CAREMARK OVERSIGHT DUTIES: RECENT DEVELOPMENTS AND IMPLICATIONS FOR CORPORATE OFFICERS

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I. INTRODUCTION

The doctrine of fiduciary duty has long been a cornerstone of corporate governance, ensuring that those in positions of power within a corporation act in the best interests of the shareholders. Among the various aspects of fiduciary duty, the duty of oversight, as articulated in the landmark *Caremark* decision, holds a particularly significant place. The *Caremark* framework imposes a duty on directors to monitor the corporation's activities, aiming to prevent illegal acts and significant corporate mismanagement.[1]

Over time, *Caremark* has evolved from a seemingly toothless tiger into a robust doctrine with significant implications for corporate governance. This evolution is evidenced by a series of influential cases that have expanded and clarified the scope of *Caremark* liability. Cases such as *Marchand v. Barnhill*, *In Re Clovis Oncology, Inc.*, *Teamsters Local 443 Health Services & Insurance Plan v. Chou*, and *In re Boeing Co. Derivative Litigation* illustrate the expanding reach of *Caremark* and its progeny.

In recent years, the focus of *Caremark* has shifted beyond traditional shareholder value to encompass broader stakeholder concerns, particularly in the realm of Environmental, Social, and Governance (ESG) oversight. This shift raises critical questions about the limits of *Caremark* and its application to contemporary corporate challenges such as sexual misconduct, cybersecurity, diversity, and climate change.

The *McDonald's* case is a particularly notable example of this evolution. Vice Chancellor Laster's opinion in *In re McDonald's Corp. Stockholder Deriv. Litig.* extended *Caremark*'s oversight duty to corporate officers, significantly impacting officer liability and Directors and Officers (D&O) insurance rates. This case also underscores the challenge of defining what constitutes 'mission-critical' oversight failures and highlights lessons for managing ESG risks.

As we look to the future, *Caremark*'s application is poised to further expand into areas like political spending and artificial intelligence, reflecting the dynamic and ever-evolving nature of corporate governance. This paper will explore these developments, examining the implications of key cases and the broader impact of *Caremark* on corporate behavior and accountability.

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[1] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, at 967 (Del. Ch. 1996).

II. THE CAREMARK FRAMEWORK

In re Caremark International Inc. Derivative Litigation (1996) is a landmark case in corporate law that shaped the duties and responsibilities of corporate directors. The *Caremark* case set a precedent by mandating that a board of directors holds a fiduciary responsibility to monitor an organization's adherence to ethical standards and regulatory compliance, marking the first court ruling to do so.[2]

The case involved Caremark International Inc., a healthcare company that faced allegations of engaging in illegal activities, specifically violating federal healthcare laws. The lawsuit claimed that the company's directors failed to properly monitor and oversee the corporation's compliance with these laws, resulting in significant legal and financial repercussions for the company.

Chancellor William T. Allen of the Delaware Court of Chancery ruled that directors have a duty to ensure that an adequate system of internal controls is in place and functioning effectively. This system should be capable of identifying and reporting potential legal violations and operational issues to the board of directors. The *Caremark* decision emphasized two main points:

1. Directors are required to make a good faith effort to implement an adequate information and reporting system within the corporation. Delaware Chancellor Allen stated that corporate boards have an "obligation to supervise or monitor corporate performance".[3] Simply being reasonably informed about the corporation is not enough; boards must ensure that information and reporting systems are in place to provide timely and accurate information to senior management and the board itself.[4]

2. Beyond just implementing such systems, directors must also continuously monitor these systems to ensure they are effective.[5] This includes reacting appropriately to red flags or warning signs that may indicate potential legal or operational issues within the company.

[2] Paul McGreal, *Caremark in the Arc of Compliance History*, 90 TEMPLE REV. 647, 648 (2018).
[3] *Caremark*, 698 A.2d 959, at 961.
[4] *Id.* at 970.
[5] *Id.* at 967.

The *Caremark* decision introduced the concept of "duty of oversight," which has become a crucial aspect of fiduciary duty in corporate law. Directors can be held liable for failing to fulfill this duty if plaintiffs can demonstrate that the directors acted in bad faith by consciously disregarding their oversight responsibilities.[6] This is a high standard to meet, requiring evidence that the directors were aware of, but ignored, significant issues within the company.

Additionally, Chancellor noted that *Caremark* claim is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgement”.[7] Although his words are often quoted and believed, Delaware courts have become more inclined to scrutinize the board's oversight efforts and allow external shareholders to access internal company documents to investigate claims of oversight failure.[8] The only remaining uncertainty concerns the scope of *Caremark.*

III. THE NOT-SO-TOOTHLESS TIGER – CAREMARK’S PROGENY

A. <u>A DEADLY SWEET PLEASURE</u>: Marchand v. Barnhill

The first case to stir the calm waters of *Caremark* cases was *Marchand v. Barnhill.* In *Marchand,* the shareholders brought a derivative suit against executives and board of directors of Blue Bell Creameries USA, Inc., a monoline company that made and sold ice cream, for breach of fiduciary duty of loyalty by failing to implement any system to monitor food safety and compliance and the case, unexpectedly, survived the motion to dismiss. Even though this decision was a surprise, when faced with the facts of the case, the reason becomes clear.

Blue Bell's ice cream caused a listeria outbreak resulting in 10 people becoming ill and 3 deaths. As a result, the company recalled all its production, laid off over a third of its workforce, and took on a private equity investment that negatively impacted shareholders. A shareholder, Jack Marchand, filed a lawsuit against Blue Bell, alleging that the board failed to fulfill their *Caremark* duties to the organization.

It is important to mention that listeria outbreak was long coming. Even though the food safety was mission critical, Blue Bell had a history of sanitation problems and was in violation of FDA rules regarding food safety prior to the listeria outbreak. Despite several facilities

[6] *Id.* at 970.
[7] *Id.* at 967.
[8] Roy Shapira, *A New Caremark Era: Causes and Consequences* 98 WASH. U. L. REV. 1857, 1860 (2021).

testing positive for listeria and management being informed about these issues, the board was not made aware until the recall in 2015. Board minutes confirm that there was no mention of sanitation issues. Even after learning about the outbreak, the board left the company's response to management. The complaint held that the board was unaware of such issues because it "failed to adopt or implement any reporting and compliance systems".[9] Considering that Blue Bell was a monoline company and the paramount importance of food safety for that product, it becomes evident why this proved to be a fatal situation.

However, Blue Bell claimed to have a compliance program that ensured that its employees were adequately trained and that the Company monitored its compliance with state and federal health regulatory guidelines. Blue Bell provided training to its employees on proper manufacturing procedures and used a third-party laboratory to test for dangerous substances. The company believed that its written policies and procedures demonstrated that it had adequate systems in place to control contamination. The defendant argued that the plaintiff could only question the adequacy of the company's systems and controls, but not their existence. Defendants argued that the plaintiff's *Caremark* claim should be dismissed based on their belief that the board's duty was to make a good faith effort to ensure the existence of an oversight system.

The trial court rejected the plaintiff's claim that Blue Bell had no systems or procedures in place for detecting and reporting unsanitary conditions, referring the abovementioned company's compliance program. According to the court, "utter failure" requires total failure, signaling that any attempt to perform oversight is sufficient. The plaintiff's second prong *Caremark* claim was dismissed by the court because the plaintiff did not show that the board knew about corporate misconduct but failed to address it. The plaintiff's argument that the board could have prevented the Listeria crisis with proper oversight was not sufficient to support a *Caremark* claim. The court ruled that having monitoring and reporting systems in place that did not work as intended was not enough to hold the directors personally liable.

The plaintiff appealed to the Delaware Supreme Court which reversed the trial court's decision to dismiss, stating that the complaint contained enough evidence to support the inference that the board "failed to adopt or implement any reporting and compliance systems".[10] The court acknowledged that Blue Bell operates in a heavily regulated industry where food safety is critical, and that management ignored warning signs of compliance

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[9] *Marchand v. Barnhill*, No. 2017-0586-JRS, 2018 WL 4657159, at 51 (Del. Ch. 2018).
[10] *Id.*

failures. The court reasoned that even though management conducted oversight of food safety, here was no system in place for compliance monitoring and reporting at the board level.

It was uncommon for a *Caremark* claim to succeed, but what made the *Marchand* case even more remarkable was that it could potentially lead to more successful *Caremark* claims in the future. This development was considered even more significant as another similar case was published by the Delaware courts less than four months later.

B. <u>SUBJECTIVE OBJECTIVE RESPONSE RATE</u>: In Re Clovis Oncology, Inc.

Clovis Oncology, Inc. was a pharmaceutical start-up that formulated a highly promising drug for cancer treatment that was, at the same time, the only drug they had on the market. The company faced two risks. First, the competition coming from AstraZeneca as it had been developing a similar drug, and second, the possibility that it will not get an FDA approval. Clovis disclosed Objective Response Rate (ORR) equal to 60%, that is similar to ORR reported by AstraZeneca.

However, in the mid-2014, the board found out that the ORR is miscalculated as the real ORR is only 42%. Nevertheless, the company continued to report the false one even after reporting the real value to the FDA. ORR of 60% was even included in the prospectus for a secondary offering. It all came down crashing in the late 2015 when FDA noticed the discrepancy after which Clovis publicly disclosed the real ORR. Not surprisingly, the stock price dropped significantly, the company stopped clinical trials, and legal actions followed – securities fraud class action lawsuits and an SEC enforcement action. Furthermore, the derivative lawsuit was filed, and it included *Caremark* claim. While *Marchand* contained *Caremark* claim from Group I, this case fell under the category of Group II.

The trial court rejected the first-prong *Caremark* claim which stated that the board failed to implement any reporting or information system or controls. The court cited that the board had a Nominating and Corporate Governance Committee that oversaw FDA requirements, and the board was aware of the clinical trial's problems. The court dismissed the first *Caremark* prong as it was difficult for plaintiffs to prove that the board had no reporting or information system or controls.

Clovis board had control in place and was performing the oversight of the company, they were also aware of the miscalculation of the ORR, and the board minutes showed that there was discussion about the drug development, signaling that they were aware of the ORR's importance. In spite of everything, the board decided to stay silent and let the wrong ORR be included in the reports, which they also signed, while being aware of the risk for the drug and stock price.

Consequently, the court then considered the second prong of the *Caremark* claim which alleged that the board failed to monitor the oversight system implemented by Clovis. The court noted the importance of the ORR protocol in testing Clovis' product, and how the board repeatedly received knowledge that the ORR protocols were improper but remained inactive in response to the improper disclosures made to the public, investors, and regulators. The court also emphasized that the board members were experts in the field and would have understood the significance of the misleading data provided by management. The court described the situation, "with hands on their ears to muffle the alarms," the board chose not to react.[11] Unlike the situation in Marchand where the board faced a process failure, the problem in Clovis appeared to be a willful failure to take action. Despite being well-informed about the company's problems and having a system in place to receive relevant information, the board did not respond appropriately. The court denied the defendant's motion to dismiss the plaintiffs' *Caremark* claim.

Remember that in *Marchand* case The Chancery court approved the motion to dismiss but the Supreme court reversed the decision. This is important because in *Clovis,* the Chancery court showed that it will not try to overrule *Marchand*. Actually, it enhanced its position – it signaled the viability for Group II *Caremark* claims, not just Group I.

C. IGNORING THE RED FLAGS: Teamsters Local 443 Health Services & Insurance Plan v. Chou

ABC, the parent company, acquired Oncology Supply Pharmacy Services ("Pharmacy"), a wholly owned subsidiary, which was involved in the purchase of single-dose sterile vials of oncology drugs. Pharmacy's business was to transfer these drugs into plastic syringes and sell them to immuno-compromised cancer patients for injection. However, Pharmacy, operating through its Pre-Filled Syringe Program, engaged in illegal activities, and was operated like a criminal organization. Pharmacy would repack FDA-approved drug products from their original glass vials into plastic syringes to create pre-filled syringes. Additionally, they would use "overfill" from the original vials to fill extra syringes. This

[11] *In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188, at 17 (Del. Ch. Oct. 1, 2019).

overfill was not intended for patient use and led to contamination as Pharmacy technicians pooled the drug product in a facility called a "cleanroom" that tested positive for bacterial contamination multiple times. Furthermore, Pharmacy staff did not follow sterile techniques or wear sterile clothing while working in the cleanroom.

The pharmacy in question, ABC, engaged in illegal activities to avoid FDA oversight, including using sham prescriptions and providing kickbacks to buyers. The Department of Justice filed a Criminal Information against ABC's subsidiary for misbranding drugs and failing to register with the FDA. ABC's subsidiary pleaded guilty and paid a $260 million penalty to the DOJ, as well as settling a False Claims Act charge for $625 million. The court found that the director defendants were likely liable under *Caremark*, they were alleged to have known of red flags and disregarded them in bad faith. The court cited *Marchand* and *Clovis* to highlight those regulatory issues are “mission critical”. Although acknowledging that ABC is a more complex corporation, the court emphasized that ABC was in a highly regulated industry and that compliance with FDA rules is the company’s is critical to the business.

The court identified three red flags that the board of ABC ignored in their analysis of "prong two" allegations. The first red flag was a 2007 report from law firm Davis Polk & Wardell (DPW) that identified significant deficiencies in ABC's compliance program, including issues related to accountability, organizational structure, centralization of decision-making, and documentation of compliance processes. Despite DPW's recommendations, the Audit Committee did not take action. The second red flag was allegations and a qui tam lawsuit brought by former Chief Operating Officer Michael Mullen, who raised concerns about regulatory exposure and described the drug health and safety risks in the overfill process. Mullen's concerns were not documented or addressed by the board, even though the qui tam lawsuit was listed in the board's signed 10-Ks in 2010 and 2011.

The court also pointed out another clear red flag that the board ignored, which was the FDA search warrant executed at Pharmacy in 2012 and the subsequent subpoena related to Mullen's qui tam case. The court noted that there was no mention of these events in any board or audit committee minutes or materials, indicating that they were never discussed. This allowed the plaintiff to infer that the board was aware of these red flags but consciously ignored them, giving rise to a reasonable inference of negligence.

D. <u>FAILURE TO PREVENT THE FALL FROM THE SKY</u>: In re Boeing Co. Derivative Litigation

The most recent and highly publicized decision to deny a motion to dismiss a *Caremark* claim was in September 2021 in the case of *In Re Boeing Company Derivative Litigation*. The facts of the case were severe and justified the Delaware Court of Chancery's decision to allow the Plaintiffs' claim to proceed. The history of Boeing, which dates to 1916, was described in the Delaware opinion, highlighting that the company's culture changed significantly after its acquisition of McDonnell Douglas in 1997, shifting from prioritizing safety to prioritizing profits.

Boeing had an increase in safety violations, and unlike other aviation companies, there was no formal process at the board level to oversee airline safety. Compliance oversight relied on the Audit Committee, but airline safety was not specifically addressed. Management did not provide safety updates to the Board, and whistleblower complaints related to safety were not received. In 2011, the Board approved the development of the 737 Max without questioning the safety implications of the modifications, which were rushed to compete with Airbus. The rushed production resulted in inadequate documentation and training materials. To address stability issues, Boeing installed MCAS software, which was later found to be triggered by a sensor vulnerable to false readings. Due to cost concerns, Boeing did not implement a system to verify the accuracy of the sensor readings.

Boeing rushed production of the 737 Max, neglected to provide sufficient training materials to address safety risks with MCAS, and concealed issues from the FAA. The Lion Air Flight 610 crash in October 2018, which resulted in the death of all 189 people on board, revealed that the pilots were unable to locate information on how to switch off MCAS from the Quick Reference Handbook. The FAA conducted a risk assessment and concluded that without alterations to MCAS, there would be a fatal crash every 2-3 years. Despite media coverage and articles explaining the MCAS failure, Boeing management told the Board that the allegations were false. The first Board meeting after the crash was optional and safety was not a focus of discussion. The Board decided to defer its own investigation into the crash until regulatory investigations were concluded or until the Board deemed it appropriate for an internal investigation.

In January 2019, the DOJ launched a criminal investigation into whether Boeing had misled the FAA during the certification of the 737 Max. In March 2019, the Ethiopian Airlines crash resulted in the grounding of the 737 Max fleet by the FAA. The Board then initiated safety reporting for the first time and established a Committee on Airplane Policies and Processes at their April meeting. In May, the Airplane Committee requested information on the crash causes and recommended the creation of another safety committee. In August 2019, the Aerospace Safety Committee was established. Plaintiffs filed a derivative lawsuit alleging that the Board had failed to implement reasonable safety monitoring systems before the crash and ignored safety concerns after the crash, which the Delaware court agreed could be sustained under the *Caremark* "prong one" claim, denying the Defendants' motion to dismiss based on the precedent set in *Marchand.*

The court held that Boeing's oversight requirement for reporting and information regarding airplane safety must be designed to prevent wrongdoing and allow directors to know about and prevent losses. The court denied the Defendants' motion to dismiss based on several factors, including the absence of a committee responsible for monitoring airplane safety, lack of regular discussions or addressing of airplane safety by the board, absence of protocols requiring management to update the board on airplane safety, failure of management to relay red or yellow flag information to the board, and the inference of scienter based on Plaintiffs' pleadings.

The court acknowledged that Plaintiffs met the requirements for a *Caremark* "prong two" claim after the Lion Air crash, as it had previously opined on the validity of a "prong one" claim. The court did not provide as much detail on the "prong two" claim.

In summary, the *Boeing* case marks the culmination of a gradual shift in the *Caremark* standard, which began with *Marchand* and indicates that Delaware courts may now be more inclined to consider and support Plaintiffs' claims of breach of fiduciary duty. This theory was previously considered one of the most challenging to prove in corporate law.

E. HIGH CUSTOMERS AND LOW CONTROL: Lebanon County Employees' Retirement Fund v. AmerisourceBergen Corporation

The landmark case of *Lebanon County Employees' Retirement Fund v. AmerisourceBergen Corporation* serves as a pivotal example in the realm of *Caremark* claims and the implications for corporate officers. This case revolves around the opioid crisis and AmerisourceBergen's alleged failure to monitor and control the distribution of opioids, leading to significant legal and financial repercussions for the company and its directors.

AmerisourceBergen Corporation, a major pharmaceutical distributor, faced a derivative lawsuit filed by shareholders Lebanon County Employees' Retirement Fund. The plaintiffs accused the company's directors and officers of failing to implement and oversee reasonable policies to prevent the unlawful distribution of opioids, despite evidence of widespread illegal sales. This failure, they argued, resulted in severe financial and reputational damage to the company, including the loss of drug distribution licenses and billions in fines and settlements.

In the *Lebanon County* case, the plaintiffs advanced two primary theories under *Caremark:*

1. Red-Flags Theory: This theory posits that the directors failed to respond adequately to numerous warnings (red flags) about the company's non-compliance with legal requirements governing the distribution of opioids.[12]

2. Massey Theory: Based on the principle that Delaware law does not permit corporate directors to intentionally violate the law, this theory argues that AmerisourceBergen's board and officers were complicit in fostering a culture of non-compliance and evasion of regulatory obligations under the Controlled Substances Act (CSA).[13]

The Delaware Court of Chancery initially dismissed the complaint, citing a decision from the United States District Court for the Southern District of West Virginia, which found that AmerisourceBergen's anti-diversion efforts complied with the CSA. The Chancery Court considered this finding persuasive and concluded that the plaintiffs could not infer that the directors knowingly failed to comply with their legal obligations. However, this decision was later appealed and reversed by the Delaware Supreme Court, emphasizing the necessity of evaluating the directors' actions based on the information available to them at the time.

The implications of this case are profound for corporate officers and directors. The case underscores that courts will scrutinize the adequacy of corporate oversight systems, especially in industries with significant regulatory obligations. Directors must ensure that robust compliance systems are in place and actively monitored.

Furthermore, directors can be held personally liable for breaches of their duty of loyalty if they fail to act in good faith by ignoring red flags or fostering a culture of non-compliance. This extends beyond mere legal compliance to encompass broader reputational risks.

Finally, the case highlights the importance of thorough documentation and transparent reporting to the board. Directors must be proactive in seeking and acting on compliance information to avoid potential liability.

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[12] *Lebanon County Employees' Retirement Fund v. AmerisourceBergen Corporation* No. 22, 2023, at 6 (Del. Dec. 18, 2023).
[13] *Id.*

In conclusion, the *Lebanon County* case serves as a critical reminder that directors and corporate officers must diligently oversee their company's compliance with legal and regulatory requirements. The evolving scope of *Caremark* claims now includes reputational risks, making it imperative for corporate boards to adopt comprehensive oversight practices to mitigate potential liabilities.

IV. From Shareholder Value to Stakeholder Value: Exploring Caremark's Limits in Relation to ESG Oversight

In recent years, various ESG issues have become significant risks for companies, including cybersecurity, diversity, and sustainability.[14] Shareholders seek ways to hold directors accountable for overseeing these risks, often through non-litigation means like activism, such as the Business Roundtable's 2019 declaration and Larry Fink's annual letters from BlackRock, urging corporate leaders to prioritize customers, employees, and environmental concerns[15], and divestment[16]. While shareholder ESG litigation has primarily focused on federal securities cases, there's potential for using corporate law's oversight duties doctrine (*Caremark)* to address ESG concerns. Understanding *Caremark's* application to ESG is crucial, as it could influence directors' decisions and expose them to reputational costs. While *Caremark* claims based solely on nonlegal oversight have yet to succeed in Delaware, there are indications of courts expanding *Caremark's* scope to include ESG risks. This analysis underscores the importance of pre-suit discovery and motions to dismiss in evaluating *Caremark's* impact on ESG.

The *Caremark* decision expanded director oversight duties beyond legal compliance to encompass oversight of the company's business performance, as emphasized by subsequent cases like *Stone v. Ritter*. The aftermath of the 2008 financial crisis, particularly the *Citigroup*[17] and *Goldman Sachs*[18] cases, challenged the notion that there was no doctrinal obstacle to extend

[14] Pamela Marcogliese et al., *Board Memo 2022: Sustainability and Beyond*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 15, 2022), https://corpgov.law.harvard.edu/2022/01/15/board-memo-2022-sustainability-and-beyond/.

[15] *Business Roundtable Redefines the Purpose of a Corporation to Promote "An Economy That Serves All Americans",* BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans; Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK (2018), https://aips.online/wp-content/uploads/2018/04/Larry-Fink-letter-to-CEOs-2018-BlackRock.pdf.

[16] Witold Henisz et al., *Five Ways that ESG Creates Value*, MCKINSEY Q. (Nov. 2019).

[17] *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009).

[18] *In re* Goldman Sachs Group, Inc. S'holder Litig., Civ. No. 5215–VCG, 2011 WL 482610, at 20-24 (Del. Ch. Oct. 12, 2011).

Caremark to business risk oversight by distinguishing between oversight of legal compliance and oversight of business risk. These cases cautioned against extending *Caremark* liability to business risks, fearing it could undermine the deference given to directors' business judgments. The 2011 *Goldman Sachs* case illustrated the reluctance to apply *Caremark* to reputational risks, emphasizing that not all reputational risks warrant liability under *Caremark.* Despite acknowledging the potential failure of reputational risk oversight, the court dismissed the failure-of-oversight claim against Goldman's directors, highlighting the inherent challenges in holding directors accountable for such risks.

However, the tide began to shift with the already discussed *Marchand* case, which is widely discussed for intensifying judicial scrutiny of corporate compliance. A significant aspect of the *Marchand* decision, often overlooked, is its emphasis on going beyond mere regulatory compliance. Despite Blue Bell's argument that it met food safety regulations, the court stressed that, as a company solely selling ice cream, any failure in product safety could profoundly impact its business, irrespective of meeting legal requirements. From this perspective, *Marchand* highlights the importance of overseeing critical reputational risks.

Subsequent successful *Caremark* claims, such as those in 2020 and 2021, frequently invoked concepts of reputational risk management. For instance, *Boeing* urged corporate boards to prioritize product safety, emphasizing that product failures can threaten a company's reputation and profitability, regardless of legal compliance. This shift in judicial interpretation demonstrates that *Caremark's* applicability extends beyond traditional claims of illegalities. While some may argue that these cases dealt with severe product safety issues, the broader implication is that courts are increasingly considering reputational risks in their assessment, suggesting a potential expansion of *Caremark's* scope to address broader ESG concerns.

Following *Boeing*, in the October 2021 *Marriott* case arguably expanded the scope of *Caremark* even further. In this instance, *Marriott* faced a significant corporate setback due to a data security breach that exposed the personal information of millions of guests. The fallout included a sharp drop in the company's stock price, along with numerous private consumer lawsuits and state investigations. Despite these challenges, a pension fund shareholder obtained access to internal cybersecurity discussions through a Section 220 request, alleging failures in addressing not only legal concerns but also reputational risks. While Delaware's Court of Chancery ultimately dismissed the case, emphasizing *Marriott's* serious approach to cybersecurity and risk mitigation, the analysis of oversight of nonlegal risks in this context is noteworthy. *Marriott* acknowledged the evolving landscape by recognizing cybersecurity as a critical risk transcending various business sectors.[19] This acknowledgment suggests a potential shift in judicial scrutiny towards reputational risk oversight, indicating a broader application of *Caremark* beyond traditional legality-focused cases.

Recent cases like *Marchand* and *Marriott* suggest a shift in judicial attitude towards extending *Caremark* liability to nonlegal risks, particularly reputational risks. *Marchand* highlighted the importance of overseeing critical reputational risks, while *Marriott* further broadened *Caremark's* scope by addressing cybersecurity breaches as a form of reputational risk. These developments indicate a growing recognition of the significance of reputational risk oversight in contemporary boardrooms.

The evolving landscape of corporate governance, with an increasing emphasis on ESG issues, suggests that the trend of extending *Caremark* to broader ESG concerns will continue. As boards increasingly prioritize reputational risk oversight, the scope of *Caremark* liability is likely to expand to encompass critical ESG issues. Ultimately, *Caremark* aims to ensure that directors actively engage in oversight of risks that could jeopardize the company's operations, regardless of whether these risks are legal or reputational in nature.

A. FROM LAWSUITS TO NORMS: The Behavioral Shifts Driven by Caremark

Asserting that the *Caremark* framework applies to ESG does not imply a likelihood of directors being held liable. When labeling a case as "successful," it simply means it survived the motion to dismiss. Consequently, one could challenge the conclusions drawn thus far about a reformed mode of oversight duties or its gradual extension to nonlegal risks. However, this objection overlooks the functioning of *Caremark* and corporate law in general. Delaware courts seldom reach final verdicts after full trials[20], and it's even rarer for them to impose personal financial penalties on directors[21]. Therefore, the impact of corporate law on behavior is primarily indirect, shaping norms and reputations within the business community. The litigation process itself imposes nonlegal costs on managers, including emotional stress and potential reputational harm from disclosed information. In the new *Caremark* litigation approach, these nonlegal costs are front-loaded, arising from pre-suit discovery and

[19] *Marriott*, C.A. No. 2019-0965-LWW, 2021 WL 4593777, at 2.

[20] Lawrence A. Hamermesh & Michael L. Wachter, *The Importance of Being Dismissive: The Efficiency Role of Pleading Stage Evaluation of Shareholder Litigation*, 42 J. CORP. L. 597, 652 (2017).

[21] Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability,* 58 STAN.L. REV. 1055, 1055 (2006).

complaints.[22] To gauge the likelihood of *Caremark* motivating directors to prioritize ESG, one must consider how courts treat plaintiffs' inspection requests and pleading-stage inferences. If courts favor plaintiffs in these aspects, directors are essentially at a disadvantage, even if they do not face direct liability.

Recent *Caremark* cases have already influenced behavior in the preliminary stages through three channels: settlements, law firm memos, and reputational fallout.

Settlements in corporate law typically occur swiftly and for substantial amounts in cases that survive the motion to dismiss. Historically, *Caremark* claims did not fit this pattern due to their minimal chance of surviving dismissal, resulting in low settlement values. However, recent successful *Caremark* cases have altered this landscape. However, it's important to note that the threat of settlements may not effectively incentivize boards to invest optimally in compliance since insurers usually cover these costs, and insurers may not necessarily push directors to improve their behavior.[23]

Instead, the impact on directors' behavior often stems from law firm memos and reputational consequences. Law firms typically advise clients on the implications of significant legal decisions. Following successful *Caremark* cases in 2019 and 2020, there was a surge in memos urging boards to prioritize legal compliance and thoroughly document compliance efforts.[24] Recent cases in 2021 have similarly influenced legal advice regarding board oversight of ESG risk, highlighting the urgency for boards to address climate-related challenges as part of their regular risk assessment practices.[25]

The point is that deterrence is driven not solely by actual sanctions but also by perceived sanctions.[26] Directors often rely on legal advisors to interpret the scope of their oversight duties. If legal advisors consistently portray issues like data privacy, racial diversity, and environmental sustainability as crucial oversight matters subject to *Caremark* scrutiny, directors are likely to respond accordingly.[27] From this perspective, *Caremark* already encompasses broader ESG concerns.

Furthermore, reputational fallout also shapes behavior by disseminating information that leads to reputational sanctions. Even in the preliminary stages of oversight duty cases,

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[22] Chris Brummer & Leo E. Strine, Jr., *Duty and Diversity*, 75 VAND. L. REV. 1, 77 (2022).
[23] Roy Shapira, *Mission Critical ESG and the Scope of Director Oversight Duties*, 732 COLUM. BUS. REV., 762 (2022).
[24] Shapira, *supra* note 8, at 1881.
[25] William Savitt, Sabastian V. Niles & Sarah K. Eddy, *Carbon, Caremark, and Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 30, 2021), https://corpgov.law.harvard.edu/2021/05/30/carbon-caremark-and-corporate-governance/.
[26] Shapira, *supra* note 23, at 763.
[27] *Id.* at 763.

damaging information about defendants can become public, affecting directors' and officers' reputations and personal esteem within their social circles.[28]

In conclusion - yes, the *Caremark* framework indeed applies to ESG risks. However, the crucial aspect to consider is not merely the types of risks but their criticality. Therefore, let's transition to a detailed examination of cross-sectional variation, identifying specific ESG issues and circumstances more likely to lead to a viable *Caremark* claim.

B. DISSECTING THE ESG RISKS: Is It Safer for Companies Ignore Sexual Harassment or Climate Change?

Not all ESG risks carry the same weight. Concerning oversight duties, only those ESG risks deemed "critical" to a company's operations fall within the scope of *Caremark*. In both practical applications and academic discourse, ESG issues are often grouped together, with fund managers relying on overall ESG scores for investment decisions and scholars engaging in debates about the entire acronym.[29] However, when considering corporate law's oversight responsibilities, it's essential to dissect ESG into its components and analyze how each component is subject to varying degrees of *Caremark* liability.

In our context, reputation acts as a moderator between ESG and *Caremark* liability. Neglecting certain ESG issues can significantly hinder a company's ability to attract talent, access capital, and expand its customer base, while other issues may not affect these aspects.[30] Understanding the criticality of an ESG risk involves determining the magnitude of its reputational impact on the company.

However, evaluating reputational ramifications can be complex, as different branches of ESG affect reputation diversely. To achieve this, this section integrates insights from how Delaware courts interpret reputational risk and how corporate boards address it in practice.

a. Sexual Misconduct

The #MeToo movement has brought attention to sexual misconduct in corporate America, leading to the resignation of top executives due to allegations.[31] Studies show that

[28] *Id.*
[29] *Id.* at 765.
[30] *Id.* at 766.
[31] Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1585-87 (2018).

sexual harassment scandals have a negative impact on stock market prices[32], and companies are now including "MeToo termination rights" in executive contracts.[33] As a result, sexual misconduct has become a significant corporate governance issue, and there is potential for *Caremark* claims against directors for not addressing misogynistic corporate culture and workplace harassment.

In sexual misconduct cases, *Caremark* claims have historically had a low probability of success.[34] For example, the *American Apparel* case involved unsuccessful attempts by shareholders to pursue derivative suits based on a *Caremark* theory of liability in cases involving alleged sexual harassment.[35] However, recent *L Brands* (Victoria's Secret) case suggests that *Caremark* claims in the context of sexual harassment may be relevant.

The *L Brands* (Victoria's Secret) case in July 2021 involved allegations of sexual harassment by top executives and the company founder's connections with Jeffrey Epstein.[36] Shareholders filed Section 220 requests[37] and *Caremark* actions, arguing that the board's failure to address the misogynistic culture caused reputational harm, which affected the company's ability to sell the brand at a premium price.[38]

The company settled by committing $80 million to address its misogynistic culture.[39] Media coverage extensively covered the complaint, naming both top executives and board members who allegedly did little to address the constant internal complaints against the harassers.[40] The settlement announcement in July 2021 reignited media coverage of the

[32] Mads Borelli-Kjaer, Laurids Moehl Schack & Ulf Nielsson, *#MeToo: Sexual Harassment and Company Value*, 67 J. CORP. F. (2021), J. CORP. F. (2021), https://doi.org/10.1016/j.jcorpfin.2020.101875.
[33] Rachel S. Arnow-Richman, James Hicks & Steven Davidoff Solomon, *Do Social Movements Spur Corporate Change? The Rise of "MeToo Termination Rights" in CEO Contracts*, 98 INDIANA L.J. 125, 126 (2022).
[34] Hemel & Lund, *supra* note 31, at 1646.
[35] *Id.* at 1616-18.
[36] Verified Stockholder Derivative Complaint, Lambrecht v. Wexner et al., No. 2021-0029-JTL, ¶ 4. (Del. Ch. Jan. 12, 2021).
[37] *Id.* at ¶ 9.
[38] *See* Kevin LaCroix, *L Brands Establishes $90 Million Fund in Sexual Misconduct Derivative Suit Settlement*, THE D&O DIARY (Aug. 2, 2021), https://www.dandodiary.com/2021/08/articles/director-and-officer-liability/l-brands-establishes-90-million-fund-in-sexual-misconduct-derivative-suit-settlement/.
[39] Sierra Jackson, *L Brands Inks Deal with Shareholders To Exit Workplace Harassment Cases*, REUTERS (Jul. 30, 2021), https://www.reuters.com/legal/litigation/l-brands-inks-deal-with-shareholders-exit-workplace-harassment-cases-2021-07-30/.
[40] *See, e.g.*, Kellie Ell & Sindhu Sundar, *L Brands Founder Leslie Wexner Faces New Complaints about 'Culture of Misogyny' at Victoria's Secret*, YAHOO! FINANCE (Jan. 15, 2021), https://finance.yahoo.com/news/l-brands-founder-leslie-wexner-202839664.html.

allegations[41], and law firms warned their clients of an increased threat of ESG-related litigation.[42]

This case proves that a *Caremark* claim can have an impact even when it does not go past the complaint stage.

i. McDonald's Case

Amidst the flames of controversy surrounding sexual harassment and the infamous *Caremark* claims, there is a high-profile case that has sparked intense discussion in recent months - the *McDonald's* derivative suit.[43] The McDonald's Corporation, its Board of Directors, and certain officer faced claims of breach of fiduciary duty from plaintiff-stockholders by allowing a corporate culture that allegedly "condoned sexual harassment and misconduct".[44] They claimed that officers ignored "red flags" signaling misconduct, breaching the *Caremark* duty.[45] The former Executive Vice President and Global Chief People Officer argued that plaintiffs failed to state a claim against him as the duty of oversight applies only to directors and not officers, but the court denied the motion and held that "corporate officers also owe the same fiduciary duties as corporate directors".[46] The court also explained that the application of the duty of oversight to officers is "context-driven" and will depend on the officer's title and responsibilities.[47]

Plaintiffs alleged that David O. Fairhurst, Chief People Officer, and former CEO Stephen J. Easterbrook created a "party atmosphere" and a "boys' club" at McDonald's headquarters, including happy hour events that made female employees feel uncomfortable.[48] Easterbrook allegedly pursued intimate relationships with staff, and Fairhurst purportedly failed to address complaints about misconduct by executives and employees.

The plaintiffs claimed that the Board turned a blind eye to workplace harassment by allowing senior executives like Easterbrook and Fairhurst to violate the Company's standards and policies, fostering a culture of harassment and excessive alcohol use in the headquarters

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[41] *See, e.g.,* Lisa Fickenscher, *Victoria's Secret Settles Lawsuit over Sex Harassment Ahead of Spinoff*, N.Y. POST (Jul. 30, 2021), https://nypost.com/2021/07/30/victorias-secret-settles-sex-harassment-suits-before-spinoff/.
[42] *See, e.g.,* Catherine M. Clarkin & Melissa Sawyer, *ESG Trends and Hot Topics,* HARV. L. SCH. F. ON CORP. GOV. (Aug. 25, 2021), https://corpgov.law.harvard.edu/2021/08/25/esg-trends-and-hot-topics/.
[43] *McDonald's*, 2023 WL 387292.
[44] *Id.* at *1.
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] *Id.* at *7, 9-10.

and restaurants. Fairhurst himself was accused of misconduct for grabbing a female employee and admitting to additional wrongdoing, but the Company kept him as head of human resources until his termination in 2019 and Easterbrook's employment was terminated around the same time.

The company faced public scrutiny concerning sexual harassment and retaliation allegations starting in 2016, with multiple civil lawsuits and EEOC complaints filed in 2019 and 2020.[49] In light of this, shareholders requested information from the Company in accordance with Section 220 of the Delaware General Corporation Law and initiated a derivative lawsuit against the Company, the Board, Easterbrook[50], and Fairhurst alleging breach of fiduciary duty by allowing a corporate culture that condoned sexual harassment and misconduct and failing to exercise duty of oversight.[51] Fairhurst moved to dismiss, but the court denied the motion, finding that the plaintiffs had stated a well-pled claim against Fairhurst based on his knowledge and role in creating the company's problems with sexual harassment and misconduct, and his own acts of sexual harassment.

ii. Implications from the McDonald's Case

1. Caremark Duties Apply to Corporate Officers

One of the reasons why Fairhurst argued that the claims against him should be dismissed was because a *Caremark* claim does not apply to officers.[52] However, the court rejected that argument - the court ruled that corporate officers have a similar oversight duty to directors, but the application of this duty may vary depending on the situation. Additionally, the court held that "officers generally only will be responsible for addressing or reporting red flags within their areas of responsibility," however, in certain circumstances, an officer may be obligated to report red flags that fall outside their area of responsibility if the situation is particularly severe.[53] The court emphasized that officers can only be held liable for violating

[49] *McDonald's,* 2023 WL 387292, at *8.
[50] Easterbrook's motion to dismiss was granted due to a settlement agreement previously negotiated between him and the Company. This agreement stated that the Company "irrevocably and absolutely releases and forever discharges Easterbrook" from any possible claims that could be brought against him by McDonald's or its shareholders. This reason was considered "plainly dispositive." *See In re McDonald's Corp. Stockholder*, No. 2021-0324-JTL, 2023 WL 266519, at *1 (Del.Ch. Jan. 16, 2023).
[51] *McDonald's,* 2023 WL 387292, at *4.
[52] *Id.* at *9.
[53] *Id.* at *19.

their oversight duty if it's proven they acted in bad faith and pointed out that "sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable."[54]

2. The Impact on Officer Liability and D&O Insurance Rates

To adequately plead an oversight claim, a plaintiff must show that an officer "intentionally acted with a purpose other than advancing the best interests of the corporation".[55] The court found that the plaintiff adequately pled that the officer, Fairhurst, engaged in bad faith by ignoring red flags and committing acts of sexual harassment.[56] Therefore, it was reasonable to infer that he ignored red flags about similar behavior by others at the company in the context of an alleged corporate culture that condoned sexual harassment.[57]

This could affect the officer's ability to invoke the company's bylaw exculpation provision, which precludes monetary liability for breaches of the duty of care but not breaches of loyalty, but this protection would not apply in situations like McDonald's.[58] The statute excludes any actions taken on behalf of the corporation, which means derivative claims for lack of oversight cannot be shielded.[59] Additionally, claims against Fairhurst for breaching the duty of loyalty and acting in bad faith cannot be protected either. Due to this, underwriters of D&O insurance policies may increase their rates.[60]

3. The Challenge of Defining 'Mission-Critical' in Oversight Claims

The *McDonald's* case raises questions about the importance of a "mission-critical" finding in oversight claims. The court did not use this phrase and may have suggested a more expansive version of the *Caremark* standard.[61] It is unclear whether workplace issues are deemed "mission-critical" and whether the court rejected that label as irrelevant to a *Caremark*

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[54] I*d.* at *30.
[55] *Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. 2019).
[56] *McDonald's*, 2023 WL 387292, at *30.
[57] *Id.* at *27.
[58] Alan Stone et al., *Corporate Officers Owe the Same Caremark Oversight Duties as Directors*, HARV. L. SCH. F. ON. CORP. GOV. (March 5, 2023) https://corpgov.law.harvard.edu/2023/03/05/corporate-officers-owe-the-same-caremark-oversight-duties-as-directors/.
[59] *Id.*
[60] *Id.*
[61] Jason M. Halper et al., *The Ramifications of The Delaware Court of Chancery's McDonald's Decision – Beyond Holding That Caremark Oversight Obligations Apply to Corporate Officers*, THE NAT. L. REV. (Feb 9, 2023), https://www.natlawreview.com/article/ramifications-delaware-court-chancery-s-mcdonald-s-decision-beyond-holding-caremark.

claim.[62] The court noted that McDonald's prioritizes creating a trustworthy workplace environment, but the issue of sexual harassment did not receive a high risk rating in the company's internal risk assessment.[63] McDonald's considers maintaining a "Respectful Workplace" as a top Tier 2 risk, which is not as critical as Tier 1 risks that are essential to the company's mission and values.[64] The decision could be interpreted as going beyond previous rulings that focused on mission-critical tasks in analyzing claims of directorial liability for inadequate oversight of a company's compliance program.[65]

4. Managing ESG Risks: Lesson from Company that Got it Wrong

The *McDonald's* case is a reminder to directors and officers about the importance of implementing internal controls and reporting systems to address corporate misconduct, particularly in the context of increasing pressure on companies to address ESG issues. Problems arising from ESG issues could have a material impact on the company, and directors and officers need to assess the quality of information monitoring systems in ESG areas and address information yielded by those systems.[66] As a result, directors and officers are becoming increasingly aware of importance of the ESG. For example, a survey conducted in 2021 revealed that over 50% of directors indicate that ESG concerns are regularly discussed in their boards' meetings.[67] Likewise, another survey demonstrated that an overwhelmingly high percentage (82%) of directors today regard reputation as a "business-critical asset".[68] Similarly, in the past two years, directors' manuals have been revised to place much greater emphasis on

iii. Reducing Officers' Anxiety: Segway Inc. v. Hong Cai

There is no doubt that corporate officers were left feeling anxious after the *McDonald's* case, as it clarified that corporate officers owe the duty of oversight just like the corporate

[62] *Id.*
[63] *McDonald's,* 2023 WL 387292, at *7.
[64] *Id.*
[65] Halper et al., *supra* note 61.
[66] *Id.*
[67] Maria Castañón Moats & Paul DeNicola, *The Corporate Director's Guide to ESG*, HARV. L. SCH. F. ON CORP. GOV. (Dec. 15, 2021) https://corpgov.law.harvard.edu/2021/12/15/the-corporate-directors-guide-to-esg/.
[68] Tal Donahue, *Managing the Intangible: Reputation in the Boardroom,* INFINITE (Aug. 3, 2018), https://infiniteglobal.com/infinite-brief/managing-the-intangible-reputation-in-the-boardroom/.

directors. The Delaware Court of Chancery's decision in *Segway Inc. v. Judy Cai* underscores critical aspects of *Caremark* claims and their implications for corporate officers. This case, along with recent developments in Delaware jurisprudence, highlights the heightened scrutiny and evolving expectations placed on corporate officers regarding oversight responsibilities.

The Vice Chancellor Will reassured corporate officers by rectifying the “misimpression that an oversight claim pursued against an officer is easier to plead than one against a director”[69] and adding that “bad faith remains a necessary predicate to any *Caremark* claim”.[70]

Segway Inc., a designer and manufacturer of personal transportation devices, experienced significant financial challenges following its acquisition by Ninebot (Beijing) Tech Co., Ltd. in 2015. These challenges included declining sales and an increase in accounts receivable. The plaintiff, Segway Inc., brought a breach of fiduciary duty action against its former President, Judy Cai, alleging that she was aware of these financial issues but failed to address or disclose them adequately.

In 2015, Segway Inc. was acquired by the Ninebot Tech Co., Ltd (“Ninebot”) and appointed the Officer as its Vice President of Finance, in charge of “the daily operations of the finance department and provided leadership and coordination in [the Company’s] administrative, business planning, accounting, and budgeting efforts.”[71] Three years later she became the President while simultaneously assuming the role of the Company’s in-house accountant.

Following the acquisition, the Company focused on selling Ninebot products. It underwent downsizing and ultimately shut down its headquarters, leading to staff layoffs and Officer’s termination. Subsequently, the company merged its finances with Ninebot's. Allegedly, during this process, discrepancies in financial information provided by the Officer to the board came to light, notably a growing backlog of accounts receivable. As a result, the company initiated legal action against the Officer, claiming she had breached her oversight duty because she “knew or should have known there were potential issues with some of [the Company’s] customers, which caused [the Company’s] accounts receivable to continuously rise”[72] and that she failed to address these issues and advise the board. The plaintiffs advanced their claim under the second prong of *Caremark*, alleging that Cai consciously disregarded red flags related to the company’s financial performance, particularly the rising accounts

[69] *Segway Inc. v. Hong Cai*, C.A. No. 2022-1110-LWW at 12. (Del. Ch. Dec. 14, 2023) (Will, V.C.).
[70] *Id.* at 1.
[71] *Id.* at 3.
[72] *Id.* at 6.

receivable. The plaintiffs argued that Cai's inaction constituted a breach of her oversight duties and that she failed to inform the board of directors about these critical issues.

The Court of Chancery stated that the allegations are "an ill fit for a Caremark claim", releasing the Officer from them.[73] The court held that general financial concerns like discovering problems with unspecified customers, declines in revenue, and increases in receivables are not significant enough red flags to warrant liability. Vice Chancellor Will of the Delaware Court of Chancery granted Cai's motion to dismiss, finding that Segway's complaint did not meet the high threshold required for a *Caremark* claim. The court emphasized that *Caremark* claims are notoriously difficult to plead successfully, as they require demonstrating that the fiduciary acted in bad faith by utterly failing to implement any reporting or information system or, having done so, consciously failing to monitor or oversee its operations.

The court noted that Segway's allegations were more aligned with a breach of the duty of care rather than the duty of loyalty. The complaint lacked specific facts indicating that Cai acted in bad faith or that she ignored clear evidence of wrongdoing. Instead, the allegations pointed to Cai's potential negligence in handling routine financial issues, which does not rise to the level required for a Caremark claim.

The Company did not provide sufficient evidence to imply bad faith on the part of the Officer. Instead, the Company attempted to hold the Officer accountable for sales decreases and receivables increases using hindsight.

The implications of the *Segway* and *McDonald's* cases for corporate officers are significant. Corporate officers are now subject to greater scrutiny regarding their oversight responsibilities. They must ensure compliance and reporting systems are in place and actively monitored.

The extension of *Caremark* claims to corporate officers reinforces that they must act in good faith in monitoring compliance risks. Failure to do so, particularly by ignoring red flags, can lead to personal liability.

Officers must be proactive in addressing compliance issues and ensuring that the board is informed of significant risks. This requires regular reviews of internal controls and timely reporting of potential issues.[74]

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[73] *Id.* at 10.
[74] *Id.* at 1.

Beyond legal compliance, officers must consider the broader reputational risks associated with failing to address significant compliance issues. Effective oversight is critical to maintaining the company's reputation and avoiding financial and legal repercussions.[75]

This case highlights the stringent requirements for pleading *Caremark* claims and the implications for corporate officers. It underscores the necessity for officers to diligently oversee compliance within their areas of responsibility and to act in good faith. As the landscape of corporate governance continues to evolve, the expectations for corporate officers' oversight duties are becoming increasingly rigorous, necessitating a proactive and comprehensive approach to risk management and compliance.

iv. Scholar's Opinion on the McDonald's Case: A Critical Perspective

In Bainbridge's opinion on the *In re McDonald's Corp. Stockholder Deriv. Litig.*, he admits that his initial reaction was deeply rooted in his long-held beliefs regarding the *Caremark* doctrine. His concern about the decision extending *Caremark's* oversight duty to officers reflects a broader apprehension about the expansion of fiduciary duties and the potential for increased litigation risks for corporate officers. However, upon further analysis, Bainbridge acknowledges some of his concerns may have been overblown, prompting a re-evaluation of the decision's implications for Business Associations.

He noted that the decision exacerbated his longstanding concerns about the expanding scope of *Caremark* liability. Specifically, Bainbridge feared that applying *Caremark* duties to officers, in addition to directors, would lead to an unrealistic standard of care and an increase in litigation. This perspective is grounded in three primary beliefs:

1. Fundamental Flaws in *Caremark:* Bainbridge has consistently argued that the *Caremark* decision was flawed from the outset. He contends that imposing oversight duties on directors—and now officers—creates an unrealistic expectation that could unduly burden corporate governance.[76]

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[75] *Id.* at 12.
[76] Bainbridge Stephen, *I May (Possibly) Have Overreacted to McDonalds: Should Business Associations Teachers Teach It?,* PROFESSORBAINBRIDGE.COM (Jan, 9, 2024) https://www.professorbainbridge.com/professorbainbridgecom/2024/01/i-may-possibly-have-overreacted-to-mcdonalds-should-business-associations-teachers-teach-it.html.

2. Misinterpretations and Expansions: Subsequent judicial decisions have, in Bainbridge's view, misinterpreted and expanded *Caremark*, leading to a broader and more unpredictable landscape of liability. This expansion, he argues, detracts from the original intent and creates unnecessary legal risks.[77]

3. Steady Expansion of Liability: Bainbridge has observed a trend of increasing *Caremark* liability in recent years, further fueling his concern about the *McDonald's* case. He fears that this expansion could stifle effective business decision-making due to the looming threat of litigation.[78]

Bainbridge revisits his initial concerns and acknowledges that some may have been unfounded. Notably, Vice Chancellor Laster's later decision regarding the potential liability of the McDonald's board clarified important limitations on *Caremark* liability. Laster reaffirmed that plaintiffs must demonstrate more than weak or grossly negligent responses by directors; they must show a serious failure of oversight indicative of bad faith.

This clarification is crucial. It reinforces that *Caremark* liability is not a catch-all for poor business decisions but is instead reserved for significant oversight failures. This distinction helps mitigate fears of an unbounded expansion of liability and aligns *Caremark* more closely with its intended purpose.

Professor recognizes that Vice Chancellor Laster's opinion has the potential to significantly expand officer and director liability beyond *Caremark*. Specifically, Laster's conclusion that Fairhurst's personal misconduct, such as sexual harassment, constituted a breach of fiduciary duty could transform aspects of employment and civil rights law into corporate law claims.

Bainbridge anticipates the potential for floodgates to open to employment-style litigation within corporate governance frameworks. This concern highlights the need for a careful balance between holding officers accountable and avoiding an overextension of fiduciary duties that could paralyze effective business management.

Additionally, the professor suggests that if future cases adopt and expand upon Laster's reasoning, it may become necessary to revisit the decision to exclude such cases from the casebook. Legal educators must remain adaptable, ensuring that teaching materials reflect the

[77] *Id.*
[78] *Id.*

most relevant and impactful developments in the field. This approach will prepare future legal professionals for the complexities of advising corporate clients in an evolving legal landscape.

In conclusion, Bainbridge's opinion on the *McDonald's* case provides a nuanced perspective on the expansion of *Caremark* liability. While his initial reaction was one of concern, a more measured analysis reveals important clarifications and limitations in Laster's decision. As legal standards evolve, it remains imperative for educators to adapt and ensure that their teachings equip students with the knowledge and skills necessary to navigate the complexities of corporate governance.

b. *Cybersecurity*

Cybersecurity poses a significant risk for companies and their boards across various industries. The annual costs of cyberattacks now amount to trillions of dollars and continue to rise.[79] Consequently, there's a clear expectation from the market for corporate boards to prioritize cyber risk oversight.

However, the question remains: could directors be held personally liable when their company experiences a cyberattack? The *Marriott* case mentioned above indicates that the answer is "yes, but" with some qualifications. Courts indeed recognize cyber-risk oversight as falling within the purview of *Caremark's* responsibilities. Vice Chancellor Will emphasized that cybersecurity has become a central compliance risk requiring board-level monitoring across sectors. Yet, establishing a *Caremark* claim in the aftermath of a cyber breach is not straightforward, as demonstrated by the high bar set by cases like *Marriott.*

Given that most large company boards have established processes for addressing cyber risks, shareholders' success in such claims is typically limited to instances where the board was aware of significant data leak risks but failed to take appropriate action.[80]

Marriott suggests that courts could designate cybersecurity as mission critical, increasing the likelihood of a failure-of-oversight claim surviving the motion to dismiss. Pre-suit actions in cases like *Marriott* indicate courts' willingness to grant shareholders access to internal cyber-risk discussions.

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[79] Martin Lipton et al., *Risk Management and the Board of Directors*, WACHTELL, LIPTON, ROZEN & KATZ (June 2020), https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28180.22.pdf.
[80] Sean Joyce & Catie Hall, *Overseeing Cyber Risk*, HARV. L. SCH. F. ON CORP. GOV. (Feb. 24, 2022), https://corpgov.law.harvard.edu/2022/02/24/overseeing-cyber-risk-2/.

Looking ahead, three key factors could influence the outcomes of future cybersecurity oversight cases. Firstly, courts may activate heightened scrutiny, particularly for companies where cybersecurity is deemed "mission critical," such as large financial institutions. Secondly, scenarios where boards fail to implement protocols to minimize harms post-breach or scrutinize management's disclosures could attract judicial attention. Finally, shareholders' ability to uncover instances where directors ignored cybersecurity red flags, potentially aided by regulatory investigations, may impact *Caremark* litigation outcomes.[81]

c. *Diversity*

The broader societal trend toward increased demands for better treatment of the workforce, particularly in areas like diversity and inclusion, has intensified in the wake of events like the George Floyd protests and the COVID-19 pandemic.[82] Regulators, investors, and companies themselves are increasingly focused on diversity and inclusion issues, with some even commissioning independent audits of their practices.[83] However, it's difficult to imagine scenarios where a failure to promote gender diversity in the boardroom or address racial biases throughout the company could result in a valid failure-of-oversight claim against the board. Recent cases have shown that shareholders' attempts to sue over diversity issues have been dismissed, as courts typically require evidence of critical failure of oversight.[84] Unless courts recognize diversity and inclusion as critical factors for certain talent-intensive industries in the future, the threat of *Caremark* claims in this context remains uncertain.

d. *Climate Change*

Companies are increasingly under pressure from investors and regulators to address climate change concerns.[85] However, does a failure by the board to consider measures to mitigate these risks open the door to a valid *Caremark* claim? Shapira argues that *Caremark*

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[81] Shapira, *supra* note 23, at 769-771.
[82] Chris Brummer & Leo E. Strine, Jr., *Duty and Diversity*, 75 VAND. L. REV. 1, at 5-6 (2022).
[83] Ron S. Berenblat & Elizabeth R. Gonzalez-Sussman, *Racial Equity Audits: A New ESG Initiative*, HARV. L. SCH. F. ON CORP. GOV. (Oct. 30, 2021), https://corpgov.law.harvard.edu/2021/10/30/racial-equity-audits-anew-esg-initiative/[https://perma.cc/27US-9KKE].
[84] See, e.g., Catherine M. Clarkin & Melissa Sawyer, *ESG Trends and Hot Topics*, HARV. L. SCH. F. ON CORP. GOV. (Aug. 25, 2021), https://corpgov.law.harvard.edu/2021/08/25/esg-trends-and-hot-topics/[https://perma.cc/4QHT-PHYU].
[85] Lisa Benjamin, *The Road to Paris Runs Through Delaware: Climate Litigation and Directors' Duties*, 2020 UTAH L. REV. 313, 372 (2020).

applies not only to clear violations of climate regulations but also to cases where boards neglect climate-related business risks, given the undeniable links between climate change and financial risks.[86] Therefore, climate-related risks pose greater challenges for the *Caremark* framework compared to other risks like cybersecurity or sexual misconduct. However, establishing causation between a company's inattention to climate issues and adverse climate events is difficult. Moreover, studies suggest that the reputational consequences of environmental misbehavior are minimal, with companies prioritizing other ESG factors like diversity and inclusion over environmental concerns in executive pay packages.[87] Therefore, only directors of major carbon-emitting companies may realistically face oversight liability for climate-related risks, particularly if they fail to comply with regulatory emissions limits. However, shareholder derivative actions in this realm face obstacles, including the long-time horizon for achieving environmental goals set by companies.

V. CAREMARK IN THE FUTURE: POLITICAL SPENDING & AI

Societal expectations and the parameters of *Caremark* are continually shifting. I have primarily focused on some of today's most pressing issues, including cybersecurity, sexual misconduct, racial diversity, and climate change. However, lesser-known issues could swiftly gain prominence, transitioning from optional to imperative from a corporate governance standpoint. For instance, consider the emerging ESG concerns surrounding corporate political spending and AI bias.

Similar to the #MeToo movement in 2017 and the events following George Floyd's killing in 2020, the January 6, 2021 attack on the Capitol has brought corporate political spending into sharp focus as political spending became a dominant topic among shareholder ESG proposals in 2021, garnering significant support and minimal resistance from companies.[88] In response to the Capitol attack, many corporate leaders pledged to alter how company political donations are allocated, inviting scrutiny over the inconsistency between their declarations and actions.[89] Consequently, political spending practices and public stances

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[86] Shapira, *supra* note 23, at 778.
[87] Luh Luh Lan, *Director's Duties and Climate Change Risk – Standard of Care Foreseeability and Enforceability,* OXFORD BUS. L. BLOG (Jul. 8, 2021), https://blogs.law.ox.ac.uk/business-law-blog/blog/2021/07/directors-duties-and-climate-change-risk-standard-care-foreseeability.
[88] Andrew Ross Sorkin, *The Rise of an Antitrust Pioneer*, N.Y. TIMES (Mar. 10, 2021).
[89] Cydney Posner, *Survey on Corporate Political Activity for 2022,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 2, 2022), https://corpgov.law.harvard.edu/2022/02/02/survey-on-corporate-political-activity-for-2022/.

on social issues have emerged as substantial sources of reputational risk for companies, potentially exposing directors to *Caremark* liability.[90]

The increased use of AI by corporations poses potential pitfalls, particularly regarding biases. As awareness of AI biases grows, corporate boards should proactively assess the extent of AI usage and susceptibility to biases within their companies.[91] The reputational risk associated with AI bias is significant; for instance, if a company publicly pledges to promote racial diversity but its main algorithm demonstrates systematic discrimination.

It is essential to note that this discussion does not cover all considerations. The aim here is to illustrate how emerging issues, which may currently be overlooked, could swiftly become prominent, posing significant reputational risks and potentially falling under the *Caremark* framework.

VI. To Extend or Not to Extend: That Is the Question

The evolving landscape of corporate governance is increasingly intertwined with Environmental, Social, and Governance (ESG) concerns. With the intensifying scrutiny on how corporations address these issues, there arises a pertinent question: Should *Caremark* claims, traditionally focused on legal compliance and business risks, be extended to include oversight of ESG risks? This question is especially critical in the context of recent judicial trends that indicate a broadening of oversight duties to encompass reputational risks. This paper explores the desirability of extending *Caremark* claims to ESG oversight, evaluating both the potential benefits and drawbacks.

A. The Case for Extending Caremark to ESG Oversight

1. Reputational and Financial Risks of ESG Negligence: As discussed, ESG concerns have become a major source of reputational and financial risk for companies. Failing to address key ESG issues can result in significant blowback, including difficulties in attracting talent, accessing capital, and maintaining consumer trust.[92] As such,

[90] Joe Nocera, *Companies Are Stuck Between Their Workers and Politicians*, N.Y. Times (May 7, 2022), https://www.nytimes.com/2022/05/07/business/dealbook/companies-abortion-florida.html.
[91] Robert Eccles, *Board Responsibility for Artificial Intelligence Oversight*, Harv. L. Sch. F. On Corp. Governace (Jan. 5, 2022), https://corpgov.law.harvard.edu/2022/01/05/board-responsibility-for-artificial-intelligence-oversight/.
[92] Shapira, *supra* note 23, at 792-800.

shareholders might pursue derivative actions, arguing that directors breached their oversight duties by neglecting critical ESG risks.

2. Judicial Trends and ESG: This paper showed that recent judicial trends suggest an openness to expanding the scope of *Caremark* to include nonlegal risks. For instance, the *Marriott* case acknowledged the potential for *Caremark* claims to encompass cybersecurity risks, even if the company met regulatory requirements. This indicates a judicial recognition that certain ESG issues, like cybersecurity, are mission-critical and warrant board oversight.

3. Aligning Corporate Practices with Societal Expectations: Extending *Caremark* claims to ESG oversight could encourage corporations to align their practices with evolving societal expectations. By holding directors accountable for ignoring critical ESG risks, courts can incentivize proactive engagement with these issues, promoting better corporate citizenship and long-term sustainability.

C. Costs

1. Hindsight Bias and Judicial Overreach: One significant drawback of extending *Caremark* to ESG oversight is the risk of judicial hindsight bias. Directors might be unfairly judged for decisions made in good faith based on information available at the time.[93] This can lead to an overreach where courts second-guess business decisions that did not pan out as expected, potentially stifling innovation and risk-taking.

2. Increased Litigation and Compliance Costs: Broadening the scope of *Caremark* claims to include ESG risks could lead to increased litigation and higher compliance costs for corporations. Directors might adopt overly cautious approaches to avoid potential liability, which could hamper business operations and strategic initiatives. The heightened scrutiny and the need for extensive documentation and reporting could strain corporate resources.

[93] *Id.*

3. Distinguishing Critical from Non-Critical ESG Risks: Not all ESG risks have the same impact on a company's operations. Courts and companies alike would face challenges in distinguishing which ESG concerns are "mission-critical" and thus subject to *Caremark* liability. This determination is complex and context-specific, varying across industries and individual companies.

D. Implications for Corporate Officers

1. Enhanced Oversight Responsibilities: If *Caremark* is extended to ESG oversight, corporate officers will need to enhance their monitoring and reporting mechanisms for ESG issues. This would require integrating comprehensive ESG metrics into their existing governance frameworks and ensuring continuous oversight and responsiveness to emerging risks.[94]

2. Proactive Engagement with ESG Issues: Corporate officers would be incentivized to engage proactively with ESG issues, conducting regular assessments and addressing potential risks before they escalate. This proactive stance can help mitigate potential legal and reputational liabilities, fostering a culture of transparency and accountability within the organization.[95]

3. Balancing Compliance with Strategic Goals: While the extension of *Caremark* to ESG oversight could promote better governance, it also necessitates a delicate balance. Corporate officers must navigate the fine line between stringent compliance and achieving strategic business goals. Effective risk management and strategic planning will be crucial in aligning ESG priorities with overall corporate objectives.[96]

The extension of *Caremark* claims to encompass ESG oversight represents a significant shift in corporate governance, reflecting the growing importance of ESG issues in today's business environment. While this expansion has the potential to promote better corporate practices and accountability, it also poses challenges in terms of increased litigation risk, higher compliance costs, and the potential for judicial overreach. Corporate officers must adapt to this

[94] *Id.*
[95] *Id.*
[96] *Id.*

evolving landscape by enhancing their oversight mechanisms and proactively engaging with critical ESG risks to navigate the complexities of modern governance successfully.

VII. CONCLUSION

The *Caremark* case established that a board of directors has a fiduciary responsibility to monitor an organization's adherence to ethical standards and regulatory compliance. The evolution of *Caremark* oversight duties has profound implications for corporate governance, especially in the context of increasing scrutiny on Environmental, Social, and Governance (ESG) issues. From its inception in the landmark *In re Caremark International Inc. Derivative Litigation* case, the duty of oversight has grown from a seemingly weak standard to a robust doctrine capable of holding directors accountable for significant failures in corporate oversight. Recent developments suggest that Delaware courts have become more inclined to scrutinize the board's oversight efforts and allow external shareholders to investigate claims of oversight failure, even in cases related to sexual misconduct.

This paper has traced the development of *Caremark* through a series of influential cases, each contributing to the expanding scope and depth of oversight duties. The cases of *Marchand v. Barnhill*, *In Re Clovis Oncology, Inc.*, *Teamsters Local 443 Health Services & Insurance Plan v. Chou*, and *In re Boeing Co. Derivative Litigation* illustrate how courts have increasingly held directors to account for failures that transcend traditional legal compliance and enter the realm of operational and reputational risks.

The potential extension of *Caremark* claims to encompass ESG oversight represents a pivotal evolution in the realm of corporate governance. As societal expectations shift and the importance of addressing ESG concerns becomes more pronounced, corporate boards and officers are increasingly held accountable for their roles in managing these risks. The landmark McDonald's derivative suit serves as a crucial example, illustrating the possible legal and reputational consequences of failing to address critical ESG issues, particularly those related to workplace misconduct.

The application of *Caremark* duties to ESG oversight underscores the necessity for corporate boards to implement robust monitoring and reporting systems. These systems ensure compliance with legal requirements and address broader ethical and reputational risks. By doing so, boards can better safeguard their organizations against potential liabilities and enhance their overall governance practices.

Extending *Caremark* claims to include ESG risks presents several challenges, such as increased litigation and the complexity of defining "mission-critical" issues. However, it also offers a significant opportunity to promote greater corporate responsibility and accountability. As companies navigate this evolving legal landscape, they must remain vigilant in their oversight duties, continuously assessing and addressing ESG risks to meet their fiduciary obligations effectively. Increased litigation risk, higher compliance costs, and the potential for judicial overreach must be carefully managed. Corporate officers and directors must balance these risks with the strategic goals of their organizations, ensuring that they fulfill their fiduciary duties without stifling innovation or strategic initiatives.

As we look to the future, the scope of *Caremark* is poised to further encompass emerging areas such as political spending and artificial intelligence, reflecting the dynamic nature of corporate governance. This expansion underscores the importance of proactive engagement with ESG issues and the need for robust internal controls and reporting mechanisms.

Ultimately, the integration of ESG concerns into the *Caremark* framework reflects a broader shift towards a more holistic approach to corporate governance. This approach recognizes the interconnectedness of financial performance, ethical conduct, and societal impact, emphasizing the need for boards to prioritize long-term sustainability and stakeholder value. By embracing this comprehensive view of their responsibilities, corporate directors and officers can contribute to creating safer, more inclusive, and resilient organizations. This proactive stance not only mitigates risks but also enhances corporate reputation and ensures long-term success in an increasingly complex and scrutinized business environment.

In conclusion, the *Caremark* doctrine has evolved significantly since its inception, adapting to the changing landscape of corporate governance. As directors and officers navigate this complex environment, they must remain vigilant and proactive in their oversight responsibilities, particularly in relation to critical ESG risks. The lessons from recent cases highlight the need for a comprehensive and integrated approach to governance that balances legal compliance, operational oversight, and reputational risk management. As the boundaries of *Caremark* continue to expand, the principles of proactive oversight and good faith engagement will remain central to effective corporate governance.

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