Prepublication Version: Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation

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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 relax some of the 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 performed by journalists appears to have detected illegal corporate actions before the inside 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 having to reveal information about the performance of their compliance programs. The changes in law 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 live up to 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, the Delaware courts will, over time, have more information to help them in assessing whether their approach to the duty to monitor needs a more thorough overhaul.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

**TABLE OF CONTENTS**

*Introduction* .................................................................................................................................................. 3  
I. Caremark and its Progeny ............................................................................................................................ 6  
   A. Graham v. Allis Chalmers ......................................................................................................................... 7  
   B. Caremark ................................................................................................................................................. 8  
   C. Good Faith as the Benchmark for the Duty to Monitor ........................................................................... 9  
   D. Stone v. Ritter: An Exercise in Taxonomy .............................................................................................. 11  
   E. Pros and Cons of the New Classification ............................................................................................... 13  
   F. The Demand Requirement ...................................................................................................................... 15  
   G. Red Flags ................................................................................................................................................ 18  
II. Scholarly Attention to the Role of News Media in Law .............................................................................. 24  
   A. The Recent Surge in Attention to Journalism in Legal Scholarship .................................................... 24  
   B. There is Good Reason to Believe That Journalists Can Serve This Function ..................................... 28  
III. Journalists Have Demonstrated an Ability to Shape the Course of *Caremark* Litigation.................. 31  
IV. Delaware Should Change its Approach to Demand Futility and Good Faith Where Journalists Get the Story First ......................................................................................................................... 36  
   A. Relaxing the Standard for Demand Futility ............................................................................................. 37  
   B. A Change in the Good Faith Standard ...................................................................................................... 40  
   C. Discovery and the Tools at Hand ............................................................................................................. 41  
   D. Red Flags ................................................................................................................................................ 42  
*Conclusion* .................................................................................................................................................. 44
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

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 – the central principle of corporate law – 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, competitive forces in markets do not always serve to prevent corporate actors from causing tremendous harm to shareholders and society at large 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 almost always prevent them from surviving a motion to dismiss. 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.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

There is good reason to believe that journalists can be effective monitors of corporate wrongdoing. This summer saw a stunning international banking scandal that demonstrated the capacity of journalists to serve the public good by detecting and reporting corporate criminality. The LIBOR rate-setting scandal serves as a remarkable instance of a purely market-based process being manipulated by powerful insiders to the detriment of all 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 in our division of enforcement started to take a look and started to learn” about the scandal. It is thus evident that regulators and the public rely on journalists to assist in law enforcement and to ensure that markets work as they are supposed to work. Corporate law should take advantage of this extralegal constraint on corporate greed by altering the jurisprudence of 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 profound 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 other topics in corporate law, which, by their nature, mainly concern the relationship between shareholders and boards of directors.
These recent corporate fiascos have demonstrated the social harms that can result from a failure of oversight and the culture of lawlessness it can engender. But corporate law does not provide an easy fix for the problem of director liability 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. It thus may seem desirable to lay responsibility for corporate wrongdoing at the feet of directors. On the other hand, reality tells us that a directorship of a public corporation is a part-time job held by individuals with many other significant responsibilities. It may be unreasonable to expect that directors can 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 compliance with positive law. While no one would argue that compliance programs are a bad thing, the decade and a half of litigation experience under *Caremark* has demonstrated that the reasonably designed 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 litigation experience suggests that the threat of liability is not a serious concern for directors. Of the 230 cases brought under Delaware law alleging *Caremark*-type violations, only twelve times did the *Caremark* claim survive the motion to dismiss. Plaintiffs achieved an adjudication of liability only once.

One of the greatest barriers to success for plaintiffs in shareholder derivative litigation is the Delaware rule that denies discovery until after the summary judgment phase. Without
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

discovery, plaintiff 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 more weight to journalistic reports of corporate illegality. 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 done 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 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.

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. When they are caught, the penalties 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. Indeed, though it may not be polite for courts to mention it, a degree of law breaking 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 that directors would probably prefer.

A. Graham v. Allis Chalmers

*Graham v. Allis Chalmers* was the first notable case to seek this middle ground.\(^1\) In *Graham*, shareholders sued the board for failing to prevent harm to the corporation caused by illegal price fixing. Relying on a 19\(^{th}\) century U.S. Supreme Court decision,\(^2\) the Delaware Supreme Court ruled that directors can be liable for corporate illegality only “if something occurs to put them on suspicion that something is wrong.”\(^3\) The court disparaged the notion that there was any “duty to install a system of corporate espionage to ferret out wrongdoing.”\(^4\) In effect, the *Graham* court established what one wag has characterized as the “one bite rule for dog owners” in the context of the duty to monitor.\(^5\) So long as there were no red flags indicating a

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\(^3\) *Graham*, 188 A.2d 125, 130.
\(^4\) *Id.*
\(^5\) Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 at 577 (2008) (hereinafter Bainbridge, *Convergence*). Bainbridge et al analogize the rule of *Graham* to the aphorism that every dog is entitled to one bite. The author’s continue the analysis, explaining that “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 based on the breed's inherently violent propensities.”
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

likelihood of the wrongdoing in question, the board could not be responsible if it occurred. Perhaps unwittingly, the Graham court thus established a legal environment in which boards had an incentive to avoid finding out about any red flags. In any event, under Graham, there was no affirmative duty for a Delaware corporation to establish a compliance program. Graham remained good law until 1996, when the Delaware Chancery Court handed down the Caremark decision, a landmark case that has come to be seen as standing for the proposition that corporate directors have a duty to monitor their corporations for illegal activities.

B. Caremark

Caremark International, Inc. was a Delaware corporation that marketed medical products and services to patients and to medical providers like doctors and hospitals. In violation of federal Medicare and Medicaid law, Caremark employees paid kickbacks to doctors and hospital administrators to prescribe their products and services. A federal investigation of the company culminated in Caremark’s paying $250 million in fines and penalties. When shareholders sued the board of directors for the loss of corporate wealth, the directors claimed that they were unaware of the wrongdoing. Such a defense is entirely plausible, for directors are, by nature, not engaged in the day to day business operations of their firms. Moreover, modern corporations often have thousands of employees with multiple layers of management oversight spread throughout a geographically far-flung field of activity. Under such circumstances, it would be harsh to make directors personally responsible for the harm to the corporation caused by actors operating deep within the corporate hierarchy. Indeed at the time of the wrongdoing in

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6 In re Caremark Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996)
7 Id. at 970-72; Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 365.
8 698 A.2d 959, 960-64.
9 Id. at 962.
10 Id.
11 Id. at 971.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

_Caremark_, Delaware law, under _Graham v. Allis Chalmers, Inc._, held that so long as directors were unaware of the unlawful activities that caused the harm to the corporation, and had no reason to be aware of it, the directors were free from personal liability.\(^\text{12}\)

In an opinion approving the settlement of the Caremark shareholders’ derivative action, Chancellor Allen acknowledged that _Graham_ might be seen as embodying a rule of blissful ignorance for directors and undertook to put the law on a different footing.\(^\text{13}\) Allen asserted that if this interpretation of _Graham_ was really the law of Delaware, then it must change.\(^\text{14}\) 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 . . . .”\(^\text{15}\) In so doing, the Chancellor moved the discussion of this sort of case away from the business judgment rule and under the rubric of the duty of good faith.\(^\text{16}\)

_C. Good Faith as the Benchmark for the Duty to Monitor_

But good faith, as we know, is a rather elastic concept that is also highly fact-dependent. 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.


\(^{13}\) _Caremark_, 698 A.2d 959, 969-70.

\(^{14}\) _Id._

\(^{15}\) _Id._ at 970.

\(^{16}\) 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. Rather, the duty of good faith falls under the duty of loyalty for doctrinal and analytical purposes under Delaware law. _Stone_, 911 A.2d 362, 369-70.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

“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 exercise reasonable oversight – is quite high.”17

Chancellor Allen further shared his opinion 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.”18 Given the utter nullity that the waste doctrine has been for decades, that is really saying something.19

In short, we can say that Caremark requires the existence of a compliance program that is reasonably designed in good faith. Nowhere does it say that the program actually has to work; it pretty much just has to exist. In the immediate wake of the Caremark opinion, one might have been able to forecast the course of Caremark litigation in the years to come. And one would have been right. Out of 228 cases brought by plaintiffs making Caremark claims over the fifteen years since Caremark, only 12 times has the Caremark claim survived a motion to dismiss. Only one case has produced a verdict for plaintiffs.20

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, no less important is the demand requirement, which magnifies the difficulties shareholder plaintiffs face.21

17 Caremark, 698 A.2d. 959 at 971.
18 Id. at 967.
21 For further discussion of the demand requirement, see infra, section ___.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

In view of Chancellor Allen’s own prognosis, and the actual experience of fifteen years of Caremark litigation, it is fair to wonder whether Caremark’s 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 doing what they are supposed to do: monitor corporate behavior to assure compliance with law and 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 only 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.” By focusing only on “concept and design,” Chancellor Allen was maintaining consistency with the general thrust of Delaware corporate law. For example, it is a bedrock tenet of the business judgment rule that the director’s duty of care involves only on the process of decision making, not the substantive decision directors reach. Unfortunately, this analytic consistency in deference to directorial autonomy can come at a steep price for shareholders and society alike, as the numerous corporate scandals of the past decade have amply demonstrated.

D. Stone v. Ritter: An Exercise in Taxonomy

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22 Caremark, 698 F.2d at 971.
23 See Brehm v. Eisner, 746 A.2d 244 (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.”
Caremark’s doctrinal impact on shareholder derivative litigation cannot be fully grasped without considering Stone v. Ritter, a 2006 case that both adopted Caremark’s dicta as the law of Delaware and radically re-interpreted its doctrinal foundations. 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 “[T]he core element of any corporate law duty of care inquiry” is “whether there was good faith effort to be informed and exercise judgment,” and “What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed.”

The Stone court was thus faced with 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. Second, that such a claim sounded in the duty of care. Stone embraced the first concept but emphatically discarded the second. 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. This view of fiduciary duties was the

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26 Caremark, 698 F.2d at 971.
27 Id.
28 Stone, 911 A.2d 362, 369-70
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

subject of some handwringing, among both judges\textsuperscript{30} and scholars.\textsuperscript{31} 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,”\textsuperscript{32} but rather is subsumed within the duty of loyalty.

E. Pros and Cons of the New Classification

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 has suggested 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.\textsuperscript{33} As Bainbridge has pointed out, Stone expands the duty of loyalty beyond its traditional bounds by including cases in which directors do not receive a personal benefit.\textsuperscript{34} Consequently, the remedies available in loyalty cases will change. Before Stone, remedies in loyalty cases were aimed at requiring defendants to disgorge benefits

\textsuperscript{30} Veasey & Di Guglielmo, supra note 21, at 1449-50. E. Norman Veasey and Christine Di Guglielmo include Jack Jacobs and Leo Strine among the triad’s judicial skeptics. See id. at 1450 n.191 (analyzing cases)


\textsuperscript{32} Stone, 911 A.2d at 370.

\textsuperscript{33} Bainbridge, Convergence, supra note 5 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).

\textsuperscript{34} Id.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

wrongfully gained. For example, in corporate opportunity cases, the corporation receives a constructive trust in the opportunity.\textsuperscript{35} In interested director cases, the court may void the related party transaction.\textsuperscript{36} After Stone, duty of loyalty cases under the duty to monitor will involve claims for damages without a corresponding wrongful benefit to the defendants. Bainbridge argued that such claims could raise challenging issues of causation that have not, to date, been part of litigation under the duty of loyalty.\textsuperscript{37}

But other effects of this re-configuration of the taxonomy of shareholder claims are likely to prove beneficial for shareholder plaintiffs, and thus arguably for shareholder welfare generally. As corporate law scholars have recognized,\textsuperscript{38} the placement of good faith claims under the duty of loyalty has removed them from the exculpatory ambit of section 102(b)(7) of the Delaware General Corporation Law.\textsuperscript{39} 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. It is evident that one of the consequences, if not, perhaps, the purpose, of Stone v. Ritter’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 the series of nearly insurmountable obstacles (no discovery, the

\textsuperscript{35} Id.
\textsuperscript{36} Id.
\textsuperscript{37} Id.
\textsuperscript{39} DEL. CODE ANN. TIT. 6 § 102(b)(7) (2012).
The onerous demand requirement, special litigation committees empower 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 v. Ritter, at a minimum, provides some relief from this treacherous gauntlet by providing some light at the end of the tunnel in Caremark cases.

**F. 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 shareholders to make a demand upon the board to bring the action to vindicate the claim the shareholders are pressing. The demand requirement may be excused, however, if the plaintiffs can demonstrate that demand would be futile. Since claims of failure to monitor usually involve non-feasance, rather than an affirmative decision taken by the board, recent Caremark cases have employed the test of Rales v. Blasband to analyze demand futility. The Rales test requires plaintiffs to establish a 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.” Under Rales, demand in a Caremark case will be excused as futile if the plaintiffs

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40 “[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.” White v. Panic, 793 A.2d 356, 371 (Del. Ch. 2000).

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


43 Id. at 934
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.”

The test for demand futility is intertwined 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. 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 under Delaware law by the 6th Circuit Court of Appeals. Recent Delaware cases give plaintiffs less reason for optimism.

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.’” In DeSimone v. Barrows, the Court of Chancery asserted that “in 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

42 Id.
43 Id.
44 McCall v. Scott, 239 F.3d 808, 818-19 (6th Cir. 2001).
45 953 A.2d 136, 141 (Del. 2008).
behavior, and that the board chose to do nothing about the control deficiencies that it knew existed."\(^{47}\)

The difficulty with the scienter requirement lies in the fact 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* test\(^ {48}\), 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 dicta from *DeSimone* indicate 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 the board’s knowledge of any particular information about a given instance of illegality. The Delaware courts apparently do not want to hear about the board’s knowledge in specific cases. Only knowledge of a systematic failure of the structure of compliance will suffice to allow a plaintiff to demonstrate demand futility. Moreover, even if a plaintiff were able to demonstrate such a structural deficiency in internal controls, such a showing would be inadequate, for the plaintiff might not be able to show that the board knew of the deficiency. The incentive remains for directors to remain willfully ignorant of the flaws in their own compliance program. The paper tiger principle is thus self-reinforcing.

It is evident, then, that in the microcosm of demand, we see a recapitulation of the broader conundrum of the duty to monitor: directors naturally cannot know everything that goes

\(^{47}\) 924 A.2d 907, 934-35 (Del. Ch. 2007).
\(^{48}\) *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984)
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

on in the corporation and thus cannot justly be held liable for illegality of which they were ignorant. Even so, directors who remain unaware of the functionality 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 discuss this solution in the context of cases involving journalistic reporting of corporate malfeasance.

G. Red Flags

Although Caremark represents a fundamental shift away from the jurisprudence of Graham, Delaware law does carry forward an important part of the analysis the prevailed under Graham: The concept of the red flag. Caremark, of course, turned Graham on its head, but over the last fifteen years, numerous cases and law review articles have discussed the concept of red flags.

So what is a red flag? In concept, a red flag is a warning, and 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 like McCall v. Scott have illustrated.49 A red flag can be a report from the compliance program. It can be the initiation of a governmental investigation or a private lawsuit. 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. So can a newspaper report detailing illegal behavior. More subtle red flags can be found in aberrations in internally generated data, such as a steep rise in highest bracket billing claims from 31% to 76% and then to 93%, when the hospital across the street is only billing 28%

49 McCall v. Scott, 239 F.3d 808, 818-19 (6th Cir. 2001).
of its claims at the highest rate. The directors in *McCall* had almost all of these red flags waved before them.\(^{50}\)

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. The court was not persuaded that the decree was “cause for suspicion”\(^{51}\) so as to require the directors to “ferret out wrongdoing.”\(^{52}\) Despite this inauspicious beginning to the jurisprudence of red flags, recent decades have witnessed 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.*,\(^{53}\) the court agreed with the plaintiffs that an abrupt shift in lending patterns between MCHC and its affiliates raised a red flag. 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.\(^{54}\) 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.\(^ {55}\) 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.”\(^{56}\) The

\(^{50}\) *Id.* at 818-21.
\(^{52}\) *Id.*
\(^{54}\) *Id.*
\(^{55}\) *Id.*
\(^{56}\) *Id.*
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

willingness of the *Dobler* court to treat this conceivably innocuous pattern of transactions as a red flag indicates that the courts have come a long way 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*, the Court of Chancery, dismissing an amended complaint for failure to show that demand should be excused, demonstrated a restrictive attitude toward red flags. 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. The following paragraph from the court’s brief opinion presents a revealing picture of the problems inherent in duty to monitor cases, specifically in understanding what constitutes a red flag.

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 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.

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.

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58 *Id.*
59 *Id.* at *3.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

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 concern 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 much 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. But this conclusion undermines 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 are inherently 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 whose corporate purpose is to sift through voluminous information and funnel significant nuggets 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 too big to manage.

In re Abbott Labs is also a useful case for understanding the Delaware courts’ conception of red flags. Abbot Labs involved the company’s non-compliance with Food and Drug Administration regulations in the manufacture of medical diagnostic devices and kits. After performing a routine inspection of Abbot Labs’ facilities, the FDA sent the company “formal certified Warning Letters.” The Wall Street Journal ran a story reporting on the

60 In re Abbot Laboratories Derivative Shareholders Litigation, 353 F.3d 795 (7th Cir. 2003).
61 Id. at 799.
FDA’s concern. Two years passed without the company remediying the problems. This led to more Warning Letters and more news reports, this time from Bloomberg News.

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. Under the consent decree, Abbott Labs agreed to pay a $10 million fine, suspend operations until it was in full compliance, and withdraw and destroy previously manufactured kits worth an estimated $250 million.

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. Hillary Sale nicely summarized the Abbott Labs 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.

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, then the focus for plaintiffs, of necessity, 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. This is so for two reasons. First, such information is now public, and, so long as it appears in a

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62 Id.
63 Id. at 800.
64 Id.
65 Id. at 801
66 Id.
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 only his own initiative and shoe leather, then it is the sort of information that a reasonably well-designed and implemented compliance program ought to have been able to discover and communicate to the board. Either way, it 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 law will enable competitive forces to test the efficacy of the compliance program under review, and will 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.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

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 a positive contribution to Caremark litigation and, by extension, to both corporate governance and societal welfare. It will also set out a plan by which the courts can step out of the way of competitive forces that can improve the efficacy of 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 been written touching on the intersection of law and journalism. This is, of course, a natural topic in areas of law and legal practice that are intimately connected with the news media. Thus we find a voluminous literature concerning the intersection of journalism and the first amendment. Similarly, articles exploring the techniques lawyers may employ in using journalists as a public relations tool in

managing litigation are not hard to find. The years since the Valerie Plame – Scooter Libby affair have seen a flowering of law review articles on the journalistic privilege to keep their anonymous sources hidden from governmental inquiry. Still another literature concerns the portrayal of racial minorities in the media and its effect on criminal law and procedure and the rights of defendants.

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, bankruptcy and antitrust law. In recent years, a small literature has emerged on the role of journalists in corporate and securities law and corporate governance.

In a 2007 article, I surveyed the roles of financial journalists in corporate law and corporate governance. 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

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76 Borden, *supra* note 8.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

the agency costs that arise from the divergence of ownership and management that is the hallmark of the corporate form. 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 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.\textsuperscript{77} Many scholars explored the role of gatekeepers – non-governmental actors such as lawyers, bankers, certified public accountants and securities analysts – in preventing corporate wrongdoing.\textsuperscript{78} A few examined the potential of shaming to restrain the unwholesome instincts of corporate actors.\textsuperscript{79} My article focused on journalists.

Among the various functions that journalists have performed are investigating fraud,\textsuperscript{80} catalyzing legal process by calling wrongdoing to the attention of governmental actors and private lawyers,\textsuperscript{81} promoting deterrence through shaming,\textsuperscript{82} and affecting legislative process.\textsuperscript{83} For each of these categories, the article chronicled actual cases in which journalists had

\textsuperscript{77} Michael Klausner, \textit{The Limits of Corporate Law in Promoting Good Governance}, in \textsc{Restoring Trust in American Business} 91, 97-8 (Jay W. Lorsch, Leslie Berlowitz & Andy Zelleke eds., 2005).

\textsuperscript{78} \textit{See} Jill. E. Fisch & Hillary A. Sale, \textit{The Securities Analyst As Agent: Rethinking the Regulation of Analysts}, 88 \textsc{Iowa L. Rev.} 1035, 1040-56 (2003); \textit{see generally} John C. Coffee, Jr., \textit{Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms}, 84 \textsc{B.U. L. Rev.} 301 (hereinafter Coffee, Gatekeeper Failure); John C. Coffee, Jr., \textit{Understanding Enron: “It’s About the Gatekeepers, Stupid,”} 57 \textsc{Bus. L.J.} 1403 (2002) (hereinafter Coffee, Understanding Enron).


\textsuperscript{80} Borden, \textit{Financial Journalists, supra} note \textsuperscript{__} at 332-56.

\textsuperscript{81} Id.; Michael J. Borden, \textit{PSLRA, SLUSA, and Variable Annuities: Overlooked Side Effects of a Potent Legislative Medicine}, 55 \textsc{Mercer L. Rev.} 681 (2004)

\textsuperscript{82} Id.

\textsuperscript{83} Id.
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 – cases involving director liability for failure to monitor illegal 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.\textsuperscript{84} 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. But in derivative actions, courts almost never take a close look at 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 a motion for summary judgment.

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 governmental legal process that benefits society by putting an end to the illegal activity.\textsuperscript{85}

\textsuperscript{84} Id. at 343-50.
\textsuperscript{85} See In re Abbot Laboratories Derivative Shareholders Litigation, 353 F.3d 795 (7\textsuperscript{th} Cir. 2003).
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

B. There is Good Reason to Believe That Journalists Can Serve This Function

Journalists can be very effective in detecting a wide variety of corporate misbehavior. Although there are limits to the kinds of contributions journalists can be expected to make to corporate law and corporate governance; for example, they should not be expected to be able to detect merely inefficient management, they are good at detecting affirmative wrongdoing. They do this in a variety of ways. They cultivate contacts within both corporations and governmental agencies, they receive information from leakers or whistleblowers, and at their best, the 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, for several reasons, 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 foundation, unflattering, but not illegal 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 SEC v. Dirks,86 a well-known insider trading case that is also a fascinating illustration of the role of financial journalists in corporate governance. In Dirks, a company called Equity Funding was engaged in a massive financial fraud.87 An employee named Ronald Secrist informed Raymond Dirks, a securities analyst covering the company, about the scheme.88 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

87 Id. at 649-50.
88 Id.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

SEC would, in turn, investigate the company.89 Blundell’s editors refused to publish Blundell’s story, fearing a libel suit.90 The information finally came out, but in a roundabout fashion that led to Dirks being investigated for insider trading violations.91 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 objection is that journalists lack the resources and expertise to sufficiently monitor corporate fraud. 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 the great majority of Caremark cases. For several reasons, this may be true. Securities analysts have much greater technical expertise than financial journalists, are well 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 a huge financial incentive to know the truth about a company’s financial status. In sum, securities analysts’ superior position with respect to resource, expertise, access and incentives argue powerfully that journalists are unlikely to add any value to the search for truth in corporate financial reporting.

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 relates to the fact that there exists in every public corporation substantial redundancy in the development, review and reporting of financial information. Companies generate their own financial numbers and those financial statements are...

89 Id.
90 Id.
91 See Borden, Financial Journalists, supra note ___ at 364-66 (discussing the intersecting roles of journalists and securities analysts).
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

audited by independent auditors. Part of the audit includes a review of what is known as internal controls, that is, systems in place to prevent fraud. So there is internal generation of data, which includes internal controls, then outside review by independent auditors, and 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.

This is not to suggest that fraudulent financial reporting doesn’t exist. Rather, given the highly 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. That is not uncommon. But in such cases, it is much more likely that the securities analysts will detect the fraud than that journalists will. 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.

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92 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. See Borden, Financial Journalists, supra note __ at 335-38.
III. 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. The fact that in each case, the journalists discovered the information before the respective corporation’s compliance system discovered and reported the information to the board, supports the claim that Delaware’s good faith standard has been insufficient to induce the level of monitoring that directorial fiduciary duty entails.

*McCall v. Scott*\(^{93}\) 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. HCA had become the target of multiple federal investigations for fraud. Management had set aggressive targets for profit growth across its network of hospitals.\(^{94}\) The plaintiffs alleged that the firm could only meet these growth targets by violating federal Medicare and Medicaid laws and regulations.\(^{95}\) Specifically, the plaintiffs alleged that HCA\(^{96}\) employees engaged in widespread “upcoding” – billing Medicare and Medicaid at for more costly interventions than those actually required or provided.\(^{97}\)

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

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\(^{93}\) McCall v. Scott, 239 F.3d 808, 818-19 (6th Cir. 2001).
\(^{94}\) *Id.* at 819
\(^{95}\) *Id.*
\(^{96}\) The alleged wrongdoing occurred before the merger of Columbia Health System, Inc and HCA.
\(^{97}\) *Id.*
interested or lacked independence” when the complaint was filed.98 The circuit court reversed this decision under the demand futility test of Rales v. Blasband,99 which requires the court to determine “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.”100 The appellate 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.”101 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.102 The Times’ investigation included a sophisticated statistical analysis of over 30 million records of Medicare patients treated in hospitals in Florida and Texas in 1995. This enormous data set included both patients treated by HCA and, for comparison, patients treated by other providers.103 In this remarkable study, the reporters

matched 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

98 Id.
99 634 A.2d 927 (Del. 1993).
100 Id. at 932.
101 Id.
103 Id.
conditions. Costs figures and referral rates were then calculated and adjusted to account for differences in conditions.\textsuperscript{104}

During the course of this investigation, the Times reporters met with certain unidentified HCA officials to discuss their reporting.\textsuperscript{105} They also contacted the federal Medicare agency, which pursued its own investigation.\textsuperscript{106} Eventually, the FBI conducted an extensive investigation which culminated in raids of several HCA offices in 1997. \textsuperscript{107} 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.\textsuperscript{108}

Because of the procedural posture of the case, the circuit court opinion did not include any finding 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 the conclusion, under the demand futility test of \textit{Rales v. Blasband}, that the plaintiffs’ allegations did, in fact, present 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.\textsuperscript{109} 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.

\textsuperscript{104} \textit{Id.}
\textsuperscript{105} \textit{Id.}
\textsuperscript{106} \textit{Id.}
\textsuperscript{107} \textit{Id.}
\textsuperscript{109} McCall v. Scott, 634 A.2d 927, 935.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

*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 be crucial to the ability of plaintiffs to have their case heard and obtain a recovery.

*In re SFBC International Securities and Derivative Litigation*\(^{110}\) presents another case where journalists were the first to uncover highly dangerous 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.\(^{111}\) Between 2003 and 2006, PDG was operating clinical trials in Florida and in two cities in Quebec Province, Canada.\(^{112}\) 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.\(^{113}\) For a number of years, PDG practices resulted in large profits and impressive growth.

As it turned out, PDG’s clinical practices involved staggering ethical violations which caused severe health problems for several of its study participants and endangered the safety of many others. What is more, PDG schemed to conceal its actions by engaging two Institutional Review Boards\(^{114}\) (IRBs), which were unable to render objective analyses of PDGs clinical practices because of conflicts of interest. One of the IRBs, known as Lee Coast, shared offices with a subsidiary of PDG.\(^{115}\) Plaintiffs alleged that employees of this IRB were “paid directly by


\(^{111}\) *Id.* at 480.

\(^{112}\) *Id.*

\(^{113}\) *Id.*

\(^{114}\) 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.

\(^{115}\) *Id.* at 481.
PDG’s accounting office and that Lee Coast did not maintain its own books and records.” The other, Southern IRB, was owned by the wife of one of the defendants, a vice president of clinical operations. Without an impartial 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. Their reporting culminated in the publication of a 28 page report 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. Volunteers were enrolled in “back to back trials . . . without adhering to minimum waiting requirements.” PDG “threatened to arrange federal deportation of Latin American immigrants who disclosed health risks in clinical trials.” Volunteers at a testing center contracted tuberculosis, and were not quarantined, resulting in the spread of the disease to other study participants. The reporters interviewed professors of medicine from Harvard Medical School and the University of Minnesota Medical School, who condemned PDG’s practices. One said, “once they 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.” Another opined that “this story suggests a serious lapse in the most basic care of

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116 Id. at 481.
117 Id.
119 Id.
120 Id.
121 Id.
122 Id.
123 Id.
patients exposed to a known communicable disease. The breach of responsibility is egregious.”

After Bloomberg published its information about PDG, the SEC, FDA and the United States Senate undertook investigations of 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.

IV. Delaware Should Change its Approach to Demand Futility and Good Faith Where Journalists Get the Story First

In summary we have seen that there are significant problems with the jurisprudence of Caremark. On its face, Caremark and its author tell us of its impotence. Fifteen years of litigation experience confirms its inadequacy as an inducement to vigorous monitoring. On a more detailed level, what is wrong with it is the overall weakness of the good faith standard, compounded by the difficulties of demand, especially as applied in cases like Wood and DeSimone, and to a lesser extent, an ambivalent attitude toward red flags.

These elements have combined make it very difficult for plaintiffs to get past a motion to dismiss, which courts commonly grant basis of the demand requirement. As a result, the law shields directors from ever having to reveal the actual workings of their compliance programs and leaves directors free to render themselves willfully blind to evidence of illegality; compliance programs have become paper tigers, or at least are encouraged by law to become

124 Id.
125 Kristy Barnes, Troubled SFBC Changes its Name in Hope of Changing its Fortunes, OUTSOURCING-PHARMA.COM, August 31, 2006.
126 Caremark, 698 A.2d at 971.
127 See supra pp. 8-9.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

paper tigers, and the real world result is that the public is harmed by illegal and dangerous corporate conduct.

What, then, can we do 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. But from the standpoint of legal process, it proved its value in assisting the federal government in bringing HCA into conformity with law, while saving 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 thus reduce social harm.

In order to unleash these potential contributions 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, the Delaware courts should adopt a
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

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 non-feasance (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.”128 Other recent cases impose a scienter requirement, under which plaintiffs must show that a majority of the board knew or should have known that their 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 program.129

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 only too 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 is not the same as internal controls in

128 230 F.3d 808, 818-19 (6th Cir. 2001).
129 DeSimone v. Barrows, 924 A.2d 907, 934-35 (Del. Ch. 2007)
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 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.”

130 Caremark, 698 A.2d. 959 at 971.
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

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 empirical experience strongly supports this prediction. Nevertheless, the Circuit Court 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.¹³¹ 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 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 are unable to make such a showing, 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*

¹³¹ 230 F.3d 808, 818-19 (6th Cir. 2001).
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 of all, 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 program. 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.” One such tool is a request for corporate records pursuant to section 220 of the DGCL. Records requests rarely yield meaningful information both because the plaintiff must

\footnote{132 See, e.g., Brehm v. Eisner, 746 A.2d 244, 248 (Del. 2000).}
\footnote{133 DEL. CODE ANN. Tit. 8 § 220 (2011).}
Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

essentially know exactly what just what document she is seeking when making the request,\textsuperscript{134} and also because corporate executives are well versed in the art avoiding paper trails in the minutes of board meetings – the easiest sort of record to obtain under section 220. The other sources of information referred to as the tools at hand are SEC filings and news media reporting.\textsuperscript{135} 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. But ironically, one finds opinion after opinion dismissing derivative actions deriding plaintiffs for relying simply on newspaper reports.\textsuperscript{136}

Doubtless there may be many cases in which complaints are hurriedly prepared in a race to the courthouse to win what Vice Chancellor Strine has called the “filing Olympics.”\textsuperscript{137} Nuisance suits are, to be sure, a problem, and 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 probably deserve the back of the judicial hand. But 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 \textit{McCall}\textsuperscript{138} and \textit{SFBC}.\textsuperscript{139} This sort of newspaper report deserves particular attention by the courts, and special treatment at the pre-trial stages.

\textbf{D. Red Flags}

\textsuperscript{134} The scope of a section 220 request is much more limited than civil discovery. \textit{See Saito v. McKesson HBOC, Inc.}, 806 A.2d 113, 114 (Del. 2002). Rather, a shareholder plaintiff must “make specific and discrete identification, with rifled precision, of the documents sought.” Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000).
\textsuperscript{135} Brehm v. Eisner, 746 A.2d 244, 248 (Del. 2000).
\textsuperscript{136} \textit{See, e.g., In re Citigroup Shareholders Litigation}, \textsuperscript{\textsuperscript{136}} 2003 WL 21384599 at *2 (Del. Ch. 2003).
\textsuperscript{137} King v. VeriFone Holdings, Inc. 994 A2d 354 at 362 (Del. Ch. 2010).
\textsuperscript{138} 230 F.3d 808 (6th Cir. 2001).
\textsuperscript{139} 495 F. Supp. 2d 477 (D.N.J. 2007).
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.\textsuperscript{140} Other cases, like \textit{In re Citigroup}, demonstrate a judicial inclination to excuse a board’s ignorance of prominent red flags, particularly with large corporations.\textsuperscript{141} This tendency appears to reflect two considerations. For one thing, 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.\textsuperscript{142} For a 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. But 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 law suits. 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 many claims made upon their time by big picture considerations both inside the corporation and in their lives outside of the corporation, this concern is misplaced. It is the job of the compliance department to review

\textsuperscript{141} 2003 WL 21384599 (Del. Ch. 2003).
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 would do well to keep an open mind about treating serious journalistic reporting as doctrinally significant red flags, and turn away from the restrictive biases on display in cases like Citigroup.143

Conclusion

The foregoing has demonstrated that journalists can and should play an important role in Caremark litigation. Talented and well-resourced journalists have demonstrated 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

Of Outside Monitors and Inside Monitors: The Role of Journalists in Caremark Litigation.

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 that is “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.