
Article

The Hidden Power of Compliance

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INTRODUCTION

As a wave of massive corporate scandals overwhelms our lives, calls to hold corporate boards accountable grow louder each day.¹ Just this fall, hackers rummaged through Equifax's records to obtain financial information for 143 million Americans.² Customers of Wells Fargo, the nation's third largest bank, saw their hard-earned money routed to 3.5 million fictitious accounts, frittered away on frivolous fees, and wasted on unwanted car insurance.³ Auto-manufacturers General Motors and Volkswagen made billion-dollar payments after failing to uncover critical defects in auto parts, resulting in many deaths and injuries⁴ and environmental damage.⁵ Yahoo, the one-time Internet giant, announced that over 3 billion email accounts were compromised by Russian hackers in the largest security breach in Internet history.⁶ And following a crude awakening to widespread sexual harassment in the workplace,⁷ many corporations are viewed as tolerating repeated violations by powerful and

1. See, e.g., Emily Flitter et al., *How Wells Fargo and Federal Reserve Struck Deal to Hold Bank's Board Accountable*, N.Y. TIMES (Feb. 4, 2018), <https://www.nytimes.com/2018/02/04/business/wells-fargo-fed-board-directors-penalties.html> (describing negotiations between the Federal Reserve and the board of Wells Fargo after the Federal Reserve imposed sanctions on Wells Fargo for fraudulent charges to customers).

2. See Ron Lieber & Stacy Cowley, *Trying to Stem Fallout from Breach, Equifax Replaces C.E.O.*, N.Y. TIMES (Sept. 26, 2017), <https://www.nytimes.com/2017/09/26/business/equifax-ceo.html>.

3. See Emily Glazer, *Wells Fargo's Year of Scandal Stretches On*, WALL ST. J. (Sept. 8, 2017), <https://www.wsj.com/articles/wells-fargos-year-of-scandal-stretches-on-1504863001>; Gretchen Morgenson, *Wells Fargo Forced Unwanted Auto Insurance on Borrowers*, N.Y. TIMES (July 27, 2017), <https://www.nytimes.com/2017/07/27/business/wells-fargo-unwanted-auto-insurance.html>.

4. See Richard Read, *GM's Ignition Switch Findings: 124 Deaths, 275 Injuries*, WASH. POST (Aug. 25, 2015), https://www.washingtonpost.com/cars/gms-ignition-switch-findings-124-deaths-275-injuries/2015/08/25/2ad3a7d4-4b44-11e5-80c2-106ea7fb80d4_story.html.

5. See Shannon Hall, *VW Causes Small but Irreversible Environmental Damage*, SCI. AM. (Sept. 29, 2015), <https://www.scientificamerican.com/article/vw-scandal-causes-small-but-irreversible-environmental-damage>.

6. *Yahoo Provides Notice to Additional Users Affected by Previously Disclosed 2013 Data Theft*, OATH (Oct. 3, 2017), <https://www.oath.com/press/yahoo-provides-notice-to-additional-users-affected-by-previously> (summarizing Yahoo's announcement that "all user accounts were affected by the August 2013 data theft," instead of only the one billion accounts previously disclosed).

7. See Catharine A. MacKinnon, *#MeToo Has Done What the Law Could Not*, N.Y. TIMES (Feb. 4, 2018), <https://www.nytimes.com/2018/02/04/opinion/metoo-law-legal-system.html>.

popular figures. With repercussions of such immense scale, policymakers⁸ and the broader public are left wondering whether corporate boards are simply incompetent or ultimately complicit.⁹

This critical distinction matters not only in the court of public opinion, but also in the courts of law. Under the most common legal bases, which we discuss below, mere incompetence would exonerate an otherwise well-intentioned board, whereas failure to respond to glaring problems results in liability. To differentiate between these two outcomes, our legal system has increasingly turned to companies' internal monitoring efforts through their compliance apparatus. For over a decade, federal regulators and criminal authorities have directed companies to intensify their compliance efforts, often in return for more favorable regulatory treatment.¹⁰ The response has been swift and impressive. Compliance departments in most public companies today engage hundreds of employees on average, and retain thousands of staff in highly regulated industries such as finance.¹¹ With expanding firepower at their disposal, the heads of legal and compliance departments find themselves in an increasingly elevated position within the corporate hierarchy, having gained a seat among top managers and a direct reporting avenue to the board.¹²

But while companies have committed unprecedented resources to build up their compliance operations, the results of their efforts are very much in doubt. Some corporate law scholars question whether in-house officers are well placed to supervise their superiors, such as the CEO and the board.¹³ Others

8. See Gretchen Morgenson, *Wells Fargo Borrower Got Unneeded Insurance, and Ruined Credit*, N.Y. TIMES (Aug. 18, 2017), <https://www.nytimes.com/2017/08/18/business/wells-fargo-loan-auto-insurance.html>.

9. See David Gelles, *'You Should Be Fired': Wells Fargo C.E.O. Faces Blistering Attacks From Senators*, N.Y. TIMES (Oct. 3, 2017), <https://www.nytimes.com/2017/10/03/business/dealbook/wells-fargo-ceo-senate-hearing.html>.

10. See *infra* text accompanying Part I.A.1.

11. See Jill Treanor, *JP Morgan Chase Hires 3,000 New Staff in Its Compliance Department*, GUARDIAN (Sept. 17, 2013), <https://www.theguardian.com/business/2013/sep/17/jpmorgan-banking> (describing the infamous "London Whale" debacle, where JP Morgan hired 3000 new compliance staff and re-assigned 1000 employees for a total increase of 4000 staff members); see also Press Release, Deutsche Bank, Deutsche Bank Reports First Quarter 2017 Net Income of €575 Million (Apr. 27, 2017), https://www.db.com/newsroom_news/2017q1-media-release.pdf (reporting that Deutsche Bank increased its compliance staff by over 2000 employees after recent failures).

12. See *infra* text accompanying Part I.B.

13. See John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the*

mistrust company employees as monitors, arguing that their insider perspective and loyalty to their firm will prevent them from seeing fraud and wrongdoing.¹⁴ Still others have dismissed compliance as institutionally ill-suited to the board-centric edifice of corporate law.¹⁵ Perhaps the harshest critics view compliance as a box-checking exercise, too formalistic and weak to uncover corporate malfeasance.¹⁶ Overall, current scholarship on compliance from a variety of perspectives reaches mostly negative conclusions.

While we share many of these concerns, our bottom line is considerably more optimistic. We come to a different outcome because we uncover a different pathway through which legal and compliance officers can wield influence that is not emphasized in prior research. We agree with existing scholarship that in-house legal and compliance experts rarely have the means or bargaining power to command top management or board members to stop violating the law. But expecting them to do so would be misplaced. Rather, we argue that legal and compliance officers have great power because they can alter board members' incentives, and ensure that board members become aware of information they might prefer to ignore. If the chief legal or compliance officer chooses to inform the board of a critical problem, it becomes much harder for directors to do nothing and still meet the good faith requirements of our laws. This internal report can flip the board's state of mind from blissful, even if negligent, ignorance to stark awareness. Hence, legal and compliance officers' hidden power lies in their ability to trigger board action by formally notifying the board of a problem, or alternatively shielding the board from this formal notification and allowing board members to preserve the veneer of ignorance.

This hidden power of compliance, we argue, sprang up unexpectedly over the last decade from parallel case law developments in Delaware fiduciary duty jurisprudence, federal securities regulation, and personal liability for compliance officers. We trace these doctrinal developments to explain how a renewed

SEC, 103 COLUM. L. REV. 1293, 1296 (2003); see also Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 AM. BUS. L.J. 203, 204–05 (2016).

14. See Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 988 (2005).

15. See Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 590 (2008).

16. See Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 941 (2017).

emphasis on evidence of awareness boosted the standing of legal and compliance officers in the eyes of the board, while also threatening board members with liability if they fail.¹⁷ We then reveal how this works in practice by analyzing the interactions between the board and its legal and compliance officers through evidence released in four major recent scandals: the GM ignition switch scandal, the Washington Mutual mortgage meltdown, the Yahoo security breach, and the Wells Fargo fake accounts scandal.¹⁸

When the Delaware Supreme Court first confirmed, in its landmark 2006 *Stone v. Ritter* opinion,¹⁹ that board members would be liable for failing to monitor misconduct only if found to be acting in bad faith, much of legal academia burst out in despair.²⁰ To meet such a demanding evidentiary standard, plaintiffs would need to provide unambiguous evidence of the directors' and officers' states of mind, thought notoriously hard to obtain. For critics, Delaware had just handed out another victory to boards. Even fervid advocates of the discretion *Stone* affords to boards did not question that proving bad faith would be truly cumbersome.²¹

To upend this widely shared belief in the literature, we closely analyze post-*Stone* jurisprudence from the last ten years in Part II, detailing the facets of bad faith in the various prongs of Delaware's monitoring doctrine. Our argument here is not that Delaware law has turned out more generous than critics feared. Rather, we argue that the precise line that Delaware jurisprudence has drawn around bad faith allows legal and compliance personnel to formulate their communications with the board in a manner that can either expose it to liability or shield it from it. The dramatic increase in monitoring resources since

17. See *infra* Parts II–IV.

18. See *infra* Part V.

19. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 364 (Del. 2006).

20. See, e.g., Megan W. Shaner, *The (Un)Enforcement of Directors' Duties*, 48 U.C. DAVIS L. REV. 271, 307 (2014). See generally Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, in CORPORATE LAW STORIES 323 (J. Mark Ramseyer ed., 2009) (arguing that the importance of *Caremark* may have been exaggerated); Eric J. Pan, *Rethinking The Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 FLA. ST. U. L. REV. 209 (2011) (viewing Delaware doctrine as too narrow).

21. See generally Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010) (underlining Chancellor Allen's intention to avoid subjecting directors to broad liability).

Stone has positioned legal and compliance officers to bridge the informational gap and provide the detailed reports required by courts to prove bad faith. For example, internal compliance reports have helped shareholders win hefty settlements in cases about illegal drug promotion against the boards of Pfizer,²² the pharmaceutics giant, and Allergan,²³ which produces Botox. Similarly, internal reports documenting failures and gaps in companies' safety, risk, and compliance systems have aided plaintiffs in their wins against boards in diverse industries such as finance²⁴ and mining.²⁵

As we explain in Part III below, the gravity of internal reports for board liability becomes clearer when taking into account parallel developments in federal securities case law, and in particular under Rule 10b-5, the most popular basis for class actions. According to 10b-5, a corporate officer commits fraud only if she issues faulty disclosure with scienter, i.e. she is aware of such faults or, at least reckless in not recognizing them.²⁶ In 2007, just a year after *Stone*, the Supreme Court's ruling in *Tellabs v. Makor* raised the evidentiary standard for successfully pleading scienter, effectively requiring hard evidence of awareness or recklessness.²⁷ As a result, the lines demarcating scienter and bad faith essentially coincide, as courts themselves have recognized.²⁸ Consequently, securities plaintiffs often pore over internal records of communications between boards and their legal and compliance officers to unearth evidence of scienter. Securities class actions have traditionally far exceeded fiduciary duty claims in terms of awards won, and are recently reaching new heights.²⁹ Thus, interactions between legal and compliance officers and the board have never been more critical.

Compliance officers have not only gained greater influence due to their role in communicating with corporate boards, but have also been held personally liable when they failed to do so.

22. See *infra* text accompanying notes 224–31.

23. See *infra* text accompanying notes 211–20.

24. See *infra* text accompanying notes 221–23.

25. See *infra* text accompanying notes 231–41.

26. 17 C.F.R. § 240.10b-5 (2018).

27. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007) (holding that although the evidence need not be a “smoking gun,” it must be “cogent and compelling” in light of other explanations).

28. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66 (Del. 2006).

29. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2017 MIDYEAR ASSESSMENT 1 (2017), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-Midyear-Assessment>.

In a highly controversial move, the SEC sanctioned the Chief Compliance Officers in financial giants Blackrock and SFX for tolerating gaps in their compliance systems, even though they were not aware of illegal conduct occurring due to these gaps.³⁰ In another example, the U.S. Attorney's Office brought charges for obstruction of justice against a Volkswagen legal counsel, whose vague instructions for record keeping gave the signal to employees to destroy evidence right around the emissions scandal revelations.³¹ Although the growing threat of liability against legal and compliance personnel has the profession up in arms, it eventually strengthens their hand vis-à-vis the board, as we argue in Part IV. By pointing to potential personal liability, legal and compliance heads are empowered to resist any undue pressure to turn a blind eye.

These developments in Delaware corporate law, federal securities law, and personal liability for legal and compliance officers are transforming the legal treatment of corporate misconduct in practice. The fines, payouts to plaintiffs, and other sanctions resulting from corporate debacles nowadays are negotiated in light of the evidence trail against management and boards left behind by legal and compliance officers. To analyze this dynamic in practice, we present case studies focusing on four mega-scandals: the General Motors ignition switch failure, the Washington Mutual collapse during the financial crisis, the security breach in Yahoo, and Wells Fargo's fake accounts fiasco.³² While legal and compliance personnel are at the heart of the inquiry in all cases, their interaction with the board in each setting is different, changing the liability outcome. Some interactions effectively shield the board from liability, as critics feared, but other interactions expose both the board and legal and compliance personnel to legal risks, in twists that prior literature did not predict. We present four different categories of interactions, which we term as follows for ease of reference: untraceable, traceable, interrupted, and incomplete.³³

Our first category, “untraceable” communications, includes settings where no evidentiary trail connects the heads of legal and compliance departments with ongoing violations or red flags, and no communication with the board happens on record. With no hard evidence of awareness, the board is off the hook, as

30. See *infra* text accompanying notes 290–95.

31. See *infra* text accompanying notes 300–06.

32. See *infra* Part V.

33. *Id.*

was the case in the General Motors (GM) ignition switch scandal. Despite settling over 100 lawsuits pointing to a potential mechanical failure, lower-tier in-house lawyers, apparently content with the small payouts to plaintiffs they secured, failed to elevate the issue to the chief legal counsel's attention.³⁴ As a result of the ensuing delay in uncovering the problem, hundreds suffered death or injury, and the company paid billions in fines, settlements, and other sanctions.³⁵ This negative outcome has predictably monopolized academic assessments of compliance, since it absolves both board and legal personnel despite their disastrous omissions. We bring to light the other scenarios below, where the outcome for corporate actors is less favorable.

Our second category, “traceable” communications, represents the polar opposite of the one above, with on-record interactions between the board and legal and compliance officers, who provide well-informed reports of employees’ illegal acts or red flags. Such a clear evidentiary link between corporate failures and the board’s state of mind is what the architects of compliance are hoping to achieve. For an illustration of this theoretical ideal on the ground, we turn to the failure of Washington Mutual (WaMu), the largest savings and loan association that collapsed during the 2007 financial crisis with assets of about \$300 billion.³⁶ WaMu’s board pursued an aggressive mortgage origination strategy, despite repeated warnings by successive compliance officers that the mortgage documentation prevented them from meeting, or even accurately assessing, the institution’s risk levels as required by law.³⁷ The resulting settlement between the board and the FDIC, who took over the floundering institution, included a rare out-of-pocket payment by board members.³⁸

As our next two categories demonstrate, interactions between the board and legal and compliance personnel are not al-

34. See ANTON R. VALUKAS, REPORT TO BOARD OF DIRECTORS OF GENERAL MOTORS COMPANY REGARDING IGNITION SWITCH RECALLS 1 (2014) [hereinafter VALUKAS REPORT], <https://www.aieg.com/wp-content/uploads/2014/08/Valukas-report-on-gm-redacted2.pdf>.

35. See *infra* text accompanying notes 324–29.

36. See Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, WALL ST. J. (Sept. 26, 2008), <https://www.wsj.com/articles/SB122238415586576687>.

37. See *infra* text accompanying notes 354–58.

38. See Kevin M. LaCroix, *A Closer Look at the WaMu FDIC Settlement*, D&O DIARY (Dec. 19, 2011), <https://www.dandodiary.com/2011/12/articles/failed-banks/a-closer-look-at-the-wamu-fdic-settlement>.

ways as clear-cut as in our first two examples. In our third setting, which we term “interrupted” communications, information about underlying violations reaches top legal and compliance officers, who never communicate it officially to the board, perhaps out of loyalty as critics fear. Although this interruption protects the board from liability, it can generate risks for legal and compliance personnel who may be seen as engineering it, as in the Yahoo example we discuss. In what became the largest cybersecurity breach in history, Russian hackers compromised over 3 billion accounts, selling personal financial information online for financial crime or espionage.³⁹ Although red flags had reached the chief legal officer of Yahoo, an independent investigation found that he neither pursued a full-scale investigation nor alerted the board officially.⁴⁰ When revelations of the hack engulfed the board, the independent investigation documented the red flags and faulted the chief legal officer for not following through.⁴¹ Protecting itself behind this lack of communication, the board publicly blamed the chief legal counsel, who promptly resigned.⁴² He now also finds himself embroiled in related litigation.⁴³ According to industry commentators and plaintiffs alike, the board used the chief legal counsel as a scapegoat.⁴⁴

In our final setting, where communications were “incomplete,” legal and compliance personnel are aware of apparent red flags, but instead of turning a blind eye they opt for half-hearted investigations and vague communications to the board. From the outside, it may seem like the compliance apparatus is humming along so as to justify the board’s good faith, but no incriminating information ever comes to the surface. If this was the strategy in

39. See *Yahoo Provides Notice*, *supra* note 6.

40. Yahoo! Inc., Annual Report (Form 10-K) 47 (Mar. 1, 2017) [hereinafter Yahoo 2016 10-K], <https://www.sec.gov/Archives/edgar/data/1011006/000119312517065791/d293630d10k.htm>; see also *infra* Part V.C.

41. Yahoo 2016 10-K, *supra* note 40 (“[T]he legal team had sufficient information to warrant substantial further inquiry . . . and they did not sufficiently pursue it.”).

42. *Id.*

43. See *Yahoo Accused of Mismanaging Millions in Humanitarian Trust Funds Intended for Chinese Political Dissidents*, COHEN MILSTEIN (Apr. 11, 2017), <https://www.cohenmilstein.com/update/yahoo-accused-mismanaging-millions-humanitarian-trust-funds-intended-chinese-political> (alleging that Yahoo executives, including Bell, turned a blind eye to the misuse of funds).

44. See David Ruiz, *Silicon Valley GCs Defend Ron Bell; Say He’s the Fall Guy*, RECORDER (Mar. 2, 2017), <http://www.law.com/therecorder/almID/1202780410330> (observing that many of Ron Bell’s colleagues supported him, even after his very public resignation).

the Wells Fargo fake accounts scandal, it clearly did not work. Opening fictitious accounts was so widespread among bank employees that even the press featured stories about misconduct.⁴⁵ For years, the chief legal and compliance officers watched over underwhelming attempts to collect information, hesitated to interview top bank executives, and submitted inconclusive reports to the board.⁴⁶ When the scandal erupted, those lackluster efforts and the shreds of evidence left behind engulfed all corporate actors. Top executives and compliance officers stepped down, had their compensation clawed back, and found themselves targeted by private plaintiffs and regulators.⁴⁷ To top it all off, the Federal Reserve took the unprecedented move of pushing for a removal of all board members, illustrating that failures of that extent are hard to tolerate.⁴⁸

We develop this argument in the paragraphs below. We first document the revolutionary growth of compliance departments in the last decade and the deep skepticism of legal academia towards that development. We then show how influential legal and compliance personnel are in creating an evidentiary path that can establish board liability, analyzing recent developments in Delaware and federal securities law. We argue that the small but growing number of cases imposing personal liability on underperforming compliance officers constitutes a backstop to undue pressures. Our case studies illustrate the application of this framework.

45. See, e.g., E. Scott Reckard, *Wells Fargo Fires Workers Accused of Cheating on Sales Goals*, L.A. TIMES (Oct. 3, 2013), <http://articles.latimes.com/2013/oct/03/business/la-fi-mo-wells-fargo-workers-fired-20131003> (discussing Wells Fargo's issues with sales pressures even before the larger fake accounts scandal broke).

46. See INDEP. DIRS. OF THE BD. OF WELLS FARGO & CO., SALES PRACTICES INVESTIGATION REPORT 11–18 (2017) [hereinafter WELLS FARGO INDEPENDENT DIRECTORS REPORT], <https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017board-report.pdf> (summarizing the findings of the report and discussing senior officers' and corporate compliance organizations' roles in allowing misconduct to continue); see also *infra* Part V.D.

47. See, e.g., *In re Wells Fargo & Co. S'holder Derivative Litig.*, No. 16-CV-05541-JST, 2017 WL 4414304, at *5 (N.D. Cal. Oct. 4, 2017); Consolidated Amended Complaint, *In re Wells Fargo & Co. S'holder Derivative Litig.*, (N.D. Cal. Feb. 24, 2017), 2017 WL 1044785; WELLS FARGO INDEPENDENT DIRECTORS REPORT, *supra* note 46, at i.

48. See Flitter et al., *supra* note 1.

I. THE COMPLIANCE EXPLOSION REACHES THE BOARDROOM

In the last ten years, the explosive growth of compliance departments has redefined the corporate landscape, demanding extraordinary resources and upending established corporate governance hierarchies. Most companies today have heavily populated compliance teams with specialized staff.⁴⁹ In fact, the costs of compliance have become so enormous that companies increasingly use “big data” technologies to monitor their records more effectively.⁵⁰ In turn, the corporate executives in charge of these small compliance armies have claimed greater attention from the board, rising to top management ranks.⁵¹ Some companies assign the role of leading the compliance function to the general counsel, while others have established dedicated chief compliance officers.⁵² Regardless of designation, these officers regularly update the board on the company’s exposure to legal risk.⁵³ Discussions on such topics as corruption, compliance and ethics, and regulatory changes are now commonplace, often built into strategic conversations about international expansion, talent development, and new product or service offerings.⁵⁴ Perhaps the best indication of the general counsels’ increased influence is their continuously rising pay, which now exceeds \$2 million on

49. See, e.g., Treanor, *supra* note 11 (noting JP Morgan Chase’s addition of 3000 compliance staff members).

50. See, e.g., *How Big Data Analytics Is Transforming Regulatory Compliance*, CREDIT SUISSE (Nov. 30, 2017), <https://www.credit-suisse.com/corporate/en/articles/news-and-expertise/how-big-data-analytics-is-transforming-regulatory-compliance-201711.html> (discussing how increasing Big Data usage led to a “45-fold increase in the number of productive alerts”).

51. See Langevoort, *supra* note 16, at 942 (noting that ethics and culture are now “an explicit compliance goal” and that companies increasingly have a Chief Ethics and Compliance Officer in order to meet this goal).

52. While there is debate among scholars as to whether the compliance function ought to be entirely separate from the general counsel, both sides agree that both positions should maintain direct access to the board, which is the foundation for our argument. See generally Bird & Park, *supra* note 13, at 204–05 (discussing the potential roles for a Chief Legal Officer in the future). But see BEN W. HEINEMAN, JR., THE INSIDE COUNSEL REVOLUTION: RESOLVING THE PARTNER GUARDIAN TENSION 441–44 (2016) (envisioning a dual-hatted Chief Legal Officer with oversight of both legal and ethical matters).

53. NAT'L ASS'N OF CORP. DIRS., 2016–2017 NACD PUBLIC COMPANY GOVERNANCE SURVEY 2 (2017), <https://www.nacdonline.org/files/2016%20Public%20Company%20Governance%20Survey%20Executive%20Summary.pdf>.

54. See *id.* (discussing generally the topics that are most frequently addressed by boards).

average for S&P 500 companies and grows larger depending on the overall size of the compliance team.⁵⁵

This Part situates our argument in the scholarly and policy literature by charting out the growth of compliance and the scholarly accounts regarding its impact. Existing work highlights that companies developed their compliance operations partly to better respond to towering criminal and regulatory sanctions, and partly because they were mandated to do so by federal law. We then explain why corporate law and business organization scholars view the ballooning of in-house legal and compliance staff with skepticism.

A. CRIMINAL ENFORCEMENT AUTHORITIES PUSH FOR COMPLIANCE

Although employee monitoring has long been a key task for corporate boards under state corporate law, the meteoric rise of compliance in recent years has been largely the result of federal intervention. Faced with a proliferation of new rules and regulations, both from Congress and from an ever-growing administrative state,⁵⁶ federal authorities looked for strategies to further incentivize private companies to toe the line.⁵⁷ Their hope was that, if better-supervised, corporate staff would be less inclined to violate the law.⁵⁸ Moreover, by instituting an internal corporate program dedicated to ensuring adherence to legal and regulatory requirements, the flow of information to regulators would improve.⁵⁹ Ultimately, the costs of compliance programs are borne by shareholders rather than the public purse.⁶⁰ Thus,

55. See EQUILAR, GENERAL COUNSEL PAY TRENDS 2016, at 8 (2016) (showing average total compensation of \$2.1 million for GCs at S&P 500 companies in 2016).

56. See, e.g., *Grudges and Kludges: Too Much Federal Regulation Has Piled Up in America*, ECONOMIST, Mar. 4, 2017, at 19 (“Between 1970 and 2008 the number of prescriptive words like ‘shall’ or ‘must’ in the code of federal regulations grew from 403,000 to nearly 963,000.”).

57. See Rachel E. Barkow, *The New Policing of Business Crime*, 37 SEATTLE U. L. REV. 435, 438 (2014) (observing that the government increased sanctions in an effort to have companies adopt more internal compliance measures).

58. See *id.* at 442–43 (2014) (“The goal of these requirements is to encourage companies to adopt programs that will help them do a better job policing, deterring wrongdoing, and creating a corporate culture of ethical and lawful behavior.”).

59. See Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2114 (2016) (“The SEC’s interventions in corporate governance have traditionally focused on measures to improve the accuracy of financial reporting.”).

60. See *id.* at 2121–28 (discussing compliance and shareholders’ role in

authorities put in place various incentives and requirements fostering the establishment of compliance programs.⁶¹

1. Fostering the Growth of Compliance

Federal criminal authorities, called on to police a burgeoning roster of corporate crimes,⁶² used their sanctioning power in order to bargain for corporate governance reforms. As early as 1991, the U.S. Sentencing Guidelines offered an up-to-ninety-five-percent reduction in penalties for companies that had previously instituted effective compliance programs.⁶³ But it was the practice of deferred prosecution or non-prosecution agreements (DPA/NPAs) that transformed compliance departments from a mitigating factor to a key sanctioning mechanism for corporations. These agreements, which represent a settlement between the Department of Justice (DOJ) and targeted companies, have become the primary tool for criminal enforcement against corporations, utilized in over sixty-three percent of cases against corporations in recent years.⁶⁴ Alongside fines or other sanctions, DPA/NPAs often require an undertaking to dramatically expand and reform the company's compliance operation.⁶⁵ Following a DPA/NPA, companies often hire hundreds of new employees to broaden the scope of their compliance efforts,⁶⁶ so as to avoid repeating the same violations in the future. Undoubtedly, eliciting

management and observing that "compan[ies] pay[] for the compliance program[s])."

61. See Paul Fiorelli, *Will U.S. Sentencing Commission Amendments Encourage a New Ethical Culture Within Organizations?*, 39 WAKE FOREST L. REV. 565, 586 (2004) ("The original organizational guidelines prompted companies to develop compliance and ethics programs.").

62. See Barkow, *supra* note 57, at 445 ("Despite increasing sanctions and the spread of corporate compliance programs . . . business crime remains a pressing problem.").

63. See Fiorelli, *supra* note 61, at 567 (finding that organizations with effective compliance programs can receive up to a ninety-five percent fine reduction).

64. BRANDON L. GARRETT, *TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS* 72 (2014).

65. See *id.*; see also Peter Spivack & Sujit Raman, *Regulating the New Regulators: Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 160 (2008).

66. See, e.g., Deferred Prosecution Agreement at 10, United States v. W. Union Co., No. 1:17-cr-00011-CCC (M.D. Pa. Jan. 19, 2017), <https://www.justice.gov/opa/press-release/file/938371/download> (mandating an improved compliance program); see also Deferred Prosecution Agreement at 6, United States v. Deutsche Bank AG, No. 3:15-cr-00061-RNC (D. Conn. Apr. 23, 2015), <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/05/22/2014-04-23-deutsche-bank-deferred-prosecution-agreement.pdf> (noting that Deutsche

the promise to hire an army of compliance officers alongside a hefty fine helps criminal authorities grab headlines and boost their standing in the business community and the nation more generally.

Legal academics were skeptical towards compliance from the very start. Criminal law scholars were puzzled by the U.S. Sentencing Guidelines' choice to offer reduced fines if a company established a compliance department.⁶⁷ It seemed like a company could get off lightly simply by committing future resources, with little assurance that crime prevention would be more effective down the line.⁶⁸ In fact, the emphasis on monitoring and procedures, hallmarks of effective compliance programs, was widely dismissed as simple "box checking."⁶⁹ Thinkers in the socio-legal tradition have questioned whether compliance staff, instead of identifying and highlighting corporate failures, suppress them due to peer pressure.⁷⁰ Legal writers have puzzled over the professional responsibilities of compliance officers who are also

Bank has significantly expanded its compliance operations); *Western Union Financial Services, Inc. Resolves Previously Disclosed Investigation by New York Department of Financial Services*, W. UNION (Jan. 4, 2018), <http://ir.westernunion.com/news/archived-press-releases/press-release-details/2018/Western-Union-Financial-Services-Inc-Resolves-Previously-Disclosed-Investigation-by-New-York-Department-of-Financial-Services/default.aspx> ("Over the past six years, Western Union increased overall compliance funding by more than 200 percent, and now spends approximately \$200 million per year on compliance, with more than 20 percent of its workforce currently dedicated to compliance functions.").

67. See generally Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007) (finding a lack of uniformity in compliance requirements and little evidence that prosecutors keep track of these reforms after they impose them); see also Fiorelli, *supra* note 61, at 567 (observing that, if a company does not establish a compliance department, it is "subject to a 400% fine multiplier").

68. See Paul Fiorelli & Ann Marie Tracey, *Why Comply? Organizational Guidelines Offer a Safer Harbor in the Storm*, 32 J. CORP. L. 467, 471, 489 (2008) (discussing how revised guidelines increased the importance of compliance programs and elevated them from being simple "check the box" programs).

69. See Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 496 (2003) (observing that effective compliance systems "contain monitoring and auditing systems"); see, e.g., Jayne W. Barnard, *Corporate Therapeutics at the Securities and Exchange Commission*, 2008 COLUM. BUS. L. REV. 793, 816–17 (2008) (noting that initial drafts of sanctions often include monitoring provisions but that monitoring is often cut in subsequent drafts).

70. See, e.g., William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1413 (1999) ("Given the role of top management in charting the course of legal and ethical compliance in corporations, it is difficult to underestimate the importance of subtle pressures to walk the fine line between law abidance and law deviation.").

in-house lawyers, thus bound by their duties to the corporate client.⁷¹

Neither of these schools of thought is particularly optimistic about compliance's ability to prevent violations and ensure adherence to the law.⁷² Rather, they betray a deep skepticism as to whether compliance would win corporate leaders' support, or whether it would remain sidelined from core corporate governance institutions.⁷³ The concern was that, as the newly-arrived hordes of compliance officers combed through the records of low-level employees, their investigations and findings might not travel up the corporate chain of command.⁷⁴

2. Compliance Enters the Boardroom

In recent years, federal criminal authorities have turned their attention towards pushing boards to open their doors to heads of compliance. DPA/NPAs often require companies to create a channel of communication through which the head of compliance can directly approach independent members of the board or senior executives.⁷⁵ Moreover, the 2010 Amendments to the U.S. Sentencing Guidelines condition any leniency in penalties on whether the person with operational responsibility for the compliance function communicates directly with the board.⁷⁶ The 2010 Amendments go further in suggesting that the head of compliance provide an annual report to the board regarding the implementation and effectiveness of the compliance program,

71. See generally Coffee, *supra* note 13 (discussing the possible roles and potential conflicts of interest for attorneys as the gatekeepers of compliance).

72. See Maurice E. Stucke, *In Search of Effective Ethics & Compliance Programs*, 39 J. CORP. L. 769, 775 (2014) (observing that the current system is not working, but that there are no guarantees that a different system would work either).

73. *Id.* (noting that "an intrinsic, ethics-based approach" has been deemphasized).

74. See Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 326 (2004) ("Reporting up the chain of command is a standard feature of internal controls and compliance programs. It is also one of the most difficult for . . . employees to meet.").

75. See, e.g., Deferred Prosecution Agreement at 11–12, United States v. VimpelCom Ltd., No. 16-cr-00137 (S.D.N.Y. Feb. 22, 2016), <https://www.justice.gov/criminal-fraud/file/828301/download> (noting the company's FCPA violations and its requirement that the company to assign compliance oversight and responsibility to one or more senior corporate executives who would report directly to the Board of Directors, or any appropriate committee of the board).

76. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f)(3)(C) (2018).

and prompt updates in case of current or potential criminal violations.⁷⁷ These reports help authorities assess whether the company's compliance department had "adequate resources" and "appropriate authority," so as to accord it with the leniency allowed by the law. By brandishing sanction relief as a payoff for reform, authorities sought to ensure that compliance heads would have no trouble garnering the board's attention, thus elevating compliance as a corporate priority.

Companies responded by setting up the institutional links required. Private consulting services sprang up to offer opinions, resources, and trainings for boards on how to effectively communicate with their compliance officer.⁷⁸ Professional associations, too, weighed in, offering specific advice regarding reporting structures, board committees, and the frequency of communication between compliance and the board.⁷⁹ As a result, heads of compliance now have the ear of top management and board members, a prerogative they can utilize to raise awareness about illegal conduct to the board. In practice, a number of surveys are revealing that compliance officers are now communicating with the board more frequently than ever before.⁸⁰ These enforcement guidelines, combined with the statutory initiatives outlined below, have gained in-house legal experts a position at the core of the action in modern corporations.

B. NEW STATUTES INSTITUTIONALIZE COMPLIANCE

Institutionalizing compliance as an internal corporate monitoring mechanism appealed not only to criminal enforcement authorities, but also to Congress and other federal regulators. For example, the Foreign Corrupt Practices Act requires truthful financial reporting practices, which would track potential bribes;⁸¹ this is now interpreted by the Securities and Exchange

77. *Id.* at cmt. 11.

78. See SOC'Y OF CORP. COMPLIANCE & ETHICS, COMPLIANCE TRAINING AND THE BOARD 2 (2017) (stating that board training is prevalent).

79. See, e.g., *About Us*, NAT'L SOC'Y COMPLIANCE PROFESSIONALS, <https://nscp.org/about-us> (highlighting "continuing education to further [compliance professionals'] knowledge and specialized skills, and regulatory involvement through representation of compliance interests").

80. See Tamina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings and New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 473 (2008) ("The large majority of respondents reported directly to the Chief Executive Officer or Chair of the Board.").

81. Foreign Corrupt Practices Act of 1977 § 103(a), 15 U.S.C.A. § 78dd-1(a).

Commission (SEC) as essentially mandating a thorough compliance effort.⁸² At other times, Congress has instituted a specialized compliance process, such as the anti-money laundering suspicious activity reporting.⁸³ Along these lines, a large number of congressional statutes institutionalize compliance processes in a range of fields such as environmental standards, healthcare, bioethics, privacy, and intellectual property.⁸⁴ Our goal here is not to provide an exhaustive list, but to underline the importance of compliance as a policymaking tool.

There are two legislative efforts that garnered national attention not only because of their subject matter and ambition, but also because they had compliance at their core: the 2002 Sarbanes-Oxley Act,⁸⁵ and the 2010 Dodd-Frank Act.⁸⁶ In both cases, a series of high-profile corporate scandals rocked confidence in national markets, and Congress responded not only through new substantive rules, but also by demanding internal reforms from corporations.

Sarbanes-Oxley essentially ushered in a federal requirement to bolster accounting compliance in public companies, which boards often implemented by hiring more compliance professionals. Coming on the heels of massive accounting fraud at Enron, WorldCom, and other companies,⁸⁷ the Sarbanes-Oxley Act mandated that all public companies build effective internal control departments, which would monitor front-line employees

82. The books and records provision of the FCPA is implemented by SEC Rule 13b2-1. See 17 C.F.R. § 240.13b2-1 (2018) (“No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.”).

83. See Stavros Gadinis & Colby Mangels, *Collaborative Gatekeepers*, 73 WASH. & LEE L. REV. 797, 870 (2016) (discussing the Annunzio-Wylie Act and noting that it “did not define what constitutes suspicious activity, nor did it elaborate on the steps that U.S. financial institutions must take in order to comply with this obligation”).

84. See generally Todd S. Aagaard, *Environmental Law’s Heartland and Frontiers*, 32 PACE ENVTL. L. REV. 511 (2015) (highlighting environmental statutes related to compliance); Kenneth A. Bamberger & Deirdre K. Mulligan, *Privacy on the Books and on the Ground*, 63 STAN. L. REV. 247 (2011) (discussing privacy regulation and compliance).

85. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.).

86. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 204, 124 Stat. 1376, 1454 (2010) (“It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States.”).

87. See Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 128 (2003).

and ensure that accounting was based on correct information.⁸⁸ To further ascertain the effectiveness of internal monitoring, Sarbanes-Oxley enlisted the help of external auditors, who, along with the company's CEO and CFO, were required to review internal controls and attest to their adequacy.⁸⁹ Besides accountants, the Sarbanes-Oxley reforms also touched upon other gatekeepers, such as securities attorneys, as we discuss below.⁹⁰ Fifteen years after their passage, whether the Sarbanes-Oxley reforms have managed to stem accounting misstatements is very much in doubt.⁹¹ But these reforms certainly puffed up compliance departments, which found themselves with a broader scope of work and additional firepower.

As the 2007 financial crisis fueled further mistrust in companies' management, Congress responded by adopting the 2010 Dodd-Frank Act. The sheer size and complexity of Dodd-Frank, which introduced over 27,000 new restrictions by some counts,⁹² made compliance departments indispensable to companies that hope to avoid breaking the law. But Dodd-Frank also included some reforms specifically geared towards compliance. Importantly, it introduced a whistleblower regime, which allows the SEC to offer to informants bounties that amount to ten to thirty percent of overall sanctions, sometimes reaching tens of millions of dollars.⁹³ Although the SEC does not require whistleblowers to address their internal compliance chiefs before alerting the agency, many of them do, and thus companies have developed compliance policies so as to better handle whistleblower complaints. Moreover, Dodd-Frank required certain private financial firms that are not tightly regulated, such as those sub-

88. Sarbanes-Oxley Act §§ 301–02.

89. See Catherine Shakespeare, *Sarbanes-Oxley Act of 2002 Five Years On: What Have We Learned?*, 3 J. BUS. & TECH. L. 333, 335 (2008) (“Section 404 requires an annual audit of management’s assessment of the effectiveness of the internal control.”).

90. See *infra* text accompanying notes 237–41.

91. See John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91, 96 (2007).

92. See Patrick McLaughlin & Oliver Sherouse, *The Dodd-Frank Wall Street Reform and Consumer Protection Act May Be the Biggest Law Ever*, MERCATUS CTR. GEO. MASON U. (July 20, 2015), <https://www.mercatus.org/publication/dodd-frank-wall-street-reform-and-consumer-protection-act-may-be-biggest-law-ever>.

93. Dodd-Frank Act §§ 922(b)–(c), 929A (2010) (amending 18 U.S.C. § 1514A).

ject to the 1940 Investment Advisers Act, to develop a compliance department and designate a chief compliance officer.⁹⁴ Overall, the role of compliance chiefs became even more prominent after Dodd-Frank.

The successive reforms of Sarbanes-Oxley and Dodd-Frank broadened the scope of compliance operations and introduced new institutional links between in-house monitors and traditional corporate organs, such as the board and its committees. These congressional efforts aligned with the DOJ's corporate enforcement strategy to strengthen the position of compliance heads and other in-house legal experts within the corporate hierarchy. Yet, whether in-house legal experts would fulfill policy-makers' expectations, and in what fashion, remained highly debated. As we outline below, corporate law scholars are generally very skeptical about whether legal and compliance experts can effectively supervise their employers.

C. CORPORATE LAW SCHOLARS DISTRUST COMPLIANCE

As a government-motivated reform, compliance poses particular challenges for a body of law that prioritizes individuals' freedom of contract, such as corporate law.⁹⁵ Particularly after the 2002 Sarbanes-Oxley Act, corporate law thinkers sought to understand how compliance fits within the constellation of actors that constitute or revolve around the modern corporation.⁹⁶

Business law had long enlisted the help of private actors outside the corporation, such as accountants, bankers, and attorneys, to monitor it in key moments, such as securities offerings. These professionals, termed "gatekeepers,"⁹⁷ assure investors that a company's disclosures are accurate by putting their reputation on the line. On top of these reputational incentives, the law imposes liability on gatekeepers who fail to perform their due diligence duties and let corporate fraud go undetected. As monitoring is also one of compliance's central goals, legal and compliance officers were swiftly categorized by legal academia

94. 15 U.S.C. § 80b-3(e)(6) (2012); 17 C.F.R. § 275.206(4)-7 (2018).

95. See Griffith, *supra* note 59, at 2130 (arguing that "corporate governance is inconsistent with current theories of the firm" which are based on contract).

96. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) ("The Sarbanes-Oxley (SOX) Act . . . is not just a considerable change in law, but also a departure in the mode of regulation.").

97. See Reiner H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 54 (1986) (explaining the concept of gatekeepers).

as another type of gatekeeper. Indeed, these in-house monitors share many of the characteristics of the outside gatekeepers. They are both part of a professional class with expertise that provides them with the skillset necessary to perform their monitoring task. Importantly, it is the failure in monitoring others' misconduct, rather than their own misconduct, which puts outside gatekeepers and internal legal and compliance experts in trouble.

As corporate lawyers set out to analyze compliance through the lens of gatekeeper theory, their predictions were, unsurprisingly, quite dire. As gatekeepers, in-house legal and compliance officers are quite weak. Unlike most other professionals, who have a roster of clients, in-house experts work exclusively for a single company, and are thus more likely to succumb to pressure from management.⁹⁸ Moreover, their long association with a single company may blunt their instincts and normalize illegality.⁹⁹ This behavioral bias might be particularly potent for lawyers, who are likely to prioritize loyalty to clients rather than gatekeeping.¹⁰⁰ Faced with these pressures, in-house compliance experts might choose to hole themselves in their offices and avoid evidence of wrongdoing.¹⁰¹ Although these pressures are common for other gatekeepers, they are counterbalanced by the threat of liability if gatekeeper approval is provided without proper due diligence. But laws rarely require in-house legal and compliance experts to provide their approval for a transaction.¹⁰² Without the threat of liability for failing to adequately monitor,

98. See JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 146 (2006).

99. See Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955, 968 (2005) ("[T]o the extent general counsel participates at an early stage in shaping major transactions and corporate policy, counsel's ability to bring detached, professional judgment to bear in assessing their legality may be compromised, especially when the question of legality is tinged in shades of gray as opposed to black and white."); see also Kim, *supra* note 14, at 1037 ("Inside counsel are subject to situational pressures . . . that induce them to acquiesce in managerial fraud.").

100. See William H. Simon, *Whom (Or What) Does the Organization's Lawyer Represent?: An Anatomy of Intraclient Conflict*, 91 CALIF. L. REV. 57, 89 (2003); see also Langevoort, *supra* note 16, at 957–58 ("[L]awyer self-interest and client self-interest are more likely to converge in cognition and corporate culture, so that in-house lawyers, especially, are not particularly reliable enthusiasts for the socially optimal compliance point.").

101. See Kim, *supra* note 14, at 1026 ("Even in the face of unethical conduct, conformity pressures . . . can lead inside lawyers to remain silent and not risk the consequences of whistle-blowing.").

102. See *infra* Part IV.

these in-house officers have less of an incentive to do an objectively diligent job and little to fall back on when pressured to turn a blind eye.

For all its analytical consistency, the gatekeeper-based portrayal of compliance is, we argue, theoretically misdirected and incomplete. It expects in-house lawyers to act as enforcers, which is not in line with either the powers entrusted to them by law or with any realistic expectations of what they can achieve. Moreover, the gatekeeper model leaves out the most important contribution of in-house legal experts. While in-house legal experts may not be able to prevent corporate leaders from behaving illegally, they can make it easier to hold corporate leaders responsible when wrongdoing occurs. This power places them at the center of corporate action, we argue in Part II below, rather than at the periphery, as current literature seems to suggest.

II. DELAWARE'S STRICTNESS PROPELS IN-HOUSE LEGAL EXPERTS TO THE FOREFRONT

Even though legal and compliance experts operate largely in the absence of strict statutory mandates and regulatory requirements, as discussed above, they are far from powerless. The advent of compliance programs, alongside state and federal rulings emphasizing the board's supervisory duties, have provided legal and compliance experts with a direct reporting avenue to the board. They submit to the board information about employees' compliance with the law, identifying potential issues as they arise from their monitoring and their other interactions. On their own, these reports do not have any direct legal consequences. The board is free to choose how much attention to pay, whether to investigate further, or whether to table the matter. From a legal status standpoint, these reports do not amount to anything more than an informal private document.

Yet, we argue, if the issue highlighted in a report becomes the center of an enforcement action by regulators or a class action by private parties, the importance of the report changes dramatically. As we discuss below, under both current fiduciary duty law and federal securities regulation, plaintiffs would ideally want a paper trail connecting the violation they have spotted with the board. This paper trail can be readily found in the legal and compliance experts' reports. Coming at the heels of an extensive investigation by a dedicated compliance department, internal reports can describe in extensive detail the underlying

misconduct. Their primary drafters are either lawyers themselves or assisted by others with legal training, and they are thus likely to cover all the aspects necessary to ensure a violation is established, as prescribed by law. By offering the evidence connecting the company with victims' claims or exposing directors to liability towards shareholders, these reports can radically alter the legal landscape for the board and its executive officers.

Pulling together all the elements discussed above reveals how explosive such a report can prove for the company's board. Before receiving this report, the board could validly claim that it had no direct knowledge of the circumstances giving rise to underlying violations by its employees, and was largely unsuspecting of the extent of the problem. That assertion may portray the board as negligent, but it also relieves its members of any liability, since negligence still falls within the contours of good faith. Once a damning internal legal report lands before the board, however, it shatters the safe haven of negligence and forces the board to confront reality. The more detailed the description, the more plentiful the examples, the more thorough the investigation, the less room the report allows the board to wiggle out of awareness, forcing directors to face the prospect of personal liability.

The transformative impact of well-informed legal reports is very much due to a much-bemoaned turn in Delaware case law in the landmark 2006 *Stone v. Ritter* ruling.¹⁰³ In *Stone*, the Delaware Supreme Court declared unambiguously that only bad faith could render directors and officers liable for failing to monitor illegal activity.¹⁰⁴ Much of the corporate law literature lamented such a high standard, as we discuss below,¹⁰⁵ viewing it as practically impossible to clear. Yet, our assessment of over ten years of Delaware jurisprudence shows otherwise. The explosive growth of internal legal and compliance departments is filling the gap, allowing legal and compliance experts to accumulate the necessary information and communicate it to the board. In doing so, we argue, they drastically alter directors' and officers' liability calculus. Below, we analyze Delaware's compliance doctrine, showing how in-house legal experts are instrumental in guiding the board's state of mind in every step.

103. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

104. *Id.* at 370.

105. See *infra* Part II.B.

A. BAD FAITH AS A FOUNDATION OF DELAWARE'S COMPLIANCE DOCTRINE

Delaware courts' first major step into the realm of compliance came with *In re Caremark*, now a mainstay of Delaware jurisprudence. *Caremark* targeted what Chancellor Allen, who wrote the case's decision, termed "an unconsidered failure of the board to act," rather than a harmful or unprofitable management action.¹⁰⁶ Shareholders complained that the board had failed to spot and prevent illegal activity that, having unfolded for years, landed the company in million-dollar fines.¹⁰⁷ Generally, the law does not prohibit inactivity, unless circumstances exist that should prod defendants to action.¹⁰⁸ Thus, to determine whether failure to act was actionable, Allen had to determine the conditions under which the board had an obligation to monitor employees in the first place.¹⁰⁹

For Allen, the stakes could not have been higher. Since its 1963 ruling in *Graham v. Allis-Chalmers Manufacturing Co.*, the Delaware Supreme Court had declared that boards ought to react when they face red flags suggesting illegality.¹¹⁰ But in companies with thousands of employees like *Caremark*, operating in highly regulated industries such as health care, boards would only rarely come across such red flags in their regular course of business. Thus, it was clear to Allen that boards could not, in good faith, stand back and wait for illegality to become known; rather, their duty should be to seek out these illegalities through active monitoring.¹¹¹ And yet, no board could ever hope to catch all the illegal conduct of its subordinates, no matter how hard it tried. If drawn too broadly, boards' duty to monitor could engulf all boards in liability, as any employee misconduct is likely to look preventable in hindsight.

106. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. 1996).

107. *See id.* at 964.

108. *See id.* at 971 (holding that directors could only be held liable for failure to act if they "should have known that violations of the law were occurring and . . . took no steps in a good faith effort to prevent or remedy that situation").

109. *See id.*

110. *See Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (holding that if a corporate director "has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him").

111. *See Caremark*, 698 A.2d at 970 ("[I]t is important that the board exercise a good faith judgment that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.").

To balance these opposing considerations, *Caremark* set the foundations of a two-pronged claim, now known as a *Caremark* claim, that defines Delaware jurisprudence in this area.¹¹² The first prong directs boards to set up a compliance system. *Caremark* does not specify the components of this system, leaving this choice to the board.¹¹³ However, the compliance system must be adequate “in concept and design” so that the board can expect, in good faith, to receive accurate and timely information about employee misconduct.¹¹⁴

The second prong of a *Caremark* claim turns its focus on whether the board, after setting up the compliance system, fully discharges the obligations that derive from that system.¹¹⁵ The Delaware Supreme Court, which espoused and developed the *Caremark* test in *Stone*, emphasized that the Board in that case actually heard presentations from compliance heads and monitored the operation of the compliance department closely through its Audit Committee.¹¹⁶ If the board is shown to have received information pointing to illegal actions by company employees, then Delaware law evaluates the board’s reaction, scrutinizing its good or bad faith in doing so.¹¹⁷

The realm of activity that fell outside *Caremark*’s two-pronged test, and relieved the board from any liability, was as important as the scope of misconduct it captured.¹¹⁸ Crucially, the gap between *Caremark*’s two prongs is considerable.¹¹⁹ It is highly likely that a board could set up a state-of-the-art compliance system, which nevertheless fails to capture employee misconduct that turns out to be highly detrimental for the company. After all, if every instance of employee misconduct resulted in liability for the board, the law would equate “bad outcome[s] with bad faith.”¹²⁰ As *Stone* clarified, Delaware courts will impose liability only if they are convinced that the board acted in bad faith, i.e. that it either evidently knew, or it can be reasonably inferred that it was aware, of underlying violations of law.¹²¹

112. See *id.* at 967–70; see also *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 364 (Del. 2006).

113. See *Caremark*, 698 A.2d 95 at 970.

114. See *id.*

115. See *id.* at 967–71.

116. See *Stone*, 911 A.2d at 372.

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

118. *Id.* at 967–71.

119. *Id.* at 971.

120. *Stone*, 911 A.2d at 373.

121. *Id.* at 370.

Mindful of the risk that any violations undetected by the company's compliance system could be used as evidence of its inadequacy with hindsight, Chancellor Allen declared that only a "sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information system exists—will establish the lack of good faith that is a necessary condition to liability."¹²² Bad faith is the necessary element that plaintiffs need to prove in order to establish that the board has been disloyal to shareholders.¹²³

B. CORPORATE LAW SCHOLARS DEBATE BAD FAITH

Once *Stone* elevated bad faith to the key ingredient of a *Caremark* claim, many corporate law scholars reacted with exasperation. The general expectation was that the bad faith requirement would render a *Caremark* claim even harder to establish than previously thought.¹²⁴ For some, the inquiry into the subjective motives of the board, which investigating bad faith invites, detracts from the goal of setting up an objectively adequate compliance system.¹²⁵ By delegating the setup of its compliance operation to reputable outside experts, a board could easily establish a good faith belief in the adequacy of its system, satisfying the first prong of a *Caremark* claim. When misconduct arises, despite the otherwise adequate compliance system, plaintiffs bear the considerable burden of showing that the board acted in bad faith, knowingly disregarding red flags. Putting their finger on such evidence, critics feared, would often prove exceedingly hard for plaintiffs. After all, Chancellor Allen himself intended a *Caremark* claim to be "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."¹²⁶

For these reasons, *Stone* seemed to further fuel preexisting concerns that compliance could act as a shield—or even just a smokescreen—behind which the board can readily hide to evade its duties.¹²⁷ Some lost faith in *Caremark*'s ability to discipline

122. *Caremark*, 698 A.2d at 971.

123. *Id.*

124. See Arlen, *supra* note 20, at 343.

125. See Griffith, *supra* note 59, at 2111 ("Corporate law looks to the motives of the board in implementing the system rather than the efficacy of the system itself.").

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

127. See Krawiec, *supra* note 69, at 491 (arguing that "internal compliance structures do not deter prohibited conduct within firms, and may largely serve a window-dressing function that provides both market legitimacy and reduced

boards, and stoically placed their hopes on federal laws and agency regulations, which could quickly outpace *Caremark* by imposing stricter standards.¹²⁸ Others called for adjusting *Caremark* liability to include shaming sanctions, arguing that corporate actors care about their reputation as much as they care about board liability.¹²⁹ When the 2007 financial crisis revealed that internal compliance leaves many risks unchecked, particularly non-legal ones,¹³⁰ there was widespread fear that the doctrine was failing its promises.

Against this opprobrium of criticism, defendants of *Stone* fought back by arguing that imposing liability on a good faith independent director would torpedo the foundations of modern corporate law.¹³¹ In this account, good faith encapsulates the business judgment rule, which allows boards to take entrepreneurial risks without constant fear of liability. The discretion that *Caremark* allows directors in establishing a compliance system should be celebrated, rather than maligned, because it preserves board autonomy.¹³² At least, critics' tepid reaction to *Stone* might seem premature, especially since federal securities doctrine was also exploring concepts related to bad faith and succeeding in striking a good balance.¹³³

Even though *Stone*'s critics and proponents fiercely disagree on the amount of effort and resources boards should devote to monitoring, they both view *Stone*'s bad faith requirement as largely protective of boards. Our task below is to explore the extent of this protection, analyzing over ten years of jurisprudence in light of the bad faith requirement. The results of our study hold surprises for both camps above. We show that, even though

legal liability"); Stucke, *supra* note 72, at 832 (noting that "too many ethics programs remain ineffective and corporate crime persists").

128. See Mercer Bullard, *Caremark's Irrelevance*, 10 BERKELEY BUS. L.J. 15, 50 (2013).

129. See David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1850 (2001).

130. See John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 67 (2014); Christina Parajon Skinner, *Misconduct Risk*, 84 FORDHAM L. REV. 1559, 1564 (2016).

131. See Strine et al., *supra* note 21; see also Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1770 (2007).

132. See Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1675–76 (2001).

133. See Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719, 738–39 (2007).

bad faith is indeed very hard to prove, it is not as impossible to establish as critics might have feared. Rather, compliance officials and legal counsel can, and often do, ring the alarm that precludes the board from remaining inactive.

C. LEGAL AND COMPLIANCE OFFICERS AS ARBITERS OF BAD FAITH

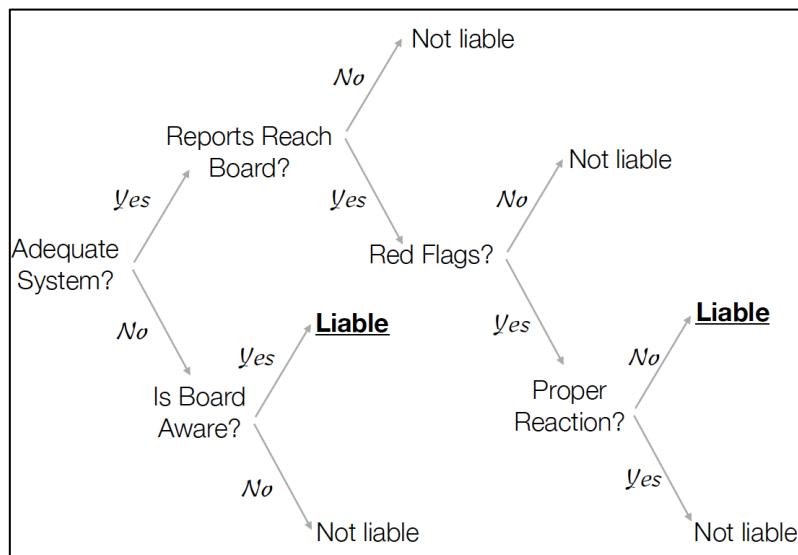
The ability of legal and compliance officers to determine whether the board remains in good faith or enters into bad faith comes, perversely, from the careful efforts of Delaware courts to prescribe director liability for violations of law by subordinates. In the decade since *Stone* was decided, a large set of judicial opinions have been continuously trying to delineate the circumstances where directors behaved in bad faith, and distinguish them from situations where the board showed appropriate loyalty and care but calamity nevertheless ensued. To follow *Stone*'s focus on bad faith, courts sought concrete, specific evidence, capable of drawing a direct link between what happened on the ground and what the board knew about it.¹³⁴ In case after case, courts were able to find this direct link when they were faced with an internal report, typically by a legal expert or compliance officer, informing the board about the underlying problem, as we show below.¹³⁵

Below, we trace the doctrinal edifice that Delaware jurisprudence has built on the *Caremark* foundations, and outline the inflection points developed for each prong. Figure 1 provides visual guidance. We show that, in every step along the way, courts turn to in-house legal experts and their work in order to determine boards' good or bad faith.

134. See, e.g., Guttman v. Huang, 823 A.2d 492, 507 (Del. Ch. 2003) ("[T]he complaint does not plead a single fact suggesting specific red—or even yellow—flags were waved at the outside directors.").

135. See, e.g., Rosenbloom v. Pyott, 765 F.3d 1137, 1151–57 (9th Cir. 2014); Westmoreland Cty. Emp. Ret. Sys. v. Parkinson, 727 F.3d 719, 726–30 (7th Cir. 2013); *In re Pfizer Inc. S'holder Derivative Litig.*, 722 F. Supp. 2d 453, 460 (S.D.N.Y. 2010); Horman v. Abney, No. 12290-VCS, 2017 WL 242571, at *8 (Del. Ch. Jan. 19, 2017); *In re Massey Energy Co. Derivative & Class Action Litig.*, No. 5430-VCS, 2011 WL 2176479, at *7–13 (Del. Ch. May 31, 2011).

Figure 1. Steps in the Caremark Framework



D. HAS THE BOARD ESTABLISHED AN ADEQUATE COMPLIANCE SYSTEM?

It is not often that courts find a company that has utterly and systematically failed to set up a compliance system, as Chancellor Allen directed them to determine.¹³⁶ But when they do, courts typically underline the role of lawyers and compliance officers in allowing these failures to continue.

1. Is There an Adequate Compliance System?

Although *Caremark* itself does not provide a definition of an adequate compliance system, courts have looked at current practice to reach this assessment. Features such as an Audit Committee that meets frequently, a well-populated compliance department, regular reviews, and board level discussions will help courts conclude that the compliance system is adequate. In *Guttmann v. Huang*, Vice-Chancellor Strine underlined the importance of presenting the court with such data about the operation of the compliance system.¹³⁷ He also made clear that, since the burden of proving compliance inadequacy falls on plaintiffs,

^{136.} See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

^{137.} *Guttmann*, 823 A.2d at 507–08.

they are much more likely to convince the court if they first submit an official request for the books and records of the company, which can provide them with the relevant information.¹³⁸ This inquiry tends to emphasize processes, rather than outcomes, as critics are quick to point out. But processes such as these are often at the hands of lawyers, who may find themselves in charge of designing and running the system. For that reason, they may end up targeted by the court.

Only extreme defects will lead courts to find a virtual lack of a compliance system. One such example involves a company that had made no actual effort nor taken any steps to establish a financial reporting system, despite Sarbanes-Oxley's clear pronouncements.¹³⁹ Eventually, fraudulent accounting, underpaying taxes, and double-borrowing on receivables drove the company to bankruptcy. The court did not hesitate to fault the company's top lawyer, even though he was not a board member, for failing to establish any reporting system that would track those failures and refer them to the SEC.¹⁴⁰ Another case, *Rich ex rel. Fuqi International v. Yu Kwai Chong*, involves a jewelry company that went bankrupt less than a year after its IPO.¹⁴¹ The board had taken some steps towards creating a compliance department, e.g., by creating an Audit Committee.¹⁴² But there was so little monitoring on the ground that the company failed to accurately record purchases, payments, and even its diamond inventory.¹⁴³ The court found that the existing compliance system was not meaningful.¹⁴⁴

2. Is the Board Aware of Failures in Its Compliance System?

Rather than on the virtual absence of a compliance apparatus, such as discussed above, *Caremark* claims often focus on a sizeable gap in an otherwise extensive and well-resourced compliance system. This gap will have come to light after a huge public scandal, perhaps one involving numerous tort victims, violations of regulatory requirements, and sometimes criminal

138. *Id.* at 504.

139. Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262 (2012).

140. See *Miller v. McDonald* (*In re World Health Alts., Inc.*), 385 B.R. 576, 592–95 (Bankr. D. Del. 2008) (explaining that the test promulgated by *Caremark* is applicable to officers of a company, not just directors, and applying the test to the in-house general counsel).

141. 66 A.3d 963, 967–71 (Del. Ch. 2013).

142. *Id.* at 982.

143. *Id.* at 983.

144. *Id.*

charges. However, the existence of regular compliance processes does not allow the court to conclude that the board has utterly failed in its monitoring mission. Yet, the gap in the compliance system is not without consequences. Plaintiffs can still claim that the board was aware of the problem, but failed to take any action to remedy it. This failure of oversight is rooted in bad faith, and is one in which lawyers can play a major part.

This type of claim was at the heart of GM's ignition switch scandal.¹⁴⁵ Due to a design defect, the switch malfunctioned and turned off the car engine at critical moments, also preventing the airbags from launching.¹⁴⁶ Although GM employees received numerous reports and lawsuits about the problem, the board remained unaware of the specifics until long after it should have.¹⁴⁷ Plaintiffs had little trouble convincing the court that there was a gap in GM's compliance process, at least in hindsight, aided in large part by the independent investigation ordered by GM's new management.¹⁴⁸ More specifically, there were multiple board committees with vague and potentially overlapping risk oversight mandates, which blunted board members' focus.¹⁴⁹ The technical department charged with collecting data and submitting reports required by the National Highway Traffic Safety Agency (NHTSA) was slow and underperforming.¹⁵⁰ Although NHTSA had complained to the head of that department, and some officers knew about these complaints, they were never discussed with the board.¹⁵¹ Finally, the legal department had received many lawsuits involving ignition switch failures, but had managed to settle these at or below a \$5 million cutoff, and thus avoided involving the General Counsel, who could have informed the board if he had known.¹⁵² Together, vagueness in board committee mandates, subpar data collection and reporting by the technical team, and misplaced cutoffs for the legal team, combined with a lack of initiative by subordinates, resulted in a gap in the GM compliance system, as the court accepted.¹⁵³

145. *In re Gen. Motors Co. Derivative Litig.*, No. 9627-VCG, 2015 WL 3958724, at *11 (Del. Ch. June 26, 2015), *aff'd*, 133 A.3d 971 (Del. 2016).

146. *Id.* at *2.

147. *Id.*

148. *See id.* at *4–9.

149. *See id.*

150. *Id.* at *8.

151. *Id.*

152. *Id.*

153. *Id.* at *17.

But, besides identifying a gap in the company's compliance processes, plaintiffs must also convince the court that this gap reflects bad faith on the board's behalf.¹⁵⁴ To establish bad faith, plaintiffs must show that the board was aware that its compliance process was not operating properly, and failed to take any remedial action regardless.¹⁵⁵ For example, a compliance report alerting the board of the looming gap would help to establish its bad faith. In GM's case, the plaintiffs were only able to point to reports that identified broad safety risks that called for greater attention.¹⁵⁶ Although these reports referred generally to quality control, none mentioned anything specific about the ignition switch problem.¹⁵⁷ The court saw these reports as lacking in specificity, and found that the board's decision to take risk mitigation measures by delegating oversight to top management sufficiently responsive.¹⁵⁸

In their search for bad faith, courts often look for motives. For example, an impending acquisition might help explain why the board was likely to disregard indications of overstated earnings.¹⁵⁹ Considerable profits from illegal activity might help explain why the board was keen to disregard red flags.¹⁶⁰ Both Chancellor Glasscock and Justice Vaughn suggested at the Supreme Court hearing of the appeal against GM that they would have been more likely to find bad faith if plaintiffs were able to point to a specific motive behind the compliance failure.¹⁶¹ Yet, plaintiffs at GM were only able to point to idleness and a stultified, bureaucratic culture within the company as the core roots of the problem.¹⁶² The court swiftly categorized these as indications of negligence, in all likelihood, but certainly not bad faith.¹⁶³

The plaintiffs, lacking outright evidence of bad faith, sought an alternative ground for their claims in recklessness.¹⁶⁴ To

154. *See id.* ("Pleadings . . . indicating that directors did a poor job of overseeing risk in a poorly managed corporation do not imply director bad faith.").

155. *Id.* at *11–12.

156. *See id.* at *17.

157. *Id.* at *14.

158. *Id.* at *16–17.

159. *See Miller v. McDonald (In re World Health Alts., Inc.),* 385 B.R. 576, 584–85 (Bankr. D. Del. 2008).

160. *See Guttman v. Huang,* 823 A.2d 492, 507–08 (Del. Ch. 2003).

161. *In re Gen. Motors Co. Derivative Litig.*, 2015 WL 3958724 at *16.

162. *Id.* at *15.

163. *Id.* at *17.

164. *Id.* at *11.

show that the board was reckless in not monitoring a situation more closely, plaintiffs drew the court's attention to exogenous circumstances requiring more intense monitoring.¹⁶⁵ For example, plaintiffs in *In re Goldman Sachs* argued that, by setting up a highly competitive compensation structure, the board should have expected that some employees would be tempted to bend ethics rules.¹⁶⁶ In other words, the mere change in the compensation structure should have heightened the board's compliance efforts.¹⁶⁷ Ultimately, this argument relies not on actual red flags, i.e., violations on the ground, but on the higher likelihood of violations. As we will see below, arguments about the increased risk of legal problems, but without examples of such problems already reaching the board, have failed to convince courts that directors have not satisfied their duties.¹⁶⁸

In contrast, when the board is found to have certain and indisputable warnings about problems in its compliance efforts, and a clear motive to disregard these warnings, courts are more willing to find bad faith. Such an indisputably clear warning to the board about compliance failures often comes in the form of regulatory action requiring the company to intensify its compliance efforts. In *Westmoreland v. Parkinson*, a pharmaceutical company had agreed that one of its products, a medical pump, could cause serious harm to patients and undertook to put in place a compliance effort to recall and repair these devices.¹⁶⁹ At first, the board invested significant effort and resources into compliance.¹⁷⁰ But when the company came up with a brand new pump, the board cut the budget of its compliance efforts in half, and directed its attention toward promoting the new pump.¹⁷¹ Throughout this period, regulators continued sending warnings to the board, thus putting directors on notice that violations were ongoing.¹⁷² The board's strategic choice to promote sales of the new pump instead of repairing the old, faulty one provided the court with the motive it required, to find that the board had

165. *Id.* at *16–17.

166. *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. 5215-VCG, 2011 WL 4826104, at *2 (Del. Ch. Oct. 12, 2011).

167. *See id.* at *19.

168. *See infra* Part II.E.1.

169. *Westmoreland Cty. Emp. Ret. Sys. v. Parkinson*, 727 F.3d 719, 722 (7th Cir. 2013).

170. *Id.* at 722–23.

171. *Id.* at 726.

172. *Id.* at 727.

acted in bad faith in reducing the intensity of its compliance efforts.¹⁷³

E. HAS THE BOARD FULLY DISCHARGED ITS OBLIGATIONS ARISING FROM ITS MONITORING SYSTEM?

After approving a compliance system in line with current practices, boards can readily satisfy *Caremark*'s first prong. However, compliance systems are not intended as a one-time adoption of a rulebook, nor as a task fully delegated to others, but as an ongoing framework for constant monitoring. The purpose of this compliance system is to keep the board informed, generating "red flags" that alert the board when employees look like they are misbehaving. Thus, when illegal activity surfaces, unavoidably the focus turns on whether the board has fully performed its monitoring role. Plaintiffs, often bolstered by multi-million dollar settlements with victims, regulators, and criminal authorities, will rush to claim that, if failures of such magnitude escaped the board's attention, it surely was a disloyal board.

These claims are unlikely to go very far in Delaware courts. Time and again, Delaware judges have stated that a *Caremark* claim must state with "particularized facts" the allegations of failure on behalf of the board as well as its bad faith.¹⁷⁴ To satisfy this standard, plaintiffs must be able to connect the failure in question with each specific member of the board. In practice, plaintiffs need to show that the board was aware of indications of illegality, that these indications amounted to "red flags" that should set the board in motion, and that the board's reaction to these red flags was lacking. Courts often consider the three steps above in one swoop, but the paragraphs below separate them for analytical purposes.

Delaware's insistence on particularized evidence of monitoring failure and bad faith had an unforeseen consequence. Circumstantial evidence, such as meetings or risk warnings, will be heavily discounted by courts. In contrast, internal legal and compliance reports, which inform the board in writing about the results of a thorough examination, are among the few documents that can easily exceed the evidentiary bar.

173. *Id.* at 728–30.

174. See *infra* notes 176–80 and accompanying text (collecting Delaware cases that set the parameters of a *Caremark* claim).

1. Have Red Flags Reached the Board?

When Delaware courts demand particularized evidence of awareness, they require specific communications addressed to each individual defendant that express the underlying red flags in no uncertain terms. Preferably, these communications will be addressed to the board as a whole. If addressed to one member, or to one committee, then they provide evidence of awareness only as far as the recipient or committee members are concerned, but courts will require further evidence that the reported facts were communicated to other directors.¹⁷⁵

Identifying evidence of board awareness has become more palatable in today's digital world, where details of meetings and presentations are readily available. Delaware courts have underlined that plaintiffs' chances of convincing the court about a *Caremark* claim are much higher after they examine the company's books and records, typically granted only after a formal request from the court.¹⁷⁶ Thus, plaintiffs have poured over company documents to unearth instances showing that information about violations had indeed reached the board.

In their efforts, plaintiffs repeatedly stumble across a key limitation. Reports of employees' violations, or strong indications of misconduct, may reach the level of senior staff within the company hierarchy, but do not get elevated to the board or to top management. In *Desimone v. Barrows*, an anonymous internal report that outlined how senior employees orchestrated stock options backdating reached only one officer in the accounting department.¹⁷⁷ Then-Vice Chancellor Strine not only rejected the argument that the board had knowledge, but pointed to the memo, which outlined employees' efforts to get around the compliance system, as evidence that the board had no reason to suspect that something was amiss.¹⁷⁸

Even direct and damning evidence of legal misconduct, such as investigations by regulators into the company, must be clearly shown to have reached the board. This requirement underlines the crucial role of legal officers, who get to control the inflow of

175. See *Guttman v. Huang*, 823 A.2d 492, 506–08 (Del. Ch. 2003) (explaining that the plaintiff failed to plead sufficient particularized factual allegations that would suggest the company's independent directors were aware of any red flags).

176. *Id.* at 504 (noting the plaintiff's failure "to use the books and records device . . . to prepare a solid complaint").

177. 924 A.2d 908, 940 (Del. Ch. 2007).

178. *Id.* at 939–40.

information to the board. In *Horman v. Abney*, plaintiffs pointed to a meeting between the vice-president of legal and compliance and the audit committee, but the minutes indicated that they talked only about “significant matters and trends.”¹⁷⁹ This circumspect wording prevented the court from inferring that the meeting included a discussion about ongoing violations of law by company employees, or about a federal investigation concerning these violations.¹⁸⁰ Even when reports of the federal investigation appeared in an internal memo, there was no evidence that the memo ever reached the board, or that it was discussed in subsequent meetings with legal officers.¹⁸¹ Similarly, in *In re SAIC*, a whistleblower report that never reached the board failed to rise to a *Caremark* red flag.¹⁸² In the court’s own words, “Delaware courts have consistently rejected . . . the inference that directors must have known about a problem because someone was supposed to tell them about it.”¹⁸³

In plaintiffs’ quest to document board awareness, finding even a single email message warning about the problem might seem like a real treasure. But courts have been reluctant to rely on one or even a few communications in order to establish scienter, especially if these communications are not entirely unambiguous. The court was faced with such a communication in *In re AIG*, the derivative suit concerning the board’s liability following the insurance giant’s near-collapse at the height of the 2007 financial crisis due to excessive risk in its credit default swaps.¹⁸⁴ Nine months before the government rescued AIG, the company’s auditors, Pricewaterhouse Coopers (PwC), had submitted two warnings to the board’s audit committee about potential weaknesses in risk management, without providing additional information about the type or extent of the problem.¹⁸⁵ PwC also

179. No. CV 12290-VCS, 2017 WL 242571, at *4 (Del. Ch. Jan. 19, 2017).

180. *Id.* at *12 (stating that the plaintiff’s argument that board minutes labeled “significant matters and trends” must have included a conversation regarding the company’s compliance violations is “wholly conclusory”).

181. *Id.*

182. *In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d 366, 382 (S.D.N.Y. 2013), *aff’d sub nom.* Welch v. Havenstein, 553 F. App’x 54 (2d Cir. 2014).

183. Cottrell *ex rel.* Wal-Mart Stores, Inc. v. Duke, 829 F.3d 983, 995 (8th Cir. 2016).

184. *In re Am. Int’l Grp., Inc. Derivative Litig.*, 700 F. Supp. 2d 419, 424–30 (S.D.N.Y. 2010), *aff’d*, 415 F. App’x 285 (2d Cir. 2011).

185. *Id.* at 427.

warned some senior executives, but these were not board members.¹⁸⁶ These few and tentative admonitions were not enough to convince the court that AIG's board was aware of the underlying problems.¹⁸⁷

Apart from reports and emails, plaintiffs have sought to use other indications of underlying trouble as evidence of board awareness, such as personnel moves. Delaware courts have been responsive to this claim only if so far as the departure was "noisy," i.e., the employee explicitly stated that disagreements with company practices were behind the move. In *In re AIG*, the Vice President of Accounting Policy resigned due to differences of opinion regarding credit default swaps, but neither he nor anyone else communicated to the board the circumstances of his resignation.¹⁸⁸ The court readily concluded that, on its own, the departure of a senior employee did not suffice to alert the board about potential misgivings.¹⁸⁹

A special type of warning for the board comes in the form of press articles regarding violations of law by the company. Particularly when these articles appear in major newspapers of wide circulation, courts assume that directors were aware of them without demanding specific evidence that they read them.¹⁹⁰ However, the article must provide specific information for violations of law, at least to the exclusion of other hypotheses.¹⁹¹

2. What Constitutes a Red Flag?

Neither *Caremark* nor *Stone*, the leading Delaware cases, provide any specific guidance on what constitutes an appropriate red flag. But by grounding the board's monitoring duties on good faith, *Stone* circumscribes the set of circumstances that would

186. *Id.* at 436.

187. *Id.* at 435–38.

188. *Id.* at 436–37.

189. *Compare id.* (rejecting the claim that the departure of the Vice President of Accounting Policy was a red flag pertaining to the company's accounting practices), *with Rosenbloom v. Pyott*, 765 F.3d 1137, 1153–54 (9th Cir. 2014) (accepting the claim that an employee's resignation after filing an ethics complaint against the company's sales division was a red flag pertaining to sales practices).

190. *In re SAIC Inc. Derivative Litig.*, 948 F. Supp. 2d 366, 370–75 (S.D.N.Y. 2013) (noting that the plaintiffs relied on a Washington Post editorial), *aff'd sub nom.* *Welch v. Havenstein*, 553 F. App'x 54 (2d Cir. 2014).

191. *Id.* at 386 ("[T]here may well be exceptional cases where news coverage of corporate illegality is so intense, widespread, and unavoidable that no member of the business public could credibly claim to have missed it.").

allow courts to conclude that a red flag has been raised.¹⁹² Plaintiffs have repeatedly tried to push the boundaries of what is a red flag, without much success. The section below begins with some approaches that were ultimately thwarted at court, and concludes with examples of red flags that courts recognized.

In their regular course of business, boards receive much information about the company, both about its past performance and about its future prospects and risks. Even though each tidbit of information is not, on its own, a red flag of illegality, combining these could help the board realize that illegal activity is underway. Although this approach overcomes the hurdle of showing that the board was aware of the information in question, courts are unwilling to infer illegality unless faced with clear evidence. One such example concerns the board in *In re SAIC*, which concerned a government procurement company responsible for a project that eventually cost ten times its initial budget.¹⁹³ A series of press articles had criticized both SAIC's overpaid employees and relaxed management, as well as the government's repeated decisions to extend the project despite subpar results and cost overruns.¹⁹⁴ In the end, SAIC employees were paying kickbacks to government officials in order to continue with the project.¹⁹⁵ However, the court refused to infer that the board was aware of the illegal practices.¹⁹⁶

Insistence upon concrete proof of both illegality and board awareness divided the Delaware Supreme Court in *City of Birmingham v. Duke Energy*, a ruling that illustrates the limits of circumstantial evidence.¹⁹⁷ The board of Duke Energy had received an avalanche of warnings over the years regarding pollutants seeping from its coal ash ponds into the drinking water sources in the area surrounding one of its plants.¹⁹⁸ When the company self-reported, the local state regulator imposed a very small fine and demanded minimal compliance reforms that did not go as far as environmental specialists had recommended.¹⁹⁹

192. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (“[A] showing of bad faith conduct . . . is essential to establish director oversight liability . . . ”).

193. *In re SAIC Inc.*, 948 F. Supp. 2d at 370–75.

194. *Id.*

195. *Id.*

196. *Id.* at 387–92.

197. 177 A.3d 47 (Del. 2017).

198. *Id.* at 56–57.

199. *Id.* at 60–61.

Eventually, a burst pipe proved the specialists right.²⁰⁰ According to the court majority, the board had relied in good faith on the adequacy of the regulator's mandated reforms because, despite some of Duke's managers contributing to the regulators' election campaigns, there was no evidence of collusion between management and the regulator.²⁰¹ Thus absent direct proof of quid pro quo corruption, the majority was unwilling to go any further to hold directors liable.²⁰² But Chief Justice Strine dissented, arguing that the board was aware of the specialists' recommendations, and therefore the inadequacy of the compliance reforms undertaken.²⁰³ In his view, a proper red flag was in place, and no further evidence was required.²⁰⁴

In industries where regulatory risk is high, and vigilance about enforcement actions is constant, boards obtain frequent assessments of the company's performance of its regulatory obligations, or its exposure to a constantly changing legal landscape. Typically, these assessments are the product of outside experts, such as auditors²⁰⁵ or external counsel,²⁰⁶ or in-house legal teams. Plaintiffs have urged courts to read these assessments as warnings about underlying violations, and argue that they constitute "red flags" in the *Caremark* sense. However, courts are unwilling to accept that a report pointing to higher risk of violations amounts to a red flag, unless it is accompanied by actual examples of violations that are already happening or have recently happened. In *Reiter v. Fairbank*, the board of Capital One had received at least twenty-five reports between 2011 and 2014 about the bank's escalating exposure to anti-money laundering compliance risk, but none pointed to a confirmed money laundering case.²⁰⁷ The court declined to rely on these risk reports as a *Caremark* red flag, falling in line with the courts in *In re AIG*²⁰⁸ and *In re Goldman Sachs*,²⁰⁹ which all recognized

200. *Id.* at 64.

201. *Id.* at 61.

202. *Id.* at 62–64.

203. *Id.* at 65 (Strine, J., dissenting).

204. *Id.*

205. *In re Am. Int'l Grp., Inc. Derivative Litig.*, 700 F. Supp. 2d 419, 437 (S.D.N.Y. 2010), *aff'd*, 415 F. App'x 285 (2d Cir. 2011).

206. *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1059 (C.D. Cal. 2008).

207. No. CV 11693-CB, 2016 WL 6081823, at *1 (Del. Ch. Oct. 18, 2016).

208. 700 F. Supp. 2d at 427.

209. *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. CIV.A. 5215-VCG, 2011 WL 4826104, at *22 (Del. Ch. Oct. 12, 2011).

that a warning about the *risk* of violations is different than a warning about an actual violation.²¹⁰

When courts do recognize that the board violated its monitoring duties under *Caremark*, they tend to rely on multiple and undisputed red flags from diverse sources. A recent high profile case where plaintiffs succeeded on a *Caremark* claim involved Allergan, the producer of Botox, and its efforts to promote off-label uses of the drug despite the express prohibition of the statute.²¹¹ The red flags for the board came both from internal sources and from regulators.²¹² A senior ethics employee resigned after only six weeks at Allergan, citing her concerns about prohibited promotions of off-label uses for Botox in a complaint discussed at a board meeting.²¹³ The FDA sent five repeated warnings to Allergan, expressing its concern about potential prohibited promotions, even though it did not launch a full investigation until it became frustrated with the company.²¹⁴ Besides these red flags, the court underlined that the surrounding circumstances of the case supported a finding of bad faith.²¹⁵ Botox was Allergan's main product, and the board closely monitored its sales and post-sale customer service, instituting client hot lines and targeting physicians whose specialty suggested off-label uses.²¹⁶ Moreover, the sheer volume of sales for Botox far exceeded the instances of approved uses in the country, suggesting that over seventy to eighty percent of the drug was directed towards off-label uses.²¹⁷ Success of this scale could not have been achieved without active promotion.²¹⁸ This realization provided the court not only with a strong indication of board awareness, but also with a motive.²¹⁹ This confluence of factors convinced the court that the board had violated its duty to monitor employees, even though plaintiffs were not able to produce a specific board decision to actually authorize off-label uses.²²⁰

Other high profile wins for plaintiffs in *Caremark* claims offer a similar combination of internal reports raising red flags

210. *Id.* at *8–15.

211. Rosenbloom v. Pyott, 765 F.3d 1137, 1141–47 (9th Cir. 2014).

212. *Id.* at 1152–54.

213. *Id.* at 1153–54.

214. *Id.* at 1153.

215. *Id.* at 1154.

216. *Id.* at 1143–45.

217. *Id.* at 1142.

218. *Id.*

219. *Id.*

220. *Id.* at 1159.

with circumstantial evidence of board awareness. In *In re Countrywide*, internal witnesses testified that they had spoken to the CEO about the bank's inaccurate risk measurement, which flouted regulatory requirements.²²¹ While the witnesses had not communicated these concerns to the whole board, the court pointed to the increasing rate of delinquencies in key loan categories, which exceeded two thirds of all borrowers.²²² That such an overwhelming reversal of fortunes was not reflected in bank reports could not have gone unnoticed by the board. At the same time, the prevalence of trades by board members provided the court with an additional motive for the delayed recognition of the problem.²²³

F. HAS THE BOARD RESPONDED APPROPRIATELY TO RED FLAGS?

By documenting problems and informing the board, the chief compliance officer will have fulfilled the main expectation our legal system places on her, and utilized one of the main weapons in her arsenal. After that move, conventional wisdom suggests, it is up to the board to decide how best to respond, taking advantage of the discretion afforded by the business judgment rule. In reality, we argue, the board's options are much narrower.

In essence, the board has two options. It can disregard the red flags, and face the consequences, if or when they arise. Alternatively, it can respond to these red flags, showing that it intends to address the compliance gaps brought to its attention and combat the underlying violations identified. The first option, disregarding the red flags, comes with a significant gamble for directors, who run the risk of being found personally liable in case a problem arises. Directors succumbing to a successful *Caremark* claim are not typically protected by directors and officers liability insurance, since they are found to have acted in bad faith. Generally, directors are loath to undertake personal liability, which can come with significant pecuniary and reputational losses, after protracted and expensive litigation. Independent directors, who now form the majority in most boards in public corporations, are thought to be particularly averse to this

221. *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1060 (C.D. Cal. 2008).

222. *Id.* at 1061–62 (“The second red flag . . . relates to the increased delinquencies in the . . . riskiest loan categories that Countrywide held for investment.”).

223. *Id.* at 1066–67.

risk, since they will be gambling away their life's worth in service of top managers' restless pursuit of higher profits.

Of course, boards can opt to respond to red flags, fulfilling their duties so as to overcome any shareholder challenges. Boards still have wide latitude to formulate their reaction as they see fit. They can decide whether a separate board committee is needed, what type of staffing or other resources might be required, or whether to hire outside help in order to set up a new compliance initiative. Nevertheless, the yardstick by which board reaction will be assessed is defined, in large part, by the reports that identified the compliance gaps and underlying violations in the first place. These reports set the end towards which the board must strive, even if it is free to choose the particular means it will utilize to do so.

The paragraphs below describe instances where the board chose to disregard red flags, and contrast them with cases where the board sought to address the red flags that had been raised, some successfully and some less so. They illustrate that, if the board wants to avoid violating its duty of loyalty, it really has to undertake concrete and effective action. Otherwise, directors expose themselves to serious repercussions, having lost all credibility in the eyes of the court.

1. Boards in Disregard of Red Flags

After courts establish that adequate red flags had indeed reached the board, they move on to the next stage of their analysis, identifying and evaluating board reactions. If the board has not really set in motion any response to the problem underlined by the red flags, then courts are likely to view inactivity as evidence of bad faith. Two characteristic examples involve pharmaceutical companies that, after having been fined by federal regulators for illegally promoting drugs' off-label uses, continued to do so.²²⁴ As a result of the federal fines, both companies established extensive new and stronger compliance mechanisms.²²⁵

224. *Rosenbloom v. Pyott*, 765 F.3d 1137 (9th Cir. 2014) (involving Allergan, Inc.); *In re Pfizer Inc. S'holder Derivative Litig.*, 722 F. Supp. 2d 453 (S.D.N.Y. 2010) (involving Pfizer, Inc.); *La. Mun. Police Emp.'s Ret. Sys. v. Pyott*, 46 A.3d 313 (Del. Ch. 2012) (involving Allergan, Inc.).

225. *Pfizer*, 722 F. Supp. 2d at 455 ("The 2002 CIA [corporate integrity agreement] required, among other things, that Pfizer's board would create and implement a compliance mechanism that would bring information about illegal marketing activities to the board's attention."); *La. Mun. Police*, 46 A.3d at 321 ("As part of the settlement, Allergan entered into a five-year Corporate Integrity Agreement . . . The agreement mandates that Allergan implement a strict

But as these compliance departments set to work, supposedly reporting ongoing violations to the board itself, the board took no measure to constrain illegal activity.²²⁶ No violators were reprimanded or fired, no new training was ordered, and no additional screening processes were set up. In reality, these boards did not end illegal promotions, presumably because it was highly profitable. In both cases, the boards chose to intensify their off-label promotion efforts.²²⁷

Eventually, both boards' lack of response despite such clear and ongoing red flags helped courts conclude that the boards were acting in bad faith. After a while, federal regulators brought new enforcement actions resulting in record-high payments, which reached a total of \$2.3 billion in Pfizer's case.²²⁸ Pfizer shareholders complained about an absence of board action that was so troubling because the newly discovered violations closely traced past misconduct, despite clear internal compliance warnings in the interim.²²⁹ In both cases, courts swiftly concluded that boards' lack of reaction amounted to a violation of their duties.²³⁰

2. Boards Respond to Red Flags

Many boards do not remain aloof in the face of red flags, but take the initiative to address the revealed problems. In formulating their response, boards can rely on the flexibility afforded by the business judgment rule. However, if its response is deemed clearly inadequate, the specter of bad faith can still haunt the board. Courts need to be convinced that boards'

compliance program . . .").

226. *Rosenbloom*, 765 F.3d at 1153 ("Given how carefully the Board was monitoring Botox sales, its relative inaction in the face of these repeated FDA warnings supports a finding of liability."); *Pfizer*, 722 F. Supp. 2d at 456 ("In the face of all these prior violations by its subsequently-acquired subsidiaries, and despite its promises to take significant steps to monitor and prevent any further violations, Pfizer itself engaged in the same misconduct . . . Pfizer kept careful track of how well their illegal activities were succeeding.").

227. *Rosenbloom*, 765 F.3d at 1142–44, 1146 (detailing the many FDA warning letters Allergan received since 2001, and noting the continuation of the illegal drug use promotion from 1997 to 2010); *Pfizer*, 722 F. Supp. 2d at 456 (noting that Pfizer expanded its departments and employed more sophisticated data-mining techniques to identify potentially susceptible physicians).

228. See Gardiner Harris, *Pfizer Pays \$2.3 Billion to Settle Marketing Case*, N.Y. TIMES (Sept. 2, 2009), <http://www.nytimes.com/2009/09/03/business/03health.html>.

229. *Pfizer*, 722 F. Supp. 2d at 457.

230. *Id.* at 463; *Rosenbloom*, 765 F.3d at 1154, 1159.

measures are designed and intended to contain the problem, rather than simply work as smokescreen for any subsequent shareholder suit.

Rarely has a Delaware court repudiated a board's actions in more certain terms than in *In re Massey*.²³¹ Then-Vice Chancellor Strine was aghast at the conduct of the CEO, who consistently ignored mandatory mining safety requirements, while publicly proclaiming that he knew more about mine conditions than federal regulators.²³² While the CEO's articulate statements betrayed his bad faith, Strine still had to explore the state of mind for the remaining members of the board, whose speech had been more guarded.²³³ The red flags were plentiful. Federal regulators had repeatedly fined the company, documenting thousands of violations per year.²³⁴ Internal reports were also damning.²³⁵ An internal compliance officer who had documented the safety failures was swiftly fired, but brought a high-profile retaliation suit against the company and won "punitive damages, back pay, and emotional and reputational damages" of \$2 million.²³⁶ Faced with both external and internal warnings, Massey's independent directors decided to react. They formed an independent committee, met regularly with compliance officers, and even saw some compliance metrics improve.²³⁷ But they failed to get any results on the ground; in the years after the committee was established, Massey's violations increased in number, rather than falling.²³⁸ Nor was the committee successful in reining in the CEO.²³⁹ When a major mining accident hit the company, directors were unable to convince the court of their good faith; the court portrayed director conduct as merely "going through the motions," and thus insufficient to counter the company's endemic non-compliance.²⁴⁰

231. *In re Massey Energy Co. Derivative & Class Action Litig.*, No. 5430-VCS, 2011 WL 2176479, at *7–13 (Del. Ch. May 31, 2011).

232. *Id.* at *7.

233. *Id.* at *15–16.

234. *Id.* at *6–8.

235. *Id.* at *6.

236. *Id.*

237. *Id.*; Certain Massey Defendants' Answering Brief at 7–8, No. 5430-VCS, (Del. Ch. May 24, 2011), 2011 WL 2138269; *In re Massey Energy Co. Derivative & Class Action Litig.*, No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011).

238. *In re Massey Energy Co. Derivative & Class Action Litig.*, 2011 WL 2176479, at *7.

239. *Id.*

240. *Id.* at *19.

In contrast, the Chancery Court praised United Parcel Service's (UPS) board in *Horman v. Abney*²⁴¹ for its reaction to red flags. Just like Abbott and Pfizer, UPS was sanctioned by federal regulators and undertook to install compliance reforms in the context of the settlement with authorities.²⁴² After a few years, when illegal cigarette shipments reemerged, UPS became aware of various potential problems through a presentation from its legal team and an internal business development memorandum.²⁴³ But rather than remaining distant, UPS's board took action. It instituted new digital screening techniques to better identify violators, it streamlined and strengthened the investigation process, it ordered new and more targeted employee training, and created a dedicated help line to invite whistleblower reports against offenders.²⁴⁴ When the Audit Committee received notice from regulators that they were planning to investigate certain UPS outposts, they launched their own internal investigations and either confirmed a problem or concluded that there were no violations.²⁴⁵ Overall, these initiatives convinced the court that UPS's board was actively trying to combat illegal shipments, rather than tolerating or encouraging them.

III. SECURITIES LAWS' SCIENTER AND INTERNAL REPORTS

In Part II above we showed that, in response to *Stone*'s²⁴⁶ renewed emphasis on bad faith, courts looked for hard evidence in communications between the board and the company's legal and compliance professionals, boosting compliance departments' influence. A parallel jurisprudential arc was already under way in federal securities law in 2006, when *Stone* was issued,²⁴⁷ and has become even more salient in the last ten years. Rule 10b-5,²⁴⁸ the most common basis for securities class actions, requires plaintiffs to establish scienter, typically by showing that defendants were aware of fraud in the company's disclosures. Importantly, the landmark 2007 Supreme Court ruling in *Tellabs*

241. *Horman v. Abney*, No. 12290-VCS, 2017 WL 242571, at *4 (Del. Ch. Jan. 19, 2017).

242. *Id.* at *3–4.

243. *Id.* at *4–5.

244. *Id.* at *3, 10, 13–14.

245. *Id.* at *13–14.

246. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

247. See *Sale*, *supra* note 133, at 720, 750, 755.

248. 17 C.F.R. § 240.10b-5 (2018).

v. Makor raised the evidentiary standards for scienter at the pleading stage.²⁴⁹ Thus, securities plaintiffs have to show that the board received information contradictory to its public statements, just like fiduciary duty plaintiffs must establish that the board received information about employees' illegal activities. This important resemblance between the two doctrines has been widely recognized by academic commentators and Delaware courts alike.²⁵⁰

The quest for hard evidence of board awareness makes internal communications between corporate leaders and their subordinates as valuable in federal securities suits as they are in *Caremark* claims. Among such exchanges, reports submitted by legal and compliance personnel are often the most conspicuous, comprehensive, and illuminating. By administering the channels connecting the board with its corporate subordinates and the outside world, legal and compliance professionals become the arbiters of the board's state of mind.

In this Part, we track the emergence of legal and compliance personnel as key players in securities suits, which further enhances their influence in the modern corporate hierarchy. Securities class actions, which overwhelmingly rely on 10b-5, far outpace fiduciary duty suits in number or size of damages claimed, reaching a Maximum Dollar Loss Index of \$300 billion in the first six months of 2017 alone.²⁵¹ The threat of such large damage claims makes it harder for boards and management to disregard legal and compliance personnel. We begin by illustrating how central the state of mind inquiry is in this body of case law. We show that concepts that are familiar from our discussion of bad faith in Part II above, such as red flags and motives, are tools that courts often use in the securities fraud context as well. For all these reasons, we argue, federal securities jurisprudence further amplifies the influence of in-house legal experts.

A. FRAUD AND STATE OF MIND IN FEDERAL SECURITIES DOCTRINE

Private enforcement of securities laws is a mainstay in the arsenal of shareholder complaints against management and boards. Once courts interpreted Rule 10b-5 to imply private rights of action for shareholders,²⁵² class actions have continued

249. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007).

250. See *infra* Part III.C.

251. See CORNERSTONE RESEARCH, *supra* note 29, at 8.

252. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737–38, 749

to lay siege to the corporate bastion. Concerned that frivolous securities suits disrupt board operation and increase the costs of doing business, both Congress and the Supreme Court have tightened the state of mind requirements in 10b-5 and demanded stricter evidence for meeting them. As a result, the federal securities law doctrine and state fiduciary duty law now closely parallel each other, as regards both substantive requirements and evidentiary standards. The paragraphs below outline the substantive similarities, while Section III.B below focuses on evidentiary aspects.

A culpable state of mind is at the center of both fiduciary duty claims and federal securities claims. Under 10b-5, a misleading statement or omission does not in itself generate liability, unless it was made with scienter, typically equated with intent to defraud or at least knowledge of doing so.²⁵³ Thus, a blameworthy mindset is an indispensable element of securities fraud, without which a misleading statement remains a regrettable accident.²⁵⁴ Of course, intent and knowledge are key constituents of bad faith under fiduciary duty law, as discussed above. Despite some initial ambivalence, most courts today accept that scienter also extends to recklessness, described as conscious disregard of consequences so obvious that the actor must have been aware of them.²⁵⁵ As a result, scienter closely resembles bad faith in state fiduciary law.²⁵⁶

A potential divergence between federal and state doctrines is that the culpable actor under federal law is, typically, the corporation that issued the securities, while *Caremark* targets the individual directors of the board. In practice, courts have bridged that difference. As corporations are fictional entities, courts infer scienter by examining the state of mind of the person who made the infringing statements or omissions, ordinarily the company's

(1975).

253. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

254. See Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 532 (2011) ("[A]ny conception of fraud must include consideration of the mental state or fault requirements that will apply to the actor's awareness.").

255. See THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12:52, at 629 (7th ed. 2016).

256. See, e.g., *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 63 (Del. 2006).

top executive.²⁵⁷ By dismissing collective approaches to scienter,²⁵⁸ courts have placed individuals at the center of the inquiry, just as they have done in the *Caremark* context.

Despite the overwhelming similarities in the concepts of scienter and bad faith, there are significant differences in other aspects of the two doctrines. As a substantive matter, the scope of the federal securities laws' antifraud provisions is much broader, extending over any instance of fraudulent misstatement or misleading omission in companies' disclosures. For example, 10b-5 violations include insider trading, which falls outside the scope of *Caremark* duties. Only a subset of cases could be brought both under the *Caremark* framework and under 10b-5, typically when the faulty disclosure concerns illegal activities by company employees.²⁵⁹ Moreover, enforcement institutions for the two regimes are only partially overlapping. While *Caremark* claims can be brought only by shareholders, federal disclosure violations can also be enforced by the SEC, and sometimes the DOJ, if they give rise to criminal liability. The SEC also has at its disposal Section 17 of the 1933 Act²⁶⁰, the last prong of which does not require scienter in order to establish fraud, but relies on negligence only.²⁶¹ But private plaintiffs typically beat the SEC in

257. See Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J.L. & BUS. 1, 8 (2009) ("Seven circuits have rejected collective scienter in favor of the traditional approach to corporate scienter that requires proof that the person responsible for the misstatement had scienter.").

258. See *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 688 (6th Cir. 2005); *Southland Sec. Corp. v. Inspire Ins. Sols., Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) ("For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.").

259. In addition to providing accurate disclosure to investors, federal securities laws require corporate boards to maintain a reasonable system of internal controls, in accordance with Section 13(b) of the 1934 Securities Exchange Act. 15 U.S.C. § 78m (2012). Although this provision was added with the passage of the Foreign Corrupt Practices Act in the 1970s, it does not provide any private rights of action, and the SEC was reluctant to utilize it for many decades. 15 U.S.C. §§ 78dd-1; see Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 454 (2001). More recently, the SEC has been bringing enforcement actions based on § 13(b). These actions would offer further support for our argument.

260. 15 U.S.C. § 78q.

261. See *Aaron v. SEC*, 446 U.S. 680, 697–700 (1980). While this might mean that SEC actions are somewhat broader than private plaintiffs' ones, they rarely reach trial, and thus it is hard to know the impact of the different standard. See Buell, *supra* note 254, at 554 ("These [SEC] cases—though not subject to the

bringing a civil lawsuit for faulty disclosure, and the SEC joins about fifteen percent of these cases.²⁶² Thus, private 10b-5 class actions, though not the sole basis for federal securities law enforcement, certainly loom large.

B. PLEADING AND PROVING SCIENTER

Providing hard evidence of a perpetrator's state of mind is notoriously elusive.²⁶³ It is little surprise, then, that Congress and courts chose to raise the evidentiary burden regarding scienter in an effort to suppress the volume of 10b-5 litigation which, according to critics, had gotten out of hand. In particular, the Supreme Court's 2007 ruling in *Tellabs v. Makor* emphasized the need for plaintiffs to provide evidence at the pleading stage showing that fraud is "at least as likely" as alternative hypotheses.²⁶⁴ To successfully plead scienter, plaintiffs need direct evidence that a top executive was aware of specific facts that rendered her statement misleading or untrue. Absent such evidence, federal courts have refused to infer knowledge on the part of a top officer by virtue only of her high managerial position, powers, and responsibilities.²⁶⁵ If they subscribed to this view, federal judges argued, scienter would be established in every case there was an error or omission, however accidental.²⁶⁶ These concerns echo Chancellor Allen's own fears when shaping the *Caremark* doctrine.²⁶⁷

In contrast, internal reports that establish top executives awareness are what courts see as the clearest evidence of scienter.²⁶⁸ These must be specific: dates, sources, and discussion of

special pleading rules for private lawsuits—almost uniformly settle.").

262. See James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 777 (2003).

263. See Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773, 791 (2004) ("Plaintiffs generally do not have direct evidence going to the defendant's subjective state of mind at the motion to dismiss stage.").

264. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 328 (2007).

265. See Geoffrey P. Miller, *Pleading After Tellabs*, 2009 WIS. L. REV. 507, 518–19 (2009) ("Still, however, the mere fact that someone was in a high position at a company is not enough, in itself, to create a strong inference that the person knew that his statements were false.").

266. See *Garfield v. NDC Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006); *City of Brockton Ret. Sys. v. Shaw Grp. Inc.*, 540 F. Supp. 2d 464, 474 (S.D.N.Y. 2008).

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

268. *Metzler Inv. GMBH v. Corinthian Colls., Inc.*, 540 F.3d 1049, 1068 (9th Cir. 2008).

contents are needed.²⁶⁹ Negative internal reports must be directly communicated and unambiguously drafted; scienter cannot be inferred from general allegations, or even from meetings whose content was never recorded.²⁷⁰ Clearly drafted internal reports are much more valuable than second-hand accounts by staff, such as internal auditors, accountants, or clerks, whose often anonymous testimony is not uniformly accepted in all courts.²⁷¹ Courts' pressing request for a paper trail connecting the top executive with the violation underlines the fundamental role of legal and compliance officers, who are often in charge of internal reporting.

Another similarity with the fiduciary duty doctrine is the increasing importance of red flags in pleading scienter. Absent direct evidence of a top manager's awareness, courts are often wary of "fraud by hindsight."²⁷² To overcome this concern, plaintiffs typically claim that disclosures' faults were so obvious and severe that managers were reckless in not recognizing red flags.²⁷³ Characteristic red flags include whistleblower reports, or noisy withdrawals of internal auditors and compliance staff.²⁷⁴ These are typically handled by in-house legal experts, whose contribution is essential in molding them into appropriate red flags for the purposes of 10b-5 litigation.

C. RECOGNIZING THE PARALLELS BETWEEN SCIENTER AND BAD FAITH

The parallels between scienter in 10b-5 actions and the *Caremark* framework are unmistakable. Just as fiduciary duty jurisprudence establishes bad faith only if the board had specific information about illegal employee conduct, 10b-5 jurisprudence finds scienter only if the board had similarly specific information that contradicted their disclosures. Courts have explicitly recognized this similarity time and again, and Delaware courts have

269. *Id.* (quoting *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1087–88 (9th Cir. 2002)).

270. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999); Greenberg v. Cooper Cos., Inc., No. 11-CV-05697, 2013 WL 100206, at *5 (N.D. Cal. Jan. 7, 2013).

271. See Gideon Mark, *Confidential Witnesses in Securities Litigation*, 36 J. CORP. L. 551, 555 (2011).

272. See Gulati et al., *supra* note 263, at 791.

273. See Dain C. Donelson & Robert A. Prentice, *Scienter Pleading and Rule 10b-5: Empirical Analysis and Behavioral Implications*, 63 CASE W. RES. L. REV. 441, 471–72 (2012).

274. *Id.* at 474.

repeatedly treated the two concepts as equivalent.²⁷⁵ In *In re Citigroup*, the Delaware Supreme Court went as far as suggesting that the scienter-based approach to bad faith ultimately provides to independent directors the same safeguards available to them under federal law.²⁷⁶ These statements suggest that Delaware judges are only too well acquainted with plaintiffs' tactics, and perhaps share some of the concerns that justify constraining class actions. But no one anticipated, we argue, that stricter evidence standards would boost the role of in-house officials tasked with documenting the internal life of the corporation.

IV. PERSONAL LIABILITY FOR LEGAL AND COMPLIANCE OFFICERS

So far, we have argued that by increasing evidentiary standards on state of mind, Delaware state law and federal securities laws ended up empowering legal and compliance experts, who are uniquely well-placed to access that evidence. But their empowerment has other roots too, arising from a growing body of law focusing on legal and compliance experts as internal monitors who can prevent wrongdoing. While it is still rare, legal and compliance officers face a growing risk of personal liability.²⁷⁷ This threat, we argue, further strengthens their bargaining position vis-à-vis directors and managers. Armed with a new legal mandate to set up supervision mechanisms, to investigate, and ultimately to report, legal and compliance experts can resist pressures to adopt evasive techniques. We discuss three common sources of personal liability: laws passed post-financial crisis to

275. See, e.g., *In re Am. Apparel, Inc. S'holder Derivative Litig.*, No. CV 10-06576 MMM (RCx), 2012 WL 9506072, at *22 (C.D. Cal. July 31, 2012) (stating that the *Caremark* framework is the legal standard that Delaware courts use to determine whether a director faces a substantial likelihood of liability for failure to monitor and properly supervise a company's operations); Reiter *ex rel.* Capital One Fin. Corp. v. Fairbank, No. CV 11693-CB, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016) (discussing the *Caremark* framework in the context of director oversight over company operations); *In re Massey Energy Co.*, C.A. No. 5430-VCS, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011) (stating that “[t]he *Caremark* liability standard . . . requires proof that a director acted inconsistent with his fiduciary duties and, most importantly, that the director *knew* he was so acting”).

276. See *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009).

277. See DANIEL J. HURSON, COMPLIANCE OFFICER LIABILITY—A GROWING OCCUPATIONAL HAZARD 5 (2017), https://www.americanbar.org/content/dam/aba/events/labor_law/2017/11/conference/papers/Hurson-COMPLIANCE-OFFICER-LIABILITY-A-GROWING-OCCUPATIONAL-HAZARD.pdf (discussing the SEC's posture regarding chief compliance officer liability).

give in-house legal experts access to, and increased influence over, the board and management; the Delaware fiduciary duty framework; and criminal liability, such as for obstruction of justice.

A. PERSONAL LIABILITY ARISING OUT OF FAILURE TO OVERSEE COMPLIANCE REGIMES

The 2002 Sarbanes-Oxley Act marks the first time that Congress gave the SEC the authority to discipline lawyers.²⁷⁸ The Act clarifies that the general counsel will “be primarily responsible for investigating and advising the board and senior management on how to address reports of material violations.”²⁷⁹ The legislative history reveals that the bill’s drafters believed that inside counsel have the power *and* the responsibility to prevent corporate misconduct.²⁸⁰ It did not take long for the SEC to begin advising general counsel to assert their authority to the board.²⁸¹

Sometimes, regulators consider compliance officers’ powers so central that their inactions render them complicit, as if they enabled the fraud. In a watershed case, U.S. criminal authorities and regulators brought suit against Thomas Haider, the former Chief Compliance Officer of MoneyGram, the money transfer retailer.²⁸² *Haider* marks the first time a compliance officer was targeted for failure to design appropriate supervision systems so as to constrain violations of the anti-money laundering statutes, a highly sophisticated compliance regime.²⁸³ The lawsuit

278. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7245).

279. Kim, *supra* note 14, at 1036 (“SEC officials have urged general counsels to play a more active role in policing compliance with Sarbanes-Oxley through the development of a more assertive relationship with the board and management.”).

280. 148 CONG. REC. S6524, S6551–52 (daily ed. July 10, 2002) (statement of Sen. John Edwards) (“If executives and/or accountants are breaking the law, you can be sure that part of the problem is that the lawyers who are there and involved are not doing their jobs.”).

281. Alan Beller, the Director of the Division of Corporation Finance of the SEC, recommended that general counsels claim “[a] place at the table at every significant discussion about how [her] company should act with respect to every important issue raised by Sarbanes-Oxley, [SEC] rules or other aspects of the new environment.” Alan L. Beller, Remarks Before the American Bar Association’s 2003 Conference for Corporate Counsel (June 12, 2003), <https://www.sec.gov/news/speech/spch061203alb.htm>. Beller also emphasized that general counsels should seek “[a]ccess to the board . . . to assure good behavior.” *Id.*

282. U.S. Dep’t of Treasury v. Haider, No. 15-CV-01518 (DSD/HB), 2016 WL 107940, at *1 (D. Minn. Jan. 8, 2016).

283. See Sue Reisinger, *Feds Settle First Ever Civil Suit Against Financial*

claimed that Haider was aware that MoneyGram agents participated in consumer fraud phishing schemes, since he had received thousands of complaints.²⁸⁴ However, he did not investigate these complaints, fire any of the participating agents, or take measures to close the compliance loopholes that allowed the schemes.²⁸⁵ Settled in 2017 for a \$250,000 civil sanction and a bar from the industry, the case represents the highest fine paid out of pocket by a compliance officer.²⁸⁶ While still infrequent, since *Haider*, there have been a number of examples of the SEC targeting compliance officers individually for “turning a blind eye” to corporate wrongdoing.²⁸⁷ For example, in *In re Meade*, the SEC sanctioned the chief compliance officer for ignoring an insider trading scam although he was aware of the employee’s insider status.²⁸⁸

But compliance officers’ liability is not necessarily tethered to some other misconduct. Rather, the mere existence of gaps in compliance programs has led to personal liability. The SEC brought proceedings against big, well-known firms with large compliance departments, namely Blackrock’s investment advisory arm²⁸⁹ and SFX Financial.²⁹⁰ In contrast to *Meade*, where the SEC alleged that the CCO all but blessed insider trading and expected to profit from it, the CCOs in Blackrock and SFX were not aware of the underlying misconduct.²⁹¹ But both CCOs were

Chief Compliance Officer, LAW.COM (May 8, 2017), <https://www.law.com/corpounsel/sites/corpounsel/2017/05/05/feds-settle-first-ever-civil-suit-against-financial-chief-compliance-officer>.

284. See Complaint at 16–18, U.S. Dep’t of Treasury v. Haider, No. CV 15-1518 (DSD/HB), 2016 WL 107940 (D. Minn. Jan. 8, 2016) (describing MoneyGram’s fraudulent activity, including Haider’s knowledge of that activity).

285. *Id.*

286. See *Former MoneyGram Executive Settles Closely Watched U.S. Money Laundering Case*, REUTERS (May 4, 2017), <https://www.reuters.com/article/us-moneygram-intl-moneylaundering/former-moneygram-executive-settles-closely-watched-u-s-money-laundering-case-idUSKBN1802P3>.

287. See, e.g., *In re Thomas E. Meade*, Investment Advisers Act Release No. 3855, 2014 WL 2601711, at *3–8 (June 11, 2014) (finding that Meade’s behavior allowed an employee to participate in insider trading).

288. *Id.*

289. See *In re Blackrock Advisors, LLC & Bartholomew A. Battista*, Investment Advisers Act Release No. 4065, 2015 WL 1776222, at *1 (Apr. 20, 2015).

290. See *In re SFX Fin. Advisory Mgmt. Enters., Inc. & Eugene S. Mason*, Investment Advisers Act Release No. 4116, 2015 WL 3653814, at *1 (June 15, 2015).

291. See *id.* at *3; *In re Blackrock Advisors*, 2015 WL 1776222, at *7–8.

aware of gaps in their compliance program.²⁹² The fines agreed to upon settlement were somewhat lower, and no bar from the securities industry was imposed.²⁹³ No matter; both compliance officers were ordered to pay substantial fines out of pocket.²⁹⁴ In this respect, the *Blackrock* and *SFX* settlements seem even more draconian.

B. PERSONAL LIABILITY ARISING OUT OF DELAWARE FIDUCIARY LAW

As we discussed above, in *In re World Health Alternatives*, the U.S. Bankruptcy Court for the District of Delaware extended *Caremark* liability to an officer, the general counsel, for the first time.²⁹⁵ The court reasoned that the duties of officers and directors are identical under Delaware law and held the general counsel personally liable for failure to prevent corporate fraud.²⁹⁶ Significantly, the court extended this personal liability even though the general counsel did not have knowledge of or involvement in the underlying conduct, nor did he benefit from it.²⁹⁷ For this reason, *In re World Health Alternatives* went far beyond Section 307 of the Sarbanes-Oxley Act, which requires counsel to report a material violation of the law of which she has *actual* knowledge.²⁹⁸ In contrast, and similar to *Blackrock* and *SFX*, *In re World Health Alternatives* requires that in-house counsel take affirmative steps to provide oversight and “safeguard against corporate wrongdoing.”²⁹⁹

C. PERSONAL LIABILITY ARISING OUT OF CRIMINAL LAW

Regulators are aware that legal and compliance professionals can conceal critical information about illegal activity by delaying the production of documents, scapegoating lower-level employees, and “aggressively promoting exculpatory evidence

292. *In re SFX Fin. Advisory Mgmt.*, 2015 WL 3653814, at *3; *In re Blackrock Advisors*, 2015 WL 1776222, at *7–8.

293. *In re Blackrock Advisors*, 2015 WL 1776222, at *4–5.

294. *Id.* at *3.

295. See *In re World Health Alts., Inc.*, 385 B.R. 576, 591–92 (Bankr. D. Del. 2008) (reasoning that a corporation’s general counsel must be held responsible for failure of oversight under *Caremark* due to their status as a corporate officer).

296. See *id.* at 592.

297. See *id.* at 589–93.

298. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7245).

299. See *In re World Health Alts., Inc.*, 385 B.R. at 590.

while dismissing clear and identifiable red flags.”³⁰⁰ Recently, enforcement authorities have shown their resolve in bringing cases against such legal and compliance professionals. Volkswagen’s \$4.3 billion settlement with the Department of Justice for obstruction of justice is one such example.³⁰¹ In-house lawyers are obligated to preserve all documents relevant to an anticipated litigation.³⁰² Volkswagen (VW) admitted that an in-house counsel, who remains anonymous, gave advice which caused employees to delete documents.³⁰³ As part of the plea bargain, VW paid \$2.8 billion in fines for the failed litigation hold alone.³⁰⁴ VW’s “botched litigation hold” became an instant case study within the legal community.³⁰⁵

Although cases against legal and compliance experts remain rare, they have triggered a pervasive fear of liability in the profession,³⁰⁶ as evidenced by a proliferation of professional resources focused on how to avoid personal liability.³⁰⁷ Perhaps counterintuitively, this fear of liability has strengthened the bargaining position of legal and compliance experts vis-à-vis the board and management. While in the past they could afford to

300. See Robert S. Khuzami, Dir., Div. of Enf’t, SEC, Remarks to Criminal Law Group of the UJA-Federation of New York (June 1, 2011), <https://www.sec.gov/news/speech/2011/spch060111rk.htm>.

301. See Press Release, U.S. Dep’t of Justice, Volkswagen AG Agrees to Plead Guilty and Pay \$4.3 Billion in Criminal and Civil Penalties; Six Volkswagen Executives and Employees are Indicted in Connection with Conspiracy to Cheat U.S. Emissions Tests (Jan. 11, 2017), <https://www.justice.gov/opa/pr/volkswagen-ag-agrees-plead-guilty-and-pay-43-billion-criminal-and-civil-penalties-six>.

302. Zubulake v. UBS Warburg LLC, 220 F.R.D. 212, 216 (S.D.N.Y. 2003).

303. See Thomas K. Potter III, *VW’s \$4.3BN Plea to Obstruction for Botched Litigation Hold*, BURR & FORMAN (Jan. 18, 2017), <http://www.burr.com/blogs/securities-litigation/2017/01/18/vws-4-3bn-plea-obstruction-botched-litigation-hold> (analyzing the legal implications of the Volkswagen case in regard to litigation holds).

304. See U.S. Dep’t of Justice, *supra* note 301.

305. See Potter III, *supra* note 303 (analyzing the legal implications of the Volkswagen case in regard to litigation holds).

306. According to a recent survey of compliance professionals, for example, nearly fifty percent expected the personal liability of compliance officers to continue to increase in 2017. See STACEY ENGLISH & SUSANNAH HAMMOND, COST OF COMPLIANCE 2017, at 5 (2017), <https://d3kex6ty6anzzh.cloudfront.net/uploads/a4/a496eba563ae8cde99b77caf83e101aaa5695580.pdf>.

307. See generally *id.* (providing a survey of risk and compliance practitioners concerning “the cost of compliance and the challenges financial services expect to face in the year ahead”); see also DLA PIPER, DLA PIPER’S 2017 COMPLIANCE & RISK REPORT (2017), https://www.dlapiper.com/compliance_survey_2017 (providing a survey of chief compliance officers in regard to “the current state of corporate compliance in an era of deepening uncertainty”).

be complicit, the specter of personal liability alters that equation.

V. THE HIDDEN POWER OF COMPLIANCE IN PRACTICE

In preceding Parts, we analyzed the doctrinal foundations of modern compliance in state corporate law, federal securities law, and personal liability for legal and compliance officers. In this Part, we explore how these different bodies of law come together in practice to form a coherent regime for governing corporate misconduct. To examine compliance in practice, we turn to a series of mega corporate failures from the last few years—GM's ignition switch scandal,³⁰⁸ Washington Mutual's mortgage crisis,³⁰⁹ Yahoo's cyber-security breach,³¹⁰ and Wells Fargo's fake accounts debacle.³¹¹ These cases captivated national attention because of the enormous harm inflicted. Millions of people saw their hard-earned money funneled to useless purposes, their privacy exposed to fraudsters, and their road safety fallen prey to faulty engineering, resulting in deaths. Addressing these failures has attracted immense public resources, ranging from regulatory investigations and sanctions,³¹² to congressional attention,³¹³ and judicial resolution.³¹⁴ Thus, these cases are emblematic of the corporate misconduct that compliance doctrine seeks to avert or sanction.

Yet, precisely because of the high stakes involved for shareholders, boards, and legal and compliance personnel, these mega failures also represent the hardest test for our argument. If compliance processes can be easily sidestepped or manipulated to exculpate corporate leaders, as critics claim, then such exculpation would be most valuable in these instances. Our case studies show that, rather than the smokescreen critics purport it to be, modern compliance often results in serious ramifications for the corporate actors involved, including not only top executives and board members, but also legal and compliance personnel.

308. See *infra* Part V.A.

309. See *infra* Part V.B.

310. See *infra* Part V.C.

311. See *infra* Part V.D.

312. See *infra* notes 326–29, 391, 394 and accompanying text.

313. See, e.g., Seth Fiegerman, *Marissa Mayer Grilled by Congress Over Massive Yahoo Security Breach*, CNN BUS. (Nov. 8, 2017), <https://money.cnn.com/2017/11/08/technology/marissa-mayer-congress/index.html>.

314. See, e.g., *infra* note 327 and accompanying text.

In all the examples we discuss below, legal and compliance personnel found themselves at the heart of the action, and their reports and omissions were often the keystone in the legal case against the board and management. Court rulings and settlement negotiations concentrated on what management and directors knew at specific points in time, and often fixated on the chief legal officer or the head of compliance.³¹⁵ In some instances, these officers were named in shareholder complaints or targeted by regulatory actions.³¹⁶ This singular attention to legal and compliance personnel illustrates that their choices, often surreptitious at the time they are made, can literally alter the legal landscape for other corporate leaders.

However, our case studies also show significant variation in liability outcomes. Directors and officers are not exonerated in all but the most egregious cases,³¹⁷ as critics would predict. Rather, the interactions between the board on the one hand, and legal and compliance personnel on the other hand sometimes lead to liability for the board, and sometimes increase legal risk for the legal and compliance officer.³¹⁸ We offer a typology of potential interactions between the board and its legal and compliance officers, and use the doctrinal analysis above to explain the liability outcome in each type, which we illustrate with a separate case study. Table 1 organizes our case studies along two axes. The y-axis displays the risk of liability faced by the board,³¹⁹ while the x-axis categorizes cases depending on whether a chief legal or compliance officer faces a substantial risk of liability. Below, we highlight how our case studies connect to each other before delving into each one in greater detail.

315. See, e.g., *infra* Part V.D.1 (discussing the Wells Fargo banking scandal).

316. See, e.g., *infra* Part V.C.3 (discussing the suits brought by Yahoo's shareholders against the company's executives).

317. See *infra* Part V.A.

318. See *infra* Part V.D.

319. Because some of our case studies include settlements, and others involve ongoing litigation, we cannot be entirely certain that they would result in liability. Thus, we focus on the most likely outcome, based on the facts and admissions that have surfaced so far.

Table 1. Liability Outcomes Depending on Different Communication Strategies

		Legal/Compliance Liability
		Low → High
Board Liability ↓	Low	<u>Untraceable</u>
	High	<u>Interrupted</u>
Board Liability ↓	Low	<p>Legal/Compliance: Not aware Board: No report Outcome: No liability for either</p> <p>Example: GM Ignition Switch</p>
	High	<p>Legal/Compliance: Aware Board: No formal report Outcome: Liability for Legal/Compliance Alone</p> <p>Example: Yahoo! Security Breach</p>
Board Liability ↓	Low	<p>Traceable</p> <p>Legal/Compliance: Aware Board: Ignores formal report Outcome: Liability for Board Alone</p> <p>Example: WaMu Mortgage Meltdown</p>
	High	<p>Incomplete</p> <p>Legal/Compliance: Muddled awareness Board: Obfuscating reports Outcome: Liability for Board and Legal/Compliance</p> <p>Example: Wells Fargo Fake Accounts</p>

Critics predict that legal and compliance personnel would operate in the board's favor, whether by overlooking violations due to a biased check-the-box mentality or by actively colluding to exonerate management. On the record, there are no formal communications that could place either the board or legal and compliance personnel in bad faith. Informal communications, if any, remain untraceable, as the upper left quadrant's heading suggests. This pessimistic prediction is indeed borne out in the GM ignition switch scandal. GM's bureaucratic legal department failed to notice the frequency of wrongful death suits connected to a particular mechanical failure. Though regrettable, this failure to take note stops short of bad faith, as discussed above, thus averting any liability for both the board and its chief legal officer. Understandably, the outcome in this quadrant looms large in scholarly discussions of compliance, since it lets both boards and legal or compliance officers off the hook, despite the disastrous repercussions of their omissions. But amidst the disparagement, academic literature has overlooked the outcomes in the remaining three quadrants, which we bring to light. Essentially, we argue, the interests of legal and compliance officers do not always align so closely with those of the board.

In the bottom left quadrant, titled “traceable,” legal and compliance personnel’s reports to the board are on the record, clear and precise, thus representing the polar opposite of untraceable communications depicted in the upper left quadrant. But while legal and compliance personnel vigorously examine and report problems, the board chooses to ignore them. When scandal erupts, compliance’s reports to the board establish its bad faith and cement its liability. In this quadrant we discuss the fiduciary duty claims against the officers of Washington Mutual, a financial company that collapsed during the 2007 financial crisis.³²⁰ Successive compliance officers submitted multiple reports to the board pointing to legal gaps in the securitization of mortgages. Nevertheless, the board ignored the warnings in favor of an aggressive loan generation and securitization strategy, which ultimately landed the company in insolvency.³²¹ The settlement included rare out-of-pocket payments for board members, illustrating the extraordinary reach of well-documented compliance concerns. The outcome in WaMu stands out because compliance reports were by far the most pivotal piece of evidence against the board.

Often, the record of communications between the board and legal and compliance personnel is not as clear as in the two quadrants on the left. In the upper right quadrant, titled “interrupted,” reports of violations by low level employees, or indications of important gaps in the company’s compliance systems have reached legal and compliance heads, who must then choose how to react. Whether out of loyalty or due to mere negligence, legal and compliance officers might be inclined to address the problem themselves without elevating it to the board. In doing so, they run the risk of a crisis erupting in their hands. In Yahoo’s case, the internal investigation exonerated the board by confirming that it was kept in the dark by its chief legal officer. It is widely thought that the chief legal officer discussed the problem with top executives and board members informally, but never submitted a written report.³²² Not only did the chief legal officer lose his job, but he is the target of lawsuits and enforcement actions. Regardless of the legal officer’s motivations in Yahoo, the outcome illustrates that shielding the board by formally withholding information from it is a strategy that can easily backfire for heads of legal and compliance departments.

320. See *infra* Part V.B.

321. See *infra* Part V.B.

322. See *infra* notes 362–64 and accompanying text.

In the bottom right quadrant, titled “incomplete,” compliance and legal officers fail to fully grasp the potentially disastrous consequences of sitting on top of sensitive information. Although both compliance and legal officers and the board are aware of problems, or of strong red flags, they fail to follow through. The Wells Fargo fake account debacle exemplifies this dual failure. Employees’ eagerness to fraudulently open accounts had grown so out of control that even the press had gotten hold of it. For over two years, internal investigations resulted in convoluted reports that both legal and compliance heads and the board seemed to accept. The compliance machinery was seen to be humming away, but the results were toothless, as critics would have feared. Yet, once the extent of the misconduct was revealed—causing public outrage, and driving customer satisfaction and share price to the ground—both management and compliance officers became targets of shareholder lawsuits and regulatory actions.³²³ Overall, the outcome at Wells Fargo seems to suggest that a less than rigorous examination of red flags might end up engulfing both the board and legal and compliance personnel in liability.

A. QUADRANT NO. 1 – UNTRACEABLE: GENERAL MOTORS

In 2014–2015, the iconic American car manufacturer General Motors recalled 30.4 million vehicles in the United States and around the world for defects.³²⁴ The most serious defect was a faulty ignition switch that caused vehicles to turn off while in motion, and prevented brakes and airbags from deploying, leading to at least 124 deaths and 275 injuries.³²⁵ As a result, GM was investigated by the U.S. Attorney’s Office, Congress, and the SEC, and attorneys general in all fifty states.³²⁶ It also defended

323. Although litigation regarding this case is still pending, early judicial rulings suggest that the case against management and compliance personnel has some merit, see *infra* text accompanying notes 395–97.

324. See Neal E. Boudette, *Supreme Court Rebuffs G.M.’s Bid to Limit Ignition-Switch Lawsuits*, N.Y. TIMES (Apr. 24, 2017), <https://www.nytimes.com/2017/04/24/business/supreme-court-general-motors-ignition-flaw-suits.html>; Chris Isidore, *GM’s Total Recall Cost: \$4.1 Billion*, CNN BUS. (Feb. 4, 2015), <https://money.cnn.com/2015/02/04/news/companies/gm-earnings-recall-costs/index.html>.

325. See Mike Spector & Christopher M. Matthews, *GM Admits to Criminal Wrongdoing*, WALL ST. J., Sept. 18, 2015, at B1; Jonathan Stempel, *GM Settles Hundreds of Ignition Switch Lawsuits*, REUTERS (June 23, 2017), <https://www.reuters.com/article/us-gm-recall-settlement/gm-settles-hundreds-of-ignition-switch-lawsuits-idUSKBN19E25A>.

326. See *GM Confirms Justice, SEC Probes on Ignition Recalls*, NBC NEWS

itself against hundreds of lawsuits.³²⁷ GM has ended up paying billions in settlements and compensation for accident victims.³²⁸ The General Counsel at the time was Michael Millikin, whose work at GM spanned forty years.³²⁹ Despite the scale of the scandal, there is no traceable evidence that Millikin had knowledge of any red flags until after the cars were recalled in 2014.³³⁰ The General Counsel's lack of knowledge protected him from liability, and also shielded the board from these red flags.³³¹

The report of the independent investigation revealed that, as early as 2005, some GM lawyers knew that the ignition switch in the Cobalt could stall while in motion, which posed a risk of injury or death.³³² In 2005, even automotive journalists began to write stories about the Cobalt stalling when drivers moved their keys.³³³ A senior inside lawyer, William Kemp, managed this line of cases and settlements.³³⁴ Conveniently, GM's policies only required that he seek the General Counsel's approval for settlements exceeding \$5 million.³³⁵ Kemp settled most of the cases at or below that level, and thus Millikin and the board remained uninformed.³³⁶ In 2007, Kemp received two crash studies related to airbag malfunctions, which concluded that the ignition switch failures and the airbag failures were linked.³³⁷ But there was no

(Apr. 24 2014), <https://www.nbcnews.com/storyline/gm-recall/gm-confirms-justice-sec-probes-ignition-recalls-n88976>; see also Press Release, Del. Dep't of Justice, 50 Attorneys General Reach \$120 Million Settlement With General Motors Over Defective Ignition Switch (Oct. 20, 2017), <https://news.delaware.gov/2017/10/20/gm>.

327. See Stempel, *supra* note 325.

328. See Joseph B. White, *\$2.4 Billion, 29 Million Cars: The Numbers Behind GM's Year of Recalls*, WALL ST. J. (July 24, 2014), <https://blogs.wsj.com/corporate-intelligence/2014/07/24/2-4-billion-29-million-cars-the-numbers-behind-gms-year-of-recalls>.

329. See Jerry Hirsch, *Embattled General Motors General Counsel Millikin to Retire*, L.A. TIMES (Oct. 17, 2014), <http://www.latimes.com/business/autos/la-fi-hy-gm-lawyer-millikin-retires-20141017-story.html>.

330. See VALUKAS REPORT, *supra* note 34, at 227 (noting that Millikin did not learn about the ignition switch's safety threat until after the recall was issued in 2014).

331. See *id.* at 233 (noting that the Board was unaware of the ignition switch safety threat until 2014).

332. See *id.* at 103.

333. See *id.* at 7 (noting that newspapers, such as the New York Times, began covering these stories).

334. See *id.* at 85.

335. See *id.* at 107.

336. See *id.* at 231.

337. See *id.* at 125 (noting that the legal team was made aware of the cases and reports in 2007).

follow-up. Kemp *finally* advised Milliken of these safety issues in 2014, after GM had already decided to recall the faulty cars.³³⁸ At that point, Mary Barra, the CEO, fired Kemp and three other GM lawyers for concealing this information.³³⁹ But Barra, to the frustration of the general public and Congress, stood by Millikin and insisted that he was “a trusted and respected confidant to senior management.”³⁴⁰

If there were indeed any informal communications between Millikin and the lawyers, they remained untraceable. Shareholders brought derivative suits under Delaware fiduciary laws, as we have discussed above.³⁴¹ Even with the help of discovery, shareholders were unable to trace any other communications. Thus, they faulted the board for maintaining siloed and bureaucratic compliance departments.³⁴² Regardless, the Court found that this did not amount to bad faith.³⁴³ As a result, in subsequent cases, such as the Wells Fargo case which we discuss below,³⁴⁴ boards point to siloed and bureaucratic compliance regimes as a defense. But our next case study, Washington Mutual, describes the exact opposite scenario.

B. QUADRANT NO. 2 – TRACEABLE: WAMU

Back in March 2005, the extraordinary boom in housing prices captivated the nation’s imagination.³⁴⁵ Among the easiest loans to access were Adjustable-Rate Mortgages (ARMs), whose interest rate was low for an initial “teaser” period (up to five

338. *See id.* at 224 (“In the same period, Kemp disclosed the Ignition Switch issue to Millikin for the first time.”).

339. *See Bill Vlasic, G.M. Layers Hid Fatal Flaw from Critics and One Another*, N.Y. TIMES (June 6, 2014), <https://www.nytimes.com/2014/06/07/business/gm-lawyers-hid-fatal-flaw-from-critics-and-one-another.html> (noting that Kemp orchestrated G.M.’s legal strategy).

340. *See Press Release, General Motors, Millikin to Retire as GM General Counsel* (Oct. 17, 2014), <http://media.gm.com/media/us/en/gm/news.detail.html/content/Pages/news/us/en/2014/Oct/1017-millikin.html>; *see also Bill Vlasic & Aaron M. Kessler, At Hearing on G.M. Recall, Mary Barra Gives Little Ground*, N.Y. TIMES (July 17, 2014), <http://www.nytimes.com/2014/07/18/business/senate-hearing-on-general-motors.html>.

341. *See supra* Part II.A.

342. *See In re Gen. Motors Co. Derivative Litig.*, No. CV 9627-VCG, 2015 WL 3958724, at *16 (Del. Ch. June 6, 2015).

343. *Id.*

344. *See infra* Part V.D.

345. *See S&P/Case-Schiller U.S. National Home Price Index*, FED. RES. BANK ST. LOUIS, <https://fred.stlouisfed.org/series/CSUSHPINSA> (last updated Mar. 26, 2019).

years usually) but rose significantly thereafter.³⁴⁶ Since many mortgage holders would have difficulty repaying the post-teaser rate, they would likely refinance before that time.³⁴⁷ Many banks offered ARMs, but few were more invested in them than WaMu, then the sixth-largest bank in the United States.³⁴⁸ WaMu's key strategy was to offer "option-ARMs" that allows borrowers to pay nothing in capital and even less than the interest on the loan at times.³⁴⁹ When it collapsed, in September 2008, WaMu became the largest bank failure in U.S. history, and one of the major events of the financial crisis.³⁵⁰

Both regulators and shareholders tried various legal channels to hold corporate boards accountable for their actions leading to and during the financial crisis. Many of these actions failed to bring satisfactory results, causing widespread frustration, because U.S. laws generally seek to protect corporate board's risk-taking prerogatives.³⁵¹ But in WaMu's case, defendant board members not only agreed to an over \$64 million dollar settlement, but also, in an extremely rare move, consented to three *board members* paying out-of-pocket sums to plaintiffs.³⁵² While insurance proceeds covered the bulk of the settlement amount, over \$25 million was paid individually by the defendant directors.³⁵³

346. See Lisa Prevost, *The Siren Call of the Adjustable-Rate Loan*, N.Y. TIMES (Aug. 22, 2013), <http://www.nytimes.com/2013/08/25/realestate/the-siren-call-of-the-adjustable-rate-loan.html> ("The renewed appeal of ARMs lies in the teaser rates offered in the opening years of the loan.").

347. See James Berman, *The Adjustable Rate Mortgage: Just Say No*, HUFFINGTON POST (Apr. 7, 2013), https://www.huffingtonpost.com/james-berman/adjustable-rate-mortgage_b_2593671.html (noting that people would try to re-finance into a fixed rate when mortgage rates rose).

348. See WASH. FOSTER SCH. BUS., WAMU'S OPTION-ARM STRATEGY 1–2, [hereinafter WAMU'S OPTION-ARM STRATEGY], http://faculty.washington.edu/rbowen/cases/WaMu_case_10_08.pdf; Eric Dash & Andrew R. Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES (Sept. 25, 2008), <http://www.nytimes.com/2008/09/26/business/26wamu.html>.

349. See WAMU'S OPTION-ARM STRATEGY, *supra* note 348, at 2.

350. See Gretchen Morgenson, *Slapped Wrists at WaMu*, N.Y. TIMES (Dec. 17, 2011), <http://www.nytimes.com/2011/12/18/business/in-a-wamu-settlement-with-the-fdic-slapped-wrists.html>.

351. See *In re Citigroup, Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009) (discussing the "business judgment rule," which gives protection "designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly").

352. See LaCroix, *supra* note 38.

353. See Press Release, FDIC, WaMu D&O Settlement Summary (Dec. 15, 2011), <https://www.fdic.gov/news/news/press/2011/pr11192a.html>.

What helped plaintiffs succeed in WaMu were the repeated attempts by WaMu's risk compliance officer to alert the board about problems in assessing the risk profile of WaMu's loans.³⁵⁴ In a series of internal memos to the CEO, the CFO, and other officers, presentations to the board, and written reports, the risk officer underlined the problems arising from a hasty, disorderly, and indiscriminate loan granting process.³⁵⁵ As a result, compliance officers claimed, the risk profile of loans granted could be higher than anticipated, placing the bank in dire straits in the event of a change in market conditions.³⁵⁶ Incredibly, by 2007, WaMu had already run through *nine* chief compliance officers in just seven years.³⁵⁷

Though drafted as risk warnings, the statements by WaMu's compliance officers also had clear legal consequences. They immediately raised indisputable red flags that alerted the board multiple times and in no uncertain terms, to the carelessness of the bank's loan granting machine.³⁵⁸ Upon receiving such warnings, the board should have shown appropriate care by responding to risk officers' concerns in some manner. Perhaps they could have ordered a review of loan granting processes. Perhaps they could have curtailed the discretion of loan granting officers somewhat. Perhaps they could have hired an external firm to conduct an audit of their risk office function. Instead, the board, believing in the CEO's goal of expanding WaMu's loan portfolio, did nothing. Plaintiffs argued that this amounted to a violation of the board's fiduciary duties of care and loyalty towards shareholders.³⁵⁹

C. QUADRANT NO. 3 – INTERRUPTED: YAHOO

Few cases illuminate the inescapable conflict of interest between the board and the General Counsel more sharply than the

354. Complaint for Gross Negligence, Negligence, Breach of Fiduciary Duty, Fraudulent Conveyance and Injunctive Relief at ¶¶ 2, 32–34, 45, 51, 58, 172, (W.D. Wash. Mar. 16, 2011), FDIC v. Killenger, No. 2:11-cv-00459, 2011 WL 4440410 [hereinafter WaMu Complaint].

355. *Id.* (noting that there were continuous warnings given by WaMu's internal risk managers regarding the lending spree and risk strategy).

356. *Id.* at ¶ 45.

357. See Steven Pearlstein, “*The Lost Bank: The Story of Washington Mutual*” by Kirsten Grind, WASH. POST (July 21, 2012), https://www.washingtonpost.com/opinions/the-lost-bank-the-story-of-washington-mutual-by-kirstengrind/2012/07/20/gJQAsPoQOW_story.html?utm_term=.e50ae0581cb6.

358. See WaMu Complaint, *supra* note 354, ¶¶ 25–30.

359. See WaMu Complaint, *supra* note 354, ¶ 195.

Yahoo data security breach debacle. Yahoo has now disclosed that between 2013 and 2014 all of its 3 billion user accounts were hacked, representing the largest data security breach in history by a wide margin.³⁶⁰ The immensely valuable personal information that was stolen, such as names, birthdates, and security passwords, is currently being bought and sold on “the dark web,” an area of the internet used for espionage and criminal activity.³⁶¹ When the board finally disclosed the breaches in late 2016, it claimed that it never received any information that constituted red flags.³⁶² Unlike in GM, Yahoo’s Chief Legal Officer Ronald Bell was in the know, but allegedly failed to elevate the issue to the Board, thus establishing a pattern of interrupted communications.³⁶³ The board then publically fired Bell and announced his resignation without pay in Yahoo’s 2016 10-K.³⁶⁴

1. The Biggest Data Security Breach in History

Yahoo was founded in 1995 and rode the dot-com bubble to a market capitalization of over \$125 billion by 2000.³⁶⁵ In 2008, Yahoo was at its heyday and declined Microsoft’s unsolicited \$44.6 billion acquisition offer.³⁶⁶ But by 2015 its revenues had dwindled and it was preparing to be acquired by Verizon for an original offer of \$4.8 billion.³⁶⁷ Trouble for Yahoo continued when on September 22, 2016, during acquisition talks with Verizon, it

360. See Taylor Armerding, *The 17 Biggest Data Breaches of the 21st Century*, CSO ONLINE (Jan. 26, 2018), <http://www.csionline.com/article/2130877/data-breach/the-biggest-data-breaches-of-the-21st-century.html>; *Yahoo Provides Notice*, *supra* note 6.

361. See Vinod Goel & Nicole Perlroth, *Hacked Yahoo Data Is for Sale on Dark Web*, N.Y. TIMES (Dec. 15, 2016), <http://www.nytimes.com/2016/12/15/technology/hacked-yahoo-data-for-sale-dark-web.html>.

362. *Id.* (noting that Yahoo claimed it did not know of the breach until enforcement authorities went to the company).

363. See Yahoo 2016 10-K, *supra* note 40, at 46–47 (“The Committee found that the relevant legal team had sufficient information to warrant substantial further inquiry in 2014, although they did not sufficiently pursue it.”).

364. See *id.* at 47.

365. See Myles Udland, *This Chart of Yahoo’s Market Cap Is Just the Most Outrageous Thing*, BUS. INSIDER (July 25, 2016), <http://www.businessinsider.com/yahoo-market-cap-over-time-2016-7>.

366. See Miguel Helft & Andrew R. Sorkin, *Microsoft Withdraws Bid for Yahoo*, N.Y. TIMES (May 4, 2008), <http://www.nytimes.com/2008/05/04/technology/04soft.html>.

367. See Brian Solomon, *Yahoo Sells to Verizon in Saddest \$5 Billion Deal in Tech History*, FORBES (July 25, 2016), <http://www.forbes.com/sites/briansolomon/2016/07/25/yahoo-sells-to-verizon-for-5-billion-marissa-mayer/#4e4d70d3450f>.

announced that at least 500 million of its accounts were hacked in late 2014 by “a state-sponsored actor.”³⁶⁸ The U.S. Justice Department indicted two Russian intelligence officers in March 2017, marking the first time that federal prosecutors brought cybercrime charges against Russian government officials.³⁶⁹ According to the indictment,³⁷⁰ the Russian government used information it obtained through the hack to spy on targets in the United States, including officials in the White House and U.S. military.³⁷¹ Yahoo’s valuation took an immediate hit and Verizon dropped its offer by \$350 million,³⁷² closing on June 8, 2017 at \$4.48 billion.³⁷³ But four months later, in October 2017, Yahoo tripled its earlier estimate and revealed *all three billion* of its user accounts had been hacked.³⁷⁴

2. The Independent Investigation Blames the Chief Legal Officer for Interrupted Communication

In its 2017 public disclosures, Yahoo pointed the finger at its Chief Legal Officer Ronald Bell and stated he failed to disclose “red flags” to the board. Yahoo’s 2017 10-K states,

[T]he Committee found that the relevant legal team had sufficient information to warrant substantial further inquiry in 2014, and they did not sufficiently pursue it. As a result, the 2014 Security Incident was not properly investigated and analyzed at the time, and the Company was not adequately advised with respect to the legal and business risks associated with the 2014 Security Incident.³⁷⁵

The disclosures emphasized the board’s lack of knowledge: “[t]he

368. See *An Important Message to Yahoo Users on Security*, BUS. WIRE (Sept. 22, 2016), <http://www.businesswire.com/news/home/20160922006198/en/Important-Message-Yahoo-Users-Security>.

369. See Vindu Goel & Eric Lichtblau, *Russian Agents Were Behind Yahoo Hack, U.S. Says*, N.Y. TIMES (Mar. 15, 2017), <http://www.nytimes.com/2017/03/15/technology/yahoo-hack-indictment.html>.

370. See Press Release, U.S. Dept. of Justice, U.S. Charges Russian FSB Officers and Their Criminal Conspirators for Hacking Yahoo and Millions of Email Accounts (Mar. 15, 2017), <http://www.justice.gov/opa/pr/us-charges-russian-fsb-officers-and-their-criminal-conspirators-hacking-yahoo-and-millions>.

371. See *id.* (noting that the hackers went after Russian and U.S. government officials, Russian journalists, and large commercial entities).

372. See Yahoo 2016 10-K, *supra* note 40, at 131; Vindu Goel, *Verizon Will Pay \$350 Million Less for Yahoo*, N.Y. TIMES (Feb. 21, 2017), <http://www.nytimes.com/2017/02/21/technology/verizon-will-pay-350-million-less-for-yahoo.html>.

373. See Press Release, Verizon, *Verizon to Acquire Yahoo’s Operating Business* (July 25, 2016), <http://www.verizon.com/about/news/verizon-acquires-yahoos-operating-business>.

374. See *Yahoo Provides Notice*, *supra* note 6.

375. See Yahoo 2016 10-K, *supra* note 40, at 47.

Independent Committee also found that the Audit and Finance Committee and the full Board were not adequately informed of the full severity, risks, and potential impacts of the 2014 Security Incident and related matters.³⁷⁶ As a result, the CEO's compensation was docked, but Bell was signaled out as *the only* employee who would lose his job. In case there was any doubt, the disclosures publicly shamed Bell, stating that, "[n]o payments are being made to Mr. Bell in connection with his resignation."³⁷⁷ Bell's public and apparently forced resignation triggered an outcry in the legal community.³⁷⁸ Fellow general counsels from technology giants like Twitter tweeted their support for Bell, and local technology newspapers published stories with headlines like, "Silicon Valley GCs Defend Ron Bell; Say He's The Fall Guy."³⁷⁹

3. Plaintiffs Challenge the Board's Account of Interrupted Communication

The impact on Yahoo was swift and severe, and is ongoing. Yahoo is the subject of federal, state, and even foreign investigations by regulatory bodies including the SEC, FTC, U.S. Attorney, and various state Attorneys General.³⁸⁰ In addition, Yahoo faces a storm of litigation brought by consumers—a staggering forty-three consumer class actions.³⁸¹ Angered by the extent of harm to the company, investors have also attempted to hold the board accountable. Shareholders have brought federal securities

376. See *id.*

377. See *id.*

378. Twitter's general counsel Vijaya Gadde tweeted, "I don't know what happened at Yahoo but I know it's easy to blame the lawyers . . . I also know that Ron Bell is a good lawyer." Vijaya Gadde (@vijaya), TWITTER (Mar. 1, 2017, 3:58 PM), <https://twitter.com/vijaya/status/837089571074519040?lang=en>. Scott Moore, a former Senior Vice President at Yahoo also tweeted, "Ridiculous. I know @ronsbell_tech who is a good man and as a lawyer he wasn't in charge of security @Yahoo #lame CYA move @marissamayer." Scott Moore (@scottm00re), TWITTER (Mar. 1, 2017, 4:25 PM), <https://twitter.com/scottm00re/status/837096533669523456>.

379. See Ruiz, *supra* note 44.

380. Aruna Viswanatha & Robert McMillan, *Yahoo Faces SEC Probe Over Data Breaches*, WALL ST. J. (Jan. 23, 2017), <https://www.wsj.com/articles/yahoo-faces-sec-probe-over-data-breaches-1485133124>.

381. See Vindu Goel, *Yahoo's Top Lawyer Resigns and C.E.O. Marissa Mayer Loses Bonus in Wake of Hack*, N.Y. TIMES (Mar. 1, 2017), <https://www.nytimes.com/2017/03/01/technology/yahoo-hack-lawyer-resigns-ceo-bonus.html>.

claims under both 10(b) and 20(a)³⁸² and filed derivative actions for fiduciary duty violations in both Delaware and California.³⁸³

The allegations in the complaints are heavily focused on the existence, adequacy, and frequency of written communication between inside legal counsel and the board. Some plaintiffs³⁸⁴ allege that the board attempted to avoid liability by ensuring that the communication between the board and the legal department would remain interrupted. For example, they claim that that Yahoo “did not maintain minutes” for meetings where the data breaches were discussed, “failed to document the discussions” they had about the breaches, and engaged in “active attempts to not document the most incriminating information the Board discussed.”³⁸⁵ Other plaintiffs opted to include Bell as a defendant on the theory that he breached his fiduciary duties of oversight and supervision by failing to protect Yahoo’s data.³⁸⁶ Still others point to specific machinations by Ronald Bell and the board including the use of code names such as “Siberia” in memos prepared by the legal department to refer to the breaches.³⁸⁷

To sum up, there is a familiar pattern in these and numerous other cases pending against Yahoo. Plaintiffs, whether investors or users, are trying to penetrate the shield of interrupted communication that the board is using as a defense. Some plaintiffs base their claim on evidence of the chief legal counsel’s apparent knowledge and target him directly for not actively reacting. Other plaintiffs do not name Bell at all, but attempt to reveal how the board was using him as a liability shield. Regardless of these differences, the outcome of these cases will rest on whether the information between legal and the Board in fact remained interrupted.

382. See Complaint & Demand for Jury Trial ¶¶ 165–66, Spain v. Mayer, No. 17CV307054 (Cal. Super. Ct. Santa Clara Cty. Ct. Mar. 7, 2017) [hereinafter Complaint, Spain v. Mayer] (discussing the derivative claim and futility).

383. See *id.*; Complaint, Okla. Firefighters Pension & Ret. Sys. v. Brandt, C.A. No. 2017-0133-SG (Del. Ch. filed Feb. 23, 2017) [hereinafter Complaint, Okla. Firefighters].

384. See Complaint, Okla. Firefighters, *supra* note 383, ¶¶ 9–12.

385. *Id.* ¶¶ 12, 116.

386. See Complaint, Spain v. Mayer, *supra* note 382, ¶ 40.

387. Amended Complaint & Demand for Jury Trial ¶ 104, *In re Yahoo! Inc. Customer Data Sec. Breach Litig.*, Nos. 16-MD-02752, 5:16-CV-06990, (N.D. Cal. Dec. 19, 2016), 2016 WL 9710969.

D. QUADRANT NO. 4 – INCOMPLETE: WELLS FARGO

While Wells Fargo was one of the few major banks to have emerged from the financial crisis on a white horse, its currently unfolding fake account scandal reflects some of the darkest days in banking history. Wells Fargo has now admitted to opening an eye-popping 3.5 million fake bank accounts by forging client signatures.³⁸⁸ *The Los Angeles Times* broke the story of Wells Fargo’s “relentless pressure to sell” in 2013, exposing the scandal.³⁸⁹ The bank has already paid upwards of \$185 million in fines to various regulatory bodies,³⁹⁰ suffered what some have estimated to be a forty percent relative hit to its stock price,³⁹¹ and it continues to battle private lawsuits and pay settlements to the tune of over \$140 million.³⁹² Perhaps the biggest hit came on February 2, 2018, when the Federal Reserve restricted growth by assets until Wells Fargo improved its risk assessment and governance, effectively prohibiting it from taking net additional deposits.³⁹³ The Federal Reserve also pushed for, without directly mandating, the resignation of any Wells Fargo’s board members who had served during the scandal and still remained on the board.³⁹⁴

Given the scale of the scandal, it is no surprise that shareholders took aim at the board and executives, and brought a shareholder derivative action in February 2017.³⁹⁵ The action has survived a motion to dismiss and Wells Fargo directors and officers are now defending against both Delaware fiduciary duty

388. Laura J. Keller, *Wells Fargo Boosts Fake-Account Estimate 67% to 3.5 Million*, BLOOMBERG (Aug. 31, 2017), <https://www.bloomberg.com/news/articles/2017-08-31/wells-fargo-increases-fake-account-estimate-67-to-3-5-million>.

389. See Reckard, *supra* note 45.

390. See Matt Levine, *Wells Fargo Opened a Couple Million Fake Accounts*, BLOOMBERG: OPINION (Sept. 9, 2016), <https://www.bloomberg.com/opinion/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts>.

391. See John Maxfield, *Chart: The Cost of Wells Fargo’s Sales Scandal*, THE MOTLEY FOOL (Sept. 6, 2017), <https://www.fool.com/investing/2017/09/06/chart-the-cost-of-wells-fargos-sales-scandal.aspx>.

392. See David Ng, *Judge Approves \$142-Million Class-Action Settlement in Wells Fargo Sham Accounts Scandal*, L.A. TIMES (July 9, 2017), <http://www.latimes.com/business/la-fi-wells-fargo-settlement-20170709-story.html>.

393. Emily Flitter et al., *Federal Reserve Shackles Wells Fargo After Fraud Scandal*, N.Y. TIMES (Feb. 2, 2018), <https://www.nytimes.com/2018/02/02/business/wells-fargo-federal-reserve.html>.

394. See *id.*

395. See Consolidated Amended Complaint & Demand for Jury Trial, *In re Wells Fargo & Co. S’holder Derivative Litig.*, No. 3:16-CV-05541, (N.D. Cal. Feb. 4, 2017), 2017 WL 1044785.

and federal security law claims.³⁹⁶ In allowing the case to proceed, the court cited “red flags” that included communications between employees and board members, multiple lawsuits, employee terminations, and the L.A. Times articles.³⁹⁷ As we discuss below, information about fraudulent sales practices first reached the legal and compliance personnel at Wells Fargo, and then the board itself at various times over the last five years.³⁹⁸ But instead of getting to the bottom of the problem, legal and compliance personnel opted for incomplete communications to the board.³⁹⁹ Though officially displeased, the board did not take further action on the ground until the scandal was revealed.

1. Legal and Compliance Personnel Become Aware of Problems

In determining how much information about the scandal reached the board, the actions of Michael Loughlin, the Chief Risk Officer (CRO) who led compliance, and James Strother, the General Counsel (GC), were instrumental. Though neither had the authority to enforce changes to the bank’s practices on the ground, they both sat on the bank’s Executive Risk Management Committee (EMRC), tasked with reporting, evaluating, and escalating issues to the Board.⁴⁰⁰ The committee met *monthly* and advised the board *quarterly*.⁴⁰¹ Dating to as far back as 2002, Wells Fargo’s low-level lawyers and compliance officers had encountered sales integrity issues, but failed to escalate them to their respective heads because they viewed them as minor risks.⁴⁰² By 2012, Loughlin was sufficiently concerned about shady sales practices to ask bank executives for a report to the EMRC.⁴⁰³ Though “very dissatisfied” with the thoroughness of the report, the EMRC did not pursue a formal investigation.⁴⁰⁴ Instead, at Loughlin’s request, the board agreed to hire hundreds more compliance professionals and allocate considerably more funding to the compliance function.⁴⁰⁵

396. *In re Wells Fargo & Co. S’holder Derivative Litig.*, 282 F. Supp. 3d 1074, 1074–75 (N.D. Cal. 2017).

397. *See id.* at 1088.

398. WELLS FARGO INDEPENDENT DIRECTORS REPORT, *supra* note 46, at 15.

399. *See id.*

400. *See id.* at 60–61.

401. *Id.* at 61.

402. *Id.* at 80.

403. *Id.* at 64.

404. *Id.*

405. *Id.* at 63.

2. Press Articles Raise Red Flags

In October and December 2013, the *Los Angeles Times* published two articles exposing an investigation by Los Angeles County into Wells Fargo's sales practices.⁴⁰⁶ The articles' claims were in line with the findings of an internal inquiry by the Enterprise Services Division, about which both the GC and CRO were extensively briefed. With the scandal already spilling over to the public domain, the response inside the bank would be critical for any future litigation or regulatory procedure. The legal department chose inaction, and "did not further escalate the existence or details of the investigation to the Board or any Board Committees at that time."⁴⁰⁷ In contrast, the CRO initially identified sales practices as a "significant risk" in written memos to the board in early 2014,⁴⁰⁸ but did not provide detailed information, and backtracked on the risk estimate within a year. At the time, neither the compliance department conducted an investigation, nor did the board ask for one.⁴⁰⁹

3. Legal and Compliance Officers Opt for Incomplete Communications

On May 4, 2015, the Los Angeles City Attorney filed a lawsuit against Wells Fargo for its sales practices, which triggered a series of inquiries by regulatory bodies.⁴¹⁰ This caught the attention of the board, which asked the GC and the Head of Community Banking, Carrie Tolstedt, for a presentation at their next meeting.⁴¹¹ The in-house lawyers and banking executives appeared to wrangle and negotiate back and forth on the drafts of the board presentation, eventually settling on omitting key information. The board's risk committee was "highly critical" of the presentation and claimed that they were "blindsided" by the fact that as many as 230 employees were terminated because of the sales practices.⁴¹² What the board did not know, however, was that the curtain was lifted only a little—the *actual* aggregate number of terminations was in fact closer to 1500 employees.⁴¹³

406. See, e.g., Reckard, *supra* note 45.

407. WELLS FARGO INDEPENDENT DIRECTORS REPORT, *supra* note 46, at 76–77.

408. *Id.* at 67.

409. *Id.* at 77.

410. *Id.*

411. *Id.* at 104.

412. *Id.* at 105.

413. *Id.* at 109.

The board turned to the CRO, Loughlin, who assured the board that he would conduct a third-party review of the sales practices, and asked for additional resources.⁴¹⁴ At the direction of the board, the risk function was expanding rapidly with significantly increased budgets and staffing. But the board did not investigate further the immediate scandal. For most of 2016, “Board members still understood it to be mostly a Southern California problem with terminations in the range of 230.”⁴¹⁵

In September 2016, Wells Fargo announced that it would pay \$100 million to the Consumer Financial Protection Bureau, the largest fine *ever* imposed by the agency, \$35 million to the Office of the Comptroller of the Currency, and a \$50 million settlement to Los Angeles.⁴¹⁶ The board only learned that approximately 5300 employees had been terminated for sales practices violations through these settlements.⁴¹⁷ In addition to the settlements, congressional hearings led by Senator Elizabeth Warren made headlines and delighted the general public as she grilled Wells Fargo’s leadership.⁴¹⁸ With the curtain now fully drawn back, the board members were forced onto the public stage, where they had to act immediately. They met in September, fired Carrie Tolstedt, and rescinded CEO Stumpf’s unvested compensation and bonus.⁴¹⁹ The board also accelerated the buildout of its compliance department. In 2016 and 2017, over 5200 compliance employees were realigned to report to the CRO.⁴²⁰

Overall, the typology we offer above helps improve our understanding of how interactions between the board and its legal and compliance officers, before a corporate failure becomes public, formulate the liability outcomes later. Although criticisms of compliance have traditionally focused on an archetypal alignment of interests between the board and its legal and compliance officers, we show that, although untraceable communications is

414. *Id.* at 70.

415. *Id.* at 108.

416. Press Release, CFPB, Consumer Financial Protection Bureau Fines Wells Fargo \$100 Million for Widespread Illegal Practice of Secretly Opening Unauthorized Accounts (Sept. 8, 2016), <https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts>.

417. WELLS FARGO INDEPENDENT DIRECTORS REPORT, *supra* note 46, at 16.

418. See Gelles, *supra* note 9.

419. See WELLS FARGO INDEPENDENT DIRECTORS REPORT, *supra* note 46, at 9–10.

420. *Id.* at 12.

a possible outcome, it is not the only one. In contrast, we illustrate a variety of strategies that legal and compliance officers followed once in possession of incriminating information. Their choices, and the ensuing board reaction, become the focus of shareholder litigation after massive scandals.

CONCLUSION

Traditional corporate law theory portrays the board as the ultimate monitor of shareholders' interests, watching over management's actions. But for decades, this theoretical construct seemed to have little bite in reality, since prevailing in *Caremark* claims was notoriously hard. Nowadays, *Caremark* plaintiffs and regulators stand a better chance, we argue, due to the staggering growth of compliance, which can produce the evidentiary record that opens the path toward board liability. In turn, the power to control this evidentiary path grants chief legal and compliance officers more influence over the board. Thus, we have introduced in the corporate law debate new actors, whose incentives and motivations are instrumental in deterring corporate wrongdoing. Below, we discuss the implications of our argument for future research and for policymaking.

The typology we offered in Part V illustrates not only the critical role of chief legal and compliance officers, but also the diverse choices they make. To better grasp what leads to these choices, further research is necessary. One potential direction in this inquiry is the institutional makeup of compliance. Because setting up compliance departments has been largely left to companies' discretion, there is wide variation in structure, powers, and resources available. For example, there is a heated debate over whether the roles of chief legal and compliance officer should be combined.⁴²¹ This variation can be leveraged for empirical studies of successful compliance operations. Moreover, since the influence of these corporate actors is only now becoming clear, a closer account of their experiences, interests, backgrounds, and professional goals would help us better understand their motivations.

For policymakers, who have been key drivers behind the compliance revolution, our analysis above shows what has been

421. See Michael Peregrine, *Compliance or Legal? The Board's Duty to Assure Clarity*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 12, 2014), <https://corpgov.law.harvard.edu/2014/08/12/compliance-or-legal-the-boards-duty-to-assure-clarity>.

achieved, but also how much is still left to do. As we have discussed above, policymakers have already understood that simply requiring companies to hire more compliance officers will not be effective, unless accompanied by changes in governance, such as providing a reporting avenue to the board. Professional associations, outside counsel, and other bodies are formulating best practices for compliance operations.⁴²² The structure of legal and compliance oversight has become a primary focus for institutional investors, who are concerned about the potential fallout.⁴²³ For those interested in boosting board accountability, this is a fertile ground for further intervention.

As the choices legal and compliance officers make in communicating with the board have far-reaching repercussions, policymakers might consider ways to further empower the heads of legal and compliance departments. One such tool consists in providing specific guidelines for how to structure reports and identify red flags, as is the case in anti-money laundering laws. Another boost to the standing of these officers within the corporation could come through broadening their liability for compliance failures. With the threat of legal sanctions over their heads, legal and compliance officers might be more steadfast toward company executives who ask them to ignore malfeasance. For now, instances of legal and compliance professionals being held personally liable for corporate misconduct remain rare.

Legal and compliance heads are particularly important in moments of crisis. At these times, companies turn to their general counsel not only for managing the fallout from past wrongdoing, but also for future leadership. Too often, the capabilities and skills of visionary CEOs are not particularly well suited to steering the company through the tumultuous waters of corporate calamity. Sometimes, the CEOs themselves are embroiled in crisis. Instead, chief legal and compliance officers are called upon to reform how the company does business, behaves towards its employees and competitors, and manages its resources. To achieve this turnaround, companies often hire new high-profile lawyers who are given extensive powers and resources. Following a year of successive crises, Uber CEO Dara Khosrowshahi's

422. See Matthew Sullivan, *Research Roundup: Unpacking Ethics and Compliance with Melanie Condron of Accenture*, ACC DOCKET (Mar. 31, 2017), <https://www.accdocket.com/articles/research-roundup-melanie-condron.cfm>.

423. See Martin Lipton, *Risk Management and the Board of Directors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 28, 2015), <https://corpgov.law.harvard.edu/2015/07/28/risk-management-and-the-board-of-directors-3>.

first major hire was a new general counsel, Tony West, who had gotten his previous company, Pepsi, recognized as one of the world's most ethical companies ten years in a row.⁴²⁴ Wells Fargo recently named Allen Parker, former managing partner of Cravath Swaine & Moore LLP, to head its legal department, emphasizing his expertise in ethical leadership.⁴²⁵ Once the backwaters of the legal profession, the chief legal counsel role has become the domain of legal superstars.

These moves confirm the meteoric rise of compliance as a core corporate function, firmly ensconced among the key duties of the board. In the modern workplace, oversight is ubiquitous, and violations of law have severe consequences all the way to top management. We are only now beginning to see the muscle of compliance in full action.

424. Hamza Shaban, *Uber Hires PepsiCo's Tony West as General Counsel*, WASH. POST: THE SWITCH (Oct. 27, 2017), https://www.washingtonpost.com/news/the-switch/wp/2017/10/27/uber-hires-pepsicos-tony-west-as-general-counsel/?utm_term=.5539e9494cb2.

425. David Lat, *A Biglaw Leader's Major Move: Wells Fargo Taps Allen Parker of Cravath as General Counsel*, ABOVE THE LAW (Mar. 7, 2017), <https://abovethelaw.com/2017/03/a-biglaw-leaders-major-move-wells-fargo-taps-allen-parker-of-cravath-as-general-counsel>.