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Contents

December 2018

FEATURES

COLUMNS

DEPARTMENTS

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by Jeffrey M. Kaplan

Directors and compliance oversight liability

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How useful to promoting compliance is the threat of personal liability to directors for failing to oversee their respective companies' compliance programs? Earlier this year, in a post in the Harvard Law School Corporate Governance Forum,[1] Donald C. Langevoort of the Georgetown University Law Center reviewed the case law under the famous *Caremark* decision.[2] He found the law itself was not particularly strong, but expressed confidence that board members were nonetheless sufficiently motivated to do the right thing, due mainly to:

Kaplan

> …pressures from regulators and enforcers at the federal level, who have come to believe in the value of a stronger board-level presence in compliance. The Organizational Sentencing Guidelines, COSO [Committee of Sponsoring Organizations of the Treadway Commission] principles and numerous regulatory pronouncements seek not only board approval of written policies and procedures and key compliance personnel decisions, but a much more interactive involvement that includes reporting lines running from the chief compliance officer (and perhaps chief legal officer) directly to the board, unfiltered by senior executives.

But not everyone agrees that *Caremark* is fit for purpose. More recently, writing in the same blog, John Armour (University of Oxford), Jeffrey N. Gordon (Columbia Law School), and Geeyoung Min (Columbia Law School) argue that:

> the *Caremark* standard is no longer sufficient to carry the freight assigned to it. In particular, it insufficiently addresses the distorted 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. Liability standards must work to offset the incentives to avoid compliance with applicable legal rules. The compliance oversight standard of *Caremark* has become a poor match for the greatly-intensified incentives of both managers and directors.[3]

The professors "propose more assertive directors' liability for compliance failures…" However, it would be "limited in quantum to a clawback of stock-based pay. This would realign directors' interests with shareholders'—directors would stand to lose in parallel with shareholders when a compliance failure materializes—but limiting liability in this way would avoid pushing boards to overinvest in compliance."

This seems like a sound proposal to me. Although I generally agree with Langevoort about the importance of regulatory expectations, nothing so focuses the mind as the real prospect of personal liability. ✳

1. Donald C. Langevoort, "Caremark and Compliance: A Twenty Year Lookback," *Harvard Law School Forum*, March 29, 2018, http://bit.ly/2RAnTOL.
2. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).
3. John Armour, Jeffrey N. Gordon, and Geeyoung Min, "Short-Changing Compliance," *Harvard Law School Forum*, September 27, 2018, https://bit.ly/2R4xnBF.