LEAD ARTICLE

CAREMARK'S BUTTERFLY EFFECT

ANGELA N. ANEIROS[*] AND KAREN E. WOODY[**]

In 1996, the Delaware Court of Chancery detailed the minimum standard for corporate boards of directors ("board") with regard to corporate compliance programs and monitoring protocols. The landmark Caremark *decision held that directors would not face liability for a breach of fiduciary duties unless they failed to implement a system of controls and compliance, or knowingly failed to monitor that system. In order to bring a successful* Caremark *claim, plaintiffs must prove that the board operated in bad faith by failing to exercise oversight in a sustained or systemic way. The Delaware Court of Chancery opinion noted that the theory underpinning a* Caremark *claim is one of the most difficult for plaintiffs to prove. As a result, boards have enjoyed nearly unlimited protection, regardless of events occurring at the company on their watch. However, this longstanding protection has begun to wane in the past four years.*

This Article contributes to the analysis of the recent shift in Caremark *claims in three ways. First, the Article details the recent evolution of the* Caremark *standard for corporate compliance required by corporate board members. Second, the Article analyzes how* Caremark*'s evolution will impact the Directors & Officers ("D&O") insurance market and what that means for corporate executives. D&O insurance plays a critical role in protecting directors and officers, who have until recently been seemingly beyond the reach of successful shareholder litigation. While the success of bringing a* Caremark *claim is still very much an uphill battle, the risk calculus has shifted, and this shift is seen in D&O insurance. Finally, the Article discusses the impact of the* Caremark *standard within current regulatory trends that corporate executives need to continue to monitor. Given the likelihood of increasing regulations in new areas, including environmental, social, and corporate governance (ESG) and*

[*] Visiting Assistant Professor, *Gonzaga University School of Law.*
[**] Associate Professor, *Washington & Lee University School of Law.*

cybersecurity, the pressure for corporate compliance and board action will continue to increase. The result: an increase in the number of Caremark *claims, further oversight expectations on directors and officers, and additional pressure on D&O insurance coverage.*

TABLE OF CONTENTS

Introduction 721
I. Derivative Lawsuits and the Business Judgment Rule 725
A. Who Is to Blame and Who Has Been Harmed? 726
B. Procedure of a Derivative Lawsuit 728
1. The derivative lawsuit high pleadings requirement 729
2. The demand requirement and business judgment rule 729
3. Demand futility and the evolution of section 220 730
II. The *Caremark* Standard 734
A. Before *Caremark* 734
B. *Caremark* 736
C. *Caremark* in Action 740
III. *Caremark* "Plus" 741
A. *Marchand*: "Mission Critical" 742
B. *Clovis Oncology* 747
C. *Hughes v. Xiaoming Hu* 750
D. *Teamsters Local 443 Health Services & Insurance Plan v. Chou* 755
E. Boeing 759
IV. The Effect of *Caremark*'s Creep on D&O Insurance 764
A. Fundamentals of D&O Insurance Coverage 764
B. The Mechanics of D&O Insurance: A Hypothetical 768
C. Consequences of Caremark's New Standard for D&O Insurance and Corporate Directors 769
D. Looking Forward: Hot Topics Demanding Further Board Oversight 773
1. ESG 774
2. Cybersecurity 775
Conclusion 776

INTRODUCTION

"Wearing a t-shirt bearing a photo of Amma Tesfamariam in her flight attendant uniform, Meselech Petros said her twenty-eight-year-old sister was not supposed to work last Sunday, but came in to cover for a friend."[1] "'What I can't forget is that she left an eight-month-old child and didn't come back,' Meselech said."[2]

On March 10, 2019, Ethiopian Airlines Flight 302, en route from Addis Ababa to Nairobi, plummeted downwards only six minutes into the flight, killing all 157 people on board.[3] Amma Tesfamariam was one of them.[4] Many of those on board the plane when it crashed were aid workers, hailing from thirty-five different countries.[5] The force of the impact of the nose-diving plane left "few bodies intact."[6] Grieving families and friends went to the area where the plane went down, and because they were unable to identify the bodies of their loved ones, they filled plastic water bottles with "earth from the crash site".[7]

The crash of Ethiopian Airlines Flight 302 was tragic and shocking; however, what is most shocking is that it was preventable. Just five months prior to the crash, a Lion Air flight out of Indonesia suffered the exact same system failure as the Ethiopian Air flight.[8] In the Lion Air crash, 189 people died when the plane crashed into the Java Sea.[9]

---

1. *Ethiopian Boeing 737 Black Boxes Show 'Clear Similarities' with Indonesian Crash*, FR. 24 (Mar. 18, 2019, 9:05 AM), https://www.france24.com/en/20190317-ethiopian-boeing-737-black-boxes-clear-similarities-indonesian-lion-air-crash [https://perma.cc/ML2H-G7EY].
2. *Id.*
3. *Id.*; David Slotnick, *The Second Boeing 737 Max Crash Happened a Year Ago, Here's What Went down, the Unanswered Questions, and the Ongoing Fallout*, BUS. INSIDER (Mar. 10, 2020, 12:12 PM), https://www.businessinsider.com/boeing-737-max-ethiopian-airlines-302-crash-year-2020-3 [https://perma.cc/KHB9-8A4L].
4. FR. 24, *supra* note 1.
5. *Id.*; David Gelles, Natalie Kitroeff & Hadra Ahmed, *Boeing Scrambles to Contain Fallout From Deadly Ethiopia Crash*, N.Y. TIMES (Mar. 11, 2019), https://www.nytimes.com/2019/03/11/business/ethiopian-airline-crash.html?action=click&module=Top%20Stories&pgtype=Homepage [https://perma.cc/QM5Q-UVS6]; Jeff Wise, *6 Minutes of Terror: What Passengers and Crew Experienced Abroad Ethiopian Airlines Flight 302*, N.Y. MAG. (Apr. 9, 2019), https://nymag.com/intelligencer/2019/04/what-passengers-experienced-on-the-ethiopian-airlines-flight.html [https://perma.cc/9WQC-8TZ7].
6. FR. 24, *supra* note 1.
7. *Id.*
8. Gelles et al., *supra* note 5.
9. *See* Hannah Beech & Keith Bradsher, *At Doomed Flight's Helm, Pilots*

In both flights, the reason for the crash was a faulty sensor onboard the Boeing 737 Max airplane.[10] The plane software used the sensor readings to adjust the moveable horizontal tail.[11] When the sensor failed, the plane software automatically activated the tail which pointed the nose directly at the ground.[12] The pilots were unaware of the faulty sensor and were not adequately trained in how to override the automatic nosedive.[13] Pilots had raised this issue to the Federal Aviation Administration (FAA), and engineers at Boeing also had raised alarm bells prior to the fatal Lion Air and Ethiopian Air crashes.[14] In other words, the crash of the Ethiopian Airlines flight, and likely that of Lion Air as well, was foreseeable.

Who or what should be held to account in the wake of such tragedies? Certainly, Boeing, the plane manufacturer, should pay a severe penalty for causing the crash. But what about Boeing's leadership? Do they have the blood of hundreds on their hands, and should they be held *personally* responsible for being at the helm of a company that failed to keep safety standards? While this question is understandable and valid, it is not, unfortunately, a specific question that corporate law allows.

Instead, the risk of personal liability for directors is predicated upon a lawsuit brought by shareholders, not the actual victims of corporate malfeasance. In other words, the families of the crash victims of the Ethiopian and Lion Airlines flights are not the plaintiffs in the *In re Boeing Company Derivative Litigation*[15] case detailed below.[16] Rather, the plaintiffs are shareholders who lost money when the corporation's stock plummeted following the catastrophic events.[17] Moreover, the shareholders did not bring the lawsuit on their own behalf—they sued on behalf of the company itself.[18] Meaning, the shareholder plaintiffs were not complaining that they individually lost money, but instead

May Have Been Overwhelmed in Seconds, N.Y. TIMES (Nov. 8, 2018), https://www.nytimes.com/2018/11/08/world/asia/indonesia-plane-crash-last-moments.html?module=inline [https://perma.cc/HPZ4-RKRH].

10. Slotnick, *supra* note 3.
11. *Id.*
12. *Id.*
13. *Id.*
14. *See infra* Section III.E.
15. No. 2019-0907-MTZ, 2021 WL 4059934, at *1 (Del. Ch. Sep. 7, 2021).
16. *See infra* Section III.E.
17. *See infra* Section III.E.
18. *See infra* Section III.E.

that Boeing, the company, was injured.[19] You read that right—the lawsuit holding Boeing directors personally liable was a lawsuit that claimed the corporation was harmed by its directors' failure to keep and monitor compliance standards.[20]

This is the issue that was faced by the Delaware Court of Chancery, and the one that sets the stage for this Article: when should boards and management be held personally liable for corporate injury when there are failures in corporate compliance?[21]

Corporate management is afforded a wide berth to make decisions regarding the business affairs of a company. Occasionally, business decisions result in some form of corporate injury, which is typically a decrease in the company's share price. The fact that a company's stock drops in value does not mean that officers and directors will be held liable for corporate mismanagement. Shareholders will not prevail in a lawsuit simply because they are angry that their stock is less valuable. This concept is canonized in the business judgment rule, which holds that management is free to make business decisions without fear of liability, provided management is not breaching their fiduciary duties to the corporation.[22] In sum, it is very difficult for plaintiff-shareholders to succeed in a lawsuit against corporate management unless they have proof that the officers and directors breached their fiduciary duties.[23]

In re Caremark International Inc. Derivative Litigation,[24] a 1996 decision by the Delaware Court of Chancery, enshrines the business judgment rule and the idea that directors will not be held liable absent evidence of their bad faith.[25] The *Caremark* opinion itself called the theory underpinning its decision the "most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[26] To get past

19. *See infra* Section III.E.
20. *See infra* Section III.E.
21. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–69 (Del. Ch. 1996).
22. *E.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (en banc), *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).
23. *See* Marchand v. Barnhill, 212 A.3d 805, 820–21, 824 (Del. 2019) (en banc) (stating that *Caremark* plaintiffs must show that a fiduciary acted in bad faith by violating their duty of loyalty); Fisher v. Sanborn, No. 2019-0631, 2021 WL 1197577, at *7 (Del. Ch. Mar. 30, 2021) ("Either prong of *Caremark* 'requires a showing that the directors knew that they were not discharging their fiduciary obligations.'" (quoting Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (en banc))).
24. 698 A.2d 959, 967–69 (Del. Ch. 1996).
25. *Id.* at 967–69.
26. *See id.* at 967.

the motion to dismiss stage when pursuing a *Caremark* claim (1) directors must establish a system to monitor and evaluate corporate compliance, and (2) directors cannot ignore that compliance system.[27] *Caremark* therefore provides a floor, or bottom threshold, that directors must meet. The floor for compliance, for nearly two decades, has been essentially "not nothing"—meaning, it would not weigh in on its effectiveness.[28]

However, recently Delaware courts have given plaintiffs a slightly better playing field. Since 2019, there have been a handful of high-profile cases where the Delaware courts have denied director-defendants' motions to dismiss—an exceedingly rare disposition that serves as a precedent for future plaintiffs.[29] Each of those cases, described in depth below, consists of fairly egregious facts suggesting breaches of fiduciary duty.[30] Nevertheless, the Delaware court found in each case that the *Caremark* standard had been met by the plaintiff's pleadings, suggesting a shift in the once impenetrable *Caremark* standard.[31]

While the shift from the baseline *Caremark* standard and broad protection of the business judgment rule is subtle, its effect has and will ripple into an oft-overlooked area: the D&O insurance market. This Article is one of the first and only articles to consider the shift in

---

27. *See* Guttman v. Huang, 823 A.2d 492, 493–94, 505–06 (Del. Ch. 2003) (explaining that pursuing a *Caremark* claim is demanding because it requires particularized facts "showing that the directors were conscious of the fact that they were not doing their jobs," with the particularized facts typically only arising in the specific case of a sustained or systematic failure of the board to exercise oversight).

28. As discussed throughout this Article, there are a few ways that plaintiffs can "piggyback" on the work of regulatory bodies to make a successful *Caremark* claim. Often, plaintiff-shareholders can infer a *Caremark* claim when there is evidence that the company's corporate management consciously violated positive law. *See infra* Part III. Meaning, when a corporation fails to comply with a regulation or law, shareholders likely will begin looking into a potential lawsuit based upon the lack of board oversight. *See* Carliss Chatman & Tammi Etheridge, *Federalizing Caremark*, UCLA L. REV. (forthcoming 2023), https://ssrn.com/abstract=4164152 [https://perma.cc/3WKV-5FAS] (stating that "a failure to comply with federal rules and regulations signals a breach of loyalty and thus grants shareholders an increased chance of recovery"). If a regulatory body successfully brings an enforcement action against a company, plaintiffs have a strong basis for arguing that compliance at the company was not taken seriously by the board, if there was a compliance program at all. *See infra* Part III for cases where plaintiffs make this argument.

29. *See infra* Part III (analyzing the relevant cases).

30. *See infra* Part III.

31. *See infra* Part III.

the *Caremark* standard as it applies to D&O insurance. While the CFO was once viewed as the most important manager of risk, D&O insurance carriers have turned their focus to the board as a critical party in mitigating risk. The connotation of this change in perception is in part due to the new standard set by recent *Caremark* claims.[32] This Article examines the true impact of the courts' decisions in recent *Caremark* claims on corporate law—risk management for corporate directors. Further, this Article discusses how the potential for compliance issues or failures will continue to increase with the expansion of corporate regulations, such as in the ESG space.

This Article consists of four parts. Part I describes the substance and procedure in Delaware courts that allow plaintiff-shareholders to sue corporate directors and officers for mismanagement. Further, this Section details the basis of the business judgment rule and the requirements to rebut the rule. Part II outlines the background and purpose of the *Caremark* standard in Delaware courts, and provides an overview of how impenetrable the *Caremark* standard has been until recently. Then, Part III details the evolution of *Caremark* by discussing the recent cases in which the *Caremark* standard has seemingly shifted. Finally, Part IV analyzes the effect of the "*Caremark* creep" on the D&O insurance market. Part IV also addresses additional areas in which boards' reliance on the *Caremark* standard will be put to the test as shareholders and other stakeholders demand more oversight into areas including ESG and cybersecurity.

I. DERIVATIVE LAWSUITS AND THE BUSINESS JUDGMENT RULE

When a catastrophic event occurs, when does the buck stop with management? More importantly, when can management be held personally liable for creating corporate injury? Officers and directors owe fiduciary duties to shareholders as well as to the corporation itself.[33] These fiduciary duties include acting in good faith, promoting the best interests of the company, and providing corporate oversight.[34]

---

32. See *infra* Part IV.

33. Denise M. Alter, *Corporate Art Collecting and Fiduciary Duties to Shareholders: Legal Duties and Best Practices for Directors and Officers*, 2009 COLUM. BUS. L. REV. 1, 7 (2009); *see, e.g.*, Miller v. McDonald (*In re* World Health Alts., Inc.) 385 B.R. 576, 592–93 (Bankr. D. Del. 2008) (discussing how the *Caremark* decision itself suggests that officers owe the same fiduciary duties as directors to the corporation and shareholders).

34. B. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 879–83 (1996) (noting that "[d]irectors owe duties of loyalty,

But what happens when corporate boards and officers breach those fiduciary duties? The answer is that the injured party sues. This corporate law concept is actually trickier than it might seem at first blush. Consequently, this Section walks through the reasons and process for bringing a derivative lawsuit.

A. Who Is to Blame and Who Has Been Harmed?

When shareholders invest in a company, they expect the board and officers to act in their best interest. This expectation is set by the fact that corporate directors and officers owe fiduciary duties to the shareholders, which include two components: care and loyalty.[35] The duty of care requires a director to exercise reasonable skill, diligence, and care when making business decisions.[36] The duty of loyalty requires directors to place the interest of the organization, and therefore the shareholders, ahead of their own interests.[37] But what happens when corporate boards or officers breach their fiduciary duties? And who is harmed when corporate boards or officers breach their fiduciary duties?

Understandably, shareholders are often the first party thought to be harmed by a breach of fiduciary duties. In this scenario, a shareholder or group of shareholders, may bring a direct lawsuit against the company alleging direct harm by the breach.[38] For example, when the

---

good faith, and care to the corporation and its shareholders" and outlining what each of these duties require); *e.g.*, Alter, *supra* note 33, at 8 n.18 (stating the duty of good faith involves "acting honestly and dealing fairly," the duty of loyalty involves "avoiding acting in a self-interested manner to the corporation's detriment," and the duty of care involves "expressing the need to pay attention, to ask questions, and to act diligently"); Marchand v. Barnhill, 212 A.3d 805, 809, 820 (Del. 2019) (en banc) (stating a duty of corporate oversight includes overseeing the company's operations and monitoring the its operational viability, legal compliance, and financial performance; failing to ensure that a reasonable information and reporting system exists breaches this duty); *see also* Priya Cherian Huskins, *Duty of Oversight Claims: Hard to Prove but Boards Need to Be Proactive*, WOODRUFF SAWYER (Mar. 3, 2021), https://woodruffsawyer.com/do-notebook/duty-oversight-claims-proactive [https://perma.cc/9REA-MF6C] ("The duty of corporate oversight is part of a director's fiduciary duty of loyalty to monitor a company's operations").

35. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1156 (1990).

36. *Id.*

37. Taylor, *supra* note 34, at 879.

38. *See* Elizabeth J. Thompson, Note, *Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?,* 35 J. CORP.

board refuses to declare a dividend despite a surplus of net profits, shareholders may sue the corporation and the board members for refusing to act in their best interest.[39] Here, the shareholder is seeking a monetary remedy directly from the company for the benefit of the shareholder.[40]

But often, the company itself is harmed by the board and officers' breach of fiduciary duties. Who should be held liable for this harm? Arguably, the board members and officers who breached their fiduciary duties should be held liable to the company. However, responsibility for bringing a claim on behalf of the company lies with the board and officers.[41] It is obviously unlikely the board or officers would bring a claim against themselves.[42] Therefore, a mechanism has been created for shareholders to stand in the shoes of the company: derivative lawsuits.[43]

Unlike a direct claim, a derivative suit is not brought for the benefit of the shareholder herself. In a derivative lawsuit, a shareholder can bring a lawsuit on *behalf* of the company naming its board and officers as defendants.[44] Here, the plaintiff-shareholder must allege the company was harmed by the directors' or officers' breach of fiduciary

---

L. 215, 219–22 (2009) (explaining why shareholders prefer direct suits and the three tests courts use to determine whether an action is direct).

39. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 682–83, 685 (Mich. 1919) (holding that shareholders may sue a corporation over an arbitrary refusal to distribute funds to stockholders when a company has a surplus net profit that it can divide among its shareholders without detriment to the business).

40. *In re* Medtronic S'holder Litig., 900 N.W.2d 401, 406 (Minn. 2017).

41. Hughes v. Xiaoming Hu, No. 2019-0112, 2020 WL 1987029, at *9 (Del. Ch. Apr. 27, 2020); *see also* DEL. CODE ANN. tit. 8, § 141(a).

42. *Compare* Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 AM. BUS. L.J. 475, 481–82 (2007) (pointing out that a policy rationale for the business judgment rule is that granting deference to directors and decreasing their risk of liability encourages qualified persons to serve and make decisions in the best interest of the company), *with* Pearce v. Superior Ct., 197 Cal. Rptr. 238, 242 (Cal. Ct. App. 1983) (acknowledging that while directors and officers can decide impartially on the advisability of suing outsiders that wronged the corporation, they "cannot be expected to sue themselves for their own misdeeds" to the corporation).

43. Ross v. Bernhard, 396 U.S. 531, 534–35 (1970).

44. *See* Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 NOTRE DAME L. REV. 75, 81 (2008) (noting how the shareholder may receive an indirect benefit from the suit based on their share in the company but will not receive a direct financial benefit, making the suit derivative rather than direct); David W. Locascio, Comment, *The Dilemma of the Double Derivative Suit*, 83 NW. U. L. REV. 729, 729 (1989).

duties.[45] Derivative suits provide an individual shareholder the ability to bring suit to enforce a corporate cause of action against the board and officers in order to obtain restitution.[46] A derivative suit is virtually the only mechanism for holding management accountable for its wrongs against the company.[47] Any monetary damages awarded to the plaintiff-shareholder in a derivative suit are paid to the corporation, not the individual shareholder.[48] This difference is significant for several reasons, particularly, because of a director's indemnification rights. Under a derivative suit, amounts paid in a settlement or judgment typically cannot be reimbursed.[49] Consequently, a director's risk exposure in derivative suits can be extremely high. Fortunately for directors and officers, derivative suits are not easy cases for a plaintiff to bring.

B. Procedure of a Derivative Lawsuit

First and foremost, in order to bring a derivative lawsuit, the plaintiff-shareholder must demonstrate a right to stand in the company's shoes.[50] Because the power to make decisions for the company lies with

---

45. Erickson, *supra* note 44, at 81.

46. *See* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) ("[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'") (quoting Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949)). Shareholder derivative suits have long been recognized as a way for shareholders to hold directors and officers accountable for misconduct.

> [A] stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management. The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.

Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *see also Ross,* 396 U.S. at 534 (stating how derivative suits permit an individual shareholder to bring suit to "enforce a *corporate* cause of action against officers, directors, and third parties").

47. *Pearce,* 197 Cal. Rptr. at 242.

48. Erickson, *supra* note 44, at 81.

49. DEL. CODE ANN. tit. 8, § 145(b).

50. *See Ross,* 396 U.S. at 534 (explaining that stockholders cannot ordinarily sue directors, but that stockholders can bring a derivative lawsuit on the corporation's behalf when the claim is one on which the corporation could have sued and when the directors refused a demand for action).

the board,[51] courts have significantly restricted shareholders' ability to proceed with a derivative suit, creating very high pleading standards. For this reason, knowing the process to bring a derivative lawsuit is critical to understand how much the deck is stacked against plaintiffs in this process.

1. The derivative lawsuit high pleadings requirement

Among the high pleading requirements, the most essential pre-filing requirement is the "demand requirement."[52] Rule 23.1 of the Federal Rules of Civil Procedure states in relevant part:

> The complaint [in a shareholder derivative action] . . . must state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.[53]

A derivative lawsuit, therefore, requires a plaintiff-shareholder to specifically plead (1) the plaintiff-shareholder made a pre-suit demand on the board, that the board wrongfully refused, or (2) explain the reason for not making the required demand.[54]

2. The demand requirement and business judgment rule

In order to fulfill the demand requirement, the plaintiff-shareholder must be able to show a "demand" to redress the alleged harm done to the company was made on the board or officers.[55] Once a demand is made, the board's refusal of the demand is "subject only to the deferential 'business judgment rule' standard of review."[56] The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith[,] and in the honest belief that the action taken was in the

---

51. Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. 2019-0816, 2020 WL 5028065, at *14 (Del. Ch. Aug. 24, 2020) (citing *Aronson*, 473 A.2d 805, at 811).

52. Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 780 (2002).

53. FED. R. CIV. P. 23.1(b)(3).

54. *See id.*

55. *Id.*; Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule,* 86 OR. L. REV. 973, 997–1000 (2007) (discussing the demand requirement as well as its justification).

56. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 101 (1991) (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 784 & n.10 (Del. 1981)).

best interests of the company."[57] Not only is a board's refusal of a litigation demand subject to the business judgment rule, but the board's actions and decisions that predicate the allegations are also subject to the business judgment rule.[58] In other words, when directors and officers make poor business decisions, those decisions do not create automatic liability for shareholders' losses. Instead, directors and officers are given the wide berth of the business judgment rule to make business decisions without fear of legal liability.

The board's decisions, including refusing shareholder demands, are therefore presumed valid unless the plaintiff-shareholder can rebut the presumption.[59] The burden is on the plaintiff to rebut the presumption by presenting evidence that at the time of making the decision-in-question, the directors were grossly negligent in not becoming adequately informed, not acting in the best interest of the company, or acting in bad faith.[60] This can be extremely difficult for shareholders to accomplish at the pleading stage, because very little, if any, discovery has been conducted.[61] Consequently, the business judgment rule has historically safeguarded directors and officers, and the majority of derivative suits are dismissed at the pleading stage.[62]

3. Demand futility and the evolution of section 220

If the plaintiff-shareholder failed to make a demand, the only alternative is pleading demand futility. The plaintiff-shareholder must comply with stringent standards, which "must demonstrate that demand on the board to pursue the claim would be futile such that the demand requirement should be excused."[63] The plaintiff must set forth particularized facts that "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly

---

57. Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 411 (2013) (quoting Parnes v. Bally Ent. Corp., 722 A.2d 1243, 1246 (Del. 1999)).

58. *Id.*; Morrissey, *supra* note 55, at 997–98.

59. *See* Chatman & Etheridge, *supra* note 28, at 23.

60. *See id.* (quoting *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2005)) (outlining the three categories of "bad faith" behavior by fiduciaries under Delaware law that can rebut the presumption of the business judgment rule: (a) subjective bad faith, (b) a lack of due care, and (c) intentional dereliction of duty).

61. *See* Bebchuk et al., *supra* note 52, at 780–81.

62. *Id.*

63. *See* Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. 2019-0816, 2020 WL 5028065, at *15 (Del. Ch. Aug. 24, 2020) (quoting *In re* Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188, at *11 (Del. Ch. Oct. 1, 2019)).

exercised its independent and disinterested business judgment in responding to a demand."[64] Specifically, a reasonable doubt that "(1) the directors [we]re disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[65] This could include facts that a director was either (1) not independent of the alleged wrongdoing or "interested in the alleged wrongdoing or not independent of someone who is"[66] or (2) faces a substantial likelihood of personal liability themselves.[67]

The first requirement examines whether the directors are independent and disinterested in the alleged wrongful act or decision.[68] The business judgment rule would not apply if a majority of directors were interested.[69] However, the business judgment rule would apply if a disinterested and independent board majority approved the alleged wrongful decision.[70]

The second requirement examines whether the plaintiff has alleged facts with particularity[71] to "support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment."[72] If there is a reasonable doubt to the validity, "the directors could face a sufficient threat of liability from the litigation that demand would be futile."[73] When alleging substantial risk of liability, plaintiffs only need to show that there is a reasonable factual basis for their claim to have merit.[74]

---

64. *Id.* (quoting *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 120 (Del. Ch. 2009)).

65. Hughes v. Xiaoming Hu, No. 2019-0112, 2020 WL 1987029, at *11 (Del. Ch. Apr. 27, 2020) (quoting Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).

66. *Teamsters*, 2020 WL 5028065, at *15 (quoting *Hughes*, 2020 WL 1987029, at *12).

67. Pamela S. Palmer, Alexandra S. Peurach, Howard M. Privette, Bianca DiBella & Samantha K. Burdick, *A New Wave of Board Diversity Derivative Litigation*, TROUTMAN PEPPER (Oct. 21, 2020), https://www.troutman.com/insights/a-new-wave-of-board-diversity-derivative-litigation.html [https://perma.cc/S3S4-8F75].

68. *Hughes*, 2020 WL 1987029, at *11 (quoting *Aronson*, 473 A.2d at 814).

69. *Id.*

70. *Id.*

71. Allegations would include such things as "bad faith, intentional wrongdoing, facts showing that the board 'utterly failed to implement any reporting or information system or controls' or 'knew evidence of corporate misconduct' (red flags) and 'consciously disregarded' a duty to act." Palmer et al., *supra* note 67 at n.ii (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (De. Ch. 1996)).

72. *Hughes*, 2020 WL 1987029, at *11 (quoting *Aronson*, 473 A.2d at 815).

73. *Id.* at *11.

74. *Id.* at *12.

While there are several avenues to plead demand futility, historically, it has been difficult for plaintiffs to plead with the required "particularized facts" the pre-filing requirement mandates without access to discovery.[75] However, plaintiffs do have an avenue for obtaining books and records to develop the necessary facts for pleading purposes: section 220 of the Delaware General Corporation Law.[76]

In the mid-1990s, when denying derivatives claims based on failure to plead the required particularized facts, Delaware courts would point to plaintiffs' failure to use section 220 to obtain such facts.[77] Section 220 provides the record-owner of any number of shares of a corporation's stock a right to inspect corporate books and records 'for "any proper purpose."[78] The statute defines proper purpose as a "purpose reasonably related to such person's interest as a stockholder."[79] A court's decision on whether a shareholder is within their inspection rights turns on two points: purpose and scope.[80]

As explained in detail by Professor Roy Shapira, in recent years, courts have "liberalized" the "proper purpose[s]" requirement and broadened the "permissible scope."[81] It is well established that investigating directors' independence and disinterestedness for purposes of showing demand futility is a proper purpose.[82] However,

75. Bebchuk et al., *supra* note 52, at 780–81 (creating reasonable doubt about either "(1) the directors are disinterested and independent" or (2) the "business judgment rule" does not apply can be "difficult for shareholders to accomplish early in the litigation, especially because the plaintiff has not had the opportunity to conduct discovery"); *see also* Chatman & Etheridge, *supra* note 28, at 5–6 (providing the Facebook Cambridge Analytica Data scandal as an example of the importance of obtaining information and "particularized facts" in order to successfully bring a claim against a company).

76. DEL. CODE ANN. tit. 8, § 220(c) (West 2022).

77. *See, e.g.*, Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1056 (Del. 2004).

78. Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands—Reprise*, 28 CARDOZO L. REV. 1287, 1288 (2006).

79. tit. 8, § 220(b).

80. Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 1949, 1965 (2021).

81. *Id.* at 1953, 1965 (detailing how section 220 rose to prominence and how the courts have expanded the use of section 220 as a pre-filing investigatory tool to assist plaintiffs in collecting the facts required to meet heightened pleading standards).

82. *See* Rock Solid Gelt Ltd. v. SmartPill Corp., No. 7100-VCN, 2012 WL 4841602, at *4 (Del. Ch. Oct. 10, 2012) (stating that plaintiffs are entitled to request documents

shareholders are required to show a credible basis for investigating wrongdoing.[83] It was once believed that only actionable wrongdoing was considered a proper purpose, but "by 2020 the courts clarified that any credible suspicion of wrongdoing" meets the minimal burden for shareholders to make a successful section 220 request.[84]

Turning to "scope," under section 220, plaintiffs bear the burden of showing the requested documents are "necessary and essential" for their stated purpose.[85] "[N]ecessary and essential" means only specific documents that address the stated purpose of the investigation that cannot be obtained elsewhere.[86] Traditionally, shareholders' inspection rights were thought to only include "classic, hard-copy company 'books and records.'"[87] Today, recent cases have expanded *what* internal documents fall within "permissible scope."[88] Courts have clarified that section 220 requests include not only formal electronic documents, but also electronically stored information, regardless of medium, so long as it implicates the company.[89] This includes meeting minutes, and all communication between directors and third parties, such as emails, text messages, LinkedIn messages, and so on.[90]

The liberalization of section 220 has led to more pre-filing investigations.[91] More importantly for the topic at hand, this has the potential to provide additional avenues for shareholders to obtain enough information to plead the particularized facts necessary to show that a pre-suit demand was excused and successfully plead demand

---

to investigate the Special Committee's independence); La. Mun. Police Emps. Ret. Sys. v. Morgan Stanley & Co., No. 5682-VCL, 2011 WL 773316, at *7–8 (Del. Ch. Mar. 4, 2011) (stating a board may not refuse an inquiry by a stockholder that is narrowly tailored to investigate a stated purpose under section 220); Haywood v. AmBase Corp., No. 342-N, 2005 WL 2130614, at *6–7 (Del. Ch. Aug. 22, 2005) (stating that a stockholder is entitled to enough information to investigate potential corporate wrongdoing but not "wide-ranging discovery that would be available in support of litigation").

83. Shapira, *supra* note 80, at 1965.

84. *Id.* at 1966.

85. Roy Shapira, *A New Caremark Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1876 (2021) (citing Saito v. McKesson HBOC, Inc., 806 A.2d 113, 116 (Del. 2002)).

86. *Id.* at 1876.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 1859.

91. *See id.* (noting how four *Caremark* claims succeeded in surviving motions to dismiss from 2019 to 2020 partly because of pre-filing investigations).

futility.[92] While this does not change plaintiffs' uphill battle to win a derivative claim, it does increase the ability for plaintiffs to surpass the first hurdle of a pre-filing demand. Moreover, the combination of pre-filing investigations and the evolution of the *Caremark* standard (discussed in Part III) has had and will continue to have, impactful consequences on the D&O insurance market, as discussed in Part IV.

II. THE *CAREMARK* STANDARD

As described above, there are instances where shareholders sue management and directors on behalf of the corporation. And certainly, there are situations where management actively engaged in malfeasance that damaged the company. But what is the role of boards with respect to prevention of corporate harm? Why should directors have any role in corporate compliance? Meaning, what is the duty of board directors regarding internal controls and compliance programs? In theory, directors have always had an indirect role in corporate compliance through hiring and firing officers of the corporation, because those officers are charged with running a company that complies with positive law.

But when should a board have the responsibility, and therefore potential liability, for overseeing legal compliance within the firm? The answer to that, at least in Delaware, has evolved over the past few decades. Understanding the importance of the *Caremark* decision requires a brief bit of background on the roles of directors under Delaware law,[93] and the central case that predates *Caremark*,[94] all of which sets the stage for the importance of *Caremark* itself. This Part describes the intersection of the board of directors and corporate compliance, and highlights how *Caremark* sets a new norm for boards and their compliance functions. This Part also delineates *Caremark*'s progeny and impact up until 2019.

A. Before Caremark

The first instance where the Delaware court tangled with the idea of whether directors should have a mandatory compliance program was in 1963, thirty-three years prior to *Caremark*.[95] In *Graham v. Allis-*

92. *Id.* at 1859.
93. *See infra* Section I.B.3.
94. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 127 (Del. 1963).
95. *See id.* at 125.

Chalmers Manufacturing Co.,[96] plaintiffs brought a derivative suit against the directors after the company pled guilty to federal antitrust violations.[97] The shareholder plaintiffs sued on behalf of the company for the injuries suffered after the guilty plea, arguing that the directors breached a duty to create a measurement system to prevent antitrust violations.[98] Unsurprisingly, given that *Allis-Chalmers* (and, in particular, the plaintiffs' argument that the defendants breached a duty for failing to have a compliance plan) was a case of first impression, the Delaware Court of Chancery dismissed the complaint.[99] The Delaware Supreme Court affirmed the dismissal, but included interesting language about the duty of directors to adopt a compliance program, or not.[100] Specifically, the court made the very strong statement that directors do not have any such duty, and instead can simply "rely on the honesty and integrity" of management "until something occurs to put them on suspicion that something is wrong."[101] More specifically, "absent cause for suspicion[,] there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[102]

In other words, the Delaware Supreme Court made clear that corporate compliance does not fall on directors. Directors only have a role to investigate if they see a red flag or somehow are aware that things are amiss within the company. Professor Jennifer Arlen provides an excellent theory regarding why the Delaware Court decided *Allis-Chalmers* in the manner that it did.[103] Professor Arlen argues that at the time the case was decided, there was "little reason" for directors to focus on compliance because there was minimal, if any, "benefit from expenditures on legal compliance."[104] Put another way, there was not much potential liability for corporations, at least in terms of criminal exposure and cost. This lack of corporate criminal liability, as Professor Arlen outlines, shifted by the mid-1990s with the rise of corporate

---

96. 188 A.2d 125 (Del. 1963).
97. *Id.* at 127.
98. *Id.* at 127, 129.
99. *Id.* at 132–33.
100. *Id.* at 130, 133.
101. *Id.* at 130–31.
102. *Id.* at 130.
103. Jennifer Arlen, *The Story of* Allis-Chalmers*,* Caremark*, and* Stone*: Directors' Evolving Duty to Monitor*, *in* CORPORATE LAW STORIES 329 (J. Mark Ramseyer ed., 2009).
104. *Id.*

criminal liability.[105] At that point, corporate violations began to have real consequences, resulting in a hit to stock price, and an increase in derivative lawsuits. The resulting rise in corporate criminal liability ushered in an era wherein corporations became acutely aware of needing a corporate compliance program.

B. Caremark

Enter *Caremark*.[106] In *Caremark*, Chancellor Allen of the Delaware Court of Chancery reviewed a proposed settlement of shareholder derivative claims that arose from the company's guilty plea and payment of criminal and civil penalties for violations of state and federal health care fraud laws.[107] Although *Caremark* should have been a mere rubber stamp on the proposed settlement, Chancellor Allen wrote a broader opinion, thereby single-handedly shifting the landscape regarding the duty of directors vis-à-vis corporate compliance programs.

Caremark International was a corporation involved in the alternative-site and home health care business that became a publicly held company when it was spun off from Baxter International, Inc. in November 1992.[108] A substantial part of Caremark's revenue came from Medicare and Medicaid reimbursement programs, which are subject to the Anti-Referral Payments Law (ARPL).[109] The ARPL prohibits health care providers from paying or giving anything of value in order to induce referrals of Medicare and Medicaid patients.[110] Caremark (operating then as Baxter) had an internal policy regarding contracts with physicians and hospitals in order to comply with the ARPL and any other kickback regulations.[111] Nevertheless, Caremark had a practice of making certain payments to physicians in return for

105. *Id.* at 330; *see also* Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2022 (2019) (citing to Caremark's federal litigation guilty plea following an extensive investigation as the precursor to increased corporate oversight); Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719, 725–26 (2007) (citing the federal investigation of Caremark, despite active attempts to avoid it by trying to comply with new Anti-Referral Payments Law).

106. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 960 (Del. Ch. 1996).

107. *Id.*

108. *Id.* at 961. Although the conduct at issue in *Caremark* occurred before the spinoff, we will refer to the offending entity here as Caremark.

109. *Id.*

110. *Id.* at 961–62; 42 U.S.C. § 1395nn(a).

111. *Caremark*, 698 A.2d at 962.

patient referrals for home infusion therapy.[112] Caremark claimed the weekly "fees" paid to doctors were not kickbacks but instead payments made for continual monitoring of patients through review of medications and lab results.[113] Because of this, Caremark insisted that the payments fell within the safe harbors of the ARPL.[114]

In 1991, the Inspector General of Health and Human Services investigated Caremark, serving it with a subpoena demanding documents regarding contracts with physicians and potential kickbacks.[115] The investigation was joined by the Department of Justice ("DOJ") in 1992, in addition to a number of separate investigations initiated by other state and federal agencies.[116]

In response, Caremark announced it would terminate all payments to physicians, establish an internal audit plan, and engaged PricewaterhouseCoopers ("PwC") as an outside auditor.[117] In 1993, the Ethics Committee of the Board reviewed the report from PwC, which had concluded there were no material weaknesses in Caremark's control structure.[118] Nevertheless, the Ethics Committee adopted a new audit charter requiring a comprehensive review of the compliance policies at Caremark.[119] In July 1993, the company issued a new ethics manual, prohibiting any payments in exchange for referrals, and instituted a confidential ethics hotline.[120]

The ultimate disposition of the investigations and indictments included Caremark reaching a landmark settlement with federal and state regulators. The settlement required Caremark to plead guilty to mail fraud and pay $161 million in penalties and fines.[121] The firm also had to pay over $85.3 million in restitution and damages, and over

---

112. *Id.* at 961–62, 964.
113. *Id.* at 961–63.
114. *Id.*; Amended Derivative Complaint at 13, *Caremark*, 698 A.2d 959 (No. 13670).
115. *Caremark*, 698 A.2d at 962.
116. *Id.*
117. *Id.* at 962–63.
118. *Id.* at 963.
119. *Id.*
120. *Id.* (noting that in 1993, Caremark also increased management supervision to try to comply with the Anti-Referral Payments Law).
121. Lisa Scott, *Caremark to Plead Guilty in Fraud Case; Feds End Hill-Rom Antitrust Probe*, MOD. HEALTHCARE (June 19, 1995, 1:00 AM), https://www.modernhealthcare.com/article/19950619/PREMIUM/506190301/caremark-to-plead-guilty-in-fraud-case-feds-end-hill-rom-antitrust-probe [https://perma.cc/4AUN-AAMZ].

$44.6 million in combined payments to all fifty states.[122] In reaction to the indictments, shareholders filed a number of derivative actions against Caremark's directors, claiming they breached their duty of care by failing to adequately supervise the conduct of Caremark employees, or institute corrective measures, which led to Caremark's extensive fines and liability.[123] The defense moved to dismiss on the grounds that the plaintiffs failed to allege particularized facts sufficient to excuse the demand requirement under Rule 23.1, and that the plaintiffs failed to state a cause of action because Caremark's charter eliminated any personal liability for directors.[124]

As noted above, the Delaware Court of Chancery was charged only with passing judgment on the reasonableness and fairness of the proposed settlement between plaintiffs and defendants.[125] Interestingly, the settlement terms required only that the board adopt stronger compliance measures, including a Compliance and Ethics Committee.[126] Nevertheless, the court focused on the plaintiffs' claim that the "directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[127] The court made clear how high the bar was for making such a claim, stating "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."[128] Indeed, Chancellor Allen wrote the now oft-quoted line: "The theory here advanced is possibly the most difficult theory in

---

122. Ronald E. Yates, *Caremark Wounds Not Deep*, CHI. TRIB. (June 19, 1995, 12:00 AM), https://www.chicagotribune.com/news/ct-xpm-1995-06-19-9506190063-story.html [https://perma.cc/524B-ARPC].

123. *Caremark*, 698 A.2d at 964 (noting that the first shareholder suit was filed on August 5, 1994, immediately after the indictment, and that shareholders continued to amend their complaints as evidence from the criminal investigations came to light).

124. *Id.* at 971 n.28. (noting that Caremark's certificate of incorporation contained a 102(b)(7) provision, which protected directors from any liability for breaching their duty of care.)

125. *Id.* at 961.

126. *Id.* at 966, 972.

127. *Id.* at 967.

128. *Id.* at 971.

corporation law upon which a plaintiff might hope to win a judgment."[129]

To reach its conclusion, the court considered the legal standards governing a director's obligation to supervise or monitor corporate operations, and held that corporate directors have a duty to assure

> that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[130]

The court revisited its holding in *Allis-Chalmers* and declined to accept a broad interpretation of that case, writing that *Allis-Chalmers* stands for the proposition that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."[131] However, according to Chancellor Allen, *Allis-Chalmers* does not stand for the fact that a "corporate board has no responsibility to assure that appropriate information and reporting systems are established by management."[132] The court cited three reasons for this interpretation:

> (1) recent Delaware case law, including *Smith v. Van Gorkom*[133] and *Paramount Communications v. QVC,*[134] that suggested the role of the board should be taken very seriously;

129. *Id.* at 967 (noting that the claim is one of a violation of the duty of care, not of loyalty).

130. *Id.* at 970.

131. *Id.* at 969 (citing Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130–31 (Del. 1963)).

132. *Id.* at 969–70.

133. 488 A.2d 858 (Del. 1985). *Van Gorkom* held independent directors liable for approving a third-party premium-paying transaction on the grounds that they had acted with gross negligence. *Id.* at 880. "Fear that verdicts like *Van Gorkom* could be common drove up directors and officers liability insurance costs and gave directors reason to be concerned about service." Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 661 (2010); *see also* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) (discussing how the *Van Gorkom* decision contributed to the insurance crisis of the 1980s).

134. 637 A.2d 34 (Del. 1994).

> (2) relevant and timely information is "an essential predicate" for meeting the board's supervisory and monitoring duty under Delaware law; and
>
> (3) the potential impact of federal organizational sentencing guidelines that require organizational compliance and responsibility.[135]

"Thus," Chancellor Allen stated, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists . . . ."[136] The court added that a "failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[137]

The court held that in order for the plaintiffs to show the directors had breached their duty of case, they would have to

> show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of . . . .[138]

Given that standard, Chancellor Allen found that settlement was fair and reasonable.[139]

C. Caremark *in Action*

As a result of *Caremark*, the board, among its other fiduciary obligations, must undertake a duty of oversight to make a good faith effort to put into place a reasonable board-level system of monitoring and reporting. Because *Caremark* was an opinion by the Delaware Court of the Chancery, and was largely advisory regarding the board's duty to monitor, the Delaware Supreme Court did not weigh in on the issue for over a decade until *Stone v. Ritter*[140] in 2006.

Stone involved a derivative claim against Directors of AmSouth Bancorporation (AmSouth). Specifically, plaintiff-shareholders sued following a government investigation that resulted in AmSouth and a subsidiary paying $50 million in fines and penalties for failures to file Suspicious Activity Reports as required by the Bank Secrecy Act and

135. *Caremark*, 698 A.2d at 970.
136. *Id.*
137. *Id.*
138. *Id.* at 971.
139. *Id.* at 972.
140. 911 A.2d 362 (Del. 2006).

anti-money laundering regulations.[141] However, the Directors neither "knew [n]or should have known that violations of law were occurring," there were no "red flags."[142] The *Stone* court held that the Directors had met their *Caremark* obligations, finding they had "discharged their oversight responsibility to establish an information and reporting system."[143]

Since *Stone*, there have only been a handful of derivative suits demanding personal liability for board members pursuant to *Caremark*. Of those claims, only five have cleared the motion to dismiss stage, and those five are examined in depth in Part III. However, the remainder of the *Caremark* claims result in dismissal due to the broad protections of the business judgment rule and the *Caremark* precedent.[144]

III. *CAREMARK* "PLUS"

Despite nearly twenty years of precedent enshrining the *Caremark* standard, Delaware courts recently have started to take a closer look at *Caremark* claims.[145] The following few cases in particular highlight the possible shift in the once-impenetrable standard required for plaintiffs to overcome a motion to dismiss. Whether these cases should be seen

141. *Id.* at 365.

142. *Id.* at 364.

143. *Id.* at 371–72.

144. *See, e.g.*, City of Birmingham Ret. & Relief Sys. v. Good, 177 A.3d 47, 59 (Del. 2017) (affirming the Court of Chancery's dismissal of a *Caremark* claim because "reports to the board showed that the[y] 'exercised oversight by relying on periodic reports' from officers" and that board presentations "identified issues [and] informed the board of the actions taken to address the[m]"); *Stone*, 911 A.2d at 372–73 (affirming the Court of Chancery's dismissal of a *Caremark* claim, in part, because an outside auditor's report "reflect[ed] that the Board approved relevant policies and procedures, delegated to employees and departments the responsibility for filing [suspicious activity reports] and monitoring compliance, and exercised oversight by relying on periodic reports from them"); *In re* Gen. Motors Co. Derivative Litig., No. 9627-VCG, 2015 WL 3958724, at *14 (Del. Ch. June 26, 2015) (dismissing a *Caremark* claim where "GM *had* a system for reporting risk to the Board, but in the Plaintiffs' view it should have been a better system"); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 127 (Del. Ch. 2009) (dismissing a *Caremark* claim because "[p]laintiffs d[id] not contest that Citigroup had procedures and controls in place that were designed to monitor risk").

145. Delaware cases are described in this Part. There was a recent case outside of Delaware that espoused many of the same principles, but obviously was not applying Delaware law: *In re* Cardinal Health, Inc. Derivative Litigation, 518 F. Supp. 3d 1046 (S.D. Ohio 2021). In that case, the judge denied the defendants' motion to dismiss. *Id.* at 1073. The case involved directors' breach of fiduciary duty related to an opioid litigation that ultimately ended with a settlement by Cardinal Health. *Id.* at 1055–60.

as canaries in the coalmine and indicators of an overall shift in the standard remains to be seen, as there are still a number of cases where the *Caremark* standard still holds.[146] Yet these recent cases suggest a movement in the standard, creating a shift that we will refer to as "*Caremark* plus."

A. Marchand*: "Mission Critical"*

The first case to take a swing at the *Caremark* fortress was *Marchand v. Barnhill*.[147] In *Marchand,* a shareholder brought a derivative lawsuit against key executives and the Board members of Blue Bell Creameries USA, Inc. ("Blue Bell") for breach of fiduciary duties.[148] Specifically, the complaint alleged that the Directors breached their duty of loyalty for knowingly failing to implement any system to monitor food safety and compliance.[149] The Delaware Court of Chancery granted the defendants' motion to dismiss, but the Delaware Supreme Court reversed.[150]

The facts in *Marchand* explain the rationale for the court's nearly unprecedented reversal of a *Caremark* claim's motion to dismiss. In 2015, Blue Bell's ice cream caused a listeria outbreak, resulting in the company recalling all of its products, shutting down production in all of its plants, and laying off over a third of its workforce.[151] All told, ten adults in four different states were sickened with listeria from the Blue Bell contamination, including one adult in Arizona, one in Oklahoma, five adults in Kansas and three adults in Texas.[152] Three of the five Kansan victims died from complications related to the listeria infection.[153] The public health tragedy was not the only unfortunate result of the listeria outbreak; due to the operational shutdown, the

---

146. *See, e.g.*, *City of Birmingham Ret. & Relief Sys.*, 177 A.3d at 51 (using the *Caremark* standard to dismiss a claim); *Stone*, 911 A.2d at 372–73 (employing *Caremark* to affirm the Court of Chancery's dismissal of a shareholder claim).

147. 212 A.3d 805 (Del. 2019) (en banc).

148. *Id.* at 807.

149. *Id.*

150. *Id.* at 808.

151. *Id.* at 807.

152. *See id.* at 814; *Multistate Outbreak of Listeriosis Linked to Blue Bell Creameries Products (Final Update)*, CTRS. DISEASE CONTROL & PREVENTION (June 10, 2015), https://www.cdc.gov/listeria/outbreaks/ice-cream-03-15/index.html [https://perma.cc/33G6-BD9Z] (noting that a total of ten people were reported to have contracted listeriosis related to the Blue Bell outbreak, all of whom were hospitalized).

153. *Marchand*, 212 A.3d at 807, 814.

company faced a liquidity crisis that resulted in a dilutive private equity investment agreement.[154]

Importantly, the listeria outbreak of 2015 was not unforeseen because, as far back as July 2009, the Food and Drug Administration (FDA) reported that Blue Bell's facilities contained various FDA violations related to food safety.[155] By 2013, the company had five positive tests for listeria in its various facilities.[156] These included infractions in the Texas, Alabama, and Oklahoma facilities.[157] Despite growing infractions related to food safety, as well as two years of evidence that listeria was a significant issue, the board was never informed about food safety issues until the recall in 2015.[158] Minutes from the January, February and March 2014 board meetings reflected no board-level discussion of listeria.[159] Over the remainder of 2014, Blue Bell received ten positive tests for listeria.[160] While management was aware of the increasing issues related to listeria, the board was not informed.[161] In fact, during the September 2014 board meeting, the only mention of sanitation issues was a passing remark that a third-party audit of sanitation issues "went well."[162]

In early 2015, Blue Bell's products again tested positive for listeria. The Texas Department of State Health Services conducted tests after being alerted of positive tests done by the South Carolina Health Department.[163] Again, Blue Bell's management did not inform the Board, and there was no discussion of listeria at the annual

154. *Id.* at 807. A dilutive private equity investment agreement is an agreement between an investor and company where the investor gives money to the company in exchange for a stake in the company, which, in effect, decreases (or "dilutes") existing stockholders' equity in that company. *See generally* David Snow, *Private Equity: A Brief Overview*, PEI MEDIA 2 (2007), https://www.law.du.edu/documents/registrar/adv-assign/Yoost_PrivateEquity%20Seminar_PEI%20Media's%20Private%20Equity%20-%20A%20Brief%20Overview_318.pdf [https://perma.cc/C3KF-W4WZ]; *Dilution*, CORP. FIN. INST. (Jan. 11, 2023), https://corporatefinanceinstitute.com/resources/equities/ dilution [https://perma.cc/5H6L-58MM].

155. *Marchand*, 212 A.3d at 811.

156. *Id.* at 812.

157. *Id.* at 811–12.

158. *Id.* at 813–14.

159. *Id.* at 812.

160. *Id.*

161. *Id.* at 813.

162. *Id.*

163. *Id.*

shareholder meeting on February 19, 2015.[164] But, by February 23rd Blue Bell initiated a limited recall of its products.[165] Two days later, the board met, marking the first time that the board learned about listeria issues.[166] The board, however, "left the company's response to management."[167] In March, Blue Bell recalled more products following infections in Kansas and South Carolina.[168] The board met again on March 25, and adopted a resolution in support of the CEO, management, and employees, encouraging them "to ensure that everything Blue Bell manufacture[s] and distributes is a wholesome and good testing [sic] product that our consumers deserve and expect."[169] By April 20, 2015, Blue Bell instituted a total recall of all products.[170] The Center for Disease Control had already begun an investigation into the outbreak, warning grocers and retailers not to sell any Blue Bell products.[171]

The plaintiff reviewed the board minutes and records for the relevant time period and made the following allegations in the complaint:

- ∞ no board committee that addressed food safety existed;
- ∞ no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports existed;
- ∞ no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks existed;
- ∞ during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- ∞ the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and

164. *Id.*
165. *Id.*
166. *Id.*
167. *Id.* at 814 (noting that instead of holding more meetings to receive updates about the troubling reports, the board delegated the company's response to management).
168. *Id.*
169. *Id.* (alterations in original).
170. *Id.*
171. *Id.*

- the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues.[172]

The Delaware Court of Chancery dismissed the complaint and reasoned that because Blue Bell had complied with FDA regulations, had ongoing third-party monitoring for contamination, and because senior management reported to the board regarding operations, there was a monitoring system in place that met the *Caremark* standard.[173] The court held that the plaintiff was challenging the effectiveness of monitoring and controls, rather than the mere existence of monitoring and controls, and the court dismissed the claim because it held that the *Caremark* standard does not require an assessment of the effectiveness of the controls.[174] On review, the Delaware Supreme Court agreed in theory with the Chancery Court's standard, but reached a different conclusion:

> [W]e are not examining the effectiveness of a board-level compliance and reporting system after the fact. Rather, we are focusing on whether the complaint pleads facts supporting a reasonable inference that the board did not undertake good faith efforts to put a board-level system of monitoring and reporting in place.[175]

The Delaware Supreme Court overturned the dismissal, thereby shifting the landscape for the likely success of a *Caremark* claim. The Delaware Supreme Court first turned its attention to the argument that Blue Bell had complied with FDA regulations and had on-going third-party monitoring. The Supreme Court rejected that argument entirely, stating:

> [T]he fact that Blue Bell nominally complied with FDA regulations does not imply that the *board* implemented a system to monitor food safety *at the board level*. Indeed, these types of routine regulatory requirements, although important, are not typically directed at the board. At best, Blue Bell's compliance with these requirements shows only that management was following, in a nominal way, certain standard requirements of state and federal law. It does not rationally suggest that the board implemented a reporting system to monitor food safety or Blue Bell's operational performance.[176]

Importantly, the court went on to state:

172. *Id.* at 822.
173. *Id.* at 816–17.
174. *Id.* at 817.
175. *Id.* at 821.
176. *Id.* at 823.

> The mundane reality that Blue Bell is in a highly regulated industry and complied with some of the applicable regulations does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a *Caremark* claim . . . [D]espite the critical nature of food safety for Blue Bell's continued success, the complaint alleges that management turned a blind eye to red and yellow flags that were waved in front of it by regulators and its own tests, and the board—by failing to implement any system to monitor the company's food safety compliance programs—was unaware of any problems until it was too late.[177]

The defendants also argued that management regularly reported to the board on operational issues.[178] The gist of the directors' argument was the following: because the board received information and performed oversight on the company's operational issues, it had fulfilled its *Caremark* obligation.[179] The Delaware Supreme Court responded by acknowledging that such a standard would be meaningless: "if that were the case, then *Caremark* would be a *chimera*."[180]

Two factors were fundamental in the court's decision: (1) the fact that Blue Bell was a "monoline" company, meaning it only makes a single product; and (2) that product is in the highly regulated industry of consumer food.[181] The court reasoned:

> [*Caremark*] require[s] that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks. In Blue Bell's case, food safety was essential and mission critical. The complaint pled facts supporting a fair inference that no board-level system of monitoring or reporting on food safety existed.[182]

Marchand was a watershed moment for plaintiffs who are nearly always unsuccessful in their *Caremark* claims. After *Marchand,* a few more cases followed suit, thereby shifting the *Caremark* standard in subtle but important ways.

---

177. *Id.* at 811, 823.
178. *Id.* at 823–24.
179. *Id.*
180. *Id.* at 824 (emphasis added).
181. *Id.* at 809, 823.
182. *Id.* at 824.

B. Clovis Oncology

The *Marchand* case was decided by the Delaware Supreme Court in June 2019.[183] Just a mere three months later, the Delaware Court of Chancery denied a motion to dismiss on a *Caremark* claim in another matter, *In re Clovis Oncology, Inc. Derivative Litigation*.[184] The *Clovis* case had marked similarities to *Marchand*, as detailed below.

Clovis Oncology, Inc. ("Clovis") is a biopharmaceutical company aimed at acquiring, developing, and commercializing cancer treatments.[185] The complaint focused on the time period in which Clovis had one drug under development, Rociletinib ("Roci"), which was to be used as a lung cancer treatment.[186] During the relevant time period referenced in the complaint, Clovis had no products on the market and also had generated no sales revenue.[187] Effectively, the company had all of its eggs in the Roci basket, and its only source of capital at that time was provided by investors.[188] The success of Roci depended upon the FDA's approval of the drug prior to taking the drug to market.[189] If Roci was successful, the market potential could be as large as $3 billion.[190]

Important to the story of Roci is the fact that a competing drug company, AstraZeneca, also had a lung cancer treatment drug in development, and AstraZeneca was essentially racing Clovis for FDA approval.[191] Because of the high stakes Clovis had riding on Roci's success and the tight competition for FDA approval, the Clovis board was regularly apprised of the progress of Roci's development.[192]

In order to receive FDA approval, Clovis needed to prove Roci's efficacy and safety in clinical trials.[193] The clinical trial protocol demanded by the FDA includes defined standards regarding how trials are conducted, how data is analyzed, and how the outcomes of the trial are measured.[194] The Roci clinical trial, called "TIGER-X," followed a

---

183. *Id.* at 805.
184. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).
185. *Id.* at *2.
186. *Id.* at *1, 4.
187. *Id.* at *4.
188. *Id.* The company had two other developmental drugs, but Roci was the most promising. *Id.* at *1, 4.
189. *Id.* at *4.
190. *Id.*
191. *Id.*
192. *See id.*
193. *Id.*
194. *Id.*

standardized trial protocol called "RECIST."[195] By using the RECIST protocol, Clovis was able to tout to investors that it was following the preferred and accepted system for new drug applications.[196] The most important criteria for RECIST is the "objective response rate" (ORR), which is the measure of success for the drug, defined in Roci's case as the tumor shrinkage after treatment.[197] Critically, for FDA approval, ORRs must be comprised of confirmed responses, meaning that the tumor shrinkage must be observed in more than just an initial scan.[198] Otherwise, the results are merely unconfirmed and should not be used in calculating ORR.[199]

As the TIGER-X trial progressed through 2014, Clovis reported a confirmed ORR of about 60%.[200] Clovis's public statements throughout 2014 presented Roci as closely competing with the results of AstraZeneca's drug trials, with ORR around 60% or more.[201] However, the Clovis board received reports that indicated the ORR was incorporating both confirmed and unconfirmed results, in contravention to trial protocols.[202] By December 2014, the board received a report stating that the ORR would drop below 60% and could be less than 50% by mid-March 2015.[203] "With hands on their ears to muffle the alarms," the board signed and certified the Clovis 2014 annual report in February 2015, knowing that the ORR reports described therein included unconfirmed responses.[204]

In September 2014 and again in July 2015, Clovis used the inflated ORR numbers in offering documents to raise additional capital.[205] In 2015, the Roci ORR numbers began to decline, with the "final" TIGER-X data in July 2015 showing that Roci's ORR was around 42%.[206] The

195. *Id.*
196. *Id.*
197. *Id.* at *5.
198. *See id.*
199. *See id.*
200. *See id.* at *2 n.13, *5.
201. *See id.*
202. *See id.* at *6. The Board also received information that only eighty percent of unconfirmed cases convert to confirmed cases. *Id.*
203. *Id.*
204. *Id.* at *7.
205. *See id.* at *6–7 (stating that the Board relied heavily on the market's positive reaction to the Roci's publicly reported ORR to make its case to investors). The September 2014 capital raise was for $287 million, and the 2015 raise was for $316 million. *Id.*
206. *Id.* at *7. This report also included that the clinical trials had problematic side effects that were more common than management was publicly reporting. *Id.* at *8.

New Drug Application to the FDA indicated that the results were around 50%.[207] The FDA requested additional data in October 2015, and Clovis was forced to disclose that the Roci confirmed ORR at that time was between 28% and 34%.[208] Meanwhile, a November 5, 2015 Clovis press releases continued to claim that Roci's ORR was 60%.[209] Less than two weeks later, however, Clovis issued another press release stating that the confirmed ORR was between 28% and 34%, sparking an immediate stock drop of over 70% and wiping out more than $1 billion in its market capitalization.[210]

Plaintiff-shareholders brought a derivative action in 2017 after making two demands to review the books and records of the company.[211] Included in the complaint was a count for breach of fiduciary duty against the individual board members, based on a *Caremark* claim.[212] The Delaware Court of Chancery held that Plaintiff-shareholders had, in compliance with Rule 23.1, pled particularized facts that the board ignored red flags that Clovis was violating the clinical trial protocols.[213] As such, the Delaware Court of Chancery denied the defendants' motion to dismiss on the first count of a breach of fiduciary duty.[214]

In analyzing the *Caremark* claim, the court noted that *Caremark* requires plaintiffs to allege particularized facts that either the directors (1) failed to implement any system of controls or reporting, or (2) that the directors, having implemented a system of controls, failed to monitor or oversee that system.[215] In *Clovis*, the court held that the facts

207. *Id.* at *7.

208. *Id.*

209. *Id.*

210. *Id.* at *8.

211. *Id.* at *9. In 2018, the SEC filed a complaint against Clovis and its executives, which resulted in consent decrees and civil penalties. *Id.* at *10.

212. *See id* at *10.

213. *See id.* at *15. The court noted that the complaint included allegations that the directors were not discharging their fiduciary obligations, which is a standard of wrongdoing "qualitatively different from, and more culpable than . . . gross negligence." *Id.* at *12 (citing Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 (Del. 2006) and *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006)).

214. *Clovis,* 2019 WL 4850188, at *18.

215. *Id.* at *12 (citing Marchand v. Barnhill, 212 A.3d 805, 821 (Del. 2019) (en banc)).

sufficiently alleged a *Caremark* "prong two" claim.[216] The standard for successfully pleading a "prong two" claim is proof that the board was aware of "red flag[s]" but chose to ignore them.[217] In Clovis's case, the court stated that the Roci clinical trial protocols and the FDA regulations were the "mission critical" issues.[218] The court pointed out that the board was aware that management was incorrectly reporting ORR responses, but "did nothing to address this fundamental departure from the RECIST protocol."[219] The court further pointed out that the Clovis board was comprised of experts who would have been well aware of the RECIST standards.[220]

Importantly, like *Marchand* before it, as well as the cases after it, *Clovis* underscored the importance of positive law in evaluating whether directors breached their fiduciary duties. That is, the fact that the corporation violated regulations of some kind, and that a federal investigation uncovered the role of the board during that time, allowed plaintiffs to piggy-back upon the work of federal investigators and administrators, keeping their claim in court.

C. Hughes v. Xiaoming Hu

The next case in the sequence is *Hughes v. Xiaoming Hu*,[221] decided by the Delaware Court of the Chancery in April 2020.[222] *Hughes* is a distinct case because it involves Kandi Technologies Group, Inc. ("Kandi"), a publicly traded Delaware corporation that is based in China.[223] Kandi became a publicly traded company through a reverse merger in 2007.[224] In 2013, Kandi entered into a fifty-fifty joint venture

---

216. *Id.* at *15. The court noted that Plaintiffs acknowledged the claim was not a "prong one" *Caremark* claim because the Board had specifically charged the Nominating and Corporate Governance Committee to provide general compliance oversight related to FDA requirements. *Id.* at *13 (citing South *ex rel.* Hecla Mining Co. v. Baker, 62 A.3d 1, 16–17 (Del. Ch. 2012)).

217. *Id.* at *13 (citing *South ex rel. Hecla Mining Co.*, 62 A.3d at 16–17).

218. *Id.* (citing *Marchand*, 212 A.3d at 805).

219. *Id.*

220. *Id.* at *14. The Board argued that the FDA implicitly condoned the reporting of unconfirmed cases given that Roci was on an accelerated timeline. The court, however, held that this factual distinction was one that could be teased out at trial and that "[d]rawing all reasonable inferences in Plaintiffs' favor," it was satisfied with the well-pled allegations that the Board consciously ignored red flags. *Id.* at *14–15.

221. Hughes *ex rel.* Kandi Tech. Grp., Inc. v. Xiaoming Hu, No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020).

222. *Id.* at *1.

223. *Id.*

224. *Id.* at *2.

with Geely Automobile Holdings, Ltd.[225] Kandi sold automobile parts to the joint venture in order to manufacture electric vehicles.[226] The joint venture then sold finished electric vehicles to Zhijiang ZuoZhongYou Electric Vehicle Service Co., Ltd. ("Service Company").[227] Kandi also owns 9.5% of the Service Company.[228] Xiaoming Hu is Kandi's CEO and Chairman of the Board.[229] He owned 28.4% of Kandi, and 13% of the Service Company.[230]

The facts of *Hughes* paint a clear picture of rampant accounting fraud. The alleged problematic activity began as far back as 2010, when Kandi's audit firm Albert Wong & Co. (AWC), which had no other clients other than Kandi, flagged a key audit risk and control weakness.[231] Specifically, AWC noted that when Kandi recorded transactions with Kandi USA, one of the company's five largest customers, Kandi used a different name for Kandi USA.[232] It turns out that Kandi USA was owned by the son of Kandi's CEO and was therefore a related party.[233] Before filing Kandi's 10-K, CEO Hu asked AWC to "resolve the issue" and to book the Kandi USA sales under a different customer's account, as well as eliminate any references to Kandi USA from the audit trail.[234] The 2010 Audit also disclosed that a number of employees held millions of dollars that belonged to the company in personal accounts.[235] The 2011 and 2012 audits also turned up key risks to the company, and Kandi disclosed in its 2013 10-K that it had "disclosure controls and procedures [that] were not effective . . . due to a material weakness."[236] The 2013 10-K outlines Kandi's commitment to remediating the deficiencies, including changing the structure so that the head of internal audit reported to the Audit Committee rather than to CEO Hu.[237] In addition, Kandi revised the Audit Committee charter to ensure that it would meet

225. *Id.*
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.*
231. *Id.* at *3.
232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.* (one unidentified employee was holding $3 million of the Company's reported year-end balance in their personal account).
236. *Id.* at *3–4.
237. *Id.* at *4.

regularly and frequently, and Kandi pledged to have the Audit Committee review any related-party transactions.[238]

Unfortunately, the Audit Committee did not deliver on its promises. In 2014, the Audit Committee met for forty-five minutes to review transactions with Kandi USA.[239] The Committee met again three weeks later in May 2014 for forty minutes, and "purportedly reviewed and approved a new 'Internal Audit Activity Charter'" as well as a new Management Policy on Related-Party Transactions, yet the Committee could not produce either of those documents in response to plaintiff's demand.[240] The Committee did not meet again for nearly an entire year.[241]

In March 2015, the Committee met for fifty minutes in order to discuss and approve the 10-K.[242] Notably, the 2014 10-K described its controls and procedures as "effective."[243] The Committee did not meet again for an entire year, and in March 2016, they met for only thirty minutes, also to discuss the new 10-K.[244] In April 2016, the full board resolved to terminate AWC as Kandi's auditor, and in May 2016, the Public Company Accounting Oversight Board instituted disciplinary proceedings and imposed sanctions against AWC.[245] In November 2016, Kandi disclosed that it had engaged in material related-party transactions with Kandi USA, as well as with the Service Company.[246]

In March 2017, Kandi announced that its financial statements from 2014 through at least the third quarter of 2016 would need to be restated.[247] In that announcement, the company also stated that it would reassess its internal controls over financial reporting and compliance programs.[248] Shortly thereafter, Kandi filed its annual 10-K for 2016, which disclosed that Kandi lacked "[s]ufficient expertise" relating to: (1) technical knowledge of GAAP requirements and SEC disclosure regulations; (2) financial statements for equity investments; (3) related-party transactions disclosures; (4) controls to ensure

238. *Id.*
239. *Id.*
240. *Id.* at *5.
241. *Id.*
242. *Id.*
243. *Id.* at *6.
244. *Id.*
245. *Id.* at *7.
246. *Id.* at *7–8.
247. *Id.* at *8.
248. *Id.*

proper classification of reporting of cash and non-cash activities related to accounts; (5) accuracy of accounting and reporting of income taxes.[249]

Shareholders initially brought a federal class action under securities laws in 2017, after the March 2017 announcement, but the lawsuit was dismissed because plaintiffs failed to plead facts with sufficient particularity to support a strong inference of scienter.[250] Hughes, the plaintiff in the Delaware lawsuit, requested to inspect the books and records under Delaware Code section 220.[251] Initially, the board did not respond, which resulted in "protracted negotiations" in order for the board to produce the requested documents.[252] Once the board provided the requested material and documents, Hughes filed the derivative action in Delaware, claiming a *Caremark* violation of fiduciary duties against the members of the board.[253]

The Delaware Court of the Chancery reiterated the two paths to *Caremark* liability: (1) a director acts in bad faith "in the sense that she made no good faith effort to ensure that the company had in place any 'system of controls[;]'"[254] or (2) having implemented a system of controls, she consciously failed to monitor or oversee its operations "thus disabling [herself] from being informed of risks or problems requiring [her] attention."[255] With regards to a claim under *Caremark*'s first prong, the court held that a plaintiff must allege that the company had an audit committee that met only sporadically and devoted "patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them . . . ."[256] Under this standard, the court stated that the complaint sufficiently alleged facts suggesting Kandi's Audit Committee met only sporadically, even after it was aware that the company "suffered from pervasive problems with its internal controls, . . . and [which the company had] pledged to correct."[257] In addition, the Audit Committee meetings were so short that the court

249. *Id.* at *8.
250. *Id.*
251. *Id.* at *9.
252. *Id.*
253. *Id.*
254. *Id.* at *14 (citing Marchand v. Barnhill, 212 A.3d 805, 822 (Del. 2019) (en banc)).
255. *Id.* (quoting Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (en banc)).
256. *Id.* (quoting Guttman v. Huang, 823 A.2d 492, 507 (Del. Ch. 2003)).
257. *Id.*

reasoned that the committee could not have discussed a year's worth of transactions during that time.[258] Moreover, some of the documents the Audit Committee allegedly reviewed and discussed during the Audit Committee's brief meetings were not produced in response to the demand to review the books and records, which supported a reasonable inference that they did not exist.[259]

For these reasons, the court held that these chronic deficiencies supported a reasonable inference that the Company's Board of Directors, acting through its Audit Committee, failed to provide meaningful oversight over the Company's financial statements and system of financial controls.[260] According to the company's own words in its 2016 10-K, it lacked personnel with sufficient expertise on US GAAP and SEC disclosure requirements for equity investments and related-party transactions.[261] The court wrote:

> The directors charged with implementing a system to oversee the Company's financial reporting thus lacked the expertise necessary to do so all along. Instead, the Audit Committee deferred to management, which dictated the policies and procedures for reviewing related-party transactions and hired and fired the Company's auditor, even though management's actions suggested that it was either incapable of accurately reporting on related-party transactions or actively evading board-level oversight.[262]

The defendants mounted two defenses to the claim: (1) relying on *General Motors*,[263] they asserted that a *Caremark* claim cannot be sustained by showing only that a monitoring system could have, or should have, been more effective; and (2) even if defendants had failed to fulfill their oversight duties, the company did not suffer any harm as a result.[264] The court rejected each argument in turn. First, the court pointed out that the board in *General Motors* was much more active than that of Kandi's.[265] While acknowledging that an Audit Committee can rely in good faith upon reports by management and other experts,

258. *Id.* at *14–15.
259. *Id.* at *14.
260. *Id.* at *15.
261. *Id.*
262. *Id.*
263. *In re* Gen. Motors Co. Derivative Litig., No. 9627-VCG, 2015 WL 3958724, at *14 (Del. Ch. June 26, 2015) (dismissing a *Caremark* claim where "GM *had* a system for reporting risk to the Board, but in the Plaintiffs' view it should have been a better system"), *aff'd*, No. 392, 2016 WL 552651 (Del. Feb. 11, 2016).
264. *Hughes*, 2020 WL 1987029, at *16–17.
265. *Id.* at *16.

Caremark nonetheless "envisions some degree of board-level monitoring system, not blind deference to and complete dependence on management."[266] In this case, the court held that the Board never established its own reasonable system of monitoring and reporting, choosing instead to rely entirely on management, and the company also produced no documents to support its rebuttals.[267]

Regarding the defense's second argument about lack of harm, the court noted that the defendants are still liable for damages incidental to their breach of duty, even in the absence of quantifiable damages.[268] The defendants' argument is an interesting one, and one that seems to attempt to conflate the requirements of bringing a complaint under the Private Securities Litigation Reform Act (PSLRA), rather than on a *Caremark* claim.[269] The court pointed out that the allegations of a breach of duty of loyalty are sufficient to support a claim for relief under *Caremark*.[270]

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

Decided just four months after *Hughes, Teamsters Local 443 Health Services & Insurance Plan v. Chou*[271] marked another victory for plaintiff stockholders who sued directors and officers of AmerisourceBergen Corporation (ABC), a pharmaceutical sourcing and distributing company, for violation of fiduciary duties under *Caremark*.[272] Like the other cases referenced in this Article, the facts paint a bleak picture of pervasive corporate misconduct. An indirect wholly-owned subsidiary of ABC, Oncology Supply Pharmacy Services ("Pharmacy"), was acquired by ABC and its sole business was to buy single-dose sterile vials

266. *Id.*
267. *Id.*
268. *Id.* at *17.
269. While similar in some ways to a *Caremark* claim, plaintiffs bringing a class action in a direct lawsuit based upon securities law would file under the PSLRA, which requires plaintiffs to show loss causation. The claim brought under the PSLRA is a securities lawsuit governed by federal law, whereas a *Caremark* claim is governed by Delaware law. Pub. L. 104-67. *Compare* Pub. L. 104-67 (Public Securities Litigation Reform Act, federal law governing securities claims), *with In re* Caremark Int'l Inc., 698 A.2d 959, 959 (Del. Ch. 1996) (Delaware law governing breaches of fiduciary duty for failure to monitor).
270. *Hughes*, 2020 WL 1987029, at *17.
271. Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. 2019-0816-SG, 2020 WL 5028065, at *1–2 (Del. Ch. Aug. 24, 2020).
272. *Id.*

of oncology drugs, put those drugs into syringes, and sell the syringes for injection to immuno-compromised cancer patients.[273]

Pharmacy, through its Pre-Filled Syringe Program, however, was "run as a criminal organization."[274] To create the pre-filled syringes, Pharmacy would remove single-dose FDA-approved drug products from their original glass vials and then repackage them into single-dose plastic syringes.[275] The single-dose vials acquired by Pharmacy included "overfill" to account for human error in filling syringes and to permit medical providers to avoid dangerous air bubbles.[276] Rather than discard the overfill, Pharmacy illegally "pooled" the overfill and used it to fill additional syringes.[277] Importantly, overfill product was not intended for patient use, and the syringes with the overfill product were unsterile and contaminated.[278] Pharmacy technicians pooled the drug product in what was called a "cleanroom" but the air in the facility tested positive for bacterial contamination on multiple occasions.[279] Moreover, Pharmacy staff did not wear sterile clothing or practice sterile techniques while in the cleanroom.[280]

Pharmacy used sham prescriptions to appear like a real pharmacy and to avoid FDA oversight., even though it was not a state-licensed pharmacy.[281] Not only did ABC profit from the extra product and revenue from the Pre-Filled Syringe Program, it also undercut its competition by providing kickbacks to buyers in order to increase its market share.[282] Unsurprisingly, the Department of Justice (DOJ) filed a Criminal Information against ABC's subsidiary in 2017.[283] The Criminal Information charged the company with misbranding drugs, in violation of the Food and Drug Commission Act, and stated that the company was in violation for failing to register with the FDA.[284] The

273. *Id.* at *1.
274. *Id.*
275. *Id.*
276. *Id.*
277. *Id.*
278. *Id.*
279. *Id.* at *6.
280. *Id.*
281. *Id.* at *1–2.
282. *Id.* at *2. The Pre-Filled Syringe Program brought in an estimated $14 million in profit each year it operated.
283. *Id.* at *6.
284. *Id.* at *6–7; *see* 21 U.S.C. § 331(a) (providing that "[t]he introduction . . . of any food, drug, device, tobacco product, or cosmetic that is adulterated or

Criminal Information alleged that the Pre-Filled Syringe Program was "known and approved at the highest levels of . . . ABC."[285]

Sixteen days after the filing of the Criminal Information, ABC's subsidiary pleaded guilty, and paid a $260 million penalty to the DOJ.[286] The company also settled a False Claims Act charge with the U.S. Attorney's office for the Eastern District of New York for $625 million.[287]

Interestingly, the court held that, based upon the allegations in the complaint, the director defendants faced a "substantial likelihood of liability under *both* prongs of *Caremark*."[288] However, given the ease with which the court could find that the complaint alleged particularized facts suggesting the defendants knew of red flags and consciously disregarded them in bad faith, the court did not need to reach the question of *Caremark*'s first prong. The court cited both *Marchand* and *Clovis* in acknowledging that regulatory issues are "mission critical" to ABC.[289] Although ABC is a "relatively more complex corporation than either Blue Bell Creameries or Clovis," the court noted that ABC operated in a highly regulated industry and that the shareholder plaintiffs alleged that compliance with FDA regulations is the company's "primary regulatory concern and is absolutely critical to its business."[290]

As for its analysis of "prong two" allegations, the court pointed to three particular issues that it considered red flags that the board "consciously ignored."[291] The first red flag was a 2007 report from law firm Davis Polk & Wardwell ("DPW") after an internal assessment of the adequacy of the compliance program.[292] DPW notified the Audit

---

misbranded" is prohibited); *id.* § 351 (describing the circumstances under which "[a] drug or device shall be deemed to be adulterated"); 18 U.S.C. § 2(providing what is required to be punished as a "principal"); *id.* § 3551 (providing the rule for several defendants).

285. *Chou*, 2020 WL 5028065, at *7.

286. *Id.* at *7–8.

287. *Id.* at *8.

288. *Id.* at *17.

289. *Id.* at *18 (*citing* Marchand v. Barnhill, 212 A.3d 805, 824 (Del. 2019) (en banc) (finding that the Board's failure to put in place a system to monitor and report on its single product was a mission critical compliance risk); and *In re* Clovis Oncology, Inc. Derivative Litig., C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *15 (Del. Ch. Oct. 1, 2019)).

290. *Id.* at *18.

291. *Id.* at *19.

292. *Id.* at *10.

Committee of the board that there were significant deficiencies in ABC's compliance program: it needed "(1) greater accountability for compliance violations; (2) better organizational structure surrounding the compliance function; . . . (4) additional centralization of compliance and security decision-making; and (5) better documentation and tracking of compliance and ethics processes."[293] Notably, the Audit Committee did not follow through on the DPW recommendations.[294] The court noted that "at a minimum" the Audit Committee was on notice that there were significant compliance gaps, "creating a void in which illegal activity could occur undetected."[295]

The second red flag ignored by the board was the allegations and related *qui tam* suit brought by the former Chief Operating Officer Michael Mullen.[296] Plaintiff-shareholders contended that Mullen raised concerns about regulatory exposure, that he was subsequently fired, and that his concerns were never documented, let alone addressed by the Board.[297] Mullen's *qui tam* suit specifically addressed the drug health and safety risk, and described the overfill process.[298] Mullen also detailed his meeting with the CEO, during which he was clear about his "grave concerns" regarding regulatory exposure.[299] The Board was aware of the *qui tam* lawsuit because it was listed in the 2010 and 2011 10-Ks that the board signed.[300]

Finally, the court addressed the clear red flag that was the FDA search warrant executed at Pharmacy in 2012, and the subsequent subpoena related to Mullen's *qui tam* case. The complaint noted that although the search warrant was reported in the press, there was no mention of it in any board or audit committee minutes or materials, suggesting that it was never discussed.[301] The same was true about the subpoena.[302] As such, the court allowed the Plaintiff the inference that the board was aware of the search warrant and subpoena, yet did not

293. *Id.*
294. *Id.*
295. *Id.* at *20.
296. *Id.* at *21.
297. *Id.*
298. *Id.*
299. *Id.*
300. *Id.*
301. *Id.* at *24.
302. *Id.*

discuss them, giving rise to a reasonable inference that the board consciously ignored those red flags.[303]

E. Boeing

The most recent, and arguably most high-profile, decision denying a motion to dismiss a *Caremark* claim occurred in September 2021, in *In re Boeing Company Derivative Litigation*.[304] Like the four cases described above, the facts of the *Boeing* matter are egregious, and provide an explanation for why the Delaware Court of Chancery was willing to proceed with the Plaintiffs' claim.

The facts of the *Boeing* matter were sketched out at the outset of this Article,[305] but warrant a little more space here. As the Delaware opinion outlines, the real story of Boeing begins well before the Lion Air crash in October 2018.[306] Boeing is a storied company, with roots dating back to 1916, when it was known as an "association of engineers."[307] However, when Boeing acquired McDonnell Douglas in 1997, the tone of the company shifted drastically.[308] Boeing employees described it as shifting from "safety to profits-first."[309] Unsurprisingly, with this shift in corporate culture, Boeing saw an uptick in safety violations.[310] Notably, and in contrast to other aviation companies, there was not any formal board-level process related to the oversight of airline safety.[311] The primary source for compliance oversight came from the Audit Committee, yet the Audit Committee of the Board did not specifically address airline safety among its compliance tasks.[312] Moreover, management's periodic reports to the Board did not include safety updates and information.[313] As such, the Board never received

303. *Id.*
304. No. 2019-0907-MTZ, 2021 WL 4059934, at *1 (Del. Ch. Sep. 7, 2021).
305. *See supra* text accompanying notes 2–6.
306. *Boeing*, 2021 WL 4059934 at *2–3.
307. *Id.* at *3.
308. *Id.*
309. *Id.* at *3. In fact, in 2000, engineers at Boeing staged a forty-day strike to call attention to the problematic corporate culture. Seemingly in response, the company moved its headquarters from Seattle to Chicago in order "to escape the influence of the resident flight engineers." *Id.* at *4.
310. *Id.* at *10–11. Between 2000 and 2020, the FAA flagged twenty safety violations and Boeing paid fines between $6000 and $13 million for the infractions. *Id.* at *4.
311. *Id.* at *5.
312. *Id.*
313. *Id.*

information, even in the form of a whistleblower complaint, if it related to safety issues.[314]

At an August 2011 board meeting, the Boeing Board approved the development of the 737 Max, which was a reconfiguration of an existing 737, with new technology and other modifications.[315] It is clear from the August 2011 board minutes that the strategy behind the 737 Max dealt with the pressure from the Airbus competition; no board member asked about the safety implications of the modifications that included much larger engines or other technology.[316] According to the Complaint, Boeing produced the 737 Max at a "frenetic" pace in order to keep up with Airbus, which resulted in hasty technical drawings, minimal training materials and deficient blueprints.[317] Because the 737 Max was an "upgrade[]" on an earlier 737 but with the engines in a different place, the Max tended to tilt too far upwards.[318] Boeing addressed this issue by installing new software called Maneuvering Characteristics Augmentation System (MCAS).[319] MCAS caused the tail to be horizontal in order to stabilize and pushed the nose down in order to do that.[320] As later discovered, the sensor that triggered MCAS "was highly vulnerable to false readings or failure for numerous reasons, such as general weather, lightning, freezing temperatures, software malfunctions, or birds."[321] For cost reasons, managers at Boeing did not adopt a system to ascertain if the signal triggering the MCAS was false.[322]

The rest of the Boeing story unfortunately is predictable. Boeing rushed production of the 737 Max, did not provide adequate training materials to address MCAS safety risks, and concealed any issues related to the 737 Max from the FAA.[323] Then, on October 29, 2018, Lion Air Flight 610 crashed into the Java Sea within minutes after taking off from Jakarta, killing all 189 persons on board.[324] The black

---

314. *Id.* at *7.
315. *Id.* at *8.
316. *Id.*
317. *Id.* at *8–9.
318. *Id.* at *8.
319. *Id.* at *8.
320. *Id.*
321. *Id.*
322. *Id.* at *9.
323. *Id.* at *8–10. Four months after announcing the 737 Max, Boeing had 1000 orders for customers worldwide, many of which were in emerging markets and relied upon the FAA safety measures rather than their own. *Id.* at *10.
324. *Id.* at *12.

box data from the crash indicated that the pilots frantically searched the Quick Reference Handbook for information on the abnormal event in order to switch off the MCAS but were unable to locate any information.[325] The FAA did a risk assessment immediately and concluded that if MCAS was not altered, there would be a fatal crash every two to three years.[326]

Management did not alert the Board about the Lion Air crash for over a week.[327] Despite a *Wall Street Journal* article explaining the reason for the crash and the issue with MCAS, management told the Board that the article was "categorically false" and that the 737 Max fleet was safe.[328] In the days following the crash, additional articles were published by *Bloomberg* and the *New York Times,* making the same allegations about the MCAS failure.[329] Again, management told the board that the media coverage was false.[330] On November 23, nearly a month after the crash, Boeing CEO Dennis Muilenburg invited the board to an optional call regarding the Lion Air crash, for which there are no minutes.[331] This was the first time the Board convened after the crash, but the meeting was optional; the first official board meeting after the crash was on December 16–17, and safety was not a focus of the discussion.[332] At the next board meeting in February, the board decided to forego its own investigation into the crash until "the conclusion of the regulatory investigations or until such time as the Board determines that an internal investigation would be appropriate."[333]

By January 2019, the DOJ opened a criminal investigation into whether Boeing had lied to the FAA when obtaining the quick approval for certification of the 737 Max.[334] Then in March 2019, the

---

325. *Id.*
326. *Id.*
327. *Id.* at *13.
328. *Id.* at *12–13.
329. *Id.* at *13.
330. *Id.*
331. *Id.*
332. *Id.* at *13–14.
333. *Id.* at *15.
334. *Id.* The end result of the investigation was that Boeing agreed to pay a criminal monetary penalty of $243.6 million, compensation payments to its customers consisting of $1.77 billion, and $500 million to a crash-victims beneficiaries fund. *Id.* In addition, Boeing estimated it had incurred non-litigation costs of $20 billion, and litigation costs of $2.5 billion. *Id.* at *20.

Ethiopian Airlines crash killed 157 passengers and crew.[335] The following day, the CEO emailed the Board to explain that management was "engaging in extensive outreach" to "reinforce our confidence in the 737 MAX."[336] Within three days of the crash, the fleet of 737 Max had been grounded by the FAA.[337]

At its April meeting, the board initiated board-level safety reporting for the first time, and established a Committee on Airplane Policies and Processes.[338] On May 6, the Airplane Committee requested information about the cause of the two crashes.[339] It also recommended that the board adopt another committee dedicated to safety.[340] On August 26, 2019, the Board created the Aerospace Safety Committee.[341]

Plaintiff-shareholders brought a derivative lawsuit in response to the corporate harm that was caused as a result of the crashes and their aftermath. Plaintiff-shareholders claimed both prongs of *Caremark* could be met: 1) before the Lion Air crash, the board failed to implement any reasonable information or reporting system to monitor safety of the airplanes; and 2) after the Lion Air crash, the board ignored red flags concerning safety and the nondisclosure of the MCAS issues, and consciously disregarded their duty to investigate and remedy the issues.[342]

The Delaware Court of the Chancery agreed that a *Caremark* "prong one" claim could be sustained and denied the Defendants' motion to dismiss.[343] Relying on *Marchand*, the court stated that the board must make a good faith effort to put in place a reasonable board-level system of monitoring and reporting.[344] That oversight requirement must be "designed to ensure reasonable reporting and information" such that it would "allow directors to know about and prevent wrongdoing that could cause losses for the Company."[345] Given this standard, the court

---

335. *Id.* at *16.
336. *Id.*
337. *Id.* at *17.
338. *Id.* at *18.
339. *Id.*
340. *Id.* at *19.
341. *Id.*
342. *Id.* at *25.
343. *Id.* at *24.
344. *Id.* at *25–26 (citing Marchand v. Barnhill, 212 A.3d 805, 821 (Del. 2019) (en banc)).
345. *Id.* at *25 (quoting *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009)).

held that, like *Marchand,* airplane safety was "essential and mission critical" to Boeing's business.[346] In particular, the court pointed to four different factors in its decision to deny the Defendants' motion to dismiss: (1) the board had no committee charged with direct responsibility to monitor airplane safety;[347] (2) the board did not monitor, discuss, or address airplane safety on a regular basis;[348] (3) the board had no regular process or protocols requiring management to apprise the board of airplane safety;[349] (4) management saw red, "or at least yellow flags, but that information never reached the Board[;]"[350] and (5) the court could infer scienter based on the facts that Plaintiff-shareholders pled.[351]

The court also agreed that Plaintiff-shareholders made a sufficient showing for a *Caremark* "prong two" claim for the time period after the Lion Air crash.[352] Because the court had already opined on the validity of a "prong one" claim, the court did not go into as much detail regarding this claim.[353]

In sum, *Boeing* represents the culmination of the subtle but important shift in the *Caremark* standard, beginning with *Marchand,* that suggests that the Delaware courts are more sympathetic to Plaintiff-shareholders' claims of breach of fiduciary duty. Once thought of as the hardest theory upon which to prevail in corporate law, there seem to be a lowering of the walls in the Caremark fortress and the protection that directors can expect. The success of a *Caremark* claim is still very elusive for plaintiffs; however, the area in which there is a likely marked difference is in D&O insurance, described below.

---

346. *Id.* at *26. The court also noted that like in the *Chou* case and others, there were external regulations that applied to Boeing's industry. *Id.* at *26 n.250 (citing Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou, No. CV 2019-0816-SG, 2020 WL 5028065, at *18 (Del. Ch. Aug. 24, 2020)). Meaning, the role of the FAA and the violations of positive law (*i.e.*, FAA regulations) was also important to the court's analysis. *Id.* at *26.

347. *Id.* at *26–27.

348. *Id.* at *27.

349. *Id.* at *28–29. The court noted that rather than a regular process, the Board only received "*ad hoc* management reports that conveyed only favorable or strategic information." *Id.* at *28.

350. *Id.* at *31. Although this seems as if the court is holding the Board responsible for information it never received, the court emphasized that this lack of information flow suggests that there was not a reporting system in place. *Id.* at *32.

351. *Id.* at *32.

352. *Id.* at *33.

353. *Id.*

IV. THE EFFECT OF *CAREMARK*'S CREEP ON D&O INSURANCE

What does the shift in the *Caremark* standard mean in practicality? In terms of the likely future success of plaintiffs on the merits, perhaps not much. Will it mean more denials of motions to dismiss? Perhaps, given that the above-listed cases hold precedential value. However, each of the above-described cases consist of egregious facts and clear breaches of fiduciary duties. The *Caremark* standard likely remains alive and well and will continue to be one of the "most difficult theories upon which to prevail."[354] Yet, even a slight shift in the standard means extra risk. This alone could send ripples into the industry that quantifies and assesses risk: the D&O insurance market. To be sure, the above cases are concerning to companies, but more so to individual directors and officers. As explained below, monetary settlements and judgments of oversight cases are typically not indemnifiable by the companies, thus D&O are personally liable. In order to protect personal assets, companies buy D&O insurance. This new standard of *Caremark* oversight has raised the risk of personal liability for directors and officers, which has placed great pressure on companies to carry substantial Side A D&O insurance.

A. Fundamentals of D&O Insurance Coverage

Corporations purchase D&O insurance to protect the board and officers against shareholder litigation.[355] In addition to protecting the assets of the corporation, the purpose of D&O insurance is to protect the directors' and officers' personal assets when they are found personally liable.[356] A strong D&O insurance policy lowers fears of having to pay with personal assets when held personally liable for a liability claim.[357] It has long been recognized that D&O insurance coverage represents a form of compensation for directors and

354. Rattner v. Bidzos, No. Civ.A. 19700, 2003 WL 22284323, at *12 & n.70 (Del. Ch. Sept. 30, 2003).

355. Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1801 (2007). Shareholder litigation covered by D&O insurance includes securities law claims as well as direct and derivative fiduciary claims. *Id.* at 1804.

356. *Id.* at 1797; *see also The Who, What & Why of Directors & Officers Insurance*, HARTFORD, https://www.thehartford.com/management-liability-insurance/d-o-liability-insurance/explained [https://perma.cc/MK5Q-UV8A] (noting the specifics of D&O coverage).

357. *See* HARTFORD, *supra* note 356 (explaining that directors and officers of companies of all sizes can be sued over their management affairs).

officers.[358] Thus, D&O insurance plays an important role in incentivizing top talent and in recruiting and retaining directors and officers.[359]

When shareholders bring a derivative suit on behalf of the company, the named defendants are individual directors or officers. The company itself may also be named as a defendant. While the exact coverage of the D&O insurance is determined by the policy language, most protections arise from the three core agreements called "Side A," "Side B," and "Side C," or A-B-C coverage.[360]

Side A has been dubbed the "personal protection" part of the policy.[361] In all practicality, it acts as professional liability insurance for covered individuals, providing reimbursement for damages, settlements, judgments, and defense costs as a result of a legal action.[362] It protects the assets of an individual director or officer for claims the company cannot or will not indemnify the individual.[363] The inability of the company to indemnify directors and officers is significant, many state laws prohibit a company from indemnifying directors and officers for any settlement portion of a derivative claim.

In particular, Delaware law specifically prohibits a company from indemnifying directors and officers for any settlement portion of a

---

358. *See, e.g.*, Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 2013 (1978) (stating that because D&O premiums are paid by the corporations, D&O insurance coverage "was nothing more than another form of compensation for the executives and a way of attracting capable managers"). Interestingly, there was a time when directors and officers were required to pay a portion of the premium.

359. René Otto & Wim Weterings, *D&O Insurance and Corporate Governance: Is D&O Insurance Indicative of the Quality of Corporate Governance in a Company?*, 24 STAN. J.L. BUS. & FIN. 105, 108 (2019); Noel O'Sullivan, *Insuring the Agents: The Role of Directors' & Officers' Insurance in Corporate Governance*, 64 J. RISK & INS. 545, 549 (1997).

360. Baker & Griffith, *supra* note 355, at 1802.

361. *See* Priya Cherian Huskins, *The ABCs of Your Private Company D&O (Policy Terms)*, WOODRUFF SAWYER (May 7, 2014), https://woodruffsawyer.com/do-notebook/do-abc/ [https://perma.cc/Y5LU-DPYQ] (explaining that D&O insurance responds when the corporation is not able to indemnify directors and officers).

362. *See Understanding the Many Facets of Side A D&O (DIC)*, GBA INS., https://www.gbainsurance.com/facets_side_a_dic_918 [https://perma.cc/9RDN-8FL8] (noting that a D&O policy "provides first dollar coverage"). D&O can extend to defense costs as a result of criminal and regulatory investigations, but it typically does not cover intentional illegal acts. *Id.*

363. Julia Kagan, *Directors and Officers (D&O) Liability Insurance*, INVESTOPEDIA (July 10, 2022), https://www.investopedia.com/terms/d/directors-and-officers-liability-insurance.asp [https://perma.cc/R3NS-QHT3].

derivative claim.[364] Specifically, the law states in relevant part "no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation."[365] For this reason, with the uptick in derivative lawsuits filed, Side A coverage has become increasingly important to directors and officers.[366] Furthermore, Side A is not subjected to any self-insured retention (SIR) or deductible.[367] SIR requires the insured to assume the initial costs of the defense expenses, such as defense costs and allowed judgments or settlements, up to the SIR amount.[368] Because Side A is not subject to SIR, the D&O insurer will pay the full amount up to the limits with no assistance from the corporation.[369]

Side B of the policy is for the benefit of the company. Side B reimburses a company for its indemnification obligation to its directors and officers.[370] For example, while Delaware law prohibits indemnification for judgments or settlements, it permits indemnification for defense costs.[371] It is usually subjected to SIR or a deductible.[372]

Side C is often referred to as the "entity coverage" part of the policy.[373] Side C guarantees the corporation is covered when the corporation is also named in the lawsuit.[374] For private companies, Side C provides broad entity coverage.[375] For public companies, however,

---

364. DEL. CODE ANN. tit. 8, § 145(b) (2022).

365. *Id.*

366. *See* Baker & Griffith, *supra* note 355, at 1802–03 (emphasizing that Side A coverage requires insurers to pay covered losses).

367. Priya Cherian Huskins, *Side A Insurance Overview for Directors & Officers*, WOODRUFF SAWYER (Aug. 12, 2020), https://woodruffsawyer.com/do-notebook/side-a-insurance-overview-directors-officer [https://perma.cc/EC5P-CWRN].

368. *Id.*

369. PRIYA CHERIAN HUSKINS, WOODRUFF SAWYER, D&O LIABILITY INSURANCE: AN OVERVIEW 3 (2018), https://woodruffsawyer.com/wp-content/uploads/2018/05/DO-Insurance-Overview-WSCo-Priya-Huskins-2018-5.pdf [https://perma.cc/LPZ5-7HFH].

370. *Id.* at 2.

371. DEL. CODE ANN. tit. 8, § 145(b) (2022).

372. Huskins, *supra* note 361.

373. Baker & Griffith, *supra* note 355, at 1802; HUSKINS, *supra* note 369, at 3.

374. Matthew T. McLellan, *Directors and Officers Liability (D&O)*, MARSH, https://www.marsh.com/us/services/financial-professional-liability/directors-and-officers-liability.html [https://perma.cc/3LWU-K3XS].

375. Huskins, *supra* note 361.

Side C only covers security claims.[376] Similar to Side B, Side C is generally subjected to SIR or a deductible.[377]

D&O policies may have supplemental agreements added to the customary three-core agreement. Side D is a common supplement, which provides "Derivative Investigation Coverage."[378] When directors receive notice of possible violations of the law, Delaware Law requires directors to exercise "good faith" and take steps to investigate the claim.[379] Side D pays for the costs associated with investigations required during a derivative suit.[380] These costs include the hiring of outside counsel; accounting, financial, and regulatory costs; and the cost of books and records requests—all common in derivative suit litigation.[381]

While coverage is dependent on the specific policy, there are common exclusions to what Side A may cover, such as intentional fraud.[382] While insurance carriers will not insure for these types of D&O claims, the negotiable aspect is the point at which such conduct becomes excluded. Traditionally, the exclusion only applies to a final adjudication of fraudulent conduct.[383] This is clearly better for an insured director or officer than if the exclusion could be triggered earlier in time. Further, almost all shareholder litigation is settled, "therefore, not adjudicated in the proceeding for which coverage is sought—the fraud exclusion does not narrow the D&O insurance

---

376. *Id.*

377. *Id.*

378. *Derivative Investigation Coverage*, INT'L RISK MGMT. INST., https://www.irmi.com/term/insurance-definitions/derivative-investigation-coverage [https://perma.cc/787V-QJFA].

379. Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006).

380. INT'L RISK MGMT. INST., *supra* note 378.

381. *Id.*

382. Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 802 (2009). Interestingly, the authors noted the following incentive from this exclusion:

> "plaintiffs' lawyers report that the fraud exclusion leads them to plead strategically, crafting their pleadings to avoid coming within the exclusion. Pleading intentional fraud would give the D&O insurers a bargaining chip that they could use in the settlement negotiations. Plaintiffs' lawyers are not anxious to give liability insurers bargaining chips, so they construct their case around allegations of reckless conduct, further reducing the effect of the fraud exclusion on settlement values."

Id. at 803.

383. *Id.* at 802.

policy to the extent that a simple reading of the D&O insurance policy might suggest."[384]

B. *The Mechanics of D&O Insurance: A Hypothetical*

To understand how D&O insurance works in practice, imagine: A Delaware-incorporated company has a $50 million D&O policy with the three core agreements—Side A, Side B, and Side C. Side B and C have an SIR of $5 million. One of the board members is prone to erratic behavior. He decides to post a series of questionable statements on social media regarding the company's stock being overvalued and his intention to take the public company private. The company experiences a stock drop. Shareholders file a derivative lawsuit in Delaware against the director alleging the board member's posts were a breach of fiduciary duty, caused the stock drop, and harmed the company. Ultimately, the case settles for $50 million. During the course of litigation, the director spent $10 million in defense costs. How does the D&O insurance apply?

First, Side A would cover the settlement cost that are not indemnifiable. Under Side A, there is no SIR or deductible. Since the case is under Delaware law, which prohibits indemnification for derivative suit settlements, the D&O insurer would cover the entire $50 million settlement.

Second, turning to Side B, under Delaware law, the company can indemnify the director for his defense costs.[385] Therefore, coverage under Side B of the D&O insurance policy would reimburse the company for the costs of indemnification *after* the SIR or deductible was met. Under this scenario, the SIR is $5 million and the defense costs were $10 million. The company would be required to assume the initial costs $5 million of the defense costs, then Side B would cover the remaining costs of $5 million.

Third, if there had been a company defense element of the derivative suit, Side C would reimburse the company for the costs, subject to the SIR. In this scenario, the Company was not named as a defendant, and therefore, Side C would not be triggered.

Finally, if the policy had a limit on corporate investigations, the company would be responsible for costs incurred over that limit unless they held Side D coverage. Side D would control the coverage amount

---

384. *Id.*
385. DEL. CODE ANN. tit. 8, § 145(b).

beyond Side C and reimburse the company for derivative investigation costs up to the limits of Side D.

The above hypothetical demonstrates the importance of a strong D&O insurance policy. Without one, directors and officers would be personally exposed to financial liability. Consequently, they would have little incentive to settle derivative suits knowing how difficult these claims are for plaintiffs to succeed. However, this would substantially increase litigation costs, and without a strong D&O policy, companies would be required to assume the increased costs. Understanding this dilemma, a shift in increased risk for directors and officers has a butterfly effect on D&O insurance.

C. *Consequences* of Caremark*'s New Standard for D&O Insurance and Corporate Directors*

While the *Caremark* standard likely continues to be one of the "most difficult theories upon which to prevail,"[386] the shift in risk has a substantive effect on D&O insurance. Historically, derivative suits were not a large threat to directors and officers or D&O insurance. Derivative suits were infrequent, and even when they were brought against directors and officers, *Caremark* created such a heavy pleading burden on plaintiffs, rarely would they make it past the motion to dismiss.[387] On the rare occasion of a settlement, the payout amounts were considered "nuisance values."[388]

Today, the derivative suit settlement landscape is much different and creates a significant risk for D&O insurers, and by extension, directors and officers. While the *Caremark* standard likely continues to be one of the "most difficult theories upon which to prevail" the shift in risk has a substantive effect on D&O insurance.[389] While many derivative suits continue to be unsuccessful past the motion to dismiss stage, others are settling for unprecedented amounts. In 2020, Alphabet, Inc. settled a derivative suit for $310 million and Wynn Resorts, Ltd. settled

386. Rattner v. Bidzos, No. Civ.A. 19700, 2003 WL 22284323, at *12 n.70 (Del. Ch. Sept. 30, 2003).
387. *See supra* Part II (discussing the *Caremark* standard).
388. *See* Priya Cherian Huskins, *Derivative Suits: Newest Threat to Board Members or 'Same Old-Same Old'?*, WOODRUFF SAWYER (Sept. 25, 2014), https://woodruffsawyer.com/do-notebook/derivative-suits [https://perma.cc/98AH-HPRR].
389. *Rattner*, 2003 WL 22284323, at *12.

a derivative suit for $41 million.[390] On July 30, 2021, L Brands, the parent company behind Victoria's Secret and Bath & Body Works, settled derivative actions filed against the two entities for $90 million.[391] These settlements, among others, resulted from a wave of derivative lawsuits focused on #MeToo issues, and many cases remain active.[392]

It is important to consider who is actually paying these large settlements: almost always it is not the directors and officers with their personal assets, nor the companies since they are prohibited from indemnifying corporate directors in derivatives claims. Cue in Side A of D&O insurance. D&O insurers are paying the settlements, without any assistance from SIR or deductibles.

Furthermore, even when the plaintiffs are unsuccessful with their *Caremark* claims, there are extensive litigation costs. Recall D&O insurance pays for the legal defense.[393] Unlike typical personal insurance where the insurer selects defense counsel and manages the defense with the ability to oversee and control costs, D&O insures do not. D&O insurance gives the insured the right to select defense counsel and manage their defense. The result of this practice routinely leads to substantial legal defense costs.[394] With the knowledge that the D&O policy will simply reimburse the insured for their defense costs (subject only to the policy limits), there is little incentive for the insured to oversee and push back on defense costs.[395] Without the ability to push back on defense counsel's billing, the result is significant payouts for defense costs.[396]

The evolution of *Caremark*'s new standard has created an increased duty of director oversight, and with that increased duty brings

---

390. Edward Segal, *After Setting a New Record in 2020, Workplace-Related Litigation Will Remain a Source of Significant Financial Exposure for Employers*, FORBES (Jan. 5, 2021, 6:00 AM), https://www.forbes.com/sites/edwardsegal/2021/01/05/after-setting-a-new-record-in-2020-workplace-related-litigation-will-remain-a-source-of-significant-financial-exposure-for-employers/?sh=10655428678b [https://perma.cc/VX3F-NBMY].

391. Joseph Hartunian, *L Brands Settles Derivative Suits*, JD SUPRA (Aug. 4, 2021), https://www.jdsupra.com/legalnews/l-brands-settles-derivative-suits-5204374/ [https://perma.cc/R2AL-82KL].

392. Palmer et al., *supra* note 67.

393. Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 8 (1989).

394. Baker & Griffith, supra note 355, at 1814–15.

395. *Id.*

396. *Id.* at 1815–16.

increased risk. If the floor for director oversight has been raised, there is a higher possibility for plaintiffs to hold directors liable for not meeting that raised floor. This has important implications for D&O underwriters who are notably concerned about the large breach of fiduciary duty suit settlements and cost of litigation.[397]

In a survey, 85% of D&O underwriters believed risk was increasing in 2022.[398] The focus on mitigating risk used to be on the CFO. However, for the past two years, D&O insurers increasingly turn to the quality of the board. When asked, "[w]ho is the most critical person at a company when you think about mitigating D&O risk?" the majority of surveyed underwriters answered the Board of Directors.[399]

An analysis of the underwriting process can provide an understanding of how D&O insurer underwriters quantify the board's influence and risk. Underwriting is the process the insurer uses to determine the risks associated with insuring a company in deciding whether to offer coverage, what amounts of coverage, and the price of coverage.[400] In assessing risk, underwriters analyze two main areas: financial health and corporate governance.[401] In assessing financial health, underwriters look at things such as the maturity of the company, the industry, market capitalization, and accounting ratios.[402] The corporate governance analysis involves an underwriter assessing

397. *See* Priya Cherian Huskins, *Five Types of Derivative Suits with Massive Settlements*, WOODRUFF SAWYER (Oct. 13, 2020), https://woodruffsawyer.com/do-notebook/five-derivative-suits-types-massive-settlements [https://perma.cc/5ZVY-MRTU] (highlighting insurers' concerns both with large payouts and with large numbers of open, unsettled cases); *see also Legal Costs and Derivative Settlements Continue to Rise*, ALLIANZ (July 2022), https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/claims-report-22-directors-and-officers-insurance.html [https://perma.cc/NF65-CUG3] (discussing trends that will likely keep D&O suits elevated for the foreseeable future given that litigation risk is a big concern); Risk in Context Podcast, *D&O Liability Trends and Strategies for 2022*, MARSH (Jan. 11, 2022), https://www.marsh.com/us/services/financial-professional-liability/insights/risk-in-context-podcast-d-o-liability-trends-and-strategies-for-2022.html [https://perma.cc/6YGH-2Y6R] (noting that risks for directors and officers are growing increasingly complex and increasingly difficult to address through D&O insurance packages).

398. WOODRUFF SAWYER, LOOKING AHEAD TO 2022: D&O CONSIDERATIONS FOR THE NEXT CALENDAR YEAR 21 (2021), https://woodruffsawyer.com/wp-content/uploads/2021/09/DO-Looking-Ahead-to-2022.pdf [https://perma.cc/KT9K-PWJC].

399. *Id.* at 29.

400. Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 508 (2007).

401. *Id.* at 516.

402. *Id.* at 514–15, 514 n.118.

the "culture" and "character" of the insured.[403] Underwriters view culture and character as potentially even more important than financial health.[404] Culture reflects an investigation into structural features of the company like incentives, compensation, and compliance programs.[405] Character goes to the "ethics and confidence of the management of the company."[406] Here, underwriters investigate the "reputation, skill set, and litigation history of each individual board member."[407] Much of this information is obtained during "underwriters' meetings," which are private meetings where underwriters can request and gather private information not publicly available.[408] Further, since 1996, some D&O insurers keep a database which lists every director and officer who has ever been a defendant in a derivative suit.[409]

In the current era of increased board oversight expectations, 74% of D&O underwriters believe corporate directors underestimate their litigation risk and are not as aware of the cost of litigation as they should be.[410] Consequently, insurance carriers are looking for directors and officers who understand and can implement strong internal controls; risk greatly decreases with corporate management who not only follows their fiduciary duties but understand what those require.[411]

Companies with good boards will want to emphasize the board's involvement in risk mitigation as they go through the D&O insurance process. To satisfy D&O underwriters, board members and officers must be aware of their increased duty of oversight. Not only must they understand the recent development of *Caremark* cases, but they must also understand what the duty of oversight expectations require. They need to consider this when shaping their policies, agendas, and processes. Directors must create monitoring mechanisms, especially

---

403. *Id.* at 516–17.
404. *Id.* at 517.
405. *Id.* at 517–23.
406. *Id.* at 517, 523.
407. *Id.* at 525.
408. *Id.* at 511–12. Because of the disclosure of private information during underwriters' meetings, underwriters enter nondisclosure agreements with potential insureds. *Id.*
409. *Id.* at 513.
410. WOODRUFF SAWYER, *supra* note 398, at 22.
411. *See id.* at 29 (noting the importance of executives who understand and implement strong internal controls).

with respect to "mission critical operations."[412] Additionally, they must be able to prove that they were actively monitoring those mechanism, they responded to any and all red flags or concerns, and how they responded.[413] In order to prove these two things, directors need to document everything in detail: "The overall indication is toward a more active and attentive board."[414]

Further, this may be a good time for directors and officers to look back at the times when directors were paying settlements out of their own pockets.[415] While D&O insurance almost always covers the settlement amount, this is not always the case. In 2005, several settlements were partially paid from directors' pockets. For example, ten former directors of WorldCom agreed to pay $18 million of their own money to settle.[416] Enron directors were required to personally pay $13 million.[417]

As Professor Shapira notes, there are likely to be further *Caremark* duty claims, and the combination of heightened standards and increased ability of claimants to conduct pre-lawsuit investigations may translate into increased numbers of sustainable *Caremark* claims going forward.[418]

D. Looking Forward: Hot Topics Demanding Further Board Oversight

Significantly, several of the recent *Caremark* cases included businesses in highly regulated industries—for example, the food safety issues that the Blue Bell Ice Cream company faced in the *Marchand* case. In other words, in each of the cases listed in Part III

---

412. *See* Kevin LaCroix, *A "New Era" of* Caremark *Claims?*, D&O DIARY (Jan. 20, 2021), https://www.dandodiary.com/2021/01/articles/director-and-officer-liability/a-new-era-of-Caremark-claims [https://perma.cc/BEX3-MNCD].

413. *See id.*

414. *Id.*

415. Ben White, *Directors Run Risk of Paying Penalties Out of Their Pockets*, WASH. POST (Jan. 20, 2005), https://www.washingtonpost.com/archive/business/2005/01/20/directors-run-risk-of-paying-penalties-out-of-their-pockets/15ec7730-d46e-4b40-acf1-a67f4d1ed83a [https://perma.cc/9SYT-L8F9].

416. Gretchen Morgenson, *10 Ex-Directors from WorldCom to Pay Millions*, N.Y. TIMES (Jan. 6, 2005), https://www.nytimes.com/2005/01/06/business/10-exdirectors-from-worldcom-to-pay-millions.html [https://perma.cc/BN9D-Q8S8].

417. Kurt Eichenwald, *Ex-Directors at Enron to Chip in on Settlement*, N.Y. TIMES (Jan. 8, 2005), https://www.nytimes.com/2005/01/08/business/exdirectors-at-enron-to-chip-in-on-settlement.html [https://perma.cc/N94R-RLCZ].

418. Roy Shapira, *A New* Caremark *Era: Causes and Consequences*, 98 WASH. U. L. REV. 1857, 1860 (2021).

describing the shift in the *Caremark* standard, there was the existence of positive law (*i.e.*, regulations) that the corporation had violated.[419] Plaintiffs in those cases were able to piggyback on federal and state investigations in order to obtain additional discovery, and they were able to point out that the violation of federal or state regulations set the stage for a likely breach of fiduciary duty by the directors.[420] With the likely increase in regulations in two specific areas—ESG and cybersecurity—there exists the corresponding likely increase in potential *Caremark* claims, resulting in increased pressure upon D&O insurance carriers.

1. ESG

ESG, which stands for "Environmental, Social, and Governance," is a framework for analyzing investments based upon ethical impact and sustainability, and it has taken corporate America by storm over the past few years. ESG has enjoyed full-throated endorsements from institutional investors,[421] corporations,[422] regulators,[423] and academics,[424] among others. The steady drumbeat demanding

---

419. *See supra* Part III.

420. For an in-depth analysis of the role the federal regulation and enforcement plays, see Chatman & Etheridge, *supra* note 14, at 38.

421. *See, e.g.*, *BlackRock ESG Integration Statement* (May 19, 2022), https://www.blackrock.com/corporate/literature/publication/blk-esg-investment-statement-web.pdf [https://perma.cc/YYZ7-NSJ4].

422. *See, e.g.*, APPLE, ENVIRONMENTAL SOCIAL GOVERNANCE REPORT 4 (2021), https://s2.q4cdn.com/470004039/files/doc_downloads/2021/08/2021_Apple_ESG_Report.pdf [https://perma.cc/YWA6-ZNW7]; COCA-COLA, 2020 BUSINESS & ENVIRONMENTAL, SOCIAL AND GOVERNANCE REPORT 3 (2020), https://www.coca-colacompany.com/content/dam/journey/us/en/reports/coca-cola-business-environmental-social-governance-report-2020.pdf; AMAZON, AMAZON'S 2021 SUSTAINABILITY REPORT 2–4 (2021), https://sustainability.aboutamazon.com/2021-sustainability-report.pdf [https://perma.cc/8THU-LNDF].

423. *See, e.g.,* Allison Herren Lee, Former Comm'r, Secs. Exch. Comm'n, Keynote Remarks at the 2021 ESG Disclosure Priorities Event (May 24, 2021), https://www.sec.gov/news/speech/lee-living-material-world-052421 [https://perma.cc/DU2F-F67U].

424. *See, e.g.*, Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 385–86 (2020) (concluding that trustees can undertake ESG investing under certain broad conditions); Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 93–95 (2010) (describing the emergence of and support of social activism by investors focused on "ESG risks). *But see* Stephen Bainbridge, *Don't Compound the* Caremark

corporate information and action related to ESG has led the SEC and other state regulators to propose rules regarding corporate disclosures of climate risk, diversity metrics, and transparency in corporate governance.[425] In March 2022, the SEC proposed climate risk disclosure rules, requiring companies to share information regarding their climate risk exposure and the attendant corporate mitigation measures.[426] With the specter of additional regulation comes additional liability, both from regulators and from plaintiffs via derivative suits, all of which puts pressure on D&O insurance policies.

In fact, ESG activism has already made inroads into D&O insurance in the form of climate change litigation and liability.[427] In particular, there are increasing allegations that companies and senior management have not adequately disclosed material risks regarding climate change, or that companies and senior management have not taken action to make their companies more eco-friendly.[428] If and when the SEC climate disclosures take effect, these claims will have more merit given the violation of positive law in the form of regulatory requirements.

2. Cybersecurity

Like ESG, the area of cybersecurity is a hot topic that raises the blood pressure of many corporate officers and directors. As cyberattacks grow more sophisticated and frequent, the potential for litigation and related D&O claims is also on the rise.[429] There have been a number of

---

Mistake by Extending it to ESG Oversight, 77 BUS. LAW. 651, 655 (2021) (arguing against expanding *Caremark* liability to ESG issues defined by outsiders as opposed to those ESG issues corporate management determines to be important to the business).

425. *See generally* Leo E. Strine, Jr., Kirby M. Smith & Reilly S. Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 IOWA L. REV. 1885 (2021) (noting how company boards can leverage existing corporate compliance programs with emerging EESG initiatives in response to such climate, diversity, and transparency demands).

426. Press Release, Secs. Exch. Comm'n, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46 [https://perma.cc/MP7U-3764].

427. *Why Are Directors and Officer's Insurance Rates Rising?*, ROGUE RISK (Aug. 13, 2022), https://www.roguerisk.com/insights/why-are-directors-officers-insurance-rates-rising [https://perma.cc/5L8D-N7MC].

428. *Id.*

429. *Id.*

lawsuits arising from cybersecurity breaches to date, as well as a handful of *Caremark* claims.[430]

Compounding the litigious landscape surrounding cybersecurity, the SEC has stepped in this space with additional proposed regulations issued on March 9, 2022, which require companies to adopt standardized measures regarding cybersecurity strategy and risk management.[431]

These new areas of regulation and risk have not gone unnoticed by D&O underwriters: in 2021, 82% of underwriters believe the governmental regulatory environment is becoming more difficult for public companies and their directors and officers, compared to 60–69% in the previous four years.[432]

CONCLUSION

Much has been written about *Caremark* and its impact. While seemingly setting the standard for corporate compliance, *Caremark* also provided a very high bar for plaintiffs seeking to bring derivative claims against boards of directors. Until 2019, *Caremark* afforded nearly impenetrable protection to boards of directors. Beginning with the *Marchand* case in 2019, the *Caremark* protection began to wane. The most recent, and most press-grabbing case was that of *Boeing* in 2021. This Article described in detail the subtle but important shift in the *Caremark* standard since 2019, but the major effect of any shift in the *Caremark* standard will be most visible in the area that governs risk: D&O insurance. Despite the recent evolution in the *Caremark* standard,

---

430. The three most notable cybersecurity *Caremark* claims relate to (1) a data breach involving Marriott, International, *Firemen's Ret. Sys. of St. Louis v. Sorenson*, No. 2019-0965-LWW, 2021 WL 4593777, at *1, *5–6 (Del. Ch. Oct. 5, 2021); (2) a data breach at Laboratory Corporation of America Holdings, Verified Shareholder Derivative Complaint at 3, *Eugenio v. Berberian*, No. 2020-0305-PAF (Del. Ch. Apr. 28, 2020); and (3) a data breach involving SolarWinds Corporation, Verified Shareholder Derivative Complaint, *In re SolarWinds Corp.*, No. 2021-0940-SG, ¶¶ 2, 33 (Del. Ch. Nov. 4, 2021). *See* H. Justin Pace & Lawrence Trautman, *Mission Critical:* Caremark, *Blue Bell, and Director Responsibility for Cybersecurity Governance*, WISC. L. REV. (forthcoming 2022) (manuscript at 1, 53), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3938128# (noting five successful *Caremark* claims between 2019 and 2021 after twenty-five years of unsuccessful claims).

431. Press Release, Secs. Exch. Comm'n, SEC PROPOSES RULES ON CYBERSECURITY RISK MANAGEMENT, STRATEGY, GOVERNANCE, AND INCIDENT DISCLOSURE BY PUBLIC COMPANIES (Mar. 9, 2022), https://www.sec.gov/news/press-release/2022-39 [https://perma.cc/Q5GW-EX29].

432. WOODRUFF SAWYER, *supra* note 398, at 28.

Plaintiffs will continue to face extreme difficulty in bringing a successful *Caremark* claim. However, the risk calculus has shifted, and that risk calculus is quantified in D&O insurance. As such, although the shift in the *Caremark* standard may be subtle, the ripple effects upon D&O insurance are not.