

GIVING COMPLIANCE ITS DUE:

CAREMARK DUTIES IN THE CONTEXT OF MERGERS AND ACQUISITIONS

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INTRODUCTION

In 2011, Caterpillar, Inc., a multi-national manufacturer of construction and mining equipment, agreed to acquire a Chinese producer of heavy mining equipment.¹ At the time, Caterpillar was pursuing an aggressive growth strategy.² In that context, the deal was largely celebrated, even garnering an award as a top M&A deal in Asia the following year.³ But the celebration was short-lived. By April of 2013, Caterpillar had written off most of what it had paid for its new asset after it discovered “deliberate, multi-year, coordinated accounting misconduct” within the target.⁴ Reuters reported in 2014 that at the time of the acquisition, according to company insiders, “Caterpillar was so bullish on China, it may have been willing to overlook some of [the target’s] problems”⁵ Court documents from one of the shareholder derivative suits that followed asserted that Caterpillar’s board had neglected to consider the results of the due diligence investigation of the Chinese target, or whether its financial problems (such as failing to hit its 2011 earnings targets) had been resolved.⁶

¹ *Caterpillar Acquires ERA Mining Machinery Limited*, MERGR, <https://mergr.com/caterpillar-acquires-era-mining-machinery-limited> (last visited Sep. 27, 2021).

² *Caterpillar CEO Outlines Aggressive Plans for Growth and Returns*, RELIABLE PLANT, <https://www.reliableplant.com/Read/26190/Caterpillar-CEO-outlines-plans> (last visited Sept. 27, 2021).

³ Aaron Ken Lee, CHINA’S ECONOMY, THE HIDDEN TRUTHS 128 (2015) (“In 2012, Asia’s top mergers and acquisition bankers gathered in Hong Kong to celebrate the top deals of the year. Advisers of Caterpillar’s \$677 million purchase of ERA Mining Machinery Ltd picked up an award for cross-border deal of the year”).

⁴ Ernest Scheyder, *Caterpillar Writes Off Most of China Deal After Fraud*, REUTERS (Jan. 18, 2013, 7:25 PM), <https://www.reuters.com/article/us-caterpillar-siwei/caterpillar-writes-off-most-of-china-deal-after-fraud-idUSBRE90H1C520130119>.

⁵ Clare Baldwin & John Ruwich, *Special Report—How Caterpillar Got Bulldozed in China*, REUTERS (Jan. 22, 2014, 8:00 PM), <https://www.reuters.com/article/us-caterpillar-china-special-report/special-report-how-caterpillar-got-bulldozed-in-china-idUSBREA0M03720140123>.

⁶ See, e.g., Opposition to Defendants’ Motion to Dismiss the Consol. Complaint at 10, *In re Caterpillar Inc. S’holder Derivative Litig.*, 2015 WL 13684900 (C.D. Ill.) (No. 1:13-cv-01104) (“The due diligence on this deal did not uncover just red flags, it revealed a five-alarm fire and yet, the ‘distracted’ Caterpillar Board ultimately approved paying \$677 million [for the target] . . . without any attempt to protect Caterpillar’s assets.”).

The Caterpillar saga is a cautionary tale on many fronts, such as the dangers of doing business in China, and the risk of an aggressive growth strategy.⁷ But perhaps its most important lesson is that boards must be engaged in pre-acquisition due diligence and include regulatory compliance in the process. Directors must avoid getting caught up in a strong CEO's enthusiasm for a deal that can blind a board to red flags.⁸ The risk is simply too great and the costs too high.

Two events of the 1990s served to bring legal and regulatory compliance into the mainstream of corporate law and governance. First, the U.S. Department of Justice (DOJ) in 1991 issued sentencing guidelines for organizations that encouraged companies to implement compliance and reporting systems, and offered "cooperation credit" for those who do and subsequently uncover violations.⁹ And in 1996, the Delaware Chancery Court held in *In re Caremark* that corporate directors have a fiduciary obligation to implement and maintain such programs.¹⁰ Such *Caremark* duties were later adopted by the Delaware Supreme Court.¹¹

⁷ See, e.g., Geoff Colvin, *The Real Reason Why Caterpillar's Doug Oberhelman is Leaving*, FORTUNE (Oct. 18, 2016, 6:00 PM), <https://fortune.com/2016/10/18/caterpillar-doug-oberhelman-retiring-why/> (explaining that the Doug Oberhelman's term as Caterpillar CEO is a reminder that "[h]igh risks bring the chance of big rewards but also of big losses"); Simon Montlake, *Cat Scammed: How a U.S. Company Blew Half a Billion Dollars in China*, FORBES (Feb. 13, 2013, 6:00 AM), <https://www.forbes.com/sites/simonmontlake/2013/02/13/cat-scammed-how-a-u-s-corporation-blew-half-a-billion-in-china/?sh=583fb28878f5> ("In the scramble to 'win in China' did Caterpillar executives lose sight of the risks? China is awash in cautionary tales of foreign investment gone awry.")

⁸ Following the Caterpillar debacle, Reuters reported that company insiders admitted that the company "was so bullish on China, it may have been willing to overlook some of [the target's] problems." Baldwin & Ruwich, *supra* note 5. See also, Patrick A. Gaughan, *Failed Merger: Failed Corporate Governance?* J. CORP. ACCT. & FIN. 1, 6–7 (2005) ("One common theme that we see in many failed deals is that we have a deal-making, strong-willed CEO and a compliant board that rubber-stamps the CEO's grandiose empire-building schemes.").

⁹ See UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1 (2018); see also Ketanji Brown Jackson & Kathleen Cooper Grilli, *The Complete Compliance and Ethics Manual 2021: Foundational Materials and Program Infrastructure*, COSMOS, <https://compliancecosmos.org/effective-ethics-and-compliance-due-diligence-during-mergers-and-acquisitions> (last visited Sept. 28, 2021) ("On November 1, 1991, the Federal Sentencing Guidelines for Organizations . . . went into effect.").

¹⁰ *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (" . . . I am of the view that 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 standard.").

¹¹ *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) ("We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability . . .").

Yet, despite the compliance failures upending M&A deals like Caterpillar's and the increased attention on corporate compliance overall, two forces have served to relegate compliance oversight in the M&A context to an interesting but hardly consequential diversion. First, while the costs of failures may initially appear significant, the true impact is often minimal in the long run. Seemingly large fines, legal expenses, and other losses borne by companies hit with failures may garner headlines and law review articles but do little to slow the progress of corporate giants like Caterpillar. Caterpillar, for its part, absorbed a \$580 million write-down on its books for fiscal year 2012 as a result of its failed Chinese deal.¹² At the end of 2013, the company's per-share profit sat at \$5.75 and its share price was \$90.87. But six years later, Caterpillar stock was trading at \$148.28 and its profit per share was \$10.74.¹³ Meanwhile, directors who fail to implement effective compliance programs, or who fail to act in the face of discovered red flags, may be at least *theoretically* liable to shareholders under *Caremark*. But *Caremark* claims have historically ended with dismissal at the pleading stage.¹⁴ If the costs of compliance failures are minor and temporary, and the risk of liability low, why bother?

Today, the tide may be shifting. Attention paid to corporate compliance and oversight may be at an all-time high.¹⁵ The American Law Institute (ALI) developed a comprehensive project to

¹² Scheyder, *supra* note 4.

¹³ *Quarterly Results*, CATERPILLAR, <https://investors.caterpillar.com/financials/quarterly-results/default.aspx> (last visited Nov. 14, 2021) (see Financial Summary Table and navigate to relevant year to view quarterly and year-end financial results); *Caterpillar Inc. (CAT)*, YAHOO! FINANCE (Nov. 12, 2021, 4:00 PM), <https://finance.yahoo.com/quote/CAT/history?p=CAT> (click on Historical Data tab, then select relevant periods to see historical stock prices).

¹⁴ Roy Shapira, *A New Caremark Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1859 (2021) (“[D]erivative actions over directors’ failure of oversight were routinely dismissed at the pleading stage, and many commentators considered *Caremark* duties largely irrelevant.”).

¹⁵ See, e.g., *Corporate Governance Has Become a Hot Topic in Recent Years*, CORPORATEMART, <http://corporatemart.com/corporate-governance-has-become-a-hot-topic-in-recent-years/> (last visited Sept. 28, 2021); *IE Law Talks: Why Corporate Compliance is a Hot Topic*, IE FOUND. (Mar. 2, 2017), <https://www.ie.edu/ie-elec-nor-observatory-on-sustainable-compliance-cultures/en/ie-law-talks-why-corporate-compliance-is-a-hot-topic/>; Melissa Oxford, *2021: Hot Topics in Business Law*, DUNLAP BENNETT & LUDWIG, <https://www.dblawyers.com/2021-hot->

study compliance and oversight systems and provide recommendations for best practices.¹⁶ The Corporate Director's Guidebook from the American Bar Association's Business Law Section now includes a chapter on Risk Oversight and Compliance which advises the corporate board to "satisfy itself that appropriate systems and processes are in place to identify, monitor, control, and—when appropriate—accept, or seek to avoid or mitigate, risk and to make necessary and desirable disclosures."¹⁷ Then, in 2019 the Delaware Supreme Court in *Marchand v. Barnhill* overturned the Chancery Court's dismissal of *Caremark* claims against the board of a packaged food products company following a listeria contamination crisis that resulted in three deaths.¹⁸ The die was cast with that decision, and by late 2021 a total of five Delaware *Caremark* cases had survived the customary motions to dismiss.¹⁹ Suddenly *Caremark* duties appear to be evolving from a theory to a very real risk for the corporate board that fails to heed its call.

Compliance risk is heightened when corporations pursue mergers, acquisitions, and other change-of-control transactions, as this paper will show. Because of this, *Caremark* duties may be especially crucial in the M&A context.²⁰ While it is commonly understood that pre-acquisition due diligence includes efforts to root out oversight failures in the target, real-world cases suggest these

topics-in-business-law/ (last visited Sep. 28, 2021) (listing Compliance as the top "hot topic" in Labor and Employment law).

¹⁶ See *Compliance and Enforcement for Organizations*, ALI ADVISER, <https://thealiadviser.org/compliance-risk-management-enforcement/> (describing the ALI's program of standards and best practices on the law of compliance and risk management for organizations which was approved at the ALI 2021 annual meeting). See also generally, James A. Fanto, *The Governing Authority's Responsibilities in Compliance and Risk Management, as Seen in The American Law Institute's Draft Principles of Compliance, Risk Management, and Enforcement*, 90 TEMP. L. REV. 699 (2018) (describing and evaluating the ALI's project on compliance and risk management as it stood in 2018).

¹⁷ ABA BUS. LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 37 (7th ed. 2020).

¹⁸ 212 A.3d 805 (Del. 2019).

¹⁹ *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 WL 4850188 (Del. Ch. 2019); *Inter-Marketing Group USA, Inc. v. Armstrong*, 2020 WL 756965 at *1 (Del. Ch.); *Hughes v. Hu*, No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch.); *In re The Boeing Co. Derivative Litig.*, 2021 WL 4059934 (Del. Ch.).

²⁰ See, e.g., *Rich ex rel. Fuqi International Inc. v. Chong*, 66 A.3d 963, 965 (Del. Ch. 2013) ("The Plaintiff here . . . ask[ed] the corporation to prosecute claims against its officers and directors for violating their *Caremark* duties.").

efforts are falling short. This paper will showcase some of these cases and propose best practices for boards pursuing mergers and acquisitions. Part I will provide background on director duties generally and what *Caremark* duties entail specifically. Part II will explore the issue of compliance in the M&A context, including the risk of successor liability, and the positive impact of compliance efforts. Finally, Part III will describe how compliance can and must be effectively integrated into pre-acquisition due diligence.

I. BACKGROUND

A. *Directors have fiduciary duties to shareholders*

The board of directors is a feature of the corporation.²¹ In publicly traded corporations, there is a division between ownership, which rests with shareholders, and control, which resides with officers and directors.²² While officers and other managers handle the day-to-day concerns, directors oversee the direction and longer-term strategy of the business on behalf of the shareholders.²³ Further, directors are generally elected by the shareholders and represent their interests.²⁴ In light of this legal responsibility, the law imposes fiduciary duties on directors.²⁵

²¹ *Board of Directors*, BLACK'S LAW DICTIONARY (11th ed. 2020) (defining Board of Directors as a "governing body of a private corporation").

²² See *In re American Intern. Refinery*, 402 B.R. 728, 742 (Bankr. W.D. La. 2008) (explaining that it is a "basic principle under state corporate law that a corporation is a separate legal entity from its shareholders"); STEPHEN M. BAINBRIDGE, *CORPORATE LAW* 95 (4th ed. 2020) ("Most public corporations are marked by a separation of ownership and control. Shareholders, who are said to own the firm, have virtually no power to control either its day-to-day operation or its long-term policies. In contrast, the board of directors and senior management, whose equity stake often is small, effectively controls both.").

²³ See BAINBRIDGE, *supra* note 22 at 95.

²⁴ *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 41–42 (Del. 1994) (explaining that state law and "the decisions of this Court have repeatedly recognized the fundamental principle that the management of the business and affairs of a Delaware corporation is entrusted to its directors, who are the duly elected and authorized representatives of the stockholders"); *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) ("The board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.").

²⁵ See, e.g., *id.* ("[F]iduciary duties are imposed on the directors of Delaware corporations to regulate their conduct when they discharge [their management] function."); *eBay Domestic Hldgs., Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010) ("[D]irectors are bound by . . . fiduciary duties and standards.").

While the exact form of these fiduciary duties has evolved over time, most courts and corporate law commentators have settled on two: the twin duties of loyalty and care.²⁶ With these, directors are also obligated to act in good faith.²⁷

Eckstein and Parchomovsky described the fiduciary duty as “arguably the single most important aspect of our corporate law system.”²⁸ Judges, in their court opinions, have described these duties in colorful terms. The *Smith v. Van Gorkom* court described them as “unyielding.”²⁹ Justice Cardozo famously described fiduciary duties as “something stricter than the morals of the market place,” requiring “the punctilio of an honor most sensitive.”³⁰

However they may be described, the fiduciary duties of loyalty and care obligate directors to act reasonably and in the best interests of the corporation and its shareholders.³¹ What this means exactly is addressed below. But it does *not* mean that directors are required to make good decisions, or that their actions result in positive outcomes.³² Claims that directors breached their fiduciary

²⁶ See, e.g., *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) (“In performing their duties, the directors owe fundamental fiduciary duties of loyalty and care to the corporation and its shareholders.”); Alan S. Gutterman, *Fiduciary Duties of Board of Directors*, BUS. TRAN. SOL. § 304:83 (2021) (“[S]tate law dictates that the corporation’s directors owe the twin fiduciary duties of care and loyalty . . .”).

²⁷ See, e.g., MODEL BUS. CORP. ACT § 8.30(a) (2020) (“Each member of the board of directors, when discharging the duties of a director, shall act . . . in good faith . . .”); A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) (“A director or officer has a duty to the corporation to perform the director’s or officer’s functions in good faith . . .”).

²⁸ Asaf Eckstein & Gideon Parchomovsky, *Toward a Horizontal Fiduciary Duty in Corporate Law*, 104 CORNELL L. REV. 803, 803 (2019).

²⁹ 488 A.2d 858, 872 (Del. 1985) (“In carrying out their managerial roles, directors are charged with an *unyielding* fiduciary duty to the corporation and its shareholders” (emphasis added)).

³⁰ *Meinhard v. Salmon*, 249 N.Y. 458, 546 (1928).

³¹ See, e.g., A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) (“A director or officer has a duty to the corporation to perform the director’s or officer’s functions . . . in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.”); MODEL BUS. CORP. ACT § 8.30(a) (2020) (“Each member of the board of directors, when discharging the duties of a director, shall act . . . in a manner the director reasonably believes to be in the best interests of the corporation.”).

³² Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 919–20 (explaining that whether a director is liable to the shareholders “is independent of the *quality* of any decision” (emphasis added)).

duties must rest on a showing of wrongdoing, something minimally equivalent to “gross negligence,” or a showing of bad faith.³³ Directors decisions are generally evaluated under a court-created presumption that they are made in good faith, in the best interests of the corporation, and on an informed basis—a presumption known as the business judgment rule.³⁴ Where a plaintiff demonstrates director gross negligence or bad faith, thus rebutting this presumption, the board’s conduct is instead subject to a higher level of scrutiny. This shifts the burden to those directors to show that their decision was completely fair to the shareholders.³⁵

1. The duty of loyalty: putting shareholders’ interests first

The Model Business Corporation Act defines the duty of loyalty generally as requiring a director to act in a manner she “believes to be in the best interests of the corporation.”³⁶ The director breaches this duty when, acting as a director, she puts her personal interests ahead of the

³³ See *In re Soporex, Inc.*, 463 B.R. 344, 406–07 (Bankr. N.D. Tex. 2011) (quoting Fletcher’s Cyclopedica, §§ 1029, 1031) (“Generally, a corporate director or officer will not be held liable for mere negligent mismanagement untainted by self-dealing. . . . [But], a director is liable for gross negligence in attending to his or her duties. Director liability for good faith error is generally confined to gross negligence”); Carter G. Bishop, *A Good Faith Revival of Duty of Care Liability in Business Organization Law*, 41 TULSA L. REV. 477, 483 (2006) (“[D]irector liability will not be imposed absent gross negligence.”).

³⁴ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (“The business judgment rule . . . is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”).

³⁵ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“[A] shareholder plaintiff challenging a board decision has the burden at the outset to rebut the [business judgment] rule’s presumption. . . . To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached [the] duty [of] good faith, loyalty or due care. . . . If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the ‘entire fairness’ of the transaction to the shareholder plaintiff.”).

³⁶ MODEL BUS. CORP. ACT § 8.30(a)(ii) (2020). The Model Business Corporation Act serves as a proposed statute that states may adopt in whole or in some modified form to govern business corporations in that state. The model act was first promulgated in 1950 by the Committee on Corporate Laws of the American Bar Association. This was preceded in 1928 by the Uniform Business Corporation Act, a product of the Conference of Commissioners on Uniform State Laws. See generally, Ray Garrett, *Model Business Corporation Act*, 4 BAYLOR L. REV. 412 (1952). The MBCA was later revised in 1984 and is often referred to as the RMBCA, but MBCA is used here for simplicity. RICHARD D. FREER & DOUGLAS K. MOLL, *PRINCIPLES OF BUSINESS ORGANIZATIONS* 172 (2nd ed. 2018). The MBCA also serves as a restatement of the corporation statutes of the various states, further refining and clarifying the law, and in this way became quite influential by representing an overview of the law of American corporations generally. See generally James D. Cox & Herbert S. Wander, *Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis*, 74 L. & CONTEMP. PROBS. 107 (2011).

corporation.³⁷ The Delaware Supreme Court asserted as early as 1939 that “directors are not permitted to use their position of trust and confidence to further their private interests”³⁸

Three typical scenarios give rise to a breach of the duty of loyalty: competing ventures, self-dealing, and usurpation of a business opportunity.³⁹ In many respects these are variations on the theme of putting other interests before the interests of the company.

While directors may engage in various businesses, they risk breaching their duty of loyalty when pursuing business initiatives that directly compete with the corporation on whose boards they serve. Generally speaking, directors risk breaching their duty of loyalty in pursuing competing ventures because success in the competing ventures inevitably comes at a cost to the companies they serve.⁴⁰ But loyalty duties are most obviously at risk in competing ventures when directors' actions directly cost the companies they serve—soliciting clients, taking strategic plans or customer lists, recruiting company employees, and the like.⁴¹

Self-dealing broadly describes conflicts of interest because a director stands to gain personally from a given decision.⁴² This is often referred to as an “interested transaction” because the director finds himself on both sides of the deal.⁴³ This can be direct (where the director is set

³⁷ *Higgins v. N.Y. Stock Exch., Inc.*, 10 Misc.3d 257, 278 (Sup. Ct. N.Y. Cnty. 2005) (“The fiduciary duty of loyalty imposes on corporate directors an obligation not to assume and engage in the promotion of personal interests which are incompatible with the superior interests of their corporation” (quoting *Foley v. D’Agostino*, 21 A.D.2d 60, 66–67 (1st Dept. 1964))).

³⁸ *Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939).

³⁹ FREER & MOLL, *supra* note 36, at 293.

⁴⁰ *Id.* (“[A] fiduciary for Company A should not be engaged in a business that competes directly with Company A. Doing so implicates the duty of loyalty because operating a competitor cannot qualify as an act taken in a manner the director reasonably believes to be in the best interests of [Company A]” (internal quotations omitted)).

⁴¹ *Id.* at 295 (“[T]he duty of loyalty is implicated if a fiduciary solicits clients or employees while still serving as a fiduciary for Company A.”). *See, e.g.*, *Duane Jones Co., Inc. v. Burke*, 117 N.E.2d 237 (N.Y. 1954).

⁴² *Self Dealing*, BLACK’S LAW DICTIONARY (11th ed. 2020) (“Participation in a transaction that benefits oneself instead of another who is owed a fiduciary duty.”).

⁴³ *See, e.g.*, *Becker v. Knoll*, 239 P.3d 830 (Kan. 2010) (“[D]irectors are considered to be interested if they either appear on both sides of a transaction or expect to derive any personal financial benefit from it in the sense of self-dealing”); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) (“Classic examples of director self-

to gain from the decision) or indirect (where the benefits of the deal serve the director's relative or friend).⁴⁴ Many states have enacted "interested director" statutes, allowing such decisions to be approved by a disinterested board majority, by a majority of the shareholders, or where the director can show that the deal is fair.⁴⁵

Usurpation of a business opportunity arises when a director engages in a business opportunity that rightly should have gone to the corporation.⁴⁶ Courts have developed a set of factors for evaluating such opportunities and the director's liability, including the corporation's level of interest in the deal, whether the director came to the opportunity in the role as a director, and the director's relationship to the corporation.⁴⁷

2. The duty of care: acting reasonably

While the duty of loyalty centers around the director's *intentions*—acting in the best interest of the corporation—the duty of care dictates the *manner* in which directors act.⁴⁸ Directors are obligated to act “with the care that a person in a like position would reasonably believe appropriate under similar circumstances.”⁴⁹ This is a duty much like the general duty of care in

interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.”).

⁴⁴ BAINBRIDGE, *supra* note 22, at 176 (“Conflicted interest transactions take two forms. In a direct transaction, the director is dealing directly with the firm, such as where a director sells property to the firm. In an indirect transaction, a person or entity in which the director has an interest is dealing with the firm.”).

⁴⁵ See BAINBRIDGE, *supra* note 22, at 180–84. See also Del. Code Ann. Tit. 8, § 144(a) (2020).

⁴⁶ See, e.g., *Mullaney, Wells & Co. v. Savage*, 78 Ill. 2d 534, 545–46 (1980) (“[I]t is a breach of fiduciary obligation for a person to seize for his own advantage a business opportunity which rightfully belongs to the corporation.”); *Demoulas v. Demoulas Super Markets, Inc.*, 677 N.E.2d 159, 180 (Mass. 1997) (explaining that a fiduciary is “prohibited from taking, for personal benefit, an opportunity or advantage that belongs to the corporation”).

⁴⁷ See FREER & MOLL, *supra* note 39, at 310.

⁴⁸ Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1197 (2004) (“The duty of due care specifies the *manner* in which directors must discharge their legal responsibilities” (emphasis added)).

⁴⁹ MODEL BUS. CORP. ACT § 8.30(b) (2020); see also *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (“[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances.”).

tort negligence actions,⁵⁰ but courts have commonly found a breach only in instances of director gross negligence or bad faith.⁵¹ Further, the business judgment rule, with its presumption of director care, precludes courts from reviewing board decisions without a showing of fraud, conflict of interest, or similar bad faith or misconduct.⁵²

Still, regardless of the standard of review, the duty of care arises in the context of board decision-making and oversight of the corporation's affairs.⁵³ It "requires that a director consider all material information reasonably available before reaching a decision."⁵⁴ Liability thus attaches not when directors make poor decisions, but when poor decisions result from their failure to avail themselves of the information necessary for prudent decision-making.⁵⁵

In some cases, a poor decision may itself serve as evidence of a lack of prudent decision-making when it defies a reasonable business explanation. In *Selheimer v. Manganese Corporation of America* in 1966, the Pennsylvania Supreme Court imposed liability on the directors of a mineral

⁵⁰ Julian Velasco, *A Defense of the Corporate Law Duty of Care*, 40 J. CORP. L. 647, 674–75 (2015) ("[C]are and negligence are the hallmarks of tort law: everyone has the duty (of a reasonable person under the circumstances) not to create unreasonable risks of harm to others. . . . Perhaps the corporate law duty of care is not a fiduciary duty at all but merely a tort law duty.").

⁵¹ *Id.* at 651 ("[A]lthough the standard of conduct for the duty of care is something like ordinary care, the standard of review is gross negligence rather than mere negligence.").

⁵² BAINBRIDGE, *supra* note 22 at 127.

⁵³ Johnson & Sides, *supra* note 48, at 1197 ("The duty of due care arises in both the discrete decision-making context and in the oversight and monitoring areas.").

⁵⁴ *In re Xtreme Power Inc.*, 563 B.R. 614, 640 (Bankr. W.D. Tex. 2016) (quoting *In re Soporex, Inc.*, 463 B.R. 344, 371 (Bankr. N.D. Tex. 2011) (internal quotations omitted)).

⁵⁵ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (illustrating how the directors breached their duty of care because they "did not adequately inform themselves . . . and . . . given these circumstances, at a minimum, were grossly negligent"). Note that under the duty of care, the obligation of informed decision-making may be articulated in different ways from state to state, but generally focuses on the *process* of decision making and not on the quality of the decisions that result from that process. Some states, including Delaware, have recognized both a procedural element, focused solely on the process of making decisions, and a substantive element, addressing the quality of the resulting decision, though Delaware's courts have been inconsistent on this point. For example, the Delaware Supreme Court rejected a claim of directors failing to exercise substantive due care in *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), but later that same year held that the business judgment rule "operates as both a procedural guide for litigants and a substantive rule of law." *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000).

producer. In that case, the court held that the board's decision to pour funds into a plant entirely unsuitable for production "defie[d] explanation" and lacked "any justification."⁵⁶ This sort of poor decision-making leading to an inexplicable loss of corporate assets is referred to as waste, and the business judgment rule will not protect such decisions. But such instances are rare, and the business judgment rule applies so long as the board acted on the basis of *any rational business purpose*, absent gross negligence or bad faith.⁵⁷

A related director duty is the obligation to inform shareholders when seeking their approval for decisions—a duty of disclosure or duty of candor.⁵⁸ The Delaware Supreme Court has explained that directors "are under a fiduciary duty to disclose fully and fairly all material obligations within the board's control when it seeks shareholder action."⁵⁹

Acting with due care takes on meaning in the directors' day-to-day role in guiding the corporation. Specifically, directors are under a duty to oversee the company, to pay attention, and to keep informed about its activities.⁶⁰ This was illustrated in *Francis v. United Jersey Bank*.⁶¹ In that case, the widow of the founder of a reinsurance business was elected to the board. She failed

⁵⁶ 224 A.2d 634, 646 (Pa. 1966).

⁵⁷ See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to *any rational business purpose*" (emphasis added).); *Brehm*, 746 A.2d at 264 n.66 ("[D]irectors' decisions will be respected by courts unless the directors . . . do not act in good faith, act in a manner that *cannot be attributed to a rational business purpose* or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available" (emphasis added)).

⁵⁸ Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, DEL. J. CORP. L. 221, 221, 226 (2009) ("[C]orporate directors and officers owe a duty to disclose material information to the shareholders. . . . [which] Delaware courts have articulated [as] an obligation of complete candor—also referred to as a duty of disclosure"); see also *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992) ("[D]irectors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material obligations within the board's control when it seeks shareholder action.").

⁵⁹ *Id.* at 84.

⁶⁰ FREER & MOLL, *supra* note 39, at 275 (explaining that "[d]irectors may breach the duty of care . . . by nonfeasance [which] is the failure to act when a duty to act existed" and that a director who is "inattentive or disengaged" is also guilty of "nonfeasance").

⁶¹ 432 A.2d 814 (N.J. 1981).

to attend meetings or familiarize herself with the business, while her sons pilfered corporate funds. The New Jersey Supreme Court, finding that the widow had breached her oversight duties, explained that directors are “under a continuing obligation to keep informed about the activities of the corporation.”⁶² They “may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look.”⁶³ In the face of this duty, directors may face liability when misconduct occurs on their watch.

3. The obligation to act in good faith

To act in good faith means, in essence, to act with good intentions.⁶⁴ For a corporate director, a lack of good faith—or bad faith—is to act with an intent to further interests contrary to those of the corporation.⁶⁵ So, directors have an obligation to act in good faith.

Often, courts have positioned this good-faith obligation as a third fiduciary duty, equal to the duties of loyalty and care.⁶⁶ But the only way directors can meet their duties of loyalty and care is to act in good faith.⁶⁷ On this basis the Delaware Supreme Court came in 2006 to hold that the obligation to act in good faith “does not establish an independent fiduciary duty” but arises from the duty of loyalty.⁶⁸ The court explained in *In re Disney Derivative Litigation* earlier that

⁶² *Id.* at 822.

⁶³ *Id.*

⁶⁴ See, e.g., *In re Farmland Indus., Inc.*, 335 B.R. 398, 408 (Bankr. W.D. Mo. 2005) (stating that good faith “requires an honesty of purpose”); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach* 29 DEL J. CORP. L. 491, 512 (2004) (“Good faith is merely the requirement that [directors] adhere to th[eir] obligations honestly.”).

⁶⁵ *In re Farmland Indus., Inc.*, 335 B.R. at 409 (“[A]n illegal action or one taken with the intent to harm the corporation constitutes an act of bad faith . . .”).

⁶⁶ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (describing “triads” of fiduciary duty, including “good faith, loyalty or due care”); *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (“[D]irectors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith.”).

⁶⁷ See, e.g., *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (explaining that a director “cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest”).

⁶⁸ *Stone ex rel. AmSouth Bancorp v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

same year that a director lacks good faith when she acts “with the intent to violate applicable positive law, or . . . intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.”⁶⁹

B. Directors’ duties have particular meaning in the M&A context

Directors play an important role in the M&A context. They are the first line of defense before a deal is presented to shareholders; they must decide whether to move forward. In this way, the board serves a gatekeeper function.⁷⁰ Given the immense consequences of M&A deals, and the importance of directors in that context, boards are subject to particular obligations.⁷¹ According to the Delaware Supreme Court, the board’s primary duties in the M&A context arise under its pre-existing fiduciary duties of loyalty and care.⁷² But when a board is responding to a potential acquisition or merger offer, its conduct may be subject to more stringent scrutiny.

1. The duties of loyalty and care in an M&A deal

As described above, the duty of loyalty imposes obligations on corporate directors to act in the best interests of the corporation and the shareholders, and thus avoid putting their own interests before those of the shareholders. As noted above, this occurs where directors are pursuing interested transactions or usurping corporate opportunities.⁷³ In the M&A context, this can arise

⁶⁹ *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 693, 755 (Del. Ch. 2005).

⁷⁰ GEVURTZ & SAUTTER, *supra* note 219, at 83 (explaining that state law generally requires board approval for a corporate sale or merger, which “places the board in the role of chief negotiator on behalf of the shareholders,” and because there can be no transaction without board approval, the directors perform a “gatekeeping function”).

⁷¹ *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 44 (Del. 1994) (“The consequences of a sale of control impose special obligations on the directors of a corporation[, including] acting reasonably to seek the transaction offering the best value reasonably available to the stockholders.”). *See also*, *Barkan v. Amsted Industries Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (explaining that where “a fundamental change of control occurs or is contemplated. . . the directors must act in accordance with their fundamental duties of care and loyalty”).

⁷² *Paramount Communications Inc.*, 637 A.2d at 43 (“The directors’ fiduciary duties in a sale of control context are those which generally attach. In short, the directors must act in accordance with their fundamental duties of care and loyalty.”).

⁷³ *See supra* at Part I, Section A.1.

where directors have a stake or interest in the deal. The most obvious of these scenarios arises where a director of an acquiring company owns shares in the target.⁷⁴

A defendant pleading facts of director conflict in an M&A deal rebuts the presumption of the business judgment rule. Courts then generally apply the more rigorous scrutiny of the entire fairness doctrine.⁷⁵ As described above, entire fairness review shifts the burden to the director defendants to show that the transaction was entirely fair to the shareholders. In Delaware, fairness has two components: fair dealing and fair price.⁷⁶ Courts first evaluate the directors' process, including the board's candor in disclosing all material information to the shareholders.⁷⁷ Then, the court assesses the fairness of the price, seeking to ensure the directors "commit[ed] themselves, inexorably, to obtaining the highest value reasonably available to the shareholders under all the circumstances."⁷⁸ The best evidence of how diligently the directors worked toward this goal is whether the price actually represents "the highest value" for the shareholders.⁷⁹

As in other corporate situations, the duty of care in the M&A context requires that a board act with reasonable diligence and is adequately informed.⁸⁰ In *Citron v. Fairchild Camera and*

⁷⁴ See generally GEVURTZ & SAUTTER, *supra* note 70, at 214–15 (describing the potential for conflicts in merge or sales transactions, and the role of the business judgment rule in evaluating the board's decisions when conflicts exist).

⁷⁵ See, e.g., *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) ("When faced with such divided loyalties, directors have the burden of establishing the entire fairness of the transaction to survive careful scrutiny by the courts.").

⁷⁶ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) ("The concept of fairness has two basic aspects: fair dealing and fair price.").

⁷⁷ *Id.* ("[Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.").

⁷⁸ *Mills Acquisition Co.*, 559 A.2d at 1280 ("'Fair price,' in the context of an auction for corporate control, mandates that directors commit themselves, inexorably, to obtaining the highest value reasonably available to the shareholders under all the circumstances.").

⁷⁹ *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995) ("In this case, because the contested action is the sale of a company, the 'fair price' aspect of an entire fairness analysis requires the board of directors to demonstrate 'that the price offered was the highest value reasonably available under the circumstances.'").

⁸⁰ *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("In the specific context of a proposed merger of domestic corporations, a director has a duty . . . to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders."); *Paramount Communications Inc. v.*

Instrument, the Delaware Supreme Court explained that its review of a board's actions in light of its duty of care is "focused on [the] board's decision making process," to determine "whether [the] board has acted in a deliberate and knowledgeable way" ⁸¹ Failure to do so gives rise to liability, or at least enhanced scrutiny, only by a showing of gross negligence. ⁸²

The duties of loyalty and care are ever-present in board decisions, whether in the M&A area or otherwise. But when facing a potential acquisition, particularly a hostile one, those duties take on greater weight, and specific obligations, under *Unocal* and *Revlon*. ⁸³

2. *Unocal* standard

The duties of directors to scrutinize M&A deals with due diligence and to make fully informed decisions may appear relatively straightforward. But how does a board manifest these

QVC Network Inc., 637 A.2d 34, 48 (Del. 1994) (explaining that when considering alternative change-of-control transactions, the board has an "obligation . . . to be diligent and vigilant[,] . . . to act in good faith . . . [and] to obtain, and act with due care on, all material information reasonably available").

⁸¹ 569 A.2d 53, 66 (Del. 1989).

⁸² *Id.* (explaining that "the concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one"); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.").

⁸³ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Commentators and courts alike have presented these obligations as "sub-duties," referring to them as "*Unocal* duties" or "*Revlon* duties." See, e.g., Philip S. Garon, Michael A. Stanchfield & John H. Matheson, *Challenging Delaware's Desirability as a Haven for Incorporation*, 32 WM. MITCHELL L. REV. 769, 819–20 (2006) (explaining how Delaware courts have expanded on directors' general fiduciary duties and "divided them into sub-duties," including those arising under *Caremark*, *Unocal*, and *Revlon*). See also, e.g., *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140, 1142 (Del. 1989) ("[P]laintiffs argue that Time's board breached its *Revlon* duties . . ."); *Revlon, Inc.*, 506 A.2d at 184 (referring to the obligations under *Unocal* as "enhanced *Unocal* duties"). Over time, these obligations have come to be seen as arising from the board's duties of loyalty and care and their corresponding standards of conduct, but subject to a heightened standard of judicial review. Thus, director conduct in the takeover context is subject to what may be called the *Unocal* or *Revlon* "standard." Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 593 (2002) ("In *Unocal*, the court used the term 'enhanced duty,' but quickly modified its terminology in *Revlon* to 'enhanced scrutiny,' which seems to capture more precisely the judicial role that is at issue" (internal citations omitted).); J. Travis Laster, *Revlon is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5, 25–26 (2013) (explaining that in responding to a takeover threat the board is held to its "same loyalty-based standard of conduct," and that what changes is "not the standard of conduct but the standard of review"). The Delaware Supreme Court added to the confusion in *Revlon*, when it referred to both the "*Unocal* standard" and "enhanced *Unocal* duties," and later referred to the board's "*Unocal* burden." *Revlon, Inc.*, 506 A.2d at 184, 185. This paper will use "standard" when referring to the board's obligations under both *Unocal* and *Revlon*.

duties in the face of a hostile bidder? This question likely arose often in the 1980s, a period rich with hostile takeovers and leveraged buyouts⁸⁴—acquisitions often funded with debt, including high-yield, highly-subordinated “junk” bonds.⁸⁵ The decade produced a series of bigger and bigger (and more highly leveraged) deals that so changed America’s corporate landscape the *New York Times* asserted it was “beginning to cause widespread alarm.”⁸⁶

Because incumbent directors likely face extinction should an M&A deal go through, their efforts to resist an unsolicited takeover bid may be self-serving, regardless of how it affects shareholder wealth. Thus, anti-takeover measures may not be in the best interests of the shareholders.⁸⁷ But such measures may be appropriate if an unwelcome bidder poses a threat to the target’s longer-term strategies and, ultimately, to the shareholders’ interests.⁸⁸

⁸⁴ See Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745, 745–49 (1990) (explaining that the takeover wave of the 1980s saw 28% of the 500 largest U.S. corporations change hands, representing \$1.3 trillion in exchanged assets); Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSPECTIVES 121, 125 (2001) (“Almost half of all major U.S. companies received ‘hostile’ takeover bids in the 1980s”); Gregg A. Jarrell, *Takeovers and Leveraged Buyouts*, LIBR. OF ECON. & LIBERTY, <https://www.econlib.org/library/Enc1/TakeoversandLeveragedBuyouts.html> (last visited Oct. 4, 2021) (providing an overview of hostile takeovers, “a prominent feature of the American business landscape during the . . . eighties”).

⁸⁵ All bonds are fixed-interest financial instruments built on debt—essentially a bond is a loan from the investor to the corporate borrower. “High-yield” or “junk bonds” carry lower credit ratings from the ratings agencies such as Standard & Poor, Fitch, or Moody’s. The lower credit rating reflects a higher risk of default. But much like borrowers with bad credit pay higher interest rates on their loans, high-yield bonds enjoy the advantage of higher potential returns (hence the name). See generally, James Chen, *High-Yield Bond*, INVESTOPEDIA (Oct. 23, 2020).

⁸⁶ Leonard Silk, *The Peril Behind the Takeover Boom*, N.Y. TIMES, Dec. 29, 1985, § 3, at 1 (explaining that “[t]he biggest wave of corporate acquisitions and buyouts in American history,” during which “American business has gone heavily into debt to pay for its multi-billion dollar takeovers” was so troubling to Federal Reserve Board Chairman Paul Volcker that he wanted to “restrict the use of junk bonds”).

⁸⁷ See Harry DeAngelo & Edward M. Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329, 356 (1983) (“[T]he dominant effect of antitakeover provisions is to allow incumbent management to protect their jobs at the expense of stockholders.”). See also John A. Pearce II & Richard B. Robinson, Jr., *Hostile Takeover Defenses That Maximize Shareholder Wealth*, 47 BUS. HORIZONS 15, 15 (2004) (explaining that corporate boards often implement defensive measures for legitimate business purposes but may also be “trying to save their jobs at the expense of wealth gains for their shareholders”).

⁸⁸ Pearce & Robinson, *supra* note 87 at 17 (“[Anti-takeover] defenses promote the interests of the target firm’s shareholders by raising takeover premiums, improving management, or protecting the firm’s long-term strategy.”).

The Delaware courts addressed the issue of board duties in the hostile takeover context in multiple cases during the 1980s. Two of these gave rise to a set of obligations for directors facing the scenario just described. The first came out of Mesa Petroleum's attempted two-tiered, front-loaded cash tender offer for Unocal, with the back end of the deal funded with junk bonds.⁸⁹

Mesa had offered \$54 per share on the front end of the deal (seeking about 37% of Unocal's outstanding stock).⁹⁰ The Unocal board met numerous times to consider this. With the assistance of investment bankers and other financial experts, including Goldman Sachs, the board determined that the offer was inadequate and ultimately rejected it.⁹¹ In its place, the board (again, with the help of experts) developed an alternative "exchange offer" by which Unocal would offer to buy its own stock for the equivalent of \$72 per share.⁹² This was a form of a self-tender offer proposed as a better-priced alternative for the Unocal shareholders—one which the board did not offer to Mesa. Mesa filed suit challenging the move.⁹³

The Chancery Court issued a preliminary injunction on Unocal's exchange offer and certified an interlocutory appeal to the state's supreme court. The issues before the supreme court generally amounted to this: (1) does a board of directors have the authority or obligation to oppose a takeover threat that it reasonably believes is not in the long-term best interests of the corporation, and (2) are the board's efforts protected by the business judgment rule?⁹⁴ At the heart of these issues is the fact that a tender offer is a direct proposal to the shareholders. Thus, the first issue raised a more fundamental question of whether a board of directors has *any* role in such a

⁸⁹ Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949–51 (Del. 1985).

⁹⁰ *Id.* at 949.

⁹¹ *Id.* at 950.

⁹² *Id.* at 950–51.

⁹³ *Id.* at 951.

⁹⁴ *Id.* at 953.

transaction. The Delaware Supreme Court answered in clear terms: when acting with a good faith belief that a hostile offer represents a threat to the company's policies and the shareholders' interests, a target's board has a particular obligation, subject to intensive scrutiny by any reviewing court, to insert itself in the proceedings and take defensive measures that are reasonable relative to the threat posed.⁹⁵

As noted above, where the board acts under its obligation to take appropriate measures in the face of a takeover threat, its conduct is subject to a more stringent level of judicial scrutiny, called the *Unocal* standard.⁹⁶ This arises where a board unilaterally takes defensive measures in response to a threat to the corporation's policies that, in turn, implicates control of the corporation (such that the directors' self-interest may be issue). The defensive measures, according to the *Unocal* court, and expanded upon by the court in *Unitrin, Inc. v. American General Corp.*, must be proportionate to the nature of the threat posed.⁹⁷

3. *Revlon* standard

A year after *Unocal*, the Delaware Supreme Court heard *Revlon v. MacAndrews & Forbes Holdings*.⁹⁸ Where *Unocal* started and ended with the board's response to a hostile threat, the

⁹⁵ *Id.* at 949 ("Unocal's board . . . had both the power and duty to oppose a bid it perceived to be harmful to the corporate enterprise."). The court also explained that because of the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders," this gives rise to an "enhanced duty": the board, on the threshold, must show that it had reasonable grounds to believe that the hostile bid was a threat (which is best supported by the approval of a board comprised mostly of outside independent directors but also by a showing of good faith and reasonable investigation), and that the board's defensive measures were, in fact, reasonable in relation to that threat. *Id.* at 955.

⁹⁶ *See, e.g., Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1372 (Del. 1995) (describing a board's actions in implementing defensive measures as "subject to the *Unocal* standard of enhanced judicial scrutiny").

⁹⁷ *Unitrin, Inc.*, 651 A.2d at 1367. The *Unitrin* court further organized the analysis of board conduct under *Unocal* into a two-prong test: reasonableness, wherein the court evaluates whether the board "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and proportionality, wherein the court assesses whether "the board of directors' defensive response was reasonable in relation to the threat posed." *Id.* at 1373.

⁹⁸ 506 A.2d 173 (Del. 1986).

Revlon court recognized that the hostile bid itself may inevitably push the company onto the auction block. When it does, the board's duties change.

The *Revlon* case involves various complex maneuvers, but at issue was the Revlon board's efforts to prevent an acquisition by one company (Pantry Pride, Inc.) while entertaining an offer by another (Forstmann Little & Co.) that would benefit the Revlon board. To resist Pantry Pride's hostile efforts, Revlon directors had approved a self-tender supported by an issue of notes (debt obligations). Revlon then began negotiating with Forstmann, providing that company with financial data it did not make available to Pantry Pride.⁹⁹ The two bidders went back-and-forth, raising their respective offers for Revlon from as low as \$42 per share to Pantry Pride's final hostile bid of \$58. By then, the Revlon board had accepted a lower offer from Forstmann wherein Forstmann agreed to support the par value of the outstanding notes, the value of which had been declining in the market.¹⁰⁰ Pantry Pride filed suit.¹⁰¹

The Delaware Supreme Court eventually took up the issue of whether defensive measures implemented "in the face of an active bidding contest for corporate control" were valid.¹⁰² The court held that in cases where a board faces a hostile takeover, as here, the board has obligations under *Unocal* to protect the interests of the corporation and the shareholders from the threat.¹⁰³ But once the board begins to explore alternative bids, and the acquisition becomes inevitable, the

⁹⁹ *Id.* at 177, 178.

¹⁰⁰ *Id.* at 178–79.

¹⁰¹ *Id.* at 179. Pantry Pride originally filed suit in August, 1985, on the ground that the Revlon board's defensive exchange offer violated its duty of candor to Revlon shareholders. By October, the Pantry Pride complaint had been amended twice, finally focusing on the board's actions in favoring Forstmann to Pantry Pride's exclusion. *See also* Jim Talley, *Pantry Pride Sues Revlon in Takeover*, SUN-SENTINEL (Aug. 23, 1985), <https://www.sun-sentinel.com/news/fl-xpm-1985-08-23-8502040534-story.html>; Robert J. Cole, *Takeover Accepted by Revlon*, N.Y. TIMES (Nov. 2, 1985), <https://www.nytimes.com/1985/11/02/business/takeover-accepted-by-revlon.html>.

¹⁰² *Id.* at 176.

¹⁰³ *Id.* at 181.

directors' primary fiduciary duty shifts "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."¹⁰⁴ As with the board's obligations under *Unocal*, the board's conduct under *Revlon* is subject to a more stringent standard of judicial review, now referred to as a *Revlon* standard.¹⁰⁵

C. Caremark duties obligate boards to implement compliance programs

A board's duties of loyalty and care encompass a more specific duty of oversight. The duty of care, as illustrated in *Francis v. United Jersey Bank* described above, obligates directors to engage in "general monitoring of corporate affairs"¹⁰⁶ The Delaware Chancery Court went further in 1996 when it imposed on the board a particular obligation to implement and maintain effective compliance and reporting programs.¹⁰⁷

1. *Caremark* reflects the evolving duty of oversight

A corporate board's standard of conduct when faced with internal misconduct was established in *In re Caremark International Derivative Litigation* in 1996¹⁰⁸—conduct which would soon be referred to as directors' *Caremark* duties.¹⁰⁹ More than 30 years before *Caremark*, the Delaware Chancery Court had held that directors could "rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong."¹¹⁰

¹⁰⁴ *Id.* at 182.

¹⁰⁵ See *In re MFW Shareholder Litigation*, 67 A.3d 496, 518 (Del. Ch. 2013) (describing *Unocal* and *Revlon* standards of review as "standards that intentionally involve judges in reviewing director behavior in a manner not permitted under the business judgment rule" that involves applying "a form of entire fairness review or at least [a] type of heightened reasonableness scrutiny").

¹⁰⁶ *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981).

¹⁰⁷ *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996).

¹⁰⁸ *Id.*

¹⁰⁹ See, e.g., *In re Goldman Sachs Group, Inc. S'holder Litig.*, 2011 WL 4826104 (Del. Ch. 2011) (describing the director's oversight obligations under *Caremark* as "*Caremark* duties").

¹¹⁰ *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. Ch. 1963).

But things had changed in the intervening decades. The court in 1996 was considering claims brought by shareholders of Caremark International, a large healthcare products and services provider.¹¹¹ The company and two of its officers had been indicted two years earlier for multiple felonies related to federal healthcare laws and ultimately paid approximately \$250 million in penalties.¹¹² The court held that a board satisfies its oversight obligations by ensuring in good faith that the corporation maintains an adequate “corporate information and reporting system.”¹¹³

In finding that boards are obligated to maintain compliance programs, the *Caremark* court recognized the expanding breadth of governmental regulations, and the government’s “increasing tendency” to impose criminal liability for noncompliance.¹¹⁴ The *Caremark* court was perhaps not widening the scope of director responsibility (and corresponding liability) so much as recognizing that the DOJ and various regulatory agencies were already doing so.¹¹⁵

In 1997, the American Bar Association modified Section 8.30 of the Model Business Corporation Act, which prescribes standards of conduct for directors. Likely reflecting the Delaware court’s imposition of *Caremark* duties the year before, the official comment to Section

¹¹¹ See, e.g., *Caremark International Inc. – Company Profile, Information, Business Description, History, Background Information on Caremark International Inc.*, REFERENCE FOR BUS., <https://www.referenceforbusiness.com/history2/8/Caremark-International-Inc.html#ixzz78q5uclfg> (last visited Oct. 9, 2021).

¹¹² *In re Caremark Int’l*, 698 A.2d at 960. For more details, see also, Thomas M. Burton, *Fee for Service: Caremark Faces Heat for Paying Doctors Who Sent it Patients – Physician-Salesman Enlisted Fellow M.D.’s, Raising Fortunes All Around – Years of Treatment for Lyme*, WALL ST. J., Nov. 11, 1994, at A1.

¹¹³ *In re Caremark Int’l*, 698 A.2d at 969.

¹¹⁴ *Id.* at 970.

¹¹⁵ Delaware has been the recognized leader in corporate law since the early 1900s, but its dominant role has been imposed upon not only by other states seeking to attract business, but especially by federal corporate regulations. Most recently, the Sarbanes-Oxley and Dodd Frank Acts have intruded on what had been largely the Delaware courts’ domain. See generally, Charles M. Elson, *Why Delaware Must Retain Its Corporate Dominance and Why It May Not*, in CAN DELAWARE BE DETHRONED? 225, 225–27 (Stephen M. Bainbridge et al. eds., 2018) (explaining how Delaware’s “preeminent role in corporate regulation” is primarily due to the strength of its chancery court which “is globally regarded as a premier, if not the premier business court,” but the state’s dominance may be at risk from the rise in federal corporate regulation).

8.30(b) now asserts that a board must ensure “appropriate systems have been established, such as those concerned with legal compliance, risk assessment or internal controls.”¹¹⁶

The *Caremark* holding was upheld by the Delaware Supreme Court a decade later in *Stone ex rel. AmSouth Bancorp. v. Ritter*.¹¹⁷ *Stone* involved a shareholder derivative action on allegations that the AmSouth directors had breached their duties under *Caremark* by failing to see that the firm adopted a reasonable compliance and reporting system to ensure compliance with the federal Bank Secrecy Act. The Delaware Supreme Court adopted the board’s standard of conduct under *Caremark*, explaining that directors became liable when 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.”¹¹⁸

2. The difficulty of bringing *Caremark* claims

The Delaware courts’ holdings in *Caremark* and *Stone* subjected directors with an affirmative duty to maintain effective compliance programs.¹¹⁹ However, the standard of review the courts have applied in reviewing board conduct under *Caremark* has nearly eliminated liability.¹²⁰ One commentator thus described *Caremark* duties as a “toothless tiger.”¹²¹

¹¹⁶ MODEL BUS. CORP. ACT § 8.30(b), official comment 2 (2020). To review the modifications to Section 8.30(b) and the official comments to that section, as introduced in 1997, see Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Electronic Filings/Standards of Conduct and Standards of Liability for Directors*, 53 BUS. LAW. 157, 166 (1997).

¹¹⁷ 911 A.2d 362, 365 (Del. 2006).

¹¹⁸ *Stone*, 911 A.2d at 370.

¹¹⁹ *In re Caremark Int’l*, 698 A.2d at 970.

¹²⁰ Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors’ Evolving Duty to Monitor* 3–4 (Law & Econ., Working Paper No. 08-57, 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1304272 (last visited Sept. 23, 2021).

¹²¹ Anne Tucker Nees, *Who’s the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 216 (2010).

Even in *Caremark*, the court ultimately found the directors had not breached their oversight duties and were relieved of liability. The court described *Caremark* claims as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”¹²² According to the court, “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.”¹²³ To be sustained, a *Caremark* claim therefore had to demonstrate a lack of good faith. The Delaware Supreme Court made this point abundantly clear in 2019, asserting that “[i]f *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.”¹²⁴

The requirement that a valid *Caremark* claim include a showing of bad faith resulted in a “parade of early dismissals,” as one commentator described it.¹²⁵ Thus, *Caremark* has seemingly represent little more than a theoretical basis of director liability.

II. THE BOARD’S COMPLIANCE OBLIGATION EXTENDS TO THE M&A CONTEXT

When directors act in bad faith or engage in fraud, it is rather easy to identify the breach of fiduciary duties. But the lack of oversight that can lead to an M&A failure is less obvious.¹²⁶

¹²² *In re Caremark Int’l*, 698 A.2d at 968.

¹²³ *Id.* at 971. *See also*, Stephen F. Funk, *In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 DEL. J. CORP. L. 311 (1997) (arguing that *Caremark* sends “conflicting signals to directors” that they must “employ effective compliance and reporting systems or face liability,” although “the lack of good faith necessary for such liability will *only* be found if they completely ignore obvious red flags and fail to implement any compliance system”).

¹²⁴ *Marchand v. Barnhill*, 212 A.3d 805, 823–24 (Del. 2019).

¹²⁵ Roy Shapira, *A New Caremark Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1863 (2021).

¹²⁶ *See, e.g.*, Gaughan, *supra* note 8, at 4 (2005) (“When a CEO or CFO engages in accounting fraud and other manipulations, it is easy to see that this is wrong and require remedies and punishment. It is much less clear when a merger turns sour and shareholders lose value in their investment . . .”).

Today, U.S. corporations operate in an environment of heavy regulation that places business at risk of compliance failures, so the need is significant for oversight, both inside and outside the M&A context. This section will illustrate that ensuring compliance throughout the organization alone does not mitigate the risk of *acquiring* a compliance breach. As such, directors' oversight duties must naturally include evaluating such risk in acquisition targets.

A. Extensive regulation raises the stakes on corporate compliance

The government accounted for less than 10% of the U.S. economy in 1900.¹²⁷ By 2020 government spending represented 44% of U.S. gross domestic product.¹²⁸ Today, there are more than 70 federal regulatory agencies issuing approximately 3,500 new rules annually,¹²⁹ and the U.S. Code of Federal Regulations now comprises 242 volumes and more than 185,000 pages.¹³⁰ Federal regulations govern virtually all aspects of business operations.¹³¹ These regulatory schemes, backed by enforcement and the risk of penalties, both civil and criminal, place a significant burden on the corporate board's oversight obligations.

The risk of non-compliance is real and measurable. Merely responding to government investigations, reports of violations, or audits can be costly,¹³² while criminal and civil penalties

¹²⁷ Christopher Chantrell, *U.S. Government Spending History From 1900*, U.S. SPENDING, https://www.usgovernmentspending.com/past_spending (last visited Oct. 10, 2021).

¹²⁸ *United States Government Spending to GDP*, TRADING ECON., <https://tradingeconomics.com/united-states/government-spending-to-gdp> (last visited Oct. 10, 2021).

¹²⁹ HOWARD BEALES, ET AL., GOVERNMENT REGULATION: THE GOOD, THE BAD, & THE UGLY 5 (2017), available at <https://regproject.org/wp-content/uploads/RTP-Regulatory-Process-Working-Group-Paper.pdf>.

¹³⁰ Susan E. Dudley, *Milestones in the Evolution of the Administrative State*, 150 DAEDALUS 33, 33–34 (2021), available at <https://regulatorystudies.columbian.gwu.edu/sites/g/files/zaxdzs3306/f/downloads/Articles/The%20Administrative%20State%20in%20the%20Twenty-First%20Century%20-%20Daedalus%20-%20June%202021.pdf>.

¹³¹ See, e.g., Committee for Economic Development of the Conference Board, *Regulation & the Economy*, CED (Sept. 27, 2017), <https://www.ced.org/reports/regulation-and-the-economy> (offering a list of various sectors of the U.S. economy affected by regulations).

¹³² See CAROL A. POINDEXTER, CRIMINAL AND CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS 1 (2016), available at <https://www.nortonrosefulbright.com/-/media/files/nrf/nrfweb/imported/20160801---criminal->

for violations can reach into the hundreds of millions of dollars, and occasionally climb above the one-billion-dollar mark.¹³³ In fact, the average cost for compliance failures is nearly \$15 million.¹³⁴ Regulatory penalties in the banking and financial markets have been especially hefty. Since 2008, banks in the U.S. were fined nearly \$250 billion.¹³⁵

The list of past violators includes recognized and popular names. For example, consumer health and beauty products leader Johnson & Johnson paid more than \$2.2 billion in 2013 in penalties relating to promotion of unapproved drug uses and illegal kickbacks, while financial services giant HSBC forfeited more than \$1.2 billion in a 2012 settlement for violating anti-money laundering laws.¹³⁶ Meanwhile, global financial services juggernaut JPMorgan Chase agreed to a \$13 billion settlement with the Department of Justice in 2013 in the wake of the financial crisis.¹³⁷ But as large as these numbers may appear to be at first glance, they can often amount only to another cost of doing business. Even JPMorgan Chase was able to absorb the \$13 billion settlement in 2013 and still showed a positive net income for the year of nearly \$18 billion.¹³⁸ The costs to the corporation of compliance failures seem to have little deterrent effect.

and-civil-liability-for-corporations-officers-and-directors.pdf (summarizing the various risks corporations face for corporate misconduct).

¹³³ CHRISTOPHER A. MYERS & MICHAEL MANTHEI, *The Business Case for Compliance Programs in 1 CORPORATE COMPLIANCE ANSWER BOOK* at 1-16 (2021 ed.) (describing the high cost of civil and criminal penalties).

¹³⁴ *The True Cost of Non-Compliance in Business*, IRIS/FMP (Dec. 4, 2018), <https://fmpglobal.com/blog/the-cost-of-non-compliance/>. See also, PONEMON INSTITUTE LLC, *THE TRUE COST OF COMPLIANCE WITH DATA PROTECTION REGULATIONS: BENCHMARK STUDY OF MULTINATIONAL ORGANIZATIONS 4* (2017), available at <https://www.corporatecomplianceinsights.com/true-cost-compliance/> [hereinafter, PONEMON STUDY].

¹³⁵ *The Not So Hidden Costs of Compliance*, ASCENT, <https://www.ascentregtech.com/blog/the-not-so-hidden-costs-of-compliance/> (last visited Sept. 22, 2021).

¹³⁶ MYERS & MANTHEI, *supra* note 133.

¹³⁷ *The Biggest Compliance Fines of the Decade*, PLANET COMPLIANCE, <https://www.planetcompliance.com/the-biggest-compliance-fines-of-the-decade/> (last visited Sept. 20, 2021).

¹³⁸ *JPMorgan Chase Reports Fourth-Quarter 2013 Net Income of \$5.3 Billion, or \$1.30 Per Share, on Revenue of \$24.1 Billion*, Press Releases, JPMORGAN CHASE & CO. (Jan. 14, 2014), <https://www.jpmorganchase.com/ir/news/2014/id-819107>.

Perhaps more effective in motivating directors to embrace their oversight role is the risk of personal liability. The DOJ has specifically called on federal prosecutors to target individual officers and directors for civil or criminal liability. In 2015, Deputy Attorney General Sally Yates issued a Memorandum on Individual Accountability for Corporate Wrongdoing, known generally as the Yates Memo.¹³⁹ In it, Yates directed federal prosecutors to focus their efforts on *individuals* responsible for misconduct and precluded releasing them from civil or criminal liability when settling with the culpable organization.¹⁴⁰ Included among the various factors Yates provided to prosecutors in considering whether to pursue prosecution of an organization was whether the corporation provided “all relevant facts about responsible individuals,” as well as the existence and adequacy of the corporation’s internal investigation.¹⁴¹

B. The cost of compliance is outweighed by the cost of non-compliance

While pressure grows in favor of implementing compliance initiatives, the cost to do so can slow the momentum.¹⁴² One study in 2017 showed that data-protection compliance cost companies an average of \$5.47 million and was significantly higher for firms in the financial services industry.¹⁴³ A 2012 report showed that regulatory compliance cost manufacturing firms \$19,564 per employee per year.¹⁴⁴ The cost of investigating failures can also be high. While being investigated for possible violations of the Foreign Corrupt Practices Act (FCPA) over seven years,

¹³⁹ Memorandum from Sally Quillian Yates, Deputy Att’y Gen., U.S. Dep’t of Justice, *Individual Accountability for Corporate Wrongdoing* (Sept. 9, 2015), available at <https://www.justice.gov/archives/dag/file/769036/download>.

¹⁴⁰ *Id.* at 4–6.

¹⁴¹ *Id.* at 3.

¹⁴² Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save Its Soul?*, 47 RUTGERS L. REV. 605, 681 (1995) (explaining that corporate compliance programs are expensive to implement and maintain).

¹⁴³ PONEMON STUDY, *supra* note 134.

¹⁴⁴ *The Cost of Federal Regulation*, NAM.ORG, <https://www.nam.org/the-cost-of-federal-regulation/>.

Walmart, Inc., spent more than \$900 million in legal and related costs (in addition to approximately \$282 million in fines).¹⁴⁵ In 2014, Avon Products settled a similar case with regulators for \$135 million, but not before it had spent nearly three times that amount on the investigation.¹⁴⁶ And Siemens AG reportedly spent over \$1 billion in legal expenses on an investigation before agreeing to \$800 million in fines in 2008.¹⁴⁷

In spite of the cost of compliance, it is the cost of failures that justifies the investment. The penalties are significant, as noted above, but they are not the end of the story. Corporations running afoul of the law may face other potential losses: harm to their reputations,¹⁴⁸ a loss of productivity, the loss of licenses required to do business, and more.¹⁴⁹ And while these costs may be difficult to quantify, multiple studies have looked at the impact of criminal wrongdoing on the corporation's value. A 1994 study showed that announcements of certain types of crime, including bribery, tax evasion, and financial reporting violations "were associated with negative abnormal stock returns."¹⁵⁰ A 1997 study showed that firms convicted of wrongdoing had lower accounting returns in the five years following the conviction, and also experienced lower sales growth in the period

¹⁴⁵ Nandita Bose, *Walmart to Pay \$282 Million to Settle Seven-Year Global Corruption Probe*, REUTERS (June 20, 2019, 12:47 PM), <https://www.reuters.com/article/us-walmart-fcpa/walmart-to-pay-282-million-to-settle-seven-year-global-corruption-probe-idUSKCN1TL27J>.

¹⁴⁶ Serena Ng & Ben Fox Rubin, *Avon to Pay \$135 Million to Settle Bribe Probe*, WALL ST. J. (May 1, 2014, 1:56 PM), <https://www.wsj.com/articles/avon-agrees-to-settlement-terms-on-bribery-probe-1398945246>.

¹⁴⁷ Mike Esterl & David Crawford, *Siemens to Pay Huge Fine in Bribery Inquiry*, WALL ST. J. (Dec. 15, 2008, 12:01 AM), https://www.wsj.com/articles/SB122919269803304383?mod=article_inline.

¹⁴⁸ MYERS & MANTHEL, *supra* note 133, at 1-15 ("In recent years, ruinous corporate scandals have brought down several large companies in the United States: WorldCom, Adelphia, Tyco, Enron, Arthur Andersen, and BellSouth. Other companies have suffered severe reputational and/or financial damage from compliance failures, sometimes even from allegations of failures.").

¹⁴⁹ See H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post Caremark Era*, 26 DEL. J. CORP. L. 1, 89-90 (2001) (explaining that the cost of defending against a criminal investigation can lead to a decline in productivity "resulting from management distraction and loss of employee morale," and the company may also "lose necessary licenses to do business, be suspended, or debarred from doing business with the government," among other costs).

¹⁵⁰ Wallace N. Davidson III, Dan L. Worrell & Chun I. Lee, *Stock Market Reaction to Announced Corporate Illegality*, 13 J. BUS. ETHICS 979, 985 (1994).

three to five years post-conviction.¹⁵¹ In 2006, GMI Ratings, a corporate governance ratings agency, reported results of a multi-year analysis. The study showed that good corporate governance was associated with better total shareholder returns, plus lower capital costs, lower insurance premiums, and enhanced reputation.¹⁵² Finally, a 2018 study showed a market capitalization loss of \$60.61 billion from a single FCPA violation, “or a per-event mean market capital loss of \$198.06 million.”¹⁵³

Walmart bears this out by example. After its alleged bribery violation was reported in 2012, the company’s stock fell nearly five percent.¹⁵⁴ While these losses may amount to no more than a speed bump for corporate giants like Walmart, they are significant for most companies.

C. Effective compliance programs reduce both risk and liability

As noted above, the value of implementing compliance and reporting systems stems from much more than court-imposed duties arising under *Caremark*. In many respects, it also reflects a sound business investment. Effective compliance systems operate much like insurance policies because they (a) have been shown to reduce the incidence of crime, regulatory violations, and other misconduct, (b) help uncover misconduct early, allowing for early intervention, and (c) can potentially reduce the corporation’s exposure to enforcement penalties.¹⁵⁵

¹⁵¹ Melissa S. Baucus & David A. Baucus, *Paying the Piper: An Empirical Examination of Longer-Term Financial Consequences of Illegal Corporate Behavior*, 40 ACAD. MGMT. J. 129, 146 (1997).

¹⁵² Howard Sherman, CEO, GMI, Corporate Governance, Risk and Rewards, Presentation Prepared for the Conference Board of Ethics and Compliance Conference (May 11, 2006).

¹⁵³ Vijay S. Sampath, Naomi A. Gardberg & Noushi Rahman, *Corporate Reputation’s Invisible Hand: Bribery, Rational Choice, and Market Penalties*, 151 J. BUS. ETHICS 743, 751, 756 (2018).

¹⁵⁴ Stephanie Clifford, *Wal-Mart Stock Falls Nearly 5%*, N.Y. TIMES (Apr. 23, 2012), <https://www.nytimes.com/2012/04/24/business/wal-mart-stock-falls-nearly-5-after-report-of-quashed-bribery-inquiry.html>.

¹⁵⁵ Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U. L. Q. 375, 376 (1993) (“[A]n effective compliance program . . . creates an atmosphere that will discourage wrongdoing[;] . . . detects misconduct as it occurs so the organization can . . . minimize their adverse consequences[;] . . . serves as a significant mitigating factor to a prosecutor considering whether to indict a company; [and] . . . significantly diminishes the organization’s exposure at sentencing.”).

1. Compliance programs can reduce enforcement penalties

By minimizing the incidence of compliance failures, the organization that implements an effective program can avoid the significant costs of such failures. But an effective compliance program also pays dividends when wrongdoing does occur in spite of that program. The DOJ's Sentencing Guidelines for Organizations, first issued in the early 1990s, encouraged corporations to implement compliance initiatives by offering "cooperation credit" for those that do.¹⁵⁶

Under the Sentencing Guidelines today, the company with an effective program subsequently facing conviction may reduce its "culpability score," and thereby reduce its fine by potentially millions of dollars.¹⁵⁷ The guidelines enumerate three criteria by which prosecutors are to determine whether such cooperation credit is to be applied: (1) whether the corporation voluntarily discloses the misconduct and assists the department in their investigation, (2) whether the corporation has an effective compliance program in place, and (3) the extent to which the organization acts to remediate the wrongdoing, including modifying its compliance program.¹⁵⁸

In practice, the DOJ and regulatory bodies like the SEC often use discretion in enforcement actions against corporations that have met the criteria, particularly those maintaining effective compliance programs. In such a case, the government may use a Deferred Prosecution Agreement (DPA) or even a Non-Prosecution Agreement (NPA) to settle the case with minimal harm to the

¹⁵⁶ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8 (2018).

¹⁵⁷ Webb & Molo, *supra* note 155, at 379. *See also*, UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8C2.5(f)(1) (2018) ("If the offense occurred even though the organization had in place at the time of the offense an effective compliance and ethics program . . . subtract 3 points."). Section 8C2.4(d) provides an "Offense Level Fine Table" that lists the amount of fine associated with a given "Offense Level" or culpability score. Under Section 8C2.5, prosecutors are directed to start with 5 points and then apply the following sections which either increase or decrease this score. UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL §§ 8C2.4(d), 8C2.5(a) (2018).

¹⁵⁸ MYERS & MANTHEL, *supra* note 133, at 1-29. *See also* UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL §§ 8C2.5(f)(1), (g) (2018).

corporation.¹⁵⁹ For example, in 2012, the DOJ elected not to prosecute Morgan Stanley after one of its managing directors pled guilty to criminal charges under the FCPA. The DOJ announced that Morgan Stanley had “maintained a system of internal controls” that helped to uncover the director’s misconduct and aided the subsequent investigation.¹⁶⁰

2. Compliance programs must be *effective*

The Enron scandal may be one of the most dramatic examples of an oversight failure in modern times.¹⁶¹ The extent of the wrongdoing was mind boggling, and the cost tremendous.¹⁶² Arthur Andersen, one of the top accounting firms in the world, was subsequently convicted for obstruction of justice. Enron and Arthur Andersen would both perish in the wake of the scandal.¹⁶³ Yet Enron had a compliance program in place when its top officers were engaged in their fraudulent scheme. This illustrates that a compliance manual sitting on the shelf is not sufficient to prevent misconduct that could eventually bring a powerful company to its knees.¹⁶⁴

¹⁵⁹ See NICOLE VANATKO, CONGR. RESEARCH SERV., IF11588, THE FOREIGN CORRUPT PRACTICES ACT (FCPA): AN OVERVIEW 1–2 (2020) (“[U]nder a deferred prosecution agreement (DPA), the agency agrees to postpone prosecuting charges it has filed against the subject company, and to later dismiss them, if the company abides by the terms of the DPA. Under a non-prosecution agreement (NPA), the agency foregoes filing and prosecuting charges if the company abides by the agreement.”).

¹⁶⁰ MYERS & MANTHEI, *supra* note 133, at 1-21. See also Press Release No. 12-534, U.S. Dep’t of Justice, Former Morgan Stanley Managing Director Pleads Guilty for Role in Evading Internal Controls Required by FCPA (Apr. 25, 2012), www.justice.gov/opa/pr/2012/April/12-crm-534.html.

¹⁶¹ See *Enron*, FBI, <https://www.fbi.gov/history/famous-cases/enron> (last visited Oct. 12, 2021), (describing the “sheer magnitude” of the Enron case as “the most complex white-collar crime investigation in the FBI’s history”).

¹⁶² See Alexei Barrionuevo, *Enron Chiefs Guilty of Fraud and Conspiracy*, N.Y. TIMES (May 25, 2006), https://www.nytimes.com/2006/05/25/business/25end-enron.html?mc=aud_dev&ad-keywords=auddevgate&gclid=Cj0KCQjw5JSLBhCxARIsAHgO2Sdu1Xr8mJxM0p_hRVWb8FvtzLKJXAEYoGZw9tdfBSxbBHMqste9y6EaAj6yEALw_wcB&gclsrc=aw.ds.

¹⁶³ See Richard A. Oppel Jr. & Andrew Ross Sorkin, *Enron’s Collapse: The Overview; Enron Collapses as Suitor Cancels Plans for Merger*, N.Y. TIMES (Nov. 29, 2001), <https://www.nytimes.com/2001/11/29/business/enron-s-collapse-the-overview-enron-collapses-as-suitor-cancels-plans-for-merger.html>; *Arthur Andersen Goes Out of Business*, ABC NEWS (Dec. 8, 2009, 10:21 AM), <https://abcnews.go.com/Business/Decade/arthur-andersen-business/story?id=9279255>. The name Andersen was later adopted by former Arthur Andersen partners for their independent tax and financial consultancy. See Chris Gaetano, *15 Years After Enron, Arthur Andersen Brand Resurges*, N.Y. SOC. CPAS (May 2, 2017) (explaining how the former Andersen partners waited before eventually deciding to purchase and use the Andersen name for their consultancy).

¹⁶⁴ MYERS & MANTHEI, *supra* note 133, at 1-4.

The U.S. government's case against Siemens AG for FCPA violations is another illustration of how enforcement agencies value effective compliance programs.¹⁶⁵ In that case, the DOJ referred to Siemens's compliance initiatives as a "paper program" that did little to mitigate the company's "historical, pervasive corrupt business practices."¹⁶⁶ Thus, to satisfy the DOJ's criteria for cooperation credit as prescribed in the Sentencing Guidelines, the organization's compliance efforts must be effective. According to the DOJ, this means "the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees," and "corporate management is enforcing the program" and not "tacitly encouraging or pressuring employees to engage in misconduct."¹⁶⁷

The U.S. Sentencing Guidelines offer seven elements that characterize effective compliance programs.¹⁶⁸ First, compliance standards must be expressed in a written code of conduct with supporting policies and procedures.¹⁶⁹ Second, the directors must understand and oversee the program, with high-level personnel managing the compliance effort with sufficient resources.¹⁷⁰ Third, the company should make efforts to avoid including among its management team any high-risk individuals—people the board knows or should know have engaged in prior misconduct.¹⁷¹ Fourth, a compliance program is effective when its elements are communicated

¹⁶⁵ See Daniel J. Grimm, *The Foreign Corrupt Practices Act in Merger and Acquisition Transactions: Successor Liability and its Consequences*, 7 N.Y.U. J.L. & BUS. 247, 270 (2010) (describing how Siemens "demonstrates the significant value enforcement agencies place on effective FCPA compliance programs").

¹⁶⁶ United States v. Siemens Aktiengesellschaft, No. 1:08-CR-367 (D.D.C. Dec. 12, 2008); see Information at ¶ 9, available at <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2013/05/02/12-12-08siemensakt-info.pdf>.

¹⁶⁷ U.S. DEP'T OF JUSTICE, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2 (June 2020), <https://www.justice.gov/criminal-fraud/page/file/937501/download>.

¹⁶⁸ See *Creating a Compliance and Ethics Program from Scratch*, 36 No. 2 ACC DOCKET 24, 26 (2018).

¹⁶⁹ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(1) (2018).

¹⁷⁰ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(2) (2018).

¹⁷¹ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(3) (2018).

throughout the organization, and the staff is trained on it.¹⁷² Fifth, the company should continually monitor and audit its program, and provide a “whistleblower” hotline for employees to report misconduct.¹⁷³ Sixth, the effective program is one that applies rewards and discipline to address both positive and negative behavior by employees.¹⁷⁴ Finally, the company must respond when noncompliance is detected, adopting changes in the compliance program to prevent further misconduct.¹⁷⁵ The most important factor in determining compliance system success is the “tone at the top.” That is, to be truly effective in deterring and detecting misconduct, the company’s leaders must both support the compliance effort and “create and foster a culture of ethics and compliance with the law at all levels of the company.”¹⁷⁶

D. Companies inherit liability from compliance failures of acquisition targets

There are numerous business reasons corporations engage in M&A deals, including leveraging synergies, gaining a technology or supply-chain advantage, opening doors to a particular market, eliminating competition, or simply to jump start growth.¹⁷⁷ A 2001 study suggested that the true driving force behind the decision to merge is actually psychological: perhaps management hubris or even fear.¹⁷⁸ Regardless, when companies come together they exchange more than just assets. Under the doctrine of successor liability, the acquiring corporation

¹⁷² UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(4) (2018).

¹⁷³ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(5) (2018).

¹⁷⁴ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(6) (2018).

¹⁷⁵ UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8B2.1(b)(7) (2018).

¹⁷⁶ U.S. DEP’T OF JUSTICE, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 10 (June 2020), <https://www.justice.gov/criminal-fraud/page/file/937501/download>.

¹⁷⁷ See Barclay Palmer, *Why Do Companies Merge with or Acquire Other Companies?*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/why-do-companies-merge-or-acquire-other-companies/> (last visited Oct. 11, 2021) (describing the various forms of corporate change transactions and why companies engage in them).

¹⁷⁸ James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1401 (2001).

also inherits the target's liabilities, including the risk of liability from criminal activity or other misconduct in the target organization.¹⁷⁹ The surviving company is then often left holding the bag, defending against potentially years-old charges for activities that preceded its involvement.¹⁸⁰ This may include regulatory compliance failures.¹⁸¹

Following M&A transactions, surviving corporations have been found liable for their predecessors' violations across an array of compliance risk areas. For example, in the late 1950s, two wholly owned subsidiaries of Schenley Industries were indicted on antitrust charges. Years later, after the subsidiaries had been merged into the parent and dissolved, Schenley was charged and paid fines for the predecessors' actions.¹⁸² In 1989 Alamo Bank was prosecuted for several Bank Secrecy Act violations that Central National Bank had committed several years before the two companies merged.¹⁸³ That same year, a federal district court found that a rubber company was liable for its pre-merger predecessor's federal customs law violations.¹⁸⁴

¹⁷⁹ Carolyn Lindsey, *More Than You Bargained For: Successor Liability Under the U.S. Foreign Corrupt Practices Act*, 35 OHIO N.U. L. REV. 959, 965–66 (2009) (“In the merger context, the purchaser becomes responsible for the debts, contracts, torts and other liabilities of the target company . . .”). See also Tom Hollobone, *Managing Regulatory and Reputational Risk in M&A Transactions*, KROLL (Oct. 9, 2019), <https://www.kroll.com/en-ca/insights/publications/compliance-risk/managing-regulatory-reputational-risk-m-and-a-transactions> (“After an acquisition, the acquirer takes on more than the target company’s assets and operations. Any company that completes an M&A transaction also assumes the liabilities of the target company—aptly named successor liability.”)

¹⁸⁰ H. Lowell Brown, *Successor Corporate Criminal Liability: The Emerging Federal Common Law*, 49 ARK. L. REV. 469, 469 (1996) (explaining the concept of successor liability that can attach to companies “[f]ollowing a merger, consolidation, or even an asset acquisition”).

¹⁸¹ Hollobone, *supra* note 179 (“The concept of successor liability is particularly noteworthy when it comes to liabilities associated with regulatory compliance obligations: the purchaser absorbs any regulatory transgressions of its target company . . . even if they occurred before the sale . . .”); Daniel J. Grimm, *The Foreign Corrupt Practices Act in Merger and Acquisition Transactions: Successor Liability and its Consequences*, 7 N.Y.U. J.L. & BUS. 247, 281 (2010) (“M&A cases are significant because they illustrate the expanded reach of enforcement proceedings beyond related corporate entities, or entities that have mutually participated in wrongful conduct—now, an entity can be subjected to an enforcement action not only for its own . . . violations, but also for the violations of unrelated entities it transacts with.”).

¹⁸² See *Melrose Distillers, Inc. v. U.S.*, 359 U.S. 271 (1959).

¹⁸³ See *U.S. v. Alamo Bank of Texas*, 880 F.2d 828, 829 (5th Circ. 1989).

¹⁸⁴ See *U.S. v. Shields Rubber Corp.*, 732 F.Supp. 569, 571 (W.D. Penn. 1989).

A predecessor's violations can leave the surviving corporation bearing the costs: fines, legal expenses, and harm to the company's reputation, brand, sales, and stock price.¹⁸⁵ This should give boards of corporations pursuing M&A deals sufficient motivation to ensure compliance risk is given its due in pre-transaction due diligence.

III. COMPLIANCE MUST BE PART OF DUE DILIGENCE IN M&A TRANSACTIONS

Regardless of the motivation behind a given M&A deal, it is essential that the parties conduct due diligence.¹⁸⁶ This is a process of investigation and information gathering that serves to inform the buyer or merging entities about the other party's true value, including its financial health and obligations such as debts, pending or potential lawsuits, long-term contracts, and more.¹⁸⁷ In order to ensure it is not taking on liabilities for criminal misconduct or regulatory failures, the acquiring company's board must ensure compliance risk is included in this process.

A. Compliance due diligence is part of the board's fiduciary duties

Under *Caremark*, and in the context of the director's general fiduciary duties, boards are obligated to include regulatory and legal compliance risk as part of M&A due diligence.

Effective compliance due diligence seeks to identify the target's compliance risks—risks which, thanks to the doctrine of successor liability described above, may ultimately become the acquiring company's liability once the deal is done.¹⁸⁸ This entails gaining an understanding of the

¹⁸⁵ Hollobone, *supra* note 179 (explaining that regulatory violations of an acquisition target can result in regulatory penalties for the acquirer “which the market will react to, potentially leading to reputational fallout, hurting the purchasing organization's brand and leading to a downswing in sales and stock prices”).

¹⁸⁶ See Wendy B. E. Davis, *The Importance of Due Diligence Investigations: Failed Mergers and Acquisitions of the United States' Companies*, ANKARA BAR REV. 5, 5–6 (2009) (describing the importance of M&A due diligence regardless of the particular type of transaction, whether “an asset purchase, stock acquisition, or merger”).

¹⁸⁷ DAVID L. ERICKSON, 1 COLO. CORPORATE FORMS § 9:55 (2d ed.) (explaining that pre-merger or acquisition due diligence involves “research and analysis of a company or organization, so that the parties can make informed decisions regarding the fair value and potential risks associated with the proposed transaction”).

¹⁸⁸ See *supra*, Part II, Section D.

target's regulatory obligations and whether, and to what extent, the target complies with and manages those risks.¹⁸⁹ It is therefore also essential that the target's compliance efforts themselves be evaluated. An overall risk assessment of the target and its business may be necessary to truly understand what the risk factors are, to uncover potential red flags, and to then be able to evaluate the effectiveness of the target's own compliance program.¹⁹⁰

1. Compliance due diligence can mitigate government penalties

The value of the M&A compliance due diligence effort is clear even if you focus on nothing more than the potential effect it might have on enforcement should a violation be uncovered during the process.¹⁹¹ To begin, the likelihood of facing an enforcement action is perhaps greater than ever. Michael DeFranco, Global Head of M&A for the multinational law firm Baker McKenzie, has asserted that “[w]e’re in a new age of enforcement, as evidenced by the ever-increasing fines and other enforcement actions taken by regulators.”¹⁹² The DOJ and the SEC alike have indicated that they will pursue enforcement against the acquirer that fails to discover a target's pre-acquisition compliance violations. Further, for all practical purposes the DOJ has included acquisition targets within the scope of a company's compliance program.¹⁹³

¹⁸⁹ See generally Altug Ozgun, Burcu Seven & Yagmur Kaya, *M&A Series: 01 Why Mergers & Acquisitions Compliance Due Diligence Can Be Life Saving*, CETINKAYA (Mar. 23, 2021), <https://iclg.com/briefing/15936-m-and-a-series-01-why-mergers-and-acquisitions-compliance-due-diligence-can-be-life-saving-turkey> (describing how M&A compliance can help the acquiring company assess the target's risk of compliance failures and uncover red flags). See also BAKER MCKENZIE, *TAKING CENTER STAGE: THE RISE AND RISE OF M&A COMPLIANCE DUE DILIGENCE* 3 (2019), <https://bakermckenzie.turtl.co/story/taking-center-stage?teaser=true> (providing a definition and description of compliance due diligence) (providing a definition and overview of compliance due diligence).

¹⁹⁰ *Id.* See also Lindsey, *supra* note 179, at 967.

¹⁹¹ Sanjiv K. Kapur, *How to Address Corruption and Compliance Issues in Global M&A Transactions*, FINANCIER WORLDWIDE MAG. (June 2018), <https://www.financierworldwide.com/how-to-address-corruption-and-compliance-issues-in-global-ma-transactions#.YUuKcLhKiHs> (asserting that compliance due diligence in the M&A space “is not done solely to discover and learn about potential problems . . . [but also] provides an effective insurance policy to mitigate potential penalties that might be assessed by the authorities if compliance issues go undetected”).

¹⁹² BAKER MCKENZIE, *supra* note 189, at 3.

¹⁹³ Kasey T. Ingram, *The Complete Compliance and Ethics Manual 2021: Effective Ethics and Compliance Due Diligence during Mergers and Acquisitions*, COSMOS <https://compliancecosmos.org/effective-ethics-and-compliance-due-diligence-during-mergers-and-acquisitions> (last visited Sept. 21, 2021) (explaining how the DOJ has “specifically

In evaluating the effectiveness of a company's compliance effort, the DOJ has called out the M&A due diligence process. Specifically, the department will consider the extent to which compliance has been integrated into its merger or acquisition process, the methods used to uncover and address misconduct, and the approach to implementing a compliance program into the target as part of a post-merger or acquisition integration process.¹⁹⁴

This was illustrated in 2016 when the SEC and the DOJ declined to prosecute Harris Corporation following alleged bribery by the head of CareFx, a Chinese subsidiary Harris had acquired five years earlier. It was Harris's due diligence prior to the acquisition, its efforts in integrating the subsidiary into its compliance efforts following the acquisition, and its voluntary disclosure and cooperation, that led to this result.¹⁹⁵

2. Uncovering compliance failures can affect valuation of the target

Like a selling company board's quest to obtain "the best price for the stockholders" under the *Revlon* standard, the board engaged in an acquisition must be mindful not to overspend. That means paying no more than the target is truly worth. As the Caterpillar board learned in 2012,¹⁹⁶ sometimes the target's value can be significantly altered by an underlying compliance failure. The

call[ed] out mergers and acquisitions as an important consideration when evaluating the effectiveness of a company's ethics and compliance program").

¹⁹⁴ U.S. DEP'T OF JUSTICE, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 9 (June 2020), <https://www.justice.gov/criminal-fraud/page/file/937501/download> ("A well-designed compliance program should include comprehensive due diligence of any acquisition targets Flawed or incomplete pre- or post-acquisition due diligence and integration can allow misconduct to continue at the target company, causing resulting harm to a business's profitability and reputation and risking civil and criminal liability.").

¹⁹⁵ See Robert Kent, *Harris Corporation Obtains FCPA Declination While Former Employee is Sanctioned*, GLOBAL COMPLIANCE NEWS (Sept. 28, 2016), <https://www.globalcompliance.com/2016/09/28/harris-corporation-obtains-fcpa-declination-former-employee-sanctioned-20160927/> ("Harris earned a declination as a result of its due diligence in advance of acquiring CareFx China, its integration of CareFx China after the closing, and its voluntary disclosure, remediation and cooperation.").

¹⁹⁶ See *supra*, INTRODUCTION; *infra*, Section B.1.

lesson is not simply that the acquirer must uncover the target's compliance risks, but that it must do so, and then act on it, before the deal closes.¹⁹⁷

In the face of discovered compliance risks or wrongdoing, an acquiring company has two choices: walk away from the deal or modify its valuation of the target and its offer price.¹⁹⁸ Walking away may seem an obvious choice since there can be no successor liability without succession. And for the board acting in the best interest of the shareholders this may be the best move. But not proceeding on a key acquisition is not an easy choice. One commentator recently noted that a compliance issue discovered during an M&A deal traditionally “meant the death of [the] transaction.”¹⁹⁹ But today, where “multibillion dollar transactions” are common and “awareness of violations of compliance issues is becoming frequent, not going forward with the transaction is often no longer a viable competitive option for an acquirer.”²⁰⁰

The bottom line is that one purpose of due diligence generally is that it helps the acquiring corporation's valuation efforts.²⁰¹ Thus, compliance due diligence is serving this purpose when it leads to the discovery of compliance shortfalls or actual violations that, in turn, lead to a change

¹⁹⁷ THEODORE N. MIRVIS, *Mergers and Acquisitions and Takeover Preparedness*, in CORPORATE GOVERNANCE: CURRENT AND EMERGING ISSUES 141 (1997) (asserting that due diligence prior to an M&A deal is “an indispensable prerequisite to informed decision making”).

¹⁹⁸ Altug Ozgun, Burcu Seven & Yagmur Kaya, *M&A Series: 01 Why Mergers & Acquisitions Compliance Due Diligence Can Be Life Saving*, CETINKAYA (Mar. 23, 2021), <https://iclg.com/briefing/15936-m-and-a-series-01-why-mergers-and-acquisitions-compliance-due-diligence-can-be-life-saving-turkey> (“The results of [due diligence] may create the need for the re-evaluation of a target's value, taking more protective measures and ensuring post-closing liabilities are provided to mitigate identified risks, or even the re-consideration of the transaction itself, depending on the risk level.”).

¹⁹⁹ Sanjiv K. Kapur, *How to Address Corruption and Compliance Issues in Global M&A Transactions*, FINANCIER WORLDWIDE MAG. (June 2018), <https://www.financierworldwide.com/how-to-address-corruption-and-compliance-issues-in-global-ma-transactions#.YUuKcLhKiHs>.

²⁰⁰ *Id.*

²⁰¹ *See, e.g.*, MOD. CORP. CHECKLISTS § 19:22 (April 2021) (“The due diligence process provides additional information that will help the acquiring company evaluate the proposed transaction.”).

in the structure of the transaction.²⁰² A modification in the price is one obvious change in response, but the acquirer may also seek to negotiate some form of indemnification, or perhaps delay the closing until the compliance issue is addressed.²⁰³

Effective due diligence resulted in medical supply distributor Cardinal Health modifying the price of its prospective merger with Syncor International in 2002. During its pre-merger due diligence, Cardinal Health discovered that Syncor had made payments to doctors in Taiwan that violated the FCPA. As a result of this discovery, the parties amended their merger agreement by which the price was reduced from \$1.1 billion to \$809 million.²⁰⁴

This all relates back to the board exercising its fiduciary duties. It is only by implementing thorough due diligence, including the target's compliance risk, that a board can claim to have "acted in good faith, and on an informed basis" in pursuing an M&A deal.²⁰⁵

B. M&A failures emphasize the need for compliance due diligence

Considering the high costs associated with compliance failures, along with the board's duty of oversight, it would seem that compliance due diligence would be something of a no-brainer. And to the extent that it is generally understood and common practice, there is no need to sound an alarm. But real-life cases reveal costly M&A failures or near misses that were due, at least in

²⁰² Wendy B. E. Davis, *The Importance of Due Diligence Investigations: Failed Mergers and Acquisitions of the United States' Companies*, ANKARA BAR REV. 5, 6 (2009) ("Due diligence generally is designed to . . . ascertain the appropriate purchase price to be paid by the buyer . . . [and] determine compliance with relevant laws and disclose any regulatory restrictions on the proposed transaction . . .").

²⁰³ Jay G. Martin & Robert W. Tarun, *Key Considerations in Conducting M&A Anticorruption Due Diligence*, 34 NO. 8 ACC DOCKET 84, 86 (2016) ("[E]ffective pre-acquisition due diligence not only helps mitigate legal risks but also allows potential acquirers to more accurately value potential targets and, if necessary, to negotiate with the target regarding a price adjustment or an inclusion of indemnification and escrow provisions in the final deal documents . . .").

²⁰⁴ Lindsey, *supra* note 179, at 968–69. *See also*, Richard L. Cassin, *Syncor's Founder Settles FCPA Charges with the SEC*, FCPA BLOG (Oct. 1, 2007), <https://fcpablog.com/2007/10/01/syncors-founder-settles-fcpa-charges-with-the-sec/>.

²⁰⁵ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986).

part, to poor board oversight.²⁰⁶ This suggests that directors are too often not giving compliance its due when it comes to M&A due diligence.²⁰⁷

1. Caterpillar's acquisition of Siwei

Caterpillar's 2012 acquisition of Zhengzhou Siwei Mechanical & Electrical Manufacturing Co., Ltd. (Siwei), a Chinese manufacturer of heavy mining equipment, illustrates the value of M&A compliance due diligence.²⁰⁸ Doug Oberhelman had been named CEO of Caterpillar in 2009 amidst high expectations.²⁰⁹ But by the end of 2016, after six years on the job, Oberhelman was on his way out as CEO,²¹⁰ Caterpillar was in the midst of the longest sales decline in its history,²¹¹ and the company was embroiled in a lawsuit with shareholders.²¹²

The beginning of the end for Caterpillar was the acquisition of Siwei, which came aboard when Caterpillar agreed to an \$886 million acquisition of ERA Mining Machinery, Ltd., which

²⁰⁶ Gaughan, *supra* note 8 (“When we consider . . . the major merger failures of recent years, we see that a common theme they share is poor corporate governance.”).

²⁰⁷ ANA L. PEREIRA AND ANA MARIA H. DE ALBA, WHITE PAPER: ANTI-MONEY LAUNDERING CONTROLS IN MERGERS & ACQUISITIONS 3 (2011) (“Recent cases of M&A have shed some light on the need to dig deeper and perform various levels of due diligence . . .”).

²⁰⁸ *Caterpillar Acquires ERA Mining Machinery Limited*, MERGR, <https://mergr.com/caterpillar-acquires-era-mining-machinery-limited> (last visited Sep. 27, 2021) (“ERA is a non-state owned hydraulic roof support manufacturer in the People’s Republic of China through its wholly-owned subsidiary Zhengzhou Siwei Mechanical & Electrical Equipment Manufacturing Co., Ltd.”).

²⁰⁹ Paul Gordon, *Caterpillar Selects Oberhelman as Next CEO*, JOURNAL STAR (Peoria, Ill.) (Oct. 22, 2009, 9:13 PM), <https://www.pjstar.com/article/20091022/NEWS/310229821> (explaining that when Oberhelman was elected vice-chairman and CEO-elect, to take effect January 1, 2010, the move “met with favorable reviews from Wall Street analysts and the investment community”).

²¹⁰ Caterpillar, Inc., *Caterpillar Chairman and CEO Doug Oberhelman Elects to Retire in 2017*, PR NEWswire (Oct. 17, 2016, 9:00 AM), <https://www.prnewswire.com/news-releases/caterpillar-chairman-and-ceo-doug-oberhelman-elects-to-retire-in-2017-jim-unpleby-elected-as-caterpillars-next-ceo-dave-calhoun-to-become-non-executive-chairman-of-the-board-300345698.html> (explaining that Oberhelman would step down as CEO on January 1, 2017, and “remain as Executive Chairman of Caterpillar until March 31, 2017, when he will retire”).

²¹¹ Bob Tita, *How Caterpillar’s Big Bet Backfired*, WALL ST. J. (Oct. 17, 2016, 9:39 AM), <https://www.wsj.com/articles/how-caterpillars-big-bet-backfired-1476639360>.

²¹² *Lowinger v. Oberhelman*, 924 F.3d 360 (7th Cir. 2019) (explaining that litigation was initiated soon following the second quarter 2013).

owned Siwei.²¹³ The deal was largely celebrated at the time.²¹⁴ But just over a year later, and only seven months after the acquisition closed, Caterpillar announced a \$580 million write-down of its new asset—most of what Caterpillar had paid for it.²¹⁵ The company announced that it had uncovered “deliberate, multi-year, coordinated accounting misconduct” going on at Siwei.²¹⁶ But while Caterpillar acted shocked at the discovery,²¹⁷ its shareholders and Wall Street analysts wondered how Caterpillar had missed obvious “red flags” prior to the transaction.²¹⁸

Siwei had been a private company until September 2010 when it completed a reverse merger with ERA Holdings, a Cayman Islands company listed on Hong Kong’s stock exchange.²¹⁹

²¹³ Caterpillar, Inc., CATERPILLAR TO MAKE OFFER TO ACQUIRE ERA MINING MACHINERY LTD., PR NEWswire (Nov. 10, 2011, 6:00 AM), <https://www.prnewswire.com/news-releases/caterpillar-to-make-offer-to-acquire-era-mining-machinery-ltd-133651378.html>.

²¹⁴ Clare Baldwin & John Ruwich, *Special Report—How Caterpillar Got Bulldozed in China*, REUTERS (Jan. 22, 2014, 8:00 PM), <https://www.reuters.com/article/us-caterpillar-china-special-report/special-report-how-caterpillar-got-bulldozed-in-china-idUSBREA0M03720140123> (“The purchase was billed as a coup for Caterpillar . . .”).

²¹⁵ Scheyder, *supra* note 4.

²¹⁶ *Id.*

²¹⁷ Montlake, *supra* note 7 (“To hear Caterpillar tell it, it sank its money into an alleged fraud.”); Scheyder, *supra* note 4 (“‘It came as a complete surprise to us,’ [a] former board member said of the fraud . . .”).

²¹⁸ See, e.g., Montlake, *supra* note 7 (explaining how “the warning signs were flashing” before Caterpillar completed the ERA acquisition); Naomi Rovnick, *Three Big Questions for Caterpillar About its \$580 Million China Loss*, QUARTZ (Jan. 28, 2013), https://qz.com/48080/?utm_term=mucp (explaining how ERA’s acquisition of Siwei should have served as a red flag to Caterpillar’s board, that “shareholders should question whether Caterpillar noticed this red flag and, if so, how it went on to investigate and justify its purchase”).

²¹⁹ Paul Gillis, *Caterpillar’s Reverse Merger*, CHINA ACCT. BLOG (Jan. 21, 2013, 11:02 PM), <https://www.chinaaccountingblog.com/weblog/caterpillars-reverse-merger.html>.

Generally, a reverse merger involves the acquisition of a corporation with publicly traded stock. The acquiring company can then operate its business through the publicly traded acquisition without its own registered offering. FRANKLIN A. GEVURTZ & CHRISTINA M. SAUTTER, *MERGERS AND ACQUISITIONS LAW* 143 (2019).

Extensive use of reverse mergers to help foreign businesses gain access to U.S. markets with minimal disclosure and registration obligations, especially among Chinese companies, led to increased regulation of the practice by the SEC, DOJ, and Congress. According to the SEC, a “Chinese Reverse Merger,” as it came to be called, involved an existing public “shell company” with minimal operations acquiring a private company that seeks access to U.S. capital markets. The public shell company survives the merger, but the private company’s management and shareholders lead the activities of the business moving forward. Between 2007 and 2010 more than 150 Chinese companies gained access to U.S. markets through reverse mergers, compared to just 56 completing traditional going-public offerings on a U.S. securities exchange. In 2010, the SEC opened investigations into Chinese companies’ accounting practices, especially among those listed on the U.S. exchanges via reverse mergers. Joseph L. Francoeur, *Current Issues in D&O Liability & Insurance 2012*, N.Y. CITY BAR 128, June 7, 2012.

Two things resulted from this one move. First, ERA became Siwei's parent (and then changed its name to ERA Mining Machinery).²²⁰ Second, Siwei became a publicly traded company, sidestepping the regulatory scrutiny usually required for going public.²²¹ Siwei and ERA's reverse-merger history alone should have served as a red flag for Caterpillar. According to Reuters, "most of the recent accounting scandals in the United States have come from small Chinese companies who went public via a reverse takeover"²²²

There were more red flags at Caterpillar. Ernst & Young, brought in to perform the pre-acquisition accounting analysis, raised several financial warning signs regarding Siwei: declining profit margins, aging accounts receivable, and cash-flow problems. Bucyrus, a company Caterpillar had acquired the year before, had itself conducted pre-acquisition research of Siwei (of which Caterpillar was aware) and had found potential fraud and corruption.²²³ In November 2011, the Caterpillar board received a request from Siwei for an immediate \$50 million loan. And just four months later, Siwei informed the Caterpillar board that ERA, Siwei's parent company, would miss its 2011 financial targets by more than \$18 million.²²⁴

After Caterpillar announced the \$580 million write-down, business and trade magazines began questioning the board's oversight and diligence prior to the acquisition.²²⁵ Multiple

²²⁰ Paul Gillis, *Caterpillar's Reverse Merger*, CHINA ACCT. BLOG (Jan. 21, 2013, 11:02 PM), <https://www.chinaaccountingblog.com/weblog/caterpillars-reverse-merger.html>; Scheyder, *supra* note 4 ("The company was previously known as ERA Holdings Global Ltd. and provided 'corporate secretarial services' before being acquired by Siwei in September 2010 through a reverse takeover.").

²²¹ Rovnick, *supra* note 218 (explaining how by way of a reverse merger a "private business escapes the regulatory scrutiny normally involved in going public," and that "Siwei was one such reverse merger").

²²² Scheyder, *supra* note 4.

²²³ *Lowinger v. Oberhelman*, 924 F.3d 360, 364 (7th Cir. 2019).

²²⁴ *Baldwin & Ruwich*, *supra* note 214.

²²⁵ *Lowinger*, 924 F.3d at 364–65 ("[S]everal major corporate news outlets, including *Forbes*, *Reuters*, and the *Financial Times*, ran articles detailing the story of the acquisition and chiding Caterpillar and its board for what those outlets viewed as insufficient investigation and oversight.").

shareholder lawsuits were filed,²²⁶ and a former director who had been on the board during the acquisition later admitted that the board had been distracted and paid little attention to the Siwei acquisition.²²⁷ “It should have been investigated further,” he would tell Reuters in 2013.²²⁸

2. Caremark had been acquired by Baxter International

Caremark, the namesake of *Caremark* duties, illustrates post-acquisition liability, after which the acquiring company would dispose of its acquisition.

Caremark was formed in 1979 as Home Health Care of America. It changed its name to Caremark in 1985 and it was acquired by Baxter International in 1987. The government began its investigation into Caremark’s Medicare reimbursements four years later.²²⁹ By the time a grand jury indicted Caremark in 1994, Baxter had spun it off and Caremark was a stand-alone publicly traded corporation.²³⁰ And although the board would eventually be cleared of liability in the shareholder lawsuit that gave rise to *Caremark* duties in 1996,²³¹ the company would pay some \$250 million in penalties plus another \$66 million in settlements with private insurers.²³²

3. McKesson Corporation’s acquisition of HBO & Co.

Even where wrongdoing within an M&A target is discovered before the deal is done, the risk remains if the board fails to do anything. Although the facts are somewhat muddled, this is

²²⁶ *Id.* at 365 (describing two separate lawsuits following the write-down: a shareholder derivative action, and a demand on the Caterpillar board to begin litigation against the company’s officers); *In re Caterpillar Inc., S’holder Derivative Litig.*, 2016 WL 5660370 (D.C. Ill.) (“Shortly after Caterpillar announced the \$580 million impairment charge, in March 2013, the first of four shareholder derivative lawsuits was filed in this Court.”).

²²⁷ Scheyder, *supra* note 4 (“A member of the Caterpillar board during the course of the Siwei deal told Reuters the board was distracted at the time by a larger transaction and paid relatively little attention to the Siwei acquisition.”).

²²⁸ *Id.*

²²⁹ Arlen, *supra* note 120.

²³⁰ *Id.* at 11.

²³¹ *In re Caremark Int’l Derivative Litig.*, 698 A.2d 959, 972 (Del. Ch. 1996).

²³² Arlen, *supra* note 120, at 14–15.

what apparently transpired in the late 1990s after McKesson Corporation, a pharmaceutical wholesaler, acquired medical software supplier HBO & Co. (HBOC) for \$14.5 billion.²³³ Less than three months after the deal was finalized,²³⁴ McKesson announced it had detected fraud in HBOC's accounting practices.²³⁵ While McKesson's communications at the time suggested that the wrongdoing was discovered then, after the deal had closed,²³⁶ McKesson shareholders alleged otherwise in a subsequent derivative suit.²³⁷

In the lawsuit, the plaintiff shareholders asserted that McKesson had actually uncovered the questionable accounting practices during its due diligence, *prior* to the deal closing, but the company proceeded without taking any action.²³⁸ Based on these allegations, the Delaware Chancery Court found that despite McKesson's "knowledge of substantial accounting problems at HBOC, it appears that nothing was done for several months."²³⁹ The court considered the shareholders' *Caremark* claims against the McKesson board for "failing to monitor HBOC's internal accounting practices before the merger and disclose HBOC's false financial

²³³ Lee Gomes, *McKesson Agrees to Acquire HBO & Co. for \$14.46 Billion*, WALL ST. J. (Oct. 19, 1998, 7:45 AM), <https://www.wsj.com/articles/SB908750143221909000>.

²³⁴ *Ex-HBOC Execs Indicted*, CNN MONEY (Sep. 28, 2000, 3:46 PM), <https://money.cnn.com/2000/09/28/companies/mckesson/>.

²³⁵ WebCPA Staff, *Former McKesson Chairman Gets 10-Year Sentence*, ACCT. TODAY (Mar. 10, 2010, 1:42 PM), <https://www.accountingtoday.com/news/former-mckesson-chairman-gets-10-year-sentence>. See also, Indictment, U.S. v. Bergonzi, 216 F.R.D. 487 (CR-00-0505) at 20, available at https://securities.stanford.edu/filings-documents/1004/MCK99/200363_o10x_00cr505.pdf.

²³⁶ See *McKesson HBOC Accused of Accounting Improprieties*, STUDY MODE RES. (Sep. 8, 2014), <https://www.studymode.com/essays/Mckesson-Hboc-Accused-Of-Accounting-Improprieties-56834670.html> (explaining that McKesson HBOC announced in April 1999 that "its auditors had discovered accounting irregularities at HBOC during a routine annual review").

²³⁷ *Saito v. McCall*, 2004 WL 3029876 (Del. Ch.) (overruled by *Lambrecht v. O'Neal*, 2 A.3d 277 (Del. 2010)).

²³⁸ *Id.* at 4 ("According to the complaint: '[T]he Former McKesson Director Defendants knew, before approving and closing the Merger, of HBOC's improper accounting practices and that they posed a 'high risk' of an SEC restatement. Despite their knowledge, the Former McKesson Director Defendants authorized . . . McKesson's CEO and a director . . . to negotiate the Merger" (internal edits omitted)).

²³⁹ *Id.* at 7.

statements.”²⁴⁰ On this basis, the claims survived summary judgment (though in the subsequent trial on the merits, the court would hold that the board did not violate its *Caremark* duties).²⁴¹

The CEO of HBOC, who became Chairman of the new combined McKesson HBOC after the acquisition, was later convicted of securities fraud and sentenced to ten years in prison.²⁴² The loss to investors was reported to exceed \$8.6 billion. McKesson HBOC’s stock price plummeted 47%,²⁴³ representing \$8.6 billion in lost shareholder value.²⁴⁴ McKesson HBOC would eventually pay \$960 million to settle a class action suit related to the fraud.²⁴⁵

4. More recent failures in M&A compliance due diligence

The cases described above are not the only examples illustrating the potential cost of failed pre-merger compliance due diligence. They are also not the most recent.

In January 2021, Argos USA, an Atlanta-based producer of ready-mix concrete, paid more than \$20 million in penalties to settle charges of antitrust violations.²⁴⁶ According to the DOJ, the illegal conduct was “limited to a small number of employees” who joined Argo as a result of its acquisition of another company, “after the conspiracy had already begun.”²⁴⁷

²⁴⁰ *Id.* at 8.

²⁴¹ Byron F. Egan, *Fiduciary Issues in M&A Transactions*, 2009 PENN ST. DICKENSON SCH. L. EXECUTIVE PROGRAM IN MERGERS AND ACQUISITIONS: PRODUCING A POSITIVE RETURN IN TROUBLED TIMES 17–18 (2009) (describing the McKesson HBOC derivative suit and the shareholder’s *Caremark* claims, which eventually fell when “facts later adduced could prove that the Company directors did not violate their duties under *Caremark* . . .”).

²⁴² WebCPA Staff, *Former McKesson Chairman Gets 10-Year Sentence*, ACCT. TODAY (Mar. 10, 2010, 1:42 PM), <https://www.accountingtoday.com/news/former-mckesson-chairman-gets-10-year-sentence>.

²⁴³ *Id.*

²⁴⁴ Milt Freudenheim, *McKesson Agrees to Pay \$960 Million in Fraud Suit*, N.Y. TIMES (Jan. 13, 2005), <https://www.nytimes.com/2005/01/13/business/mckesson-agrees-to-pay-960-million-in-fraud-suit.html>.

²⁴⁵ *Id.*

²⁴⁶ David Allison, *Feds Charge Atlanta Concrete Giant Argos USA with Price Fixing*, ATLANTA BUS. CHRON. (Jan. 5, 2021, 2:40 PM), <https://www.bizjournals.com/atlanta/news/2021/01/05/feds-charge-argos-usa-price-fixing-savannah.html>.

²⁴⁷ Deferred Prosecution Agreement, *U.S. v. Argos U.S.A., L.L.C.*, 2021 WL 194713 (4:21-CR-2) at 4, *available at* <https://www.justice.gov/atr/case-document/file/1350996/download>.

And in June 2021 a UK-based engineering firm, John Wood Group, agreed to a \$177 million settlement of bribery and corruption charges with the DOJ and the SEC, as well as authorities in the U.K. and Brazil. The charges stemmed from bribes paid to officials in Brazil by employees of Amec Foster Wheeler, a subsidiary Wood later acquired.²⁴⁸

So long as companies or their employees continue to engage in misconduct, those companies—and their potential acquirers—will continue to be at risk, and compliance due diligence will remain an essential board obligation.

C. The increasingly sharp bite of Caremark duties

The potential risk of loss from a compliance failure in an M&A deal should be sufficient to motivate directors to take their pre-merger oversight obligations seriously. Unfortunately, the duties imposed under *Caremark* may have served as little more than a gentle reminder, given the difficulty shareholders faced in bringing successful *Caremark* claims.²⁴⁹ But this reality may be shifting. *Caremark* claims brought in the last two years have had very different outcomes.

The Delaware Supreme Court reversed the Chancery Court’s dismissal of *Caremark* claims in *Marchand v. Barnhill*, a 2019 case arising out of a food safety crisis involving Blue Bell ice cream that led to three deaths.²⁵⁰ The *Marchand* court emphasized that the role of the court under *Caremark* is not to “examin[e] the effectiveness of a board-level compliance and reporting system after the fact, [but] whether the . . . board did not undertake good faith efforts” to implement a compliance system.²⁵¹ By that standard, the court found that the shareholder-plaintiff’s claim could

²⁴⁸ OE Staff, *Engineering Firm Wood to Pay \$177M to Settle Amec Foster Wheeler’s Brazil Bribery Case*, OFFSHORE ENGINEER (June 29, 2021), <https://www.oedigital.com/news/488801-engineering-firm-wood-to-pay-177m-to-settle-amec-foster-wheeler-s-brazil-bribery-case>.

²⁴⁹ See *supra*, Part I, Section C.2.

²⁵⁰ 212 A.3d 805 (Del. 2019).

²⁵¹ *Id.* at 821.

avoid dismissal based on allegations that the board had failed to consistently monitor food safety and respond to red flags.²⁵² In particular, the court pointed out that food safety was the “most central safety and legal compliance issue facing the company.”²⁵³

Later in 2019 the chancery court denied a motion to dismiss *Caremark* claims against pharmaceutical company Clovis Oncology stemming from alleged misrepresentations of trial data for its new lung cancer drug.²⁵⁴ The court emphasized that the board’s oversight function is particularly critical “when the company is operating in the midst of ‘mission critical’ regulatory compliance risk” and must be “more rigorously exercised” in that context.²⁵⁵

Early in 2020, a *Caremark*-based derivative suit was brought against the general partner of an oil pipeline company for failure to “implement or properly oversee a pipeline integrity reporting system.”²⁵⁶ A pipeline had ruptured in 2015, spilling more than 3,000 barrels of oil into the Pacific Ocean near “environmentally sensitive coastal areas” of California.²⁵⁷ In holding that the plaintiff had sufficient evidence to survive a motion to dismiss, the Delaware Chancery Court in *Inter-Marketing Group USA v. Armstrong* asserted that the company’s board had “ignored the Company’s most intrinsically critical business operation and made no good faith effort to implement a board-level pipeline integrity reporting system.”²⁵⁸

²⁵² *Id.* at 822.

²⁵³ *Id.* at 824.

²⁵⁴ *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 WL 4850188 at *1 (Del. Ch. 2019).

²⁵⁵ *Id.* at *13 (quoting *Marchand*, 212 A.3d at 824).

²⁵⁶ *Inter-Marketing Group USA, Inc. v. Armstrong*, 2020 WL 756965 at *1 (Del. Ch.).

²⁵⁷ *Id.* at *3. The spill resulted in environmental damage, a \$257 million clean-up effort, heavy fines, a decline in the company’s stock price by nearly 40%, and nine criminal convictions. *Id.*

²⁵⁸ *Id.* at *15.

The Delaware Chancery Court in late 2020 again denied a motion to dismiss *Caremark* claims against a China-based auto parts company.²⁵⁹ Here, the court upheld the plaintiff-shareholder's claims based on evidence that the company's internal compliance function demonstrated "chronic deficiencies"²⁶⁰ and represented merely the "trappings of oversight."²⁶¹ The board had installed an audit committee, but it consisted of directors who "lacked the expertise" for oversight, met only sporadically, and "regularly overlooked important issues."²⁶² With this holding, the court made clear that the "mere existence of an audit committee and the hiring of an auditor does not provide universal protection against a *Caremark* claim."²⁶³

The most recent Delaware court decision in which *Caremark* claims survived a motion to dismiss came down in late 2021.²⁶⁴ The claim was brought against members of the board and management of aircraft giant Boeing following two crashes involving the 737 MAX aircraft in which everyone on board died.²⁶⁵ The disasters left the new airplane grounded for twenty months which, in turn, led to billions of dollars of lost orders (and lost shareholder value), costly investigations, multiple lawsuits, and more.²⁶⁶ The court found that the shareholder plaintiffs sufficiently plead a case based on allegations that the directors had "turn[ed] a blind eye to a red

²⁵⁹ Hughes v. Hu, No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch.).

²⁶⁰ *Id.* at 15.

²⁶¹ *Id.* at 16.

²⁶² *Id.* at 15.

²⁶³ *Id.* at 14.

²⁶⁴ *In re The Boeing Co. Derivative Litig.*, 2021 WL 4059934 (Del. Ch.).

²⁶⁵ *Id.* at *1.

²⁶⁶ *Id.* at *20. See also Martin L. Seidel, et al., *Recent Delaware Decision Highlights Heightened Board Oversight Requirements in Caremark Cases*, HOLLAND & KNIGHT (Sept. 30, 2021), <https://www.hklaw.com/en/insights/publications/2021/09/recent-delaware-decision-highlights-heightened-board-oversight> ("The two crashes – one in 2018 and the other in 2019 – caused severe reputational harm to the company, resulting in the grounding of the 737 MAX, cancellation of billions of dollars in aircraft orders and billions of dollars in lost revenue, as well as significant litigation and non-litigation costs.").

flag representing airplane safety problems” that ultimately left the directors susceptible to a “substantial likelihood of liability for Boeing’s losses.”²⁶⁷

These recent cases suggest that *Caremark* duties perhaps have some bite after all, and directors will be answerable to their obligations, especially in highly regulated businesses where compliance is particularly important. Whether or not a court ultimately finds a breach of *Caremark* duties and the directors subject to liability, compliance breakdowns are costly. Failing to get the cases dismissed, the boards in these situations are likely to settle before the *Caremark* claims ever gets reviewed on the merits, but the risk of liability may be at an all-time high.²⁶⁸

D. Elements of effective compliance due diligence

A company seeking to root out compliance risk or active wrongdoing in an acquisition or merger target organization must apply virtually the same process it would undertake in developing its own compliance program. The difference in this context is simply that the microscope is now aimed at the target rather than internally. Just as with an internal risk assessment, the goal of compliance due diligence is to reveal weaknesses in the target’s compliance system, uncover compliance violations or other misconduct, and determine where the target company is most vulnerable to compliance liability.²⁶⁹

Some goals of compliance due diligence include (1) determining the overall compliance risk profile of the target; (2) uncovering red flags representing potential current violations or wrongdoing; (3) assessing the impact such compliance violations are likely to have for the

²⁶⁷ *In re The Boeing Co. Derivative Litig.*, 2021 WL 4059934 at *1.

²⁶⁸ Even in the 1996 case of *Caremark* itself, where liability did not attach, the company paid more than \$250 million in settlements and fines. *In re Caremark Int’l Derivative Litig.*, 698 A.2d 959, 960–61 (Del. Ch. 1996).

²⁶⁹ See, e.g., Jacques Giard & Caroline Leblanc, *Assessing the Value of Compliance Due Diligence in M&A—Insight Into the Challenges and Benefits*, KROLL (Feb. 17, 2021), <https://www.kroll.com/en/insights/publications/financial-compliance-regulation/assessing-value-compliance-due-diligence-ma> (explaining how compliance due diligence is a type of audit “like an effective compliance program,” and that “it is essential to take a risk-based approach . . .”).

transaction in the short term, and for the corporation's well-being in the longer term; (4) evaluating the effectiveness of the target's own compliance program, including individual elements such as training, a hotline or other reporting mechanism, and ongoing audits, among other things; and (5) understanding the ethical culture of the target to determine the extent to which compliance or noncompliance are innate to the company's DNA.²⁷⁰

A risk assessment should be undertaken to evaluate an acquisition target's risk in all the common risk areas: antitrust, accounting and securities law, labor and employment, bribery or other corruption, worker safety, the environment, confidential information, document retention, employee harassment or discrimination, data privacy, and more. Also, the company's industry can raise specific compliance risks, such as product liability or food safety.²⁷¹

Of course, if an acquisition proceeds in the face of target non-compliance discovered during due diligence, the acquiring company must act quickly to address the problem as if it were its own (since it eventually will be). The company must therefore extend its own compliance program across the target organization as quickly as possible. It must train the target's management and staff, distribute its code of conduct, and install a hotline to enable internal reporting of misconduct, among other steps. Perhaps most important, and possibly the most difficult, is that the acquiring company must thoroughly investigate and self-report to the DOJ or other regulatory bodies any compliance failures uncovered during due diligence.²⁷²

²⁷⁰ Kasey T. Ingram, *The Complete Compliance and Ethics Manual 2021: Effective Ethics and Compliance Due Diligence during Mergers and Acquisitions*, COSMOS <https://compliancecosmos.org/effective-ethics-and-compliance-due-diligence-during-mergers-and-acquisitions> (last visited Sept. 21, 2021) (providing an overview of the M&A due diligence process and, specifically, the objectives of due diligence).

²⁷¹ See Jay G. Martin & Robert W. Tarun, *Key Considerations in Conducting M&A Anticorruption Due Diligence*, 34 No. 8 ACC DOCKET 84, 86 (2016); PEREIRA & DE ALBA, *supra* note 207.

²⁷² See generally U.S. DEP'T OF JUSTICE, *EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 2* (June 2020), <https://www.justice.gov/criminal-fraud/page/file/937501/download> (explaining the elements of an effective compliance program in the context of M&A deals, and how companies must act to remedy and self-report when misconduct is uncovered in a merger or acquisition target); see also PEREIRA & DE ALBA, *supra* note 207.

By ensuring such steps are taken during pre-acquisition due diligence, the board will ensure that it is meeting its fiduciary duties, enhancing the value of the transaction, and helping to avoid significant compliance failures (and their associated costs) downstream.

IV. CONCLUSION

Directors are obligated to act in the best interests of the shareholders, to ensure their decisions are fully informed, and to provide oversight to the corporation's general operations. Under *Caremark*, those oversight duties translate into a specific obligation to implement and maintain effective compliance systems to prevent and uncover wrongdoing.²⁷³ In the context of mergers and acquisition, this means the board cannot simply serve as a minion for an enthusiastic CEO, rubber-stamping proposed acquisitions. Indeed, the duty of oversight and the obligation to maintain an effective compliance program apply specifically to pre-acquisition due diligence.

When boards include compliance risk as part of M&A due diligence, there are costs: transactions may take longer and the investigations potentially expensive. But Caterpillar's former CEO, Doug Oberhelman, is likely to agree that such efforts are ultimately worth the expense and delay. The significant cost of a compliance failure, in penalties, legal fees, lost sales, and reputational damage, is likely sufficient motivation for most corporate boards to take this oversight obligation seriously when pursuing a deal.

While such pre-merger oversight may be the norm, there are still too many compliance breaches arising in M&A targets that leave surviving companies with heavy costs and years of litigation. For those directors who continue sleep at the wheel, the increasing stringency of *Caremark* claims may finally ensure they give compliance its due when pursuing M&A deals.

²⁷³ *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).