TAKING COMPLIANCE SERIOUSLY

John Armour,[*] *Jeffrey Gordon,*[**] *and Geeyoung Min*[***]

ABSTRACT

How can we ensure corporations play by the "rules of the game"—that is, laws encouraging firms to avoid socially harmful conduct? Corporate compliance programs play a central role in society's current response. Prosecutors give firms incentives—through discounts to penalties—to implement compliance programs guiding and monitoring employees' behavior. However, focusing on the incentives of firms overlooks the perspective of managers, who decide how much firms invest in compliance.

We show that stock-based pay, ubiquitous for corporate executives, creates systematic incentives to short-change compliance. Compliance is a long-term investment for firms, whereas managers' time-horizon is truncated at the date they expect to liquidate stock. Moreover, investors find it hard to value compliance programs, because firms routinely disclose little or nothing about their compliance activities. We show that stock-compensated managers prefer not to disclose compliance, because it can reveal private information about a firm's propensity to misconduct: the greater a firm's misconduct risk, the more valuable to it is an investment in compliance. As a result, both managers and markets are likely myopic about compliance.

How can this problem be resolved for the benefit of society and shareholders? Boards of directors are supposed to act as monitors to control managerial agency costs. We show that the increasing use of stock-based compensation for directors, justified as a means of encouraging more vigorous oversight of business decisions, also has a corrosive effect on boards' monitoring incentives for compliance. Directors in theory face

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[*] Professor of Law and Finance, University of Oxford; Steven & Barbara Friedman Visiting Professor of Law, Columbia Law School.

[**] Richard Paul Richman Professor of Law, Columbia Law School; Visiting Professor, University of Oxford.

[***] Adjunct Assistant Professor of Law and Postdoctoral Fellow in Corporate Law and Governance, Ira M. Millstein Center, Columbia Law School.

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liability for compliance oversight failures, but only if so comprehensive as to amount to bad faith. We argue that this standard of liability, established in an era before ubiquitous stock-based compensation, has now become too lax.

We propose more assertive directors' liability for compliance failures, limited in quantum to a proportionate clawback of stock-based pay. This would realign directors' interests with those of shareholders—directors would stand to lose in parallel with shareholders should a compliance failure materialize—but limiting liability in this way would avoid pushing boards to overinvest in compliance. We outline ways in which this proposal could be implemented either by shareholder proposals or judicial innovation.

TABLE OF CONTENTS

Introduction 3
I. Why Compliance Matters 12
A. The "Rules of the Game" 12
B. Effective Compliance Programs 16
C. Resourcing Compliance 19
II. Short-Changing Compliance 22
A. Stock-Based Compensation 22
B. Managerial Myopia about Compliance 23
C. Upside Bias Devalues Compliance 27
D. Market Myopia About Compliance 29
III. Board Oversight of Compliance 34
A. The Board's Role in Compliance Oversight 34
B. The Monitoring Board and "Skin in the Game" 38
C. Perverse Effects of Directors' Focus on Stock Price 41
D. Interacting Managers' and Directors' Incentives 42
IV. *Caremark* and its Limitations 43
A. Caremark Duties 43
B. The "good faith" standard 45
C. The Caremark standard's balance 48
D. The Growing Imbalance 50
E. Lack of guidance from Delaware Courts 50
F. Mixed messages from elsewhere 53
V. The Case for a "Compliance Clawback" 55
A. A self-limiting liability proposal 55
B. What Does "Effective" Compliance Look Like? 57
C. The Supply of Directors 58
D. Implementing Compliance Clawbacks 60
1. ... Shareholder Route 60
2. ... Judicial Route 61

Conclusion 63
Appendix I: General Model for Non-Disclosure 63
Appendix II: Delaware Oversight Duties Opinions 67

INTRODUCTION

It takes your breath away. Over nearly a decade Wells Fargo, one of the largest banks in the US—and recipient of $25 billion in government capital support during the financial crisis—engaged in widespread consumer credit violations in three separate business areas: opening unauthorized credit card and other accounts for existing customers; wrongfully charging fees for extensions of home mortgage commitments; and wrongfully forcing auto loan debtors to take on insurance. Millions of account-holders were affected. As these practices come to light, the consequences for Wells-Fargo have been severe, not only $100s of millions in fines, but also a cap placed on its growth until its governance, risk management, and compliance functions have been reordered to the satisfaction of the Federal Reserve.[1] Wells Fargo's own special committee investigation documented that failures in the bank's compliance program were a contributing cause to the corrosion of the firm's culture.[2]

This is not an isolated example. A series of recent corporate scandals all follow a depressingly similar pattern: directors and officers appear to have short-changed compliance with law in the pursuit of short-term financial gains. This is consistent with Volkswagen's cynical falsification of emissions tests for diesel fumes;[3] the focus of firms like BP and Duke Energy on cost-cutting seemingly at the expense of compliance with safety and environmental regulation;[4] banks' pursuit of customer acquisition at the

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[1] In the Matter of Wells Fargo & Co. (Bd of Gov. FRB) (Dkt. 18-007-B-HC (Feb. 2, 2018).

[2] Independent Directors of Board of Wells Fargo & Co., Sales Practices Investigation Report (Apr. 10, 2017).

[3] *See* John Armour, *Volkswagen's Emissions Scandal: Lessons for Corporate Governance?*, Oxford Business Law Blog (Part I, May 17, 2016; Part II, 18 May 2016); JACK EWING, FASTER, HIGHER, FARTHER: THE INSIDE STORY OF THE VOLKSWAGEN SCANDAL (2017).

[4] *See*, on BP: ABRAHAM LUSTGARTEN, RUN TO FAILURE: BP AND THE MAKING OF THE DEEPWATER HORIZON DISASTER (2012); Joel Amernic & Russell Craig, *CEO speeches and safety culture: British Petroleum before the Deepwater Horizon disaster* 47 CRIT. PERSP. ACC. 61 (2017); on Duke Energy: Jonathan M. Katz, *Duke Energy is Charged in Huge Coal*

expense of compliance with anti-money laundering and terrorist financing restrictions;[5] and firms like Equifax and Facebook's seemingly casual approach to the integrity of personal data.[6] In each of these cases, social costs have eventually been brought to bear on the firms in the form of enforcement (or in some cases reputational) penalties, associated with sharp stock price declines. The problems seem not so much to be shareholders profiting at society's expense, but failures in corporate governance harming both society and shareholders.

The conventional view of corporate governance is that managers should maximize the firm's value on behalf of shareholders, subject to the constraints imposed by law.[7] These constraints—known colloquially as the "rules of the game"—seek to align shareholders' welfare with social welfare by imposing penalties for socially harmful corporate acts.[8] These penalties bite only if they are enforced. To facilitate this, prosecutors give firms incentives—through discounts to penalties—to implement compliance programs guiding and monitoring employees' behavior.[9] Such programs

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Ash Leak, N.Y. TIMES, Feb. 20, 2015; City of Birmingham Retirement and Relief System v. Good, Del., 177 A.3d 47 (2017).

[5] *See, e.g.,* Michael Corkery & Ben Protess, *Citigroup Agrees to $97.4 Million Settlement in Money Laundering Inquiry*, N.Y. TIMES, May 22, 2017; Andrew Ross Sorkin, *U.S. Bancorp Fined $613 Million for Money-Laundering Violations*, N.Y. TIMES, Feb. 15, 2018; Department of Justice, Settlement Between Department of Justice and Western Union will Provide $586 Million to Victims of Fraud, Mar 14, 2018.

[6] *See, e.g.,* on Equifax: AnnaMaria Andriotis, Michael Rapoport, & Robert McMillan, *'We've Been Breached': Inside the Equifax Hack*, WALL ST. J., Sep. 18, 2017; Lalita Clozel, *Equifax Ordered by Eight States to Beef Up Cybersecurity*, WALL ST. J., June 27, 2018; on Facebook: Deepa Seetharaman & Kirsten Grind, *Facebook's Lax Data Policies Led to Cambridge Analytica Crisis*, WALL ST. J., Mar 20, 2018; Deepa Seetharaman, *Facebook Shares Tumble as Growth Outlook Darkens*, WALL ST. J., Jul 25, 2018.

[7] *See, e.g.,* MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962); FRANK H. EASTERBOOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35-39 (1991); HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 23, 53-65 (1996); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 18-27 (2008); STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 2-3 (2012); John Armour, Henry Hansmann, Reinier Kraakman & Mariana Pargendler, *What is Corporate Law?*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, at 13-15, 22-24 (3rd ed., Reinier Kraakman et al, 2017)

[8] The term "rules of the game" was coined by Friedman, *supra* note 7.

[9] Some regulations specify compliance programs that firms must establish *ex ante*. More generally, prosecution and sentencing guidelines suggest more lenient treatment should be

work to lower the likelihood, and increase the probability of detection, of relevant misconduct.[10]

However, focusing on the incentives of firms overlooks the perspective of managers, who decide how much firms invest in compliance. Stock-based pay, ubiquitous for corporate executives, creates systematic incentives to short-change compliance.[11] As the decade-long run of fraud at Wells Fargo illustrates, detection and enforcement of misconduct typically take many years. Compliance is consequently a long-term investment for firms. Yet managers' time-horizon is truncated by the date they expect to liquidate stock.[12]

Distortions in managerial incentives created by stock-based pay would not be a problem if the present value of compliance investment were taken into account in the stock price. A second conventional assumption in corporate governance is that the stock market impounds the present value of investments into stock prices.[13] Consequently, where corporate investments are expected to yield value in the future, their present value will show up in

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offered *ex post* where firms have implemented "effective" compliance programs. These channels are detailed *infra,* Section I.A.

[10] Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes* 72 NYU L. REV. 687 (1997) (compliance regimes harness firms' informational advantage over regulators and prosecutors regarding employees' behavior); Alexander Dyck, Adair Morse, & Luigi Zingales, W*ho Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213 (2010) (evidencing significant role of private mechanisms in detecting corporate frauds).

[11] For prior discussion of links between managerial compensation and compliance failures, see Armour, *supra* note 3 (VW's CEO had very high-powered financial incentives to pursue corporate growth and was in the final year of his tenure); Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U CHI. L. REV. 323, 355-58 (2017) (noting managers may derive private benefits from corporate non-compliance owing to the structure of their compensation).

[12] *See infra*, Section II.B. A separate problem arises where managers are paid in stock options. With options, managers receive more if the firm's stock price improves, but do not lose more if it goes down. This consequently introduces an "upside bias" to investment decision-making. This can lead option-compensated managers to undervalue compliance investment, because this does not add value in good states but reduces losses in bad states. *See infra*, Section II.C.

[13] *See, e.g.*, Easterbrook & Fischel, *supra* note 7, 18-19; Hansmann, *supra* note 7, 23; Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1543-47 (2007); *Cf.* LYNN STOUT, THE SHAREHOLDER VALUE MYTH 63-65 (2012).

stock price today.[14] A theory of compliance failure caused by stock-based pay must show why markets cannot assess the present value of compliance.

We show that this logic may fail for investments in compliance. Investors likely find it hard to value compliance programs, because firms routinely disclose little or nothing about their compliance activities.[15] We model how stock-compensated managers prefer not to disclose compliance, because it can reveal private information about a firm's propensity to misconduct: the greater a firm's misconduct risk, the more valuable to it is an investment in compliance.[16] As a result, both managers and markets are likely myopic about compliance. Managers consequently have incentives to underinvest in corporate compliance programs.

A third standard assumption in corporate governance is that oversight by boards of independent directors can help to control managerial agency costs, including as respects compliance.[17] We show that boards' incentives to engage in compliance oversight have suffered a parallel weakening to those of managers.[18] Directors traditionally received fixed compensation, giving them only 'low-powered' incentives to engage with the strategic and operational decisions of the firm.[19] This provoked concerns that boards were too passive.[20] Since the mid-1990s, there has been a consequent sea-change

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[14] *See, e.g.*, Macey, *supra* note 7, at 266 ("[B]asic financial theory indicates that rational [shareholders] will fully support any and all long-term investment decisions by companies even if those decisions will not result in a payoff for the portfolio company for many years because the *expected future cash flows* will have an immediate impact on a firm's share price, which is simply the value of those cash flows discounted to present value.")

[15] See Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2100 (2016) (firms are not required to report information on compliance in their public filings, meaning details of compliance programs are not publicly available).

[16] *See infra*, Section II.D and Appendix I.

[17] *See e.g.*, Bainbridge, *supra* note 7, 50-60 (charting rise of "monitoring board" model) Gordon, *supra* note 13, 1535-40 (same); Renée B. Adams, Benjamin E. Hermalin, & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LIT. 58, 65-74 (2010) (review of empirical literature on board assessment of CEO performance).

[18] *See infra*, Section III.

[19] *See* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 147-48 (1997) (median annual retainer for outside directors in 1962 was $2,000; rising to $6,000 by 1975, $15,000 by 1981 and $18,900 by 1985).

[20] *See* NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF NACD BLUE RIBBON COMMISSION ON DIRECTOR COMPENSATION (1995) (arguing the need to incentivize directors); Elson, *supra* note 19, 156-64 (arguing fixed salary causes boards to be too

in directors' compensation practices.[21] Directors of US public companies now receive the majority of their compensation in the form of stock-based pay, similar to managers in structure, albeit less in absolute amount.[22] While this gives directors more "skin in the game", encouraging engagement, it paradoxically undermines their incentives with respect to compliance, for the same reasons we identify for managers. Rather than serving to rein in managers' excesses, boards risk becoming their cheerleaders.

We argue that the tendency to short-change compliance can be addressed through a more assertive potential liability regime for compliance oversight failures. Of course, if managers knowingly sanction corporate crime, then they will face individual criminal penalties. But targeting them for liability is difficult because most enforcement measures against persons require proof of intent, and knowledge is diffuse within the firm, sometimes strategically so.[23] The problem of proving individual knowledge and intent apparently was the impediment to prosecutions of senior bank officials following the financial crisis.[24]

As regards civil liability for directors under corporate law, the current Delaware position was established in 1996 by Chancellor Allen in *Caremark*.[25] His well-known opinion articulated two things: First, that boards needed to assure the existence of:[26]

> [I]nformation and reporting systems … that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board,

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passive).

[21] *See, e.g.,* Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229, 2229 (2005) (noting that the number of Fortune 1000 firms using stock-based remuneration increased from just over 200 in 1992 to almost 500 in 1995).

[22] *See* FW COOK, 2016 DIRECTOR COMPENSATION REPORT, 5-6 (2016); NACD/Pearl Meyer, What's Next for Director Compensation in 2018?, 7-8 (2017).

[23] *See e.g.*, SAMUEL W. BUELL, CAPITAL OFFENSES: BUSINESS CRIME AND PUNISHMENT IN AMERICA'S CORPORATE AGE (2016), 130-32.

[24] Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POL. REV. 265 (2014).

[25] In re Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959, 968 (Del Ch. 1996) (Allen, C.) (referring to "increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements" as well as the value of corporate compliance programs under the federal sentencing guidelines). *See* generally,

[26] *Id.* at 970.

> each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

But second, liability would be triggered only by a failure of oversight so comprehensive as to call into question the board's good faith.[27] The necessary degree of oversight failure to trigger liability was later characterized by the Delaware Supreme Court as an "utter fail[ure] to implement any reporting or information controls."[28]

Caremark was an innovation in its time, introducing for the first time the idea of a general duty to implement a system of monitoring and controls. Prior Delaware caselaw had suggested that directors were "entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong"—that is, a "red flag".[29] Chancellor Allen articulated the new standard against a background of rapid increases in fines for corporate crimes coupled with the introduction in 1994 by the US Sentencing Commission of sentencing discounts for firms with an effective compliance system in place.[30]

However, we argue that *Caremark* is no longer sufficient to carry the freight assigned to it.[31] The corporate governance context has continued to evolve, and *Caremark*'s standard of liability does not respond to the peculiarly problematic incentives created for compliance investment and oversight by the rise of stock-based pay. The present regime is likely to engender "box-ticking" compliance programs: meeting the low hurdle that some sort of "compliance program" must exist but lacking the level of investment necessary to secure a real change in behavior. Liability standards

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[27] *Id.*

[28] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[29] Graham v. Allis-Chalmers Mfg. Co 188 A.2d 125, 130 (Del. 1963).

[30] *See* generally, Hillary A. Sale, *Monitoring* Caremark's *Good Faith*, 32 DEL. J. CORP L. 719 (2007) (detailing history of *Caremark*); 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) (same); Donald C. Langevoort, *Caremark and Compliance: A Twenty Year Lookback*, forthcoming TEMPLE L. REV. (2018) (review of subsequent developments).

[31] The *Caremark* standard has been criticized on a basis tangential to the one advanced here, namely that its scope should extend also to business risk as well as compliance risk: *see e.g.*, 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); Bainbridge, *supra* note 7, 169-176; Claire A. Hill & Brett H. McDonnell, *Reconsidering Board Oversight Duties After the Financial Crisis* 2013 U. ILL. L. REV. 859 (2013). We do not consider this claim here.

must work to offset the incentives to avoid compliance with applicable legal rules; they should function as a complement that maximizes the value of the firm for shareholders and society. The compliance oversight standard of *Caremark* has become a poor match for the greatly-intensified incentives of both managers and directors.[32]

Moreover, by setting the hurdle for directors so low, the *Caremark* standard effectively precludes judicial consideration of compliance issues. This means Delaware courts have foregone any role as interlocutors and duty-setters on compliance matters. One of the historical roles of the Delaware Chancery Court has been to build out the substance of fiduciary duty in wide-ranging contexts, not just through liability determinations but through developing ideas of "best practice" in the course of detailed analysis of particular cases.[33] The almost-invariable dismissal of cases alleging the

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[32] This is also a lesson from the Enron/WorldCom scandal. Enron's board failed to detect fraud in its financial reports perpetrated by executives desperate to sustain the firm's stock price until they could exercise their (very considerable) option packages: *see* John C. Coffee, Jr, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269; JOHN ARMOUR AND JOSEPH A. MCCAHERY, AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US 1-7 (2006). The lesson is that very high-powered compensation incentives for executives mean boards must step up to their jobs in a different way. The Sarbanes-Oxley Act of 2002 responded to this by introducing a bespoke compliance oversight regime for financial reporting, subject to scrutiny by a firm's auditors: *see, e.g.,* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002). However, firms are subject to a wide array of legal obligations that are not so readily identifiable and manageable. Ramping up the board's responsibilities and liability risk for more diverse compliance oversight failures, in presence of these high-powered compensation incentives, is the project before us.

[33] *See, e.g.,* See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997) (Delaware Court of Chancery combines infrequent liability with frequent guidance as to best practice for directors); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CINN. L. REV. 1061 (2000) (role of Delaware courts in developing law in response to new developments is a key competitive advantage in the competition for corporate charters); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005) (describing role of Delaware Courts in developing law); Lawrence A. Hammermesh, *The Policy Foundations of Delaware Corporate Law*, 106 Colum. L. Rev. 1749, 1776-82 (2006) (Delaware's legislature consciously defers to case-by-case lawmaking by courts); Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporate Law*, 4 VA. L. & BUS. REV. 333 (2009) (Delaware judges in opinions and writing extrajudicially give "penumbral" guidance as to best practice without

board's failure of compliance oversight per the *Caremark* standard has cut off this path for development.[34] This has left a vacuum regarding best practice regarding compliance into which federal prosecutors have stepped, increasingly requiring firms to upgrade their compliance programs as a condition for a settlement.[35] Unfortunately, this discretionary "regulation by settlement" is seemingly ill-equipped to give boards guidance as to how to discharge their responsibilities.[36]

We propose more vigorous financial consequences for directors implicated in compliance failures.[37] This should take the form of a clawback of stock-based compensation where there has been a relevant compliance failure by directors. This would extend the director's time horizon beyond the point at which the stock is liquidated and realign the directors' payoffs with those of the shareholders generally. The clawback should be proportionate to the failure and the harm caused to the firm. But in no case would directors be liable for more than they have received through stock-based compensation. This measured way of assessing liability would minimize risks of creating incentives for overinvestment in compliance.

We suggest two ways forward for implementing this framework. On the one hand, we invite the Delaware courts to reconsider the *Caremark* framework, because their guidance on these fiduciary dimensions would be highly valuable. This would entail recognition of the directors' statutory and fiduciary duties to assure the firm's compliance with law, in light of the specific compliance risks in the stock-based compensation packages awarded

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triggering liability.)

[34] *See infra*, Section IV.E and Appendix II.

[35] *See* Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 886-902 (2007) (data on use of deferred prosecution agreements to mandate increases in compliance activity); Wulf A. Kaal & Timothy A. Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 1993-2013*, 70[1] BUS. LAW. 61,82-84, 92-99 (2014) (data on use of deferred prosecution agreements to mandate changes in corporate governance); Rachel E. Barkow, *The New Policing of Business Crime*, 37 SEATTLE U. L. REV. 435, 457-60 (2014) (characterizing DPAs as part of a "new policing" of business crime).

[36] Jennifer Arlen, *Removing Prosecutors from the Boardroom: Deterring Crime Without Prosecutor Interference in Corporate Governance*, in PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 62, 76–81 (Anthony S. Barkow & Rachel E. Barkow eds., 2011); James R. Copeland, *The Shadow Regulatory State: The Rise of Deferred Prosecution Agreements*, 14 CIV. JUST. REP. (2012); Arlen & Kahan, *supra* note 11, 375-81 (critiquing the practice).

[37] *See infra*, Section V.

by the board. But shareholders also have the power to insist on firm-level adoption of alternative dispute resolution procedures that would produce the same results.[38] Shareholders could make use of initiative procedures to effectuate by-law amendments,[39] could condition approval of stock-based compensation plans on such procedures,[40] or could otherwise condition their positive support of directors.

To recapitulate: Serious law violations by corporate actors in which responsibility is so diffuse that no one is responsible are corrosive of the long-term viability of a regime focused on shareholder value. Locating responsibility within the firm is important. The directors, as monitors, need to step up. A system of expert evaluators of the directors' performance in compliance oversight, combined with appropriate liability limits, strikes a reasonable balance. This is a system that shareholders can create even if courts do not. We think it would count as a meaningful act of "stewardship" to move forward on this proposal, particularly since the stewardship goal is to facilitate long-term social wealth maximization.[41]

The rest of this paper is structured as follows. Section I reviews corporate compliance programs: their rationale; regulatory incentives for firms to adopt them; and the features said to characterize 'effective' programs. In Section II, we present our model showing how stock-based executive compensation creates particularly strong incentives for short-changing compliance, which may be harmful both for shareholders and society. Section III then explains how the move to stock-based compensation for directors has undermined

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[38] In setting the standard of care—that is, what should count as a "failure" in compliance oversight triggering a clawback, an arbitration-style expert panel could be convened, which could usefully assess how well directors performed their oversight functions of assuring a compliance program effective for their particular firm, and follow up appropriately on any red flags the program might raise.

[39] See Del. Gen. Corp. L. § 109. Access to the issuer proxy to present at least precatory proposals for such a by-law adoption by the board is governed by SEC Rule 14a-8,17 CFR 240.114-8

[40] Stock exchange listing rules require shareholder approval for public company equity compensation plans. See NYSE Listed Company Manual § 303A.08 and NASDAQ Listing Rule 5635(c). Recent Delaware cases have indicated that shareholders must ratify grants of stock-based compensation to directors to bring such director decisions within the business judgment rule. See, e.g., Calma v. Templeton, 114 A.3d 563 (Del. Ch. 2015); In re Investors Bancorp, Inc. Stockholders Litig., 177 A.3d 1208 (Del. 2017).

[41] *See, e.g.*, BlackRock, The Investment Stewardship Ecosystem, https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf.

their ability to oversee the firm's compliance efforts. In Section IV, we turn to the balance struck in *Caremark*, arguing that in light of changes in managers' and directors' incentives, the original formulation is now too lax. Section V sets out our proposals for a "compliance clawback" determination that would assess the quality of the board's compliance oversight. The final section concludes.

I. WHY COMPLIANCE MATTERS

A. The "Rules of the Game"

Corporations are generally structured so as to give managers incentives to generate returns for their investors.[42] Clearly, there are many situations where firms might profit at the expense of other members of society—for example, through releasing untreated pollutants, or marketing products that have a propensity to cause harm. It is a premise of a well-functioning market economy that firms are effectively constrained from causing such social harms, or "externalities".[43] Milton Friedman, who famously claimed that the social responsibility of business extended to no more than making profits, was explicit in presupposing a set of "rules of the game" that constrain firms from engaging in socially harmful activities:[44]

> "[T]here is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits *so long as it stays within the rules of the game*" (emphasis added).

Provided the rules of the game are appropriately defined so as to control externalities, the logic of Friedman's position is that making profits in ways that abide by these rules will necessarily enhance social welfare.

Thus, regulatory and criminal obligations are commonly imposed on firms to ensure that they "pay their way" in terms of the social costs of their activities.[45] Environmental laws seek to ensure that the costs of industrial

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[42] *See e.g.,* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 53-65 (1996).

[43] More technically, social welfare is maximized by encouraging firms to invest in precautions against causing harm up to the point at which the marginal cost of additional precaution would equal the value of the marginal reduction in social harm. *See* generally STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 77-80, 92-94, 177-182 (2004).

[44] MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962).

[45] Of course, to say that these rules are "appropriately designed" in the sense of optimally

pollution are internalized by polluters. Workplace and product safety regulations set minimum standards for firms with respect to harms to which their work environment or products may expose workers or consumers. Antitrust laws restrict firms' pursuit of anticompetitive practices, and laws such as the Foreign Corrupt Practices Act of 1977 seek to prevent firms undermining the functioning of public institutions.

Where firms pay penalties for socially harmful activities, then the shareholders are forced to internalize the costs, and managers who are focused on profits are thereby also made to focus on compliance. In economic terms, the penalty for the firm to pay for non-compliance should be set according to the level necessary to make it rational for firms to internalize social costs of their activities.

This virtuous circle of compliance presupposes that a violation triggers enforcement. In practice, the complexity of corporate affairs and the finite resources of enforcement agencies mean that the probability of enforcement may only be small.[46] Under these circumstances, deterrence theory prescribes a higher penalty so as to set the *expected* cost of non-compliance equal to the social costs of the proscribed conduct.[47] High penalties can be imposed on corporations in the form of fines and compensatory payments. While the $62 billion paid by BP in fines and clean-up costs after its Deepwater Horizon oil

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proscribing socially harmful activities is no straightforward assumption. The capacity of relevant institutions to deliver appropriate rules is a central fault-line in debates about market functioning. *See* generally George J. Stigler, *The Theory of Economic Regulation* 2 BELL J. ECON. 3 (1971) (arguing regulators are captured by the interests of the industry they regulate); THE POLITICS OF REGULATION (James Q. Wilson ed., 1980) (emphasizing importance of ideology of regulators); TIMOTHY BESLEY, PRINCIPLED AGENTS? THE POLITICAL ECONOMY OF GOOD GOVERNMENT (2006) (outlining conditions under which regulatory intervention is successful). *See* also Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 J. L. & ECON. 255 (considering when private law, criminal law, and regulation are preferable modes of enforcement). Our concern here is not, however, whether the rules of the game are set correctly, but rather how firms are made to observe them.

[46] See Roy Shapira & Luigi Zingales, Is Pollution Value-Maximizing? The DuPont Case. NBER Working Paper 23866 (2017) (Internal corporate documents disclosed in environmental litigation against DuPont reveal polluting was a rational decision based on low probability of enforcement.)

[47] See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 1969 (1968); A. Mitchell Polinsky and Steven Shavell, *The Optimal Use of Fines and Imprisonment*, 24 J. PUB. ECON. 89 (1984); A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence* 28 J. LEG. STUD. 1 (1999).

spill is an outlier,[48] the mean corporate fine exceeded $15 million in 2010, and penalties measured in hundreds of millions of dollars are by no means uncommon.[49] Where a firm depends on a regulatory license, then penalties that remove this license can effectively force it out of business.[50]

The problem is that very high corporate penalties have real *ex post* costs: jobs may be lost, and firms forced into bankruptcy.[51] This provides a rationale for corporate compliance programs. The basic idea is that firms are able to monitor and control misbehavior amongst their employees far more cheaply than are public authorities.[52] Because the firm has better information about its employees' behavior than the regulator, this delegation is efficient. "Compliance" is the name given to institutions established internally by firms in order to carry out such delegated enforcement. Such institutions can reduce both the incidence of misconduct and the need for socially wasteful corporate penalties.

Firms have since 1994 been offered explicit discounts to any penalties that might be imposed for misconduct, provided the firm had previously implemented an effective compliance program.[53] The best-known channel is through corporate sentencing. Since 1994, under US Sentencing Commission

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[48] *BP Draws Line Under Gulf Spill Costs*, FIN. TIMES, July 14, 2016.

[49] See BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS 292-93 (2014) (average fine in 2010 approaching $16 million; 20 largest corporate fines since 2001 all exceeded $250 million).

[50] The prosecution of Enron's auditor, Arthur Andersen, resulted in its dissolution. The firm had employed 85,000 worldwide, 28,000 in the US, only a few thousand of whom were partners. Concerns about the economic impact of the loss of a regulatory license shaped Department of Justice charging decisions relating to the behavior of large banks in the run-up to the financial crisis.

[51] See Buell, *supra* note 23, at 114-119. These are problematic both on efficiency grounds (the *ex post* destruction of value is a deadweight loss) and on fairness theories (many of the persons who suffer these losses will not have been culpable in any way). They are also likely to trigger political objections to extensive liability.

[52] Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes* 72 NYU L. REV. 687 (1997).

[53] The rationale is that installing a corporate compliance program may have an ambiguous effect on firm value. It will likely lower the incidence of misconduct by a firm's employees, it may also increase the rate of detection of any misconduct that does occur. It is difficult for profit-maximizing managers to justify expenditure on compliance programs if the effect on the firm's expected liabilities is ambiguous. A penalty discount conditional on establishing a compliance program creates an unambiguous benefit, a "carrot" to induce the setting up of such a program: Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEG. STUD. 833 (1994).

Guidelines, if a convicted firm had previously established an "effective" compliance program, this can be taken into account in sentencing to reduce its penalty, currently by up to eighty per cent.[54] Less visibly, but increasingly significant in practice, effective compliance programs are also a relevant factor for prosecutors in deciding whether to bring a criminal case against a firm.[55] Rather than proceed with a prosecution, authorities may instead enter into a "deferred prosecution agreement" (DPA) with a firm.[56] While this will typically still involve the payment of a substantial penalty, it avoids a formal conviction for the firm, with associated loss of regulatory licenses. And, even if a firm is convicted, the fact that it had an effective compliance program in place at the time of the misconduct is a relevant factor for government agencies in assessing whether to waive the default position of debarring a convicted firm from procurement exercises.[57]

In addition to discretionary penalty discounts, there are also specific compliance-related obligations for various activities such as anti-money laundering, insider trading and structural separation checks for financial institutions,[58] internal controls over the production of financial information for publicly-traded firms,[59] and checks regarding the making of corrupt payments for all firms.[60]

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[54] US SENTENCING COMMISSION, 2016 GUIDELINES MANUAL, §8C2.5, §8C2.6. *See* Jennifer Arlen, *The Failure of the Organizational Sentencing Guidelines* 66 U. MIAMI L. REV. 321 (2011) (discounts offered are insufficient to induce compliance).

[55] DEPARTMENT OF JUSTICE (OFFICES OF THE UNITED STATES ATTORNEYS), US ATTORNEYS' MANUAL, §9.28.800.

[56] DPAs have become the primary response to wrongdoing by large corporations in recent years: see Garrett, *supra* note 49, at 62-67.

[57] General Services Administration (GSA), FEDERAL ACQUISITION REGULATION, §9.406-1(a) (debarment); §9.407-1(a)(2) (suspension). The burden of demonstrating responsibility is on the contractor.

[58] Investment Advisers Act of 1940, Rule 206(4)-7 (safeguards against insider trading by personnel); Bank Secrecy Act of 1970, 31 USC §5318(h) (Anti-Money Laundering Programs) and 12 CFR 21.21 (Procedures for Monitoring Compliance); Volcker Rule, Subpart D 12 CFR §44.20; enhanced requirements for large banks: 12 CFR §44.20(c); Appendix B to Part 44, Enhanced Minimum Standards for Compliance Programs, all derived from provisions of the Dodd-Frank Act.

[59] Sarbanes-Oxley Act of 2002 §404.

[60] Foreign Corrupt Practices Act of 1977, 15 USC §§78dd-1 et seq.

B. Effective Compliance Programs

Discretionary discounts to corporate penalties are available to firms that have established "effective" compliance programs before the misconduct occurred. But what does an "effective" program entail? In theory, "effective compliance" would minimize the sum of the costs of misconduct and of the costs of avoiding and detecting such misconduct.[61] In practice, there is little consensus as to how this should be achieved. When industry participants speak of "effective" compliance programs, they generally refer to official stipulations as to the features that will be *deemed* to constitute an effective program; it does not necessarily follow that they are actually effective in the sense of minimizing joint costs.[62] Indeed, despite much exhortation, especially from professional consultants who offer to assist in designing compliance programs, relatively little is known about the structure and efficacy of corporate compliance.[63] Our concern here is not how a particular compliance program should be structured, but rather how firms are encouraged to put one in place. We therefore focus on the structure of "effective" compliance programs envisaged by official stipulations.[64]

There are a variety of ways in which authorities can signal to firms what sort of compliance activities are expected. The most obvious is simply to set

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[61] Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (Jennifer Arlen ed., 2015).

[62] For critiques of the current approach, *see e.g.*, Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance* 81 WASH. U. L.Q. 487 (2003); Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009); Todd Haugh, *The Criminalization of Compliance*, 92 NOTRE DAME L. REV. 1216 (2017). *Cf* Richman, *supra* note 24, at 277-78 (practice of deferred prosecution agreements is only ten years old and so may be too soon to evaluate long-run impact).

[63] *See e.g.*, Griffith, *supra* note 15, 2105-2106; Donald J. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 933 (2017); Hui Chen & Eugene Soltes, *Why Compliance Programs Fail and How to Fix Them* HARV. BUS. REV. 116 (2018). Corporations are not required to disclose any information about compliance programs under relevant accounting rules, and it is rare for them to do so voluntarily. There is considerable debate regarding how the efficacy of compliance programs should be assessed, given the obvious difficulties in determining the underlying rate of criminal misconduct.

[64] Given the lack of solid evidence about the functioning of compliance programs, there is considerable debate as to how closely, if at all, prosecutors' stipulations as to what constitute "effective" compliance programs relate to what is socially optimal: *see* sources cited *supra* note 62 and Langevoort, *supra* note 30.

out substantive requirements.[65] This approach was taken in early sector-specific compliance requirements, such as the Bank Secrecy Act of 1970's provisions regarding internal controls to check money laundering.[66] Unfortunately, the very asymmetries of information that motivate delegation of compliance to firms mean that regulators are not well-placed to stipulate how firms should control employees' misconduct. Substantive requirements consequently lend themselves to formalistic or "tick-box" exercises, widely considered to be a waste of resources.

Another approach is to recruit a gatekeeper. For example, in relation to financial reporting, the Sarbanes-Oxley Act of 2002 requires public companies' auditors to certify the quality of the firm's internal controls. This effectively delegates the production of detailed standards regarding effective compliance to the professional services firms conducting audits (and their regulators). It has spawned a large body of doctrine on the part of accounting firms regarding compliance, which recent initiatives seek to link to risk management in the boardroom.[67]

Outside the context of financial controls, the regnant approach for prosecutors is to combine generic minimum standards with *ex post* review of the extent and good faith of the firm's compliance efforts.[68] This leaves scope to the firm—which has all the relevant information—to determine *ex ante* what sort of activities will be most cost-effective in reducing the risk of misconduct. It also permits a much more searching scrutiny than is possible simply through *ex ante* specification. The most comprehensive recent statement of this approach is the Department of Justice's 2017 guidance on *Evaluation of Corporate Compliance Programs*,[69] which itself draws on and synthesizes prior accounts.[70] Key components of an "effective" compliance

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[65] See *supra*, text at notes 57-60.

[66] These mandated a set of "minimum requirements" that covered firms were expected to meet.

[67] See, e.g., Ethics & Compliance Institute, Principles and Practices of High-Quality Ethics & Compliance Programs: Report of ECI's Blue Ribbon Panel (2016); Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management: Integrating Strategy and Performance (2017).

[68] This review is conducted in the context of misconduct having occurred, and essentially asks whether, had the firm taken reasonable additional steps in its compliance program, the misconduct might have been caught earlier or avoided. See, e.g., Department of Justice, Evaluation of Corporate Compliance Programs, 1-2 (2017).

[69] *Id.*

[70] See *id* at 1, citing DEPARTMENT OF JUSTICE, *supra* note 55; US SENTENCING

program include the following:[71]

Design. Firms are expected to orient their compliance policies in accordance with an assessment of which areas of their activities are most exposed to compliance risk, and in relation to which regulations. Compliance policies and procedures should be dynamic: regularly reviewed and updated according to changes in regulation or business environment.

Resourcing. There should be an executive function within the firm designated as 'Compliance', to whom responsibility is assigned for implementing the program (the head of which is often titled as Chief Compliance Officer or "CCO"). It should be adequately resourced according to the size of the firm and the nature of the risks,[72] and enjoy autonomy from, and the support of, management.[73]

Governance. The autonomy of the compliance function should be reinforced by internal oversight and monitoring by the board of directors, usually through a committee of independent directors—either the Audit Committee or, where established, a separate Compliance Committee. A direct channel of reporting from compliance personnel to the board is thought to be a means of fostering not only autonomy within the compliance program but also open upward transmission of information.

Operational Integration. A key aspect of program implementation is the degree of integration with business activities. This includes steps taken to train employees about compliance, and measures to promote compliance internally and communicate this externally. It is also entails meaningful incentives for compliance: most obviously that persons found to have broken the rules should actually be subject to disciplinary proceedings, but also efforts to ensure that the firm's variable compensation policies do not create incentives to flout the rules.

COMMISSION, *supra* note 54; DEPARTMENT OF JUSTICE & SEC, FCPA: A RESOURCE GUIDE TO THE US FOREIGN CORRUPT PRACTICES ACT (2012); OECD, GOOD PRACTICE GUIDANCE ON INTERNAL CONTROLS, ETHICS AND COMPLIANCE (2010) and OECD, ANTI-CORRUPTION ETHICS AND COMPLIANCE HANDBOOK FOR BUSINESS (2013).

[71] This discussion draws on Department of Justice, *supra* note 68.

[72] An *ex post* review may scrutinize whether the compliance department ever asked for additional resources and the responses received from management.

[73] Support can be evaluated by looking for concrete actions taken by senior management to demonstrate their support for compliance. Do they themselves follow the precepts established by the compliance program? Autonomy raises questions about the compliance function's stature relative to other strategic functions of the firm, and whether it has a direct reporting line to the board as opposed to going through senior management.

Integrity. A confidential whistle-blower mechanism is regarded as a key reporting channel. Firms should expect not only to have such a system in place, but regularly to evaluate whether it is used, and if so, what happens. More generally, compliance programs should be subject to regular internal review and testing, by an independent internal audit function.[74]

C. Resourcing Compliance

Given the expected benefits to firms that implement effective compliance programs, the design of such programs should be regarded as an investment decision by value-maximizing firms.[75] The potential outlay to resource an effective compliance program may be considerable. This begins with the direct costs of employing compliance staff and training employees regarding compliance. Potentially more far-reaching, however, are the costs of integrating the program into the firm's business structure. Done properly, this entails careful assessment of the incentives created by aspects of the firm's business model. Particularly important are the way in which performance targets are set for employees. Managers seeking to improve results are often drawn to implementing performance targets for employees that focus on metrics like sales, costs, or task completion. These metrics are chosen because they are readily measurable and have an obvious link to the firm's financial health. However, the pursuit of such metrics to the exclusion of other considerations has clear potential to trigger failures in other valuable dimensions of performance, such as safety measures or compliance with law.[76] Of course, most employees have natural instincts to be concerned with these issues, but their internal ethical or safety concerns can be overcome by sufficiently strong financial incentives.[77] As a result, the compliance

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[74] Firms should also consider whether, and in the case of internal controls on financial reporting are required, to commission an external audit of their compliance functions.

[75] *See e.g.*, Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage* 19 U. PA. J. BUS. L. 285 (2017) (advocating an "efficient investment-risk" approach to compliance).

[76] For example, Wells Fargo's use of aggressive sales-based performance targets for employees was a major factor in the 'false sales' scandal that emerged. See Independent Directors of Board of Wells Fargo & Co., *supra* note 2.

[77] *See e.g.*, BRUNO FREY, NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATION (1997) (account of possible crowding out by "extrinsic" motivation, such as financial incentives, of "intrinsic" motivation, such as altruism and ethical concern); Sverre Grepperud & Pal Andreas Pedersen, *Crowding Effects and Work Ethics* 20 LABOUR

implications of performance targets are a joint function of the definition of the targets themselves and the intensity of the financial incentives—in terms of rewards (penalties) for meeting (missing) targets.

For example, prior to the financial crisis, it was widespread in the financial sector for employees to receive most of their income based on "narrow" performance metrics such as sales or revenues.[78] Unfortunately, it became clear that sales-based compensation leads employees to shift products to clients that were not in clients' interests: indeed, this was the core of the problem in the Wells Fargo scandal.[79] Moreover, revenue-based compensation for traders generated incentives to overlook risks associated with the positions taken that might materialize in subsequent periods.[80]

Similar considerations operate at the level of recruitment. Firms that take compliance seriously will instigate background checks for new employees, and be particularly chary about recruiting personnel with prior documented failings in any of the relevant compliance dimensions. Firms implementing less stringent checks will be likely to recruit a higher proportion of employees with prior misconduct records. In some contexts, this may actually boost the firm's profitability in the short run.[81]

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125 (2006) (where crowding-out is present, optimal contracts may need to forego financial incentives); Jared Harris & Philip Bromiley, *Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation* 18 ORG. SCI. 337 (2007) (theory and empirical results showing link between incentive compensation for senior managers and financial statement misrepresentation); Alain Cohn, Ernst Fehr & Michel André Maréchal, *Business Culture and Dishonesty in the Banking Industry* 516 NATURE 86 (2014) (experimental results suggesting prevailing business culture in the banking industry undermines norms of honesty).

[78] *See e.g.*, Financial Services Authority (UK), Reforming Remuneration Practices in Financial Services, Consultation Paper 09/10 (2009).

[79] See Independent Directors of Board of Wells Fargo & Co., *supra* note 2. In this setting, "compensation" means not only immediate dollar payments but promotion opportunities on the upside and retention risk on the downside.

[80] A thoughtful study by Archarya, Litov and Sepe reports that the extent to which employees' compensation varied with financial firms' performance was strongly correlated with risk-taking before the financial crisis and poor financial performance in the crisis: Viral Acharya, Lubomir P. Litov & Simone M. Sepe, Seeking Alpha, Taking Risks: Evidence from Non-Executive Pay in US Bank Holding Companies, working paper NYU / University of Arizona (2014).

[81] See Mark Egan, Gregor Matvos & Amit Seru, The Market for Financial Adviser Misconduct, Working Paper, Stanford Graduate School of Business (2017) (documenting that financial advisors who are fired for misconduct are likely to be re-hired by firms that themselves have higher overall rates of misconduct, which in turn specialize in areas with

Effective compliance programs thus require firms to assess how the firm's employee recruitment and performance metrics are likely to impact incentives to obey applicable regulation. Taking full account of the compliance implications of these variables may necessitate significant modifications, dulling the performance impact of the incentive schemes. As a consequence, effective compliance can easily prove costly. For a value-maximizing firm, the extent to which such costs are worth occurring is an investment decision: a function of the expected benefit in terms of reduced exposure to penalties. Unfortunately, as Section II explains, compensation practices for executives tend to bias management incentives towards underinvestment in compliance.

While it seems clear that many firms have implemented compliance programs,[82] there is a dearth of quantitative empirical literature on corporate compliance activities. This is because firms rarely include the details of their compliance activities in public disclosure.[83] The limited available information comes through practitioner surveys, typically conducted by large accounting firms, which have developed compliance consulting practices.[84] The reliability of such surveys is open to question. For example, PwC's annual *State of Compliance* report, a widely-cited source,[85] reported in 2016 that 20 percent of companies have a board-level compliance committee.[86] For a separate paper on compliance committees, we analysed data provided by BoardEx on board structure of public companies and learned that in 2016 only 3.4 per cent of public companies had stand-alone Compliance Committees; expanding the definition to include any board committee with "compliance" in its name (like "Audit and Compliance"), increased the population of firms with such a committee to 5.1 per cent.[87] This suggests that the selection bias in practitioner surveys is likely to overstate the extent

high proportions of unsophisticated clients).

[82] *See* Stavros Gadinis & Amelia Miazad, The Hidden Power of Compliance, working paper, Berkeley Law School, 7 (2018) ("explosive growth" of compliance departments over past decade).

[83] Griffith, *supra* note 15, 2100.

[84] *Id*., 2100-2106 (summarizing information in practitioner surveys).

[85] See *id*, 2100-2105; Bird & Park, *supra* note 75, 287; Joseph E. Murphy, *Policies in Conflict: Undermining Corporate Self-Policing*, 69 RUTGERS U.L. REV. 421, 423 (2017).

[86] PWC, STATE OF COMPLIANCE STUDY 2016: LAYING A STRATEGIC FOUNDATION FOR STRONG COMPLIANCE AND RISK MANAGEMENT, 15 (2016).

[87] John Armour, Brandon Garrett, Jeffrey N. Gordon & Geeyoung Min, Board Compliance, working paper (2018).

of compliance activity among public companies.

II. SHORT-CHANGING COMPLIANCE

A. Stock-Based Compensation

Stock-based compensation is now ubiquitous for senior US corporate executives.[88] There are two principal types: stock options, and restricted stock awards ("RSUs"). Options give executives the right to buy the firm's stock at specified times at a specified "strike" price. Awards of restricted stock pay executives with stock, which they are required to hold for a specified period (hence "restricted"). In each case, the value of the award to the executive increases as the firm's stock price improves; this creates a powerful alignment between the executive's interests and those of stockholders, focusing the executive's mind on actions that will improve the stock price. The difference between options and RSUs is on the downside: if the stock price falls below the option exercise price, options may expire "out of the money," whereas RSU will retain value. Stock options may seem to encourage more risk-taking (since the downside is capped) but performance vesting for RSUs and performance-tied additional grants of RSUs can produce compensation of similar incentive power.[89] A shift from options to RSUs beginning in the early 2000s was driven principally by the loss of exceptionally favorable accounting treatment for options.[90]

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[88] *See e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); Steven N. Kaplan, *CEO Pay and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges*, 25 J. APP. CORP. FIN. 8 (2013); Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, in HANDBOOK OF THE ECONOMICS OF FINANCE (George Constantinides, Milton Harris, & Rene Stulz, eds. 2013).

[89] See JAMES REDA ET AL, STUDY OF 2015 SHORT-TERM AND LONG-TERM INCENTIVE DESIGN CRITERIA AMONG TOP 200 S&P 500 COMPANIES (Dec. 2016), at 5, 11,12 (increasing shift to performance-based awards, motivated in part by ISS policy in say-on-pay review), available at https://ssrn.com/abstract=2916206.

[90] Murphy, *supra* note 88, figures 2.4, 2.5, 2.6, traces the shift in the composition of executive compensation over the 20-year 1992-2011 period, showing a marked rise in stock-based pay but also showing a shift in the latter half of the period from stock options to restricted stock. Earlier in the period options typically were not expensed, meaning they were "free" in accounting terms. Shareholder pressure and then a change in accounting rules, FAS 123R, subsequently required such expensing. *Id*., at 97-100, and direct stock grants. Murphy, *id*. at 100, describes the favorable accounting treatment of performance-based share grants.

In this section, we show that just as high-powered performance pay for employees may create risks for compliance, high-powered performance pay for executives creates incentives to underinvest in compliance programs overall. This is likely to manifest itself in compliance programs that are more 'check box' in form: inadequately resourced, lacking in operational autonomy, and poorly integrated into business operations. While discussion of perverse side-effects of high-powered incentive compensation has been with us at least since Enron,[91] the implications for compliance have not previously been analyzed closely and turn out to be particularly grave. We consider two ways in which stock-based pay can encourage managers to underinvest in compliance, and then explain why the market is unable to see through this.

B. Managerial Myopia about Compliance

The first problem concerns a divergence in *time-horizon*. Managers who have stock-based pay—whether RSUs or options—will care about the stock price, but only over the time period for which they hold the stock. This foreshortening of the manager's time horizon can create divergences of interest. Actions that boost the firm's stock price in the short run, but will harm it in the long run, may appeal to managers (but ultimately hurt investors).[92] Effective compliance programs require firms to incur costs in the short-term in return for a reduction in expected penalties in the medium- to long-term.[93] However, if investors cannot readily determine the relevant attributes of the firm's compliance program,[94] then the stock price will not fully reflect the expected benefit to the firm of compliance investment as it is made. Rather, the benefit will only be quantifiable when and if enforcement actually occurs—by which time, of course, it is too late. Given these conditions, executives paid in stock over a finite time horizon will tend to behave myopically with respect to compliance, discounting excessively its

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[91] *See e.g.*, John C. Coffee, Jr, *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269; Gary Giroux, *What Went Wrong? Accounting Fraud and Lessons from the Recent Scandals*, 75 SOC. RES. 1205 (2008).

[92] See, e.g., Bebchuk & Fried, *supra* note 88, at 183-85.

[93] As we have seen, these are not just the direct costs of compliance personnel, but can extend deeply into a firm's business model, including the opportunity cost—in terms of short-term profitability—of using very high-powered incentive compensation schemes for employees. See *supra*, Section I.C.

[94] This assumption is defended in Section II.D.

benefits to the firm.

To see this, assume that a CEO is paid in stock that vests over (say) a six-year period. At the end of this period, the CEO sells her stock, quite possibly leaving the firm.[95] Assume further that owing to its business model and regulatory environment, her firm has a five per cent risk in any given year of being investigated for misconduct by its employees. This risk captures the combined effect of the employees' propensity to misconduct and the chance of detection and enforcement by authorities. While it is conventional to describe enforcement risk as a probability, the more accurate description is that it is a *hazard rate*—the probability of a firm being investigated in any given year.[96]

Assume for simplicity that the hazard rate remains constant from year to year.[97] Figure 1 shows the cumulative probability that enforcement will have occurred within a particular number of years from today, given an annual hazard rate of five per cent.[98] Bearing in mind that the firm's expected penalty at $t = 0$ is the actual enforcement penalty multiplied by the probability of enforcement, we can understand the cumulative probability function as modelling how the firm's expected cost of enforcement evolves over time. As the cumulative probability of enforcement is increasing over time, the firm's expected enforcement cost also increases over time.[99] Investment in an effective compliance program could reduce the cost to the firm of enforcement. The size of the potential enforcement cost provides a benchmark against which to assess the extent to which compliance investment is in shareholders' interests.

The dotted vertical line at $t = 6$ shows the time horizon of a CEO who holds stock only for the first six years from the starting point. The continued growth in the cumulative probability of enforcement after six years will not affect her payoffs. The potential benefit to the manager of investment in compliance over her period of stock ownership is considerably less than the

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[95] Studies suggest the average CEO can expect to hold her job for roughly six years: Kaplan, *supra* note 88, at 15.

[96] *See e.g.*, ALEXANDER J. MCNEIL, RÜDIGER FREY & PAUL EMBRECHTS, QUANTITATIVE RISK MANAGEMENT: CONCEPTS, TECHNIQUES AND TOOLS 391-94 (2015).

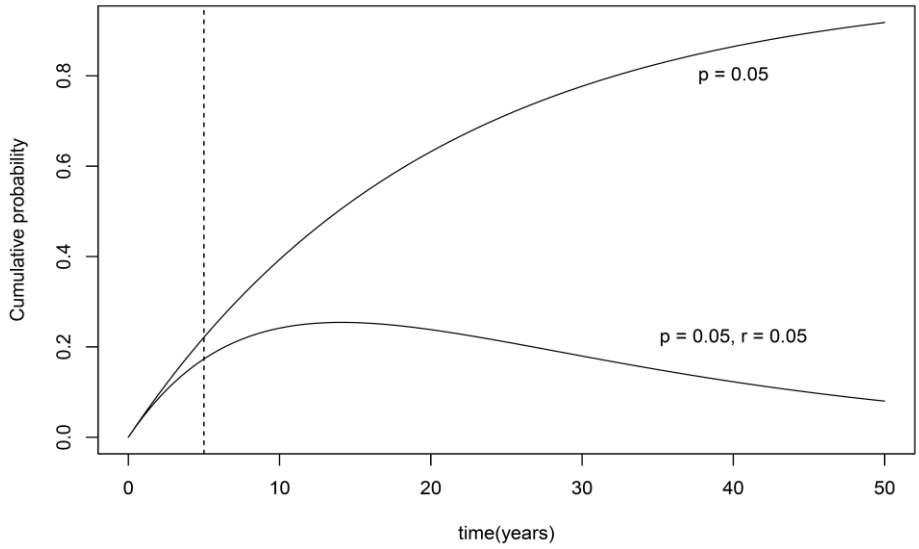
[97] That is, the probability of enforcement occurring has an exponential distribution. We relax this assumption below. See *infra*, text at note 102.

[98] The cumulative distribution function *P(t)* represented in the plot takes the form $P = pe^{-pt}$.

[99] This is because the expected cost to the firm of enforcement is a function of the actual cost of enforcement (penalties, etc) discounted by the probability that enforcement will not occur. See sources cited *supra*, note 47.

potential benefit to shareholders over the long-term. Because the manager does not share in the full benefit to the firm—which increases over time—the manager can improve her returns by underinvesting in compliance and transferring the resources into substitute projects that will deliver greater results within her time-horizon.

Figure 1: Cumulative probability of enforcement with constant hazard rate of five per cent.



Of course, the expected costs modeled by the cumulative probability line are expressed in future dollars. Compliance expenditure must be incurred in present dollars. It is elementary corporate finance that future cash flows are discounted to present value in order to determine the net present value of an investment.[100] The lower curve illustrates the effect of discounting the expected payments to present value, using a discount rate of (say) five per cent.[101] A crude interpretation of the impact of discounting would be that although the firm may face a high cumulative probability of enforcement over a long period of time, it does not need to devote large amounts of resources to the problem today, because it may have other projects with a higher net

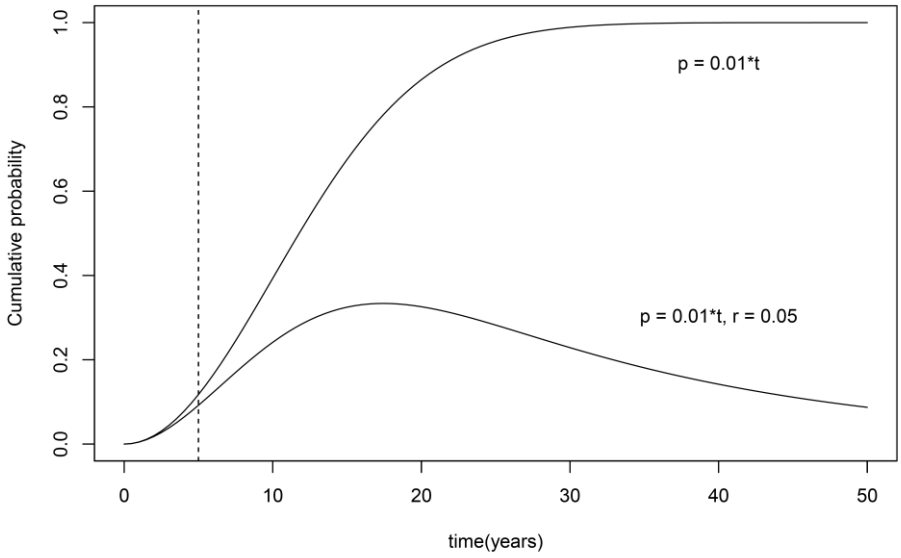
[100] *See e.g.,* RICHARD BREALEY, STEWART MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE, 12th ed. 19-27, 132-39 (2017).

[101] In the current market environment, this discount rate is high, consequently under-representing the expected cost to the firm of enforcement.

present value (NPV) that it can pursue—and then use the proceeds to cover any future liabilities. As Figure 1 illustrates, discounting does not solve the problem of the CEO's truncated time horizon. The expected cost, even discounted to present value, continues to rise until after year ten.

This point is even starker if, rather than assuming a constant probability of enforcement, we consider a case where the annual probability of enforcement (the 'hazard rate') is rising over time, as illustrated by Figure 2. While a constant annual probability of enforcement might be appropriate for potential isolated incidents of misconduct, an increasing annual hazard rate might be more appropriate for thinking about misconduct that grows in scale over time, or which is covered up.

Figure 2: Cumulative probability of enforcement with hazard rate increasing annually by one per cent.



More fundamentally, the crude interpretation of the impact of discounting overlooks the firm's need to manage its liquidity.[102] Imagine a firm's managers decide, on the basis of the crude discounting approach, that they will not invest resources in a compliance program but rather in an alternative project that yields a higher NPV. Their reasoning is that the alternative

[102] *See e.g.,* Tim Opler, Lee Pinkowitz, René Stulz & Rohan Williamson, *The Determinants and Implications of Corporate Cash Holdings*, 52 J. FIN. ECON. 3 (1999).

project will yield more, in present value terms, than an investment in an effective compliance program, once the future benefits of the latter are discounted to present value. Yet the timing of the cash outflow triggered by an enforcement action is hard to predict, making it difficult for the managers to know whether the alternative project's payoffs will be available to fund it. If the firm does not have the cash available to pay the penalties, then it will need to engage in costly liquidation of assets or incur costly refinancing. A liquidity shortfall so severe as to make a firm unable to pay debts as they fall due is likely to trigger bankruptcy.[103] In any case, a liquidity shock can harm a firm's ability to make investments, especially in R&D.[104] Ordinarily, firms manage the risks associated with unpredictable adverse liquidity events using insurance or derivatives.[105] However, this is prohibited in relation to most forms of corporate misconduct. This means that a net present value calculation of the benefits of investment in compliance puts only a lower bound on its value to the firm's shareholders.

C. Upside Bias Devalues Compliance

The time-horizon problem discussed in Section II.B is common to all forms of stock compensation: both RSUs and options. However, there is an additional way that option compensation in particular exerts a tendency for executives to undervalue compliance programs. This is because while options motivate executives to pursue risky business ventures by increasing the payoff associated with good outcomes, the value of the options to the executive does not continue to decrease once the stock price falls below the strike price, so the manager is indifferent to the benefits to shareholders of activities that reduce the loss suffered to the firm in bad states (such as

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[103] *See, e.g.*, René Stulz, *Rethinking Risk Management*, 9 J. APP. CORP. FIN. 8, 12-13 (1996); Sheen Liu, Peter Woodlock, Howard Qi & Yan Alice Xie, C*ash Reserve and Venture Business Survival Probability*, 11 J. ENTREP. FIN. 123 (2006) (start-up businesses with higher cash-flow volatility are more likely to fail).

[104] *See e.g.*, Bernadette A. Minton & Catherine Schrand, *The Impact of Cash Flow Volatility on Discretionary Investment and the Costs of Debt and Equity Financing*, 54 J. FIN. ECON. 423, 453 (1999) (greater cash flow volatility associated with increased financing costs); see also Jeff Zeyun Chen & Philip B. Shane, *Changes in Cash: Persistence and Pricing Implications*, 52 J. ACC. RES. 599 (2014) (unexpected cash flow reductions triggering 'severe' declines in market price); Meike Ahrends, Wolfgang Drobetz & Tatjana Xenia Puhan, Cyclicality of Growth Opportunities and the Value of Cash Holdings, Working Paper, University of Hamburg (2016).

[105] Stulz, *supra* note 103.

investment in compliance, or more generally, insurance against low-probability, high-impact events). For the valuation of an option package priced at near the current stock price, the difference between a "bad" impact on the stock and a "worse" impact is irrelevant: the options will be out-of-the-money in either case. Consequently, a manager paid purely in options may prefer to substitute resources away from compliance investment (which produces no benefit to her) in favor of projects that are likely to increase the stock price. In contrast to the time-horizon problem analyzed in Section II.B, options distort managerial investment incentives even where the managers and shareholders share the same time horizon.

This tendency of options to induce excessive focus on "upside" is well-documented. For example, executive stock options have been reported to contribute to accounting manipulation[106] (including the Enron scandal),[107] bank risk-taking prior to the financial crisis,[108] and underinvestment in safety precautions.[109] Their adverse incentives for compliance have also been noted.[110] However, the perverse effects of stock options are just one aspect of the broader problems for compliance associated with stock-based compensation, which encompass all forms of compensation that is geared to stock price appreciation. The problem cannot be resolved simply by eschewing the use of options in executive compensation in favor of restricted stock.

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[106] Xiaomeng Zhang, Kathryn M. Bartol, Ken G. Smith, Michael D. Pfarrer, & Dmitry M. Khanin, *CEOs On the Edge: Earnings Manipulation and Stock-Based Incentive Misalignment*, 51 ACAD. MANAG. J. 241 (2008); Hermann Achidi Ndofor, Curtis Wesley & Richard L. Priem, *Providing CEOs With Opportunities to Cheat: The Effects of Complexity-Based Information Asymmetries on Financial Reporting Fraud*, 41 J. MANAG. 1774 (2013); Andrew C. Call, Simi Kedia & Shivaram Rajgopal, *Rank and File Employees and the Discovery of Misreporting: The Role of Stock Options*, 62 J. ACC. & ECON. 277 (2016).

[107] *See, e.g.*, Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002); Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35 (2006).

[108] *See* John Armour, *Bank Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 1108 (Jeffrey N. Gordon & Wolf-Georg Ringe, eds., 2018).

[109] Adam J. Wowak, Michael J. Mannor & Kaitlin D. Wowak, *Throwing caution to the wind: The effect of CEO stock option pay on the incidence of product safety problems*, 36 STRAT. MANAG. 1082 (2015).

[110] Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation through Nonprosecution*, 84 U CHI. L. REV. 323 (2017).

D. Market Myopia About Compliance

The foregoing analysis holds only if investors cannot readily determine whether a firm's compliance program is 'effective' such that it would merit a reduction in penalties conditional on enforcement, or, more generally, if investors are unable to determine whether a company's business model (including compliance measures) presents above-average compliance risks. If investors could make such a determination, then managers would have little to gain by myopic or upside-biased underinvestment in corporate compliance. Investors would anticipate the loss in value associated with such underinvestment, and the stock price would fall. This would hurt the value of stock-based compensation today. Sophisticated investors can and do make such adjustments in reaction to many strategic decisions by executives. Their ability to do so acts as a countervailing force that constrains concerns about managerial myopia and upside bias in many contexts.[111] The question is therefore whether compliance differs in any way from other investments that makes it particularly hard for investors to assess its value.

The same question can be viewed from the other end of the telescope. It has long been appreciated in theory that if markets find some types of investment particularly hard to value, this will distort the incentives of managers who focus on the stock price.[112] A growing body of evidence suggests that the value of investment in R&D activity is harder for markets to assess—by virtue of its very novelty—than more straightforward capital expenditure.[113] If compliance investment is imperfectly assessed by the

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[111] Indeed, evidence that RSUs encourage risk-taking more intensively the shorter a CEO's tenure—consistent with the foreshortening effect of the time horizon—can be interpreted as *positive* for shareholders if markets are able to assess the long-term implications of investment in this way: *see* Wanrong Hou & Steven R Lovett, *Stock-Based Incentives and CEO Tenure: Their Effects on Risk-Taking and Performance Extremeness*, ACAD. MANAG. PROC. (2017).

[112] *See e.g.*, Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989); John M. Bizjak, James A. Brickley & Jeffrey L. Coles, *Stock-based incentive compensation and investment behavior* 16 J. ACC. & ECON. 349 (1993).

[113] *See e.g.*, Jie He & Xuan Tian, *The Dark Side of Analyst Coverage: The Case of Innovation*, 109 J. FIN. ECON. 856 (2013) (exogenous reduction in analyst coverage associated with an increase in innovation); Vivian W. Fang, Xuan Tian & Sheri Tice, *Does Stock Liquidity Enhance or Impede Firm Innovation?*, 69 J. FIN. 2085 (2014) (exogenous increases in liquidity associated with subsequent declines in innovation in affected firms); Shai Bernstein, *Does Going Public Affect Innovation?*, 70 J. FIN. 1365 (2015) (firms that

market, is there anything unique about this? Our analysis suggests the answer is yes, whichever way the question is posed. Compliance investment turns out to be *especially* difficult for the market to assess, making the time-horizon and upside-bias problems we have described particularly intense in this context.

Clearly, there are technical challenges to understanding the detail of how a firm's compliance program operates. Yet similar challenges are present in understanding the technical nature of most firm's business operations, and these do not prevent analysts from providing an assessment.[114] The difference with compliance is that the extent to which a firm must invest to yield an 'effective' compliance program is likely to be a function of the firm's underlying misconduct risk, which cannot credibly be revealed to the market, and which many firms prefer not to reveal in any event. Consequently, firms that have a higher-than-average risk of misconduct have incentives to seek to hide this by disclosing no more than the average level of compliance expenditure and other compliance-related activity.

To see this, consider the following numerical example (a more general model is set out in Appendix I). Assume that there are two time periods. At the beginning of the first period ($t = 0$), there are two types of firm, with variations in their business practices affecting their propensity to experience employee misconduct and subsequent prosecution. 'High-risk' firms compensate employees with aggressively loaded performance bonuses, and implement only very lax checks on employee backgrounds during recruitment. 'Low-risk' firms deploy only more moderate compensation incentives, and their employees undergo thorough screening prior to being hired. These differences mean high-risk firms have greater probability of being investigated and penalized for employee misconduct. Assume that managers know their firms' risk types, but investors do not. Assume further that (say) 10 per cent of firms are high risk, the remaining 90 per cent are low risk, and that these proportions are known to both investors and managers.

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undertake IPOs reduce innovation, measured by patent citations, relative to firms that pull their IPOs for exogenous reasons); John Armour & Luca Enriques, Financing Disruption, Working Paper, Oxford University 22-25 (2017) (reviewing literature); JONATHAN HASKEL & STIAN WESTLAKE, CAPITALISM WITHOUT CAPITAL: THE RISE OF THE INTANGIBLE ECONOMY 169-74 (2018) (reviewing literature).

[114] *See* generally Mark T. Bradshaw, Analysts' Forecasts: What Do We Know after Decades of Work?, Working Paper, Boston College (2011) (review of literature regarding analyst activity).

At the end of the second period ($t = 2$), firms may be investigated by the authorities, which will reveal any misconduct. This reflects the intuition that there is often a long lead time before enforcement. Firms found by the authorities to have engaged in misconduct must then pay a penalty, the expected cost of which has a mean of $10 million.[115] Assume that for high-risk firms the probability of being investigated and penalized in the second period is 0.5 and for low-risk firms it is 0.1.[116]

Firms may choose to implement an effective compliance program at the end of the first period ($t = 1$). Any firm subsequently penalized by the authorities that has in place an effective compliance program receives a discount of 50 per cent, being required to pay only $5 million by way of penalty.[117] As we have seen in Section I.C, implementing an effective compliance program requires integration with a firm's business. Consequently, it is costlier for high-risk firms to implement effective compliance programs than for low-risk firms. In our example, the high-risk firms must change their recruitment and compensation practices (or hire teams of internal auditors for close monitoring of employee conduct) that have an adverse impact on revenues. Assume that the cost of implementing an effective compliance program is $600,000 for high-risk firms and only $200,000 for low-risk firms.

We assume all parties to be risk neutral, and the time value of money is nil. Recall that for any firm that is penalized, having an effective compliance program in place reduces the penalty by $5 million. The expected benefit to a firm of implementing an effective compliance program is therefore a function of that firm's probability of being penalized. For low-risk firms, the expected benefit is $500,000, and for high-risk firms it is $2.5 million.[118] Both types of firm would maximize their expected value by implementing effective compliance programs.[119]

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[115] This can be interpreted to include payments made under a deferred or non-prosecution agreement and any fines payable following conviction.

[116] Similar results obtain if high-risk firms must pay a higher penalty than low-risk firms.

[117] Note that the probability of enforcement is assumed not to change. If the firm implements an effective compliance program, that will both reduce the likelihood of misconduct and increase the probability of detection conditional on misconduct, having an overall neutral effect on the risk of enforcement: see *supra* note 53.

[118] This is calculated as follows: for low-risk firms, the benefit is 0.5 x (0.1 x $10,000,000) = $500,000; for high-risk firms it is 0.5 x (0.5 x $10,000,000) = $2,500,000.

[119] For low-risk firms, an effective compliance program has a net present value of $300,000 ($500,000 benefit minus $200,000 cost); for high-risk firms such a program has a

Assume now that firms publish financial statements at the end of each period. A firm that incurs expenditure on compliance in the first period will need to reflect the impact of this in its financial statements.[120] This encompasses, as we have seen, not simply direct costs of compliance personnel, but indirect impact on revenues through changes in business practices. Simply declaring an increase in costs and a reduction in revenues without further explanation will cause investors to infer that the firm's business model is troubled, and result in an adverse market reaction. Low-risk firms will therefore wish to justify the costs incurred as resulting from implementation of a compliance program. However, if high-risk firms make an equivalent disclosure, they reveal to investors not only that they have implemented an effective compliance program, but that their firm has a high underlying risk of misconduct. Even with an effective compliance program in place, high-risk firms still face a mean residual expected penalty of $2.5 million, as opposed to $500,000 for low-risk firms.

As we have seen, a high-risk firm cannot readily incur the costs of compliance without explaining them. What if it simply mimics the compliance effort of a low-risk firm, incurring costs of only $200,000? This would not be enough for the high-risk firm to implement a sufficiently strong compliance program to be deemed 'effective'—rather this would be more of a tick-box affair that would be insufficient to attract a discount from any penalty payable at $t = 2$. From the shareholders' point of view, implementing such a program would be a waste of resources, actually *reducing* the high-risk firm's value by the cost of the program; that is, $200,000. However, it would mean that at $t = 1$, investors would be unable to distinguish high-risk from low-risk firms, keeping the high-risk firm's stock price artificially high.

If investors anticipate this, then they will factor in the expected effects on firm value of misconduct, compliance, and enforcement as a blended average. For high-risk firms, which comprise 10 per cent of the population, the expected impact is $200,000 spent on an ineffective compliance program combined with an expected penalty that remains at $5 million, without discount: a total expected cost to investors of $5.2 million. For low-risk firms, comprising the remaining 90 per cent of the population, the expected impact is $200,000 spent on an effective compliance program and an expected penalty that is now reduced to only $500,000:[121] a total expected cost to

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net present value of $1,900,000 ($2,500,000 benefit minus $600,000 cost).

[120] Not to do so would amount to securities fraud.

[121] The low-risk firm's original expected penalty was 0.1 x $10,000,000 = $1,000,000.

investors of $700,000. Putting these together yields a weighted average expected compliance and penalty cost of $1.15 million,[122] which investors, unable to distinguish firm types, will rationally factor into the valuation of every firm.

A high-risk firm that disclosed compliance costs of $600,000 at $t = 1$ would reveal its type to investors. Investors would infer that its expected penalty is $2.5 million. The high-risk firm's market capitalization would fall by $1.95 million, being the extent to which its revealed penalty and compliance costs ($3.1 million) exceed the blended average penalty and compliance costs of $1.15 million that investors would otherwise attribute to the firm. If the managers of the high-risk firms are paid in stock that vests at $t = 1$, then they will improve their personal returns by causing the firm to invest only $200,000 in its compliance program, so investors are unable to draw this inference. This will harm the value of a high-risk firm at $t = 2$, by increasing the expected penalty it must pay (as well as wasting the costs of the ineffective compliance program), but by this time the managers will have sold their stock and retired.

Low-risk firms of course would like to signal their type to investors, as this would result in a corresponding increase in their valuation. The problem is that the myopic behavior of managers in the high-risk firms 'jams' the low-risk firms' signal of low compliance expenditure. Low-risk firms are no longer able to differentiate themselves if high-risk firms emulate their behavior.

This simple example features only two types of firm, designated according to whether they were at high or low risk of encountering misconduct and subsequent enforcement. Where, more realistically, firm risk level can be partitioned more finely, then the result may be expected to converge on all firms emulating the behavior of the lowest-risk type.[123] Where in expectation it would be value-maximizing for such firms not to engage in compliance efforts, then we may expect the entire population to shade on compliance.

The predictions change, however, if a firm is the subject of enforcement activity. Investors are likely to treat this as a signal that it is a higher-risk type than was previously known. We may therefore expect such firms to publicize extensive investments in compliance, which investors will anticipate are now

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This is reduced by the compliance program to 0.5 x (0.1 x $10,000,000) = $500,000.

[122] This is calculated as follows: (0.1 x $5,200,000) + (0.9 x $700,000) = $1,150,000.

[123] *See e.g.,* BERNARD SALANIÉ, THE ECONOMICS OF CONTRACTS: A PRIMER, 2nd ed., 87 (2005).

justified. By similar logic, if many firms in the same industry have been subjects of enforcement proceedings, then investors may raise their evaluation of the baseline risk for the entire industry.

This analysis predicts that firms paying managers with stock-based compensation will generally invest little in compliance activity. An exception would be firms that are already known by investors to be at high risk of enforcement: firms that have been the subject of enforcement actions or are in industries where enforcement actions are frequent. As their high underlying risk of enforcement is already known to the market, such firms do not fear revealing this as a by-product of high investment in compliance. At the same time, they stand to gain if compliance investment reduces their expected enforcement exposure. This hypothesis is consistent with our parallel empirical work on the adoption of board-level compliance committees, which are most commonly found in industries that have been the target of vigorous enforcement action, such as banks, pharmaceuticals, and healthcare, and are generally more likely to be implemented by firms that are the subject of a prior Department of Justice enforcement action.[124]

This Section has shown how stock-based pay is likely to give managers incentives to focus on the short term as regards compliance. It seems plausible that investors cannot easily assess misconduct and enforcement risk for many firms. Under these circumstances, managers focused on short-run stock price performance have incentives to short-change compliance. This is likely to harm both the firm's shareholders and society more generally in the long run.

III. BOARD OVERSIGHT OF COMPLIANCE

A. The Board's Role in Compliance Oversight

We saw in Section I.B that the board is expected to play a role in overseeing the functioning of an effective compliance program.[125] The Department of Justice' guidance regarding effective compliance provides that responsibility for internal oversight and monitoring of compliance programs should lie with the board of directors, usually through a committee of independent directors—either the Audit Committee or, where established,

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[124] See Armour et al, *supra* note 87.

[125] See *supra*, text to notes 73-74.

a separate Compliance Committee.[126] Boards are expected to understand the goals and operation of their firm's compliance function—which knowledge should be supported by regular reporting and a clear flow of information.[127] A direct channel of reporting from compliance to the board is a means of fostering not only autonomy within the compliance program but also open upward transmission of information.

The board's responsibility for compliance oversight has longstanding roots in the corporate enabling statutes as well as the widespread acceptance of the "monitoring board" model. Delaware Corporate law permits a corporation "to conduct … any lawful business or purposes"[128] and, the statement of omnibus corporate purpose in the charter is framed in terms of "any lawful act or activity."[129] The board's responsibility for assuring that the corporation stays within these "lawfulness" boundaries flows directly from the statutory mandate that "the business and affairs" of a corporation "shall be managed by or under the direction of a board of directors."[130]

The board's compliance oversight role also reflects a more general characterization of boards of US public companies as performing a "monitoring" function. The board's role in this widely-held view is to monitor the executives—from recruitment, through the oversight of strategic choices, to the control of conflicts of interest, particularly as regards compensation—and including compliance. Within this model, almost all the members of the board, bar the CEO, are 'independent' directors—that is, not tied by any employment relationship to the firm or its management.

This "monitoring board" has been well established as the corporate governance model for nearly forty years.[131] The board has not always been conceived of in this way. Historically, a board's role was largely to provide advice to the CEO and, incidentally, to be available to approve corporate actions of direct conflict, such as the CEO's compensation contact. The board was repurposed as a monitoring organ during the 1970s and 1980s, eventually consisting almost exclusively of independent directors with a

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[126] DEPARTMENT OF JUSTICE, *supra* note 68, at 2.

[127] The United States Sentencing Guidelines have since 2010 required that effective compliance programs entail direct communication with the board from the person tasked with executive responsibility for the compliance program: U.S. Sentencing Guidelines Manual § 8C2.5(f)(3)(C).

[128] Del. Gen. Corp. L. § 101 (b)

[129] Id, § 102(a)(4).

[130] Id., § 141(a).

[131] This history is traced in Gordon, *supra* note 13, at 1514-35.

monitoring charge. This transformation was promoted by academic theorizing in the wake of corporate debacles like the failure of Penn Central and the so-called "questionable payments" scandal of the mid-1970s.[132] A critical factor was the willingness of the Delaware courts to credit deliberation by an independent board in responding to a hostile takeover bid.[133] When confronted with a proposal that is likely to result in loss of their jobs and the associated emoluments, managers face an obvious conflict; thus board review, deliberation and oversight of defensive measures adds the critical element of legitimacy.[134]

Compliance monitoring fits into this paradigm. The board has an especially important monitoring role where managerial self-interest may be in conflict with shareholder interests. As Section II demonstrated, the high-powered incentives put in place to align managerial and shareholder interests in the overall performance of the firm give managers particular incentives to underinvest in compliance measures. Managers' short-term payoff opportunities conflict with long-term shareholder interests. Shareholders face losses from: fines and damages assessed for non-compliance; business opportunities foregone because of disruptive liquidity shocks associated with significant payouts; and stock price declines as investors come to re-assess the earnings and growth rate of the firm when it complies with applicable law. Managers, unlike shareholders as a group, can exit before the realization of compliance failure losses, and very rarely face personal prosecution for corporate misconduct.[135] Under current arrangements, managers frequently cash out of stock-based positions, even before leaving the firm, in the interest of "diversification."[136] Even an (unrealistic) requirement of an indefinite holding period would not fully resolve the short-termist conflict, since managers' tenure is frequently tied to stock-based measures of performance.

The critical feature is this: high-powered stock-based incentives for

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[132] MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971); MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976).

[133] Gordon, *supra* note 14, at 1523-26.

[134] *Id*.

[135] *See* Brandon L. Garrett, *The Corporate Criminal as Scapegoat* 101 VA. L. REV. 1789, 1801-19 (2015) (presenting data showing that in two-thirds of deferred and non-prosecution agreements with corporations over 2001-12, no individual officers or employees are prosecuted; where individual prosecutions occurred, they were usually of subordinate employees rather than officers; and where individuals were convicted, their sentences were lighter than the average for the crimes in question).

[136] See generally, Bebchuk & Fried, *supra* note 88, at 176-79.

managers require the board to step up to a high-powered monitoring complement. Indeed, the added compliance risks associated with high-powered managerial incentives was one of the fundamental lessons of the financial disclosure scandals that produced the Sarbanes-Oxley Act.[137] The Act created a bespoke compliance regime that includes outside vetting of internal financial controls[138] and direct tasking of the audit committee of the board with special compliance oversight responsibilities.[139] But financial controls are just the tip of the iceberg. Over the period of the 1970s through the 1990s Congress passed a host of regulatory statutes in the environmental area,[140] workplace health and safety,[141] and business practices aimed at various elements of corporate behavior.[142] These new regulatory obligations were in addition to measures previously adopted in the food and drug area, for example,[143] and other domains in which unchecked corporate behavior

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[137] See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003). See also *supra* note 32.

[138] Section 404 of the Sarbanes-Oxley Act of 2002, 15 USC § 7262, requires the issuer's auditor to certify the adequacy of the issuer's "internal control structure and procedures for financial reporting."

[139] Section 301 of the Sarbanes-Oxley Act of 2002 makes the audit committee "directly responsible for the appointment, compensation, and oversight of the work" of the firm's auditor. Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(2) (2007). Section 202 of Sarbanes-Oxley provides that "[a]ll auditing services . . . provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer." *Id.* § 78j-1(i)(1)(A). Section 201 of Sarbanes-Oxley prohibits the provision of certain non-audit services by the firm's auditor, *id.* § 78j-1(g), and required preapproval of the audit committee for non-prohibited services, *id.* § 78j-1(h). *See* Strengthening Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47,265, Public Utility Holding Company Act Release No. 27,642, Investment Company Act Release No. 25,915, Investment Advisers Act Release No. 2103, 68 Fed. Reg. 6006 (Feb. 5, 2003). *See* Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 79 SEC Docket 2876 (Apr. 9, 2003); 17 C.F.R. § 240.10A-3(b) (2007) (codifying Exchange Act Rule 10A-3(b)).

[140] *E.g.,* Federal Water Pollution Control Act Amendments of 1972; Environmental Pesticide Control Act of 1972; Safe Drinking Water Act of 1974; Clean Water Act of 1977; Water Quality Act of 1987; Clean Air Act of 1970, as amended in 1977 and 1990; Occupational Health and Safety Act of 1970; Mine Safety and Health Act of 1977,

[141] *E.g.,* Occupational Health and Safety Act of 1970; Mine Safety and Health Act of 1977.

[142] *E.g.*, Bank Secrecy Act of 1970; Foreign Corrupt Practices Act of 1970

[143] *E.g.,* the Food and Drug Act of 1938.

could impose externalities. Unlike financial disclosure, which can be addressed by a generally-specified compliance regime, these many different statutes, applying to different firms in different ways, require compliance oversight efforts tailored to the individual firm in light of its business model and other relevant features.

B. The Monitoring Board and "Skin in the Game"

The working assumption in corporate governance circles has been that even with high-powered managerial incentives that might incline managers to short-termist calculation, board compliance oversight could work effectively because the board's low-powered incentives would supply the complementary long-term perspective. Boards were predominantly compensated in fixed stipends, served long-terms that would extend beyond the term of any particular CEO, and had reputations that would be stained by corporate law violations. This assumption has been undercut by the changing patterns of *director* compensation since the mid-1990s, a shift to stock-based compensation which both increases the "power" of directors' economic incentives but also clearly sets increasing the stock price as the target by which director service will be judged.

Traditionally, directors were paid a fixed salary.[144] However, an influential 1995 critique from the National Association of Corporate Directors asked how the payment of a fixed retainer for simply showing up to board meetings created incentives for engagement.[145] The problem was two-fold. Low pay creates little incentive for effort. But high fixed pay can

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[144] Elson, *supra* note 19, 147-48 (1997) (median annual retainer for outside directors in 1962 was $2,000; rising to $6,000 by 1975, $15,000 by 1981 and $18,900 by 1985).

[145] NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF NACD BLUE RIBBON COMMISSION ON DIRECTOR COMPENSATION (1995) ("NACD Report"). This both distilled and advanced the contemporary theorizing about the need to incentivize directors. See Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 S.M.U. L. REV. 127, 162-64 (1996). Indeed, director compensation was not legally recognized in the United States until the late 1940s, although informal modes flourished, such as meeting fees, passing of stock tips, and even salaries. *Id.* at 138, 142. As of 1979, the median NYSE firm paid an annual director retainer of less than $10,000. SEC Staff Report, S. Comm. on Banking, Housing, and Urban Affairs, 96th Cong., SEC Staff Report on Corporate Accountability (Comm. Print 1980) (surveying 1200 major firms drawn from NYSE, Amex, Nasdaq, and OTC/regional exchanges in 1978-79), at 605 tbl.9.

compromise the independence of directors with respect to executives, given that there are ways in which executives can influence the length of directors' tenure. As the matter was put by Albert "Chainsaw Al" Dunlap, a member of the NACD panel (and CEO of Scott Paper Co):[146]

> "What kind of contribution will the directors ever make if they don't have a vested interest in the company's financial success? They've got to show they believe in the company, that they're willing to stand behind their choices. … Any director who isn't willing to be paid 100 per cent in stock doesn't believe in the company."

Since the mid-90s, however, and partly in response to the critique, directors' compensation changed quite significantly.[147] To heighten the incentives for performance-monitoring by the newly-arriving independent directors, director compensation has followed the structure of CEO pay by moving to stock-based pay. According to survey data from compensation consultants FW Cook and Pearl Meyer, board members of large public companies who have no executive role can today expect to receive a total compensation of approximately $250,000, of which around 60 per cent will be stock-based.[148] The stock-based component is primarily comprised of RSUs, with a component in some cases of stock options.[149]

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[146] ALBERT J. DUNLAP, MEAN BUSINESS 218 (1996).

[147] *See* Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229, 2229 (2005) (noting that the number of Fortune 1000 firms using stock-based remuneration increased from just over 200 in 1992 to almost 500 in 1995).

[148] FW COOK, 2016 DIRECTOR COMPENSATION REPORT, 5-6 (2016); NACD/Pearl Meyer, What's Next for Director Compensation in 2018?, 7-8 (2017). There is some industry variation, with technology sector firms making slightly higher use of stock-based compensation (70%, on average) and financial services making the least use (47%). Independent directors who sit on specific committees are often—but by no means universally—offered some sort of uplift to compensate them for the extra work involved. As of 2016, 41% of large cap companies offered a retainer for audit committee membership, and a further 21% offered meeting fees, with 38% having no uplift (*id*, 13). However, the absolute sums involved in these uplifts are modest. Independent directors sitting on the audit committees of large cap firms that pay retainers for committee membership receive a median uplift of $10,000. This rises to $25,000, or approximately one-tenth of their 'base' director compensation, for chairing the audit committee (*id*, 13-14).

[149] FW Cook, supra note 148, at 6. Options are very much a minority pursuit, accounting for only 3% of mean director compensation at large public companies: *id.* The use of options also varies across industries, from 8% of total director compensation in the technology sector to only 1% in the financial sector: *id.*

Directors' wealth is affected also in other ways by changes in their firm's stock price. In an important study tracking the fortunes of Fortune 500 directors elected in 1994-96 over a 5-year period, David Yermack considered the combined effect of: incentives from compensation received, changes in equity ownership, changes in disclosed conflicts of interest, and board seats obtained and departed from—in relation to changes in the stock price of their firms. He calculates that directors' personal wealth was increased (reduced) by 11 cents for every $1,000 increase (decrease) in the market value of their firms, and that more than half of this effect was accounted for by changes in the value of stock compensation.[150]

Of course, this is far lower than the intensity of incentives achieved for CEOs.[151] This naturally raises the question of whether directors' stock compensation creates economically meaningful incentives.[152] Yermack points out that, although smaller than for executives, directors' stock-based compensation incentives are "nontrivial". In his sample, a one standard-deviation change in a firm's stock market performance results in a change in a director's expected wealth by about $285,000.[153] The intensity of these incentives seems likely to have increased in the interim, as the aggregate amount of director rewards has continued to grow.[154]

Independent directors are typically very wealthy. Many will have served as senior executives in large companies or enjoyed successful professional careers in law or accounting.[155] Against a net worth measured in tens or hundreds of millions, even changes of a quarter of a million dollars may not be particularly significant. Yet to focus solely on the direct financial effects is to overlook the symbolic impact of performance-related pay on intrinsic motivation. 'Intrinsic' motivation encompasses the desire of conscientious

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[150] David Yermack, *Remuneration, Retention and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281, 2306 (2004).

[151] For example, Fahlenbrach and Stulz document that CEOs of banks during the financial crisis earned $24 for every $1,000 increase in firm valuation: Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis* 99 J. FIN. ECON. 11, 17 (2011).

[152] Bebchuk & Fried, *supra* note 88, 34.

[153] Yermack, supra note 150, at 2282.

[154] Yermack's study period coincided with an extraordinary surge in the value of public company stocks at the end of the twentieth century, during which the ratio of executive compensation to firm value fell to an all-time low.

[155] *See e.g.*, SPENCER STUART, U.S. BOARD INDEX 2017, 11 (2017) (professional backgrounds of directors of S&P500 companies).

individuals to 'do a good job', or of competitive individuals to succeed.[156] As well as extrinsically motivating action directly through financial returns, performance pay also gives directors a highly salient benchmark for evaluating the 'success' of their tenure. Directors are typically highly focused, goal-oriented individuals who are used to having their performance evaluated by a variety of metrics and are highly competitive in their pursuit of success by whatever metric is applied. In this context, payment in stock reinforces a shared assumption that the metric by which performance is to be measured is the stock price—an aspect of "corporate culture".[157] In other words, stock-based pay may motivate behavior even with modest amounts of financial variation by functioning as a highly salient metric for performance. This conjecture is borne out by studies showing that stock-based pay for directors is associated with a positive impact on firm value,[158] and meaningful differences in corporate behavior—including greater corporate risk-taking[159] and richer voluntary disclosures.[160]

C. Perverse Effects of Directors' Focus on Stock Price

The shift to stock-based compensation increases the alignment of directors' rewards with the stock price, at least at the point at which they come to sell their stock, which will usually be at the end of their tenure plus a dignified waiting period.[161] As we have seen, this gives directors greater incentive to engage with the firm in controlling managerial conflicts and pushing the latter to increase the value of the stock price. However, these

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[156] *See e.g.,* Frey, *supra* note 71; SUCCESSFUL MANAGEMENT BY MOTIVATION: BALANCING INTRINSIC AND EXTRINSIC INCENTIVES (Bruno Frey & Margit Osterloh eds, 2001).

[157] *See* David M. Kreps, *Corporate Culture and Economic Theory*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (James E. Alt, & Kenneth A. Shepsle eds., 1990); David M. Kreps, *Intrinsic Motivation and Extrinsic Incentives* 87 AM. EC. REV. PAP. & PROC. 359 (1997); Anjan Thakor, *Corporate Culture in Banking,* F.R.B.N.Y. EC. POL. REV. (Aug) 5 (2016); John R. Graham, Campbell R. Harvey, Jillian Popadak, & Shivaram Rajgopal, Corporate Culture: Evidence from the Field, NBER Working Paper No. 23255 (2017).

[158] See Fich & Shivdasani, *supra* note 147.

[159] See Yuval Deutsch, Thomas Keil & Tomi Laamanen, *A Dual Agency View of Board Compensation: The Joint Effects of Outside Director and CEO Stock Options on Firm Risk*, 32 Strat. Manag. J. 212 (2010). See also sources cited *infra*, notes 161-166.

[160] Partha Sengupta & Suning Zhang, *Equity-Based Compensation of Outside Directors and Corporate Disclosure Quality*, 32 CONTEMP. ACC. RES. 1073 (2015).

[161] 'About a year' is the apparent norm.

same incentives for directors have a tendency to replicate the problems of short-changed compliance that we analyzed in Section II. If directors are simply "weathervanes for the stock market",[162] then unless their time horizons are substantially longer than those of the managers, they are unlikely to function effectively in reducing managerial agency costs in the form of the time-horizon problem.[163]

It is difficult to measure the extent of this effect on compliance directly, because firms report so little about their compliance activity.[164] However, a few studies report corrosion of contiguous monitoring responsibilities associated with stock-based director pay. Granting options to directors was associated in the early 2000s with weaker oversight of option backdating by executives.[165] And stock-based pay for Audit Committee members is associated with greater frequency of accounting restatements.[166]

D. Interacting Managers' and Directors' Incentives

It is hard to meter the effect of changing director compensation on directors' compliance oversight efforts, though the sign is likely to be negative. The undoubted fact is this: *Managers'* incentives have massively ratcheted up in power since the 1980s in light of the performance focus on shareholder value. As we have shown, this entails the risk of management's short-termist willingness to underinvest in compliance, both in devising a business model and in creating the formal compliance apparatus. High-powered incentives to promote shareholder value call for high-powered compliance both to protect long-term shareholder interests as well as to protect society. Thus the board's compliance oversight duties need to be geared both by its statutory duty to assure that the corporation's activities are lawful, and also part of the board's fiduciary duty of loyalty to shareholder

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[162] Leo Strine, *ex tempore*, as confirmed by email correspondence on file with authors dated July 31, 2018.

[163] The upside bias problem is likely to be less of an issue for directors, for whom option compensation is rare. See sources cited *supra*, note 148.

[164] It is consistent, however, with the fact that very few companies go as far as establishing a board-level Compliance Committee: see Armour et al, *supra* note 87.

[165] Donal Byard & Ling Yi, The Impact of Directors' Option Compensation on their Independence, working paper (2005).

[166] Deborah S. Archambeault, F. Todd Dezoort, & Dana R. Hermanson, *Audit Committee Incentive Compensation and Accounting Restatements* 25 CONTEMP. ACC. RES. 956 (2008).

interests. The board determines both the amount and form of executive compensation.[167] Its statutory and fiduciary duties include the obligation of compliance oversight that complements the compensation scheme it has put in place.[168]

IV. *CAREMARK* AND ITS LIMITATIONS

A. Caremark Duties

The *Caremark* standard can be understood as a careful attempt by Delaware courts to balance two competing goals: on the one hand, the desire to encourage boards to engage with their executives about their firms' compliance activities, and on the other, the desire not to induce boards to expend corporate resources excessively on compliance programs as a means of insuring board members against liability risk.[169]

Conceptually, we may distinguish two stages at which directors' compliance oversight is engaged. The '*ex post* stage' concerns responses to information received by the board that suggests something may be amiss—so-called 'red flags'.[170] Where it comes to directors' attention that there is, or may be, misconduct taking place, then this will trigger a fiduciary duty to investigate and take appropriate consequent steps.[171] The degree of investigation and subsequent action demanded is a function of the extent of the evidence of misconduct available to the directors, and the seriousness of the consequences of potential misconduct. Note, though, that the extent of this *ex post* duty depends crucially on the quality of the information coming to the board. To what extent does the board have a positive duty to ensure an

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[167] *See* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); In re Walt Disney Derivative Litigation, 907 A.2d 693 (2005); In re the Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del. Ch. 2011).

[168] See *supra*, Section III.A, and *infra*, Section IV.A.

[169] *See generally* sources cited *supra* note 30; *see also* Charles M. Elson & Christopher J. Gyves, In re Caremark: *Good Intentions, Unintended Consequences*, 39 WAKE FOREST L. REV. 691, 701-2 (2004) (potential liability encourages boards to waste resources on ineffective compliance programs).

[170] We might alternatively style these two modes of oversight as 'chronic'—continuing—and 'acute'—in response to particular events.

[171] Graham v. Allis-Chalmers 188 A 2d 125 (Del. 1963); In re Massey Energy Company Derivative and Class Action Litigation, 2011 WL 2176479 (Del. Ch., 2011); Melbourne Municipal Firefighters' Pension Trust Fund v. Jacobs, 2016 WL 4076369 (Del. Ch., 2016); In re Wells Fargo & Co Shareholder Derivative Litigation (N.D. Cal., 2017); Oklahoma Firefighters Pension & Retirement System v. Corbat (Del. Ch., 2017).

upward flow of information regarding compliance? This is what may be termed the '*ex ante* stage' of compliance oversight: review of the firm's implementation of a compliance program and general monitoring of that program's performance.

Until the mid-1990s, it was thought that directors of Delaware companies were under no positive duty to monitor employees' conduct. In the well-known 1963 case of *Graham* v. *Allis-Chalmers*,[172] the Delaware Supreme Court held that boards were 'entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.'[173] More colorfully, the Court went on to explain that 'absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.'[174] In other words, directors meeting in the smoky boardrooms of the 1960s had license to adopt a 'don't ask, don't tell' approach to misconduct by subordinates. Provided directors could plausibly deny suspicion of any relevant misconduct, they would not face liability. We can see that far from encouraging boards to implement effective corporate compliance programs, *Allis-Chalmers* gave them an incentive not to do so.

Seen from today's perspective, this appears obviously problematic. However, the *Allis-Chalmers* position reflects all of: limited expectations for director vigilance in the advisory board model; a sparser regulatory environment in which compliance concerns were more distant; a belief that public company managers, being of especially good character, were not likely to violate the law; and perhaps even a view about firm value maximization at the time. Before authorities began granting any penalty discounts or prosecution leniency for the existence of a compliance program, it was far from obvious that implementing a compliance program was in shareholders' (as opposed to society's) interests. A compliance program might deter misconduct by employees, but it would also increase the likelihood that any misconduct occurring would come to light.[175] It seems quite plausible that shareholders would have wanted boards to adopt a correspondingly casual approach to overseeing compliance.

Directors' *ex ante* oversight obligations changed significantly in 1996,

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[172] 188 A 2d 125 (Del. 1963).
[173] *Id.*, 130.
[174] *Id.*, 130.
[175] Arlen, *supra* note 53.

with *In re Caremark International Inc., Derivative Litigation.*[176] Although the opinion was strictly concerned only with approval of a settlement between the parties, Chancellor Allen took the opportunity to announce to boards that their obligations had moved on since the 1960s:[177]

> [I]t would, in my opinion, be a mistake to conclude that … corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

In other words, boards now had an *ex ante* obligation, not conditional on red flags or notice of any irregularities, to ensure that their company had in place a monitoring system to generate timely information regarding the employees' compliance. This new obligation to implement a compliance program complemented closely the initiatives taken in sentencing around the same time.[178] Given that the Sentencing Guidelines now gave stronger incentives to companies for implementing effective compliance programs, it was consistent with maximizing firm value to encourage boards to follow through. The implication of an *ex ante* duty interacts with the *ex post* elements of monitoring. Requiring firms to implement compliance programs means that boards will inevitably be more frequently exposed to 'red flags', and consequently find their *ex post* obligations triggered.[179]

B. The "good faith" standard

A core concern with director liability is that it will instill an overly cautious approach to decision-making. The idea is best-known in relation to business decisions, where it underpins the 'business judgment rule'.[180] If directors anticipate potential liability for 'bad' decisions, they will be less

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[176] 698 A.2d 959 (Del. Ch. 1996).

[177] *Id.,* 970.

[178] *Id.,* 969. *See supra,* text to notes 54-55.

[179] Gadinis & Miazad, *supra* note 82.

[180] *See, e.g.,* S. Samuel Arsht, *The Business Judgment Rule Revisited* 8 Hofstra L. Rev. 93, 97-111 (1979) (reviewing historical origins of the rule).

willing to pursue courses of action that might involve downside risk for the firm.[181] This is problematic, from diversified shareholders' perspective, if directors pass up opportunities with higher expected values because they are concerned about downside outcomes. Any liability risk faced by directors is undiversified, meaning they will behave in a risk-averse fashion. The business judgment rule consequently grants directors a presumption that they acted consistently with their duties where they make a well-informed business decision in good faith.

Chancellor Allen's opinion in *Caremark* singled out cases where boards fail to take *any* action as regards compliance.[182] Total failure to act does not amount to a business decision, and so would not attract the protection of the business judgment rule. However, the more interesting question concerns the *extent* of the board's obligations. In *Caremark* itself, Chancellor Allen characterized the extent to which the board requires the company to implement compliance systems as a question of business judgment:[183]

> Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law.

Although Chancellor Allen couched these monitoring obligations in terms of directors' duty of care, he made clear that the key question was whether the board had made "a *good faith* judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations" (emphasis added).[184] This reflected the fact that in 1986, the Delaware legislature had modified the DGCL to permit companies to exculpate directors from monetary liability for

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[181] *See, e.g.*, Gagliardi v. TriFoods Int'l. Inc., 683 A.2d 1049 (Del. Ch 1996); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine* 57 VAND. L. REV. 83, 110-117 (2004) (reviewing risk-taking argument).

[182] In re Caremark International Inc., Derivative Litigation 698 A.2d 959, 968 (Del. Ch. 1996)

[183] *Id*. at 970.

[184] *Id.*

breaches of duty not involving bad faith or disloyalty.[185] Subsequent caselaw has accordingly characterized directors' monitoring duties as part of their overarching duty of loyalty.[186]

The practical question for boards is the extent to which they are required by their duties to act in relation to monitoring. The answer, at least as regards *ex ante* oversight, is that their actual obligation is minimal. In Chancellor Allen's view, the *Caremark* duty would only be violated by "a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists."[187] Or, as it was subsequently put by the Delaware Supreme Court in *Stone v. Ritter*:[188]

> (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

It is not excessively reductionist to characterize this continuing monitoring obligation as binary: either there is some effort, or there is no effort. Any level of positive effort will suffice for directors to meet their fiduciary obligations in this context. This is reflected in statements regarding the sorts of board-level failures that would be necessary to ground a claim for liability:[189]

> [C]ontentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.

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[185] DGCL §102(b)(7). See generally James B. Behrens, *Delaware Section 102(b)(7): A Statutory Response to the Director and Officer Liability Insurance Crisis* 65 WASH. U.L.Q. 481 (1987).

[186] Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[187] Caremark, *supra* note 176 at 971.

[188] Stone v. Ritter, *supra* note 186, at 370.

[189] Guttman v. Huang 823 A.2d 492, 507 (Del. Ch., 2003). See also David B. Shaev Profit Sharing Account v. Citigroup, Inc. 2006 WL 391931 at 5 (Del. Ch., 2006).

The recent case of *Horman v. Abbey*,[190] concerning allegations of *Caremark* violations by the board of UPS in relation to the transportation of illegal tobacco products, provides an illustrative example. The fact that the plaintiffs conceded that the board had established an Audit Committee whose responsibilities included "oversight of 'the Company's compliance with legal and regulatory requirements. ...'" and that the board was "provided updates about legal compliance through reports from the UPS Legal Department" was fatal to their claim that the board had failed to implement any reporting or compliance systems.[191] By simply establishing these structures, the board had met the *ex ante* part of their *Caremark* obligations.

C. The Caremark *standard's balance*

Chancellor Allen, as we have seen, viewed the extent to which a board implements a compliance program as "obviously" a matter of business judgment.[192] It is worth exploring the underlying rationale for this. Facially, decisions about the structure of a corporate compliance program seem far-removed from decisions about which lines of product to push or where to open a factory. Yet there are indeed commonalities. The design of an effective compliance program entails judgments about firm-level risks and the interaction of corporate strategy—and especially compensation policy—and compliance risk.[193] These depend on firm-specific information and expertise with which directors are likely to be better-endowed than courts. This mirrors the well-known "institutional competence" rationale for the business judgment rule.[194]

More problematic, perhaps, is the issue of risk-taking. Business judgment review is intended to encourage decision-makers to be risk-neutral in their selection of projects that maximize expected value for shareholders.[195] Is this desirable where what is at stake is compliance with laws imposed on corporations to secure the wider benefit of society? An argument in favor

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[190] 2017 WL 242571 (Del. Ch., 2017).

[191] *Id*, at 8.

[192] See *supra*, text to note 177.

[193] See *supra*, Section I.B.

[194] See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. L. 1437, 1439, 1442-43 (1985). Bainbridge, *supra* note 181, 117-124 (judges are not business experts).

[195] Joy v. North 692 F.2d 880, 886 (2d Cir. 1982), cert den. 460 U.S. 1051 (1983); Gagliardi v. Trifoods International, Inc. 683 A. 2d 1049 at 1052-3 (Del. Ch. 1996).

emerges from the uncertainty over what exactly *works* in compliance.[196] It is socially optimal for firms to minimize the joint costs of compliance and law-breaking.[197] Given that there is lack of clarity over which compliance mechanisms are most effective, the selection of appropriate mechanisms entails elements of risk. If directors fear liability, they may tend to be risk-averse in their design of compliance programs, causing their firms to waste money on measures that do not deliver meaningful reductions in misconduct rates. This may harm not only shareholders, by incurring inefficiently high compliance costs, but also society, through poorly-specified compliance programs and the opportunity cost of lack of experimentation with new compliance technology.

Moreover, on the theory that well-advised boards of public companies are populated by people who try to 'do the right thing', articulating a modest legal obligation coupled with lengthy *dicta* about what best practice might entail permits the court to give a steer where appropriate, without forcing conduct where inappropriate.[198] Delaware cases often can be seen as "parables" of good vs. questionable behavior by officers and directors even where liability is not imposed.[199] The goal appears to be to establish exemplary "standards of conduct" even while being chary with liability-imposing "standards of review."[200]

The framework established by *Caremark* imposes what is essentially a binary obligation on boards with respect to the establishment of a compliance program. So long as *something* has been set up, then the way in which it is designed and implemented is a matter for the board's business judgment. The rationale for framing the obligation in this way had two components: (i) a desire to avoid inducing *overinvestment* in compliance programs by directors concerned about liability; (ii) optimism regarding the provision of non-binding judicial guidance to parties.

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[196] See *supra*, Section I.B.

[197] Miller, *supra* note 61.

[198] This interpretation of *Caremark* is based on the casebook co-authored by (former) Chancellor Allen: see WILLIAM T. ALLEN & REINIER KRAAKMAN, CASES AND MATERIALS ON THE LAW OF BUSINESS ORGANIZATIONS, 5th ed., 244 (2015).

[199] See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997).

[200] See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1295 (2001) (endorsing distinction of Prof. Mel Eisenberg).

D. The Growing Imbalance

Chancellor Allen's approach in *Caremark* thus struck a balance between encouraging boards to think seriously about organizational compliance in light of the Federal Sentencing Guidelines, without invoking concerns about forcing boards to implement inappropriate and costly compliance programs or putting courts in the difficult business of evaluating compliance regimes. This balance was struck before observers appreciated the impact of stock-based compensation (for both managers and directors) on the company's incentives to invest in appropriate compliance measures. High-powered incentives invited short-termist compliance strategies by managers, through a business model that would take significant compliance failure risks and/or through lax internal compliance monitoring. The move to give directors "skin in the game" through stock-based pay for directors aligned directors' financial incentives on this point with those of executives. Directors now have incentives to tolerate a sub-optimal compliance regime, both *ex ante* in the design of the regime and *ex post*, in the follow-up of warning signs. The *Caremark* framing of directors' oversight duties does nothing to ameliorate the incentives that stock-based compensation for directors tends to create towards underinvestment in compliance. Our fundamental point is that changes in managers' pay along with changes in directors' pay mean that the balance of concern about overinvestment versus underinvestment in corporate compliance has shifted toward the latter.

E. Lack of Guidance from Delaware Courts

The second rationale for *Caremark*'s approach was that the courts might square the circle of liability and incentives by giving non-binding guidance about best practice. The *Caremark* opinion itself went out of its way to provide guidance that was unnecessary for the decision in hand, but would be useful to directors who were seeking to perform their roles in good faith. It is worth reflecting on the extent to which this sort of approach has been reflected in the subsequent case law.

We reviewed all Delaware judicial opinions since *Caremark* that involved litigation of oversight duties. Our searches revealed 41 cases giving rise to one or more opinions,[201] of which almost all (39) had the procedural

[201] Where a case was appealed and resulted in multiple opinions, we focus on the highest court in which the case was heard.

posture of a motion to dismiss.[202] In 32 (82 per cent) of these motions to dismiss, the motion was successful.[203] Only nine cases have yielded opinions concluding that, assuming the truth of particularized facts alleged in the plaintiff's pleadings, the case should survive the initial screening of a motion to dismiss.[204] Of these, four involved failures in *ex ante* monitoring—that is, total failure to establish any meaningful system of controls.[205] A further three involved *ex post* oversight failures—namely, conscious disregard of 'red flags' indicating misconduct.[206] The remaining two involved boards plausibly giving knowing support to corporate lawbreaking.[207]

However, the only judicial guidance offered to parties in these opinions relates to whether the plaintiff has pleaded sufficiently particularized facts to sustain a reasonable likelihood that directors would face liability. A representative recent example is *In re General Motors Company Derivative*

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[202] See Appendix II for the cases.

[203] *Id*.

[204] Two of these cases had a different procedural posture: ATR-Kim Eng Financial Corp. v. Araneta, 2006 WL 4782272 (Del.Ch. 2006) (trial on the merits); In re Massey Energy Co. Derivative and Class Action Litigation, 2011 WL 2176479 (Del. Ch. 2011) (request for preliminary injunction to restrain merger).

[205] ATR-Kim Eng Financial Corporation, *supra* note 204; In re American International Group, Inc., 965 A.2d 763 (Del. Ch. 2009); Rich, ex rel. Fuqi International, Inc. v. Yu Kwai Chong, 66 A.3d 963 (Del. Ch. 2013); In re China Agritech, Inc., Shareholder Derivative Litigation, 2013 WL 2181514 (Del. Ch. 2013).

[206] Saito v. McCall, 2004 WL 3029876 (Del. Ch. 2004); In re Massey Energy, *supra* note 204; Stewart v. Wilmington Trust SP Services, 112 A.3d 271 (Del. Ch. 2015).

[207] Louisiana Municipal Police Employees' Retirement System v. Pyott, 46 A.3d 313 (Del. Ch. 2012); Kandell on behalf of FXCM, Inc. v. Niv, 2017 WL 4334149 (Del. Ch. 2017); see also City of Birmingham Retirement and Relief System v. Good, Del., 177 A.3d 47, 65 (Del. 2017) (dissent of Strine CJ).

Litigation,[208] in which Vice-Chancellor Glasscock noted:[209]

> The Complaint does not allege a total lack of any reporting system at GM; rather, the Plaintiffs allege the reporting system should have transmitted certain pieces of information, namely, specific safety issues and reports from outside counsel regarding potential punitive damages. In other words, GM had a system for reporting risk to the Board, but in the Plaintiffs' view it should have been a better system. Contentions that the Board did not receive specific types of information do not establish that the Board utterly failed "to attempt to assure a reasonable information and reporting system exists … "

Given that the bar for monitoring obligations is set so low, showing a breach of duty in relation to *ex ante* monitoring requires plaintiffs to show that the board had failed to ensure that their firm had *any* sort of compliance program. Consequently, the judicial discussions restrict themselves to defining egregious malpractice, as opposed to providing any guidance on

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[208] 2015 WL 3958724 (Del. Ch. 2015). See also e.g., Guttman v. Huang, 823 A.2d 492, 506-7 (Del. Ch. 2003) ("[The plaintiff's] conclusory complaint is empty of the kind of fact pleading that is critical to a Caremark claim, such as contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."); In re David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, *5 (Del. Ch. 2006) ("The plaintiff conceded at oral argument that Citigroup had a wide range of compliance systems in place, and that they had no reason to believe that these systems were not functioning in a basic sense."); In re Lear Corp., 967 A.2d 640, 654 (Del. Ch. 2008) ("The complaint makes clear that the Lear board held regular meetings and received advice from several relevant experts. The plaintiffs have therefore not come close to pleading facts suggesting that the Lear directors 'consciously and intentionally disregarded their responsibilities' and thereby breached their duty of loyalty."); South v. Baker, 62 A.3d 1, 18 (Del. Ch. 2012) ("The complaint … pleads affirmatively that the Board established a Safety Committee and charged the committee with (i) reviewing health, safety and environmental policies … These pled facts do not support an inference of an 'utter failure to attempt to assure a reasonable information and reporting system exists,' but rather the opposite."); Horman v. Abney, 2017 WL 242571, *8 (Del. Ch. 2017) ("The Audit Committee's Charter, also referenced in the Complaint, establishes that the Audit Committee's general responsibility for oversight includes oversight of 'the Company's compliance with legal and regulatory requirements. ...' Thus, the Complaint itself reveals that the Plaintiffs have not plead particularized facts that the Board 'utterly' failed to adopt or implement any reporting and compliance systems.")

[209] In re General Motors, *supra* note 208, *2.

good practice.[210] Consequently, there is little basis for the view that Delaware courts take the opportunity to provide guidance to boards without triggering liability, in the context of oversight duties.

F. Mixed messages from elsewhere

The absence of guidance from Delaware courts leaves a vacuum in corporate law regarding what effective board engagement with compliance should look like. Other enforcement agencies, however, have not been so reticent. The most notable has been the trend for prosecutors to include stipulations about compliance programs in deferred and non-prosecution agreements ('DPAs').[211] These agreements are entered into between prosecutors and firms whereby the authorities do not proceed with prosecution in return for the payment of a penalty by the firm and other undertakings. As discussed in Section I, whether or not the firm has an effective compliance program is a relevant consideration for whether prosecutors will be willing to agree to a DPA rather than proceed with prosecution.[212] However, it is only one of many factors, another of which is the firm's willingness to improve its practices in light of the discovery of misconduct.[213] In many DPAs, firms' compliance programs are judged to be ineffective by prosecutors, but the firm undertakes to improve its practices going forward by way of "remediation".[214] Whether or not this is achieved is then scrutinized through the appointment of a "corporate monitor," a

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[210] See ATR-Kim Eng Financial Corp. v. Araneta, 2006 WL 4782272 (Del. Ch. 2006) *19 (no reporting system in place; board did not meet regularly and deferred entirely to chairman and controlling shareholder); In re American International Group, Inc., 965 A.2d 763, 799 (Del. Ch. 2009) ("diversity, pervasiveness, and materiality" of misconduct so extensive that relevant directors must have realized internal controls were inadequate); Rich, ex rel. Fuqi International, Inc. v. Yu Kwai Chong, 66 A.3d 963, 983 (Del. Ch. 2013) (Audit Committee exerted no control over company's operations in China, where its sole asset, a Chinese jewelry company, was located); In re China Agritech, Inc., Shareholder Derivative Litigation, 2013 WL 2181514, *19-*20 (Del. Ch. 2013) (Audit Committee never met).

[211] See generally, Wulf A. Kaal & Timothy A. Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance: Evidence from 1993-2013*, 70 BUS. LAW. [1], [11]-[22] (2014); Garret, *supra* note 49, 58-70; Arlen & Kahan, *supra* note 110, at 330-43.

[212] See *supra*, notes 55-56 and text thereto.

[213] Department of Justice, *supra* note 55, 9-28.740, 9-28.1000.

[214] See Kaal & Lacine, supra note 211, 44-47 (75% of N/DPAs in sample over 1993-2013 contained undertakings by the firm to implement, or improve, a compliance program.)

prosecutor-appointed professional whose role is to oversee the implementation of an improved compliance regime.[215]

The undertakings given by firms in DPAs regarding compliance are the result of the exercise of prosecutorial discretion. As such, they give no generalizable guidance to other firms as to what best practice might involve. Moreover, such agreements are outside the rule of law.[216] In a recent paper, Arlen and Kahan question the justification for such discretionary exercises, concluding that one possible justification may be that agency costs within the firm mean that its managers have insufficient incentives to implement compliance programs.[217] We agree that agency costs justify intervention to enhance compliance incentives and share their assessment that DPAs are a distinctly second-best way to do this.[218] However, we view the phenomenon as a response to widespread incentive problems in corporate boards regarding compliance, and the absence of any imperative from corporate law for boards to take further action.

A second channel of agency activism has been administrative enforcement against individual executives. Most notable in this arena has been SEC enforcement in relation to compliance with securities regulation.[219] A series of recent enforcement actions have pronounced CEOs' conduct to have been negligent.[220] While these decisions are not beyond the rule of law,

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[215] *Id*. (corporate monitors appointed in 46% of N/DPAs).

[216] See Brandon Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007); Jennifer Arlen, *Removing Prosecutors from the Boardroom: Deterring Crime Without Prosecutor Interference in Corporate Governance*, in PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 62, 76–81 (Anthony S. Barkow & Rachel E. Barkow eds., 2011); James R. Copeland, *The Shadow Regulatory State: The Rise of Deferred Prosecution Agreements*, 14 CIV. JUST. REP. (2012).

[217] Arlen & Kahan, *supra* note 110, 354-66.

[218] *Id*., 375-85.

[219] See generally, Luis A. Aguilar, *The Role of Chief Compliance Officers Must be Supported*, SEC PUBLIC STATEMENT, June 29, 2015; Court E. Golumbia, *"The Big Chill": Personal Liability and the Targeting of Financial Sector Compliance Officers*, 69 HASTINGS L.J. 45 (2017).

[220] Most of these proceedings involve executives of investment advisory firms censored for failure to adopt, implement and review written policies and procedures and a code of ethics reasonably designed to prevent violations under the Investment Advisers Act of 1940. See In re Wunderlich Securities, Inc., SEC Administrative Proceeding No 3-14403, May 27, 2011 (fine of $50,000 and $45,000 respectively for CCO and CEO of investment adviser); In re Equitas Capital Advisors, LLC, SEC Administrative Proceeding No 3-15585, October 23, 2013 (fine of $35,000 for CEO of investment adviser); In re Blackrock Advisors, LLC, SEC Administrative Proceeding No 3-16501, April 20, 2015 (fine of $60,000 for CCO of

they create a different problem: the incentives to implement compliance become sectoral and driven by the agendas of regulators as opposed to integration with the firm's business model. This makes it difficult for firms to think about compliance systems in a holistic way, as opposed to responding in disparate and unconnected ways to a series of imperatives imposed by subject-matter agencies.[221] One of the benefits of having greater incentives from corporate law would be that firms would be encouraged to take a more holistic approach to the development of their compliance programs.

V. THE CASE FOR A "COMPLIANCE CLAWBACK"

A. A self-limiting liability proposal

As we have shown, the increasing importance of stock-based compensation and an evolving sense of the duties of public company directors mean the framework established by *Caremark* is ripe for reconsideration. However, such reconsideration needs to bear in mind two points. First, the policy concerns reflected in *Caremark* are still important: the development of *Caremark* duties must be sensitive to genuine concerns about defensive decision-making and doubts about the institutional competence of judges to review directors' decisions.[222] Second, the freedom of the Delaware Chancery Court to evolve precedent in this area is constrained by section 102(b)(7) of the DGCL, which permits companies to exculpate directors for breach of duties not involving bad faith or disloyalty. In this Section, we articulate a way forward that would give directors more effective incentives to engage in compliance oversight while being responsive to these concerns.

The general concern about defensive decision-making is that if directors face greater liability, they will be less willing to take on risky business projects. Of course, in most contexts, liability for failures in compliance oversight would not affect decision-making in relation to 'ordinary' business

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investment adviser); In re Pekin Singer Strauss Asset Management Inc., SEC Administrative Proceeding No 3-16646, June 23, 2015 (President, Chairman and co-CEO of investment adviser each fined $45,000); In re SFX Financial Advisory Management Enterprises Inc., SEC Administrative Proceeding No 3-16591 (fine of $25,000 for CCO of investment adviser).

[221] Veronica Root, *Coordinating Compliance Incentives*, 102 CORNELL L. REV. 1003 (2017).

[222] See *supra* Section IV.C.

decisions, in the sense of setting strategy and selecting business projects. The goals of the business judgment rule would be preserved.

A more specific version of the concern about defensive decision-making is that liability for failures in compliance oversight may lead directors to cause their firms to *overinvest* in compliance.[223] This is because spending the company's money on compliance would insure directors against potential liability. Of course, up to a point, this is exactly what liability *should* do: our claim is that boards currently lack sufficient incentives to oversee compliance. However, the concern is that heightening the *Caremark* standard would cause boards to flip from too little to too much expenditure.

This concern about overinvestment in compliance is strongest if directors face liability measured by the amount of penalties paid out by the corporation following a compliance failure. Such penalties are set by reference to the social harm caused by the corporate misconduct in question, rather than the marginal incentives of directors overseeing the firm's activities. Average fines for corporations convicted of a Federal crime are in excess of $12m,[224] and when disgorgement, forfeiture, restitution, and liabilities in follow-on civil lawsuits are added in, a corporation's total financial liabilities following prosecution can easily be ten times this.[225] Making directors personally liable in this amount, even with a small probability, would likely outweigh the current incentives for underinvestment in compliance, as total variable compensation is far less than this.

To avoid triggering overinvestment in compliance, we suggest framing liability not in terms of "compensating" the corporation for its financial exposure—in relation to which the directors' causal contribution will have been minor—but rather in terms of "clawing back" or *disgorging* the directors' variable compensation earned on the basis of inadequate compliance oversight.[226] In contrast to standard loss-based measures, liability measured in this way is self-limiting in quantum: no director will face

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[223] *See, e.g.*, Elson & Gyves, *supra* note 169.

[224] Garrett, *supra* note 49, 292 (Figure A.1 detailing average corporate fines 1994-2012).

[225] *Id.*, 294.

[226] "Compliance clawbacks" have been previously been proposed for executives: *see, e.g.*, W. Robert Thomas, *The Ability and Responsibility of Corporate Law to Improve Criminal Fines*, 78 OHIO ST. L.J. 601, 647-50 (2017); Langevoort, *supra* note 30, [5]-[6]. Such clawbacks can and should be included in executive compensation agreements negotiated by boards. Our proposal, by contrast, would apply to directors, in order to encourage their engagement with compliance oversight—including the negotiation of such clauses for executives.

financial exposure exceeding what she has received from the firm in the form of stock compensation.[227] Rather, the remedy for failures in compliance oversight tracks the potential benefit to the director from short-changing compliance. This symmetry means that the liability solution tracks the compensation problem. Moreover, liability to disgorge compensation gains resonates with traditional gain-based remedies for breach of the duty of loyalty.

B. What Does "Effective" Compliance Look Like?

Institutional competence concerns about director liability center on the court's lack of expertise with respect to corporate decisions. Permitting the court to determine what constitutes an "inadequate" decision will encourage directors to please judges, and if judges are less competent than directors themselves, will reduce the quality of decision-making.

However, in the context of compliance oversight, this general concern is attenuated. A specific problem for compliance oversight is that there is no clear consensus as to what a socially optimal—or even an "effective" in the sense of reducing expected corporate penalties—compliance program looks like.[228] Unlike general business decisions, directors' incentives vis-à-vis compliance oversight do not track shareholder returns. The problems discussed in Section II mean that directors' judgment regarding compliance programs is likely systematically to be biased toward underinvestment. There is no *a priori* reason for thinking that courts will do a worse job of setting parameters for compliance investment than will directors themselves.

Moreover, the choice is not simply between directors and courts. As we saw in Section IV.F, corporate law's hesitancy in policing directors' oversight responsibilities has effectively ceded the field for developing notions of "effective" compliance to an *ad hoc* range of interventions by prosecutors. While the costs of engaging with the question of what sort of compliance program is effective may be high, the costs of not doing so—and leaving this to prosecutorial discretion—are arguably higher.

A compliance clawback could be implemented in a variety of ways, opening a range of possible institutional fora—with differing competencies—for assessment of whether a "failure" had occurred. Our

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[227] To be sure, the loss to a director found liable would also include reputation, but this would have the valuable benefit of permitting firms to assess more clearly the extent of an individual's propensity to engage with compliance concerns.

[228] See *supra*, Section I.B.

preference is for an alternative dispute resolution procedure that would over time generate learning about compliance regimes that might usefully inform practice as well as instill accountability. For example: if the firm resolves a compliance enforcement action, criminal or civil, through payment of a fine or accepting some other sanction, an appropriate board committee, perhaps the governance committee, should trigger an "accountability proceeding." This proceeding could be presided over by a panel of compliance and industry experts, perhaps three, who would conduct an internal investigation that would (i) evaluate the compliance system within the firm as well as the particulars of the compliance failure, (ii) assess the extent of directors' responsibility, and (iii) determine the appropriate clawback of the accumulated stock of responsible former and current directors. In other words, the panel would consider the board's engagement at both the *ex ante* stage of compliance oversight, including the integration of the compliance regime to the firm's business model, and the *ex post* stage, including the board's alertness to any red flags. The panel's findings and determinations should be made public. This proceeding would weigh and assess responsibility in an expert way. And crucially, it would help generate case studies to aid future parties' understanding of what makes for an effective compliance regime.

Clearly, this approach would not necessarily yield an optimal balance of the competing policy considerations discussed. Our claim is more modest: that it would deliver an improvement on the current, manifestly sub-optimal, position.

C. The Supply of Directors

An oft-voiced concern is that greater liability would chill the supply of qualified directors. We consider that this argument has no real force independent of the more powerful concerns discussed above. Provided that the quantum of liability is measurable in advance, and that it is clear what directors must do to avoid it, then any concerns new board members may have about potential liability can be met through negotiations over their pay. Our proposal meets the first of these conditions, and we believe will make a credible job of meeting the second.

Moreover, a number of precedents exist for the imposition of liability in the form we propose—or even more extensively—without having had adverse effects on board recruitment. Executives of US public companies have been at risk for clawbacks since 2002 for incentive-based payments that

are based on accounting fraud,[229] and this was extended by the Dodd-Frank Act of 2010 to include all cases of accounting misstatement.[230] The UK's Financial Conduct Authority's new Senior Managers Regime for banks, in force since 2016, imposes on senior executives and directors with delegated responsibilities a 'duty of responsibility' for compliance within their area of authority (defined objectively).[231] The duty, which will be extended to senior managers of all UK financial services firms by the end of 2018, is enforceable by the regulator and breaches may be met not only with disgorgement of compensation but also unlimited fines.[232] While this goes considerably further than anything we propose here, it does not appear to have resulted in UK banks failing to attract senior managers, although they are needing to pay more to do so.[233]

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[229] Sarbanes-Oxley Act, § 304 (SEC authorized to seek clawback of performance-based compensation from CEO and CFO in cases of accounting restatement accompanied by misconduct in financial reporting); see SEC v. Jensen, 835 F.2d 1100 (9th Cir 2016). Because SEC action is required to obtain the clawback in such cases, this provision is widely regarded as ineffective. See Jesse M. Fried, Rationalizing the Dodd-Frank Clawback, Harvard Law School Discussion Paper No 876 (2016) (in over 8,000 financial restatements during decade following enactment of SOX, SEC recovered pay from only six executives who had not personally engaged in misconduct.)

[230] Dodd-Frank Act, § 904, 31 USC 78j-4 (requiring issuers to develop a clawback policy for excess incentive-based based pay in light of a material restatement of financial results). An SEC rule proposal in 2015 to implement the section specifically was not adopted. Nevertheless, firms are adopting what some have called "quasi-clawbacks." See Shearman & Sterling, Embracing the Quasi-Clawback, April 19, 2018, available at https://www.shearman.com/perspectives/2018/04/embracing-the-quasi-clawback.
Clawbacks have also been implemented by boards (such as the Wells Fargo board) when notorious lapses generated sufficient shareholder pressure. See John C. Coffee, Shareholder Activism in the Era of Trump: What Strategy Works?, Columbia Blue Sky Blog, Nov. 21, 2016, available at http://clsbluesky.law.columbia.edu/2016/11/21/shareholder-activism-in-the-era-of-trump-what-strategy-works/.

[231] See Financial Conduct Authority (UK), Guidance on the duty of responsibility: final amendments, PS17/9 (2017); Financial Conduct Authority, The Duty of Responsibility for insurers and FCA solo-regulated firms, CP17/42 (2017).

[232] Financial Services and Markets Act (UK) 2000, §§ 66A(5)(d), as amended by Bank of England and Financial Markets Act 2016 (UK).

[233] While some anecdotal evidence suggests the new regime is making recruitment of key compliance staff more difficult (see, e.g., Jennifer Thompson, *Accountability rules hit hiring of senior staff, says recruiter*, Fin. Times, August 28, 2017), other anecdotes suggest compliance professionals find themselves "in a strong bargaining position" (see, e.g., Nick Evans, *How will the Senior Managers Regime affect compliance jobs?*, Barclay Simpson Industry News, April 18, 2016, www.barclaysimpson.com (last accessed August 1, 2018).

D. Implementing Compliance Clawbacks

We see two routes by which compliance clawbacks in the form we have framed them could be implemented as a matter of corporate law: a "shareholder route" and a "judicial route". Our preference is for the former.

1. Shareholder Route

As we have seen, directorial inattention to compliance ultimately harms investors as well as society, because the firm is in the long run liable to pay a larger penalty. Suitably motivated shareholders have two complementary levers at their disposal to implement a compliance clawback. The first is that stock exchange listing rules require shareholder approval of equity compensation plans.[234] Under state law (Delaware in particular), shareholder approval of stock-based pay for directors seems a critical element in assuring that a business judgment rule standard rather than an entire fairness standard governs in the event that such grants are subsequently challenged as excessive and resulting from director self-dealing.[235] Shareholders, such as institutional investors, who believe that directors' stock-based compensation should be subject to clawback in the event of compliance failures, could withhold their vote subject to appropriate undertakings in the plan documents for a decision procedure like the one described above. Since stock-based compensation raises loyalty concerns, it is appropriate for shareholders to set limits on the terms of such equity grants.

A complementary tack would be for shareholders to add a clawback determination process through an amendment to corporate by-laws using the shareholder initiative power under Delaware corporate law and similar such laws.[236] This would invite negotiation with the board over procedures that could workably set-up the clawback scheme. Such a measure would be shareholder "self-help" that does not require legislative change or even widespread adoption across all firms. An organization like ISS or the Council on Institutional Investors might devise model by-law provisions that would

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This is consistent with a need to offer greater compensation and operational autonomy to attract personnel to roles carrying the new compliance responsibilities.

[234] See NYSE Listed Company Manual § 303A.08; Nasdaq Listing Rule 5635(c).

[235] The recent important cases are Seinfeld v. Slager (Republic Services), 2012 WL 2501105 (Del. Ch. June 29, 2012); Calma v. Templeton (Citrix), 114 A.3d 563 (Del. Ch. 2015); Espinoza v. Zuckerberg (Facebook), 124 A. 3d 47 (Del. Ch. 2015); and Investors Bancorp, C.A. No. 12327-VCS (Del. Ch. Apr. 5, 2017).

[236] See Del. Gen. Corp. L. §109.

be available for shareholder initiative. ISS might well initiate a consultation among its shareholder constituents to evaluate the demand for such a provision.

Of course, the "shareholder route" to implementation of compliance clawbacks by shareholders relies on activism investors with a concern for the long-term interests of the company. The extent to which such activism exists or can be harnessed is beyond the scope of this paper; suffice it to say that this route is non-viable if it cannot. We think that stronger compliance oversight should be an important priority of large institutions now interested in "stewardship". Compliance failures at large public companies sour public sentiment about the legitimacy of a corporate governance system that prioritizes shareholder interests. A single firm's compliance failure can in this way ramify across a diversified portfolio. Thus asset managers whose core products are diversified portfolios of public company stock have a strong reason, from a customer perspective, to favor governance innovations that would reduce such risks.

2. Judicial Route

A judicial route to implementing compliance clawbacks would be to characterize oversight of compliance as a conflict-of-interest issue where directors are compensated in stock. This would have the facially attractive feature of sidestepping the barrier erected by section 102(b)(7), because a conflict of interest is a duty of loyalty concern *per se*. However, if director stock compensation creates a conflict of interest over compliance issues, it is hard to see why it does not do so in relation to all other issues involving weighing short-term and long-term risk considerations.[237] Courts have been chary of accepting such arguments in the past,[238] on the basis that almost all decisions become subject to entire fairness review if compensation is taken as a basis for conflict of interest.

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[237] Two of us have indeed argued for such wider characterization elsewhere: John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value,* 6 J. LEG. ANALYSIS 37 (2014). However, we suggested that implementation would require modification of 102(b)(7).

[238] *See e.g.*, Kamin v. American Express Co. 86 Misc.2d 809, 812-815 (NY SC, 1976) ("Certainly, every action taken by the Board has some impact on earnings and may therefore affect the compensation of those whose earnings are keyed to profits. That does not disqualify the inside directors, nor does it put every policy adopted by the Board in question. All directors have an obligation, using sound business judgment, to maximize income for the benefit of all persons having a stake in the welfare of the corporate entity.")

An alternative path to judicial reconsideration of *Caremark* would be to embed more substantive content into the notion of "good faith". A director, the argument would go, cannot say she is acting in good faith to pursue her company's interests—consistently with her duty of loyalty—if she neglects the most "basic and obvious" elements of her job. By adding substance to the "basic and obvious" elements, the Chancery Court has a route by which *compliance-specific* obligations can be heightened, consistent with section 102(b)(7). Delaware Courts have on several occasions stated that such substantive development would undermine section 102(b)(7)'s concern with the supply of qualified directors.[239] However, as Section V.C argues, these concerns have little independent force. Moreover, in various other cases, Delaware Chancery judges have been willing to read modest substantive content into the notion of "good faith."[240]

Moreover, compliance oversight responsibilities do not rest on fiduciary duties alone. As noted above, corporations are obliged under Delaware Corporate Law to limit themselves to "lawful activities." Directors have a direct statutory duty, per section 141(a), to manage or oversee the management of the "business and affairs" of the corporation. What could be more fundamental to this duty than to undertake appropriate oversight of the corporation's compliance with law?

If neither shareholder self-help nor judicial engagement is pursued, there remains a third, "default" option: prosecutors will continue to seek to give teeth to compliance obligations through *ad hoc* negotiated settlements with firms. This approach is, for the reasons discussed in Section IV.F, distinctly inferior to an approach whereby corporate law gives boards incentives to take the initiative in fleshing out the scope of their compliance programs. Doing nothing, in other words, is not an option.

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[239] *See, e.g.*, Desimone v. Barrows, Del. Ch., 924 A.2d 908, 935 (2007) ("By reinforcing that a *scienter*-based standard applies to claims in the delicate monitoring context, *Stone* ensured that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded.")

[240] *See, e.g.*, Saito v. MacCall, Del. Ch., 2004 WL 3029876, *7 fn 71 (2004) ("A committee of the board, acting in good faith, would have openly communicated with each other concerning the accounting problems Andersen disclosed and would have shared the information with the entire McKesson HBOC board."); Rich ex rel. Fuqi International, Inc. v. Yu Kwai Chong, Del. Ch., 66 A.3d 963, 983 (board had established Audit Committee, but court concluded that company's admission of "incorrect and untimely movements of inventory" was evidence, given the importance of inventory control to a jewelry company, of absence of "any *meaningful* controls" (emphasis in original)).

CONCLUSION

To return to an important theme: Serious law violations by corporate actors in which responsibility is so diffuse that no one is responsible are corrosive of the long-term viability of a regime focused on shareholder value. The directors, as monitors, need to step up. They have voted for and approved executive compensation packages laden with high-powered stock-based incentives, which carry risks for evasion of law. They have approved stock-based compensation for themselves. The political economy that sustains economic decision-making by private firms depends, over the long-term, on a popular belief that those responsible for controlling corporate misbehavior are personally at risk when compliance fails. The scheme we propose will provide a measure of public "settling up". A system of expert evaluators of the directors' performance in compliance oversight, combined with appropriate liability limits, strikes a reasonable balance. This is a system that shareholders can create even if courts do not. We think it would count as a meaningful act of "stewardship" to move forward on this proposal, particularly since the stewardship goal is to facilitate long-term social wealth maximization.

APPENDIX I: GENERAL MODEL FOR NON-DISCLOSURE

A. Assumptions.

We make the following assumptions. Firms vary according to their likelihood of attracting the attention of public enforcers. Absent a compliance program, 'high-risk' firms face an expected enforcement penalty $\overline{p_h}$, whereas 'low-risk' firms face an expected enforcement penalty $\overline{p_l}$, where $\overline{p_h} > \overline{p_l} > 0$. For simplicity, all parties are assumed to be risk neutral, and the time value of money is nil.

The proportion of the population of firms that is high-risk is φ $(0 < \varphi < 1)$, and the proportion that is low-risk is $(1 - \varphi)$. The value of φ is common knowledge for both managers and investors. Sources of variance in risk of enforcement are grounded in aspects of firms' business practices that are observable to managers but not to investors. These include matters such as the pre-hiring checks on the integrity of employees, how employee compensation practices operate, and so forth.

An effective compliance program costs high-risk firms c_h and low-risk firms c_l to implement, where $c_h > c_l > 0$. Compliance activity has no *net* effect on expected probability of enforcement (it reduces expected incidence, but increases expected detection rate, of misconduct). However, having an

effective compliance program in place leads prosecuting authorities to discount the penalty if enforcement occurs. This discount is never complete, so we denote it as σ $(0 < \sigma < 0.5)$. A firm of type i, $(i \in \{h, l\})$ with an effective compliance program in place consequently lowers its expected enforcement penalty to $(1 - \sigma)\overline{p_i}$. A firm that has a compliance program which is *ineffective*, however, receives no discount. To focus the remainder of the discussion on economically interesting cases, we restrict the analysis to cases where it is value-maximizing for firms to implement a compliance program, i.e. for firm i, $\sigma\overline{p_i} > c_i$.

B. Timeline.

There are two periods. At the beginning of the first period (t = 0), the firm's market capitalization is v. A manager of a firm of type i is tasked with reviewing whether or not the firm should implement a compliance program costing c_i. Any approved expenditure is spent by the firm during the first period.

At the end of the first period (t = 1), the firm's financial statements are published. Accounting rules do not require disclosure of compliance expenditure as a separate category, but firms may choose to disclose such information voluntarily.

At the end of the second period (t = 2), the firm is potentially the subject of a criminal investigation. Firms that have not invested in compliance programs incur a penalty with expected cost $\overline{p_i}$, whereas firms that have invested in a compliance program incur only $(1 - \sigma)\overline{p_i}$.

C. Analysis

1. Long-term value maximization

Consider first the benchmark case where managers are motivated to maximize the firm's expected value at the end of the second period (t = 2). The decision whether to establish a compliance program can be treated similarly to any other capital budgeting decision for the firm. Under our assumptions it is value-maximizing for firm i to implement a compliance program because $\sigma\overline{p_i} > c_i$. Investment in compliance yields the firm an expected 'return' at period 2 equal to $\sigma\overline{p_i} - c_i$.

2. Managerial short-termism

We now consider how the analysis changes if the managers are paid in stock, which vests in period 1. The managers now have incentives to focus not on the firm's value in period 2, but on its market capitalization in period 1.

Disclosure and revelation. At t = 0, investors do not know firm i's type. However, if the firm discloses its level of compliance expenditure at t = 1, this will reveal its type at that point. Because high-risk firms face a greater residual expected enforcement penalty than do low-risk firms, this revelation will cause the market capitalization of low(high)-risk firms to increase (decrease). This revelation effect will be salient for managers who are concerned with maximizing the market capitalization at t = 1.

Disclosure decision. Might managers of a high-risk firm choose simply to disclose lower compliance costs than their firm actually incurred? If a high-risk firm invests in a compliance program costing c_h but only discloses c_l of compliance costs, would this permit high-risk firms to continue to pool their market valuation with low-risk firms at t = 1? It seems unlikely that managers would procure their firm to misstate its overall expenditure, as this would subject them to personal civil and criminal liability for securities fraud. More plausibly, they might take advantage of the fact that firms are not required to disclose compliance expenditure as such simply to allocate the costs to other categories—for example, general employment costs. However, this will also be unfruitful, because investors will treat the additional expenditures simply as reducing earnings going forwards, which will also lower the firm's valuation.[241] Consequently, managers may be expected to support truthful disclosures in period 1. This then calls into question the impact of compensation incentives on the decision regarding investment in compliance.

Compliance decision. In light of the analysis of the disclosure decision, consider now how the managers' concerns about revelation at t = 1 may affect their incentives regarding the compliance investment decision at t = 0. Managers of high-risk firms may be tempted to implement only a compliance program of the sort that would be adequate for a low-risk firm, but not a high-risk firm. Such firms would then (truthfully) disclose compliance expenditures of c_l. Investors would not now be able to distinguish between high and low-risk firms at t = 1.

However, this results in high-risk firms not expending enough resources on compliance to deliver an effective compliance program. Note that for a high-risk firm to spend only c_l does not maximize the firm's expected value at t = 2. This provides only an ineffective compliance program, which does not generate any reduction in penalties from the authorities should enforcement occur at t = 2. A high-risk firm that spends only c_l on

[241] Indeed, investors may be able to infer the firm's type from the presence of an unexplained earnings shock in period 1.

compliance consequently reduces its expected value at t = 2, relative to a high-risk firm that spends c_h, by $\sigma\overline{p_h} - c_h - c_l$. That is, the firm foregoes the opportunity to receive a discount on expected enforcement costs through having had an effective compliance program, and wastes resources on an ineffective compliance program.

Rational investors will infer that if all firms disclose c_l, then with probability φ, a firm making low compliance expenditure is in fact high-risk. Investors will expect firms' average expected compliance and residual enforcement costs under these circumstances to be as follows:

$$(1-\varphi)((1-\sigma)\overline{p_l} + c_l) + \varphi(\overline{p_h} + c_l) \qquad (1)$$

This is the probability-weighted mean of low-risk firms which implement effective compliance programs, and high-risk firms which do not (and so receive no discount to their expected enforcement penalties) and which incur wasteful expenditure on ineffective compliance in order to mimic low-risk firms.

If managers of a high-risk firm choose to invest c_h, they will reveal the firm's type at t = 1. Investors will assess the firm's expected compliance and residual enforcement costs as follows:

$$(1-\sigma)\overline{p_h} + c_h \qquad (2)$$

Managers of high-risk firms focused on maximizing the firm's market capitalization at t = 1 will consequently only choose to invest c_h if the firm's expected compliance and residual enforcement costs from implementing the high-quality compliance program (2) are less than investors' assessment of these costs for the blended population average (1). Conversely, it follows that managers of high-risk firms will choose only to invest c_l, and mimic a low-risk firm's compliance investment, where the following condition (from (1) and (2)) holds:

$$(1-\sigma)\overline{p_h} + c_h > (1-\varphi)((1-\sigma)\overline{p_l} + c_l) + \varphi(\overline{p_h} + c_l)$$

$$\Rightarrow \quad (\overline{p_h} - \overline{p_l})(1-\sigma-\varphi) + (c_h - c_l) - \sigma\varphi\overline{p_l} > 0 \qquad (3)$$

Inequality (3) is more likely to be satisfied where φ is small and $\overline{p_h}$ is large relative to $\overline{p_l}$. This implies that underinvestment in compliance at high-risk firms will be most likely when: (i) there is dispersion in firms' risk of prosecution relative to peers; and (ii) only a modest fraction of firms faces high risk of prosecution.

APPENDIX II: DELAWARE OVERSIGHT DUTIES OPINIONS

Case Name	**Citation**	**Year**	**Judge**	**Misconduct**	**Procedural posture**	**Result**
Ash v. McCall	2000 WL 1370341	2000	Chandler	Financial Reporting	Motion to Dismiss	Granted
White v. Panic	793 A.2d 356	2000	Lamb	CEO Sexual Harassment	Motion to Dismiss	Granted
Rattner v. Bidzos	2003 WL 22284323	2003	Noble	Financial Reporting	Motion to Dismiss	Granted
In re Citigroup Inc. Shareholders Litig.	2003 WL 21384599	2003	Lamb	General Mismanagement	Motion to Dismiss	Granted
Guttman v. Huang	823 A.2d 492	2003	Strine	Financial Reporting	Motion to Dismiss	Granted
Production Resources Group, LLC v. NCT Group, Inc.	863 A.2d 772	2004	Strine	General Mismanagement	Motion to Dismiss	Granted
Beam ex rel. Martha Stewart Living, Omnimedia, Inc. v. Stewart	833 A.2d 961	2004	Chandler	Insider Lending	Motion to Dismiss	Granted
Saito v. McCall	2004 WL 3029876	2004	Chandler	Financial Reporting	Motion to Dismiss	Denied
Atr-Kim Eng Financial Corp. v. Araneta	2006 WL 4782272	2006	Strine	Self-Dealing	Trial on Merits	Defendants Liable
David B. Shaev Profit Sharing Account v. Armstrong	2006 WL 391931	2006	Lamb	Complicity in Fraud	Motion to Dismiss	Granted
Stone v. Ritter	911 A.2d 362	2006	Supreme Court	BSA/AML violations	Motion to Dismiss	Granted
Canadian Commercial Workers Indus. Pension Plan v. Alden	2006 WL 456786	2006	Parsons	Self-Dealing	Motion to Dismiss	Granted
Globis Partners, L.P. v. Plumtree Software, Inc.	2007 WL 4292024	2007	Parsons	Failure to Comply with GSA Contract Clause	Motion to Dismiss	Granted
Desimone v. Barrows	924 A.2d 908	2007	Strine	Options Backdating	Motion to Dismiss	Granted
In re Career Education Corp. Derivative Litig.	2007 WL 2875203	2007	Parsons	Falsifying Records	Motion to Dismiss	Granted

In re Lear Corp. Shareholder Litig.	967 A.2d 640	2008	Strine	Approval of Merger Agreement	Motion to Dismiss	Granted
In re American International Group, Inc.	965 A.2d 763	2009	Strine	Financial Reporting	Motion to Dismiss	Denied
In re Citigroup Inc. S'holder Derivative Litig.	964 A.2d 106	2009	Chandler	Losses from Exposure to Subprime Lending	Motion to Dismiss	Granted
In re Dow Chemical Co. Derivative Litig.	2010 WL 66769	2010	Chandler	Bribery	Motion to Dismiss	Granted
In re Massey Energy Co.	2011 WL 2176479	2011	Strine	Worker Safety, Clean Water Act violations	Preliminary Injunction	Denied
In re Goldman Sachs Group, Inc. Shareholder Litig.	2011 WL 4826104	2011	Glasscock	CDO Activities Before Financial Crisis	Motion to Dismiss	Granted
South v. Baker	62 A.3d 1	2012	Laster	Safety Violations	Motion to Dismiss	Granted
Louisiana Mun. Police Employees' Ret. Sys. v. Pyott	46 A.3d 313	2012	Laster	Illegal Misbranding of Pharmaceuticals	Motion to Dismiss	Denied
TVI Corporation v. Gallagher	2013 WL 5809271	2013	Parsons	Financial Reporting	Motion to Dismiss	Granted
Harold Grill 2 IRA v. Chenevert	2013 WL 3014120	2013	Strine	Misrepresentation to Federal Authorities	Motion to Dismiss	Granted
In re Diamond Foods, Inc. Derivative Litig.	2013 WL 755673	2013	Strine	Financial Reporting	Motion to Dismiss	Granted
In re China Auto. Sys. Inc. Derivative Litig.	2013 WL 4672059	2013	Noble	Financial Reporting	Motion to Dismiss	Granted
Rich ex rel. Fuqi Int'l, Inc. v. Yu Kwai Chong	66 A.3d 963	2013	Glasscock	Financial Reporting	Motion to Dismiss	Denied
In re China Agritech, Inc. Shareholder Derivative Litig.	2013 WL 2181514	2013	Laster	Fraud	Motion to Dismiss	Denied
Raul v. Astoria Fin. Corp.	2014 WL 2795312	2014	Glasscock	Disclosure Violations	Motion to Dismiss	Granted
Stewart v. Wilmington Trust SP Services., Inc.	112 A.3d 271	2015	Parsons	Financial Reporting	Motion to Dismiss	Denied

In re Gen. Motors Company Derivative Litig.	2015 WL 3958724	2015	Glasscock	Product Defect	Motion to Dismiss	Granted
Ironworkers Dist. Council of Phila. & Vicinity Ret. & Pension Plan v. Andreotti	2015 WL 2270673	2015	Glasscock	Patent Infringement	Motion to Dismiss	Granted
Sandys v. Pincus	2016 WL 769999	2016	Bouchard	Disclosure Violations	Motion to Dismiss	Granted
Melbourne Mun. Firefighters' Pension Tr. Fund on Behalf of Qualcomm, Inc. v. Jacobs	2016 WL 4076369	2016	Montgomery-Reeves	Antitrust Violations	Motion to Dismiss	Granted
Reiter on Behalf of Capital One Fin. Corp. v. Fairbank	2016 WL 6081823	2016	Bouchard	BSA/AML Violations	Motion to Dismiss	Granted
In re Massey Energy Co. Derivative & Class Action Litig.	160 A.3d 484	2017	Bouchard	Safety Violations	Motion to Dismiss	Granted
Oklahoma Firefighters Pension & Ret. Sys. v. Corbat	2017 WL 6452240	2017	Glasscock	Various	Motion to Dismiss	Granted
Horman v. Abney	2017 WL 242571	2017	Slights	Violation of Cigarette Tax Regulations	Motion to Dismiss	Granted
Kandell, on behalf of FXCM Inc v. Niv	2017 WL 4334149	2017	Glasscock	Violation of Dodd-Frank Regulations	Motion to Dismiss	Denied
City of Birmingham Retirement and Relief System v. Good	177 A.3d 47	2017	Supreme Court	Violation of Clean Water Act	Motion to Dismiss	Granted