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From Director Liability to Officer Liability to ESG Caremark Claims: A Natural Evolution?

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FROM DIRECTOR LIABILITY TO OFFICER LIABILITY TO ESG CAREMARK CLAIMS: A NATURAL EVOLUTION?

ABSTRACT

With the McDonald's decision, officers and directors could face Caremark liability for the first time, and this decision could also lead to an influx of ESG-based Caremark claims in Delaware Courts. This Comment explains that, while ESG Caremark claims would force corporations to adopt ESG oversight systems to avoid liability, the very political, social, and legal environment that created a growing call for ESG Caremark claims presents a beneficial opportunity for corporations to appeal to consumers and investors by proactively adopting ESG oversight systems. Corporations are at a nexus where they can either willingly adopt ESG oversight systems and reap the benefits or wait until the courts or the government force their hand, miss the opportunity, and simultaneously face fines.

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INTRODUCTION

The potential personal liability that corporate directors and officers face for a failure to oversee the corporation expands greater than ever, so it is only fair that corporate opportunity expand with it. *Caremark* claims, which originate from *In re Caremark International Inc. Derivative Litigation*,[1] establish a cause of action for shareholder derivative suits that allows the board of directors' liability for a failure to oversee the corporation based on a director's duties of care and loyalty.[2] As the Delaware Court of Chancery in *In re Caremark* explained:

> [A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.[3]

Modern *Caremark* liability cases have established a two-prong test for *Caremark* claims. Corporate directors can be found liable if they either "utterly failed to implement any reporting or information system or controls" or, "having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention" can prove liability.[4] *In re McDonald's Corp.* seemingly adapted this two-prong test to apply to corporate officers.[5] Corporate boards implemented oversight, or overwatch, systems to protect themselves from *Caremark* liability.[6] In the *Caremark* context, oversight systems monitor a corporation's regulatory compliance risks and involve reporting and addressing these risks at the board or executive management level.[7]

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

2 *Id.* at 969—70.

3 *Id.* at 970.

4 Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

5 *In re* McDonald's Corp. S'holder Deriv. Litig., C.A. 2021-0324-JTL at 1—2 (Del. Ch. Jan. 25, 2023) ("The Delaware Supreme Court has held that under Delaware law, corporate officers owe the same fiduciary duties as corporate directors, which logically includes a duty of oversight . . . [as vice-president] he had an obligation to make a good faith effort to put in place reasonable information systems so that he obtained the information necessary to do his job and report to the CEO and the board, and he could not consciously ignore red flags indicating that the corporation was going to suffer harm.").

6 *What is Oversight and How Does it Relate to Governance?*, CANADIAN AUDIT & ACCOUNTABILITY FOUNDATION (last visited Jan. 27, 2023), https://www.caaf-fcar.ca/en/oversight-concepts-and-context/what-is-oversight-and-how-does-it-relate-to-governance ("Oversight refers to the actions taken to review and monitor public sector organizations and their policies, plans, programs, and projects.").

7 *Id.*

In recent years, there was an increase of *Caremark* claims in Delaware courts. These claims normally focus on regulatory aspects and a failure to monitor corporate compliance with state and federal law, especially financial and product liability focused regulations.[8] However, *Caremark* claims' rise coincided with a growing call for companies to focus on environmental, social, and corporate governance ("ESG") issues.[9] In fact, "83% of consumers think companies should be actively shaping ESG best practices."[10] ESG is a broad area, and issues under its umbrella include environmental sustainability, climate change, resource scarcity, labor practices, talent, product safety, data privacy, diversity, inclusion, sexual discrimination and relationships in its local communities, executive and board compensation, internal audits and controls, anti-corruption, and shareholder rights.[11] That some ESG aspects remain unregulated and voluntary rather than mandatory furthers this complexity. For instance, while the Clean Air and Water Acts heavily regulate environmental protection, diversity and inclusion initiatives remain mostly voluntary for corporations, with some efforts even encountering litigation.[12] Thus, corporations must determine the value of adopting those still unregulated ESG aspects. Corporations that impose voluntary ESG requirements perhaps agree with Merrick Dodd's argument that corporations are not just vehicles for

8 *See* Gail Weinstein, Warren S. de Wied, & Philip Richter, *Caremark Liability for Regulatory Compliance Oversight*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (July 8, 2019), https://corpgov.law.harvard.edu/2019/07/08/*Caremark*-liability-for-regulatory-compliance-oversight/.

9 *See Beyond Compliance: Consumers and Employees Want Businesses to do More on ESG*, PWC (last visited Jan. 26, 2023) https://www.pwc.com/us/en/services/consulting/library/consumer-intelligence-series/consumer-and-employee-esg-expectations.html; Simon-Kucher & Partners, *Recent Study Reveals More Than a Third of Global Consumers Are Willing to Pay More for Sustainability as Demand Grows for Environmentally-Friendly Alternatives*, BUSINESS WIRE (Oct. 12, 2021) https://www.businesswire.com/news/home/20211014005090/en/Recent-Study-Reveals-More-Than-a-Third-of-Global-Consumers-Are-Willing-to-Pay-More-for-Sustainability-as-Demand-Grows-for-Environmentally-Friendly-Alternatives ("Globally, 85 percent of people indicate that they have shifted their purchase behavior towards being more sustainable in the past five years.").

10 *Id.*

11 Megan Baroni & Jonathan H. Schaefer, *What is ESG and How Could It Impact You?*, 12 NAT'L L. REV. 309 (2022); Thomas Brock & Ariel Courage, *What Is Environmental, Social, and Governance (ESG) Investing?*, INVESTOPEDIA (Sep. 27, 2022), https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp#toc-environmental-social-and-governance.

12 Environmental Protection Agency, *The Clean Air Act in a Nutshell: How It Works* (Mar. 22, 2013), https://www.epa.gov/sites/default/files/2015-05/documents/caa_nutshell.pdf; Kelsey Simpkins, *7 Things to Know About the Clean Water Act After 50 years*, UNIVERSITY OF COLORADO BOULDER (April 20, 2022), https://www.colorado.edu/today/2022/04/20/7-things-know-about-clean-water-act-after-50-years; Kenneth Ross & Ted Dorenkamp, *Product Liability and Safety in the United States: Overview*, THOMAS REUTERS (Sep. 1, 2020), https://uk.practicallaw.thomsonreuters.com/w-012-8129?transitionType=Default&contextData=(sc.Default); Reed L. Russell & Juliet A. Girad, *Proceed With Caution: Voluntary Diversity Efforts Must be Undertaken with Care to Limit Litigation Risk for Employers*, 95 No. 6 Fla. Bar J. 52 (2021).

creating money but must also contribute to the community.[13] Some scholars directly tied *Caremark* claims and ESG together and advocated for ESG-based *Caremark* claims.[14]

With the Delaware Court of Chancery's landmark ruling in *In re McDonald's Corp. Derivative Litigation*, corporate officers and directors can face *Caremark* liability for the first time since *Caremark* claims' creation nearly 30 years ago.[15] The *In re McDonald's* decision carries the potential for a second transformation of *Caremark* claims. In *In re McDonald's*, a former vice president faced liability because he consciously ignored sexual harassment notices in the workplace and did not create an oversight system to monitor human resources.[16] Instead of a failure to oversee finances or products, *In re McDonald's* directly addressed a corporation's failure to oversee the ESG issues of gender and sexual harassment. *In re McDonald's* could signal the welcome of more ESG-based *Caremark* claims in the Delaware legal system.

With ESG *Caremark* claims' potential expansion, corporate officers and directors may risk liability if they do not adopt ESG oversight systems. But, beyond avoiding liability for corporate officers and directors, corporations that implement ESG oversight systems can gain important benefits. In this comment, I analyze consumer trends, the political environment, case law, current monitoring systems, and potential costs to explain those benefits, and I advocate for corporations to voluntarily adopt ESG oversight systems.

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[13] Lynn A. Stout, *Bad and Not-so-Bad Arguments for Shareholder Primacy*, CORNELL LAW FACULTY PUBLICATIONS (Paper 448, 2002), http://scholarship.law.cornell.edu/facpub/448.

[14] Leo E. Strine, Jr., Kirby M. Smith, & Reilly S. Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 IOWA L. REV. 1885 (2021).

[15] McDonald's, *supra* note 5 at 1; *See also Officer Liability, Supersized: Delaware Court of Chancery Holds Caremark Duty of Oversight Now Applies to Corporate Officers*, Baker Botts LLP (Jan. 26, 2023) ("Importantly, while the Court held that officers and directors both owe duties of oversight, it also held that the particular oversight required for any officer would depend on that officer's particular role and may be narrower than for a director. 'Although the duty of oversight applies equally to officers, its context-driven application will differ.' Some officers, like the CEO or the Chief Compliance Officer, 'likely will have company-wide oversight portfolios.' Other officers have particular areas of responsibility, and the officer's duty only applies within that area. 'For example, the . . . Chief Legal Officer is responsible for legal oversight and for making a good faith effort to establish reasonable information systems to cover that area.' An officer's duty to address and report serious misconduct (*i.e.*, red flags) generally only exists within the officer's area, although a 'sufficiently prominent' red flag—for example, credible information that the corporation is violating the law—might require an officer to act even if it fell outside the officer's domain."), https://www.bakerbotts.com/thought-leadership/publications/2023/january/delaware-court-of-chancery-holds-*Caremark*-duty-of-oversight-now-applies-to-corporate-officers.

[16] *Id.*

I. The Public and Governmental ESG Atmosphere

The *McDonald's* decision outwardly indicates the Delaware Court of Chancery's openness to ESG *Caremark* claims, and there is growing public and governmental support for ESG initiatives. According to PricewaterhouseCoopers, "well over half of all consumers (59%) say a company's purpose and values play an important role in their purchasing decisions," and "younger consumers (17-38 years) are almost twice as likely to consider ESG issues when making purchasing decisions than consumers over 38 years old."[17] It is not just consumers that care about ESG. Corporate employees and investors push for ESG objectives.[18] If corporations adapt this push, they can benefit from it too, as almost 25% of investment in the U.S. went toward ESG-oriented corporations in 2019.[19] This, with consumers' increasing willingness to change their buying habits based on a corporation's perceived ESG attitude, creates an incentive for corporations to adopt ESG goals and objectives.[20]

The growing call from the public for ESG focused corporations bleeds into inner corporate operations. Shareholder activist campaigns are increasingly common and increasingly hostile toward corporate boards.[21] This results in votes against corporate directors.[22] In fact, a shareholder activist campaign focused on environmental sustainability ousted two Exxon Mobil board members.[23] This atmosphere created a "race to the top, where the top corporations are trying to 'out green' one another" to appeal to shareholders, investors, and even employees.[24]

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[17] *How Can Consumer-facing Companies Weave Social Justice Into Their DNA?*, PWC, (last visited Jan. 27, 2023), https://www.pwc.com/us/en/industries/consumer-markets/library/esg-metrics-influence-buying.html.

[18] Tine Thygesen, *Everyone Is Talking About ESG: What Is It and Why Should It Matter To You?*, FORBES (Nov. 8, 2019), https://www.forbes.com/sites/tinethygesen/2019/11/08/everyone-is-talking-about-esgwhat-is-it-and-why-should-it-matter-to-you/?sh=656780fa32e9.

[19] *Id.*

[20] *Id.*

[21] Richard Mattison et al., *Key Trends That Will Drive the ESG Agenda in 2022*, S&P GLOBAL SUSTAINABILITY (Jan. 31, 2022), https://www.spglobal.com/esg/insights/featured/special-editorial/key-esg-trends-in-2022.

[22] *Id.*

[23] Esther Whieldon, *Thought Leadership: Exxon Board Ouster Marks Tipping Point for Investor Climate Engagement*, S&P GLOBAL SUSTAINABILITY (last visited Nov. 5, 2022), https://www.spglobal.com/esg/insights/thought-leadership-exxon-board-ouster-marks-tipping-point-for-investor-climate-engagement.

[24] Telephone Interview with Joshua D. Marks, Counsel, Parker Poe (Nov. 9, 2022).

The federal government increased its emphasis on ESG-related issues as well, especially ESG reporting. Since the Biden administration encouraged environmental protection in its policy implementation, even federal bills not strictly focused on the environment contain terms aimed at helping the environment. For example, the Inflation Reduction Act provides for clean-energy tax credits, rebates for green vehicles, and rewards for oil and gas companies for cutting methane emission.[25] In total, the Biden administration added 57 environmental policies and overturned 83 of the Trump administration's less environmentally friendly policies.[26]

The Biden administration's environmental protection laws and regulations add to an already extensive body of regulatory law, particularly the Clean Air and Water Acts. The Clean Air Act allows the EPA to set a standard for air quality and require that states adopt plans that meet this standard.[27] The Clean Water Act similarly allows the government to set water quality standards and controls companies' discharge in waterways.[28] The Clean Water and Air Acts stand out as some of the earliest ESG regulations, having passed in 1972 and 1970 respectively.[29] While the Biden administration's policies mostly relate to greater environmental regulation and protection, the Securities and Exchange Commission ("SEC") under the administration focuses broadly on ESG issues.

Several proposals from the SEC aim to require ESG disclosures in more situations. Foremost, an SEC proposal from May 2022 would require investment funds that consider ESG factors to make disclosures to the government regarding their strategies in fund prospectuses, annual reports, and adviser brochures.[30] The requirement would apply to the following ESG funds:

- Integration Funds. Funds that integrate ESG factors alongside non-ESG factors in investment decisions must describe how they incorporate ESG factors into their investment process.

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[25] Alicia Adamczyk, *The Biden Administration Is Making It Easier to Invest in Sustainable Funds in Your 401(k)*, CNBC (Oct. 20, 2021), https://www.cnbc.com/2021/10/20/biden-admin-is-making-it-easier-to-invest-in-esg-funds-in-your-401k.html.

[26] *Id.*

[27] Environmental Protection Agency, The Clean Air Act in a Nutshell: How It Works (Mar. 22, 2013), https://www.epa.gov/sites/default/files/2015-05/documents/caa_nutshell.pdf.

[28] Kelsey Simpkins, *7 Things to Know About The Clean Water Act After 50 Years*, UNIVERSITY OF COLORADO BOULDER (Apr. 20, 2022), https://www.colorado.edu/today/2022/04/20/7-things-know-about-clean-water-act-after-50-years.

[29] *Id.*

[30] Fact Sheet: ESG Disclosures for Investment Advisers and Investment Companies, U.S. Securities and Exchange Commission, (2022) https://www.sec.gov/files/ia-6034-fact-sheet.pdf.

- ESG-Focused Funds. Funds for which ESG factors are a significant or main consideration must provide detailed disclosure, including a standardized ESG strategy overview table.
- Impact Funds. A subset of ESG-Focused Funds that seek a particular ESG impact must disclose how they measure progress on their objective.”[31]

A separate SEC proposal focuses exclusively on climate disclosures. The proposal would require that domestic and foreign registrants with the SEC disclose a variety of information, including their greenhouse gas emissions, climate related goals, governance of climate risks, and climate related financial statements.[32] Additionally, an SEC proposal under the Biden administration that makes it easier for employers to offer 401ks that account for ESG factors sponsors ESG investment.[33] If enacted, these proposals would create a much larger ESG regulatory sphere. Corporations that already implemented ESG initiatives push for these proposals because they want a verifiable-independent standard to measure against their competitors that did not adopt ESG initiatives.[34] Since shareholders increasingly use corporate disclosures as support for ESG shareholder campaigns, additional SEC disclosure requirements will aid them in this.[35]

The SEC seems more willing to wade into ESG regulatory waters and already has a method to enforce its proposals. In March of 2021, the SEC created a Climate and ESG Task Force in the Division of Enforcement.[36] The task force develops “initiatives to proactively identify ESG-related misconduct” with a focus on “any material gaps or misstatements in issuers’ disclosure of climate risks under existing rules.”[37] In May of 2022, the task force helped charge BNY Mellon Investment Adviser, Inc. “for misstatements and omissions about Environmental, Social, and Governance (ESG) considerations in making investment decisions for certain mutual funds that it managed,” which resulted in a $1.5 million penalty.[38] In July 2022, the task force helped charge a Tampa

31 *Id.*
32 *Id.*
33 *Id.*
34 Telephone Interview with Joshua D. Marks, Counsel, Parker Poe (November 9, 2022).
35 *Id.*
36 Press Release, U.S. Securities and Exchange Commission, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (March 4, 2021), https://www.sec.gov/news/press-release/2021-42.
37 *Id.*
38 Press Release, U.S. Securities and Exchange Commission, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022), https://www.sec.gov/news/press-release/2022-86.

insurance distributer for "concealing extensive consumer complaints about short-term and limited health insurance products."[39] The insurance distributer paid over $11 million in penalties.[40]

The SEC under the Biden administration continuously proposes and enforces more ESG regulations, and many corporations and shareholders support them. If enacted, the ESG disclosure regulations would incredibly help shareholders who attempt to bring ESG *Caremark* suits. Since Delaware courts are friendlier to any *Caremark* suit that involves a failure to comply with government regulation, ESG Caremark claims are more likely to succeed against any corporation that fails to follow these disclosure regulations.[41] Additionally, shareholders could use the ESG data from these disclosures in their ESG *Caremark* suits to support claims that the board provided false information to the SEC or was aware of ESG issues but did not act. Thus, the SEC's ESG regulations could provide the necessary ammo for ESG *Caremark* liability claims' multiplication in Delaware courts.

The current political and public atmosphere is a double-edged sword for corporations confronted with ESG *Caremark* liability. On one hand, the government increasingly proposes ESG regulations that would provide shareholders with greater legal footing for ESG *Caremark* claims against corporate officers and directors. On the other, consumers and investors have never cared more about ESG issues and are willing to change their buying habits to support ESG focused corporations.

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39 Press Release, U.S. Securities and Exchange Commission, SEC Charges Tampa-Based Health Insurance Distributor and its Former CEO with Making False Statements to Investors (Jul. 20, 2022), https://www.sec.gov/news/press-release/2022-126.

40 *Id.*

41 *In re* Facebook, Inc., 2019 WL 2320842 at *14 n.150 (Del. Ch., May 30, 2019) ("In other words, it is more difficult to plead and prove *Caremark* liability based on a failure to monitor and prevent harm flowing from risks that confront the business in the ordinary course of its operations. Failure to monitor compliance with positive law, including regulatory mandates, on the other hand, is more likely to give rise to oversight liability."); *See* Stephen M. Bainbridge, *Don't Compound the Caremark Mistake by Extending it to ESG Oversight* (UCLA Sch. L., Law-Econ Rsch. Paper No. 21-10, Sep. 2021) ("Although *Caremark* has been applied almost exclusively with respect to law and accounting compliance, the original *Caremark* decision contemplated applying the oversight duty to the corporation's 'business performance.' As I have observed elsewhere, there is therefore 'no doctrinal reason that *Caremark* claims should not lie in cases in which the corporation suffered losses, not due to a failure to comply with applicable laws, but rather due to lax risk management.' Indeed, several cases have indicated that liability could arise in just such a case. In addition, at least two recent cases have found *Caremark* claims to be well pleaded where plaintiff alleged that the board of directors had no system in place to monitor to safety issues, albeit in highly regulated industries."), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3899528.

Corporations that create ESG oversight systems can tie these issues together and address both to their benefit. For instance, ESG oversight systems would help preemptively combat the proposed governmental ESG disclosures. If corporations already have an oversight system that monitors and collects information on the corporation's ESG data, they can simply use this system to give ESG data to the government for disclosure purposes. Corporations that embrace these systems now can save regulatory compliance costs in the future. In addition, due to their greater appeal with ESG-minded consumers, ESG oversight systems' adoption can result in increased market share and financial gain. In fact, "46[% of people] said they would be prepared to pay more for better ESG performance, despite the cost-of-living pressures being felt around the world."[42] As corporations can market ESG initiatives to get consumers to forego less ESG-friendly competitors, they should market their ESG oversight system's adoption to prove their dedication to ESG initiatives.[43] ESG oversight systems can also collect ESG data for future marketing purposes. As previously mentioned, oversight systems monitor corporate compliance risks, so an ESG oversight system would monitor and collect a corporation's ESG compliance data. Once collected, corporations could give helpful data to their marketing team to further boost their ESG appeal.[44] Finally, because ESG oversight systems would monitor potential ESG risk, they would help catch any ESG problems before they turn into public relations disasters.[45]

Even if none of these benefits appeal to corporations, "78% of people [believe] that companies have a duty to be good citizens," and "71% expect them to launch ESG action" according to the SEC Newgate ESG Monitor report.[46] These consumer beliefs mirror corporate social responsibility.[47] "Business

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[42] Elizabeth Wiredu, *Half of Consumers Would Pay More for Better ESG Despite Cost-of-Living Pressures*, PRWeek (Oct. 19, 2022), https://www.prweek.com/article/1802558/half-consumers-pay-better-esg-despite-cost-of-living-pressures.

[43] Terry E. Cohen, *Why Businesses Should Care What Consumers Think About Their ESG Efforts*, PUNDIT (Aug. 10, 2022) https://www.triplepundit.com/story/2022/consumer-attitudes-esg/752006 ("In May 2022, Glow found that 1 in 4 consumers in the U.S., Australia and the U.K. started, switched or stopped use of a brand with sustainability and social responsibility concerns as a factor.")

[44] Leeya Hendricks, *How Marketing Teams can Tackle the Challenge that is ESG*, FORBES https://www.forbes.com/sites/forbescommunicationscouncil/2022/03/21/how-marketing-teams-can-tackle-the-challenge-that-is-esg/?sh=14291da18414 (recommending that, for ESG marketing purposes, businesses audit their commitment to ESG at every level).

[45] Carsten Boehme, *Why Does Communications Fail so Often in "ESG Crisis"?*, Instinctif Partners (March 16, 2022) https://instinctif.com/thinking/esg-crises-communication-fail/ ("Environmental issues, Social aspects and responsible corporate Governance seem to create a special explosive that can destroy reputations and careers in a very short time.")

[46] *Id.*

[47] Tim Stobierski, *Types of Corporate Social Responsibility to be Aware of*, HARVARD BUSINESS SCHOOL ONLINE (Apr. 8, 2021), https://online.hbs.edu/blog/post/types-of-corporate-social-responsibility.

leaders have recognized that they have a responsibility to do more than simply maximize profits for shareholders and executives."[48] "Rather, they have a social responsibility to do what's best not just for their companies, but people, the planet, and society at large."[49] Accordingly, especially now that corporations have notice that ESG oversight systems are necessary, if corporations suffer an ESG-related mishap, they should expect that consumers turn away from their brand. Thus, corporations should view ESG oversight systems' implementation as an opportunity to benefit, rather than a burden.

Not only would proactively adopting ESG oversight systems result in such benefits, but a proper ESG oversight system would perfectly defend against ESG *Caremark* claims. Even better, the nearly 30 years' worth of *Caremark* case law provides a free guide for corporations to design their ESG oversight systems, as past *Caremark* decisions detail proper *Caremark* oversight systems' necessary elements. Additionally, and perhaps more importantly, many corporations already adopted *Caremark* oversight systems that incorporate the oversight system elements such case law recommends. Consequently, corporations that adapt their existing oversight systems to monitor for ESG liability will not pay to create entirely new ESG oversight systems.

II. PRE-MARCHAND: THE DIFFICULTY IN PROVING A *CAREMARK* CLAIM

Historically, Delaware courts hesitated to find merit in *Caremark* liability claims. Even in the *Caremark* decision itself, the court noted that this liability theory was "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[50] This was especially true before the *Marchand* decision. A successful *Caremark* claim was rare, but even those that failed gave insight into how a board can properly design an oversight system to protect itself from *Caremark* liability. This insight is fundamental in determining the necessary components in a proper ESG oversight system, whether current corporate oversight systems have these components, and if existing oversight systems can adapt to monitor for ESG issues.

A. Unsuccessful Caremark Claims

In re General Motors Co. perhaps best shows that plaintiffs must meet a high burden of proof to successfully plead a *Caremark* claim.[51] There, a faulty

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48 *Id.*
49 *Id.*
50 Caremark, 698 A.2d at 967.
51 *In re* General Motors Co., 2015 WL 3958724 (Del. Ch. June 26, 2015).

ignition switch in General Motors cars "caused the vehicle's engine and electrical system to shut off, which disabled power steering and power brakes, and also caused the vehicle's airbag to not deploy in the event of a crash."[52] This resulted in several serious injuries and deaths.[53] As the court in *In re General Motors* said:

> [T]he factual scenario underlying this matter is sadly familiar. An iconic American company produces a product or service that goes terribly awry, causing the company financial and reputational damage, and perhaps doing damage to society at large as well. A stockholder of the company wishes to sue derivatively on behalf of the company, to recoup its losses by holding directors liable under theories of breach of fiduciary duty.[54]

The General Motors board did not catch the faulty ignition switch, even with an overwatch system for product safety. The overwatch system included a Finance and Risk Committee, a Chief Risk Officer ("CRO"), outside counsel, and in-house counsel.[55] The Finance and Risk Committee, comprised of some board members, reviewed the internal communications, cash flow, insurance issues, tax planning, strategic investment, and other financial documents and communications.[56] The CRO was "responsible for identifying the Company's risks and stress testing key risk scenarios," and had the "responsibility of coordinating the Company's risk management and mitigation strategies."[57]

General Motors had a large in-house counsel department that reviewed product liability cases and claims.[58] In-house counsel had authorization to approve settlements up to $5 million without the board's or General Counsel's approval.[59] General Motors would bring in outside counsel to advise it on certain product liability cases.[60] It was through this mechanism that in-house counsel knew of the faulty ignition switches. King & Spalding, which provided in-house counsel advice at the time, thought "a jury would almost 'certainly' find that the ignition switch was unreasonably dangerous."[61] In-house counsel then settled a claim that involved the faulty ignition switches for $5 million.[62] Since this

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52 *Id.* at *1.
53 *Id.*
54 *Id.*
55 *Id.* at *1, *8.
56 *Id.* at *1.
57 *Id.*
58 *Id.* at *8.
59 *Id.*
60 *Id.*
61 *Id.* at *9.
62 *Id.*

settlement was at the $5 million maximum, in-house counsel could pay without alerting the board, so the board never knew of these cases or the faulty ignition switches.[63]

That in-house counsel never alerted the board was the basis for the plaintiff's *Caremark* liability claim. General Motors had an overwatch system, so the plaintiff could not allege the directors "utterly failed to implement any reporting or information system or controls."[64] However, the plaintiffs could allege, under the second *Caremark* claim prong, that, when it implemented an overwatch system, the board consciously did not monitor or oversee its operations and disabled its ability to be informed of risks or problems that required its attention.[65] Essentially, the plaintiffs argued, the board then chose to ignore the overwatch system and make sure it received no reports about it. The court held the board of General Motors did not consciously fail to monitor its operations or inform itself of risks because there were no "red flags."[66] In other words, there were no indicators to the board that its overwatch system did not function properly.[67]

The court passed the blame to the individuals who operated the overwatch system, rather than the board, for the system's failure.[68] While the board did not "conscientiously disregard[]" the system, the court did not say the board was blameless, merely that the overwatch system was not an utter failure.[69] The board neither informed itself on some aspects of the overwatch system nor placed the proper people in certain positions, but they were not solely responsible for the failure. This ruling illustrates how high the bar is to establish a *Caremark* claim. A board can be partly responsible for a failure in oversight that leads to injury, but still avoid liability if the right system exists.

Moreover, the court denied *Caremark* liability, even though General Motors' business operated in a highly regulated environment. General Motors even had a regulatory duty to inform the National Highway Traffic Safety Administration if it learned that any of its vehicles contained a defect.[70] Though *Caremark* claims more likely succeed against corporations in heavily regulated

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63 *Id.*
64 *Id.* at *15.
65 *Id.* at *9.
66 *Id.* at *13
67 *Id.*
68 *Id.* at *17.
69 *Id.*
70 *Id.* at *5.

environments, the claim against General Motors did not satisfy the high bar for *Caremark* claims.

In re General Motors is a prime illustration of most *Caremark* claims because many facts went against the board of directors, but the verdict was ultimately in its favor. A product defect led to serious injury and death, individuals at General Motors knew of the defect, no one reported the defect to the board, and the corporation operated in a heavily regulated sector. Nonetheless, the board escaped liability because, while the court admitted it was negligent, the individuals who operated the system received the blame for the overwatch system's failure. In the following cases, there are several different facts, but the board escaped liability because they had an overwatch system. A proper overwatch system in place, even if it fails, is the strongest defense to a *Caremark* claim, and the following cases further define what constitutes a proper overwatch system.

As corporate boards face the possibility that they must design ESG oversight systems, it is critical to understand what constitutes a proper overwatch system. This understanding from case law is necessary for boards to determine if their oversight systems contain the proper elements and adapt these existing systems to monitor ESG issues. If proper, this adaptation unlocks one of the many benefits to adopting ESG oversight systems because corporate officers and directors have the ideal defense against any ESG *Caremark* claims.

The Delaware Court of Chancery again emphasized the "high bar required to state a *Caremark* claim" in *Firemen's Retirement System of St. Louis on behalf of Marriott International, Inc. v. Sorenson.*[71] Unlike *In re General Motors*, the board in *Marriott* knew of the problem and did not fix the issue. Yet, the Delaware Court of Chancery granted Marriott's motion to dismiss.

"In the fall of 2018, Marriott International, Inc. discovered a data security breach that had exposed the personal information of up to 500 million guests, and a series of stockholder and consumer actions followed," including this litigation.[72] Marriott's acquisition of Starwood Hotels and Resorts, which had gaps in its data protection systems, exposed it to the data breach.[73] In 2017, Marriott caught the data protection issue thanks to its overwatch system, but it

71 Firemen's Ret. Sys. St. Louis *ex rel*. Marriott Int'l, Inc. v. Sorenson, 2021 WL 4593777 at *1 (Oct. 5, 2021).
72 *Id.*
73 *Id.*

never fixed the issue, which resulted in the 2018 breach.[74] The plaintiffs alleged this failure to rectify the data protection gaps exposed the board to *Caremark* liability because it consciously did not monitor or oversee its operations.[75] The Delaware Court of Chancery thought differently.

Marriott's overwatch system functioned like the system in *In re General Motors*. Marriott had an audit committee comprised of some board members that it "expected to have an understanding of the business implications of cyber risks."[76] It hired Ernst & Young and PricewaterhouseCoopers as outside advisors.[77] Marriott "established a Security Operations Center, an Incident Response plan, and related procedures."[78] As mentioned in the complaint, the Marriott board and the Audit Committee also received cyber security reports.

> [T]he Board and Audit Committee were 'routinely apprised' on cybersecurity risks and mitigation, provided with annual reports on the Company's Enterprise Risk Assessment that specifically evaluated cyber risks, and engaged outside consultants to improve and auditors to audit corporate cybersecurity practices. The Complaint also describes internal controls over the Company's public disclosure practices. And when management received information that the plaintiff describes as 'red flags' indicating vulnerabilities, the reports were delivered to the Board.[79]

Both the Audit Committee and PricewaterhouseCoopers's assessment alerted the Marriott board to potential cyber risks.[80] Management told the board that it addressed, or would address, the issues.[81] Based on this, the court held the board did not "consciously ignore[]" cyber security red flags.[82] Like General Motors, Marriott avoided *Caremark* liability because it had an overwatch system and the court deemed that its failure fell on the management level, rather than exclusively on the board.[83]

It is noteworthy that, like in *In re General Motors*, Marriott operated in a highly regulated sector when the data breach occurred. This decision came at a time when "the President of the United States has named cybersecurity a 'top

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74 *Id.* at *13.
75 *Id.*
76 *Id.* at *3.
77 *Id.*
78 *Id.*
79 *Id.* at *13.
80 *Id.* at *16.
81 *Id.*
82 *Id.* at *17.
83 *Id.*

priority and essential to national and economic security.'"[84] Thus, while a *Caremark* claim's pursuit against a corporation in a highly regulated sector might increase the chances of success, this factor alone is not dispositive.[85]

Marriott allowed the Delaware Court of Chancery to stress that an existing overwatch system is the greatest defense a corporation has against *Caremark* claims. It outweighs negative factors, like operating in a regulated environment, board awareness, and even the overwatch system's failure. Therefore, while *Caremark* claims' expansion with ESG claims does create more potential liability for corporations, corporations can adopt ESG oversight systems and protect their officers and directors. It is a bonus that these systems' adoption also benefits the corporation's position with consumers.

As a final emphasis, the decision in *City of Birmingham Retirement and Relief System v. Good et al*. presents extreme facts, yet there was still no *Caremark* liability because the corporation had a proper overwatch system.[86] The case started when "a stormwater pipe ruptured beneath a coal ash pond at Duke Energy Corporation's Dan River Steam Station in North Carolina."[87] "The spill sent a slurry of coal ash and wastewater—containing lead, mercury, and arsenic—into the Dan River, fouling the river for many miles downstream."[88] When Duke Energy subsequently paid $102 million in fines for a Clean Water Act violation, a derivative suit to hold the board of directors personally liable for the fine began.[89]

Like General Motors and Marriott, Duke Energy had an overwatch system. Duke Energy had a Regulatory Policy and Operations Committee that heard reports on the companies risks and compliance.[90] One of these presentations alerted the Regulatory Policy and Operations Committee to the company's potential coal ash risk.[91] However, like in *Marriott*, the committee heard that "work was underway to mitigate the risk," and had specific mitigation examples.[92] After the presentation, the Duke Energy board received a similar presentation that discussed the coal ash risk and the steps to mitigate the risk.[93]

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84 *Id.* at *11.
85 *Id.* at *12.
86 City of Birmingham Ret. and Relief Sys. v. Good et al., 177 A.3d 47 (Del. 2017).
87 *Id.* at 50
88 *Id.*
89 *Id.*
90 *Id.* at 57.
91 *Id.*
92 *Id.*
93 *Id.* at 57—58.

The court considered the presentations as a proper oversight system. Like the court in *In re General Motors*, the court here did not view the board as blameless, but the board did not consciously disregard the risk because management told it that steps were taken to mitigate the risks.[94] In other words, the "plaintiffs' complaint unsuccessfully attempted "to equate a bad outcome with bad faith."[95]

Furthermore, environmental regulation and the Clean Water Act were at the case's forefront. If the court ruled differently here, this case might have encouraged more ESG focused *Caremark* claims. Another point that Chief Justice Strine highlighted in his dissent, was the number of regulations Duke Energy violated. According to Justice Strine:

> Under the facts as pled, the only surprising thing about the Dan River spill that gave rise to the state regulator's issuance of a $6.8 million fine, twenty-three Notice of Violation letters, twenty-six Notice of Deficiency letters, and a finding that Duke committed more than 760 daily violations of environmental regulations, in addition to other severe civil and criminal penalties related to Duke's operations at other sites, is that something like it did not happen years earlier.[96]

Strine stated that there was potential foul play between Duke Energy and its local regulatory authority.[97] There was never confirmation because the case was dismissed before discovery.[98] Nonetheless, the regulatory violations' magnitude and foul play allegations were still not enough to overcome the high bar necessary for a *Caremark* claim.

As the three previous cases did not survive motions to dismiss, they illustrate the difficulty in proving a *Caremark* liability claim. Nevertheless, demand futility presents another obstacle to proving *Caremark* claims. Demand futility refers to the requirement that, before filing a shareholder derivative suit, shareholders must either demand that the board of directors address the issue or prove in court that such a demand was futile.[99] If the shareholders make a demand, they risk the board controlling the litigation.[100] If the shareholders do not, they face the difficulty of proving the board is not independent or not

94 *Id.* at 59.
95 *Id.*
96 *Id.* at 68 (Strine, C.J., dissenting).
97 *Id.* at 68—69 (Strine, C.J., dissenting).
98 *Id.* at 69 (Strine, C.J., dissenting).
99 Heather Sultanian, *Delaware Supreme Court Clarifies the Standards for Demand Futility*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Oct. 27, 2021), https://corpgov.law.harvard.edu/2021/10/27/delaware-supreme-court-clarifies-the-standards-for-demand-futility/.
100 *Id.*

disinterested.[101] As Heather Sultanian explained on the Harvard Law School Forum on Corporate Governance:

> For alleged violations of the board's oversight duties under *Caremark*, the test articulated in *Rales v. Blasband* applies to assess demand futility. Under Rales, the plaintiffs must plead particularized facts raising "reasonable doubt of the board's independence and disinterestedness when the demand would reveal board inaction of a nature that would expose the board to 'a substantial likelihood' of personal liability.[102]

Such a demand or proving demand futility in court add another hoop through which plaintiffs must jump to successfully plead a *Caremark* claim, further decreasing the litigation's survival odds. The demand futility requirement with the defense of a proper overwatch system destined these *Caremark* claims' failure. This would be the same fate ESG *Caremark* claims would meet if faced with a proper ESG oversight system. However, before corporations can unlock this exceptional benefit, they must design and implement a proper ESG oversight system.

B. What Constitutes a Proper Overwatch System?

In re General Motors, *Marriott*, and *Good et al*. illustrate the difficulty in proving *Caremark* claims; however, they serve a second purpose. The commonalities between the three corporations' overwatch systems provides a guide for how a board can create a proper overwatch system to avoid *Caremark* liability and can apply to ESG oversight. More precisely, a proper overwatch system can feature risk assessments, audit committees, a dedicated risk officer, reports given to the board, and outside counsel or consultants.

The overwatch systems examined in *Marriott* and *Good et al*. both featured risk assessments. In *Marriott*, there was an annual risk assessment that monitored cybersecurity risks presented to the Audit Committee. In *Good et al.*, there were regular risk reports on regulatory compliance to the Regulatory Policy and Operations Committee. Thus, another common element for proper overwatch systems is an audit committee. Marriott, General Motors, and Duke Energy all had committees, usually comprised of some board members and other management officials, that either investigated risks or heard presentations and reports on potential risk. The committees in each corporation had different names, but their purpose was the same: auditing the company for some risk. It

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101 *Id.*

102 Good et al., 177 A.3d at 55.

was the combination of these risk assessments and audit committees in Marriott's and Duke Energy's overwatch systems that led to the discovery of the very risk that caused damage to the corporations. This could explain why courts often look for both risk assessments and audit committees when they examine overwatch systems. As mentioned earlier, some committees discussed, but did not properly handle, these risks, but the corporations still avoided *Caremark* liability. Consequently, it is better that an overwatch system has regular risk reports and audit committees to catch risks, even if no one properly handles some risks.

On the other hand, the overwatch system in *In re General Motors* did not feature regular risk assessments, but there was a Chief Risk Officer. After the Chief Risk Officer identified risks to the company and created strategies to address them, the Chief Risk Officer reported to a Finance and Risk Committee. Thus, even though there may not have been regular risk assessments, like the overwatch systems of Marriott and Duke Energy, there was still a sub-committee that knew of potential risks to the corporation.

A common feature in General Motors's and Marriott's overwatch systems was outside counsel. General Motors hired King & Spalding to advise it on its position after the faulty ignition switches' discovery. Marriott hired Ernst & Young and PricewaterhouseCoopers to conduct a cyber risk assessment. Outside counsel and consultants can be an important component of a proper overwatch system because it shows the board did not consciously disregard the risk. If a board pays for an opinion outside the corporation and is willing to open the corporation to outside investigators, it seems to the court that the board did not try to skirt around potential risks.

A final element of a proper overwatch system, and one that incorporates several other elements, is board awareness. Board awareness means that reports, presentations, or some other method alerts the corporation's board of the risks to the corporation. The Audit Committee's reports and PricewaterhouseCoopers's risk assessment alerted the Marriott board of risks. The Regulatory and Policy Committee's presentations alerted the Duke Energy board of risks. Thus, board awareness often involves other aspects of the overwatch system such as risk assessments, outside counsel, or audit committees. These boards rarely investigated risk themselves, but instead relied on other parts of the overwatch system for reports. If reports and presentations regularly inform a board of risk, it inherently does not consciously disregard risks.

Possibly more interesting is that the General Motors board did not know of risks to the corporation through any presentations or reports, yet its overwatch system was still proper. The court thought that General Motors did not consciously disregard the risk because its overwatch system had enough other proper safeguards, like a Chief Risk Officer, outside counsel, and a Finance and Risk Committee. Accordingly, it was proper for General Motors to delegate responsibility to management because their overwatch system was comprehensive enough. While General Motors succeeded, not properly reporting to the board may be the riskiest oversight element to omit due to the recent *In re McDonald's* decision. In *In re McDonald's* a corporate officer faced *Caremark* liability partly because he did not report known sexual harassment instances, including his own, to the board.[103] Thus, not properly reporting to the board may not result in liability for directors, but it could for officers now.

Nonetheless, courts have not held that all these factors are necessary for a proper overwatch system, and no one element is essential. For example, Duke Energy's overwatch system did not rely on outside counsel, and neither Marriott nor Duke Energy's overwatch system had a designated Chief Risk Officer. The overwatch system in *In re General Motors* had no regular risk assessments and did not report risks to the board, but the court deemed it a proper overwatch system. Courts give corporations some leeway in designing a proper overwatch system. However, the more safeguards an overwatch system has, the more protection a corporation has against *Caremark* liability.

On the other hand, each additional overwatch system safeguard increases costs to the corporation. There is a tension between maximizing protection and minimizing costs. This is especially important with ESG *Caremark* claims' potential expansion because corporations would have to monitor for ESG risks to avoid liability. Luckily, corporations can adapt already existing overwatch systems to monitor ESG risks and minimize an ESG oversight system's

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[103] *In re* McDonald's Corp. S'holder Deriv. Litig., C.A. 2021-0324-JTL (Del. Ch. Jan. 25, 2023). ("[A]n indispensable part of an officer's job is to gather information and provide timely reports to the board about the officer's area of responsibility."); *See also Officer May Have Liability for Ignoring "Red Flags" of Sexual Harassment Problem at the Company (Under Caremark)—and for His Own Sexual Harassment (as a Duty of Loyalty Violation)—McDonald's*, Fried, Frank, Harris, Shriver & Jacobson LLP ("[O]fficers should be made aware that, while their oversight responsibility generally extends only to the issues within their respective domains (*e.g.*, financial issues for the CFO; legal issues for the CLO), they may have an obligation to report "up the chain" if they become aware of particularly egregious red flags even outside their own domain. Companies should consider implementing training programs, or reviewing existing training programs, with respect to key compliance matters."), https://www.friedfrank.com/news-and-insights/officer-may-have-liability-for-ignoring-red-flags-of-sexual-harassment-problem-at-the-company-under-caremark-and-for-his-own-sexual-harassment-as-a-duty-of-loyalty-violation-mcdonald-s-10944.

implementation cost. The benefits ESG oversight systems provide are plentiful and include defending against ESG *Caremark* claims, preemptively complying with proposed ESG regulations, appealing to consumers, assisting with marketing efforts, protecting against public relations disasters, and satisfying moral expectations. Corporations can take advantage of these benefits and mitigate the costs. However, before we can look at the potential finances involved with ESG *Caremark* claims, we must examine the recent rise in successful *Caremark* claims. These successful *Caremark* cases are just as important as the unsuccessful ones because they pinpoint the rare situations where oversight systems exist, but corporations were still liable. Corporations must note these scenarios while they create their ESG oversight systems, or they risk losing the benefit of a near perfect defense to ESG *Caremark* claims.

III. POST-MARCHAND: THE RISE OF *CAREMARK* LIABILITY CLAIMS

Starting with *Marchand v. Barnhill et al*. in 2019, a series of *Caremark* claims survived motions to dismiss in Delaware courts.[104] Various theories attempt to explain this development. Some view these cases as a complete shift of the *Caremark* analysis and believe the previously high *Caremark* standard is now lower.[105] Proponents highlight the court's focus on "mission critical" compliance, which allows a plaintiff to meet the high *Caremark* requirements if their claim involves a corporation's essential regulatory compliance issues.[106] However, Delaware courts repeatedly emphasized the difficultly in pleading a *Caremark* claim and still require a showing that directors either "utterly failed to implement any reporting or information system or controls" or, "having implemented such a system or controls, consciously failed to monitor or oversee its operations."[107] It seems that, in these courts' view, "mission critical compliance" is one way a plaintiff can meet the high *Caremark* standard, rather than a theory that lowers the standard itself.

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[104] Marchand v. Barnhill et al., 212 A.3d 805 (Del. 2019).

[105] Edward B. Micheletti, Bonnie W. David, & Ryan M. Lindsay, *The Risk of Overlooking Oversight: Recent Caremark Decisions From the Court of Chancery Indicate Closer Judicial Scrutiny and Potential Increased Traction for Oversight Claims*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Dec. 15, 2021), https://www.skadden.com/insights/publications/2021/12/insights-the-delaware-edition/the-risk-of-overlooking-oversight; Angela E. Aneiros & Karen E. Woody, *Caremark's Butterfly Effect*, 72 AM. U. L. REV. (forthcoming 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4197520; Roy Shapira, *A New Caremark Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1860 (2021).

[106] *Id.*

[107] Marchand, 212 A.3d at 820.

Others view the influx in *Caremark* claims not as a shift, but as an adherence to traditional standards.[108] To them, the increase in *Caremark* claims merely means more corporations expose themselves to *Caremark* liability and plaintiffs can meet the high *Caremark* standards.[109] Yet, others suggest that courts repeating the high standard to plead a *Caremark* claim has little effect when they allow *Caremark* claims to survive motions to dismiss.[110] They argue that, in practice, the bar is lower because courts seem more willing to hold a plaintiff has met the "high" bar to prove *Caremark* liability.[111] While these cases prompted an increase in attention on *Caremark* liability, they also led to an increase in use of *Caremark* liability claims.[112]

Not only have *Caremark* claims' use and success increased, but the Delaware Court of Chancery expanded *Caremark* claims to their greatest extent yet with the completely new theory of officer liability, thanks to *In re McDonald's*. Due to the Delaware Court of Chancery's recent history of expanding *Caremark* liability and the *In re McDonald's* case's ESG nature, ESG *Caremark* claims seem like a logical next step. Corporations should not ignore the possible rise of ESG *Caremark* claims. In fact, there are already ESG advocates who tie *Caremark* claims with ESG issues, even in areas where ESG has no regulation yet.[113] The benefits that come with an ESG oversight system's adoption are numerous, with protection from ESG *Caremark* claims perhaps the most obvious. However, to take advantage of this ESG *Caremark* defense, corporations must first construct a correct ESG oversight system. An examination of the recent successful *Caremark* liability cases clarifies pitfalls

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108 David A. Katz & Laura McIntosh, *Oversight and Compliance Reminder*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Aug. 1, 2019), https://corpgov.law.harvard.edu/2019/08/01/oversight-and-compliance-reminder/.

109 *Id.*

110 Edward B. Micheletti, Bonnie W. David, & Ryan M. Lindsay, *The Risk of Overlooking Oversight: Recent Caremark Decisions From the Court of Chancery Indicate Closer Judicial Scrutiny and Potential Increased Traction for Oversight Claims*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Dec. 15, 2021), https://www.skadden.com/insights/publications/2021/12/insights-the-delaware-edition/the-risk-of-overlooking-oversight.

111 *Id.*

112 Roger A. Cooper & Mark E. McDonald, *Caremark Claims on the Rise Fueled by Section 220 Demands*, CLEARY GOTTLIEB (Jan. 11, 2021), https://www.clearygottlieb.com/news-and-insights/publication-listing/*Caremark*-claims-on-the-rise-fueled-by-section-220-demands.

113 Leo E. Strine, Kirby M. Smith, & Reilly S. Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 IOWA L. REV. 1885 (2021); E. Norman Veasey & Randy J. Holland, Caremark *at the Quarter-Century Watershed: Modern-Day Compliance Realities Frame Corporate Directors' Duty of Good Faith Oversight, Providing New Dynamics for Respecting Chancellor Allen's 1996* Caremark *Landmark*, 76 BUS. LAW. 1, 27 (2021); 23 Soyoung Ho, *SEC Commissioner: Board of Directors Have Big Role to Play on ESG*, WGL-ACCTALERT Vol. 15 No. 127 (July 6, 2021).

corporations must avoid when they design oversight systems. Once I explore those pitfalls a proper overwatch system must consider, this comment will focus on how corporations can potentially minimize ESG oversight systems' costs to reap the maximum benefit to the corporation.

Marchand v. Barnhill et al. was the first in a series of Delaware cases in which plaintiffs who brought *Caremark* claims defied the norm and survived motions to dismiss. The plaintiffs claimed Blue Bell's board of directors breached its duty of loyalty under the first *Caremark* prong when it did not "implement any system to monitor Blue Bell's food safety performance or compliance."[114] In contrast to the *Caremark* claims thus far, this case examined whether Blue Bell had an overwatch system in place at all, rather than whether the corporation's existing overwatch system was proper. The directors argued they created an overwatch system and that the court should determine their liability under the second, and harder to prove, *Caremark* prong.[115] While the court disagreed with the directors, its ruling defines when a corporation's safeguards fall so below the standard that an overwatch system is nonexistent.

The claim in *Marchand* arose from a listeria outbreak Blue Bell suffered in 2015, which caused several consumers' deaths.[116] This resulted in large product recalls, plant shut downs, and the layoff of over a third of Blue Bell's workforce.[117] Subsequently, a shareholder derivative suit was filed against the board for a breach of its duty of loyalty under *Caremark*.[118] The case turned on whether the directors implemented any overwatch system in the corporation. Even the court acknowledged that a finding that Blue Bell had any overwatch system would result in deference to the board of directors.[119] Ultimately, the court found no overwatch system existed, and it based its determination on several factors, including that, before the listeria outbreak:

- There was no board committee that addressed food safety;
- There was no regular process or protocol that required that management keep the board apprised of food safety compliance practices, risks, or reports;
- During a key period before three customers' deaths, management received reports that contained red, or at least yellow, flags, and

[114] Marchand, 212 A.3d at 809.
[115] *Id.* at 822—24.
[116] *Id.* at 807.
[117] *Id.*
[118] *Id.*
[119] *Id.* at 821.

the period's board minutes revealed no evidence of their disclosure to the board;

- Management gave the board certain favorable information about food safety, but not important records that presented a much different picture; and
- The board meetings lacked any suggestion that there was any regular discussion of food safety issues.[120]

Additionally, Blue Bell's simple compliance with FDA safety regulations was insufficient to prove an overwatch system's existence.[121] *Marchand* started a shift in *Caremark* success in Delaware courts, but the facts were extreme. The Blue Bell board essentially did nothing to monitor food safety. Even when management had the opportunity to act, it ignored the signs.

Marchand set the minimum for what a corporation must do to avoid liability under the first *Caremark* prong. There must be affirmative action beyond meeting regulatory requirements for a court to determine that an overwatch system existed. Marchand seemingly extended *Caremark* liability, but it did so under the first *Caremark* prong when it determined no overwatch system existed. Subsequent cases went farther when they used the second *Caremark* prong and found liability, even when a board enacted an overwatch system.

For example, in *In re Clovis Technology, Inc.*, the board had an overwatch system that was ineffective enough to fall under the second *Caremark* prong. Here, a faulty clinical trial for the cancer drug, Roci, led to the corporation misleading the market "regarding the drug's efficiency."[122] The board knew the clinical trial used methods to produce inflated results, yet it continued to present them to investors and the public.[123] The Clovis board established a Corporate Governance Committee, which "was 'specifically charged' with 'provid[ing] general compliance oversight . . . with respect to . . . Federal health care program requirements and FDA requirements.'[124] There was evidence that "[t]he Board . . . reviewed detailed information regarding [Roci's] TIGER-X trial at each Board meeting."[125] As the board took affirmative action to create an overwatch system, the minimum, the board was not liable under the first *Caremark*

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120 *Id.* at 822
121 *Id.*
122 *In re* Clovis Technology, Inc, 2019 WL 4850188 at *1 (Del. Ch., Oct. 1, 2019).
123 *Id.* at *5—6.
124 *Id.* at *13
125 *Id.*

prong.[126] Nonetheless, this bare minimum overwatch system was insufficient, as Clovis' overwatch system disregarded red flags.

The court in *In re Clovis* explained what constitutes liability under the second *Caremark* prong. To consciously fail to monitor an overwatch system, a board must choose to ignore red flags that "are either waived in one's face or displayed so that they are visible to the careful observer."[127] But, as *Marchand* made clear, the careful observer's "gaze is fixed on the company's mission critical regulatory issues."[128] The Clovis board knew its clinical trial used methods contrary to FDA requirements because it received reports from its overwatch system that said as much.[129] Furthermore, Clovis is a pharmaceutical corporation, so one of its mission critical business components is drug production and testing.[130] The board's disregard of reports and continuing use of the faulty trial results, especially when they led to a drastic fall in stock price, was enough for the plaintiffs to successfully plead under the second *Caremark* prong.

Seeing that the court found liability, even with an overwatch system, *In re Clovis* was a further shift in *Caremark* liability standards. Furthermore, the decision gives insight into ESG *Caremark* claims' possible argument. As *In re Clovis* and *Marchand* suggest, if plaintiffs convince a court that ESG issues were mission critical to the corporation, a successful ESG *Caremark* plea becomes more likely. This argument could be especially potent against ESG Investment Funds and corporations that incorporated ESG goals into their marketing. These corporations willingly integrated ESG into their business plans, and thus, brought attention to ESG issues as their businesses' mission critical components. Additionally, new SEC regulations would require that corporations disclose ESG metrics. Consequently, shareholders would have access to the necessary information to prove their ESG *Caremark* claims. This access combined with a lessened "mission critical" standard may be the key to unlock more ESG *Caremark* claims.

In re Clovis was rare at the time because a court found *Caremark* liability, even with an overwatch system. Previously, an overwatch system's mere existence was a near perfect defense to *Caremark* claims. Cases decided in *In re*

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[126] *Id.*
[127] *Id.*
[128] *Id.*
[129] *Id.* at *6.
[130] *Id.* at *13.

Clovis's wake underscore that an overwatch system's establishment alone does not provide a perfect defense, especially if the board ignores the system.

In *Teamsters Local 433 Health Services Insurance Plan et al. v. Chou et al.*, a shareholder derivative action was brought against AmerisourceBergen Corporation ("ABC") after the revelation that one of its subsidiaries' cancer treatment practices completely violated FDA regulation.[131] Presentations, reports from Davis Polk, legal suits, and a DOJ subpoena gave the ABC board notice of this issue.[132] Based on this inaction, the court determined the board could face liability under the second *Caremark* prong, and denied the motion to dismiss.[133] *Teamsters* cemented the court's ruling in *In re Clovis* that there must be action beyond a mere review for a court to determine that the board did not consciously disregard red flags and, thus, has avoided second-prong *Caremark* liability.[134] The court's decision also highlighted FDA compliance's mission critical status, given the fact that ABC was in the drug manufacturing business.[135]

The *Marchand*, *In re Clovis*, and *Teamsters* decisions' delivery in quick succession marked the opening salvo in what would become an active era of *Caremark* claims. ESG *Caremark* claims could be the next evolution in this activity. Besides demonstrating the potential for ESG *Caremark* claims, these cases emphasize the importance of not only oversight systems' creation, but proper maintenance. In *Marchand*, the Blue Bell board faced liability under the first *Caremark* prong when it did not enact any oversight system. In *In re Clovis* and *Teamsters*, boards faced liability not because their oversight systems failed, but because they worked, and the directors ignored the systems' red flags. Thus, to provide a defense to *Caremark* claims, an oversight system must not only have careful design with guidance from case law to include risk assessments, audit committees, a dedicated risk officer, reports given to the board, and outside counsel or consultants, but the board and officers must also not ignore the system's warnings.

An ESG oversight system would be subject to these same requirements. While there is a risk that corporations could become more vulnerable to ESG *Caremark* claims, an ESG oversight system with proper implementation that

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131 Teamsters Local 433 Health Services Insurance Plan et al. v. Chou et al., 2020 WL 5028065 at *1 (Del. Ch. 2020).

132 *Id.* at *20 – 26.

133 *Id.* at *25.

134 *Id.*

135 *Id.*

directors do not ignore, would provide a near perfect defense to these claims. When this is added to the other benefits of ESG oversight system adoption, like consumer attraction, assistance with marketing efforts, protection from public relations disasters, and satisfaction of moral expectations, the wisdom of an ESG oversight system's implementation outweighs its disadvantages.

IV. THE FINANCIAL REPERCUSSIONS OF ESG *CAREMARK* LIABILITY

The fact that *Caremark* liability forces corporations to accept additional costs is possibly the most obvious argument against the theory.[136] Costs for ESG oversight systems could include outside counsel's payment to evaluate ESG risks, regular audits for ESG risk, an ESG officer, and the development of strategy for when an ESG incident does occur. However, "78% of people [believe] that companies have a duty to be good citizens," and "71% expect them to launch ESG action," according to the SEC Newgate ESG Monitor report.[137] As most consumers think that corporations are responsible for accepting these costs anyway, to not would directly go against consumer expectations. Additionally, ESG oversight systems' benefits outweigh this cost. Corporations can use these systems to defend against ESG *Caremark* claims, preemptively comply with proposed ESG regulations, appeal to consumers, assist with marketing efforts, protect against public relations disasters, and satisfy moral expectations. Finally, an ESG oversight system's creation cost and implementation has mitigation opportunities. As the many advisory letters to corporations on the topic evidence, corporations have known for years about the need for *Caremark* oversight systems. Moreover, the advice in these advisory letters matches the oversight elements that case law recommends. Thus, any corporation that created an oversight system based on the advice in these advisory firms' letters can adapt its existing oversight systems to monitor for ESG liability to mitigate corporate costs.

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[136] *See* Stephen M. Bainbridge, *Don't Compound the Caremark Mistake by Extending it to ESG Oversight* (UCLA Sch. L., Law-Econ Rsch. Paper No. 21-10, Sep. 2021) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3899528 ("compliance with *Caremark* obligations as they already exist is costly and time consuming.").

[137] Carsten Boehme, *Why Does Communications Fail So Often in "ESG Crisis"?*, INSTINCT IF PARTNERS (Mar. 16, 2022) https://instinctif.com/thinking/esg-crises-communication-fail ("Environmental issues, Social aspects and responsible corporate Governance seem to create a special explosive that can destroy reputations and careers in a very short time.")

A. The Ideal Overwatch System

In Robert C. Bird's study after *Caremark* claims' rise, Bird compiled data from advisory firm letters to determine what oversight components advisory firms recommended most frequently to corporations.[138] Bird divided the recommendations into three categories: (1) board composition, (2) changes to board practices, and (3) changes to operational engagement.[139] Under the board composition category, advisory firms consistently recommend formation of a standing compliance committee, augmentation of board member expertise, reevaluation of the value of independent directors, and evaluation of close personal ties amongst directors.[140] In the changes to board practices category, advisory firms recommend a board-reporting-system's institution to monitor risk, board minutes' augmentation through better documentation, and compliance's addition as a regular agenda item.[141] Finally, under the changes to operational engagement category, advisory firms recommend that corporations set expectations for management, develop a compliance system in the firm, determine the nature of fundamental compliance risks that face the company, and prepare plans promptly when a problem arises.[142]

According to Bird, the strongest *Caremark* oversight system would incorporate all these recommendations. At a bare minimum, a corporation should incorporate the most frequently recommended components, like forming a standing compliance committee, instituting a board-reporting-system, augmenting board minutes, and setting expectations for management.[143]

B. Mitigation of ESG Caremark Oversight System Costs

For any corporation that follows the advisory letters cited, an ESG oversight system's creation does not involve starting from scratch. Therefore, these corporations can minimize ESG oversight systems' cost to maximize the

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[138] Robert c. Bird, *Caremark Compliance for the Next Twenty-Five Years*, 58 AM. BUS. L. J. 63 (2021).

[139] *Id.* at 93 – 96.

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] *Id.* (These frequent advisory firm recommendations match up with the earlier case law analysis. For instance, in *Good et al.*, *General Motors*, and *Marriott*, the court noted that the fact that the corporations had committees which identified compliance risks weighed in favor of the existence of a proper oversight system. Similarly, in *Marriott* and *Good et al.*, directors received presentations on the corporations' compliance risks, which matches up with the idea mentioned in the advisory firm letters of a board reporting system. Furthermore, the fact that these advisory firm letters each had differing recommendations supports the indication in case law that there is not one oversight element essential to a proper oversight system, but there are elements common in successful oversight systems.).

benefits they provide. Corporations can use the lessons and practices they learned while they created a previous oversight system to adapt this new ESG system. Furthermore, looking at the various recommendations in the advisory firms' letters, some of the recommendations consist of behavioral changes, while others involve hiring advisors or conducting internal audits. Thus, an oversight system's components do not all necessarily require a large financial investment. Several suggested components focus on additional job responsibilities for existing roles. For instance, the suggestions to augment board minutes to mention mission critical compliance and add compliance as an agenda item only highlight things that the board should already do. These minor additions should not drastically increase corporate costs, but they could protect against millions of dollars in fines.

Conversely, the biggest potential for cost with ESG *Caremark* oversight systems is ESG compliance risk identification and then a system's creation to monitor these risks and report them to the board. Evidenced by the existence of the numerous advisory firm letters, this often involves advisory firms' payment to create a monitoring system tailored to a corporation's business. Individuals must manage this system. Yet, as in the case law, usually board members and existing managers take this role, so a corporation can train current employees for it. This training may very well cost the corporation, but it is a lesser cost than a salary's creation for a new employee. Additionally, there are several factors that can mitigate the cost of hiring outside counsel to identify ESG risks and create a system to report them.

Firstly, due to a prior oversight system's creation, many corporations already have a working relationship with a firm that knows how to create an oversight system for their business. If their management and board are familiar with the system, corporations who have existing *Caremark* oversight systems know what elements they want from a system. All these factors place corporations with existing oversight systems in an ideal position to create an ESG *Caremark* oversight system because they can take what they already learned and apply it to an ESG oversight system. These corporations must only pay advisory firms to identify ESG risks because they already paid to develop the infrastructure necessary to report and manage risks.

Another potential mitigating factor on ESG oversight system costs is that overseas corporations must develop systems that monitor ESG issues due to stricter regulations abroad. The European Union ("EU") has a comprehensive regulatory system that includes many ESG regulations. Of specific importance, the EU finalized its Corporate Sustainability Reporting Directive ("CSRD") at the start of 2023.[144] The CSRD is like the SEC's proposed disclosure requirements, but the CSRD covers more businesses, requires more disclosure, and entered EU law. Foreign corporations with a presence in the EU must comply with the CSRD or risk blockage from the market.[145] The directive requires a wide range of disclosures about each corporation's environmental objectives, climate mitigation, working conditions, respect for human rights, risk management, and business ethics.[146]

Due to the CSRD, American corporations with a presence in the EU must monitor ESG aspects of their business. If corporations create committees dedicated to ESG monitoring and report these findings to the board, they could easily adapt the necessary CSRD monitoring as a *Caremark*-style oversight system. This way corporations would meet EU requirements and have preemptive protection from ESG *Caremark* claims in U.S. courts. It may even be cost effective to apply ESG monitoring to the corporation as a whole, rather than applying it to only its EU business, a phenomenon known as the "Brussels Effect."[147] When corporations outside the EU must forcibly comply with the EU's higher regulatory standards, the corporations find that only having their businesses' EU-side comply with EU regulations, while their non-EU business operates entirely differently, leads to inefficiency.[148] Hence, they adapt their entire business to EU regulations.[149] Nations outside the EU then adopt regulations like those in the EU because their national businesses already follow EU regulations.[150] Due to the Brussels Effect, even corporations with a minimal, or non-existent, EU presence should consider ESG oversight adoption to save costs in the future. Moreover, as recent SEC proposals evidence, the U.S. may not be far behind the EU in ESG reporting regulations' adoption.

With ESG *Caremark* claims looming, corporations can utilize their existing oversight structures to mitigate ESG oversight systems' creation costs. With *Caremark* claims' rise, more corporations created oversight systems with advisory firms' assistance. This advice and the oversight systems subsequently created with it can serve as a guide and help cut corporate costs. Corporations can take existing oversight structures and apply them to ESG issues, rather than

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144 *EU Adopts Expansive Corporate Sustainability Reporting Requirements*, SULLIVAN & CROMWELL (Jan. 9, 2023), https://www.sullcrom.com/files/upload/sc-publication-eu-finalizes-esg-reporting-rules-with-international-impacts.pdf.

145 *Id.*

146 *Id.*

147 *See* ANU BRADFORD, THE BRUSSELS EFFECT: HOW THE EUROPEAN UNION RULED THE WORLD (2020).

148 *Id.*

149 *Id.*

150 *Id.*

creating entirely new systems. The EU now requires ESG-specific oversight systems and reporting. Corporations that operate in the EU can apply this ESG oversight system company-wide; corporations outside the EU can use these EU ESG oversight systems as examples in their own system's creation. ESG oversight systems will involve neither corporate costs' doubling nor starting from scratch, but rather already existing structures' adaptation. An ESG oversight system's implementation now can save costs in the future too, as it appears more ESG regulations, both domestically and abroad, are on the horizon. ESG oversight systems' cost minimization allows corporations to maximize ESG oversight systems' other benefits.

CONCLUSION

Corporations often see the expansion of ESG *Caremark* claims as a situation they must fear and resist. However, adept corporations can proactively adopt ESG oversight systems to take advantage of this situation and reap benefits. ESG issues are already at the market's forefront. With more consumers willing to change their buying habits to buy from ESG-focused corporations, corporations with ESG initiatives attract more investors. Corporations can implement ESG oversight systems to tap into this consumer desire for ESG initiatives. Thus, ESG oversight systems' implementation allows corporations to attract consumers, assist their marketing efforts, protect against public relations disasters, and satisfy moral expectations. Politicians, government agencies, and the SEC increasingly push new ESG regulations too. Corporations that adopt ESG oversight systems and comply with proposed ESG regulations ahead of time can save regulatory costs in the future. Corporations can also frame an ESG oversight system's adoption as an ESG initiative to appeal to political, investor, and consumer audiences to garner economic benefit. Additionally, perhaps the greatest benefit, an ESG oversight system would protect corporate officers and directors against future ESG *Caremark* liability.

Corporations will not shoot in the dark when they develop ESG oversight systems either. *Caremark* case law provides a plethora of insight into what makes a proper *Caremark* oversight system. Unsuccessful *Caremark* claims show that a proper oversight system's existence, even if it fails, can be enough to ward off liability. Successful *Caremark* claims show that only corporations that do not create an oversight system at all, or completely ignore their oversight system, will be liable. Plus, case law provides examples of a variety of proper oversight system components, like the formation of specific compliance committees and regular reports to the board. Corporations can use this case law as a reference when they construct ESG oversight systems and unlock the protection benefit for officers and directors from ESG *Caremark* claims.

The current environment indicates it is increasingly likely that corporate boards must implement ESG oversight systems either to avoid ESG *Caremark* liability for officers and directors or to comply with government regulations domestically and abroad. Corporations should view ESG oversight systems' implementation as another way to create benefits for the corporation by capitalizing on the broad interest in ESG initiatives. Potential benefits to corporations include consumer attraction, assistance with marketing efforts, protection from public relations disasters, and satisfaction of moral expectations. Corporations even have a roadmap for this task due to case law's, advisory firms', and existing oversight systems' guidance. Corporations have a unique opportunity because the market is at a nexus where corporate stakeholders are interested in ESG issues, but the U.S. government does not require full ESG compliance or disclosure. Corporations can either create ESG oversight systems and appeal to stakeholders and, thus, be willing adaptors and innovators, or drag their feet until the courts or government force their compliance.

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