Evolution of Director Oversight Duties and Liability under Caremark: Using Enhanced Information-Acquisition Duties in the Public Interest

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Abstract

Corporate law primarily operates to reduce agency costs, but it also has an important role to play in protecting society from social harms resulting from corporate crime. Society needs to leverage corporate law to help deter misconduct because agency problems and under-enforcement undermine the deterrent effects of corporate criminal liability. Unlike other fiduciary duties, these fiduciary duties should be structured to induce directors to act in society's interests to deter organizational misconduct, even when shareholders profit from misconduct.

This Chapter examines Delaware's approach to directors' fiduciary duties to deter organizational misconduct. Delaware has long held directors liable for knowingly causing misconduct, or allowing it to continue, even to benefit the firm. Delaware also imposed oversight duties on directors through the Caremark doctrine. Yet Caremark as originally formulated is ineffective because it gives directors full discretion over the firm's compliance function and their oversight of it. Directors thus can avoid liability under Caremark while adopting internal systems and oversight that enhance corporate profits by enabling corporate crime. This Chapter shows that in order to deter misconduct more effectively directors should be subject to more precise duties to obtain information about, and oversee the investigation of, detected violations of laws in which the firm or society has a materially heightened interest in compliance. It then discusses a series of new Caremark cases and shows how they create such duties and appear to imply them to promote social welfare, even when shareholders might profit from crime.

Keywords: corporate governance, corporate crime, Caremark, director oversight duties, good faith, bad faith, corporate liability, entity liability, director fiduciary duties

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1. Introduction

Large publicly-held corporations reside at the core of our society and can affect it for good or ill. Our legal system must address two separate concerns. The first is agency costs. Agency costs arise when corporate directors or senior executives use their control over the firm to benefit themselves at shareholders', their firms', and our economy's expense. The second is externalities: companies in pursuit of profit regularly impose harm on others that they do not have to bear, directly or indirectly, and thus are inclined to ignore.[1] These harms include those from activities society has prohibited, for example, environmental misconduct, price-fixing, corruption, securities fraud, health care fraud, and the knowing sale of unsafe products.

Corporate law seeks to ameliorate both problems by imposing fiduciary duties on directors whose breach can lead to personal liability for damages. Corporate law primarily uses fiduciary duties to address agency costs, largely through doctrines designed to deter directors from favoring their own interests.[2] Yet fiduciary duties also play an important role in deterring corporate misconduct. Delaware courts have long imposed liability on directors who knowingly cause their companies to commit corporate misconduct even if it benefits the firm. In addition, Delaware now imposes enhanced oversight duties on directors with respect to certain types of corporate misconduct with even greater potential to deter corporate crime even when it is profitable. These fiduciary duties are important to the effort to deter corporate crime because agency problems and under-enforcement undermine the deterrent effects of corporate criminal liability.

This Chapter examines the recent evolution in Delaware law on directors' fiduciary duties to deter corporate misconduct. It explains both why society needs to impose fiduciary duties on directors designed to induce them to deter misconduct. It then explains why such duties must be specific and narrow. The Chapter then examines Delaware's historic approach, as set forth in *In re Caremark International,*[3] and shows why it has failed to induce directors to take effective steps to deter corporate crime. It examines Delaware's recent case law expanding *Caremark* and explains why Delaware is correct that to impose enhanced duties on directors to adopt systems to inform them about—and to ensure they are informed about—detected misconduct and compliance deficiencies that are material to the firm or society. It also explains why such duties are needed to protect society, even when shareholders do not benefit materially from deterring corporate crime and may even profit from misconduct.

Corporate law needs to impose fiduciary duties on directors designed to induce them to deter corporate misconduct in order to enable society to effectively deter misconduct. Society

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[1] Although companies can cause social harm in several ways, this chapter focuses on harms resulting from corporate misconduct.

[2] These fiduciary duties include the duty to act in good faith on behalf of the firm, to avoid self-interested transactions that are not appropriately approved, and to take due care in the process of decision-making.

[3] *In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996).

relies primarily on criminal liability for individual wrongdoers and their corporate employers[4] to deter organizational misconduct.[5] Under ideal circumstances, properly structured corporate criminal liability[6] should suffice to deter by inducing companies to prevent, detect, investigate, and self-report misconduct, and share their information with enforcement authorities to increase the threat of individual liability.[7] Yet in practice corporate criminal liability does not adequately deter as a result of two problems: agency costs and under-enforcement.

Corporate criminal liability is ineffective in causing companies to actively deter misconduct, even when structured to ensure companies are better off when they deter misconduct, when corporate directors and senior managers obtain private benefits from the misconduct or weak internal controls.[8] Corporate criminal liability also is fails to adequately deter because companies face such a remote risk of having their misconduct detected and sanctioned[9] that they regularly expect to profit from misconduct. As a result, directors acting in their companies' interests often

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[4] Throughout this chapter, corporate criminal liability refers to corporate liability which shares the core features of corporate criminal liability: (1) expression by society that the conduct was immoral or unethical; (2) threat of substantial financial penalties; (3) possibility of serious collateral consequences such as debarment or exclusion, and (4) enforcement by an enforcement agency not directly subject to capture by the industry against whom the enforcement action is brought. Administrative corporate liability can, but does not always, have these features, and it may not carry the same expressive force. In addition, in some countries (such as the U.S.), corporations can use their political influence to suppress enforcement intensity by administrative and civil authorities. See Jennifer Arlen, *Countering Capture: A Political Theory of Corporate Criminal Liability*, J. CORP. LAW (forthcoming).

[5] See generally Jennifer Arlen & Samuel Buell, *The Law of Corporate Investigations and the Global Expansion of Corporate Criminal Enforcement*, 93 S. CAL. L. REV. 697 (2020) (discussing law and practice of U.S. liability for organizational misconduct); SAMUEL W. BUELL, CAPITAL OFFENSES: BUSINESS CRIME AND PUNISHMENT IN AMERICA'S CORPORATE AGE (2016) (same); Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007) (same).

[6] See *supra* note 4.

[7] For a discussion of why deterrence requires the imposition of both corporate and individual liability and the optimal structure of corporate liability, see *infra* Section 1.A; see, e.g., Jennifer Arlen & Lewis Kornhauser, *Battle for Our Souls: A Psychological Justification for Corporate and Individual Liability for Organizational Misconduct*, U. ILL. L. REV. (forthcoming); Jennifer Arlen, *The Potential Promise and Perils of Introducing Deferred Prosecution Agreements Outside the U.S.*, *in* NEGOTIATED SETTLEMENTS IN BRIBERY CASES: A PRINCIPLED APPROACH 156 (Abiola Makinwa & Tina Søreide eds., 2020); Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 NYU L. Rev. 687 (1997).

[8] For example, directors and officers of firms that are at risk of failing or are materially under-performing relative to peers may benefit from committing or overlooking evidence of securities fraud designed to make the company look healthier than it is, even when shareholders are harmed by, and would want to deter, the misconduct. See Jennifer Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691 (1992). In addition, companies may enable CEOs to assault employees or others for their personal benefit, even when such acts harm the firm, because other executives fear reprisals from the CEO should they intervene. *Cf.* KEN AULETTA, HOLLYWOOD ENDING: HARVEY WEINSTEIN AND THE CULTURE OF SILENCE (2022).

[9] One reason companies face a small risk of detection is that enforcement authorities are woefully underfunded. See Arlen, supra note 4; *infra* Section 1.B; see also Eugene Soltes, *The Frequency of Corporate Misconduct: Public Enforcement Versus Private Reality*, 26 J. FIN. CRIME 923 (2019) (presenting evidence of firms committing hundreds of violations a year, none of which were detected). Offenses eligible for whistleblower bounties can have a higher risk of detection and sanction, but SEC resource constraints undermine its whistleblower bounty program because only the SEC can bring the enforcement action; whistleblowers cannot proceed on their own. See generally, David F. Engstrom, *Bounty Regimes*, *in* THE RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 334 (Jennifer Arlen ed., 2018) (describing the SEC whistleblower bounty system).

In addition, the sanctions imposed on those who are detected are not large enough to counteract the low probability of sanction.

structure their companies' internal operations to promote productivity in ways that predictably induce corporate crime.[10]

Corporate law can, and should, counteract both problems by imposing fiduciary duties on directors (and officers) that are structured to induce them to actively deter misconduct.[11] These duties should be structured to address both agency costs and under-deterrence by providing directors with a personal motive to act in society's best interests by deterring misconduct even when the company would benefit from it. These duties also should be structured to promote a central goal of corporate liability: inducing firms to detect, investigate, terminate and self-report detected misconduct.[12]

Director liability should not be predicated on traditional tort liability rules—such as strict liability for detected misconduct or negligence liability for ineffective deterrence. The former would lead directors to devote excessive resources to deterrence and cause them to resist detection, self-reporting, and cooperation with respect to misconduct.[13] The latter would have no effect, if courts applied the Business Judgment Rule or would be impracticable, as Delaware Courts do not have the information needed to effectively assess whether directors are optimally seeking to deter misconduct.[14]

Nor should corporate law rely solely on its long-standing duty that directors may not knowingly cause the firm to violate the law, even if it would be profitable.[15] Under Delaware law, companies cannot deliberately violate criminal laws in pursuit of profit. In turn, directors who knowingly cause companies to violate the law are deemed to have acted in bad faith—even if they did so to benefit the firm—and can be personally liable for any losses the firm suffers as a result.[16] This duty and associated liability is essential to deterrence but is not sufficient because directors can boost corporate profits in ways that induce corporate crime without ordering it or creating evidence that they knew it would occur. Their ability to pursue profit through misconduct is greatest when they avoid learning about detected misconduct, as such information would trigger their duty to terminate it.[17]

Thus, in addition to this duty, corporate law needs to impose oversight duties on directors that require them to ensure that the firm adopts systems to detect misconduct and requires them to exert on-going oversight both the firm's compliance efforts and any its response to detected suspected misconduct. Directors who intentionally neglect these duties should be liable for any resulting harm to the company. Oversight duties are particularly effective when they induce directors to have the firm detect and inform them about detected misconduct.

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10 For a discussion of how companies can increase productivity at the cost of an increased risk of corporate crime see Arlen & Kornhauser, *supra* note 7.

11 Director liability should supplement, not replace, corporate criminal liability. Arlen & Kornhauser, *supra* note 7.

12 See Arlen & Kornhauser, *supra* note 7; Arlen & Kraakman, *supra* note 7.

13 See *infra* Section 1.B.

14 *Id.*

15 See Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (With Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1281-82, 1316 (2001); Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 710, 719–21 (2019); .Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO L. REV. 629, 648 –55 (2010); *Graham v. Allis-Chalmers Mfg. Co*., 188 A.2d 125 (Del. 1963); see also Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause*, 99 TEX. L. REV. 1423 (2021) (discussing the infusion of public aims through the duty of good faith).

16 See *infra* Section 2.A.

17 E.g., *Allis-Chalmers Mfg. Co*., 188 A.2d at 125; see *infra* Section 2.A.

In order to be effective, however, directors' oversight duties cannot be designed to address agency costs alone but should be structured to promote society's interest in deterring misconduct. The limitations of oversight duties designed to only address agency costs are evident in Delaware's original approach to oversight duties, as set forth in Chancellor William Allen's 1996 decision in *In re Caremark International*.[18] *Caremark* required directors to ensure that their companies adopted an information and reporting system designed to deter, detect and inform them about corporate misconduct and to assert on-going oversight over the system, including by responding to red flags.[19] Yet in formulating *Caremark*, Chancellor Allen assumed that directorial oversight duties were needed to address only one problem: agency costs.[20] He assumed that directors could be granted full discretion over compliance once subject to a fiduciary duty and liability regime that muted agency costs—as his regime was intended to do. Specifically, he assumed that liability only needed to deter bad faith intentional neglect; absent bad faith, the Delaware court could induce directors to actively seek to deter corporate misconduct simply by expressing that directors have a duty to adopt and oversee an information and reporting system to ensure the firm's compliance with the law, even without a material threat of liability.[21] Given this premise, he imposed oversight duties on directors but gave them full discretion to decide what system to adopt and how to implement it, under the protection of the Business Judgement Rule.[22]

Yet *Caremark* did not induce most directors to adopt effective systems to deter corporate crime or to effectively oversee compliance or investigations for a simple reason: corporate crime is profitable and efforts to deter it are costly.[23] Thus, directors acting in good faith to benefit the *firm* have good reason to use their discretion to adopt internal structures that promote productivity, even at the expense of increasing the risk of misconduct.[24] They also often could benefit their firms by remaining ignorant of detected misconduct thereby avoiding their duty to terminate it. *Caremark* left them free to do so by giving them discretion to focus their oversight of compliance on inputs to compliance—such as policies and scope of training—while allowing them to ignore the impact of compensation and promotion policies on misconduct and the most important evidence on compliance effectiveness: information on detected suspected material misconduct. The Business Judgment Rule also enabled directors to satisfy their duty to oversee investigations by delegating to executives who could provide them status reports.

Chancellor Allen was correct in concluding that director liability should be determined by a bad faith standard and not negligence.[25] The central flaw in *Caremark* was his decision to give directors full discretion over the structure of the firm's system for deterring misconduct and their oversight over that system. Chancellor Allen assumed that fiduciary duties only need to address agency costs, that the regime he created would do so, and thus that directors given full discretion would actively seek to ensure their companies' compliance with the law if told to do so. He was incorrect for a simple reason: corporate crime is profitable, and compliance is costly. Thus,

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[18] 698 A.2d at 959.
[19] *Id.*
[20] Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, 323, in CORPORATE STORIES (J. Mark Ramseyer ed., 2009).
[21] Arlen, *supra* note 20 (presenting Chancellor Allen's underlying assumptions in formulating *Caremark*, based on interviews with him).
[22] *Caremark*, 698 A.2d at 959.
[23] See *infra* Section 3 & note 109
[24] See Soltes, *supra* note 9.
[25] See *infra* Section 1.B.

directors given discretion will use it to benefit their firms, their shareholders and themselves by adopting internal structures that promote both profit and the risk of misconduct.[26]

To reduce externalities and promote corporate law's prohibition on profit through unlawful means,[27] corporate law needs to impose oversight duties on directors that are more precise—and constraining—those imposed by *Caremark;* these duties also must protect social interests and not just shareholders'. Courts cannot simply require directors to take effective steps to deter corporate crime or to adopt an effective compliance function because they do not have the information needed to apply such a standard.[28] Directors' oversight duties should be more narrowly tailored and aimed at conduct that is undeniably optimal for directors. They also should promote a core goal of corporate criminal liability: to induce companies to detect, investigate and terminate misconduct and share their information with enforcement officials.[29]

Courts can enhance deterrence, without overly impinging on directors' authority over internal corporate operations, by imposing fiduciary duties on directors to act in good faith to adopt systems to detect misconduct,[30] and also to establish procedures to ensure that the board (or a designated committee) is informed about detected suspected misconduct and detected deficiencies in the firm's internal systems for deterring misconduct with respect to types of misconduct whose deterrence is especially important to the firm or to society.[31] Directors also should be required to exert direct oversight over investigations of material misconduct. Social interest can be determined based on both the harm sought to be avoided—e.g., risk of personal injury or death—and whether the law expressed a strong interest in deterrence by imposing either enhanced regulatory oversight over the risk or a duty to report violations on the firm.

These requirements would enhance deterrence for multiple reasons.[32] First, compliance effectiveness is difficult, if not impossible, to determine from an assessment of inputs (e.g., policies, training and practices) alone. Directors should be required to receive information about detected material misconduct in the firm because this information is the single best indicator of whether the firm's internal systems induce or deter misconduct, and where in the firm any problems reside.[33] Second, these duties should reduce the expected duration of misconduct by channeling information about misconduct to directors who have the power and legal obligation to terminate it.[34] These duties also reduce management's ability to undermine investigations and bury information about misconduct. Third, channeling information about misconduct to (independent) directors enhances the likelihood that the firm will self-report detected misconduct and fully cooperate with enforcement authorities as directors are less likely than management to face conflicts of interest.[35] Finally, such duties would encourage directors to adopt more effective

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[26] See *infra* note 55.
[27] See *infra* note Section 2.A.
[28] See *supra* Section 1B.
[29] See *supra* Section 1A.
[30] Directors should be subject to a baseline duty to act in good faith to detect misconduct—including by implementing an anonymous and well-publicized internal reporting system—because otherwise the imposition of a duty to become informed about detected misconduct, coupled with liability if they fail to terminate it, may perversely lead them to have the company not seek to detect misconduct.
[31] See *infra* Section 4.
[32] For a discussion of why shareholder derivative litigation based on harms to the company resulting from detected litigation operates to induce directors to deter misconduct even when, ex ante, shareholders benefit from allowing misconduct see *infra* Section 4.C.
[33] See *infra* Section 4.A.
[34] See *infra* Section 2.A.
[35] See *infra* Section 4.A; see generally Arlen & Buell, *supra* note 5 (discussing these incentives).

systems to deter misconduct by reducing the expected duration, and thus expected benefit to the firm, of detected misconduct while increasing its expected cost to directors.[36]

Recently, Delaware courts have issued a series of decisions in *Caremark* cases that impose such enforcement oversight duties on directors to obtain information about, and oversee the investigation of, certain types of detected misconduct.[37] Consistent with the above analysis, these duties are only imposed for certain types of legal risk. The first cases only imposed these enhanced duties when oversight of the risk in question was essential to the *firm's* financial health. Yet in more recent cases the court appears to apply enhanced duties to obtain information about detected misconduct that society has a strong interest in deterring: as evidenced by the threat to personal safety and the intensity of regulatory oversight that includes a self-reporting duty. Delaware law could enhance deterrence by adopting clear rules imposing such information-acquisition duties on directors when society has a heightened interest in compliance, notwithstanding shareholders' preferences, thereby inducing directors to deter, detect and terminate misconduct even when shareholders might prefer that it remain in the shadows.

This Chapter proceeds as follows. Section 1 explains why corporate law needs to supplement corporate liability for organizational misconduct with personal liability imposed on directors arising from detected misconduct and explains why neither strict *respondeat superior* nor negligence liability for suboptimal misconduct are efficient. It recommends the imposition of oversight duties on directors designed to protect both the firm and society. Section 2 discusses the directors' duty not to knowingly cause the firm to violate the law and explains why it alone will not lead directors to actively seek to deter misconduct. Directors also should be subject to oversight duties. Sections 3 analyzes Delaware's initial formulation of oversight duties, *Caremark*, which gives directors broad discretion to decide whether to become informed about detected misconduct or assert active oversight over investigations. Directors afforded such discretion are unlikely to use it to exercise adequate oversight when companies profit from misconduct. Section 4 shows why directors should be subject to more precise duties to obtain information about, and oversee the investigation of, detected violations of laws in which the firm or society has a materially heightened interest in compliance. It then discusses the new *Caremark 2.0* cases and shows how they create such duties and have laid the foundation for extending them to deterring legal risks to serve society's interests. Section 5 concludes.

1. Why Director Liability is Needed to Deter Corporate Misconduct

The Section explains why corporate criminal law cannot reliably deter organizational misconduct unless directors also face personal liability for their own actions enabling corporate misconduct. It shows that this liability must be structured both to protect shareholders from directorial agency costs and to promote social welfare by inducing directors to deter organizational misconduct. This Section then shows that director liability should not be governed by traditional tort doctrines, such as strict liability or negligence. Narrower duties targeted an enhancing directors' information about misconduct, and incentives to deter, are superior.

A. Why Directorial Oversight Liability is Needed to Deter Corporate Crime

Organizational misconduct occurs regularly and causes serious harm to individual victims and society. Corporations and their employees regularly benefit from such misconduct. Companies

[36] See *infra* Section 4.A.
[37] See *infra* Section 4.B.

benefit from enhanced sales or reduces costs resulting from corruption, antitrust violations, tax fraud, and environmental offenses; employees in turn benefit from the bonuses, promotions or enhanced job security provided to employees who materially benefit the firm.[38]

Society relies primarily on corporate and individual criminal and regulatory liability to deter organizational misconduct. Individual liability can deter by imposing expected sanctions that exceed individuals' benefit from crime.[39] It also potentially deters by expressing society's view that the misconduct violates ethical norms.[40] Yet individual liability only deters through these channels when employees face a sufficiently high threat of detection and sanction to render the threat salient to employees at the moment they are considering whether to violate the law.[41]

At present, employees generally do not consider their risk of punishment when contemplating criminal conduct because government enforcement authorities do not detect and sanction misconduct reliably enough to create the requisite material risk of detection.[42] The most effective way for enforcement authorities to increase the expected threat of sanction is to induce companies to use their informational advantage to detect, investigate, self-report, and provide evidence of misconduct.[43] They also should be induced to deter by restructuring their compensation and promotion policies,[44] internal job structures,[45] internal controls,[46] and lived culture to promote compliance.[47] To induce such actions, companies need to be held criminally liable for their employees' crimes,[48] and subject to expected sanctions that ensure they do not profit from crime. Corporate liability also must be structured to incentivize them to detect, investigate, self-report and fully cooperate with enforcement authorities.[49]

In the U.S., companies are criminally liable for their employees' crimes committed in the scope of employment, and are subject to a corporate enforcement policy intended to induce them to detect, self-report and cooperate.[50] Yet they are not adequately deterred for at least two reasons:

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[38] For a discussion of how corporate compensation and promotion policies induce corporate crime *see*, *e.g.*, Arlen & Kraakman, *supra* note 7; Arlen & Kornhauser, *supra* note 7; MAX H. BAZERMAN & ANN E. TENBRUNSEL, ch. 6, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT (2011). Beyond this, companies can promote misconduct by priming employees with repeated reminders about financial returns. *E.g.*, Maryam Kouchaki, et al., *Seeing Green: Mere Exposure to Money Triggers a Business Decision Frame and Unethical Outcomes*, 121 ORG. BEHAV. & HUM. DECISION MAKING PROCESSES 53 (2013); see also Yuval Feldman, *Behavioral Ethics Meets Behavioral Law and Economics*, ch. 9, *in* OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW (Eyal Zamir & Doran Teichman eds., 2014), at 216.

[39] Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); *see* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994).

[40] E.g., Arlen & Kornhauser, *supra* note 7. For an explanation of the implications for deterrence of the empirical psychological literature on human decision-making see Arlen & Kornhauser, *supra* note 7; see also BENJAMIN VAN ROOIJ & ADAM FINE, THE BEHAVIORAL CODE: THE HIDDEN WAYS LAW MAKES US BETTER …OR WORSE (2021); YUVAL FELDMAN, THE LAW OF GOOD PEOPLE: CHALLENGING STATES' ABILITY TO REGULATE HUMAN BEHAVIOR (2018).

[41] See Arlen & Kornhauser, *supra* note 7 (discussing why salience is important).

[42] See, e.g., *id*; Arlen & Kraakman, *supra* note 7; see also *supra* note 9.

[43] E.g., Arlen & Kornhauser, *supra* note 7 (explaining why the probability of sanction must be material and salient). Companies also can deter by reducing employees' expected benefit from misconduct, Arlen & Kraakman, *supra* note 7, and altering their internal operations. Arlen & Kornhauser, *supra* note 7.

[44] Arlen & Kraakman, *supra* note 7; Arlen, *supra* note 39.

[45] Arlen & Kornhauser, *supra* note 7.

[46] Arlen & Kraakman, *supra* note 7.

[47] Arlen & Kornhauser, *supra* note 7; see *supra* note 38.

[48] Arlen & Kraakman, *supra* note 7; Arlen & Kornhauser, *supra* note 7.

[49] See, *e.g.*, Arlen & Kornhauser, *supra* note 7; Arlen & Kraakman, *supra* note 7; Arlen, *supra* note 7.

[50] See generally Arlen & Buell, *supra* note 5.

agency costs and under-enforcement. Companies fail to actively deter misconduct, even when they face optimal sanctions, when the people who control them—the board of directors and senior management—benefit from either misconduct or inadequate deterrence.[51] And companies often earn expected profits from misconduct and weak compliance because enforcement authorities rarely detect and sanction their misconduct.[52] Thus, companies can profit from structuring their compensation arrangements and internal systems to promote productivity and misconduct.[53] They also regularly do not self-report detected misconduct, confident that it will not be detected if they keep silent.[54] As a result, directors seeking to promote shareholders' interests often can do so through weak compliance and internal structures that promote misconduct.[55]

Corporate law can and should intervene to reduce both problems by imposing fiduciary duties on directors designed to induce them to deter and terminate misconduct, coupled with a threat of personal liability. Unlike traditional fiduciary duties, which serve to reduce agency costs between directors and shareholders, these duties should also aim to serve society's interests by

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[51] *See, e.g.,* Arlen & Carney, *supra* note 8 (discussing how corporate liability will not reliably induce senior management to detect and terminate securities fraud by others if they also would be harmed were the firm's true financial picture to become public); Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Non-Prosecution*, 84 U. CHI. L. REV. 323 (2017); John Armour, et. al, *Taking Compliance Seriously*, 37 YALE J. REG. 1 (2020) (discussing how agency costs can lead firms not to adopt optimal compliance). But see Assaf Hamdani & Reinier Kraakman*, Rewarding Outside Directors*, 105 MICH. L. REV. 1677 (2007).

[52] See, e.g., Arlen, *supra* note 7 (discussing how corporate criminal enforcement cannot adequately deter because companies face too small a risk of detection); Roy Shapira, *A New Caremark Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1889 (2021); see also Soltes, *supra* note 9.

Under-deterrence is attributable, in part, to companies' use of their political influence to induce elected officials to undermine corporate enforcement. *See*, *e.g.*, Daniel Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 760–83 (1998); Arlen, *supra* note 4; see also Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POL'Y REV. 265, 273–74 (2014) (following the financial crisis, Congress publicly increased funding for corporate enforcement but then quietly refused to appropriate the money).

[53] See Arlen & Kornhauser, *supra* note 7. The potential for companies to suffer costs from reputational damage resulting from organizational misconduct does not eliminate the under-deterrence problem. First, under-detection undermines deterrence, as firms do not suffer reputational damage costs from misconduct that is not detected. Second, companies generally do not suffer reputational damage costs from misconduct, such as environmental offenses, that does not harm their counter-parties, customers or suppliers. See Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993). Finally, firms may not suffer material reputational damage costs if they can assuage counter-parties' concern about their future behavior by intervening post-crime to remediate the causes of the misconduct. See Cindy R. Alexander & Jennifer Arlen, *Does Conviction Matter? The Reputational and Collateral Effects of Corporate Crime*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING ch. 11 (Jennifer Arlen ed., 2018); see also John Armour, Colin Mayer, & Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets*, 52 J. FIN. & QUANT. ANALYSIS 1429 (2017).

[54] For a discussion of how companies can induce corporate crime through their quest for profits see Arlen & Kornhauser, *supra* note 7; see also Arlen & Kraakman, *supra* note 7 (discussing compensation systems); Bazerman & Tenbrunsel, *supra* note 38, at Chapter 6.

[55] Companies' ability to profit from misconduct likely explains why institutional shareholders do not use their influence to induce companies to improve compliance or risk management. See Leo Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 13 (2010) see also Leo Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L. J. 1870, 1918-19 (2017) (pension fund activism does not seek to promote improved risk management and enhanced internal accountability that would benefit the funds' employee beneficiaries).

Company profit also incentivizes directors to undertake actions that boost productivity and misconduct, as they receive substantial stock compensation as a result of pressure from institutions and corporate governance activists. This compensation aligns directors' interests with shareholders at the expense of society's interest in deterrence.

providing directors with a self-interested motivation to deter misconduct even when it would profit the firm and its shareholders.

B. Scope of Directors' Liability: Inefficiency of Strict Liability and Negligence

Before discussing the scope of liability, it is worth addressing why society should not rely on two traditional forms of tort liability: strict liability or negligence.

Imposing strict liability on directors through directorial *respondeat superior* for all detected misconduct would be inefficient because it would give directors excessive incentives to deter misconduct at the expense of corporate productivity and profit. Directors would bear enormous personal costs should misconduct occur; they could reduce this risk by using corporate resources and changing internal operations in ways that reduce productivity, primarily at shareholders' expense.[56] Strict liability thus would provide them excessive incentives to deter misconduct to protect themselves, reducing both corporate and social welfare. Strict liability also would create perverse incentives to reduce corporate efforts to detect or self-report[57] misconduct, as both actions risk increasing directors' expected liability.[58]

Directors also should not be liable for substantively negligent decisions to implement an ineffective compliance function.[59] Neither courts nor regulators can reliably determine whether directors have implemented effective internal systems to deter misconduct because optimal deterrence requires a host of inter-dependent, firm-specific interventions at all levels of the firm, each of which involves trade-offs between productivity and deterrence.[60] Some of the most important interventions—such as compensation, promotion, and disciplinary policies and practices reform—fall outside company compliance programs and involve interventions directed at line managers who are likely beyond directors' full control.[61] Courts' assessment of compliance also risks being distorted by hindsight bias.[62] Thus, negligence liability would likely either be ineffective or subject directors to an excessive threat of liability that they could not reliably avoid,

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[56] This problem could be addressed in theory by tying sanctions to directors' proportionate share of the benefit, yet this solution is not practicably viable. Courts cannot reliably determine directors' share of the benefit, as some of the benefit may take subtle forms, including retention on a board from which they otherwise might have been terminated.

[57] For a discussion of why corporate enforcement policy should be structured to induce self-reporting, and an example of an enforcement policy structured to do so, see AM. L. INST., PRINCIPLES OF THE LAW OF COMPLIANCE AND ENFORCEMENT (AM. L. INST. 2022).

[58] The analysis resembles why strict corporate liability deters corporations from detecting misconduct. Arlen, *supra* note 39.

[59] In addition, such liability would be ineffective unless DGCL § 102(b)(7) would not apply to such actions.

[60] See Arlen & Kornhauser, *supra* note 7 (discussing the host of interventions that are needed). For a discussion of the distinction between the compliance function and a compliance program see *Title 5, Compliance,* PRINCIPLES OF THE LAW OF COMPLIANCE AND ENFORCEMENT FOR ORGANIZATIONS (Am. L. Inst. 2023).

[61] See Arlen & Kornhauser, *supra* note 7; see also Arlen & Kahan, *supra* note 51. Consistent with this conclusion, the Department of Justice's 20-page guidance on effective compliance identifies the features of the firm's internal operations that enforcement officials should evaluate—including the firm's compensation policies and promotion/termination practices—and questions that they should ask without precisely specifying what constitutes effective compliance. U.S. Department of Justice, Criminal Division, *Evaluation of Corporate Compliance Programs* (June 2020), https://www.justice.gov/criminal-fraud/page/file/937501/download. The American Law Institute's newly adopted Principles of Compliance and Enforcement for Organizations also provide guidance on features that are important without providing specific recommendations about what is required for effective compliance. Am. L. Insti., *Compliance*, *supra* note 60.

[62] See Hamdani & Kraakman, *supra* note 51; see also Miriam H. Baer, *Organizational Liability and the Tension Between Corporate and Criminal Law*, 19 J. L. & POL'Y 1 (2010) (observing that companies can be held criminally liable for corporate misconduct even if they took effective steps to deter misconduct and had a good culture).

thereby inducing them to do either too little or too much to deter. Moreover, imposing liability on directors for substantively negligent compliance-related decisions, while affording Business Judgement protection[63] to other business decisions would distort companies' internal governance by inducing directors to give excessive focus to compliance to the detriment of business decisions.[64] Finally, negligence liability also would undermine deterrence if, as suggested above, directors could not be confident of their ability to avoid negligence liability should misconduct occur. This would mute directors' incentives to have the firm detect misconduct and would lead them to resist the self-reporting of detected misconduct so vital to deterrence.[65]

C. Inducing Information Production & Acquisition

A superior approach to director liability is to impose specific fiduciary duties on directors to eschew (or terminate) corporate crime and to act in good faith to ensure that the firm adopts effective systems to detect misconduct and provides the board with information about both compliance deficiencies and detected misconduct involving misconduct that is material to the firm or society. Boards also should act in good faith to ensure they obtain and devote sufficient attention to this information and retain ultimate oversight over investigations. These information enhancement duties have the advantage of inducing boards to leverage companies' comparative advantage in detecting, investigating and terminating misconduct to deter, detect, investigate, self-report and cooperate with respect to, misconduct.[66] These duties can be enforced by derivative suits to enable the company to recover from losses from misconduct.[67] These information-acquisition duties are only effective, however, if structured to serve society's interests in deterring material misconduct even when companies might profit from it. The next sections evaluate both why such duties are needed and examine Delaware's approach to imposing such duties on directors.

2. Corporate Law's Foundational Fiduciary Duty to Protect Social Interests

Most fiduciary duties are designed to ameliorate agency costs between directors and shareholders. Yet corporate law has long imposed a duty on directors designed to protect society: the duty not to knowingly cause the firm to engage in, or to allow the firm to continue to commit, corporate crime, even when shareholders could benefit from crime. This Section shows that this duty is vital to the law's ability to use directorial duties to deter corporate crime, but it is not sufficient. Directors need to also be subject to information-acquisition duties that ensure they are informed about misconduct, thereby triggering their duty to terminate it.[68]

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63 The Business Judgement rule protects directors from being held liable for negligent substantive business decisions.

64 For a discussion of the inefficiencies that result when a principal needs an agent to perform two tasks but can only monitor and impose sanctions for negligent performance of one task, see Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership and Job Design*, 7 J. LAW, ECON. & ORGAN. 24 (1991).

65 See *supra* Section 1.A.; Arlen & Kornhauser, *supra* note 7; Arlen & Kraakman, *supra* note 7.

66 See Arlen & Kornhauser, *supra* note 7; Arlen & Kraakman, *supra* note 7.

67 Derivative suits have several advantages. They are brought before expert appointed judges. See *infra* Section 5. Derivative plaintiffs often have better and more expedition access to information through DGCL § 220 than do private plaintiffs. See *infra* Section 4.C. Once the firm has suffered losses from misconduct, derivative plaintiffs will be motivated to sue even if, ex ante, they benefit from misconduct.

68 The existence of this duty distinguishes oversight duties for legal risk from oversight duties for business risk. *Caremark* cases predicated on inaction require proof that the directors' breach was the proximate cause of the firm's

A. Directors' Duty Not to Knowingly Cause or Permit Corporate Crime

Traditional fiduciary duties are designed to lead directors to act to benefit the firm, rather than themselves. Consequently, they do not suffice to deter directors from promoting corporate crime because companies regularly profit from corporate misconduct.

Yet corporate law has never been structured purely to promote pursuit of corporate profits. At its roots it contains injunctions designed to protect society's interests, even at shareholders' expense. Corporate law prohibits companies from pursuing profits through illegal conduct. It expressly requires companies to pursue profits within the bounds of the law, regardless of whether allegiance to shareholder welfare would counsel otherwise.[69] Corporate law provides that a corporation may be organized to "conduct or promote lawful businesses or purposes;" the standard corporate purpose clauses provide that the "purpose of the corporation is to engage in any lawful act or activity."[70] This duty to comply with the law enjoins unlawful conduct even when the company would profit from it.[71]

Corporate law effectuates this obligation not to violate the law by imposing a duty on directors not to knowingly cause the firm to violate the law and to terminate any misconduct they detect.[72] This duty is enforced by the threat of personal liability to the firm for any losses sustained should directors breach this duty. Because companies act outside their lawfully granted authority when they intentionally commit crimes, directors who knowingly approve a business plan that violates the law engage in ultra vires conduct even if it benefits the company financially.[73] Consequently, directors have no recourse to the Business Judgement Rule, but instead are deemed to have acted in bad faith, leaving them personally liable for any harm befalling the firm as a result.[74] Liability for bad faith is not covered by either indemnification policies or D&O insurance.

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losses. *Caremark*, 698 A.2d at 959; accord *Stone*, 911 A.2d at 362. In the case of unlawful conduct, plaintiffs can establish directors' breach caused harm by showing that directors would have learned of the misconduct but for their breach. By contrast, with business risk, evidence that directors would have learned about a material business risk but for the breach does not establish that they would have refrained from taking the risk as many risks are profitable; risk-taking decisions are covered by the Business Judgement Rule.

[69] E.g., *In re Massey Energy Company Derivative and Class Action*, C.A. No. 5430-VCS (Del. Ch. 2011) ("Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue "lawful business" by "lawful acts."); see, e.g., Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. REV. 629, 648-55 (2010); see also ROBERT C. CLARK, CORPORATE LAW, § 1.2, at 18 (1986) (corporate law provides that companies' pursuit of profit is constrained by the requirement that the company must comply with its legal obligations to those affected by its activities); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 NYU L. REV. 733, 738, 745, 756–57 (2005) ("[M]ost advocates of a duty to profit-maximize concede it should have an exception for illegal conduct.").

[70] Delaware General Corporation Law § 101(b), 102; see Strine, et al., *supra* note 69, at 650.

[71] This obligation is in effect corporate law's original recognition that companies owe obligations to society that constrain their pursuit of profit. This doctrine roots these obligations in injunctions established by society's legal authorities. The recent ESG movement seeks to impose additional obligations on companies beyond those that society's legislatures and regulators have imposed on firms.

[72] See, e.g., Strine, et al., *supra* note 69, at 650; John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA . L. REV. 1099, 1172–73 (1977).

[73] See Leo E. Strine, Jr. et al., *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and ESG Strategy*, 106 IOWA L. REV. 1885, 1887 (2021); Strine, et al., *supra* note 69, at 648-50.

[74] *Id.*, at 650-54; see, e.g., *La. Mun. Police Employees' Ret.* Sys. *v. Pyott*, 46 A.3d 313 (Del. Ch. 2012) (directors who cause the company to violate the law are disloyal and liable for the harm they cause); *Massey Energy*, 2011 WL 2176479, at *20; *Metro Comm'n Corp. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 131, 163–64 (Del. Ch. 2004) ("[u]nder Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the

This duty and associated liability provides directors with a personal incentive to make decisions not to knowingly cause the firm to violate the law, and to terminate violations they are informed about,[75] even when they and shareholders would profit from misconduct. In so doing, it reduces under-deterrence.

While this duty predates *Caremark*, directors' liability for knowingly causing or allowing misconduct is now treated as a form of *Caremark* liability.[76]

B. Why This Duty is Not Sufficient

Society cannot rely solely on this duty to deter misconduct by large firms. Most forms of corporate misconduct—including environmental violations, price-fixing, corruption, and money laundering—result from actions taken by people deep within the firm.[77] Directors (and senior officers) can enable the firm to profit from corporate crime, without ordering it or knowing that it would occur, by structuring the firms internal systems to lead employees to prioritize productivity and profit at all costs. For example, they can predicate compensation, promotion and tenure on employees' contribution to the firm's profits,[78] establish a culture that prioritizes loyalty to the firm and its financial welfare, disperse responsibility for decisions that could violate the law widely,[79] and adopt a compliance program that neither effectively deters nor detects misconduct.[80] They can avoid the injunction to terminate detected misconduct by establishing compliance programs, internal reporting, and investigation systems that do not channel information about detected suspected material misconduct to directors.[81]

Accordingly, corporate law needs to supplement the duty to not knowingly violate the law with directorial oversight duties that require them to ensure that the firm and directors acquire information about corporate misconduct. Directors should be subject to duties to act in good faith to have the firm detect misconduct, to establish systems to ensure that they are informed about

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fiduciary believes that the illegal activity will result in profits for the entity"); *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) ("[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."); see also *Miller v. Am. Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974) (concluding that directors may not knowingly violate the law); *Roth v. Robertson*, 118 N.Y.S. 351, 353 (N.Y. Gen. Term 1909) (holding that directors and officers who knowingly cause corporate crimes engage in ultra vires acts and must be liable for any loss the company suffers as a result).

[75] *E.g.*, *Allis-Chalmers Mfg. Co.*, 188 A.2d at 125; *Caremark*, 698 A.2d at 959. Directors who allow misconduct to continue face a material threat of liability even when misconduct benefits the firm because damages are based on the companies' gross losses (independent of any profit) and, *ex post*, once misconduct is detected, shareholders (and their lawyers) benefit if they can use *Caremark* to shift the resulting losses to the directors.

[76] Consistent with Delaware law, this Chapter treats the directors' duty not to knowingly engage in misconduct as a *Caremark* duty, but it predates *Caremark* and arguably roots in DGCL § 101(b); 102. See, e.g., Strine, et al., *supra* note 69, at 650-655 (discussing this source of liability); *Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou*, No. CV 2019-0816-SG (Del. Ch. Aug. 24, 2020) (concluding demand is excused due to well-pled allegations that the directors ignored red flags that AmerisourceBergen Corp. "operated as a criminal enterprise").

[77] *See, e.g.*, Arlen & Kraakman, *supra* note 7.

[78] Arlen, *supra* note 39; Arlen & Kraakman, *supra* note 7; Jonathan Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 BU L. REV. 315 (1991).

[79] See Arlen & Kornhauser, *supra* note 7.

[80] See *id.*; see also Donald Langevoort, *Culture of Compliance*, 54 AM. CRIM. L. REV. 933 (2017). For a discussion of why director and officer liability predicated on traditional criminal law doctrines will not suffice see Samuel Buell, *Criminally Bad Management*, ch. 3, in THE RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING, (Jennifer Arlen ed., 2018).

[81] Management also has a duty to terminate detected misconduct, but they regularly face greater incentives to allow it to continue. See *supra* text accompanying notes 35 & 85.

detected misconduct that is material to the firm or society,[82] to ensure that they actually receive and attend to such information, and to exert oversight over investigations.[83] Information-acquisition duties that increase directors' likelihood of learning about misconduct, coupled with both a duty to terminate misconduct and personal liability for deliberate breach, can reduce the expected duration and scope of misconduct by giving directors a personal incentive to detect and terminate misconduct even when it is likely to benefit the firm and themselves.[84]

These directorial oversight duties are superior to a more general duty to adopt an effective compliance program for two reasons. First, the duty to obtain information about detected material misconduct should be optimal for all firms, at least when limited to legal risks that are material to the firm or society. Boards cannot effectively assess or ensure their companies' legal compliance unless they obtain the most important information available on compliance: information about material misconduct occurring within the firm.[85] Thus, boards cannot satisfy a duty to ensure compliance unless they act in good faith to have the firm detect and ensure that they are informed about legal risks that are material to the firm or society. These duties channel information about detected suspected misconduct to agents of the firm (outside directors) who are less plagued by conflicts of interest in investigating and terminating misconduct than senior management is.

Second, unlike duties to adopt a compliance program,[86] courts can practicably implement these information-acquisition oversight duties because courts are equipped to assess the procedures, policies and practices directors adopt to obtain and assess information about misconduct.[87] They can reliably obtain information on whether directors established systems to inform themselves of detected material misconduct, ensured that they obtained this information, and can assess whether directors asserted sufficient oversight to ensure a proper response.

These information-acquisition duties are only effective, however, if structured to serve society's interests in deterring material misconduct even when companies profit from it.

3. Delaware's Foundational Oversight Duties: *Caremark* and *Stone*

In 1996, in *In re Caremark Int'l,* Delaware took an important first step towards imposing fiduciary duties on directors designed to induce them to adopt systems to inform them about the

[82] See *supra* Section 4.A. Society's interest can be assumed to be sufficiently strong when misconduct presents a material risk of personal injury or death and society subjects the activity to intensive regulation that includes a duty to report misconduct or risk of harm. *Id.*

[83] This latter duty gives authority over investigations to the firm's least conflicted agents, the outside directors.

[84] See *supra* note 55.

[85] See, e.g., Eugene Soltes, *Evaluating the Effectiveness of Corporate Compliance Programs: Establishing a Model for Prosecutors, Courts, and Firms*, 14 J. LAW & BUS. 965 (2018) (assessment of compliance program effectiveness must be based on evidence on outputs, such as reported misconduct); Eugene Soltes, *Measuring Compliance and the Emergence of Analytics*, in MEASURING COMPLIANCE (Melissa Rorie & Benjamin van Rooij, eds. 2022); see also Garrett & Mitchell, *supra* note 86 (prosecutors should attend more to outcome data in assessing compliance programs); Hui Chen, *The Use and Measurement of Compliance Programs in the Legal and Regulatory Domains*, in MEASURING COMPLIANCE, supra (same).

[86] See *supra* Section 1.B. Some regulators do seek to assess corporate compliance *ex ante*. In some cases, compliance relates to a sufficiently narrow task that this is possible. But in many other cases, regulators do not assert effective oversight over compliance in part because they often fail to seek the right information—including information on the firm's compliance and promotion practices and on detected misconduct. See Brandon L. Garrett & Gregory Mitchell, *Testing Compliance*, 83 L. & CONTEMP. PROB. 47 (2020) (discussing how to improve enforcement officials' oversight of compliance).

[87] Cf. *Smith v. Van Gorkom*, 488 A.2d 858 (1985).

firm's compliance with the law and to maintain oversight of such systems.[88]This Section analyses the duties and liability rule imposed by *Caremark*, highlighting its positive contribution to corporate law and identifying the reasons why it has failed to induce directors to either act proactively to deter corporate crime or to ensure that they were informed about misconduct. The next section assesses recent cases reforming *Caremark* in light of these recommended reforms.

A. Caremark 1.0

In 1996, Chancellor William Allen revolutionized Delaware law on directors' duties to oversee their companies' compliance with the law when he used a negotiated settlement of *In re Caremark International Inc. Derivative Litigation*[89] to impose on directors a duty to exercise oversight over the firm's compliance with the law.

Chancellor Allen concluded that the board cannot satisfy its duties to the firm unless it ensures that the firm has an information and reporting system reasonably designed to provide senior management and the board with accurate and timely information about the firm's compliance with the law; the board also must assert ongoing oversight over the system and investigation of any material misconduct detected.[90]

To achieve this, *Caremark* in effect imposed duties on the board: to (1) ensure that the firm adopts an information and reporting system designed to provide the firm, management, and directors with accurate and timely information about the firm's compliance with the law; (2) exercise on-going oversight over the effectiveness of firm's compliance function and its system to detect and inform appropriate corporate actors about misconduct; (3) exercise good faith oversight over the firm's investigation of suspected misconduct (along with the preexisting duty to terminate it); and (4) terminate all detected misconduct.[91]

In selecting the liability rule to govern violations of these duties, Chancellor Allen rejected negligence liability on the grounds it risked subjecting directors to liability even when they took due care as a result of court error; this would induce them to take excessive care.[92] He concluded that directors should only be liable if they acted in bad faith, as defined by deliberate and sustained neglect of their oversight duties.[93]

This bad faith liability standard could have provided directors with strong incentives to exert active oversight over corporate misconduct if Chancellor Allen imposed precise oversight duties on directors that required them to take specific actions. Chancellor Allen chose not to do so, however. Instead, he gave them full discretion to decide what systems to adopt to ensure compliance with the law, what information the board should obtain as part of its oversight of the firm's compliance, and the precise level of oversight the board should exercise over investigations.[94] As a result, directors who adopt a system, regularly obtain reports on the procedures and policies of the compliance program, and assert some oversight over investigations are protected from liability by the Business Judgement Rule[95] even if the systems they adopted were inadequate and they failed to adopt processes to give them vital information about

88 *Caremark*, 698 A.2d at 959. *Caremark* was eventually affirmed by the Delaware Supreme Court in *Stone v. Ritter*. *Stone*, 911 A.2d 362 (2006).
89 698 A.2d 959 (Del. Ch. 1996).
90 *Id.*
91 *Id*.
92 Arlen, *supra* note 20, at 340-43.
93 *Id*.
94 See, e.g., *id.*; Armour et al., *supra* note 51, at 45-47.
95 *Caremark*, 698 A.2d at 959. See, e.g., Arlen, *supra* note 20, at 340-43.

compliance: specifically information on detected misconduct. Directors only risk liability if they act in bad faith by utterly failing to adopt a system, failing to comply with a specific compliance mandate imposed by federal law, or engaging in intentional sustained neglect of their duties by not obtaining any information on the firm's compliance or having no response to detected suspected misconduct.[96]

Chancellor Allen gave directors full discretion over how to satisfy their oversight duties because he assumed they would use it to deter corporate crime. This assumption was rooted in his unstated view that director oversight liability was only needed to address one problem: director-shareholder agency costs.[97] He believed *Caremark* would do this.

Chancellor Allen concluded that directors were potentially plagued by two types of agency costs. The first type is "hard agency costs," arising when directors personally benefit from the misconduct or weak compliance.[98] Chancellor Allen concluded he could address hard agency costs by threatening directors with liability for bad faith on the theory that directors with a material conflict would be more likely to act in bad faith.[99]

The second type, which he thought was the dominant problem, is "soft agency costs," which are reasons directors may fail to act in the firm's interests that do not directly implicate their own self-interest. These include inertia and directors' concern that they would undermine their relationship with senior management by adopting a system to oversee management's compliance with the law when other firms do not.[100] Chancellor Allen believed he could ameliorate soft agency costs by simply imposing a duty on *all* directors to exercise oversight over the firm's compliance with the law. Following *Caremark*, directors who implement an effective information and reporting system could not be seen as casting aspersions on management; they would simply be doing their jobs.[101]

Given his assumptions that directors generally only suffered from soft agency costs and would have no reason not to actively seek to ensure that the firm adopted and maintained an effective compliance function if informed that they had duties to do so, Chancellor Allen concluded he could achieve his goal of inducing effective oversight while leaving directors with full discretion to determine what measures the firm and they should take to ensure the firm's compliance with the law.

B. Why Caremark *Did Not Have Its Desired Effect*

Caremark did not have Chancellor Allen's intended effect. The threat of liability for bad faith did not operate to induce directors to adopt effective compliance programs or assert effective

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96 *Caremark*, 698 A.2d at 959.

97 Arlen, *supra* note 20, at 340-43; see also Donald C. Langevoort, *Caremark and Compliance: A Twenty-Year Lookback*, 90 TEMPLE L. REV. 741-742 (2018) (concluding that while *Caremark* does not create strong duties, boards would face strong external pressure to respond appropriately).

98 *Id.*; *cf.* Arlen & Kahan, supra note 51 (discussing such agency costs and steps that prosecutors can take to address them).

99 *Id.*

100 Arlen, *supra* note 20, at 340-43.

101 *Id.*

oversight.[102] Large companies engage in wide-spread and long-term misconduct[103] that effective systems would likely have deterred or shortened.

Caremark was ineffective for two interconnected reasons. First, the duties it imposed were so general that directors could avoid liability for bad faith without adopting an effective compliance function or exercising effective oversight over it. Directors could satisfy their *Caremark* duties by adopting some form of internal information and reporting system, that provided them with some information about the system (for example, information on policies and employee training), and by ensuring that they regularly received brief reports from compliance that included such information, even if they failed to adopt an effective compliance function, failed to ensure that the system provided them with information essential to their ability to effectively oversee compliance (such as information about detected misconduct) and failed to devote the needed amount of time and attention to compliance oversight.[104] Indeed, in *Stone v. Ritter*, directors avoided liability for bad faith because the firm had a compliance program and directors exercised on-going oversight over the firm's ethics policies and its training programs, even though the compliance program was materially under-resourced and directors did not assert effective oversight over either detected deficiencies in the system or detected misconduct.[105] Thus, *Caremark* relied on directors' own commitment to deterring corporate crime.

Second, Chancellor Allen erred in assuming that compliance and detecting misconduct was in companies' best interests,[106] and thus that directors exercising good faith business judgement would adopt effective compliance programs, seek to obtain information about detected misconduct, and terminate it upon discovery. Companies regularly profit from crime because they face only a remote likelihood of detection and sanctions.[107] They also benefit from deficient compliance, as effective compliance is costly and can reduce productivity.[108] Accordingly, directors given discretion to exercise their business judgement to serve their firms generally will

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[102] For example, only 5 percent of boards have a compliance committee. John Armour, et al., *Board Compliance*, 104 MINN. L. REV. 1191 (2020). Others delegate compliance to the audit committee which often is too burdened with overseeing the firm's financial statements to devote sufficient attention to other forms of compliance.

[103] See Soltes, *supra* note 9 (presenting evidence of hundreds of violations none of which were detected and determining that firms face a very low threat of having their misconduct detected and sanctioned).

[104] Information on outputs of compliance—e.g., detected misconduct—are the most important information about compliance program effectiveness. See citations in supra note 85.

Directors generally are only liable under *Caremark* in one of three situations, two of which root in the pre-*Caremark* duty not to violate the law. First, when directors knowingly adopt a business plan that would have the firm violate the law. See *supra* Section 2. Second, where directors fail to act after being informed that the firm is likely violating the law. *Id.*; see Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, MINN. L. REV. 2135 (2018)., Finally, when directors fail to comply with a specific oversight duty imposed by an external legal source—such as duties imposed by federal law on audit committees. *In re China Agritech, Inc. S'holder Derivative Litig.*, No. CIV.A. 7163-VCL, 2013 WL 2181514 (Del. Ch. May 21, 2013) (the audit committee violated its legal duties by failing to meet and having material conflicts). A rare pre-*Caremark* 2.0 case imposing liability beyond these situations involved a closely-held company whose directors exerted no oversight over the controlling shareholder. *ATR-Kim Eng Fin. Corp. v. Araneta*, No. CIV.A. 489-N, (Del. Ch. Dec. 21, 2006), *aff'd sub nom.* Araneta v. Atr-Kim Fin. Corp., 930 A.2d 928 (Del. 2007).

[105] See *Stone*, 911 A.2d. at 362; see *supra* note 85 (discussing the importance of information on detected misconduct).

[106] Caremark, 698 A.2d at 959 (discussing the U.S. Sentencing Guidelines reforms).

[107] See *supra* Section 2. In addition, because corporations profit from crime, directors will as well, giving them personal incentives to under-invest in compliance. *See, e.g.,* Armour et al., *supra* note 51, at 38-39; Shapira, *supra* note 52, at 1891.

[108] See Arlen & Kornhauser, *supra* note 20.

favor suboptimal compliance measures; they also will not seek to be informed about material misconduct, as the receipt of information about misconduct would obligate them to terminate it.[109]

4. Caremark 2.0: Enhanced and Specific Information-Acquisition Duties

This Section shows that director oversight liability could be improved by imposing specific duties on directors to adopt systems to ensure that they are informed about detected misconduct, assert sufficient oversight to obtain and assess this information, and actively oversee the investigation of misconduct, with respect to misconduct the firm or society has a material interest in deterring. It then discusses recent Delaware case law that imposes such duties for certain categories of legal risk and provides reasons to conclude that Delaware may be recognizing the need to impose such duties when deterrence would benefit society, even if the firm itself might not benefit.

A. Improving Director Liability

The central challenge for director liability is how to induce directors to deter misconduct that benefits the firm, without inducing them to implement excessive measures to deter, deterring detection and self-reporting of misconduct, or imposing due care requirements that courts cannot reliably assess.[110] Director oversight liability can achieve these goals by imposing a set of specific, objectively verifiable duties on directors to undertake measures that generally are vital to boards' ability to ensure compliance with the law. Given the range of demands on boards, these duties should be limited to situations where the legal violation is sufficiently material to either the firm or society to justify requiring directors to exercise enhanced oversight over compliance.

Although courts cannot practicably subject directors to a duty to adopt an effective compliance program,[111] courts can materially enhance compliance by imposing duties on directors to (1) adopt internal systems designed to detect[112] and to inform the directors about suspected violations of legal injunctions, (2) obtain regular and on-going reports about deficiencies in the firm's oversight system and detected suspect material violations, and (3) oversee investigations of suspected misconduct in this category.[113] Courts should impose a duty to detect and ensure that directors are informed about material misconduct because boards cannot reliably assess the effectiveness of their firms' compliance programs unless they receive, and assess, information

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[109] See *supra* Section 2.A.

By contrast, Professor Todd Haugh claims that *Caremark* materially enhanced compliance through its impact on director's intuitive choices. Todd Haugh, *Caremark's Behavioral Legacy*, 90 TEMPLE L. REV. 611 (2018). Yet this is unlikely because directors personally benefit from crimes that profit the firm and empirical studies show that people's intuitive choices favor self-interest; they employ a host of mental tricks to enable them to select the self-interested choice and feel ethical. See Arlen & Kornhauser, *supra* note 3. Also, liability does not effectively deter self-interested choices when the threat of sanction is too low to be salient. See *id*.

Haugh notes that evidence that corporate expenditures on compliance increased dramatically between 1996 and 2011, Haugh, *supra*, at 630. Yet there are a host of explanations other than *Caremark*. These include: (1) dramatic increase in enforcement against firms engaged in foreign corruption after 2006; (2) increased corporate enforcement following the Department of Justice's (DOJ) embrace of deferred- and non-prosecution agreements; and (3) the promulgation of federal laws imposing enhanced compliance program duties. E.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.); PATRIOT ACT (requiring financial institutions to implement effective systems relating to money-laundering).

[110] See *supra* Section 1.B.

[111] See *supra* Section 1.B.

[112] See *supra* note 30.

[113] *Id.*

about detected material misconduct and its root causes.[114] Moreover, ensuring that directors receive this information triggers directors' duty to terminate detected misconduct. These duties enable courts to limit liability to director bad faith while still imposing duties that can induce directors to enhance companies' deterrence.

These duties should not be limited to situations where the company benefits from deterring misconduct. Companies regularly benefit from crime and from adopting systems that rarely detect misconduct. Yet such crimes often cause substantial harm to society. To adequately deter profitable crimes, society needs to supplement criminal liability with director oversight liability structured to induce directors to detect and terminate misconduct that imposes material costs on society. Thus, when misconduct is profitable, these enhanced director oversight duties should be used to effectively *create*—rather than eliminate—an agency cost, by providing directors with a personal incentive to implement measures likely to deter misconduct even when likely to reduce corporate profits.

Yet courts should not require directors to become informed about every instance of misconduct. Companies are subject to a host of laws and regularly detect misconduct of varying significance to society.[115] Directors' time is precious and information about less important misconduct may deflect attention better allocated elsewhere. Thus, these duties should be restricted to information about misconduct that is sufficiently material to the firm or society to justify requiring directors to become informed about it and oversee the investigation. As an initial matter, courts could restrict the new enhanced oversight duties to legal risks whose violation presents significant probability of serious personal injury or death[116] or where society has evidenced a heightened interest in compliance through intensive regulation, especially if it includes a duty to report detected violations or potential harms.

Such information-acquisition duties can help deter by reducing the expected duration, and thus expected social cost, of misconduct. Directors informed about misconduct are legally obligated to terminate it.[117] In addition, giving directors primary authority over investigations of suspected misconduct increases the likelihood that misconduct will be confirmed by reducing senior management's ability to soft peddle the investigation to protect the firm's and their own reputations or financial interests.[118]

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[114] See *supra* note 85. These duties are important even in firms that have an internal reporting system to detect misconduct because companies do not reliably ensure that information about material misconduct—and in turn the revealed deficiencies in the firm's compliance function—reach the board. Chief Compliance Officers (CCOs) often do not provide directors such information—or do not do so in a way that targets particularly material misconduct. CCOs can face implicit or explicit pressure from senior management to not highlight detected misconduct. In addition, boards (and audit committees) regularly do not devote sufficient time to CCO reports on compliance (beyond financial statements) or require CCOs to produce this information.

[115] See Soltes, *supra* note 9.

[116] Deterring such crimes benefits both society and the firm in situations where the violation would harm customers who are able to determine that the firm caused their harm. See *supra* note 52 (discussing costs from reputational damage). It also can benefit the firm when the violation would harm shareholders. See Arlen & Carney, *supra* note 8 (discussing securities fraud).

[117] Channeling information to the board is important even though officers also are required to terminate detected misconduct because directors face fewer conflicts of interest to comply with this duty. Officers are more likely to personally benefit from misconduct. See *supra* note 8. They also are more likely to suffer negative consequences, such as termination or the imposition of a monitor, from the revelation of serious misconduct. See, e.g., Arlen & Kahan, *supra* note 51 (discussing corporate management turnovers and acquisitions following detected misconduct as well as monitors); Alexander and Arlen, supra note 53 (same).

[118] See *supra* note 117.

These information-acquisition duties also should enhance deterrence by increasing directors' *ex ante* incentives to implement more effective systems to deter misconduct. Directors gain less from enabling profitable misconduct when obligated to become informed about material detected misconduct because such information-channeling reduces the expected duration and magnitude of any such misconduct.[119] These duties also increase directors' expected cost of misconduct because misconduct can trigger their liability under *Caremark* and risks reputational damage as a result of shareholders' information rights.[120] Thus, even when the company profits from misconduct, directors obligated to obtain information about detected misconduct may benefit from deterring it.

Finally, information-acquisition duties should promote corporate self-reporting, thereby increasing individual wrongdoers' expected cost of engaging in misconduct.[121] Directors informed about misconduct are more likely than senior management to cause the firm to report to federal authorities as long as federal enforcement policy ensures such actions are in the company's best interests,[122] because they are less likely than senior management is to suffer personal costs as a result.[123] Thus, unlike directorial *respondeat superior* or negligence liability, this duty operates to enhance corporate criminal liability's ability to deter, rather than undermine it.[124]

B. Caremark 2.0

Over the last several years, Delaware Courts started to modify the *Caremark* doctrine to impose duties on directors that appear to be consistent with, albeit not identical to, the regime set forth in Section 4.A.

In addition to the original *Caremark* duties, Delaware imposes enhanced, and more specific, oversight duties on directors in certain circumstances. Directors are required to adopt systems to ensure they are informed about detected misconduct; they are required to ensure they receive this information on a regular basis; and they are expected to ensure that they are informed about and oversee investigations. This section refers to these duties as *Caremark 2.0* duties. Because these duties impose specific information-acquisition requirements that go beyond what many boards are doing, derivative plaintiffs' claims have survived motions to dismiss in situations where defendants would have prevailed under *Caremark*'s original formulation.[125]

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119 See *supra* text accompanying notes 113-118. Directors cannot avoid learning about it by delegating investigations to management, because this too would be a breach of duty under the proposed enhanced director oversight liability rule.

120 Misconduct is a precondition for potential liability, and directors face enhanced scrutiny. Moreover, as discussed below, directors face costs even absent liability because detected misconduct can provide a basis for shareholders to obtain detailed internal records—including directors' emails—to determine whether this misconduct was attributable to mismanagement. See *infra* Section 4.C;

121 Arlen & Kraakman, *supra* note 7; see *supra* Section 1.A.

122 For a discussion of federal enforcement policy see Arlen & Buell, *supra* note 5.

123 See *supra* note 117-**Error! Bookmark not defined.**.

124 See *supra* Section 1.B.

125 Recent *Caremark* cases where plaintiffs have survived motions to dismiss for failure to make a demand include *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *Chou*, No. CV 2019-0816-SG; *In re Clovis Oncology, Inc. Derivative Litig.,* No. CV 2017-0222-JRS (Del. Ch. Oct. 1, 2019); *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021). Plaintiffs have prevailed in gaining the right to inspect corporate books and records under § 220 based on claims of mismanagement arising from credible evidence of misconduct in the following cases: *Lebanon Cty. Employees' Ret. Fund v. AmerisourceBergen Corp.*, No. CV 2019-0527-JTL (Del. Ch. Jan. 13, 2020), aff'd, 243 A.3d 417 (Del. 2020); *In re Facebook, Inc. Section 220 Litig.*, No. CV

Delaware courts have not imposed these duties on all firms in all situations. Consistent with Section 4.A, Delaware courts have only imposed these duties when compliance with the law is particularly important. Most of the cases predicate enhanced duties on evidence that oversight of compliance with the legal duty in question was mission critical to the firm. This is consistent with a shareholder-centric view of the role of these duties. But in recent cases the Delaware court appears to recognize that these enhanced oversight duties should be imposed when society has a strong interest in deterring misconduct, for example because the violation risks serious personal injury or death to multiple people.

1. Marchand v. Barnhill

Delaware's first case imposing enhanced and more specific information-acquisition oversight duties is *Marchand v. Barnhill.*[126] *Marchand* involved a *Caremark* claim arising out of a listeria outbreak at an ice cream company, Blue Bell, that killed multiple people and sickened others. Plaintiffs claimed the board breached its duties by not ensuring that they were informed about either detected deficiency in the firm's food safety systems or detected food safety problems (e.g., listeria). Applying *Caremark*, the Chancery Court dismissed because Blue Bell had a compliance program and thus did not intentionally neglect the duty to establish one. It also asserted regular oversight of it by receiving information about the firm's *procedures* for ensuring food safety. This sufficed to preclude a finding of bad faith because *Caremark* vests the board with discretion to decide whether to ensure it is informed about detected compliance deficiencies or safety violations, even when, as here, the firm is legally obligated to report detected violations and may kill customers if they are not properly dealt with.[127]

The Delaware Supreme Court reversed reasoning that, Blue Bell's compliance with its legal duty to ensure food safety was so vital—mission critical—to the firm that the board could not satisfy its oversight duties unless it implemented procedures to provide it with information about detected safety violations and ensured that it regularly received such reports. The board also had to oversee the investigation and resolution of those problems.

Having established these information acquisition duties, the *Marchand* court determined that plaintiff had met the burden to establish the board breached these duties in bad faith for purposes of surviving dismissal of the complaint. Although Blue Bell had a compliance program, the Blue Bell board had not adopted any procedures to ensure that it was informed about food safety violations, such as listeria outbreaks. Moreover, it did not actually obtain information about food safety violations: it was not informed of tests showing listeria in the firm's ice cream.[128] Plaintiffs created a reasonable belief that the board engaged in intentional sustained neglect of its duty to be informed about food safety violations because it (1) neither delegated responsibility to oversee food safety to a committee of the board nor established protocols to ensure that management apprised the full board about food safety, and (2) did not establish a process to ensure that the board received information about adverse events; and (3) there was no evidence in the board minutes that the board regularly discussed food safety.[129]

The court in imposing these duties to acquire information about detected violations did not impose similar duties on all firms. The Delaware Supreme Court rooted its new duties in the court's

2018-0661-JRS (Del. Ch. May 30, 2019), as revised (May 31, 2019), *judgment entered sub nom. In re Facebook, Inc*. (Del. Ch. 2019).

126 *Marchand*, 212 A.3d at 824.

127 *Id.*

128 *Id.*

129 *Marchand*, 212 A.3d at 822.

traditional concern for corporate welfare and restricted these duties to situations where deterring the misconduct was essential to the firm. Blue Bell's board could not provide effective oversight without ensuring it was apprised of food safety violations because food safety was an "essential and mission critical regulatory compliance risk" for the firm. Blue Bell only made one type of product; its market would evaporate if its ice cream regularly killed customers.[130]

Yet the opinion indicates that such duties may be justified by society's especially strong interest in legal compliance. The court noted that society has a heightened interest in ensuring companies' compliance with laws designed to protect people from personal injury and death, as is expressed by subjecting this industry to heightened regulatory oversight that includes corporate duties to self-report detected violations.[131] The court did not address whether *Caremark 2.0* duties could be predicated on a strong social interest in deterring misconduct that presents a substantial risk of personal injury even when compliance failures were not a mission critical risk for the firm.[132]

2. Teamsters Local 443 v. Chou

In 2020, the Delaware court imposed enhanced *Caremark 2.0* duties in circumstances in which the primary justification for imposing these enhanced duties appears to be society's interest in protecting people from death and serious permanent injury, in *Teamsters Local 443 v. Chou*.[133]

Chou involved claims that the board of AmerisourceBergen Company breached its duties to ensure that its subsidiaries complied with laws governing the sale of cancer drugs.[134] The board would not have been liable under C*aremark*'s original formulation because the board did not utterly neglect its duties: the firm had a compliance program, the Chief Compliance Officer (CCO) reported to the board on efforts to improve compliance, and the board hired an outside law firm to identify weaknesses.

Yet, according to plaintiff, the board breached its oversight duties because, upon receiving notice of problems—and of a DOJ investigation—it did not obtain information about either the DOJ investigation or the success of efforts to bring the subsidiary into compliance.[135] While under *Caremark* the board would have had discretion to decide what information to receive, the Delaware court decided to impose enhanced *Caremark 2.0* duties, which included a duty to ensure that the board was informed about the firm's response to remediating detected violations. The court justified the heightened duties by stating that lack of compliance with laws in question were

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[130] *Marchand*, 212 A.3d at 824 (stating "food safety was essential and mission critical"); *see also id.* at 822 (observing that food safety "has to be one of the most central issues at the company" and "a compliance issue intrinsically critical to the company's [monoline] business operation"). The determination of what constitutes a mission critical risk appears to focus on risks whose realization could materially threaten the firm's future welfare. This is a narrower set of concerns than those that firms might describe as "mission critical" in their statements to the public, such as diversity or protecting the climate. Compare with Veronica Root Martinez, *The Diversity Risk Paradox*, 75 VAND. L. REV. EN BANC 115, 116-17 (2022) (suggesting that such public statements about diversity might serve as the basis of a *Caremark* claim).

[131] *Id.*

[132] The next case, *In re Clovis Oncology, Inc. Derivative Litig.*, did not resolve this issue as it again involved a company in a highly-regulated industry that made only one product, cancer treatments; but society also has heightened interest in ensuring compliance with these laws as evidenced by both the intensity of the regulations and companies strong self-reporting duties, and also the nature of the potential harm, serious injury and death. *In re Clovis Oncology, Inc. Derivative Litig.*, No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019).

[133] *Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou*, No. 2019-0816-SG (Del. Ch. Aug. 24, 2020).

[134] *Id.*

[135] *Id.*

"mission critical risks."[136] Yet compliance with these laws does not appear to have been mission critical to the *firm*. The suit was against the board of the parent company; the oversight duties involved activities in a subsidiary that accounted for only a small portion of the parent's revenues.[137] Even debarment of the subsidiary following a conviction does not appear to have presented a mission critical risk for the parent.

The imposition of enhanced duties here appears to rest on society's strong interest in ensuring compliance with rules designed to protect pharmaceutical customers from risk to their persons. The court focused on the risk of personal injury or death that can result from violating these duties; it also noted that society had expressed its strong interest in ensuring compliance with these legal duties through the intensity of its regulation of this activity and the imposition of self-reporting requirements.

3. In re Boeing Company Derivative Litigation

In Re Boeing Company Derivative Litigation[138] is a case in which enhanced duties serve society's interests, but arguably also serve shareholders' interests. Yet the opinion appears to evidence a particular concern for society's interest in customer safety.

Boeing involved *Caremark* claims for damages to the firm resulting from the crash of two Boeing 737 MAX planes. Plaintiff alleged that the board (1) failed to set up an effective system to enable it to oversee airplane safety; (2) failed to exercise on-going oversight of that system; and (3) failed to adequately oversee the investigation.[139] The board would have faced little risk of liability under *Caremark 1.0* because Boeing is well known for having a strong compliance program and the board received regular reports from the firm's compliance officer. The company also investigated the first crash.

The court in *Boeing* concluded that the Boeing board was subject to enhanced *Caremark 2.0* duties for several reasons. First, Boeing operates "in the shadow of 'essential and mission critical' regulatory compliance risk." Second, Boeing's products are widely-distributed and used by consumers who can be killed by safety violations.[140] Third, Boeing was subject to intensive regulation that included a duty to report detected safety problems.

The court found that the plaintiff could satisfy his burden to show that the board acted in bad faith because it failed both to establish a system to inform it about plane safety and to obtain information about plane safety. The board entirely neglected its duty to adopt systems to ensure it was informed about detected safety violations or misconduct because (1) the board did not establish a committee charged with direct responsibility to monitor airplane safety, (2) the board did not itself monitor, discuss, or address airplane safety on a regular basis, (3) it did not establish a system to monitor for safety violations or ensure board oversight of detected problems; and (4) it did not establish protocols requiring management to apprise it of airplane safety problems. The Court found that scienter was established because the Board knew that there was no committee focused on safety, knew they had not scheduled meetings to discuss it, and knew that they were not receiving regular updates on it.

The court also found that the plaintiff could meet his burden of showing the board utterly failed to exert ongoing oversight by obtaining information about plane safety violations.[141]

[136] *Id.*
[137] Shapira, *supra* note 52.
[138] *In re the Boeing Co. Derivative Litig.*, No. 2019-0907 (Del. Ch. Sept 7, 2021).
[139] *Id.*
[140] *Id.* at 26.
[141] *Id.* at 34.

Following the crash of Boeing's first 737 MAX aircraft, directors failed to immediately request information about the causes of the crash and passively accepted the information provided by management without requiring an independent assessment, even after newspaper articles revealed a likely technical flaw with the plane.[142]

4. Summary

These *Caremark 2.0* cases are consistent with the director liability regime set forth in Section 4.A in imposing specific duties on directors to ensure that they are informed about and exert oversight over the *outputs* of compliance—specifically, direct evidence of deficiencies and evidence of detected suspected misconduct. These cases also appear to indicate that the Delaware court may be willing to extend these duties to situations in which compliance protects people from personal injury or death from risks that society has expressed a particularly strong interest in deterring. The resulting heightened information-acquisition duties can, if properly implemented, enhance deterrence in the ways discussed in Section 4.A without risking over-deterrence that would flow from the imposition on directors of either negligence liability for ineffective oversight or strict *respondeat superior* liability for corporate misconduct.[143] Whether the court will consistently apply such duties to legal risks that primarily serve social interests remains to be seen.

C. Potential Threat to Directors of Caremark 2.0 Liability

Caremark 2.0 can enhance directors' incentives to deter misconduct even though it relies on actions brought by shareholders who regularly benefit from weak compliance. Even when shareholders benefit from crime *ex ante*, once misconduct has been detected and has produced losses for the firm, some shareholders will be motivated to leverage *Caremark* to shift those losses to directors if they can.

Derivative plaintiffs are likely to be able to recover without having to establish bad faith by a preponderance of the evidence because directors do not take *Caremark* cases to trial on the merits. *Caremark* liability is predicated on bad faith, placing directors outside the protections of DGCL 102(b)(7), indemnification provisions or most D&O insurance. To induce settlement, plaintiffs simply need sufficient evidence to survive motions to dismiss the complaint, on demand futility and the merits. The standard for demand futility is quite favorable to plaintiffs. Plaintiffs must provide evidence that creates a reasonable belief that directors knowingly neglected their duties. Courts in *Caremark 2.0* cases allow plaintiffs to establish such neglect when boards, in response to plaintiffs' request for books and records, do not produce evidence (such as board committee mandates and board minutes) demonstrating that the board or relevant board committee received information on detected suspected covered violations, obtained such information on an on-going basis, and asserted effective oversight over investigations.[144]

Moreover, corporate criminal liability is not a prerequisite to liability under *Caremark*. Directors are potentially liable for losses beyond penalties, including costs of investigations and legal costs. While plaintiffs need to create a reasonable belief that these losses resulted from a legal violation, plaintiffs may be able to predicate this reasonable belief on the findings of government investigations that have not yet produced a criminal settlement.[145]

142 *Id.*
143 See supra Section 2.B.
144 E.g., *Marchand*, 212 A.3d at 824; *Boeing*, supra.
145 *In re Facebook, Inc. Section 220 Litig.*, No. 2018-0661-JRS, (Del. Ch. May 30, 2019); *Lebanon Cnty. Emps.' Ret. Fund v. AmerisourceBergen Corp*., No. 2019-0527-JTL (Del. Ch. Jan. 13, 2020).

Finally, *Caremark* provides directors with an incentive to proactively deter misconduct to avoid reputational damage they may suffer when detected misconduct induces shareholders to request corporate books, records and emails under DGCL § 220 to determine whether the misconduct resulted from mismanagement.[146] Shareholders who provide a credible basis for concluding that their company engaged in misconduct potentially attributable to mismanagement can obtain a broad range of records beyond official records, such as board meetings. These records include directors' and senior officers' email exchanges relating to the issue.[147] The resulting revelations can damage directors' reputations.[148]

5. Conclusion

Societies continue to struggle with how to effectively deter corporate crime without imposing excessive costs on legitimate productive enterprises. Corporate liability is essential to this effort, but it cannot optimally deter on its own. Managers and directors may fail to respond in corporations' best interests because they personally benefit from crime or weak compliance. Alternatively, they may promote profitable misconduct when the threat of corporate enforcement is sufficiently low.

To promote social welfare, states need to leverage corporate law's ability to deter through narrowly tailored duties imposed on directors, enforced by the threat of liability for bad faith. Corporate law requires directors not to knowingly commit misconduct and to terminate any they learn about. But this duty is not effective without additional duties designed to ensure that directors are informed about detected misconduct.

Delaware's primary doctrine for inducing director oversight over compliance, *Caremark*, neither imposes the requisite duties nor induces directors to obtain this information in situations where companies profit from misconduct. To efficiently deter corporate crime, directors must be required to ensure that they are informed about detected material misconduct and should oversee the investigation of this information. These duties can enhance deterrence if they are imposed (1) when compliance is vital to the firm and (2) in relation to laws designed to guard against serious permanent injury or death that evidence society's strong interest in compliance by requiring companies to report detected safety problems. Such information-acquisition duties can give effect to Delaware's directorial duty not to violate the law by increasing the likelihood that directors learn about misconduct and thus feel pressured to terminate it.

One benefit of *Caremark 2.0* liability is that it relies on private litigation by shareholders, which is less vulnerable to political capture by companies than public enforcement. Companies have considerable ability to leverage their financial resources to influence elected officials. In turn, both Congress and the White House regularly take actions that undermine federal corporate

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146 See Shapira, supra note 52, at 1877-79.

147 Shareholders can obtain corporate records, including relevant emails by management and directors, even if they cannot establish that the board is liable under *Caremark*. See *AmerisourceBergen Corp. v. Lebanon Cty. Employees' Ret. Fund*, 243 A.3d 417 (Del. 2020); Delaware General Corporation Law § 220; see also *In re Facebook, Inc. Section 220 Litig.*, No. CV 2018-0661-JRS, 2019 WL 2320842 (Del. Ch. May 30, 2019), *as revised* (May 31, 2019), *judgment entered sub nom. In re Facebook, Inc.* (Del. Ch. 2019). Notwithstanding reputational damage costs, directors' costs of detection should be less than managements' as senior management is most likely to be implicated in any misconduct that could plausibly implicate directors, as, for example, allegedly is the case with both AmerisourceBergen and Facebook (now Meta).

148 E.g., *Boeing*, *supr*a.

enforcement.[149] Corporations cannot readily deploy their political influence to curtail *Caremark* litigation, which is brought by private litigants whose budgets lie beyond companies' influence. Moreover, *Caremark* cases fall under the jurisdiction of Delaware Chancery Court judges who are appointed and have no need for companies' campaign contributions. Corporations also cannot as successfully lobby the Delaware legislature to curtail *Caremark* derivative litigation because powerful institutional shareholders have the political influence and incentives to block efforts to limit directors' liability for bad faith.

[149] See, e.g., Arlen, *supra* note 52.

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