad apples,” or engage in “greenwashing” with, for instance, a splashy charitable initiative. A company would presumably conceal this sort of cost-benefit computation, as neither regulators nor the public would look upon it with favor.

A formalist approach to compliance might be unacceptable for instrumental reasons: ultimately, taking all costs into account, including reputational costs and those associated with regulatory disfavor, it might not be profitable. Indeed, computing with much confidence the net costs or net benefits of formalist compliance would be impossible, so companies might reasonably be inclined to err on the side of caution. In any event, being caught making the computation would probably increase a company’s costs. Maybe there is a moral component to the decision—companies “should not” be taking a formalist approach. The two answers are related, making the distinction ultimately unintelligible: the reputational hit might in part reflect a moral assessment.

V. WHERE TO GO BEYOND LAW: ETHICS AND REPUTATION

Ultimately, I do not propose to answer the question of whether formalist compliance is unacceptable for purely instrumental reasons, or whether there are additional, perhaps “moral,” reasons. I instead take the rejection of formalist compliance as a given, and consider what form the apparently chosen alternative, what I am calling the Caremark penumbra, seems to be taking. The Caremark penumbra effectively “requires” that when a company is managing its overall risk, it should not aggregate its risks of legal liability with one another or with the company’s other risks, nor should it too readily conclude that some of these risks (compliance risks) are tolerable. It need not, and indeed cannot, have a zero-tolerance policy toward compliance risks, but neither can it compute costs and benefits narrowly as it would in other contexts, quantifying its ability to avoid detection or ameliorate harms (via greenwashing or other techniques) to justify taking the risk as a profit-maximizing strategy. A company can have a “risk appetite” as to compliance risks, but only for the purpose of assuring that it is

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26. See generally Robert S. Kaplan & Anette Mikes, Managing Risks: A New Framework, HARV. BUS. REV., June 2012, at 48. Note, too, that compliance risks for this purpose do not include certain legal risks, such as those associated with a new product launch when the company believes that another company may, wrongfully, claim patent infringement.
devoting sufficient resources to minimization of these risks.

Compliance and risk-management guidance routinely refer to, incorporate, and counsel inculcation of ethical standards and codes of conduct.\textsuperscript{27} The ethos encouraged is not “that which is not forbidden is permitted.” Rather, it eschews “close to the line” behavior, and encourages regard for ethics, as well as responsibility in risk-taking. This goes beyond what reducing legal liability would seem to require, helping to shape companies’ compliance obligations more broadly, including those in the companies’ ethics codes. Notably, at least part of the story is an obligation for the company to be mindful of the harm it can do to third parties beyond anything that might be legally actionable.

VI. WHERE DOES THE PENUMBRA EXTEND?

Where might the Caremark penumbra extend? A promising line of inquiry involves economies of scope as to legal liability and reputational costs, wherein the same measures that minimize one also minimize the other. Recall the salesperson selling “dog” securities to naïve but nominally sophisticated investors. Even if targeting those investors is legal, a compliance program should attempt to prevent the practice, for several reasons. First, steering clear of actual lawbreaking should be harder if one allows this practice, which arguably violates the spirit of the law while honoring the letter. People apt to go up to the line sometimes go over it, especially insofar as the harms that motivate the law are largely present in near-the-line cases. Second, there are reputational costs if such a practice is discovered—a discovery that might also lead to regulatory scrutiny and regulatory action. Indeed, in surveys, companies list reputational harms near the top of their lists of concerns.\textsuperscript{28}

Government regulators take into consideration whether a company has a robust compliance program, one which goes beyond a narrow focus on not breaking the law, when determining how to proceed when illegality is suspected.\textsuperscript{29} Indeed, discovery of illegality or close-to-the-line behavior can motivate regulatory or other legal action for political reasons. And consider what happened to Martin Shkreli after his company took advantage of what was


arguably a loophole to raise the price of a previously cheap and quite necessary drug, Daraprim. The patent had expired, but under FDA rules, the drug could not be made and sold without surmounting certain hurdles, which Shkreli’s company was able to render virtually insurmountable:

For decades, there wasn’t any competition to Daraprim for the simple reason that there wasn’t much money to be made selling it. In the face of [Shkreli’s company, Turing’s] humongous price hike, the obvious solution is for someone to undercut his price—especially since Daraprim is fairly simple to make—but thanks to the complex rules governing drug sales in the U.S., that’s not so easy. A potential competitor would have to go through the arduous process of getting approval from the Food and Drug Administration (F.D.A.) by showing that its drug is equivalent to Daraprim. This is difficult, because Shkreli’s company, Turing Pharmaceuticals, tightly controls its distribution, making it hard to get the samples to do testing.30

Congressional hearings, terrible publicity, and an investigation of Shkreli led to a trial and eventual conviction on unrelated charges.31 Shkreli was sentenced to seven years in jail, a sentence he is serving as of the time of this writing.32

That what Shkreli did would provoke outrage was predictable, as was that it would contribute to a desire to punish him. But the specifics would have been harder to predict. Indeed, this is probably generally true: what provokes outrage may be fairly predictable, but where that outrage leads is far less so. Consider this example, of an expansive use of law arguably fueled in part by outrage. In a recent case, municipalities were allowed to sue a bank under the Fair Housing Act (F.H.A.) for damages suffered as part of the fallout from the financial crisis. As articulated by the concurrence and dissent in the case, Bank of America v. City of Miami:

Miami’s theory is that, between 2004 and 2012, petitioners’ allegedly discriminatory mortgage-lending practices led to defaulted loans, which led to foreclosures, which led to vacant houses, which led to decreased property values, which led to reduced property taxes and urban blight. Miami seeks damages from the lenders for reduced property tax revenues and for the cost of increased municipal services—“police, firefighters, building inspectors, debris collectors, and others”—deployed to attend to the blighted areas. The Court


today holds that Congress intended to remedy those kinds of injuries when it enacted the FHA . . . .

Finally, there are substantive areas where we can expect what law is attempting to achieve and what reputation requires to align. Cyber risks come to mind. Even if a company did all that was legally required to keep customer information safe, a security breach could have an enormous negative effect on the company’s reputation.

VII. INTRODUCING COMPLICATIONS: WHAT DOES REPUTATION REQUIRE?

Firms want to have good reputations. But what does having a good reputation require? The answer is not simple or mechanical—unlike getting a bad reputation, which can be achieved with a little focused effort (think of what Shkreli did!). Moreover, there are more than just “good” or “bad” reputations, and what counts as good or bad may differ depending on the context. For instance, what is valued in a divorce or criminal defense lawyer may be aggressiveness in finding spirit-violative ways to advance her client’s interests, whereas what is valued for a head of compliance would be the opposite. The aggressive criminal lawyer has a “good” reputation; the aggressive head of compliance has a bad one, and has trouble getting or keeping his job. These examples also illustrate another complexity of reputation—reputation to whom? There are many examples of reputations that are good for a subset of society, but apparently bad for society as a whole. Indeed, Shkreli’s willingness to do anything to make money, including making a huge profit from a necessary and cheap-to-manufacture drug, the development costs of which had been long recovered, would garner him a good reputation in certain circles. Another example of a reputation that may be good for profits but bad for the broader society is one for “financial maneuvering,” which Richard Painter and I define in our book Better Bankers, Better Banks as bankers’ cleverness in crafting and employing end-runs around covenants and regulations. Banks’ clients, and their shareholders, may like this behavior; regulators do not, nor would, presumably, the broader public if it knew and understood what the banks were doing.

Examples of good-for-a-subset, bad-for-broader-society reputations are common and notorious. And sometimes, they are surprising. Consider the following:

In a September 26, 2007, e-mail to Lloyd Blankfein, Goldman’s chief executive officer, a senior Goldman banker said that “the institutions don’t and I wouldn’t expect them to, make any comments like ur good at making money for urself but not us. The individuals do sometimes, but while it requires the utmost humility from us in response I feel very strongly it binds clients even closer to the firm, because the alternative of take ur money to a firm who is an under performer and not the best,
just isn’t reasonable. Clients ultimately believe that association with the best is good for them in the long run.”

That is, as Richard Painter and I argued in our book *Better Bankers, Better Banks*, that “[s]ome bankers apparently believe that . . . some sorts of problematic behavior are a sign of intelligence and skill”—and they may be right. In the book, we recount another similar story, from an Anderson Cooper interview with a disillusioned former Goldman Sachs banker, Greg Smith:

*Anderson Cooper:* Smith says he grew even more disillusioned after the Senate hearings, when he and a Goldman Sachs partner met in Asia with a major client, the head of one of the biggest funds in the world.

*Greg Smith:* And he looks me and a partner in the eye and says, “Let me be honest with you guys. We don’t trust you at all. But don’t worry. There’s nothing to worry about. We’re gonna keep doing business with you because you’re the biggest bank. You’re the smartest. And actually we have to do business with you.”

Now my jaw almost dropped because hearing from one of your biggest clients that they don’t trust you when your whole mantra and reputation is built on trust, to me, it was the worst possible thing you can hear. And then I leave the meeting and the partner from Goldman Sachs who I was with is jubilant. “This is great news. The client is gonna keep doing business with us because they have to.”

The 2008 financial crisis did enormous harm to many people, and to the broader society. *Caremark*-qua-law was not much help: though the crisis yielded a number of *Caremark* suits, they were suits that plaintiffs lost. In *In re Citigroup Inc. Shareholder Derivative Litigation*, the court rejected the possibility that directors would be liable for failure to properly deal with business (as opposed to legal) risk. In *In re Goldman Sachs Group, Inc. Shareholder Litigation*, the court rejected the possibility that directors would be liable for establishing and not sufficiently overseeing a compensation structure that incentivized excessive risk-taking. But perhaps reputation can do what the law did not. Firms would like to be thought well of by their regulators. But William Dudley, the President of the Federal Reserve Bank of New York, had this to say:

I reject the narrative that the current state of affairs is simply the result of the actions of isolated rogue traders or a few bad actors within these firms. . . . [T]he problems originate from the culture of the firms . . . .

What do I mean by the culture within a firm? Culture relates to the

35. *Id.* at 3.
36. *Id.* at 2–3.
38. 964 A.2d 106 (Del. Ch. 2009).
implicit norms that guide behavior in the absence of regulations or compliance rules—and sometimes despite those explicit restraints. Culture exists within every firm whether it is recognized or ignored, whether it is nurtured or neglected, and whether it is embraced or disavowed. Culture reflects the prevailing attitudes and behaviors within a firm. It is how people react not only to black and white, but to all of the shades of grey. Like a gentle breeze, culture may be hard to see, but you can feel it. Culture relates to what “should” I do, and not to what “can” I do.

A number of factors have contributed to the cultural failures that we have seen. . . . One important element affecting culture has been the shift in the prevailing business model away from traditional commercial and investment banking activities to trading; that is, from client-oriented to transaction-oriented activities. Clients became counterparties—the other side of a trade—rather than partners in a long-term business relationship. In general, interactions became more depersonalized, making it easier to rationalize away bad behavior, and more difficult to identify who would be harmed by any unethical actions.

High-powered pay incentives linked to short-term profits, combined with a flexible and fluid job market, have also contributed to a lessening of firm loyalty—and, sometimes, to a disregard for the law—in an effort to generate larger bonuses. Often allegiance to an external network of traders has been more important than the ties the trader has to his or her particular employer. . . .

Although cultural and ethical problems are not unique to the finance industry, financial firms are different from other firms in important ways. . . . Financial firms exist, in part, to benefit the public, not simply their shareholders, employees and corporate clients. Unless the financial industry can rebuild the public trust, it cannot effectively perform its essential functions. For this reason alone, the industry must do much better.42

Dudley’s pronouncements are of a piece with other recent accounts of bad culture as a source of behavior that hurts the broader society.43 This emphasis by regulators and commentators helps marshal reputational forces to make such behavior more costly to firms engaging in it. Consider the reputational costs to General Motors (defective ignition switches that went unreported for years).44


Wells Fargo (“ghost accounts” set up by bankers exhorted to sell eight products per customer), and Volkswagen (software used to conceal the extent of diesel cars’ emissions). The legal costs and fines have been appreciable, but the reputational costs have arguably been larger, with visceral aspects of the respective scandals commanding an enormous amount of attention. The “GM nod,” which was “a practice of GM managers sitting in a room, nodding in agreement at steps that need to be taken, then leaving the room and doing nothing,” came in for considerable criticism in the media, as did the frequent intrusive exhortations from mid and senior-level managers to the Wells Fargo rank-and-file to meet unrealistic sales targets. Finally, as one article noted about VW: “VW is fair game for every comedian. ‘What’s not green and rhymes with lie? A Volkswagen TDI.’ ‘Not the worst thing Germany ever did.’ ‘And just when we were beginning to trust the Germans again.’”

VIII. WHAT DOES PROFIT MAXIMIZATION REQUIRE?

Firms are supposed to maximize profits. There is considerable debate as to whether they are supposed to do this to the exclusion of taking others’ interests into account. Profit maximization, also referred to as shareholder profit maximization, is traditionally contrasted with—one might say, opposed to, in both senses of the term opposed—taking other stakeholders’ interests into consideration. For example, paying employees a wage above market would supposedly not be consistent with shareholder maximization. But it could be, if the benefits of doing so, including reputational benefits, were higher than the costs. A more expansive approach to profit maximization takes into account an evolving and recursive notion of reputation—and ethics, insofar as the company’s reputation takes into account its ethics. This returns us to the question asked in the previous Section: what does reputation require?

One might be tempted, at first blush, to make a principled distinction between spirit-violative or close-to-the-line reputational costs and the costs of not doing some “good” thing such as discounting prices for drugs in poor


48. Hill, A Personality Theory, supra note 18, at 76.

countries. But the real distinction may be between matters as to which norms have arisen and matters as to which norms have not. The websites of many major corporations tout their good works, and in interviews with people in the field, I have been told that companies believe their reputations would suffer if they did not depict themselves as attending to the issues that have been anointed as those responsible companies attend to. In this regard, consider the following:

Sometimes norms evolve over time, as did the widespread expectation in most developed countries that companies should pollute minimally (if at all). A change in the behavior or policies of a leading company can cause stakeholders’ expectations to shift quite rapidly, which can imperil the reputations of firms that adhere to old standards. For example, the “ecomagination” initiative launched by General Electric in 2005 has the potential to raise the bar for other companies. It committed GE to doubling its R&D investment in developing cleaner technologies, doubling the revenue from products and services that have significant and measurable environmental benefits, and reducing GE’s own greenhouse emissions.

One might think that the difference between not being bad and being good would be straightforward: for instance, not polluting would be “not being bad” whereas cleaning a community park would be “being good.” Indeed, one type of “being bad,” negative externalities, which are, as the name suggests, harms imposed on third parties, is a generally accepted rationale for law, with pollution as the paradigmatic example. Law often aims to make the firms “internalize”—that is, bear the costs of—the externality. But, as I have previously argued, there is no uncontroversial way to specify a baseline from which deviations, positive or negative, are to be measured. Negative relative to what? And what costs are deemed imposed by a firm’s actions? Consider the 2008 financial crisis: what costs later incurred (and by whom) should be paid by the banks if the banks were to internalize the externality? Returning again to the pollution example, if a company makes a product that pollutes and makes ten units of profit, but society, bearing the clean-up costs, expends five units, the problem is solved when the five unit cost is imposed on the company; it does the clean-up. If the profit were only four units, the company would presumably cease making the product. What are the clean-up costs for the financial crisis?

Thus, a profit-maximizing firm will have to consider not only what law requires but also what reputation requires, as well as what law encourages. It is in principle possible that the latter, what reputation requires, as well as what law encourages, will increasingly come to include corporate social responsibility of

some sort.53 In this regard, consider the large institutional investor BlackRock’s recent letter as to the necessary and important relationship between profit and social purpose:

Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.54

Is this convergence a good thing? Contrast the dictates of reputation with those of law. The distinction between what is illegal and what is not illegal is not necessarily principled. Rationales for law include requiring the internalization of negative externalities, making markets work better, and preventing fraud. But what succeeds in becoming law, much less law that is fairly and successfully enforced, is not always fully justified by these rationales, nor is everything that would be justified by the rationales illegal.

Reputation is heavily influenced by norms. But norms can reflect unconsidered and self-serving sentiments that deny market realities, such as is arguably the case with surge pricing.55 Moreover, norms can be dictated by fads and salient events; pendulums can swing in extreme directions, indeed sometimes swinging dramatically in short periods of time.

When GlaxoSmithKline pioneered the development of anti-retroviral drugs to combat AIDS, its reputation for conducting cutting-edge research and product development was reinforced and shareholders were pleased. They were initially on board when GSK led a group of pharmaceutical companies in suing the South African government after it passed legislation in 1997 allowing the country to import less expensive, generic versions of AIDS drugs covered by GSK patents. But in 2001, GSK shareholders did an about-face in reaction to an

53. That being said, the convergence will presumably not be complete; sometimes the numbers at issue are so huge that even a significant reputational hit might be worthwhile given the money at stake.


55. I expand on this argument in Claire A. Hill, Cheap Sentiment, 81 LAW & CONTEMP. PROBS. 67 (2018).
intensifying campaign waged by NGOs and to the trial proceedings, which made GSK and the other drug companies look greedy and immoral. With its reputation plunging, GSK relented and granted a South African company a free license to manufacture generic versions of its AIDS drugs—but the damage was already done.56

But what is the alternative? A return to a narrower shareholder-focused view of the corporation seems impossible—and also, I would argue, undesirable.

CONCLUSION

Caremark's force is far more “soft” than “hard”—directors hardly need fear liability under Caremark. I have argued that Caremark’s considerable, albeit soft, force is on balance a good thing. The 2008 financial crisis underlined how much damage can be done when a corporation’s ethos is to make money without taking broader societal interests into account. In pushing companies toward expansive “compliance” programs that also include concern for reputation, Caremark helps companies fulfill what are increasingly seen as the responsibilities of good corporate citizenry.

56. Eccles, Newquist & Schatz, supra note 51.