COMMENTARY

CAREMARK AND COMPLIANCE: A TWENTY-YEAR LOOKBACK

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ABSTRACT

The Delaware Chancery Court's decision in In re Caremark *was and is a landmark decision. This brief Commentary takes a look back at* Caremark *on three issues that pertain to its contemporary relevance inside the corporate boardroom: (1) framing the cost-benefit assessment on the question of how much to spend on compliance; (2) how and when to force certain compliance matters to real-time board-level attention; and (3) using selection, promotion, and compensation decisions to influence the culture and risk-taking "temperature" of the firm.*

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INTRODUCTION

In nearly all narratives of how compliance has grown as a legal subject and field of practice in the last two decades, the Delaware Chancery Court's decision in *In re Caremark International Inc. Derivative Litigation*[1] plays a featured role.[2]

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1. 698 A.2d 959 (Del. Ch. 1996). *Caremark* was endorsed by the Delaware Supreme Court a decade later in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), which obviously became the more authoritative citation. Nonetheless, *Caremark* is the standard label in the literature and Delaware case law, and so I will use it here. On extensions and limitations in the *Caremark* approach for risk management beyond legal compliance, see Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 985–90 (2009).

2. *See, e.g.*, GEOFFREY PARSONS MILLER, THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE 55–61 (2014); John H. Walsh, *A History of Compliance*, *in* MODERN COMPLIANCE: BEST PRACTICES FOR SECURITIES & FINANCE 5, 29–30 (David H. Lui & John H. Walsh eds., 2015)

Chancellor William T. Allen's opinion predicted the abandonment of the Delaware Supreme Court's older and heavily criticized approach in *Graham v. Allis-Chalmers Manufacturing Co.*,[3] which had limited the board of directors' compliance oversight obligation to situations where red flags were waving in the board's face.[4] It said (though entirely in dicta) that the board had an affirmative obligation to assure itself in good faith that the corporation had a system of internal reporting and compliance controls to monitor for illegal activities.[5] Since that time, compliance has grown in size, scope, and stature at nearly all large corporations.[6]

There is a lively academic debate over whether *Caremark*'s causal impact on the unmistakable growth curve of compliance has been overstated.[7] After all, the holding in the decision (approving a de minimis settlement) was that the standard for holding directors of Delaware corporations liable for monetary damages under a test requiring "sustained or systematic failure . . . to exercise oversight" would be exceedingly hard for plaintiffs to prove, which is not a particularly threatening message.[8] Plus, federal law had already been trending strongly in the direction of a robust corporate compliance obligation in many disparate fields of regulation (for example, antitrust, financial services, healthcare, and defense contracting) and—as *Caremark* duly noted[9]—the Organizational Sentencing Guidelines had made the presence and quality of compliance (including board oversight) a substantial factor in the size and severity of any federal penalty for criminal wrongdoing.[10] Within a few years would come even bigger waves of pressure from Washington, via the emergence of deferred prosecution agreements, corporate charging decisions, and—for public companies—the mandates of the Sarbanes-Oxley Act.[11] This required new board structures, internal control processes, and whistleblower protections

(describing *Caremark* and its early influence).

3. 188 A.2d 125 (Del. 1963). Famously, the court rejected the idea that boards were obliged to install a corporate system of "espionage" to spy on employee behavior. *Graham*, 188 A.2d at 130.

4. *Id.* at 130.

5. *Id.*

6. *See* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 949–51 (2009); Sean J. Griffith, *Corporate Governance in an Age of Compliance*, 57 WM. & MARY L. REV. 2075, 2077 (2016).

7. *See* Mercer Bullard, Caremark*'s Irrelevance*, 10 BERKELEY BUS. L.J. 15, 19 (2013). Similarly, Jennifer Arlen says that *Caremark* failed to nudge boards sufficiently to make a difference and that it took the accumulation of federal initiatives to make compliance a higher corporate priority. *See* Jennifer Arlen, *The Story of* Allis-Chalmers*,* Caremark*, and* Stone*: Directors' Evolving Duty to Monitor*, *in* CORPORATE LAW STORIES 323, 324–25 (J. Mark Ramseyer ed., 2009).

8. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).

9. *Id.* at 969.

10. *See, e.g.*, Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U. L.Q. 375, 378–79 (1993).

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

to address the risk of financial misreporting,[12] which arises in the face of any material corporate wrongdoing.[13]

Whatever its causality, *Caremark* no doubt did in its time focus the attention of elite corporate lawyers, who used their considerable influence inside the boardroom to grab the attention of directors and insist on more rigorous internal procedures.[14] As has happened with other seminal "message" opinions,[15] the lawyers probably trumpeted the dicta and subtly downplayed how tiny the remaining liability risk was in order to upgrade compliance (a legal function) as a corporate priority. It would be no surprise, then, if directors came to believe that the *Caremark* threat was greater than the actual holding indicated.

But we need not obsess over history. *Caremark* is at the very least a label attached to what all now agree is a necessary and proper subject of attention for every board of directors: corporate compliance as a function within the broader task of enterprise risk management. In this brief Commentary, I want to address some lingering issues that flow out of *Caremark*, touching on the nature and design of compliance programs and the role of the board therein. None of this is meant to be critical of Chancellor Allen or the opinion he authored, but rather to identify ways in which what was said back then no longer suffices to address the contemporary milieu of aggressive compliance.

As many corporate governance scholars have come to accept, corporations are complex interactive systems of processes, routines, and feedback, the efficacy of which cannot be taken for granted and hence becomes the crucial focus of the CEO and senior management team.[16] The overwhelming complexity is daunting—perhaps beyond even the collective brainpower of the C-suite to comprehend—yet can and must be managed to the extent possible. Like all enterprise risks, compliance risks emerge, move, and change in ways not always visible within the architectural sight lines of the firm.

It is at least arguable that independent directors do not have the capacity to engage with this complexity, so that *Caremark* was wise to demand almost

12. *Id.*

13. *See, e.g.*, Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 268–72 (2004).

14. *See* Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719, 720 (2007).

15. *See* Walsh, *supra* note 2, at 30 (quoting lawyers about their advice to boards shortly after *Caremark*); *Roundtable: The Legacy of* Smith v. Van Gorkom, DIRECTORS & BOARDS, Spring 2000, at 28, 32–37 (remarks of Ira Millstein); *cf.* Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L. J. 375, 416 (1997) (arguing that lawyers gain power vis-à-vis their clients in proportion to the seriousness of the legal threat perceived by the client).

16. A relatively early expression of this is ROBERT CHARLES CLARK, CORPORATE LAW (1986), especially Section 3.4.2 and Appendix A. *See also* Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 950–52 (2006); Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMP. L. REV. 451, 459 (2003). More recently, the systems approach has been applied to help define a corporation's legal purpose in Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579 (2018).

nothing beyond asking that *some* compliance system exists. Independent boards have limited time, attention, and expertise, which should thus be deployed only when and where most useful. Yet government enforcers and standard setters today insist on a much greater board role without necessarily defining how or why it will be constructive. The remaining sections of my Commentary address three possibilities: (1) framing the cost-benefit assessment on the question of how much to spend on compliance; (2) forcing certain compliance matters to real-time board-level attention; and (3) using selection, promotion, and compensation decisions to influence the culture and risk-taking "temperature" of the firm. None of these is unfamiliar as a subject within the now vast literature on compliance, but I think there are still points and perspectives as to each that both connect back to *Caremark* and deserve more attention.

I. WAS *CAREMARK* MISLEADING?: TRADEOFFS AND EXTERNALITIES

For all the progress that has been made in both scholarly research and practitioner sophistication about compliance, quantitative metrics that help answer the basic questions—how much in the way of corporate resources should be devoted to compliance and how should those resources best be deployed—are elusive. Within the corporate control system, feedback with respect to high-level risk events is (fortunately) not frequent enough to calibrate with precision. To be sure, a brokerage firm, for example, can use changes in the number of regulatory inquires and customer complaints as indicators that compliance strategies are working or not, but these numbers can vary for any number of reasons and do not necessarily capture larger, less frequent risks. Similarly, surveys and other measurement tools regarding "ethical climate" can be helpful but leave open the question of what, precisely, to do about any dark clouds.[17] Put simply, there is always more that can be done in compliance—especially in the technology and manpower for audit and surveillance[18]—and an unavoidable fear that should a legal catastrophe happen, enforcers and the media will conclude in hindsight that what was done was not enough. On the other hand, compliance is not a profit center, making it hard to compete for funding with corporate functions that are, especially when the focus is on the short term.

Caremark was quite clear that these resources and deployment choices are matters of business judgment, and hence receive strong deference when made in good faith.[19] This plays into the minimalist board role—from this perspective, it suffices that management present its compliance plan for board-level feedback and/or approval on a regular basis. A claim by management that additional expenditures would not be cost-justified in light of its subjective risk assessment

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17. *See* Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 970–71 (2017) [hereinafter Langevoort, *Cultures of Compliance*].

18. For an interesting set of thoughts about technology and the costs of compliance, see William S. Laufer, *A Very Special Regulatory Milestone* (Univ. of Pa., Dep't of Criminology, Working Paper No. 2017-4.0, 2017), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3034699 [perma: http://perma.cc/A7WM-RVVL].

19. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996).

is presumptively reliable, all the more so if buttressed by an independent consultant's report.[20] Given the complexity of the compliance system (embedded inside the even more complicated corporate operating system), these resource allocations are hard for board members to question. *Caremark* certainly gives them no reason to do so.

The court's teaching that compliance is a matter of business judgment, however, can easily be misleading.[21] It suggests that the cost-benefit tradeoffs are made by reference to the long-run best interests of the corporation and its shareholders, so that the answer to the question "how much compliance is enough" is when the costs to the corporation exceed the benefits *to it* in terms of reduction in perceived risk. Indeed, that is conventional Delaware corporate law.[22] This is not to say that the board has the right to authorize illegal behavior because it is likely to be profitable—intentional illegality is ultra vires and outside the protection of the business judgment rule.[23] But *Caremark* was assuming the situation where there is no contemporaneous knowledge much less approval of criminality at the board level, so that the lawsuit is simply about efficient monitoring from a corporate (that is, shareholder) wealth perspective.

As Geoffrey Miller has demonstrated, such stress on business judgment is troubling. From a regulator's or enforcer's perspective, the goal of a compliance obligation is to cause corporations to invest in compliance up to the level where the preventive costs equal the *social* harm caused by the wrongdoing, not the harm to the corporation from being caught.[24] Their judgment as to the adequacy of expenditures (or compliance efforts as a whole) should thus be designed to penalize firms that underinvest in legal precaution from a social risk perspective, even if the judgment might be reasonable in terms of expected shareholder value.

To illustrate, consider the portion of a compliance program focused on foreign bribery as interdicted by the Foreign Corrupt Practices Act of 1977 (FCPA).[25] FCPA compliance is challenging, to be sure—the law is murky at numerous points, regulators vary over time in the likelihood and severity of enforcement, and the points of legal risk (opportunities for potentially unlawful payments) are numerous. From a shareholder perspective, the risk of sanction has to be taken very seriously, but so do the potential costs. And there is strong evidence that, on average and over time, FCPA sanctions are significantly less

20. *See* Stone v. Ritter, 911 A.2d 362, 371–72 (Del. 2006) (giving weight to consultant's report on bank's anti-money laundering compliance efforts).

21. *See* Bullard, *supra* note 7, at 20–24.

22. *E.g.*, Ebay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010) (stating the maximization of long term wealth of the corporation as only legitimate business objective).

23. *See* John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1172–73 (1977) [hereinafter Coffee, *Beyond the Shut-Eyed Sentry*].

24. *See* Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 247, 254–55 (Jennifer Arlen et al. eds., 2018); *see also* Langevoort, *Cultures of Compliance*, *supra* note 17, at 937–39.

25. *See* 15 U.S.C. §§ 78dd-1 to -3 (2012).

than the money to be made when violations remain undetected.[26] So even though a board could not authorize or knowingly tolerate violations, it could under *Caremark* choose to follow management's preference for moderation in how the firm deals with FCPA risks, without fear of state law fiduciary duty liability.

All that changes, however, when we move from state law fiduciary duties to federal or state regulatory enforcement.[27] If a violation occurs and is detected, the company may face increased sanctions if business judgment led it to invest suboptimally in precaution. True, regulators and enforcers may err in their own assessment of the cost-benefit tradeoffs, ignoring a multitude of indirect costs and adopting a motivationally inflated view of benefits. Jennifer Arlen and Marcel Kahan, for example, warn against regulators straying too far from the norm of corporate efficiency in making judgments about compliance,[28] and their fears about institutional competence are reasonable. My impression is that prosecutors have shown some naïveté in their faith in particular compliance and governance strategies. But in principle, at least, regulators and enforcers who have prosecutorial discretion and the ability to seek compliance-related sanction adjustment have no reason to feel beholden to *Caremark*'s focus on corporate well-being, and almost surely do not in fact.[29]

Instead, they will be looking to see a more active board-level engagement that accepts that compliance is not simply a matter of looking out for the best interests of the firm. This idea helps frame the kind of conversation that should occur between management and the board. Credit for good compliance comes when those in control of the company accept responsibility for the social harms that come from wrongdoing and seek to identify and avoid them by all reasonable means. To be clear, this is not an expectation that the board should abandon its fiduciary responsibilities, but rather that it should recognize the variable nature of the threat to the firm from poor compliance: a more severe sanction that, rationally, justifies a higher level of precaution.

Of course, one might argue that management should understand this on its own and take the (socially) optimal compliance precautions in the firm's best interests. But there are at least two sets of concerns to make us worry about excessive managerial autonomy regarding compliance strictures, both now fairly

26. *See* Jonathan M. Karpoff et al., Foreign Bribery: Incentives and Enforcement 3 (Apr. 7, 2017) (unpublished manuscript), http://www.ssrn.com/abstract=1573222 [perma: http://perma.cc/G75K-S8JZ].

27. Once regulators start focusing on compliance, their standards soon become de facto requirements, if not de jure ones. *See, e.g.*, Bullard, *supra* note 7, at 27–38. Bullard focuses on health care as an example of federal preemption of compliance, but the same point can be made about many other regulatory domains. *Id.*

28. *See* Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Nonprosecution*, 84 U. CHI. L. REV. 323, 327–28 (2017) (limiting compliance-related interventions to wrongdoing indicating clear agency cost problems); *see also* Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1, 50–56 (2014) [hereinafter Cunningham, *Deferred Prosecutions*]; Griffith, *supra* note 6, at 2105–06.

29. *See* Langevoort, *Cultures of Compliance*, *supra* note 17, at 937–40.

familiar. One is the presence of agency costs. For reasons having to do with hiring, compensation, and retention incentives, executives face a cost-benefit calculus for legal risk-taking that differs from the long-run best interest of the firm. They may choose a strategy that creates risk of sanction for the company in order to keep their jobs and perquisites.[30] But the same kinds of pressures to cheat may also arise from an *excessive* commitment to the firm's best interests, as where a cover-up is launched to avoid legal responsibility for something that has gone wrong or to avoid loan defaults and the like that would occur if the hidden problems were revealed. I (and others) have written extensively about what motivates managerial misbehavior, and this vast debate need not be repeated here.[31] Suffice it to say that managerial motivations toward legal compliance are not fully aligned with either the corporation's best interests *or* the optimal avoidance of social harm. Regulators' hopes thus turn to the board of directors.

How well boards do here is open to question, given informational imbalances and the boards' own skewed incentive structure.[32] But some agenda items for active discussion seem obvious. Today, especially, clawback provisions in executive compensation packages are seen as an important risk-reducing device, as to compliance and otherwise.[33] To design an optimal clawback requires careful consideration of the compliance risk environment and the pressures that may motivate conscious or unconscious cheating behaviors. That exercise itself is a valuable one, and should not be bottled up just in the work of the compensation committee of the board.

We will turn to other things for boards to think about shortly. For now, I would simply suggest that compliance oversight requires seeing how easily management's internal perspective can undervalue (and undermine) a truly potent compliance structure, turning it into cosmetic compliance.[34] The board that wants full compliance credit if and when a violation occurs had better be able to demonstrate awareness and response, and not simply wave the flag of "business judgment."

So, what about *Caremark*? The foregoing discussion and what is yet to come go well beyond the holdings and dicta in *Caremark* and its Delaware corporate law progeny. To be sure, dicta found in the opinion is meant to prompt *some*

30. Because of diffusion of knowledge and responsibility within complex firms, individual prosecutions are less frequent, though by no means unlikely. My view, developed at length elsewhere, is that psychology and culture make executives willing to engage in or tolerate noncompliance even when rationally it might be prudent to obey the law. *See* DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 33–60 (2016).

31. *Id.*; *see also, e.g.*, Arlen & Kahan, *supra* note 32; Coffee, *Beyond the Shut-Eyed Sentry*, *supra* note 23.

32. *See* LANGEVOORT, *supra* note 30, at 90–91.

33. *See generally* Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721 (2011) (detailing clawback provisions and discussing their prevalence).

34. *See* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 491 (2003) ("[A] growing body of evidence indicates that internal compliance structures do not deter prohibited conduct within firms, and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability.").

attention to the status of internal compliance. But this is all by way of what in the end animates the Delaware corporate vision: it is up to the shareholders to elect directors who care about their interests and monitor accordingly. As Chancellor Allen says, there are limits on how sorry to feel for the shareholders if they fail to do so and some compliance catastrophe occurs.[35] By contrast, the evolving regulatory vision of corporate compliance responsibilities is to see the harms from corporate wrongdoing to persons with no franchise at all. On that *Caremark* says naught, and thus seems a bit less relevant in modern optimal compliance debates.

II. WAS *CAREMARK* NAÏVE?: BOARD KNOWLEDGE AND DISTORTED INFORMATION FLOW

Caremark was clear that the point of the obligation of inquiry was to make it more likely that compliance and other risk-related information would come to the attention of both senior management *and* the board so that they could carry out their fiduciary responsibilities in an informed fashion.[36] How to do so was left to business judgment, and so once again there is relatively little guidance. Although the court does acknowledge that no system can be fail-safe, the opinion reads almost as if a competent system, once in place, should ordinarily generate reliable information for all interested parties to process. It seems so straightforward.

The reality is messier; compliance is always a struggle. Within the complex corporate system, information is diffused among many parties. Often, no one person or group will know enough to appreciate the full legal risk, and even if they do, they may have incentives to conceal or distort. Work in organization psychology emphasizes that these blind spots, blockages, and distortions are not necessarily in bad faith (though they certainly are sometimes), but rather are the byproduct of routinization that make the truth hard to discern.[37] Further complication arises from the subjective nature of law and legal risk. Law is often full of ambiguity, even when factual questions are posed clearly. Feedback is often lacking. As a result, legal risk-related information inside the firm is constantly shifting, and subject to wishful thinking.

Many fascinating issues arise out of this messiness about how managers construe legal risk, which scholars in law and the social sciences have been studying for some time. For our purposes here, I want to focus on just one issue: What is the right internal policy for when management should bring a legal compliance matter to the attention of the board?

One subtle aspect of *Caremark* comes into play here. The Chancellor stressed that no "red flags" had come to the attention of the board that did or

35. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968 (Del. Ch. 1996).

36. *See id.* at 967–68.

37. *See* Malloy, *supra* note 16, at 457–59; *see also* Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL'Y 807, 813–14, 835–36 (2010).

should have alerted them of the compliance risk.[38] So what is the standard for director liability for situations where there were red flags? In two widely noted federal courts of appeals decisions applying Delaware law not long after *Caremark*, the courts refused to dismiss cases against the board members pending further factual inquiry into what the board members knew and how they responded.[39] Plaintiffs' lawyers with *Caremark* type cases soon were working hard to fill their complaints with numerous warning signs that the board should have pursued.[40]

We need not determine here precisely what the law is with respect to red flag cases (especially when the company has a Section 102(b)(7) exculpatory clause in its charter to protect directors from duty of care liability).[41] All we need to see for now is that the moment the board is brought into the compliance risk discussion, liability exposure increases to at least a small extent, and *Caremark* itself no longer sets the applicable standard. This shift may be even more dramatic under federal law.[42] Under the federal securities laws, for example,

38. *See Caremark*, 698 A.2d at 971–72.

39. *See In re* Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 811 (7th Cir. 2003); McCall v. Scott, 239 F.3d 808, 826 (6th Cir.) *amended on denial of reh'g*, 250 F.3d 997 (6th Cir. 2001). The fact that these cases were not decided by Delaware courts led plaintiffs to prefer non-Delaware venues for *Caremark* type claims. This is no longer quite so easy due to charter or bylaw provisions mandating that derivative claims be brought in Delaware courts. *E.g.*, Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. REV. 485 (2016).

40. *See, e.g.*, Verified Stockholders' Derivative Complaint at 36, Westmoreland Cty. Emp. Ret. Sys. v. Parkinson, 727 F.3d 719 (7th Cir. 2013) (No. 10-cv-6514) (applying Delaware law).

41. In *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the Delaware Supreme Court indicated that such cases require plaintiffs to show a *conscious* disregard of the compliance risk in the face of whatever "red flags" information came to its attention, which is hardly an easy standard for plaintiffs to meet. *Id.* at 370. And indeed, most such claims fail. *See, e.g.*, *In re* Qualcomm Inc. FCPA Stockholder Derivative Litig., C.A. No. 11152-VCMR, 2017 WL 2608723, at *5 (Del. Ch. June 16, 2017). But there have been cases where the flags were red enough to permit such an inference, and so this remains the route of choice. *See, e.g.*, *Westmoreland Cty. Emp. Ret. Sys.*, 727 F.3d at 729–30 (applying Delaware law); *In re* Intuitive Surgical S'holder Derivative Litig., 146 F. Supp. 3d 1106, 1119 (N.D. Cal. 2015); *In re* Massey Energy Co., C.A. No. 5430–VCS, 2011 WL 2176479, at *21 (Del. Ch. May 31, 2011). For a review and assessment of these red flag cases, see Ezra Wasserman Mitchell, *Caremark*'s Hidden Promise (Aug. 2, 2017) (unpublished manuscript), http://ssrn.com/abstract=3012419 [perma: http://perma.cc/UBU5-B7S4]. As a matter of Delaware corporate law, many of the *Caremark* cases just cited were decided based on whether plaintiffs' failure to make demand on the board of directors to bring the suit is excused as futile, which is typically resolved by reference to whether the directors face a significant threat of personal liability. That inquiry, in turn, is complicated by the fact that most Delaware corporations have adopted charter provisions under Section 102(b)(7) that exculpate directors from liability for breach of the duty of care absent bad faith. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2018). Indeed, *Stone* essentially adopts a bad faith standard for all *Caremark* claims. Of course, even with a skeptical judiciary, the pressures to settle may be considerable. For a more approving assessment of a *Caremark* claim once a settlement agreement promises to terminate litigation, see *In re Pfizer Inc. Shareholder Derivative Litigation*, 780 F. Supp. 2d 336, 340–42 (S.D.N.Y. 2011).

42. There can be substantial disclosure obligations with respect to compliance risks, especially for public companies. *See* Hillary A. Sale & Donald C. Langevoort, *"We Believe":* Omnicare*, Legal Risk Disclosure and Corporate Governance*, 66 DUKE L.J. 763, 768 (2016). The extent to which the securities laws substitute more aggressively for weak state corporate law fiduciary duty principles is

disclosure cases require a showing of scienter, which includes subjective recklessness.[43] Being brought into the loop provides evidence of this, and also triggers a greater possibility of control person liability[44] or (for securities firms) "duty to supervise" liability.[45]

So, board members will not welcome any such escalation. No doubt there are circumstances where the legal dangers are so imminent and large that failure to escalate would be a clear breach of fiduciary duty on the part of whatever senior managers knew of the risks—the duty of "candor inside the corporation" about which I have written elsewhere.[46] But given the messiness noted earlier, many situations will be more ambiguous as to either the probability or the magnitude of the risk. There, one can start imagining arguments for putting off informing the board for the moment.

Take, for example, a situation where lawyers at a health care corporation authorized a form of contractual arrangement with hospitals and pharmacies. There were possible arguments for illegality, but the legal team made the judgment that these economically beneficial deals would likely be upheld if challenged. Subsequently, however, two things have changed. First, there is evidence that certain sales staff have made informal modifications to the approved arrangements that might be troubling, the extent of which at this point has not yet been determined. Secondly, federal regulators have become notably more aggressive in pursuing cases involving marketing practices. Right now, the legal team is quietly investigating and has asked the sales department to stop the practice of one-off modifications. So, who should know this, and by what means? Suppose the company then gets a request from federal regulators inquiring about sales and marketing practices, via a letter being sent out to a large number of firms in the industry. Or a specific request to discuss such practices with enforcement staff from the regulators or the Department of Justice. What about a subpoena?

There is no obvious answer under these varying facts, at least until the subpoena. But I can easily imagine this kind of information getting bottled up, with potentially unfortunate consequences for the company. This is a sensitive matter over which the lawyers want control, and sharing complete information

well documented. *See* Donald C. Langevoort, *Seeking Sunlight in* Santa Fe*'s Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 450–52 (2001); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860–61 (2003).

43. *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 706–09 (8th ed. 2017).

44. *See* Marc I. Steinberg & Forrest C. Roberts, *Laxity at the Gates: The SEC's Neglect to Enforce Control Person Liability*, 11 VA. L. & BUS. REV. 201, 212 (2017) ("Control person liability may also be extended to lower level managers and department heads if they exercised the requisite amount of control over the primary violator(s).").

45. *See* 15 U.S.C. § 78o(b)(4)(E) (2012); James A. Fanto, *Surveillant and Counselor: A Reorientation in Compliance for Broker-Dealers*, 2014 BYU L. REV. 1121, 1143–48.

46. Officers who intentionally keep directors in the dark on an important matter are almost surely violating fiduciary and agency law responsibilities. *See* Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1195 (2003).

with a widening circle of corporate officials necessarily diminishes that control. No doubt there is some belief, realistic or not, that the problem can be made to go away by distancing the company from the now-riskier practice without drawing attention to the matter. In the background—conscious or not—is accountability and self-interest. Potentially, the lawyers are to blame either for originally providing imprudent legal advice or for failing to understand what was really happening and not adjusting their advice in light of new circumstances. Human nature is to double down, via what psychologists call "defensive bolstering": increasing one's commitment to the original decision.[47] The lawyers may try to find sympathetic outside counsel to concur. All of this may diminish the perceived compliance risk and thus understate the actual risk.

This is a test of character and competence for the lawyers, and there is considerable variation in how chief legal officers will perform.[48] The *Caremark* related question is whether the board should, as a matter of policy, insist that it be brought into matters like these and, if so, how and when. The *Caremark* opinion again says nothing, so that once more it is a matter of good faith business judgment. If that is all, then it is probably safe to assume that most boards will allow senior management to exercise discretion on what to report up, with the implicit understanding that compliance matters are for management to handle and only extraordinary circumstances should require board attention. That is not entirely unreasonable. Legal compliance is not specifically within the expertise of most board members, and there will not necessarily be productive conversations in this highly scripted portion of the meeting beyond the exhortation that the matter be handled properly.

Today, however, I doubt that well-advised boards take this position (though some probably wish they could).[49] The reason, once again, stems mainly from pressures from regulators and enforcers at the federal level who have come to believe in the value of a stronger board-level presence in compliance.[50] The Organizational Sentencing Guidelines, Committee of Sponsoring Organizations of the Treadway Commission principles, and numerous regulatory pronouncements seek not only board approval of written policies and procedures and key compliance personnel decisions, but also a much more interactive involvement that includes reporting lines running from the chief compliance officer (and perhaps chief legal officer) directly to the board, unfiltered by senior executives.[51] While these are rarely so specific as to define

47. *See* Philip E. Tetlock et al., *Social and Cognitive Strategies for Coping with Accountability: Conformity, Complexity, and Bolstering*, 57 J. PERSONALITY & SOC. PSYCHOL. 632, 634 (1989).

48. *See generally* BEN W. HEINEMAN, JR., THE INSIDE COUNSEL REVOLUTION: RESOLVING THE PARTNER-GUARDIAN TENSION (2016) (describing the increase in the chief legal officer's importance and authority in the corporate sphere over the past twenty years). For an economics perspective on these developments, see generally Robert C. Bird et al., *The Role of the Chief Legal Officer in Corporate Governance*, 34 J. CORP. FIN. 1 (2015).

49. *See* Rebecca Walker & Jeff Kaplan, *Reporting to the Board on the Compliance and Ethics Program*, COMPLIANCE & ETHICS PROF., June 2014, at 59, 64–65.

50. *E.g.*, Griffith, *supra* note 6, at 2107–09.

51. These are discussed extensively in practice-oriented compliance treatises. *E.g.*, JEFFREY

the time frame or materiality threshold for reporting up, the assumption seems to be that boards want and need awareness and involvement on an accelerated basis as to significant compliance risks. Otherwise, the board will too often be the last to know.

As noted earlier, many scholars and practitioners have criticized federal regulators and enforcers for naïvely assuming the virtues of certain corporate governance interventions without proof that they really work or are without significant costs.[52] To them, *Caremark*'s legacy of minimalism and deference is to be celebrated—private ordering will do better at getting compliance responsibilities to the right place. Under normal governance conditions, the board and the management team will work out an acceptable understanding for when compliance matters are to be escalated, a decision which need not be second-guessed simply because it tilts heavily toward managerial prerogative.

What we see here is something of a replay of Section I. The contemporary federal perspective seems to be that management is too often inclined to ignore or bury compliance warnings and risks and cover up when events pass the illegality threshold. Forcing more board-level involvement early on is the only practicable alternative at the highest level of the firm, naïve or not. Hence the emphasis on real-time interaction not only with senior management but the chief legal and compliance officer, supplemented by the positioning of legal and compliance personnel in key committees and organization chart checkpoints, so that there are more routes by which information can indeed reach the board and force it to respond.[53]

Nothing guarantees that this will actually happen—sound information flow practices on paper are often enough frustrated in practice. But the evidence we have on independent director presence does suggest some efficacy in reducing firm-level risk and instilling a better attitude toward compliance.[54] As corporate governance norms continue to move in the direction of board empowerment and professionalization, we cannot readily dismiss the possibility that the "information forcing" function associated with the burdens and responsibilities of added board-level compliance will do some good.[55]

This is also consistent with the approach to compliance that focuses on the optimal expenditure of resources to avoid social harm, not just harm to the corporation and its shareholders. Presumably, independent directors are more likely than insiders to accept the legitimacy of societal demands for caution over risk-taking when the harms from corporate wrongdoing are spread widely while

KAPLAN & JOSEPH E. MURPHY, COMPLIANCE PROGRAMS AND THE ORGANIZATIONAL SENTENCING GUIDELINES (2015 ed.).

52. *E.g.*, Cunningham, *Deferred Prosecutions*, *supra* note 28.

53. For a good survey of these kinds of mandatory reforms, see generally Wulf A. Kaal & Timothy Lacine, *The Effect of Deferred Prosecution and Non-Prosecution Agreements on Corporate Governance: Evidence from 1995–2013*, 70 BUS. LAW. 61 (2015).

54. *See, e.g.*, Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1835–36 (2007) (discussing "speed bump" from independent director involvement in risk management).

55. *See* Sale & Langevoort, *supra* note 42, at 787–88.

its profits are thoroughly internalized in the form of salaries, bonuses, dividends, and stock price appreciation. Or such is the normative expectation, even if not all independent directors have yet gotten the message.

III. WAS *CAREMARK* INCOMPLETE?: INCENTIVES AND CORPORATE CULTURES

When *Caremark* was decided, the neoclassical law and economics scholarship was still fairly dominant. Its stress on rationality and market efficiency readily led to private ordering solutions to corporate law problems, including compliance. If legal sanctions are set correctly, the firm—and those whose interests are aligned with the firm—have sufficient incentives to seek to avoid violations via an efficient level of internal compliance. If legal sanctions are instead set too low or are underenforced, under this view it is not the corporation's problem to solve.

Much has changed since then. Today, as we have seen, compliance expectations are much higher, not tied to the corporation's narrow self-interest.[56] But scandals continue to grab headlines. Part of the reason for compliance failure, no doubt, is because there are still positive returns to wrongdoing because of underenforcement.[57] But the risks to high-level officials from corporate prosecutions and regulatory sanctions go beyond fines and penalties—stock prices drop, the firm suffers reputational harm, and more. Boards are more likely to fire the CEO or subordinates out of anger or frustration, or at least reduce their pay.[58] There are ample disincentives to corporate illegality, all of which should have a robust deterrence effect.

Perhaps the biggest change in thinking about compliance since *Caremark* is the realization that unhealthy corporate cultures can defeat even the most well-intentioned preventatives installed by senior management and the board.[59] Indeed, the phrase "culture of compliance" has become standard in describing what regulators and enforcers now want to see.[60] And this goes well beyond anything that can be described in a set of policies and procedures, tonal speeches from the top, or written statements of values and ethics.

We are increasingly coming to see how and why ethical and legal lapses occur. Corporate cultures are belief systems—transmitting to loyal, committed managers and employees a sense of what is valued, and what is denigrated. They help coordinate the activities of numerous stakeholders, an essential task in

56. *See supra* Section I.

57. *See supra* notes 25–27.

58. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1032–40 (2010). *But see* Messod D. Beneish et al., *Explaining CEO Retention in Misreporting Firms*, 123 J. FIN. ECON. 512, 515–17 (2017) (explaining that outside directors may not actually be incentivized to make "value-maximizing decisions").

59. There is now a large body of literature on this. *See, e.g.*, 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, 351–59 (2016); Langevoort, *Cultures of Compliance*, *supra* note 17, at 943–46.

60. *See* Langevoort, *Cultures of Compliance*, *supra* note 17, at 940–44.

making the complex corporate system function. When corporations are under immense competitive pressure to succeed (often driven by shareholders), belief systems can become facilitators for what it takes to survive and thrive—the grease in the corporate machinery. When circumstances create temptations to behave illegally, those beliefs can provide rationalizations that explain why what is profitable is also morally acceptable, via what psychologists call "motivated inference."[61] Once these kinds of rationalizations take hold, wrongdoing starts to happen—first in small steps, then in bigger ones.[62]

It is a difficult managerial task to simultaneously drive profits and growth while preserving a strong sense of compliance. Typically, the former is directly rewarded via raises and promotions and the latter more through exhortations and soft praise, if that. Compliance professionals have come to appreciate the immensity of the task and the need to prevent the memes that reverberate through the corporate culture from enabling dangerous beliefs that stimulate legal risk-taking, which is not an easy task.

Caremark gives no hint of any of this, though that is not a criticism. At the time, culture and norms were not central to thinking about governance or compliance. Today they are, with regulators and enforcers willing—for better or worse—to pass judgment on a company's ethical climate when deciding whether to charge the corporation or just individuals, or how big a fine to seek. The lesson is an important one as they work through their growing number of compliance-related assignments. As I put it recently in a survey of compliance cultures:

> In the end, the most important message about cultures of compliance is for corporate leaders and, especially, for boards of directors. It is much too easy to look around and see good people working hard at difficult jobs and assume that a good compliance culture exists simply because everyone has been warned of the damage that can come from getting caught doing wrong. Or worse, to assume that an observable abundance of intensity, loyalty and creativity are signs that all is good.[63]

We have seen wrongdoing emerge from within the most celebrated of companies, often when—and perhaps because—boards engaged in their own sort of motivated inference, failing to appreciate that it was time to turn down internal corporate temperature a bit before things got out of control.

One small irony, however, comes from *Caremark*'s curt dismissal of *Graham*'s warning against fiduciary duty leading to intracorporate espionage.[64] Today, those fears are very much still with us, all the more so as technology creates surveillance tools unimaginable in 1996, much less 1963. Surveillance

61. *See, e.g.*, Francesca Gino et al., *Motivated Bayesians: Feeling Moral While Acting Egotistically*, 30 J. ECON. PERSP. 189, 191–95 (2016).

62. *See, e.g.*, John M. Darley, *The Cognitive and Social Psychology of Contagious Organizational Corruption*, 70 BROOK. L. REV. 1177, 1177–81 (2005) (discussing the erosion of an organization's commitment to compliance).

63. Langevoort, *Cultures of Compliance*, *supra* note 17, at 977 (footnote omitted).

64. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969–70 (Del. Ch. 1996).

intensity, as many have pointed out, may be effective at promoting command and control, but comes at a cost in terms of a culture of trust and integrity that is hard to measure but very much worth worrying about.[65]

CONCLUSION

Caremark's legacy today takes two forms. It remains part of the canon of authorities regularly cited as the impetus to taking compliance seriously in boardrooms and executive suites, and it still generates a steady flow of litigation, if not significant recoveries, by shareholders of companies that suffered the trauma of a compliance failure. But it is also cited and embraced by critics of the federal presence who see unchecked costs to the obsession with compliance and wish to return to more business judgment deference to boards and managers, not federal bureaucrats, on how best to design and implement compliance systems.

Chancellor Allen was no ideologue, and he understood that he was addressing only the shareholder litigation piece of the far larger compliance puzzle. In extrajudicial writings, he was sensitive to the biases and distorted incentives that plague high-stakes corporate decisionmaking, hoping that independent lawyers, directors, and others understood the need to step up regardless of the diminished liability threat.[66] Those thoughts have even more resonance today, as the short-term market pressures on corporations have grown all the more intense.[67] They are strongly felt in the boardroom. But there are also countervailing pressures in the direction of "publicness": the societal expectations that economically powerful entities have an obligation to temper the risks they take when the harms from bad decisions are felt outside corporate boundaries. Compliance is a crucial part of this, which the Chancellor understood and wanted to promote as much as he could within the restrictive confines of the case before him. To be clear, I do not think that *Caremark* was misleading, naïve, or incomplete. The Chancellor knew that if boards failed to become more sophisticated and sensitive to doing this well—the cultural part as well as the policies and procedures—external pressures would continue to grow

65. Heavy monitoring itself produces reactance, frustrating compliance. Inculcating a sense of trust is necessary for optimal behavior, yet trust will sometimes be abused. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 72; Gary R. Weaver, *Encouraging Ethics in Organizations: A Review of Some Key Research Findings*, 51 AM. CRIM. L. REV. 293, 297 (2014); *see also* Fanto, *supra* note 45, at 1123–24; Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1215, 1218–23 (2017); Scott Killingsworth, *Behavioral Ethics: From Nudges to Norms*, ETHIKOS, Jan.–Feb. 2017, at 1, 1–5; Milton C. Regan, Jr., *Moral Intuitions and Organizational Culture*, 51 ST. LOUIS U. L.J. 941, 981–82 (2007).

66. *See generally, e.g.*, William T. Allen, *Corporate Governance and a Business Lawyer's Duty of Independence*, 38 SUFFOLK U. L. REV. 1 (2004) (discussing the various modern tensions inherent in the role of a business attorney).

67. Such market pressures include activist investors, whose influence does not appear to be integrity producing regardless of its immediate impact on the issuer's stock price. *See* John C. Coffee, Jr., *Preserving the Corporate Superego in a Time of Stress: An Essay on Ethics and Economics*, 33 OXFORD REV. ECON. POL'Y 221, 231–34 (2017); Jillian Popadak, A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value 3 (Oct. 2013) (unpublished manuscript), http://www.ssrn.com/abstract=2345384 [perma: http://perma.cc/42NX-AXET].

without regard to cost or efficiency. That is even more so today.