

OF OUTSIDE MONITORS AND INSIDE MONITORS: THE ROLE OF JOURNALISTS IN CAREMARK LITIGATION

Michael J. Borden*

ABSTRACT

In this article I argue for a change in Delaware corporate law that would allow for competitive forces to improve the quality of corporate compliance programs, thus reducing harm to society from corporate illegality and improving shareholder welfare. Specifically, courts should remove some obstacles that prevent plaintiffs in shareholder derivative actions from forcing defendant directors to demonstrate the efficacy of their compliance programs in cases where outside monitoring by journalists appears to have detected illegal corporate actions before those actions have been detected by the internal monitoring of the compliance department. Currently, the rigorous demand requirement and the deferential good faith standard in duty to monitor cases cause most *Caremark* claims to be dismissed at the demand phase, thus shielding defendant directors from revealing information about the performance of their compliance programs. The changes I suggest will force corporate defendants to reveal information that will allow courts to compare the monitoring performed by journalists with that done by compliance programs. Where the outside monitors are outperforming the inside monitors, directors may be responsible for failing to perform their duty to monitor, which requires them to establish systems to detect and report illegal behavior by employees. By implementing the modest changes I suggest, Delaware courts will, over time, have more information to help them assess whether their approach to the duty to monitor needs a more thorough overhaul.

*Associate Professor of Law, Cleveland-Marshall College of Law. This Article benefitted from the helpful comments of numerous colleagues. In particular, I would like to thank Joel Topcik and Miranda Hunt. I also appreciate the outstanding research assistance of William Doyle, Megan Lewallen and Angela Krupar, and the financial support of the Cleveland-Marshall Fund.

TABLE OF CONTENTS

ABSTRACT.....	921
TABLE OF CONTENTS.....	922
INTRODUCTION.....	923
I. CAREMARK AND ITS PROGENY.....	926
A. Graham v. Allis-Chalmers.....	926
B. Caremark.....	927
C. Stone v. Ritter: An Exercise in Taxonomy.....	930
D. The Demand Requirement.....	932
E. Red Flags.....	935
II. SCHOLARLY ATTENTION TO THE ROLE OF NEWS MEDIA IN LAW.....	939
A. The Recent Surge in Attention to Journalism in Legal Scholarship.....	939
III. JOURNALISTS CAN MONITOR COMPLIANCE PROGRAMS.....	943
A. Journalists Have Demonstrated an Ability to Shape the Course of Caremark Litigation.....	945
IV. DELAWARE SHOULD CHANGE ITS APPROACH TO DEMAND FUTILITY AND GOOD FAITH WHEN JOURNALISTS GET THE STORY FIRST.....	950
A. Relaxing the Standard for Demand Futility.....	951
B. A Change in the Good Faith Standard.....	953
C. Discovery and the Tools at Hand.....	954
D. Red Flags.....	955
CONCLUSION.....	956

INTRODUCTION

Competition lies at the heart of our capitalist system. It is an article of faith among advocates of a laissez-faire approach to markets that competition, and not governmental intervention, will allow for the most efficient allocation of goods and services throughout an economy. Corporate law provides one particularly pure example of this reluctance of the state to interfere in private ordering. The business judgment rule, a central principle of corporate law, on some level can scarcely be called a legal principle at all. Rather, it is a doctrine of abstinence founded on the notion that courts should refrain from meddling in the corporate boardroom. Yet as we have seen with disheartening regularity in the years since Enron's collapse, competitive forces in markets do not always serve to prevent corporate actors from causing tremendous harm to shareholders and society by engaging in wrongful activities of various sorts.

Corporate law makes a token effort to induce corporate directors to reduce the likelihood of such malfeasance by imposing a duty to monitor, which requires that corporations have compliance departments tasked with ensuring that corporate employees abide by applicable law. This article argues that the duty to monitor, in its current form, is too weak to cause corporations to establish truly effective compliance programs. I argue that journalists can serve as outside monitors that compete with the inside monitoring performed by compliance programs. In cases where the outside monitors outperform the inside monitors, the law should allow shareholder plaintiffs to use that fact to overcome the procedural hurdles that usually prevent them from surviving a motion to dismiss when they sue. By relaxing these procedural obstacles, the law will allow competitive forces to create pressure on corporations to do more to avoid socially harmful and shareholder wealth-reducing illegality.

There is good reason to believe that journalists can be effective monitors of corporate wrongdoing. The summer of 2012 saw the revelation of a stunning international banking scandal that demonstrated journalists' ability to serve the public good by detecting and reporting corporate criminality. The LIBOR rate-setting scandal serves as an instance of a purely market-based process manipulated by powerful insiders to the detriment of those who rely on the integrity of international lending rates. Gary Gensler, the chairman of the Commodities Futures Trading Commission, revealed that "there were articles in the spring of 2008 by the Wall Street Journal" following which "staff and [CFTC's] division of enforcement started to take a look . . . and tried to learn" about

the scandal.¹ Gensler's comments suggest that regulators and the public depend on journalists to assist in law enforcement and to ensure that markets function. Corporate law should take advantage of this extralegal constraint by modifying the duty to monitor to clear the way for journalists to make their contributions.

Over fifteen years have passed since Chancellor Allen's celebrated opinion in *In re Caremark International Inc. Derivative Litigation*, and courts, lawyers, and scholars are still struggling with a fundamental question of corporate law and governance: to what extent are corporate directors responsible for monitoring the behavior of corporate employees and ensuring their compliance with the law? This question is so important because, apart from raising interesting and difficult legal questions, it implicates social issues that have captured the nation's attention since the Enron and WorldCom scandals, and more recently with the mortgage finance catastrophe and the LIBOR scandal. In this respect, *Caremark* litigation differs from many other topics in corporate law, which mainly concern the relationship between shareholders and boards of directors.

These recent corporate fiascos have demonstrated that social harms that can result from a failure of oversight and the corporate culture of lawlessness it can engender. However, corporate law does not provide an easy answer to the question of if or how to hold directors liable for the wrongs of corporate employees. On one hand, the board is the entity charged by statute with the duty to manage the affairs of the corporation. Thus, it may seem desirable to lay responsibility for corporate wrongdoing at the feet of directors. On the other hand, a directorship of a public corporation is in reality a part-time job held by individuals with many other significant responsibilities. It may be unreasonable to expect directors to ensure that none of a corporation's thousands of employees harm the corporation or the public by breaking the law.

Caremark and its progeny have attempted to resolve this dilemma by fashioning a duty to monitor that requires boards to establish, in good faith, a reasonably designed information and reporting system—a compliance program—to monitor adherence to positive law. While no one would argue that compliance programs are a bad thing, the decade and a half of litigation following *Caremark* has demonstrated that the “in good faith” standard is mostly snarl, with very little bite. This deferential standard, combined with well-entrenched procedural hurdles, create the risk that compliance programs can become paper tigers: legally sufficient to pass *Caremark* muster, but practically ineffective to prevent wrongdoing. The

1. *The Diane Rehm Show: The Global Banking Scandal* (WAMU 88.5 FM Washington DC broadcast Jul. 9, 2012), <http://thedianerehmshow.org/shows/2012-07-09/global-banking-scandal/transcript>).

jurisprudence suggests that the threat of liability is not a serious concern for directors. Of the 248 cases brought under Delaware law alleging *Caremark*-type violations, only fourteen times did the *Caremark* claim survive the motion to dismiss.² Plaintiffs achieved an adjudication of liability only once.³

One of the greatest barriers to success for plaintiffs in shareholder derivative litigation is the Delaware rule, which denies discovery until after the demand phase. Without discovery, plaintiffs are relegated to what the Delaware courts call the “tools at hand,” mainly SEC filings, public records, and news media reports. These tools have been insufficient to generate the particularized facts the plaintiffs must plead to survive a motion to dismiss. This Article will argue that courts should give particular weight to journalists’ reports of corporate illegality, both at the demand phase and when applying the substantive standard of good faith. This focus on journalists expands on an earlier article I wrote titled *The Role of Financial Journalists in Corporate Governance*. In that article, I surveyed the various ways that financial journalists influence corporate law and corporate governance. In the context of *Caremark*, I argued that journalists could serve as a sort of competitive benchmark against which to assess the efficacy of corporate compliance programs. I reasoned that if the external monitoring by journalists could discover corporate wrongdoing before the internal monitors are able to discover and report it to the board, then there would be reason to suspect that the *Caremark* standard was, in fact, promoting inert compliance systems.

Part I of this Article explains *Caremark* and its progeny, detailing its development and the difficulties it presents for plaintiffs. Part II provides background on the recent increase in scholarly attention paid to journalists’ impact on the law. Part III explores the role journalists have played in *Caremark* litigation. In Part IV, I discuss my proposal for relaxing the demand requirement and creating a presumption of bad faith when journalistic reporting of illegality appears to predate any attempt by the board to address the wrongdoing.

2. For examples of *Caremark* claims that failed to survive a motion to dismiss, see, e.g., *In re Abbott Labs. Derivative S’holders Litig.*, 325 F.3d 795 (7th Cir. 2003) (overturning the district court’s granting of a motion to dismiss); *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001) (same); *In re Pfizer Inc. S’holder Derivative Litig.*, 722 F. Supp. 2d 453, 461 (S.D.N.Y. 2010) (excusing investors from making pre-suit demand on corporation’s board after they demonstrated substantial likelihood that majority of board members faced personal liability).

3. *ATR-Kim Eng. Fin. Corp. v. Araneta*, No. 489-N, 2006 WL 4782272, at *1 (Del. Ch. Dec. 21, 2006).

I. CAREMARK AND ITS PROGENY

Corporate employees, at all levels of the organizational structure, sometimes break the law in their efforts to carry out the company's business. The consequences of such law-breaking can be severe, causing significant losses of shareholder wealth. Such losses often prompt shareholders to sue directors for damages to compensate the corporation for the loss. At the heart of the law's lenient response to such lawsuits is the recognition that directors cannot be expected to know what every corporate employee is doing, and thus cannot be held liable for every instance of law breaking that harms the firm financially.⁴ Indeed, though it may not be polite for courts to mention it, a degree of law-breaking in market conduct often benefits shareholders. The courts have struggled for decades to find an appropriate intermediate position between the extremes of making the board the guarantor of corporate rectitude and encouraging an aloof, "ignorance is bliss" attitude among directors.

A. *Graham v. Allis-Chalmers*

*Graham v. Allis-Chalmers Manufacturing Co.*⁵ was the first notable case to explore this middle ground. In *Graham*, shareholders sued the board for failing to prevent harm to the corporation caused by illegal price fixing. Relying on a 19th century U.S. Supreme Court decision,⁶ the Delaware Supreme Court ruled that directors could be held liable for corporate illegality only if "something occurs to put them on suspicion that something is wrong."⁷ The Delaware Supreme Court disparaged the notion that there was any "duty . . . to install . . . a corporate system of espionage to ferret out wrongdoing."⁸ In effect, the *Graham* court established the "one-bite rule for dog owners" in the context of the duty to monitor.⁹ So

4. See Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 561 (2008) ("Directors are not expected to know in minute detail everything that happens on a day-to-day basis . . . Delaware case law was unclear for many years as to whether boards have an obligation to monitor proactively the conduct of corporate subordinates.").

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

6. *Briggs v. Spaulding*, 141 U.S. 132 (1891).

7. *Graham*, 188 A.2d at 130.

8. *Id.*

9. See Bainbridge, *supra* note 4, at 577-78 (analogizing the rule of *Graham* to the aphorism that every dog is entitled to one bite. The authors explain, "At common law, of course, the one-bite rule actually was somewhat more complicated. When a dog bit someone, the master could be held liable only if the master knew or had reason to know the dog had a propensity to bite. A prior bite would constitute the requisite knowledge, thus giving rise to the colloquial name for the rule, but the requisite knowledge also could be

long as there were no red flags indicating a likelihood of the wrongdoing in question, the board could not be held responsible if it occurred. Perhaps unwittingly, the *Graham* court thus established a legal environment in which boards had an incentive to avoid discovering wrongdoing. In any event, *Graham* did not impose an affirmative duty for Delaware corporations to establish compliance programs. *Graham* remained good law until 1996, when the Delaware Chancery handed down the *Caremark*¹⁰ decision—a landmark case that is seen as standing for the proposition that corporate directors have an affirmative duty to monitor their corporations for illegal activities.¹¹

B. *Caremark*

Caremark International, Inc. was a Delaware corporation that marketed medical products and services to patients and to medical providers.¹² In violation of federal Medicare and Medicaid law, Caremark employees paid kickbacks to doctors and hospital administrators who prescribed their products and services.¹³ A federal investigation of the company culminated in Caremark paying \$250 million in fines and penalties.¹⁴ When shareholders sued the board of directors for the loss of corporate wealth, the directors claimed that they were unaware of the wrongdoing.¹⁵ Such a defense is entirely plausible, for directors generally are not engaged in the day-to-day business operations of their firms. Moreover, modern corporations are geographically diverse organizations that often have thousands of employees and multiple layers of management oversight. Under such circumstances, it would be harsh or unfeasible to hold directors personally responsible for the harm caused by actors far removed from the control of the the directors. Indeed, at the time of the wrongdoing in *Caremark*, Delaware law under *Graham* held that so long as directors were unaware of the unlawful activities that had caused the harm to the corporation and had no reason to be aware of it, the directors were

based on the breed's inherently violent propensities.”).

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

11. *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (holding “that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations . . .”).

12. *Caremark*, 698 A.2d at 959-64.

13. *Id.* at 962.

14. *Id.*

15. *Id.* at 971.

free from personal liability.¹⁶

In an opinion approving the settlement of the Caremark shareholders' derivative action, Chancellor Allen acknowledged that *Graham* might be seen as promoting blissful ignorance for directors and undertook to put the law on a different footing.¹⁷ Allen asserted that if this interpretation of *Graham* was really the law of Delaware, then it must change.¹⁸ In dicta, Allen explained that in order to avoid liability for corporate wrongdoing, the board must "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"¹⁹ In so doing, Chancellor Allen moved the discussion about personal director liability away from the business judgment rule and towards the rubric of the duty of good faith.²⁰

But good faith, by its nature, is a rather elastic and fact-dependent concept. It is the sort of standard that typically leads to unpredictability in litigation, leaving directors and the bar wondering about what behavior amounts to good or bad faith. Perhaps eager to simplify this guessing game, Chancellor Allen proceeded to clarify the meaning of good faith in the context of the duty to monitor:

Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high.²¹

Chancellor Allen further opined that the sort of claim involved in the case was "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."²² This is a strong statement,

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

17. *Caremark*, 698 A.2d at 969-70.

18. *Id.*

19. *Id.* at 970.

20. In 2006, *Stone v. Ritter* made clear that the duty of good faith was not an independent fiduciary duty, creating a "triumvirate" of fiduciary duties along with care and loyalty. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006). Rather, the duty of good faith falls under the duty of loyalty for doctrinal and analytical purposes under Delaware law. *Id.*

21. *Caremark*, 698 A.2d at 971.

22. *Id.* at 967.

given the utter nullity that the waste doctrine has been for decades.²³

In short, we can say that *Caremark* requires corporations to have a compliance program reasonably designed in good faith. Corporate law does not require that the program function; it merely must exist. In the sixteen years since *Caremark*, plaintiffs have brought approximately 250 cases alleging violations of Delaware's duty to monitor. The *Caremark* claim survived a motion to dismiss only fourteen times.²⁴ Only one case has produced a verdict for plaintiffs.²⁵

There are several possible reasons why plaintiffs have fared so dismally under *Caremark*. It may be that the good faith standard for legally sufficient compliance programs is too low. It is also possible that the vast majority of cases lacked merit. A third reason may be that the demand requirement magnifies the difficulties shareholder plaintiffs face.²⁶

In view of Chancellor Allen's own prognosis, and the actual experience of fifteen years of *Caremark* litigation, it is fair to wonder whether the *Caremark* good faith standard has proven too deferential to directors and whether it has promoted the creation and maintenance of paper tigers—inert compliance programs that are legally sufficient but inadequate to curb wrongdoing. With the vast majority of cases disposed of on the pleadings, defendants are not required to demonstrate that the compliance programs are actually performing their intended function: monitoring corporate behavior to assure compliance with law and to report relevant information to the board. The procedural advantage that defendants enjoy shields them from having to prove the effectiveness of their information and reporting systems. Indeed, even in the rare case that does go to trial, the *effectiveness* of the compliance system is not even at issue; it must be “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”²⁷ By focusing only on “concept and design,” Chancellor Allen remained consistent with the general thrust of

23. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 46 (2004) (noting that “cases in which it is possible to demonstrate ‘waste’ are—like the Loch Ness Monster—so rare as to be possibly nonexistent.”).

24. See, e.g., *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795 (7th Cir. 2003) (overturning the district court's granting of a motion to dismiss); *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001) (same); *In re Pfizer Inc. Shareholder Derivative Litig.*, 722 F. Supp. 2d 453, 461 (S.D.N.Y. 2010) (excusing investors from making pre-suit demand on corporation's board after they demonstrated substantial likelihood that majority of board members faced personal liability).

25. *ATR-Kim Eng. Fin. Corp. v. Araneta*, No. 489-N, 2006 WL 4782272, at *1, *20 (Del. Ch. Dec. 21, 2006).

26. For further discussion of the demand requirement, see *infra* section D.

27. *Caremark*, 698 A.2d at 970.

Delaware corporate law. It is a bedrock tenet of the business judgment rule that the director's duty of care involves only the process of decision-making, not the substantive decision reached.²⁸ Unfortunately, this analytic consistency of deference to directorial autonomy may come at a steep price for shareholders and society, as the numerous corporate scandals of the past decade have demonstrated.

C. *Stone v. Ritter: An Exercise in Taxonomy*

Caremark's doctrinal impact on shareholder derivative litigation cannot be fully grasped without considering *Stone ex rel. AmSouth Bancorporation v. Ritter*,²⁹ a 2006 case that both adopted *Caremark's* dicta as the law of Delaware and radically re-interpreted its doctrinal foundations.³⁰ *Caremark's* analysis of a board's duty of good faith in exercising oversight appeared to be grounded in the duty of care. For example, the opinion stated that "the core element of any corporate law duty of care inquiry" is "whether there was good faith effort to be informed and exercise judgment."³¹

What should be understood, but may not be widely considered by courts or commentators, is that compliance with a director's duty of care can never be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed.³²

The *Stone* court thus faced a *Caremark* decision that seemed to commit Delaware law to two doctrinal positions: first, that good faith was the touchstone for any analysis of a claim of a board's failure to exercise appropriate oversight, and, second, that such a claim was grounded in the duty of care. *Stone* embraced the first concept but emphatically discarded the second.³³ The years immediately following *Caremark* saw a degree of confusion concerning the appropriate place of good faith in the taxonomy of corporate fiduciary duties. Some in the Delaware bar and bench had begun to embrace a view of Delaware corporate law as embodying a triad of fiduciary duties: care, loyalty, and good faith.³⁴ This view of fiduciary

28. See *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) ("As for the plaintiffs' contention that the directors failed to exercise 'substantive due care,' we should note that such a concept is foreign to the business judgment rule Due care in the decisionmaking context is *process* due care only.").

29. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

30. Bainbridge, *supra* note 4, at 585-86.

31. *Caremark*, 698 A.2d at 971.

32. *Id.*

33. *Stone*, 911 A.2d at 369-70.

34. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) ("The directors

duties was the subject of some handwringing, among both judges and scholars.³⁵ The *Stone* court put an end to this construct, clarifying that “the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty,” but rather is subsumed by the duty of loyalty.³⁶

The decision to place the duty of good faith under the rubric of the duty of loyalty has interesting implications for shareholder suits. Steven Bainbridge suggests that *Stone*'s placement of good faith in the duty of loyalty threatens the coherence of the system of remedies available under the duty of loyalty.³⁷ Bainbridge notes that *Stone* expands the duty of loyalty beyond its traditional bounds by including cases in which directors do not receive a personal benefit.³⁸ Consequently, the remedies available in loyalty cases will change. Before *Stone*, remedies in loyalty cases aimed at requiring defendants to disgorge benefits wrongfully gained. For example, in corporate opportunity cases, the corporation receives a constructive trust in the opportunity.³⁹ In interested director cases, the court may void the related party transaction.⁴⁰ After *Stone*, duty of loyalty cases under the duty to monitor will involve claims for damages without a corresponding

of Delaware corporations have a triad of primary fiduciary duties”); McMullin v. Beran, 765 A.2d 910, 920 (Del. 2000) (noting that plaintiffs must successfully allege breach of one of the “triad of fiduciary duties of care, loyalty or good faith”); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) (en banc) (“The director’s fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty.”).

35. See, e.g., Robert Baker, *In re Walt Disney: What It Means to the Definition of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation*, 4 FLA. ST. U. BUS. REV. 261, 267-68 (2005) (discussing the duty of good faith); Carter G. Bishop, *A Good Faith Revival of Duty of Care Liability in Business Organization Law*, 41 TULSA L. REV. 477, 482-83 (2006) (noting that “because loyalty, care, and good faith are not uniformly triadic, divergent corporate law standards . . . ha[ve] lead to intolerable confusion and incoherence.”); Matthew R. Berry, Comment, *Does Delaware’s Section 102(b)(7) Protect Reckless Directors From Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125, 1128 (2004) (“Delaware courts do not agree whether the duty of good faith is an independent fiduciary duty or merely a part of the duty of loyalty, but courts do agree that directors who act in bad faith are personally liable for any resulting damages.”).

36. *Stone*, 911 A.2d at 370.

37. Bainbridge, *supra* note 4, at 585-86. See also Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006) (critiquing the placement of *Caremark* claims in the duty of loyalty); Leo E. Srine, Jr., Lawrence A. Hammermesh, R. Franklin Balotti, Jeffrey M. Gorris, *Loyalty’s Core Demand: the Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010) (explaining that the duty of loyalty is, at its core, “the obligation to act in good faith to advance the best interests of the corporation.”).

38. Bainbridge, *supra* note 4, at 585-86.

39. *Id.*

40. *Id.*

wrongful benefit to the defendants. Bainbridge argues that such claims could raise challenging issues of causation that have not, to date, been part of litigation under the duty of loyalty.⁴¹

But other effects of this re-configuration of the taxonomy of shareholder claims are likely to prove beneficial for shareholder plaintiffs, and thus may be beneficial to shareholder welfare generally. As corporate law scholars have recognized,⁴² by placing good faith claims under the duty of loyalty and clarifying that they do not implicate the duty of care, Delaware courts have removed them from the exculpatory ambit of section 102(b)(7) of the Delaware General Corporation Law.⁴³ Section 102(b)(7) permits corporations to include in their charters a provision insulating directors from liability for breaches of fiduciary duties, but section 102(b)(7) prohibits exculpation in cases involving breaches of the duty of loyalty or for actions not in good faith.⁴⁴ It is evident, then, that one of the consequences (if not the purpose) of *Stone*'s taxonomic maneuver was to remove *Caremark* claims from the class of cases in which directors enjoy immunity from liability. But this benefit only partially clears the very uncertain path to a monetary recovery for shareholder plaintiffs.

From the plaintiff's perspective, the entire process of derivative litigation may seem like a cruel joke. The set-up is a series of nearly insurmountable obstacles (no discovery, the onerous demand requirement, special litigation committees empowered to dismiss the rare case that survives the demand phase, and director-protective substantive rules of decision like the business judgment rule) and the punch line is section 102(b)(7). *Stone*, at a minimum, provides some relief for plaintiffs.

D. The Demand Requirement

Another important piece of the puzzle in *Caremark* litigation, as in all shareholder derivative suits, is the demand requirement—the most formidable of the procedural obstacles shareholder plaintiffs encounter. Because the real plaintiff in interest in a shareholder derivative action is the corporation itself, and because the board is the only entity with the authority to manage the affairs of the corporation, the law requires

41. *Id.*

42. See, e.g., John L. Reed & Matt Neiderman, "Good Faith" and the Ability of Directors to Assert Section 102(b)(7) of the Delaware General Corporation Law As a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111, 116-17 (2004) ("[C]ourts and commentators seem to agree that an exculpatory charter provision precludes monetary liability for pure 'duty of care' claims and not for duty of loyalty or 'good faith' claims.").

43. DEL. CODE ANN. tit. 8, § 102(b)(7) (2013).

44. *Id.*

shareholders to make a demand upon the board to bring the action that the shareholders are pressing.⁴⁵ The demand requirement may be excused, however, if the plaintiffs can demonstrate that demand would be futile.⁴⁶

Since claims of failure to monitor usually involve nonfeasance, rather than an affirmative decision taken by the board, recent *Caremark* cases have employed the test of *Rales v. Blasband*⁴⁷ to analyze demand futility.⁴⁸ The *Rales* test requires plaintiffs to establish reasonable doubt that “as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”⁴⁹ Demand in a *Caremark* case will be excused as futile if the plaintiffs can plead “particularized facts that support an inference that the directors ‘did possess knowledge of facts suggesting potential . . . improprieties . . . and took no action to respond to them.’”⁵⁰

The test for demand futility intertwines with the substantive standard for success on the merits under *Caremark* and *Stone*. As the court explained in *McCall v. Scott*, demand will be excused if the particularized facts alleged in the complaint present a substantial likelihood of liability on the part of the director.⁵¹ Assuming that a majority of board members are named as defendants, such a showing would suffice to raise the requisite reasonable doubt that the board as a whole would be unlikely to exercise independent and disinterested business judgment in responding to the demand. The reasoning employed by the *McCall* court ruling for the plaintiffs on the demand issue suggests that in certain cases, overcoming the demand requirement might be an attainable goal. But it is important to recognize that *McCall* was decided by the Sixth Circuit Court of Appeals applying Delaware law. Recent Delaware cases give plaintiffs less reason for optimism.

45. See *White v. Panic*, 793 A.2d 356, 371 (Del. Ch. 2000) (“[R]equiring demand in failure to monitor cases is consistent with the board’s managerial prerogatives because it permits the board to have the opportunity to take action where it has not previously considered doing so”) (internal quotations omitted).

46. *Id.* at 371.

47. *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

48. See *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008) (“The second (*Rales*) test applies where the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board’s oversight duties.”); *DeSimone v. Barrows*, 924 A.2d 908, 913 (Del. Ch. 2007) (“[T]he question of whether [Plaintiff] has satisfied his burden under Rule 23.1 must be answered by applying the test set forth in *Rales v. Blasband*.”); *McCall v. Scott*, 239 F.3d 808, 816 (6th Cir. 2001) (“[B]ecause this case involved the ‘absence of a conscious board decision,’ demand futility should be evaluated under the *Rales* test.”).

49. *Rales*, 634 A.2d at 934.

50. *Guttman v. Huang*, 823 A.2d 492, 506-07 n.36 (Del. Ch. 2003) (quoting *Ash v. McCall*, No. Civ.A. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000)).

51. *McCall*, 239 F.3d at 818-19.

In *Wood v. Baum*, the Delaware Supreme Court explained that a “plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had ‘actual or constructive knowledge’ that their conduct was legally improper.”⁵² In *DeSimone v. Barrows*, the Court of Chancery asserted that:

[I]n order to state a viable *Caremark* claim . . . a plaintiff must plead the existence of facts suggesting that the board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed.⁵³

The difficulty with the scienter requirement is that it is very difficult for plaintiffs to plead particularized facts about what the directors knew without the benefit of discovery. Whether under the *Rales* test or the older *Aronson*⁵⁴ test, a large majority of shareholder derivative actions meet their end at the demand phase of the litigation. Yet, as mentioned previously, plaintiffs must obtain the particularized facts needed to establish demand futility without the benefit of discovery.

The dictum from *DeSimone* indicates a gap between the jurisprudence of demand in the Delaware courts and the approach taken in cases like *McCall*. Note that the focus is on the board’s knowledge of the deficiencies of internal controls, not on the board’s knowledge of any particular information about a given instance of illegality. Only knowledge of a systematic failure of the structure of compliance will suffice to allow a plaintiff to demonstrate demand futility.⁵⁵ Moreover, even if a plaintiff were able to demonstrate a structural deficiency in internal controls, such a showing could still be inadequate, for the plaintiff might not be able to show the board’s knowledge of the deficiency. The incentive remains for directors to remain willfully ignorant of flaws in their compliance programs.

It is evident, then, that in the microcosm of demand, we see a recapitulation of the broader issues surrounding the duty to monitor: directors cannot have knowledge of everything that occurs within a corporation and thus cannot be held liable for illegality of which they were ignorant. Even so, directors who remain unaware of the internal controls within the compliance program can rest assured that the demand requirement will not be excused. The solution to this Gordian knot is to embrace the *McCall* court’s approach to demand futility. In Part IV, I will

52. *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008).

53. *DeSimone*, 924 A.2d 908, 940 (Del. Ch. 2007).

54. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

55. *DeSimone*, 924 A.2d at 940.

discuss this solution in the context of cases involving journalistic reporting of corporate malfeasance.

E. Red Flags

Although *Caremark* represents a fundamental shift away from the jurisprudence of *Graham*, Delaware law maintains an important part of the analysis that prevailed under *Graham*, the concept of the red flag. *Caremark*, although turning *Graham* on its head, did not affect discussions of red flags in cases and law review articles.⁵⁶

So what is a red flag? In concept, a red flag is a warning, an indication of the presence of a risk. It is a signal to slow down and apprise oneself of the nature of the risk and to adjust course if necessary. Red flags can arise in many contexts, as recent cases, including *McCall v. Scott*,⁵⁷ have illustrated. A red flag can be a report from the compliance program,⁵⁸ the initiation of a governmental investigation or a private lawsuit,⁵⁹ a warning from external auditors that they are concerned about their ability to issue a clean opinion on a financial statement can be a red flag,⁶⁰ or a newspaper report detailing illegal behavior.⁶¹ More subtle red flags can be found in aberrations in internally generated data.⁶² The directors in *McCall* had almost all of these red flags waved before them.⁶³

Although we can view *Graham* as the origin of the proposition that red flags put a board on notice of a particular instance of the duty to monitor, it is interesting to note that in *Graham* itself, the court was reluctant to take the idea too seriously. The plaintiffs in *Graham* argued that a 1937 consent decree should have sufficed to inform the board that there was a “biting dog” on the premises.⁶⁴ The court was not persuaded that the decree was

56. See, e.g., *In re SFBC Int'l Sec. and Derivative Litig.*, 495 F. Supp. 2d 477, 485 (D.N.J. 2007) (“The Complaint, however, alleges endemic mismanagement of the company, raising plenty of red flags concerning the improper and even possibly illegal practices in which the company was engaged.”); *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1271 (Del.Ch.1995) (“[T]he complaint does not plead with particularity what obvious danger signs were ignored or what additional measures the directors should have taken.”).

57. *McCall v. Scott*, 239 F.3d 808, 818-19 (6th Cir. 2001).

58. *Id.* at 818-21.

59. *Id.*

60. *Id.*

61. *Id.*

62. See, e.g., *id.* (finding a red flag where, in a Medicaid case, the highest bracket billing claims rose from 31% to 76% and then to 93%, when the hospital across the street was only billing 28% of its claims at the highest rate).

63. *Id.*

64. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 129 (Del. 1963).

“cause for suspicion”⁶⁵ so as to require the directors to “ferret out wrongdoing.”⁶⁶ In recent decades, courts have applied more careful judicial scrutiny of circumstances that ought to pique a board’s attention and thus implicate the duty to monitor.

In *Dobler v. Montgomery Cellular Holding Co.*, the court agreed with the plaintiffs that an abrupt shift in lending patterns between Montgomery Cellular Holding Company (“MCHC”) and its affiliates raised a red flag.⁶⁷ The facts of the case showed that during an earlier phase of the company’s operations, entities affiliated with MCHC had advanced money to MCHC, with the outstanding amount totaling \$12 million.⁶⁸ After a change of control of the company, the advances began flowing in the opposite direction, with MCHC advancing funds in excess of \$13 million to its affiliates.⁶⁹ In response to these facts, the court stated that “while ‘advances’ to affiliates in some contexts may be entirely proper, the plaintiffs have provided credible evidence that these ‘advances’ are suspect.”⁷⁰ The willingness of the *Dobler* court to treat this conceivably innocuous pattern of transactions as a red flag indicates that the courts have evolved since *Graham*.

This is not to say, however, that the Delaware courts have uniformly embraced an expansive approach to red flags. In *In re Citigroup Inc. Shareholders Litigation*, for example, the Court of Chancery dismissed a complaint for failure to show that demand should be excused, indicating a restrictive attitude toward red flags.⁷¹ The plaintiffs had brought the action against Citigroup in the wake of the collapse of Enron Corporation, claiming that Citigroup had been complicit in Enron’s fraudulent off-balance sheet financing.⁷² The following paragraph from the court’s opinion reveals the problems courts have had in defining what constitutes a red flag in duty to monitor cases:

At argument, in response to questioning by the court, the plaintiffs’ counsel suggested that the Amended Complaint adequately alleges a series of “red flags” that should have put the director defendants on notice of the offensive conduct or the weakness of the corporation’s internal controls. Further

65. *Id.* at 133.

66. *Id.*

67. *Dobler v. Montgomery Cellular Holding Co. Inc.*, No. Civ.A. 18105 NC, Civ.A. 18499, 2001 WL 1334182, at *4 (Del. Ch. Oct. 19, 2001).

68. *Id.*

69. *Id.*

70. *Id.*

71. *In re Citigroup Inc. S’holders Litig.*, No. 19827, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003).

72. *Id.*

questioning revealed, however, that these “red flags” are comprised of a series of internal corporate memoranda and e-mails disseminated at the level of Citigroup’s operating subsidiaries. There is nothing in the Amended Complaint to suggest or to permit the court to infer that any of these ever came to the attention of the board of directors or any committee of the board. How, exactly, a member of the Citigroup board of directors was supposed to be put on inquiry notice by something he or she never saw or heard of is not explained. The answer to the question is obvious. “Red flags” are only useful when they are either waived in one’s face or displayed so that they are visible to the careful observer.⁷³

Assuming that these internal memoranda detailed Citigroup’s knowledge of or involvement in the accounting irregularities at Enron, the court’s refusal to label the documents as a red flag seems troubling. At a minimum, it is difficult to reconcile this position with the treatment of the pattern of advances in *Dobler*, a case decided just two years earlier.

It appears that the difference between the two cases lies in the scale of the corporation in question. MCHC was a small cellular phone service, with relatively few employees and, presumably, close contact among all the parties involved. In such firms, the board is likely to have a much more comprehensive view of the totality of the transactions the firm undertakes. By contrast, at an institution such as Citigroup, the scope of operations, the worldwide footprint, the enormous volume of transactions, and the significant outside demands on its high-profile directors makes it easier for a court to conclude that memoranda distributed at executive meetings of corporate subsidiaries are somehow invisible to the board of directors of the parent corporation. This conclusion, however, undercuts the entire conception of the duty to monitor under *Caremark*. *Caremark*’s scheme of monitoring and compliance is premised on the recognition that directors of large corporations usually are unable to have actual knowledge of the day-to-day events in the life of their firms. For this reason, the law permits them to delegate their compliance obligations to employees who sift through voluminous information and funnel significant nuggets of information upward to the board. To say that the memoranda were not red flags because the board never saw them is to miss the point entirely, and also suggests that such firms are, from the point of view of ethics and compliance, too big to manage.

*In re Abbott Laboratories Derivative S’holders Litig.*⁷⁴ is also a useful case for understanding the Delaware courts’ conception of red flags.

73. *Id.*

74. *In re Abbott Labs. Derivative S’holders Litig.*, 325 F.3d 795 (7th Cir. 2003).

Abbott Laboratories involved the company's non-compliance with Food and Drug Administration regulations in the manufacture of medical diagnostic devices and kits.⁷⁵ After performing a routine inspection of Abbott Labs' facilities, the FDA sent the company "formal certified Warning Letters."⁷⁶ The Wall Street Journal ran a story reporting on the FDA's concerns.⁷⁷ Two years passed without the company remedying the problems. This led to more Warning Letters and more news reports.⁷⁸

Finally, after six years of noncompliance, with the accompanying regulatory Warning Letters and ample coverage in the press, the FDA filed a complaint in federal court, along with a consent decree.⁷⁹ Under the consent decree, Abbott Labs agreed to pay a \$100 million fine, suspend operations until it was in full compliance, and withdraw and destroy previously manufactured kits worth an estimated \$250 million.⁸⁰

In denying the defendants' motion to dismiss, the court emphasized the board's failure to act upon the numerous red flags and held that the complaint supported a theory of liability based on a "conscious disregard of a known risk" or severe recklessness.⁸¹ Hillary Sale nicely summarized the *Abbott Laboratories* case and the significance of red flags:

The allegations, of course, had not been proved. They are, however, revealing about when boards can get in trouble for not insisting on better internal information or for not intensifying their monitoring or changing their approach when the situation warrants. In the face of red flags, boards need to ask questions and question answers. The failure to do so raises questions about whether the board has fulfilled its good-faith obligations and about whether the board has acted with "conscious disregard" of its responsibilities or engaged in behavior sufficiently egregious to surface concerns about intentionality.⁸²

If the good faith standard hinges on what the directors knew, or ought to have known, and it is not possible to get discovery to determine what the directors actually knew because of demand requirements, then the focus for plaintiffs shifts to a determination of what they *ought* to have known. My claim is that defendants ought to know what is written about their firms in the newspapers for two reasons. First, such information is now public, and,

75. *Id.* at 799

76. *Id.*

77. *Id.* at 800.

78. *Id.*

79. *Id.* at 801.

80. *Id.*

81. *Id.* at 811.

82. Hillary Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719, 742 (2007).

as long as it appears in a prominent national publication, there is no reason to constrain the concept of constructive knowledge so as to exclude it.

Second, if the information could be discovered by an outside journalist relying on only his own initiative and shoe leather, then that information is the type that a reasonably well-designed and implemented compliance program ought to have discovered and communicated to the board. Either way, the information ought to be sufficient to raise genuine issues of material fact about either the board's actual knowledge or the adequacy of the compliance program so as to allow the plaintiffs to survive the motion to dismiss and the motion for summary judgment. By allowing such cases to continue beyond the summary judgment phase, Delaware would enable competitive forces to test the efficacy of the compliance program under review, and would put all corporations on notice that their compliance programs will have to perform at least as well as the outside monitoring carried out by journalists. Part IV will expand on this claim.

II. SCHOLARLY ATTENTION TO THE ROLE OF NEWS MEDIA IN LAW

The remainder of this article will concern itself with the possibility that corporate monitors outside of the firm, namely journalists, can make and have made positive contributions to *Caremark* litigation and, by extension, to both corporate governance and social welfare. It will also describe a plan by which the courts can step out of the way of competitive forces that can improve corporate compliance programs.

A. *The Recent Surge in Attention to Journalism in Legal Scholarship*

In recent years, legal scholars have begun focusing their attention in a more serious fashion on the role of journalism and the news media in law. Law review articles for decades had been rife with cursory references to the supporting role that news media might play in legal reform, public awareness of legal issues, and the process of litigation. However, beyond these superficial, if ubiquitous, mentions, precious little in the way of careful, systematic investigations of the role of journalism in law could be found in the literature.

In the last decade, however, scores of articles have touched on the intersection of law and journalism. This is a natural topic in areas of law and legal practice that intimately connect with the news media. Thus, much legal literature focuses on the intersection of journalism and the first

amendment.⁸³ Similarly, articles exploring the techniques lawyers may employ in using journalists as public relations tools in managing litigation are plentiful.⁸⁴ The years since the Valerie Plame–Scooter Libby affair have seen a burst of law review articles on the journalistic privilege to keep anonymous sources hidden from governmental inquiry.⁸⁵ Other literature concerns the portrayal of racial minorities in the media and its effect on criminal law and procedure and the rights of defendants.⁸⁶

83. See, e.g., Eunice Eun, *Journalists Caught in the Crossfire: Robert Novak, the First Amendment, and Journalist's Duty of Confidentiality*, 42 AM. CRIM. L. REV. 1073, 1073 (2005) (“[J]ournalists should be able to publish information in the public interest without being restrained by fear of criminal charges.”); Mary-Rose Papandrea, *Citizen Journalism and the Reporter's Privilege*, 91 MINN. L. REV. 515, 522 (2007) (“Since the 1970s the Court has routinely rejected claims that the press was entitled to any special First Amendment protections that the public at large did not equally enjoy.”); Mark Weidemaier, *Balancing, Press Immunity, and the Compatibility of Tort Law with the First Amendment*, 82 MINN. L. REV. 1695, 1697 (1998) (“The press enjoys substantial newsgathering freedom, and there is currently little evidence that newsgathering tort suits have substantial First Amendment implications.”).

84. See, e.g., Michele DeStefano Beardslee, *Advocacy in the Court of Public Opinion, Installment One: Broadening the Role of Corporate Attorneys*, 22 GEO. J. LEGAL ETHICS 1259, 1283 (2009) (“[L]awyers must ensure that the right information is disclosed in the proper manner and PR executives help the lawyer determine what a consumer or stockholder might consider ‘material’ and therefore necessary to disclose.”); Kathleen F. Brickey, *From Boardroom to Courtroom to Newsroom: The Media and the Corporate Governance Scandals*, 33 J. CORP. L. 625, 659-60 (2008) (noting how “[t]he combination of articles, background information, documents, exhibits, transcripts, and blogs available via the Internet . . . allowed interested members of the public to learn about the rise and fall of Enron and to follow the trial on a real-time basis.”).

85. See, e.g., Mark Gomsak, *The Free Flow of Information Act of 2006: Settling the Journalist's Privilege Debate*, 45 BRANDEIS L.J. 597, 599 (2007) (“This Note posits that a federally legislated qualified journalist's privilege would . . . curb the judiciary's disregard of the confidentiality of journalists' sources . . .”); William E. Lee, *The Priestly Class: Reflections on A Journalist's Privilege*, 23 CARDOZO ARTS & ENT. L.J. 635, 636 (2006) (“[M]any journalists regard judicial orders compelling the identification of confidential sources as an ‘assault on journalistic freedom.’”); Jeffrey S. Nestler, *The Underprivileged Profession: The Case for Supreme Court Recognition of the Journalist's Privilege*, 154 U. PA. L. REV. 201, 204 (2005) (“The phrase ‘freedom of the press’ . . . can support the creation of a privilege protecting reporters from having to reveal the nature of confidential information they received from sources who wished to remain anonymous.”).

86. See, e.g., Neil F. Carlson & Leonard M. Baynes, *Rethinking the Discourse on Race: A Symposium on How the Lack of Racial Diversity in the Media Affects Social Justice and Policy*, 21 ST. JOHN'S J. LEGAL COMMENT. 575, 579 (2007) (noting that media coverage of Hurricane Katrina “confirmed and fed into existing negative stereotypes of African Americans as violent and prone to crime.”); Richard Delgado & Jean Stefancic, *Images of the Outsider in American Law and Culture: Can Free Expression Remedy Systemic Social Ills?*, 77 CORNELL L. REV. 1258, 1261-75 (1992) (documenting the social construction of racial stereotypes, particularly through entertainment and pop-culture media); John Tehranian, *The Last Minstrel Show? Racial Profiling, the War on Terrorism and the Mass Media*, 41 CONN. L. REV. 781, 798 (2009) (“Racial profiling in the war on terrorism has

Legal scholars have paid somewhat less attention to the intersection of journalism and other legal topics. One can find far fewer articles on the impact of journalists on topics such as environmental law,⁸⁷ bankruptcy,⁸⁸ and antitrust law.⁸⁹ In recent years, a small body of literature has emerged on the role of journalists in corporate and securities law and corporate governance.⁹⁰

In a 2007 article, I surveyed the roles of financial journalists in corporate law and corporate governance.⁹¹ The article arose from the recognition, in the wake of the Enron and WorldCom scandals, that corporate law can only go so far in promoting its goal of minimizing the agency costs that arise from the divergence of ownership and management that is the hallmark of the corporate form.⁹² Without effective enforcement mechanisms, the law has only a limited capacity to affect the behavior of corporate actors, particularly when those actors are bent on engaging in economically inefficient action, whether by failing to diligently and carefully discharge their duties pursuant to the corporate contract with

betrayed our fundamental constitutional values and undermined our fealty to non-discrimination principles. . . . [I]n that regard, the mass media has a central role.”)

87. See, e.g., Molly J. Walker Wilson & Megan P. Fuchs, *Publicity, Pressure, and Environmental Legislation: The Untold Story of Availability Campaigns*, 30 CARDOZO L. REV. 2147 (2009) (describing the impact of journalists on public perception of the debate over climate change and the consequent impact on legislation).

88. See, e.g., Melissa B. Jacoby, *Negotiating Bankruptcy Legislation Through the News Media*, 41 HOUS. L. REV. 1091 (2005) (arguing that news media helped reframe debates about bankruptcy law and legislation).

89. See, e.g., Donald R. Simon, *Big Media: Its Effect on the Marketplace of Ideas and How to Slow the Urge to Merge*, 20 J. MARSHALL J. COMPUTER & INFO. L. 247, 251 (2002) (discussing the ways that big media mergers tend to impoverish public discourse and the marketplace of ideas).

90. See, e.g., Borden, *The Role of Financial Journalists in Corporate Governance*, 12 FORDHAM J. CORP. & FIN. L. 311 (2007) [hereinafter Borden, *Financial Journalists*]; Damian Tambini, *What Are Financial Journalists For?*, 11 JOURNALISM STUDIES 158 (2010) (questioning the degree to which financial journalists understand their role in corporate governance); Cheryl L. Wade, *The Sarbanes-Oxley Act and Ethical Corporate Climates: What the Media Reports; What the General Public Knows*, 2 BROOK. J. CORP. FIN. & COM. L. 421 (2008) (addressing the news media’s role in informing the public about corporate ethics).

91. Borden, *Financial Journalists*, *supra* note 89.

92. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 2007-10* (2004) (explaining the weaknesses in the system of shareholder voting, its negligible frequency, and SEC proposals to strengthen it); *id.* at 45-48 (explaining both the procedural hurdles and substantive rules of law that inhibit shareholders from successfully pursuing claims against managers and directors in derivative actions); Michael Klausner, *The Limits of Corporate Law in Promoting Good Governance*, in *RESTORING TRUST IN AMERICAN BUSINESS* 91-93 (Jay W. Lorsch, Leslie Berlowitz & Andy Zelleke eds., 2005) (explaining the general weakness of shareholder voting and derivative actions as disciplinary mechanisms).

shareholders, by wrongfully appropriating corporate assets, or by harming society at large. In a 2005 article, Michael Klausner argued that scholars should focus their attention upon extralegal forms of enforcement in order to generate new insights that might contribute to a better culture of corporate governance and adherence to law.⁹³ Many scholars explored the role of gatekeepers—non-governmental actors such as lawyers, bankers, certified public accountants, and securities analysts—in preventing corporate wrongdoing.⁹⁴ A few articles explored the concept of “shaming” to restrain the instincts of corporate actors.⁹⁵ My article focused on journalists.

Journalists perform various functions, including: investigating fraud,⁹⁶ catalyzing the legal process by calling wrongdoing to the attention of governmental actors and private lawyers,⁹⁷ promoting deterrence through shaming,⁹⁸ and affecting the legislative process.⁹⁹ For each of these categories, the article chronicled actual cases in which journalists succeeded in influencing corporate law and governance. In one other category, the role I posited for journalists was purely speculative. I hypothesized that journalists could influence the standard of review in *Caremark* cases involving director liability for failure to monitor illegal

93. Michael Klausner, *The Limits of Corporate Law in Promoting Good Governance*, in *RESTORING TRUST IN AMERICAN BUSINESS* 97-98 (Jay W. Lorsch, Leslie Berlowitz & Andy Zelleke eds., 2005)

94. See, e.g., Jill E. Fisch & Hillary A. Sale, *The Securities Analyst As Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1040-56 (2003) (analyzing the role of security analysts in identifying and preventing corporate wrongdoing); see generally John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 353-360 [hereinafter Coffee, *Gatekeeper Failure*] (discussing the pros and cons of attorneys serving as gatekeepers); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403 (2002) [hereinafter Coffee, *Understanding Enron*] (discussing the apparent failure in the market for gatekeepers).

95. See, e.g., Jayne W. Barnard, *Reintegrative Shaming in Corporate Sentencing*, 72 S. CAL. L. REV. 959, 966 (1999) (“[I]ncreasing evidence suggests that well-crafted shaming sanctions—especially as applied to top-level corporate executives—can serve as an effective influence on individual and corporate behavior.”); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1268 (1999) (stating that reports highlighting shortcomings of directors, “with their consequence of shaming and the loss of esteem, may have been one factor in making directors more attentive.”); Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J. L. & ECON. 365 (1999) (discussing the deterrent effects of shaming federal white-collar offenders).

96. Borden, *Financial Journalists*, *supra* note 89, at 332-56.

97. *Id.*; see also Michael J. Borden, *PSLRA, SLUSA, and Variable Annuities: Overlooked Side Effects of a Potent Legislative Medicine*, 55 MERCER L. REV. 681, 715 (2004) (“Beginning in early 1998, reporters in the financial press began to call attention to the problem of annuities being sold into qualified plans.”).

98. Borden, *Financial Journalists*, *supra* note 89, at 332-56.

99. *Id.*

behavior in the interior of a corporation. I suggested that if journalists are regularly able to discover corporate wrongdoing before the corporation's compliance program is able to learn about it and report it to the board, then there is good reason to believe that the good faith standard of *Caremark* and its progeny is defective and should be changed.¹⁰⁰ This claim rests on the evident laxity of the *Caremark* standard and the consequent suspicion that it strips corporate boards of any incentive to ensure that compliance programs are more than paper tigers. Since a vibrant and well-designed compliance program should know what is going on within a corporation, it stands to reason that cases in which journalists, operating without subpoena power, are able to learn more than the inside monitors deserve a close look by the courts. In derivative actions, however, courts rarely examine how the compliance program actually functions. As we have seen, this is a result of the pleading standards in a derivative action, including the demand requirement, together with the fact that plaintiffs are not entitled to discovery until they have survived the demand phase.

To be sure, there may be cases in which compliance programs are carried out with vigor and integrity, and yet still fail to discover the actions of determined and furtive malefactors. In such instances, journalistic reporting may not be instrumental in a shareholder derivative action, but may nonetheless lead to a governmental legal process that benefits society by putting an end to the illegal activity.¹⁰¹

III. JOURNALISTS CAN MONITOR COMPLIANCE PROGRAMS

Journalists can be very effective in detecting corporate misbehavior. There are, however, limits to the kinds of contributions journalists can be expected to make to corporate law and corporate governance; for example, while they may not be able to detect merely inefficient management, they may be good at detecting affirmative wrongdoing. Journalists do so in a variety of ways. They cultivate contacts within both corporations and governmental agencies, receive information from leakers or whistleblowers, and use their skepticism and diligence to process large amounts of information from various sources, piecing together disparate fragments of data to create a coherent picture of what is happening within a corporation or an industry.

Still, some might doubt the wisdom of relying on journalists to promote good corporate governance. For example, journalists are not experts in law. They might over-sensationalize a story, which has, at its

100. *Id.* at 343-50.

101. See *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795 (7th Cir. 2003) (involving journalistic reporting by both *The Wall Street Journal* and *Bloomberg News*).

foundation, unflattering, albeit legal, behavior. Furthermore, many of the best journalists work within institutions that sometimes have interests that impede a journalist's work. For example, the fear of a libel action can cause an editor to spike a story. This is what happened in *Dirks v. SEC*,¹⁰² an insider trading case that illustrates the role of financial journalists in corporate governance. In *Dirks*, a company called Equity Funding was engaged in a massive financial fraud.¹⁰³ An employee named Ronald Secrist informed Raymond Dirks, a securities analyst covering the company, about the scheme.¹⁰⁴ Dirks quickly called William Blundell, a *Wall Street Journal* reporter he knew, hoping the *Journal* would run a story on Equity Funding and that the SEC would, in turn, investigate the company.¹⁰⁵ Blundell's editors refused to publish Blundell's story, fearing a libel suit.¹⁰⁶ The information finally came out, but in a roundabout fashion that led to Dirks being investigated for insider trading violations.¹⁰⁷ The saga of Secrist, Dirks, and Blundell stands as a cautionary tale about the limitations on journalists' ability to affect corporate law and governance.

Another impediment to journalists' monitoring is their lack the resources and expertise. Securities analysts, some would argue, are in a far better position to uncover the kinds of accounting and securities fraud that lie at the heart of many *Caremark* cases. Securities analysts have much greater technical expertise than financial journalists, are paid to focus on a small number of firms within a particular industry, have greater access to chief financial officers and other top executives, and have financial incentives to know the truth about a company's financial status. In sum, securities analysts' position with respect to resources, expertise, access, and incentives suggests that journalists are unlikely to add any value to the search for truth in corporate financial reporting. Nevertheless, we must not forget that executives at Enron successfully deceived the securities analysts for years before journalists revealed their accounting and securities fraud.¹⁰⁸

Indeed, the superiority of securities analysts over journalists is but one of two major reasons why *Caremark* cases involving accounting or securities fraud are not good candidates for a journalistic contribution. The second reason stems from public corporations' substantial redundancy in the development, review, and reporting of financial information.

102. *Dirks v. S.E.C.*, 463 U.S. 646 (1983).

103. *Id.* at 649-50.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.* at 650-51.

108. See Borden, *Financial Journalists*, *supra* note 89, at 335-38 (discussing Jonathan Weil's groundbreaking investigation of Enron after years of fraud).

Companies generate their own financial numbers, which are audited by independent auditors. Part of the audit includes a review of internal controls, the systems in place to prevent accounting fraud. There is internal generation of data, which includes internal controls, followed by outside review by independent auditors; finally there is the requirement by the Sarbanes-Oxley Act that the audited financial statements be certified by the CEO and CFO, both of whom are typically board members. Given the layers of scrutiny already applied to corporations' internal controls, a journalist may not be able to find information not already caught in the company's own wide reviewing net.

This is not to suggest that some corporations are not guilty of fraudulent financial reporting. Rather, given the rigidly structured review of the financial reporting process, it is highly unlikely that journalists will be able to outperform the internal monitors. If there is fraud in financial reporting, the insiders are very likely to know about it. Of course, accounting and securities fraud can be perpetrated without the board's knowledge. In such cases, however, it is much more likely that the securities analysts will detect the fraud than that journalists will.¹⁰⁹ Nevertheless, as the rest of this article will show, journalists can play an important role in *Caremark* litigation, and in so doing, can both enhance shareholder welfare and minimize social harm that results from corporate illegality.

A. Journalists Have Demonstrated an Ability to Shape the Course of Caremark Litigation.

Two cases brought in recent years demonstrate the capacity for journalists to influence *Caremark* litigation. In both of these cases, journalistic investigations have revealed the kinds of liability-creating activities that give rise to a *Caremark* claim. In each case, the journalists discovered the information before the respective corporation's compliance system did and reported the information to the board, supporting the claim that Delaware's good faith standard has been insufficient to induce appropriate monitoring.

109. Enron stands as a surprising counter-example. The perpetrators of financial fraud at Enron were, for various reasons, able to hoodwink both analysts and SEC examiners alike. It was actually a journalist from a regional edition of *The Wall Street Journal* who was able to piece together disparate strands of Enron's financial disclosure and accounting methods to demonstrate that Enron was reporting inflated earnings. The article he wrote was the first in a cascading series of revelations that unfolded over a period of months, leading to the implosion of the company. Borden, *Financial Journalists*, *supra* note 89, at 335-38.

McCall v. Scott was a shareholder derivative action brought against the directors of Columbia/HCA, a corporation that operated 45% of all for-profit hospitals in the United States.¹¹⁰ HCA had become the target of multiple federal investigations for fraud. Management had set aggressive targets for profit growth across its network of hospitals.¹¹¹ The plaintiffs alleged that the firm could only meet these growth targets by violating federal Medicare and Medicaid laws and regulations.¹¹² Specifically, the plaintiffs alleged that HCA¹¹³ employees engaged in widespread “upcoding”—billing Medicare and Medicaid for more costly interventions than those actually required or provided.¹¹⁴

The district court dismissed the derivative action for failure to satisfy the demand requirement, ruling that the plaintiffs had failed to show “that a majority of the directors were interested or lacked independence.”¹¹⁵ The Delaware circuit court reversed this dismissal under the demand futility test of *Rales v. Blasband*,¹¹⁶ which the circuit court interpreted as requiring a determination of “whether or not the particularized factual allegations . . . create a reasonable doubt that, as of the time the complaint is filed, [a majority of] the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”¹¹⁷ The circuit court held that plaintiffs can establish such reasonable doubt when the “particularized allegations in the complaint present ‘a substantial likelihood’ of liability on the part of the director.”¹¹⁸ In so holding, the court pushed the demand inquiry beyond the sterile principle of director independence to include consideration of the facts of the case and their likelihood of satisfying the substantive legal standard of the cause of action.

In reviewing the allegations, the circuit court paid careful attention to an astonishing bit of investigative journalism on the part of three reporters from *The New York Times*.¹¹⁹ The *Times*’ investigation included a sophisticated statistical analysis of over 30 million records of Medicare

110. *McCall v. Scott*, 239 F.3d 808, 818-19 (6th Cir. 2001).

111. *Id.* at 819.

112. *Id.*

113. The alleged wrongdoing occurred before the merger of Columbia Health System, Inc. and HCA.

114. *Id.* at 814.

115. *Id.* at 815.

116. *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

117. *McCall*, 239 F.3d at 816.

118. *Id.* at 817 (quoting *Rales*, 634 A.2d 927).

119. Martin Gottlieb, Kurt Eichenwald and Josh Barbabel, *Biggest Hospital Operator Attracts Federal Inquiries*, N.Y. TIMES, Mar. 28, 1997, <http://www.nytimes.com/1997/03/28/business/biggest-hospital-operator-attracts-federal-inquiries.html>.

patients treated in hospitals in Florida and Texas in 1995.¹²⁰ This enormous data set included both patients treated by HCA and, for comparison, patients treated by other providers.¹²¹ In this remarkable study, the reporters:

[M]atched records of these patients with bills for hospital readmission, admissions to rehabilitation and skilled nursing units, outpatient services and doctor bills within 30 days of discharge. To account for differences among patients, hospital stays were grouped into 1,500 categories that took into account the type and severity of patient conditions. Costs figures and referral rates were then calculated and adjusted to account for differences in conditions.¹²²

During the course of the investigation, the *Times* reporters met with unidentified HCA officials to discuss their reporting.¹²³ They also contacted the federal Medicare agency, which pursued its own investigation.¹²⁴ Eventually, the FBI conducted an extensive investigation that culminated in raids of several HCA offices in 1997.¹²⁵ The *Times* refrained from publishing its story until the FBI undertook the first of its raids. In 2002, Columbia/HCA completed its settlements with a host of governmental agencies, paying a total of nearly \$1.7 billion.¹²⁶

Because of the procedural posture of the case, the circuit court opinion did not include any findings of fact concerning whether the board had learned from internal channels about the upcoding activities before the *Times* reporters discovered it. Nevertheless, the court relied heavily on the *Times* report and the federal criminal investigation it sparked to reach its conclusion. The court found that, under the demand futility test of *Rales v. Blasband*, the plaintiffs' allegations presented a substantial likelihood of liability on the part of the directors and thus raised a reasonable doubt that a majority of the board could exercise its independent and disinterested business judgment in responding to a demand.¹²⁷ The derivative action settled in 2003 for an undisclosed sum, with HCA also agreeing to significant changes in the structure and operation of its compliance program.¹²⁸

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. Associated Press, *Hospital Chain Ends Fraud Case*, N.Y. TIMES, Dec. 19, 2002 at C1.

127. *McCall v. Scott*, 239 F.3d 808, 818-19 (6th Cir. 2001).

128. N.Y.C. COMPREHENSIVE ANN. FIN. REP. OF THE COMPTROLLER, at xiv (2003),

McCall thus shows that where courts are willing to consider the actual allegations of wrongdoing contained in the complaint at the demand stage, journalistic reporting can crucially affect plaintiffs' ability to have their case heard and obtain a recovery. Moreover, the settlement indicates that compliance at HCA was not satisfactory. The alterations to the compliance program would not have occurred without the investigative work of the journalists and the court of appeal's willingness to overrule the district court on the issue of demand futility.

*In re SFBC International Securities and Derivative Litigation*¹²⁹ presents another case where journalists were the first to uncover suspect corporate activity that led to a *Caremark* claim. SFBC, which had come to be known as PharmaNet Development Group, Inc. ("PDG"), managed the implementation of clinical testing on behalf of pharmaceutical companies.¹³⁰ Between 2003 and 2006 PDG operated clinical trials in Florida and in two cities in Quebec Province, Canada.¹³¹ PDG's business plan involved rapid growth and expansion, and relied on inducing pharmaceutical companies to enter into service contracts by assuring them that PDG could "quickly enlist study participants and process clinical trials" at its large facilities in Miami and Montreal.¹³² For a number of years, PDG's practices resulted in large profits and impressive growth.

As it turned out, PDG's clinical practices involved staggering ethical violations that caused severe health problems for several of its study participants and endangered the safety of many others.¹³³ In addition, PDG schemed to conceal its actions by engaging two Institutional Review Boards¹³⁴ ("IRBs"), which were unable to render objective analyses of PDG's clinical practices because of conflicts of interest.¹³⁵ One of the IRBs, known as Lee Coast, shared offices with a subsidiary of PDG.¹³⁶ Plaintiffs alleged that employees of this IRB were "paid directly by PDG's accounting office and that Lee Coast did not maintain its own books and records."¹³⁷ The other, Southern IRB, was owned by the wife of one of the defendants, a vice president of clinical operations.¹³⁸ Without an impartial

<http://www.comptroller.nyc.gov/bureaus/acc/CAFR-FYJun03/CAFR-FY-Ending-June03.pdf>.

129. *In re SFBC Int'l Sec. and Derivative Litig.*, 495 F. Supp. 2d 477 (D.N.J. 2007).

130. *Id.* at 480.

131. *Id.*

132. *Id.*

133. *Id.*

134. IRBs are private organizations authorized by the FDA to oversee clinical trials to ensure safety and compliance with FDA regulations relating to clinical testing processes.

135. *In re SFBC*, 495 F. Supp. 2d at 480-81.

136. *Id.* at 481.

137. *Id.*

138. *Id.*

review of the clinical trials, PDG was able to flout FDA regulations, industry standards, and biomedical ethics, thereby endangering the health and safety of numerous study participants.

Reporters from *Bloomberg News* conducted a year-long investigation of safety issues in pharmaceutical testing.¹³⁹ Their reporting culminated in the publication of a 28-page report¹⁴⁰ and several follow up stories that detailed a number of ethical and safety violations, and served as a primary source for both the plaintiff's complaint and the court's analysis of the case.¹⁴¹ *Bloomberg* reported that volunteers "participated in more than one clinical trial . . . at the same time . . . ignoring required waiting periods."¹⁴² In addition, PDG "threatened to arrange federal deportation of Latin American immigrants who disclosed health risks in clinical trials."¹⁴³ Journalists also found that volunteers at a testing center contracted tuberculosis and were not quarantined, resulting in the spread of the disease to other study participants.¹⁴⁴ The reporters interviewed professors of medicine from Harvard Medical School and the University of Minnesota Medical School, who condemned PDG's practices. One said, "[t]hey had a person coughing up blood, to allow him to expose others to TB is wrong . . . I've never heard of this happening in a clinical trial before . . . I've seen TB spread like this in a prison."¹⁴⁵ Another opined, "[t]his story suggests a serious lapse in the most basic care of patients exposed to a known communicable disease. The breach of responsibility is egregious."¹⁴⁶

After *Bloomberg* published its information about PDG, the SEC, FDA, and the United States Senate investigated the wrongdoing. As a result of these revelations, PDG shuttered its Miami testing operations, saw the resignation of its CEO, its president, and its chief legal counsel, and settled with its shareholders for nearly \$30 million.¹⁴⁷ As for the derivative litigation, a district court denied the defendants' motion to dismiss for

139. David Evans, Michael Smith, and Liz Willen, *Big Pharma's Shameful Secret*, BLOOMBERG NEWS, (Dec. 2005), <http://www.dcscience.net/pharma-bloomberg.pdf>.

140. *Id.*

141. *In re SFBC*, 495 F. Supp. 2d at 481.

142. *Id.*

143. Michael Smith and David Evans, *SFBC Threatens Human Drug Testers for Disclosing Health Risks*, BLOOMBERG NEWS (Nov. 16, 2005), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&refer=&sid=aH1Vx92KNTWA>.

144. *Id.*

145. *Id.*

146. *Id.*

147. Kristy Barnes, *Troubled SFBC Changes its Name in Hope of Changing its Fortunes*, OUTSOURCING-PHARMA.COM, (Aug. 31, 2006), available at <http://www.outsourcing-pharma.com/Clinical-Development/Troubled-SFBC-changes-its-name-in-hope-of-changing-its-fortunes>.

failure to make demand.¹⁴⁸ The defendants argued that the complaint failed to allege that the directors knew or should have known about the improper activities, relying on the claim that the majority of the board was not involved in day-to-day operations.¹⁴⁹ Quoting heavily from the Bloomberg report, which furnished the bulk of the allegations in the complaint, the court excused demand, concluding that all of the directors “faced a substantial likelihood of personal liability for the misconduct . . . preventing them from disinterestedly considering a demand by shareholders.”¹⁵⁰

IV. DELAWARE SHOULD CHANGE ITS APPROACH TO DEMAND FUTILITY AND GOOD FAITH WHEN JOURNALISTS GET THE STORY FIRST

In summary, we have seen that there are significant problems with the jurisprudence of *Caremark*. On its face, *Caremark* seems impotent.¹⁵¹ Fifteen years of litigation experience confirms its inadequacy as an inducement to vigorous monitoring.¹⁵² On a more nuanced level, *Caremark* plaintiffs struggle with the overall weakness of the good faith standard, compounded by the difficulties of demand, especially as applied in cases like *Wood* and *DeSimone*. To a lesser extent, plaintiffs also face a hurdle in courts’ ambivalent attitude toward red flags.

These elements have combined to make it very difficult for plaintiffs to get past a motion to dismiss, which courts commonly grant on the basis of the demand requirement. As a result, the law shields directors from having to reveal the actual workings of their compliance programs and leaves them free to remain willfully blind to evidence of illegality. Furthermore, compliance programs have been allowed to become paper tigers, resulting in illegal and dangerous corporate conduct causing public harm.

What, then, can be done about this problem? I have demonstrated that journalists have a distinct capacity to make important contributions in *Caremark* cases. The remarkable reporting of *The New York Times* in analyzing a vast data set to demonstrate Medicare fraud was a *tour de force* of data analysis in its own right. From the standpoint of legal process, it proved its value in assisting the federal government in bringing HCA into conformity with law and reforming its compliance program, while saving

148. *In re SFBC Int’l Sec. and Derivative Litig.*, 495 F. Supp. 2d 477, 484-86 (D.N.J. 2007).

149. *Id.*

150. *Id.*

151. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

152. *See supra* Part I.

the American taxpayer over two billion dollars through the 2002 settlement. The more traditional reporting of *Bloomberg News* in uncovering highly dangerous bioethics violations stands as further evidence of the power of journalists to assist in *Caremark* litigation. Despite these impressive achievements, doctrinal and procedural impediments persist in constraining the potential of journalists to make a real impact in shareholder derivative litigation, an impact that could enhance shareholder welfare, improve the quality of compliance programs, and reduce social harm.

In order to allow journalists to improve the effectiveness of corporate compliance, courts must alter their approach to several key doctrinal issues. In this Part, I will suggest changes in the way that courts deal with demand, red flags, and the overall contours of the good faith doctrine in order to strengthen *Caremark* and improve corporate compliance to both improve shareholder welfare and reduce harm to society caused by corporate law breaking.

A. Relaxing the Standard for Demand Futility

In order to clear the way for the contributions of journalists to make a real impact in improving corporate monitoring and compliance with law, Delaware courts should adopt a slightly more flexible approach to demand futility where plaintiffs allege facts suggesting that outside monitors (i.e. journalists) have uncovered corporate illegality before the board appears to have become aware of it. This will force defendants to reveal just what information their compliance program has produced, and whether that information has made its way to the board. The revelation of this information is essential to ensure that corporate compliance programs are actually functioning effectively.

As we have seen, there is currently some doctrinal disarray surrounding the standard for demand futility in cases involving nonfeasance (i.e. where the board has failed to act, as opposed to cases involving a challenge to an affirmative board decision). Under *McCall v. Scott*, a court will excuse demand if the complaint includes allegations of fact sufficient to indicate a “substantial likelihood of liability on the part of [the director].”¹⁵³ Other recent cases impose a scienter requirement, under which plaintiffs must show that a majority of the board knew or should have known that its conduct was improper, with one case holding that to satisfy this requirement, the pleadings must show that the board knew about and ignored deficiencies in internal controls within the compliance

153. *McCall v. Scott*, 239 F.3d 808, 818-19 (6th Cir. 2001).

program.¹⁵⁴

Delaware courts should turn away from the jurisprudence of *DeSimone* and embrace the holding of *McCall*. If *DeSimone* remains the law, a well-counseled board will know that plaintiffs will be unable to successfully argue demand futility if the board is unaware of flaws in a compliance program's internal controls. Indeed, a rational board will gladly avoid a careful assessment of internal controls within the compliance program. It is important, in this connection, to note that internal controls in compliance are not the same as internal controls in financial accounting. In the latter context, corporations have strong legal and financial reasons to establish and monitor effective internal controls. The Sarbanes-Oxley Act, the federal securities laws and Generally Accepted Accounting Principles and Standards loom as the policemen on that beat. Moreover, it is the job of independent auditors to test, evaluate, and opine on the effectiveness of these internal controls. But when the law imports the concept of internal controls to the compliance setting, things become rather amorphous. It is all too easy for a board to remain intentionally ignorant of any systematic flaws with internal controls in compliance, and, given the limitations on discovery, all too difficult for plaintiffs to plead facts indicating that the board was aware of such flaws and did nothing about it. Finally, it is worth mentioning that there is nothing in *Caremark* to indicate that corporate compliance programs must have a system of internal controls in the first place.

Rather than follow an approach that shields ineffective compliance from any judicial scrutiny, I propose that courts follow the *McCall* approach to demand, which will excuse demand as futile if plaintiffs can show a substantial likelihood of liability on the part of the defendant directors. Since demand is thus tied to the substantive standard for success on the merits, it is necessary at this stage to consider the substantive standard for liability—the good faith standard. Recall that under *Caremark*, defendants must show that they have established, in good faith, a reasonably designed compliance program, and that, per Chancellor Allen, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system [exists]—will establish the lack of good faith that is a necessary condition to liability.”¹⁵⁵

It is not difficult to read the foregoing and conclude that a plaintiff will be unable to surmount the demand requirement in any case in which a corporation has an active compliance program in place. In fact the

154. *DeSimone v. Barrows*, 924 A.2d 908, 934-35 (Del. Ch. 2007).

155. *Caremark*, 698 A.2d at 971.

empirical experience strongly supports this prediction.¹⁵⁶ Nevertheless, the Sixth Circuit in *McCall* excused demand on the strength of allegations of recklessness in ignoring warning signals that indicated widespread fraud on the part of corporate employees, despite the existence of a compliance program.¹⁵⁷ The Delaware courts should thus adopt a slight modification to the good faith standard in certain cases.

B. A Change in the Good Faith Standard

In order to further ensure that *Caremark*'s requirement of a compliance program becomes a vibrant check on a board's duty to monitor, I suggest that Delaware change its approach to the evaluation of claims of breach of the duty of good faith at the demand and summary judgment phase. I propose that where the plaintiff alleges that journalists have uncovered illegal corporate action before the corporation has either acknowledged the wrongful activity or taken steps to remedy it, the court should erect a presumption of bad faith. Corporate defendants can rebut this presumption by showing that the compliance program was aware of the problem and had begun to take steps to address it, including notifying the board of material illegality. Plaintiffs should have access to appropriately limited discovery to investigate the response of the compliance program. If the defendants were unable to make such a showing sufficient to convince the trier of fact, then the inefficacy of the compliance program would amount to a breach of the duty of good faith.

Under this approach, boards will be forced to reveal something of the workings of their compliance programs. Courts and other observers will discover how effective the *Caremark* standard has been in inducing effective compliance, and can decide whether it needs to be reformulated. More importantly, Delaware corporations will know that they can no longer hide behind the legal shield offered by the minimalistic standard for good faith and the demand requirement. Finally, shareholders and society should benefit from higher quality compliance programs.

Those who might fear that this change in the good faith standard will go too far toward making directors personally liable for every naughty act of corporate employees need not worry. First, the materiality standard ensures that only serious or widespread wrongdoing will lead to a finding of bad faith. Second, the proposed change does not require compliance programs to prevent or stop illegal activities; it only requires heightened attentiveness and reporting by the compliance department to the board.

156. See *supra*, Section I.D (discussing the demand requirement).

157. *McCall*, 239 F.3d at 818-19.

Only where the external monitoring done by journalists is more effective than the internal monitoring of the compliance program will the board even be forced to disclose the actions of the compliance officers.

C. Discovery and the Tools at Hand

The highly limited availability of discovery in the earlier stages of derivative litigation plays an important role in the case for relaxing demand requirements where journalistic reporting has uncovered the wrongdoing at the center of a duty to monitor case. Plaintiffs are not entitled to normal civil discovery, but Delaware courts consistently exhort them to resort to the “tools at hand.”¹⁵⁸ One such tool is a request for corporate records pursuant to section 220 of the DGCL.¹⁵⁹ However, records requests rarely yield meaningful information because the plaintiff must know exactly what document she is seeking when making the request,¹⁶⁰ and also because corporate executives are well-versed in the art avoiding paper trails in the minutes of board meetings. The other sources of information referred to as the “tools at hand” are SEC filings and news media reporting.¹⁶¹ In view of the frequency with which the Delaware courts instruct litigants to pursue the “tools at hand”, one might expect that information gathered by journalists would be afforded some special status. Ironically, however, the Delaware courts persist in dismissing derivative actions while deriding plaintiffs for relying simply on newspaper reports.¹⁶²

There may be many cases in which complaints are hurriedly prepared

158. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 248 (Del. 2000) (“A pleader may rely on factual statements in the media as some of the ‘tools at hand’ . . .”).

159. DEL. CODE ANN. tit. 8, § 220 (2013).

160. The scope of a section 220 request is much more limited than civil discovery. See *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 114 (Del. 2002) (noting that section 220 “does not open the door to the wide ranging discovery that would be available in support of litigation.”). Rather, a shareholder plaintiff must “make specific and discrete identification, with rifled precision, of the documents sought.” *Brehm*, T at 266.

161. *Brehm*, 746 A.2d at 248.

162. See, e.g., *In re Citigroup S’holders Litig.*, No. 19827, 2003 WL 21384599, *1-3 (Del. Ch. June 5, 2003) (dismissing suit which “[r]el[ied] extensively on information gleaned from this governmental report and some other news sources . . .”). But see Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands*, 28 *Cardozo L. Rev.* 1287 (2006). Radin offers a thorough exploration of the recent jurisprudence of section 200 demands. Radin reviews the recent cases involving requests for records under section 220 and concludes that section 220 affords plaintiffs the ability to engage in pre-complaint investigation for the purpose of improving the drafting of complaints. He also notes that “corporations and their counselors accordingly are taking steps to minimize litigation risk by ensuring that corporate actions likely to be challenged by shareholders . . . are documented in carefully prepared minutes and board materials ready to be produced upon receipt of a section 220 demand.” *Id.* at 1413.

in a race to the courthouse to win what Chancellor Strine has called the “filing Olympics.”¹⁶³ Nuisance suits are, to be sure, a problem. Complaints that merely recite facts from newspaper articles written in the wake of a drop in stock price or after corporate wrongdoing has become public knowledge deserve swift dismissal. It is essential to distinguish the sort of lazy *ex post* fact-gathering by plaintiffs’ lawyers bringing marginal suits from the highly valuable investigative reporting of the kind on display in *McCall* and *In re SFBC*. This sort of newspaper report deserves particular attention by the courts, and special treatment at the pre-trial stages.

D. Red Flags

The recent cases addressing red flags indicate an inconsistent approach. At times, the Delaware courts have shown a willingness to take a nuanced look at evidence that might constitute a red flag.¹⁶⁴ Other cases, like *In re Citigroup*, demonstrate a judicial inclination to excuse a board’s neglect of prominent red flags, particularly with large corporations.¹⁶⁵ This tendency appears to reflect two considerations. First, large corporations with deep pockets are often the subject of nuisance litigation driven by the profit motive of the law firm that can attain lead counsel status by winning the race to the courthouse.¹⁶⁶ Second, boards of giant corporations by necessity focus only on the big picture. They meet infrequently and their outside members have significant other engagements that leave them little time to follow any but the most important strategic issues. Neither of these reasons stands up to scrutiny.

As to the problem of nuisance litigation, the restrictive approach to red flags must be viewed as part of a filtering apparatus which is important both as a matter of judicial economy and protection of corporate resources. Yet nothing marks the entire system of shareholder derivative litigation more than its highly redundant system of procedural obstacles aimed at thwarting frivolous lawsuits. With so many mechanisms firmly rooted in corporate jurisprudence, there is no need to gild the lily by turning a blind judicial eye toward real evidence of red flags that are relevant to a plaintiff’s claim of a breach of the duty to monitor.

As to the realities of limitations on directors’ attention, given the

163. *King v. VeriFone Holdings, Inc.* 994 A.2d 354, 355 (Del. Ch. 2010).

164. *See, e.g., Dobler v. Montgomery Cellular Holding Co.*, No. CIV.A. 18105 NC, CIV.A. 18499, 2001 WL 1334182, *4 (Del. Ch. Oct. 19, 2001) (holding that advances made to affiliates were suspect and sufficient red flags).

165. *Citigroup*, 2003 WL 21384599, at *2.

166. *See Roberto Romano, The Shareholder Suit: Litigation Without a Foundation*, 1991 WL 371124 (LRI), 7 J.L. ECON. & ORG. 55 (1991) (arguing that the interests of plaintiffs’ attorneys in derivative actions are poorly aligned with those of the shareholders).

many claims made upon their time by big picture considerations both inside the corporation and in their lives outside the corporation, this concern is misplaced. It is the job of the compliance department to review all relevant issues and funnel material concerns to the board. Furthermore, the entire board need not occupy itself with minor compliance issues. A committee of the board, perhaps composed of inside directors, could occasionally review red flag issues brought to their attention by the compliance officer.

A more expansive approach to red flags, then, can function as an important part of the judicial analysis of the demand issue. If courts are willing to excuse demand based on a likelihood of liability on the part of the directors, and if that determination turns on whether the defendants were reckless in ignoring red flags that ought to have alerted them to illegal activity, then Delaware courts should keep an open mind about treating serious journalistic reporting as doctrinally significant red flags and turn away from the director-friendly biases on display in cases like *In re Citigroup*.

CONCLUSION

The foregoing has demonstrated that journalists can and should play an important role in *Caremark* litigation. Talented and well-resourced journalists have displayed an ability to outperform corporate compliance programs by uncovering socially damaging corporate misdeeds before the compliance program. In cases like *Scott*, an ambitious journalistic investigation enabled the federal government to recover \$1.7 billion dollars lost to Medicare fraud. But the federal treasury is not the only loser in such cases; shareholders and the public suffer as well. Thus, the deterrent effect of civil liability must also play a role in improving director monitoring of corporate illegality. In order for *Caremark*'s good faith standard to have more than mere aspirational value, more cases must be able to proceed past a motion to dismiss so that defendants will be forced to reveal more about how their compliance programs actually operate. Assertions, in the answer to a complaint, that there is a compliance program "adequate in design and concept" to assure that important information gets to the board are not sufficient. The changes in law recommended in this article will foster a healthy competition between the outside and inside monitors that will benefit everyone by reducing socially harmful activity through improved overall detection of corporate wrongdoing.