CAREMARK IN THE ARC OF COMPLIANCE HISTORY

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ABSTRACT

In 1996, the Delaware Chancery Court's In re Caremark International Inc. Derivative Litigation *decision was the first to recognize a director's fiduciary duty to oversee a corporation's compliance and ethics program. Two decades later, this Article locates* Caremark *within the ongoing history of compliance and ethics programs by tracing the parallel evolutions of the* Caremark *duty and another compliance and ethics landmark—the 1991 U.S. Sentencing Guidelines, which provided the first legal incentive for organizations to design, implement, and operate an effective compliance and ethics program. These two histories converged at an important point that yielded the* Caremark *decision: The Sentencing Guidelines influenced the 1996 Chancery Court decision to recognize the* Caremark *duty. Over the following twenty years, though, these histories sharply diverged. While amendments to the Sentencing Guidelines developed a robust account of director responsibilities, Delaware case law stalled, leaving* Caremark*'s promise unfulfilled.*

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INTRODUCTION

In the compliance and ethics field, *In re Caremark International Inc. Derivative Litigation*[1] is one of the few judicial decisions that professionals will know by name.[2] In 1996, the Delaware Chancery Court's decision was the first to recognize a director's fiduciary duty to oversee a corporation's compliance and ethics program,[3] which instantly raised the visibility and urgency of compliance and ethics in the board room.[4] And even though this duty was not law until later confirmed by the Delaware Supreme Court in a case by another name,[5] the compliance and ethics community still refers to the "*Caremark* duty" due to the original decision's path-breaking analysis and impact.

Two decades later, we can ask where *Caremark* falls within the ongoing history of compliance and ethics. This Article does so by describing the parallel evolutions of the *Caremark* duty and another compliance and ethics landmark—the 1991 U.S. Sentencing Guidelines (Sentencing Guidelines) that provided sentencing leniency for organizations with an effective compliance and ethics program.[6] These two histories converge at an important point that gives us the *Caremark* decision. That is, the 1991 Sentencing Guidelines influenced the 1996 Chancery Court decision to recognize the *Caremark* duty.[7] Over the following twenty years, the histories then diverge: subsequent amendments to the Sentencing Guidelines develop a robust account of director responsibilities, while Delaware case law stalls, leaving the *Caremark* duty as largely symbolic.

Section I of this Article examines the pre-*Caremark* compliance and ethics landscape, where companies and courts saw compliance and ethics programs as the appropriate response to the discovery of corporate wrongdoing. That Section also discusses the Delaware Supreme Court's first encounter with the director's fiduciary duty of oversight, which incorporated the reactive approach into the legal test. Section II then describes the origins of the U.S. Sentencing Guidelines

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

2. Three other contenders would be *Ellerth*, *Faragher*, and *Kolstad*, all of which address corporate vicarious liability under the federal civil rights laws. Burlington Indus., Inc. v. Ellerth, 524 U.S. 742, 746–47 (1998); Faragher v. City of Boca Raton, 524 U.S. 775, 780 (1998); Kolstad v. Am. Dental Ass'n, 527 U.S. 526, 545 (1999).

3. *See Caremark*, 698 A.2d at 967.

4. *See* H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L. 1, 16 (2001).

5. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

6. U.S. SENTENCING GUIDELINES MANUAL (U.S. SENTENCING COMM'N 1991).

7. *Caremark*, 698 A.2d at 969; *see also infra* notes 120–23 and accompanying text.

for organizations, which offered the first general legal incentive for preventive compliance and ethics programs. Section III turns to the *Caremark* decision, where we see that the Chancery Court's opinion relies in part on the Sentencing Guidelines in reformulating the director's duty of oversight. We see that while this landmark case decision innovated by recognizing a preventive duty for directors, judicial scrutiny of directors' decisions remained quite deferential. Section IV then describes the 2004 amendments to the Organizational Sentencing Guidelines that increased the expectations of directors in response to the Enron and other financial scandals. Section IV also shows that these same forces did not lead the Delaware courts to heighten the fiduciary duty for directors. Rather, the Delaware Supreme Court's 2006 decision recognizing the *Caremark* duty maintained the clear deference to director decision making. The Conclusion briefly notes the implications of this history for a future issue of importance—what is the *Caremark* duty of corporate officers.

I. PRE-*CAREMARK* COMPLIANCE AND FIDUCIARY DUTY

This Section sketches the background for understanding the shift worked by the Sentencing Guidelines and *Caremark*. Part I.A briefly describes how organizations historically took a reactive approach to compliance and ethics programs. Such programs were not seen as a part of proactive risk management, but rather as the consequence of discovering and remediating corporate wrongdoing.[8] The focus of compliance and ethics, then, was to avoid recidivism. Part I.B shows how the Delaware Supreme Court adopted this reactive approach in its first decision addressing a director's fiduciary duty of oversight. A director would breach that duty only by reacting improperly to corporate wrongdoing; the duty did not require directors to take reasonable preventive steps.[9]

A. *The Early History of Compliance and Ethics Programs*

The history of compliance and ethics programs has moved from ad hoc reaction to the discovery of wrongdoing to preventive risk management strategies increasingly required by law. Starting with the heavy electrical equipment scandals of the 1950's, corporations would implement an ethics program as part of their punishment for wrongdoing.[10] In those cases, which are discussed further in the next Part, manufacturers of heavy electrical equipment, such as industrial transformers and generators, conspired to fix prices and rig bids in violation of United States antitrust law.[11] Companies and corporate officers were indicted and convicted of criminal violations, with the companies paying fines and some corporate officers sentenced to modest prison terms.[12] In

8. *See supra* notes 4–7 and accompanying text.

9. *See Graham v. Allis-Chambers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

10. JED S. RAKOFF ET AL., CORPORATE SENTENCING GUIDELINES: COMPLIANCE AND MITIGATION § 5.02[l][a] (1st ed. 1993).

11. Myron W. Watkins, *Electrical Equipment Antitrust Cases—Their Implications for Government and for Business*, 29 U. CHI. L. REV. 97, 97 (1961).

12. *Id.* at 100.

response to this misconduct, organizations in the industry developed and implemented measures to prevent reoccurrence of these antitrust violations.[13]

This reactive approach was seen again in the foreign bribery scandals in the mid-1970s.[14] During the Watergate hearings, among the testimony about payments to the Committee for the Re-Election of the President, corporate leaders spoke about bribes to foreign government officials in exchange for contracts and other business.[15] This drew the attention of staff at the Securities and Exchange Commission (SEC), who asked how companies would record the bribes on their corporate books.[16] After an SEC amnesty program drew over 400 companies to disclose their prior bribery practices, Congress enacted the Foreign Corrupt Practices Act (FCPA),[17] which made it a crime under United States law to bribe another country's officials.[18] Since that time, companies subject to the FCPA have developed measures to prevent recurrence of foreign bribery.[19]

The reactive approach continued with the insider trading and government contracting scandals of the 1980s.[20] The government prosecuted investment firms, such as Drexel Burnham Lambert, and individuals, such as Michael Miliken and Ivan Boesky, for insider trading.[21] And Congress reacted with the Insider Trading and Securities Fraud Enforcement Act of 1988,[22] which required written policies and procedures designed to prevent and detect insider trading.[23] After fraud in government contracting came to light, President Ronald Reagan appointed the Packard Commission to investigate and recommend reforms in government contracting.[24] The Commission's final report recommended that government contractors adopt codes of ethics and contract compliance measures to avoid future fraud.[25] Once again, compliance and ethics programs served

13. *See* RAKOFF ET AL., *supra* note 10, § 5.02[l][a].

14. *See* Stanley Sporkin, *The Worldwide Banning of Schmiergeld: A Look at the Foreign Corrupt Practices Act on Its Twentieth Birthday*, 18 NW. J. INT'L L. & BUS. 269, 269–74 (1998).

15. *See id.* at 271–72.

16. *See id.*

17. *Id.*

18. 15 U.S.C. §§ 78dd-l to -3 (2012).

19. Sporkin, *supra* note 14, at 281 ("Self-regulatory and internal compliance programs have become commonplace.").

20. Harvey L. Pitt & Karl A. Groskaufmanis, *A Tale of Two Instruments: Insider Trading in Non-Equity Securities,* 49 BUS. LAW. 187, 187–88 (1993).

21. *See id.* at 216–18.

22. Insider Trading and Securities Fraud Act of 1988, Pub. L. No. 100–704, 102 Stat. 4677 (codified as amended in 15 U.S.C. § 78).

23. *See* Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783, 1791–92 (1994).

24. David Packard, *Forward* to PRESIDENT'S BLUE RIBBON COMM'N ON DEF. MGMT., A QUEST FOR EXCELLENCE: FINAL REPORT TO THE PRESIDENT, at xi (1986).

25. PRESIDENT'S BLUE RIBBON COMM'N ON DEF. MGMT., *supra* note 24, at xxix ("To assure that their houses are in order, defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance.").

mainly to prevent repeat violations rather than create an organizational commitment to ethical values and following the law.[26]

The Delaware Supreme Court's first engagement with compliance, discussed in the next Part, took place within this history of reactive implementation of compliance and ethics programs. It is not surprising, then, that the court adopted the reactive approach in addressing a corporate director's fiduciary duty for legal compliance. We now turn to that case.

B. The Reactive Approach to Fiduciary Duty: Graham v. Allis-Chalmers

The Delaware Supreme Court first addressed a corporate director's fiduciary duty to oversee legal compliance in *Graham v. Allis-Chalmers Manufacturing Co.*[27] The case arose out of the heavy electrical equipment antitrust scandal discussed above, and it involved a shareholder derivative suit to recover damages from corporate directors and officers for losses due to the corporation's violation of the federal antitrust laws.[28] Because the evidence showed that the directors did not know about the antitrust violations while they were occurring, the shareholders claimed that the directors had breached their fiduciary duty by failing "to take action designed to learn of and prevent anti-trust activity on the part of any employees of Allis-Chalmers."[29]

The court summarized its analysis as follows:

> [D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a *corporate system of espionage* to ferret out wrongdoing which they have no reason to suspect exists.[30]

The court's use of the word "espionage" to describe a compliance and ethics program is notable for two reasons. First, it focuses on the monitoring and investigatory functions of a compliance and ethics program to the exclusion of many other important components, such as training and communication. In doing so, the court expressed a cramped view of a compliance and ethics program.[31] Second, the word "espionage" suggests that a compliance and ethics program would place the employer and its employees in a hostile relationship. As discussed below, however, an effective compliance and ethics program will foster a culture of trust and respect. In framing its analysis, the court took a

26. RAKOFF ET AL., *supra* note 10, § 5.02[l][b]–[c].

27. 188 A.2d 125 (Del. 1963).

28. *Graham*, 188 A.2d at 128. The corporation and a number of its officers pled guilty to the federal criminal charges. Watkins, *supra* note 11, at 98–99.

29. *Graham*, 188 A.2d at 127.

30. *Id.* at 130 (emphasis added).

31. *See* Robert T. Miller, *Wrongful Omissions by Corporate Directors:* Stone v. Ritter *and Adapting the Process Model of the Delaware Business Judgment Rule*, 10 U. PA. J. BUS. & EMP. 911, 935–36 (2008) (stating that the *Allis-Chalmers* rule could imply that directors do not have a duty to be informed about subordinates' activities).

negative view of compliance and ethics programs.[32]

In deciding that the Allis-Chalmers directors had not breached their fiduciary duty, the court adopted the reactive approach to legal compliance. The directors had responded to the indictments by taking actions "to end . . . and prevent . . . recurrence" of antitrust violations, and they did not have a duty to act sooner:

> Plaintiffs [(shareholders)] say these steps should have been taken long before, even in the absence of suspicion, but we think not, for we know of no rule of law which requires a corporate director to assume, with no justification whatsoever, that all corporate employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities.[33]

Graham, then, embraces the reactive approach to legal compliance of its era. As we will see later, it was not until over thirty years later that *Caremark* would prescribe preventive action by corporate directors.

The passage just quoted evinces an impoverished conception of compliance and ethics programs. Consider the assumption that precautionary measures are needed only if "all corporate employees are incipient law violators."[34] This statement denies two important roles for a compliance and ethics program. First, employees can cross a legal line through well-meaning ignorance of what the law requires.[35] The compliance and ethics program can educate and support these ethical employees. Second, a *single* rogue employee can violate the law and cause significant harm to the organization.[36] Even the most careful hiring process will not catch all "incipient law violators," and so an employer might reasonably assume that some percentage of their workforce could seize the opportunity to engage in misconduct.[37] A well-designed compliance and ethics program can

32. *See infra* Section IV.

33. *Graham*, 188 A.2d at 130–31.

34. *Id*. This leaves aside the court's use of the "checkrein" image, which is "a short rein looped over a hook on the saddle of a harness to prevent a horse from lowering its head." *Checkrein*, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/checkrein [perma: http://perma.cc/5S8M-2VP3] (last visited July 14, 2018). It is curious that the court chose to analogize a compliance and ethics program to an equine practice.

35. For example, the Bank Secrecy Act requires that banks file a suspicious activity report to document a customer's daily cash transactions that exceed $5,000. *See* Bank Secrecy Act of 1970, Pub. L. No. 91–508, §§ 221–23, 84 Stat. Ann. 1114, 1122 (codified as amended at 31 U.S.C. § 5313). A bank employee who has not been trained on this law could cause their employer to violate the law without intending to do so.

36. For example, the Department of Justice declined prosecution against Morgan Stanley for foreign bribery because it concluded that the company had adequate antibribery controls, and the wrongdoer actively worked to circumvent those controls. Press Release, Dep't of Justice Office of Pub. Affairs, Former Morgan Stanley Managing Director Pleads Guilty for Role in Evading Internal Controls Required by FCPA (Apr. 25, 2012), http://www.justice.gov/opa/pr/former-morgan-stanley-managing-director-pleads-guilty-role-evading-internal-controls-required [perma: http://perma.cc/U4BP-AD5N].

37. *Graham*, 188 A.2d at 130; *see also* Megan F. Hess & Earnest Broughton, *Fostering an Ethical Organization from the Bottom up and the Outside in*, 57 BUS. HORIZONS 541, 544 (2014).

deter and detect such rogue employees. [38]

The court's narrow view of corporate compliance and ethics programs could also be seen in its conclusion that the Allis-Chalmers directors had no ground to suspect antitrust wrongdoing.[39] While it was conceded that the directors did not know of the price fixing and bid rigging activity at issue, Allis-Chalmers had entered a consent decree with the Federal Trade Commission in 1937 to settle allegations of—*wait for it*—price fixing and bid rigging.[40] The court, however, rejected the argument that this prior, identical wrongdoing should have put the directors on notice of future possible antitrust violations.[41] The court noted that the 1937 consent decree was created too long ago to have been known by or relevant to most of the then-current directors.[42] And those directors who knew of the consent decree had investigated that incident and concluded that Allis-Chalmers had not committed the alleged antitrust violations; the company had only entered the consent decree to avoid the expense of litigation.[43] Consequently, there were no prior antitrust violations that should have raised a red flag.[44]

The court's dismissive treatment of the 1937 consent decree illustrates the distance between the reactive approach and the current preventive approach. The original Organizational Sentencing Guidelines, which are discussed next, require organizations to implement compliance standards that address risks endemic to their industry. The following provision is particularly relevant:

> If because of the nature of an organization's business there is a substantial risk that certain types of offenses may occur, management must have taken steps to prevent and detect those types of offenses. . . . If an organization employs sales personnel who have flexibility in setting prices, it must have established standards and procedures designed to prevent and detect price fixing.[45]

Under this guidance, the prior antitrust enforcement action (regardless of the actual result) indicates that an organization like Allis-Chalmers must address compliance with the antitrust laws.[46] Today, this point is straightforward and uncontroversial.[47] The next Section discusses the turning point that took compliance and ethics in this preventive direction.

38. Hess & Broughton, *supra* note 37, at 547.

39. *See Graham,* 188 A.2d at 129–31.

40. *Id.* at 129.

41. *Id.* at 130.

42. *Id.* at 129 ("The difficulty the argument has is that only three of the present directors knew of the decrees, and all three of them satisfied themselves that Allis-Chalmers had not engaged in the practice enjoined and had consented to the decrees merely to avoid expense and the necessity of defending the company's position.").

43. *Id.*

44. *See id.*

45. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 cmt. 3(K)(ii) (U.S. SENTENCING COMM'N 1991).

46. *See id.*

47. See *infra* Section III for a discussion of *Caremark*'s shift to a preventative compliance model.

II. THE ORIGINAL U.S. SENTENCING GUIDELINES FOR ORGANIZATIONS

In 1984, Congress set in motion a process that would lead to the now canonical statement of the elements of an effective compliance and ethics program. The Sentencing Reform Act of 1984[48] created the U.S. Sentencing Commission, charged with drafting guidelines that would bring consistency to sentencing for federal crimes.[49] The Commission first drafted and proposed guidelines for sentencing individual offenders, which went into effect in 1987.[50] These guidelines implemented a formulaic approach where the judge calculated a criminal sentence based on the seriousness of the offense along with enumerated mitigating and aggravating factors.[51]

Four years later, the Commission promulgated guidelines for the sentencing of organizations in what has become a watershed moment for the field of compliance and ethics.[52] The Organizational Sentencing Guidelines followed the same approach as the individual Sentencing Guidelines, establishing a sentencing formula based on the seriousness of the offense and the defendant's culpability.[53] Relevant to the current discussion, the Commission included a specific mitigating factor for an organization that had an "effective program to prevent and detect violations of law."[54] The existence of such a program would decrease the organization's culpability and, in turn, reduce the overall fine.[55] This Sentencing Guideline was the first law to provide a financial benefit for a pre-existing compliance and ethics program.[56] In doing so, it bent the arc of compliance history from reactive to preventive—organizations had an important legal incentive to design, implement, and continuously operate a compliance and ethics program regardless of whether wrongdoing had occurred.[57]

Importantly, the Sentencing Guidelines provided general criteria for assessing the effectiveness of a compliance program (Table 1 lists the eight

48. Sentencing Reform Act of 1984, Pub. L. No. 98–473, tit. II, § 217, 98 Stat. 1976, 2017 (codified as amended at 28 U.S.C. § 991).

49. Brent E. Newton & Dawinder S. Sidhu, *The History of the Original United States Sentencing Commission, 1985–1987*, 45 HOFSTRA L. REV. 1167, 1184–87 (2017).

50. *Id.* at 1184–87, 1208.

51. In 2005, the Supreme Court held the Guidelines violated the Sixth Amendment by removing sentencing from the finder of fact. United States v. Booker, 543 U.S. 220, 231–32 (2005). The Court's remedy was to strike the statutory provision that made the Guidelines mandatory, leaving them as considerations in the sentencing process. *See* Corp. Compliance Comm., *Corporate Compliance Survey*, 60 BUS. LAW. 1759, 1780–82 (2005).

52. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (U.S. SENTENCING COMM'N 1991).

53. Corp. Compliance Comm., *supra* note 51, at 1759–60.

54. U.S. SENTENCING GUIDELINES MANUAL § 8C4.11.

55. Paul E. McGreal, *Counteracting Ambition: Applying Corporate Compliance and Ethics to the Separation of Powers Concerns with Domestic Surveillance*, 60 SMU L. REV. 1571, 1585 (2007) [hereinafter McGreal, *Counteracting Ambition*].

56. *Id.*; *see also* Maurice E. Stucke, *In Search of Effective Ethics & Compliance Programs*, 39 IOWA J. CORP. L. 769, 770 (2014).

57. *See* Stucke, *supra* note 56, at 770 ("In 1991, the U.S. Sentencing Commission's Organizational Guidelines provided firms strong financial incentives to have effective ethics and compliance programs . . . ." (footnotes omitted)).

elements of an effective compliance program).[58] Two observations about these criteria are important for present purposes. First, the Sentencing Guidelines spoke entirely about compliance with criminal law, describing the purpose of a qualifying program as "due diligence . . . to prevent and detect criminal conduct by its employees and other agents."[59] There is no mention of cultivating a corporate culture or communicating the organization's ethics or values.

TABLE 1: U.S. SENTENCING GUIDELINES

1. Standards and procedures[60]
2. Oversight by high-level personnel[61]
3. Delegation of substantial discretionary authority[62]
4. Communicate standards[63]
5. Monitor and audit standards[64]
6. Enforce standards through discipline[65]
7. Respond to detected wrongdoing[66]
8. Ongoing risk assessment[67]

Second, the original Sentencing Guidelines did not set forth a specific role for the board in the compliance and ethics program. Rather, they indirectly addressed the board in the following provision: "Specific individual(s) within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures."[68] "High-level personnel" are then defined as follows:

> "High-level personnel of the organization" means individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization. The term includes: a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest.[69]

The Sentencing Guidelines do not explain what it means to "oversee" the

58. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 cmt. 3(K).

59. *Id.*

60. *Id.*

61. *Id.* at cmt. 3(K)(2).

62. *Id.* at cmt. 3(K)(3).

63. *Id.* at cmt. 3(K)(4).

64. *Id.* at cmt. 3(K)(5).

65. *Id.* at cmt. 3(K)(6).

66. *Id.* at cmt. 3(K)(7).

67. While the original Sentencing Guidelines did not expressly state that a risk assessment was an element of an effective compliance and ethics program, that step was implicit in the other steps. For example, an organization will not know the risks on which its needs standards, procedures, and training without a risk assessment. *Cf. id.* at cmt. 3(K).

68. *Id.* at cmt. 3(K)(2).

69. *Id.* at cmt. 3(B).

legal compliance program, or the different roles that various high-level personnel ought to play.

While the original Sentencing Guidelines did not specify the board's compliance and ethics role, their general approach was in tension with *Graham*. The Sentencing Guidelines take a preventive approach under which high-level personnel, including directors, must act regardless of suspicions or red flags of wrongdoing. Consequently, even absent corporate wrongdoing, directors who took no action concerning a compliance and ethics program would not meet their oversight expectation under the Sentencing Guidelines. As the next Section discusses, this preventive approach exerted a gravitational pull on the Delaware law governing a director's fiduciary duty.

III. *IN RE CAREMARK INTERNATIONAL INC. DERIVATIVE LITIGATION*[70]

After two decades, popular knowledge of a landmark case like *Caremark* can be reduced to a slogan-like statement that stands in for the decision and its rationale. When this happens, we lose the nuance, logic, and implications of the court's original reasoning. This Section carefully reviews the Chancery Court's *Caremark* opinion to recapture its lost meaning. The discussion shows that *Caremark* held the promise that Delaware courts would evolve the director's duty of oversight as the field of compliance and ethics matured. As we see later in Section IV, that promise was never fulfilled.

A. Background

Caremark was a shareholder derivative lawsuit against directors for their alleged failure to prevent illegal conduct that cost the corporation over $250 million.[71] Caremark International, Inc. (Caremark) operated health care businesses that included prescription drug insurance programs and patient services.[72] In the patient services segment, Caremark's receipt of Medicare and Medicaid reimbursements made it subject to a federal law that prohibited certain payments to health care providers in exchange for referrals, or what might be called "kickbacks."[73] Caremark's physician services contracts raised a known risk under this law.[74] For example, some of these contracts provided consulting and research fees to physicians who referred patients to Caremark.[75] While the services contracts did not require physician referrals, the possibility of receiving future contracts created a financial incentive to do so.[76]

70. 698 A.2d 959 (Del. Ch. 1996).

71. *Id*. at 960–61.

72. During the time period covered by the litigation, Caremark had acquired another health care company, and the some of the illegal practices at issue were carried on by the acquired company. *Id.* at 961. For simplicity of discussion, the text refers to Caremark regardless of which entity initiated the practices discussed.

73. *Id.* at 961–62.

74. *Id.* at 962.

75. *Id.*

76. *Id.*

Another practice of concern was monitoring agreements between Caremark and physicians. Under these arrangements, a physician received fees reimbursed under Medicare and Medicaid to monitor patients who were receiving care from Caremark.[77] The potential for monitoring fees could provide a financial incentive for the physician to refer a patient to Caremark instead of a health care provider that would not provide a monitoring agreement.[78]

Caremark's legal risk was heightened by federal regulations that created a safe harbor for financial arrangements between referring physicians and health care providers.[79] Caremark acknowledged that some of its services contracts and monitoring agreements did not fall within the safe harbor, and so they would be independently scrutinized under federal law.[80] In deciding to continue with these practices, Caremark relied on the uncertainty of federal law and the advice of counsel that the practices were lawful.[81]

In 1991, federal officials initiated an investigation of Caremark's practices under the federal antireferral law.[82] Caremark responded by prohibiting contracts for monitoring fees, revising guidelines on arrangements with physicians and health care providers, and increasing management oversight of such arrangements.[83] Caremark was then indicted in two separate federal proceedings for alleged violations of the federal antireferral law, and the shareholder derivative lawsuit soon followed.[84] To settle the federal charges, Caremark plead guilty to a lesser offense that would allow the company to continue in the Medicare and Medicaid programs.[85] Caremark also discontinued financial arrangements with most physicians, paid criminal and civil fines, and entered a Corporate Integrity Agreement that required strengthening its compliance measures.[86]

The *Caremark* opinion was the Chancery Court's decision on the parties' motion to approve a proposed settlement of the shareholder derivative lawsuit.[87]

77. *Id.*

78. *Id.* at 962–63.

79. *Id.* at 963.

80. *Id.* at 962–63.

81. *Id.* at 962 ("Caremark repeatedly publicly stated that there was uncertainty concerning Caremark's interpretation of the law."); *id*. ("Caremark contends that the narrowly drawn regulations gave limited guidance as to the legality of many of the agreements used by Caremark that did not fall within the safe-harbor."); *id*. ("Caremark asserts that its management, pursuant to advice, did not believe that such payments were illegal under the existing laws and regulations."); *id.* at 963 ("Although there is evidence that inside and outside counsel had advised Caremark's directors that their contracts were in accord with the law, Caremark recognized that some uncertainty respecting the correct interpretation of the law existed.").

82. *Id*. at 962. The first investigation was initiated by the Office of Inspector General of the U.S. Department of Health and Human Services, with the U.S. Department of Justice later joining the investigation. *Id.*

83. *Id.* at 962–63.

84. *Id.* at 963–65.

85. *Id.* at 961–62.

86. *Id.* at 965–66.

87. *Id.* at 960–61.

The legal standard for the motion was whether the proposed settlement was fair and reasonable to the corporation and its shareholders, which required the court to weigh the strength of the plaintiffs' claims in relation to proposed terms.[88] It was in assessing the plaintiffs' claims that the court discussed the nature of a director's fiduciary duty to oversee a corporation's compliance with the law.[89]

B. Corporate Law Policy Rationales

To frame its analysis, the *Caremark* court carefully stated the nature of the plaintiff's claim against the directors: "The claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[90] The court noted an important aspect of such a claim: the plaintiffs did not allege that the directors had either an improper motive or a conflict of interest.[91] In other words, the directors believed they were acting in the best interest of the corporation, and no conflicts of interest tainted their judgment. Such a claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[92] The remainder of this Part reviews four policy rationales raised by this "most difficult theory in corporation law."

First, the court noted that corporate law disfavors liability for non-conflicted directors, citing the policy discussion in *Gagliardi v. TriFoods International, Inc.*[93] That case tied the scope of director liability to the interests of an economically rational shareholder:[94]

> Shareholders can diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the *highest risk adjusted rate of return first.* Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.[95]

Shareholders maximize their returns, then, when directors make rational decisions concerning the risk adjusted rate of return of alternative decisions. The *Gagliardi* court noted that broad director liability interferes with a disinterested

88. *Id.* at 966.

89. *Id.*

90. *Id.* at 967.

91. *Id.*

92. *Id.*

93. *Id.* (citing Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996)).

94. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004); Kay Xixi Ng, *Inside the Boardroom: A Proposal to Delaware's Good Faith Jurisprudence to Improve Board Passivity*, 6 DEPAUL BUS. & COM. L.J. 393 (2008).

95. *Gagliardi*, 683 A.2d at 1052.

director's rational decisionmaking:

> If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). . . . Given this disjunction, only a very small probability of director liability based on "negligence", "inattention", "waste", etc., could induce a board to avoid authorizing risky investment projects to any extent![96]

Raising the bar for disinterested director liability—for example, by making it "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment"[97]—fosters rational director decisionmaking that promotes "shareholder welfare in the long-term."[98]

A second policy reason weighing against disinterested director liability is to prevent "substantive second guessing [of directors] by *ill-equipped judges or juries*."[99] While Delaware courts are rightly praised for their expertise in corporate law, judges are not experts in managing and overseeing corporations. Indeed, it should not be surprising that the qualities and characteristics sought in a director or officer, such as business experience and knowledge of the relevant industry,[100] would not be sought in a state court judge. And the same is even more so for lay jurors who come from the general citizenry. Given this relative lack of expertise, corporate decisionmaking would not be well served if the judgments of "ill-equipped judges or juries" could impose liability on directors and management.

A third policy rationale for limited judicial intervention is that the primary shareholder remedy for poor director performance ought to be the power to elect directors.[101] Sections 212 and following provisions of the Delaware General Corporation Law describe the shareholder's voting rights,[102] including the calling

96. *Id.*

97. *Caremark*, 698 A.2d at 967.

98. *Gagliardi*, 683 A.2d at 1053; *see also Caremark*, 698 A.2d at 968 n.16 ("The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what an [sic] persons of ordinary or average judgment and average risk assessment talent regard as 'prudent' 'sensible' or even 'rational', such persons will have a strong incentive at the margin to authorize less risky investment projects.").

99. *Caremark*, 698 A.2d at 967 (emphasis added).

100. *See* Joann S. Lublin & Thomas Gryta, *GE Housecleaning Will Alter Board's Makeup*, WALL ST. J. (Nov. 19, 2017, 5:53 PM), http://www.wsj.com/articles/ges-woes-trigger-a-major-board-shakeout-1510967633 [perma: http://perma.cc/VZ3C-MSCF].

101. *Caremark*, 698 A.2d at 968 ("If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors."); *see also* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members.").

102. DEL. CODE ANN. tit. 8, § 212(a) (West 2018) (entitling shareholders to one vote per share

and conduct of shareholder meetings,[103] filling board vacancies,[104] and voting by proxy.[105] While limited in practice by the realities of modern proxy voting,[106] voting on directors is still a shareholder's primary legal means to influence and address director behavior. This makes sense in light of Section 141(a)'s general commitment that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."[107] If shareholders could easily seek judicial review of the substance of director business decisions, judges would effectively sit as a superboard empowered to "manage" the corporation. Also, the precedents from these judicial decisions would surely influence board decisions, which would deprive corporations of the directors' business judgment.

The *Caremark* court noted a fourth policy rationale for deferential judicial review in passing: aggressive judicial review and expansive director liability would discourage qualified individuals from serving on corporate boards.[108] Those with the experience and expertise to be considered for director positions will have other opportunities, and they will decide how to allocate their time based on the relative risk-return of their options. A greater likelihood of liability will increase the risk of serving as a director and thus make that option less attractive. And conversely, greater deference to director decision-making "makes board service by qualified persons more likely."[109]

C. *The Business Landscape*

Having discussed corporate law policies, the court next addressed the

unless otherwise specified); *id*. § 214 ("Cumulative voting").

103. *Id.* § 211.

104. *Id.* § 223.

105. *Id.* § 212(b)–(e).

106. For major public corporations, the vast majority of shares are voted by proxy prior to the shareholder meeting. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,027–28 (proposed June 18, 2009) (codified at C.F.R. pts. 200, 232, 240, 249, 274). And so, while shareholders may nominate director candidates at the annual shareholder meeting, doing so would be futile because most shareholders have already cast their votes by proxy. *Id.* Management of the corporation solicits voting proxies from shareholders entitled to vote through materials drafted to comply with both Delaware corporate law and federal securities laws. *Id.* The management proxy solicitation materials, however, typically only include a proxy voting card for management's nominees for director. *Id.* If a shareholder or group of shareholders wish to solicit proxy votes for other director candidates, they would need to send shareholders a separate set of proxy solicitation materials with the names of the other director nominees. *Id.* Such a separate proxy solicitation is generally cost prohibitive; a 2009 SEC rule proposal estimated the cost of such a solicitation as $368,000. *Id.* at 29,073. ("According to a study of proxy contests conducted during 2003, 2004, and 2005, the average cost to a soliciting shareholder of a proxy contest is $368,000. The costs included those associated with proxy advisors and solicitors, processing fees, legal fees, public relations, advertising, and printing and mailing." (footnote omitted)). Consequently, shareholders of large public corporations will typically see one nominee per board seat, and their only option will be to vote for, against, or withhold the vote for management's nominee. *Id.* at 29,027–28.

107. DEL. CODE ANN. tit. 8, § 141(a).

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

109. *Id.*

elephant in the room—*Graham*'s holding that directors do not owe a duty of oversight until they learn of wrongdoing.[110] To assess *Graham*'s continued validity, the *Caremark* opinion carefully reviewed the changes in the legal and business landscape over the prior thirty years.[111] The question was: "Can it be said today that, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that a corporate information gathering and reporting system exists . . . respecting . . . compliance with applicable statutes and regulations?"[112] To answer this critical question, the court discussed three aspects of the then-current corporate context bearing on a director's duty of oversight.

First, in the modern large corporation, directors make only a few, high-level decisions, such as sale or merger of the corporation or hiring of the chief executive officer.[113] Other important decisions, along with day-to-day operations of the corporation, are delegated to a cascading level of officers and employees within the organization.[114] And these decisions can significantly affect an organization's success: "[O]rdinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals."[115] In making "ordinary business decisions," officers and employees can cause the organization to violate the law and incur significant loss and disruption to the business.[116] To adequately oversee these risks, directors must have some way to receive the information needed to ensure that officers and employees are making reasonable efforts to comply with the law.[117]

Second, two intervening legal developments had raised the stakes of the duty of oversight. One development was "an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations."[118] This trend increased the likelihood that a corporation would suffer the financial, reputational, and other consequences of a criminal violation.[119] With this

110. *See supra* notes 27–29 and accompanying text.

111. *See Caremark*, 698 A.2d at 967–70.

112. *Id*. at 969.

113. *Id.* at 968.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.* at 968–72.

118. *Id.* at 969.

119. Even if a criminal investigation does not result in a conviction of the corporation, the announcement and settlement of the matter can have financial and other costs. For example, some research shows that the announcement of a criminal investigation can decrease stock price in the near- and mid-terms. *See* Melissa S. Baucus & David A. Baucus, *Paying the Piper: An Empirical Examination of Longer-Term Financial Consequences of Illegal Corporate Behavior*, 40 ACAD. MGMT. J. 129, 132 (1997); Wallace N. Davidson III, Dan L. Worrell & Chun I. Lee, *Stock Market Reactions to Announced Corporate Illegalities*, 13 J. BUS. ETHICS 979, 983 (1994). Also, settlement of a criminal matter can include appointment of an independent monitor, and the corporation must pay the

increased risk of loss should come a correspondingly increased duty to oversee that risk.

A second, related development was the adoption of the Organizational Sentencing Guidelines discussed above in Part I.B. The *Caremark* court noted the significance of this development in a passage that is worth considering in whole:

> In 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission adopted Organizational Sentencing Guidelines which *impact importantly* on the prospective effect these criminal sanctions might have on business corporations. The Guidelines set forth a uniform sentencing structure for organizations to be sentenced for violation of federal criminal statutes and provide for penalties that equal or *often massively exceed those previously imposed on corporations*. The Guidelines offer *powerful incentives* for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.[120]

The italicized language above highlights two changes to the legal landscape. First, the court emphasized the increased magnitude of modern criminal sanctions—"often massively exceed those previously imposed on corporations."[121] Second, in the face of these significant sanctions, the mitigating factors in the Organizational Sentencing Guidelines offer "powerful incentives" for corporations to implement a compliance and ethics program. The court then linked these developments to its fiduciary duty analysis: "Any rational person attempting in good faith to meet an Organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers."[122] The question, then, was how a fiduciary duty would expect a director "to take into account" an ethics program as part of their duty of oversight.[123]

Third, recent Delaware decisions had sharpened the understanding and importance of director fiduciary duties. For one, "in recent years the Delaware Supreme Court has made . . . clear . . . the seriousness with which the corporation law views the role of the corporate board."[124] In addition, the court highlighted

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monitor's costs (including their fees) as well as the cost of implementing the monitor's recommendations. Julie DiMauro, *Deferred Prosecution Agreements: Working with the Independent Monitor*, THOMSON REUTERS (May 5, 2015), http://blogs.thomsonreuters.com/answerson/deferred-prosecution-agreements-working-independent-monitor/ [perma: http://perma.cc/S9MF-JDTX]. In addition, working with a monitor can disrupt ordinary business and cause losses to productivity. *Id.*

120. *Caremark*, 698 A.2d at 969 (emphasis added).

121. *Id.*

122. *Id.* at 970.

123. *Id.* at 698.

124. *Id.* at 970. The court noted that this emphasis could be seen "especially in its jurisprudence concerning takeovers, from *Smith v. Van Gorkom* through *Paramount Communications v. QVC*." *Id.* (first citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); then citing Paramount Commc'ns v. QVC Network, Inc. S'holders' Litig., 637 A.2d 34 (Del. 1994)).

"the elementary fact that relevant and timely *information* is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law."[125] Combined, these two recognitions exert a gravitational pull away from the hands-off approach in *Graham*. That is, the increased importance of the board's role along with the need for an effective information system to perform that role raised the expectations for director conduct.

D. *The Caremark Standard of Liability*

The *Caremark* court next turned to synthesizing the relevant corporate law policies surrounding business and regulatory context, and the *Graham* precedent into a revised director fiduciary duty of oversight.[126] In doing so, the court balanced opposing interests. On the one hand, corporate law policies indicated the continued importance of appropriate deference to board decisions.[127] On the other hand, the changed business and regulatory landscape showed an increased need for ongoing board oversight of an organization's ethics program.[128] The resulting test went beyond *Graham* to require directors to take affirmative steps regardless of suspicion of wrongdoing, and tempered that duty with great deference to director decisions concerning the steps to be taken. The court stated the director's revised duty of oversight as follows:

> [O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.[129]

While the court's precise standard is not entirely clear, this passage suggests deferential judicial scrutiny of a director's preventive actions. The phrases "utter failure to attempt" and "sustained or systematic failure" both suggest extreme forms of nonaction or mismanagement. An "utter failure to attempt" indicates that the board took no action to initiate a compliance and ethics program, and so any visible or documented action in that direction would satisfy the standard. And a "sustained or systematic failure of the board to exercise oversight" suggests both that the failure occurred over a significant time period, and that the failure was not isolated to a discrete compliance function or part of the organization. This hands-off reading of the standard is supported by the court's statement that "the level of detail that is appropriate for such an information system is a question of business judgment."[130] In short, the *Caremark* standard for director oversight of a corporation's ethics program could be stated simply as

125. *Caremark*, 698 A.2d at 970.

126. *Id.*

127. *See supra* notes 99–105 and accompanying text.

128. *See supra* notes 99–100 and accompanying text.

129. *Caremark*, 698 A.2d at 971 (emphasis added).

130. *Id.* at 970.

"do something, and then continuing doing something."

The court's summary application of its new standard reinforces its deferential nature. A single paragraph sets forth that analysis:

> Here the record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function. To the contrary, insofar as I am able to tell on this record, the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts. If the directors did not know the specifics of the activities that lead to the indictments, they cannot be faulted.[131]

This passage is consistent with the court's characterization of the board's behavior at the outset of its opinion: "the record tends to show an active consideration by Caremark management and its Board of the Caremark structures and programs that ultimately led to the company's indictment and to the large financial losses incurred in the settlement of those claims."[132] While neither passage identifies the aspects of the "corporation's information systems" that the court had in mind, the opinion's fact discussion provides a reference point.[133] Table 2 matches the steps taken by Caremark with the relevant element of the Sentencing Guidelines.

TABLE 2: SENTENCING GUIDELINES COMPARED TO CAREMARK COMPLIANCE MEASURES

Sentencing Guidelines[134]	***Caremark***
1. Standards and procedures	– The 1989 adoption of a Guide on contracts with hospitals and physicians that was updated annually.[135] – In 1991, Caremark's revised its Forms and Guide to reflect recent HHS regulations.[136] – "Audit & Ethics Committee adopted a new internal audit charter requiring a comprehensive review of compliance policies and the compilation of an employee ethics handbook concerning such policies."[137]
2. Oversight by high-level personnel	– In April 1992, the board oversaw dissemination of the revised Guide.[138] – In September 1992, the board implemented a

131. *Id.* at 971–72.

132. *Id.* at 961.

133. *Id.* at 960–66.

134. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 cmt. 3(K) (U.S. SENTENCING COMM'N 1991).

135. *Caremark*, 698 A.2d at 962.

136. *Id.*

137. *Id.* at 963.

138. *Id.*

	requirement that management approve certain contracts with physicians.[139] – In 1993, "the chief financial officer was appointed to serve as Caremark's compliance officer."[140]
3. Delegation of substantial discretionary authority	
4. Communicate standards	– "Caremark's management reported to the Board that Caremark's sales force was receiving an ongoing education regarding the ARPL and the proper use of Caremark's form contracts . . ."[141] – Employees received "revised versions of the ethics manual" and were required "to participate in training sessions concerning compliance with the law."[142]
5. Monitor and audit standards	– Caremark attempted "to centralize . . . management structure in order to increase supervision over its branch operations."[143] – "Throughout the period of the government investigations, Caremark had an internal audit plan designed to assure compliance with business and ethics policies."[144] – In 1993, "new policies requiring local branch managers to secure home office approval for all disbursements under agreements with health care providers and to certify compliance with the ethics program."[145]
6. Enforce standards through discipline	– "Prior to the distribution of the new ethics manual, on March 12, 1993, Caremark's president had sent a letter to all senior, district, and branch managers restating Caremark's policies that no physician be paid for referrals, that the standard contract forms in the Guide were not to be modified, and that deviation

139. *Id.*
140. *Id.*
141. *Id.*
142. *Id.*
143. *Id.* at 962.
144. *Id.* at 963.
145. *Id.*

	from such policies would result in the immediate termination of employment."[146]
7. Respond to detected wrongdoing	– After the Minnesota indictment, "the Board met and was informed by management that the investigation had resulted in an indictment."[147] – After the Ohio indictment, Caremark took steps to "terminate all remaining financial relationships with physicians in its home infusion, hemophilia, and growth hormone lines of business," "extended its restrictive policies to all of its contractual relationships with physicians," and "terminated its research grant program which had always involved some recipients who referred patients to Caremark."[148]
8. Ongoing risk assessment	– "On February 8, 1993, the Ethics Committee of Caremark's Board received and reviewed an outside auditors report by Price Waterhouse which concluded that there were no material weaknesses in Caremark's control structure. Despite the positive findings of Price Waterhouse, however, on April 20, 1993, the Audit & Ethics Committee adopted a new internal audit charter requiring a comprehensive review of compliance policies . . . ."[149]

Table 2 shows that Caremark took substantial action concerning referral payments, much of which was with board oversight. Indeed, the only element for which the opinion does not specifically mention some action is due diligence in delegation of discretionary authority. And for even that element, it is quite possible that the new and revised policies and procedures for centralizing and overseeing physician contracts included some form of due diligence in selecting and promoting managers who would have approval authority. In all, then, Caremark and its board can be said to have "done something" about each element of the Sentencing Guidelines.

It is notable that the *Caremark* court does not evaluate the effectiveness of the company's various compliance actions. The opinion's statement of the facts simply recites the actions taken by the board and management, and the analysis summarily concludes that there was no "sustained failure to exercise their oversight function."[150] There is no scrutiny of the quality of Caremark's efforts

146. *Id.* at 963 n.5.
147. *Id.* at 964.
148. *Id.* at 965.
149. *Id.* at 963.
150. *Id.* at 971.

in the legal analysis. Rather, that discussion is limited to noting the existence of board action regardless of its quality or effectiveness. And because the court simply stated its conclusion, it is unclear what quantum of board action is required to satisfy this low threshold.

The role of the Sentencing Guidelines in the *Caremark* analysis, then, is quite modest. They provided an impetus to move from *Graham*'s reactive approach to require that directors take some preventive action. The court, however, did not use the Sentencing Guidelines to evaluate the extent and effectiveness of the directors' preventive actions. There are three possible reasons for this limited approach.

First, a limited judicial role gives appropriate deference to corporate directors for the reasons discussed in Part III.B. For example, an increased risk of legal liability for failure of oversight could discourage qualified candidates from serving as directors, or could harm shareholders by decreasing directors' risk tolerance.[151] Also, judges and juries will not have the experience and expertise to evaluate the quality of a compliance and ethics program.[152] Consequently, the judicial role should be limited to the bare factual determination whether some steps were taken to address legal compliance.

Second, as one commentator has noted, we should expect formalistic, deferential legal scrutiny from legal rules that require a *yes* or *no* decision, as opposed to a decision of varying degrees.[153] The *Caremark* standard requires such a decision because a judge must decide whether or not a director has satisfied his duty of oversight: the decision will be yes, the director met his duty, or no, they did not. And the difference in consequences of being on one side of this line or the other is quite stark—legal liability or no legal liability. In such cases, courts and other decision makers tend to seek objectively verifiable decision criteria that require little (if any) subjective or qualitative analysis.[154]

Third, the original Sentencing Guidelines did not specify a role for the board, and the *Caremark* court did not take the initiative to fill that gap.[155]

151. *See supra* notes 90–91 and accompanying text.

152. *See supra* notes 99–100 and accompanying text.

153. This observation has been made by compliance professional Joseph Murphy in various forums, though it does not appear in writing. I have also confirmed this observation with Mr. Murphy in correspondence by email.

154. For example, the Supreme Court has held that an employer may avoid liability for supervisor sexual harassment if the employer had in place reasonable measures to prevent and detect unlawful harassment. *See* Burlington Indus., Inc. v. Ellerth, 524 U.S. 742 (1998); Faragher v. City of Boca Raton, 524 U.S. 775 (1998). The decision is "yes/no" in that a court must decide whether or not the employer had reasonable measures in place. *See Faragher*, 524 U.S. at 806–07. One commentator has noted that the analysis in cases applying *Ellerth* and *Faragher* tends to be formalistic, relying on whether the employer could show policies, procedures, training, and enforcement. *See* Blair T. Jackson & Kunal Bhatheja, *Easy as P.I.E.: Avoiding and Preventing Vicarious Liability for Sexual Harassment by Supervisors*, 62 DRAKE L. REV. 653, 658 (2014). The judicial analysis did not consider other elements of an ethics program, or the quality or effectiveness of the policy, procedures, training, and enforcement.

155. *See* U.S. SENTENCING GUIDELINES MANUAL § 8A1.2, cmt. 3(k) (U.S. SENTENCING COMM'N 1991); *Caremark*, 698 A.2d 959.

Recall that the original Sentencing Guidelines only spoke to the responsibility of high-level personnel for oversight of the ethics program, and the board was listed as one actor within high-level personnel.[156] The board's role was not further specified. Given the policy reasons favoring deference to director decisionmaking, the Sentencing Guidelines' silence may have counseled against the *Caremark* court breaking new ground in this area. As discussed in Part IV.A, the 2004 amendments to the Sentencing Guidelines have further defined the board's role.[157] The question, then, is whether the *Caremark* duty would evolve to reflect the board's enlarged and sharpened role in an effective compliance and ethics program.

IV. POST-*CAREMARK* DEVELOPMENTS

As commentators have noted, the *Caremark* decision did not require the court to decide whether Caremark's directors had violated their fiduciary duty of oversight. Instead, the duty was discussed as part of the court's decision on the proposed settlement, which required the court to assess the terms of the settlement in relation to the strength of the plaintiff's claims.[158] Because the duty was discussed in that context, some commentators described the duty of oversight discussion as dicta.[159]

Despite its atypical origin, the duty recognized in *Caremark* quickly received traction in the Delaware Chancery courts.[160] And any question of the duty's ultimate validity was put to rest by the Delaware Supreme Court in its 2006 decision in *Stone v. Ritter*.[161] Two years before that decision, however, the U.S. Sentencing Commission amended the Organizational Sentencing Guidelines to provide greater guidance on the board's role of oversight.[162] As discussed next in Part IV.A, the amendments elevated the importance and visibility of the board's oversight role, and enumerated certain actions and expectations entailed by board oversight. *Stone*, then, raised two questions about *Caremark*. First, would the Delaware Supreme Court affirm the board's fiduciary duty of oversight recognized in *Caremark*?[163] Second, if so, would the Delaware Supreme Court strengthen that duty by taking account of the heightened oversight expectations set forth in the 2004 Sentencing Guidelines amendments?[164] Part IV.B addresses these two questions.

156. *See supra* notes 49–53 and accompanying text.

157. *See infra* Part IV.A.2.

158. *See supra* notes 87–89 and accompanying text.

159. *See* Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 973 (2009); Paul E. McGreal, *Corporate Compliance Survey*, 64 BUS. LAW. 253, 272 (2008).

160. Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007); David B. Shaev Profit Sharing Account v. Armstrong, No. Civ. 1449-N, 2006 WL 391931 (Del. Ch. Feb. 13, 2006); Guttman v. Huang, 823 A.2d 492 (Del. Ch. 2003); White v. Panic, 793 A.2d 356 (Del. Ch. 2000).

161. 911 A.2d 362 (Del. 2006).

162. *See infra* Part IV.A.2.

163. *Stone*, 911 A.2d 362.

164. *Id.*

A. 2004 Amendments to the Organizational Sentencing Guidelines

In early 2002, about ten years after the original Organizational Sentencing Guidelines went into effect, the Commission convened an Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (Advisory Group) to "review the general effectiveness of the federal sentencing guidelines for organizations . . . . [with] particular emphasis on examining the criteria for an effective program to ensure an organization's compliance with the law."[165] For about eighteen months, the Advisory Group conducted research and heard testimony about organizations' experiences with and best practices for corporate compliance and ethics programs.[166] Their work culminated in a Report that summarized their research and proposed amendments to the Sentencing Guidelines. The remainder of this Part discusses the research and proposals relevant to the director's fiduciary duty of oversight.

1. New Focus on Ethical Culture

The Advisory Group's first proposed amendment was to change the name and purpose of an ethics program to highlight the importance of organizational culture. The Report noted the consensus on such a shift: "[T]he effectiveness of compliance programs could be enhanced if, in addition to due diligence in maintaining compliance programs, organizations also took steps to build cultures that encouraged employee commitment to compliance."[167] To recognize this new emphasis, the Advisory Group proposed expanding the scope of a compliance and ethics program to include the duty to "promote an organizational culture that encourages a commitment to compliance with the law."[168] The Advisory Group concluded that a values-based approach was more effective in preventing legal violations, and so the mitigating factor for a compliance and ethics program ought to encourage organizations to do so.[169]

Since this proposed amendment would be used by courts in the sentencing of organizations, the Advisory Group was sensitive to the concern that courts should avoid "determinations of whether a particular organization has adopted a good 'set of values' or appropriate 'ethical standards,' subjects which may be very difficult, if not impossible, to evaluate in an objective, consistent manner."[170] Consequently, the Advisory Group suggested objective indicia for determining whether an organization had taken a values-based approach: "Such

165. Press Release, U.S. Sentencing Comm'n, Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group (Feb. 21, 2002), http://www.ussc.gov/about/news/press-releases/february-21-2002 [perma: http://perma.cc/ZX6J-T32T].

166. AD HOC ADVISORY GRP., REPORT OF THE AD HOC ADVISORY GROUP ON THE ORGANIZATIONAL SENTENCING GUIDELINES (2003), http://www.ussc.gov/sites/default/files/pdf/training/organizational-guidelines/advgrprpt/AG_FINAL.pdf [perma: http://perma.cc/C327-MLNG].

167. *Id.* at 51.

168. *Id.* at 54.

169. *Id.*

170. *Id.* at 55.

a culture is demonstrated by organizational actions which encourage employees to choose lawful behaviors and to expect that their conduct will be evaluated by others within the organization in terms of how well the employees have pursued lawful conduct."[171] As this passage indicates, an organization's "actions" will evidence its commitment to an ethical culture. The actions expected are those already required of the organization for an effective compliance and ethics program: "[T]he Advisory Group anticipates that the dual objectives of reasonable prevention and positive culture will be taken into account by organizations as they shape and implement steps in the seven areas covered by [the Sentencing Guidelines]".[172] An organization shows its commitment to an ethical culture by "tailoring" each element of the compliance and ethics program to promote "positive internal support for law compliance."[173] In short, promoting an ethical culture focuses on *how* the ethics program is designed, implemented, and operated, and does not add another element to the program itself.

The Sentencing Commission adopted these proposed amendments and forwarded them to Congress.[174] Perhaps to emphasize the inclusion of ethics, the Sentencing Commission's amendments also changed the terminology used in the Sentencing Guidelines.[175] Where the original provision referred to "an effective program to prevent and detect violations of law,"[176] the amended provision now referred to "an effective compliance *and ethics* program."[177] The amended Sentencing Guidelines went into effect in 2004.[178]

2. The Role of the Board of Directors

The Advisory Group also addressed the role of corporate directors in overseeing an organization's compliance and ethics program. The Report noted the original Sentencing Guidelines' "total silence" on the board's role[179] and that any effort to provide further guidance must not "make the definition of responsibilities too particular."[180] Recent history, however, had made clear that it was "essential" to say more about the role of board members:

> [T]he corporate scandals that exploded shortly following the tenth anniversary of the adoption of the organizational sentencing guidelines demonstrated that the involvement of officers and directors in corporate crime was not confined to small businesses. The corporate

171. *Id.*

172. *Id.*

173. *Id.*

174. Sentencing Guidelines for United States Courts, 69 Fed. Reg. 28,994, 28,994 (May 19, 2004).

175. *Id.* at 29,019.

176. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2, cmt. 3 (U.S. SENTENCING COMM'N 1991).

177. *Id.* § 8B2.1 (emphasis added).

178. *Id.*

179. AD HOC ADVISORY GRP., *supra* note 166, at 58.

180. *Id.* at 57.

> scandals of 2002 greatly contributed to the public's lack of confidence in the capital markets. In virtually all of the scandals, the alleged malfeasance occurred at the senior management and/or governing authority level. Where there was no actual malfeasance by members of the governing authority, there were often instances of negligence. This situation led the Advisory Group to consider the particular role of the governing authority of the organization.[181]

Like the *Caremark* opinion, the Report supports its proposed amendments by reference to recent business and legal developments.[182] Recall that the *Caremark* court had noted escalating criminal penalties and promulgation of the original Sentencing Guidelines in support of a preventive board role.[183] Here, the Advisory Group cites the role of directors and executives in the 2002 corporate finance scandals in support of heightened compliance and ethics program oversight responsibilities for directors and senior management.[184]

In addition to the noted scandals, the Advisory Group learned that strong commitment from the board and senior management—what is often called "tone at the top"—is critical to the success of a compliance and ethics program.[185] The Report summarized the testimony and written comments: "The central theme was to amplify the role of the governing authority, providing direct access between the governing authority (or one of its committees) and a company's compliance officer, ensuring prompt and unfiltered communications."[186] Drafting an amended guideline posed two challenges, though. First, any guidance must leave room for directors to exercise appropriate business judgment in meeting their duty of oversight.[187] Second, since the Sentencing Guidelines apply to organizations of all sizes and in all industries, any new requirements must allow an organization the flexibility to tailor the compliance and ethics program to its circumstances.[188] The Advisory Group's task was to craft an amendment that provided meaningful guidance while allowing adequate flexibility.

To navigate between this legal Scylla and Charybdis, the proposed amendment focused on the board's knowledge and oversight of the compliance and ethics program: "The organization's governing authority shall be knowledgeable about the content and operation of the program to prevent and detect violations of law and shall exercise reasonable oversight with respect to the implementation and effectiveness of the program to prevent and detect violations of law."[189] In fleshing out this requirement, the Advisory Group's

181. *Id.*

182. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 966–68 (Del. Ch. 1996); AD HOC ADVISORY GRP., *supra* note 166, at 58–59.

183. *See supra* notes 120–23 and accompanying text.

184. AD HOC ADVISORY GRP., *supra* note 166, at 58.

185. *Id.* at 57–58.

186. *Id.*

187. *Id.* at 58–59.

188. *Id.*

189. *Id.* at 59.

Report addressed four key questions:

First, of which aspects of a compliance and ethics program should a director be knowledgeable?[190]

Second, how should directors gather and receive information about the compliance and ethics program?[191]

Third, how often should directors gather and receive information about the compliance and ethics program?[192]

Fourth, what actions does director oversight of a compliance and ethics program entail?[193]

Appendix A contains the Advisory Group's commentary on these questions and shows that body's attempt to balance affirmative guidance and prudent flexibility.[194] On the one hand, the commentary identifies the aspects of the program with which directors should be familiar, minimum steps for gathering and receiving information, and suggested timing for these efforts.[195] Further, director oversight entails active monitoring of the ethics program, including substantive evaluation of the information received through monitoring and periodic reports.[196] On the other hand, the proposed amendment and commentary leave the structure, process, and formality of these functions to the business judgment of directors working with senior management.[197]

The Sentencing Commission adopted the proposed amendments described above,[198] and they went into effect in November 2004 when Congress did not make any changes.[199] Just as the original Organizational Sentencing Guidelines prompted the *Caremark* court to recognize a director's fiduciary duty of oversight, one might have anticipated that the 2004 amendments could prompt the Delaware courts to flesh out that duty.[200] *Caremark* had left the board's oversight duty relatively unspecified, which was consistent with the original Sentencing Guidelines' silence on the role of directors.[201] Would the Delaware

190. *Id.* at 60.

191. *Id.*

192. *Id.*

193. *Id.* at 60–61.

194. *See infra* Appendix A (citing AD HOC ADVISORY GRP., *supra* note 166, at 58–61).

195. *See infra* Appendix A (citing AD HOC ADVISORY GRP., *supra* note 166, at 58–61).

196. *See infra* Appendix A (citing AD HOC ADVISORY GRP., *supra* note 166, at 58–61).

197. *See infra* Appendix A (citing AD HOC ADVISORY GRP., *supra* note 166, at 58–61).

198. The Sentencing Commission's only change to the proposed amendment was to change the reference to a "program to prevent and detect violations of law" to "the compliance and ethics program." *See* U.S. SENTENCING GUIDELINES MANUAL app. C, amend. 673 (U.S. SENTENCING COMM'N 2004).

199. Sentencing Guidelines for United States Courts, 69 Fed. Reg. 28,994, 28,994 (May 19, 2004).

200. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) ("[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.").

201. *Id.*

courts revisit that approach after the 2004 amendments? The next Part turns to that question.

B. Delaware Supreme Court Recognition of the Duty of Oversight in Stone v. Ritter[202]

As a prelude to the court's decision in *Stone*, it is important to note a contemporaneous development in Delaware corporate law—the litigation over the hiring and firing of an executive at the Walt Disney Company.[203] About five months before deciding *Stone*, the Delaware Supreme Court, in *In re Walt Disney Co. Derivative Litigation*,[204] reaffirmed the deferential approach to judicial review of director conduct.

A brief aside about *Disney* sets the stage for consideration of *Stone*. The *Disney* case involved a shareholder derivative lawsuit against the company's directors for the hiring and later termination of Michael Ovitz as the company's president.[205] The shareholders alleged that the directors had breached their fiduciary duty by, first, approving an employment contract that provided Ovitz with overly generous severance for a termination without cause, and second, for later terminating Ovitz without cause and triggering the severance provision.[206] While it was clear that the directors had not followed best practices in approving the compensation in Ovitz' employment contract,[207] it was not clear whether their conduct breached their fiduciary duty. Traditional business judgment rule analysis would likely protect the directors from liability since director negligence, carelessness, or even gross negligence would not breach the duty.[208] As with the 2004 Sentencing Guidelines amendments, however, the *Disney* litigation arose in the aftermath of corporate scandals that questioned the effectiveness of public company directors.[209] Congress had reacted to these scandals by federalizing aspects of corporate governance that had previously been left to the states.[210] As the case was heard on appeal, the question was whether circumstances would push the Delaware Supreme Court to heighten a director's fiduciary duty.

The *Disney* opinion began with an overview of the two director fiduciary

202. 911 A.2d 362 (Del. 2006).

203. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006).

204. 906 A.2d 27 (Del. 2006).

205. *Disney* 906 A.2d at 30.

206. *Id.*

207. *Id.* at 55 (noting "the Chancellor's determination that . . . the compensation committee's decision-making process fell far short of corporate governance 'best practices'").

208. *Id.* at 64–65.

209. *See supra* notes 179–81 and accompanying text.

210. For example, the Sarbanes-Oxley Act of 2002 required that public companies have an audit committee, set forth responsibilities and procedures for audit committee selection and oversight of auditors, and required that audit committee members be independent directors. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 301, 116 Stat. 745, 775 (codified as amended at 15 U.S.C. § 78j-1(m)). Conversely, Delaware law permits corporate boards to form committees, though it does not require them to do so. 8 DEL. CODE ANN. tit. 8, § 141(c) (West 2018).

duties under Delaware corporate law: the duty of care and the duty of loyalty.[211] The difference between these duties is critical because the Delaware General Corporation Law allows a corporation to exculpate or indemnify directors for a breach of the duty of care, but not for a breach of the duty of loyalty or behavior not taken in good faith.[212] Disney had adopted an exculpation provision, and so its directors would only be liable for a breach of the duty of loyalty or actions taken in bad faith.[213] The question on appeal was whether the directors' alleged inattention to Ovitz's hiring and termination breached the duty of loyalty or was made in bad faith.[214]

The court identified three types of director misconduct that could arguably fall under "bad faith."[215] First, "conduct motivated by an actual intent to do harm" was "classic, quintessential bad faith."[216] Second, a step down in culpability was a director's "intentional dereliction of duty, a conscious disregard of one's responsibilities";[217] the court decided that such conduct falls within the meaning of bad faith.[218] Third, the Disney shareholder representatives urged the court to take a step further down the culpability ladder to recognize "gross negligence" as a form of bad faith.[219] The court refused to go that far, noting that it would be inconsistent with Delaware statutory and case law.[220] The court then applied the middle level of scrutiny—intentional dereliction or conscious disregard—in deciding that the directors' conduct in hiring and terminating Ovitz, while careless, did not constitute bad faith.[221]

Later that same year, in *Stone v. Ritter*, the Delaware Supreme Court considered the proper standard for a director's duty of oversight.[222] The case involved shareholders' claim that the directors had failed to adequately oversee AmSouth Bancorporation's compliance with federal banking and anti-money laundering laws.[223] Two customers of AmSouth had opened several accounts

211. For a general overview of these two fiduciary duties, see Claire A. Hill & Brett H. McDonnell, Essay, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1771–77 (2007).

212. DEL. CODE ANN. tit. 8, § 102(b)(7)(i)–(ii) (allowing for exculpation of director liability except for "breach of the director's duty of loyalty to the corporation or its stockholders" or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law"); *id.* § 145 (permitting indemnification of corporate officers and directors).

213. *Disney*, 906 A.2d at 62.

214. *Id.*

215. *Id.* at 64–67.

216. *Id.* at 64.

217. *Id.* at 66.

218. *Id.* at 66–67 (providing two reasons for which "such misconduct is properly treated as a non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith").

219. *Id.* at 64–65. This portion of the opinion is dictum given that the court affirmed the finding below that the shareholders had "failed to establish gross negligence." *Id.* at 64.

220. *Id.* at 66 ("There is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.").

221. *Id.*

222. Stone v. Ritter, 911 A.2d 362, 364–67 (Del. 2006).

223. *Id.* at 364.

that were used in a Ponzi scheme that defrauded over forty investors.[224] When the scheme was discovered, the two customers were criminally prosecuted, and AmSouth was investigated for violations of federal law in opening and maintaining the investors' accounts.[225] AmSouth settled the enforcement actions by paying $50 million in fines and signing a Deferred Prosecution Agreement that required (among other things) enhanced compliance measures.[226] The shareholders claimed that AmSouth directors had breached their duty to oversee compliance with federal banking and anti-money laundering laws, which led to the legal violations and consequent financial harm to the corporation.[227]

In defining a director's duty of oversight, the *Stone* court faced the tug of opposing forces. On the one hand, the recent corporate scandals and the 2004 Sentencing Guidelines amendments pulled toward a heightened standard for directors.[228] On the other hand, the recent *Disney* decision reaffirmed a lenient "good faith" standard for directors despite the shadow of the financial reporting scandals.[229] The court was ultimately unmoved by the legal and business developments since *Caremark*, adopting Disney's "good faith" standard as the *Caremark* duty.[230] The court stated its rule in the following terms:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[231]

The remainder of this Part unpacks four implications of the legal rule stated in this passage.

First, the last sentence of the passage ties the *Caremark* standard to the *Disney* formulation of a director's fiduciary duty. The court describes the two-part test as a measure of a director's "good faith," which is the *Disney* standard.[232] Also, the court clarifies that this good faith standard is part of the director's duty of loyalty, as opposed to the duty of care. Consequently, a

224. *Id.* at 365.

225. *Id.* at 364.

226. *Id.* at 365.

227. *Id.* at 367.

228. AD HOC ADVISORY GRP., *supra* note 166, at 58.

229. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006).

230. *Stone*, 911 A.2d at 370 ("We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability . . . ."); *see also Disney*, 906 A.2d at 65.

231. *Stone*, 911 A.2d at 370.

232. *Id.*; *see Disney*, 906 A.2d at 65.

corporation cannot waive or indemnify a director against his *Caremark* duty.[233]

Second, by framing the *Caremark* duty in terms of *Disney* good faith, *Stone* adopts a standard of intentional or knowing violation of a director's duty.[234] The court confirms this with its statement that "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."[235] Consequently, plaintiffs cannot prevail by claiming that a director should have known or must have known about his obligation to act.[236] Instead, plaintiffs must plead specific facts showing that directors had knowledge that required action and yet stayed their hand.[237] Delaware courts have taken this standard to heart, repeatedly dismissing claims that rest on allegations of less than knowledge or conscious disregard.[238]

Third, instead of providing its own analysis of the issue, the *Stone* court merely recited the analysis from the *Caremark* opinion.[239] A series of quotes, paraphrases, and summaries of *Caremark*'s legal discussion occupies over a full page in the Atlantic Reporter.[240] Consequently, *Stone* omits any reference to the original Sentencing Guidelines, the 2004 amendments to the Sentencing Guidelines, or the corporate scandals that precipitated both enactments, all of which could have supported a heightened duty for directors.[241] In the only original portion of the analysis, the *Stone* court linked the *Caremark* duty to the *Disney* discussion of good faith, which rejected a heightened duty.[242] In short, *Stone* shows that the Delaware Supreme Court had no appetite for ratcheting up a director's duty of oversight for a compliance and ethics program.

Fourth, as codified in *Stone*, the *Caremark* duty has two components—an *initial* duty to take some steps to implement an ethics program, and an *ongoing* duty to oversee operation of the ethics program.[243] The initial duty is stated in

233. *See supra* note 218 and accompanying text.

234. *Stone*, 911 A.2d at 370.

235. *Id.*

236. *See infra* note 238 and accompanying text.

237. *See infra* note 238.

238. *See* South v. Baker, 62 A.3d 1, 14 (Del. Ch. 2012); Desimone v. Barrows, 924 A.2d 908, 940 (Del. Ch. 2007) ("Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so."); Guttman v. Huang, 823 A.2d 492, 506–07 (Del. Ch. 2003) ("Their conclusory complaint is empty of the kind of fact pleading that is critical to a *Caremark* claim, such as contentions that . . . the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."); *see also* Morefield *ex rel.* Computer Sciences Corp. v. Bailey, 959 F. Supp. 2d 887, 906 (E.D. Va. 2013) ("The existence of deficiencies in the internal audit practice does not equate to the Board members being conscious of a failure to do their jobs."); Kococinski v. Collins, 935 F. Supp. 2d 909, 924 (D. Minn. 2013) ("[The shareholder's] presentation of . . . red flags falls short of pleading particularized facts supporting an inference that the outside directors actually knew the financial reports were false and misleading.").

239. *Stone*, 911 A.2d at 370.

240. *Id.* at 368–70.

241. *Id.*

242. *Id.* at 369.

243. *Id.* at 370 (citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969 (Del. Ch.

remarkably deferential terms—"directors *utterly* failed to implement *any* reporting or information system or controls."[244] To "utterly fail" suggests a complete absence of action; "any" suggests that it does not matter what action is taken, as long it is related in some manner to an ethics program. In short, the words "utterly" and "any" indicate that directors must simply take some step toward creating and implementing an ethics program to satisfy the duty. And once some step is taken, the ongoing duty is not triggered until a director sees a red flag indicating either a weakness in the compliance and ethics program or possible corporate wrongdoing. Only then must a director, now conscious of a problem, take some additional action. Otherwise, directors have wide discretion in overseeing the organization's compliance and ethics program.

CONCLUSION

This Article has placed *Caremark* within the arc of compliance history, focusing on the parallel paths of Delaware director fiduciary duty law and the Sentencing Guidelines for organizations. These paths intersected and diverged at times that shaped the modern law and practice of corporate compliance and ethics programs. They intersected when the Chancery Court's *Caremark* decision recognized the original Sentencing Guidelines' transformative shift from a reactive approach to a preventive approach to compliance and ethics programs. *Caremark* relied on this change to switch from the reactive fiduciary duty stated in *Graham* to a preventive fiduciary duty that required directors to do something about compliance and ethics.[245] *Caremark* left open, however, what directors were required to do.[246] This ambiguity was understandable as the original Sentencing Guidelines did not specify the board's role in an effective compliance and ethics program.[247]

The paths then diverged as the Sentencing Guidelines were amended to identify an increased role for the board in overseeing an organization's compliance and ethics program.[248] The 2004 Sentencing Guidelines amendments ratcheted up the requirements for an effective compliance and ethics program in response to the Enron and other financial scandals of the early 2000s.[249] These amendments included a more robust oversight role for the board.[250] In the *Disney* and *Stone* cases, however, the Delaware Supreme Court did not follow the Sentencing Commission's lead. Instead, those cases held that the board owed a relatively light fiduciary duty of oversight under which directors were not liable unless they intentionally or knowingly disregarded that duty.[251] In the face of

1996)).

244. *Stone*, 911 A.2d at 370 (emphasis added).

245. *See supra* Part I.B and accompanying text; *see also Caremark*, 698 A.2d at 969.

246. *Caremark*, 698 A.2d at 971–72.

247. U.S. SENTENCING GUIDELINES MANUAL § 8A.1.2 (U.S. SENTENCING COMM'N 1991).

248. *Id.* § 8B2.1.

249. *See supra* notes 180–84 and accompanying text.

250. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1 (U.S. SENTENCING COMM'N 2016).

251. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006); Stone v. Ritter,

concerns over director neglect, the court sided with the corporate law policies favoring deference to director decision making.

In its 2009 decision in *Gantler v. Stephens*,[252] the Delaware Supreme Court held that corporate officers owe the same fiduciary duties as directors,[253] which includes the *Caremark* duty of oversight. This holding, however, raises two questions concerning the *Caremark* duty: First, which "officers" owe a *Caremark* duty? Second, what is the nature of the officers' *Caremark* duty?[254] Despite its breadth and depth on many issues of corporate law, Delaware decisions offer little guidance on either of these questions.[255] I have discussed both issues previously, and so I do not offer an extended discussion here.[256] Rather, I note how the arc of compliance history discussed in this Article suggests an answer to the second question.

Recall that four corporate law policy rationales discussed in Part III.B persuaded the Delaware courts to adopt a deferential version of the *Caremark* duty.[257] These policies also apply to decisionmaking by corporate officers and may in fact have greater urgency in the context of corporate officers. For example, Delaware judges and juries would be equally, if not less, equipped to review the business decisions of corporate officers. Delaware law allows the board to delegate operational decisions to officers who are closer to the day-to-day information and considerations needed to make those decisions.[258] Indeed, because of that better knowledge and expertise, directors are permitted to rely on the reports and business decisions of corporate officers. At an even further distance from this decisionmaking, judges and juries are not well situated to reassess officers' actions.

In addition, the concerns about rational, risk-based decisionmaking and encouraging service by qualified candidates may be higher for officers than for directors. This is because Delaware law does not allow a corporation to exculpate an officer from liability for breach of the duty of care; a corporation

911 A.2d 362, 370 (Del. 2006).

252. 965 A.2d 695 (Del. 2009).

253. *Gantler*, 965 A.2d at 708–09 ("In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold." (footnote omitted)).

254. For more on the general issue of the proper fiduciary duty standard for corporate officers, see generally Michael Follett, Note, Gantler v. Stephens: *Big Epiphany or Big Failure? A Look at the Current State of Officers' Fiduciary Duties and Advice for Potential Protection*, 35 DEL. J. CORP. L. 563 (2010).

255. Lyman P. Q. Johnson, *Dominance by Inaction: Delaware's Long Silence on Corporate Officers* 4–5 (2017) (Wash. & Lee Pub. Legal Studies Research Paper Series, Accepted Paper No. 2017-11, 2017) ("It is an ironic feature of Delaware corporate law that neither its corporation statute nor its case law says very much about the responsibilities of the most influential actors—for good or bad—in corporate affairs, i.e., executive officers.").

256. *See* Paul E. McGreal, *Corporate Compliance Survey*, 65 BUS. LAW. 193, 211–14 (2009).

257. *See supra* Part III.B.

258. DEL. CODE ANN. tit. 8, § 141(a) (West 2018) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

may only indemnify officers for such liability.[259] The prospect of facing a trial and verdict on a fiduciary duty claim would surely cause an officer to be more cautious, even if the corporation has committed to cover attorney's fees and money damages. And that prospect of heightened liability would discourage some qualified candidates from accepting officer positions, or at least cause them to require increased compensation to offset the increased risk.

In sum, the arc of compliance history points to a deferential *Caremark* standard for officers. The corporate law policies favoring deference point in that direction, and the *Disney* and *Stone* decisions show that these policies outweigh concerns with director mismanagement or inattention highlighted in the 2004 Sentencing Guidelines amendments. If Delaware courts apply the same weighting when analyzing an officer's fiduciary duty, the *Caremark* duty would require the same showing of knowing or intentional inaction or wrongdoing.

259. *Id.* §§ 102(b)(7), 141(e).

APPENDIX

Excerpt from Report of the Ad Hoc Advisory Group on the U.S. Sentencing Guidelines for Organizations

First, of what aspects of a compliance and ethics program should a director be knowledgeable?

> The knowledge about program features and operations that members of a governing authority should gain includes: practical management information about the major risks of unlawful conduct facing their organization; the primary compliance program features aimed at counteracting those risks; and, the types of problems with compliance that the organization and other parties with similar operations have encountered in recent activities.[260]

Second, how should directors gather and receive information about the compliance and ethics program?

> The proposal does not specify the fact finding procedures or methods that members of a governing authority should use in acquiring this type of information, leaving it to particular organizations to gather and deliver this sort of information to governing authority members in the ways that best fit the organization's overall operations.
>
> Typically, however, members of a governing authority will gain information on the features and operation of a program to prevent and detect violations of law through reports from senior organization managers or other experts.[261]

Third, how often should directors gather and receive information about the compliance and ethics program?

> The proposal anticipates that members of a governing body will update their information about program features and operations periodically. This update would occur at least annually, and more frequently when legal changes or shifts in organizational activities raise new compliance risks for the organization.[262]

Fourth, what actions does director oversight of a compliance and ethics program entail?

> The provisions of the proposal describing the oversight duties of governing authority members recognize that effective management requires that governing authorities be proactive in seeking information about compliance problems, evaluating that information when received, and monitoring the implementation and effectiveness of responses when compliance problems are detected.[263]

260. AD HOC ADVISORY GRP., *supra* note 166, at 60.

261. *Id.*

262. *Id.*

263. *Id.* at 61.