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Federalizing *Caremark*

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U.C.L.A. Law Review

Federalizing *Caremark*

Carliss Chatman and Tammi S. Etheridge

ABSTRACT

When corporations misbehave, the normal government response is to saddle the industry with more federal oversight requirements. But reactive policies fail to curb corporate misconduct and can incentivize corporations to ignore or break the law due to the ever-increasing cost of compliance. Even though shareholders have to foot the bill when the corporations get caught ignoring or breaking the law, it is extremely difficult for shareholder plaintiffs with genuinely meritorious claims to recover for damages because, under *Caremark*'s requirements, it is nigh-impossible to demonstrate the bad faith necessary to survive a motion to dismiss using conventionally available information; of the seventeen *Caremark* claims that have been brought in Delaware since the case was decided, only five have survived a motion to dismiss.

Therefore, this Article proposes "federalizing *Caremark*." That is, the Delaware Court of Chancery, being the extremely influential metonymy of American corporate law that it is, should formally recognize and adopt the holdings common to the five successful cases. All of those cases were able to show the officers exhibited per se bad faith by leveraging agency-developed information regarding red flags that were ignored, breaches of the duty of oversight, and knowing violations of the law for profit. If Delaware courts chose to effectively federalize *Caremark*, then the per se bad faith standard would enable shareholder derivative suits to survive the dreaded motion to dismiss and possibly even win as a matter of law upon a motion for summary judgment. Federalizing *Caremark* would also more effectively prevent corporate misbehavior than would continually increasing oversight and regulatory requirements because it merely utilizes mechanisms already in place (i.e., agencies, regulations, shareholder claims, state courts).

Corporate law scholarship rarely acknowledges its intersection with administrative law. In doing so, however, this Article establishes a bright line administrative remedy to the overwhelmingly steep hurdle shareholders face in derivative litigation.

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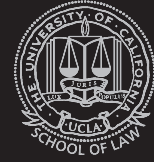

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INTRODUCTION

During the 2016 presidential campaign, Donald Trump employed Cambridge Analytica, a political data firm, to help identify the personality traits of individual American voters and influence their voting behavior through targeted digital ads.[1] Cambridge Analytica acquired access to private data from more than 87 million Facebook users and provided it to the Trump campaign.[2] The data collected by Cambridge Analytica, including details on the users' identities, friend networks, and "likes," came from a 2014 Facebook personality survey which,[3] according to The New York Times, "scrape[d] some private information from [users'] profiles and those of their friends."[4] Approximately 270,000 users participated in the survey and thus consented to having their data harvested.[5] Yet, Cambridge Analytica had access to some 87 million profiles in total, including the source data associated with each.[6] Facebook justified its role

1. *See* Kevin Granville, *Facebook and Cambridge Analytica: What You Need to Know as Fallout Widens*, N.Y. TIMES (Mar. 19, 2018), https://www.nytimes.com/2018/03/19/technology/facebook-cambridge-analytica-explained.html [https://perma.cc/TV99-H45K] ("The idea was to map personality traits based on what people had liked on Facebook . . . ."); Matthew Rosenberg, Nicholas Confessore & Carole Cadwalladr, *How Trump Consultants Exploited the Facebook Data of Millions*, N.Y. TIMES (Mar. 17, 2018), https://www.nytimes.com/2018/03/17/us/politics/cambridge-analytica-trump-campaign.html [perma.cc/DP6M-XF6K] (explaining that researchers paid users to download an app which documented information from both the user and their Facebook friends); *see generally Facebook, Social Media Privacy, and the Use and Abuse of Data: Joint Hearing Before the S. Comm. on Com., Sci., & Transp. and S. Comm. on the Judiciary*, 115th Cong. (2018) (describing ongoing privacy concerns surrounding the collection of user data).
2. *See* Cecilia Kang & Sheera Frenkel, *Facebook Says Cambridge Analytica Harvested Data of Up to 87 Million Users*, N.Y. TIMES (Apr. 4, 2018), https://www.nytimes.com/2018/04/04/technology/mark-zuckerberg-testify-congress.html [https://perma.cc/4V3R-QRSK].
3. Demographic information collected from the survey included details about race, gender, sexual orientation, political affiliation, and more nuanced data, such as propensity for substance abuse. Notably, while Facebook permitted such activity at the time of the scandal, it has since been banned. *See* Nimish Sawant, *Facebook, Cambridge Analytica and the Alleged 'Data Breach': Here's All You Need to Know*, FIRSTPOST (Mar. 21, 2018, 10:34 AM), https://www.firstpost.com/tech/news-analysis/facebook-cambridge-analytica-and-the-alleged-data-breach-heres-all-you-need-to-know-4395747.html [https://perma.cc/ 7WEU-WHKQ] (stating that users would receive a "personality prediction" after taking a personality test).
4. Rosenberg et al., *supra* note 1.
5. Sawant, *supra* note 3.
6. *See* Kang & Frenkel, *supra* note 2 ("Facebook . . . said that the data of up to 87 million users may have been improperly shared with a political consulting firm connected to President Trump during the 2016 election . . . .").

in the scandal by noting that the company routinely allows researchers access to users' data for academic purposes, a practice that all users consent to when they create their Facebook account.[7] Facebook blamed the individual who sold the data to the Trump campaign for his misuse of that material and pointed to its policy explicitly prohibiting users' data from being sold or transferred "to any ad network, data broker or other advertising or monetization-related service" in its defense.[8]

Many daily Facebook users, of which there are more than 185 million in the United States and Canada,[9] were outraged. In the immediate aftermath of the scandal, Facebook's stock dropped 7.8 percent, which effectively wiped out all the company's 2018 stock market gains, and the company lost approximately $50 billion in market capitalization.[10] Lawsuits quickly followed.[11] Plaintiffs filed several class action suits, many blaming the company's data leaks and subsequent cover up for its reputation damage.[12] One suit argued that Facebook "made

7. *See* Granville, *supra* note 1 ("Facebook in recent days has insisted that what Cambridge did was not a data breach, because it routinely allows researchers to have access to user data for academic purposes—and users consent to this access when they create a Facebook account.").
8. A myriad of litigation followed the Cambridge Analytica scandal, and this policy statement is referenced constantly in opinions regarding Facebook's consent-based arguments. *See, e.g.*, *In re* Facebook, Inc. Sec. Litig., 405 F. Supp. 3d 809, 822 (N.D. Cal. 2019); *In re* Facebook, Inc., Consumer Priv. User Profile Litig., 402 F. Supp. 3d 767, 808 (N.D. Cal. 2019).
9. *See* Press Release, Fed. Trade Comm'n, FTC Imposes $5 Billion Penalty and Sweeping New Privacy Restrictions on Facebook (July 24, 2019) [hereinafter FTC Press Release], https://www.ftc.gov/news-events/news/press-releases/2019/07/ftc-imposes-5-billion-penalty-sweeping-new-privacy-restrictions-facebook [https://perma.cc/L764-CLSA] ("More than 185 million people in the United States and Canada use Facebook on a daily basis.").
10. Dani Alexis Ryskamp, *Facebook Faces Shareholder Lawsuit Over Cambridge Analytica Data Security Concerns*, EXPERT INST. (June 23, 2020), https://www.expertinstitute.com/resources/insights/facebook-faces-shareholder-lawsuit-over-cambridge-analytica-data-security-concerns [https://perma.cc/8PZS-CBJV].
11. *See, e.g.*, *In re* Facebook, Inc., Consumer Priv. User Profile Litig., 325 F. Supp. 3d 1362, 1363 (U.S. Jud. Pan. Mult. Lit. 2018) (describing plaintiffs' motion to centralize eight distinct actions, pending in four districts, in the Northern District of California, and anticipating the inclusion of an additional twenty-two potentially related actions, pending in six more district); *In re* Facebook, Inc. S'holder Derivative Priv. Litig., 367 F. Supp. 3d 1108 (N.D. Cal. 2019); *In re Facebook, Inc. Sec. Litig.*, 405 F. Supp. 3d at 809.
12. *See, e.g.*, *In re Facebook, Inc. Sec. Litig.*, 405 F. Supp. 3d at 833 ("Plaintiffs allege that [Facebook] concealed the full extent that Cambridge Analytica damaged Facebook's image and thus mislead investors. Finally, Plaintiffs allege that [Facebook] materially misle[d] investors by repeatedly assuring investors that Facebook was [compliant with personal data regulation], when, in fact, it was not.") (citations omitted); *In re Facebook, Inc., Consumer Priv. User Profile Litig.*, 402 F. Supp. 3d at 767 ("Facebook argues that the plaintiffs have not adequately alleged that they were damaged by any breaches. But that is wrong.").

materially false and misleading statements."[13] Another argued that Facebook's senior managers violated their fiduciary duties by allowing the initial misappropriation of user data and, after learning of it in 2015, failing to inform affected Facebook users or shareholders.[14] Moreover, many lawsuits recognized the potential for future costs resulting from the leaks, "including regulatory investigations, lost business, exposure to litigation, and other damages."[15] While most class action suits were shareholder derivative suits brought on behalf of shareholders and the corporation, some were brought on behalf of Facebook users seeking damages from the company for failing to protect their data.[16] Despite the numerous and valiant attempts to hold Facebook liable to its shareholders and users, no litigation has been successful to date.[17]

A U.S. Federal Trade Commission (FTC) investigation into the connection between Facebook and Cambridge Analytica ultimately provided a remedy for shareholders and stakeholders.[18] The FTC conducted a year-long investigation

13. *In re Facebook, Inc. Sec. Litig.*, 405 F. Supp. 3d at 818 ("Plaintiffs are persons who purchased shares of Facebook common stock between February 3, 2017, and July 25, 2018 (the 'Class Period'), who believe [Facebook officials] made materially false and misleading statements and omissions in connection with the purchase and sale of Facebook stock.").

14. *In re* Facebook, Inc. Section 220 Litig., No. CV 2018–0661-JRS, 2019 WL 2320842, at *7 (Del. Ch. May 30, 2019, revised May 31, 2019) (explaining that the U.S. Federal Bureau of Investigation, U.S. Securities and Exchange Commission (SEC), U.S. Department of Justice (DOJ), and U.S. Federal Trade Commission (FTC) jointly investigated Facebook's data security practices, including "the extent to which Facebook knew that its users' data was misappropriated and disseminated in 2015[,] and the reasons [Facebook] failed to inform its users or investors of the breaches in real time.").

15. S'holder Derivative Complaint at 2, Hallisey *ex rel.* Facebook, Inc. v. Zuckerberg, No. 5:18-CV-01792, 2018 WL 1441014 (N.D. Cal. Mar. 22, 2018).

16. *In re Facebook, Inc., Consumer Priv. User Profile Litig.*, 402 F. Supp. 3d at 776 ("The plaintiffs are current and former Facebook users who believe that their information was compromised by the company."); *In re* Facebook, Inc. Internet Tracking Litig., 956 F.3d 589, 596 (9th Cir. 2020) ("Plaintiffs claim that internal Facebook communications revealed that company executives were aware of the tracking of logged-out users and recognized that these practices posed various user-privacy issues.").

17. *See* Francesca Fontana, *Lawsuits Against Facebook Over Data Privacy Issues Are Piling Up*, THE STREET (Mar. 29, 2018, 12:07 PM), https://www.thestreet.com/technology/everyone-who-is-suing-facebook-for-cambridge-analytica-14536213 [https://perma.cc/GUR3-W37J] (listing sixteen separate user and shareholder lawsuits against Facebook, Inc.); Brian White, *Judge Slams Door on One Facebook Privacy Class Action Lawsuit*, TOP CLASS ACTIONS (Jan. 28, 2021), https://topclassactions.com/lawsuit-settlements/privacy/judge-slams-door-on-one-facebook-privacy-class-action [https://perma.cc/RL4S-BD5J] (stating that the case was dismissed after the plaintiff missed a deadline).

18. Complaint at 1, United States v. Facebook, Inc., No. 19-CV-2184 (D.D.C. July 24, 2019) ("This action seeks to hold Facebook accountable for its failure to protect consumers' privacy as required by the 2012 Order and the FTC Act.").

into the incident and concluded that Facebook violated a 2012 FTC Order that prohibited it from making misrepresentations about the privacy or security of consumers' personal information and the extent to which it shares personal information—such as names and dates of birth—with third parties.[19] In the resulting settlement agreement with the agency, Facebook agreed to pay a record-breaking $5 billion penalty to the U.S. Treasury's General Fund[20] and to "submit to new restrictions and a modified corporate structure that will hold the company accountable for the decisions it makes about its users' privacy."[21] Specifically, the 2012 FTC Order required Facebook "to restructure its approach to privacy from the corporate board-level down, and establishes strong new mechanisms to ensure that Facebook executives are accountable for the decisions they make about privacy, and that those decisions are subject to meaningful oversight."[22] Moreover, the U.S. Department of Justice (DOJ) announced that it would file a complaint on behalf of the FTC alleging that Facebook repeatedly used deceptive disclosures and settings to undermine users' privacy preferences in violation of its 2012 FTC Order.[23]

In a typical shareholder derivative action, a shareholder or group of shareholders will bring suit against the corporation's directors or officers to protect the interest of the corporation. The most common allegation is that the corporation has suffered share value loss due to some action or inaction by the board. Here, Facebook was both forced to pay large fines and to defend against a DOJ action, which would certainly lower the value of Facebook in the short term. Without more, however, these costs are not enough to succeed in the derivative action. Courts have held that the Facebook shareholders could not prove board knowledge or draw any causal connection between such knowledge and board wrongdoing.[24] Proving this causal connection has historically been

19. FTC Press Release, *supra* note 9; Statement of the Comm'n on *In re Facebook, Inc.*, Docket No. C-4365 (Aug. 10, 2012), https://www.ftc.gov/system/files/documents/public_statements/293551/120810facebookstatement.pdf [https://perma.cc/2LBY-KYZV]; Stipulated Order for Civil Penalty, Monetary Judgment, & Injunctive Relief, No. 19-CV-2184 (D.D.C. July 24, 2019).
20. Although there have been cases where the FTC earmarks money to pay consumers seeking redress or to fund consumer education, this was not one such instance. *See* Annie Palmer, *Here's Where Facebook's Record $5 Billion Fine Goes*, CNBC (July 25, 2019, 10:50 AM), https://www.cnbc.com/2019/07/25/heres-where-facebooks-record-5-billion-fine-goes.html [https://perma.cc/RC8N-TSTN].
21. FTC Press Release, *supra* note 9.
22. *Id.*
23. *See Facebook, Inc.*, No. 19-CV-2184.
24. For discussions of failure to monitor and regulate Facebook, *see, e.g.*, Hillary A. Sale, *Monitoring Facebook*, 12 HARV. BUS. L. REV. 401 (2022); John Armour, Jeffrey Gordon &

an insurmountable hurdle for shareholders, yet with ever increasing frequency, shareholders have successfully overcome this hurdle by relying on *Caremark*.

In *Caremark*,[25] Caremark, a provider of health care products and services for out-of-hospital treatment,[26] pled guilty to mail fraud and paid $250 million in criminal and civil fines pursuant to a plea agreement. The plea agreement concluded an extensive investigation by the DOJ and the Department of Health and Human Services into alleged violations of federal and state health care laws prohibiting payments to physicians for patient referrals. Shareholders sued Caremark's board of directors for losses resulting from the agreement, which required the Delaware Chancery Court to review the plea agreement "to evaluate the fairness and adequacy of the consideration offered to the corporation in exchange for the release of all claims made or arising from the facts alleged." Ultimately, the court upheld the agreement as adequate, but in reaching its conclusion, the court also determined that the failure to comply with federal rules and regulations signaled a breach of good faith and loyalty.

Given that the FTC has now found Facebook to have violated a FTC order during the relevant period, Facebook shareholder suits may soon find more purchase with the courts. Plaintiff shareholders in a new Delaware case can now argue, like those in *Caremark*, that Facebook's failure to comply with FTC rules and regulations signaled a breach of good faith and loyalty. This is the strongest of the many claims that have been brought by Facebook shareholders because claims based on an obvious failure to comply with federal rules and regulations are often the only way to overcome the numerous obstacles to shareholder success in state courts. In the case of the Cambridge Analytica breach, such a claim would be impossible without the evidence provided by the FTC investigation and the associated order.[27]

Caremark's holding—that a failure to comply with federal rules and regulations will signal a breach of good faith and loyalty to the court—raises practical questions. Chief among these is whether the U.S. Congress should respond to corporate scandals by expanding the reach of the U.S. Securities and Exchange Commission (SEC) even though Delaware has modeled a way to

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Geeyoung Min, *Taking Compliance Seriously*, 37 YALE J. ON REG. 1, 57–58 (2020); Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 1949 (2021).

25. 698 A.2d 959 (Del. Ch. 1996).

26. Caremark is now doing business as CVS Caremark.

27. *See* Sbriglio v. Zuckerberg, No. 2018–0307-JRS, 2021 WL 3565692 (Del. Ch. Aug. 6, 2021).

regulate corporate behavior effectively using the common law,[28] while also supplying shareholders with the weapons they need to pursue private actions against directors and providing state regulators with ready enforcement actions.[29] We propose that the answer to this question is no. If there is a proven violation of a federal rule or regulation or other red flag provided by federal administrative agencies, the *Caremark* standard should be established, allowing shareholders to survive a motion to dismiss, shifting the burden to the directors to prove otherwise.

This approach to breaches of fiduciary duty not only adds teeth to shareholder litigation but also has the potential to benefit society more broadly. The expansion of federal oversight of corporate behavior through market-based compliance schemes has failed to result in beneficial outcomes for corporations

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28. *See, e.g.*, E. Norman Veasey, *What Would Madison Think? The Irony of the Twists and Turns of Federalism*, 34 DEL. J. CORP. L. 35, 43 (2009) (arguing that more than 60 percent of the Fortune 500 are incorporated in Delaware because the State has both "embraced the federalism model and adopted a wide range of corporate innovations—most notably the establishment of a neutral body of experts to review and recommend changes to its corporation law and the cultivation of a cadre of judges and lawyers with special expertise in business law"); Lawrence E. Hamermesh, Jack B. Jacobs & Leo E. Strine, Jr., *Optimizing the World's Leading Corporate Law: A Twenty-Year Retrospective and Look Ahead*, 77 BUS. LAW. 321 (2022) (analyzing the pros and cons of Delaware corporate law). In addition, Delaware law may be selected to govern sophisticated transactions even if the parties have no connection with the State of Delaware. As a result, Delaware entities and law appear regularly in commercial transactions around the world and serve as a model throughout.
29. While securities regulations do provide shareholders with the ability to recover, the Private Securities Litigation Reform Act (PSLRA) and its loss causation standard has made recovery more burdensome for shareholders than it would be under *Caremark*. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104–67, 109 Stat. 737; Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105–353, 112 Stat. 3227; Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 538, 540 (1998); Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1489–90 (2006). *But see* Érica Gorga & Michael Halberstam, *Litigation Discovery and Corporate Governance: The Missing Story About the "Genius of American Corporate Law"*, 63 EMORY L.J. 1383, 1395 (2013) (discussing the benefits of discovery and shareholder litigation, including the role of discovery in developing corporate and securities laws, and the culture of corporate disclosure); Jessica Erickson, *The Gatekeepers of Shareholder Litigation*, 70 OKLA. L. REV. 237, 237–38 (2017) (explaining that "[s]hareholder litigation is a key tool in controlling . . . agency costs" but that it is also vulnerable to its own agency cost challenges because "[m]ost shareholder plaintiffs lack sufficient incentives to closely monitor the[] lawsuits" so that "plaintiffs' attorneys can make litigation decisions that benefit themselves at the expense of their shareholder clients."). As a result, *Caremark* is the only meaningful opportunity for shareholders to recover from a business or market failure.

or for society.[30] The Securities Act of 1933 (Securities Act),[31] the Securities Exchange Act of 1934 (Exchange Act),[32] the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley),[33] changes in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) (on soft regulation of pay, alongside derivative markets),[34] and other regulations focused on the securities market represent attempts to keep the securities market under control. But they have not prevented the rise of unregulated retail investing,[35] the proliferation of cryptocurrency scams,[36] the reliance on cult of personality investment suggestions

30. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1526–27 (2005); Mercer Bullard, Caremark*'s Irrelevance*, 10 BERKELEY BUS. L.J. 15, 44–50 (2013) (identifying examples of industry-specific, process-based, and activity-based federal regulation that comprise the strongest determinants of corporate compliance); Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 AM. BUS. L.J. 203 (2016) (noting that federal reforms "have substantially increased the cost of compliance"); Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care as Responsibility for Systems,"* 31 J. CORP. L. 949, 950 (2006) (explaining controversy over Part 404 of Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 21 (2002) (arguing that Sarbanes-Oxley is unlikely to do a better job than self-correcting markets). *See also* Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78u-6 (2010); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).
31. Codified as 15 U.S.C. § 77a *et seq.*
32. Codified as 15 U.S.C. § 78a *et seq.*
33. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified as amended in scattered sections of Titles 15, 18, 19, 28, and 19 of the U.S.C.).
34. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376–2223 (2010) (codified as amended in scattered sections of Titles 12 and 15 of the U.S.C.).
35. The ongoing retail versus institutional investor drama involving Robinhood, its users, GameStop, Melvin Capital, and r/wallstreetbets perfectly illustrates how unregulated retail investing can lead to unforeseeable and bizarre market results which harm unwary, casual participants. *See* Jody Godoy, *Robinhood Agrees to Settle Customer Lawsuit Over 2020 Outages*, REUTERS (May 27, 2022, 5:40 PM), https://www.reuters.com/business/finance/ robinhood-agrees-settle-customer-lawsuit-over-2020-outages-2022–05–27 [https://perma.cc/ J5BK-KD7Q]; Tara Siegel Bernard, *Amateur Investors Rode the Bull Up. Now the Bear Looms.*, N.Y. TIMES (May 19, 2022), https://www.nytimes.com/2022/05/18/your-money/stock-market-crash-trading-retail.html [perma.cc/H3GZ-TRWZ]; Caitlin McCabe, Gunjan Banerji & Alexander Osipovich, *The Unraveling of Robinhood's Fairy Tale*, WALL ST. J. (June 18, 2022, 12:00 AM), https://www.wsj.com/articles/the-unraveling-of-robinhoods-fairy-tale-11655524803 [https://perma.cc/NGR9-NDYX]; Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors*, 22 NEV. L.J. 51 (2021).
36. *See* FED. TRADE COMM'N, REPORTS SHOW SCAMMERS CASHING IN ON CRYPTO CRAZE (June 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/Crypto%20Spotlight%20FINAL %20June%202022.pdf [https://perma.cc/GH3D-NNG3] (describing the growing number of cryptocurrency scams, particularly on social media, and estimating more than $1 billion in

and market manipulation through social media,[37] the privacy concerns that are the focus of Facebook's Cambridge Analytica litigation,[38] or the First Amendment issues that an unregulated social media market raises.[39] Instead, the basic shape

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damages to some 46,000 people between 2021 and mid 2022 alone); Rebecca M. Bratspies, *Cryptocurrency and the Myth of the Trustless Transaction*, 25 MICH. TECH. L. REV. 1 (2018); Kevin V. Tu, *Crypto-Collateral*, 21 SMU SCI. & TECH. L. REV. 205 (2018); Peter J. Henning, *A Taxonomy of Cryptocurrency Enforcement Actions*, 14 BROOK. J. CORP. FIN. & COM. L. 227 (2020).

37. *See* Mehrnoosh Mirtaheri, Sami Abu-El-Haija, Fred Morstatter, Greg Ver Steeg & Aram Galstyan, *Identifying and Analyzing Cryptocurrency Manipulations in Social Media*, 8 IEEE TRANSACTIONS ON COMPUTATIONAL SOC. SYS. 607 (2021); J.T. Hamrick, Farhang Rouhi, Arghya Mukherjee, Amir Feder, Neil Gandal, Tyler Moore & Marie Vasek, *An Examination of the Cryptocurrency Pump and Dump Ecosystem*, U. CHI. BECKER FRIEDMAN INST. FOR ECON. (2019), https://bfi.uchicago.edu/wp-content/uploads/Gandal-Neil-etal-An-examination-of-the-cryptocurrency-pump-and-dump-ecosystem.pdf [https://perma.cc/BT2D-E276]; *see also* Press Release, Commodity Futures Trading Comm'n, CFTC Charges Two Individuals with Multi-Million Dollar Digital Asset Pump-and-Dump Scheme (Mar. 5, 2021), https://www.cftc.gov/PressRoom/PressReleases/8366–21 [https://perma.cc/4PRY-Y9FE] (discussing John McAfee's repeated and illegal manipulation of cryptocurrency valuations via social media representations); Rachel Sandler, *John McAfee Indicted on Fraud, Money Laundering Charges in Pump-And-Dump Crypto Scheme*, FORBES (Mar. 5, 2021, 2:49 PM), https://www.forbes.com/sites/rachelsandler/2021/03/05/john-mcafee-indicted-on-fraud-money-laundering-charges-in-pump-and-dump-crypto-scheme/?sh=35f12efc2669 [https://perma.cc/L9CP-QAXL]; *Dogecoin A 'Victim Of Pump And Dump Scheme' By Elon Musk, Says Analyst*, BUS. INSIDER (June 15, 2021, 3:16 AM), https://markets.businessinsider.com/news/stocks/dogecoin-a-victim-of-pump-and-dump-scheme-by-elon-musk-says-analyst-1030522149 [https://perma.cc/5UPC-X6XN]; *see also* Carliss Chatman, *Corporate Family Matters*, 12 U.C. IRVINE L. REV. 1, 37 (2022) (discussing the impact of Elon Musk's cult of personality on Tesla).

38. Facebook's questionable attitude toward user privacy is anything but new. Consider the following infamous instant messenger conversation a nineteen-year-old Mark Zuckerberg had with a friend at Harvard shortly after launching "The Facebook":

    Zuckerberg (Z): Yeah so if you ever need info about anyone at Harvard.
    Z: Just ask.
    Z: I have over 4000 emails, pictures, addresses, SNS.
    [Friend]: What? How'd you manage that one?
    Z: People just submitted it.
    Z: I don't know why.
    Z: They "trust me[.]"
    Z: Dumb fucks.

    Nicholas Carlson, *Well, These New Zuckerberg IMs Won't Help Facebook's Privacy Problems*, BUS. INSIDER (May 13, 2010, 11:19 AM) https://www.businessinsider.com/well-these-new-zuckerberg-ims-wont-help-facebooks-privacy-problems-2010-5 [https://perma.cc/E9MG-3YW5]; *see also* Sale, *supra* note 24, at 407–10; Armour et al., *supra* note 24, at 57–58; Shapira, *supra* note 24, at 1966.

39. Tech companies have harvested, tracked, sold, and bought user information for years, if not decades, and many times they do so in cooperation with and under the direction of the government. *See* Glenn Greenwald & Ewen MacAskill, *NSA Prism Program Taps in to User Data of Apple, Google and Others*, GUARDIAN (June 7, 2013, 3:23 PM),

of corporate law in the United States has remained the same since the 1980s, and in some ways, recovery is more difficult for shareholders and stakeholders.[40] What has changed is the cost of being a public corporation—driven higher by ever-increasing costs of compliance.[41]

https://www.theguardian.com/world/2013/jun/06/us-tech-giants-nsa-data [https://perma.cc/S9HS-N2X8]. *See also* Glenn Greenwald, *NSA Collecting Phone Records of Millions of Verizon Customers Daily*, GUARDIAN (June 6, 2013, 6:05 AM), https://www.theguardian.com/world/2013/jun/06/nsa-phone-records-verizon-court-order [https://perma.cc/8MYT-6PAZ] ("The [top secret National Security Agency (NSA)] order requires Verizon on an ongoing daily basis to give the NSA information on all telephone calls in its systems . . . .") (internal quotation marks omitted); Craig Timberg & Barton Gellman, *NSA Paying U.S. Companies for Access to Communications Networks*, WASH. POST (Aug. 29, 2013), https://www.washingtonpost.com/world/national-security/nsa-paying-us-companies-for-access-to-communications-networks/2013/08/29/5641a4b6–10c2–11e3-bdf6-e4fc677d94a1_story.html [https://perma.cc/MQH6-3DJK] ("Voluntary cooperation from the 'backbone' providers of global communications dates to the 1970s under the cover name BLARNEY, according to documents provided by former NSA contractor Edward Snowden."); Joseph Menn, *Spy Agency Ducks Questions About 'Back Doors' in Tech Products*, REUTERS (Oct. 28, 2020, 6:16 AM), https://www.reuters.com/article/us-usa-security-congress-insight/spy-agency-ducks-questions-about-back-doors-in-tech-products-idUSKBN27D1CS [https://perma.cc/G6W6-GB55] ("The NSA has long sought agreements with technology companies under which they would build special access for the spy agency into their products, according to [the Snowden leaks] . . . . These so-called back doors enable the NSA and other agencies to scan large amounts of traffic without a warrant."). *See generally* Press Release, WikiLeaks, Vault 7: CIA Hacking Tools Revealed (Mar. 7, 2017), https://wikileaks.org/ciav7p1 [https://perma.cc/TM9H-23PX]; Snowden Surveillance Archive, CANADIAN JOURNALISTS FOR FREE EXPRESSION, https://www.cjfe.org/snowden [https://perma.cc/VN4K-PAVA] (explaining that Snowden began whistleblowing in June 2013). Scholars have proposed imposing separate fiduciary duties on those who maintain user information. *See* Jack M. Balkin, *Information Fiduciaries and the First Amendment*, 49 U.C. DAVIS L. REV. 1183, 1205–09 (2016); *see also* Andrew F. Tuch, *A General Defense of Information Fiduciaries*, 98 WASH. U. L. REV., 1897, 1898–99 (explaining the proposal to impose the duties of care, confidentiality, and loyalty). *See generally* Neil Richards & Woodrow Hartzog, *A Duty of Loyalty for Privacy Law*, 99 WASH. U. L. REV. 961 (2021).

40. *See, e.g.*, Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1326–27 (2013) (explaining that "[t]he theoretical framework within which we understand corporate law and corporate governance dates back to the finance literature of the late 1970s and the legal literature of the 1980s" when, "in the absence of transaction costs," market forces would lead "managers, shareholders, creditors, employees, and others" "to create governance arrangements and adopt legal rules that would minimize agency costs and thereby maximize firm value").

41. *See* Francesco Trebbi & Miao Ben Zhang, *The Cost of Regulatory Compliance in the United States* 2–4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 30691, 2023) (finding that the average U.S. firm spends between 1.3 and 3.3 percent of its total wage bill on regulatory compliance, and that the wage bill has grown at an annual rate of about 1 percent a year from 2002 to 2014, roughly half of the average annual gross domestic product growth rate over the period); *see also* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L. Q. 487, 491 (2003) ("[I]nternal compliance structures do not deter

This Article proposes more formally adopting the approach of recent Delaware cases that have survived a motion to dismiss. The Article makes two normative claims. First, in addressing new problems, we must be careful not to rely on the same solutions that have previously left the door open for attendant risks. Said differently, further expansion of SEC authority is likely to be unproductive. Second, we should rely on agencies—rather than state corporate governance law alone—to protect stakeholders. This approach would have the added benefit of providing shareholders with the information they need to check board action when necessary. Federalizing *Caremark* is,[42] therefore, a better solution than yet another securities market-based reporting and compliance regime.

The Article proceeds in three parts. Part I examines the goals of the SEC in securities regulation, explaining the pros and cons of the existing market-based reporting and compliance regimes for shareholders (both in and outside of litigation). Part I also examines the role of litigation in protecting shareholders. Part II describes in detail *Caremark* and its progeny, specifically those cases in which *Caremark* claims have survived a motion to dismiss, to situate the common law within the shareholder protection system and to show how these cases best reflect the symbiotic relationship between state breach of loyalty claims and federal regulations. Part II also applies the current approach to the ongoing Facebook and Cambridge Analytica scandal to model this relationship. Finally, Part III argues for federalizing *Caremark*, a more effective solution that provides industry oversight and compliance via the existing agency processes, and briefly describes some of the benefits that would inure from this process.

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prohibited conduct within firms, and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability.").

42. A question that has long been posed in the area of corporate law is whether the federal government is better equipped than the states—particularly Delaware, given its decades of experience and ongoing expertise—to oversee corporate law and governance. Presently, federal law coexists amicably with state law. Federal law, through the SEC, mandates federal disclosure regulation, whereas state law maintains primacy over internal corporate affairs. In proposing to "federalize" *Caremark*, we mean to formally link the state-based rights and obligations of a corporation's owners and managers to federal, industry-specific regulations. Said differently, since the SEC cannot regulate those aspects of corporate governance which are the province of state law but can regulate more broadly as to health and safety, we propose that shareholders be given explicit authority to rely on federal agency rules, regulations, and fact finding to prove a state-based breach of duty to the shareholders.

I. SHAREHOLDER PROTECTION MECHANISMS IN ADMINISTRATIVE LAW

In a perfect world functioning with a perfect competition paradigm, all markets would have many sellers and many products, all consumers would have perfect information about those products, and no unforeseeable externalities would exist because any positive or negative effects would be internalized by the buyers and sellers of those products.[43] Yet, reality seldom adheres to this idealized economy.[44] In its absence, the government must rely on a limited number of mechanisms to address any departures from a theoretically perfect competitive model.[45] Legislation and regulation function as one such mechanism.

The use of regulation in this manner is traditionally justified in two ways. The first justification, rooted in economic theory, is one of market failure.[46] The principle of market failure suggests that negative byproducts (e.g., monopolies, pollution, fraud, mistake, mismanagement, discriminatory pricing, excessive rates) accompany self-regulation within the free market and thus governmental regulations are necessary to curb self-regulation.[47] This logic provides the basis

43. Jerry M. Santangelo, Note, *Changing Configurations of Antitrust Law: Judge Posner's Applications of His Economic Analysis to Antitrust Doctrine*, 32 DEPAUL L. REV. 839, 842 (1983) (describing a perfect competition model as one in which "no individual or entity possesses the ability to influence market conditions," and the conditions which must be present for perfect competition to exist, including perfect information). The efficient capital market hypothesis extends upon this idea by proposing that the capital market functions with almost perfect competition, and whenever new information comes into the market, it is immediately reflected in stock prices. Accordingly, neither technical nor fundamental analysis can generate excess returns for investors. For discussions on efficient capital market hypothesis and informational efficiency, *see* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 28–33 (4th ed. 2015) (discussing three versions of the hypothesis).

44. Mark Thoma, *When Markets Aren't Perfect, Government Can Help*, CBS NEWS (May 3, 2016, 5:45 AM), https://www.cbsnews.com/news/when-markets-arent-perfect-government-can-help [https://perma.cc/83C7-MJPX] ("Perfectly competitive markets have attractive features. They deliver goods and services to consumers at the lowest possible price, use resources efficiently and respond flexibly to changes in tastes and technology . . . . But no market is perfectly competitive. All fail to one degree or another to live up to their promise.").

45. *Id.* ("When government steps in to try to correct these market failures -- breaking up a monopoly, regulating financial markets, forcing firms to pay the full cost of the pollution they cause, ensuring that product information is accurate and so on -- it's . . . an attempt to make these markets conform [to the perfectly competitive model].").

46. Economic justifications have their origins in the New Deal, when the "policing model" of regulation was in its heyday. Assuming that individuals and corporations could best promote their own well-being through market transactions, this model recognized "the limited responsibility of government for economic well-being." Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189, 1192 (1986).

47. *Id.*

for many of the early regulatory statutes, especially those like the Securities Act and the Exchange Act, which were intended to stabilize an ailing domestic economy.[48]

The second justification is rooted in democratic theory and suggests that the population collectively will occasionally demand more from society than any one individual will seek for themselves, triggering our sense of social justice and welfare, and thus requiring government intervention.[49] Social considerations such as employment discrimination, environmental quality, consumer protection, and occupational safety justify government mandates in these areas.[50] The federal government routinely grounds its policies in social welfare. In 1993, for example, President William J. Clinton signed Executive Order 12866, which requires federal agencies to promulgate regulations that "are required by law, are necessary to interpret the law, or are made necessary by compelling need, such as material failures of private markets *to protect or improve the health and safety of the public, the environment, or the well being of the American people.*"[51]

Government action to limit market failures in the context of health, safety, and environmental regulation became popular in the 1970s with Congress's creation of almost every major risk or environmental regulation agency, including the U.S. Consumer Product Safety Commission, the U.S. Occupational Safety and Health Administration, the U.S. Environmental Protection Agency (EPA), the U.S. Nuclear Regulatory Commission, and the U.S. National Highway Traffic Safety Administration.[52] These new social regulations were necessary, in part, to protect people from aspects of market behavior in which they do not voluntarily participate. For instance, it is difficult to address the problem of air pollution with

48. *See* Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 194 (2004) ("And even if the original proponents of federal securities regulation did not correctly specify the market failure at play, the findings here are consonant with the larger agenda of the Progressive movement. Progressives did not consider regulatory intervention an alternative to market mechanisms, but rather as a way to promote the workings of markets by correcting market failures.").

49. *See* LISA SCHULTZ BRESSMAN, EDWARD L. RUBIN & KEVIN M. STACK, THE REGULATORY STATE 35 (2020) ("Much government regulation stems from the recognition that, as a society, we may aspire to certain norms of conduct for their own sake."); CASS SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE 57 (1990) ("Some statutes . . . might be described as collective desires, including aspirations, preferences about preferences, or considered judgments on the part of significant segments of society. Laws of this sort are a product of deliberative processes on the part of citizens and representatives. They cannot be understood as an attempt to aggregate or trade off private preferences. This understanding of politics recalls Madison's belief in deliberative democracy.").

50. BRESSMAN ET AL., *supra* note 49, at 35.

51. Exec. Order 12866, 58 Fed. Reg. 190 (Oct. 4, 1993) (emphasis added).

52. *See* Rabin, *supra* note 46, at 1284.

market-based solutions, as there is neither a market for a commodity produced nor any market-based compensation for victims of pollution.[53] In the face of such hurdles, even a perfect free market would not suffice, and thus social regulation becomes necessary.

Shareholder derivative suits exist somewhere at the margin of market failure and social purpose. At issue here are market failures resulting from inadequate or asymmetric information.[54] Shareholders delegate untethered power and policymaking ability to directors and officers, in part to take advantage of their experience and expertise. In return for this delegation, shareholders believe that the directors and officers will maximize their profits. Profit maximization is the shared interest between management and shareholders. Yet, only management knows to what extent the firm follows federal rules and regulations. As such, managers who have failed to comply can withhold this information to the detriment of shareholder profits. In fact, there is no real incentive for the firm to voluntarily disclose such shortcomings, and there is no other way for shareholders to discover them. Consequently, shareholders and their profits are in a position of acute vulnerability. In such instances, we expect legislation and regulation to protect the investments of people in the market and to eliminate or reduce the subordination of shareholders in relation to directors and officers.

Subpart A below provides an overview of protection-based legislation and regulation. Subpart B then explains the shortcomings of current SEC-based protections. Next, Subpart C considers how state law serves as a gap filler due to the SEC's deference to state law. Both Subparts B and C illustrate that the current system leaves many regulatory gaps that can be addressed by fully embracing the relationship between industry-specific regulations, explored in Subpart D, and the *Caremark* standard.

53. *See generally* APPROACHES TO CONTROLLING AIR POLLUTION (Ann F. Friedlaender ed., MIT Press 2003) (discussing whether direct government approaches or indirect market-like mechanisms are better at reducing air pollution); John P. Dwyer, *The Use of Market Incentives in Controlling Air Pollution: California's Marketable Permits Program*, 20 ECOLOGY L.Q. 103 (1993).

54. ROBERT BALDWIN, MARTIN CAVE & MARTIN LODGE, UNDERSTANDING REGULATION: THEORY, STRATEGY, AND PRACTICE 18 (2d ed. 2012) ("Competitive markets can only function properly if consumers are sufficiently well informed to evaluate competing products. The market may, however, fail to produce adequate information and may fail for a number of reasons.").

A. Protection-Based Legislation and Regulation

Individual investors provide financing to companies, much like banks, through the purchasing of stocks and bonds issued by the companies.[55] The Exchange Act thus created the SEC to protect investors, maintain efficient capital markets, and facilitate capital formation.[56] To do so, the SEC helps ensure that investors "have access to certain basic facts about an investment prior to buying it, and so long as they hold it" by requiring public companies "to disclose meaningful financial and other information to the public," thereby creating "a common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security."[57] Moreover, the SEC notes that "only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions."[58]

The securities regulatory scheme is thus based on a policy of full and fair disclosure, on the belief that the market will operate efficiently if there is a fully informed public.[59] Congress has amended the laws several times since 1933 and 1934, usually in response to financial scandals. Federal securities laws include the Securities Act,[60] the Exchange Act,[61] the Trust Indenture Act of 1939,[62] the Investment Company Act of 1940,[63] the Investment Advisers Act of 1940,[64]

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55. *See Invest*, BLACK'S LAW DICTIONARY (9th ed. 2009) ("To loan money upon securities of a more or less permanent nature, or to place It in business ventures or real estate, or otherwise lay it out, so that it may produce a revenue or income."); Drake v. Crane, 29 S.W. 990, 994 (Mo. 1895); Stramann v. Scheeren, 42 Pac. 191, 195 (Colo. 1895); *see also* Una v. Dodd, 39 N.J. Eq. 173, 186 (Ch. 1884), *rev'd*, 40 N.J. Eq. 672 (1885).
56. "The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust." *About the SEC*, SEC, https://www.sec.gov/about.shtml [https://perma.cc/J4W2-PBTF].
57. Comments of Jim R. Hall on SEC File No. S7-08-09 (available at SEC online directory, https://www.sec.gov/comments/s7-08-09/s70809-2762.htm [https://perma.cc/VRS7-MFUR]).
58. *Id.*
59. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249). Taking effect in October of 2000, Regulation FD (Fair Disclosure) addresses the selective disclosure by issuers of material nonpublic information. It is designed to promote the full and fair disclosure of information by issuers. *Id.*
60. 15 U.S.C. §§ 77a–77mm.
61. 15 U.S.C. §§ 78a–78rr.
62. 15 U.S.C. §§ 77aaa–77bbbb.
63. 15 U.S.C. §§ 80a-1–80a-64.
64. 15 U.S.C. §§ 80b-1–80b-18c.

Sarbanes-Oxley,[65] Dodd-Frank,[66] the Jumpstart Our Business Startups Act of 2012,[67] and the Fixing America's Surface Transportation Act of 2015.[68] In addition, the SEC is empowered with the ability to supplement the statutes with regulations.[69]

The Exchange Act imposes registration and reporting requirements on issuers of certain types of securities.[70] Typically, a publicly traded corporation is required to file reports quarterly (Form 10-Q) and annually (Form 10-K) with the SEC.[71] Some aspects of Forms 10-Q and 10-K are always required and others are based on specified numerical thresholds.[72] Other aspects are discretionary, based on a determination of materiality,[73] a standard that requires officers to make a

65. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745.
66. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376–2223 (2010) (codified as amended in scattered sections of Titles 12 and 15 of the U.S.C.).
67. Jumpstart Our Business Startups Act of 2012, 15 U.S.C. § 77d-1.
68. Fixing America's Surface Transportation Act of 2015, Pub. L. No. 114–94, 129 Stat. 1312.
69. Notably, the SEC is not the only government entity that regulates the securities market. The Commodities Futures Trading Commission regulates sales of commodity and financial futures and options. The Financial Industry Regulatory Authority (FINRA) regulates broker-dealers and activities by national exchange members. Stock exchanges, such as NASDAQ and the New York Stock Exchange, also have listing standards that greatly influence the corporate governance norms for publicly traded companies. Lastly, states have "blue sky" laws, which are antifraud laws designed to protect investors by requiring issuers of securities to register and disclose details about their offerings. "Blue sky laws generally [fall] within one of three categories: antifraud, registration or licensing of securities professionals, and registration or licensing of securities." Christopher R. Lane, *Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 326 (2005) (quoting 1852 Mass. Acts 303 (citing Louis Loss & Edward M. Cowett, *Blue Sky Law* 3–4 (1958)); *see also* Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 18–33 (1983).
70. 15 U.S.C. § 78l.
71. 15 U.S.C. §§ 78l, 78m(a); THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION 200 (5th ed. 2020).
72. *See* Business and Financial Disclosure Required by Regulation S–K, Securities Act Release No. 10,064, Exchange Act Release No. 77,599, 81 Fed. Reg. 23,916, 23,925 (Apr. 22, 2016); 17 C.F.R. §§ 229.101(c)(ii), 229.601(b), 229.404 (West 2021).
73. The Materiality standard was first adopted in the Securities Act § 17(a), 15 U.S.C. § 771q (2012) (declaring it unlawful to "obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact"), and then reified in the Securities Exchange Act § 18(a), 15 U.S.C. § 78r (imposing liability on any person "who shall make or cause to be made" any "false or misleading" statement of "material fact" in "any application, report, or document" filed under the act). The modern standard of materiality was first articled in *TSC Industries, Inc. v. Northway, Inc.*, a 1973 U.S. Supreme Court case stating: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," or, said differently, "there must be a substantial likelihood that . . . the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." 426

judgment call that could be challenged after the fact.[74] The Exchange Act also requires officers, directors, and 10 percent beneficial owners to file reports of all transactions in the company's shares and requires any person acquiring 5 percent of an equity security to disclose such fact.[75] Sarbanes-Oxley empowered the SEC to promulgate additional disclosures as it deems necessary to protect investors.[76] In determining what must be disclosed under these provisions, the regulations and case law all rely on a materiality standard.[77]

Companies are not expected to predict the future, but they are expected to be honest about the past. The Exchange Act prohibits fraud in connection with all securities transactions under Rule 10b-5, regardless of whether the company is publicly traded.[78] For publicly traded companies, information having an impact

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U.S. 438, 449 (1976) (citations omitted). *See also* Dale A. Oesterle, *The Overused and Under-Defined Notion of "Material" in Securities Law*, 14 U. PA. J. BUS. L. 167, 169 (2011) ("Simply put, the abstract formulation of the materiality standard frequently does not fit the holdings on the facts. The reason becomes obvious as the case law accumulates—the concept as defined explicitly by the Supreme Court is over-broad and the courts are crafting specific exclusions." (citation omitted)); Richard C. Sauer, *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 BUS. LAW. 317, 317 (2007) ("Too little information provides an inadequate basis for investment decisions; too much can muddle and diffuse disclosure and thereby lessen its usefulness. The legal concept of materiality provides the dividing line between what information companies must disclose—and must disclose correctly—and everything else. Materiality, however, is a highly judgmental standard, often colored by a variety of factual presumptions."); John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41, 42 (1998); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 869 (2003).

74. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS, 49 (4th ed. 2015).

75. 15 U.S.C. §§ 16(a), 13(d).

76. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745, § 409.

77. *See* George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. REV. 602, 617–18 (2017) (giving examples of various regulations that require disclosure based on materiality); Oesterle, *supra* note 73, at 170; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673–74 (1984) (noting asymmetric information in the securities market).

78. The SEC has infused the materiality standard into many of its rules and regulations. *See, e.g.*, 17 C.F.R. § 240.10b-5 (2021) (governing the selling and purchasing of securities) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, to employ any device, scheme, or artifice to defraud."). Rule 10b-5 states, in relevant part, that it shall be unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." 17 C.F.R. § 240.10b-5. Courts have distilled this rule into six elements: (1) material misrepresentation or omission; (2) scienter; (3) connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance

on the business or financial condition must be disclosed either in the next quarter on the Form 10-Q, or for some matters, within four business days on Form 8-K.[79] Thus, all false statements can trigger liability, but a failure to make statements only imposes liability for issuers of publicly traded securities.[80] This creates an incentive to remain silent unless there is a benefit to providing the public with information. Nondisclosure alone does not violate 10b-5 without an independent duty.[81] The sources of these independent duties are often state law or industry-specific agencies.[82]

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upon the misstatement or omission; (5) economic loss; and (6) loss causation. *See* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008).

79. Form 8-K is a form typically used to notify investors of specified events. *See* Tash Bottum, *Material Breach, Material Disclosure*, 103 MINN. L. REV. 2095, 2108–09 (2019) (explaining that Form 8-K is used to convey market-sensitive information to institutional investors, individual investors, and the general public whenever required under the terms of the Securities Exchange Act of 1934 (Exchange Act) and its related regulations); *see also* SEC, CURRENT REPORT (FORM 8-K), at 2 (2021) (stating that Form 8-K "shall be used for . . . reports of nonpublic information required to be disclosed by Regulation FD" and that the form "satisfies all the substantive requirements" of the FD regulation).

80. 17 C.F.R. § 240.10b-5 (West 2021); Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,594 (Mar. 25, 2004) and Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, 69 Fed. Reg. 48,370 (Aug. 10, 2004); 17 C.F.R. § 240.12b-2 (West 2021).

81. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent duty to disclose, is not misleading under Rule 10b-5."); *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993) ("[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts."); *see also* Allan Horwich, *The Legality of Opportunistically Timing Public Company Disclosures in the Context of SEC Rule 10b5-1*, 71 BUS. LAW. 1113, 1120-21 (2016). Horwich writes:

> [T]here is no obligation under the securities laws to make a disclosure immediately or by a certain date unless (1) a specific SEC rule requires that disclosure be made at or before a time certain; (2) a half-truth has been uttered, requiring disclosure of the additional information necessary in order to make the statement made not misleading; or (3) disclosure is (i) required by a duty to update a prior affirmative statement that is no longer accurate or (ii) required by a duty to correct a statement that was untrue when made.

Id.

82. *See e.g.*, Faith Stevelman Kahn, *Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure*, 34 GA. L. REV. 505, 505 (discussing the relationship between disclosure and fiduciary duties) (2000); Chatman, *Corporate Family Matters, supra* note 37, at 10.

B. The Shortcomings of SEC-Based Protections

The SEC attempts to ensure that individual investors have ready access to pertinent information about the likely risks and rewards of investing in individual companies because such information encourages investment and helps to ensure that scarce investment capital flows to the most deserving project.[83] Despite its intentions, however, the SEC has not always been able to prevent public firms from deceiving potential or actual investors.[84] Both securities law and investor protection are subject to the incomplete law problem;[85] neither companies nor the government can anticipate every actionable lack of due care on the part of directors and managers.[86] Potential harms thus abound.

One problem is that the SEC's jurisdiction is severely limited by both its constitutionally-based authority and federalism more generally. Because the SEC has authority through the Commerce Clause,[87] which allows for federal regulation of interstate commerce,[88] the SEC must focus its attention on the aforementioned capital market failures.[89] The SEC's greatest tools are its periodic

83. *See About the SEC*, SEC, https://www.sec.gov/about.shtml [https://perma.cc/J4W2-PBTF].
84. *See e.g.*, Michael R. Siebecker, *Trust & Transparency: Promoting Efficient Corporate Disclosure Through Fiduciary-Based Discourse*, 87 WASH. U. L. REV. 115, 118 (2009) ("Excessive amounts of disclosure, or communication of poor-quality information, can actually impede rather than promote corporate accountability. Unintentional obfuscation may turn into bald deception, as corporations seek market advantages by promoting a false socially responsible image."); Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*, 126 YALE L.J. 262, 302–09 (2016) (discussing the role of private voluntary disclosure of campaign finance expenditures and the risk of harm).
85. *See, e.g.*, Katharina Pistor and Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931, 932 (2003) ("A law may be incomplete if it attempts to specify comprehensively actions that shall be covered but fails to include some which could result in similar harmful outcome.").
86. DGCL 102(b)(7) makes very few breaches of the duty of care actionable. *See* Thomas C. Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239 (1987); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004); Dennis R. Honabach, *Smith v. Van Gorkom: Managerial Liability and Exculpatory Clauses–A Proposal to Fill the Gap of the Missing Officer Protection*, 45 WASHBURN L.J. 307 (2006).
87. *See, e.g.*, Herman Goralnik, *Securities as Subjects of Interstate Commerce*, 19 ST. LOUIS L. REV. 69, 69–70 (1933) ("Likewise, it is clear that the constitutional power relied upon as the basis for [the Securities Act of 1933] derives from the commerce clause, as well as from the power to regulate the mails."); *see also* U.S. CONST. art. I, § 8; *see* Securities Act of 1933, § 2 (7); *see also* U.S. CONST. art. I, § 8.
88. *See* U.S. CONST. art. I, § 8 ("The [U.S.] Congress shall have Power . . . to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . .").
89. Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 880–81, 893, 907 (2006); Marc I. Steinberg, *The Federalization of Corporate Governance—An Evolving Process*, 50 LOY. U. CHI. L.J. 539, 540–

and special reporting mechanisms and its oversight of special events, such as proxies at shareholder meetings and initial public offerings. These tools do not provide shareholders with a means to address harm. In fact, the federal system permits very few private rights of action,[90] leaving shareholders unable to address any harms at the federal level. Yet the capital markets are inextricably linked to corporations, and corporations, in turn, are subject to corporate governance at the state level. This creates a regulatory loophole for those harms related to corporate governance.[91] In such cases, shareholders can rely on state law, but due to procedural hurdles, shareholders must often wait for federal administrative fact finding to successfully pursue those state claims.[92]

The only area of corporate governance subject to federal control is the regulation of the capital markets,[93] so the federal system is reactionary by nature. The Exchange Act focuses on the structure and operation of securities markets, and the SEC's regulation of the market is limited by the bounds of the Exchange Act.[94] As such, the SEC is excluded from the traditional domain of the states: corporate governance.[95] The concern of the regulatory system is the market impact of fraudulent reports, which hide the flaws and failures of a company from the target audience, the "reasonable investor."[96] These structures trigger the strongest penalties and requirements when actions alter the information available to investors on the open market.[97]

A properly structured disclosure regime can protect investors and promote good corporate governance, but when that structure facilitates manipulation, it undermines the purpose of the system. Unscrupulous management can use the

41 (2019); Lisa M. Fairfax, *Whitman and the Fiduciary Relationship Conundrum*, 89 FORDHAM L. REV. 409, 434 (2020) ("The law of insider trading makes it abundantly clear that demonstrating liability requires the existence of a fiduciary relationship. Yet there is less clarity on whether state or federal law governs the question about what types of relationships are included in the definition of a fiduciary relationship.").

90. *See* CARLISS CHATMAN & CARLA REYES, BUSINESS ORGANIZATIONS: AN EXPERIENTIAL APPROACH 587–91 (2022).

91. *See* Jones, *supra* note 89, at 880–81, 893, 907; Steinberg, *supra* note 89, at 540–41; Fairfax, *supra* note 89, at 434; Thompson & Sale, *supra* note 73, at 869.

92. *See, e.g.*, City of Birmingham Ret. & Relief Sys. v. Good, 177 A.3d 47 (2017); *In re* Massey Energy Co., No. 5430–VCS., 2011 WL 2176479 (Del. Ch. May 31, 2011); *In re* General Motors Co. Deriv. Litig., No. 9627–VCG, 2015 WL 3958724 (Del. Ch. June 26, 2015).

93. Thompson & Sale, *supra* note 73.

94. HAZEN, PRINCIPLES OF SECURITIES REGULATION, *supra* note 71; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 39–40 (3d ed. 2003).

95. HAZEN, PRINCIPLES OF SECURITIES REGULATION, *supra* note 71; Business Roundtable v. S.E.C., 905 F.2d 406, 408 (D.C. Cir. 1990).

96. Chatman, *Corporate Family Matters, supra* note 37, at 46–47.

97. *Id.*

federal mandatory disclosure standard in conjunction with the business judgment rule to evade state law duties.[98] To determine whether a breach has occurred, shareholders need extensive information to meet the burden of proof.[99] If a company is too big or too complex for many matters that are potentially triggering to be material, and therefore mandatory, the necessary information can be concealed to defraud and harm investors.[100] Thus, with most publicly traded corporations, the shareholders can only get access to the information they need when it is material to investigations by industry-specific agencies.[101] The minutia of day-to-day operations and compliance do not meet the standard for mandatory reporting.[102]

Outside of the limited items that must be filed in the interim reports on Form 8-K, all other disclosures under the Exchange Act are voluntary.[103] The existence of voluntary disclosures makes matters worse.[104] When combined with

98. *Id.* The business judgment rule prevents the court from substituting its judgment for the judgment of directors if the director decisions can be attributed to any rational business purpose. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1988).
99. *See* Shapira, *supra* note 24; Sale, *supra* note 29.
100. Georgiev, *supra* note 77, at 645–46 (arguing that materiality blind spots make it easier for management to engage in fraud, waste, or suboptimal practices and can hinder monitoring by a firm's board of directors); *see* Mihailis E. Diamantis, *Functional Corporate Knowledge*, 61 WM. & MARY L. REV. 319, 354 n.217 (2019).
101. *But see* 8 Del. C. § 220 (2021).
102. *See* Sale, *supra* note 29.
103. Section 409 of Sarbanes-Oxley provides "[e]ach issuer reporting under Section 13(a) or 15(d) . . . disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer . . . as the Commission determines . . . is necessary or useful for the protection of investors and in the public interest." Sarbanes-Oxley Act § 409. *See also* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,594 (Mar. 25, 2004), *and* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, 69 Fed. Reg. 48,370 (Aug. 10, 2004). Following amendments in 2004, Form 8-K requirements now include entry into or termination of a material non-ordinary course agreement; creation of a material direct financial obligation or a material obligation under an off-balance sheet transaction; departure of directors or principal officers, election of directors, appointment of principal officers; and amendments to Articles of Incorporations or Bylaws. There are also mandatory disclosures under the Foreign Corrupt Practices Act (FCPA) which are designed to combat international bribery and corruption. Under the FCPA, companies are subject to sanctions for failure to keep an adequate system of internal controls. *See* Karen E. Woody, *Securities Law as Foreign Policy*, 15 NEV. L.J. 297, 307 (2014).
104. Voluntary disclosure and private ordering, including agreements between industry groups and stock exchanges, while well meaning, can serve as an end run around securities regulation and can compromise what the system is designed to protect. These disclosures can manipulate the market and have even greater consequences. *See, e.g.*, Haan, *supra* note 84, at 302–09

mandatory disclosures based on materiality and state law definitions that make it clear that each entity is a distinct legal person, voluntary disclosure can be utilized to reveal what is positive, while concealing what is less favorable under the protection of materiality.[105] Voluntary disclosures need not be complete; they need only to be true.[106] Companies are, however, required to correct information previously reported if it becomes untrue.[107]

The worst corporate scandals are born out of market manipulation,[108] but the systems in place at the SEC do not enable shareholders to intervene at a point that can protect all stakeholders or to seek to redress their own harms.[109] Corporate scandals are also born out of ambiguity and complexity—an ambiguity that is encouraged by a focus on positive periodic reports, payment of regular

(discussing the role of private voluntary disclosure of campaign finance expenditures and the risk of harm).

105. *See* Siebecker, *supra* note 84, at 118.

106. *See* Georgiev, *supra* note 77, at 613 ("Firms are free to disclose other information on a voluntary basis as long as it is not false or misleading.").

107. *See* Backman v. Polaroid Corp., 910 F.2d 10 (1st Cir. 1990) (en banc); *In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236 (3d Cir. 1989).

108. *See, e.g.*, Chatman, *Corporate Family Matters, supra* note 37 (discussing the Theranos and Enron scandals).

109. *See* Henry T. C. Hu, *Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1608 (2012) (noting that not only is it difficult to communicate financial realities when they are fully understood, but it will often be the case that the realities are not fully understood); Mihailis E. Diamantis, *Functional Corporate Knowledge*, 61 WM. & MARY L. REV. 319, 327–28 (2019) (arguing the use of respondeat superior enables corporations to diffuse knowledge across individuals, so that no one has the requisite knowledge in its entirety; today's corporate behemoths do not have to try to spread information widely because of their size and complexity); Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, COLUM. BUS. L. REV. 81, 113 (2006) ("[W]here the case against a single actor within an organization does not contain all of the requisite elements of the crime, respondeat superior liability would not attach to the corporation."); Dan K. Webb, Steven F. Molo & James F. Hurst, *Understanding and Avoiding Corporate and Executive Criminal Liability*, 49 BUS. LAW. 617, 625 (1994) ("Given the often complex and decentralized nature of many corporations, it is sometimes difficult, if not impossible, to prove that any single corporate agent acted with the necessary intent and knowledge to commit an offense."); Carliss N. Chatman, *Myth of the Attorney Whistleblower*, 72 SMU L. REV. 669, 689 (2019) (discussing the role of complex business structure in the Enron scandal); FIN. ACTION TASK FORCE & EGMONT GRP. FIN. INTEL. UNITS, CONCEALMENT OF BENEFICIAL OWNERSHIP 26 (2018) ("A key method used to disguise beneficial ownership involves the use of legal persons and arrangements to distance the beneficial owner from an asset through complex chains of ownership. Adding numerous layers of ownership between an asset and the beneficial owner in different jurisdictions, and using different types of legal structures, can prevent detection and frustrate investigations."); Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 709, 712–14 (2019); Chatman, *Corporate Family Matters, supra* note 37, at 44.

dividends, and other surface indications of a company's success.[110] The line between good governance aimed at profit maximization and criminal or fraudulent corporate behavior is difficult to discern when the people who are typically the most egregious bad actors are also the same people tasked with aggressively using all the legal tools available to produce positive results. A company may legally paint itself in the best light by manipulating business structures, tax laws, accounting rules, and other regulations with the assistance of attorneys and other experts and may be deemed to be in breach of its duties if it fails to do so.[111] This behavior can go unchecked by the SEC but not by agencies focused on the primary line of business.[112]

C. State Common Law as Gap Filler

A symbiotic relationship exists in the governance of corporations, with states handling the formation and structure of entities, and the SEC monitoring and mandating reporting and compliance for the sake of the capital markets.[113] The SEC has, historically, given deference to state law on matters of corporate governance.[114] Although the definition of a security is within the purview of SEC jurisdiction, that definition does not turn on whether an entity is a corporation,

110. *See* Hu, *supra* note 109, at 1608 (arguing that not only is it difficult to communicate financial realities when they are fully understood, but it will often be the case that the realities are not fully understood).

111. *See* Diamantis, *supra* note 100, at 325–26 (noting that "[t]he line between criminal and innocent conduct frequently turns on what defendants knew," making monitoring of employees and compliance leaving the company worse off); Maurice E. Stucke, *In Search of Effective Ethics & Compliance Programs*, 39 J. CORP. L. 769, 779–80 (2014) (describing penalties and prosecutions as a means to deter corporate crime as well as to increase compliance efforts by firms).

112. *See infra* Part II (describing four cases wherein corporate bad behavior failed to give rise to SEC involvement but did garner the attention of industry-specific federal agencies).

113. Chatman, *Corporate Family Matters, supra* note 37, at 41; *see also* Richard W. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROBS. 193, 194, 196 (1958) ("The power to incorporate is conferred by the states under general incorporation laws. . . . [T]he drive for federal incorporation, which has evoked interest from time to time, appears to have been blunted by the enactment of the federal securities legislation administered by the Securities and Exchange Commission."); Steinberg, *supra* note 89, at 540–41 (2019).

114. *See* Chatman, *Myth of the Attorney Whistleblower*, *supra* note 109, at 693 ("[D]eference to state ethical codes . . . means that the SEC Standards and the Model Rules act merely as a warning . . . ."); *see also* Thomas L. Hazen, *Tulips, Oranges, Worms, and Coins- Virtual, Digital, or Crypto Currency and the Securities Laws*, 20 N.C. J.L. & TECH. 493, 517 (2019).

partnership, or limited liability company alone.[115] States are responsible for bringing corporations into existence, defining the requirements for formation, and maintaining that form.[116] The federal regime is focused on regulations outside of the scope of those operations, taking aim at protecting the market for securities by regulating the quality of information available to investors.[117]

Members of Congress have introduced bills to federalize corporate governance through the creation of federal charters and federal governance norms, but these bills—introduced as early as 1903 to more recently with legislation by Senator Elizabeth Warren in 2018—have failed to pass.[118] While there is little appetite in Congress to take over corporate governance wholesale, in times of crisis the federal response, as exhibited by Sarbanes-Oxley and Dodd-Frank, is to expand into governance by expanding disclosure requirements.[119] Many scholars have written on the expense and lack of value add caused by recent legislative expansion of the SEC, including Dodd-Frank and Sarbanes-Oxley.[120] The limited range of SEC authority bears partial responsibility for these shortcomings. The legislation is also limited by the nature of contracting and corporate governance.[121] Corporations can choose to be public, private, or a

115. *See* Securities Act of 1993 § 2(1); Securities Exchange Act of 1934 § 3(a)(10); SEC v. Howey, 328 U.S. 293, 297 (1946).

116. *See*, e.g. DGCL 102; MBCA § 2.04; *see* Jennings, *supra* note 113; Chatman, *Corporate Family Matters, supra* note 37; Carliss N. Chatman, *The Corporate Personhood Two-Step*, 18 NEV. L.J. 811, 816 (2018).

117. *See* Chatman, *Family Matters*, *supra* note 37, at 40.

118. *See id.*

119. *See Lawson v. FMR LLC*, 571 U.S. 429, 429 (2014) ("To safeguard investors in public companies and restore trust in the financial markets following the collapse of Enron Corporation, Congress passed the Sarbanes–Oxley Act of 2002."); Koch v. S.E.C., 793 F.3d 147, 150 (D.C. Cir. 2015) ("Like the crash in 1929, the wreckage wrought by the Great Recession of 2008 produced calls for reform, ultimately resulting in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111–203, 124 Stat. 1376 (2010)).

120. *See e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1526–27 (2005) (noting that the literature suggesting that the proposed mandates would not be effective was ignored by legislators as they drafted Sarbanes-Oxley, rendering the quality of the legislation suboptimal); STEPHEN M. BAINBRIDGE, THE COMPLETE GUIDE TO SARBANES-OXLEY 110 (2007); Kate Livak, *Defensive Management: Does the Sarbanes-Oxley Act Discourage Corporate Risk-Taking?*, 2014 U. ILL. L. REV. 1663, 1665 nn.4–11, 1673 (2014) (summarizing the literature critical of Sarbanes-Oxley and noting the private company trend); Chatman, *Myth of the Attorney Whistleblower*, *supra* note 109, at 689 (discussing the role of complex business structures in the Enron scandal).

121. *See, e.g.*, Chatman, *The Corporate Personhood Two-Step*, *supra* note 116, at 816; J. Robert Brown, *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 378–79 (2004) (outlining three concerns about public company governance that need to be addressed by federal law, including the imposition of standards that would

combination of the two; they can choose where to incorporate, headquarter, and do business; they can choose to divide the business up amongst entities of various sizes and forms; and, most importantly for securities purposes, corporate management has the freedom to decide what is material and what to disclose voluntarily.[122] These choices, based in the freedom to contract and the parameters for corporate governance found in state law, prevent a market-monitoring crisis-based approach from having its intended impact.

The case of climate disclosures offers a good example of federal reliance on increased disclosure during times of crisis. In an attempt to deal with the ongoing climate crisis, the SEC proposed a rule that would require all SEC registrants to include climate-related disclosures in their registration reports and in their periodic reports on March 21, 2022.[123] The disclosures would include information about climate-related risks that are "reasonably likely to have a material impact on their business, results of operations, or financial condition."[124] Companies would also include climate-related financial statement metrics in a note to their audited financial statements.[125] Finally, companies would disclose information about greenhouse gas emissions, "which have become a commonly used metric to assess a registrant's exposure to such risks."[126] Former SEC chairmen and commissioners agree that the SEC has overreached, arguing that "the Proposal

restrict the ability of management to influence the process of electing directors. "Consistent with Sarbanes-Oxley and the treatment of audit committees, the nominating committee should have independent financing to enable it to adequately perform its duties without untoward influence from interested members of the board."); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 129–30 (1985); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 12–13, 69 (1991).

122. U.S. SMALL BUSINESS ADMINISTRATION, CHOOSE A BUSINESS STRUCTURE (2022) https://www.sba.gov/business-guide/launch-your-business/choose-business-structure [https://perma.cc/7YC2-T98Z].

123. The proposed rule changes would require a registrant to disclose information about (1) the registrant's governance of climate-related risks and relevant risk management processes; (2) how any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short, medium, or long term; (3) how any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook; and (4) the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a registrant's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements.

124. Press Release, SEC, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors, (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46 [https://perma.cc/QV5Q-TJZG].

125. *Id.*

126. *Id.*

oversteps the Commission's congressionally delegated regulatory authority" because "though nominally framed as an investor protection initiative, the Proposal represents a roundabout way of regulating greenhouse gas emissions themselves . . . ."[127] It is unclear that the SEC is the right agency to implement the most effective regulations in this (or many other) area(s). Climate change threatens every sector and every industry. It is near universal. If the real concern is the resiliency of public companies to face impending climate disasters, like hurricanes, wildfires, or flooding, the way to uncover underlying risks is not through SEC disclosure statements. Instead, the agencies that address the underlying risks associated with climate change, such as the EPA, are better equipped to respond to those issues directly.

Since SEC authority is functionally limited to the provision of quality information to investors (often through disclosure requirements), and SEC regulations are deferential to state law, the SEC is incapable of protecting shareholders from directors and officers who engage in risky behavior. Shareholders are also increasingly unable to protect themselves, in part because Congress has been hostile to shareholder litigation over concerns that corporations are plagued with lawsuits by overzealous plaintiffs' attorneys taking advantage of the will to settle.[128] The Private Securities Litigation Reform Act of 1995 (PSLRA) is Congress's solution to what it deemed to be excessive securities litigation based on shifts in stock price rather than fraud, and it is aimed at obtaining fees for attorneys, not remedies for investors.[129] Reforms in the PSLRA include a heightened pleading standard that requires plaintiffs to include allegations giving rise to a strong inference of fraudulent intent, an automatic stay of discovery upon the filing of a motion to dismiss, lead plaintiff provisions, and a statutory safe harbor for forward-looking statements.[130] These reforms operate under an assumption that the necessary information for a successful securities fraud claim will be publicly available.[131] But corporate families are able to conceal

127. Harvey L. Pitt, *The Proposed SEC Climate Disclosure Rule: A Comment from Former SEC Chairmen and Commissioners*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 1, 2022).

128. Sbriglio v. Zuckerberg, No. 2018-0307-JRS, 2021 WL 3565692 (Del. Ch. Aug. 6, 2021).

129. S. REP. NO. 104-98, at 4–9, 12–13 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 690–92; H.R. REP. NO. 104-50(l), at 15, 18–19 (1995) (adopting the view of the "many executives" who "believe that the civil liability system has been twisted and is operating unfairly against them"); *see* Choi & Thompson, *supra* note 29, at 1489–90, 1492; Sale, *supra* note 29.

130. 15 U.S.C. §§ 78u-4(a)(3), 78u-4(b), 78u-5 (2000).

131. *See* Adam C. Pritchard, *Securities Law in the Roberts Court: Agenda or Indifference?*, 37 J. CORP. L. 105, 109, 134 (2011); Choi & Thompson, *supra* note 29, at 1489–90, 1492–93 (examining Private Securities Litigation Reform Act of 1995 (PSLRA) reforms and their effectiveness); Shannon Rose Selden, *(Self-)Policing the Market: Congress's Flawed Approach to*

the information necessary to pursue litigation using size and complexity to manipulate what they are required to report,[132] which in turn limits the ability of investors to address potential fraud by pursuing litigation.[133]

As a result of the PSLRA, shareholders who believe they have been harmed by conflicts of interest and self-dealing that do not rise to the level of insider trading are left to recover in the state court system. Similarly, when malfeasance is a breach of fiduciary duty under state law but does not meet the heightened standards for misrepresentation and other securities violations, shareholders have only a state remedy available.[134]

State business codes define the requirements for corporate formation and for governance.[135] There are no legal requirements for board membership in the state statutes.[136] When a corporation has a desire to go public or to cultivate outside investors, market forces tend to incentivize companies with board members that lend the company an air of legitimacy and expertise.[137] The board manages the corporation on behalf of shareholders, acts as a fiduciary, and owes the shareholders duties of loyalty, care, and good faith.[138] The board must ensure that information given to stockholders, the government, and the public is accurate and in compliance with both state requirements and securities regulations.[139] This is

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Securities Law Reform, 33 J. LEGIS. 57, 76–77 (2006) (discussing the reforms in the PSLRA and the overreliance on market theory that results in Congress's belief that information is publicly available).

132. *See* Chatman, *Corporate Family Matters, supra* note 37.
133. Shareholders do have other sources of information. See discussion of Del. Code Ann. tit. 8 § 220 below.
134. *See* Matthew C. Turk & Karen E. Woody, *The Leidos Mixup and the Misunderstood Duty to Disclose in Securities Law*, 75 WASH. & LEE L. REV. 957, 1000–07 (2018) (citing Steckman v. Hart Brewing, Inc., 143 F.3d 1293 (9th Cir. 1998)) (providing an example in which defendants challenged plaintiffs' class action on the grounds that plaintiffs' showing was not sufficient to state a cause of action under Sections 11 and 12, arguing that alleged violations of Item 303 did not necessarily give rise to a cause of action under Sections 11 and 12 of the Securities Act of 1933).
135. *See* Amy Deen Westbrook & David A. Westbrook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688, 708 n.91 (2018) ("[C]orporate governance has traditionally been a matter of state corporations law . . . .").
136. *See e.g.* Del. Code Ann. tit. 8 § 102.
137. *See* Chatman, *Corporate Family Matters*, *supra* note 37, at 10.
138. *See* Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 245–46 (2009) (recognizing that corporate law is based on the concept that boards of directors owe duties to the corporation and its stockholders).
139. *See* CHATMAN & REYES, *supra* note 90, at 382 ("Failure to tell the truth and omitting material information from statements made by directors may constitute violations of the duty of loyalty in at (the very) least three contexts: when directors make statements to public markets, when directors make statements to shareholders, and when directors make statements in connection with a proxy fight.").

accomplished through the institution of proper internal controls, audits, and legal compliance. Corporate officers are hired by the board and handle the day-to-day operations of the corporation.[140] Directors and officers are tasked with exercising care and loyalty for the general wellbeing of the entire corporation or to outsource when they cannot provide adequate oversight.[141] When considering whether directors and officers are in breach of these duties, courts defer to the business judgment of directors and officers under a doctrine known as the business judgment rule.[142]

The PSLRA combines with *Caremark*[143] to make it difficult for shareholders to redress harm in the courts. The SEC's periodic mandatory reporting and voluntary and mandatory disclosures have thus far failed to give shareholders the information needed to survive *Caremark*.[144] So, because the SEC defers to states and the PSLRA aggressively seeks to eliminate frivolous lawsuits, there is nothing in securities regulation or the state court system to protect shareholders from directors and officers whose risky behavior puts investments and the market at risk but falls short of triggering *Caremark* duties.

Individually, each of these policies—developed independently to address particular problems—makes sense. But taking a step back, it becomes clear these policies combine to form a nearly unbridgeable gap between a rock—federal deference to states regarding corporate governance—and a hard place—breathtakingly steep procedural obstacles to recovery in state courts. This gap is one into which many shareholders, even ones with meritorious claims, often fall because they are unable to access the information needed to support an actionable, state court claim. *Caremark* and its progeny offer a means by

140. *Id.* at 587–91.

141. *See* Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, WIS. L. REV. 573, 575–76 (2000) (explaining director liability and the rational basis test used to analyze their decisions); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 290–91 (1986) (describing the minimal distinction between the duty of care and the duty of loyalty).

142. *See* Davis, *supra* note 141, at 573–74 ("[The business judgment rule] is briefly described as a doctrine holding that directors of corporations should not be liable for what amounts to a good faith exercise of business judgment . . . ."); Fischel & Bradley, *supra* note 141, at 283–84 ("Courts have applied the rule to transactions between parent corporations and their subsidiaries, compensation decisions within a firm, decisions to resist takeover attempts, and decisions to terminate derivative suits. The rule thus immunizes a wide range of corporate conduct from anything more than cursory judicial review.").

143. 698 A.2d 959 (Del. Ch. 1996).

144. Chatman, *Corporate Family Matters*, *supra* note 37, at 42; Fedders, *supra* note 73, at 42; Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1090–91 (2007).

which these discrepancies in policy may be resolved to improve federal-state cooperation and empower shareholder claims.

D. Industry-Specific Regulation as Gap Filler

Federal agencies can provide an additional check on corporate behavior through licensing, industry regulation, and other compliance norms, particularly in highly regulated industries.[145] The promotion of industry-specific goals over generic, market-based goals in corporate governance offers numerous benefits. A general regulation establishes a right or obligation that applies across industries and is triggered by general characteristics of a behavior, product, service, or enterprise.[146] Similar issues that cut across industries are dealt with in the same way.[147]

The problem with this approach is that industries are largely heterogeneous and consequently require broad regulations about the types of behaviors that are generally acceptable at the expense of defining rules imposing specific conditions on corporations.[148] For example, in the case of corporate governance, as previously discussed, most U.S. federal securities regulations of public company corporate governance are driven by disclosure rather than substantive requirements.[149] Likewise, to list a security on the New York Stock Exchange or Nasdaq, a company must agree to abide by the corporate governance

145. Thompson & Sale, *supra* note 73, at 869 (describing the historic push toward federal regulation).
146. *See id.* at 958.
147. *See id.*
148. Paul G. Mahoney and Chris William Sanchirico, *General and Specific Legal Rules*, 161 J. INSTITUTIONAL & THEORETICAL ECON. 329, 330 (2005). Mahoney and Sanchirico write:

> Were a legislature, court, or administrative agency fully-informed about the social costs and benefits of all activities in all states of the world, it could in principle devise a unique and socially optimal set of rules for each activity. However, when the legal decision maker is not fully-informed and must rely on the information of interested parties, there will be circumstances in which generally applicable rules, although perhaps non-optimal for any given activity considered in isolation, will come closer to achieving optimal outcomes for all activities in aggregate.

Id.
149. HOLLY J. GREGORY & CLAIRE H. HOLLAND, GETTING THE DEAL THROUGH: CORPORATE GOVERNANCE 5 (2021) ("Both the Securities Act and the Exchange Act have addressed questions of corporate governance by mandating disclosure, rather than through normative regulation."), https://www.sidley.com/-/media/publications/2023-corporate-governance--usa.pdf?la=en&rev=269a18fb7936463cbcfa99e9d613718a [https://perma.cc/6DBE-32PQ].

requirements provided in the relevant exchange's listing rules.[150] The corporate governance guidelines and best practice codes merely recommend how a public company's board should organize their structure and processes.[151] Yet, these "best practices" may vary wildly by industry.[152] The problem created by using broad regulations across heterogenous industries is also evident as it relates to SEC disclosure requirements that trigger disclosure of Corporate Social Responsibility matters.[153] Engagement with corporate social responsibility varies wildly by industry.[154] Many industries would be better served by meaningful social and

150. *Id.* at 6 ("Listing rules provide an additional source of corporate governance requirements. To list a security on any of the three major listing bodies – the New York Stock Exchange (NYSE) . . . or the Nasdaq Stock Market (Nasdaq) – a company must agree to abide by specific corporate governance listing rules.").

151. *Id.*

152. *See* Jackie Krafft, Yiping Qu & Jacques-Laurent Ravix, *Corporate Governance, Industry Dynamics and Firms Performance: An Empirical Analysis of a Best Practice Model*, 74 RECHERCHES ÉCONOMIQUES DE LOUVAIN 1 (2008) (studying the best-practice model of corporate governance in a world where a large diversity of industry dynamics exists, and finding that this model shapes industry dynamics and related performance, and that industries that have adopted this normative model may be worse off than companies that have adapted to their specific industry dynamics); Lawrence A. Cunningham, *The Illusion of Corporate Governance "Best Practices"*, DIRS. & BOARDS, https://www.directorsandboards.com/articles/singleillusion-corporate-governance-best-practices [https://perma.cc/K54T-F9G2] (arguing that the recent development of best practices is harmful, in part, because practices developed by a particular company and its shareholders are preferable to those developed by index funds, proxy advisors, or policy entrepreneurs); Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 992 (2009) (describing compliance as "exactly the type of contextual, fact-specific topic that should be the province of experts within industry-specific agencies").

153. Business Description Disclosure, 17 C.F.R § 229.101; Material Known Events and Uncertainties Disclosure Included in Management's Discussion and Analysis of Financial Condition and Results of Operations, 17 C.F.R. § 229.303; Risk Factor Disclosure, C.F.R. § 229.503; Commission Guidance Regarding Disclosure Related to Climate Change, SEC Release Nos. 33–9106, 34–61469, FR-82 (Feb. 8, 2010); Securities Exchange Act of 1934, 13(p)(1), 15 U.S.C. § 78m(p)(1). *See also, e.g.*, Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 653, 657–58 (2016); Tamara Belinfanti, *Forget Roger Rabbit—Is Corporate Purpose Being Framed?*, 58 N.Y. L. SCH. L. REV. 675, 678 (2013); Andrew Johnston, *Facing Up to Social Cost: The Real Meaning of Corporate Social Responsibility*, 20 GRIFF. L. REV. 221, 222 (2011); Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, 84 HARV. BUS. REV. 78 (2006); Lyman Johnson, *Reclaiming an Ethic of Corporate Responsibility*, 70 GEO. WASH. L. REV. 957, 964–66 (2002); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579, 653–57 (1997); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 240–42 (1990).

154. Surprisingly, industries with the largest negative impact on the environment are most likely to disclose. Almost all tobacco, chemical, and automobile companies issue Corporate

environmental regulations that nullify negative impacts rather than these permissive disclosure schemes.

In contrast, industry-specific rules and regulations establish rights and obligations for specific industries and, therefore, are more narrowly tailored to the regulatory needs of each industry.[155] For example, the U.S. Office of the Comptroller of the Currency, the U.S. Federal Reserve System, and the U.S. Federal Deposit Insurance Corporation regulate banks; the U.S. National Credit Union Administration regulates credit unions; the U.S. Consumer Financial Protection Bureau (CFPB) regulates nonbank mortgage originators and servicers; the states license mortgage loan officers and mortgage brokers and oversee the insurance industry; the SEC regulates the stock market; and cryptocurrencies are largely unregulated.[156] Cryptocurrencies are largely unregulated because cryptocurrency does not fit neatly into any current industry or classification and, as demonstrated by the failure of FTX, mere securities regulation is insufficient in the face of a systemic governance failure.[157] While on its face this seemingly

Social Responsibility reports. Jingwei Maggie Li, Shirley Lu & Salma Nassar, *Corporate Social Responsibility Metrics in S&P 500 Firms' 2017 Sustainability Reports*, U. CHI. SCH. BUS: RUSTANDY CTR. (2021), https://www.chicagobooth.edu/-/media/research/sei/docs/csr-metrics-rustandy-center-report_final.pdf [https://perma.cc/3HBD-KXNS]. *See also, e.g.*, Nizan Geslevich Packin & Benjamin P. Edwards, *Regulating Culture: Improving Corporate Governance With Anti-Arbitration Provisions for Whistleblowers*, 58 WM. & MARY L. REV. ONLINE 41, 46 (2016); Tom C. W. Lin, *Incorporating Social Activism*, 98 B.U. L. REV. 1535, 1600–02 (2018) (discussing the impact of social activists and activism on corporate governance); Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1199, 1201–03 (1999) (discussing the SEC and the need for expanded social disclosure requirements for public reporting companies in order to further social and financial transparency).

155. *See* CONSUMER AFFS. VICTORIA, CHOOSING BETWEEN GENERAL AND INDUSTRY SPECIFIC REGULATION 2 (2006) ("Industry-specific regulation is generally more narrowly focused because it is constrained to a defined industry sector."); Baer, *supra* note 152, at 958.

156. *See* Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221, 226–26 (1995); Milton R. Schroeder, The Law and Regulation of Financial Institutions, ¶ 2.03 (LexisNexis A.S. Pratt); Kevin V. Tu, *Crypto-Collateral*, 21 SMU SCI. & TECH. L. REV. 205 (2018); Rebecca M. Bratspies, *Cryptocurrency and the Myth of the Trustless Transaction*, 25 MICH. TECH. L. REV. 1 (2018); Hazen, *Tulips, Oranges, Worms*, *supra* note 114, at 49; Peter J. Henning, *A Taxonomy of Cryptocurrency Enforcement Actions*, 14 BROOK. J. CORP. FIN. & COM. L. 227 (2020).

157. FTX was, for a time, one of the world's largest cryptocurrency exchanges. Kalley Huang, *Why Did FTX Collapse? Here's What to Know*, N.Y. TIMES (Nov. 10, 2022), https://www.nytimes.com/2022/11/10/technology/ftx-binance-crypto-explained.html [https://perma.cc/U7LF-JWZZ]. On the FTX exchange, customers could trade digital currencies for other digital currencies or traditional money, and vice versa. *Id.* Mr. Bankman-Fried, the company's owner, "spent millions of dollars lobbying U.S. legislators to institute crypto-friendly regulation." He "tout[ed] its best-in-class controls, including a proprietary 'risk engine,' and FTX's adherence to specific investor protection principles and detailed

endless web of regulation might seem unnecessarily convoluted, this arrangement is preferable. Lacking the breadth of generic rules, industry-specific regulations can be more prescriptive.[158] This distinction is particularly noticeable with small groups of similarly situated firms where expertise is paramount, such as in the communications, transportation, and financial industries.[159] For example, the U.S. Office of Federal Housing Enterprise Oversight and the U.S. Commodities Futures Trading Commission each prescribe governance structures and rules specific to the types of companies and industries they regulate.[160] If not for those highly specialized agencies, the federal government would be left to paint with a broad brush where a one-size-fits-all model may not adequately regulate a company's corporate governance.

Additionally, industry-specific regulations serve an important procedural role. When Congress passes legislation, it does not eliminate a problem. Instead, it provides tools—usually to an agency—to help redress that problem.[161] The agency, in turn, seeks out the best way to promote compliance, including educating the industry about the consequences associated with any undesirable practices.[162] Enforcement thus becomes necessary to prevent such practices. Yet

terms of service." Press Release, SEC, SEC Charges Samuel Bankman-Fried with Defrauding Investors in Crypto Asset Trading Platform FTX (Dec. 13, 2022), https://www.sec.gov/news/press-release/2022-219 [https://perma.cc/33SN-HCBQ]. In reality, however, the company routinely engaged in risky trading options that are unlawful in the United States. Huang, *supra*. In 2021, a major investor sold his stake in FTX and publicly expressed concerns about the financial health of the company. These actions spooked investors who, in turn, withdrew from FTX, causing the company to fall into bankruptcy. *Id.* Ultimately, the SEC charged Bankman-Fried with defrauding investors out of billions of dollars and misusing funds belonging to FTX customers, claiming that "FTX's collapse highlights the very real risks that unregistered crypto asset trading platforms can pose for investors and customers alike." Press Release, SEC, *supra*.

158. CONSUMER AFFS. VICTORIA, *supra* note 155, at 2 ("Because it applies to more homogeneous problems, industry-specific regulation often sets more prescriptive rules than general regulation does.").

159. *Id.* at 14 ("Industry-specific regulation works best for industries that can be clearly defined and are relatively static, where there are specific or technical problems that cannot be dealt with through general regulation and the consequences for consumers if problems occur are large. In these cases, industry-specific regulation may be a proactive way to reduce the risk of significant consumer detriment.").

160. Baer, *supra* note 152, at 958–59.

161. *See* WILLIAM N. ESKRIDGE JR., JAMES J. BRUDNEY, JOSH CHAFETZ, PHILIP P. FRICKEY & ELIZABETH GARRETT, LEGISLATION AND REGULATION: STATUTES AND THE CREATION OF PUBLIC POLICY 435 (2020) (arguing that Congress utilizes administrative processes to complement statutory decisionmaking because the agencies have expertise in their areas, Congress "lacks the time to resolve innumerable first-order implementation questions," and agencies can be flexible in addressing "post-enactment changes in technological, scientific, or social circumstances").

162. Baer, *supra* note 152, at 959.

the agency does not have unlimited resources to address every instance of bad behavior.[163] In fact, many industry-specific agencies, such as the U.S. Department of Agriculture and the U.S. Food and Drug Administration (FDA), fail to address corporate governance at all.[164] Additional resources could allow these agencies to better promote compliance and prosecute offenders, but the potential effect of additional resources is unclear, in part because agencies choose what areas to prioritize and—in doing so—may miss significant issues. Moreover, many enabling statutes limit coverage such that agencies would be prevented from addressing issues outside of their direct authority anyway.[165] When the agency does not suffer from these limitations, industry-specific regulations make it easier for the agency to collect evidence and to prove breaches. This could, for example, make it easier for an agency to prove that a firm ignored a privacy regulation with an intent to defraud shareholders, whereas the shareholder might otherwise fall short of collecting enough evidence to show intent. Further, an agency regulator is often given more extensive oversight and enforcement powers under industry-specific regulations when compared with general regulations.[166] This is

163. *Id.* at 988.
164. *But see* Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 561–62 (1984) ("Many industries are regulated under various statutes and by different regulatory agencies, and the law that governs those companies often has implications for corporate governance. The federal communications law, for example, prohibits foreign ownership of a television station, and the effect of this prohibition on control transactions, including tender offers, is significant.").
165. GOV. ACCOUNTABILITY OFF., PRINCIPLES OF FEDERAL APPROPRIATIONS LAW, CHAPTER 2: THE LEGAL FRAMEWORK 2, https://www.gao.gov/assets/2019-11/675709.pdf [https://perma.cc/R53F-TJK6] ("Enabling or organic legislation is legislation that creates an agency, establishes a program, or prescribes a function, such as the Department of Education Organization Act or the Federal Water Pollution Control Act."); CONSUMER AFFS. VICTORIA, *supra* note 155, at 5 ("[T]he coverage or enforcement provisions of general legislation may make it impossible or more difficult or expensive to address problems; for example [Australia's] Fair Trading Act applies to conduct in trade and commerce. Consumer issues in areas like fundraising would fall outside this definition."); *see also* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1417 (1989) ("The corporate code in almost every state is an 'enabling' statute. An enabling statute allows managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator and without effective restraint on the permissible methods of corporate governance."); *id.* at 1427 ("The history of corporate law has been that states attempting to force all firms into a single mold are ground under as well. Corporations flee to find more open-ended statutes that permit adaptations. This is the reason for the drive toward enabling laws that control process but not structure.").
166. *See* CONSUMER AFFS. VICTORIA, *supra* note 156, at 5 ("In the case of enforcement, the powers to collect evidence to identify breaches of the regulation may be stronger under industry-specific regulation than they are under general regulation. Also, the prescriptiveness of industry regulation makes it easier to prove a breach of [an] Act.").

particularly important in the context of developing and prosecuting reporting and mandatory information provisions.

Most importantly, some problems or industry-specific characteristics are so unusual that they require industry-specific regulation to be effective. For example, many of the numerous U.S. laws governing advertising are enforced by the FTC.[167] These include statutes that prohibit deceptive practices and govern specific marketing practices, such as the FTC Act, which prohibits 'unfair or deceptive acts or practices;' the Lanham Act, which is the federal false advertising statute; and Dodd-Frank.[168] Further, the FDA is charged with regulating prescription drug and biomedical advertising;[169] the CFPB has authority to implement and enforce federal consumer financial law for 'non-bank' financial companies;[170] the U.S. Department of Transportation has jurisdiction to regulate airline advertising;[171] the SEC has control over the false advertising of securities;[172] Financial Industry Regulatory Authority (FINRA) has a variety of rules and guidelines affecting advertising by its members;[173] and the U.S. Federal Alcohol Administration regulates unfair competition—including false advertising—in connection with the interstate sale of alcoholic beverages.[174] In each of these instances, an industry benefits from discrete advertising regulations that address specific consumer concerns. These regulations are thus more proactive and more likely to reduce the risk of reoccurrence.[175]

167. *See Enforcement*, FED. TRADE COMM'N, https://www.ftc.gov/enforcement [https://perma.cc/X62X-2FXA].
168. TERRI SELIGMAN & JORDYN EISENPRESS, GETTING THE DEAL THROUGH: ADVERTISING AND MARKETING, U.S. (2021), https://fkks.com/uploads/news/2021_Advertising_Marketing.pdf [https://perma.cc/Z877-UD2W].
169. *See*, e.g., 21 C.F.R. § 312.7(a) (2009).
170. *See*, e.g., 12 U.S.C. § 5491.
171. *See*, e.g., 49 U.S.C. § 41712.
172. *See*, e.g., Securities Act of 1933, 15 U.S.C. § 77; Securities Exchange Act of 1934, 15 U.S.C. § 78a.
173. *See*, e.g., Communications with the Public, FINRA Rule 2210 (2019).
174. *See*, e.g., 27 U.S.C. §§ 205(e)-(f).
175. Regulators will frequently try to address a wide range of industries and situations by writing very detailed and prescriptive rules. Regulated parties, in turn, then cannot decipher whether and how such rules apply to them. Moreover, even when full regulatory compliance exists, businesses are often subject to increased regulation whenever corporate scandal erupts, resulting in increased complexity of and difficulty in complying with the regulatory code. Workers who see an increasing number of regulations as irrelevant to their jobs are then less motivated to comply with any of the rules. *See, e.g.*, Andrew Hale, David Borys & Mark Adams, *Regulatory Overload: A Behavioral Analysis of Regulatory Compliance*, 20-21 (George Mason U. Mercatus Ctr., Working Paper No. 11-47, 2011), https://www.mercatus.org/system/files/Reg_Overload_HaleBorysAdams_WP1147.pdf [https://perma.cc/V777-5TPF] (arguing that when firms are subject to too many rules that are,

Industry-specific agencies can also help to negotiate nationally consistent solutions to specific problems, as opposed to promulgating general rules, which could affect industries outside the area of concern.[176] Industry-specific agencies have this capability due to the level of expertise concentrated within them and the power that the federal government wields.[177] The government's engagement in policymaking is more likely to garner support from regulated firms (relative to rulemaking or adjudicating), making it more privy to the realities of the market.[178] As a result of firms' willingness to engage with a specialized agency, through mechanisms like comments and public meetings, agencies are better able to develop workable policies that are less restrictive, less burdensome, and more effective than they might otherwise be. This has the added benefit of helping the industry understand the priorities of its relevant agencies and helps businesses to understand the regulation's impact on their business.[179] Moreover, industry-specific regulation helps the public to see that the government is addressing the precise area of their concern.[180]

Thus, in the context of corporate governance, industry-specific agencies can change culture, beyond routine monitoring and reporting. More specialized federal agencies can establish and enforce industry-specific norms and promote best practices through our proposed approach. Although they also have limited authority to control state businesses under the Commerce Clause, these agencies can regulate all businesses in a particular sector.[181] While these measures are intended to protect all stakeholders, there are collateral benefits for shareholders, primarily in the form of information that can be used to pursue state shareholder remedies.[182] When these efforts are acknowledged by Delaware and considered when allowing a shareholder plaintiff's claim to advance, it is an

in part, inapplicable to their specific industries, compliance is reduced because workers will often forget, ignore, or simply become unable to prioritize).

176. *See* Baer, *supra* note 152, at 958–59.
177. *Id.*
178. *Id.* at 968–69.
179. Michael Sant'Ambrogio & Glen Staszewski, *Democratizing Rule Development*, 98 WASH. U. L. REV. 793, 795–96 (2021).
180. *Section 2: Views of Government Regulation*, PEW RSCH. CTR. (Feb. 23, 2012), https://www.pewresearch.org/politics/2012/02/23/section-2-views-of-government-regulation [https://perma.cc/QTM6-G64B] ("In general, more Americans say that government regulation of business is harmful than say it is necessary to protect the public. At the same time, when asked about regulations in specific areas, such as food safety and environmental protection, there is broad support for strengthening regulations or keeping current regulations as they are now rather than reducing regulations.").
181. U.S. CONST. art. I, § 8, cl. 3.
182. *See infra* note 137.

acknowledgment of agency expertise and resources as well as the harm to investors caused by a failure to give deference to these agencies.[183]

II. THE *CAREMARK* STANDARD, STATE DEFERENCE, AND DEATH BY PROCESS

The Delaware Court of Chancery decided *Caremark* in response to the diminished viability of breach of duty claims,[184] and, in so doing, gave rise to a new era of compliance and profoundly changed the bounds of fiduciary duties.[185] *Caremark* placed a new duty of oversight within the realm of the duty of loyalty, making it much more than just an elevated level of attention to business, as the duty of care and good faith require.[186] *Caremark* claims, however, remain difficult to prove because, as discussed above, corporate fiduciaries have great leeway in what they believe to be the best course of action based on their company's business and resources. After all, "[b]usiness decision-makers must operate in the real world, with imperfect information, limited resources, and uncertain future. To impose liability on directors for making a 'wrong' business decision would cripple their ability to earn returns for investors by taking business risks."[187]

183. *See infra* note 18F2.
184. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2022); DEL. CODE ANN. tit. 8, § 145 (West 2022); Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 660–61 (2010) ("Fear that verdicts like Van Gorkom could be common drove up directors and officers liability insurance costs and gave directors reason to be concerned about service. Section 102(b)(7) was the General Assembly's answer to that problem."); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 65–66 (Del. 2006) (articulating the difference between a bad faith decision, which involves subjective bad intent, gross negligence, and a breach of fiduciary duty, which is an "intentional dereliction of duty, a conscious disregard for one's responsibilities").
185. *See* Leo E. Strine, Jr., Kirby M. Smith & Reilly S. Steelet, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 IOWA L. REV. 1885, 1889 (2021) ("By engaging in a thoughtful updating and integration of existing regulatory reporting and compliance and [environment, employee, social, and governance ("EESG")] processes, corporate leaders can efficiently generate robust information about their EESG performance and legal compliance to share with stakeholders and simultaneously fulfill their duty to monitor the corporate enterprise."); *see also* Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE. J. ON REGUL. 499, 561–62 (2020) (discussing corporate disclosure to shareholders and how in the past, voluntary sustainability reports were insufficient to satisfy public demand and were often incomplete and inconsistent, while post *Caremark*, directors of corporations have a duty to make good faith efforts to ensure that an adequate internal corporate information and disclosure system exists, preventing businesses from concealing information from investors).
186. *See infra* notes 143–44 (discussing the business judgment rule and good faith).
187. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009).

Collectively, plaintiffs have brought seventeen *Caremark* claims in Delaware, but only five have survived a motion to dismiss: *Marchand v. Barnhill*,[188] *In re Clovis*,[189] *Teamsters Local 443 Health Services & Insurance Plan v. Chou*,[190] *Hughes v. Hu*,[191] and *In re Boeing Co. Derivative Litig.*[192] Plaintiffs in each of these cases successfully relied on fact finding from a collateral source—federal agency investigations and enforcement actions—to support their common law fiduciary duty claims.[193] Therefore, evidence of a failure to comply with federal oversight and regulations can be used as a per se breach of loyalty in Delaware.

If Delaware formally adopts this approach to *Caremark* claims, then *Caremark* would effectively be federalized, the balance of federal-state powers and deference could be more intelligently maintained, and shareholders would have easier access to more and better information on which to base their claims. Accordingly, this Part discusses *Caremark* and its attendant procedural difficulties, analyzes the five cases where plaintiffs have survived a motion to dismiss, compiles the most important takeaways from those cases, and concludes with an application of those lessons to the Facebook and Cambridge Analytica scandal.

A. *Caremark* Standard and Procedural Impossibility

In *Caremark*, the court explained directors have a duty to ensure "information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board . . . to reach *informed judgments* concerning both the corporation's *compliance with law* and its *business performance*."[194] This duty of oversight, as a part of the duty of good faith, demands that an adequate monitoring system capable of informing directors exists and also demands that directors actually utilize the information provided in their business considerations. If a director fails to "make a good faith effort to oversee the company's operations," then the director is liable for breach of

188. 212 A.3d 805, 807 (Del. 2019).
189. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. 2019).
190. No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020).
191. No. 2019-0112-JTL, 2020 WL 1987029 (Del.Ch. Apr. 27, 2020).
192. No. 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sep. 7, 2021).
193. *See infra* Part II.B.
194. *In re* Caremark Int'l Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (emphasis in the original).

loyalty.[195] A "failure to do so under some circumstances may, in theory at least, *render a director liable for losses caused by non-compliance with applicable legal standards*."[196] Thus, in analyzing liability for breaches of duty under *Caremark*, it is appropriate for a court to distinguish between the oversight of a company business and the oversight of a company's legal and regulatory compliance.[197] There is potential in this bifurcated approach, but, as the unsuccessful *Caremark* plaintiffs demonstrate, there is always a hefty procedural burden on shareholders in derivative claims.

That hurdle is the business judgment rule.[198] The business judgement rule presumes directors act in compliance with their fiduciary duties when making

195. *Id.* at 970 ("[I]t is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.").
196. *Id.* (emphasis added).
197. *In re* Facebook, Inc. Section 220 Litig., No. 2018-0661-JRS, 2019 WL 2320842, at *14 n.150 (Del. Ch. May 31, 2019), as revised (May 31, 2019), judgment entered *sub nom*. *In re* Facebook, Inc. (Del. Ch. 2019) ("In other words, it is more difficult to plead and prove *Caremark* liability based on a failure to monitor and prevent harm flowing from risks that confront the business in the ordinary course of its operations. Failure to monitor compliance with positive law, including regulatory mandates, is more likely to give rise to oversight liability."). *See also In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009) ("There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a [c]ompany's business risk."); *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215-VCG, 2011 WL 4826104, at *21 (Del. Ch. Oct. 12, 2011) ("As a preliminary matter, this Court has not definitively stated whether a board's *Caremark* duties include a duty to monitor business risk."); Asbestos Workers Loc. 42 Pension Fund *ex rel.* v. Bammann, No. 9772-VCG, 2015 WL 2455469, at *14 (Del. Ch. May 21, 2015) ("It is not entirely clear under what circumstances a stockholder derivative plaintiff can prevail against the directors on a theory of oversight liability for failure to monitor business risk under Delaware law; the Plaintiff cites no examples where such an action has successfully been maintained.") (emphasis in original); Reiter *ex rel.* Cap. One Fin. Corp. v. Fairbank, No. 11693-CB, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016) ("In applying the *Caremark* theory of liability, even in the face of alleged red flags, this Court has been careful to distinguish between failing to fulfill one's oversight obligations with respect to fraudulent or criminal conduct as opposed to monitoring the business risk of the enterprise."); Okla. Firefighters Pension & Ret. Sys. v. Corbat, No. 12151-VCG, 2017 WL 6452240, at *18 (Del. Ch. Dec. 18, 2017) ("Banamex made a risky business decision that turned out poorly for the company. That suggests a failure to monitor or properly limit *business* risk, a theory of director liability that this Court has never definitively accepted. Indeed, evaluation of risk is a core function of the exercise of business judgment.") (emphasis in original).
198. There is some debate over whether the business judgment rule is truly a procedural hurdle in *Caremark* litigation. Professor Roy Shapira argues that since *Caremark* claims are merely about omission, for example, the director did not do enough and no business decision has been made, the business judgment rule does not formally apply. *See, e.g.*, Roy Shapira, *Mission Critical ESG and the Scope of Director Oversight Duties*, COLUM. BUS. L. REV. 732, 751 n.64 (2022) ("The business judgment rule does not apply to failure-of-oversight claims, as these do

business decisions, and—as a result—courts will not second-guess those decisions or insert themselves into business operations unless shown otherwise.[199] This necessarily places the initial burden of proof on the plaintiff who, in order to survive a motion to dismiss, must rebut the presumption of the business judgment rule by showing the conduct or decision at issue was made in "bad faith."[200]

What types of behavior demonstrate bad faith? Do such actions violate duties of care, loyalty, or both? Delaware courts have grappled with such questions before, but in one particularly important fiduciary duty case—*In re the Walt Disney Company Derivative Litigation*[201]—the court offered the following categories of "bad faith":

> [A]t least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label. The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm . . . . The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent . . . [gross negligence without more does not constitute bad faith] . . . . [The] third category is what the Chancellor's definition of bad faith—intentional dereliction of duty, a conscious disregard for one's responsibilities—is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith. In our view it must be . . . .[202]

Caremark's focus is on categories two and three, the lack of due care resulting from gross negligence and the intentional dereliction of duty, thus creating two prongs to a bad faith *Caremark* argument, either of which can rebut the presumption of the business judgment rule and enable a derivative shareholder's claim to survive a motion to dismiss. *Caremark*'s dual prongs of bad faith may be satisfied if directors have (1) failed to implement monitoring systems in

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not involve making a concrete business decision.") (citing Stephen Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004)). For our purposes, this distinction is semantic. We simply mean that one is presumed to have exercised adequate business judgment if the court finds the company has done enough.

199. CHATMAN & REYES, *supra* note 90, at 501.

200. *Id.* at 487.

201. 906 A.2d 27, 64–66 (Del. 2005).

202. *Id.* Additionally, under Delaware's Section 102(b)(7), gross negligence is not an actionable breach of duty of care. Furthermore, if the court finds the potential for waste, then the board's decisions must be in bad faith because they cannot be attributed to any rational business purpose related to the company.

contravention of their duty of care or regulatory requirements, or (2) shown a "conscious disregard for one's responsibilities" by "non-compliance with applicable legal standards" by failing to use the monitoring systems in place.[203] Showing "an utter failure to attempt to assure a reasonable information and reporting system exists" to inform directors' business decisions will demonstrate bad faith under prong one.[204] Showing that "having implemented such a system or controls," the directors "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention" will demonstrate bad faith under prong two.[205]

But defining bad faith does not provide shareholders with the evidence to prove it. How do shareholders obtain information regarding the existence of red flags or bad faith without discovery? Shareholders are provided with inspection rights, found in Delaware's General Corporation Law (DGCL) Section 220, which enables a shareholder to inspect a corporation's books and records for a proper purpose.[206] The difficulty with a *Caremark* claim is that a shareholder may not know the full scope of materials or have knowledge to provide the court with a proper purpose for the full scope of potential harm without some other external fact finding.

At common law, shareholders enjoyed a right to inspect the corporation's books and records simply because of their shareholder status.[207] The common law awarded such rights of inspection in recognition of the shareholder's equitable interest as an owner of the company—a residual owner with a claim on the company's assets.[208] The common law presumed the shareholder had a proper purpose to inspect the documents and to prevent shareholder access, the law

203. *Caremark*'s prongs also provide the parameters for the exclusion found in Section 102(b)(ii) for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."

204. Marchand v. Barnhill (Blue Bell), 212 A.3d 805, 807 (Del. 2019) (citing *Caremark*); *see also In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (explaining in part the first prong of the *Caremark* standard, which is proving that there was "utter failure to attempt to assure a reasonable information and reporting system exists").

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

206. Geeyoung Min & Alexander M. Krischik, *Realigning Stockholder Inspection Rights*, 27 STAN. J.L. BUS. & FIN. 225, 233 (2022); Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 140 n.23 (2009); White v. Panic, 783 A.2d 543, 556–57 (Del. 2001) ("Contrary to the plaintiff's argument, this case demonstrates the salutary effects of a rule encouraging plaintiffs to conduct a thorough investigation, using the 'tools at hand' including the use of actions under 8 Del. C. § 220 for books and records, before filing a complaint.").

207. CHATMAN & REYES, *supra* note 90, at 587.

208. *Id.*

required the corporation to demonstrate that bad faith or improper purpose motivated the shareholder.[209] This principle is codified in Section 220:

> (b) Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from:
>
> (1) The corporation's stock ledger, a list of its stockholders, and its other books and records . . .
>
> In every instance where the stockholder is other than a record holder of stock in a stock corporation, or a member of a nonstock corporation, the demand under oath shall state the person's status as a stockholder, be accompanied by documentary evidence of beneficial ownership of the stock, and state that such documentary evidence is a true and correct copy of what it purports to be. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder. In every instance where an attorney or other agent shall be the person who seeks the right to inspection, the demand under oath shall be accompanied by a power of attorney or such other writing which authorizes the attorney or other agent to so act on behalf of the stockholder. The demand under oath shall be directed to the corporation at its registered office in this State or at its principal place of business.
>
> (c) . . . Where the stockholder seeks to inspect the corporation's books and records, other than its stock ledger or list of stockholders, such stockholder shall first establish that:
>
> (1) Such stockholder is a stockholder;
>
> (2) Such stockholder has complied with this section respecting the form and manner of making demand for inspection of such documents; and
>
> (3) The inspection such stockholder seeks is for a proper purpose.
>
> Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders and establishes that such stockholder is a stockholder and has complied with this section respecting the form and manner of making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection such stockholder seeks is for an improper purpose.[210]

209. *Id.*
210. *See* DEL. CODE ANN. tit. 8, § 220 (West 2010).

The statute makes a distinction between stock lists and general books and records, the former of which is easier to obtain by request.[211] The burden is on the corporation to establish that a demand for stock ledgers is improper.[212] While the prerequisite to the inspection of books and records is virtually identical to the inspection requirements for a demand for the stock list, the burden is on the shareholder to establish a proper purpose.[213] Section 220 states that, to be proper, the purpose must reasonably relate to the person's interest as a stockholder. Merely stating a proper purpose is insufficient. Delaware courts require that shareholders proffer some level of evidence of the alleged wrongdoing that enables the court to infer that mismanagement, waste, or corporate wrongdoing may have occurred prior to making an inspection request.

What is a person's interest as a stockholder? Does a shareholder's interest in the social responsibility of the corporation suffice as an interest as a stockholder? At what point does disagreement with management policies become reasonably related to a person's interest as a stockholder? Ironically, shareholders are often able to meet the "credible basis" burden for inspection in the same way that they are able to survive a motion to dismiss under *Caremark*—with administrative findings.[214]

Shareholder inspection rights can offer a pre-litigation discovery opportunity that can help offset the heavy procedural hurdles, even with the requirement to establish that the request reasonably relates to the stockholder's interests. While stronger than the burden for stock lists and ledgers, the burden for books and

211. CHATMAN & REYES, *supra* note 90, at 587–591.

212. *See* DEL. CODE ANN. tit. 8, § 220 (West 2010) ("Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders and establishes that such stockholder is a stockholder and has complied with this section respecting the form and manner of making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection such stockholder seeks is for an improper purpose.").

213. State of Minn. *ex rel.* Pillsbury v. Honeywell, Inc., 191 N.W.2d 406, 409–10 (Minn. 1971); Saito v. McKesson HBOC, Inc., 806 A.2d 113, 116 (Del. 2002); NVIDIA Corp. v. City of Westland Police and Fire Ret. Sys., 282 A.3d 1, 12-28 (Del. 2022); Hightower v. SharpSpring Inc., No. 2021-0720-KSJM, 2022 WL 3970155, at *17 (Del. Ch. Aug. 31, 2022); Rivest v. Hauppauge Digital Inc., No. 2019-0848-PWG, 2022 WL 3973101, at *16 (Del. Ch. Sept. 1, 2022).

214. *See, e.g.*, Lebanon Cnty. Employees' Retirement Fund. AmerisourceBergen Corp., No. CV 2019-0527, 2020 WL 132752, at *9 (Del. Ch. 2020) ("Ongoing investigations and lawsuits can provide the necessary evidentiary basis to suspect wrongdoing or mismanagement warranting further investigation. This type of evidence is strong when governmental agencies or arms of law enforcement have conducted the investigations or pursued the lawsuits."); Carapico v. Phila. Stock Exch., Inc., 791 A.2d 787, 792 (Del. Ch. 2000) (finding an "SEC inquiry" and "SEC Order" were "sufficiently concrete" to suspect mismanagement).

records is still the lowest burden possible under Delaware law.[215] Delaware courts have recently liberalized their interpretation of Section 220 requirements and, as such, "shareholders and their attorney are better able to plead with particularity facts that implicate directors' mental state and awareness to overcome the *Caremark* pleading hurdle."[216] In fact, the Delaware Court of Chancery has gone so far as to adopt a presumption of inadequate representation for those who file *Caremark* claims without utilizing Section 220 first.[217] While plaintiffs must utilize Section 220, it can be difficult to do so without the information they obtain from administrative findings. In this regard, Section 220 is not the key to surviving the motion to dismiss. It is merely another step on the road to recovery.

The potential benefit of the proposal in this article—to give judicial recognition of administrative findings in *Caremark* claims—is that these administrative findings, or the fact that a business is subject to regulation by an administrative agency, may be sufficient to meet the Section 220 burden. For example, for a food company that must meet strict guidelines to maintain compliance with state and federal food safety norms, a negative inspection by the FDA and or a state agency is of obvious interest to shareholders, even before there is a major incident. If an agency action is per se evidence of a breach of duty, the possibility of such an action is in a shareholder's interest.

B. Surviving Motion to Dismiss by Agency Action

Agency regulations are positive law and, as such, already bind the courts (within the bounds of judicial deference).[218] Agency fact finding, in the form of adjudications, investigations, and enforcement actions, can provide further evidence for the courts, while helping shareholders to bolster their derivative claims against directors. Presently, only five Delaware cases have survived motions to dismiss under the *Caremark* standard. Plaintiffs in each of these cases

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215. *Hightower*, 2022 WL 3970155 at *13–14 (noting that the credible basis standard "imposes the lowest possible burden of proof" because it "does not require a stockholder to prove that wrongdoing actually occurred" or "to show by a preponderance of the evidence that wrongdoing is probable").

216. Roy Shapira, *A New* Caremark *Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1859 (2021).

217. *Id.* at 1869 (citing La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 335–36 (Del. Ch. 2012) (Pyott I)); South v. Baker, 62 A.3d 1, 22–24 (Del. Ch. 2012); Cal. State Tchrs.' Ret. Sys. v. Alvarez, 179 A.3d 824, 853 (Del. 2018).

218. "A system of law promulgated and implemented within a particular political community by political superiors, as distinct from moral law or law existing in an ideal community or in some nonpolitical community. Positive law typically consists of enacted law—the codes, statutes, and regulations that are applied and enforced in the courts." *Positive law*, BLACK'S LAW DICTIONARY (7th ed. 1999).

were able to sufficiently allege that corporate officers had acted in bad faith because external agency actions—such as investigations, reports, subpoenas, and other clear violations of agency standards—made them aware of compliance problems that could have been avoided if the corporations had, and the officers utilized, adequate monitoring systems.

This Subpart discusses these five cases and analyzes how the red flags and agency actions which should have alerted each board to problems instead served as the evidence plaintiff shareholders needed to overcome their rebuttal burdens regarding the directors' bad faith.

1. *Marchand v. Barnhill* (*Blue Bell*)

Marchand v. Barnhill (*Blue Bell*) shows that due care involves more than just mere legal and regulatory compliance. Plaintiffs in *Blue Bell* succeeded under prong one of *Caremark*, demonstrating that leveraging information collected by agencies regarding systemic deficiencies in oversight, monitoring, and regard for prior regulatory warnings should be enough to show per se bad faith by directors.

In February 2015, the South Carolina Department of Health and Environmental Control discovered listeria in Blue Bell's Chocolate Chip Country Cookie Sandwiches and Great Divide Bars using random product sampling.[219] The South Carolina findings prompted Texas officials to investigate the Blue Bell production facility in Brenham, Texas, where the two products were manufactured.[220] There, listeria was discovered in the same two products tested in South Carolina.[221] It was also discovered in Scoops, another Blue Bell ice cream product manufactured on the same production line.[222]

By March 2015, two people had contracted the Blue Bell strain of listeria and were undergoing treatment at the same hospital in Kansas.[223] Three other cases with differing strains of listeria were identified in that hospital as well.[224] Health officials believed that all five of the infections were due to consumption of milkshakes made with Blue Bell products while in the hospital.[225] Upon

219. *Multistate Outbreak of Listeriosis Linked to Blue Bell Creameries Products (Final Update)*, CTR. FOR DISEASE CONTROL & PREVENTION (June 10, 2015, 10:30 AM), https://www.cdc.gov/listeria/outbreaks/ice-cream-03-15/ [https://perma.cc/6H7R-VACK].
220. *Id.*
221. *Id.*
222. *Id.*
223. *Id.*
224. *Id.*
225. *Id.*

investigation, the Kansas Department of Health and Environment found listeria in the Blue Bell chocolate ice cream cups collected from the Kansas hospital.[226] But they discovered it was the strain of listeria found in ice cream cups from Blue Bell's Broken Arrow, Oklahoma manufacturing facility, a different strain of listeria than those found in the people infected in Kansas and the products sampled in Texas and South Carolina.[227] Ultimately, ten people were infected with several strains of Blue Bell listeria in four states: Arizona (one), Kansas (five), Oklahoma (one), and Texas (three).[228] All ten people were hospitalized, and three of the five Kansas victims died.[229]

In late March and early April, and partly in response to a U.S. Centers for Disease Control and Prevention recommendation against serving or eating Blue Bell products,[230] Blue Bell Creameries voluntarily shut down production in Broken Arrow, partially shut down production in Brenham, and removed all products from the affected production lines from the market.[231] The consequences of these decisions included the disposal of over eight million gallons of product,[232] the eventual shutdown of all plants, the layoff of more than a third of the company's workforce, and a liquidity crisis which forced the company to accept a dilutive private equity investment that harmed shareholders.[233]

Shareholder plaintiffs brought suit and were able to survive a motion to dismiss by sufficiently alleging that Blue Bell's board had not undertaken any efforts to ensure food safety.[234] The *Blue Bell* court based its holdings on several important facts. Specifically, there was no board committee to address food safety, nor a schedule on which the board would assess whether any key food safety risks existed. There were no regular processes or protocols requiring management to keep the board apprised of food safety compliance practices, risks, or reports. In fact, during the period leading up to the deaths of the three victims, management

226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.* ("At this point in the investigation, CDC [Center for Disease Control and Prevention] recommended that consumers not eat and institutions and retailers not serve any products made at the company's Oklahoma facility, in addition to any previously recalled or withdrawn products.").
231. *Id.*
232. Denise Marquez, *Blue Bell to Dispose of 8 Million Gallons of Ice Cream After Recall*, LUBBOCK AVALANCHE-JOURNAL (Apr. 22, 2015, 6:43 PM), https://www.lubbockonline.com/story/entertainment/local/2015/04/22/blue-bell-dispose-8-million-gallons-ice-cream-after-recall/14981003007 [https://perma.cc/X87X-HXFY].
233. Marchand v. Barnhill (Blue Bell), 212 A.3d 805, 807 (Del. 2019).
234. *Id.* at 820.

had received reports containing what should have been considered red or possibly yellow flags, but board minutes of the same period revealed no evidence they were disclosed to the board. Management instead gave favorable information about food safety to the board, rather than much more important, negative reports. Board meetings lacked any regular discussion about food safety at all.[235]

According to Chief Judge Leo Strine, Blue Bell, as a company which makes and relies on a single product, "can only thrive if its consumers enjoyed its products and were confident that its products were safe to eat."[236] But Blue Bell's board "had no committee overseeing food safety, no full board-level process to address food safety issues, and no protocol by which the board was expected to be advised of food safety reports and developments . . . [and] during a crucial period when yellow and red flags about food safety were presented to management, there was no equivalent reporting to the board and the board was not presented with any material information about food safety."[237] Accordingly, the court held "the complaint alleges specific facts that create a reasonable inference that the directors consciously failed 'to attempt to assure a reasonable information and reporting system exist[ed].'"[238]

The court also noted that both state and federal agencies were involved.[239] As discussed above, Blue Bell is subject to state agency oversight and regulations, and "[a]t the time of the listeria outbreak, Blue Bell operated in three states, and each had issued rules and regulations regarding the proper handling and production of food to ensure food safety."[240] At the federal level, the FDA had notified Blue Bell of several deficiencies within its facilities both before and after the listeria outbreak began.[241] The FDA requires food manufacturing companies "to comply with regulations and establish controls to monitor for, avoid and remediate contamination and conditions that expose the Company and its products to the risk of contamination."[242] FDA regulations require food manufacturers to conduct operations "with adequate sanitation principles" and to "prepare . . . and implement a written food safety plan" which must include identification of potential food safety hazards, preventative analyses, methods of implementation,

235. *Id.* at 822.
236. *Id.* at 809.
237. *Id.*
238. *Id.* (citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d at 971 (Del. Ch. 1996)).
239. *Id.*
240. *Id.*
241. *Id.* at 810.
242. *Id.*

sanitation standards, monitoring, and more.[243] But when the FDA sent Blue Bell reports and letters, such as one stating its facilities had not been constructed "in such a manner as to prevent drip and condensate from contaminating food, food-contact surfaces, and food-packing material,"[244] Blue Bell did not seek to rectify the problems because there was no reporting system in place to convey the information to the board on an ongoing basis.[245]

In its defense, Blue Bell blamed the government for its failures, arguing there could be no breach of duty because both state and federal governments regularly inspected its facilities.[246] The court was unpersuaded, explaining that "[a]t best, Blue Bell's compliance with these requirements shows only that management was following, in a nominal way, certain standard requirements of state and federal law. It does not rationally suggest that the board implemented a reporting system to monitor food safety or Blue Bell's operational performance."[247]

Regarding *Caremark*'s bad faith requirements and a plaintiff's burden to overcome the initial business judgment rule presumption, the court stated, "[t]he mundane reality that Blue Bell is in a highly regulated industry and complied with some of the applicable regulations does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a Caremark claim."[248] The court in *Blue Bell* focused on prong one of *Caremark*, highlighting Blue Bell's failure to implement a monitoring system and its negligent lack of attentiveness, while recognizing that nominal regulatory compliance is not enough to shield directors from liability and that plaintiffs can leverage agency information to bolster their shareholder claims. The following case builds on *Blue Bell* and illustrates how plaintiffs can succeed under *Caremark*'s second prong.

2. *In re Clovis Oncology, Inc.* Derivative Litigation

Like *Blue Bell*, *In re Clovis Oncology, Inc.* is a 2019 Delaware Chancery Court case in which the court found that the board ignored multiple warning signs—this time about company management inaccurately reporting a drug's efficacy in

243. *Id.*
244. *Id.*
245. *Id.*
246. *Id.* at 822–23.
247. *Id.*
248. *Id.*

violation of clinical trial protocols and federal regulations.[249] As was the case in *Blue Bell*, several of these warning signs originated from federal regulators.

In 2014, Clovis Oncology, a biopharmaceutical manufacturer, was developing a new lung cancer treatment drug called Rociletinib (Roci).[250] Like all new drugs, Roci was required to undergo the FDA's new drug approval process, which requires companies prove a drug's efficacy and safety by conducting clinical trials with FDA-approved protocols.[251] These protocols include disclosing information about how the trial will be conducted, how the resulting data will be analyzed, and how the trial will measure success.[252] If a company does not follow the approved procedure, then the FDA will not approve the new drug for market.[253] Time was of the essence, however, because while Roci was under development, Clovis had no other products on the market to generate sales revenue, meaning the company's entire operating budget relied on investor capital.[254] Clovis created this arrangement because it expected Roci to be a blockbuster drug capable of tapping into a $3 billion annual market.[255]

As part of the Roci approval process, Clovis opted to incorporate a well-known clinical trial protocol called RECIST.[256] RECIST required the company to designate a success-defining metric for the trial known as the objective response rate (ORR), which "measures the percentage of patients who experience meaningful tumor shrinkage when treated with the drug. This metric is important both to the FDA in its approval process and to physicians in deciding whether to prescribe the drug."[257] Under the terms of the clinical trial protocol, Clovis was to calculate ORR based on confirmed responses.[258] Several reports verified Clovis was including unconfirmed responses in ORR calculations.[259] The board was

249. *In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188, at *1, *13 (Del. Ch. 2019).
250. *Id.* at *1.
251. *Id.*
252. *Id.*
253. *Id.*
254. *Id.* at *2, *4.
255. *See id.* at *4.
256. RECIST "has become the most widely used system for assessing response in cancer clinical trials, and is the preferred and accepted system for use in new drug applications to regulatory agencies." Director Defendants Answer to the Supplemental Consolidated Verified Shareholder Derivative Complaint, *In re Clovis Oncology, Inc.*, 2020 WL 127877, ¶ 83 (quoting Manola et al., *Assessment of Treatment Outcome*, UICC MANUAL OF CLINICAL ONCOLOGY 40, 44 (Brian O'Sullivan et al. eds. 9th ed. 2015)).
257. *In re Clovis Oncology, Inc.*, 2019 WL 4850188, at *5.
258. *Id.*
259. *Id.*

aware of the discrepancy as early as June 12, 2014, but it did nothing to respond to it or other indications of noncompliance with RECIST, such as problems with informed consent, patient eligibility, data reliability, recordkeeping, and adverse reporting practices violations.[260]

Instead, during the clinical trial phase, in press releases, investor calls, SEC filings, and statements to medical journals, Clovis management maintained that, "per RECIST," Roci had a confirmed ORR of about 60 percent; in addition, Clovis reported an ORR of 50 percent directly to the FDA in a June 9, 2015 meeting about its new drug application.[261] Company management also often noted Roci's ORR was at least as encouraging as the nearest competing products' ORR.[262] When the board received the final protocol numbers on July 7, 2015, the data showed Roci's actual ORR was only 42 percent.[263]

The FDA was aware of the conflicting ORR reports and requested additional support for the new drug application in October 2015, calling a meeting with Clovis executives in November 2015.[264] The executives at the meeting learned the FDA would only credit confirmed responses on the application and insisted that Clovis comply with the protocol.[265] When Clovis issued a public press release on November 18, 2015, to acknowledge Roci's confirmed ORR was only 28–34 percent, the company's stock price dropped by 70 percent and wiped out more than $1 billion in market capitalization.[266] In May of the following year, Clovis withdrew its new drug application for Roci and terminated all ongoing Roci studies.[267] The company and board members were later named as defendants in several securities fraud class actions which resulted in hundreds of millions of dollars in settlements and payouts, a follow-on FDA investigation, and an onerous SEC consent decree.[268]

Delaware's Chancery Court noted that plaintiffs would struggle to meet the first prong of *Caremark* because the board had reviewed detailed information about Roci's development at its board meetings, as provided by the Nominating and Corporate Governance Committee charged with "provid[ing] general compliance oversight . . . with respect to . . . Federal health care program

260. *Id.* at *6–7.
261. *Id.*
262. *Id.*
263. *Id.* at *7.
264. *Id.* at *8.
265. *Id.*
266. *Id.*
267. *Id.*
268. *Id.* at *9.

requirements and FDA requirements."[269] Therefore, there was an oversight system in place, and the board had access to its information. But this was ultimately to the detriment of the board, because to prevail under the second prong, plaintiffs must show that the board knew that noncompliance was an issue and willfully ignored that fact.[270] Accordingly, the court concluded the allegations of a failure to monitor an oversight system clearly implicated *Caremark*'s second prong, because the board knew the protocol incorporated RECIST,[271] RECIST ORR calculations were only supposed to include confirmed responses,[272] industry practice and FDA guidance required that study managers only report confirmed responses,[273] management publicly reported unconfirmed responses to keep up with the competition's response rate,[274] and because the board knew management was incorrectly reporting responses but chose to do nothing about it.[275]

Similar to the food safety considerations of *Blue Bell*, the court noted that Roci's trial was mission critical to Clovis, and the drug's accompanying regulatory issues demanded the gaze of the "careful observer," that is, "one whose gaze is fixed on the company's mission critical regulatory issues."[276] Roci, and by extension Clovis, were doomed as soon as the FDA learned of the company's serial noncompliance with RECIST; it was inevitable that the company's stock price would plummet once word of Clovis's misconduct circulated.[277] The court therefore denied the defendant's motion to dismiss the *Caremark* claim because it concluded there was "a causal nexus between the breach of fiduciary duty and the corporate trauma,"[278] and because the "failure of oversight caused monetary and reputational harm to the Company" when "the Board consciously ignored red flags that revealed a mission critical failure to comply with the RECIST protocol and associated FDA regulations."[279]

269. Director Defendants Answer to the Supplemental Consolidated Verified Shareholder Derivative Complaint, *In re Clovis Oncology, Inc.*, No. 2017-0222-JRS, 2020 WL 127877, ¶ 279.
270. *In re Clovis Oncology, Inc.*, 2019 WL 4850188 at *13 (noting that plaintiffs must show a "'red flag' of non-compliance waved before the Board Defendants but they chose to ignore it") (citing South v. Baker, 62 A.3d 1, 16–17 (Del. Ch. 2012)).
271. *Id.*
272. *Id.*
273. *Id.*
274. *Id.*
275. *Id.*
276. *Id.* (citing Blue Bell).
277. *Id.*
278. *Id.* at *15.
279. *Id.* (citing Director Defendants Answer to the Supplemental Consolidated Verified Shareholder Derivative Complaint, *In re Clovis Oncology, Inc.*, No. 2017-0222-JRS, 2020 WL 127877, ¶¶ 18, 222–23).

Clovis supplements the *Blue Bell* holdings in several ways. In *Blue Bell*, there was superficial, albeit borderline negligent, compliance with at least some of the applicable laws and regulations; in *Clovis*, the board knowingly and actively concealed its noncompliance. In *Blue Bell*, the absence of oversight systems and the directors' inaction implicated prong one; in *Clovis*, the board's use of oversight systems to facilitate malfeasance rather than fiduciary duties implicated prong two. But, most importantly, and to a greater degree in *Clovis* than in *Blue Bell*, the existence of agency-produced information regarding the defendants' statutory and regulatory violations were readily accessible for plaintiffs to use as evidence in their own derivative claims. The following case goes even further in linking agency findings to a *Caremark* breach.

3. *Teamsters Local 443 Health Services & Insurance Plan v. Chou*

The most important feature of *Teamsters Local 443 Health Services & Insurance Plan v. Chou* (*Teamsters*) is that it affirms and relies on both previous cases to further solidify the precedence they began: when corporate fiduciaries invite administrative attention by flouting the law in a highly regulated field to the catastrophic detriment of their product and shareholders, shareholders' derivative claims can use the information developed by agency action to show the per se bad faith of the fiduciaries and overcome their difficult *Caremark* burden.[280]

The *Teamsters* story began in 2001 when AmerisourceBergen Corporation (ABC), a pharmaceutical sourcing and distributing company, acquired Oncology Supply Pharmacy Services (Pharmacy) as part of a larger merger.[281] Despite clear involvement in the medical-pharmaceutical industry, neither ABC nor Pharmacy were registered with the FDA as drug manufacturers or packagers.[282] Instead, ABC intentionally portrayed Pharmacy as a state-regulated pharmacy to avoid FDA regulatory oversight, but even then it "did not function in accordance with local state laws, and functioned solely to repackage drug product from vials to [pre-filled syringes] on a massive commercial scale."[283] Pharmacy's sole function, called the Pre-Filled Syringe Program, revolved around creating, repackaging, and shipping pre-filled syringes to oncology practices, medical centers, and

280. Teamsters Local 443 Health Servs. & Ins. Plan, No. 2019-0816-SG, 2020 WL 5028065 at *1 (Del. Ch. Aug. 24, 2020).
281. *Id.*
282. *Id.*
283. *Id.* at *7 (citation omitted).

physicians to treat immunocompromised patients.[284] The court describes Pharmacy's program:

> Pharmacy created the pre-filled syringes by removing FDA-approved drug products from their original glass vials and repackaging them into single-dose plastic syringes. When Pharmacy would remove the desired dosage of oncology drug from its original glass vial a small amount of drug product would be left over—this is known as 'overfill.' When packaging drug products, manufacturers intentionally include overfill to help with accurate dosage, as it accounts for human error in filling syringes and permits the medical provider to avoid dangerous air bubbles. Overfill is not intended for patient use. Pharmacy would extract the overfill from FDA-compliant vials and combine the contents from multiple vials—this is known as 'pooling.' The pooled excess drug product was repackaged into new syringes. By pooling overfill, the Pre-Filled Syringe Program was able to create more doses than it bought from the original drug manufacturers.[285]

Pharmacy also had an incentive program which gave technicians who produced more syringes extra bonuses.[286] At the height of its operation, the Pre-Filled Syringe Program generated more than $14 million in profit a year for ABC.[287] These practices were clearly illegal. Accordingly, the U.S. Attorney's Office subpoenaed Pharmacy, and FDA agents executed a search warrant on its Dothan, Alabama facility in 2012.[288]

The court acknowledged that the director defendants' actions implicated both prongs of *Caremark*,[289] something that is rather hard to accomplish given that the prongs are typically mutually exclusive. But, because the court ultimately found for plaintiffs under prong two, it only noted that ABC's "woefully inadequate compliance system" regarding another of its subsidiaries "sp[oke] to a lax approach (at best) to compliance at ABC."[290] The court reiterated that, under prong two, bad faith requires a showing that directors were "conscious of the fact that they were not doing their jobs, and that they ignored red flags" which were

284. *Id.* at *3.
285. *Id.* at *4 (internal citations omitted).
286. *Id.* at *6.
287. *Id.* at *5.
288. *Id.* at *24.
289. *Id.* at *25.
290. *Id.* at *26.

"waved in [their] face or displayed so that they [were] visible to the careful observer."[291]

The court relied on three particular red flags in determining the directors had exhibited bad faith. The first and most obvious dealt with an assessment, the Davis Polk Report, of ABC's compliance program.[292] The Davis Polk Report notified ABC's Audit Committee of numerous deficiencies in its compliance program, including the fact that the corporation failed to include ABC subsidiaries like Pharmacy in any sort of compliance program at all, and then recommended five areas for improvement.[293] ABC's board and Audit Committee did nothing in response to the report.[294] The court had little trouble determining this met *Caremark*'s second prong, because there was a clear oversight mechanism in place—the Audit Committee—and the board learned of the deficiencies outlined in the report through the Audit Committee.[295]

The second red flag dealt with a former ABC subsidiary's Chief Operating Officer (COO), Michael Mullen, who was fired for raising concerns about the legality of Pharmacy's Pre-Filled Syringe Program "business model that created regulatory exposure," and subsequently filed a federal *qui tam* suit which said the Program was an illegal "overfill laundering scheme" that "undermined accurate pricing by government healthcare programs."[296] The court determined the board was aware of Mullen's allegations because they were aware of and making disclosures about his *qui tam* suit.[297]

The third red flag dealt with the FDA's search warrant and the DOJ's subpoena. The court dismissed the search warrant as a possible bad faith red flag because there was no evidence the board had actual knowledge of the warrant or its execution.[298] The corporation disclosed the subpoena in ABC's Form 10-K filed with the SEC in 2010, allowing the court to reasonably infer the board "did nothing to correct the underlying mission critical compliance shortcoming at Pharmacy."[299]

291. *Id.* (citation omitted).
292. *Id.* at *20.
293. *Id.*
294. *Id.*
295. *Id.*
296. *Id.* at *11, *13.
297. *Id.* at *21 ("[T]he Board *did* sign ABC's 2010 and 2011 Form 10-Ks that disclosed Mullen's *qui tam* suit. I may consequently draw the inference that the Defendant Directors . . . were aware of Mullen's allegations . . . [because] the Board disclosed Mullen's suit in November 2010, and the Pre-Filled Syringe Program continued [] until January 2014.").
298. *Id.* at *13, *24.
299. *Id.* at *24.

It is important to note how the first, second, and third red flags interconnect. Mullen's interaction with the DOJ led it to issue the subpoena; prompted other agency involvement by the FDA, through its search warrant and its investigation into ABC's regulatory violations, and the SEC, through ABC's 10-K filing; and ultimately gave plaintiffs substantiating material for their *Caremark* claim.

Teamsters, like *Blue Bell*, involved a company enabled in its malfeasance by the federal-state regulatory governance gap and, to a lesser extent, its inadequate or inconsistent oversight and compliance programs. Notably, all three cases involved the highly regulated[300] food and medicine industries and, at least for the period relevant to the litigation, involved "monoline" companies relying on a single "essential and mission critical" product or service for their financial success.[301]

4. Other Successful *Caremark* Cases

As demonstrated by the similarities shared by *Blue Bell*, *Clovis*, and *Teamsters*, relying on agency actions and regulations is a consistent method of bolstering a *Caremark* claim. *In re Boeing Company Derivative Litigation* (*Boeing*) and *Hughes v. Hu*, however, are two outlying Delaware-based *Caremark*

300. The Authors use the term "highly regulated" to refer to those industries subject to consistent and ongoing regulatory involvement and oversight. The McLaughin-Sherouse List (List), which ranked all industries according to RegData Industry Regulation Index, was published in 2014 by George Mason University's Mercatus Center. According to this List, the ten most federally regulated industries in 2014 included three types of manufacturing (petroleum and coal products manufacturing, motor vehicle manufacturing, and pharmaceutical and medicine manufacturing); two types of financial services industries (nondepository credit intermediation and depository credit intermediation); two modes of transportation (scheduled air transportation and deep sea, coastal, and Great Lakes water transportation); and two industries involving natural resources (fishing and oil and gas extraction). Notably, the most regulated state industries are (1) administrative and support services, which includes industries such as employment services; (2) collection agencies, telephone call centers, and professional, scientific, and technical services; (3) waste management and remediation services; (4) chemical manufacturing; (5) petroleum and coal products manufacturing; (6) paper manufacturing; (7) animal production and aquaculture; (8) ambulatory healthcare services; (9) insurance carriers and related activities; and (10) mining (except oil and gas). Kofi Ampaabeng et al., *A Policymaker's Guide to State RegData 2.0*, MERCATUS CTR. GEO. MASON (Oct. 2020), https://www.mercatus.org/publications/regulation/policymaker%E2%80%99s-guide-state-regdata-20 [https://perma.cc/7A5Z-RWN9].
301. *Id.* at *18 (citing Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805 (Del. 2019) and *In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. 2019)).

cases with uniquely specific topical considerations that nevertheless managed to survive motions to dismiss.[302]

Boeing was a 2021 case about Boeing's 737 MAX airplane, two of which crashed—into the Java Sea in October 2018 and in Ethiopia in March 2019—killing everyone aboard.[303] Boeing, like Blue Bell, Clovis, and Pharmacy, falls within a highly regulated industry; thus, airplane safety is mission critical. Here, mission critical means that the system or its associated product is so essential to the business's operation that a disruption will result in serious impact on not only the business's operations, but also the business's profits. The *Boeing* court noted *Blue Bell* had "remarkably similar" prong one allegations: the board had no committee to monitor or report on airplane safety;[304] the company lacked internal reporting systems to bring safety concerns to the board's attention;[305] the board did not monitor, discuss, or address airplane safety on a regular basis;[306] and the board had no regular process or protocols requiring management to apprise the board of airplane safety issues.[307] Company management knew the 737 MAX had numerous, potentially catastrophic safety concerns, the worst being a defective maneuvering control system.[308] All of these constituted red flags. Accordingly, the court determined the plaintiffs carried their burden under both prong one and prong two.[309]

The key difference in *Boeing* is the plaintiffs had no opportunity to rely on agency action or information because, unlike in the previous cases, Boeing was either successful in its deceptions of the U.S. Federal Aviation Administration (FAA) or the FAA was uninterested in seriously investigating the company. Boeing misled the FAA by failing to disclose known safety issues about the plane's maneuvering characteristics augmentation system.[310] But, even when the

302. Hughes v. Xiaoming Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *18 (Del.Ch. Apr. 27, 2020); *In re* Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 WL 4059934 at *36 (Del. Ch. Sep. 7, 2021).
303. *In re Boeing Co. Derivative Litig.*, 2021 WL 4059934, at *1.
304. *Id.*, *26–27.
305. *Id.*
306. *Id.*
307. *Id.* at *29.
308. *Id.* at *31.
309. *Id.* at *25–*26. The court's holding in II.A.1.b. is somewhat confusing. The section begins by clearly stating plaintiffs were also able to allege particularized facts necessary to establish a prong two *Caremark* claim, but then, later in the same section, the court states "I need not decide today whether Plaintiffs' prong two theory is cognizable in view of my conclusion that the Board utterly failed under prong one."
310. *Id.* ("Boeing did not update the 2014 FAA [U.S. Federal Aviation Administration] Assessment for [the Maneuvering Characteristics Augmentation System (MCAS)] as revised. Boeing's

maneuvering control problem arose, Boeing simply told the FAA that "it should not reference [it] in its report because it was 'outside the normal operating envelop[e].'"[311] The court acknowledged "Boeing and its well-connected leadership had significant sway over the FAA, and the FAA often permitted Boeing to self-regulate."[312] Obviously, such an arrangement would impede the FAA's ability to respond appropriately.

Hughes v. Hu is an outlier because it is defined as much by its international character as it is by *Caremark*.[313] *Hughes* involves a Chinese automotive parts company, and therefore might be better known for its broader implications regarding the "operational incompatibility" between Delaware corporate governance standards and typical non-American business practices.[314] *Hughes* centered around routine accounting and business decisions and the company's consistent failure to submit proper financial reports and implement internal controls for related-party transactions. The case focused little on highly regulated industries or single-product reliance and the need for mission-critical regulatory compliance.[315] Nevertheless, the *Hughes* court, again noting *Blue Bell*'s similarity, found sufficient facts to support an inference of bad faith under *Caremark*'s first prong because, while the company did have an audit committee, it "met

technical pilots deceived the FAA by failing to disclose that MCAS as revised activated only upon the [angle of attack] sensor signal, regardless of speed, increasing the likelihood that MCAS would activate."). The DOJ opened a criminal investigation into whether Boeing had defrauded the FAA when obtaining certification of the 737 MAX in January 2019. Boeing settled with the DOJ in 2021, agreeing to pay $2.513 billion, including a $243.6 million criminal penalty, $1.77 billion in compensation to Boeing's 737 MAX airline customers, and $500 million to a crash victim beneficiaries' fund.

311. In one personal text, Boeing's Chief Technical Pilot, Mark Forkner, told a colleague of the problem he was having with the technology and then texted: "so basically I lied to the regulators (unknowingly)." *In re Boeing Co. Derivative Litig.*, 2021 WL 4059934 at *9.

312. *Id.* at *9. Whether courts should rely on federal agencies knowing that some are subject to capture is an important question. Regulatory capture occurs whenever a federal agency prioritizes the interest of a specialized interest group over the public. *See* Scott Hempling, *"Regulatory Capture": Sources and Solutions*, 1 EMORY CORP. GOVERNANCE & ACCOUNTABILITY REV. 23, 24–25 (2014). The problem is that a rent-seeking, relatively small interest group can leverage its resources to command some or all of the benefits of a program that would otherwise be a public good. *Id.* Significantly, the costs are almost always borne by the taxpayers. *Id.* at 28. The public discourse has generally concluded that the FAA is captured and that its capture is to blame for the deaths associated with the 737 MAX. *See, e.g.*, *Regulatory Capture May Be Responsible for Boeing's Recent Problems*, ECONOMIST (Mar. 23, 2019), https://www.economist.com/business/2019/03/23/regulatory-capture-may-be-responsible-for-boeings-recent-problems [https://perma.cc/4G49-6RRA].

313. Hughes v. Xiaoming Hu, No. 2019-0112-JTL, 2020 WL 1987029, at *1 (Del.Ch. Apr. 27, 2020).

314. Ian J. Murray, Hughes v. Hu*: Territorial Adjustments in Determining Caremark Liability for Foreign-Based Delaware Incorporated Companies*, 80 MD. L. REV. 1247 (2021).

315. *Hughes*, 2020 WL 1987029 at *1.

sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation."[316]

C. Lessons Learned

The forgoing cases have survived an extremely difficult litigation standard.[317] Under the second prong of *Caremark*, Delaware courts have distinguished between an inadequate or flawed effort to carry out duties and a conscious disregard for duties, dismissing *Caremark* claims that only demonstrate inadequate or flawed efforts that fall short of bad faith.[318] Plaintiffs who merely plead that directors did a poor job of overseeing risk in a poorly-managed corporation do not prove that directors acted in bad faith.[319] Administrative findings like those in the cases above help to prove that directors had, or should have had, actual or constructive knowledge that the conduct was legally improper, giving rise to a *Caremark* claim that can survive a motion to dismiss.

The forgoing cases have three important factors in common. First is the mission-critical nature of the company's shortcoming. Thus, in *Blue Bell*, Blue Bell—a food manufacturer—failed to monitor food safety.[320] As a result, the company was forced to cease production.[321] In *Clovis*, the company had only one product on the market.[322] The company's success or failure was wholly dependent on the FDA's authorization of this blockbuster drug.[323] Nevertheless, the board failed to monitor its system of oversight and adhere to FDA protocols.[324] In *Teamsters*, the failure to adhere to FDA regulations despite operating as a

316. *Id.* at *14.

317. *See* Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006) ("[A] claim that directors are subject to personal liability for employee failures is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.") (internal quotation marks omitted); Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003) ("A Caremark claim is a difficult one to prove."); *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."); Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019) ("Caremark claims are difficult to plead and ultimately to prove out.").

318. *See, e.g.*, City of Birmingham Ret. & Relief Sys. v. Good, 177 A.3d 47, 55 (2017); *In re* Massey Energy Co., No. 5430-VCS, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011).

319. *In re* General Motors Co. Deriv. Litig., No. 9627-VCG, 2015 WL 3958724 at *17 (Del. Ch. June 26, 2015).

320. *Id.* at 809.

321. *Id.* at 807.

322. *In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188, at *14 (Del. Ch. 2019).

323. *Id.* at *4, *14.

324. *Id.* at *15.

pharmaceutical sourcing and distributing company was inherently problematic.[325] This failure was especially egregious, however, because the Pharmacy generated substantial annual revenue for the parent company.[326] This leads to the second commonality. Each of these failures caused substantial monetary damages and reputational harm to the companies,[327] enough money to rightfully upset shareholders by its loss.[328] Finally, each case involved some federal agency action. In *Blue Bell*, the court concerned itself with the various warnings of the FDA.[329] In *Clovis*, the court focused on the company's failure to abide by FDA regulations and guidance pertaining to its protocol agreement.[330] In *Teamsters*, the court's evidence was the result of a federal subpoena from the U.S. Attorney's Office based on findings of the FDA.[331] In every instance where plaintiffs have survived a motion to dismiss, they have relied on federal or state standards, regulations, investigations, findings, warnings, orders, or some combination thereof.[332] While these factors are glaringly obvious in the aforementioned cases, they are not unique and are readily apparent in other instances.[333]

D. Application to Facebook

The obvious difference between the failed claims against Facebook resulting from the Cambridge Analytica Data scandal and the successes in *Blue Bell*, *Clovis*, and *Teamsters* is the lack of reliance on the violation of a federal rule or regulation to prove both the existence of red flags and the failure to respond appropriately.[334] Facebook shareholders were unable to seek similar recovery because all the information that would have helped them pursue suits against the company was

325. Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. 2019-0816-SG, 2020 WL 5028065, at *1 (Del. Ch. Aug. 24, 2020).
326. *Id.* at *2; *but see* Roy Shapiro, *The Challenge of Holding Big Business Accountable*, CARDOZO L. REV. 158, 262 (2022) (describing AmerisourceBergen (ABC) as a pharmaceutical giant and the Pharmacy's revenue as a tiny fraction of ABC's overall revenues).
327. *See, e.g.*, Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805, 807, 821 (Del. 2019).
328. *See, e.g.*, *id.* at 807, 815.
329. *Id.* at 810.
330. *In re* Clovis Oncology, Inc. Derivative Litig., No. 2017-0222-JRS, 2019 WL 4850188, at *4, *8, *15 (Del. Ch. Oct. 1, 2019).
331. Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. 2019-0816-SG, 2020 WL 5028065, at *24 (Del. Ch. Aug. 24, 2020).
332. *See, e.g.*, *id.* at *25; *see also Blue Bell*, 212 A.3d at 822–24; *In re Clovis Oncology, Inc.*, 2019 WL 4850188 at *15.
333. *See, e.g.*, *In re Boeing Co. Derivative Litig.*, 2021 WL 4059934, at *1.
334. *See In re* Facebook, Inc. Sec. Litig., 405 F. Supp. 3d 809 (N.D. Cal. 2019).

withheld from them.[335] While the company knew that it was toeing the privacy line as early as 2010, the only reliable source of information for shareholders and investors was SEC disclosures and, unfortunately for Facebook's shareholders and investors, SEC disclosures do not provide this type of information.[336] Instead, plaintiffs were forced to rely on privacy breaches of which the company was rumored to be aware.[337] Facebook shareholders would have greatly benefited from the existence of some industry-specific agency that could both oversee and intervene.[338] In its absence, they had to settle for the FTC's recent finding that Facebook violated a 2012 FTC Order.[339]

In a new derivative suit against Facebook, filed on November 12, 2021, Facebook shareholders argue that Facebook Chief Executive Officer Mark Zuckerberg and COO Sheryl Sandberg, among others (combined, "defendants"), "knowingly and intentionally operated Facebook in contravention of law."[340] Specifically, these defendants "caused Facebook to violate the 2012 Consent Order, resulting in a $5 billion fine borne by Facebook and its stockholders[.]"[341] Plaintiffs further allege that "Facebook's violation of the 2012 Consent Order and laws and regulations governing data privacy was not a result of tangential business operations, [rogue] employees or good-faith misinterpretations of the law, but a top-down concerted effort to operate Facebook's core business in an illegal manner."[342] Here, plaintiffs have successfully dispensed with (1) the business judgment rule ("not a result of tangential business operations"); (2) vicarious liability exclusions ("not a result of . . . [rogue] employees"); and (3) a negligence or gross negligence defense ("not a result of . . . good-faith misinterpretations of the law").[343]

Count one of the complaint also sets up strong arguments for bad faith (by invoking the duty of loyalty via compliance failure, as seen in successful *Caremark* prong two claims): "Each director and officer of the Company owed to the

335. *See id.* at 832 (granting motion to dismiss because plaintiffs failed to adequately plead scienter).
336. *See id.* at 822–25.
337. *See id.* at 836.
338. Proposals in this area abound. *See, e.g.*, Michael A. Cusumano, David B. Yoffie & Annabelle Gawer, *Pushing Social Media Platforms to Self-Regulate*, REGUL. REV., (Jan. 3, 2022), https://www.theregreview.org/2022/01/03/cusumano-yoffie-gawer-pushing-social-media-self-regulate [perma.cc/2S5M-EHBU].
339. FTC Press Release, *supra* note 9.
340. Second Amended and Consol. Verified S'holder Derivative Complaint ¶ 392, *In Re* Facebook, Inc. Derivative Litigation, No. 2019-0307-JRS, 2021 WL 5405962 (Del. Ch. Nov. 12, 2021).
341. *Id.* The 2012 FTC Order is also referred to as the 2012 Consent Order.
342. *Id.*
343. *Id.*

Company and its shareholders a fiduciary duty to exercise good faith and diligence in the administration of the affairs of the Company, ensuring the Company's business was being conducted lawfully . . . ."[344] Notably, this argument is only possible now due to the existence of the 2012 FTC Order.[345] Plaintiffs can piggyback off the FTC investigation, findings of fact, and final adjudication, whereas before this option was not available to them.[346] If this approach is successful, it will allow plaintiffs to rely on government action both prior and subsequent to any board inaction. Although this seems highly unlikely, because plaintiffs in each of the aforementioned cases overcame their motion to dismiss by relying on red flags emanating from the government prior to the board's inaction—rather than any post hoc countermeasures—it would be a boon for shareholders in derivative actions going forward if it were to succeed.[347]

III. FEDERALIZING *CAREMARK*

We propose harnessing the symbiotic relationship between Delaware corporate governance and federal regulatory agency oversight by federalizing *Caremark*. This proposal would allow Delaware to use the threat of litigation to discourage corporate misbehavior by relying on federal administrative fact finding combined with the *Caremark* standard. While it is an incremental approach, this proposal has the benefit of allowing more cases to proceed to discovery, and most likely to settlement and motion to dismiss, without opening the floodgates to all litigation. Shareholders, when armed with information from a federal agency, will be able to investigate the intentions of directors and officers beyond the presumption of good faith that exists when corporations appear to comply with regulations through a combination of existing systems and lack of major catastrophes. In this regard, federalizing *Caremark* is intended to be an intervention before shareholders are given the red flags found in the cases that have survived to date, or—in the worst case scenario—where a corporation's failure eliminated all potential for shareholder and stakeholder recovery.

This Part will first explain the reasons for federalizing *Caremark*, then discuss the collateral consequences and benefits of the proposal.

344. *Id.* ¶ 394.
345. *See* Stipulated Ord. for Civ. Penalty, Monetary Judgment, and Injunctive Relief, USA v. Facebook, Inc., No. 19-cv-2184 (D.D.C. July 24, 2019).
346. *See id.*
347. *See Teamsters Loc. 443*, 2020 WL 5028065, at *25; *Blue Bell*, 212 A.3d at 822–24; *In re Clovis Oncology, Inc.*, 2019 WL 4850188, at *15.

A. Why Federalize *Caremark*?

History shows that the federal government is not better equipped than the states, particularly Delaware given its decades of experience and ongoing expertise, to oversee corporate law and governance. Federal law, through the SEC, mandates federal disclosure regulation, and state law maintains primacy over internal corporate affairs. In proposing to "federalize" *Caremark*, we mean to formally link the state-based rights and obligations of a corporation's owners and managers to federal, industry-specific regulations. Said differently, because the SEC cannot regulate those aspects of corporate governance that are the province of state law but can regulate more broadly as to health and safety, we propose shareholders be given explicit authority to rely on federal agency rules, regulations, and fact finding to prove a state-based breach of duty to the shareholders. This proposal seeks to minimize the expansion of federal regulation of corporate governance generally through its power to regulate the markets, while expanding the ability of shareholders to protect their investments and intervene in their own interest and in the interests of stakeholders generally before the point of crisis or total market failure.

Our pattern of legislating from crisis to crisis has the potential to deny states the ability to control corporate governance, an area historically within their domain, while increasing the expense of compliance and, using prior efforts as an example, failing to provide shareholders and stakeholders with measurable improvements. If states desire to maintain control of corporate governance, they should take an opportunity to address areas where business entities law and the law of fiduciary duties have failed in the past. The symbiotic relationship among state courts and federal regulatory agencies is only sustainable if states take appropriate measures to curb the market impact of corporate malfeasance directly. Federalizing *Caremark* is a measure that strikes an appropriate balance—it acknowledges what the administrative state does best by allowing shareholder plaintiffs to utilize those findings, without opening the floodgates to litigation.

Given the predominant lesson of these recent cases—a failure to comply with federal rules and regulations signals a breach of loyalty and thus grants shareholders an increased chance of recovery—it becomes clear that SEC interventions into corporate governance frequently arise much too late to be of any meaningful use to shareholders in derivative suits (much like the 2012 FTC

Order in Facebook's Cambridge Analytica Scandal).[348] Consequently, if the government truly means to protect shareholders in the marketplace, as it claims,[349] it would be in everyone's best interest to formalize plaintiffs' right to rely on a proven violation of a federal rule or regulation as a red flag for purposes of *Caremark*.[350] In any instance where the plaintiff can readily rely on a violation proven in a final federal or state rule and adjudication, she should have a prima facie claim under *Caremark*'s prong two. *Clovis* is a good example of this scenario. In *Clovis*, the red flag was waved once the board was made aware of the company's serial noncompliance with the FDA-sanctioned RECIST trial protocol.[351]

To the extent that the violation is not so obvious but inures from a general departure from federal standards under prong one, courts should do the same. For example, in *Blue Bell*, the court focused on the FDA's general principles requiring food manufacturers to conduct operations "with adequate sanitation principles" and to "prepare . . . and implement a written food safety plan."[352] The court points to the FDA's notifications of systematic deficiencies within the manufacturing plants and notes that Blue Bell did not rectify the problems because there was no reasonable reporting system in place.[353] The focus on prong one, however, means that the failure to adhere to FDA norms is not dispositive, because the court does not get to the second prong.[354] In these instances, plaintiffs' burden should also be deemed met as to prong two.[355]

Lastly, even in situations where plaintiffs' claims are based on federal decisions that are not final or do not emanate from those federal agencies with industry-specific expertise, as with the search warrants and subpoenas at issue in *Teamsters*, the plaintiffs' pleading burden should also be deemed met for *Caremark* prong two.[356] The *Teamsters* court recognized that directives issued by the court on behalf of federal agencies could also serve as red flags, finding

348. *See, e.g.*, *Teamsters Loc.* 443, 2020 WL 5028065 at *25; *Blue Bell*, 212 A.3d at 822–24; *In re Clovis Oncology, Inc.*, 2019 WL 4850188 at *15.
349. "The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust." *About the SEC*, SEC, https://www.sec.gov/about.shtml [https://perma.cc/J4W2-PBTF].
350. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
351. *In re Clovis Oncology, Inc.*, 2019 WL 4850188 at *14–15.
352. *Blue Bell*, 212 A.3d at 810.
353. *Id.* at 821.
354. *Id.* at 822.
355. *Id.*
356. *See* Teamsters Loc. 443 Health Services & Ins. Plan v. Chou, No. CV 2019-0816-SG, 2020 WL 5028065, at *24 (Del. Ch. Aug. 24, 2020).

the company's failure to address the mission critical shortcomings implicated in the U.S. Attorney's Office subpoena sufficed as an adequate pleading under prong two.[357]

Legal obedience is a cornerstone of all corporate statutes,[358] yet federalizing *Caremark* helps to encourage firms to go beyond the requirement of mere legal obedience. Section 101(b) of the DGCL states: "A corporation may be incorporated or organized under this chapter to conduct or promote any lawful businesses or purposes, except as may otherwise be provided by the Constitution or the law of this State."[359] Given this statutory mandate, courts should not afford deference to fiduciaries who have directed a corporation to violate the law.[360] When a corporate director or officer engages in unlawful behavior on behalf of the corporation, they are unable to rely on the business judgment rule defense.[361] Further, "a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity."[362] The proposal here fully aligns with these preexisting principles.

Moreover, compliance with *Caremark* duties goes beyond what is required merely to avoid liability.[363] Professor Claire Hill best illustrates this point by way of an example: "A seller of securities is, by law, not allowed to lie about the

357. *Id.*

358. Leo E. Strine Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 649 (2010).

359. Del. Code Ann. tit. 8, § 101(b) (2022).

360. TW Servs., Inc. v. SWT Acquisition Corp., Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989); Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003); Desimone v. Barrows, 924 A.2d 908, 934–35 (Del. Ch. 2007); Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121, 131 (Del. Ch. 2004). *See also* Andrew S. Gold, *Pernicious Loyalty*, 62 Wm. & Mary L. Rev. 1187, 1208 (2021) (arguing that acting within the law is an aspect of the duty of loyalty); Strine et al., *supra* note 358, at 651. *But see* Pollman, *supra* note 109, at 718 (offering that some corporate disobedience could have the potential to provide value to the extent innovation or legal change can benefit society).

361. *See, e.g.*, Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974) (holding that shareholders had stated a claim for breach of fiduciary duty arising from the alleged violation of federal campaign finance law and noting the business judgment rule "cannot insulate the defendant directors from liability if they did in fact breach [a statutory prohibition], as plaintiffs have charged"); Roth v. Robertson, 118 N.Y.S. 351, 354 (N.Y. Sup. Ct. 1909) (sustaining recovery from a director who used corporate funds to bribe individuals who had threatened to complain about the corporation operating in violation of the state's Sunday closing laws).

362. *Metro Commc'n Corp. BVI*, 854 A.2d at 131; *see also Guttman*, 823 A. 2d at 506 n.34 ("[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.").

363. Claire A. Hill, *Caremark as Soft Law*, 90 TEMP. L. REV. 684 (2018) (arguing "*Caremark* can have a considerable penumbra beyond what law requires, encompassing other aspects of corporate good citizenship").

securities' quality to his buyer. A proper compliance program will, of course, train a company's sellers not to lie. It will also attempt not to hire sellers who would lie, or fire those who have lied."[364] Beyond these efforts, a strong *Caremark* regime also incentivizes compliance officers to look to behaviors that fall just short of the illegal behavior.[365]

While the programs that prohibit such behavior may be implemented with *Caremark* in mind, they have the added benefit of:

> [I]nstill[ing] a robust compliance culture that respects the spirit as well as the letter of the law, and a robust risk culture that sensitizes employees to the dangers of excessive risk-taking, as well as instituting processes by which employees through the company report compliance issues and monitoring and continually improving the compliance process.[366]

Where reducing legal liability would require only a formalistic approach to abiding by law, the malleability of a federal approach to *Caremark* encourages both a regard to ethics and a responsibility in risk taking. Ultimately, requiring the company to be mindful of any harms it can do beyond what is legally actionable helps to shape not only the company's compliance obligations, but also its ethics.[367]

It must be reiterated that federalizing *Caremark* does not ensure shareholder victory at trial or even at summary judgment. Currently, *Caremark* is used to end the possibility of shareholder recovery at the motion to dismiss phase of trial, meaning that absent the exercise of inspection right under Section 220, the presumption that directors with a system in place are acting in good faith prevents shareholder plaintiffs from engaging in discovery into their mental states. As a result, since *Caremark*, the capital markets have suffered many failures that were undiscovered by both shareholders and the SEC. Instead, in the case of Enron and World-Com, the subprime loan crisis, Theranos, and most recently FTX, the system allowed bad actors to shelter behind the business judgment rule while evading detection through the reporting mechanisms found in securities regulations. In the current regime, plaintiffs' attorneys lack the incentive to dig into 10-K, 10-Q, and 8-K forms before a precipitous drop in stock price, and shareholders lack the incentive to exercise inspection rights if directors and officers can post consistent gains or make credible promises of future growth. By allowing mere discovery when a federal administrative agency has negative findings in the primary area of business, federalizing *Caremark* provides an inventive for

364. *Id.* at 685.
365. *Id.*
366. *Id.* at 687.
367. Bruce D. Fisher, *Positive Law as an Ethic: Illustrations of the Ascent of Positive Law to Ethical Status in the Commercial Sector*, 25 J. BUS. ETHICS 115 (2000).

shareholders to engage in deeper oversight and for directors and officers to do more than merely create systems.

B. Collateral Benefits

There are many collateral benefits to federalizing *Caremark*. These include the potential to incentivize the proper expansion of the administrative state, provide clarity to current definitions found in securities regulation, and expand grounds for shareholders to inspect books and records. Although federalizing *Caremark* will have no impact in cases where there is no administrative agency responsible for a company's primary line of business, as is the case with Facebook (social media) and more recently FTX (cryptocurrency), it does have the potential to impact both corporate behavior and federal regulation of corporations.

Arguably, if industry-specific administrative findings provide plaintiffs with the information necessary to survive a motion to dismiss, such information is material for purposes of reporting pursuant to securities regulations governing both voluntary and mandatory reporting.[368] If the information is deemed material, a failure to report would be a violation of the law and could give rise to civil and administrative action. This creates a dual incentive–first to avoid violations of industry norms and second to alert shareholders when such violations occur. Because this information would provide shareholders with the ability to pursue a claim for breach of fiduciary duty or, as noted above, the SEC with grounds for a securities violation, it would always fit the parameters of Section 220 inspection rights.[369]

If the courts will simply permit evidentiary discovery beyond inspection rights and allow plaintiffs to proceed up to a motion for summary judgment or settlement, shareholders (on behalf of all stakeholders) will be better able to assess the risks inherent in corporate policies. Empowering shareholders is better than adhering to the same old alternative, more federal reporting monitoring regimes. The Delaware courts in particular are more specialized than the SEC or FINRA at assessing the sufficiency of corporate governance, just as industry-specific agencies are better suited to assess behavior that is harmful to all stakeholders.

368. *See infra* Part I.A (defining materiality and discussing reporting requirements for purposes of securities regulation).
369. *See infra* Part II.A (describing Section 220 and explaining inspection rights).

Combining these forces has the potential to provide a remedy that is more narrowly tailored than expansion of a reporting regime.[370]

CONCLUSION

As the SEC contemplates its role in current and future crises caused by corporations, it is important to acknowledge what has worked, and what has not worked, with prior SEC interventions. The current regulatory regime does not change corporate culture or resolve the other issues underlying a market failure. Culture is not changed by merely monitoring and reporting, and cultural change is necessary to make measurable and material improvements to corporate operations. Further, the SEC's system of reporting and monitoring alone does not provide shareholders or stakeholders with the information they need to discover harmful behavior by corporations at a time when state law remedies, including those for shareholder derivative suits for breaches of fiduciary duty, would be helpful. Instead, an enforcement and regulatory regime that mandates compliance with best practices and norms is best for preventing conduct.[371] The SEC is not the proper agency to address climate change or the privacy and First Amendment issues that have arisen from social media, nor is it in a position to prevent the next major crisis that could lead to market failure.

When there is evidence of the possibility that no board level oversight system exists, or that if it does it is poorly monitored as evidenced by administrative findings, our proposal simply allows shareholder plaintiffs to overcome the onerous burden of motion to dismiss to move forward with litigation. This proposal allows such a case to move past motion to dismiss with a new presumption in favor of plaintiffs before the necessity of intervention by the Court of Chancery and the U.S. Supreme Court, as was required for the *Blue Bell* plaintiffs to prevail. This creates a shift in defensive strategy towards proof of good faith efforts made in the best interest of the company through discovery sufficient to prevail on a motion for summary judgment instead of proof of mere existence of systems at motion to dismiss when agencies provide reason for interrogation of director and officer

370. *See infra* Part I.C (arguing that the traditional expansion of reporting requirements has thus far failed to bring about the expected changes to corporate behavior); Part I.D (arguing that industry-specific agencies are by their nature more narrowly tailored and thus more prescriptive).

371. Scott Killingsworth, *Modeling the Message: Communicating Compliance Through Organizational Values and Culture*, 25 GEO J. LEGAL ETHICS 961, 966–68 (2012).

behavior. This is a better means of determining whether the everyday actions of directors and officers may violate the law.

Tethering federal dispensations to *Caremark*'s second prong specifically helps shareholders overcome the many procedural hurdles they face. To the extent that such plaintiffs possess this evidence, they should always overcome a motion to dismiss, which is arguably the most difficult of the *Caremark* hurdles. Defendants will be able to rebut or disprove the evidence in either a motion for summary judgment or a trial. This approach would not only add teeth to shareholder litigation but would also remedy the failed attempts at federal oversight of corporate behavior through market-based compliance schemes, and thus align nicely with broader governmental goals and policies concerning the uses of federal regulation.[372]

The beauty of what Delaware has been able to implement with the *Caremark* standard is that it allows the state government to capitalize on the lessons learned more broadly in the administrative state.[373] That is to say that, while corporate governance has traditionally been subject to a complex combination of general rules and regulations resulting from the SEC, the states, the exchanges, and various self-regulating bodies, scant attention has been paid to the role of industry-specific regulation in accomplishing these broader goals.[374] While general rules can alleviate some problems requiring government intervention, in practice, industry-specific approaches are best.[375] This is becoming clearer as new challenges regularly emerge.[376] FDA best practice regulations sufficed to modify behavior in *Marchand v. Barnhill*, *In re Clovis*, and *Teamsters Local 443 Health Services & Insurance Plan v. Chou*.[377] Likewise, FAA best practice regulations had the potential to modify behavior in *In re Boeing Company Derivative Litigation*.[378] Each of these cases were decided under Delaware's *Caremark* standard.[379] They

372. *See Multistate Outbreak of Listeriosis Linked to Blue Bell Creameries Products (Final Update)*, *supra* note 219.

373. *See* Sale, *supra* note 29.

374. *Id.*

375. *See* Baer, *supra* note 152, at 959.

376. *See id.* at 988.

377. *See* Marchand v. Barnhill, 212 A.3d 805, 807 (Del. 2019) (finding the company in breach of FDA regulations to the detriment of shareholders); In re Clovis, No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. 2019) (same); Teamsters Local 443 Health Services & Insurance Plan v. Chou, No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020) (same).

378. *See In re* Boeing Co. Derivative Litig., No. 2019–0907-MTZ, 2021 WL 4059934, at *4 (Del. Ch. Sept. 7, 2021) (finding the company in breach of FAA regulations to the detriment of shareholders).

379. In *In re* Caremark Int'l Inc. Derivative Litig., the Delaware Chancery Court held that "a director's obligation includes a duty to attempt in good faith to assure that a corporate

illustrate the success of industry-specific agency findings for shareholders and the general public, but also the failure of the compliance regime combined with securities monitoring and periodic reporting to do the same. In fact, almost every *Caremark* case to survive a motion to dismiss in the twenty-seven years post-*Caremark* involved federal administrative findings from an industry-specific agency.[380] Although this fact finding is not an explicit requirement for surviving a motion to dismiss, it is the approach with the highest and possibly only probability for success,[381] and should be acknowledged by the Delaware courts.

Presently, a symbiotic relationship exists between Delaware and federal industry-specific administrative agencies that, if acknowledged, could provide shareholders and stakeholders with the tools they need to address harms caused by corporate governance failures. Federalizing *Caremark* is one step towards strengthening this relationship. Although industry-specific agencies are better equipped to remedy these harms, they are only as beneficial as they are capable of adequately monitoring their industries to protect all stakeholders. Providing adequate protection to shareholders, the capital markets, and all stakeholders requires action at both the state and federal level. Delaware should allow shareholders' *Caremark* claims to survive a motion to dismiss any time there are facts from industry-specific agency action, and if shareholders are relying on these findings, industry-specific agencies must be given the tools they need to properly monitor the industries they oversee.

information and reporting system, which the board concludes is adequate, exists . . ." The court added that "failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." 698 A.2d 959, 970 (Del. Ch. 1996).

380. *See infra* Parts II.B–C (summarizing the relevant cases and outlining their similarities).

381. *See* James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 55–56 (2016) ("Indeed, the division between [*In re* Massey Energy Co.] and [*In re* Citigroup Inc. S'holder Derivative Litig.] may be that Citigroup involved a challenge to legitimate business practices, whereas Massey is riveted, as was Caremark, on the directors' conscious disregard of the corporation's adherence with the law when implementing business strategies."); Donald C. Langevoort, *Caremark and Compliance: A Twenty-Year Lookback*, 90 TEMP. L. REV. 727, 735 (2018) ("[T]he moment the board is brought into the compliance risk discussion, liability exposure increases to at least a small extent, and Caremark itself no longer sets the applicable standard."); Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2139 (2019) ("This hidden power of compliance . . . sprang up unexpectedly over the last decade from parallel case law developments in Delaware fiduciary duty jurisprudence, federal securities regulation, and personal liability for compliance officers."); Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 590–91 (2008).