

TOWARD A SYSTEMS ARCHITECTURE IN CORPORATE GOVERNANCE

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ABSTRACT:

A new and powerful systems architecture is driving corporate governance. This architecture will improve board of directors' decision-making, strengthen compliance and risk management protocols, empower gatekeepers such as lawyers and accountants to better monitor, and enhance the social contract between business and society. The purpose of this article is to promote a systems approach to decision-making in matters of corporate governance, highlight the importance given to systems by recent Delaware courts, and present recommendations for boards of directors to optimally situate themselves within an effective organization-wide system of governance.

INTRODUCTION

A new and powerful systems architecture is driving corporate governance. This architecture will improve board of directors' decision-making, strengthen compliance and risk management protocols, and empower gatekeepers such as lawyers and accountants to better monitor the enterprise. This perspective is not only underdeveloped in the literature,¹ but comes at an ideal time. A subtle but powerful turn toward systems thinking has recently appeared in judicial opinions, which the academic literature has yet to recognize. Recognizing the systems turn in corporate governance and incorporating explicit systems protocols in judicial practice will dramatically improve the evolution of governance law and provide boards with badly needed certainty on how to prevent needless liability from shareholder litigation.

A system is a comprehensive and multilayered framework of input, processes, and outputs that obtain, manage, and deliver information to others

1. See, e.g., Tamara Belinfanti & Lynn Stout, *Contested Visions: The Value of Systems Theory for Corporate Law*, 166 U. PA. L. REV. 579, 600 (2018) (noting that “systems theory currently is not a staple of contemporary corporate law and governance discussions.”); Mariel Rodak, *It’s About Time: A Systems Thinking Analysis of the Litigation Finance Industry and its Effect on Settlement*, 155 U. PA. L. REV. 503, 526 (2006) (stating that “[d]espite such developments in other disciplines, the application of systems thinking to law has been comparatively limited”). This manuscript advocates for a systems architecture in corporate governance at the firm-level. For a recent macro view of corporate governance infrastructure see Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. (forthcoming Jan. 2021) (“More specifically, we describe the corporate governance machine and its three reinforcing components: law, institutions, and culture.”).

who in turn return new information to the system which is processed and disseminated through the organization.² A systems architecture perspective not only considers a system's logical flow and design, but also embraces the conceptual structure of the system, its functional outcomes, and needs of important stakeholders.³ It is this broader perspective to systems thinking, largely absent in the literature, that we incorporate in this manuscript.

The absence of a systems approach is not just a theoretical problem. The absence of this approach can be fatal, and it can start with something as innocuous as ice cream. Blue Bell Creameries is one of the largest and oldest manufacturers of ice cream products in the United States.⁴ Blue Bell appeared to have a robust compliance program: outside firms audited the company, regulators inspected its facilities, and safety manuals guided worker conduct. Yet regarding compliance, Blue Bell was a company adrift. In spite of its critical importance to the business, the board of directors held periodic meetings with no board-level discussion of food safety.⁵ Surely, their compliance program would protect them from harm—managers had operations under control, and everything would be fine.

In 2015, Blue Bell products became contaminated with a dangerous bacteria that thrived in cold and damp environments, causing widespread infection including ten hospitalizations and three deaths amongst Blue Bell consumers.⁶ Blue Bell's board of directors, despite their essential role in

2. See *infra* notes 18–24 and accompanying text (summarizing the various definitions of a system).

3. See Hannu Jaakkola & Bernhard Thalheim, *Architecture-Driven Modeling Methodologies*, 22 MODELING & KNOWLEDGE BASES 97, 98 (2011) (listing what the derived models of a system's architecture represent). See also John Klein & Hans van Vilet, *A Systematic Review of System-of-Systems Architecture Research*, in QOSA '13: PROC. OF THE 9TH INT'L ACM SIGSOFT CONF. ON QUALITY OF SOFTWARE ARCHITECTURES 13, 13 (2013) ("We define the architecture of a system as the set of structures needed to reason about the system, which comprise elements, relations among them, and properties of both."); MLC Federal Inc. Cont. Cas. Fed., B-254696, ¶ 108,011, at n.3, 1994 WL 17099983 (Comp. Gen. Jan. 10, 1994) ("The architecture of a system defines its attributes . . . that is, the conceptual structure and functional behavior of the machine, as distinct from the organization of the data flow, the logical design, the physical design, and the performance of any particular implementation."); John W.L. Ogilvie, *Defining Computer Programs Parts Under Learned Hand's Abstractions Test in Software Copyright Infringement Cases*, 91 MICH. L. REV. 526, 534 (1992) ("[A] system architecture begins to describe how the program operates. The system architecture describes the program in terms of various modules and their interconnections.").

4. See *The Little Creamery*, BLUE BELL CREAMERIES, <https://www.bluebell.com/the-little-creamery/#our-history> [<https://perma.cc/YPN9-WKKX>] (last visited Jan. 13, 2021) (providing background on the company).

5. *Marchand v. Barnhill*, 212 A.3d 805, 822 (Del. 2019).

6. Cyrus B. Parks & Laura B. Cardinal, *Family Firms and Stakeholder Management: Crisis at Blue Bell Ice Cream*, in THE ROUTLEDGE COMPANION TO RISK, CRISIS AND

leadership and monitoring the organization, did not address the multiple and troubling failures found by FDA inspections years before the fatal *listeria* outbreak.⁷ These included improper disinfection procedures, mixing of condensation and debris in the manufacturing process, and frequent problems with contamination.⁸

In response to these failures, a shareholder brought a derivative suit against Blue Bell in the Delaware courts, alleging in part that the board of directors breached their duty of loyalty pursuant to standards set in the seminal decision *In re Caremark Int'l Inc. Derivative Litigation* (*Caremark*).⁹ What is now known as a *Caremark* claim is one of the hardest corporate law claims to plead and prove against a board of directors.¹⁰ The Court of Chancery of Delaware duly dismissed plaintiff's *Caremark* allegations against Blue Bell due to insufficient evidence that the board breached its duties to the company.¹¹ That changed on appeal. The Supreme Court of Delaware in *Marchand v. Barnhill* surprisingly reversed the lower court's dismissal and allowed plaintiff's *Caremark* claim to proceed.¹² The court's core reasoning was based upon the principle that Blue Bell lacked an interlinked, interdependent, and coordinated *system* of board-level compliance and monitoring in the organization.¹³ The court concluded that Blue Bell's board did not meet its minimum duties toward company shareholders, and allowed plaintiff's claim to proceed.¹⁴

Delaware courts have been signaling for years that a system of compliance is what would be expected from boards in order to avoid liability under *Caremark*. However, only quite recently have the courts articulated the importance of systems thinking so prominently. Boards can no longer assume that the mere presence of a compliance function, and sporadic engagement with that function, will shield them from potential liability. A systems approach to governance by boards is now a necessity. Boards must ensure the presence of a comprehensive framework that receives information from internal and external stakeholders, transmits that information up through the enterprise to the board of directors, and then implements

EMERGENCY MANAGEMENT 341, 341–42 (Robert P. Gephart, Jr., ed. 2019).

7. *Id.* at 342.

8. *Id.*

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

10. *See infra* notes 198–200 and accompanying text (discussing the difficulty of proving *Caremark* claims).

11. *Marchand v. Barnhill*, No. 2017-0586-JRS, 2018 WL 4657159 (Del. Ch. Sept. 20, 2018).

12. *Marchand v. Barnhill*, 212 A.3d 805, 824 (Del. 2019).

13. *Id.* at 823–24.

14. *Id.* at 824.

compliance mandates from an engaged and proactive board of directors. If the Blue Bell board had such a rigorous program in place, three of their customers might be alive today.

The purpose of this article is to develop a systems architecture approach to decision-making in matters of corporate governance, highlight the importance given to systems by recent Delaware courts, and show how boards can optimally situate themselves within the emerging regulatory reality of systems-based corporate governance. Part I introduces systems thinking and its potential for transforming governance in organizations. Part II shows how systems thinking in the *Marchand* decision, and the four lower court siblings that followed, collectively referred to as “the governance quartet”¹⁵ helped influence the courts’ decisions to let their *Caremark* claims survive a motion to dismiss. Part III reinforces the systems turn in corporate governance by highlighting a judicial shift from rigid gatekeeping toward a holistic understanding of the board and its responsibilities to the firm.

Shifting our focus to the board of directors, Part IV illuminates how boards can build a systems architecture of corporate governance. By responding to frequent calls in the literature to open the “black box” of board operations,¹⁶ we theorize the board of directors as not just a monolith but a collection of coequal individuals who not only collaborate toward a common goal, but also display group behaviors such as coalitions, groupthink, social isolation, and dissent.¹⁷ We show how applying a systems architecture to a

15. Following *Marchand*, four *Caremark* claims survived motions to dismiss in Delaware’s Court of Chancery between October 2019 and August 2020. Although these four represent a small number of the *Caremark* claims brought before that court, they are significant given how rare it is for such claims to survive a motion to dismiss. See *infra* note 91 (highlighting the difficulty in meeting the standard of care required by *Caremark* to succeed on a claim). These cases are: *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019), *Inter-Mtg. Grp. USA, Inc. v. Armstrong*, C.A. No. 2017-0030-TMR, 2020 WL 756965 (Del. Ch. Jan. 31, 2020), *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020), and *Teamsters Local 443 Health Svcs. & Ins. Plan v. Chou*, C.A. No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020). We refer to these four cases collectively as the “governance quartet” because they highlight the need for systems architecture in corporate governance.

16. See, e.g., Bernard C. Bailey & Simon I. Peck, *Boardroom Strategic Decision-Making Style: Understanding the Antecedents*, 21 CORP. GOV.: AN INT’L REV. 131, 131 (2013) (referencing the “black box”); Hans van Ees, Jonas Gabrielsson & Morten Huse, *Toward a Behavioral Theory of Corporate Governance*, 17 CORP. GOV.: AN INT’L REV. 307, 315 (2009) (similar); Amedeo Pugliese et al., *Boards of Directors’ Contribution to Strategy: A Literature Review and Strategic Agenda*, 17 CORP. GOV.: AN INT’L REV. 292, 293 (2009) (similar); Andrew M. Pettigrew, *on Studying Managerial Elites*, 13 STRATEGIC MGMT. J. 163, 175 (1992) (similar).

17. See, e.g., Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards as Strategic Decision-Making Groups*, 24 ACAD. MGMT.

board's decision-making not only discourages potentially harmful group effects but also augments the board's ability to function at its highest level of corporate governance, benefitting employees, shareholders, and society at large. Part V concludes.

I. SYSTEMS THINKING IN ORGANIZATIONS

This Part introduces systems thinking. Part I.A. summarizes the history and development of systems and their various applications in business, government, and academia. While there are many different definitions of a system, most concentrate around a few key concepts which will be relied on in this Article. Part I.B. examines systems thinking in the legal environment of business. This subpart shows that systems concepts and ideas have played a limited though promising role in legal scholarship, particularly in the areas of corporate law and corporate governance.

A. *A History and Development of the Systems Thinking*

One of the many useful definitions of a system is that it is “an arrangement of physical components, or a set or collection of things, connected or related in such a manner as to form and/or act as an entire unit, an entity or whole.”¹⁸ A system has also been defined as a “complex unity formed of many often diverse parts subject to a common plan or serving a common purpose.”¹⁹ Not merely a collection of things, systems have a

REV. 489, 492 (1999) (discussing board effectiveness).

18. Robert D. Hart, *A Natural Ecosystem Analog Approach to the Design of a Successional Crop System for Tropical Forest Environments*, 12 *BIOTROPICA* 73, 73 (1980). A system can also be defined more symbolically: “A system $S = (T, R)$ where T is a set of things and R is a relation defined on T . The things (T_i) are interdependent or interrelated and form a unified whole.” Stephanie M. White, *Systems Theory, Systems Thinking*, in *IEEE SYS CONF. PROC.* 1 (2015), available at <https://ieeexplore.ieee.org/document/7116787> [<https://perma.cc/53MY-BQXA>]. Systems have been criticized as difficult to define, in part because they are so widely applicable that only the broadest terms can meaningfully encompass what a system is and does. See HITESH GUPTA, *MANAGEMENT INFORMATION SYSTEM: AN INSIGHT* 14 (Int'l Book House Pvt. ed., 2011) (stating that “[t]here are more than a hundred definitions of the word *system*”); Alexander Backlund, *The Definition of System*, 29 *KYBERNETES* 444, 444 (2000) (“There are many definitions of *system*”).

19. *Vermont Law School's First Annual Alumni Energy Symposium – Symposium Proceedings November 6, 2014*, 16 *VT. J. ENVTL. L.* 255, 274 (2015) (remarks of Michael Myers, New York State Attorney General's office); Pamela Samuelson, *Questioning Copyrights in Standards*, 48 *B.C. L. REV.* 193, 209–10 & n.114 (2007) (citing popular dictionary definition of a system); Keith Myers, *Medical Errors: Causes, Cures, and Capitalism*, 16 *J.L. HEALTH* 255, 260 (2001-02) (similar).

defined form, function, and purpose.²⁰ Systems have a specific design that can be measured and evaluated according to the outputs that the system generates.²¹ A system relies upon not only components that make up the system, but also the interactions between those components that make the system work.²² The word system originates from the Greek verb *sunistánai*, which meant “to cause to stand together.”²³ Thinking about concepts as systems is also “one of the most powerful ideas in science” and is a “unique” and “broadly useful” method for thinking and learning.²⁴

The earliest systems approaches were developed in the military during the second world war.²⁵ In the 1950s, Professor Jay Forrester at MIT created the Systems Dynamics Group to use computer simulations to predict and to illustrate systems behavior.²⁶ One of his first applications of systems dynamics involved a business, specifically management of production, inventories, headcount, and profit at a division of General Electric.²⁷ Early experts like Forrester perceive systems as involving patterns of behavior produced by policies that created repercussions elsewhere in the organization.²⁸ Forrester also presciently perceived that the purpose of system or simulation was not to provide a specific answer, but build a process

20. DONELLA H. MEADOWS, *THINKING IN SYSTEMS: A PRIMER* 11 (2008).

21. Belinfanti & Stout, *supra* note 1, at 598–99.

22. MICHAEL C. JACKSON, *SYSTEMS THINKING: CREATIVE HOLISM FOR MANAGERS* 3 (2003).

23. Simon Bell & Stephen Morse, *Systems Thinking and Gauging Sustainable Development*, in *SYSTEMS FOR SUSTAINABILITY: PEOPLE, ORGANIZATIONS, AND ENVIRONMENTS* 407, 408 (Frank A. Stowell et al. eds., 1997).

24. Rosemary Hipkins et al., *The Interplay of Context and Concepts in Primary School Children's Systems Thinking*, 42 *J. BIOL. EDUC.* 73, 73 (2008) (citing JAMES RUTHERFORD & ANDREW AHLGREN, *SCIENCE FOR ALL AMERICANS* (1990)); Barry Richmond, *Systems Thinking/System Dynamics: Let's Just Get on With It*, 10 *SYSTEM DYNAMICS REV.* 135, 135 (1994).

25. Thomas P. Hughes & Agatha C. Hughes, *Introduction*, in *SYSTEMS, EXPERTS, AND COMPUTERS: THE SYSTEMS APPROACH IN MANAGEMENT AND ENGINEERING, WORLD WAR II AND AFTER 2* (Thomas P. Hughes & Agatha C. Hughes eds., 2000). However, it can be argued that systems thinking has been present as far back as ancient societies where writings on Roman engineering and water supplies applied a systemic lens. M.A. Sinclair, *Ergonomics Issues in Future Systems*, 50 *ERGONOMICS* 1957, 1958 (2007). According to this source, the first relevant use of the word “system” appeared in 1619 in a discussion of astronomy and planets. *Id.*

26. *What is Systems Thinking?*, CORP. FIN. INST., <https://corporatefinanceinstitute.com/resources/knowledge/strategy/systems-thinking/> [<https://perma.cc/AMA9-98UD>]. See also David C. Lane, *A Model Simulator: The Lives of Jay W. Forrester*, 12 *J. SIMULATION* 90, 92–93 (2018).

27. Lane, *supra* note 26, at 92.

28. See Lane, *supra* note 26, at 95 (explaining one view of systems' influences and implications).

through which managers could interact, learn, and then develop a shared basis for action.²⁹

During the 1960s and 1970s a systems approach became more aggressively embedded in organizational thinking.³⁰ Scholars of the period highlighted the importance of perceiving organizations as systems.³¹ An organization, as scholars of the day described, was perceived as an “open system which, from the human point of view, converts individual needs and expectations into outputs.”³² Systems were understood as not only mechanistically efficient, but also helpful for improving the management of inputs, utilizations of outputs, and design systems processes in order to have the optimal fit for the organizations they serve.³³ Systems were also understood as serving the needs of the broader environment in the organizational context.³⁴

As systems applications matured in the 1970s and 1980s, streams of research broke off into different subfields such as systems engineering, cybernetics, critical systems thinking, and mathematical approaches to systems thinking.³⁵ More recent and modern contributions of systems theory to a variety of fields have both broadened and deepened the applicants of systems research.³⁶ Systems theory also found applications in business subfields such as strategy, knowledge management, the environment, health, and corporate social responsibility.³⁷

Today, systems typically possess two or more individual elements that are distinct from one another.³⁸ These elements are the component parts of any system and constitute the basis upon which further traits of a system are organized. Furthermore, systems take these component parts and

29. Lane, *supra* note 26, at 95.

30. Steven A. Cavaleri, *In Search of a Pragmatic Systems Method*, 67 J. NEW PARADIGM RSCH. 266, 269 (2011).

31. *Id.*

32. Michael Beer & Edgar F. Huse, *A Systems Approach to Organizational Development*, 8 J. APP. BEHAV. SCI. 79, 85 (1972).

33. *Id.*

34. *Id.*

35. John Mingers & Leroy White, *A Review of The Recent Contribution of Systems Thinking to Operational Research and Management Science*, 207 EUR. J. OPERATIONAL RSCH. 1147, 1147 (2010); M.C. Jackson & P. Keys, *Towards a System of Systems Methodologies*, 35 J. OPERATIONAL RSCH. SOC'Y 473, 481 (1984) (discussing the then current “[o]perational [r]esearch in crisis” debate and its relevance to different problem context and problem solving methodologies).

36. Mingers & White, *supra* note 35, at 1147–53 (surveying a variety of systems research methods and their history and recent developments).

37. Mingers & White, *supra* note 35, at 1152–57.

38. MEADOWS, *supra* note 20, at 11.

interconnect them in some way. Elements that are interconnected share some relationship with one another that is greater than what can be found by chance.³⁹ This interconnectedness between individual components results in these components creating their own patterns of behavior over time.⁴⁰

Modern systems contain processes that are fully integrated with one another. In integrated systems, the whole of a system is greater than the sum of its parts, and systems create synergies through how the parts of the system interact with one another.⁴¹ Integrated systems generate new behaviors, functions, or outputs that would have been unrealized without a functioning system in place.⁴²

Systems also operate toward a goal or central objective.⁴³ This central objective serves as the purpose for why the system functions, though such purpose may not be expressed explicitly except through the operation of the system itself.⁴⁴ Systems can be nested within one another, creating sub-systems inside of broader systems that function together.⁴⁵ Systems are also resilient, and are able to avoid, survive, and recover from disruptive events.⁴⁶ Finally, and quite significantly, systems are able to evaluate and prioritize systems processes by level of criticality. A critical system is one whose

39. See Saskia Kunnen & Paul van Geert, *General Characteristics of a Dynamic Systems Approach*, in *A DYNAMIC SYSTEMS APPROACH TO ADOLESCENT DEVELOPMENT* 15, 18–19 (Saskia Elske Kunnen ed. 2012) (comparing systems to “networks”).

40. Patricia Briscoe, *Global Systems Thinking in Education to End Poverty: Systems Leaders with Concerted Push*, 43 *INT’L STUD. EDUC. ADMIN.* 5, 7 (2015).

41. Roald P. Verhoeff et al., *The Theoretical Nature of Systems Thinking. Perspectives on Systems Thinking in Biology Education*, 40 *FRONTIERS IN EDUC.* 1, 5 (2018) (“In the holistic perspective the system as a whole is emphasized, and complex systems learning is aimed at understanding . . . phenomena as emerging from the dynamic interactions between components across different levels of organization.”); Rajneesh Chowdhury, *Healthcare Knowledge Management and Information Technology: A Systems Understanding*, in *HEALTHCARE KNOWLEDGE MANAGEMENT: ISSUES, ADVANCES AND SUCCESSES* 42 (Rajeev Bali & Ashish Dwivedi, eds., 2007).

42. See Kurt Klingensmith & Azad M. Madni, *Resilience Concepts for Architecting an Autonomous Military Vehicle System-of-Systems*, in *DISCIPLINARY CONVERGENCE IN SYSTEMS ENGINEERING RESEARCH* 65, 71 (Azad M. Madni et al. eds., 2018) (reviewing the many benefits of systems implementation).

43. See Belinfanti & Stout, *supra* note 1, at 599 (stating that a core characteristic of a system is that “the elements operate as a unified whole to serve a given function or purpose”). See also APRIL J. WELLS, *GRID APPLICATION SYSTEMS DESIGN* 198 (2008) (“Every system has a central objective.”).

44. MEADOWS, *supra* note 20, at 14.

45. MEADOWS, *supra* note 20, at 15–16.

46. Scott Jackson & Timothy L.J. Ferris, *Resilience Principles for Engineered Systems*, 16 *SYS.’ ENGINEERING* 152, 153 (2013) (evaluating various principles for their capacity to contribute to avoidance, survival, or recovery behavior in systems).

failure would result in a serious impact on its functioning.⁴⁷ The level of criticality of a system determines how much time and effort is invested in ensuring that the system functions correctly.⁴⁸ Systems cognizant of criticality can allocate limited resources to protecting critical processes from unexpected degradation.

Not only is understanding systems characteristics important, but adopting a systems way of thinking is necessary to fully understand how a system architecture works. Systems thinking is a process for thinking about systems.⁴⁹ Systems thinking begins with an awareness of feedback between independent actors and how that loops in feedback and counteracts or otherwise balances one another.⁵⁰ This awareness enables comprehension of multiple perspectives on the scope of a problem.⁵¹ In time, systems thinking perceives the vast and complex interrelationships between things and observes patterns of change rather than merely snapshots of activity.⁵² Ultimately, systems thinking powerfully simplifies complex entities by enabling viewers to see the deeper designs of an entity that underlie its activity.⁵³ Such insight can illuminate the core of how a system and its architecture work, and enable the viewer to predict the impact of change on a system's operation and goals.⁵⁴

A systems approach is essential thinking for organizations. As one leader in systems thinking presciently explains:

As our personal relationships, technologies, jobs, institutions and communities continue to grow increasingly complex and interdependent, the occurrence of [problems that impact beyond their own immediate area] will increase. . . . As interdependency increases, we must learn to learn in a new way. It's not good

47. Cf. Kristian Cedervall Lauta, *Regulating a Moving Nerve: On Legally Defining Critical Infrastructure*, 6 EUR. J. RISK REG. 176, 178–79 & n.11 (2015) (defining a critical infrastructure from a government perspective as one “whose disruption, failure or destruction would have a serious impact on the functioning of society, the economy or the state”).

48. See Alan Burns & Robert I. Davis, *A Survey of Research into Mixed Criticality Systems*, 50 ACM COMPUTING SURVEYS 1, 2 (2017) (“The criticality of a component determines the level of rigour applied in the design and analysis used to determine its correct functionality and resource usage.”).

49. Ross P. Arnold & Jon P. Wade, *A Definition of Systems Thinking: A Systems Approach*, 44 PROCEDIA COMPUT. SCI. 669, 670 (2015) (“Systems thinking is, literally, a system of thinking about systems.”) (emphasis in original).

50. PETER M SENGE, *THE FIFTH DISCIPLINE: THE ART AND PRACTICE OF THE LEARNING ORGANIZATION* 73 (2006).

51. Arnold & Wade, *supra* note 49, at 673.

52. SENGE, *supra* note 50, at 73.

53. SENGE, *supra* note 50, at 73.

54. Arnold & Wade, *supra* note 49, at 673.

enough simply to get smarter and smarter about our particular “piece of the rock”. We must have a common language and framework for sharing our specialized knowledge, expertise and experience with “local experts” from other parts of the web. . . . In short, interdependency demands systems thinking. Without it, the evolutionary trajectory that we’ve been following since we emerged from the primordial soup will become increasingly less viable.⁵⁵

Systems thinking is a method by which individuals can understand this interdependency and respond to it in a way that effectively meets whatever challenge is presented.

B. Systems Thinking in the Legal Environment of Business

Although systems thinking originated in quantitative fields, this approach is just starting to take root in qualitatively-driven legal scholarship.⁵⁶ The recent literature is coming to accept corporations as complex and interactive entities that function in a systems architecture.⁵⁷ A corporation is essentially a system that comprises different subsystems such

55. BARRY RICHMOND, SYSTEMS THINKING: FOUR KEY QUESTIONS 3–4 (1991), http://static.clexchange.org/ftp/documents/whyk12sd/Y_1993-05STFourKeyQuestions.pdf [<https://perma.cc/7AVC-AGYW>].

56. See, e.g., Anthony J. Colangelo, *A Systems Theory of Fragmentation and Harmonization*, 49 N.Y.U. J. INT’L L. & POL. 1, 3–5 (2016) (highlighting contributions of systems theory to international law); Mariel Rodak, *It’s About Time: A Systems Thinking Analysis of the Litigation Finance Industry and its Effect on Settlement*, 155 U. PA. L. REV. 503 (2006) (applying a systems approach to litigation finance); James Salzman et al., *Regulatory Traffic Jams*, 2 WYO. L. REV. 253, 270–71 & n.51 (2002) (stating that “authors have used a systems approach to examine corporate law, civic republicanism, constitutional decision making, jurisprudence, private capital raising, and many other fields” and citing sources); Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479, 512–20 (1997) (offering examples of how systems thinking can improve judicial process); Charles J. Pope, *Domestic Violence and the Courts—The Systems Approach*, 73 MICH. B.J. 946, 948 (1994) (advocating a “cross systems” approach that brings together various stakeholders and coordinates responses to domestic violence). See also Meredith J. Ross, *A “Systems” Approach to Clinical Legal Education*, 13 CLINICAL L. REV. 779, 781 (2013) (applying a “systems approach” to discrimination which the author defines as a “emphasis on teaching law students how particular systems—such as the criminal justice system, the mental health system, or the juvenile justice system—work at a day-to-day operational level. This approach encompasses both skills acquisition and social justice goals.”).

57. Donald C. Langevoort, *Caremark and Compliance: A Twenty-Year Lookback*, 90 TEMP. L. REV. 727, 729 (2018) (“As many corporate governance scholars have come to accept, corporations are complex interactive systems of processes, routines, and feedback, the efficacy of which cannot be taken for granted and hence becomes the crucial focus of the CEO and senior management team.”).

as a management team, finance department, and information technology.⁵⁸ These systems interact through processes in order to achieve the corporation's goals.⁵⁹ Corporations can also be perceived as part of larger systems such as a national economy or private conglomerate.⁶⁰

Regarding corporate governance, no part of governance can be understood on its own, but only within the larger framework to which it contributes.⁶¹ As a result, the "corporate governance system compris[es] a wide array of complementary institutions, incentive structures, constraints, and practices that work together to create a whole that is greater than the sum of its parts."⁶² More recently, systems theory has been applied to corporate law to show that managerial accountability erodes when shareholder value is perceived through a long-term lens.⁶³ Systems theory is then applied in order to develop a novel and more unified theory of understanding corporations.⁶⁴

Today, a small but promising literature applies systems theory to compliance and its practices. Compliance has a variety of stakeholders, such as regulators, firm, and management—inter-organizational structures that play a role in influencing a compliance system and to which a compliance function must respond.⁶⁵ A compliance function must also interact with, and be informed by, the legal environment of business in which it operates. Cases, statutes, regulations, and other sources of law are themselves a large system of rules and principles.⁶⁶ This system is not only expansive, but also adaptable in that numerous components interact with one another and adapt themselves to changing mandates from society.⁶⁷

From this perspective, two systems interact with one another. The necessary complexity, and even unnecessary convolution,⁶⁸ of laws relevant

58. Belinfanti & Stout, *supra* note 1, at 602.

59. Belinfanti & Stout, *supra* note 1, at 602.

60. Belinfanti & Stout, *supra* note 1, at 602.

61. Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1076 (2004).

62. *Id.* at 1075–76.

63. Belinfanti & Stout, *supra* note 1, at 583.

64. Belinfanti & Stout, *supra* note 1, at 583.

65. David Orozco, *A Systems Theory of Compliance Law*, 21 U. PA. J. BUS. L. 244, 270–90 (2020). Systems theory is also valuable to regulators who can use such thinking to help achieve regulatory excellence. Agnus Corbett, *A Systems Approach to Regulatory Excellence*, in *ACHIEVING REGULATORY EXCELLENCE* 255, 256 (Cary Coglianese ed. 2017).

66. Salzman et al., *supra* note 56, at 270. *See also* Lynn M. LoPucki, *supra* note 56, at 488–89 (referring to judiciary use of systems).

67. Salzman et al., *supra* note 56, at 270–71.

68. Robert C. Bird, *VUCA*, 12 VA. L. & BUS. REV. 367, 414 (2018) (defining convolution as "any complexity within a given system that is either unnecessary or inhibitory to the

to business can inflate the costs necessary to comply with legal rules.⁶⁹ Firms may be forced to spend significant resources to interpret and apply complex external rules, and may even experience frustrating dilemmas where successful compliance with one regulation frustrates the firm's capacity to comply with another regulation.⁷⁰ The result can be a cascading effect of feedback loops, whereby the compliance function is constantly responding to changes from other parts of the organization in order to meet the demands of external legal mandates.⁷¹

Further sharpening the understanding of compliance as a system, compliance has been theorized as a function of a variety of external factors that exert either a positive or negative force on internal compliance behavior.⁷² This view perceives compliance as a system of interlinked and interdependent forces that combine to produce a variety of outcomes within the enterprise.⁷³ The effects of these forces are intermediated by economic determinants and institutional determinants that impact how compliance practices will ultimately be implemented.⁷⁴ An effectively functioning system must be able to adapt to these changing forces, respond to stakeholder demands, such as a new regulatory regime, and swiftly incorporate those demands through its organization.⁷⁵

Looking at the compliance function from a business perspective, the success or failure of the compliance function is at least as much a management function as it is a legal function.⁷⁶ Most management functions perceive business functional areas as systems to be developed and managed.⁷⁷ The same should apply to compliance. Compliance is more than “legal lite”, but rather a complex business function that warrants the same sophisticated treatment as other functional areas.

Compliance functions, processes, and goals fit squarely within the definition of a system.⁷⁸ A compliance function is a dynamic and evolutionary system of processes that interdepend and interact with one

system's essential functions”).

69. Salzman et al., *supra* note 56, at 271.

70. Salzman et al., *supra* note 56, at 272.

71. Salzman et al., *supra* note 56, at 272.

72. Orozco, *supra* note 65, at 292.

73. Orozco, *supra* note 65, at 292.

74. Orozco, *supra* note 65, at 292.

75. See J.B. Ruhl, *Law's Complexity: A Primer*, 24 GA. ST. U. L. REV. 885, 887–88 (2008) (illustrating how systems and legal theory can intertwine).

76. Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMP. L. REV. 451, 459 (2003).

77. *Id.* at 459–60.

78. Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage*, 19 U. PA. J. BUS. L. 285, 291 (2017).

another. A firm's compliance system is unique to itself and responds to the firm's own "legal mix" of legal and regulatory challenges.⁷⁹ Compliance functions are also laden with processes and protocols that enable them to receive information from and communicate with various stakeholders in the organization. As a result, compliance as a discipline can benefit from systems thinking as much as any other business function in the organization.

II. SYSTEMS THINKING IN *CAREMARK* CLAIMS: *MARCHAND V. BARNHILL* AND THE GOVERNANCE QUARTET

An enduring principle of corporate governance is that a board of directors is obligated by two distinct duties toward the firm's shareholders. The first obligation is the duty of care. This duty requires a board to manage the affairs of the organization for the benefit of its shareholders.⁸⁰ A board member should act in good faith and as a reasonable person would under similar circumstances in order to advance the best interests of the corporation.⁸¹ The second obligation is the duty of loyalty, the obligation currently of most relevance to this manuscript,⁸² which requires a board member place the interests of the corporation over his or her own interests in making decisions on behalf of the company.⁸³

79. Robert C. Bird, *Law, Strategy, and Competitive Advantage*, 44 CONN. L. REV. 61, 74 (2011). Cf. William J. Woodward, Jr., *Contractarians, Community, and the Tort of Interference with Contract*, 80 MINN. L. REV. 1103, 1109 n.16 (1996) (discussing how lawyers advise clients with a legal mix that supports proposed courses of action).

80. Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 414 (2009).

81. *Id.* See also MODEL BUS. CORP. ACT § 8.30 (AM. BAR ASS'N 2017) (listing standards of conduct for directors).

82. The *Caremark* claim, the subject of this manuscript, was originally based on a breach of a board's duty of care. Robert T. Miller, *The Board's Duty to Monitor Risk After Citigroup*, 12 U. PA. J. BUS. L. 1153, 1156 n.24 (2010). However, the Delaware Supreme Court arguably "ripped the *Caremark* claim from its original home in the duty of care and reinvented it as a duty of loyalty." Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 975 (2009). This change appears to arise from *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003), in which the court stated:

Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations' compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith.

Id.

83. See, e.g., Lawrence Scheinert, *Hewlett-Packard's Spy Games and the "Duty of Caremark": How Inconsistent Standards Governing a Director's Duty of Care Disgraced a*

Since the court's 1963 ruling in *Graham v. Allis-Chambers Manufacturing Co.*, a board did not breach its obligations to shareholders unless the board encountered clear and present warnings signs suggesting illegal conduct.⁸⁴ However, in many industries such warning signs rarely reached the board of directors.⁸⁵ In order to balance the opposing interests of the need to respond to legality and the limited capacity of the board to seek out very possibility of wrongdoing, the court in *Caremark* required boards to make at least a good faith attempt to ensure that an adequate information and reporting system exists in the organization.⁸⁶ The failure to do so could render a board liable for losses from the improper conduct that arises from that failure to monitor.⁸⁷ Thus, the board maintains an obligation to ensure a monitoring and reporting system exist that can prevent illegality, but does not require the board to affirmatively root out specific instances of non-compliance in the organization.

Caremark kept shareholder claims on a tight leash. As the court explained in its now oft-quoted opinion, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”⁸⁸ The court made clear that its test held plaintiffs to a “quite high” standard that is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”⁸⁹ Such a difficult test was intended to stimulate good faith efforts by directors, but not be so burdensome that it deterred qualified individuals from serving on boards.⁹⁰

In the intervening years, *Caremark* claims were frequently unsuccessful, and such claims rarely survived long enough to impose liability on a director.⁹¹ One Delaware court even derided “the parade of

Company, 18 U. FLA. J.L. & PUB. POL'Y 447, 454 (2007) (briefly explaining this principle).

84. Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2158 (2019).

85. *Id.*

86. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

87. *Id.*

88. *Id.* at 971.

89. *Id.* at 967, 971.

90. *See id.* at 971.

91. Mercer Bullard, *Caremark's Irrelevance*, 10 BERKELEY BUS. L.J. 15, 17 (2013) (“Chancellor Allen established a heightened standard of care in *Caremark* while suggesting that it would very rarely, if ever, result in personal liability.”); Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1643 (2018) (noting that “*Caremark* claims rarely succeed”). *See also* Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 990 (2009) (stating that claims alleging failures in risk management rarely result in liability).

hastily filed Caremark complaints that Delaware courts have dismissed.”⁹² The pathway for imposing liability seemed quite narrow, and continued to be so, until a recent Delaware Supreme Court case, followed in close succession by the governance quartet raised the possibility of a broader or more flexible view of *Caremark* and its associated duties to shareholders.

A. Marchand v. Barnhill

In 2015, Blue Bell Creameries, a major ice cream manufacturer, suffered an outbreak of *listeria*.⁹³ The specific type of *listeria* species, *listeria monocytogenes*, is one of the most virulent human pathogens and can be especially dangerous for developing fetuses and immune-compromised individuals.⁹⁴ Over twenty percent of individuals who develop listeriosis as a result of a *listeria* infection die as a result.⁹⁵ Like other *listeria* outbreaks,⁹⁶ this outbreak had serious and fatal consequences. Three customers died and ten customers were hospitalized from *listeria monocytogenes* traced to consumption of Blue Bell ice cream.⁹⁷ In addition, shareholders suffered losses arising from the operational shutdown associated with the *listeria* outbreak.⁹⁸ The company was also forced to accept a dilutive private equity investment as a result of a liquidity crisis.⁹⁹ As a result, a stock holder sued two executives and members of the board of directors, alleging that they breached their duties of loyalty and care by failing to oversee Blue Bell’s operations and disregarding risks of contamination of Blue Bell’s ice cream.¹⁰⁰

The *Caremark* claim was filed in the Delaware Court of Chancery.¹⁰¹ After reviewing the facts and the relevant legal landscape, the court

92. *In re China Agritech, Inc. S’holder Derivative Litig.*, C.A. No. 7163-VCL, 2013 WL 2181514, at *40 (Del. Ch. Feb. 21, 2013). See also Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253, 281 (2014) (citing case for the principle that successful *Caremark* facts “are not easily alleged.”).

93. *Marchand v. Barnhill*, 212 A.3d 805, 807 (Del. 2019).

94. Kim Bosquet, *A Meticulous Food Safety Plan Today Avoids Handcuffs Tomorrow*, 14 J. FOOD L. & POL’Y 271, 278 (2018).

95. *Id.*

96. *Id.* (noting that “the deadliest foodborne illness outbreak in the U.S. since the early 1900s” was an outbreak of *listeria monocytogenes* that resulted in thirty-three deaths and 150 illnesses).

97. Parks & Cardinal, *supra* note 6, at 341–42.

98. *Marchand*, 212 A.3d at 807.

99. *Id.*

100. *Id.*

101. *Marchand v. Barnhill*, No. 2017-0586-JRS, 2018 WL 4657159, at *16 (Del. Ch. Sept. 27, 2018).

evaluated the plaintiff's *Caremark* claims.¹⁰² The court stated that in order to prove a *Caremark* claim, the plaintiff had to show either "(1) the directors utterly failed to implement any reporting or information system or controls; or (2) having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."¹⁰³ Evaluating the first prong, the court noted that plaintiff described the "intense regulatory scrutiny" under which Blue Bell operated and the internal systems and controls it had in place for detecting and reporting unsanitary conditions.¹⁰⁴ However, the trial court noted that no allegation was made showing that such controls were not implemented.¹⁰⁵ In responding to plaintiff's allegation that the board utterly failed in its oversight duty because it "had no audit or other supervisory structure" responsible for relevant controls, the court stated that no authority exists requiring directors to create certain committees to monitor and manage business risks, especially when evidence showed that risk management measures had been taken in Blue Bell's operations.¹⁰⁶ The court then characterized plaintiff's claim as a challenge to effectiveness of controls, not the existence of controls, and concluded that such a challenge is not a basis for first prong *Caremark* liability.¹⁰⁷

Finding itself unable to determine whether or not plaintiff intended to advance a second-prong argument, court quickly rejected plaintiff's second prong claim.¹⁰⁸ The court characterized plaintiff's arguments as Blue Bell could have anticipated the *listeria* crisis had the company possessed proper oversight.¹⁰⁹ The court stated this argument is not a *Caremark* claim and dismissed the plaintiff's complaint with prejudice.¹¹⁰

The plaintiff appealed to the Delaware Supreme Court, which took care to state that it was not examining the effectiveness of a board-level compliance and reporting system, but rather whether a reasonable inference exists that the board failed to make good faith efforts to implement a system of monitoring and reporting.¹¹¹ The court then presented a laundry list of allegations that Blue Bell lacked a monitoring and reporting infrastructure

102. *Id.*

103. *Id.* (quotation marks omitted).

104. *Id.* at *17.

105. *Id.*

106. *Id.* at *18 (quotation marks omitted).

107. *Id.*

108. *Id.* at *18–19.

109. *Id.* at *19.

110. *Id.* at *20.

111. *Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. 2019).

related to food safety compliance, practices, risks, or reports.¹¹² The board had no dedicated food safety committee, no process for regular reporting by management on food safety, and no schedule for the board to regularly consider food safety.¹¹³ In addition, the board received only limited information about deficiencies in Blue Bell's plants from management and did not appear to have regular discussions about food safety in its meetings.¹¹⁴ Such deficiencies in plant operations, the court recounted from plaintiff's complaint, could have been rectified if a reasonable reporting system to the board had been in place.¹¹⁵

The court stated the Blue Bell's nominal compliance with FDA regulations did not necessarily imply that it had a "system to monitor food safety *at the board level*."¹¹⁶ The court concluded: "The mundane reality that Blue Bell is in a highly regulated industry and complied with some of the applicable regulations does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a *Caremark* claim."¹¹⁷ The board's mere discussion of general operations was not enough to thwart a *Caremark* claim, for if the court let this be sufficient, "*Caremark* would be a chimera."¹¹⁸ The court reversed the trial court's decision and allowed plaintiff's *Caremark* claims to proceed.¹¹⁹

*B. Ignoring Systemic Wrongdoing: In re Clovis Oncology, Inc.,
Derivative Litigation and Hughes v. Hu*

Less than three months after the Delaware Supreme Court decided *Marchand*, the Court of Chancery decided the *Clovis* case. *Clovis* involved a pharmaceutical company that had a promising and potentially lucrative drug at the early stages of clinical trials.¹²⁰ This drug, Rociletinib or 'Roci', would be a direct competitor to rival firm AstraZeneca, which was also racing to develop its own promising and lucrative drug targeted at the same market.¹²¹ If Clovis could get the drug approved by the FDA, and bring it to

112. *Id.* at 822.

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at 823 (emphasis in original).

117. *Id.*

118. *Id.* at 824.

119. *Id.*

120. *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *1 (Del. Ch. Oct. 1, 2019).

121. *Id.* at *4.

market quickly, it would have a significant influence on the company's financial fortunes.¹²²

FDA approval requires proof of safety and efficacy in clinical trials. Clovis and the FDA agreed that the company would use for the clinical trial a well-established protocol known as RECIST.¹²³ A key metric for the drug's success in the clinical trial is the objective response rate (ORR), which measures the percentage of patients who experience a meaningful benefit as a result of the drug.¹²⁴ The board was "laser-focused" on the drug's ORR because it was an important measure for both the FDA and investors, upon whose capital Clovis entirely relied upon for funding.¹²⁵

Problems began when the board of directors learned that Clovis was improperly calculating Roci's ORR as more successful than it really was.¹²⁶ Inaccurately optimistic clinical trial results were reported to the public, investors, securities analysts, and the FDA over a significant period of time.¹²⁷ Evidence of Clovis's failure to follow RECIST and reports of inflated ORRs repeatedly reached the board of directors, and the board did not take any concrete action in response. As the trial court remarked, "[w]ith hands on their ears to muffle the alarms," the board signed and approved Clovis' 2014 annual report which contained the aforementioned misleading statements.¹²⁸ The charade continued until late 2015, when the public was finally informed of Roci's true and much-lower ORR than previously stated, and the firm's stock price immediately dropped seventy percent, wiping out one billion in capital as a result.¹²⁹

Clovis shareholders sued the company, alleging in part a *Caremark* claim that the board failed to institute an oversight system for the clinical trial and consciously ignored with a series of red flags regarding those trials.¹³⁰ Citing the presence of a nominating and corporate governance board committees, and extensive reviews of the clinical trial at each board meeting, the court concluded that plaintiffs did not show sufficient evidence of a lack of reporting or information system controls to sustain a *Caremark* claim.¹³¹

The court, however, did find evidence sufficient to support the

122. *Id.*

123. *Id.*

124. *Id.* at *5.

125. *Id.*

126. *Id.* at *6.

127. *Id.* at *6–7.

128. *Id.* at *7.

129. *Id.* at *8.

130. *Id.* at *13.

131. *Id.*

Caremark claim that the board failed to monitor its oversight system. The board was fully aware that management was misstating clinical trial results and not following required protocols.¹³² The board was comprised of experts in the pharmaceutical industry that understood the consequences of Clovis's actions.¹³³ The court concluded that it was "satisfied they have well-pled that the Board consciously ignored red flags that revealed a mission critical failure to comply with the RECIST protocol and associated FDA regulations."¹³⁴ The court then denied defendants' motion to dismiss the *Caremark* claim and allowed that claim to proceed.¹³⁵

Coupled with *Marchand*, the *Clovis* decision received attention about whether it portended a potential new trend for *Caremark* litigants.¹³⁶ Six months later another *Caremark* claimant survived a motion to dismiss in a case that again emphasized the court's concern about directors muffling their ears toward systemic wrongdoing within the company.¹³⁷ Unlike the specific instance of inaccurate calculation of Roci's ORR that should have raised an alarm in *Clovis*,¹³⁸ the shareholders in *Hughes v. Hu* sued based on "persistent problems with the Company's system of financial oversight over a prolonged period"¹³⁹ that resulted in harm to the organization.

The company at issue in *Hughes*, Kandi Technologies Group, was based in China but became a Delaware public company in 2007 through a reverse merger of a still publicly listed but defunct company.¹⁴⁰ Kandi sold parts to a joint venture in which it has fifty percent ownership to manufacture electric vehicles.¹⁴¹ The electric vehicles are then sold to a third company in which Kandi has less than a ten percent ownership interest and this third company then sells and leases the electric vehicles.¹⁴²

A 2010 audit of the company revealed "key audit risks" and a "key

132. *Id.*

133. *Id.* at *14.

134. *Id.* at *15.

135. *Id.*

136. See Robert C. Bird, *Caremark Compliance for the Next Twenty-Five Years*, 58 AM. BUS. L.J. 63 (2021) (discussing the evolution of *Caremark* cases). See also John Jenkins, *Something's Happening Here: Caremark Bites Another Board*, DEAL LAWYERS (Oct. 2, 2019), <https://www.deallawyers.com/blog/2019/10/somethings-happening-here-caremark-bites-another-board.html> [<https://perma.cc/TUT2-5SKR>] ("Is Caremark becoming a more viable theory of liability, or is board's conduct in these cases just more egregious than in prior cases?").

137. *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020).

138. *Clovis Oncology, Inc.*, 2019 WL 4850188, at *7.

139. *Hughes*, 2020 WL 1987029, at *13.

140. *Id.* at *2.

141. *Id.*

142. *Id.*

control weakness” for related-party transactions.¹⁴³ The audit further identified, although did not address it as a key control weakness, that several of the employees of the company, including its CEO Hu, held large sums of the company’s cash resources in personal bank accounts.¹⁴⁴ Audit reports for the years 2011, 2012, and 2013 continued to raise issues about the financial controls and processes of the company that remained unaddressed and instead often showed repeated occurrences of risky practices concerning related-party transactions raised in the 2010 audit.¹⁴⁵ All the more remarkable, the auditing firm reporting these concerns was not independent of Kandi Technologies Group, as it had no other clients than the company.¹⁴⁶ In March 2014, the company again reported a material weakness in its financial reporting, including lack of oversight by the audit committee and inadequate policies regarding related-party transactions.¹⁴⁷

Despite the serious nature of the lack of financial controls and procedures and a pledge by the company to address the numerous inadequacies, the audit committee did not meet again for two months.¹⁴⁸ Two May meetings were intended to review related-party transaction policies but lasted less than an hour and the company could not produce reports from the meetings.¹⁴⁹ This pattern of few audit committees, lack of financial controls, and no oversight continued with the only tangible action taken by the board was approval to fire their auditing firm.¹⁵⁰ Ultimately, in March 2017 the company announced that its financial statements between 2014 and 2016 were unreliable and that the financial reports would be restated.¹⁵¹ During the relevant time period, Kandi Technologies Group had three people serve as the Chief Financial Officer.¹⁵² Three directors participated on the audit committee along with CEO Hu over the relevant time period when audits reported major financial inadequacies.¹⁵³

In denying the motion to dismiss the court found the shareholders allegations supported an inference that the audit committee “met sporadically, devoted inadequate time to its work, had clear notice of

143. *Id.* at *3.

144. *Id.*

145. *Id.* at *3–4.

146. *Id.* at *3.

147. *Id.* at *4.

148. *Id.*

149. *Id.* at *4–5.

150. *Id.* at *6–8.

151. *Id.* at *8.

152. *Id.* at *9.

153. *Id.* at *9.

irregularities and consciously turned a blind eye to their continuation.”¹⁵⁴ Instead, the audit committee relied on management for reports, policies and procedures, and hiring and firing the external auditors.¹⁵⁵ Despite having the structure of oversight, no true oversight was demonstrated by board members on the audit committee or non-audit committee board members.¹⁵⁶ The directors themselves, particularly those on the audit committee, lacked the expertise necessary to perform the oversight function that was their obligation¹⁵⁷

The *Clovis* court chastised directors muffling their ears while alarms were raised and the *Hughes* court similarly rebuked directors for turning a blind eye when serious and systemic company wrongdoing should have triggered closer examination of financial processes. In *Clovis*, the court noted that the directors’ expertise in the pharmaceutical industry meant they knew the consequences of these actions while in *Hughes*, the directors lacked the skills and independence to perform the oversight function adequately. In each case, the companies failed the standard of oversight demanded in *Caremark* and *Marchand*.

C. Critical Information Flows: Teamsters Local 443 Health Services & Insurance Plan v. Chou and Inter-Marketing Grp. USA, Inc. v. Armstrong

Two *Caremark* claims survived motions to dismiss in addition to *Hughes* in 2020. Both claims echo the *Marchand* court’s focus on compliance in highly regulated industries at the board level.¹⁵⁸ These cases

154. *Id.* at *14

155. *Id.*

156. *Id.* at *15. *See also In re McKesson Corporation Derivative Litig.*, Case No. 17-cv-01850-CW, 2018 WL 2197548, at *23 (N.D. Cal. May 14, 2018) (“Defendants claim that they were simply ignorant of what was happening with the company because they were constantly reassured that if any problems existed, they were being addressed. At this stage, however, Plaintiffs have plausibly alleged sufficient factual allegations constituting multiple ‘red flags’ that Defendants ignored.”).

157. *Hughes*, 2020 WL 1987029, at *15

The directors charged with implementing a system to oversee the Company’s financial reporting thus lacked the expertise necessary to do so all along. Instead, the Audit Committee deferred to management, which dictated the policies and procedures for reviewing related-party transactions and hired and fired the Company’s auditor, even though management’s actions suggested that it was either incapable of accurately reporting on related-party transactions or actively evading board-level oversight.

158. *See Marchand v. Barnhill*, 212 A.3d 805, 823 (Del. 2019) (addressing compliance in context of a highly regulated industry).

demonstrate that failure to address known compliance deficits can rise to the level of bad faith that will permit a *Caremark* claim to survive. In *Teamsters Local 443 Health Services & Insurance Plan v. Chou*,¹⁵⁹ the court focused on the mission critical compliance addressed in *Marchand*.¹⁶⁰ Shareholders of AmerisourceBergen Corporation (“ABC”) sued alleging that ABC’s board failed to oversee a division of its operations that resulted in criminal and civil liability. In analyzing the claim the court noted that the purpose of the corporation was to manufacture, distribute, and package pharmaceutical drugs. Therefore ABC, like Blue Bell and Clovis, operated in a highly regulated industry.¹⁶¹ When operating in such an environment the mission is intrinsically connected to legal compliance. Thus, “flouting laws meant to ensure the safety and purity of drugs destined for patients suffering from cancer is directly inimical to the central purpose of ABC’s business.”¹⁶² Although ABC is a significantly more complex operation than either Blue Bell or the biopharmaceutical firm Clovis, that does not relieve the board of diligent oversight, but rather makes the oversight all the more central to board responsibilities.¹⁶³

ABC acquired Oncology Supply Pharmacy Services (“Pharmacy”) as part of a larger merger in 2001. The business of Pharmacy was to buy single dose vials of oncology drugs, fill a syringe, and then sell that syringe to cancer patients for injection.¹⁶⁴ The vials that Pharmacy acquired intentionally had “overfill,” meaning there was additional medication than required for a single injection to account for human error and to allow discharge to remove air bubbles.¹⁶⁵ The extra amount of medication is not meant for use, but Pharmacy illegally aggregated the extra amounts and used it to fill additional syringes.¹⁶⁶ This resulted in contamination of the aggregated drugs.¹⁶⁷ This illegal practice was uncovered and resulted in ABC criminal and civil liability.

Should directors be responsible for the criminal enterprise in one subsidiary of a large and complex operation? The court opined on the *Caremark* claim:

It is true that directors are not omniscient, that their eyes cannot be

159. C.A. No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020).

160. *See infra* Part III.D.

161. *Chou*, 2020 WL 5028065 at *18.

162. *Id.*

163. *Id.* at *3–4

164. *Id.* at *4.

165. *Id.* at *12.

166. *Id.* at *1.

167. *Id.* at *5.

on every sparrow, and that not every failure of oversight is the result of bad faith. Here, however, ABC operated a criminal enterprise. The directors ignored such red flags as did exist, and, in addition, permitted a woefully inadequate reporting system with respect to the business line in which Pharmacy operated.¹⁶⁸

The major red flag relied on by the court for *Caremark* claim analysis was a *qui tam* action filed against ABC by Michael Mullen, the former COO of the division responsible for Pharmacy and a member of ABC's Corporate Ethics Committee.¹⁶⁹ When Mullen identified significant business issues within his division, which included Pharmacy, he formulated strategic initiatives to address the issues and alerted board level management.¹⁷⁰ After several months of raising safety and regulatory compliance issues, Mullen was fired.¹⁷¹ He then filed a *qui tam* complaint alleging that the overfill program acted as a kickback scheme and price concession to physician customers.¹⁷² Although ABC's counsel became aware of the complaint, he did not disclose the complaint to the board directly.¹⁷³ However, the complaint was disclosed in ABC's Form 10-K filed with the SEC in 2010 and 2011.¹⁷⁴ These filings were signed by the members of the board.¹⁷⁵

The court found that failure to address the issues raised by the *qui tam* action, require reports and updates on implementation of compliance initiatives, or take other actions concerning the syringe-filling program infers bad faith by the board and potential *Caremark* liability.¹⁷⁶ Management learned about the *qui tam* action and terminated a high-level employee without a system that required such critical information to flow to the directors.¹⁷⁷ Furthermore, the board offered only cursory references to the compliance issue while the court expected "a tangible reaction to—as opposed to a review of—the mission critical compliance failures at Pharmacy."¹⁷⁸

The fourth of the post-*Marchand* cases to survive a motion to dismiss is *Inter-Marketing Grp. USA, Inc. v. Armstrong*.¹⁷⁹ Similar to *Chou*,

168. *Id.* at *2.

169. *Id.* at *11.

170. *Id.*

171. *Id.* at *12.

172. *Id.* at *13.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.* at *17.

177. *Id.* at *21.

178. *Id.* at *25.

179. C.A. No. 2017-0030-TMR, 2020 WL 756965 (Del. Ch. Jan. 31, 2020) (concerning a

adequate information flow to the board from operations so that directors can take action on compliance failures is a central focus of this decision. Plains All American Pipeline's sole business was owning and maintaining pipelines throughout North America.¹⁸⁰ In 2015 one of these pipelines located in California ruptured, spilling 3,400 barrels of oil in the Pacific Ocean and in environmentally sensitive areas along the coast.¹⁸¹ The spill was caused by pipe corrosion.¹⁸² The clean-up efforts alone cost the company \$257 million.¹⁸³ Later, the company was found criminally liable for its pipeline maintenance.¹⁸⁴

In a breach of contract claim, the court employed *Caremark* analysis.¹⁸⁵ Similar to Blue Bell's failure to implement director level oversight of consumer safety and legal compliance, the board of Plains failed to implement a system of pipeline integrity and management oversight.¹⁸⁶ Rather, the record showed that the decision to investigate problematic pipelines was made, "probably three or four, maybe five or six levels down" from top management.¹⁸⁷ Safety issues related to the pipelines were not discussed at the board level.¹⁸⁸ What the board received about the pipelines were "activity-level" reports that detailed projections for the year relative to actual pipeline activity.¹⁸⁹ These amounted to graphs "devoid of substance" and did not demonstrate that the board "ever considered pipeline integrity variances or that the explanations contained more substantive information than the general activity-level reports."¹⁹⁰ Given that the one purpose of the company was to maintain pipelines, this lack of detailed information about how well the pipes were maintained did not meet the oversight obligation of the company's directors.¹⁹¹

Similar to compliance risks ignored by directors in *Marchand* and the other post-*Marchand* decisions surviving the motion to discuss, delegating

Delaware general partnership but utilizing Delaware corporate law analysis).

180. *Id.* at *2.

181. *Id.* at *3.

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.* at *10 ("This opinion does not rule that a general partner's contractual requirement to act in 'the best interests of the [p]artnership' imposes duties identical to those identified in *Caremark*. Nonetheless, this opinion does as the parties have and analyzes these contract based oversight liability claims using *Caremark's* established framework.").

186. *Id.* at *13.

187. *Id.* at *12.

188. *Id.*

189. *Id.* at *14.

190. *Id.*

191. *Id.*

oversight for compliance to an audit committee does not create a system for adequate disposal of oversight. Although the board of Plains delegated to an audit committee responsibility for overseeing legal and compliance issues, no reports indicated the committee performed pipeline integrity reviews, which was the board's central compliance risk.¹⁹²

As individual cases, *Marchand* and the governance quartet decisions are significant in their own right because they are rare examples of *Caremark* claimants surviving a motion to dismiss. These cases also offer opportunities to evaluate and revisit the nature and scope of *Caremark* claims as the *Caremark* case reaches its twenty-fifth year as a seminal case in corporate governance.¹⁹³ Most importantly for purpose of this manuscript, however, these decisions present evidence of a fundamental shift toward a way of thinking about the monitoring and reporting systems of organizations that ensure compliance with relevant laws and policies. This shift in thinking toward a systems understanding of corporate governance represents a new paradigm in perceiving how compliance programs are expected to function in organizations. This paradigm did not emerge overnight, and the next Part explores how courts incorporated systems thinking, and not just gatekeeping, in their decisions about corporate governance.

III. FROM GATEKEEPING DISCOURSE TO SYSTEMS THINKING IN *CAREMARK* CLAIMS

The incorporation of systems thinking into the *Marchand* and governance quartet cases did not happen overnight. This perspective is the result of a long evolution of Delaware cases that date back to the original *Caremark* decision in 1996.¹⁹⁴ This Part highlights a gradual shift in *Caremark* cases from a reliance on gatekeeping unworthy plaintiffs who merely challenge the effectiveness, and not the existence, of compliance controls, toward an emphasis on perceiving compliance as a holistic system with attendant responsibilities for the board of directors. Section A chronicles the decline of gatekeeping discourse. Section B shows the subtle development and recognition of systems thinking, and its associated broader liability for board members, under more recent *Caremark* claims.

192. *Id.* at *13.

193. *See generally* Bird, *supra* note 136 (discussing the evolution of *Caremark* cases).

194. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). *See also* Paul E. McGreal, *Caremark in the Arc of Compliance History*, 90 *TEMPLE L. REV.* 647, 668-77 (2018) (tracing the evolution of *Caremark* claims from a compliance perspective since 1996).

A. *The Decline of Gatekeeping Discourse*

Caremark claims have a high burden of proof. Proving that a board of directors failed in a sustained or systemic fashion to exercise oversight over a firm's monitoring system requires a veritable mountain of evidence. With *Caremark* claims a not infrequent occurrence in Delaware courts, the motion to dismiss phase of litigation serves as an important gatekeeping function that keeps most *Caremark* claims from going to trial.¹⁹⁵ By placing the burden on plaintiffs to plead plausibly and with precision at the initial stages of litigation, the weakest claims are filtered out.¹⁹⁶ Courts keep judicial workload in check and defendants remain unburdened from costly discovery and summary judgment motions arising from unmeritorious litigation.¹⁹⁷

The motion to dismiss has played an influential role in *Caremark* litigation, with failed *Caremark* claims creating a veritable graveyard of unfavorable precedent. Reviewing the guiding language of *Caremark* cases in isolation and acknowledging the high failure rate of *Caremark*-based litigants, it would be reasonable to conclude that courts have all but “slammed the door shut” on future litigation.¹⁹⁸ Reinforcing this notion yet further is that barrier-setting *Caremark* language has been repeatedly relied upon by *Caremark* courts. Over 187 court cases over a twenty-plus year period have noted that *Caremark* is notable for being one of, if not the most, difficult theories of proof in corporate law.¹⁹⁹ Furthermore, over 200 secondary sources have similarly acknowledged that *Caremark* liability is exceedingly difficult to establish.²⁰⁰

That does not necessarily mean, however, that *Caremark*'s prohibitory

195. Cf. Michael Daly Hawkins & Matthew J. Stanford, *Uproot or Upgrade? Revisiting Section 230 Immunity in the Digital Age*, 06/23/2020 U. CHI. L. REV. ONLINE 1, 5 (explaining that motions to dismiss serve a gatekeeping function in civil litigation). For a general discussion of gatekeeping in the corporate context, see Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735 (2004).

196. Hawkins & Stanford, *supra* note 195, at 5.

197. Hawkins & Stanford, *supra* note 195, at 5–6.

198. See MARK A. SARGENT & DENNIS R. HONABACH, D&O LIABILITY HANDBOOK, THE TRADITIONAL LEGAL FRAMEWORK—THE OVERSIGHT CASES § I:7 (2020).

199. A Westlaw search for “Caremark”/p (“most difficult” or “among the hardest”) in the “Cases” database on December 2, 2020 yielded 187 cases. This search is the same as one conducted in Claire A. Hill, *Caremark as Soft Law*, 90 TEMP. L. REV. 681, 682 n.3 (2018), which yielded 155 cases. The seminal statement of this concept is unsurprisingly found in *In re Caremark Int'l Inc. Derivative Litig.*, 968 A.2d 959, 967 (Del. Ch. 1996) (stating that an oversight claim “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment”).

200. A Westlaw search for “Caremark”/p (“most difficult” or “among the hardest”) in the “Secondary Sources” database on December 2, 2020 yielded 215 examples.

language will always retain the same influence that it did in 1996. Although guiding language established by an earlier court can remain intact, the influence of that language and the interpretive gloss it is given by later courts can change over time.²⁰¹ Conversely, ostensibly rigorous judicial language can be so eroded that its interpretation remains a mere shadow of its plain meaning.²⁰²

Similarly, evidence now suggests that an interpretive drift is occurring in *Caremark* claims. Comparing the original *Caremark* case to its recent progeny highlights its changing influence. The 1996 *Caremark* case went to great lengths to keep the barriers facing shareholder-plaintiffs high, constraining a viable claim to only the “utter failure to attempt” to ensure a reasonable reporting system.²⁰³ The court called this a “demanding test” and a theory that “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”²⁰⁴ Viewing this language in isolation could leave one to wonder why the *Caremark* court bothered to open the door to liability at all.

201. Perhaps the most famous example of such an evolution is constitutional law scholar Gerald Gunther’s interpretation of the phrase ‘strict scrutiny’. Gunther argued that, although the courts applying strict scrutiny were ostensibly giving elevated review to certain legislation, what was really happening was that the determination that the strict scrutiny standard applied inevitably meant that the legislation would be struck down as unconstitutional. Gerald Gunther, *The Supreme Court, 1971 Term - Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection*, 86 HARV. L. REV. 1, 8 (1972). For an empirical perspective, see Adam Winkler, *Fatal in Theory and Strict in Fact: An Empirical Analysis of Strict Scrutiny in the Federal Courts*, 59 VAND. L. REV. 793, 795–96 (2006) (studying all strict scrutiny cases between 1990 and 2003 in federal courts and concluding that, “strict scrutiny is far from the inevitably deadly test imagined by the Gunther myth and more closely resembles the context-sensitive tool described by [Justice] O’Connor”).

202. Under the Commerce Clause of the U.S. Constitution, the Congress may regulate if the subject has a “substantial economic effect on interstate commerce.” *Wickard v. Filburn*, 317 U.S. 111, 125 (1942). Yet in spite of the use of the word “substantial,” courts are highly deferential to the actions of Congress in regulating commercial activities. In the context of eminent domain, government agencies may only seize privately-owned land when it is “necessary” to further a public use but courts have interpreted the word “necessary” so loosely that virtually any proffered interest by the government constitutes sufficient necessity to seize private land. Robert C. Bird, *Reviving Necessity in Eminent Domain*, 33 HARV. J.L. & PUB. POL’Y 239, 243–46 (2010).

203. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) (“Such a test of liability—lack of good faith as evidenced by sustained or systemic failure of a director to exercise reasonable oversight—is quite high.”); *id.* (“[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”).

204. *Id.* at 967, 971.

Viewing the same Delaware court system interpreting the same claim over two decades later, however, reveals a cognizable turn away from this prohibitive language. Instead of having a dominant influence on the court's analysis, the *Marchand* court relegated the "utter failure" concept to single unanchored quotation in the text and two references in the footnotes.²⁰⁵ None of these references seemed to drive the court's thinking in any significant way. Similarly, the oft-quoted notion that a *Caremark* claim was the "most difficult theory in corporation law" received only parenthetical attention in a single footnote.²⁰⁶ The court cited this language for the proposition that "*Caremark* claims are difficult to plead and ultimately to prove out."²⁰⁷ Finally, whereas *Caremark* made clear that it offered a "demanding test" for liability,²⁰⁸ that language was not relied upon in *Marchand*. Although not a wholesale rejection of *Caremark* constraints, it arguably represents a step down from being the "most difficult theory in corporation law" to one that is merely challenging to plead and prove.²⁰⁹ Intriguingly, the *Marchand* court did not go out of its way to emphasize *Caremark*'s narrow opening for liability, a prominent theme in the original *Caremark* case.

Some deemphasis of *Caremark*'s gatekeeping language is also arguably present in *Clovis*. The *Clovis* opinion was written by a trial judge and not the supreme court, and mindful of its obligations to *stare decisis*, it not surprising to see *Clovis* hewing closer to prior precedent than *Marchand*. *Clovis* did not note that the *Caremark* claim was a "demanding test" for liability. *Clovis* twice stated that a plaintiff must show that the directors "completely fail[ed] to implement" a system or controls for one prong of a *Caremark* claim,²¹⁰ but did not mention the "utter failure" language.²¹¹ The reminder that *Caremark* was "the most difficult theory" to plead and prove was cited for the proposition that "a *Caremark* claim is among the hardest to plead and prove."²¹²

Similar deemphasis is present in the *Caremark* claims surviving motion to dismiss after *Clovis*. These subsequent cases do not describe *Caremark* as a "demanding test" but characterize it more as a necessary check on directors that fail in necessary oversight. For instance, in *Chou* the court acknowledges that *Caremark* liability is rarely imposed but does not credit

205. *Marchand v. Barnhill*, 212 A.3d 805, 809, 821 n.104, 822 n.106 (Del. 2019).

206. *Id.* at 820 n.99.

207. *Id.* at 820.

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

209. *Marchand*, 212 A.3d at 820; *Caremark*, 698 A.2d at 967.

210. *Clovis*, 2019 WL 4850188, at *12–13.

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

212. *Clovis*, 2019 WL 4850188, at *12.

the difficulty of the standard but rather that “it is fortunately rare that directors, otherwise unconflicted, should nonetheless take actions knowingly inimical to the corporate interest, such as ignoring a known duty to act to prevent the corporation from violating positive law.”²¹³ The *Hughes* court described *Caremark* liability “conceptualized as flowing from an overarching failure by the directors to take the action necessary to protect the corporation.”²¹⁴ These subsequent cases take their cue from the earlier judicial signaling in *Marchand*.

In spite of the presence of gatekeeping language, the courts found in all these cases that the plaintiffs met the pleading burden and allowed the claims to survive a motion to dismiss. Both courts and commentators have noted that *Caremark* claims rarely succeed,²¹⁵ and thus the survival of this claim in four cases in less than twelve months following the *Marchand* decision is significant.

The “utter failure” language and other admonitions like it will not simply vanish from the *Caremark* lexicon. However, there appears to be a perceptible deemphasis of the gatekeeping language that makes *Caremark* claims so difficult to plead and prove. When judicial language appears to be mentioned only in passing, rather than a keystone of the standard to be applied, that language will lose its influential power.

If *Caremark*'s gatekeeping language may have been relaxed, as *Marchand* and the governance quartet appear to indicate, the question remains of what evidence might fill the vacuum. Not only has there been a shift away from narrowly allowing *Caremark* claims, but there has been a meaningful rise in systems thinking when evaluating whether the board has met its duty of care.²¹⁶ The next section highlights how systems thinking is playing an emergent historical role in *Caremark* cases.

213. *Teamsters Local 443 Health Svcs. & Ins. Plan v. Chou*, C.A. No. 2019-0816-SG, 2020 WL 5028065, at *1 (Del. Ch. Aug. 24, 2020).

214. *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029, at *13 (Del. Ch. Apr. 27, 2020).

215. See, e.g., *In re China Agritech, Inc. S'holder Derivative Litig.*, C.A. No. 7163-VCL, 2013 WL 2181514, at *20 (Del. Ch. Feb. 21, 2013) (skeptically referring to *Caremark* oversight claims as a “parade of hastily filed *Caremark* complaints that Delaware courts have dismissed” and that there are “rare *Caremark* complaints that prior decisions have found adequate”); Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 COLUM. L. REV. 1583, 1643 (2018) (noting that “*Caremark* claims rarely succeed”); Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 1013, 1042 (2019) (stating that *Caremark* claims have a “rare path of survival”).

216. See *Marchand*, 212 A.3d at 824 (“If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty.”).

B. The Recognition and Development of Systems in Firms

While the apparent relaxation in *Caremark* claims appears to be relatively recent, the use of systems and systems thinking has a long and evolving history. Systems thinking began over fifty years ago with *Graham v. Allis-Chalmers*,²¹⁷ a 1963 Delaware Supreme Court decision that was the then seminal case in corporate governance about the directorial duty to monitor for illegal acts by subordinates.²¹⁸ In *Graham*, senior management became embroiled in a price-fixing conspiracy in violation of antitrust law, resulting in fines and penalties for the firm.²¹⁹ Prior to *Graham*, there were no cases that challenged a board's failure to act to monitor whether management was engaging in misconduct.²²⁰ Instead, they involved affirmative decisions made by the board.²²¹ *Graham* held that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."²²² *Graham* also remarked, "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."²²³

A few points are notable from *Graham*'s language. *Graham* does not entirely bar claims against directors, but rather notes that the duty to monitor may exist if a "cause for suspicion" exists to do so.²²⁴ This is reflected in modern cases by requiring shareholder plaintiffs to show some failure of the board to respond to warning signs of misconduct in order to survive a motion to dismiss. A "corporate system of espionage" invokes, although with gentler language, the concept of the monitoring function in a company.²²⁵

Furthermore, underlying both holdings is the concept of a system. *Graham* anticipates that when a cause for suspicion arises, boards must take action through a system of monitoring. Perhaps *Graham* only contemplated monitoring systems when problems appeared, but today such systems are

217. 188 A.2d 125 (Del. 1963).

218. See Gregory S. Rowland, *Earnings Management, The SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 195 n.114 (2002) (referring to *Graham* as a seminal case); Primo Fontana, *CERCLA Derivative Suits*, 27 B.C. ENVTL. AFF. L. REV. 741, 746 (2000) (same).

219. *Graham*, 188 A.2d 125, 129–30 (Del. 1963).

220. Jack B. Jacobs, *Fifty Years of Corporate Law Evolution: A Delaware Judge's Retrospective*, 5 HARV. BUS. L. REV. 141, 149 (2015).

221. *Id.* at 149.

222. *Graham*, 188 A.2d at 130.

223. *Id.*

224. *Id.*

225. *Id.*

ubiquitous in most modern organizations in the form of compliance programs. Whether inadvertently or by design, *Graham* set the stage for more mature discussions of systems in duty of oversight cases.

When *Caremark* was decided twenty-three years later, the court confronted the systems-related holding. The court asked itself whether *Graham* would have tolerated an interpretation that corporate directors have no duty “to assure that a corporate information gathering and reporting systems exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations?”²²⁶ The court “certainly [did] not believe so” and doubted that such a “broad generalization of the *Graham* holding would have been accepted by the Supreme Court in 1963.”²²⁷ After reviewing *Graham* and later cases, the *Caremark* explicitly refuted such an anti-systems idea, stating that it would be a “mistake to conclude that . . . *Graham*[’s statement] concerning ‘espionage’ means that corporate boards may satisfy their obligation to be reasonably informed . . . without assuring themselves that information and reporting systems exist in the organization” that provide timely and accurate information to the board of directors.²²⁸ *Caremark* was thus written explicitly with systems of reporting and monitoring in mind, leaving the door open for future courts to further rely on systems language in evaluating boards’ obligations to the organization.

This perspective carried forward to *Marchand* and the governance quartet. All five of the cases rejected the notion that ad-hoc compliance, the antithesis of systemic thinking, would be sufficient to withstand a *Caremark* claim against the board. For example, the company in *Marchand* argued that it conformed to FDA regulations in its food safety practices.²²⁹ However, the court cited that such conformance does not necessarily infer that the board

226. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996).

227. *Id.* at 969.

228. *Id.* at 970. The court’s full statement, essentially a single run-on sentence, was:

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

Id. at 970.

229. *Marchand v. Barnhill*, 212 A.2d 805, 823 (Del. 2019).

actually implemented a system to monitor food safety.²³⁰ In addition, the court said such nominal conformance does not necessarily infer that an appropriate monitoring system engaged the board.²³¹ Similarly, *Clovis* did not accept that the mere existence of two relevant board sub-committees, the nominating and corporate governance committee and the audit committee, were enough to thwart a potential *Caremark* claim.²³² In both *Hughes* and *Inter-Marketing Group* the existence of an audit committees with compliance obligations did not suffice to survive motions to dismiss.²³³ Boards cannot expect compliance functions in isolation from one another and not in coordination with the broader needs of the organization as sufficient compliance to withstand *Caremark* liability.

Finally, and perhaps most bluntly, modern holdings have increased their reliance on systems language. In the original *Caremark* case, the word ‘system’, or some derivative of it, appeared sixteen times.²³⁴ In the *Marchand* case, a shorter opinion than *Caremark*, ‘system’ or its derivative appeared forty-six times.²³⁵ In the *Clovis* and *Inter-Marketing* cases, where the *Caremark* claim received significantly less written attention than in *Caremark* or *Marchand*, both still used the term fifteen times, largely for citing language from *Caremark* and *Marchand* with approval.²³⁶ In *Hughes* the word or its derivative was used twenty-seven times.²³⁷ While a single term does not conclusively inform substance, judges do choose words carefully and strategically in order to achieve descriptive and normative goals.²³⁸ The increased use of the systems concept when comparing the

230. *Id.*

231. *Id.*

232. *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *2-*3 (Del. Ch. Oct. 1, 2019).

233. *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029, at *15 (Del. Ch. Apr. 27, 2020); *Inter-Matg. Grp. USA, Inc. v. Armstrong*, C.A. No. 2017-0030-TMR, 2020 WL 756965, at *13 (Del. Ch. Jan. 31, 2020).

234. This was measured by downloading a pdf of the Westlaw version of the opinion, converting it to a Word document, and then using the search functions to count the number of times the word “system” or its derivatives appeared in the document.

235. *Marchand*, 212 A.3d 805 *passim* (Del. 2019).

236. *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188 *passim* (Del. Ch. Oct. 1, 2019). Twice the word “system” was used, but only to describe the RECIST protocols in a context unrelated to the *Caremark* claim. *Id.*; *Inter-Mktg. Group*, 2020 WL 756965 *passim*. This includes the use of the word “systematic” when quoting from the complaint. *In re Clovis Oncology, Inc.*, 2019 WL 4850188 at *12.

237. *Hughes*, 2020 WL 1987029 *passim*. In *Chou* the term was used just fourteen times with the opinion focused on “red flag” language to determine that the board should have demanded more information.

238. See, e.g., Rachael K. Hinkle et al., *A Positive Theory and Empirical Analysis of Strategic Word Choice in District Court Opinions*, 4 J. LEGAL ANALYSIS 407, 436–40 (2012)

Caremark and *Marchand* opinions is noteworthy.

C. The Increasing Expectations of Board Process and Engagement

In addition to recognizing the relevance of a system in *Caremark* cases, courts have also faulted boards for lacking adequate system traits in their information and reporting systems. Some of *Marchand's* most cogent criticisms were levied against failures of process by Blue Bell. Functioning processes are essential for making a system work. It is through established processes that systems receive, evaluate, and transmit information to other parts of the system in order to achieve a particular goal.²³⁹

In *Marchand*, the board lacked functioning system processes that would enable information to reach the board for consideration. First, the board lacked a food safety committee.²⁴⁰ Given the nature of Blue Bell's business, such a committee in hindsight appears to be an obvious need to make a compliance system work. A board subcommittee can act as a first line of evaluation of issues before invoking the limited time and resources of the full board of directors. This process will enable information passing through a compliance system to reach members of the board more readily and allow members of the board who have a specific expertise in food safety to be dedicated to the task. In addition, the court cited as problems the lack of a regularized process to report food safety issues to the board and for the board to consider future food safety risks.²⁴¹ These criticisms highlight that *Marchand* was not only concerned with a reactive system process to respond to problems, but also proactive systems process to receive information about and take action on safety risks that could become problems in the future.

(finding a statistically significant increase in the use of certain language by judges depending on the ideological distance between district and appellate courts). The authors also present an insightful discussion of the uses and importance of judicial text. *Id.* at 408–12. This does not necessarily mean, however, that rigid interpretations of words and word counts should dominate interpretation. For example, a reader should be cautious of when courts rely on dictionary definitions to interpret terms, as doing so encourages using words mechanically and in isolation. Adam Liptak, *Justices Turning More Frequently to Dictionary, and Not Just for Big Words*, N.Y. TIMES (June 13, 2011), <https://www.nytimes.com/2011/06/14/us/14bar.html>.

239. LoPucki, *supra* note 58, at 583; Mingers & White, *supra* note 37, at 1148 (conducting a literature review of systems thinking in operational research and management science and finding that structure and process are fundamental to systems thinking); Linda Booth Sweeney & John D. Sterman, *Bathub Dynamics: Initial Results of a Systems Thinking Inventory*, 16 SYSTEMS DYNAMICS REV. 249, 250 (2000) (stating that system thinking skills require in part the discovery and representation of feedback processes).

240. *Marchand v. Barnhill*, 212 A.2d 805, 822 (Del. 2019).

241. *Id.*

Marchand also criticized the board for lacking evidence of any discussion of food safety issues.²⁴² This again is evidence of a failure of process. Even if warning signs were being raised by employees, and transmitted up the chain of authority by managers, this information was not reaching the board of directors. For whatever reason, the board was unable to realize it was being kept in the dark on critical matters of firm operations. The absence of a functioning system and its processes contributed to the poor oversight resulting in customer injuries and deaths. A board cannot remain uneducated about key risks facing the organization and expect to avoid *Caremark* liability.

In addition, *Marchand* makes clear that the board of directors must meaningfully engage with any compliance system. No system of information, no matter how well its processes may be, will function if the recipients of that information cannot engage with it effectively. Attorneys for Blue Bell argued that the plaintiff did not articulate a *Caremark* claim because management discussed general operations with the board at management's discretion.²⁴³ For the *Marchand* court, that was not enough. The court dismissed this argument, stating that "if that were the case, then *Caremark* would be a chimera."²⁴⁴ Virtually any meeting between management and the board could invoke some operational issue,²⁴⁵ and if that sufficed as a compliance system then a board's obligation to compliance under *Caremark* would practically disappear. The court chided Blue Bell for lacking a specific schedule for discussing important food safety risks.²⁴⁶

Similarly, the governance quartet require meaningful engagement of the board of directors. The *Clovis* case highlights the fact the board appeared unacceptably avoidant of the problems facing the organization.²⁴⁷ There appeared to be no justifiable reason why the *Clovis* board did not meaningfully engage with, and make decisions on, the questionable test results for the new drug. In *Hughes*, the court described the board as having the "trappings of oversight" but noted that, like their counterparts in *Marchand* they were not engaged in a reporting system.²⁴⁸ The ABC audit committee "never received any reports specifically concerning compliance at Pharmacy," and "had no committee specifically designated to oversee

242. *Id.*

243. *Id.* at 824.

244. *Id.*

245. *Id.*

246. *Id.* at 822.

247. *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *7 (Del. Ch. Oct. 1, 2019).

248. *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029, at *16 (Del. Ch. Apr. 27, 2020).

compliance with FDA rules and regulations.”²⁴⁹ The board in *Inter-Marketing* was focused on revenue producing activity and left pipeline maintenance to managers despite this being the major compliance risk for the company.²⁵⁰ Even the best system of compliance cannot be effective if key participants in that system fail to interact with the information that system provides.

D. The Noteworthy Introduction of Criticality into Caremark Analyses

Finally, systems thinking invokes the concept of criticality. In the context of systems thinking, criticality is the notion that functions can be identified for the relative importance to the functioning of the system overall.²⁵¹ Evaluating criticality is a method of prioritizing processes and connections within a given system based on their importance to the system’s overall mission.²⁵² Criticality also assesses the potential risk that a failure of such a process or connection would derail the mission of the organization.²⁵³ Compliance criticality in organizations evaluates risks for reputational damage, civil and criminal liability, and loss of consumer confidence, amongst other risks.²⁵⁴ Risks that cannot be evaluated for criticality remain as residual risks, which firms manage with information available.²⁵⁵

Marchand and its progeny expect that that boards must attend closely to mission critical risks facing the organization.²⁵⁶ A mission critical risk is

249. *Teamsters Local 443 Health Svcs. & Ins. Plan v. Chou*, C.A. No. 2019-0816-SG, 2020 WL 5028065, at *11 (Del. Ch. Aug. 24, 2020).

250. *Inter-Mtg. Grp. USA, Inc. v. Armstrong*, C.A. No. 2017-0030-TMR, 2020 WL 756965, at *14 (Del. Ch. Jan. 31, 2020).

251. T.R. Moss & J. Woodhouse, *Criticality Analysis Revisited*, 15 *QUALITY & RELIABILITY ENGINEERING INT’L* 117, 117 (1999).

252. *Id.*

253. Celia Paulsen et al., *Criticality Analysis Process Model: Prioritizing Systems and Components*, NAT. INST. STDS. & TECH. iv (Apr. 2018), <https://nvlpubs.nist.gov/nistpubs/ir/2018/NIST.IR.8179.pdf> [<https://perma.cc/8MZE-FQUK>]; Moss & Woodhouse, *supra* note 251, at 117.

254. DELOITTE, *COMPLIANCE RISK ASSESSMENTS: THE THIRD INGREDIENT IN A WORLD-CLASS ETHICS AND COMPLIANCE PROGRAM 4* (2015), available at <https://www2.deloitte.com/us/en/pages/risk/articles/compliance-risk-assessments-the-third-ingredient-in-a-world-class-ethics-and-compliance-program.html> [<https://perma.cc/U92E-LC3W>].

255. *See id.* at 5 (explaining that organizations should gather employee input and existing materials to leverage expertise to efficiently manage residual risks).

256. *See, e.g., Recent Delaware Decisions Signal Renewed Focus on Board-Level Compliance Oversight*, PAUL WEISS (Nov. 13, 2019), <https://www.paulweiss.com/practices/transactional/mergers-acquisitions/publications/recent-delaware-decisions-signal-renewed-focus-on-board-level-compliance-oversight?id=30213> [<https://perma.cc/KSS6-XYZ3>]

one that involves essential functions of the organization or implicates a primary goal of the firm. A mission critical risk can derail a firm's core strategies and can generate serious financial losses for the enterprise.²⁵⁷ Mission critical risks should warrant heightened attention by anyone whose responsibility is relevant to that system. This, of course, includes heightened attention by boards of directors.

Marchand speaks of "mission critical" risks in their evaluation of *Caremark* claims and that language is repeated by *Clovis* and *Chou*.²⁵⁸ *Marchand* identified food safety as a critical issue for Blue Bell's continued success.²⁵⁹ This is certainly a reasonable inference from a company that focuses on the manufacture and sale of ice cream products. *Marchand* also integrated criticality in proof requirements for *Caremark* claims, stating that "[w]hen a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a compliance issue *intrinsicly critical* to the company's business operation, then that supports an inference that the board has not made the good faith effort that *Caremark* requires."²⁶⁰

(explaining that regulatory compliance should be considered a mission critical risk to companies in highly regulated industries). The advisory explained:

Highly regulated industries beware. *Marchand* and *Clovis* suggest that Delaware courts are more inclined to find *Caremark* liability where "a monoline company operates in a highly regulated industry." That is because regulatory compliance for these companies should be considered "mission critical," and boards in such industries should ensure that they implement reasonable compliance policies and programs and require periodic board level reporting on the function of such programs and any issues identified as a result of these programs. As noted in *Clovis*, this type of key regulatory risk requiring compliance with positive law can be distinguishable from the overall package of business risks that boards oversee and that may be more or less critical to varying degrees.

Id. See also *The Risk-Intelligent Enterprise: Fundamental Steps*, EXECUTIVE COMPENSATION STRATEGIES NEWSL. (Nov. 2006) (characterizing mission critical risks as those that have the "highest adverse impact on company value and strategic objectives").

257. See *Mission-Critical Systems and Why you Need Them Managed*, GB TECH (Jan. 17, 2020), <https://www.gbtech.net/mission-critical-systems-and-why-you-need-them-managed/> [<https://perma.cc/7PNT-GK79>]; Caroline McDonald, *High Performance Risk Management*, RISK MGMT. MONITOR (Nov. 17, 2017) (describing a mission-critical risk as "any activity, asset, resource, service or system that materially impacts (positively or negatively) the organization's ability to successfully achieve its strategic goals and objectives"), <https://www.riskmanagementmonitor.com/tag/mission-critical/> [<https://perma.cc/NZ7N-LMP3>].

258. See also *Inter-Mtg. Grp. USA, Inc. v. Armstrong*, C.A. No. 2017-0030-TMR, 2020 WL 756965, at *15 (Del. Ch. Jan. 31, 2020) (observing the board of directors "consciously failing to oversee its mission-critical objective of maintaining pipeline integrity").

259. *Marchand v. Barnhill*, 212 A.2d 805, 811 (Del. 2019).

260. *Id.* at 822 (emphasis added). The good faith effort referred to in this quotation is the board's obligation to conduct a "good faith effort to implement an oversight system and then to monitor it." *Id.* at 821.

Marchand also invoked criticality in its holding, concluding “food safety was essential and mission critical” and that the plaintiff pled sufficient facts inferring that “no board-level system of monitoring or reporting on food safety existed.”²⁶¹ In each of the important turning points of *Marchand*, identification of facts, requirement of proof, and conclusion of law, criticality was relied upon as a relevant factor for determining the resolution of a *Caremark* claims.

The *Clovis* case invoked criticality thirteen times, relying significantly on principles articulated in *Marchand*.²⁶² *Clovis* involved reporting of trial protocols of a single, potentially valuable drug, and *Clovis* reasonably found that Roci was “intrinsicly critical to the company’s business operation.”²⁶³ *Clovis* also relied on *Marchand*’s language that a board’s oversight function is important for monitoring “mission critical” compliance risks.²⁶⁴ *Clovis* also stated that “as *Marchand* makes clear, the careful observer is one whose gaze is fixed on the company’s mission critical regulatory issues.”²⁶⁵ *Clovis* also remarked that mission critical operations require elevated attention by the board when compared to other issues.²⁶⁶ Like *Marchand*, *Clovis* also invoked criticality when reaching legal conclusions: “Drawing all reasonable inferences in Plaintiffs’ favor, I am satisfied they have well-pled that the Board consciously ignored red flags that revealed a mission critical failure to comply with the RECIST protocol and associated FDA regulations.”²⁶⁷

Embracing the concept of mission critical risk defined in the *Marchand* and *Clovis* decisions, *Chou* uses the term “critical” twenty-two times in the text and two additional times in the footnotes.²⁶⁸ Similar to *Clovis*, the court identified health and safety as the critical compliance risk in the pharmaceutical industry.²⁶⁹ It emphasized “flouting laws meant to ensure the safety and purity of drugs destined for patients suffering from cancer is directly inimical to the central purpose of ABC’s business.”²⁷⁰ Like *Marchand*, the notion of mission critical functions raising the obligation of boards in *Caremark* claims was conspicuous in its thinking.

261. *Id.* 824.

262. Although the court relied significantly on criticality, some of the uses of the word “critical” were not related to evaluating the *Caremark* claim.

263. *Clovis*, 2019 WL 4850188, at *1.

264. *Id.* at *12 (citing *Marchand* 212 A.3d at 824).

265. *Id.* at *13.

266. *Id.*

267. *Id.* at *15.

268. *Teamsters Local 443 Health Svcs. & Ins. Plan v. Chou*, C.A. No. 2019-0816-SG, 2020 WL 5028065 *passim* (Del. Ch. Aug. 24, 2020).

269. *Id.* at *18

270. *Id.*

E. Corporate Governance Vexillology: Flags as System Outputs for the Board

Boards need to be aware of not only that mission critical risks that demand elevated attention, but, in the wake of *Marchand* and the governance quartet, must also be able to perceive direct or indirect warning signs that something is amiss in the organization. In systems language, these warning signs comprise feedback outputs from a functioning system. Identifying and understanding feedback is necessary for keeping a system effective.²⁷¹ In organizations, a system provides feedback to system stakeholders.²⁷² Stakeholders then receive the system output, integrate their own information, and resubmit that information back into the system. The result is a self-reinforcing “feedback loop,” by which users receive output from a system and combined with their own information submit more detailed inputs back into the system, resulting in a more effective system overall.²⁷³

Courts evaluating *Caremark* claims expect boards to obtain feedback from the organization, assess it properly, and respond with instructions that disseminate through the enterprise. In systems language, boards must be able to receive system outputs, identify such outputs as risks, and send inputs back through the system to be implemented both efficiently and effectively. In order to articulate these principles, courts have used the imagery of flags as warnings for the board of directors.

For purposes of *Caremark* cases, a warning flag is a signal or other indication that should be reasonably available to, and understood by, the board of directors that further investigatory or other actions should be taken in response. Stated more simply, a warning flag is a problem that a board should know about and look into further. Warning flags have been a frequent source of study in the corporate governance literature.²⁷⁴

271. Arnold & Wade, *supra* note 51 at 676; Mingers & White, *supra* note 35, at 1148.

272. Beer & Huse, *supra* note 32, at 84. Feedback is dependent on the presence of a functioning system infrastructure in order to be effective. Richmond, *supra* note 26, at 143 (“Without the infrastructure, there can be no feedback system.”).

273. Andrea M. Matwyshyn, *Material Vulnerabilities: Data Privacy, Corporate Information Security, and Securities Regulation*, 3 BERKELEY BUS. L.J. 129, 185-202 (2006) (explaining how feedback loops improve performance through communication, control, and a functioning system). Cf. Emily Gardner, *Adaptive Management in the Face of Climate Change and Endangered Species Protection*, 40 ECOLOGY L.Q. 229, 248 (2013) (highlighting a six-step feedback loop of “assessment, design of management actions and associated monitoring and research, implementation of management according to design, monitoring, evaluation of outcomes, and adjustment of management based on evaluation of initial management actions” in the environmental context).

274. See, e.g., Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2153, 2171-79 (2019) (discussing at length the importance of warning flags);

Marchand relied significantly on warning flags in order to determine whether their respective claims survived a motion to dismiss. Four separate times, *Marchand* noted the board's failure to consider both 'yellow flags' and 'red flags' about growing safety issues at the firm.²⁷⁵ A red flag is clearly a warning about the presence of a material risk.²⁷⁶ A red flag is also a "signal to slow down and apprise oneself of the nature of the risk and to adjust course if necessary."²⁷⁷ Red flags can originate from a compliance program report, the initiation of a government lawsuit or investigation, a warning from external auditors, aberrations in internally generated data, or a journalists report citing illegal behavior.²⁷⁸ Information that courts would consider red flags can originate from both internal and external sources, such as internal reports from management or external changes to the legal environment.²⁷⁹

Marchand also specifically cited the presence of yellow flags as relevant evidence.²⁸⁰ If red flags represent clear warnings about the presence of a material risk, then yellow flags represent evidence that is a step down from clear notices of caution. Yellow flags may indicate that boards need to address indirect or second-order information, or attend to risks that require some inference or inferential step in order to perceive clearly as risks to the firm.²⁸¹ Examples of yellow flags could include a sudden departure of a compliance officer, reporting irregularities from an important function, rapid change in compliance procedures, or the introduction of a new product in an unfamiliar market. None of these are necessarily *Caremark*-triggering liabilities on their own, but each raises the potential for problems such that they warrant additional scrutiny by the board of directors. Inclusion of yellow flags should not be a complete surprise to boards or their advising attorneys, as the very judge who authored the *Marchand* opinion published

Ezra Wasserman Mitchell, *Caremark's Hidden Promise*, 51 LOY. L.A. L. REV. 239, 275-81, 284-86 (2018) (similar).

275. *Marchand v. Barnhill*, 212 A.3d 805, 809, 811, 816, 822 (Del. 2019).

276. Michael J. Borden, *Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation*, 15 U. PA. J. BUS. L. 921, 935 (2013).

277. *Id.*

278. *Id.* (citing *McCall v. Scott*, 239 F.3d 808, 818-21 (6th Cir. 2001)). See also Mitchell, *supra* note 276, at 275-86 (exploring the role of red flags in governance cases in detail).

279. Mitchell, *supra* note 276, at 277.

280. *Marchand*, 212 A.3d at 809, 811, 816, 822.

281. See Leo E. Strine, Jr., *Warning—Potential Danger Ahead!: A Business Judge's Starting List of Yellow Flags for the Conscientious Independent Director*, DIRECTORS & BOARDS, 3d. Q. 2004, at 25 (defining as yellow flags "warning signals . . . that ought to trigger concern and extra caution on your part"). These included related-party transactions, failure to retain top advisers, tolerance of non-contributing board members, overburdened board members, a request to rush a decision, or deficiencies in the flow of information. *Id.* at 26-27.

a list of potential yellow flags for boards in 2004.²⁸²

In *Marchand*, significant government investigations into food safety predated Blue Bell's *listeria* outbreak.²⁸³ In addition, troubling indications were given to management by Blue Bell's own tests.²⁸⁴ The board either didn't hear of the warnings or failed to take action on them when presented. The board's failure to receive notices of deficiencies in safety resulted in the injury and death of customers was sufficient for the court to conclude the plaintiffs met their pleading burden to survive dismissal of their complaint.²⁸⁵

In *Clovis*, the court specifically found that, assuming the truth of pled facts, that the "[b]oard ignored red flags that Clovis was not adhering to the clinical trial protocols, thereby placing FDA approval of the drug in jeopardy."²⁸⁶ *Clovis* required that, when a plaintiff alleges that a board failed to monitor an implemented oversight system, it must show that a red flag of non-compliance appeared before the board but the board ignored the warning anyway.²⁸⁷ Such flags, *Clovis* warned, either have to be "waived in one's face or displayed so that they are visible to the careful observer."²⁸⁸ Taking its cue from *Marchand*, *Clovis* defined the careful observer as someone who is focused on the mission of the company and its critical regulatory challenges.²⁸⁹ An expertly knowledgeable board ignoring significant departures from established standards of clinical protocols appears to fall readily into the red flag category.

The *Chou* court carefully details red flags that the board disregarded in bad faith.²⁹⁰ It found that the board of directors was on notice of a compliance failure in the operations of Pharmacy from a report it received in 2008.²⁹¹ The board did not respond to this red flag of potential health and safety gaps. Then a more significant red flag was the *qui tam* suit filed by a former ABC executive.²⁹² The suit was filed in 2010 but the illegal pre-filled syringe program continued in operation until 2014 because the board ignored

282. *Id.*

283. *Marchand*, 212 A.3d at 811–12.

284. *E.g., id.* at 811 ("But despite the critical nature of food safety for Blue Bell's continued success, the complaint alleges that management turned a blind eye to red and yellow flags that were waved in front of it by regulators and its own tests. . . .").

285. *Id.* at 824.

286. *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *1 (Del. Ch. Oct. 1, 2019).

287. *Id.* at *13.

288. *Id.*

289. *Id.*

290. *Teamsters Local 443 Health Svcs. & Ins. Plan v. Chou*, C.A. No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020).

291. *Id.* at *20.

292. *Id.*

these red flags. The court concluded that these “allegations are sufficient to reasonably infer that the Board consciously ignored red flags regarding the Pre-Filled Syringe Program and its attendant mission critical compliance risks.”²⁹³

Boards must become vexillologists of corporate governance. Boards must know when flags appear, what they mean, and how they should respond.²⁹⁴ Boards must also recognize that what constitutes a red or yellow flag will change over time. This means that boards must remain continually vigilant about what practices courts will deem sufficient warnings that demand a board response. Information perceived as beneath the attention of the board today may become the ‘yellow flags’ of warning tomorrow. Similarly, the ‘yellow flags’ of warning today may become the critical ‘red flags’ of immediate threat tomorrow. The identification, evaluation, and response to red and yellow warning flags cannot happen effectively without a system of compliance containing robust methods of feedback. That system must reach from the organization to the board of directors and turn back outward toward the organization.

IV. BUILDING A SYSTEMS ARCHITECTURE IN CORPORATE GOVERNANCE

With systems thinking emerging in *Caremark* cases, and the growth of systems thinking in the literature, the time is ripe for development of a systems architecture in corporate governance.

This Part will be divided into three sections. The first will focus on system inputs that a board should be expected to receive in order to fulfill their fundamental obligations. The second section will highlight board processes, particularly those that function inside the ‘black box’ and treat board members as individuals in a group rather than a monolith. These processes will be necessary for boards to manage information effectively. Information is of minimal use if it cannot influence decision making, and the third section will explore how boards can ensure that their output and

293. *Id.* at *24.

294. One author has thoughtfully proposed a five-factor analysis in order to determine whether a concern raises itself to the level of a red warning flag: “(1) the potential harm to the company, (2) the time directors had to react, (3) the particular source of the red flag, (4) the frequency of the red flag, and (5) the availability of the information in forming the red flag.” Anne Tucker Nees, *Who’s the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 239 (2010). The author further remarks, “[b]y focusing on these elements to establish a conscious disregard, a court would avoid finding liability for a mere mismanagement of ‘business risk’ and strike the correct balance between director authority and shareholder accountability.” *Id.* at 239–40.

instructions can effectively emanate from the board and reach the appropriate stakeholders that can make board directives a reality.

A. Inputs to the Board of Directors

A board of directors denied information about the organization is effectively blind. Boards without informational inputs cannot correct company problems. Such boards also cannot monitor essential functions that could most expose the corporation to liability. Boards must rely on management as information intermediaries in order to get the inputs necessary to be effective. The most obvious source of such information would be the CEO of the organization. No other individual has a greater firm-wide responsibility or considers broad strategic directions of the firm more than the leader of the corporation. Filtered through subordinates, the CEO should be, at least in theory, the dominant gateway for receiving relevant inputs for the board of directors.

However, reporting information on compliance and monitoring issues, especially when that information implies strategic mistakes or reflects negatively on the c-suite, results in a divergence of interest between the CEO and the board of directors. Essentially a principal-agent problem,²⁹⁵ the CEO is incentivized to underweight the significance of bad news presented to the board because it could impact the CEO's pay, benefits, or continued tenure with the firm. CEOs are not only incentivized to take excessive risks,²⁹⁶ they may have the personality type that overvalues risky behavior and undervalues both the cost of risks and the monitoring necessary to keep firm risks at a minimum.²⁹⁷ This does not imply that CEOs are unable to provide objective information, but only that boards should rely on diverse range of inputs in order for it to meet its *Caremark* obligations.

Perhaps the most prominent source of information is the chief legal

295. The notion of the principal-agent problem in organizations traces its originals to the seminal work of Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). See also Eugene M. Fama, *Agency Problem and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (arguing that the separation of security ownership and control can be an efficient form of economic organization).

296. Justin Chircop, Monica Tarsalewska & Angela Tzreciakiewicz, *Are CEOs Encouraged to Take Too Much Risk?*, CLS BLUE SKY BLOG (Feb. 14, 2020), <https://clsbluesky.law.columbia.edu/2020/02/14/are-ceos-encouraged-to-take-too-much-risk/> [ps://perma.cc/4V6P-BH29].

297. Steven Neil Kaplan & Morten Sorensen, *Are CEOs Different? Characteristics of Top Managers* 11 (NBER, Working Paper No. w23832, 2017) (“CEOs are significantly more likely . . . to be perceived as risk takers.”). Executives perceived as risk takers are also associated with greater general ability, interpersonal skills, and charisma. *Id.* at 15.

officer (CLO) of the enterprise. The modern CLO has great stature in the executive suite,²⁹⁸ trusted with a variety of functions ranging from deal-maker to litigator and crisis manager.²⁹⁹ The CLO is also influential in alleviating the principal-agent problem, a fundamental goal of the monitoring function of corporate governance and the board of the directors.³⁰⁰ CLOs often serve as the “gatekeepers” of corporate legality, deterring misconduct by management and reporting such misconduct as needed to the board of directors.³⁰¹

The CLO has significant incentives that motivate her to perform the monitoring function that boards require. Like other officers, the CLO has a duty of care to act in good faith and in the best interests of the corporation.³⁰² This also includes monitoring the activities of the company and investigating misconduct.³⁰³ As an attorney, the CLO also has obligations under the Model Rules of Professional Conduct, who is a “public citizen having special responsibility for the quality of justice.”³⁰⁴ Attorneys may also be required to withdraw representation if a client persists in action that the attorney believes is criminal or fraudulent conduct.³⁰⁵ Furthermore, the CLO’s ultimate client is not individuals in management such as the CEO or CFO, but rather the corporation itself.³⁰⁶

Another clear source of inputs for the board of directors is the rising prominence of the chief compliance officer (CCO). While the CCO may or may not be an attorney, her focus is specifically on the compliance and

298. See, e.g., *A Guardian and A Guide*, *ECONOMIST* (Apr. 7, 2012), <https://www.economist.com/business/2012/04/07/a-guardian-and-a-guide/> [<https://perma.cc/DCH3-KG33>]. See also Benjamin W. Heineman, Jr., *The General Counsel as Lawyer-Statesman*, *HARV. L. SCH. F. CORP. GOV.* (Sep. 15, 2010), <https://corpgov.law.harvard.edu/2010/09/05/the-general-counsel-as-lawyer-statesman/> [<https://perma.cc/WU48-W3Q3>] (“The ideal of the modern general counsel is a lawyer-statesman who is an acute lawyer, a wise counselor and company leader and who has a major role assisting the corporation achieve that fundamental fusion which should, indeed, be the foundation of global capitalism.”).

299. Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 *AM. BUS. L.J.* 203, 219 (2016).

300. *Id.*

301. David A. Delman & Paul A. Bruno, *Up the Ladder and Out the Door: Saying “No” to the CEO*, 46 *INT’L LAW.* 1007, 1018 (2012).

302. Bird & Park, *supra* note 301, at 221.

303. *Id.*

304. MODEL RULES OF PROF’L CONDUCT pmbl. ¶ 1 (AM. BAR ASS’N 2020), available at https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_preamble_scope/ [<https://perma.cc/WP9Z-95EA>].

305. *Id.* Rule 1.16(b)(2–3).

306. Robert C. Bird & Stephen Kim Park, *Organic Corporate Governance*, 59 *B.C. L. REV.* 21, 59 (2018).

monitoring functions of the organization. This may include implementing compliance programs, ensuring appropriate information reaches the right constituents, training employees on evolving compliance obligations, and performing investigations when compliance related misconduct occurs. Unlike the CLO, the CCO may not have an attorney-client relationship with the corporation,³⁰⁷ and will not be expected to serve as an advocate in the face of litigation or government investigation. Also unlike the CLO, the CCO is less likely to be in the cadre of senior management, instead serving as a relatively autonomous management leader with a broad mandate to prevent and remediate misconduct in the organization.³⁰⁸ Compliance leadership requires point-of-contact engagement with business practice, as one CCO explained: “[c]ompliance is getting up out of your chair and following your clients back into their business and making sure they really are doing all of the things that you’ve advised them to do.”³⁰⁹

Ensuring sufficient inputs to the board of directors involves more than simply designating the CLO, CCO, and perhaps other risk related officers³¹⁰ as sources of *Caremark*-related information. Inputs must be clearly defined by reporting lines and responsibilities in order to be adequate. A reporting line is the designation of an individual or entity to whom an individual is in some way responsible or accountable to in an organization.³¹¹

In order for *Caremark*-related inputs to effectively reach the board of

307. See, e.g., THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF FINANCIAL PLANNERS, SEC ADVISER EXAMINATIONS—REGULAR INSPECTIONS § 6:3 n.4 (2020) (“Note that the SEC does not recognize the attorney-client privilege as extending to the work of an adviser’s CCO merely because the CCO is a lawyer.”) (citing *In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014)); *Panel IV: Compliance Officer Empowerment*, 6 AM. U. BUS. L. REV. 255, 262-63 (2017) [hereinafter *Compliance Panel*]; Robert F. Roach & Mara Davis, *Protecting Attorney-Client and Attorney Work-Product Privileges*, City Bar Ctr. for Continuing Legal Educ. (Feb. 28, 2012) (“[S]imply because a CCO is an attorney or reports to the [general counsel] does not mean that his or her communications and work-product are privileged from disclosure.”).

308. Alexandra Foster, *Where the CCO Fits in the C-Suite: A Corporation’s Moral Compass*, 6 AM. U. BUS. L. REV. 175, 184 (2017).

309. Michele DeStefano, *Compliance and Claim Funding: Testing the Borders of Lawyers’ Monopoly and the Unauthorized Practice of Law*, 82 FORDHAM L. REV. 2961, 2977 (2014) (interviewing an anonymous CCO).

310. For example, firms may retain a chief risk officer, who identifies emerging risk, ensures a firm’s risk exposure matches its risk appetite and manages the firm’s companywide risk level. See Peter Green & Jeremy Jennings-Mares, *IIF’s Final Report on Market Best Practices for Financial Institutions and Financial Products*, 27 BANKING & FIN. SERVICES POL’Y REP. 1, 1 (2008).

311. See *Reporting line*, MACMILLAN DICTIONARY, <https://www.macmillandictionary.com/us/dictionary/american/reporting-line> [<https://perma.cc/Z8TZ-B3PU>] (last visited Jan. 14, 2021) (defining “reporting line”).

directors, relevant reporting lines must be robust. Most general counsel agree that the CLO should have a direct reporting line to the CEO.³¹² For compliance and monitoring purposes, however, this may not be enough. A CEO that has otherwise captured the board of directors may not convey compliance and monitoring concerns from legal to the board.³¹³ Even if these concerns are communicated, the CEO may not relay them with the same urgency that a CLO might use to communicate an important compliance matter. A CLO that reports to the CFO, who may already have an unsettlingly cozy connection with prominent auditing firms,³¹⁴ may not be incentivized to convey compliance problems as robustly as the CCO or CLO.³¹⁵

In the new *Caremark* environment, CLO must have more than mere “exposure” to the board of directors.³¹⁶ A CLO should have dual reporting lines both to the CLO and to the board of directors.³¹⁷ Due to diverging perspectives on risk and compliance, other c-suite members may perceive this elevation as a threat.³¹⁸ Boards must have the fortitude to push back against management who challenge their decisions.³¹⁹ CLOs must have the fortitude to push back if a CEO entertains thoughts of excluding the

312. Veta T. Richardson, *What Happens When GCs Aren't Empowered*, ACC DOCKET (Jan. 01, 2019), <https://www.accdoCKET.com/what-happens-when-gcs-arent-empowered> [https://perma.cc/G5Q8-RFN6].

313. See Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921, 935 (2007) (explaining “CEO capture” as the ability of the CEO to “dominate the board. Over time, the board becomes a subset of her friends. She remains in place not so much because her performance is up-to-snuff, but rather because her friends appreciate her attributes”); Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 291–92 (2004) (explaining how the board of directors can be captured by the CEO).

314. Omari Scott Simmons, *Chief Legal Officer 5.0*, 88 FORDHAM L. REV. 1741, 1762 (2020).

315. See *id.* (explaining factors that impact a CLO’s effectiveness).

316. Richardson, *supra* note 314, at 3 (suggesting “exposure at the board level” at a minimum would elevate the status of the CLO and the firm’s commitment to compliance and ethics).

317. Simmons, *supra* note 316, at 1762.

318. *Supra* note 316, at 1762–63.

319. See Cynthia A. Montgomery & Rhonda Kaufman, *The Board’s Missing Link*, HARV. BUS. REV., Mar. 2003, at 86 (explaining that boards have traditionally been perceived as “friends, acquaintances, and former colleagues of the CEO who basically provided a sounding board with very little push back in the way of real constructive tension or independent thought leadership.”); John Okray, *A Discussion with Steven Walker, General Counsel, Secretary, and Head of Board Advisory Services at the National Association of Corporate Directors*, 61 FED. LAW. 48, 49 (2014) (explaining that board members “should not be afraid to provide constructive tension and question management”).

company's top attorney from meetings with the board of directors.³²⁰

This reporting line should be specific and periodic, with a report by the CLO a regularized part of the full board's regular agenda. This reporting line should be periodic, require an opt-in or be otherwise burdened with nudges that push the CLO away from the center of important board conversations. If the CLO has to request a meeting with the board, for example, she knows that such a request will raise a red flag amongst fellow c-suite executives. However, CLOs may not want to raise that red flag because of their desire to "get along" with their fellow business executives.³²¹ Just as boards can be captured by CEOs, so can CLOs be captured by the norms and goals of fellow executives.³²²

Whereas formal reporting lines are important for a CLO in order to communicate *Caremark*-related inputs to the board, such reporting lines are critical for the CCO.³²³ While the CLO has been a fixture in organizations since the nineteenth century,³²⁴ the CCO is a relative newcomer, with little of the reputation cachet held by an organizations' top lawyer. The CCO also does not yet have an established place in the group of elite executives that report directly to the CEO. Finally, the CCO's role as guardian of the legal and ethical integrity of the enterprise may put the CCO at odds with cultures in more traditional departments that emphasize risk taking and value creation over risk minimization and value protection.

In addition, the CCO may be the very manager from which the board receives the most information to satisfy their *Caremark* duties. The position's focus in part on monitoring and audit may result in the CCO being the first high-level manager to ferret out misconduct. Unshackled by the complicating attorney-client relationship a CLO has to the enterprise,³²⁵ the CCO can speak freely, and perhaps sometimes disconcertingly, about any

320. See Joshua Nimmo, *Ethical Regulation for Financial Lawyers: Negative Certification as a Response to the Financial Crisis*, 28 GEO. J. LEGAL ETHICS 745, 764 (2015) (advocating for a negative certification process that would enhance attorney due diligence to reduce risk).

321. See JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 195 (2006) (explaining in-house counsel's vulnerability to capture and the erosion of gatekeeping roles).

322. See Bird & Park, *supra* note 301, at 243 (explaining that firm culture may encourage attorneys to subordinate their professional role and implicitly perceive that management, rather than the corporation, is the appropriate client).

323. Compliance Panel, *supra* note 309, at 260; Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2095 (2016) (calling reporting lines a "critical aspect of effective compliance").

324. Deborah A. Demott, *The Discrete Roles of General Counsel*, 74 FORDHAM L. REV. 955, 958 & n.14 (2005) (chronicling the history of the general counsel).

325. See *supra* notes 286–290 and accompanying text.

misconduct to the board of directors.

These factors compel the CCO to have a reporting line to the board of directors.³²⁶ This reporting line can be either a “straight line” or a “dotted line” report to the full board or a relevant board subcommittee such as audit or compliance.³²⁷ This information flow enables information from the CCO’s subordinates to pass freely from their desks to the company board.³²⁸ Even with the increasing pressure that boards face regarding compliance obligations, such a requirement, although common, is not yet a universal practice in organizations.³²⁹

B. Processes for Board of Directors Decision Making

A board cannot simply collect information about compliance and monitoring practices in order to protect itself from a *Caremark* claim. A board must have effective processes to adequately respond to information received. Fortunately, information is readily available about best practices in corporate governance. For example, the Business Roundtable has articulated detailed guidelines for effective corporate governance practices in their *Principles of Corporate Governance*.³³⁰ Among other recommendations, the document recommends optimal roles for the board and management respectively, the roles of audit, governance, and other committees, as well as engagement with long-term shareholders on issues of

326. Compliance Panel, *supra* note 309, at 260 (transcribing statement by law firm panelist: “Reporting lines are so critical and the CCO in my view should report through either a direct line or a dotted line to a committee of the board or to the board itself or to an independent committee of the board, preferably an audit committee of the Board of Directors.”).

327. *Id.* See also Miriam H. Baer, *Compliance Elites*, 88 *FORDHAM L. REV.* 1599, 1600 n.3 (2020) (“The term, ‘dotted-line reporting’ ordinarily describes an informal, looser reporting relationship between the CCO and the company’s board of directors, whereby the CCO can relay information of importance directly to the board, rather than going through the CEO or general counsel.”); Priscilla Claman, *Are you Considering a Job with Two Managers?*, *HARV. BUS. REV.*, May 13, 2013, <https://hbr.org/2013/05/are-you-considering-a-job-with/> [<https://perma.cc/YQX6-GBQJ>] (“In . . . organizational structures, you typically have two bosses: a ‘straight-line’ direct boss, who is the person who prepares your performance review and decides on your raise; and a ‘dotted-line’ boss, who may also assign you work but has less control over your review.”).

328. Griffith, *supra* note 325, at 2095.

329. *Id.* at 2102 & n.116 (citing a 2014 study reporting that 79% of CCOs have a dotted reporting line to the board of directors).

330. BUSINESS ROUNDTABLE, *PRINCIPLES OF CORPORATE GOVERNANCE* 3-4 (Aug. 2016), <https://s3.amazonaws.com/brt.org/Principles-of-Corporate-Governance-2016.pdf> [<https://perma.cc/C3YR-UCAV>].

corporate concern.³³¹ There are also a number of online sources that summarize best practices for boards.³³² These include implementing clear written mandates and responsibilities for board members, separation of the roles of the CEO and Chair of the Board, and the assignment of each director to an area of focus in their respective subcommittees.³³³ Regulatory matters are discussed either quarterly or at every board meeting in nearly half of boards surveyed.³³⁴

Boards report implementation of forward-looking practices that are engaged with business and societal trends. Many surveyed boards are seeking to increase their racial and gender diversity.³³⁵ A majority of boards have specifically allocated cyber risk, corporate social responsibility, sustainability, and social impact risks to the agendas of relevant subcommittees.³³⁶ A majority of boards do report that they receive results from culture surveys, review investigation findings, and receive information about reports from company hotlines.³³⁷ An increasing number of boards are implementing evaluations of individual board of directors.³³⁸ Board processes appear to be generally robust, and are poised to improve over time.

Yet beneath the surface of future promises are troubling reports that question the effectiveness of such processes in practice. A significant number of directors self-report that they lack the full information they need to make effective decisions.³³⁹ Only thirty-seven percent of directors reported that their board is fully cognizant of the organization's plan to

331. *Id.* at 3.

332. *See, e.g., The Top 5 Corporate Governance Best Practices That Benefit Every Company*, MCINNES COOPER (Sep. 16, 2014), <https://www.mcinniscooper.com/publications/legal-update-the-top-5-corporate-governance-best-practices-that-benefit-every-company/> [<https://perma.cc/9JCE-DHKM>] (summarizing corporate best practices); *The Public Company Handbook: A Corporate Governance and Disclosure Guide for Directors and Executives - Fifth Edition*, PERKINS COIE (5th ed. 2016), <https://www.perkinscoie.com/en/chapter-7-corporate-governance-best-practices-in-the-boardroom.html/> [<https://perma.cc/7Y54-M9PG>] (summarizing best practices in chapter 7).

333. *Id.*; PERKINS COIE, *supra* note 334.

334. DELOITTE & SOCIETY FOR CORP. GOV., BOARD PRACTICES REPORT: COMMON THREADS ACROSS BOARDROOMS 6 (2018), <https://www2.deloitte.com/us/en/pages/center-for-board-effectiveness/articles/us-board-practices-report-common-threads.html> [<https://perma.cc/4NNG-6DUU>].

335. *Id.* at 16.

336. *Id.* at 6.

337. *Id.*

338. SPENCER STUART, 2020 U.S. SPENCER STUART BOARD INDEX 24 (2020), https://www.spencerstuart.com/-/media/2020/december/ssbi2020/2020_us_spencer_stuart_board_index.pdf [<https://perma.cc/P4XF-2BJH>] [hereinafter Board Index].

339. David A. Nadler, *Building Better Boards*, HARV. BUS. REV., May 2004, at 102, 110.

manage a crisis.³⁴⁰ Only half of surveyed directors believed that their board fully comprehended issues related to environmental and social governance, and even fewer believed that these issues have a financial impact on the organization.³⁴¹ Board succession plans are an important concern, but fewer than half of board members report that succession plans are shared with the entire board of directors.³⁴² Boards also have a troubling habit of ducking difficult conversations regarding the performance of individual directors and whether a given director should be reappointed.³⁴³ Whether due to dominant personalities or a hesitance to erode collegiality, over one-third of board members reported difficulty in raising a dissenting opinion in board meetings.³⁴⁴ A recent survey of corporate directors found that almost half of board members think that at least one fellow director should be replaced.³⁴⁵

What is the source of this dichotomy? Although boards may be governed by formal processes, there may be informal processes and effects that nonetheless erode board effectiveness. A board of directors is, at its core, a team. Whereas a group is a collection of individuals defined by collocation or common identity, a team is a collection of individuals with specialized areas of expertise who work toward a common goal.³⁴⁶ The team otherwise known as a board of directors is typically comprised of a large group of elite and well-educated people who meet periodically to address and resolve complex questions.³⁴⁷ Teams in organizations can generate a variety of positive effects ranging from high productivity to lower turnover.³⁴⁸

340. PWC, TURNING CRISIS INTO OPPORTUNITY, PWC'S 2020 ANNUAL CORPORATE DIRECTOR'S SURVEY 4 (2020), <https://www.pwc.com/us/en/services/governance-insights-center/assets/pwc-2020-annual-corporate-directors-survey.pdf> [<https://perma.cc/4VGU-7GSB>].

341. *Id.*

342. *Id.*

343. *Id.*

344. *Id.* at 16.

345. *Id.* at 4.

346. *See, e.g., Deborah C. Saltman et al., Groups or Teams in Health Care: Finding the Best Fit*, 13 J. EVALUATION CLINICAL PRAC. 55, 55-56 (2006) (explaining the difference between groups and teams). *See also Building a Winning Board Team*, STARBOARD LEADERSHIP CONSULTING LLC, <https://www.starboardleadership.com/board-chair-companion/building-a-winning-board-team/> [<https://perma.cc/4GNK-MYBW>] (“A well-functioning board of directors is very much like a successful sports team—a group of talented individuals, each with unique and complementary strengths, all setting aside their personal agendas to help the entire organization achieve success.”).

347. Forbes & Milliken, *supra* note 19, at 492.

348. *See, e.g., Linda I. Glassop, The Organizational Benefits of Teams*, 55 HUM. REL. 225, 246 (2002) (finding that team structures in organizations are associated with higher productivity, reduced turnover, and a flatter management structure). *See generally* A.W. Richter, J.F. Dawson & M.A. West, *The Effectiveness of Teams in Organizations: A Meta-*

Although board members acting as a team can improve decision making, boards are no less vulnerable to social-psychological factors that can inhibit any group's effectiveness.³⁴⁹ Some boards can be so driven by conflict between board members that otherwise rational decision-making processes are suppressed.³⁵⁰ Instead, “[b]ehind-the-scenes coalition building, off-line lobbying, withholding of information, attempting to change decision positions through private cooptation, and controlling agendas” take over board discourse.³⁵¹ Boards embroiled in conflict engage with formal processes, but do so in fashion that emphasizes intra-group factional victories over the long-term success of the enterprise.³⁵²

Boards can also be dangerously disengaged with the weaknesses and threats facing the enterprise. Such boards can have formal processes in place, but rely too much on management or the CEO to direct the strategic goals of the company.³⁵³ Such boards may be unfamiliar with many aspects of the company such that, even if the board chose to rely on formal processes, its decisions would be impaired by a cloud of ignorance.³⁵⁴ The protective shields of the broadly-interpreted business judgment rule, the duty of loyalty, and the duty of care have arguably allowed board disengagement to flourish.³⁵⁵ Described as a disengaged or caretaker board, such boards are poorly involved in initiatives important to the CEO or shareholders.³⁵⁶ Boards can even devolve into a “gentleman’s club” that emphasizes ceremony and conformity over actual decision making.³⁵⁷ They also appear

Analysis, 22 INT’L J. HUM. RES. MGMT. 2749 (2011) (conducting a literature review of analyses of team performance in organizations).

349. Forbes & Milliken, *supra* note 19, at 492. See also Diane Coutu, *Why Teams Don’t Work*, HARV. BUS. REV., May 2009, at 98 (explaining psychological conditions that determine team success and failure).

350. Bernard C. Bailey & Simon I. Peck, *supra* note 16, at 136 (classifying this type of behavior as a “contested board”).

351. *Id.*

352. *Id.* at 136–37.

353. Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 811 (1994).

354. Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN’S L. REV. 767, 781–82 (2002) (citing Enron’s board of directors as an example).

355. Samuel R. Foreman, *Bored Boards: The Directorial Disengagement Dilemma*, 50 WASHBURN L.J. 147, 149–51 (2010).

356. Morten Huse, *Relational Norms as a Supplement to Neo-Classical Understanding of Directorates: An Empirical Study of Boards of Directors*, 22 J. SOCIO-ECON. 219, 225 (1993); John A. Pearce II & Shaker A. Zahra, *The Relative Power of CEOs and Boards of Directors: Associations with Corporate Governance*, 12 STRAT. MGMT. J. 135, 136 (1991).

357. Nadler, *supra* note 340, at 104 (“And everyone knows what boards should be: seats of challenge and inquiry that add value without meddling and make CEOs more effective but not all-powerful.”).

poised to be held liable through *Caremark*-related litigation.

Boards are also ideal environments for homogeneity to thrive. In part based on an innate tendency toward homophily,³⁵⁸ board members tend to have similar ideologies, social status, and cultural backgrounds.³⁵⁹ They also share the common interest of seeking and maintaining a position on a board.³⁶⁰ This can result in team cohesiveness, but it can also cause a mode of processing information becomes so dominant that it smothers realistic appraisals of alternative courses of action.³⁶¹

Board processes especially matter for boards because the very nature of board activities makes them uniquely vulnerable to process losses. Boards are typically comprised of large groups of people. The larger a group becomes, the more difficult it is to implement processes that are effective for all members of that group. A board is also a group that meets only sporadically,³⁶² limiting the benefit of any cumulative knowledge effects that can arise from repeated interaction with a subject. Furthermore, whether serving on individual committees or meeting as the full group, board members are interdependent of each other in their review and evaluation of information.³⁶³ If a single board member or a small group shirk their responsibilities in the evaluation of information or process, it can erode the effectiveness of other board members. Finally, topics that merit sustained board attention are rarely cut and dry. Boards must struggle with difficult problems that lack an easy answer.³⁶⁴ Boards depend on process in order to work, and the absence of effective processes can slide boards into dysfunction. These social-psychological factors and process losses, fundamental forces in the systems architecture of any organization, can be the undoing for boards that unexpectedly find themselves on the receiving end of a *Caremark* claim.

Boards must address social-psychological challenges in order for their formal processes to work effectively. The first and perhaps most effective

358. Homophily is the tendency of similar people to associate with one another. For an in-depth examination of homophily, see Gueorgi Kossinets & Duncan J. Watts, *Origins of Homophily in an Evolving Social Network*, 115 AM. J. SOC. 405 (2009).

359. Andrew Howard, *Groupthink and Corporate Governance Reform: Changing the Formal and Informal Decisionmaking Processes of Corporate Boards*, 20 S. CAL. INTERDISC. L.J. 425, 428–29 (2011).

360. *Id.* at 429.

361. *Id.* at 428.

362. Forbes & Milliken, *supra* note 17, at 492.

363. *Id.* See also Ruth Wageman, *Interdependence and Group Effects*, 17 ADMIN. SCI. Q. 145–47 (1995) (explaining the concept of group-related interdependence in depth).

364. Alessandro Minichilli et al., *Board Task Performance: An Exploration of Micro- and Macro-Level Determinants of Board Effectiveness*, 33 J. ORG. BEHAV. 193, 196 (2012).

reform boards can make is the abolition of groupthink. Groupthink is a way of thinking that embeds a dominant mode of processing information so firmly within a group or culture that it overrides realistic appraisals of alternative courses of action.³⁶⁵ Boards can eliminate groupthink by formalizing the devil's advocate role at every board meeting.³⁶⁶ Board members can take turns shouldering this contrarian responsibility during board discussions.³⁶⁷ This discourages blunt challenges from being perceived as a personal attack on someone else's idea, thereby sustaining the important norm of collegiality that is fundamental to making boards successful.

Proper framing of discussions can also discourage groupthink. Framing is a process by which individuals develop a particular perspective or orientation about their thinking on a particular issue.³⁶⁸ Frames contextualize events, shape attitudes, and influence discourse, ultimately generating an "organiz[ation of] everyday reality."³⁶⁹ For example, when a company labels a product "75% fat free" instead of "25% fat," and consumers state a preference for the "fat free" labeled product over the "fat amount" labeled product, that company is framing a product attribute in order to persuade.³⁷⁰

Boards can use framing with similar effectiveness during board meetings. When initially raising issues for discussion, boards should adopt a neutral posture towards the subject in order to avoid influencing other board members through framing of the issue. An expression of initial preferences by the board member raising the issue can discourage open inquiry by the board or a subcommittee that must address it.³⁷¹ Similarly, expressing expectations for a board's engagement with an issue can

365. Irving Janis, *Groupthink of Irving Janis*, in *A FIRST LOOK AT COMMUNICATION THEORY* 235, 237 (E. Griffin ed. 1991); Irving L. Janis, *Groupthink*, *PSYCHOLOGY TODAY MAG.*, 1971, at 43.

366. Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 *U. CIN. L. REV.* 1233, 1304–06 (2003).

367. *Id.* at 1304.

368. Dennis Chong and James N. Druckman, *Framing Theory*, 10 *ANN. REV. POL'Y SCI.* 103, 104 (2007).

369. *Id.* at 106.

370. See Irwin P. Levin & Gary Gaeth, *How Consumers Are Affected by the Framing of Attribute Information Before and After Consuming the Product*, 15 *J. CONSUMER RES.* 374, 374 (1988) (finding a consumer preference for ground beef labelled "75% lean" over a product labelled "25% fat"). See also Chris Janiszewski, Tim Silk & Alan D.J. Cooke, *Different Scales for Different Frames: The Role of Subjective Scales and Experience in Explaining Attribute-Framing Effects*, 30 *J. CONSUMER RES.* 311, 311–13 (2003) (reviewing framing literature).

371. Janis, *supra* note 366, at 75.

discourage the board from thinking out of the box on a subject.³⁷²

Once an issue is evaluated, boards can also establish a “last chance” discussion of the issue.³⁷³ During this discussion, board members are given the opportunity to air any residual doubts or concerns over the decision made.³⁷⁴ This also allows the board to rethink the issue one more time, perhaps with the clarity of new reflection, before a final decision is made to commit to a certain strategy.³⁷⁵ Decisions that appear particularly comfortable or self-reinforcing to the board should be given extra scrutiny.³⁷⁶ This is not because the board lacks competence in making decisions, but rather because decisions that appear on the surface to be routine can discourage serious scrutiny that can prevent bad decision making.

Finally, and perhaps most fundamentally, boards must cultivate a culture that encourages the expression, deliberation, and resolution of dissent. The presence of dissent is healthy for organizations.³⁷⁷ Dissent in groups can force individuals to justify their ideas with objective information instead of their own personal preferences.³⁷⁸ A “culture of candor” encourages not only frank discussions but a genuine reliance on formal processes that protect the board from mismanagement.³⁷⁹ Such a culture can also enable board to communicate candid messages to management and also signal to management that the board is engaged, independent, and monitoring the organization.³⁸⁰ A board accustomed to candor and healthy levels of disagreement can be more effectively primed to resist the “shimmer effect” of letting charismatic CEOs run amok free of board restraint.³⁸¹ Executives do not like listening to contrarians, making the boards’ role as a check on management rapacity even more important to the organization.³⁸²

372. *Id.*

373. *Id.* at 76.

374. *Id.*

375. *Id.*

376. Avery Blank, *3 Ways to Avoid Groupthink (and Gain Respect)*, FORBES (Jan. 21, 2020), <https://www.forbes.com/sites/averyblank/2020/01/21/3-ways-to-avoid-groupthink-and-gain-respect/>. See also Janis, *supra* note 366, at 76 (discussing remedies against groupthink in organizational decision-making).

377. Garry Emmons, *Encouraging Dissent in Decision-Making*, HARV. BUS. SCH. WORKING KNOWLEDGE (Oct. 1, 2007), <https://hbswk.hbs.edu/item/encouraging-dissent-in-decision-making> [https://perma.cc/AD7U-8NLF].

378. Bird & Park, *supra* note 301, at 54 (citing Augustin Landier, David Sraer & David Thesmar, *Optimal Dissent in Organizations*, 76 REV. ECON. STUD. 761, 762 (2009)).

379. James O’Toole & Warren Bennis, *What’s Needed Next: A Culture of Candor*, HARV. BUS. REV., Jun. 2009, at 54, 58–60.

380. *Id.* at 56.

381. *Id.* at 57.

382. *Id.* at 61.

A culture of candor vividly displayed by a board can also serve as a model for management and the rest of the organization to follow.³⁸³ The responsibility to imbue a company with a culture of candor begins and ends with the board of directors.³⁸⁴ Without such a culture, even the most thorough processes may not be enough to prevent mismanagement that can trigger *Caremark*-related claims.

C. Board Outputs to Management and the Organization

Even the most process sensitive and engaged board of directors cannot be effective if their system outputs, typically directives to management to take or refrain from a certain action, are not implemented in the organization. Boards are not involved in the direct implementation of their directives. The output that boards produce is thus “entirely cognitive in nature.”³⁸⁵ As a result, initiatives to optimize the effectiveness of board output must significantly rely on cognitive processes in order to function effectively.

Boards are usually not lacking for business experience or intellectual vigor. Board members of large companies are typically comprised of working or retired CEOs, as well as experienced executives and other leaders.³⁸⁶ Compliance is certainly a subject with which company leaders have familiarity. However, that knowledge does not necessarily mean that boards are fully knowledgeable about how to issue the most effective board-driven directives about compliance to an organization.

Knowledge gaps can appear due to compliance acting as a distinct function that has traditionally been the domain of lawyers and other legally educated personnel rather than individuals trained primarily in business. This gap between formal legal requirements and the skillset of businesspeople who are supposed to comply with those requirements is wider than legal professionals think.³⁸⁷ Businesspeople may more likely perceive lawyers as hired guns that defend lawsuits than proactive

383. Joel Katz, *Creating a Speak-Up Culture*, COMPLIANCE WEEK (Apr. 1, 2013), <https://www.complianceweek.com/creating-a-speak-up-culture/3990.article> [<https://perma.cc/VSN9-MRFT>] (“The commitment to foster an environment where employees feel comfortable escalating concerns must begin with a company’s board of directors and executive management. From there, it cascades down through the organization.”).

384. O’Toole & Bennis, *supra* note 379, at 61.

385. Forbes & Milliken, *supra* note 19, at 492.

386. *See, e.g.*, BOARD INDEX, *supra* note 340, at 9 (providing statistics on the functional backgrounds of new S&P 500 independent directors).

387. Robert C. Bird, *The Many Futures of Legal Strategy*, 47 AM. BUS. L.J. 575, 578 (2010).

proponents of a robust compliance function.³⁸⁸ Furthermore, while lawyers were once consistent members of boards of directors, their influence on boards fluctuates over time, and board members cannot necessarily guarantee that they will have adequately trained legal counsel in the room when making decisions.³⁸⁹ There are also a variety of arguments that some have made against lawyers belonging in the boardroom, including that there is no room for lawyers to participate, lawyers are not businesspeople, and lawyers are too specialized, and lawyers focus too much on the minutiae to be effective.³⁹⁰

Without the guiding hand of counsel of the board room, and a knowledge gap between law and business, the compliance function can appear more foreign to board members than other functions of the enterprise. Faced with making difficult decisions related to compliance and monitoring of the company, board members are already constrained by time pressures imposed by crowded board agendas.³⁹¹ Board members also have their own personal obligations that limit their attention to a given firm's board service.³⁹² These constraints, in conjunction with the previously highlighted board pressures to avoid dissent or uncomfortable topics,³⁹³ may encourage board members to take mental shortcuts that undermine good decision making.³⁹⁴

Board decisions can also be tainted by confirmation bias, the tendency

388. Robert C. Bird, *Pathways of Legal Strategy*, 14 STAN. J.L. BUS. & FIN. 1, 4 (2008).

389. See Ashby Jones, *Law-Firm Lawyers Kissing Their Board Seats Goodbye*, WALL. ST. J. (Jan. 30, 2006), <https://www.wsj.com/articles/SB113823471859156442> [<https://perma.cc/3935-FP2M>]. See also Scott B. Guernsey et al., *Banking on the Lawyers* 49 (Cornell Legal Studies, Research Paper No. 20-13, 2020) (finding that lawyer-directors at banks are associated with management of bank risk and significant increase in firm value).

390. See *Do Lawyers Belong in the Boardroom as Non-Executive Directors?*, SPENCERSTUART (July 2013), <https://www.spencerstuart.com/research-and-insight/do-lawyers-belong-in-the-boardroom-as-non-executive-directors> [<https://perma.cc/3NVK-DL5M>] (summarizing arguments both for and against a lawyer's presence in the boardroom).

391. See Lawrence Loh, *The Crowded Agenda of Corporate Governance*, ETHICAL BOARDROOM, <https://ethicalboardroom.com/the-crowded-agenda-of-corporate-governance/> [<https://perma.cc/X8HB-CN7H>] (advocating for reduction of "governance clutter").

392. Board members are nothing if not busy people. Eliezier M. Fich & Anil Shivdasani, *Are Busy Boards Effective Monitors?*, 51 J. FIN. 689, 695-96 (2006) (sampling directors of large U.S. public companies and finding that over half of outside directors serve on three or more boards at once).

393. See *supra* Part IV.B.

394. Dale E. Jones & Ralph Weber, *Memo to Boards: Here's How to Avoid Confirmation Bias*, DIVERSIFIED SEARCH GROUP (Dec. 21, 2019), <https://diversifiedsearch.com/insights/perspectives/memo-to-boards-heres-how-to-avoid-confirmation-bias/> [<https://perma.cc/R2JB-TULX>]. For a detailed explanation of the perils of such mental shortcuts, see DANIEL KAHNEMAN, *THINKING FAST AND SLOW* (2011).

by group members to rely on information that confirms their initial opinions or a desired conclusion.³⁹⁵ Applied to compliance, confirmation bias can encourage the unfounded conclusion that there are no compliance problems in the company. Reaching such a conclusion is tempting even in the face of contradictory evidence: it is not only a desirable result for conflict-free board meetings but also mentally the path of least resistance.

The result of these cognitive and other pressures can result in the dangerously superficial practice of checkbox compliance masquerading as board outputs. Checkbox compliance is a decision-making process that encourages conformance to a set of standards with little regard to the spirit or purpose for which the standards were devised.³⁹⁶ Predictable preferences undermine authentic decision-making that enable board monitoring to function.³⁹⁷ Checkbox compliance improperly elevates form over function, symbolism over reality, and process over outcome. The goal of checkbox compliance can be to plow through monitoring issues as expeditiously as possible so that more time can be dedicated to the “important” subjects of strategy and operations.

Boards can conduct checkbox compliance in a variety of ways. A board may spend a specific period of time on compliance issues only because the agenda requires it, rather than any specific motivation to evaluate a firm’s compliance function. Discussions of compliance matters may be substantive in name only and performed only for the purpose of showing that board minutes reflected a ‘discussion’ of the compliance function in order to deflect accusations of mismanagement. Boards can also raise discussion of compliance issues with the belief that no problems exist already firmly in the minds of board members.

In order for boards to produce effective outputs that have a meaningful impact on the enterprise, boards must transform their understanding of the compliance and monitoring functions. First, and perhaps foremost, boards must dispatch any perception that compliance is merely a checkbox to complete. The compliance function is not just a necessary evil, but a critical part of the proper functioning of any organization.³⁹⁸

395. Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TULANE L. REV. 1363, 1401–02 (2002).

396. See Chong Ee, *Checkbox Compliance*, 67 INTERNAL AUDITOR 55, 55–56 (2010) (explaining how compliance processes in organizations sometimes favor form over substance).

397. See Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State*, 56 DUKE L.J. 377, 436 (2006) (discussing tools to improve administrative accountability).

398. Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage*, 19 U. PA. J. BUS. L. 285, 301, 302 n.65 (2017).

Matters of compliance must be given substantive time and energy on board agendas, even if that agenda already appears crowded with other matters that compete for the board's time. Compliance decision making should not be oversimplified merely because problems with compliance have not occurred in the past. Any outputs that the board makes to management and beyond should be developed with regularized involvement with key legal and compliance professionals such as the CLO and CCO.

Once boards have embraced compliance as a matter of substantive importance, boards must also treat compliance with the sophistication that it requires. Boards must recognize that compliance is more complex than ensuring a company meets a certain standard and that not every non-compliant practice encountered should be completed the same. Rather than binary states of legality and illegality, governance is better understood as a continuum of possibilities, which each possibility demanding a different response.³⁹⁹ For example, firms that are slightly out of compliance may merely require trivial actions handled entirely by management and outside the purview of the board.⁴⁰⁰ By contrast, non-compliance that significantly deviates from standards may require action by the board and a rethinking of the policies that led to the noncompliance. States of critical non-compliance can trigger severe penalties, harmful negative publicity, and a long-term loss of status in the industry, and may require immediate and decisive action by boards. Firms can even be in substantial over-compliance with regulatory standards.⁴⁰¹ This can provide a measure of safety against wrongdoing, but can also drain unnecessary resources and frustrate goal-focused employees.⁴⁰² Regardless of the condition, a board's output must encourage a calibrated reporting and monitoring system by which employees are empowered and trusted to both solve a problem themselves when appropriate and also feel fully free to take matters to a responsive board when circumstances dictate.⁴⁰³

Boards must also be comfortable with managing risk pragmatically and given limited available temporal and monetary resources.⁴⁰⁴ Boards will

399. *Id.* at 286–87.

400. *Id.* at 291.

401. *Id.* at 307.

402. *Id.* at 307–08.

403. *Id.* at 291 (citing Timothy F. Malloy, *Regulating by Incentives: Myths, Models, and Micromarkets*, 80 TEX. L. REV. 531, 535–36 (2002)).

404. See DELOITTE, *THE RISK INTELLIGENT ENTERPRISE: ERM DONE RIGHT 7* (2013) [hereinafter *ERM DONE RIGHT*], <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Governance-Risk-Compliance/dtl-grc-riskintelligent-erm-doneright.pdf> [<https://perma.cc/J3EU-H5U7>] (explaining that in evaluating response to risk, “[r]esource availability and allocation will, of course, need to be primary factors in these considerations”).

have to manage these limitations by triaging governance risks according to their severity and likelihood and recommend appropriate policies to management. Risks that are looming and substantial require sustained and rigorous oversight. Visualization tools such as heat maps can not only help boards evaluate and triage relevant threats, but help the board perceive more clearly perceive firm risks in relation to one another.⁴⁰⁵ This encourages the board to promote mitigating the greatest amount of risk relative to the cost necessary to mitigate it.⁴⁰⁶ Risk intelligent board members and executives should have a comfort level with risk that allows them to be confident that their carefully risk-assessed decisions will be supported by relevant stakeholders.⁴⁰⁷

Finally, boards must understand that any system of governance must be customized to the firm's unique needs. It is not uncommon for board members to serve on boards of multiple companies.⁴⁰⁸ However, what requires monitoring at one organization may be entirely different than the governance demands of another. Although laws typically apply to all enterprises within a jurisdiction, each board must manage its own custom challenges for conforming to legal rules.⁴⁰⁹ Whereas intellectual property may be a high priority for a pharmaceutical firm, for example, it may be of little relevance to a trucking company. As a firm grows from small to medium size, various carve outs exempting small firms from compliance obligations may disappear, requiring firms to deal with a new group of rules.

405. See Richard Acello, In *the Matrix*, 100 A.B.A. J. 33, 33 (2014) (describing a risk matrix used by law firm Ropes & Gray in the FCPA context that evaluates on a “heat-map basis where your biggest risks are . . . so clients can align their compliance resources with developing trends”); Dimitris Karagiannis et al., *Compliance Evaluation Featuring Heat Maps (CE-HM): A Meta-Modeling-Based Approach*, 7328 LECTURE NOTES IN COMP. SCI. 414 (2012) (depicting heat maps); Ahmed Awad & Mathias Weske, *Visualization of Compliance Violation in Business Process Models*, 43 LECTURE NOTES IN BUS. INFO. PROCESSING 182 (2009) (depicting various visualization models); Gerlinde Berger-Walliser et al., *Promoting Business Success Through Contract Visualization*, 17 J.L. BUS. & ETHICS 67, 68 (2011) (describing the benefits of visualization in the contractual context).

406. Bird & Park, *supra* note 398, at 313.

407. See ERM DONE RIGHT, *supra* note 406, at 5 (discussing the increased attention on risk management from boards of directors and stakeholders).

408. See, e.g., Sean Barry, *Are Board Members Overcommitted?*, HARV. L. SCH. F. CORP. GOV. (Aug. 9, 2018) (stating that “approximately 19% of Russell 3000 board members currently occupy more than one board seat, making it far from an oddity for a director to sit on multiple boards”); Anna Bergman Brown et al., *Are Directors Holding Multiple Board Seats Too Busy or Well-Connected?*, CLS BLUE SKY BLOG (May 24, 2018), <https://clsbluesky.law.columbia.edu/2018/05/24/are-directors-holding-multiple-board-seats-too-busy-or-well-connected/> [<https://perma.cc/3CPY-H45B>] (noting that “[d]irectors frequently hold multiple board seats, simultaneously lending their expertise to the boards of multiple firms”).

409. Bird, *supra* note 179, at 74.

The result is a unique “regulatory risk mix” which boards must first understand and then apply to the firm’s business units.⁴¹⁰ As the firm’s business units and interests change, so do the governance demands of the enterprise. Boards must produce outputs that are tailored to the firm’s needs.

V. CONCLUSION

Modern corporate governance should be viewed through the lens of a system. A systems approach perceives governance as a collection of inputs, processes, and outputs that take in and convey information to stakeholders. The systems idea is not purely theoretical, the recent cases of *Marchand v. Barnhill* and the governance quartet show that courts are perceiving boards’ governance obligations through the lens of systems language. How much change the courts will embrace remains to be seen, but a broader view of *Caremark* claims is now emerging, and systems thinking is a part of that change. The governance quartet may soon become a quintet, an octet, or beyond, as an increasing number of lower courts take the lead of *Marchand* and its progeny.

This interpretive shift is not merely theoretical. Changes in court interpretation of *Caremark* claims require a response from boards. A number of strategies are available for boards to respond to this call for systems thinking. A board that perceives governance as a continuous process customized to the firm’s needs and managed within the context of risk intelligence will be the most successful. A board that does not embrace systems thinking does so at its peril and exposes itself to liability over the long-term.

410. Bird, *supra* note 179, at 74.