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Caremark and Compliance: A Twenty Year Lookback

Donald C. Langevoort
Georgetown University Law Center, langevdc@law.georgetown.edu

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Caremark and Compliance: A Twenty Year Lookback

Donald C. Langevoort*

In nearly all narratives of how compliance has grown as a legal subject and field of practice in the last two decades, the Delaware Chancery Court’s decision in In re Caremark plays a featured role. Chancellor Allen’s opinion predicted the abandonment of the Delaware Supreme Court’s older and heavily criticized approach in Graham v. Allis-Chalmers, which had limited the board of directors’ compliance oversight obligation to situations where red flags were waving in the board’s face. It said (though entirely in dicta) that the board had an affirmative obligation to assure itself in good faith that the corporation had a system of internal reporting and compliance controls to monitor for illegal activities. Since that time, compliance has grown in size, scope and stature at nearly all large corporations.

There is a lively academic debate over whether Caremark’s causal impact on the unmistakable growth curve of compliance has been overstated. After all, the holding in the decision (approving a de minimis settlement) was that the standard for holding directors of Delaware corporations liable for monetary damages under a test requiring “sustained and systematic indifference” to compliance oversight would be exceedingly hard to prove. Plus federal law had already been trending strongly in the direction of a robust corporate compliance obligation in many disparate fields of regulation (e.g., antitrust, financial services, healthcare, defense contracting) and—as Caremark duly noted—the Organizational Sentencing

* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center.
3 188 A.2d 125 (Del. 1963). Famously, the court rejected the idea that boards were obliged to install a corporate system of “espionage” to spy on employee behavior. Id. at 130.
4 See Sean J. Griffith, Corporate Governance in an Age of Compliance, 57 Wm. & Mary L. Rev. 2075 (2016); Miriam Hechler Baer, Governing Corporate Compliance, 50 B.C. L. Rev. 949 (2009).
Guidelines had made the presence and quality of compliance (including board oversight) a substantial factor in the size and severity of any federal penalty for criminal wrongdoing.\(^6\) Within a few years would come even bigger waves of pressure from Washington, via the emergence of deferred prosecution agreements, corporate charging decisions, and—for public companies—the mandates of the Sarbanes-Oxley Act, which required new board structures, internal control processes and whistleblower protections to address the risk of financial misreporting, which arises in the face of any material corporate wrongdoing.\(^7\)

Whatever its causality, *Caremark* no doubt did in its time focus the attention of elite corporate lawyers, who used their considerable influence inside the boardroom to grab the attention of directors and insist on more rigorous internal procedures.\(^8\) As has happened with other seminal “message” opinions,\(^9\) the lawyers probably trumpeted the dicta and subtly downplayed how tiny the remaining liability risk was in order to upgrade compliance (a legal function) as a corporate priority. Then, and even now to an extent, it was frustratingly hard to get officers and directors to devote the time, resources and attention necessary to manage legal risks.

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

As many corporate governance scholars have come to accept, corporations are complex interactive systems of processes, routines and feedback, the efficacy of which cannot be taken for granted and hence becomes the crucial focus of the CEO and senior management team.\(^10\) The overwhelming complexity is daunting—perhaps beyond even the collective

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\(^7\) E.g., Lawrence Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism and Other Ills*, 29 J. Corp. L. 267 (2004).


brainpower of the C-Suite to comprehend—yet can and must be managed to the extent possible. Like all enterprise risks, compliance risks emerge, move and change in ways not always visible within the architectural sight lines of the firm.

It is at least arguable that independent directors haven’t enough capacity to engage with this complexity, so that Caremark was wise to demand almost nothing beyond asking that some compliance system exists. Independent boards have limited time, attention and expertise, which should thus be deployed only where most useful. Yet government enforcers and standard-setters today insist on a much greater board role without necessarily defining how or why it will be constructive. The remaining sections of my commentary address three possibilities: (1) framing the cost-benefit assessment on the question of how much to spend on compliance; (2) forcing certain compliance matters to real-time board-level attention; and (3) using selection, promotion and compensation decisions to influence the culture and risk-taking “temperature” of the firm. None of these is unfamiliar as a subject within the now vast literature on compliance, but I think there are still points and perspectives as to each that both connect back to Caremark and deserve more attention.

I. WAS CAREMARK MISLEADING?: TRADE-OFFS AND EXTERNALITIES

For all the progress that has been made in both scholarly research and practitioner sophistication about compliance, quantitative metrics that help answer the basic questions—how much in the way of corporate resources should be devoted to compliance and how should those resources best be deployed—are elusive. Within the corporate control system, feedback with respect to high level risk events is (fortunately) not frequent enough to calibrate with precision. To be sure, a brokerage firm, for example, can use changes in the number of regulatory inquiries and customer complaints as indicators that compliance strategies are working or not, but these numbers vary for any number of reasons and do not necessarily capture larger, less frequent risks. Similarly, surveys and other measurement tools regarding “ethical climate” can be helpful but leave open the question of what, precisely, to do about any dark clouds.11 Put simply, there is always more that can be done in compliance—especially in the technology and manpower for audit and surveillance12—and an unavoidable fear that should a legal catastrophe happen, enforcers and the media will conclude in hindsight that what was done wasn’t enough. On the other hand, compliance is not a profit center, making

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it hard to compete for funding with corporate functions that are, especially when the focus is on the short-term.

Caremark was quite clear that these resources and deployment choices are matters of business judgment, and hence receive strong deference when made in good faith. This plays into the minimalist board role—from this perspective, it suffices that management present its compliance plan for board-level feedback and/or approval on a regular basis. A claim by management that additional expenditures would not be cost-justified in light of its subjective risk assessment is presumptively reliable, all the more so if buttressed by an independent consultant’s report. Given the complexity of the compliance system (embedded inside the even more complicated corporate operating system), these resources allocations are hard for board members to question. Caremark certainly gives them no reason to do so.

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

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

To illustrate, consider the portion of a compliance program focused on foreign bribery as interdicted by the Foreign Corrupt Practices Act. FCPA compliance is challenging, to be sure—the law is murky at numerous points, regulators vary over time in the likelihood


\[14\] See Bullard, supra, at 20-24.


\[16\] Geoffrey P. Miller, An Economic Analysis of Effective Compliance Programs, in JENNIFER ARLEN, ED., RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (forthcoming, 2017); see also Langevoort, Cultures of Compliance, supra, at 938-39.
and severity of enforcement, and the points of legal risk (opportunities for potentially unlawful payments) are numerous. From a shareholder perspective, the risk of sanction has to be taken very seriously, but so do the potential costs. And there is strong evidence that, on average and over time, FCPA sanctions are significantly less than the money to be made when violations occur and remain undetected. 17 So even though a board could not authorize or knowingly tolerate violations, it could under Caremark choose to follow management’s preference for moderation in how the firm deals with FCPA risks, without fear of state law fiduciary duty liability.

All that changes, however, when we move from state law fiduciary duties to federal or state regulatory enforcement. 18 If a violation occurs and is detected, the company may face an upward adjustment in sanction if business judgment led to suboptimal investment in precaution from a societal perspective. True, regulators and enforcers may err in their own assessment of the cost-benefit tradeoffs, ignoring a multitude of indirect costs and adopting a motivationally-inflated view of benefits. Jennifer Arlen and Marcel Kahan, for example, warn against regulators straying too far away from the norm of corporate efficiency in making judgments about compliance, 19 and their fears about institutional competence are reasonable. Prosecutors have shown some naïveté in their faith in particular compliance and governance strategies. But in principle, at least, regulators and enforcers who have prosecutorial discretion and the ability to seek compliance-related sanction adjustment have no reason to feel beholden to Caremark’s focus on corporate well-being, and almost surely do not in fact. 20

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

Of course, one might argue that management should understand this on its own and take the (socially) optimal compliance precautions in the firm’s best interests. But there are at

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18 Once regulators start focusing on compliance, their standards soon become de facto requirements, if not de jure ones. See Bullard, supra, at 27-38. Bullard focuses on health-care as an example of federal preemption of compliance, but the same point can be made about many other regulatory domains.
19 Jennifer Arlen & Marcel Kahan, Corporate Governance Regulation through Non-Prosecution, U. Chi. L. Rev. (forthcoming, 2017)(limiting compliance-related interventions to wrongdoing indicating clear agency cost problems); see also Griffith, supra; Lawrence Cunningham, Deferred Prosecution and Corporate Governance, 65 Fla. L. Rev. 1 (2014).
20 See Langevoort, Cultures of Compliance, supra, at 939-40.
least two sets of concerns to make us worry about excessive managerial autonomy regarding compliance strictures, both now fairly familiar. One is the presence of agency costs. For reasons having to do with hiring, compensation and retention incentives, executives face a cost-benefit calculus for legal risk-taking that differs from the long-run best interest of the firm. They may choose a strategy that creates risk of sanction for the company in order to keep their jobs and perquisites. But the same kinds of pressures to cheat may also arise from an excessive commitment to the firm’s best interests, as where a cover-up is launched to avoid legal responsibility for something that has gone wrong or to avoid loan defaults and the like that would occur if the hidden problems were revealed. I (and others) have written extensively about what motivates managerial misbehavior, and this need not be repeated here. Suffice it to say that managerial motivations toward legal compliance are not fully aligned with either the corporation’s best interests or the optimal avoidance of social harm. Regulators’ hopes thus turn to the board of directors.

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

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

So what about Caremark? The foregoing discussion—and what is yet to come—goes well beyond the holdings or dicta in it or its Delaware corporate law progeny. To be sure, dicta found in the opinion calls for boards some curiosity about the status of internal compliance. But this is all by way of what in the end animates the Delaware corporate vision: it’s up to the shareholders to elect directors who care about their interests and monitor accordingly. As Chancellor Allen says, there are limits on how sorry to feel for the

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21 Because of diffusion of knowledge and responsibility within complex firms, individual prosecutions are less frequent, though by no means unlikely. My view, developed at length elsewhere, is that psychology and culture make executives willing to engage in or tolerate non-compliance even when rationally it might be prudent to obey the law. See DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET AND THE DILEMMAS OF INVESTOR PROTECTION ch. 2 (2016).

22 Id. at 90-91.


shareholders if they fail to do so and some compliance catastrophe occurs. By contrast, the evolving regulatory vision of corporate compliance responsibilities is to see the harms from corporate wrongdoing to persons with no franchise at all. On that Caremark says naught, and thus seems a bit less relevant in modern optimal compliance debates.

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

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

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

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

One subtle aspect of Caremark comes into play here. The Chancellor stressed that no “red flags” had come to the attention of the board that did or should have alerted them of the compliance risk. So what is the standard for director liability when there were red flags? In two widely noted federal court of appeals decisions applying Delaware law not long after Caremark, the courts refused to dismiss cases against the board members pending further

factual inquiry into what the board members knew and how they responded. Plaintiffs’ lawyers with Caremark type cases soon were working hard to fill their complaints with numerous warning signs the board should have pursued.

We need not determine here precisely what the law is with respect to red flag cases (especially when the company has a “102(b)(7)” exculpatory clause in its charter to protect directors from duty of care liability). The Delaware Supreme Court’s recent decision in City of Birmingham Retirement System v. Good (prompting a dissent by Chief Justice Strine) suggests that the bar is still high. All we need to see for now is that the moment the board is brought into the compliance risk discussion, liability exposure increases to at least a small extent, and Caremark itself no longer sets the applicable standard. This shift may be even more dramatic under federal law. Under the federal securities laws, for example, disclosure cases require a showing of scienter, which includes subjective recklessness. Being brought into the loop

26 McCall v. Scott, 239 F.3d 808 (6th Cir. 2001); In re Abbott Laboratories Derivative Shareholder Lit., 325 F.3d 795 (7th Cir. 2001). The fact that these cases were not decided by Delaware courts led plaintiffs to prefer non-Delaware venues for Caremark type claims. This is no longer quite so easy in the fact of charter or by-law provisions mandating that derivative claims be brought in Delaware courts.

27 In Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court indicated that such cases require plaintiffs to show a conscious disregard of the compliance risk in the face of whatever “red flags” information coming to its attention, which is hardly an easy standard for plaintiffs. And indeed, most such claims fail. E.g., In re Qualcomm FCPA Deriv. Lit., 2017 WL 2608723 (Del. Ch., June 16, 2017). But there have been cases where the flags were red enough to permit such an inference, and so this remains the route of choice. E.g., In re Massey Energy Co., 2011 WL 2176479 (Del. Ch. 2011); Westmoreland County Employee Retirement System v. Parkinson, 727 F.3d 719 (7th Cir. 2013)(applying Delaware law); In re Intuitive Surgical Shareholder Deriv. Lit., 146 F. Supp.3d 1106 (N.D. Cal. 2015). For a review and assessment of these red flag cases, see Ezra Wasserman Mitchell, Caremark’s Hidden Promise, available at https://ssrn.com/abstract=3012419 (Aug. 2, 2017). As a matter of Delaware corporate law, many Caremark cases are decided based on whether plaintiffs’ failure to make demand on the board of directors to bring the suit is excused as futile, which is typically resolved by reference to whether the directors face a significant threat of personal liability. That inquiry, in turn, is complicated by the fact that most Delaware corporations have adopted charter provisions under Section 102(b)(7) that exculpate directors from liability for breach of the duty of care absent bad faith. Indeed, Stone essentially adopts a bad faith standard for all Caremark claims. Of course even with a skeptical judiciary, the pressures to settle may be considerable. For a more approving assessment of a Caremark claim once a settlement agreement promises to terminate litigation, see In re Pfizer Inc., 780 F. Supp.2d 336 (S.D.N.Y. 2011).

28 2017 WL 6397490 (Del., Dec. 15, 2017). The case deals with not only bad faith but conscious disregard of law.

provides evidence of this, and also triggers a greater possibility of control person\textsuperscript{10} or (for securities firms) "duty to supervise" liability.\textsuperscript{11}

So, board members will not welcome any such escalation. No doubt there are circumstances where the legal dangers are so imminent and large that failure to escalate would be a clear breach of fiduciary duty on the part of whatever senior managers knew of the risks—the duty of "candor inside the corporation" about which I have written elsewhere.\textsuperscript{12} But given the messiness noted earlier, many situations will be more ambiguous as to either the probability or the magnitude of the risk. There, one can start imagining arguments for putting off informing the board for the moment.

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

There is no obvious answer under these varying facts, at least until the subpoena. But I can easily imagine this kind of information getting bottled up, with potentially unfortunate consequences for the company. This is a sensitive matter over which the lawyers want control, and sharing complete information with a widening circle of corporate officials necessarily diminishes that control. No doubt there is some belief, realistic or not, that the problem can be made to go away by distancing the company from the now-risker practice without drawing attention to the matter. In the background—conscious or not—is accountability and self-interest. Potentially, the lawyers are to blame either for the imprudence of the original legal advice or for failing to understand what really was happening and adjust the advice in light of new circumstances. Human nature is to double down, via what psychologists call defensive bolstering: increasing their commitment to the original


\textsuperscript{12} Officers who intentionally keep directors in the dark on an important matter are almost surely violating fiduciary and agency law responsibilities. See Donald C. Langevoort, \textit{Agency Law Inside the Corporation: Problems of Candor and Knowledge}, 71 U. Cinn. L. Rev. 1187 (2003).
decisions. They may try to find sympathetic outside counsel to concur. All of this may diminish the perceived compliance risk, and thus understate the actual risk.

This is a test of character and competence for the lawyers, and there is considerable variation in how chief legal officers will perform.33 The Caremark-related question is whether the board should as a matter of policy insist that it be brought into matters like these, and if so, how and when. The Caremark opinion again says nothing, so that once more it is a matter of good faith business judgment. If that is all, then it is probably safe to assume that most boards will allow senior management to exercise discretion on what to report up, with the implicit understanding that compliance matters are for management to handle and only extraordinary circumstances should require board attention. That is not entirely unreasonable. Legal compliance is not specifically within the expertise of most board members, and there will not necessarily productive conversations in this highly-scripted portion of the meeting beyond the exhortation that the matter be handled properly.

Today, however, I doubt that well-advised boards take this position (though some probably wish they could).34 The reason, once again, stems mainly from pressures from regulators and enforcers at the federal level, who have come to believe in the value of a stronger board-level presence in compliance. The Organizational Sentencing Guidelines, COSO principles and numerous regulatory pronouncements seek not only board approval of written policies and procedures and key compliance personnel decisions, but a much more interactive involvement that includes reporting lines running from the chief compliance officer (and perhaps chief legal officer) directly to the board, unfiltered by senior executives. While these are rarely so specific as to define the time frame or materiality threshold for reporting up, the assumption seems to be that boards want and need awareness and involvement on an accelerated basis as to significant compliance risks. Otherwise, the board will too often be the last to know.

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

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33 See generally BENJAMIN W. HEINEMAN, JR., THE INSIDE COUNSEL REVOLUTION (2016); from an economics perspective, see Robert C. Bird et al., The Role of the Chief Legal Officer in Corporate Governance, 34 J. Corp. Fin. 1 (2015).

34 See Rebecca Walker & Jeff Kaplan, Reporting to the Board on the Compliance and Ethics Program, Compliance and Ethics Professional, June 2014, at 59, 64-65.
What we see here is something of a replay of Part I. The contemporary federal perspective is that management is too often inclined to ignore or bury compliance warnings and risks, and cover-up when events pass the illegality threshold. Forcing more board-level involvement early on is the only practicable alternative at the highest-level of the firm, naïve or not. Hence the emphasis on real-time interaction not only with senior management but the chief legal and compliance officer(s), supplemented by the positioning of legal and compliance personnel in key committees and organization chart checkpoints, so that there are more routes by which information can indeed reach the board and force it to respond.

Nothing guarantees that this will actually happen—sound information flow practices on paper are often enough frustrated in practice. But the evidence we have on independent director presence does suggest some efficacy in reducing firm-level risk and instilling a better attitude toward compliance. (By contrast, there is far less evidence that independent director presence makes companies more profitable.) As the norms of corporate governance continue to move in the direction of board empowerment and professionalization, we cannot readily dismiss the possibility that the “information forcing” function associated with added board-level compliance burdens and responsibilities will do some good.35

This is also consistent with the approach to compliance that focuses on the optimal expenditure of resources to avoid social harm, not just harm to the corporation and its shareholders. Presumably, independent directors are more likely than insiders to accept the legitimacy of societal demands for caution over risk-taking when the harms from corporate wrongdoing are spread widely, while its profits are thoroughly internalized in the form of salaries, bonuses, dividends and stock price appreciation. Or such is the normative expectation, even if not all independent directors have yet gotten the message.

III. WAS CAREMARK INCOMPLETE?: INCENTIVES AND CORPORATE CULTURES

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

Much has changed since then, largely because of federal-level prodding. Today, compliance expectations are much higher, not tied to the corporation’s narrow self-interest. But to many, procedural and organizational reforms in compliance have not been as successful.

at deterring wrongdoing as we hoped. Scandals continue to grab headlines. Part of this, no
doubt, is because there are still positive returns to wrongdoing because of under-
enforcement. But the risks to high-level officials from corporate prosecutions and regulatory
sanctions go beyond fines and penalties. Stock prices drop; the firm suffers reputational harm;
etc. Boards are more likely to fire the CEO or subordinates out of anger or frustration, or at
least reduce their pay. There are ample disincentives to corporate illegality, all of which
should have a robust deterrence effect.

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

We are increasingly coming to see how and why ethical and legal lapses occur.
Corporate cultures are belief systems—transmitting to loyal, committed managers and
employees a sense of what is valued, and what is denigrated. They help coordinate the
activities of numerous stakeholders, an essential task in making the complex corporate system
function. When corporations are under immense (often shareholder-driven) competitive
pressure to succeed, belief systems can become facilitators for what it takes to survive and
thrive, the grease in the corporate machinery. When circumstances create temptations to
behave illegally, those beliefs can provide rationalizations that explain why what is profitable is
also morally acceptable, via what psychologists call motivated inference. Once these kinds of
rationalizations take hold, wrongdoing starts to happen, in small steps, then bigger ones.

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

Caremark gives no hint of any of this, though that is not a criticism. At the time,
culture and norms were not central to thinking about governance or compliance. Today they
are, with regulators and enforcers willing—for better or worse—to pass judgment on a

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36 See note — supra.
37 See Marcel Kahan & Edward Rock, Embattled CEOs, 88 Tex. L. Rev. 987 (2010). But see Messod D. Benesh
et al., Explaining CEO Retention in Misreporting Firms, J. Fin. Econ. (forthcoming, 2017).
38 There is now a large literature on this. For discussion and citations, see David Hess, Ethical Infrastructure and
Evidence-based Corporate Compliance and Ethics Programs: Policy Implications from Empirical Evidence, 12 NYU J. L. &
Bus. 317 (2016); Langevoort, Cultures of Compliance, supra, at 943-46.
39 E.g., John H. Darley, The Cognitive and Social Psychology of Contagious Organizational Corruption, 70 Brook. L.
company’s ethical climate when deciding whether to charge the corporation or just individuals, or how big a fine to seek. The lesson is an important one as they work through their growing number of compliance-related assignments. As I put it recently in a survey of compliance cultures, “[i]n the end, the most important message about cultures of compliance is for corporate leaders and, especially, boards of directors. It is much too easy to look around and see good people working hard at difficult jobs and assume that a good compliance culture exists simply because everyone has been warned of the damage that can come from getting caught doing wrong. Or worse, to assume that an observable abundance of intensity, loyalty and creativity are signs that all is good.”

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

One small irony, however, comes from Caremark’s curt dismissal of Graham’s warning against fiduciary duty leading to intra-corporate espionage. Today, those fears are very much still with us, all the more so as technology creates surveillance tools unimaginable in 1996, much less 1963. Surveillance intensity, as many have pointed out, may be effective at promoting command and control, but at a cost in terms of a culture of trust and integrity that is hard to measure but very much worth worrying about.

IV. CONCLUSION

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

Chancellor Allen was no ideologue, and understood that he was addressing only the shareholder litigation piece of the far larger compliance puzzle. In extra-judicial writings, he

40 Langevoort, Cultures of Compliance, supra, at 978.
was sensitive to the biases and distorted incentives that plague high-stakes corporate decision-making, hoping that independent lawyers, directors and others understood the need to step up regardless of the diminished liability threat.\footnote{E.g., William T. Allen, Corporate Governance and a Business Lawyer’s Duty of Independence, 38 Suffolk L. Rev. 1 (2004).} Those thoughts have even more resonance today, as the short-term market pressures on corporations have grown all the more intense.\footnote{Including activist investors, whose influence does not appear to be integrity-producing regardless of its immediate impact on the issuer’s stock price. See John C. Coffee, Jr., Preserving the Corporate Superego in Times of Stress: An Essay on Ethics and Economics, 33 Oxford Rev. Econ. Pol’y 221 (2017); Jillian Popadak, A Corporate Cultural Channel: How Increased Shareholder Governance Reduces Firm Value, available at www.ssrn.com/abstract=2345384 (May 2014).} They are strongly felt in the boardroom. But there are also countervailing pressures in the direction of “publicness:” the societal expectations that economically powerful entities have an obligation to temper the risks they take when the harms when things go bad are felt outside corporate boundaries. Compliance is a crucial part of this, which the Chancellor understood and wanted to promote as much as he could within the restrictive confines of the case before him. To be clear, I don’t think that Caremark was misleading, naïve or incomplete. The Chancellor knew that if boards fail to become more sophisticated and sensitive to doing this well—the cultural part as well as the policies and procedures—external pressures will continue to grow without regard to cost or efficiency. That is even more so today.