IS DEFINING CORPORATE "RIGHT-DOING" THE SOLUTION TO CORPORATE "WRONG-DOING"?

Much ink has been been spilled on organizational and individual behavior as to how to create a better compliance structure in any entity. We all assume that the purpose of a corporate compliance department is to prevent, deter, and remediate corporate wrong-doing in various ways depending on the type of company, its size, and its situation. There is no "one-size-fits-all" baseball cap system, but rather it's a "one size fits one" system to be effective. So taking a macro view of the problem, let's look at the key players and key issues that a contemporary organization faces, and how they factor into where we are today, and where we need to go to design better corporate compliance systems. Why? Many companies are spending significant funds on compliance issues. Nevertheless, there are plenty of compliance issues that compliance departments have failed to prevent, and newer issues are occurring every day. So how should we look at these corporate governance failures? To answer that question requires we first step back and briefly review federal and state laws to provide a legal framework of how we got here today.

I. FEDERAL COMPLIANCE

At the federal level, two major players in the corporate compliance sector are the Securities and Exchange Commission ("SEC") and the U.S. Department of Justice ("DOJ"). Both made major pronouncements at the end of 2023 to set the stage for their activities in 2024 and beyond. So let's take a look at both agencies to see their past and present enfordement activities, and where they are headed moving forward.

[a] With regards to the SEC, in his remarks to the American Bar Association on December 8th, 2023, Chair of the U.S. Securities and Exchange Commission Gary Gensler, summarized both the history of the SEC over the past 90 years, and also the key projects he has been working on during his administration. More specifically, Chair Gensler references the two (2) New Deal statutes we all know, namely the Securities Act

of 1933, and the 1934 Act, then lists three (3) post New Deal Acts that help shape the historical trends we see today. Lastly he mentions four (4) projects the SEC is working on today. He grouped his brief remarks into three (3) parts, namely; the New Deal, the post New Deal, and what has been happening since the 2020s under his leadership that ties them in together.

The "New Deal" basically consisted of two [2] major Acts, namely;

a) The Securities Act of 1933 [SA33] This law addressed the original distribution of stock to the general public. Section 11 sets forth corporate directors and officers' liability for inaccurate representation of material facts in public offerings.

b) The Securities and Exchange Act of 1934 [SEA34] This law addressed trading in securities. Section 10 addresses insider-trading relating to short swing profits. Section 14 required disclosures and guardrails around solicitations of authority to vote on shareholders behalf (ie. "proxies").

The post-New Deal was characterized by [3] securities laws, namely;

a) The Williams Act of 1968: In this Act Congress added to Section 14 relating to tender offers and disclosure requirements from beneficial owners attempting to gain control of a company.

b) The Sarbanes-Oxley Act of 2022 ["SOX"]: In this Act, Congress revisited corporate governance–related issues due to the historic bankruptcies of Enron and Worldcom. Congress required companies to now have audit committees and other processes in place to promote the integrity of audits. It also included requirements for insiders' accountability for accurate disclosures and important clawback provisions. SOX was enacted in 2002 shortly after the 2001 Enron scandal when Enron filed for bankruptcy after a major restatement of its financial statements, and also the 2002 WorldCom scandal where it tried to hide the decline of its business through fraudulent accounting practices that ultimately resulted in its filing for bankruptcy as well. The overall background of each scandal is that some public

companies were wildly violating generally accepted accounting principles (GAAP) to meet quarterly projections of earnings and revenue. This basically kept investors misinformed about what the true value was of the stock interest in these companies. Simply put, SOX was enacted to address accounting misconduct that put investors at serious risk of losing their investment. SOX attempted to solve these scandals by redefining what "materiality" meant in information reporting, and also issued new rules that clarified when revenue could be recognized by a company.

c) The Dodd-Frank Act of 2010: In this Act Congress returned to corporate governance related issues by enacting several more rules such as clawbacks and executive compensation restrictions.

Fast forward to today, and Chair Gensler concluded his remarks by listing four (4) projects the SEC is actually involved in addressing corporate governance rulemaking initiatives. These were done to update the SEC's "rules set to keep pace with ever-evolving technology and business models", etc. but nevertheless in keeping with the principles going back to the creation of the SEC in the 1930's. Briefly, the four (4) SEC projects today are as follows:

- Executive Compensation: In 2022, the SEC fulfilled a number of mandates in the Dodd-Frank Act regarding same. Basically, if a company makes a material error in its financial statement where an executive receives compensation by hitting that milestone, the company can "claw back" the compensation erroneously awarded to same. As of December 1, 2023 all issuers that list securities on the exchanges must develop and implement their claw back policies. In addition, the SEC adopted rules regarding disclosure of executive pay versus performance so that companies are now required to make clear disclosures to investors on executive compensation paid and the company's financial performance for transparency purposes.

- Insider Trading: In 2022 the SEC adopted amendments to the SEC Act rule 10b 5-1 that addressed gaps in the original rule enacted in 2000 which enabled insiders to benefit from the rules liability protections yet they were still trading on the basis of material non-public information. Basically, executives getting stock-based

compensation are prohibited from using material non-public information to get an unfair advantage when trading their shares over regular shareholders. The new rules contained such requirements as insiders certifying that they are not in possession of material non-public information, etc. The rule was made effective in February 2023.

- Proxy Voting: In 2021, the SEC adopted rules relating to universal proxy voting. Shareholders hold directors and managers accountable for the corporation by electing directors, and proxy voting is the typical process to do so. Basically, the new rules put investors voting in person on the same footing as voters by proxy investors who now receive more detailed information about proxy votes for transparency purposes, and adopted rules governing proxy voting advice, and shareholder proposals for inclusion in proxy statements.

- Beneficial Ownership: Lastly, in October 2023, the SEC adopted rules to shorten the deadlines when beneficial owners must inform the public of their positions. By shortening the deadline from 10 days to 5 business days, it aligns with the current market to provide investors material information in a more real-time basis to reduce asymmetries. It amends the Williams Act [as amended in 1970] that required beneficial owners to report their control positions of more than 5% in 10 days.

So why has the SEC focused on these four (4) projects in the 2020's? According to Chair Gensler, they follow "Congress vision" that, as a federal regulator, the SEC's role is to work alongside state law to address corporate governance-related issues for the purpose of aligning incentives for all parties involved, and thereby build trust in the markets.

[b] With regards to the DOJ, the department is actively working on writing new Corporate Compliance Policies ("CCP") to address criminal corporate compliance behavior. In her remarks to the Society of Corporate Compliance and Ethics 22nd Annual Compliance and Ethics Institute in late 2023, Deputy Attorney General Lisa O. Monaco announced various compliance policies and enforcement activities to promote a "culture of compliance" in companies today because of the national security issues (e.g. terrorism, financing, sanctions evasion, circumvention of export controls cyber security,

etc.) that create a sense of urgency for the DOJ to address in white-collar crime. So how is the DOJ moving forward with their projects? Deputy Attorney Monaco listed four (4) areas of improvement. They are: (1) expansion of corporate enforcement actions due to dramatic increase in national security issues, (2) creation of new tools to penalize corporate misconduct as well as incentivize good corporate citizenship, (3) promotion of voluntary self-disclosures in the mergers and acquisition safe harbor policy, and (4) new specific performance and safe harbor remedies to design compliance systems to incentivize good behavior and deter bad behavior. So let's discuss these four areas in more detail.

With regard to Item #1, national security, the DOJ recognizes that companies confront new and complex geopolitical ecosystems that require more sophisticated compliance systems to mitigate their risk. To both incentivize good compliance systems, and deter bad systems, the DOJ looks at both sides of the coin. For example, the DOJ has added 25 new corporate crime prosecutors in the National Security Division and named a Chief Counsel for Corporate Enforcement. The DOJ has also increased the prosecutions by 40% in the Criminal Division Bank Integrity unit to hold banks accountable for U.S. sanctions violations in the Bank Security Act.

With regard to Item #2, new tools the DOJ has now started to use more tailored legal and equitable remedies for both good and bad behavior. Bad behavior will now be met with such relief as divesture of certain business lines, specific performance as part of restitution and remediation, and tailored compensation and compliance requirements. The DOJ goal is to both reward compliance and to deter wrongdoing. For example, regarding executive compensation systems, the DOJ has created a new pilot program that requires adding compliance-promoting criteria to corporate compensation systems in order to integrate compliance policies with compensation policies. This all begins internally at a company through corporate resolutions that approve these new policies such as clawbacks and withholding compensation on a dollar for dollar basis of executive pay (plus penalties) due to executive misconduct. The DOJ message to companies is "don't wait until you get caught". The DOJ is making clear that good corporate governance must now include good corporate compliance programs.

With regard to Item #3, voluntary disclosures, the DOJ is incentivizing the acquiring company to timely disclose misconduct in the target company in the M&A process. The DOJ has initiated a new department-wide safe harbor policy which will be tailored to each DOJ enforcement sector for implementation purposes. The corporate deadlines for these disclosures, and the subsequent remediation of the misconduct depends on the type of misconduct and when it was discovered (e.g. one year from the date of M&A closing to fully remediate the misconduct). There are many exceptions such as a non-impact on civil merger enforcement, aggravating factors, recidivist analysis, etc., but the overall new strategy of the DOJ is to have companies de-risk their deals with timely compliance related due diligence. And if a company still refuses to "get with the program" so to speak, it will be subject to full successor liability for all misconduct of the target company. So, the goal is to ensure acquiring companies protect their shareholders, promote good compliance, and thereby further the DOJ's mission of fighting corporate crime.

So what is the "bottom line" for the DOJ? According to Deputy Attorney General Lisa Monaco, the days of companies viewing corporate-enforcement matters as only a "cost of doing business" are gone. Corporate executives today need to re-double their time and attention to compliance programs, executive compensation programs, and due diligence acquisitions. The new incentives and deterrence's are in place, or in process, so laggards will not be suffered lightly by the DOJ. So what's one example? In the M&A sector of the DOJ, prosecutors will ask three key questions, namely; (1) is your corporate compliance program well designed, (2) is your corporate compliance program applied earnestly and in good faith, and (3) is your corporate compliance program working in practice?

The overall purpose of these DOJ enforcement measures it to provide articulated guidance to companies as to what it means to create a legitimate compliance program. The new enforcement measures provide incentives, deterrences, pilot programs, voluntary disclosures, and safe harbors to make corporate compliance culture the future of doing business in 2024 and beyond. Deputy Attorney General Monaco concluded by

stating that corporate compliance officers are at the front line of dealing with corporate risk, so the shared goal is to have successful compliance programs to create a sustainable company for all stakeholders. Good corporate governance is good for all.

Summarizing this section, at the federal level both the SEC and the DOJ are addressing new issues with better solutions based on incentives for right-doing, and deterrents for wrong-doing, to reframe corporate compliance from the old constructs of compliance as a cost only, to a better corporate model that promotes sustainability by better aligning risk and rewards up front for all parties.

II. STATE COMPLIANCE

To reiterate, corporate law is regulated at both the federal and state level. But from a practical perspective, federal securities laws are basically addressing public companies (and certain other private companies). State corporate laws fill in the rest of the compliance regulations most companies must comply with. Federal law creates several mandatory corporate governance mechanisms for all publicly traded companies, so it is effectively a federalization of key securities issues. State corporate government statutes were enacted to address more state specific corporate governance matters of an entity because corporations are created by state law, not federal law. Federal laws address the issue of shareholder rights and responsibilities. State corporate laws deal more with directors and officers rights and responsibilities. As such, state laws are considered more direct whereas federal laws are considered more indirect. These two major regulatory systems together result in corporations designing compliance systems needed to operate as legal entities as necessary.

So how does this work from a state case law perspective? According to Miriam H. Baer, compliance is defined as a system of policies and controls that organizations adopt to deter violations of the law and to assure external authorities that they are taking steps to deter violations of law. (Governing Corporate Compliance, 50 BCL Rev 949,958 (2009). Externally, we discussed above how federal law creates the rules that publicly traded companies must comply with in order to provide investors accurate information to make

decisions on. Internally, in the organization itself, state laws affect how a corporation is successful in designing a compliance program that enables it to meet the challenges on a state level by directors and officers. In the article entitled Corporate Compliance Achilles' Heel (p.791), she writes that the seminal state case of In re: Caremark International Inc., 698 A 2d 959 (Del. Ch. 1996), now referred to simply as the Caremark case, the fiduciary duty of care was cited as the reason for the Board of Directors legal requirement to exercise oversight of corporate officer obligations to install oversight systems. Subsequent state law cases articulated the parameters of what the duty meant to ensure corporate compliance programs were legal. So let's briefly review what others have written about Caremark and its progeny regarding corporate compliance systems.

In the article in the ABA Business Journal [2020-2021] entitled "**Caremark at the Quarter-Century Watershed: Modern Day Compliance Realities Frame Corporate Investors Duty of Good Faith Oversight**" (Vol. 76, Issue 1) by N. Veasey and R. Holland, the co-authors point out in the abstract regarding the *Caremark* case that the court held, regarding the Board of Directors duties that:

> The proper exercise of good faith requires that "[a] director's obligation includes a duty to assure that a corporation's information and reporting system . . . exists, and that the failure to do so under some circumstances may . . . render a director liable for losses caused by non-compliance with applicable legal standards. [But] . . . only a sustained or systematic failure of the board to exercise oversight - such as utter failure to attempt to assume a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability.

In *Caremark*, the Plaintiff had argued that the directors had failed their fiduciary duty of care and loyalty to the company by violating the Anti-Referral Payments Law ("ARPL") in the form of a "kickback" to the referring health care providers. Ultimately the case was settled, and Caremark paid $98.5 million to private insurers for past damages. In addition, Caremark agreed to restructure its corporate governance structure by adding board-level compliance and ethics committees, including two non-management directors, and arranging certain times to meet each year. Basically, it was a "failure of the board to act" type liability claim. The authors summarize the *Caremark*

case by simply stating that a board of directors must conceive, design, and monitor a compliance system in "good faith."

Over the past 25 years, the courts have tried to sort out what *Caremark* means in various fact patterns. Is the duty set forth in *Caremark* a new fiduciary duty? Is the duty a mere element to the duty of loyalty? Does the "good faith" element replace the duty of care (which can be exculpated) or a subset of the duty of loyalty? Does good faith require proof of intentional bad faith to assert a violation of same? How should a company comply with this case law? And how has this "good faith" standard evolved in the past quarter century as to what an effective oversight and monitoring program looks like to prevent "red flags"? I will highlight three [3] "red flag" cases below for discussion purposes on how Caremark has been interpreted.

[a] In Stone v. Ritter, 911 A.2d 362 (Del. 2006), the Court made it clear "that a failure to act in good faith is not conduct that results . . . in the direct imposition of fiduciary liability." The reason is because the failure to act in good faith is a "subsidiary element" (i.e., a condition) of the fundamental duty of loyalty. So proof of bad faith is a prerequisite subset of a violation of the duty of loyalty. But how do you prove it? The ABA author argues that courts look for "red flags." The *Stone* case clarified *Caremark* by placing the condition (i.e., not duty) of good faith squarely under the fiduciary duty of loyalty. Because a director can be personally liable, this acts as an incentive for companies to seek and approve directors with the proper expertise. (NB. The business judgment rule (BJR) is not a subject of this paper.)

[b] In Marchand v. Barnhill, 212 A.3d 805 (Del. Ch. 2019), the court stated that the Plaintiff failed to act in good faith because it ignored several "red flags" of a serious listeria outbreak in the company plant, and then failed to do anything about it over time. The Court stated that there were no protocols for management to deliver reports to directors, no board committee, and no process for board level discussions regarding same. As such, the court held that the combination of all the above factors constitutes bad faith as representing the "mindset of a disloyal director".

[c] In In re Clovis Oncology, Inc. Derivative Litigation 2019 WC 4850188 (Del. 2019), the court addressed the "red flags" of a failure to monitor an oversight system, even though the company had in fact implemented a compliance system. So the second condition of the *Caremark* case was cited as dispositive, and the defendant corporation was held liable because the corporate directors failure to monitor its compliance systems.

So what are some key "take-away" recommendations for directors from this ABA article? They are as follows:

(1) The Board needs to own the oversight and monitoring of risk and compliance systems of the company (e.g., compliance committee, CCOs as well as GCs, etc.).

(2) "Red flags" are key indicators that a court will look at to determine whether the board of directors took their duties seriously.

(3) Board of directors meetings need to be structured to allow for robust discussion on all compliance systems, not just financial systems as done in the past.

(4) Documentation by the board of directors as to what they did, why, and their follow up, is critical to show compliance with a directors duty of care (e.g., the corporate minute book needs to be updated and accurate.)

The ABA authors conclude by stating that "the enduring legacy of *Caremark* is that an independent director violates their fiduciary duties of loyalty if they fail to discharge their oversight responsibilities in "good faith." So what would a "good faith" system look like? Corporations started to address same with more ramped up independent audit committees and compensation committees, etc. So the more the regulators and the courts articulate compliance standards, the more corporations ramp up their board of director assignments, committees, and compliance systems to comply with same. Secondly, to solve the differences between profit hungry, short-term investors, and greater risk management legislation in view of all the scandals,

shareholders have stepped up their direct and derivative litigation to reframe companies as a stakeholder-centric, sustainable, long-term association.

Given the above, what does a more robust compliance system look like? For transparency and strategy purposes, perhaps management and the board should be able to explain to its stakeholders their on-going compliance systems. By doing so, it will help the board of directors identify what expertise it needs to monitor the system for *Caremark* purposes because just having an audit committee and related committees is not sufficient. Once the committees are set up, the reporting alignment of an officer–to–board level system must be carefully structured to optimize same in a functionally sensible way. Ultimately, cross checking of management data creates a synergy for a broader view of how a company operates to make the governance and management function strategically articulated. With careful thought, corporate leaders can position their companies to better identify and address known and emerging risks, and adopt goals for responsible corporate behavior, and then establish eco-systems designed to promote and measure better legal compliance. In some cases real solutions require real structural compliance systems change in order to be both efficient and in compliance with federal and state law.

III. LOOKING FORWARD

So how did it all happen? Where were the directors in all these scandals? Why did they fail in their duties to the corporation, and why were the other corporate "gatekeepers" unable to stop the fraud? Some writers say that "the shift of executive compensation from cash to equity, and the weakness of corporate boards and auditors, were all contributing factors to the securities fraud at the turn of the century. Others claim it was simply that we need to address better accuracy in reporting systems by public companies. Or perhaps the black-box theory of business made internal organizational issues secondary to financial outputs. More likely it is all the above. Regardless, strategic changes in organizational compliance syatems is needed to solve these corporate compliance matters.

Historically speaking, many writers trace the history of the problem to the shareholder primacy ideology over the past 50 years, from Milton Friedman "free markets" and "Reagonomics", to the financial inequality and economic insecurity that we have today. At the macro level, it raised the question of the so-called efficiency of "free market" deregulation. The solution, they proffer, is stakeholder centric companies that focus on long-term value by addressing their whole ecosystem. As we all know, the U.S. taxpayers rescued the financial industry in 2008. Such corporate misjudgment, coupled with the lack of build up of corporate reserve accounts (instead many corporations did large stock buy-backs and dividends), could once again cause a financial crunch. By treating stakeholders more as an "end in themselves," this creates a more sustainable behavior in a broader ecosystem. It also ties into the enlightened self-interest culture of reputational branding, that too often companies have failed as well in the past decade, in their shareholder primacy quest to turn a large profit (think Enron). Again, the first principle of corporate law is that corporations may only conduct "lawful business by lawful means." So to conduct a business lawfully, the seminal *Caremark* case is often cited to reiterate the purpose of proper governance, viz; to reach informed judgments concerning both corporate compliance with the law AND simultaneously facilitate good business performance by not overly second-guessing business decisions.

As we mentioned at the beginning of this article, many corporate compliance systems have not worked. So what if a compliance system plays a more strategic role in flagging risk and aligning rewards? And if so, what role corporate principals play to design a new compliance system? Merely setting up the system is not sufficient compliance under current state law per *Caremark* and its progeny. So what should "monitoring" include to be effective?

In the **ABA Business Lawyer** (Spring 2023/volume 78/Issue 2), the former Supreme Court Delaware Chief Justice Leo Strine, Jr. wrote an article entitled "Good Corporate Citizenship We Can All Get Behind" Toward a Principled Non-Ideological Approach to making Money the Right Way". His intent is to map out a "non-partisan, principled conception of good corporate citizenship drawing on shared assumptions of the right and the left about the place of corporations in our society and the realities of

corporate governance." [Id. at 329] As he simply states, you must address how the conduct of corporations affects the interests of both the stockholders and its stakeholders (i.e. workers, communities where it operates, customers, taxpayers, and the environment.) So the days of corporate "externalities" may be winding down, but what will be the new scope of "internalities"? Strine's baseline is that corporations should support "the basic institutions of the society upon which the corporation depends", but leave behind "debatable issues of politics and faith largely to human investors, workers and consumers to decide for themselves." [Id. at 329] It's a straight-forward two-part concept. In Section I: Introduction, Strine simply states that his central goal is to "identify some methods by which corporations and institutional investors might improve the ability of the corporate sector to make money the right way". [Strine at 331] The law confers on corporations certain rights and powers apart from human beings, but the law also has concomitant limitations on its conduct and behavior. Both must be understood to address their positive contribution to corporate stakeholders. Strine believes that the combination of such powers and limitations are amenable to his "good corporate citizenship model", and then describes and defends his model thereafter.

In Section V, Strine sets forth his vision of what he calls his "good corporate citizenship" model. For Strine, the solution can't rely on just regulatory structures (i.e. rules and standards), but rather creating corporate policies that take into consideration corporate rights concomitant with corporate limitations. As Strine asks "are we stuck with corporations that callously seek profit in a manner wholly abstracted from social context, and with none of the real world heart and soul concerns that animate sole proprietors and ordinary workers in their conduct?" [Id. at 358] His answer is no because By-Laws and policies are private law, so as such their elasticity enables them to be more company specific solutions, within the broader rules of public law as hard stops to errant policies. His two-tier approach to corporate governance (at its floor level) basically embraces the Hippocratic construct of "first do no harm". So what direction is the Strine policy headed? For starters, his opening policy statement says, in pertinent part, as follows: "[m]ake no mistake about it, we know our job is to deliver solid profits for our investors in a sustainable way, but also recognizing that by sustainable we mean sustainable. We are not going to seek profit the wrong way. Our shareholders don't just

invest in us, they invest in the entire economy, and they pay taxes and need jobs. They live in the real world . . . [so] we will pay a living wage and benefits . . . and do so in all nations and regions where we operate. We will focus on safety and quality. . . We will try not to harm the environment or contribute to climate change that endangers our economy and well-being." [Id at 358]

In Section VI, Strine sets forth several board approved sample model policies to address corporations rights and duties. He divides them into direct interest vs. indirect interest policies. His proposed direct interests, **Tier 1** model policies take into consideration such matters as (1) ethical profits, (2) sustainability, (3) respect for stakeholders, (4) employee living wages and benefits, (5) safety and quality of its products, and (6) fair taxes, etc. for approval by the board. For **Tier 2**, so-called indirect interests, he proposes a unanimous vote, such as "the entire board will approve any corporate policies in political and social issues, and will only address those more important to the company." [Id. at 363 - 368] So Strine basically sets up two tracts of corporate interests. Strine calls it a principled approach based on shared values. He then lists a dozen or so sample policies that fit his definitions and goals above.

Why is this important? Creating corporate right-doing principles matter because, without employee buy-in, a company will be less likely to deter non-compliant, wrong-doing activities. As mentioned above, older corporate compliance systems must be upgraded to identify new red flag risks, and then managed to effectively address same. Compliance systems are expensive, and ones that don't work are even more expensive. Federal and state law requirements identify WHAT corporate duties and obligations are, but they are by no means a complete systematic methodology for HOW a monitoring system should operate. So the question is can a company articulate a principled good corporate citizenship model to align with new corporate compliance systems? Externally, a company must recognize that the two government legal systems should be strategically viewed as complimentary so its necessary to align compliance with both. Internally, corporate "wrong-doing" compliance measures, to be effective, must address the question of what would corporate "right-doing" measures look like. For only by doing so

can the shareholder-director-officer-employee-stakeholder eco-system be truly successful for all constituents, both internally and externally.

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