Conceptualizing *Caremark*

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*Compliance and ESG have been the two biggest developments in corporate governance over the past decade. Companies are facing increased regulatory and societal demands. In response, companies are pouring billions of dollars into compliance programs meant to detect and prevent wrongdoing by their employees. Yet until recently, corporate law has played a surprisingly limited role in holding directors and officers accountable for compliance failures. This situation has changed dramatically over the past few years. Nowadays, virtually every corporate fiasco is followed by an oversight-duty lawsuit against the company's directors for not doing enough to prevent the debacle. But the rapid resurgence of oversight duties has created a mismatch: the doctrine has become one of the most important in corporate law yet remains one of the least underarticulated. This Article bridges this mismatch by conceptualizing the doctrine (often dubbed* Caremark*, after Delaware's leading precedent). In particular, the Article makes the following four contributions.*

*First, the Article clarifies what determines a breach of oversight duties. The standard of review across all types of oversight duty claims is bad faith. Failure-of-oversight claims thus usually boil down to what courts can infer about directors' mental state from external evidence about directors' actions and the circumstances in which they took them. The Article identifies the external "markers" that courts use to infer directors' bad faith: from the centrality of the compliance risk in question, to the relationship between past warnings and current problems, to the clarity of the legal obligations that were violated. Second, the Article articulates the main policy arguments behind each Caremark claim, namely, combatting "willful blindness," "cosmetic compliance," corporate recidivism, managerial short-termism, and perverse incentives to externalize costs on society. Third, the Article highlights several ostensibly procedural aspects of oversight duty litigation that have a disproportionate impact on corporate behavior: from privileges to "laches" (when are* Caremark *claims time-barred?) to how to deal with findings by noncorporate legal forums. Across all these issues, corporate law courts have adopted in a series of rulings on first impression in 2023 a "liberal" approach that boosts the ability to hold individual decisionmakers accountable. Finally, the Article evaluates the overall desirability of the resurgence in oversight duty litigation and identifies concrete policy implications, such as how to calculate damages when the company profited from skirting regulations, or what deference to give to the company's own investigation of failure-of-oversight claims*.

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Roy Shapira[[1]](#footnote-1)\*

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# Introduction

Every major corporate fiasco these days is followed by a derivative action in corporate law against the company’s directors for not doing enough to prevent the debacle. To illustrate, think of Boeing 737 Max crashes, Walmart’s involvement in the opioid crisis, Facebook’s violations of user privacy, sexual misconduct at McDonald’s, false allegations of vote stealing by Fox, and so on. All these cases rest on the same legal principle, namely, director oversight duties. The logic of this is straightforward: the board of directors is the corporate organ responsible for risk oversight. And while directors are not expected to detect and prevent all wrongdoing by lower-level employees, they are expected to keep apprised of important compliance risks and to address red flags.[[2]](#footnote-2)

The oversight duty doctrine is corporate law’s tool for policing the effectiveness of corporate compliance programs. With compliance having emerged as a major corporate governance issue,[[3]](#footnote-3) companies are pouring hundreds of billions of dollars into internal programs meant to detect and prevent wrongdoing by their employees.[[4]](#footnote-4) If these costly programs fail, shareholders have the right to bring an oversight duty claim to hold directors and officers accountable for the attendant legal and financial harms suffered by the company. In fact, the effect of oversight duties extends beyond the interests of shareholders. These duties also impact broader social issues, such as product safety (Boeing), data privacy (Facebook), public health (Walmart), and democratic discourse (Fox). Oversight duties thus represent a departure from the conventional wisdom that treated corporate anti-social behavior as a matter for other laws and regulations, rather than as an internal corporate law issue.

As a result, the stakes of understanding and calibrating oversight duties could not be higher. Yet the doctrine is underarticulated, and many fundamental questions remain unanswered. For example, we know that the standard of review in failure-of-oversight cases is bad faith.[[5]](#footnote-5) But we do not know how courts will apply the standard to real-world situations. How deeply will courts probe the effectiveness of board oversight? When will courts hold directors liable not only for what they knew but also for what they should have known? Beyond the uncertainties regarding how to determine a breach, we do not know which form of causation applies or how to calculate damages in oversight duty cases. Additionally, it is unclear what the scope of oversight duties entails. Do these duties apply to overseeing business risks or strictly to overseeing clear illegalities? Do they apply to third-party compliance advisors or solely to corporate insiders? Perhaps the most significant concern is that we do not have a strong understanding of the policy rationales that support oversight duty claims.

These fundamental questions have yet to be fully explored because the oversight duty doctrine is still in a nascent stage. Although the doctrine has existed in various formulations for over six decades,[[6]](#footnote-6) in practice, it lay dormant much of this time and was widely perceived by corporate legal scholars and practitioners as an irrelevant, toothless tiger.[[7]](#footnote-7) Failure-of-oversight claims (often dubbed *Caremark* claims, after Delaware’s leading precedent) were routinely dismissed due to a combination of a high evidentiary bar and the procedural stance in these cases.[[8]](#footnote-8) This situation has changed dramatically over the past few years.[[9]](#footnote-9) The courts are now showing (1) increased willingness to scrutinize board oversight efforts and fault directors not just for what they knew but also for what they did not know, and (2) increased willingness to grant shareholders access to internal company documents in order to investigate potential failure-of-oversight claims.[[10]](#footnote-10) The combination of the courts’ increased willingness to scrutinize directors’ conduct and plaintiffs’ improved ability to expose directors’ conduct has resulted in a series of successful *Caremark* cases, and a slew of pending *Caremark* claims.[[11]](#footnote-11)

The rapid resurgence of the doctrine of oversight duties thus created an incongruity. The doctrine has become one of the most relevant theories in corporate law, yet it remains one of the least articulated.[[12]](#footnote-12) This Article bridges this gap by conceptualizing the doctrine. It synthesizes the growing body of case law, highlights areas of uncertainty, and identifies areas where newly developed law deviates from the social optimum. In the process, the Article makes the following four contributions.

First, the Article clarifies what determines a breach of oversight duties. There are three variants of oversight duty claims. The *information-systems* variant requires directors to implement a system that monitors misconduct and reports back to them. The *red-flags* variant requires directors to identify and address obvious warning signs. And the *business-plan* (*Massey*[[13]](#footnote-13)) variant prohibits directors from affirming a plan that is based on making profits by skirting regulations.[[14]](#footnote-14) Because the standard of review across all three variants is that of bad faith, plaintiffs must present evidence of directors’ state of mind in order to prove a breach. However, mental states are not directly observable, and directors rarely openly condone lawbreaking or admit to not even trying to oversee risks. As a result, failure-of-oversight cases boil down to what courts can infer about directors’ subjective intent from objective evidence of their actions and the circumstances in which they took them.[[15]](#footnote-15)

In each one of the three types of claims, courts use different external “markers” to infer directors’ bad faith. In information-systems claims, courts examine the centrality of the compliance risk in question. The idea is to distinguish legitimate decisions to delegate oversight of certain risks from bad-faith decisions to deliberately overlook problematic practices. When directors delegate oversight of the company’s most critical risks and uncritically accept whatever information is supplied to them, it is likely that they are not trying in good faith to engage in oversight. The key question is therefore what missions are critical.

In red-flags claims, courts examine how clear the warning signs were and how directly they were tied to the trauma the corporation suffered. Directors are constantly receiving reports about potential and emerging risks and are not expected to act in response to each one. Failing to identify and address the risk amounts to bad faith only when the warnings are obvious and imminent. The key question, then, is which flags are red (as opposed to merely yellow).

In business-plan (*Massey*) claims, courts focus on the clarity of the legal obligations and the pervasiveness of the violations of these obligations. Large corporations operate in a dynamic regulatory environment and often assume the risk that regulators will disagree with their operational decisions. The business-plan theory distinguishes commonplace assumptions of legal risks from premediated decisions to violate clear preexisting regulatory requirements.

When making all these distinctions, corporate law courts rely on rules-of-thumb and “theory of mind” tests.[[16]](#footnote-16) These are analogous to measures other courts apply to infer scienter in different settings, such as federal courts in securities fraud litigation.[[17]](#footnote-17) Comparing these contexts helps to clarify the unique challenges that litigation involving oversight duties presents.

The Article’s second contribution comes from identifying the main policy arguments behind each *Caremark* claim. Corporate law commentators have long lamented that the case law has never fully articulated the “why” behind oversight duty claims.[[18]](#footnote-18) For example, why is maximizing profits by skirting regulations a breach of loyalty? Why are some types of director ignorance considered blameworthy and others not? Understanding the why is critical for applying the what of legal doctrines. And it is especially critical with oversight duties, given how context-specific the bad-faith inquiry is, and how dynamic compliance risks are. This Article identifies the following rationales by distilling the rapidly emerging case law and borrowing insights from the literature on corporate deterrence.

The information-systems theory is primarily designed to combat *willful blindness*. Directors have strong incentives to remain ignorant about decisions that prioritize profits over everything else. Information-system theory counters these incentives by emphasizing culpable ignorance and proper documentation. The courts’ increased tendency to classify issues as “mission critical” means that directors now increasingly face liability for what they should have known. And the courts’ increased willingness to grant shareholders access to internal communications incentivizes directors to maintain a proper record of all internal discussions regarding compliance risks. As a result, damning information about misconduct inside the company is more likely to flow up the organizational hierarchy, and the company is more likely to deal with problems early before they deteriorate.

The red-flags theory serves to combat *cosmetic compliance*.[[19]](#footnote-19) When courts examine whether directors saw and addressed red flags, they focus on whether directors were merely “going through the motions” or genuinely attempting to address noncompliance. The red-flags theory also helps combat corporate *recidivism*. Repeated rule violations count as red flags that put directors on notice. The more a company is recidivist, the more likely directors are to be personally liable for future problems. The prospect of red-flags claims thus incentivizes directors to address the root causes of recidivism.

The business-plan theory has a two-pronged rationale. It can be interpreted as *minimizing agency costs*. For example, corporate managers may suffer from short-termism when approving a business plan that is based on making profits from violating the law. Managers whose pay is tied to short-term yardsticks benefit from projects whose returns accrue in the short term, while the costs of illegalities (fines and reputational fallouts) may surface only over the long term. The business-plan theory can also be interpreted as *minimizing externalities*. Here the focus is on minimizing harm to third party stakeholders, such as the environment and nearby communities, rather than on minimizing harm to long-term shareholders.

The notion of a corporate law doctrine dealing with externalities runs counter to conventional wisdom that suggests that corporate law should accept as given whatever other regulators determine.[[20]](#footnote-20) In other words, once other regulators calibrate rules and sanctions, companies should be able to decide whether the sanction is a price worth paying for rule violations that benefit the company. Just as corporate law allows companies to breach contracts and pay expectation damages (“efficient breach”), so should corporate law allow companies to violate regulations and pay fines (“efficient lawbreaking”), or so the argument goes.[[21]](#footnote-21) However, the efficient lawbreaking approach is flawed on many levels. For one, it assumes that regulatory sanctions accurately reflect the social harm caused by the misbehavior in question. In reality, large companies do not consider expected sanctions as inevitable but can dilute them in a number of ways, such as by hiding information from the regulator. Companies can thus engage in behaviors that are beneficial to the company even when they are extremely costly from a social perspective.[[22]](#footnote-22) Therefore, there is value in providing a corporate law mechanism that disincentivizes corporate decision-makers from engaging in such behaviors.[[23]](#footnote-23)

The Article’s third contribution is to highlight several ostensibly procedural aspects of oversight duty litigation that have a disproportionate impact on corporate behavior. Consider for example five issues that the courts addressed on first impression during 2023. One important question is how to treat privileges and redactions. Defendant directors frequently invoke attorney-client and work-product privileges and heavily redact internal documentation of compliance discussions. *Walmart* clarified just how much heavy redactions can backfire at the pleading stage, where they may serve as indications that the directors never discussed or failed to properly address central compliance risks.[[24]](#footnote-24) Another question involves how to deal with findings by noncorporate legal forums. Most *Caremark* claims come at the heels of public enforcement or litigation against the company in other courts. *AmerisourceBergen* limited defendants’ ability to rely on factual findings that had exonerated the company in other courts.[[25]](#footnote-25) A third question is how much deference courts should give to a Special Litigation Committee (SLC) appointed by the company to investigate whether to pursue *Caremark* claims. *Chou* applied the traditional framework and deferred to the SLC’s decision to dismiss well-pled claims against directors.[[26]](#footnote-26) However, this Article explains that the value of SLCs is limited in *Caremark* settings, and so it is far from clear that the standard deference to SLCs should be exercised.

Yet another question revolves around when *Caremark* claims become time barred. The issue of timeliness is especially crucial in *Caremark* settings, because the purported failure of oversight typically occurs over a period of several years. *Walmart* and *AmerisourceBergen* implemented a liberal approach to accrual methods, lookback dates, and equitable tolling, thereby significantly reducing the likelihood that future *Caremark* claims will be time-barred.[[27]](#footnote-27) The fifth issue that was addressed on first impression during 2023 is the one that received the most attention, namely, *McDonald’s* clarification that corporate officers have oversight duties too.[[28]](#footnote-28) This Article highlights two important differences between the duties of officers and those of directors, which could make claims against the latter more likely to survive than claims against the former.

There are also two core questions that remain unanswered but are likely to be addressed in the forthcoming months. One concerns the scope of third-party liability. Virtually all the important compliance decisions in large companies are outsourced to third-party advisors.[[29]](#footnote-29) Yet these outside advisors are rarely held accountable for compliance failures.[[30]](#footnote-30) In other words, while directors are increasingly held accountable for remaining in the dark about noncompliance, those who were paid to create the information environment for directors are not. This is attributable in large part to the intricacies of the aiding-and-abetting doctrine and how it interacts with *Caremark*. However, the Article calls attention to a few seemingly disparate developments in *McDonald’s* and *Walmart* that could potentially revive aiding-and-abetting claims in *Caremark* settings. Last but certainly not least among the unanswered questions in oversight duties is how to assess causation and remedies. Here the Article draws on longstanding fiduciary law principles to clarify the elements required to prove breach, the type of causation that applies, and the method of calculating damages when the company profited from violating the law.

The Article’s final set of contributions concerns policy implications: the Article evaluates the overall desirability of the resurgence in oversight duty litigation and identifies concrete lessons for courts. The main disadvantages of the revamped mode of oversight duties are that it exacerbates the risk of judicial hindsight bias and discourages corporate investment in remedial measures. The main advantages are that it nicely complements the flaws of public enforcement and facilitates market discipline. Overall, the evolution of oversight duty is likely to prove socially advantageous. However, there are still areas that can be further improved. The Article provides specific recommendations for addressing regulatory rent-seeking and for incorporating company size into *Caremark* claims assessments.

A few words on scope and terminology are in order at the outset. Unless noted otherwise, references to corporate law are to Delaware corporate law. Most large corporations are governed by Delaware law, and other states tend to follow its lead.[[31]](#footnote-31) References to corporate directors in the Article usually also include corporate officers, with the exception of Section V.E, which explains how the oversight duties of officers are similar in principle but different in practice to those of directors. Finally, oversight duty doctrine has been developing at a breakneck pace, with most of the relevant court decisions in this Article dating from 2022 and 2023. I emphasize this point here because it affects how readers should approach this Article. It would not be surprising if some of trends described here will be reversed in two or three years. What one needs to glean from this Article is not necessarily specific conjectures, but rather the general mode of reorganizing the case law, identifying the key questions, and ascertaining the underlying logic that animates oversight duties.

The Article proceeds in seven parts. Part I provides the background of the causes and consequences of the resurgence of oversight duties. Parts II–IV examine the two primary questions—how to infer bad faith, and what is the underlying policy rationale—for each of the three *Caremark* claims. Part V highlights seven secondary questions that will determine the prospect of oversight liability going forward, from privileges to “laches” and “judicial notice.” Part VI outlines policy implications. A short Conclusion clarifies the Article’s original contributions by juxtaposing them to the extant literature and acknowledges the Article’s limitations.

1. \* Professor of Law, Reichman University; Research Member, ECGI. I conducted most of the research for this project while serving as Visiting Professor at UC Berkeley School of Law, and I thank the school for its generous support. I also thank Joel Friedlander, Amir Licht, Amanda Rose, and [thanks to come] for helpful comments and discussions. [↑](#footnote-ref-1)
2. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). [↑](#footnote-ref-2)
3. Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 Wm. & Mary L. Rev. 2075, 2077 (2016). [↑](#footnote-ref-3)
4. *See, e.g.*, Eugene Soltes, *Evaluating the Effectiveness of Corporate Compliance Programs: Establishing a Model for Prosecutors, Courts, and Firms*, 14 N.Y.U. J.L. & Bus. 965, 969 (2018). [↑](#footnote-ref-4)
5. Stone, 911 A.2d 362, 370. [↑](#footnote-ref-5)
6. Allis-Chalmers, 188 A.2d 125,130 (Del. 1963); *In re* Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). [↑](#footnote-ref-6)
7. *See, e.g.*, Anne Tucker Nees, *Who’s the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 Del. J. Corp. L. 199, 216 (2010). [↑](#footnote-ref-7)
8. *See*, *e.g.*, Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 Vand. L. Rev. 2013 (2019) (providing a comprehensive overview of *Caremark* claims up until 2019). [↑](#footnote-ref-8)
9. Section I.A *infra*. [↑](#footnote-ref-9)
10. *Id*. [↑](#footnote-ref-10)
11. *Id*; Const. Indus. Laborers Pension Fund et al. v. Bingle et al.**,** 2022 Del. Ch. LEXIS 223, at \*3 (“*Caremark*claims, once relative rarities—have in recent years bloomed liked dandelions after a warm spring rain”). [↑](#footnote-ref-11)
12. To illustrate just how important *Caremark* has become for practitioners *see, e.g.*, Jennifer Kay & Mike Leonard, *Delaware’s Judge Laster is Making His Mark on Corporate America*, Bloomberg Law (Jul. 31, 2023), <https://news.bloomberglaw.com/us-law-week/delawares-judge-laster-is-making-his-mark-on-corporate-america> (discussing the “transformation of *Caremark* cases from long-shot lawsuits that were barely worth bringing into a staple of Delaware’s corporate accountability regime”); Kevin LaCroix, The Top Ten D&O Stories of 2022, D&O Diary Blog (Jan. 3, 2023), <https://www.dandodiary.com/2023/01/articles/director-and-officer-liability/the-top-ten-do-stories-of-2022/> (placing *Caremark* at the top of important corporate governance issues). To illustrate just how underarticulated *Caremark* is, see the discussion accompanying notes 86–88 *infra*. [↑](#footnote-ref-12)
13. After Delaware’s leading precedent: *In re* Massey Energy Co. Deriv. and Class Action Litig., 2011 Del. Ch. LEXIS 83, (Del. Ch. May 31, 2011). [↑](#footnote-ref-13)
14. A business-plan claim is technically not a failure-of-oversight claim, but courts often group all three variants together for practical reasons. Section I.B *infra*. [↑](#footnote-ref-14)
15. *Cf*. Allen v. El Paso*,* 113 A.3d 167, 178 (Del. Ch. 2014). [↑](#footnote-ref-15)
16. Ontario Provincial Council of Carpenters' Pension Trust. v. Walton, 294 A. 3d 65, 91 (Del Ch. Apr. 12, 2023) (“Walmart I”). [↑](#footnote-ref-16)
17. *Infra* note 114 and the accompanying discussion. [↑](#footnote-ref-17)
18. *Infra* notes 86–88 and the accompanying discussion. [↑](#footnote-ref-18)
19. “Cosmetic compliance” denotes check-the-box programs that seem sound from the outside but do very little to curb corporate wrongdoing. See *infra* note 235 and the sources therein. [↑](#footnote-ref-19)
20. Section V.C *infra*. [↑](#footnote-ref-20)
21. *Id*. [↑](#footnote-ref-21)
22. *Infra* notes 307–312 and the accompanying discussion. [↑](#footnote-ref-22)
23. *See also* Jennifer Arlen, The Compliance Function (working paper, 2023), <https://ssrn.com/abstract=4502973>. [↑](#footnote-ref-23)
24. Ontario Provincial Council of Carpenters' Pension Trust. v. Walton, 2003 Del. Ch. LEXIS 92 (Del Ch. Apr. 26, 2023) (“Walmart II”). [↑](#footnote-ref-24)
25. Lebanon City Employees’ Ret. Fund. V. Collis, 2023 Del. LEXIS 422 (Del. 2023). [↑](#footnote-ref-25)
26. Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, 2023 LEXIS 576 (Del. Ch. Nov. 17, 2023). [↑](#footnote-ref-26)
27. Walmart I, 294 A. 3d 65; Lebanon City Employees’ Ret. Fund. V. Collis, 287 A.3d 1160 (Del. Ch. Dec. 15, 2022). [↑](#footnote-ref-27)
28. *In re* McDonald's Corp. Deriv. Litig., 289 A.3d 343, 359-360 (Del. Ch. Jan. 26, 2023) (“McDonald’s I”). [↑](#footnote-ref-28)
29. Asaf Eckstein & Roy Shapira, *Compliance Gatekeepers*, Yale. J. Reg. (forthcoming), <https://ssrn.com/abstract=4419560>, at Part I. [↑](#footnote-ref-29)
30. *Id*. at Part II. [↑](#footnote-ref-30)
31. *See* Charlotte Morabito, *Here’s Why More Than 60% Of Fortune 500 Companies Are Incorporated in Delaware*, CNBC (Mar. 13, 2023), <https://www.cnbc.com/2023/03/13/why-more-than-60percent-of-fortune-500-companies-incorporated-in-delaware.html> (on how most large companies incorporate in Delaware); Kevin LaCroix, *Cardinal Health Opioid-Related Derivative Suit Settled for $124 million*, D&O Diary Blog (May 30, 2022), <https://www.dandodiary.com/2022/05/articles/shareholders-derivative-litigation/cardinal-health-opioid-related-derivative-suit-settled-for-124-million/> (an example of out-of-Delaware developments that mimic the trends described here). [↑](#footnote-ref-31)