FEDERALIZING *CAREMARK*

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ABSTRACT

American corporations have a long history of carelessness and Caremark *has made it difficult for shareholders to recover against them for it. In 2018, for example, the world discovered that Donald Trump had wrongfully collected the personal data of up to 87 million Facebook users. Facebook's failure to address the unchecked collection and use of users' data cost the company more than $50 billion in market capitalization alone. Despite clear losses, shareholder litigation has thus far been unsuccessful. The normal governmental response to such corporate failures of oversight is to saddle corporations with more federal oversight, even though this purely reactive behavior has consistently failed to curb corporate misconduct. The consequence for regulated firms is thus an ever-increasing cost of compliance with no marked change in behavior. Meanwhile, shareholders are left with few options for recovery because, in the face of asymmetrical information, there is insufficient evidence to meet onerous pleading requirements found in state and federal laws such as* Caremark.

This Article proposes a better solution—the use of federal administrative determinations as presumptive evidence of corporate mismanagement. It describes the existing limitations of both SEC and common law-based protections in the context of shareholder derivative litigation for lapses in oversight, explores the factual commonalties of those plaintiffs that have been successful in this area, and proposes that Delaware can preempt corporate misbehavior, while reducing the need for more federal oversight, by relying on federal administrative fact-finding combined with the Caremark *standard to promote shareholder successes in derivative litigation. Corporate law*

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scholarship rarely acknowledges its intersection with administrative law. Thus, scholars have not considered the possibility that shareholders can easily rely on the determinations of federal agencies to establish evidence of a director's failure of oversight under Caremark.

This Article considers the need for such an approach, particularly the failures of market-based responses to corporate carelessness, and the implications of such an approach, especially the benefits of relying on the expertise associated with industry-specific governance. It argues that Delaware should adopt a formal rule whereby plaintiffs can use existing, industry-specific federal compliance systems as a proxy for expertise, and any breaches thereof as an indicator of clear but rebuttable red flags. By establishing a bright line administrative remedy to the overwhelmingly steep hurdle shareholders face in derivative litigation, this Article invites scholars to consider creative administrative law solutions to existing corporate law problems.

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INTRODUCTION

During the 2016 presidential campaign, Donald Trump employed Cambridge Analytica to help him identify the personality traits of individual American voters in his effort to influence their voting behavior through targeted digital ads.[1] In turn, Cambridge Analytica, a political data firm, acquired access to and provided the Trump campaign with private data from more than 87 million Facebook users.[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 raw profiles in total. Facebook justified its role in the scandal by noting that the company routinely

[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 ("The idea was to map personality traits based on what people had liked on Facebook . . . ."); Matthew Rosenberg et al., *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 (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] Granville, *supra* note 1.

[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, such behavior 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), https://www.firstpost.com/tech/news-analysis/facebook-cambridge-analytica-and-the-alleged-data-breach-heres-all-you-need-to-know-4395747.html (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.

allows researchers access to users' data for academic purposes, a practice that all users consent to when they create their Facebook account. 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.[6]

Many daily Facebook users, of which there are more than 185 million in the United States and Canada, 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.[7] Shareholder lawsuits quickly followed.[8] Several class action suits were filed as well, many blaming the company's data leaks and subsequent cover-up for its reputation damage.[9] One suit argued that Facebook made "made materially false and misleading statements."[10] Another argued that Facebook's senior managers failed in their fiduciary duties by failing to prevent the initial misappropriation of user data and, after learning of it in 2015, failing to inform affected Facebook users or

[6] A myriad of litigation followed the Cambridge Analytica scandal, and this policy statement is one that 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).

[7] Dani Alexis Ryskamp, *Facebook Faces Shareholder Lawsuit Over Cambridge Analytica Data Security Concerns*, EXPERT INST., https://www.expertinstitute.com/resources/insights/facebook-faces-shareholder-lawsuit-over-cambridge-analytica-data-security-concerns/ (June 23, 2020).

[8] *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) ("Plaintiffs in one Northern District of California action move under 28 U.S.C. § 1407 to centralize this litigation in the Northern District of California. This motion involves eight actions pending in four districts, as listed on Schedule A. The Panel also has been notified of 22 potentially related actions ("potential tag-along actions") pending in six districts. Plaintiffs in fifteen actions and potential tag-along actions and responding defendants support centralization in the Northern District of California, in the first instance or in the alternative. Plaintiffs in six actions and potential tag-along actions support centralization . . . .") (citations omitted); *In re* Facebook, Inc. S'holder Derivative Priv. Litig., 367 F. Supp. 3d 1108 (N.D. Cal. 2019); 405 F. Supp. 3d at 809.

[9] *See, e.g.*, 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); 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.").

[10] 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.").

shareholders.[11] Moreover, many lawsuits recognized the potential for future costs resulting from the leaks, "including regulatory investigations, lost business, exposure to litigation, and other damages."[12] While most class action suits were shareholder derivative suits brought on behalf of shareholders and the corporation, some were also brought on behalf of Facebook users, seeking damages from the company for failing to protect user data.[13] Despite the numerous and valiant attempts to hold Facebook liable to its shareholders and users through litigation, none of these cases have been able to provide such remedy to date.[14]

It was the Federal Trade Commission's investigation into the connection between Facebook and Cambridge Analytica that ultimately provided remedy for shareholders and stakeholders alike.[15] The FTC conducted a year-long investigation into the incident and concluded that Facebook violated a 2012 FTC Order that prohibited Facebook 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

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[11] *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) ("On July 2, 2018, The Washington Post reported the FBI, SEC and DOJ had teamed up with the FTC in its investigation of Facebook's data security practices. The federal investigations widened in scope to address the extent to which Facebook knew that its users' data was misappropriated and disseminated in 2015 and the reasons the Company failed to inform its users or investors of the breaches in real time.").

[12] 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).

[13] 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."); *In re* Facebook Priv. Litig., 791 F. Supp. 2d 705, 708 (N.D. Cal. 2011) ("Plaintiffs allege that Defendant intentionally and knowingly transmitted personal information about Plaintiffs to third-party advertisers without Plaintiffs' consent.").

[14] *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 (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/ (stating that the case was dismissed after the plaintiff missed a deadline).

[15] Complaint at 1, United States v. Facebook, Inc., No. 19-CV-2184 (D.C. filed 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.").

birth, with third parties.[16] 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,[17] 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."[18] Specifically, the 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."[19] Moreover, the Department of Justice (DOJ) announced that it would file a complaint on behalf of the Commission alleging that Facebook repeatedly used deceptive disclosures and settings to undermine users' privacy preferences in violation of its 2012 FTC order.[20]

While the payment of such large fines and the expense of defending against a DOJ action lowers the value of Facebook in the short term, which should enable shareholders to succeed in court, it is the FTC findings that may breathe new life into Facebook shareholder litigation, as a new Delaware case has the potential to upset the shareholders' losing streak and enable them with a direct remedy from management.[21] Plaintiffs in the case have effectively set up a strong *Caremark* claim against defendants—a claim that was not possible without the evidence provided by the FTC investigation.

Recognizing that a failure to comply with federal rules and regulations signals a breach of good faith and loyalty to the court—under *Caremark*—raises a whole host of practical questions. Chief among these is whether we still need Congress to respond to corporate scandals by expanding the reach of the Securities and Exchange Commission (SEC) when Delaware has modeled a way to regulate corporate behavior effectively and efficiently

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[16] Press Release, Fed. Trade Comm'n, FTC Imposes $5 Billion Penalty and Sweeping New Privacy Restrictions on Facebook (July 24, 2019), https://www.ftc.gov/news-events/news/press-releases/2019/07/ftc-imposes-5-billion-penalty-sweeping-new-privacy-restrictions-facebook [hereinafter FTC Press Release]; 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; Stipulated Order for Civil Penalty, Monetary Judgment, & Injunctive Relief, No. 19-CV-2184 (D.C. filed July 24, 2019).

[17] 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, https://www.cnbc.com/2019/07/25/heres-where-facebooks-record-5-billion-fine-goes.html (July 25, 2019, 10:50 AM).

[18] FTC Press Release, *supra* note 16.

[19] *Id.*

[20] *See* United States v. Facebook, Inc., No. 19-CV-2184.

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

using the common law, while also supplying shareholders with the weapons they need to pursue private actions against directors and providing state regulators with ready enforcement actions.[22] 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 deemed met, allowing shareholders to survive a motion to dismiss and shifting the burden to the directors to prove otherwise.

This approach to breaches of fiduciary duty not only adds teeth to shareholder litigation, but it 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 the corporations or for society.[23] The Securities Act of 1933[24] and Securities Exchange Act of 1934,[25] the Sarbanes-Oxley Act,[26] changes in the Dodd-

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[22] While Securities Regulations do provide shareholders with the ability to recover, the PSLRA and its loss causation standard has made it more burdensome for shareholders than *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 positives 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 way for shareholders to recover before a business or market failure. As a result, *Caremark* is the only way for shareholders to recover before a business or market failure.

[23] *See* Mercer Bullard, Caremark*'s Irrelevance*, 10 BERKELEY BUS. L.J. 15, 44–50 (2013) (identifying examples 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").

[24] Codified as 15 U.S.C. § 77a *et seq.*

[25] Codified as 15 U.S.C. § 78a *et seq.*

[26] 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.).

Frank Act (on soft regulation of pay, alongside derivative markets),[27] and other regulations focused on the securities market have not prevented the rise of unregulated retail investing,[28] the proliferation of cryptocurrency scams,[29] the reliance on cult of personality investment suggestions and market manipulation through social media,[30] the privacy concerns that are the focus

[27] 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.).

[28] 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/; Meghan Marin, *Amateur Investors Rode the Bull Up. Now the Bear Looms.*, N.Y. TIMES (May 18, 2022), https://www.nytimes.com/2022/05/18/your-money/stock-market-crash-trading-retail.html; Caitlin McCabe et al., *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.

[29] *See Reports Show Scammers Cashing in on Crypto Craze*, FED. TRADE COMM'N (June 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/Crypto%20Spotlight%20FINAL%20June%202022.pdf ("Since the start of 2021, more than 46,000 people have reported losing over $1 billion in crypto to scams . . . more than any other payment method. . . . [R]eported losses in 2021 [involving crypto] were nearly sixty times what they were in 2018. . . . Nearly half the people who reported losing crypto to a scam since 2021 said it started . . . on a social media platform. During this period, nearly four out of every ten dollars reported lost to a fraud originating on social media was lost in crypto, far more than any other payment method.") (emphasis omitted) (citations omitted).

[30] Mehrnoosh Mirtaheri et al., *Identifying and Analyzing Cryptocurrency Manipulations in Social Media*, 8 IEEE TRANSACTIONS ON COMPUTATIONAL SOC. SYS. 607, 607–17 (2021); J.T. Hamrick et al., *An Examination of the Cryptocurrency Pump and Dump Ecosystem*, U. CHI. BECKER FRIEDMAN INST. FOR ECON. (Nov. 22, 2019), https://bfi.uchicago.edu/wp-content/uploads/Gandal-Neil-etal-An-examination-of-the-cryptocurrency-pump-and-dump-ecosystem.pdf; *see also* Press Release, Commodity Future Trading Comm'n, CFTC Charges Two Individuals with Multi-Million Dollar Digital Asser Pump-and-Dump Scheme (Mar. 5, 2021), https://www.cftc.gov/PressRoom/PressReleases/8366-21 (discussing John McAfee's repeated and illegal manipulation of cryptocurrency valuations via social media representations); Rachel Sander, *John McAfee Indicted On Fraud, Money Laundering Charges In Pump-And-Dump Crypto Scheme*, FORBES (Mar. 5, 2021, 1:15 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; Shivdeep Dhaliwal, *Dogecoin A 'Victim Of Pump And Dump Scheme' By Elon Musk, Says Analyst*, BUS. INSIDER (Jun. 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.

of Facebook's Cambridge Analytica litigation,[31] or the First Amendment issues that an unregulated social media market have brought to light.[32] Instead, the basic shape of corporate law in the United States has remained the same since the 1980s and is in some ways recovery is more difficult for

[31] 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: Yeah so if you ever need info about anyone at Harvard
Z: Just ask.
Z: I have over 4,000 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; *see also infra* note 36.

[32] Tech companies have been harvesting, tracking, selling, and buying user information for years, if not decades, and many times they do it in cooperation with and under 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), https://www.theguardian.com/world/2013/jun/06/us-tech-giants-nsa-data (Greenwald and MacAskill were two of the original journalists that Snowden entrusted his leaks to); 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 ("The [top secret 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 ("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 ("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/; Snowden Archive, CANADIAN JOURNALISTS FOR FREE EXPRESSION, https://www.cjfe.org/snowden (last visited June 29, 2022) (Snowden began whistleblowing in June 2013).

shareholders and stakeholders. What has changed is the cost of being a public corporation—driven by ever-increasing costs of compliance.[33]

This Article proposes that the approach of recent Delaware cases that have survived a motion to dismiss be adopted more formally. The Article makes two normative claims. The first is that 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. The second is that a more workable approach is to rely on agencies, rather than state corporate governance law alone, to protect stakeholders. This has the added benefit of providing shareholders with what they need to check board action when necessary.[34] Federalizing *Caremark* is, therefore, a better solution than yet another securities market-based reporting and compliance regime.

The Article proceeds in four parts. Part I examines the goals of the SEC in securities regulation, explaining the pros and cons of the existing market-

[33] The debate about climate change disclosures illustrates the debate on the effectiveness of compliance regimes to change corporate behavior. Cite to briefs opposed to climate-change disclosures and ESG disclosures; sources that note failures; but see those in favor. See 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 prohibited conduct within firms, and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability . . . ."); John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 67 (2014); Christina Parajon Skinner, *Misconduct Risk*, 84 FORDHAM L. REV. 1559, 1564 (2016) (proposing "compliance stress testing" which would "enhance regulatory supervision" by making compliance goals a part of standard bank regulation).

[34] *See, e.g.*, Matteo Gatti & Chrystin Ondersma, *Can a Broader Corporate Purpose Redress Inequality? The Stakeholder Approach Chimera*, 46 J. Corp. L. 1, 9 (2020) ("Without specific mandates to corporations and without enforcement mechanisms, these measures do little more than increase managerial discretion."); Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 165 (2020) ("[S]upport for stakeholderism may well be strategic: an attempt to advance a managerialist agenda dressed in stakeholder clothing to make it more appealing to the general public . . . ."); Dorothy S. Lund, *Corporate Finance for Social Good*, 121 COLUM. L. REV. 1617, 1636 (2021) ("[I]t is possible that some management teams would use their enhanced discretion to waste money or maximize their private benefits, leading to economic harm—if not now, then at some time in the future."); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250, 275 (1999) ("Our analysis rests on the observation—generally accepted even by corporate scholars who adhere to the principal-agent model—that shareholders are not the only group that may provide specialized inputs into corporate production. Executives, rank-and-file employees, and even creditors or the local community may also make essential contributions and have an interest in an enterprise's success.") (footnote omitted); Grant M. Hayden & Matthew T. Bodie, *The Corporation Reborn: From Shareholder Primacy to Shared Governance,* 61 B.C. L. REV. 2419, 2456-57 (2020) (discussing the differences in regulation-related roles played by shareholders, employees, creditors, suppliers, and consumers).

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 *Caremark* and its progeny, specifically those cases where *Caremark* claims have survived a Motion to Dismiss, in detail 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. Part III argues for the federalizing of *Caremark*, a more effective and efficient 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. Finally, Part IV describes some of the legal and policy justifications for taking such an approach. The Article then concludes.

I. SHAREHOLDER PROTECTION MECHANISMS IN ADMINISTRATIVE LAW

Our regulatory structure is a necessary design in our federalist government, but in the area of corporate governance it prevents the federal government from taking measures that are known to be preventative.[35] Culture is not changed by merely monitoring and reporting, and cultural change is what is necessary to make measurable and material improvements to corporate operations. Instead, an enforcement and regulatory regime that mandates compliance with best practices and norms is best for preventing conduct.[36] Corporate governance places greater impact on our state law system, which has the potential to provide synergies that benefit all stakeholders, as states are responsible for all stages of corporate activity from formation to dissolution. But, as the system currently operates, leaving corporate governance all to the states and mandating only federal reporting, there is no appetite for maximizing the potential of these synergies. Under the current regime, the norms for misconduct are imposed on those with state-issued licenses who have a higher duty to operate using professional judgment and are positioned to serve as intermediaries and gatekeepers.[37] Corporate culture is otherwise limited only by the state law spectrum from

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[35] *See* Carliss N. Chatman, *Corporate Family Matters*, 12 U.C. IRVINE L. REV. 1, 42 (2021) [hereinafter Chatman, *Family Matters*]; HENRY N. BUTLER & LARRY E. RIBSTEIN, THE CORPORATION AND THE CONSTITUTION 4 (1995) ("[N]o one is forced to use the corporate form of organization: there is freedom of choice in organizational form. . . . This fundamental choice constrains the ability of corporate managers to misbehave.").

[36] Scott Killingsworth, Modeling the Message: Communicating Compliance Through Organizational Values and Culture, 25 GEO J. LEGAL ETHICS 961, 966-67 (2012).

[37] *See* THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION 188-89 (2006); A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 LEWIS & CLARK L. REV. 19, 33 (2006); Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 413 (2008).

the business judgment rule protection, which provides coverage for directors and officers who make informed decisions, even when there is loss, to absolute liability for waste.[38]

This Part explains the shortcomings of the SEC-based protections. Then, this Part explains how state law serves as a gap filler due to deference to state law by the SEC. Both sections illustrate that the current system leaves many regulatory gaps that can be addressed by fully embracing the relationship between industry-specific regulations and the *Caremark* standard.

A. The Shortcomings of SEC-Based Protections

Our system of federalism creates a regulatory loophole for corporate governance.[39] When it comes to corporate governance generally, federal agencies only regulate capital markets, but through licensing, industry regulation, and other compliance norms federal agencies provide greater oversight of specific industries.[40] The SEC has authority through the Commerce Clause, which enables the federal regulation of interstate commerce. As a result, the federal regulation of the capital markets is principally focused on externalities—primarily the regulation of the market

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[38] *See* Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 573–74 (2000); 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, 283–84 (1986). There are certainly areas and industries that allow the federal government to do more. The Food and Drug Administration's (FDA) regulation of pharmaceuticals and the food supply is an example. *See, e.g.*, Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805, 822 (Del. 2019). This case illustrates the type of regulation needed to prevent conduct and to provide shareholders with remedies in return because the failure to comply with federal mandates in turn invokes an actionable failure to assume *Caremark* duties. *Blue Bell* also illustrates that securities regulation is not enough as there are limits to the power of market regulation. The litigation is powered by the initial FDA violation; no securities misconduct is discoverable without it. Donald C. Langevoort, *Getting (Too) Comfortable: In-House Lawyers, Enterprise Risk, and the Financial Crisis*, 2012 WIS. L. REV. 495, 500, 518 (2012); Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. ILL. L. REV. 1131, 1150 (2013).

[39] See 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, 540–41 (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."); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance*: *Reflections upon Federalism*, 56 VAND. L. REV. 859, 869 (2003).

[40] Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 869 (2003) (describing the historic push toward federal regulation).

for publicly traded securities. Many federal securities regulations do not allow for a private right of action—meaning that shareholders are unable to directly address harms at the federal level. Instead, they must depend on state law and, due to procedural hurdles, typically they must wait for federal administrative fact finding to successfully pursue those state claims. The SEC's greatest tools are its periodic and special reporting mechanisms, and its oversight of special events like proxies at shareholder meetings and initial public offerings (IPOs). These tools do not provide shareholders with a means to address harm.

The securities regulatory scheme is 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. Congress has amended the laws several times since 1933 and 1934, usually in response to financial scandals. Federal securities laws include: Securities Act of 1933 (Securities Act or '33 Act);[41] Securities Exchange Act of 1934 (Exchange Act or '34 Act);[42] Trust Indenture Act of 1939;[43] Investment Company Act of 1940 ('40 Act);[44] Investment Advisers Act of 1940 (Advisers Act);[45] Sarbanes-Oxley Act of 2002 (SOX);[46] Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010 (Dodd-Frank);[47] Jumpstart Our Business Startups Act of 2012 (JOBS Act);[48] and Fixing America's Surface Transportation Act of 2015 (FAST Act).[49] In addition, the SEC, established by the Exchange Act, is empowered with the ability to supplement the statutes with regulations.[50]

[41] 15 U.S.C. § 77a *et seq.*
[42] 15 U.S.C. § 78a *et seq.*
[43] 15 U.S.C. §§ 77aaa–77bbbb.
[44] 15 U.S.C. §§ 80a-1–80a-64.
[45] 15 U.S.C. §§ 80b-1–80b-18c.
[46] Sarbanes-Oxley Act of 2002.
[47] Dodd-Frank
[48] 15 U.S.C. § 77d-1.
[49] Fixing America's Surface Transportation Act of 2015, Pub. L. No. 114-94, 129 Stat. 1312.
[50] Notably, the SEC is not the only government entity that is a source of regulation of the securities market. The Commodities Futures Trading Commission (CFTC) regulates sales of commodity and financial futures and options. The Financial Industry Regulatory Authority (FINRA) regulates broker-dealers and activities by national exchange members. The stock exchanges, such as NASDAQ and the NYSE, also have listing standards that greatly influence the corporate governance norms for publicly traded companies. Lastly, states have "blue sky" laws, which are anti-fraud 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 (2005) (citing Louis Loss & Edward M. Cowett, *Blue Sky Law* 3–4 (1958)); *see generally* Jonathan R. Macey, *Origin of the Blue Sky Laws*, 70

The 1934 Act imposes registration and reporting requirements on issuers of certain types of securities.[51] Typically, a publicly traded corporation is required to file reports quarterly (Form 10-Q) and annually (Form 10-K) with the SEC.[52] Some aspects of Forms 10-Q and 10-K are always required and others are based on specified numerical thresholds.[53] Other aspects are discretionary, based on a determination of materiality, a standard that requires officers to make a judgment call that could be challenged after the fact.[54] The 1934 Act also requires officers, directors, and ten percent beneficial owners to file reports of all transactions in the company's shares and requires any person acquiring five percent of an equity security to disclose.[55] Sarbanes empowered the SEC to promulgate additional disclosures as it deems necessary to protect investors.[56] In determining what must be disclosed under these provisions, the regulations and case law all rely on the materiality standard.[57]

Companies are not expected to predict the future, but they are expected to be honest about the past. The 1934 Act prohibits fraud in connection with all securities transactions under Rule 10b-5, regardless of whether the company is publicly traded.[58] For publicly traded companies, information having an impact 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.[59] Thus, all false statements can trigger liability, but a failure to make statements only imposes liability for issuers of publicly

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TEX. L. REV. 347 (1991); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 18–33 (1983).

[51] 15 U.S.C. § 78l.

[52] 15 U.S.C. §§ 78l, 78m(a); Thomas Lee Hazen, *Principles of Securities Regulation* 200 (2d ed. 2006).

[53] *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).

[54] Stephen J. Choi & A.C. Pritchard, *Securities Regulation: Cases and Analysis*, 49 (4t Ed. 2015).

[55] §§ 16(a), 13(d).

[56] Sarbanes-Oxley Act § 409.

[57] *See* George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality*, 64 UCLA L. REV. 602, 617–18 (2017) (giving examples of various regulations that require disclosure based on materiality); Dale A. Oesterle, *The Overused and Under-Defined Notion of "Material" in Securities Law*, 14 U. PA. J. BUS. L. 167, 170; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 V. L. REV. 669, 673–74 (1984) (noting asymmetric information in the securities market).

[58] 17 C.F.R. § 240.10b-5 (West 2021).

[59] 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).

traded securities.[60] There is 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. The sources of these independent duties are state law or industry-specific agencies. So even the SEC disclosure regime relies on the symbiotic relationship that enables shareholders to pursue *Caremark* claims.[61]

The only area of corporate governance subject to federal control is the regulation of the capital markets,[62] so the federal system is by nature reactionary. The Securities Exchange Act of 1934 focuses on the structure and operation of securities markets, and the SEC's regulation of the market is limited by the bounds of the 1934 Act.[63] As such, the SEC is excluded from the traditional domain of the states, corporate governance.[64] 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." These structures trigger the strongest penalties and requirements when actions alter the information available to investors on the open market.

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 federal mandatory disclosure standard in conjunction with the business judgment rule to evade state law duties. To determine whether a breach has occurred, shareholders need extensive information to meet the burden of proof. 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.[65] 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.[66] The minutia of day-

[60] 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).
[61] Federalizing *Caremark* could create a duty to disclose more administrative irregularities and findings or be the impetus for more successful Section 220 requests. *See* notes below.
[62] Thompson & Sale, *supra* note 39.
[63] Hazen, *supra* note 37; Joel Seligman, *The Transformation of Wall Street* 39–40 (3d ed. 2003).
[64] Hazen, *supra* note 37; Business Roundtable v. S.E.C., 905 F.2d 406, 408 (D.C. Cir. 1990).
[65] Georgiev, *supra* note 57, at 646 (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).
[66] But see Section 220 notes below.

to-day operations and compliance do not meet the standard for mandatory reporting.

Outside of the limited items that must be filed in the interim reports on Form 8-K, all other disclosures under the 1934 Act are voluntary.[67] The existence of voluntary disclosures makes matters worse, not better.[68] When combined with 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.[69] Voluntary disclosures need not be complete; they need only to be true.[70] Companies are, however, required to correct information previously reported if it becomes untrue.

The worst corporate scandals are born out of market manipulation, 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. To make a company look as positive as possible in public filings,

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[67] Section 409 of the Sarbanes 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, 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; 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).

[68] 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 what the system is designed to protect. These disclosures can manipulate the market and have even greater consequences. *See, e.g.*, 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).

[69] *See* 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.").

[70] Georgiev, *supra* note 57, at 607.

management will walk as close to the line as possible without crossing it.[71] 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 dividends, and other surface indications of a company's success.[72] 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.[73] This behavior can go unchecked under the SEC but not industry-specific agencies.

B. 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. The SEC has, historically, given deference to state law on matters of corporate governance.[74] Although the definition of a security is within the purview of SEC jurisdiction, it does not turn on whether an entity is a corporation, partnership, or LLC alone.[75] States are responsible for bringing corporations into existence, defining the requirements for formation,

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[71] *Id.*

[72] *See* Henry T. C. Hu, *Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEX. L Rev. 1601, 1608 (2012) (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).

[73] *See* Diamantis, *supra* note 65 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).

[74] *See* Carliss N. Chatman, *Myth of the Attorney Whistleblower*, 72 SMU L. REV. 669, 693 (2019) ("[D]eference to state ethical codes . . . means that the SEC Standards and the Model Rules act merely as a warning . . . ."); *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.").

[75] *See* Securities Act § 2(1); Securities Exchange Act § 3(a)(10); SEC v. Howey, 328 U.S. 293, 297 (1946).

and maintaining that form. 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.

Bills to federalize corporate governance through the creation of federal charters and federal governance norms have been introduced in Congress and failed to be made into law starting as early as 1903 to more recently with the introduction of legislation by Elizabeth Warren in 2018.[76] While there is little appetite in Congress to take over corporate governance wholesale, in times of crisis the federal response, as exhibited by Sarbanes and the Dodd-Frank Act,[77] is to expand into governance in the ways the SEC has been allowed historically, primarily through the expansion of disclosure.[78] If states desire to maintain control of corporate governance, they should heed these warnings, taking 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.

This spirit of deference impacts many ancillary matters that in other circumstances may trigger federal preemption. This is in part because Congress has been hostile to shareholder litigation over concerns that corporations were plagued with lawsuits by overzealous plaintiffs' attorneys taking advantage of the will to settle.[79] 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 is aimed at obtaining fees for attorneys not remedies for investors.[80] 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.[81] These reforms operate under an assumption that the necessary information for a successful securities fraud claim will be publicly

[76] *See supra* Note 41.
[77] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[78] *See* Steinberg, *supra* note 41 at 541–43.
[79] *See supra* Note 21.
[80] 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, *infra* note 113, at 1489–90, 1492; Sale, *supra* note 210.
[81] 15 U.S.C. §§ 78u-4(a)(3), 4(b), 78u-5 (2000).

available.[82] But, corporate families are able to conceal the information necessary to pursue litigation using size and complexity to manipulate what they are required to report,[83] which in turn limits the ability of investors to address potential fraud by pursuing litigation.

As a result of the PSLRA, shareholders who believe they have been harmed by conflicts of interest and self-dealing that does 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.[84]

State business codes define the requirements for corporate formation and for governance.[85] There are no legal requirements for board membership in the state statutes. Market forces tend to impose requirements on corporations, with a desire to cultivate outside investors or to go public, to choose a board that lends an air of legitimacy and expertise. The board manages the corporation on behalf of the shareholders, acts as a fiduciary, and owes the shareholders duties of loyalty, care, and good faith.[86] The board must ensure that information given to stockholders, the government, and the public is accurate and in compliance with both state requirements and the securities regulations. This is accomplished through the institution of proper internal

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[82] *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 121, at 1489–90, 1492–93 (examining PSLRA reforms and their effectiveness); Shannon Rose Selden, *Self-Policing the Market: Congress's Flawed Approach to 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).

[83] *See infra* Part III.A.

[84] *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 plaintiff's class action on the grounds that their 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); Chatman, *Family Matters*, at 42 ("Thus, if the family definition allows more information to come into the domain of mandatory reporting, the SEC's deference to state law norms means that the corporate family structure could have an impact on securities regulations, including the definition of fraud, 10b-5 litigation, and on the definition of conflicts across multiple regulatory schemes. Through private litigation, aided with the additional information accessible to shareholders of corporate families, investors may help uncover fraud and be compensated for their losses.").

[85] *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 . . . .").

[86] *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).

controls, audits, and legal compliance. Corporate officers are hired by the board and handle the day-to-day operations of the corporation. Directors and officers are tasked with exercising care and loyalty for the general well-being of the entire corporation or to outsource when they cannot provide adequate oversight.[87] 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.[88]

The PSLRA combines with *Caremark* 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*. So, while the SEC defers to states, and the PSLRA helps to eliminate frivolous lawsuits, there is nothing in the securities regulations or the state court system alone to protect shareholders as directors and officers engage in behavior that may be problematic but not over the line.

Individually, each of these policies, developed independently to address particular problems, makes sense. But, take a step back, and it becomes clear these policies combine to form a nearly unbridgeable gap between a rock, federal deference to states regarding corporate governance, and 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 only because they are unable to access the information they need to support an actionable, state-court claim. Caremark and its progeny offer a means by which these discrepancies in policy may be resolved to improve federal-state cooperation and empower shareholder claims.

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[87] *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).

[88] *See* Davis, *supra* note 90 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 90, 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.").

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,[89] and, in so doing, gave rise to a new era of compliance and profoundly changed the bounds of fiduciary duties.[90] *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. However, *Caremark* claims 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."[91]

Seventeen *Caremark* claims have been brought in Delaware, but only five have survived a motion to dismiss: *Marchand v. Barnhill*, *In re Clovis*, *Teamsters Local 443 Health Services & Insurance Plan v. Chou*, *Hughes v. Hu*, and *In re Boeing Co. Derivative Litig*. 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. Therefore, evidence of a failure to comply with federal oversight and regulations can be used as a *per se* breach of loyalty in Delaware.

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[89] *See* DEL. CODE ANN. Tit. 8, § 102(b)(7) (West); DEL. CODE ANN. Tit. 8, § 145 (West); *see* Leo E. Strine, Jr. et al., *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").

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

[91] *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 126 (Del. Ch. 2009).

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*,[92] Caremark pled guilty to mail fraud charges and, as part of the plea agreement, had to pay $250 million in related criminal and civil fines. The plea agreement concluded an extensive investigation by the Department of Justice and the Department of Health and Human Services into alleged violations of federal and state health care laws regarding paying 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 considered the legal standards governing a director's duty to supervise or monitor corporate operations.

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***."[93] 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," [94] then the director is liable for breach of loyalty. A "failure to do so under some circumstances may, in theory at least***, render a director liable for losses***

[92] 698 A.2d 959 (Del. Ch. 1996).
[93] *Id.* at 970.
[94] *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.").

caused by non-compliance with applicable legal standards."[95] Thus, for 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.[96] 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.[97] The business judgement rule presumes directors act in compliance with their fiduciary duties when making business decisions, and courts will not second-guess those decisions or insert

[95] *Id.*

[96] *In re* Facebook, Inc. Sec. 220 Litig., No. 2018-0661-JRS, 2019 WL 2320842, at *14 (Del. Ch. May 31, 2019), as revised (May 31, 2019), judgment entered sub nom. *In re* Facebook, Inc. ("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 Deriv. Litig., 964 A.2d at 131 ("There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a company'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.* JPMorgan Chase & Co. v. Bammann, No. 9772-VCG, 2015 WL 2455469, at *14 (Del. Ch. May 22, 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.").

[97] There is some debate around 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, i.e. the director did not do enough, no business decision has been made and, as such, the busines judgment rule does not formally apply. See, e.g., Roy Shapira, *Mission Critical ESG and the Scope of Director Oversight Duties*, X COL. BUS. L. REV. X (2023) ("The business judgment rule does not apply to failure-of-oversight claims, as these do not involve making a concrete business decision.") (citing Stephen Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004)), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4107748. 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.

themselves into business operations unless shown otherwise. 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."

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*, 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….[98]

Thus, there are two prongs to bad faith of at least the second and third categories under *Caremark*, either of which can rebut the presumption of the business judgment rule and enable a derivative shareholder claim to survive a motion to dismiss. 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.[99] 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.[100]

[98] 906 A.2d 27 (Del. 2005); 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.

[99] *Marchand*, 212 A.3d at *807 (citing Caremark); *see also In re* Caremark Int'l Inc. Deriv. 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").

[100] *Stone*, 911 A.2d at 370–72.

But defining what bad faith is does not provide shareholders with the actual evidence showing 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 DGCL Section 220, which enables a shareholder to inspect a corporation's books and records for a proper purpose. 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 status as a shareholder. 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. The common law presumed the shareholder had a proper purpose to inspect the documents and to prevent shareholder access, the law required the corporation to demonstrate that bad faith or improper purpose motivated the shareholder. 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:
>
> 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.[101]

The statute makes a distinction between stock lists and general books and records, with the former request being easier to obtain. The burden is on the corporation to establish that a demand for stock ledgers is improper. The prerequisite to the inspection of books and records is virtually identical to the inspection requirements for a demand for the stock list, however, the burden is on the shareholder to establish a proper purpose.

DGCL § 220 states that, to be proper, the purpose must be reasonably relate to the persons 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 burden for inspection in the same way that they are able to survive a motion to dismiss under *Caremark*—with administrative findings.

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 stock holder's interests. While stronger than the burden for stock lists and ledgers, the burden for books and records is still the lowest burden possible under Delaware law. According to Roy Shapira, Delaware courts has recently

[101] *See* DEL. CODE ANN. Tit. 8, § 220 (West).

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.[102] 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.[103] While plaintiffs must utilize Section 220, it is often difficult to do so without the information they obtain from administrative findings. In this regard, it is not Section 220 that is the key to surviving the motion to dismiss. Section 220 is merely another step for 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 Blue Bell, with a business focused on one industry that must meet strict guidelines to maintain compliance with state and federal food safety norms, the results of inspections by the FDA and state agencies could be deemed to be of 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 interests.

B. Surviving Motion to Dismiss By Agency Action

Agencies already use and rely on laws and regulations to define, implement, and monitor red flags. Agency adjudications, investigations, and enforcement actions, therefore, provide ample evidence for shareholders to access to bolster their derivative claims against directors. *Caremark*'s dual prongs of bad faith may be satisfied if directors have (1) failed to implement monitoring systems in contravention of their duty of care or regulatory requirements, or (2) if they have evidenced a "conscious disregard for one's responsibilities" by "non-compliance with applicable legal standards" because they failed to use the monitoring systems in place.[104]

Only five Delaware cases have survived motions to dismiss under the *Caremark* standard, but plaintiffs in each of these cases accused corporate

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

[103] 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).

[104] *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."

officers of bad faith because external agency actions, such as investigations, agency regulations or guidance, and subpoenas, were enough to make them aware of the existence of a problem that could have been avoided if only the corporation had adequate monitoring systems in place that the officers utilized.

This subsection discusses the five cases where such failure occurred and analyzes how the red flags and agency actions which should have alerted the board to a problem instead served as the evidence shareholders needed to overcome their rebuttal burden to show the directors' bad faith.

1. Marchand v. Barnhill

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

The facts of *Marchand* began in February 2015 when the South Carolina Department of Health and Environmental Control discovered listeria in Blue Bell's Chocolate Chip Country Cookie Sandwiches and Great Divide Bars through random product sampling.[105] The South Carolina findings prompted Texas officials to investigate the Blue Bell production facility in Brenham, Texas, where the two products were manufactured.[106] There, listeria was discovered in the same two products tested in South Carolina, but it was also in Scoops, another Blue Bell ice cream product manufactured on the same production line.[107]

By March 2015, two people contracted the Blue Bell strain of listeria and were being treated at the same hospital in Kansas.[108] Three other cases with differing strains of listeriosis were identified in that hospital as well.[109] Health officials believed that all five of the infections were due to victims consuming milkshakes made with Blue Bell products while in the hospital.[110] Upon investigation, the Kansas Department of Health and Environment did find listeria in the Blue Bell chocolate ice cream cups collected from the Kansas

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[105] Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805 (Del. 2019); *see also 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/.
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.*

hospital.[111] But, they discovered it was the same strain of listeria found in ice cream cups from Blue Bell's Broken Arrow, Oklahoma manufacturing facility, meaning the strain of listeria was different from those found in the people infected in Kansas and from the products sampled in Texas and South Carolina.[112] Ultimately, ten people were infected with several strains of Blue Bell listeria in four states: Arizona (1), Kansas (5), Oklahoma (1), and Texas (3).[113] All ten people were hospitalized, and three of the five Kansas victims died.

In late March and early April, and partly in response to a CDC recommendation against serving or eating Blue Bell products, 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.[114] The consequences of these decisions included the disposal of over eight million gallons of product,[115] 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.[116]

When they brought suit, the shareholder plaintiffs 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.[117] The *Marchand* Court based its holdings on several specific facts showing: there was no board committee to address food safety; there were no regular processes or protocols requiring management to keep the board apprised of food safety compliance practices, risks, or reports; there was no schedule for the board to consider whether any key food safety risks existed; during the period leading up to the deaths of the three victims, management 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; the board was instead given favorable information about food safety by management, but was not given the much more important, negative reports; and the board meetings lacked any regular discussion about food safety.[118]

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[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] 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/.
[116] *Marchand*, 212 A.3d at *807.
[117] *Id.* at *820.
[118] *Marchand*, 212 A.3d at 822.

According to Chief Judge Strine, as a company which makes and relies on a single product, "Blue Bell can only thrive if its consumers enjoyed its products and were confident that its products were safe to eat."[119] 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."[120] 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].'"[121]

The court also noted that both state and federal agencies were involved. Obviously, Blue Bell is subject to state agency oversight and regulations, as evidenced by the multiple state agency investigations discussed above, 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."[122]

At the federal level, the Food and Drug Administration ("FDA") had notified Blue Bell of several deficiencies within its facilities both before and after the listeria outbreak began.[123] 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."[124] 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, sanitation standards, monitoring, and more.[125] 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,"[126] Blue Bell did not seek to

[119] *Id.* at *809.
[120] *Id.*
[121] *Id.* (citing *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d at 971).
[122] *Id.*
[123] *Id.* at *810.
[124] *Id.*
[125] *Id.*
[126] *Id.*

rectify the problems because there was no reporting system in place to convey the information to the board on an ongoing basis.[127]

In its defense, Blue Bell essentially blamed the government for its failures, arguing there could be no breach of duty because both state and federal governments regularly inspected its facilities.[128] 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."[129]

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."[130]

The court in *Marchand* focuses on prong one of *Caremark,* how Blue Bell had no monitoring system in place, the company's negligent lack of attentiveness, how nominal regulatory compliance is not enough to shield directors from liability, and how plaintiffs can leverage agency information to bolster their shareholder claims. The following case builds on *Marchand* and illustrates how plaintiffs can succeed under *Caremark*'s second prong.

2. In re Clovis Oncology, Inc. Derivative Litigation

In re Clovis Oncology, Inc. is another 2019 Delaware Chancery Court case where the court likewise found that the board ignored multiple warning signs—this time about company management inaccurately reporting a drug's efficacy in violation of clinical trial protocols and federal regulations.[131] As was the case in *Marchand*, 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").[132] Like all drugs, Roci was required to undergo the FDA's new drug approval process which requires the company to prove the drug's efficacy and safety by conducting clinical trials with FDA-approved protocols.[133] These protocols include information about how the trial will be conducted, how the

[127] *Id.*
[128] *Id.* at 822-23.
[129] *Id.*
[130] *Id.*
[131] *In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *13.
[132] *Id.* at *1.
[133] *Id.*

resulting data will be analyzed, and how the trial will measure success.[134] If a company does not follow the approved procedure, then the FDA will not approve the new drug for market.[135] However, time was of the essence, 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.[136] This arrangement only made sense because Clovis expected Roci to be a blockbuster drug capable of tapping into a $3 billion annual market.[137]

Clovis opted to incorporate a well-known clinical trial protocol called "RECIST."[138] RECIST requires 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."[139] Under the terms of the clinical trial protocol, Clovis was to calculate ORR based on confirmed responses.[140] Several reports verified Clovis was including unconfirmed responses in ORR calculations.[141] The board was aware of the discrepancy as early as June 12, 2014, but it did nothing to respond to it or other indications of non-compliance with RECIST, such as problems with informed consent, patient eligibility, data reliability, recordkeeping, and adverse reporting practices violations.[142]

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%; Clovis went as far as reporting an ORR of 50% directly to the FDA in a June 9, 2015 meeting about its New Drug Application.[143] Company management also often noted Roci's ORR was at least as encouraging as the nearest competing product's (set to hit markets soon).[144] When the board received

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[134] *Id.*
[135] *Id.*
[136] *Id.* at *2, *4.
[137] *Id.* at *4.
[138] 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." Compl. ¶ 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)).
[139] *In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *5.
[140] *Id.*
[141] *Id.*
[142] *Id.* at *6-7.
[143] *Id.*
[144] *Id.*

the final protocol numbers on July 7, 2015, the data showed Roci's actual ORR was only 42%.[145]

The FDA was aware of the conflicting ORR reports and requested additional support for the new drug application in October 2015 and called a meeting with Clovis executives in November.[146] The executives at the meeting learned the FDA would only credit confirmed responses on the application and insisted that Clovis comply with the protocol.[147] When Clovis issued a public press release on November 18, 2015, to acknowledge Roci's confirmed ORR was only 28-34%, the company's stock price dropped by 70% and wiped out more than $1 billion in market capitalization.[148] In May of the following year, Clovis withdrew its new drug application for Roci and terminated all ongoing Roci studies.[149] The company and board members were later named as defendants in several securities fraud class actions which resulted hundreds of millions of dollars in settlements and payouts, a follow-on FDA investigation, and an onerous SEC consent decree.[150]

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 requirements and FDA requirements."[151] 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 a "'red flag' of non-compliance waived before the Board Defendants but they chose to ignore it."[152]

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;[153] RECIST ORR calculations were only supposed to include confirmed responses;[154] industry practice and FDA guidance required that study managers only report confirmed responses;[155] management publicly reported unconfirmed

[145] *Id.* at *6-7.
[146] *Id.*
[147] *Id.*
[148] *Id.* at *8.
[149] *Id.*
[150] *Id.* at *9.
[151] Complaint ¶ 279.
[152] *Id.* (citing South v. Baker, 62 A.3d 1, 16–17 (Del. Ch. 2012)).
[153] *Id.*
[154] *Id.*
[155] *Id.*

responses to keep up with the competition's response rate;[156] and the Board knew management was incorrectly reporting responses, but chose to do nothing about it.[157]

Similar to the food safety considerations of *Marchand*, 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."[158] Roci, and by extension Clovis, was doomed as soon as the FDA learned of the company's serial non-compliance with RECIST; it was inevitable that the company's stock price would plummet once word of Clovis' conduct got out.[159] 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,"[160] 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."[161]

Clovis supplements the *Marchand* holdings in several ways. In *Marchand*, there was superficial, albeit borderline-negligent, compliance with at least some of the applicable laws and regulations; in *Clovis* the board knowingly and actively obfuscated its non-compliance. In *Marchand*, prong one was implicated because of the absence of oversight systems and the directors' inaction; in *Clovis*, prong two was implicated because the board had oversight systems in place but used them to facilitate malfeasance instead of fiduciary duties. But most importantly, and to a greater degree in *Clovis* than in *Marchand*, 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.

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

The most important feature of *Teamsters Local 443 Health Services & Insurance Plan v. Chou* 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, then shareholders bringing derivative claims can use the information developed by agency

[156] *Id.*
[157] *Id.*
[158] *In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *13 (citing Marchand).
[159] *Id.*
[160] *Id.*
[161] *Id.* at *15, and (citing Compl. ¶¶ 18, 222-23).

action to show the *per se* bad faith of the fiduciaries to overcome their difficult *Caremark* burden.[162]

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.[163] Despite clear involvement in the medical-pharmaceutical industry, neither ABC nor Pharmacy were registered with the FDA as drug manufacturers or packagers.[164] Pharmacy was intentionally portrayed 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."[165] 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 physicians to treat immunocompromised patients.[166] 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.[167]

[162] *Teamsters Local 443 Health Serv. & Ins. Plan*, 2020 WL 5028065, at *1.
[163] *Id.*
[164] *Id.*
[165] *Id*. at 7 (citing the Criminal Information, ¶ 13).
[166] *Id.* at *3.
[167] *Id.* at *4 (internal citations omitted).

Pharmacy also had an incentive program which gave technicians who produced more syringes extra bonuses.[168] At the height of its operation, the Pre-Filled Syringe Program generated more than $14 million in profit for ABC a year.[169] These practices were clearly illegal. Accordingly, the United States Attorney's Office subpoenaed Pharmacy and FDA agents executed a search warrant on its Dothan, Alabama facility in 2012.[170]

The court acknowledged that the director defendants' actions implicated both prongs of *Caremark*, 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 ABC's "woefully inadequate compliance system" regarding another of its subsidiaries "sp[oke] to a lax approach (at best) to compliance at ABC."[171] 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 "waved in [their] face or displayed so that they were visible to the careful observer."[172]

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. 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. ABC's board and Audit Committee did nothing in response to the report. The court had little trouble determining this met *Caremark*'s prong two because obviously there was an oversight mechanism in place, the Audit Committee, and the board learned of the deficiencies outlined in the report through the Audit Committee.[173]

The second red flag dealt with a former ABC subsidiary's Chief Operating Officer, 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."[174] The

[168] *Id.* at *6.
[169] *Id.* at *5.
[170] *Id.* at *24.
[171] *Id.* at *26.
[172] *Id.* (quoting David B. Shaev Profit Sharing Acct. v. Armstrong, No. Civ.A. 1449-N, 2006 WL 391931, at *5 (Del. Ch. Feb. 13, 2006), aff'd, 911 A.2d 802 (Del. 2006)).
[173] *Id.* at 20.
[174] *Id.* at 11, 13.

court determined the board was aware of Mullen's allegations because they were aware of and making disclosures about his *qui tam* suit.[175]

The third red flag dealt with the FDA's search warrant and the DOJ's subpoena. Regarding the search warrant, the court dismissed it as a possible bad faith red flag because there was no evidence the board had actual knowledge of the warrant or its execution. 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."[176]

It is especially important to note how the second, third, and first red flags interconnect for the point of this Article. Mullen's interaction with the DOJ led to it issuing the subpoena, prompted other agency involvement with the FDA, both through its search warrant and an evaluation of how ABC had violated its regulations, and the SEC, through ABC's 10-K filing, and ultimately led to the plaintiffs in *Teamsters* having access to far more substantiating material for their *Caremark* claim.

Teamsters is like *Marchand* because ABC was enabled in its malfeasance by the federal-state regulatory governance gap, and, to a lesser extent, because of its inadequate or inconsistent oversight and compliance programs. *Teamsters* is like *Clovis* in that the companies in both cases are part of the pharmaceutical industry and actively and knowingly broke the law. All three are similar in that they operate in the highly regulated industries of food and medicine, and, at least for the period relevant to the litigation, were "monoline" companies relying on a single "essential and mission critical" product or service for their financial success.[177]

4. Other Successful *Caremark* Cases

As demonstrated by the similarities shared by *Marchand*, *Clovis*, and *Teamsters*, relying on agency actions and regulations is a consistent method of bolstering a *Caremark* claim. However, *In re Boeing Company Derivative Litigation* and *Hughes v. Hu* are two outlying Delaware-based *Caremark* cases with uniquely specific topical considerations that nevertheless managed to survive the dreaded motion to dismiss.

Boeing was a 2021 case about Boeing's 737 MAX airplane, which crashed in the Java Sea in October 2018 and in Ethiopia in March 2019 killing

[175] *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.")
[176] *Id.* at 13, 24.
[177] *Teamsters Local 443*, at *18 (citing Marchand and Clovis).

everyone aboard both times.[178] Boeing, like Blue Bell, Clovis, and Pharmacy before it, is a part of a highly regulated industry and airplane safety is thus mission critical. The *Boeing* court noted *Marchand* had "remarkably similar" prong one allegations: the board had no committee to monitor or report on airplane safety;[179] the company lacked internal reporting systems to bring safety concerns to the board's attention;[180] the board did not monitor, discuss, or address airplane safety on a regular basis;[181] and the board had no regular process or protocols requiring management to apprise the board of airplane safety issues.[182] Company management knew the 737 MAX had numerous, potentially catastrophic safety concerns, the worst being a defective maneuvering control system.[183] All of these constitute red flags and the court accordingly determined the plaintiffs carried their burden under both prong one and prong two.[184]

The key difference in *Boeing* is the plaintiffs there would not have been able to rely on agency action or information even if they had tried, because, unlike in the previous cases, Boeing was either successful in its deceptions of the FAA or the FAA was uninterested in seriously investigating the company. Boeing misled the FAA by failing to disclose known safety issues. But, even when the maneuvering control problem did come up, Boeing simply told the FAA that "it should not reference [it] in its report because it was 'outside the normal operating envelop[e].'"[185] The court acknowledged "Boeing and its well-connected leadership had significant sway over the FAA, and the FAA

[178] *In re* Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 WL 4059934, at *1 (Del. Ch. Sep. 7, 2021).
[179] *Id.* at *26-27.
[180] *Id.*
[181] *Id.*
[182] *Id.* at *29.
[183] *Id.* at *31.
[184] *Id.* *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 state particularized facts necessary to state a prong two *Caremark* claim, but then, later in the same section, it 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."
[185] 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)." *Id.* at *9.

often permitted Boeing to self-regulate."[186] Obviously, such an arrangement would impede the FAA's ability to respond appropriately.[187]

Hughes v. Hu is an outlier because it is defined as much by its international character as it is by *Caremark*.[188] *Hughes* involves a foreign 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.[189] *Hughes* is mostly concerned with the company's consistent failure to submit proper financial reports and implement internal controls for related-party transactions; it is not so much concerned with highly regulated industries or single-product reliance and the need for mission-critical regulatory compliance.[190] Instead, the case is concerned with routine accounting and business decisions.

Nevertheless, the *Hughes* court, again noting *Marchand*'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 sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation."[191]

C. Lessons Learned

The forgoing cases have three important factors in common. First is the mission-critical nature of the company's shortcoming. In this context, mission critical means that the system or its associated product is so essential

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[186] *In re* Boeing Co. Derivative Litig., 2021 WL 4059934, at *9. It does raise an important question, however, about how much the court should rely on federal agencies knowing that some are subject to capture. 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 the 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., https://www.economist.com/business/2019/03/23/regulatory-capture-may-be-responsible-for-boeings-recent-problems.

[187] The DOJ would open a criminal investigation into whether Boeing had defrauded the FAA when obtaining certification of the 737 MAX in January 2019. Boeing would settle 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.

[188] *Hughes v. Hu*, 2020 WL 1987029 (Del.Ch., 2020).

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

[190] *Id.* at *1.

[191] *Id.* at *14.

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.[192] Thus, in *Marchand*, Blue Bell—a food manufacturer—failed to monitor food safety[193]. As a result, the company was forced to cease production[194]. In *Clovis*, the company had only one product on the market.[195] The company's success or failure was wholly dependent on the FDA's authorization of this blockbuster drug.[196] Nevertheless, the board completely failed to monitor its system of oversight and adhere to FDA protocols.[197] In *Teamsters Local 443 Health Services & Insurance Plan*, the failure to adhere to FDA regulations despite operating as a pharmaceutical sourcing and distributing company was inherently problematic.[198] This failure was especially egregious, however, because Pharmacy generated substantial annual revenue for the parent company.[199] This leads to the second commonality. Each of these failures caused substantial monetary damages and reputational harm to the companies.[200] So much money that shareholders would be rightfully upset by its loss.[201] Finally, each case involved some federal agency action. In *Marchand*, the court concerned itself with the various warnings of the FDA.[202] In *Clovis*, the court focused on the company's failure to abide by FDA regulations and guidance pertaining to its protocol agreement.[203] In *Teamsters Local 443 Health Services & Insurance Plan*, the court's evidence was the result of a federal subpoena from the US Attorney's Office based on findings of the FDA.[204] In every instance where plaintiffs have survived a motion to dismiss, they have relied on federal or state standards, regulations,

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[192] *See* Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805, 822, 824 (Del. 2019).
[193] *Id.* at 809.
[194] *Id.* at 807.
[195] *In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *14 n.208 (Del. Ch. Oct. 1, 2019).
[196] *See id.* at *4, *14.
[197] *Id.* at *15.
[198] *See* Teamsters Loc. 443 Health Services & Ins. Plan v. Chou, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020).
[199] *See id.* at *2; *but see* Roy Shapiro, *The Challenge of Holding Big Business Accountable*, CARDOZO L. REV. 158 (2022) (describing AmerisourceBergen ("ABC") as a pharmaceutical giant and the subsidiary's ("Pharmacy") revenue as a tiny fraction of ABC's overall revenues.
[200] *See, e.g.*, Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805, 807, 821 n.105 (Del. 2019).
[201] *See, e.g.*, *id.* at 807, 815.
[202] *Id.* at 810.
[203] *See In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *4, *8, *15 (Del. Ch. Oct. 1, 2019).
[204] *See* Teamsters Loc. 443 Health Services & Ins. Plan v. Chou, 2020 WL 5028065, at *24 (Del. Ch. Aug. 24, 2020).

investigations, findings, warnings, orders, or some combination thereof.[205] And while these factors are glaringly obvious in the aforementioned cases, they are not so unique that they are not readily apparent in other instances.[206]

D. Application to Facebook

The obvious difference between the failed claims against Facebook resulting from the Cambridge Analytica Data scandal and the successes in *Marchand*, *Clovis*, and *Teamsters Local* 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.[207] Facebook shareholders were unable to seek similar recovery because all the information that would have helped them to pursue the company was withheld from them.[208] 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 them, SEC disclosures do not provide this type of information.[209] Instead, plaintiffs were forced to rely on privacy breaches of which the company was rumored to be aware.[210] Facebook shareholders would have greatly benefited from the existence of some industry-specific agency that could both oversee and intervene.[211] In its absence, they must settle for the FTC's recent finding that Facebook violated a 2012 Order.[212]

In a new derivative suit against Facebook, filed on November 12, 2021, Facebook shareholders argue that Facebook CEO Mark Zuckerberg and Facebook COO Sheryl Sandberg, among others (combined, "Defendants"), "knowingly and intentionally operated Facebook in contravention of law."[213] Specifically, these Defendants "caused Facebook to violate the 2012 Consent Order, resulting in a $5 billion fine borne by Facebook and its

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[205] *See Teamsters Loc. 443 Health Services & Ins. Plan*, 2020 WL 5028065, at *25; *see also Marchand*, 212 A.3d at 822–24; *see also In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *15.

[206] *See, e.g.*, *In re* Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 WL 4059934, at *1 (Del. Ch. Sep. 7, 2021).

[207] *See In re* Facebook, Inc. Sec. Litig., 405 F. Supp. 3d 809 (N.D. Cal. 2019).

[208] *See generally id.* at 832 (plaintiffs failed to adequately plead scienter).

[209] *See id*. at 822.

[210] *See id.* at 836.

[211] Proposals in this area abound. See, e.g., Michael A. Cusumano, David B. Yoffie, and Annabelle Gawer, Pushing Social Media Platforms to Self-Regulate, The Regulatory Review, available at https://www.theregreview.org/2022/01/03/cusumano-yoffie-gawer-pushing-social-media-self-regulate/

[212] FTC Press Release, *supra* note 16.

[213] Second Amended and Consol. Verified S'holder Deriv. Complaint at ¶ 668., In Re FACEBOOK INC. Derivative Litigation., 2021 WL 5405962 (Del. Ch. Nov. 12, 2021) (No. 2018-0307-JRS).

stockholders….”[214] 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.”[215] 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”).[216]

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 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 ….[217] Notably, this argument is only possible now due to the existence of the FTC Order.[218] Plaintiffs can piggyback off the FTC investigation, findings of fact, and final adjudication whereas this option was not available to them before and would not be in the absence of the FTC ruling.[219] If this approach is successful, it will allow plaintiffs to rely on government action both prior and subsequent to any board inaction. And 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.[220]

III. FEDERALIZING *CAREMARK*

Given the predominant lessons 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 FTC

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[214] *Id.*
[215] *Id.*
[216] *Id.*
[217] *Id.* at ¶ 671.
[218] *See* Stipulated Ord. for Civ. Penalty, Monetary Judgment, and Injunctive Relief, USA v. Facebook, Inc., No. 19-cv-2184, 2019 WL 3318596 (D.D.C. July 24, 2019).
[219] *See id.*
[220] *See Teamsters Loc. 443 Health Services & Ins. Plan*, 2020 WL 5028065, at *25; *see also Marchand*, 212 A.3d at 822–24; *see also In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *15.

Order in Facebook's Cambridge Analytica Scandal).[221] Consequently, if the government truly means to protect shareholders in the marketplace, as it claims,[222] it would be in everyone's best interest to formalize the plaintiff's right to rely on a proven violation of a federal rule or regulation as a red flag for purposes of *Caremark*.[223] In any instance where the plaintiff can readily rely on a violation proven in a final federal or state dispensation (namely, final rules and adjudications), 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 waived once the board was made aware of the company's serial non-compliance with the FDA-sanctioned RECIST trial protocol.[224]

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 *Marchand* 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."[225] 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 specifically because there was no reasonable reporting system in place.[226] 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.[227] In these instances, plaintiffs' burden should also be deemed met as to prong two.[228]

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 Local 443*, the plaintiff's pleading burden should also be deemed met for *Caremark* prong two.[229] The *Teamsters* court recognized that directives issued by the court on behalf of federal agencies could also serve as red flags and found the company's failure to address the mission critical

[221] *See, e.g.*, *Teamsters Loc. 443 Health Services & Ins. Plan*, 2020 WL 5028065, at *25; *see also Marchand*, 212 A.3d at 822–24; *see also In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *15.

[222] "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." https://www.sec.gov/about.shtml

[223] See In re Caremark Intern. Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[224] *In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *14–15 (Del. Ch. Oct. 1, 2019).

[225] Marchand v. Barnhill (*Blue Bell*), 212 A.3d 805, 810 (Del. 2019).

[226] *Id.* at 821.

[227] *Id.* at 822.

[228] *Id.*

[229] *See* Teamsters Loc. 443 Health Services & Ins. Plan v. Chou, 2020 WL 5028065, at *24 (Del. Ch. Aug. 24, 2020).

shortcomings implicated in the U.S. Attorney's Office subpoena sufficed as an adequate pleading under prong two.[230]

Legal obedience is a cornerstone of all corporate statutes,[231] yet federalizing *Caremark* in this way helps to import best practices to firms by going beyond the requirement of mere legal obedience. Section 101(b) of the Delaware General Corporation Law 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."[232] Given this statutory mandate, courts should not afford deference to those fiduciaries who have directed the corporation to violate the law. When a corporate director or officer does engage in unlawful behavior on behalf of the corporation, they are unable to rely on the business judgment rule defense.[233] 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."[234] The proposal here fully accords with these preexisting principles.

Moreover, compliance with *Caremark* duties goes beyond what is required merely to avoid liability.[235] 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 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."[236] Beyond these efforts, a strong *Caremark* regime also incentivizes compliance officers to look to behaviors that fall just short of the illegal behavior, like lying.[237]

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[230] *Id.*

[231] Leo E. Strine Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 649 (2010).

[232] Del. Code Ann. tit. 8, § 101(b) (2022).

[233] *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).

[234] Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121, 131 (Del. Ch. 2004; *see also* Guttman v. Huang, 823 A. 2d 492, 506 n.34 (Del. Ch. 2003) ("[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.").

[235] Claire Ariane Hill, *Caremark as Soft Law*, 90 TEMPLE L. REV. 684 (2018) (citing Penumbra, MERRIAM-WEBSTER, http://www.merriamwebster.com/dictionary/penumbra).

[236] *Id.* at 685.

[237] *Id.*

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.[238]

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 in court helps to shape not only the company's compliance obligations, but also its ethics.[239]

IV. JUSTIFICATIONS FOR FEDERALIZING *CAREMARK*

Tethering federal dispensations to *Caremark*'s second prong specifically helps shareholders to 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 thus 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.[240] This Part of the Article explores some of the legal justifications for such an approach, including market failure, democratic theory, and asymmetrical information justifications, strict liability for wrongdoers, the benefits of industry-specific rules and regulations, and the limitations of market-based crisis theory administrative action.

A. Market Failure, Democratic Theory, and Asymmetrical Information Justifications

In a perfect world functioning with a perfect competition paradigm, all markets would have many sellers and many products, all consumers would

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[238] *Id.*
[239] 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).
[240] *See supra* note 217.

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.[241] Yet, reality seldom adheres to this idealized economy. In its absence, the government must rely on a limited number of mechanisms to address any departures from a theoretically perfect competitive model.[242] The most obvious mechanism is seen in the form of taxation, where heavier or lighter taxes on certain products or activities make them more or less financially attractive. However, the government more frequently attempts to control behavior directly through regulation.

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.[243] The principle of market failure suggests that negative by-products (*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.[244] This logic provides the basis for many of the early regulatory statutes, especially those like the Securities Act of 1933 and the Securities Exchange Act of 1934, which were intended to stabilize an ailing domestic economy.[245]

The second justification is rooted in democratic theory and suggests that people will occasionally demand more from society than any one individual

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[241] 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); Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 111–12 (2006); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 640–41 (2003) (distinguishing between informational efficiency and fundamental value efficiency); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 646–47 (1995); Lawrence A. Cunningham, *Capital Market Theory, Mandatory Disclosure, and Price Discovery*, 51 WASH. & LEE L. REV. 843, 844–45 (1994); Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 854–56 (1992); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 618 (1988) ("the connection between prices in the public trading markets for stocks and the allocation of real resources is a weak one, and that stock markets may have far less allocative importance than has generally been assumed.").

[242] *See supra* note 236.

[243] 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." *See* Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189, 1192 (1986).

[244] *Id.*

[245] *Id.*

will seek for themselves, triggering our sense of social justice and welfare, and thus requiring government intervention.[246] These social considerations include diverse regulatory areas such as employment discrimination, environmental quality, consumer protection, and occupational safety, and justify government mandates regarding the same:

> Federal agencies should promulgate only such regulations as 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….[247]

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 Consumer Product Safety Commission, the Occupational Safety and Health Administration, the Environmental Protection Agency, the Nuclear Regulatory Commission, and the National Highway Traffic Safety Administration.[248] These new social regulations were necessary, in part, to protect people from those aspects of market behavior to which they do not voluntarily consent to participate. For instance, it is difficult to try to tackle the problem of air pollution with market-based solutions, since there is neither market for a commodity produced nor any market-based compensation for victims of the pollution.[249] 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 is the question of market failures resulting from inadequate or asymmetric information. 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

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[246] *Id.*
[247] Executive Order 12866.
[248] *See* Rabin, *supra* note 238, at 1284.
[249] *See generally* APPROACHES TO CONTROLLING AIR POLLUTION (Ann F. Friedleander ed., MIT Press 1978) (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. 103-17 (1993).

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, shareholder profits and thus shareholders themselves 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 the relationship between directors and officers on one hand and shareholders on the other.

The Securities and Exchange Act of 1934 thus created the Securities and Exchange Commission to protect investors, maintain efficient capital markets, and facilitate capital formation.[250] To do so, it 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."[251] Moreover, the SEC notes that "only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions."[252]

Individual investors provide financing to companies, much like banks, through the purchasing of stocks and bonds issued by the companies. The SEC attempts to ensure that these 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.[253] Despite the best of intentions, however, the SEC has not always been able to prevent public firms from deceiving potential or actual investors.[254] Both securities law and investor protection are subject to the incomplete law problem; neither companies nor the government can anticipate every actionable lack of due care on the part of directors and managers. Potential harms thus abound.

B. Benefits of Industry-Specific Governance

The beauty of what Delaware has been able to implement with the *Caremark* standard is that it allows the state government to capitalize off the

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[250] "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." https://www.sec.gov/about.shtml
[251] *Id.*
[252] *Id.*
[253] *See supra* section I.A.
[254] *See* the cases discussed throughout this Article.

lessons learned more broadly in the administrative state.[255] 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.[256] And while general rules can alleviate some problems requiring government intervention, the reality is that in practice industry-specific approaches are best.[257] This is becoming more obvious as new challenges regularly emerge.[258]

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, enterprise, etc.[259] In this way, similar issues that cut across industries are dealt with in the same way.[260] 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 rather than defining any particular rules imposing specific conditions on corporations. In the case of corporate governance, for example, as previously discussed, most U.S. federal securities regulation of public company corporate governance is disclosure-driven rather than having any meaningful substantive requirements.[261] Likewise, to list a security on the NYSE or Nasdaq, a company must agree to abide by the corporate governance requirements provided in the relevant exchange's listing rules.[262] The corporate governance guidelines and "best practice" codes merely recommend how a public company's board should organize their structure and processes.[263] Yet, these "best practices" vary wildly by industry. This problem is also evident as it relates to the SEC disclosure requirements that tend to trigger disclosure of CSR matters.[264]

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255 *See* Sale, *supra* note 26, at 720.
256 *Id*. at 754.
257 *See* Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C.L. REV. 949, 959 (2009).
258 *See* Baer, *supra* note 286, at 988.
259 *See Id.* at 958.
260 *See id.*
261 Holly J. George, Getting the Deal Through: Corporate Governance, U.S. (2014).
262 *Id.*
263 *Id.*
264 Regulation S-K Item 101: Business description disclosure; Regulation S-K Item 103: Legal proceedings disclosure; Regulation S-K Item 303: Material known events and uncertainties disclosure included in Management's Discussion and Analysis of Financial Condition and Results of Operations; Regulation S-K Item 503(c): Risk factor disclosure; SEC Release Nos. 33-9106; 34-61469; FR-82 (8 February 2010): Guidance regarding climate change disclosure; Exchange Act Rule 13p-1: Conflict minerals disclosure. *See also, e.g.*, Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring*

Engagement with corporate social responsibility also varies wildly by industry.[265] Many industries would be better served by meaningful social and environmental regulations that nullify their negative impacts rather than these permissive disclosure schemes.

In contrast, industry-specific rules or regulations set up rights and obligations for the specific industry.[266] They are, therefore, more narrowly tailored. So, for example, Banks are regulated by The Office of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corp, but the National Credit Union Administration regulates credit unions, nonbank mortgage originators and servicers are regulated by the Consumer Financial Protection Bureau, mortgage loan officers and mortgage brokers are licensed by the states, the stock market is regulated by the SEC, the insurance industry is overseen by the states, and cryptocurrencies are largely unregulated.[267] While on its face this seemingly endless web of regulation might seem unnecessarily convoluted, this arrangement is actually for the best. Because the rules apply to more homogenous problems, industry-specific regulations are more prescriptive than general regulations. This distinction is particularly noticeable with small groups of similarly situated firms where expertise is paramount, as with communications, transportation, financial institutions, etc. So, for example, the Office of Federal Housing Enterprise Oversight and the Commodities Futures Trading Commission each prescribe governance structures and rules

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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*, 24 J. CORP. L. 751, 803, 806 (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).

265 Surprisingly, industries with the largest negative impact on the environment are most likely to disclose. In that vein, almost all tobacco, chemical, and automobile companies issue CSRs. https://www.chicagobooth.edu/-/media/research/sei/docs/csr-metrics-rustandy-center-report_final.pdf

266 *See* Baer, *supra* note 286, at958

267 *See* Jane E. Willis, *Banks and Mutual Funds: A Functional Approach to Reform*, 1995 COLUM. BUS. L. REV. 221, 226-26 (1995); The Law and Regulation of Financial Institutions, § 2.03 Federal Banking Regulatory Agencies (A.S. Pratt, No. 30, 2022); The Law and Regulation of Financial Institutions, § 2.06; Thomas L. Hazen, Tulips, Oranges, Worms, and Coins- Virtual, Digital, or Crypto Currency and the Securities Laws, 20 N.C. J. L. & TECH 493, 493 (2019).

specific to the types of companies and industries they regulate.[268] 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 provide a good analysis of a company's corporate governance.

Additionally, industry-specific regulations serve an important procedural role. Contrary to common belief, when Congress passes legislation, it does not eliminate a problem. Instead, it provides tools (usually to an agency) to help redress that problem. The agency, in turn, seeks out the best way to promote compliance, including educating the industry about the consequences associated with any undesirable practices.[269] Enforcement thus becomes necessary to prevent such practices. Yet, the agency does not have unlimited resources to address every instance of bad behavior.[270] In fact, many industry-specific agencies, such as the USDA and FDA, fail to address corporate governance at all.[271] Perhaps they would if they had more resources to promote compliance or prosecute offenders, but there is no guarantee, in part because the agency chooses what areas to prioritize and in doing so, may miss some significant issues. Moreover, many enabling statutes limit coverage in a way that would prevent the agency from addressing certain problems anyway.[272] When the agency does not suffer from these limitations, industry-specific regulations make it easier for the agency to collect evidence and to prove a breach thereof. So, for example, it might be easier to prove that a firm ignored a privacy regulation than that it did so with an intent to defraud shareholders. Further, an agency regulator is often given more extensive oversight and enforcement powers under industry-specific regulations when compared with general regulations.[273] This is particularly important in the context of developing and prosecuting reporting and mandatory information provisions.

Most importantly are those instances when a problem or the characteristics of an industry are so unusual that they require industry-specific regulation to be effective. For example, many U.S. laws govern advertising and many of those are enforced by the Federal Trade Commission.[274] These include statutes that prohibit both deceptive practices and those that 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 the Dodd-Frank Wall Street

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[268] Baer, *supra* note 286, at 958-59.
[269] *Id.* at 959
[270] *Id.* at 988.
[271] Baer, *supra* note 286, at 959-61.
[272] *See, e.g.*, …
[273] Baer, *supra* note 286, at 959-60.
[274] *See* FEDERAL TRADE COMMISSION, ENFORCEMENT (Sept. 22, 2022) https://www.ftc.gov/enforcement.

Reform and Consumer Protection Act.[275] Further, the US Food and Drug Administration (FDA) is charged with regulating prescription drug and biomedical advertising;[276] the CFPB has authority to implement and enforce federal consumer financial law for 'non-bank' financial companies;[277] the Department of Transportation has jurisdiction to regulate airline advertising;[278] the Securities Exchange Commission has control over the false advertising of securities;[279] the Financial Industries Regulatory Authority (FINRA) has a variety of rules and guidelines affecting advertising by its members;[280] and the Federal Alcohol Administration regulates unfair competition, including false advertising, in connection with the interstate sale of alcoholic beverages.[281] In each of these instances, the 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.

Industry-specific agencies can also help to negotiate nationally consistent solutions to specific problems rather than any changes to a general regulation that might affect industries outside the area of concern.[282] This results from the level of expertise concentrated within the agency and the power that the federal government wields.[283] 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.[284] As a result of firms' willingness to engage with the specialized agency, through mechanisms like comments and public meetings, those 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 the agency and helps businesses to understand the regulation's impact on their business.[285] Moreover, industry-specific regulation helps the public to see that the government is addressing the precise area of their concern.

[275] Terri Segliman & Jordyn Eisenpress, *Getting the Deal Through: Advertising and Marketing, U.S*. (L. Bus. Rsch. Ltd. 2021).
[276] *See*, e.g.,21 CFR 312.7(a).
[277] *See*, e.g.,12 USC section 5491.
[278] *See*, e.g.,49 USC section 41712.
[279] *See*, e.g., Securities Act of 1933 and Securities Exchange Act of 1934.
[280] *See*, e.g., FINRA Rule 2210.
[281] *See*, e.g., 27 USCA section 205(e), (f).
[282]*See* Baer, *supra* note 286, at 958-59.
[283] *Id.*
[284] *Id.* at 968-69.
[285] Michael Sant'Ambrogio & Glen Staszewski, *Democratizing Rule Development*, 98 Wash. U. L. Rev. 793, 795-96 (2021).

In the context of corporate governance, industry-specific agencies can thus 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.[286] 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.[287]

C. Limitations of the SEC

Many scholars have written on the expense and lack of value add caused by recent legislative expansion of the SEC, including the Dodd-Frank Act and Sarbanes-Oxley.[288] The limited range of SEC authority bears partial responsibility for these shortcomings. The legislation is also limited by the very nature of contracting and corporate governance.[289] Corporations can choose to be public, private, or a 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

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[286] U.S. Const. art. I, §8, cl. 3.

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[288] *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, rendering the quality of the legislation sub-optimal).; 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 and noting the private company trend); 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).

[289] *See, e.g.*, Carliss N. Chatman, *The Corporate Personhood Two-Step*, 18 Nev. L.J. 811, 816 (2018); 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 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 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).

to decide what is material and what to disclose voluntarily.[290] 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 the intended impact.

The case of climate disclosures offers the perfect example. Within hours of becoming President on January 20, 2021, Joe Biden reinstated the US to the Paris Climate Accords, noting that "[i]n [his] view, we've already waited too long to deal with this climate crisis and we can't wait any longer."[291] In response to the President's call to action, 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.[292] 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."[293] Companies should also include climate-related financial statement metrics in a note to their audited financial statements.[294] Finally, companies should disclose information about greenhouse gas emissions, "which have become a commonly used metric to assess a registrant's exposure to such risks."[295] According to the SEC Chair, Gary Gensler, these disclosures will provide investors with "consistent, comparable, and decision-useful information for making their investment decisions, and will provide consistent and clear reporting obligations for issuers."[296] This aligns with the broader mission of the SEC, which according to Gensler is that "investors get to decide which risks to take, as long as public

[290] U.S. SMALL BUSINESS ADMINISTRATION, *Choose a Business Structure* (Sept. 22, 2022) https://www.sba.gov/business-guide/launch-your-business/choose-business-structure

[291] *Remarks by President Biden Before Signing Executive Actions on Tackling Climate Change, Creating Jobs, and Restoring Scientific Integrity*, Speeches and Remarks, THE WHITE HOUSE (Jan. 27, 2021), https://www.whitehouse.gov/briefing-room/speeches-remarks/2021/01/27/remarks-by-president-biden-before-signing-executive-actions-on-tackling-climate-change-creating-jobs-and-restoring-scientific-integrity/.

[292] 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.

[293] https://www.sec.gov/news/press-release/2022-46

[294] Id.

[295] Id.

[296] https://www.sec.gov/news/press-release/2022-46

companies provide full and fair disclosure and are truthful in those disclosures."[297]

On the other side of this debate, chief financial officers argue that complying with the proposed rules will be an excessive financial burden and offer little utility for investors.[298] The SEC itself estimates the cost of compliance with the proposed rule at $640,000 in the first year for large companies (with ongoing prices dropping to $530,000 in subsequent years), the vast majority of which will be allocated toward outside professional costs.[299] But some experts have noted that the costs could be much higher than SEC estimates.[300] A group of sixteen Republican governors expressed deep concern in their opposition to the SEC's proposed rule in a letter to the agency:

> [Y]our proposed rule veers far outside the SEC's authority as a federal agency. The proposed rule will harm businesses and investors in our states by increasing compliance costs and by larding disclosure statements with uncertain and immaterial information that the federal government—let alone the SEC—is not equipped to judge.[301]

Former SEC Chairmen and Commissioners agree that the SEC has overreached, arguing that "the Proposal 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…."[302] Clearly, environmental regulation is not within the scope of the SEC's mandate. Instead, the former Chairmen and Commissioners recommend that financial materiality should remain the standard for any climate-related disclosure because it is objective, does not overwhelm investors with useless

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[297] Id.

[298] See, e.g., https://www.wsj.com/articles/finance-teams-gear-up-for-potential-new-sec-climate-disclosure-rules-11654857000?mod=markets_major_pos12 ("We understood that when the SEC started talking about [the rule], that this was going to be a lot of work and you're not going to do it with arms and legs," said Sameer Ralhan, the CFO of chemical producer Chemours Co., referring to the need for technology to tackle potential new disclosure requirements.).

[299] https://www.wsj.com/articles/finance-teams-gear-up-for-potential-new-sec-climate-disclosure-rules-11654857000

[300] Id.

[301] The letter is signed by Kay Ivey of Alabama, Mike Dunleavy of Alaska, Doug Ducey of Arizona, Asa Hutchinson of Arkansas, Brad Little of Idaho, Kim Reynolds of Iowa, Tate Reeves of Mississippi, Mike Parson of Missouri, Greg Gianforte of Montana, Pete Ricketts of Nebraska, Dough Burgum of North Dakota, Kevin Stitt of Oklahoma, Krisit Noem of South Dakota, Greg Abbott of Texas, Spencer Cox of Utah, and Mark Gordon of Wyoming.

[302] https://corpgov.law.harvard.edu/2022/07/01/the-proposed-sec-climate-disclosure-rule-a-comment-from-former-sec-chairmen-and-commissioners/

or irrelevant information, and thereby promotes meaningful and useful disclosure.[303]

Other critics of the proposed rule have noted that it does not cover private companies, some of which are very large. To the extent that companies forgo going public to avoid the added complexity of emissions reporting or sell off their dirty assets to private companies, so that publicly traded companies continue to look clean, this will still be a market failure. This critique in particular speaks to the limiting nature of contracting and the corporate structure.

On one hand, climate change reform is important.[304] It is also true that investors have limited to no access to companies' climate-related exposure and can benefit from this information.[305] On the other hand, it is unclear that the SEC is the right agency to implement the most effective regulations in this area. 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, flooding, etc., the way to uncover underlying risks is not through SEC disclosure statements. Instead, an agency with expertise in the field of climate change could adopt best practice regulations.[306] The SEC is ill-equipped to deal with many areas of protection in which it attempts to wade. For example, the SEC cannot adequately address social media freedom of speech and privacy.[307] Securities regulations have also failed to stop workplace harassment, or to measurably diversify the leadership of corporations.[308] Instead, what is evident is that shareholders and all stakeholders benefit most from practical tools that allow

[303] Id.

[304] https://www.un.org/sustainabledevelopment/climate-change/

[305] https://www.washingtonpost.com/business/investors-deserve-better-disclosure-on-climate-risk/2022/07/20/e00379f8-0830-11ed-80b6-43f2bfcc6662_story.html

[306] This is particularly important in the case of climate change because it is almost impossible to measure physical risk. Without industry-specific guidance or standard-setting bodies, there is no indication that the SEC or the public will get accurate information or what will happen if it is not. The upstart climate intelligence software industry, including catastrophe modeling and machine learning, remains untested and unproven and thus the analytical barriers are not to be overstated. An agency with knowledge in these areas would know exactly how to overcome these hurdles and, if not, could leverage its extensive resources to figure out how to do so. In contrast, many public companies (especially small ones) may not ever be able to do so. The Environmental Protection Agency is obviously the agency currently best equipped to deal with these complex issues.

[307] Daniel J. Solove & Danielle Keats Citron, *Risk and Anxiety: A Theory of Data-Breach Harms*, 96 TEX. L. REV. 737, 745 (2018).

[308] *See* Cheryl L. Wade, *Transforming Discriminatory Corporate Cultures: This Is Not Just Women's Work*, 65 Md. L. Rev. 346, 377 (2006) ("Corporate governance is defined as the relationship among various participants in determining the direction and performance of corporations.") (internal quotation marks omitted).

them to advocate in their own interest and nudge corporate behavior in the right direction. This proposal does just that.

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*.[309] Likewise, FAA best practice regulations had the potential to in *In re Boeing Company Derivative Litigation*.[310] Each of these cases also happen to have been decided under Delaware's *Caremark* standard.[311] They 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 26 years post-*Caremark* involved federal administrative findings from an industry-specific agency.[312] 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,[313] and should be acknowledged by the Delaware courts.

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[309] *See* cases *supra* Section II.B

[310] *See In re* Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 WL 4059934, at *77 (Del. Ch. Sep. 7, 2021).

[311] In *In re Caremark International Inc. Derivative Litigation*,[311] the Delaware Chancery Court held that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[311] 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."

[312] Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2139 (2019)

[313] *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 Deriv. 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 .... [T]he facts required to satisfy even Massey reflect such an abandonment of the directors' monitoring role as to suggest outright complicity in the lawless acts rather than a want of oversight."); 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 et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 590 (2008).

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. It is evident that the current regulatory regime does not change corporate culture or resolve the other issues underlying a market failure. Further, the SEC's system of reporting and monitoring standing alone does not provide shareholder or stakeholders with the information they need to discover harmful behavior by corporations at a time when state law remedies, including shareholder derivative suits for breaches of fiduciary duty, would be helpful. 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.

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 industries 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 actions. 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.

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