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Caremark's Hidden Promise

Ezra Wasserman Mitchell

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In re Caremark, *decided in 1996, established for the first time a director's duty to monitor under Delaware law. A significant amount of jurisprudence and commentary has developed. Almost all of this literature parses the language of the case and those following, and disregards the underlying claims for damages. As a result of this linguistic focus, many have concluded that the duty to monitor largely is toothless and, importantly, deals only with claims of failure to monitor legal risk. A duty to monitor business risk has been disavowed.*

Following the money reveals a different story. Classifying the cases according to their damages claims reveals that, in fact, Delaware courts have gone far toward extending the duty to monitor to business risk, while at the same time doctrinally disavowing that they have done so.

Closely related to this monitoring duty is the pre-conditional duty of good faith, which is breached by directors' knowledge of wrongdoing. Once again, doctrine masks important distinctions that are revealed by a close examination of the facts of the cases. Analysis reveals that Delaware courts may be failing to make an important distinction with regard to forms of notice. Making this distinction would help to shore up the duty to monitor without imposing unreasonable demands on directors.

These two lines of analysis lead to the conclusion that a meaningful duty to monitor both legal and business risk is well along in development. Extracting and reassembling the facts would realize Caremark*'s original promise.*

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During the two decades following Chancellor William Allen's important opinion in *In re Caremark International, Inc.*,[1] judges have labored to make sense of its implications for the legal responsibilities of the board of directors in a variety of contexts.[2] Interesting scholarly work has been done, from dismissals of the *Caremark* doctrine as having no real teeth to the celebration of its recognition of meaningful legal duties imposed on the board of directors.[3] But, for several

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1. 698 A.2d 959 (Del. Ch. 1996).

2. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006); Wood v. Baum, 953 A.2d 136 (Del. 2008); Rich *ex rel* Fuqi Int'l v. Chong, 66 A.3d 963 (Del. Ch. 2013); Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007); *In re* Citigroup Inc., 964 A.2d 106 (Del. Ch. 2009); *In re* The Goldman Sachs Grp., Inc., No. CIV.A. 5215-VCG, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011); Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763 (Del. Ch. 2009); *In re* China Agritech, Inc., C.A. No. 7163-VCL, 2013 WL 2181514 (Del. Ch. May 21, 2013); Melbourne Mun. Firefighters' Pension Tr. Fund *ex rel.* Qualcomm, Inc. v. Jacobs, No. 10872-VCMR, 2016 WL 4076369, at *1 (Del. Ch. Aug. 1, 2016), *aff'd*, 158 A.3d 449 (Del. 2017); *In re* The Dow Chemical Co. Derivative Litig., No. 4349-CC, 2010 WL 66769 (Del Ch. Jan. 11, 2010); Reiter v. Fairbank, No. 11693-CB, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016); *In re* Massey Energy Co., C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011); Sandys v. Pincus, No. 9512–CB, 2016 WL 769999 (Del Ch. Feb. 29, 2016); Ironworkers Dist. Council of Phila. & Vicinity Ret. & Pension Plan v. Andreotti, C.A. No. 9714–VCG, 2015 WL 2270673 (Del. Ch. May 8, 2015); ATR-Kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N, 2006 WL 3783520 (Del. Ch. Dec. 21, 2006). Other courts, applying Delaware law, have engaged in a similar struggle.

3. FRANK PARTNOY, DELAWARE AND FINANCIAL RISK (Steven Davidoff Solomon & Randall Thomas eds., 2017) (arguing that *Caremark* should be extended to cover financial risk); Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967 (2009) (evaluating the wisdom of extending *Caremark* claims to risk management); Stephen M. Bainbridge, Star Lopez, and Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008) [hereinafter Bainbridge et al., *Convergence of Good Faith*] (elucidating the relationship between oversight jurisprudence and good faith); Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075 (2016) (making a case that regulatory compliance regimes are overtaking and transforming corporate governance); Hillary A. Sale & Donald C. Langevoort, *"We Believe": Omnicare, Legal Risk Disclosure and Corporate Governance*, 66 DUKE L.J. 763 (2016); Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719 (2007) (praising *Caremark* for focusing boards on broader accountability); H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L 1 (2001) (evaluating board's place in monitoring regulatory compliance); Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 VA. L. & BUS. REV. 433 (2011) (favoring Delaware's restraint in imposing management accountability); Jennifer Arlen, *The Story of Allis-Chalmers,* Caremark*, and* Stone*: The Directors' Evolving Duty to Monitor in* CORPORATE LAW STORIES 323, 344–45 (J. Mark Ramseyer ed., 2009) (providing an evolutionary account of oversight liability and its interplay with federal criminal law); Daniel S. Kleinberger, *Delaware Dissolves the Glue of Capitalism: Exonerating from Claims of Incompetence Those Who Manage Other People's Money,* 38 WM. MITCHELL L. REV. 737, 739 (2012) (observing a decay in managers' personal responsibility under Delaware law and calling for a restoration); Robert T. Miller, *The Board's Duty to Monitor Risk after* Citigroup, 12 U. PA. J. BUS. L. 1153 (2010) (making the case that extending *Caremark* is tantamount to repealing the business judgment rule).

reasons grounded in articulated Delaware doctrine, it is rare for a *Caremark* claim to pass the pleadings stage.[4]

Two stand out among these reasons. First, the articulation of *Caremark* duties is limited to those circumstances in which corporate damages have resulted from the assessment of criminal and regulatory penalties as a consequence of corporate legal violations. As a doctrinal matter, *Caremark* jurisprudence has yet to expand to address losses caused by failed business decisions, which are the essence of the corporation's reason for being. Second, the scienter-based "not in good faith" requirement that goes hand in hand with *Caremark* has led to what I shall call a "jurisprudence of red flags." This jurisprudence overlooks subtle distinctions in types of information that may or may not come to a board and the dramatic changes that have taken place in the world of information technology since *Caremark* was decided. The circumstances under which a Delaware court will find bad faith in an oversight context are therefore highly limited.

I argue that the promise of *Caremark* lies in a sharper understanding of the realities beneath the doctrine. The good news is that Delaware's *Caremark* cases already contain the necessary elements to impose meaningful oversight duties on the board. They simply need to be extracted and reassembled.

First, Delaware courts have already opened up *Caremark* jurisprudence to the evaluation of business decisions, despite their assertions to the contrary. To understand this, it is necessary to focus on the damages sought in a number of *Caremark* cases and the board behavior that allegedly proximately caused them. Second, while *Caremark* itself focused only on alleged red flags arising from internal monitoring,[5] cases already have accepted externally-generated red flags as plausible support for the necessary element of scienter that establishes directorial bad faith. I shall demonstrate that external red

4. This fact has led two scholars to state that *Caremark* is declining in importance. Hillary A. Sale & Donald C. Langevoort, *"We Believe": Omnicare, Legal Risk Disclosure and Corporate Governance*, 66 DUKE L.J. 763, 773 (2016) (examining interplay between federal disclosure regulation and oversight liability). Nonetheless, cases continue to be brought and judges continue to evaluate the claims seriously. To be fair, it is rare for any litigation against directors to pass the pleadings stage in Delaware except for litigation brought addressing conflict of interest claims, claims one might call traditional loyalty cases. That said, Delaware doctrine has developed in this context so the study of these cases remains the key to understanding Delaware law.

5. *In re Caremark*, 698 A.2d at 963. This was also the case in Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006), in which the Delaware Supreme Court accepted *Caremark* as part of Delaware corporate law.

flags may be considerably more available and informative for the board than internal red flags, are easily and cheaply accessible, and therefore should be taken seriously as a separate category of monitoring tools.

Guiding *Caremark* jurisprudence towards more meaningful monitoring duties also corrects for the possible judicial oversight of the dramatic, and relatively recent, changes in the nature of the board itself.[6] *Caremark* was not only an important statement of law. It was also a judicial recognition of the transformation of the role of the board.[7] Much of the history of twentieth-century corporate law is the story of a board in search of a purpose, a board composed largely of internal managers whose daily work significantly overlapped board function.[8] Before the 1970s, there was very little literature on the function of the board in a public corporation and, indeed, precious little literature about the board itself.[9] But the political and economic turmoil of the early part of that decade led to the start of a critical examination of the board's appropriate role. This culminated in the creation of the modern monitoring board, as articulated by the American Law Institute's *Principles of Corporate Governance* and as embraced by the Delaware courts throughout the 1980s and early 1990s.[10] By the time *Caremark* was decided, the monitoring board was a fact. *Caremark* arguably gave the monitoring board something to do. But subsequent jurisprudence has left the board again in search of a significant role.

Unlocking the promise of *Caremark* is important. In the absence of a serious monitoring function, what is the board to do?[11] And if

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6. I don't mean to suggest that Delaware judges are unaware of these changes. Of course they are. They helped to create them. What I am suggesting is that this transformation has been lost in doctrinal rhetoric and needs to be rediscovered.

7. Jennifer Arlen acknowledges this in Jennifer Arlen, *The Story of Allis-Chalmers,* Caremark*, and* Stone*: The Directors' Evolving Duty to Monitor in* CORPORATE LAW STORIES 323, 342 (J. Mark Ramseyer, ed., 2009).

8. See generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1568 (2007) for an excellent history of the development of the monitoring board.

9. *See generally* Lawrence E. Mitchell, *The Trouble with Boards in* PERSPECTIVES ON CORPORATE GOVERNANCE (F. Scott Kieff & Troy A. Paredes eds., Cambridge University Press 2010) (providing a comprehensive history of legal interest in the board and the creation of the modern monitoring board).

10. *See also* Gordon, *supra* note 8, at 1481.

11. *See generally* Mike Burkart et al., *Why do Boards Exist? Governance Design in the Absence of Corporate Law* (Eur. Corp. Governance Inst., Finance Working Paper No. 504/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2902617.

there is little for the board to do, why do we have a board in the first place? Perhaps it would be sufficient for shareholders directly to elect a CEO who would be responsible for making business decisions and coordinating regulatory compliance, presumably with the help of external experts.[12] Perhaps, and more plausibly, the growing world of regulation and its demands for corporate compliance with external requirements is the contemporary substitute for meaningful corporate governance.[13] Legal recognition of these possibilities has not yet occurred, and for many reasons may be undesirable.

So we are now confronted with the same question Melvin Eisenberg faced when he published *The Structure of the Corporation*,[14] the American Law Institute began its corporate governance project,[15] and Chancellor Allen issued *Caremark*: What is the appropriate role of the board? And, unlike the situation then-existing, corporate directors today are well compensated. It is compensation they should earn.

The paper proceeds as follows: I will begin in Part I by following the money. *Caremark* claims are derivative. The nature of the claimed damages and the way the courts address them can tell us at least as much about the meaning of *Caremark* as can the repeated recitation of doctrine. This focus on damages requires an analysis of proximate cause. Cases fall into four categories.

The first category contains what have been referred to as "traditional *Caremark* claims" and contains those cases in which the illegal conduct unquestionably proximately caused the corporation's losses. Criminal or civil penalties and fines were imposed.

The second category includes cases in which corporate losses were allegedly due to the board's failed business decisions in the

12. Lawrence E. Mitchell, *On the Direct Election of CEOs*, 32 OHIO N.U. L. REV. 261, 275–86 (2006).

13. Sean Griffith has convincingly demonstrated in a recent paper that the very nature of the corporation as a private enterprise serving its constituents is being threatened by the web of external federal and state regulation and the compliance regimes they impose. Griffith, *supra* note 3 at 2118–40. Whatever one may think of Delaware's relative laxity, its legislature and courts have created a relatively coherent corporate law regime that functions, at least in a quotidian fashion. Professor Griffith suggests that, once again, Delaware is facing a loss of that franchise as a result of these developments. *See generally* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (describing the back and forth between Delaware and the federal government in creating corporate law).

14. MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (Beard Books 1976).

15. Culminating in PRINCIPLES OF CORPORATE GOVERNANCE § 2.01 (AM. LAW INST. 1994).

absence of illegal conduct (or in which potential illegal conduct was irrelevant). Delaware doctrine claims it refuses to allow these kinds of circumstances to sustain *Caremark* claims.[16]

The third category begins to demonstrate that, despite doctrine to the contrary, *Caremark* jurisprudence already evaluates losses arising from business risk. This category, blended cases, includes those cases in which legal violations occurred and were related to the claimed losses, but the losses arguably were proximately caused by other factors, including poor business decisions. The principal importance of illegality in these cases is to provide a doctrinal hook that permits courts to elide the appearance of evaluating business decisions.[17]

The last category contains a single case: *In re Massey Energy*.[18] The losses in *Massey* were related to legal violations but clearly would have occurred even in the absence of a regulatory regime.[19] Violation of the law was not the proximate cause of the corporation's losses. *Massey*, I will argue, is the case that comes closest to opening up *Caremark* jurisprudence to the possibility of fulfilling its promise by imposing a monitoring duty on the board that covers all dimensions of corporate operations, business as well as legal.

The extension of *Caremark* to business risk is also hampered by doctrinal statements that obscure the actual distinction between process and substance and have led courts to avoid review in perfectly plausible business cases. Delaware courts have created a strong barrier between evaluating the process by which boards make decisions and evaluating the substance of those decisions. The cases dealing with business risk seem grounded in the fear that evaluation of the underlying board decisions would lead them to engage in the latter, a fear which seems to arise from this doctrinal conflation.[20] This has

16. *In re* Citigroup Inc., 964 A.2d 106, 126 (Del. Ch. 2009); *see also In re* The Goldman Sachs Grp., Inc., No. CIV.A. 5215-VCG, 2011 WL 4826104, at *21 (Del. Ch. Oct. 12, 2011) (noting that the Delaware Supreme Court has not yet decided whether failure to monitor business risks is enough to sustain a *Caremark* claim although noting that the court in *Citigroup* "seemed to suggest the possibility of such a claim"). *See generally* PARTNOY *supra* note 3.

17. I am not arguing that the courts intentionally are hiding the ball. My argument, as it proceeds, will show that adherence to doctrine masks the reality.

18. *In re* Massey Energy Co., C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011).

19. This is obviously true because, in *Massey*, the corporation failed to follow the regulatory regime. *See id.* at *11.

20. The exception is the opinion in *Dow Chemical* where Chancellor Chandler clearly articulates this distinction in a fairly straightforward case arguably involving legal risks. *In re* The Dow Chemical Co., No. 4349-CC, 2010 WL 66769, at *5 (Del. Ch. Jan. 11, 2010).

unnecessarily discouraged Delaware courts from applying *Caremark* (which itself is about process) to evaluate the processes by which business decisions are made. A focus on separating the process of monitoring from the substance of monitoring will make this clear.

In Part II, I will examine the jurisprudence of red flags. The presence of red (or sometimes yellow) flags provides the basis for the directorial scienter necessary to sustain the bad faith portion of a *Caremark* claim.[21] But the doctrinal articulation of the concept of red flags is too broad. *Caremark*, although it did not make this distinction, focused on the existence of internal red flags.[22] Subsequent cases have also failed to make this distinction. But separating these flags into two categories reveals important differences that, when understood, permit a more subtle understanding of good faith.

Dividing red flags into internal and external red flags (or internally and externally-generated information) leads to the conclusion that there is little justification for exculpating boards from the responsibility to know what is reasonably at hand.[23] In the process, I will show that Delaware courts already have accepted the presence of external red flags as a predicate for liability. This should be made explicit and external flags treated as an independent category.

Delaware courts might resist this distinction for fear of making directors responsible for knowing too much information or digging up obscure information. There should be no fear. Just as the board has transformed over the past four decades, dramatic changes in the way we access information have taken place since *Caremark*. Technology has made the process of gathering and sorting information a

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21. As Stephen Bainbridge and his coauthors have pointed out, and the Delaware courts have embraced, *Caremark* claims are, essentially, claims that directors acted in bad faith. Stephen M. Bainbridge et al., *Convergence of Good Faith*, *supra* note 3.

22. There was no need to on the facts of the case. *In re* Caremark Int'l Inc., 698 A.2d 959 (Del. Ch. 1996).

23. Delaware jurisprudence only credits red flags 'waved in one's face' of directors or displayed so as to be apparent to a careful observer. Wood v. Baum, 953 A.2d 136, 143 (Del. 2008). *But see* Reiter v. Fairbank, No. 11693-CB, 2016 WL 6081823 at *16 (Del. Ch. Oct. 18, 2016) (holding demand not futile where board failed to act after learning about evidence of criminal corporate behavior); *In re* China Agritech, Inc., 2013 WL 2181514 (Del. Ch. May 21, 2013); *In re Massey Energy*, 2011 WL 2176479 (Del. Ch. May 31, 2011) (noting failure of board to act meaningfully in reaction to the presence of red and yellow flags in what the court saw as a corporate business plan predicated on the violation of mine safety laws); Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763, 798–99 (Del. Ch. 2009) (discussing how the board tolerated "inadequate internal controls and knowingly fail[ed] to monitor their subordinates' compliance with legal duties" in the context of a corporation operated as a "criminal organization."). I will argue that this "face waving" doctrine disregards the transformation of information technology.

considerably easier and much cheaper task than it was when *Caremark* was decided. I will argue that the courts should incorporate these changes into the board's duties.

Part III concludes.

I. Types of Risk

The cases and literature on *Caremark* generally have focused on doctrinal statements about the nature and extent of *Caremark* duties and have paid little attention to the nature of the damages at issue. In particular, they have not examined the requisite links between the allegedly failed directorial monitoring and the losses that such failures are said to have caused. This is not surprising. Most *Caremark* cases never make it past the pleadings stage and so the question of damages does not come up in an actionable way. As a result, the extent to which Delaware courts already have expanded *Caremark* jurisprudence is obscured. A study of the cases is instructive.

I categorize the cases in terms of the kind of risk at issue, following the doctrinal distinction between legal risk and business risk employed by the courts. The reality is more nuanced, and reveals that the cases align along a spectrum. Delaware courts have gone a long way toward incorporating business losses (in addition to legal losses) resulting from failed or inadequate monitoring of bad business decisions into their evaluations of *Caremark* claims. In one case, the Chancery Court has gone so far as to accept the failure to monitor business risk as a basis for such a claim.[24]

A. Legal Risk

The first type of case addresses what is generally known as legal risk and has sometimes been referred to as a "traditional *Caremark* claim."[25] Legal risk is simply the possibility that employees of the corporation might cause it to violate positive law, resulting in substantial criminal or civil penalties and sometimes judgments in favor of private parties.[26] For obvious reasons, this kind of risk is greatest for corporations operating in regulated industries, and the cases generally reflect this. Traditional *Caremark* cases present little question that the illegal conduct at issue was the proximate cause of

24. *In re* Massey Energy Co., 160 A.3d 484, 497 (Del. Ch. May 4, 2017).
25. *In re* Citigroup Inc., 964 A.2d 106, 123 (Del. Ch. 2009).
26. *In re* The Dow Chemical Co., No. 4349-CC, 2010 WL 66769 at *5 (Del Ch. Jan. 11, 2010).

the corporate losses for which derivative plaintiffs seek redress. The fines and penalties for which plaintiffs seek corporate reimbursement were the direct result of illegal conduct.

Caremark itself is too well known to merit extensive discussion. Briefly, Caremark is a major health care company, engaged in patient care and managed services as well as various therapeutic services and prescription drug plans. The company earned substantial revenue from Medicare and Medicaid reimbursement.[27] It was therefore required to comply with a variety of regulations, including the federal Anti-Referral Payments Law ("ARPL").[28] While attempting to comply with these regulations, Caremark took the position that there were ambiguities in determining the limits of such laws and publicly stated that it was uncertain of its own interpretations.[29] It appears that Caremark chose to operate its business somewhat aggressively.

In any event, Caremark found itself under investigation by the Department of Health and Human Services and the Department of Justice, resulting in a federal grand jury indictment, the discovery of violations, substantial fines and civil damages, and a comprehensive settlement that included Caremark's obligation to improve its monitoring practices.[30] Derivative litigation followed the indictment and resolved in the settlement at issue in the case.[31]

The Chancellor's obligation to approve the settlement included a central determination of whether that settlement was "fair and reasonable," a determination that necessarily required that he evaluate the strengths and weaknesses of the derivative claims.[32] The central legal question was whether the directors had breached "their duty of attention or care," "possibly the most difficult theory in corporate law upon which a plaintiff might hope to win a judgment,"[33] difficult because, as the Chancellor had written in *Gagliardi v. TriFoods Int'l Inc.*,[34] any other liability standard would distort the risk/reward

27. *In re Caremark*, 698 A.2d at 961.
28. *Id.*
29. *Id.* at 962.
30. *Id.* at 962–66.
31. *Id.* at 966.
32. *Id.* at 966–72.
33. *Id.* at 967.
34. 683 A.2d 1049 (Del. Ch. 1996). I will address this particular bit of Delaware mythology later in this paper.

calculus of corporate directors leading to a dearth of qualified candidates willing to serve.[35]

Important for this paper and subsequent jurisprudence is the Chancellor's careful distinction between judicial evaluation of the wisdom of the board's decision—which can never be questioned absent a fiduciary breach—and the nature of the process used to arrive at the decision, which can always be open to judicial evaluation. Thus, he looked at the processes by which the board established internal monitoring procedures to determine whether it had adequately performed its oversight role.[36] Despite its failure to detect the illegal activity at issue, he concluded that it had.[37]

Important, too, is the court's focus on the fact that the risks at issue were legal risks, a focus that "has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements . . . ."[38] External legal requirements had also been at issue in the 1963 case of *Graham v. Allis-Chalmers*,[39] a case that held the board only to the standard of actual notice of illegal activity for liability to be imposed. The court here rejected that standard in favor of one that required the board to assure itself of the existence within the corporation of reasonable information and reporting systems, and thus gave birth to oversight liability.[40]

Despite this focus on legal compliance, the Chancellor left open the possibility that such information and reporting systems might be required to provide monitoring of other risks, noting that information and reporting systems sufficient to satisfy the board's duty must represent "a good faith attempt to provide senior management and the Board with information respecting material acts, events, or conditions within the corporation, *including* compliance with applicable statutes

35. *In re Caremark*, 698 A.2d at 967 (citing Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049 (Del. Ch. 1996)). The observation of directors' risk/reward calculus, often articulated as a fear that too high a standard of liability would discourage qualified directors from serving, is something of a mantra in Delaware jurisprudence. Yet I have never seen a Delaware court cite any evidence whatsoever to support its own resolutions of this calculus.

36. *Id.* at 963.

37. *Id.* at 972.

38. *Id.* at 969.

39. 188 A.2d 125 (Del. 1963).

40. *In re Caremark*, 698 A.2d at 970.

and regulations."[41] Yet no subsequent Delaware case in which the risks at issue were described as other than legal risks has survived a motion to dismiss.

This is probably because no such case has presented sufficient evidence of board failure, of the presence of adequate red and yellow flags to alert the board to the possible failure of its information systems. But I suspect there is more. As I will discuss below, the court in the important *Citigroup* case, despite its care, elided (as a matter of fact, not of doctrine) the distinction between reviewing process and reviewing substance that the Chancellor was at pains to make in *Caremark*.[42] This has led, despite some ambiguous language, to an unnecessary inference that *Caremark* duties are centered on legal risks alone.[43]

The Delaware Supreme Court's canonization of *Caremark* in *Stone v. Ritter* was a case involving legal risks similar to the type of risks posed in *Caremark* itself, that is to say external legal risk.[44] Similarly, the damages at issue—fines and regulatory penalties—were proximately caused by employee misconduct.[45] Custodial account holders at AmSouth Bancorporation managed a Ponzi scheme in the face of corporate failure to comply with the federal Bank Secrecy Act and anti-money laundering regulations because employees did not file required suspicious activity reports.[46] The result was indictment of the bank followed by a deferred prosecution agreement under which it paid significant fines and additional civil penalties as a result of regulatory prosecution.[47] Derivative litigation followed.

The Supreme Court accepted the Chancery Court's characterization of the matter as a "'classic *Caremark* claim . . . [,] a claim of directorial liability for corporate loss . . . predicated upon

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41. *Id.* at 969 (emphasis added); *see also* Bainbridge et al., *Convergence of Good Faith*, *supra* note 3 (noting Allen's statement that monitoring was to cover not only legal risk but business performance).

42. *In re Caremark*, 698 A.2d at 972.

43. I discuss *Citigroup* in the following section. In Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003), then-Vice Chancellor Strine noted that *Caremark* "is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations' compliance with legal standards . . . ."

44. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006). Indeed the ur-case on the duty to monitor, *Graham*, 182 A.2d at 127, also dealt with external regulation—in that case, the anti-trust laws.

45. *Stone*, 911 A.2d at 365.

46. *Id.*

47. *Id.* at 365–66.

ignorance of liability creating activities within the corporation . . . ."[48] "Liability creating activities" are, of course, violations of law. Accepting the conclusions of an independent report of the bank's internal compliance monitoring systems, or at least concluding that the board could reasonably have accepted its conclusions that such systems were adequate, the court held that the complaint was properly dismissed for plaintiff's failure to make demand.[49] It was important to the decision that the members of the board were untainted by interest, dependence, or the substantial likelihood of liability.[50] The court had little more to say on the matter, essentially embracing the language and reasoning of *Caremark* itself.[51]

B. Business Risk

The next category of risk is business risk. Business risk cases present situations where the plaintiff seeks to redress losses proximately caused by business decisions that turned out badly. The argument is that these losses would not have occurred but for the board's failure to monitor the corporation's business.

If legal risk characterizes traditional *Caremark* claims, claims based on business risk doctrinally appear to remain beyond the Pale. These, it is said, are claims that Delaware jurisprudence will never

48. *Id.* at 364.

49. *Id.* at 369.

50. *Id.* at 367.

51. It had quite a lot to say on the issue of good faith. *See infra* note 167–171 and accompanying text. Similar cases involving straightforward legal risks include: Horman v. Abney, C.A. No.12290-VCS, 2017 WL 242571 (Del. Ch. Jan. 19, 2017) (dismissing a straightforward Caremark claim based on penalties and fines for regulatory violations because of inadequate particularized pleadings); Reiter v. Fairbank, No. 11693-CB, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016) (straightforward legally-based *Caremark* claim alleging board's failure to detect violations of the Bank Secrecy Act, while reciting the Delaware mantra that *Caremark* duties are grounded in legal risk and not business risk); Melbourne Mun. Firefighters' Pension Tr. Fund on Behalf of Qualcomm, Inc. v. Jacobs, No. 10872-VCMR, 2016 WL 4076369 (Del. Ch. Aug. 1, 2016), *aff'd*, 158 A.3d 449 (Del. 2017) (demand not excused as to *Caremark* claim for allowing antitrust violations when no particularized facts demonstrated that directors failure to act in the face of three red flags constituted bad faith); Ironworkers Dist. Council of Philadelphia & Vicinity Ret. & Pension Plan v. Andreotti, C.A. No. 9714–VCG, 2015 WL 2270673 (Del. Ch. May 8, 2015) (finding a violation of intellectual property laws and breach of licensing agreement). There are facts in the opinion that might suggest this case could be seen as a blended case, but it is unclear if it would be more appropriate to treat it as a legal case. *Stone*, 911 A.2d at 367; La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313 (Del. Ch. 2012) (denying motion to dismiss straightforward *Caremark* claim based on criminal and regulatory violations and resulting penalties and fines); *see also In re* Duke Energy Corp., No. 7705-VCG, 2016 WL 4543788 (Del. Ch. Aug. 31, 2016) (upholding a straightforward bad faith claim against a Rule 23.1 motion to dismiss because of the well-pled allegations that the board had knowingly caused the corporation to violate positive law).

permit because it is for the boards, not the courts, to make business decisions, and monitoring business risk appears to be treated as a business decision. Courts may only review process. Thus, courts in the few straightforward business risk cases refuse to review these decisions as breaching Delaware's divide between substance and process review.[52]

As I have already noted, *Caremark* expressly left open the possibility that board failure to monitor business risk could lead to oversight liability.[53] A duty to monitor business risk makes sense. Directors are chosen for their business expertise, not their legal expertise. And while criminal and regulatory penalties can often be substantial, they rarely are so great as to destroy or even severely cripple a corporation. Bad business decisions do have that potential. Among the few tasks for which the monitoring board unquestionably is responsible is monitoring the CEO. What does that monitoring entail? His business success. At least to this extent, the board is already responsible for monitoring business risk. To limit enforceable monitoring, then, to legal risk thus implies a very different, and somewhat peculiar, notion of the corporation.[54] The question is whether the duty to monitor goes beneath the CEO's business performance.

The 2009 *Citigroup* case was one of several derivative actions brought by shareholders following the 2008 financial crisis.[55] Plaintiffs sought to impose liability on the corporation's directors for failing adequately to monitor and manage its exposure in the subprime mortgage market (and for failing to assure thorough and accurate financial reporting).[56] Plaintiffs pled demand futility, alleging the board's substantial risk of liability because of its disregard of

52. There is little point in attempting to review these cases from a proximate cause perspective because they are dismissed on the very nature of the claims as evaluating inappropriate risk. *Citigroup* implicitly rejected any notion of the failure to monitor as proximate cause by holding that the alleged red flags were irrelevant to the company. *Goldman*, as I will soon discuss, has a more plausible connection. Nonetheless, the cases are important for the analysis of the blended cases I discuss below.

53. *In re* Caremark Int'l Inc., 698 A.2d 959, 971 (Del. Ch. 1996).

54. Professor Griffith already sees potentially dangerous changes in corporate purpose arising from rapidly evolving and pervasive regulatory regimes. Griffith, *supra* note 3.

55. *In re* Citigroup Inc., 964 A.2d 106, 113 (Del. Ch. 2009).

56. *Id.* at 114.

significant red flags that ought to have put it on notice that it should pay greater attention to this risk.[57]

In holding that demand was not excused, and thus dismissing the case, the court distinguished *Caremark*, noting that a traditional Caremark claim involved the failure of a board to monitor violations of the law, whereas the complaint here was based upon the "defendants' alleged failure to properly monitor Citigroup's *business risk* . . . ."[58] Although the court noted that it might be possible for a plaintiff to sustain the burden of proving a *Caremark* claim regarding business risk under some set of facts,[59] this seems implausible in light of the court's central reasoning, which I quote at length:

> Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them—the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a "right" or "wrong" decision.[60]

Were there any question that the Chancellor understood *Caremark* to be limited to legal claims, such doubt was erased two pages later.

> To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to

57. I discuss the issue of red flags separately in Part II.
58. *In re Citigroup*, 964 A.2d at 123.
59. *Id.* at 126.
60. *Id.* at 124.

> monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions. . . . To impose liability on directors for making a 'wrong' business decision would cripple their ability to earn returns for investors by taking business risks. "Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law."[61]

With such powerful statements of director-protective Delaware judicial policy, it is hard to imagine a case of business risk monitoring that could sustain a plaintiff's complaint.[62]

I suppose it is possible to read this language as the court's interpretation of the complaint as alleging a failed business decision rather than a failure to monitor. But that possibility is undercut by at least two observations. First, the court opened its opinion by describing the claim as a failure to monitor, thus at least implicitly recognizing the distinction that it later elided between judicial review of the monitoring procedures and processes and the substantive business decision to enter the subprime market.[63]

Second, the red flags asserted by plaintiffs also pointed to a duty to monitor rather than to the substance of the decision. The red flags that were pled did not specifically point to Citigroup's investment behavior but to the risks of the subprime market more generally. These risks—these red flags—had nothing to do with Citigroup itself, as the court hastens to point out.[64] That is all the more reason to read the

61. *Id.* at 126.

62. *See In re* The Dow Chemical Co., No. 4349-CC, 2010 WL 66769 (Del. Ch. Jan. 11, 2010) (refusing to evaluate the board's decision to agree to an unconditional merger as a "business decision," despite its failure to note possible bribery that could have affected the results of the deal).

63. The opinion acknowledges this in its second sentence. "Plaintiffs brought this action . . . alleging, in essence, that the defendants breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced in the subprime lending market . . . ." *In re Citigroup*, 964 A.2d at 111.

64. *Id.* at 114–15. "As will be more fully explained below, the 'red flags' alleged in the eighty-six page Complaint are generally statements from public documents that reflect worsening conditions in the financial markets, including the subprime and credit markets, and the effects of those worsening conditions had on market participants, including Citigroup's peers." *Id.* at 114–15; *see also id.* at 128 (repeating this analysis). I will discuss in Part II why these red flags should have been sufficient.

complaint as alleging a monitoring failure rather than a decisional failure. If plaintiffs had indeed been alleging the latter, the evidence would have to have been directed at internal Citigroup decision-making. It was not.

It is, perhaps, understandable that the court conflated the two types of decisions. Delaware courts are famously averse to the possibility of appearing to evaluate the substance of corporate business decisions, frequently asserting their lack of business expertise and the undesirability of hindsight evaluations of risky decisions that may have been rational at the time they were made but turned out rather badly.[65]

But Delaware courts do evaluate corporate business decisions, at least in non-loyalty cases, on the basis of process. That is, in fact, the very posture of the business judgment rule that by definition arises in cases that challenge business decisions. Although it may be argued that the business judgment rule covers business decisions made at the board level and *Caremark* monitoring looks at decisions made deeper in the enterprise, there is little reason to distinguish the board's process of establishing monitoring mechanisms for (arguably more consequential) business risks from its process of establishing monitoring mechanisms to ensure legal compliance.

Evaluating the decision-making process of a board of directors is precisely what Delaware courts do all the time. The lifeblood of the Delaware courts from a corporate law perspective is a stream of derivative cases alleging that decisions made by a corporation's board should lead to the board's liability. Although the enactment of section 102(b)(7) permitting exculpatory charter provisions largely has eradicated direct care claims,[66] this kind of review survives in everything from derivative demand analysis to cases reviewing executive compensation,[67] to takeover cases, to *Caremark* itself. In those cases, courts regularly reiterate that what they are doing is reviewing the process by which a board made a decision, not the decision itself.[68]

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65. I hasten to point out that Delaware courts protest too much, employing their own business judgment in cases where demand is alleged to be futile. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

66. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2018).

67. *In re* Walt Disney Co., 906 A.2d 27 (Del. 2006).

68. *See id.* at 52.

Would the result have been different had the court evaluated the *Citigroup* case on this basis rather than dismissing it as the kind of business decision courts will not review? *Citigroup* was relatively easy, because there is no evidence in the opinion that the board had made an affirmative decision to enter the subprime market, nor does it appear that plaintiffs made such an allegation. The result would likely have been the same. But the contours of the board's monitoring responsibilities would have been broader.

Goldman Sachs[69] is different. The board there did make an affirmative decision by approving the employee compensation plan that was at issue in the case.[70] The court refused to review the board's failure to monitor the compensation regime, identifying the issue as inviting the kind of business decision review declined in *Citigroup*.[71] But it would have been perfectly consistent with Delaware jurisprudence for the court to have asked whether the compensation scheme was of a nature to require monitoring mechanisms and to evaluate any process the board might have used to consider this question. I discuss *Goldman* further in the subsection immediately following.

C. Blended Risk

Cases have been brought that go beyond traditional *Caremark* claims and deal with the board's failure to monitor other kinds of risks. While, unsurprisingly, the typical result is dismissal, some of these cases fully evaluate the *Caremark* claim at the pleading stage without analyzing the nature of the alleged wrong or the types of damages sought. In fact, as Vice Chancellor Laster wrote in *Pyott*, a case decided after *Citigroup*, "[t]he list of corporate traumas for which stockholders theoretically could seek to hold directors accountable is long and ever expanding: regulatory sanctions, criminal or civil fines, environmental disasters, accounting restatements, misconduct by officers or employees, massive business losses, and innumerable other potential calamities."[72] Although the Vice Chancellor used the word "theoretically," he did so citing *Caremark* itself, with no reference to

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69. *In re* The Goldman Sachs Grp., Inc., No. CIV.A. 5215-VCG, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011).

70. *Id.*

71. *Id.* at *22.

72. La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 340 (Del. Ch. 2012).

Citigroup.[73] Oversight liability for failed business decisions appears to remain plausible. A close examination of the cases demonstrates that courts have already, at least implicitly, allowed these claims to be made.[74]

I refer to these cases as blended cases because, in each of them, some sort of legal violation was present, but losses caused by the legal violations, if any, were only part of the damages for which plaintiffs sought recompense. Damages were also sought, sometimes generally and sometimes more specifically, for losses caused by bad business oversight. Thus, while the cases do not explicitly embrace oversight monitoring of business risk, they do illustrate the difficulty of isolating the proximate cause of damages, or at least all of the damages, in oversight liability cases.

Rich v. Chong[75] is a case suggesting that *Caremark* jurisprudence goes beyond the traditional fact pattern and would appear to impose a duty to monitor internal financial controls as well, a monitoring function that clearly implicates business risk as well as legal risk. The damages claimed in *Rich* proximately resulted from corporate mismanagement, although regulatory action had begun.

Rich was a derivative suit brought by the shareholder of a Delaware holding company, the sole asset of which was Fuqi, a Chinese jewelry company.[76] Less than a year after its initial public offering, the company announced a restatement of its financials. Additional negative disclosures followed the plaintiff's prompt demand on the board, as a result of all of which the price of the stock dropped from its IPO level of $21.50 a share in July 2009 to $1 at the time the case was heard in 2013.[77] The board failed to respond to

73. *Id.* at 340 ("[O]rdinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals.") (citing *In re* Caremark Int'l Inc., 698 A.2d 959 (Del. Ch. 1996).

74. It is possible to over-read some of these cases because few have made it past the pleadings stage and none of them have resulted in an opinion evaluating liability on the merits of the case. In blended cases, however, the courts have not relied upon (and rarely have discussed) the nature of the damages as a reason to dismiss the claims the way the court did in *Citigroup*. That the cases are blended, that is, including law violations as well as failed business decisions, may be the reason for this, but it nonetheless stands that significant business losses resulting from risky decisions characterize these cases.

75. Rich *ex rel* Fuqi Int'l v. Chong, 66 A.3d 963 (Del. Ch. 2013).

76. *Id.* at 966.

77. *Id.* The drop in share price is, of course, not a proper form of damages to be sought under a derivative claim.

plaintiff's demand for two years, although it did appoint a special internal investigation committee whose activities were halted when the corporation failed to pay its outside auditor, counsel, and forensic specialists, and its members resigned (as did four of its seven directors and three of its officers).[78]

The court had little trouble permitting the plaintiff to pursue his *Caremark* claim, despite the fact that the board had not yet responded to his demand nor had the special committee completed its investigation.[79] The board's abandonment of its investigation, especially in the face of apparent financial wrongdoing (and when the corporation publicly admitted that its internal controls were inadequate) was an abdication of board responsibility sufficient to remove the protection of the business judgment rule because of an apparent failure of the board to act in good faith.[80]

The court also refused to dismiss the complaint for failure to state a claim under *Caremark*, reciting the now-familiar *Stone v. Ritter* mantra that "[t]he essence of a *Caremark* claim is a breach of the duty of loyalty arising from a directors' bad-faith failure to exercise oversight control over the company."[81] Applying the plaintiff-friendly standards of Rule 12(b)(6) (having gotten over the more difficult hurdle of Rule 23.1 because of the board's abdication of its investigation), the court enumerated the corporation's own various admissions of the inadequacy of its internal financial monitoring systems, leading the court to conclude that Fuqi had "no meaningful controls in place."[82] The court also found sufficient red flags to permit the inference that the directors knew that Fuqi's internal controls were inadequate, thus satisfying the scienter requirement necessary to establish the lack of good faith that sustains a *Caremark* claim.[83]

The damages claimed are telling. The case was pled as one involving the board's failure to establish a meaningful system of internal controls, leading to misstatements in SEC filings and an SEC investigation.[84] The company had sustained no damages from legal

78. *Id.* at 972.
79. *Id.* at 973.
80. *Id.* at 978.
81. *Id.* at 980.
82. *Id.* at 983.
83. *Id.* at 984.
84. Verified Derivative Complaint at 2, Rich *ex rel* Fuqi Int'l v. Chong, 66 A.3d 963 (Del. Ch. Apr. 25, 2013) (No 7616-VCG), 2012 WL 2357870.

fines and penalties at the time of filing, and the complaint reflects this by asking for damages "including, but not limited to, costs and expenses incurred in connection with the accounting restatement process, the SEC's investigation and the Company's NASDAQ delisting proceedings."[85] More broadly, and apparently contemplating additional unspecified damages, it demands that the company be awarded "the amount of damages sustained by the Company as a result of the Individual Defendants' breaches of fiduciary duty."[86] Among those damages that later were alleged were the Company's payment of $120 million to an unidentified Chinese party that appears simply to have disappeared.[87] This payment does not, on its face, appear to be a result of legal or regulatory violations, and thus can be seen as constituting a loss resulting from a business risk that does not fit the pattern of a traditional *Caremark* claim. The claim is that the board failed to monitor the corporation's internal financial practices leading to its failure to uncover the financial mismanagement. Thus, *Rich* appears to accept an expanded board oversight role.[88]

Several other cases are similar. *Desimone v. Barrows*[89] dealt with corporate harm due to option backdating, and *Goldman Sachs*[90] addressed management compensation practices, although neither case survived a motion to dismiss.[91] In contrast, *AIG*[92] survived the pleadings stage.

The wrongdoing in *Desimone* was brought to light by an SEC investigation, leading Sycamore Networks, Inc. to have to restate its

85. *Id.* at ¶ 73.

86. *Id.*

87. Plaintiff's Answering Brief in Opposition to Defendant's Motion to Dismiss at 6, Rich *ex rel.* Fuqi Int'l, Inc. v. Chong, 66 A.3d 963 (Del. Ch. Apr. 25, 2013) (No. 7616-VCG), 2012 WL 4293959.

88. Saito v. McCall, No. CIV.A. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004), *overruled by* Lambrecht v. O'Neal, 3 A.3d 277 (Del. 2010). In *Saito*, the *Caremark* claim survived a motion to dismiss, and thus might fall into the same category, but it is unclear from the opinion and an earlier opinion in the case, Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000), what the nature of the damages sought were. Although the action was derivative, the only corporate harm discussed was a drop in share price. *See also* Canadian Commercial Workers Indus. Pension Plan v. Alden, 2006 WL 456786 (Del. Ch. Feb. 22, 2006) (dismissing *Caremark* claims alleging failure to monitor internal fiduciary self-dealing transactions on other grounds).

89. 924 A.2d 908 (Del. Ch. 2007).

90. *In re* The Goldman Sachs Grp., Inc., No. CIV.A. 5215-VCG, 2011 WL 4826104, at *1–2 (Del. Ch. Oct. 12, 2011).

91. In *Desimone*, part of the complaint survived a Rule 23.1 motion to dismiss but not a Rule 12(b)(6) motion. *Desimone*, 924 A.2d at 947, 950.

92. Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763 (Del Ch. 2009).

earnings. Plaintiff also had discovered the existence of an internal memo suggesting that options granted to six "rank and file employees" were backdated to the lowest trading price in the quarter preceding the grants, which memo led the corporation's Audit Committee to launch an internal investigation.[93] Plaintiff also alleged backdated grants to Sycamore's officers and outside directors.[94]

The court disposed of the *Caremark* aspect of the complaint by observing that the complaint failed to allege any facts suggesting the inadequacy of Sycamore's internal controls, and the absence of any red flags that would have created the requisite scienter to sustain a finding that the directors had "abdicated their oversight responsibilities by failing to take remedial action."[95] The court apparently found no need to discuss the nature of the harm to the corporation itself or, relatedly, the type of monitoring in which the board was to engage. It does appear, however, that the principal complaint as to the relief sought for the corporation through the derivative action could not have been a drop in stock price caused by the restated financials because that was harm caused to the stockholders and thus the subject of a direct action rather than a derivative action.

The complaint makes this clear. Among the damages alleged to be suffered by the company were underpayment by the employees to the corporation upon exercise of their backdated options.[96] When options are granted below market price, "then the employee pays less and the company gets less money for the stock when the option is exercised."[97] And while exposure to regulatory penalties was also alleged, plaintiffs sought payment of "substantial monetary damages as a result of the [defendants' breaches of fiduciary duty] . . . as well as further and even greater damage in the future, including damage to the Company's reputation, business, and good will."[98]

The same is largely true for *Goldman Sachs*, in which a claim for demand futility also failed. While the court treated *Goldman* as a

93. *Desimone*, 924 A.2d at 922–23.

94. *Id.* at 914.

95. *Id.* at 940.

96. *Id.* at 913.

97. Amended Derivative Action Complaint, Desimone v. Barrows, 924 A.2d 908 (Del. Ch. June 7, 2007) (No.2210-VCS), 2006 WL 4780283, at 2.

98. *Id.* at 22, 30. Also alleged was a generalized complaint that "the Company has sustained and will continue to sustain significant damages in the millions of dollars." *Id.* at 34.

business risk case, I analyze it here because the complaint's assertion of unethical (although not illegal) conduct by *Goldman* employees was an obvious attempt to bring the case within traditional *Caremark* doctrine and the losses claimed were clearly proximately caused by business decisions.

The central complaint in *Goldman* was that the compensation structure established by the board created a divergence between the interests of management and the interests of outside stockholders, creating incentives for management to increase net revenue without regard to the risks.[99] Having created this system, the complaint alleged, the board breached its *Caremark* duties by failing to monitor management appropriately in light of the compensation scheme it had approved.[100] The losses proximately caused by the alleged board oversight failures were business losses, not fines and penalties.[101]

The case is notable, for my purposes, for two points made by the court, and one that is implicit in the decision. First, the court noted that the risky conduct engaged in by management might have been unethical but it was not illegal as contemplated by *Caremark*. Management was permitted to pursue such legal conduct, despite the risk of ethical violations, so reports about risk did not raise red flags for monitoring from the perspective of the board.[102]

Second, the court recognized the board's decisions as business monitoring decisions in contrast to legal monitoring decisions. Stating that *Citigroup* had left open the question of whether the board had a duty to monitor business risk, the court stated that if a duty to monitor business risk existed, the court would not be permitted to look at the substance of the decision at all.[103] This is an important observation, and the only statement I have found in *Caremark* business risk cases clearly to acknowledge the difference between procedure and substance in evaluating the kinds of corporate behavior the board is obliged to monitor. *Goldman* thus leaves open a path to the court's

99. *In re* The Goldman Sachs Grp., Inc., No. CIV.A. 5215-VCG, 2011 WL 4826104, at *3 (Del. Ch. Oct. 12, 2011).

100. Second Amended Shareholder Derivative Complaint at *79, *In re* The Goldman Sachs Grp., Inc., 2011 WL 4826104 (Del. Ch. Oct. 12, 2011) (No. 5215-CC), 2010 WL 5069059.

101. Indeed, among the damages alleged was repayment by the defendants of over-payments of compensation to employees. *Id.* at *79.

102. *In re* The Goldman Sachs Grp., Inc., No. CIV.A. 5215-VCG, 2011 WL 4826104, at *20 (Del. Ch. Oct. 12, 2011).

103. *Id.* at *22.

eventual recognition that its evaluation of a board's monitoring of non-legal risks does not necessarily (or even logically) entail an examination of the business risks themselves.

Indeed, it would have been an important correction to a significant dimension of corporate behavior *Caremark* did not address, a correction that could then have made *Caremark* evaluation more meaningful and complete. The issue is one of incentives. Legal and regulatory regimes, by threatening corporations with penalties for violation, create exogenous incentives for corporations to obey the law. Compensation regimes create endogenous incentives for employees to work to increase corporate profit. While compensation arguably leading to corporate damages was squarely at issue in *Goldman*, it is probable that the structure of Caremark's compensation system (and that of AmSouth Bancorporation and so many other corporations) rewarded individual employee success in increasing profits.[104] It doesn't take much to understand that these compensation incentives can undercut exogenous legal incentives, especially when considered from the perspective of an individual employee in a large organization rather then the perspective of the organization itself. While the conduct in *Goldman* was alleged to be unethical rather than illegal, a discussion of the role of compensation schemes in the monitoring context would have been helpful and important. But the court foreclosed the possibility of this analysis by labeling the decision an un-analyzable business decision.[105] This missed opportunity for a richer analysis of the realities of corporate governance has further stunted *Caremark's* ability to grow.

Goldman illustrates the proposition that even the responsible monitoring of legal risks is unlikely to ensure actual corporate legal compliance in the face of compensation schemes that create different incentives. It is almost certainly the case that a Delaware court would be uncomfortable evaluating the incentives created by compensation

104. *See also* Reiter v. Fairbank, No. 11693-CB, 2016 WL 6081823 (Del. Ch. Oct. 18, 2016) (incentives to bring in volume from the legally risky check-cashing business); Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006) (incentives to accommodate profitable customers); Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763 (Del Ch. 2009) (promise of significant stock compensation if target share price is maintained); *In re* Dow Chemical Co., 2010 WL 66769 (Del Ch. 2010) (noting distinction between monitoring business risk and monitoring fraudulent and criminal conduct).

105. Critical in the case as well was the absence of red flags. *In re Goldman Sachs Grp.*, 2011 WL 4826104, at *20.

schemes, asserting once again its incompetence to evaluate business decisions. *Goldman* implies the way, by presenting the possibility of reviewing the processes by which boards monitor potentially legally risky compensation schemes in light of employees' economic incentives.

AIG is an easy case from a *Caremark* perspective. The complaint survived motions to dismiss in a situation where blatant illegality was obvious and the focus of the opinion was only on the inside directors who allegedly took part in the company's various schemes.[106] While the defendants certainly broke laws and paid enormous fines and expenses consistent with traditional *Caremark* claims, the proximate cause of a significant amount of the corporation's losses were business losses arising from business decisions (or non-decisions) that created extraordinary risk for the company.[107] Indeed, the complaint pleads that defendants' actions caused damage to the company's reputation and good will, increased its cost of capital, and led to "a loss of business and business opportunities."[108] There certainly were violations of law. But the complaint further alleges that defendants' breaches of fiduciary duties included, among other things, "failing to ensure that AIG not engage in any unsafe, unsound, or illegal business practices . . . ."[109]

AIG[110] involved a variety of alleged manipulations of the company's financial statements, tax avoidance schemes, conspiracies with others to rig markets, and the sale of expert fraud assistance to other companies, leading to $1.6 billion in fines (with regulatory processes still proceeding at the time of the opinion) and a loss of $3.5 billion in the company's equity. The scope, extent, and clear intent of the manipulations were so extraordinary as to lead then-Vice Chancellor Strine to pointedly describe AIG as a "criminal organization."[111]

106. The case was also easy because it involved a motion to dismiss for failure to state a claim, a much easier standard for plaintiffs to plead than the more restrictive Rule 23.1. The Vice Chancellor ruled that demand futility under Rule 23.1 had been satisfied by the special litigation committee's express neutrality with respect to plaintiffs' demand. *Am. Int'l Grp.*, 965 A.2d at 807.

107. *Id.* at 791.

108. First Amended Combined Complaint at 190, 193, Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763 (Del. Ch. 2009) (No. 769-VCS), 2008 WL 4618463.

109. *Id.* at 192.

110. *Am. Int'l Grp.*, 965 A.2d at 763.

111. *Id.* at 796.

The court's evaluation of plaintiff's *Caremark* claim is anti-climactic. The complaint did not assert the absence, inadequacy, or ignorance of internal controls "in one discrete instance of serious wrongdoing."[112] There was no need for red flags. Rather, "[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary,"[113] leading to the almost unavoidable inference that the defendants, who both knew of and participated in the fraud, clearly knew that AIG's internal controls and monitoring system were inadequate. This was enough to sustain the claim.

And then there is *Massey*.

D. *In re* Massey Energy Company Derivative and Class Action Litigation[114]

Massey stands alone. It does so not because of the blatantly bad misconduct at issue. After all, *AIG* and *Rich* also dealt with bad behavior, although not leading (as far as I know) to death. *Massey's* importance is not in these facts.

Massey stands alone because of the kind of risks the company took and the losses that they proximately caused. In this respect, *Massey* is different from other *Caremark* cases.

In traditional *Caremark* cases, the losses claimed are the fines and penalties imposed upon the corporation because of its violations of law. In the blended cases, losses included fines and penalties but additional losses were caused by bad business decisions. In *Rich*, for example, the $120 million that allegedly disappeared in China likely was a fraudulent payment, but it could also have been the result of a risky business decision.[115] In *Desimone*, the option backdating claim, which survived a motion to dismiss because directors were interested, arguably violated fiduciary duties, but loss was as a result of insufficient payment to the corporation for the stock.[116] The direct losses at AIG were largely caused by fraudulent transactions that resulted in substantial fines and penalties, but the allegedly significant

112. *Id.* at 799.

113. *Id.*

114. *In re* Massey Energy Co., C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011); *see also In re* Massey Energy Co., 160 A.3d 484 (Del. Ch. 2017) (dismissing *Caremark* complaint because plaintiffs lost derivative standing following the merger of Massey into Alpha).

115. Rich *ex rel* Fuqi Int'l v. Chong, 66 A.3d 963 (Del. Ch. 2013).

116. Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007).

reputational losses and increased cost of credit were losses arising from business risks.[117] AIG could well have suffered much of the loss at issue by legal yet aggressive business decisions. In this case they crossed the line into fraud.

The distinction between business losses occasioned by illegal behavior and business risk is blurry. The blended cases are transitional (conceptually, if not chronologically). One could perhaps argue that, at least in cases like *AIG* and, to a lesser extent perhaps, *Goldman*, business risk was at issue because of decisions to pursue especially aggressive corporate policies.[118] But the cases were not presented that way.

Massey involved straightforward business risk. Of course, there were multiple violations of laws and regulations, compliance with which might have prevented the mine disaster that gave rise to the litigation. But the losses in *Massey* were proximately caused by violations of mine safety practices, not by the violation of mine safety regulations.[119] It wasn't legal fines that were at issue but mass tort liability, lost profits, and severely damaged reputation, all stemming from an alleged business policy of placing profits above safety.[120] The violation of mine safety regulations, while paralleling this behavior, were incidental to the harm.

Massey found itself confronted with extensive liability and serious reputational harm following an explosion at one of its mines that killed 29 miners.[121] What made this accident more compelling than a typical business failure is the position taken by Blankenship, the company's CEO, Inman, his friend and enabler, and a complacent outside board—that Blankenship and the company knew far more about mine safety than federal regulators. This attitude led them consistently to violate federal mine safety laws. It was the company's

117. *Am. Int'l Grp.*, 965 A.2d at 763.

118. Perhaps the statement in the text sounds silly given the pervasive fraud at AIG. But one does wonder whether aggression short of illegality might have produced a different result in light of the fact that, as was not alleged in *Citigroup*, directors were intimately involved in the aggressive conduct. Certainly the increased cost of credit would have been a possibility. Damaged reputation might have been as well because, as an insurance company, AIG is heavily reliant on its reputation (as is Citigroup). I raise the points merely to suggest that the line between highly aggressive financial conduct and unlawful financial conduct may be a thin one.

119. *In re Massey Energy*, 160 A.3d.

120. There almost certainly were grounds for survivors' tort claims regardless of the regulatory regime.

121. *In re Massey Energy*, 160 A.3d at 487.

clear policy to risk the lives of workers in order to maximize corporate profit. It was management's disregard of mine safety practices that led to the mine disaster.[122]

This case was presented in an interesting posture. Following the mining disaster, plaintiffs filed derivative suits to recover Massey's losses from the directors and responsible officers.[123] Thereafter, the board began to seek a merger partner because of the company's crippled financial position following the disaster, leading to a merger of the company into Alpha Natural Resources, Inc.[124] The merger agreement said nothing about the derivative suits, which passed to Alpha in the merger, thus making any judgment equally beneficial to Alpha shareholders and Massey shareholders.[125] Plaintiffs argued that the board should have valued the derivative claim separately, excluded it from its assets, and placed it in trust for the Massey shareholders.[126] Thus the case involved an action to enjoin the merger.[127] The court dismissed the complaint.[128]

In order to reach this decision, the Vice Chancellor was required to assess the derivative claims themselves, which centrally included a *Caremark* claim.[129] He had little trouble finding that the board likely had failed to "make a good faith effort to ensure that Massey complied with its legal obligations."[130] Enumerating the various red and yellow flags waived at the board, including a series of mine safety violations,

122. This latter conclusion was made by a report commissioned by West Virginia's governor. *Id.* at 492. While Blankenship's aggressiveness may have led Massey to appear to be more irresponsible than other mine operators, the history of mining regulation is one of continual challenges by operators to regulators. In 2009, 27.4% of all violations were appealed, and some estimates suggest that mine owners were litigating 67% of all significant violations and penalties. Patrick R. Baker, *The American Coal Miner, the Forgotten Natural Resource: Why Legislative Reforms Are a Viable Solution to Solving the Case Backlog Before the Federal Mine Safety and Health Review Commission Sparked by Tougher Enforcement of New Coal Mining Health and Safety Laws and Regulations*, 13 VT. J. ENV. L. 141, 143–44 (2011). Few changes were made in mine safety regulation during the preceding 30 years despite significant technological progress, *id.* at 147, and it has been argued that the rigidity of the Mine Act (and its operation as a strict liability statute) stifles the flexibility needed by operators to craft the safety solutions best suited to them. Karen L. Johnston, *The Federal Mine Safety and Health Act of 1977: Is It Suffering from a Mid-Life Crisis?*, 78 DENV. U. L. REV. 441, 452 (2001).

123. *In re Massey Energy*, 160 A.3d at 487.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.* at 497.

continued adversity to the regulatory authority, repeated flouting of mine safety rules, and increases in violations, the court concluded that "there seems little doubt that a faithful application of the plaintiff-friendly pleading standard would preclude a dismissal of [plaintiffs'] claims at the pleading stage."[131] The court noted, "a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law."[132]

Then-Vice Chancellor Strine was very careful in his articulation of his analysis. That does not change what in fact he did.

The first observation is that, in making his evaluation of the *Caremark* claims, the then-Vice Chancellor bent the line between procedure and substance. It has long been a precept of Delaware jurisprudence, clearly articulated in the passage from *Citigroup* quoted above and of course in *Caremark* itself, that courts are to review only the procedures by which the board makes its decision, and not the substance of that decision. As Chancellor Allen noted:

> What should be understood, but may not widely be understood by courts or commentators . . . is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed.[133]

Plaintiffs in *Massey* had alleged the board's failure "to make a good faith effort to ensure that Massey complied with applicable laws designed to protect the safety of miners."[134] They further alleged that Blankenship and a compliant board and management "fostered a business strategy expressly designed to put coal production and higher profits over compliance with the law."[135] Going on to challenge the board's good faith, the plaintiffs argued that, "[r]ather than respond to numerous red and yellow flags by aggressively correcting the

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131. *Id.*

132. *In re* Massey Energy Co., C.A. No. 5430-VCS, 2011 WL 2176479, at *20 (Del. Ch. May 31, 2011). At the time of the merger, the board had not made a decision as to whether to pursue the derivative claims. Without much discussion, the court appears to have concluded that they would survive Rule 23.1 pleading standards no matter what the board's decision would be or would have been. *Id.* at *21.

133. *In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996).

134. *In re Massey Energy Co.* , 2011 WL 2176479, at *19.

135. *Id.*

management culture at Massey that allegedly put profits ahead of safety, the Board allowed itself to continue to be dominated by Blankenship."[136]

Leaving aside the good faith implications of law violation for a moment, what plaintiffs appear to have been alleging is that the board made an affirmative business decision to accommodate Blankenship's policy, an observation that is bolstered by the fact that the board took no steps to terminate Blankenship as CEO until his interference with the merger led his friend and supporter, Inman, to suggest that he leave his post. The support for this behavior as an affirmative business decision is further supplied by the court's inference that the board went "through the motions" in the face of red flags, making no "good faith efforts to ensure that Massey cleaned up its act."[137] Perhaps the clearest indication that the court is actually reviewing a substantive business decision comes in the following passage describing plaintiffs' allegations: "[I]nstead of using their supervisory authority over management to make sure that Massey genuinely changed its culture and made mine safety a genuine priority, the independent directors are alleged to have done nothing of actual substance to change the direction of the company's real policy."[138]

On the other hand, Chancellor Allen in *Caremark*:

> That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests.[139]

Stepping back to look at plaintiffs' allegation, it should be apparent that the issue is one of disagreement over a business decision. There simply is no discussion of process. Indeed, in evaluating the likelihood of the claim's success, then-Vice Chancellor Strine discusses the fact that the board did in fact engage in some sort of

136. *Id.*

137. *Id.* Although the board appeared somewhat passive in the face of Blankenship's domination, it is well to remember that "the decision not to act is just as much of a decision as a decision to act." La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 341 (Del. Ch. 2012).

138. *In re Massey Energy*, 2011 WL 2176479, at *19 (emphasis added).

139. *In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996).

monitoring process, which ordinarily would lead to the failure of the oversight claim.[140] The process brought about no change, but it is standard Delaware jurisprudence to acknowledge that the failure to make changes is itself a business decision.[141] It seems evident that plaintiffs are complaining about the board's refusal to change its business policy to one more attractive to the plaintiffs. Then-Vice Chancellor Strine apparently accepted this allegation in evaluating the claim as one that would withstand a motion to dismiss.

Even if one were to find a purely process-based evaluation here, the evaluation of plaintiffs' position suggests a breach of a different core Delaware precept. The shareholder plaintiffs clearly are arguing that the business policy they would have liked the board to pursue was superior to the business policy the board actually did pursue. That is a legal posture forbidden to shareholders, even in a derivative suit. For one of the most unbreakable tenets of Delaware jurisprudence has been that it is the board, and the board alone, that makes corporate policy.[142] No matter how much shareholders may disagree, their only meaningful remedy is to replace the board with new members at the next annual election.[143] Thus the centerpiece of plaintiffs' complaint should have been a non-starter in a Delaware court.[144]

This brings me to the alleged legal violations, the hook upon which the whole opinion hangs. After all, as *Disney*, *Stone*, and other cases point out, knowingly causing the corporation to violate the law is behavior not in good faith. In light of the confluence of the duty to monitor with the duty of good faith,[145] one might reply by pointing out that the entire *Caremark* discussion is just good faith in other clothing.

And yet legal violations are really not the issue here. That is where the good faith argument fails as a matter of reality. It is also where the Vice Chancellor bent the legal risk-business risk barrier laid out in *Citigroup*. The deaths of the miners, and thus the lion's share of the losses suffered by Massey, were the result of the mine explosion,

140. *In re Massey Energy*, 2011 WL 2176479, at *20.
141. *See, e.g.*, *La. Mun. Police Emps.' Ret. Sys.*, 46 A.3d at 340–41.
142. *In re* Time Inc., C.A. No. 10670, 1989 WL 79880 (July 14, 1989).
143. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).
144. The court discusses the shareholders' role in electing directors in the context of an assessment of the legitimate losses they can claim to have suffered, suggesting the "justice" of shareholders suffering losses having experienced super-normal gains as a result of Massey's bad short-term behavior. *In re Massey Energy*, 2011 WL 2176479, at *29 n.185.
145. Oklan, *supra* note 3.

not a violation of law in the manner contemplated by *Caremark* and *Stone*. In fact, the Vice Chancellor recognized that the directors and officers "could face large liability claims" based on lost mining *profits* as well as settlements with miners' families and fines.[146] Lost mining profits are not regulatory fines or criminal penalties. They are not, at least here, the result of legal penalties. Moreover, mine safety regulations, while they have the teeth of law behind them are based, among other things, on best industry practices.[147] Those practices would exist regardless of whether they were articulated as matters of positive law. It was the decision to save money by cutting corners on safety standards that led to the mine disaster, not regulatory violations.

The *Massey* losses are conceptually and practically different from corporate losses arising from the payment of criminal or regulatory penalties, as was the case in *Caremark* and *Stone*. To see this, imagine if federal mine safety regulations were more lax than they were, permitting practices that were sub-optimal and posing greater risk to miners. This is entirely plausible, and it is in fact the daily work of regulatory agencies to make assessments of the costs and benefits of regulation. Suppose federal mine safety rules exposed miners to at least some of the dangers present at the Upper Big Branch mine. Assume that Massey fully complied with these regulations. Or suppose there were no regulations at all and Massey pursued an aggressive cost-cutting policy leading to underinvestment in ideal (but not legally-mandated) safety conditions. In either of these cases, the explosion may have happened anyway. If so, the same workers would have died, the same claims would have been made by survivors, the same loss of profits would have occurred, and the company would have suffered the same reputational damage. In fact, looking beyond

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146. *In re Massey Energy*, 2011 WL 2176479, at *29 n. 185; *see also* Verified Amended Shareholder Derivative Complaint at 51, New Jersey Bldg. Laborers Pension Fund v. Blankenship, 2011 WL 2176497 (Del. Ch. 2010) (No. 5430-VCS), 2010 WL 2771297 at ¶¶ 139, 141 (consistent failure to address poor safety conditions of mines leading to, among other things, reputation loss and loss of shareholder value, violations of company's internal policies, and severe reputational harm); Verified Shareholder Consolidated Derivative Complaint at 2–3, 79, *In re* Massey Energy Co. Derivative Litig. (Del. Ch. 2011) (No. 5430-VCS), 2011 WL 190841 at ¶ 1 (board conscious of putting profits over safety), ¶ 2(severe reputational harm and loss of shareholder value), ¶ 173 (disregard of internal as well as external safety regulations), ¶ 174 (board endorsed "patently unsafe work conditions in order to minimize cost and maximize output"); Verified Shareholder Third Amended Derivative and Class Action Complaint at 31, *In re* Massey Energy Co., 2017 WL 1739201 (Del. Ch. 2017) (No. 5430-VCS), 2011 WL 2028545 at ¶ 80 (lost profits from damaged mine).

147. 30 U.S.C. § 811(a) (West 1979).

the legal context, the then-Vice Chancellor himself implicitly recognized this: "Subterranean mining will never be a risk-free or entirely clean business. That is a reality . . . ."[148] Seen this way, the real importance of the mine safety regulations at issue in *Massey* was to fit the case into a *Caremark* framework. The risks undertaken by the company were business risks, not legal risks. The losses were a result of risky business.[149]

Any doubt that a business decision, and hence business risk, was at issue was laid to rest by Chancellor Bouchard in the most recent iteration of the case decided in May 2017. Dismissing the derivative litigation for plaintiffs' loss of standing as a result of the merger, the Chancellor quoted plaintiffs' characterization of the fiduciary breach as defendants' "causing Massey to employ a deliberate and systematic business plan of willfully disregarding both internal and external safety regulations," and noting that the allegations "would state a viable derivative claim for relief under *Caremark*."[150]

To be sure, one cannot say what the analysis of the lawsuit would have been in the absence of a regulatory regime. Perhaps the legal violations were a necessary hook to allow the court to find likely bad faith without appearing to violate fundamental doctrinal principles of Delaware jurisprudence. One wonders, however, whether a contemporary court would really permit directors to escape liability for causing workers' deaths with the constructive knowledge that their business plan was likely to do just that. Such a posture might have passed muster in a 19th century court, but surely not today.

Shorn, then, of doctrinal rhetoric, *Massey* engaged in an evaluation of the very type of business risk the *Citigroup* court so pointedly rejected as part of Delaware jurisprudence. Then-Vice Chancellor Strine did the right thing and, in so doing, provided a means of infusing *Caremark* with meaning and giving teeth to the notion of a monitoring board. *Massey* makes business risk reviewable.

While *Massey* belongs in its own category as a case decided by a Delaware court, another case applying Delaware law to a *Caremark* claim is instructive because of its similarity to *Massey*. *Intuitive*

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148. *In re Massey Energy*, 2011 WL 2176479, at *23.

149. This is true even in the case of the miners' survivors' damages claims. Businesses regularly evaluate the balance between risk, even to life, and profitability, as then-Vice Chancellor Strine observed in *Massey*. Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 984 (2009).

150. *In re* Massey Energy Co., 160 A.3d 484, 487–88 (Del. Ch. 2017).

Surgical involved plaintiffs' allegations that the board knew that its principal product was defective, took no steps to correct the defect, and violated FDA regulations by engaging in covert (unreported) recalls.[151] Sustaining the complaint against a Rule 23.1 motion to dismiss,[152] the court identified the damages plaintiffs sought: "Defendants' misconduct harmed Intuitive's reputation; damaged its goodwill with the medical community, commentators, the press, and the public; and resulted in a decline in stock price, revenue, and sales for Intuitive."[153]

None of these damages are regulatory but are, instead, clear business losses. Like the losses in *Massey*, Intuitive suffered these alleged losses in the presence of a regulatory regime. But the losses plaintiff alleged could just have well been sustained in the absence of such regulation. If Intuitive had concealed its product defects (resulting in loss of life) from the medical community, the public, the scholars, the commentators, and the press, precisely the same damages would have arisen upon the ultimate revelation of the defects and concealments.

Caremark jurisprudence already incorporates review of the board's failure to monitor business risk. All the courts have to do is recognize this and make it explicit.

E. Discussion

I'm not so innocent as to suggest that *Massey*, taken alone, represents a change in Delaware jurisprudence. *Massey* was an easy case. The company's business policy, at least as articulated by the court, appears to have been despicable. There were indeed violations of law. And the Vice Chancellor did not actually have to rule on the *Caremark* claim itself, only that the allegations in the complaint were sufficient to survive a motion to dismiss, thereby giving the derivative claims at least some potential value in the merger.

There is something far more important that the case does represent. *Massey* suggests that, when pressed by facts it finds sufficiently compelling, a Delaware court can do all of the things that *Caremark* jurisprudence says it cannot do. It can consider a business

151. *In re* Intuitive Surgical., 146 F. Supp. 3d 1106 (N.D. Cal. 2015).

152. This refers to Federal Rule 23.1, not Delaware Rule 23.1, but the court applied Delaware law in its analysis.

153. *In re Intuitive Surgical*, 146 F. Supp. 3d at 1114.

decision as a business decision. It can even pass judgment on that decision. Looking past doctrine to damages in *Massey* and the blended cases paves a way forward to developing doctrine that has the potential to give real teeth to the duty to monitor and to make monitoring a meaningful directorial occupation.

Nothing in the nature or function of the monitoring board would lead to the conclusion that its only monitoring function is to monitor legal risks. The doctrinal limitation to legal risks is disappointing and inconsistent with reality. After all, just as judges are not business experts, directors are not legal experts. Perhaps legal risks are the most externally obvious and easy to identify causes of significant corporate financial loss, but neither the Delaware General Corporation Law nor the ALI Principles of Corporate Governance, which laid out the case for, and established, the modern monitoring board, limit the board's responsibilities to monitoring legal risk.[154] Delaware's statute simply states that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."[155] The mandate of the board is powerful and broad, giving it the sole responsibility for business decision-making.[156] Limiting the board's legal responsibilities (or at least the extent of its enforceable responsibilities) to monitoring legal risk seems, at a minimum, rather inconsistent with its statutory and judicial mandate.

Moreover, the board has changed from the time of *Graham v. Allis-Chalmers* and even *Caremark*. Not only has it changed from managing to monitoring, but it has also evolved from a pastime to a real paying job. When *Caremark* was decided, corporate directors earned median base compensation of $33,750 in manufacturing companies, $31,700 in non-financial services companies, and $30,200 in financial services companies.[157] Median stock option grants were $45,000.[158] Median director compensation at the Fortune 500 companies was $260,200 in 2016 (with cash compensation of

154. DEL. CODE ANN. tit. 8, § 141(a) (2016); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (AM. LAW INST. 2008).

155. DEL. CODE ANN. tit. 8, § 141(a) (2016).

156. *See generally* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

157. KAY WORELL, CORPORATE DIRECTOR'S COMPENSATION IN 1997: A RESEARCH REPORT (The Conference Board 1998).

158. *Id.*

$105,000).[159] Whatever the legitimacy of the court's unsubstantiated fear of insufficient qualified board candidates may have been, board members today are paid real money. In fact an outside director's income solely from a Fortune 500 board seat puts him (or sometimes her) in the top 6.6% of American household income.[160] While it is true that board members are expected to have some expertise in business (although the famous exonerated Disney board gives something of the lie to that frequent assertion), I suspect that there are many highly intelligent business and finance professionals with incomes far below that of the typical board member who, with a little training, could serve as competent directors and who might have the incentive to do so because the money would actually mean something to them.

After all, a corporation's legal department, working perhaps with an outside legal auditor just as its financial department works with an outside auditor, ought to be able to do a better and more comprehensive job than the board does, certainly better than is expected under the *Caremark* standard. Why not simply leave in place a CEO, monitored by securities analysts and outside experts, and save us all the trouble, expense, and litigation of a board in the first place?

One reason that is often repeated is that somebody is needed to monitor the CEO. The previous paragraph gave one possibility for accomplishing this goal without a board. Another possibility is the web of external regulations in which the board is embedded, suggesting compliance regimes and their internal compliance requirements provide a new, if troubling, form of corporate governance,[161] which would focus on legal risk. But the realization of legal risk is hardly the only way for a corporation to lose money.

The argument is often made that directors are part time workers (although with significantly higher incomes than most part-timers), with full time day jobs and little time to attend to the corporation's affairs. Whatever the legitimacy of this argument in 1963 or even 1996, the world has changed. Contemporary directors can do so much

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159. *Compensation for Outside Corporate Directors Stabilizing, Willis Towers Watson Study Finds*, WILLIS TOWERS WATSON (July 27, 2017), https://www.willistowerswatson.com/en/press/2017/07/compensation-for-outside-corporate-directors-stabilizing.

160. *Percentage Distribution of Household Income in the United States in 2016*, STATISTA (Sept. 2017), https://www.statista.com/statistics/203183/percentage-distribution-of-household-income-in-the-us/.

161. Griffith, *supra* note 3.

more in the limited time available. This observation brings me to the second aspect of *Caremark's* promise.

II. THE JURISPRUDENCE OF RED FLAGS

A. The Issue

There are two kinds of red flags present in the cases: internal red flags and external red flags.[162] As in the case of business risk, Delaware jurisprudence already implicitly incorporates the breadth of red flags necessary to realize *Caremark's* potential. Understanding the differences between the two kinds of flags and the relevance of those differences is important to evaluating what directors knew or should have known about corporate problems and to developing the kind of comprehensive doctrine that achieves the level of directorial responsibility at which *Caremark* purports to aim.

In accepting *Caremark* as Delaware law, the Supreme Court interpreted its standard of knowing indifference to require that directors have actual rather than constructive knowledge of the corporate conduct at issue in order to sustain liability.[163] Because the situation of each director is likely to be different and liability appears to turn on an individual state of mind, the court describes this as requiring a subjective evaluation of each director's scienter.[164]

The actual knowledge requirement is doctrinally a little peculiar. *Caremark* itself was a reaction to the earlier *Allis-Chalmers* case in which the court absolved the board of a duty of inquiry in the absence of their knowledge or constructive knowledge of any wrongdoing.[165] *Caremark* imposed a duty of monitoring that would ensure, or at least make more likely, that information about internal illegal conduct would reach the board, thus replacing the don't ask don't look incentive established by *Allis-Chalmers* with a requirement to have information transmission systems in place and to monitor those systems.[166] In this respect it was a significant advance beyond *Allis-Chalmers*. Yet the knowledge requirement has returned.[167] *Caremark*,

162. *See infra* notes 163–172 and accompanying text.
163. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006).
164. *Id.*
165. Arlen, *supra* note 3.
166. *Id.*
167. *Stone*, 911 A.2d at 370.

at least in theory, makes it more likely that the board will acquire knowledge.

Doctrinally, this knowledge requirement derives from the notion of bad faith. In *Stone v. Ritter* the court identified two kinds of bad faith in the context of oversight liability. The first is found when a board "utterly failed to implement any reporting or information system or controls."[168] The second occurs when directors' conscious failure "to monitor or oversee" the operations of the monitoring system prevents them from being informed.[169] "In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations,"[170] in other words, scienter.[171]

A plaintiff can satisfy the knowledge requirement, at least sufficiently to withstand a Rule 23.1 motion to dismiss, by pleading with particularity the presence of red (and sometimes yellow) flags which should have alerted directors to the presence of wrongdoing, or

168. *Id.*

169. *Id.*

170. *Id.*

171. I do not explore the meaning of good faith in depth in this paper because the Delaware courts' reduction of the concept to scienter in oversight cases seems well-established (and because my discussion of red flags jurisprudence reveals the potential expansion of the boundaries of scienter), conversance with the debate about its meaning during the evolution of the concept as judicially applied provides helpful context for understanding the relatively reductive nature of its understanding by the courts. The literature on good faith is substantial, although diminished after the Delaware Supreme Court's limitation of the concept in *Stone*. *See* Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131 (2006) (exposing good faith as one of several complicating factors leading to jurisprudential confusion and complexity); Claire A. Hill & Brett H. McDonnell, Stone v. Ritter *and The Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769 (2007) (using good faith to expand the spectrum of fiduciary obligation): Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2007) (exploring the manner in which good faith could be used to overcome intractable structural bias problems); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004) (drawing on scienter to give good faith functional meaning); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006) (engaging in a careful analysis of the meaning of good faith and arguing for its normative desirability as a matter of Delaware jurisprudence); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005) (analyzing good faith as a rhetorical device rather than a substantive standard); Leo Strine et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporate Law*, 98 GEO. L.J. 629 (2010) (examining good faith's place in Delaware jurisprudence and noting the expansion of the duty of loyalty beyond conflict claims and defining it as the negative duty not to act in bad faith); Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441 (2007) (contrasting meaning of good faith with "not in bad faith" and arguing that significant substantive consequences follow from the language); Elizabeth A. Nowicki, *A Director's Good Faith*, 55 BUFF. L. REV. 457 (2007) (working to provide a definition of good faith that enhances board accountability).

at least sufficient evidence thereof to have stimulated them to attend to their monitoring machinery.

While the court has separated flags by color, it has overlooked a more fundamental difference in the nature of the information that would underlie them; internal and external information.

This is understandable. After all, the goal of *Caremark* internal monitoring systems is to discover wrongdoing within the corporation, for that is where liability-creating activity occurs. But information about the corporation and potential wrongdoing often is generated outside the corporation as well, information that is relevant both to regulatory losses and to business losses.

The first type of information, internal information, is generated within the corporation, through the conduct and behavior of employees in the ordinary course of business, and ideally flows up to the board through the monitoring mechanisms required by *Caremark*. Members of the board typically learn of this kind of information at board meetings and committee meetings.

The second type of information is external information. External information originates in newspaper articles, government and regulatory investigations and reports, television news and documentaries, social media like LinkedIn postings, and the like. Members of the board currently learn of this kind of information in the same manner as does the general public.

One might expect that directors should be required to be more attentive to internal information, given their responsibility to monitor the corporation. But, for reasons I will discuss, the contemporary monitoring board's structure and modern technology lead to the conclusion that members of the board should be required to be more attentive to external information.

My analysis proceeds in three steps. First is an examination of the cases, demonstrating the unacknowledged presence of both types of red flags. Then I will explain why the board is more likely to be better informed by external information than internal information in the case of a misbehaving corporation. Finally, I will discuss the board's ability to channel and receive that information as easily (if not more so) as it can obtain internal information.

B. The Cases

The few cases in which *Caremark* claims survive a Rule 23.1 motion to dismiss are instructive. *In re China Agritech, Inc.*[172] involved a company that essentially was a fraudulent operation for the benefit of its founders. This *Caremark* claim survived largely because the Audit Committee and the board were dysfunctional. Yet the Audit Committee undertook a formal (if ultimately insufficient) investigation of allegations made, among other places, in an externally-generated report by a "self-described consultant and private investor with more than ten years of business experience" in China and Southeast Asia.[173] Published on the website www.seekingalpha.com, the report went into great detail describing the absence of any meaningful business and operations of the company.[174] While the board appears to have been sufficiently corrupt as to need no red flags, and while its investigation of this report was cursory and appears to have been predetermined, the report was significant to the plaintiff's establishment of a well-pleaded complaint.[175]

In *Rich v. Chong*, another case surviving a motion to dismiss, one of three actionable red flags was an externally-generated NASDAQ letter threatening the company with delisting if it failed to bring its internal systems up to SEC requirements.[176] In *Saito v. McCall*, a substantial portion of the defendant board members were put on notice following information discovered during due diligence of its merger partner, information arguably generated internally but not information that would have arisen through the kind of monitoring systems contemplated by *Caremark*.[177] In *Pyott*, one of the most significant red flags that the court said should have put the board on notice of internal wrongdoing was information provided by the FDA to the company about the activities of an outside sponsored speaker at company-held

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172. 2013 WL 2181514 (Del. Ch. May 21, 2013).

173. *Id.* at *4.

174. *Id.* at *4–5.

175. *In re China Agritech* is, admittedly, an imperfect case for an example because so much bad conduct was going on internally. At the same time, it is only in those cases of really bad conduct that Rule 23.1 dismissal motions are sustained.

176. Rich *ex rel* Fuqi Int'l v. Chong, 66 A.3d 963, 984 (Del. Ch. 2013).

177. Saito v. McCall, No. CIV.A. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004), *overruled by* Lambrecht v. O'Neal, 3 A.3d 277 (Del. 2010).

dinners.[178] In *Massey*, the court cited newspaper accounts of the company's bad behavior as well as an official West Virginia report issued after the mining disaster blaming Massey's management for the event and government (externally generated) citations.[179] In *Abbott Depakote*, the district court, applying Delaware law, identified externally-generated red flags that included a letter from the US Department of Justice to Abbott's law department informing it that the DOJ was investigating its off-label marketing of Depakote, directing the company not to destroy documents, and informing it that the DOJ planned to issue subpoenas.[180] The court treated these subpoenas as a second red flag and noted that these two "new" red flags (newly pleaded after the court's Rule 23.1 dismissal of an earlier complaint) had been waved in the board's face "or displayed so that they are visible to the careful observer."[181]

A final example is *Intuitive Surgical*, another case surviving a Rule 23.1 motion to dismiss, where the court relied on red flags that were indisputably external.[182] The company had violated FDA regulations by, among other things, failing to file required FDA reports regarding complaints of defects in its leading product, and plaintiffs alleged that the defendants, including the outside directors, both knew of the defects and "authorized or turned a blind eye to three covert corrective actions" undertaken by the company.[183] The plaintiff pled three red flags; two scholarly articles published in medical journals reporting on the product failure, and 95 products liability suits against the company.[184] The court concluded that "it is reasonable to infer that scholarly studies evaluating the da Vinci system and its performance would be known by the board."[185]

178. L.A. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313 (Del. Ch. 2012) (FDA letters were significant red flags in a parallel federal case applying Delaware law).

179. *In re* Massey Energy Co., C.A. No. 5430-VCS, 2011 WL 2176479, at *7–8 (Del. Ch. May 31, 2011).

180. *In re* Abbott Depakote, No. 11 C 8114, 2013 WL 2451152, at *3 (N.D. Ill. June 5, 2013).

181. *Id.* at *7. A *Caremark* claim survived a Rule 23.1 motion to dismiss in *Saito* on grounds that the directors had actual knowledge of financial irregularities. In an earlier iteration of the case, Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000), the complaint was dismissed without prejudice. I will discuss the red flags at issue below because they technically appeared in a dismissed case.

182. *In re* Intuitive Surgical, 146 F. Supp. 3d 1106, 1116 (N.D. Cal. 2015).

183. *Id.* at 1111.

184. *Id.* at 1116.

185. *Id.* at 1117.

One can wonder whether a Delaware court would go so far as to hold outside directors responsible for knowing the contents of scholarly medical journals. But that is not important to *Intuitive's* relevance. Relevant is the fact that the court saw no need to distinguish between internal and external red flags, implicitly acknowledging that the board is responsible for noticing material information about the company regardless of source.

These examples are of red flags in the few cases where the board's behavior was sufficiently egregious to support a *Caremark* complaint beyond the pleading stage. It is hard to know how significant they might independently have been because the patterns of misbehavior and corruption in which they were embedded were so severe that it would have been hard for a responsible court to have dismissed them.

Cases dismissed at the pleading stage where such pervasive misconduct was lacking follow a similar pattern of including external and internal red flags. For example, the court in *Horman v. Abney*[186] identified four red flags.[187] Two of these were internally generated, but two were external—an Assurance of Discontinuance Agreement imposed by the State of New York and allegations from the City and State of New York that the company was not in compliance with the AOD.[188] The court made no distinction as to the relative relevance of the internal and external red flags, dismissing the complaint because the board had in fact taken action in response to them.[189] In *Dow Chemical*, an external red flag was a publicly alleged bribery charge.[190] The court, without commenting on its external origin, dismissed it as "not a 'red flag'" because of the unreliability of the source.[191] All of the alleged red flags in *Citigroup* were external, including newspaper articles, a *Bloomberg* report, credit-rating downgrades by Standard and Poor's and Moody's, and a Freddie Mac announcement, among others.[192] While concluding that the alleged red flags had no specific connection to Citigroup and therefore were

186. C.A. No.12290-VCS, 2017 WL 242571 (Del. Ch. 2017).
187. *Id.* at *10.
188. *Id.* at *3, *10–14.
189. *Id.* at *14–15.
190. *In re* The Dow Chemical Co., No. 4349-CC, 2010 WL 66769, at *12–13 (Del Ch. Jan. 11, 2010).
191. *Id.*
192. *In re* Citigroup Inc., 964 A.2d 106, 115, 128 (Del. Ch. 2009).

insufficient to support scienter, the court made no distinction between the sources of these red flags and internally generated information.[193]

All of the red flags in *Melbourne* were external, consisting of investigations and the imposition of significant penalties by the Korean and Japanese antitrust authorities.[194] Interestingly, Vice Chancellor Montgomery-Reeves somewhat ambiguously observed that she did not need to decide whether these matters actually constituted red flags because plaintiffs had failed adequately to plead that the Qualcomm board's response constituted bad faith.[195] She went on to analyze the complaint on the assumption that they were red flags.[196]

Four red flags were pleaded in *Ash v. McCall*,[197] three of which were external and consisted of a *Bloomberg* report, two reports by an independent institutional investor research organization, and articles in *The Atlanta Constitution*.[198] The court again did not distinguish between the sources of the red flags, dismissing the complaint because they were overcome by "green flags," positive reports to the board by its accounting firm and investment bank, on which the court held the board was entitled to rely.[199]

The distinction between internal information and external information is an important one if *Caremark* jurisprudence is to realize its potential. Contrary to what might be expected, I will argue that a requirement that directors pay attention to external red flags at least as much as internal red flags is more likely to lead to meaningful monitoring. I don't at all dismiss the duty to monitor internal information. After all, this is the kind of information that the board is meant to access through internal monitoring systems. But for reasons I will discuss, it may well be that external information is more reliably

193. The court did note that the alleged red flags were little more than "public documents," but the importance of this observation goes to the fact that they "reflected the worsening conditions in the subprime mortgage market and in the economy generally" and did not specifically address Citigroup's situation. *Id.*

194. Melbourne Mun. Firefighters' Pension Tr. Fund *ex rel.* Qualcomm, Inc. v. Jacobs, No. 10872-VCMR, 2016 WL 4076369, at *3–4, *8 (Del. Ch. Aug. 1, 2016), *aff'd,* 158 A.3d 449 (Del. 2017).

195. *Id.* at *9.

196. *Id.*

197. Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341, at *4 (Del. Ch. Sept. 15, 2000).

198. *Id.*

199. *Id.* at *9–10.

available to the board. It is also technologically rather easily accessible.

C. Structural Holes and Information Blockage

I begin by repeating the observation that the average public board today is an independent monitoring board, in contrast to the managing boards that sat prior to the 1980s.[200] This difference marks an important distinction in directors' access to information. In an earlier study I explored the theory of structural holes to show how the composition of a board affects information control and access.[201] In a board composed of a mix of inside and outside directors, information flows to outside directors both through the CEO and through board insiders. These inside directors have their own independent sources of information deep within the corporation as a result of their day-to-day work and are not solely reliant for their information on the CEO. While circumstantial reasons might exist in certain cases for insiders to restrict the information they are willing to give their outsider colleagues,[202] it is theoretically possible, and indeed probable, that information flows at least somewhat horizontally around the board.

In contrast, with a board composed of outsiders except for the CEO, information flows to outside directors only one way: through the CEO himself. Boards will receive reports from corporate employees, but those employees are unlikely to have the kind of independent relationships with outside directors that board colleagues will have with one other, and are unlikely ever to stray from the script approved by the CEO.[203] It is, therefore, probable that the information available to outside directors will be more controlled and constricted in outsider boards than in insider boards.

AIG presents a case in which cooperation in the active internal concealment of information by the CEO[204] was probably necessary for the insiders to sustain their fraudulent schemes.[205] Even a case devoid

200. Gordon, *supra* note 8, at 1465, 1475.

201. Lawrence E. Mitchell, *Structural Holes, CEOs, and the Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313 (2005).

202. The fear of being fired might be one.

203. Fear of firing again presents itself.

204. Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763, 774, 795–96 (Del. Ch. 2009).

205. In Desimone v. Barrows, 924 A.2d 908, 916–17 (Del. Ch. 2007), the two insiders on the board were not recipients of the options at issue.

of evidence of actual wrongdoing, like *Citigroup*,[206] presents a situation where insiders might prefer to prevent outside directors from being fully-informed of their activities.[207]

The distinction between types of red flags and the problem of structural holes is nicely illustrated by *Sandys v. Pincus*. Shortly after the company completed its IPO, it requested that its underwriters waive their lockup provision so that certain employee-shareholders (including directors) could participate in a secondary offering of the stock.[208] It so happened that, at the time of the request and the secondary offering, these insiders allegedly knew that the company's financials significantly overstated its financial performance.[209] When the company restated its financials, the stock price dropped 81 percent over a six-month period.[210] In dismissing the complaint, the court noted that the outside directors had not been given the relevant financial information.

Of course not. If the insiders had disclosed the company's true financial condition to the outsiders as they prepared to sell their stock in a secondary offering that significantly overpriced the shares, it is likely that a responsible board would have prohibited the offering. While *Sandys* and *AIG* are extreme, they are good illustrations of the problems that outside directors can face when seeking information on an almost completely outsider board. Internal information may be concealed and thus unavailable. As the cases surveyed in Part II.b illustrate, external information may be more plentiful and reliable.

This analysis shows that it may be more likely that directors on independent boards will be put on notice of wrongdoing by external red flags than by internal red flags. It is for this reason that I argue that boards should be held to a higher explicit expectation of *Caremark* good faith notice by external information. As was true with respect to

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206. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 129 (Del. Ch. 2009).

207. One reason might be compensation incentives, as in the *Goldman* case. *In re* The Goldman Sachs Grp., Inc. S'holder Litig., No. CIV.A. 5215-VCG, 2011 WL 4826104, at *1 (Del. Ch. Oct. 12, 2011). *Citigroup* didn't squarely place the issue of compensation on the table but it is reasonable to think that the employee compensation schemes in the two corporations were not dramatically different.

208. Sandys v. Pincus, No. 9512-CB, 2016 WL 769999, at *3 (Del Ch. Feb. 29, 2016), *rev'd*, 152 A.3d 124 (Del. 2016).

209. *Id.*

210. *Id.* at *4. As I noted in Part I, it is interesting to observe that the nature of the derivative damages claimed by plaintiffs was unclear.

the business decisions I discussed in Part I, the tools already exist in the cases.

The importance of holding outside directors responsible for external red flags is underscored by an observation made by the Delaware courts themselves. Wrongdoers generally don't leave paper trails.[211] This undoubtedly correct observation suggests yet another limitation on the utility of internally-generated information. If *Caremark* is to have real teeth or, to put it differently, if the duty to monitor is to mean something, it seems as if external red flags are the avenue by which this will happen.

D. The Duty to Monitor in a World of Information

The realization that external red flags may provide more and better information to independent directors than internal red flags leads to further analysis. Courts frequently repeat the assertion that independent directors have limited time to give to corporate affairs. It is possible that this observation would lead them to demand less of directors with respect to external red flags, no matter how much better and more available is this kind of information.

Delaware courts have not done this, in part perhaps because they have not acknowledged the distinction. But the analysis is important. I certainly do not mean to discourage Delaware courts from expecting directors to rely on external red flags. But there is no reason for them to be discouraged, even on the assumption that independent directors have limited time because, as I shall argue, limited time is all it would take for independents to inform themselves of external red flags. Thus the facts argue for an enhanced duty to monitor external red flags.

It is important to be precise about what a heightened requirement that directors attend to external red flags would mean. Chancellor Chandler wrote in *Citigroup* that *Caremark* requires directors to ensure that "reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that

211. *See, e.g.*, La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 357 (Del. Ch. 2012) ("[S]adly, sophisticated corporate actors at times engage in illegal behavior and attempt to hide their misconduct with the appearance of legal compliance."); Am. Int'l Grp., Inc. v. Greenberg, 965 A.2d 763, 795 (Del. Ch. 2009) ("That inference is that those who engage in sophisticated forms of financial fraud do their best not to leave an obvious paper trail. Rather, consistent with their improper objectives, those at the top of such schemes try to conceal their roles and not leave marked paths leading to their doorsteps.").

could cause losses for the Company."[212] This is an objective inquiry that necessarily looks at the world beyond doctrinal doors. And judicial review of corporate monitoring systems is procedural. Courts generally do not evaluate whether the system is a good one or not.[213] That would be a violation of fundamental principles of Delaware law.[214] Judicial review of the procedures by which a board adopted an external red flag monitoring system would be consistent with Delaware process jurisprudence.

The review of the reasonableness of reporting and information systems is a matter of process. Directors' scienter necessary to sustain a *Caremark* claim is said to be a subjective evaluation of directorial intent. The two connect where the presence of a reasonable reporting and information system brings red flags to directors' attention, red flags which they then disregard at their peril. One can, therefore, attribute scienter only to directors who one reasonably would have expected to see red flags and act upon them.[215]

What may be considered "reasonable" changes over time. Behavior that might be considered reasonable in one age may no longer be considered reasonable as human knowledge and technology develop. Thus, the reasonable driver in control of a 1920 Model T on the roadways of that time would perhaps be forgiven for conduct considered unreasonable by the driver of any modern automobile on any modern city street or highway. A reasonable manufacturer of canned food products at the turn of the twentieth century undoubtedly faced a different concept of reasonableness than would a similar manufacturer today.

The same might be true for corporate directors, but the courts of Delaware have developed the jurisprudence of red flags without explicit regard to changes in its own analogue of automotive and food safety, the world of information. I don't think it requires proof to say that this world has changed dramatically since *Caremark* was decided.

A reasonable reporting and information system in 2017 should be expected to be based upon these technological developments. Given

212. *In re* Citigroup Inc., 964 A.2d 106, 131 (Del. Ch. 2009).

213. *See, e.g., In re* Caremark Int'l Inc., 698 A.2d 959, 970 (Del. Ch. 1996) ("Obviously the level of detail that is appropriate for such an information system is a question of business judgment.").

214. *See id.* (referencing the business judgement rule).

215. That is to say, if the red flags were waved in the director's face. Wood v. Baum, 953 A.2d 136, 143 (Del. 2008).

the importance of external red flags in keeping directors informed, directors should be charged with the responsibility of taking advantage of this new technology.

The counter argument will almost certainly be the standard one: we do not want drivers and food processors to take risks with our safety. We do want directors to take risks. But the objection is incomplete. Even with respect to drivers and food processors, we balance our desire to diminish their risk-taking with the realities of the activity. We want people to drive, so we determine an optimal level of safety by roughly calibrating the cost of diminished risk to a point beyond which the activity is diminished to unacceptable levels. So too, with food processors. So too, with directors.

All that courts need to do is to balance the risks in light of the realities. And the job of Delaware courts in evaluating the manner in which boards balance this risk in their specific corporate contexts is probably considerably easier than in other tort contexts. While driver liability and products liability look to the actual substance of behavior, all Delaware courts really need to do is to look at the board process by which its reporting and information systems are designed. If the process is reasonable in light of the corporation's business, regulatory environment, and overall risk profile, then the inquiry is complete and the directors are absolved, unless of course red flags put directors on notice of corporate wrongdoing.

Embracing this reality changes the cost calculus and provides a path towards making monitoring more meaningful. A single information officer or corporate librarian can easily be tasked with creating a system that automatically captures newspaper and regulatory agency announcements about their corporations.[216] While some companies receive more public attention than others, the labor is essentially the same and the work is performed automatically and mechanically. From a corporate perspective, the accumulation of this information is nearly costless.

But that is not the objection. The objection would be that busy directors have no time to read the information. This objection is considerably overstated. In the first place, most corporations just don't receive that much press. While Apple generated more than 1,150,000

216. It is almost certainly the case that corporations already designate this responsibility to one or more corporate employees.

Google entries in 2016, Publix Super Markets generated only 5,020. This may seem like a lot, but a quick tour through the first 10 pages or so of Google results for Apple showed nothing that might be relevant to a director. Moreover, it is reasonable to assume that any news of real importance will eventually find its way to the major national papers and the principal local papers where the corporation does business, thus diminishing the number of sources directors could be expected to read. Sorting mechanisms established by a corporate librarian would presumably winnow these down considerably. Finally, a glance at the headline and the lede paragraph of any article should readily allow a director to decide whether it is necessary to read more. The amount of labor that is likely to be required is hardly unreasonable to expect for a director earning the Fortune 500 average of $260,000.[217]

It is not my purpose to prescribe the kinds of external information reporting systems that any given corporation will adopt, for surely that will change with the specific corporation and depend upon factors like its size, the nature of its industry, the extent of its regulatory regime, the geographical scope of its operations and its sales, and the like. A reasonable reporting and information system for Apple will likely be different from a reasonable reporting and information system for Publix Super Markets, as will a reasonable reporting and information system for a corporation in a regulated industry like Caremark. The judicial evaluation of what is a reasonable monitoring system for external information should focus on the same kinds of board processes as are used for evaluating the reasonableness of monitoring systems for internal information.

The concept of "reasonable" has changed. Delaware courts should acknowledge this and incorporate it into their jurisprudence.

Wal-Mart Stores illustrates the ease and importance of acquiring this kind of information.[218] When *The New York Times* reported on an alleged bribery scheme at Wal-Mart, derivative suits were filed in Arkansas and Delaware.[219] The Delaware plaintiffs did their homework by demanding access to Wal-Mart's books and records.[220]

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217. *See* Chris Morris, *Pay Raises for Corporate Board Members Far Outpace Average Americans'*, FORTUNE (Oct. 18, 2017), http://fortune.com/2017/10/18/board-of-directors-pay/.

218. *In re* Wal-Mart Stores, Inc., No. CV 7455-CB, 2016 WL 2908344, at *21 (Del. Ch. May 13, 2016), *supplemented*, 167 A.3d 513 (Del. Ch. 2017).

219. *Id.* at *1.

220. *Id.*

The Arkansas plaintiffs were less diligent and, before the Delaware plaintiffs had arrived at the pleadings stage, were dismissed on a Rule 23.1 motion by the Arkansas court.[221] The Delaware defendants moved to dismiss the complaint on the ground of issue preclusion.[222]

Among the questions addressed by the Delaware court was whether an Arkansas court would consider a plaintiff who failed to demand corporate books and records before filing a derivative suit to be an adequate corporate representative.[223] Ruling from Delaware law, the court decided that an Arkansas court would not view such a plaintiff as inadequate, contributing to its decision to dismiss the complaint based on issue preclusion.[224]

In light of Delaware's repeated and sometimes strident admonitions "to use the tools at hand" to ensure that derivative suit pleadings are sufficiently particular, this ruling seems strange. But the court seemed to recognize that the tools had changed. The Arkansas plaintiffs had not sought books and records from the corporation.

"But, as their counsel attests, crucial excerpts from a number of key documents underlying the *New York Times* article were available on the article's webpage."[225] In her view, these underlying documents "provided sufficient particularized allegations to surmount the demand futility hurdle."[226] "Several of the documents from the article's webpage were featured in both complaints, including one of the most crucial excerpts from Wal-Mart's internal reports—the statement that 'there is reasonable suspicion to believe that Mexican and USA laws may have been violated.'"[227] The court continued, "Plaintiffs found that statement important enough to quote it nine times in the Delaware Complaint and to feature it in their supplemental briefing as well."[228] "This key phrase was included in the excerpts on the *New York Times* website and was relied upon extensively in the Arkansas Complaint."[229]

221. *Id.*
222. *Id.*
223. *Id.*
224. *Id.*
225. *Id.* at *21.
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*

The Arkansas plaintiffs had not used the traditional "tools at hand," the very same tools available at the time of *Caremark*.[230] Indeed the court remarked that perhaps it would have been better for the plaintiffs to have done so, apparently limiting that phrase to refer to Delaware section 220.[231] But, in an implicit recognition that the tools have changed, the court concluded that the Arkansas plaintiffs were nevertheless adequate class representatives.[232]

III. CONCLUSION

As others have observed, the corporate scandals of the turn of the century and the corporate irresponsibility that brought about the 2008 financial crisis have heightened public awareness of the central role of the board of directors not only in ensuring good corporate management but also, in a broader sense, the smooth and efficient functioning of the American economy. While *Caremark* appeared to offer promise, subsequent jurisprudence can lead to the conclusion that corporate boards appear generally to have been absolved of meaningful monitoring responsibility. Yet the contemporary board model and the consequent composition of boards leaves monitoring as their job, and demands that they engage in meaningful monitoring in order to fulfill it.

A close look at the cases suggests that *Caremark* jurisprudence in fact has been evolving, at least conceptually, towards the development of a meaningful monitoring role. The way has been blocked, however, by a relentless judicial and scholarly focus on doctrinal formulae. Excavating beneath the doctrine reveals that the elements necessary to construct a meaningful monitoring duty already exists.

It is my hope to have encouraged the Delaware courts to put the pieces together. A duty to monitor business risk is already emergent

230. *Id.*

231. *Id.*

232. It is worth noting a significant asymmetry between the knowledge plaintiffs are expected to have to survive a Rule 23.1 motion to dismiss and the knowledge directors are obligated to have in monitoring the corporation, a mismatch that favors directors. While plaintiffs are required to "use the tools at hand" to discover adequate facts, directors are under no such obligation. To the contrary, they are permitted repose until a red flag is 'waved in their faces.' Wood v. Baum, 953 A.2d 136, 143 (Del. 2008). Yet the same technology—the same tools—that have developed since *Caremark* are as available to the directors as to the plaintiffs. In fact, given their respective roles, the kind of information relevant to *Caremark* claims is far easier obtained by boards than plaintiffs. And, in light of the dramatic differences in their respective powers and responsibilities to their corporations and, indeed, to the economy in which they function, sound thinking would tell us that this mismatch is backwards.

and should be refined and acknowledged if the monitoring board is to have any real meaning. The obligation of directors to be informed about their corporations has never been easier to fulfill. *Caremark's* hidden promise should thus be realized.