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Hughes v. Hu: *Territorial Adjustments in Determining Caremark Liability for Foreign-based Delaware Incorporated Companies*

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NOTE

HUGHES V. HU: TERRITORIAL ADJUSTMENTS IN DETERMINING CAREMARK LIABILITY FOR FOREIGN-BASED DELAWARE INCORPORATED COMPANIES

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In *Hughes v. Hu*,[1] the Delaware Court of Chancery addressed the *Caremark* liability[2] of Kandi Technologies Group, Inc.,[3] a Delaware corporation that principally does business in China.[4] The court[5] noted that Kandi's board of directors did not implement nor maintain sufficient board-level oversight controls for the company's accounting practices or related-party transactions.[6] Therefore, the court correctly[7] held that Kandi's board of directors faced a substantial threat of liability under *Caremark* and denied the board's motion to dismiss the shareholder derivative suit.[8] The court's decision was consistent with precedent,[9] but the holding is likely to

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1. C.A. No. 2019-0112-JTL, slip op. (Del. Ch. Apr. 27, 2020).

2. *Caremark* liability, also referred to as "*Caremark* claims," arises when a director breaches their fiduciary duty of loyalty by not making "a good faith effort to oversee the company's operations." Marchand v. Barnhill, 212 A.3d 805, 820–21 (Del. 2019), *vacated*, No. 2017-0586-JRS, 2018 Del. Ch. LEXIS 316 (Del. Ch. Sept. 27, 2018).

3. Kandi Technologies Group, Inc. is primarily in the business of developing, producing, and distributing parts of electric vehicles. *Kandi Technologies Group Inc. Profile*, REUTERS, https://www.reuters.com/companies/KNDI.OQ (Feb. 5, 2021, 3:59 PM). Kandi also produces off-road vehicles. *Id.*

4. *Hughes*, slip op. at 4, 28–29.

5. This Note will refer to the Delaware Court of Chancery as the "Delaware Court of Chancery," the "Delaware Chancery Court," the "court of chancery," and the "chancery court" interchangeably, and the Delaware Supreme Court as the "Delaware Supreme Court."

6. *See infra* Section I.B.

7. *See infra* Section IV.A.

8. *Hughes*, slip op. at 37–38.

9. *See infra* Section IV.A.

exacerbate a recent trend.[10] The trend is the avoidance of and exodus by corporations—particularly those principally operating abroad—from choosing Delaware as their source of corporate governance law.[11] This heightened avoidance is because the holding in *Hughes* represents a potential operational incompatibility between Delaware corporate governance standards and typical non-American business practices.[12] Directors of foreign corporations will likely see the *Hughes* holding as a signal for potential litigation risks should they continue their typical business practices and incorporate in Delaware.[13]

After synthesizing Delaware's *Caremark* jurisprudence, this Note calls for Delaware courts to factor in a business's underlying market practices[14] when determining the acceptable level of oversight for companies.[15] This approach would not lessen the requirements for boards under the duty of oversight but rather allow for the Delaware courts to better assess a company's "good faith" efforts in meeting the duty.[16] Although the Delaware legislature could also attempt to address this issue, the Delaware courts have the greater institutional capacity to reach case-by-case determinations.[17] By allowing for "territorial adjustments" when considering *Caremark* liability, Delaware can maintain its preeminent position as an international supplier of corporation law.[18]

I. THE CASE

A. The Company and the Parties

The case of *Hughes v. Hu*[19] concerns seven members from Kandi Technologies Group's (the "company") executive management and board of directors who served during the company's accounting control problems.[20] The named defendants include the company's CEO and chairman of its board of directors: Xiaoming Hu; three successive CFOs: Xiaoying Zhu, Cheng

10. *See infra* Section IV.B.
11. *See infra* Section IV.B.
12. *See infra* notes 258–278 and accompanying text.
13. *See infra* notes 258–278 and accompanying text.
14. *See infra* notes 296–302.
15. *See infra* Section IV.C.
16. *See infra* notes 313–320 and accompanying text.
17. *See infra* notes 286–295 and accompanying text.
18. Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 426 (2003) ("Delaware . . . is widely recognized as the most significant jurisdiction for corporate-law purposes . . . ."); *see infra* Section IV.C.
19. C.A. No. 2019-0112-JTL, slip op. (Del. Ch. Apr. 27, 2020).
20. *Id.* at 1–2.

Wang, and Bing Mei; and the three directors who formed the company's audit committee: Jerry Lewin, Henry Yu, and Liming Chen.[21] The company is a publicly-traded Delaware corporation—currently based in Jinhua, China—specializing in manufacturing parts used in electric vehicle production.[22] The company was created via a reverse merger[23] in 2007 with a—now-defunct but still publicly listed—Delaware corporation to access American capital markets.[24] William Hughes, Jr. ("Hughes") is a shareholder in the company and brought this derivative suit on behalf of the company.[25]

B. A Timeline of Events: Sustained or Systemic Failures

Although the series of events that ultimately lead to this case span several years, the timeline of the facts can be broken into roughly three distinct periods.[26] Section I.B.1 details the issues with the company's financial reports between 2010 and 2014 and the company's resolution to address them.[27] Section I.B.2 describes the sustained problems with the company's financial reports after 2014 and the key admissions of unreliability that eventually lead to this case.[28] Section I.B.3 details the plaintiff's Section 220 request and the company's response.[29]

1. Audits and Reports Between 2010 And 2014

The company's outside auditing firm, AWC (CPA) Limited (hereinafter "AWC"),[30] identified "key audit risks" and "a key control weakness" involving the company's treatment of related-party transactions[31]—transactions in which the parties are connected by some preexisting

21. *Id.* at 1–2, 18–19.

22. *Id.* at 4. The company is listed on the NASDAQ Stock Market under the ticker symbol, KNDI. *Kandi Technologies Group Inc. Profile*, REUTERS, https://www.reuters.com/companies/KNDI.OQ (Feb. 5, 2021, 3:59 PM).

23. "Reverse [m]ergers" are a means for private companies to access American capital markets without going through the lengthy and complex process of going public. SEC. & EXCH. COMM'N, INVESTOR BULLETIN: REVERSE MERGERS 1 (2011), https://www.sec.gov/investor/alerts/reversemergers.pdf. Generally, the public company—acting as a "shell"—acquires the private company, and the "shareholders of the private operating company exchange their shares for a large majority of the shares of the public company." *Id.*

24. *Hughes*, slip op. at 4.

25. *Id.* at 1.

26. *See infra* Sections I.B.1–3.

27. *See infra* Section I.B.1.

28. *See infra* Section I.B.2.

29. *See infra* Section I.B.3.

30. The court appeared skeptical of the AWC's independence as AWC had no other clients other than the company. *Hughes*, slip op. at 5.

31. *Id.* at 5.

means[32]—during its limited audit of the company's 2010 financial statements (the "2010 Audit").[33] In the two subsequent audits—the 2011 and 2012 audits, respectively—AWC identified additional risks.[34]

As part of its 2013 10-K annual report[35] ("2013 10-K"), the company disclosed that its "disclosure controls and procedures were not effective as of December 31, 2013, due to a material weakness."[36] The company's 2013 10-K also described the company's efforts to address the material weakness's contributing sources and pledged that its audit committee would review all related-party transactions.[37]

The company's audit committee[38] met twice within two months of the 2013 10-K filing: once for forty-five minutes and again, three weeks later, for forty minutes.[39] During these meetings, the audit committee reviewed

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32. Will Kenton, *Related-Party Transaction*, INVESTOPEDIA, https://www.investopedia.com/terms/r/related-partytransaction.asp (Oct. 27, 2020).

33. *Hughes*, slip op. at 5. Specifically, AWC found that the company recorded transactions with one of their largest customers, Kandi USA, under a different name. *Id.* AWC inquired if Kandi USA was a related party—Kandi USA is owned by the CEO's son, Wangyuan Hu, and therefore a related party—but received no response. *Id.* AWC did not follow up. *Id.* At the CEO's behest, AWC eliminated any references to Kandi USA in their audit trail by placing the questioned transactions in another customer's account. *Id.* Additionally, AWC found that the company parked large amounts of cash in an officer's and employee's personal bank accounts. *Id.* AWC conducted no additional investigation as to why the company placed the money in the personal bank accounts, nor did AWC inquire if the cash constituted a disclosure worthy related-party transaction. *Id.* at 5–6.

34. In the 2011 audit, AWC identified a borrower in possession of a single note valued at $33.1 million—out of a $37.9 million notes receivable balance—had not paid interest on the note in 2011. *Id.* at 6–7. AWC conducted no additional evaluation of the borrower's creditworthiness, nor did it raise concern regarding the note's collectability. *Id.* Similar to the risks identified in the "2010 Audit," AWC's 2012 audit (the "2012 Audit") revealed the company had several transactions not properly marked as related-party transactions. *Id.* at 7.

35. Under federal securities laws, companies must routinely disclose information to the public. SEC. & EXCH. COMM'N, FORM 10-K, https://www.investor.gov/introduction-investing/investing-basics/glossary/form-10-k (February 10, 2021) ("The annual report on Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements.").

36. *Hughes*, slip op. at 7. The court noted three factors from the 2013 10-K contributing to the "material weakness": (i) the company's internal audit department head reported to its CEO and not its audit committee; (ii) communication between the company's internal audit department and its audit committee was lacking; and (iii) the company did not annually evaluate the effectiveness of its audit committee. *Id.* at 7–8.

37. *Id.* at 8.

38. Members of the audit committee at this time consisted of all three director-defendants: Yu (chair and member since July 2011), Chen (member since May 2012), and Lewin (member since 2010). *Id.* at 8. Non-committee members sometimes attended audit committee meetings; however, the core composition did not change during the time in question. *Id.* at 8–9, 11–12

39. *Id.* at 8–9.

and approved a suite of items related to company matters.[40] The company failed to produce documents from either of these meetings in response to the plaintiff's Section 220 demand.[41] In July 2014, the audit committee chair reviewed the remediation measures with management, the company's internal audit team, and AWC.[42] In its November 2014 disclosure, the company determined that the new internal controls "were effective" as of September 30, 2014.[43]

2. Audits and Reports Post-2014

The audit committee next met one year later, on March 13, 2015, to review and approve the company's Annual Report on Form 10-K for the 2014 calendar year (the "2014 10-K").[44] In fifty minutes, the committee reviewed the company's year-end financial results and approved a "Policy of Related-party Transaction Relating to JV Shareholder."[45] Three weeks after the 2014 10-K was filed, the company's board of directors—via unanimous written consent—adopted a sweeping set of resolutions.[46]

The audit committee's next meeting—lasting thirty minutes—was on March 7, 2016, to review and approve the company's Annual Report on Form 10-K for the 2015 calendar year (the "2015 10-K").[47] At this meeting, the company's management represented that the company did not engage in any related-party transactions with Kandi USA during 2015.[48] However, company management did report that the company engaged in related-party sales with the service company, describing those transactions as mainly

40. During the first meeting, the audit committee reviewed both "matters relating to relationship transaction[s]," documents regarding the company's contract with Eliteway, and potential procedures for approval of "relationship transaction[s]." *Id.* at 8–9. During the latter meeting, the audit committee reviewed and approved a new "Internal Audit Activity Charter'" and a new "Management Policy on Related-Party Transactions." *Id.* at 9.

41. *Id.* at 9, 18. Requests pursuant to Section 220 of the Delaware General Corporation Law allows shareholders to inspect "for any proper purpose" the business's books and records. DEL. CODE ANN. tit. 8, § 220(b) (2020).

42. *Hughes*, slip op. at 10.

43. *Id.*

44. *Id.* at 11. There were no meetings of the audit committee between the 2014 10-K meeting and the meeting on May 30, 2014. *Id.* at 9, 11.

45. *Id.* at 11. At the 2014 10-K's filing, two days after its review, the company again described its disclosure controls and procedures as "effective." *Id.*

46. *Id.* The court drew attention to three resolutions in particular: (i) the audit committee, as well as then-director Ni Guangzheng, qualified as independent directors for NASDAQ listing purposes; (ii) Yu and Lewin qualified as audit committee financial experts; and (iii) retaining AWC as the company's independent auditor for the fiscal year ending December 31, 2015. *Id.* at 11–12.

47. *Id.* at 12. Again, the audit committee had no recorded meetings between the 2014 10-K meeting and the 2015 10-K meeting. *Id.* at 11–12.

48. *Id.* at 12–13.

involving "battery sales."[49] On March 14, 2016, the company filed its 2015 10-K.[50] The company again described its disclosure controls and procedures as "effective."[51] Within two weeks of filing the 2015 10-K, the company's audit committee—via unanimous written consent—approved a different description of the related-party transactions between the company and the service company.[52]

On April 12, 2016, the company's board of directors immediately replaced AWC with BDO China Shu Lun Pan CPAs ("BDO") as the company's auditor.[53] The Public Company Accounting Oversight Board (the "PCAOB") brought disciplinary proceedings against AWC for AWC's handling of the 2010, 2011, and 2012 audits shortly after the company replaced its auditor (the "PCAOB Orders").[54] The PCAOB Orders prompted NASDAQ to request that the company verify its cash balances.[55]

The audit committee reviewed the company's Quarterly Report on Form 10-Q[56] on August 1, 2016, for one hour.[57] The committee also discussed BDO's cash balance audit, the company's related-party transactions from the last six months,[58] and the Chinese Government's delay in subsidy payments to the joint venture.[59]

In November 2016, the company disclosed that it had engaged in material transactions with Kandi USA—under its trade name Eliteway—in

49. *Id.* The service company was Zhejiang ZuoZhongYou Electric Vehicle Service Co., Ltd. *Id.* at 4.

50. *Id.* at 13.

51. *Id.*

52. *Id.* at 13. The consent approved related-party transactions with the service company—totaling $42,032,060—and authorized management to conduct related-party transactions with the service company for the remainder of 2016. *Id.*

53. *Id.* at 14.

54. *Id.*

55. *Id.* BDO began the audit on July 11, 2016, and, at the inquiry of Lewin on the company's audit committee, reported no adverse findings. *Id.*

56. Unlike the annual filing of the Form 10-K, the Form 10-Q is filed quarterly and consists of "unaudited financial statements" which provide "a continuing view of the company's financial position during the year." SEC. & EXCH. COMM'N, FORM 10-Q, https://www.investor.gov/introduction-investing/investing-basics/glossary/form-10-q (February 10, 2021).

57. *Hughes*, slip op. at 15.

58. The company's only reported related-party transactions were with the service company. *Id.* at 15.

59. *Id.* The Chinese government phased out the subsidy program in September 2016 after investigations showed that Chinese manufacturers had structured their operations in a way to receive subsidies for both producers and purchasers of electric vehicles. *Id.*

2012.[60] The company also disclosed additional related-party transactions—totaling $10.4 million as of December 31, 2016—with the service company.[61]

In March 2017, the company announced that financial statements between 2014 through the third quarter of 2016 "could not be relied upon and needed to be restated" (the "March 2017 Announcement").[62] The company committed to providing restatement financial statements.[63] Shortly following the March 2017 Announcement, the company filed its Annual Report on Form 10-K for the 2016 calendar year.[64] It disclosed that the company lacked both "sufficient expertise" in financial statement reporting techniques and "effective controls" to classify certain cash and non-cash activities properly.[65]

3. Section 220 submission

As a result of both the March 2017 Announcement and 2016 10-K, on May 10, 2017, Hughes sought to inspect the company's books and records.[66] After the company initially declined to respond, Hughes filed for compliance in the Delaware Chancery Court.[67] After protracted negotiations, the company's board of directors provided some documents.[68] However, the company stipulated that any remaining requested materials "either do not exist or had been withheld on privilege grounds."[69]

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60. *Id.* at 16. The company claimed that these transactions were conducted at "arm's length." *Id.* An arm's-length transaction is "[a] transaction between two unrelated and unaffiliated parties," or "[a] transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises." *Transaction*, BLACK'S LAW DICTIONARY (11th ed. 2019).

61. *Hughes*, slip op. at 16.

62. *Id.* After the company made the March 2017 Announcement, four securities class actions and one derivative lawsuit were filed in the United States District Court for the Southern District of New York. *In re* Kandi Techs. Grp., Inc. Sec. Litig., 17 Civ. 1944 (ER), 2019 WL 4918649, at *3 (S.D.N.Y. Oct. 4, 2019); *Hughes*, slip op. at 18. The district court dismissed the securities class actions holding that the plaintiffs did not plead sufficiently particular facts that would support the required strong inference of scienter. *In re Kandi Techs. Grp., Inc. Sec. Litig.*, 2019 WL 4918649, at *3–6.

63. *Hughes*, slip op. at 16.

64. *Id.* at 17.

65. *Id.*

66. *Id.* at 17–18; DEL. CODE ANN. tit. 8, § 220(b) (2020).

67. *Hughes*, slip op. at 18.

68. *Id.* at 3, 18.

69. *Id.* at 3 (quoting Hughes v. Kandi Techs. Grp., Inc., C.A. No. 2017-0700-JTL, Dkt. 24, Stipulation of Dismissal With Prejudice, at 2).

C. Procedural History of Current Litigation

On February 14, 2019, Hughes filed suit in the Delaware Court of Chancery, alleging that the defendants "individually and collectively, breached their fiduciary duties by willfully failing to maintain an adequate system of oversight, disclosure controls and procedures, and internal controls over financial reporting."[70] Hughes also alleged that the defendants were unjustly enriched by receiving bonuses tied to the inaccurate financial reporting.[71] The defendants denied the allegations and moved to dismiss the complaint under Court of Chancery rules 23.1 and 12(b)(6).[72] On April 27, the court denied the defendants' motions for dismissal, permitting the case to move forward.[73]

II. LEGAL BACKGROUND

"*Caremark* claims" are a subset of shareholder derivative suits available under Delaware law.[74] *Caremark* claims allow shareholders, on behalf of the corporation, to bring action against directors who either failed to implement or properly monitor systems of oversight.[75] Section II.A discusses the origins and requirements of shareholder derivative suits under Delaware law.[76] Should shareholders decide that demand[ing] the board to act—a requirement for shareholder derivative suits—would be futile, the shareholders must plead why the court should excuse this requirement.[77] Section II.B reviews the current tests that Delaware courts use to evaluate "demand futility."[78] Section II.C examines the foundation and evolution of *Caremark* claims.[79] Section II.D surveys Delaware courts' current jurisprudence of *Caremark* claims.[80]

70. *Id.* at 18–19.

71. *Id.* at 19.

72. *Id.*

73. *Id.* at 40.

74. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (describing how a "failure to act in good faith" can in turn lead to a company's director violating their duty of loyalty); Louisiana Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 340 (Del. Ch. 2012) ("A breach of fiduciary duty claim that seeks to hold directors accountable for the consequences of a corporate trauma is known colloquially as a *Caremark* claim . . . .").

75. *Hughes*, slip op. at 1, 21, 29–31.

76. *See infra* Section II.A.

77. *See e.g.*, Rales v. Blasband, 634 A.2d 927, 932–34 (Del. 1993) (describing the demand requirement and under what circumstances it can be excused).

78. *See infra* Section II.B.

79. *See infra* Section II.C.

80. *See infra* Section II.D.

A. Shareholder Derivative Suits

Under Delaware corporation law, a company is managed by its duly elected board of directors.[81] While the directors are responsible for the corporation's affairs, shareholders are not left powerless to address transgressions made by the board against the corporation.[82] However, a shareholder's ability to bring derivative suits is restricted by several procedural requirements.[83] Section II.A.1 details the history and creation of shareholder derivative suits.[84] Section II.A.2 discusses the various "standing requirements" that shareholders must overcome before they can bring a shareholder derivative suit.[85]

1. Origin of Derivative Suits

Under longstanding American jurisprudence, "[c]orporations are creatures of state law, and . . . state law will govern the internal affairs of the corporation."[86] Delaware's corporation law—of which Kandi is bound by because it is incorporated in Delaware[87]—provides that shareholders elect the company's board of directors[88] to manage the corporation's affairs in the shareholders' stead.[89] The practical effect of this arrangement is the separation of ownership (shareholders) and control (directors)—which in turn allows for more traditional corporate characteristics such as limited liability.[90] This exchange in power has additional consequences for directors.[91] Directors gain a "triad" of fiduciary duties aimed at protecting both the interests of the corporation and the best interests of its

81. DEL. CODE ANN. tit. 8, §§ 141(a), 142(a), 211(b) (2020).

82. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

83. *See infra* Section II.A.2.

84. *See infra* Section II.A.1.

85. *See infra* Section II.A.2.

86. Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977) (quoting Cort. v. Ash, 422 U.S. 66, 84 (1975)).

87. *Hughes*, slip op. at 1.

88. DEL. CODE ANN. tit. 8, § 211(b) (2020).

89. *Id.* § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."). Actual day-to-day management of the corporation is typically done by a selection of officers by the board. *Id.* § 142(a).

90. *See* Lynda J. Oswald, *Bifurcation of the Owner and Operator Analysis Under CERCLA*, 72 WASH. U. L. Q. 223, 233 n.43 (1994) (discussing the corporate form and how the corporation is a "separate and distinct" entity from its shareholders).

91. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("The existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders." (citing Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938), *aff'd,* 5 A.2d 503 (Del. 1939)).

shareholders.[92] Delaware courts have extrapolated from these fiduciary duties a presumption that directors' business decisions must be made on both an informed and "good faith" basis.[93] This presumption is called the "business judgment rule," which functionally serves as a powerful defense when directors' business decisions are questioned by shareholders.[94]

Shareholders primarily exercise control over directors' actions through their power to elect, retain, and remove the company's directors;[95] however, shareholders are not powerless when directors' actions harm the corporation.[96] Through shareholder derivative suits, shareholders have the codified right to try and bring actions on behalf of the corporation itself.[97] However, shareholders of Delaware incorporated companies must overcome several arduous common law and statutory procedural requirements to pursue such a remedy.[98]

92. *Compare* Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) (stating that the three fiduciary duties are the duty of loyalty, the duty of care, and the duty of good faith), *with* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.").

93. *Cede & Co.*, 634 A.2d at 360 ("[P]resumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company." (quoting *Aronson*, 473 A.2d at 812)).

94. *Id.* at 361 ("The rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'" (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971))).

95. DEL. CODE ANN. tit. 8, § 211(b) (2020). Under Delaware law, shareholders are also permitted to vote on matters such as the approval of charter or by-law amendments. *Id.* § 109(a).

96. *Aronson*, 473 A.2d at 811.

97. Hawes v. Oakland, 104 U.S. 450, 454–59 (1882) (discussing the early English and American case law regarding shareholder derivative suits). The nature of these suits are either "the equivalent of a suit by the shareholders to compel the corporation to sue" or "a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it." *Aronson*, 473 A.2d at 811. Shareholder derivative suits are inherently incongruent with the notion that directors are empowered to manage the business and affairs of the corporation and, as such, a shareholder's right to seek such a remedy is limited to two situations: "(i) the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or (ii) demand is excused because the directors are incapable of making an impartial decision regarding the litigation." Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 21 (Del. Ch. Apr. 27, 2020) (citing Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993)). Federal and state governments, including Delaware, have codified the shareholders' power to seek derivative actions. FED. R. CIV. P. 23.1.; DEL. CH. CT. R. 23.1.

98. *See infra* Sections II.A.2., II.B.

2. *Standing Requirements for Shareholder Derivative Suits under Delaware Corporation Law*

To prevail in a shareholder derivative suit, a shareholder must first show that they were a shareholder at the time of the challenged transaction(s).[99] The shareholder must also maintain ownership throughout the litigation.[100] Second, the shareholder must show that their action adequately represents the corporation's interest and fellow shareholders.[101] The third and final procedural hurdle that shareholders must overcome is the demand requirement.[102]

Upon receiving the shareholder demand, the board can choose to file the suit itself—resolving the matter—or to reject the demand.[103] However, a rejected demand does not waste the shareholder's single "arrow."[104] If the shareholder can convince the court that the board wrongly rejected their demand,[105] the shareholder maintains "the right to bring the underlying action."[106] In Delaware, shareholders can also overcome the demand

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99. This requirement of share ownership is found both in the Delaware Court of Chancery rules as well as codified in the Delaware General Corporation law, with near identical language. DEL. CH. CT. R. 23.1(a); DEL. CODE ANN. tit. 8, § 327. Delaware, unlike some states, do not require a minimum ownership stake in order to bring a derivative suit. *See, e.g.*, COLO. REV. STAT. ANN. § 7-107-402(3) (2021) (allowing for a shareholder owning less than a prescribed amount of stock to post bond); N.Y. BUS. CORP. LAW § 627 (2020) (allowing the same).

100. Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).

101. *Id.* at 1036–39. Delaware law categorizes shareholder cases based on "where the recovery . . . flows": direct or derivative. *Id.* at 1036. The cases are separated by a two-question inquiry. First, "who suffered the alleged harm (the corporation or the suing stockholders, individually)?" *Id.* at 1033. Second, "who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Id.* Should the plaintiff-shareholder adequately show that the action is derivative in nature, the shareholder bringing the suit must submit an affidavit disclaiming that they have not, nor will they, receive any benefit from serving as the representative party. DEL. CH. CT. R. 23.1(a)–(b).

102. DEL. CH. CT. R. 23.1(a) ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."). The demand requirement seeks to maintain a fundamental precept of Delaware corporation law—that directors, not shareholders, run the company—by requiring shareholders to first exhaust their "intracorporate remedies." *Aronson*, 473 A.2d at 811–12.

103. *In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 985–86 (Del. Ch. 2007).

104. Grimes v. Donald, 673 A.2d 1207, 1218–19 (Del. 1996) ("If a demand is made, the stockholder has spent one—but only one—'arrow' in the 'quiver.' The spent 'arrow' is the right to claim that demand is excused. The stockholder does not, by making demand, waive the right to claim that demand has been wrongfully refused.").

105. *See infra* Section II.B.

106. *Grimes*, 673 A.2d at 1219.

requirement by showing that their demand on the board would be futile, otherwise known as "demand futility."[107]

B. Overcoming the Demand Rule ("Demand Futility")

Although Delaware courts are deferential to directors' business judgments,[108] they are also cognizant that external influence "sterilizes . . . discretion" and prevents directors from being considered "proper persons to conduct litigation on behalf of the corporation."[109] As such, two fact-specific[110] inquiries—based on separate but related factual scenarios—have arisen in Delaware corporate jurisprudence to determine if demand is futile.[111] These two inquiries are known as the *Aronson*[112] and *Rales*[113] tests, respectively.

1. When the Current and Challenged Board is the Same

In the seminal case, *Aronson v. Lewis*,[114] the Delaware Supreme Court considered a situation where the directors who approved the challenged transaction were the same directors who would consider a demand.[115] The court devised a two-pronged test specifically for this factual situation.[116] The first prong of the *Aronson* test examines "the independence and disinterestedness of the directors,"[117] while the second prong reviews the

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107. *Aronson*, 473 A.2d at 814 ("The rule emerging from these decisions is that where officers and directors are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation. Thus, demand would be futile.").

108. *See id.* at 812 ("Absent an abuse of discretion, that ['business'] judgment will be respected by the courts.").

109. *Id.* at 814. *But see id.* at 815. ("[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors . . . .").

110. Wood v. Baum, 953 A.2d 136, 140 (Del. 2008). Delaware courts routinely express that when considering a demand's futility, any reasonable inference draw in the plaintiff-shareholder's favor must be drawn from "particularized facts" and "inferences that are not objectively reasonable cannot be drawn in the plaintiff's favor." *See id.* (citing Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004)).

111. *Id.*

112. *See infra* Section II.B.1.

113. *See infra* Section II.B.2.

114. 473 A.2d 805 (Del. 1984).

115. *Id.* at 808–12; Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 22–23 (Del. Ch. Apr. 27, 2020).

116. *Aronson*, 473 A.2d at 814

117. *Id.* The court went on to say that should there be an "'interested' director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases." *Id.* at 815. Under such circumstances—not being under the protection of the business judgment rule—directors face significant risk from the suit. *Id.*; *Hughes*, slip op. at 23.

"alleged wrong . . . against the factual background alleged in the complaint."[118]

The court rejected the notion that:

> [A]ny board approval of a challenged transaction automatically connotes "hostile interest" and "guilty participation" by directors, or some other form of sterilizing influence upon them. Were that so, the demand requirements of our law would be meaningless, leaving the clear mandate of Chancery Rule 23.1 devoid of its purpose and substance.[119]

Moreover, the court held that the shareholders must establish "reasonable doubt," by the allegation of "particularized facts," in both the notion that the directors were "disinterested and independent"[120] and that the "challenged transaction was . . . a valid exercise of business judgment."[121]

2. When the Board has Changed after the Challenged Conduct

Because the *Aronson* test covered a factually specific situation,[122] it did not transpose well to cases where the "board had not acted or where the board's membership had changed."[123] As such, in *Rales v. Blasband*,[124] the Delaware Supreme Court readdressed the demand futility question where "the test enunciated in [*Aronson*] is not implicated."[125] In *Rales*, the board that considered the demand was not the same board that had made the

118. *Aronson*, 473 A.2d at 814.

119. *Id.*

120. Directors are considered "interested" when they will receive a personal benefit from a transaction, and the shareholders do not equally benefit. Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993). Directors can also be "interested" where they are not independent of someone whom is "interested" in the challenged transaction. *Hughes*, slip op. at 25–26.

121. *Aronson*, 473 A.2d at 814. The *Hughes* court put it succinctly, "[t]he central legal question was therefore whether the complaint's allegations about the directors' involvement in the decision to approve the challenged transaction rendered them incapable of making an impartial decision regarding whether to institute litigation concerning the transaction." *Hughes*, slip op. at 22.

122. *See Hughes*, slip op. at 24 (noting that the *Aronson* test only addressed situations where "the same board that would consider a demand had made the decision being challenged in the derivative suit").

123. *Id.*

124. 634 A.2d 927 (Del. 1993).

125. *Id.* at 930 (emphasis added). Although the court was explicit in saying that "a court should not apply the *Aronson* test for demand futility where the board that would be considering the demand did not make a business decision which is being challenged," the court further elaborated the "principle scenarios" in which not to apply the *Aronson* test: (1) where a majority of the directors who made the challenged decision have been replaced; (2) the subject of the derivative suit is not a business decision of the board; and (3) where the challenged decision was made by the board of a different corporation. *Id.* at 933–34.

underlying challenged decision.[126] To address this issue, the court articulated a more comprehensive demand futility test:

> [W]hether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its *independent* and *disinterested business judgment* in responding to a demand. If the derivative plaintiff satisfies this burden, then demand will be excused as futile.[127]

The court also explained a two-step process when a board responds to a stockholder demand letter.[128] First, the directors must "determine the best method to inform themselves of the facts relating to the alleged wrongdoing and the considerations."[129] Next, the board must consider the "alternatives available to it, including the advisability of implementing internal corrective action and commencing legal proceedings."[130]

Delaware courts have noted that the *Rales* and *Aronson* tests essentially seek to accomplish the same task—determining directors' impartiality.[131] However, Delaware courts have further expressed that while *Rales* is not a "universal demand requirement,"[132] the more broadly articulated test does provide a "cleaner, more straightforward formulation to probe the core issue in the demand futility" analysis.[133]

126. *Id.* at 930–31.

127. *Id.* at 934 (emphasis added).

128. *Id.* at 935. This process must also be done "free of personal financial interest and improper extraneous influences." *Id.*

129. *Id.* The court noted that should a factual investigation be required, it must be conducted "reasonably and in good faith." *Id.* (citing Levine v. Smith, 591 A.2d 194, 213 (Del. 1991)); Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990).

130. *Rales*, 634 A.2d at 935; *see also* Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984) (discussing the role of the demand requirement as a "form of alternate dispute resolution" that requires the stockholder to exhaust "his intracorporate remedies").

131. Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 27 (Del. Ch. Apr. 27, 2020).

132. Sandys v. Pincus, C.A. No. 9512-CB, 2016 WL 769999, at *13 n.60 (Del. Ch. Feb. 29, 2016), *rev'd*, 152 A.3d 124, 134 (Del. 2016) (reversing the chancery court's dismissal under rule 23.1 and remanding for further proceedings).

133. *Id.* at *13. The court further elaborated that the core issue in demand futility analysis is, "whether there is a reason to doubt the impartial[ity] of the directors, who hold the authority under 8 *Del. C.* § 141(a) to decide [for the corporation] whether to initiate, or refrain from entering, litigation." *Id.* (alteration in original) (internal quotation marks omitted) (quoting Teamsters Union 25, 119 A.3d 44, 67 (Del. Ch. 2015)); *see Hughes*, slip op. at 26–27, 27 n.2 (claiming, and providing ample supporting case law, that the more broadly articulated *Rales* test "supersedes and encompasses" the more "special application" *Aronson* test).

*C. The Duty of Oversight and "*Caremark*" Claims*

As noted above, shareholder derivative suits are a means under Delaware corporation law for shareholders to try and bring actions on behalf of the corporation itself when the board has violated one of its fiduciary duties.[134] As such, the board is subject to various "standing" requirements[135]—one of which is the previously discussed "Demand Rule."[136] In situations where the plaintiff can show that their demand on the board would be futile, a shareholder may bring a derivative suit.[137] One type of shareholder derivative suit—spawned from the broad's duty of oversight—is the "*Caremark* claim."[138] Section II.C.1 discusses the history surrounding the creation of the duty of oversight and the subsequently created *Caremark* liability.[139] Section II.C.2 details how the duty of oversight's intellectual underpinnings have shifted over the years.[140] Lastly, Section II.C.3 examines the specific parameters of the duty of oversight.[141]

1. Acceptance of Caremark *Liability*

Foundationally, directors are bound by specific fiduciary duties "to protect the interests of the corporation and to act in the best interests of its shareholders."[142] Courts, acting as a proxy for societal expectations, have imposed additional duties on boards as views of corporate board responsibilities have morphed over time.[143] The most prominent of these new duties is the aptly named "duty of oversight."[144]

In the seminal case *In re Caremark International Inc. Derivative Litigation*,[145] the Delaware Court of Chancery accepted what the *Graham v.*

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134. *See supra* Section I.A.1.

135. *See supra* Section II.A.

136. *See supra* Section II.B.

137. *Hughes*, slip op. at 21.

138. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (describing how a "failure to act in good faith" can in turn lead to a company's director violating their duty of loyalty).

139. *See infra* Section II.C.1.

140. *See infra* Section II.C.2.

141. *See infra* Section II.C.3.

142. Cede & Co. v. Technicolor, 634 A.2d 345, 360–61 (Del. 1993) (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)). The court further identified the three fiduciary duties: the duty of loyalty, the duty of care, and the duty of good faith. *Id.* at 361.

143. *See infra* notes 153–160 and accompanying text. *See generally* Dalia T. Mitchell, *The Import of History to Corporate Law*, 59 ST. LOUIS U. L.J. 683, 688–92 (2015) (discussing the "revolution" during the 1970's and 1980's in director duties and responsibilities).

144. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996). While all referencing the same duty, the "duty of oversight" has been called by other names such as "duty to monitor." Mitchell, *supra* note 143, at 684.

145. 698 A.2d 959 (Del. Ch. 1996).

Allis-Chalmers Manufacturing Co.[146] court rejected thirty-three years earlier.[147] *Graham* was a derivative suit against the company's directors for damages caused by violations of federal antitrust laws.[148] The court—treating the case like a torts case[149]—found that the board's activity was wholly limited to "matters concerning the general business policy of the company," given that the company's decentralized nature made board-level considerations of "specific problems" impracticable.[150] In a final proclamation, the *Graham* court noted that "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."[151]

Thirty-three years later in *In re Caremark*, the Delaware Court of Chancery reevaluated *Graham*'s pronouncement on the board's duty to establish systems of monitoring.[152] Chancellor Allen elaborated that a "broad generalization" of *Graham*'s holding[153] would not be accepted by the, then-current, Delaware Supreme Court.[154] Chancellor Allen noted that recent Delaware Supreme Court jurisprudence[155] demonstrated the "seriousness with which the corporation law views the role of the corporate board,"[156] and that "relevant and timely *information*" was a necessary component to the

146. 188 A.2d 125 (Del. 1963).

147. *Compare In re Caremark Int'l*, 698 A.2d at 969–70 (discussing that directors have a duty to "assure that a corporate information gathering and reporting systems exists"), *with Graham*, 188 A.2d at 130 ("[A]bsent 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.").

148. *Graham*, 188 A.2d at 127.

149. *Id.* at 130 ("[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."); *see* Mitchell, *supra* note 143, at 683–84 (discussing that early duty of care cases had origins in torts).

150. *Graham*, 188 A.2d at 128.

151. *Id.* at 130 (emphasis added).

152. *In re Caremark Int'l*, 698 A.2d at 969–70.

153. Chancellor Allen stated the following:

> Can it be said today that, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that a corporate information gathering and reporting systems exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations?

Id. at 969.

154. *Id.* at 969–70.

155. *Id.* at 970 (citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)).

156. *Id.*

board's "supervisory and monitoring role" under Delaware Corporate law.[157] In total, these recent developments meant that for a board to "satisfy their obligation to be reasonably informed concerning the corporation," the board had an affirmative duty to ensure systematic monitoring.[158]

Chancellor Allen's final action was to find a proper fiduciary home for this new duty of oversight.[159] In a judicial two-step, Chancellor Allen noted that the board's obligation of oversight was a "duty to attempt in good faith to assure that a . . . reporting system . . . [was] adequate,"[160] and that the duty of good faith was a "core element of any . . . *duty of care* inquiry."[161] However, *Caremark* did not overturn *Graham*, and therefore, Chancellor Allen's extensive description of this new "duty of oversight" was almost entirely dicta.[162] It would take another thirteen years for the duty articulated in *Caremark* to become law.[163] The Delaware Supreme Court in *Stone v. Ritter*[164] set forth the two prongs that would become the basis for *Caremark* claims: "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus

157. *Id.* (noting that "relevant and timely *information*" was required for the execution of the board's "supervisory and monitoring role" under Section 141 of the Delaware General Corporation Law. Chancellor Allen also noted the federal organizational sentencing guidelines on business organizations were indicative of a duty of oversight. *Id.* ("Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers."). *See generally* Paul E. McGreal, Caremark *in the Arc of Compliance History*, 90 TEMP. L. REV. 647, 648 (2018) (discussing the 1991 U.S. Sentencing Guidelines' influence on the *Caremark* decision).

158. *In re Caremark Int'l*, 698 A.2d at 970.

159. *Id.* at 968–70.

160. *Id.* at 970.

161. *Id.* at 968 (emphasis added). Placing the duty of oversight within the duty of care meant that this new duty would be subject to the business judgment rule; therefore, as long as the board exercised "good faith" in establishing and running the newly required monitoring systems, the board would not be held "liable for [its] failure to reveal violations of law or duties by officers or employees." Mitchell, *supra* note 143, at 693. The court elaborated on the level of detail such systems would require:

> Obviously[,] the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law.

In re Caremark Int'l, 698 A.2d at 970.

162. *Graham* was a decision from the Delaware Supreme Court, and as such, Chancellor Allen had no authority to overturn *Graham*. *Id.* at 969. *See generally* Todd Haugh, *Caremark's Behavioral Legacy*, 90 TEMP. L. REV. 611, 616, 618 (stating that Chancellor Allen employed "extensive use of dicta to 'author a mini-treatise' on oversight liability").

163. Stone v. Ritter, 911 A.2d 362, 364–65 (Del. 2006).

164. 911 A.2d 362 (Del. 2006).

disabling themselves from being informed of risks or problems requiring their attention."[165]

2. Shifting of the Duty of Oversight

In the time between *Caremark* and *Stone*, the several intellectual underpinnings of the duty of oversight significantly changed.[166] The duty of oversight's ancestral home, as established in *Caremark*, was within the duty of care.[167] But shortly before *Caremark*'s acceptance in *Stone*, the Delaware Supreme Court—based on the "plain and intentional terms" of *Caremark*—moved the duty of oversight within the duty of loyalty.[168] This *Guttman v. Huang*[169] articulation of the duty of oversight's home is what the *Stone* court accepts verbatim.[170]

The underlying requirement to "act in good faith" followed the duty of oversight's move to its new home within the duty to loyalty.[171] Yet the court did not further define the duty to act in good faith.[172] The Delaware Supreme Court in *In re Walt Disney Co. Derivative Litigation*[173] provided the "conceptual guidance" as to the meaning of "good faith" in the corporate context.[174] Specifically, the court observed that there are at least three categories of good faith.[175] All three categories require the fiduciary to either act intentionally without the corporation's best interests in mind or to

165. *Id.* at 370.

166. *See infra* notes 168–177 and accompanying text.

167. *In re Caremark Int'l*, 698 A.2d 959, 968 (Del. Ch. 1996).

168. Guttman v. Huang, 823 A.2d 492, 506 (Del. 2003) ("Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care . . . its plain and intentional terms . . . articulates a standard for liability for failures of oversight . . . that the directors breached their duty of loyalty . . . .").

169. 823 A.2d 492 (Del. Ch. 2003).

170. *Stone*, 911 A.2d at 369–70 (quoting *Guttman*, 823 A.2d at 506 n.34).

171. *Id.* at 369–70 (calling the requirement to act in good faith "'a subsidiary element' . . . 'of the fundamental duty of loyalty'") (quoting *Guttman*, 823 A.2d at 506 n.34). In *Caremark*, the court famously said that "only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition." *In re Caremark Int'l*, 698 A.2d at 971.

172. *In re Caremark Int'l*, 698 A.2d at 971; *see* Mitchell, *supra* note 143, at 697–99 (discussing that by "reintroduc[ing]" the concept of good faith," the Delaware courts then had the task of defining it).

173. 906 A.2d 27 (Del. 2006).

174. *Id.* at 64–65.

175. *Id.* at 67. The first category is "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation." *Id.* The second occurs "where the fiduciary acts with the intent to violate applicable positive law." *Id.* The third occurs "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Id.*

disregard their duties.[176] Similar to *Stone*'s incorporation of *Guttman*, *Stone* incorporated *Walt Disney*'s definitions of good faith[177] into its final articulation of the duty of oversight.[178]

3. Business Risk vs. Legal Risk

Three years after the acceptance of *Caremark* claims in *Stone*, the Delaware Chancery Court gave additional guidance on the duty of oversight's parameters.[179] In *In re Citigroup Inc. Shareholder Derivative Litigation*,[180] shareholders claimed that the board breached its fiduciary duties by failing to monitor the potential risk, which resulted in significant losses arising from the company's exposure to the subprime lending market.[181] Ultimately, the *Citigroup* court found that the losses were a result of "business risk."[182] Therefore the business judgment rule would shield the directors unless the shareholders could show that the directors were acting without "good faith and in the honest belief that the action taken was in the best interests of the company."[183] The court noted that—to grant the kind of "judicial second guessing" the plaintiffs were asking for—it would have to "abandon such bedrock principles of Delaware fiduciary duty law."[184]

Regarding the plaintiff's complaint, Chancellor Chandler stated in the opinion that the "[p]laintiffs' theory . . . [was] a bit of a twist on the traditional *Caremark* claim.[185] Moreover, Chancellor Chandler sharply noted that there is a "significant difference[] between failing to oversee employee fraudulent

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176. *Id.*

177. The *Stone* court referred to "good faith" by articulating it in the negative. Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006). The *Stone* court invoked the second definition of bad faith in *Walt Disney*. *Id.* at 369–70. *See generally* Ann M. Scarlett, *Imitation or Improvement? The Evolution of Shareholder Derivative Litigation in the United States, United Kingdom, Canada, and Australia*, 28 ARIZ. J. INT'L & COMPAR. L. 569, 589 (2011) (discussing *Stone*'s interpretation and incorporation of good faith in the newly accepted duty of oversight).

178. *Stone*, 911 A.2d at 369–70.

179. *See infra* notes 180–188 and accompanying text.

180. 964 A.2d 106 (Del. Ch. 2009).

181. *Id.* at 111.

182. *Id.* at 123–25.

183. *Id.* at 124–25. In a particularly damning excerpt, the court stated that "[w]hen one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly." *Id.* at 124. The court opined that "[i]t is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk" and that "[i]n any investment there is a chance that returns will turn out lower than expected." *Id.* at 126.

184. *Id.* at 126.

185. *Id.* at 123 ("In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law.").

or criminal conduct ["legal risk"] and failing to recognize the extent of a Company's business risk.[186] The *Citigroup* decision not only reaffirmed that cases of "business risk" are exceedingly difficult to prosecute under *Caremark* jurisprudence,[187] but also seemingly narrowed the scope of *Caremark* claims to only those involving "legal risk."[188]

*D. Current "loosening" of "*Caremark*" Claims*

In the seminal *Caremark* case, the Delaware Chancery Court noted that its newly created theory was "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[189] Since the acceptance of *Caremark* claims in *Stone*,[190] this prophetic pronouncement has mostly been accurate, with the majority of cases resolved through summary judgment in favor of the directors.[191] However, in recent years the Delaware Chancery Court appears to be increasing the "survivability" of *Caremark* claims.[192]

This trend in increased "survivability" began a year before *Hughes v. Hu*,[193] as the Delaware Courts began to consider the potential inferences that could be drawn when a board does not adequately oversee industry specific compliance risks.[194] In *Marchand v. Barnhill*[195]—the first case in this increased "survivability" trend—the Delaware Supreme Court held that when a board fails to inform itself of "compliance issue[s] *intrinsically critical* to

186. *Id.* at 131 ("While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different.").

187. *Id.* ("Oversight duties under Delaware law are not designed to subject directors . . . to *personal liability* for failure to predict the future and to properly evaluate business risk.")

188. *See In re* Gen. Motors Co. Derivative Litig., No. 9627-VCG, 2015 WL 395872, at *17 (Del. Ch. June 26, 2015), *aff'd*, 133 A.3d 971 (Del. 2016) ("Pleadings, even specific pleadings, indicating that directors did a poor job of overseeing risk in a poorly-managed corporation do not imply director bad faith."); *In re* Dow Chem. Derivative Litig., No. 4349-CC, 2010 WL 66769, at *9–10 (Del. Ch. Jan. 11, 2010) (affirming *Citigroup*'s strict approach to oversight liability).

189. *In re* Caremark Int'l Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

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

191. *See, e.g.*, *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009) (failing to survive a motion to dismiss by defendants). *But see, e.g.*, *In re* China Agritech, Inc. S'holder Derivative Litig., C.A. No. 7163-VCL, 2013 WL 2181514, at *27 (Del. Ch. May 21, 2013) (surviving motion to dismiss brought by defendants). *See generally* Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2036–37, 2045 (2019) (describing that the low survival rate of these cases are due to some combination of the exacting pleading requirements and low standard for "good faith" oversight).

192. *See infra* notes 195–205 and accompanying text.

193. C.A. No. 2019-0112-JTL, slip op. (Del. Ch. Apr. 27, 2020).

194. *See infra* notes 195–205 and accompanying text.

195. 212 A.3d 805 (Del. 2019) *vacated*, 2018 Del. Ch. LEXIS 316 (Del. Ch. Sept. 27, 2018) (missing plaintiffs' *Caremark* claims).

the company's business operation" it is proper to make an inference of bad faith by the board.[196] Furthermore, the court stressed that while the board can rely on management,[197] the duty of oversight means that (at a minimum) the board must "exercise *its* duty of care" in creating systems of monitoring and reporting on "the corporation's *central compliance risks*."[198]

Just a few months later, in *In re Clovis, Inc. Derivative Litigation*,[199] the Delaware Court of Chancery refined *Marchand*'s notion of "'mission critical' . . . risk"[200] to include the "regulatory environments in which their businesses operate," particularly, impositions created by "positive law."[201] The *In re Clovis* court's "expansion" of *Caremark* liability still incorporates the protections of the business judgment rule[202] while limiting the board's discretion concerning regulatory mandates.[203] The court noted that although a "board's oversight function must be more rigorously exercised" when the "company operates in an environment [with] externally imposed regulations," that oversight need not be "omniscien[t]" but rather a "good faith effort."[204]

The court also touched on the notion that although managers run the day-to-day operations of corporations—and therefore are presumably more knowledgeable about on-the-ground matters—management cannot solely be left to handle "mission critical" regulatory mandates.[205] Despite more

196. *Marchand*, 212 A.3d at 822 (emphasis added).

197. In *Gantler v. Stephens*, the Delaware Supreme Court, in a case of first impression, explicitly held that corporate officers owe the same fiduciary duties as directors. 965 A.2d 695, 708–09 (Del. 2009).

198. *Marchand*, 212 A.3d at 824 (Del. 2019) (emphasis added). In *Marchand*, management had been getting reports about a growing listeria presence in company plants; however, board minutes show "no report or discussion of the increasingly frequent positive tests that had been occurring." *Id.* at 812. Other documents showed that for over two years, the board remained unaware of the growing problem, except for a positive report from the company's third-party auditor for sanitation. *Id.* at 813. The first board-level discussion occurred two days after a limited recall. *Id.* at 812–14.

199. *In re* Clovis Oncology, Inc. Derivative Litig., C.A. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

200. *Id.* at *12–13 (citing *Marchand* extensively).

201. *Id.* at *12. The court stressed that they were not expecting "omniscience" by the board but simply evidence of good faith efforts. *Id.* at *13.

202. *Id.* at *12–13.

203. *See id.* at *12 ("[T]he legal academy has observed that Delaware courts are more inclined to find *Caremark* oversight liability at the board level when the company operates in the midst of obligations imposed upon it by positive law yet fails to implement compliance systems,or fails to monitor existing compliance systems . . . ." (citing *In re* Facebook, Inc. Sec. 220 Litig., 2019 WL 2320842, at *14 (Del. Ch. May 31, 2019))).

204. *Id.* at *13 (citing *Marchand*, 212 A.3d at 821, 824).

205. *Id.* at *12–13 (citing *Marchand*, 212 A.3d at 823–24 (Del. 2019)). The court effectively accounted that the board itself must play a role in "implementing and then overseeing a more structured compliance system." *Id.* at *12 (citing *Marchand*, 212 A.3d at 823–24).

Caremark claims surviving motions to dismiss, the Delaware Court of Chancery remains steadfast to the strict underlying pleading requirements of Chancery rule 23.1[206] that *Caremark* claims require.[207]

III. THE COURT'S REASONING

A. The Court's Holding

Writing for the court, Vice Chancellor Laster held that Hughes successfully presented a set of particularized facts supporting his allegation that the defendants breached their fiduciary duty by failing to maintain a board-level system for monitoring the company's financial reporting.[208] Therefore, the court denied the defendants' motions to dismiss under Court of Chancery rules 23.1 and 12(b)(6).[209]

B. "Demand Futility" Analysis

The court first discussed the proper analytical standard for this case.[210] Because Hughes sought to bypass the board and directly move forward with the litigation on the company's behalf, the court noted that he first needed to seek excusal from making a demand.[211] The court noted that the Delaware Supreme Court created two tests to determine if a complaint had sufficiently pled demand futility: the *Aronson*[212] and *Rales*[213] tests.[214] The court found

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206. *See infra* note 241 and accompanying text.

207. *Compare Marchand*, 212 A.3d at 817, 824 (Del. 2019) (surviving motion to dismiss) *and* Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 40 (Del. Ch. Apr. 27, 2020) (surviving motions to dismiss), *with In re* MetLife Inc., C.A. No. 2019-0452-SG, 2020 WL 4746635, at *12–14 (Del. Ch. Aug. 17, 2020) (stating that the pleadings were phrased too broadly), *and In re* GoPro, Inc. S'holder Derivative Litig., C.A. No. 2018-0784-JRS, 2020 WL 2036602, at *9 (Del. Ch. Apr. 28, 2020) (stating that the "[p]laintiffs''[c]omplaint is a model of . . . imprecision").

208. *Hughes*, slip op. at 36–38.

209. *Id.* at 40.

210. *Id.* at 22–29 (discussing at length whether to use the *Aronson* or *Rales* test).

211. *Id.* at 21. Normally, plaintiffs seeking to prosecute derivative suits are limited to situations where "(i) the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or (ii) demand is excused because the directors are incapable of making an impartial decision regarding the litigation." *Id.* (citing Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993)). Therefore, to avoid first making a litigation demand, plaintiffs must allege "with particularity" their reasoning for not seeking a litigation demand. *Id.* The court in *Hughes*, determined that the facts of the case implicated the second situation. *Id.* at 22.

212. *Id.* at 22–24. See *supra* Section II.B.1 for more a detailed discussion of the *Aronson* test.

213. *Id.* at 25. See *supra* Section II.B.2 for more a detailed discussion of the *Rales* test.

214. *Hughes*, slip op. at 22 (citing Wood v. Baum, 953 A.2d 136, 140 (Del. 2008)). A critical distinction between the tests is the board's composition at both the time of the challenged decision and the consideration of the demand. *Id.* at 22–24. The *Aronson* test considers a situation where the board is the same at both time points, while the *Rales* test—due to its more comprehensive

that the complaint against the defendants was not "framed" as an *Aronson*-style lawsuit—challenging either a specific transaction or particular decision—but rather a more general challenge to the company's persistent problems.[215] As such, the court applied the more generalized *Rales* standard.[216]

C. The Caremark *Claim*

The court began by addressing the first claim,[217] which alleged that the defendants "breached their fiduciary duties by willfully failing to maintain an adequate system of oversight, disclosure controls and procedures, and internal controls over financial reporting."[218] The court found that the plaintiff adequately demonstrated that the board of directors—acting through the audit committee—showed "bad faith conduct" by failing to implement and monitor meaningful systems and controls for corporate oversight.[219] The court also dismissed the defendants' argument that since the company did not suffer harm, the defendants should not be subject to liability.[220] As such, the directors faced a substantial threat of liability under both *Caremark* claim paths, and the motion to dismiss as to Count I under rule 23.1 was denied.[221]

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nature—considers only the board's ability to consider the demand when the complaint was filed. *Id.*

215. *Id.* at 28–29. Moreover, the court held that the central theory of the complaint was a duty of oversight claim. *Id.* at 28. The court regarded this duty—otherwise referred to as a *Caremark* claim—as outflowing from a company's directors' failure to act in protection of the corporation. *Id.* at 28–29.

216. *Id.* at 29.

217. There was a second asserted claim for unjust enrichment. *Id.* at 38. However, the court quickly determined that because the analysis of the second claim ("Count II") "treads the same path as the demand futility analysis for Count I," it implicates the same conduct and, as such, the demand is futile. *Id.* at 39. Therefore, this claim will not be discussed further.

218. *Id.* at 29.

219. *Id.* at 2, 34, 36–38. "For both potential sources, 'a showing of bad faith conduct . . . is essential to establish director oversight liability.'" *Id.* at 30 (alteration in original) (quoting Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)).

220. *Id.* at 37. Defendants argued that there was no effect on net income and, as such, there was no "harm." *Id.* The court noted that "Delaware law dictates that the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly," and that the cost of restatements, harm to reputation, and defense of several lawsuits amounts to "harm." *Id.* at 37 (quoting Thorpe ex rel. Castleman v. CERBCO, Inc., 676 A.2d 436, 445 (Del. 1996)).

221. *Id.* at 31, 34, 37–38. "Directors face a substantial threat of liability under *Caremark* if '(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.'" *Id.* at 30 (quoting *Stone*, 911 A.2d at 370). The court also noted that the pleading under rule 23.1 was more stringent than under rule 12(b)(6) and, as such, held that a "complaint that survives a motion to dismiss pursuant to [r]ule 23.1 will also survive a [rule] 12(b)(6) motion to

IV. ANALYSIS

In *Hughes v. Hu*,[222] the Delaware Chancery Court correctly held that the Kandi board of directors faced a substantial threat of liability under the duty of oversight and therefore denied the directors' motion to dismiss.[223] Section IV.A discusses why the court correctly decided *Hughes*.[224] Section IV.B considers why the *Hughes* holding will likely exacerbate the current trend of foreign-based corporations disfavoring Delaware as their corporate governance law source.[225] Finally, Section IV.C explains why Delaware courts should consider a corporation's principal business market when determining potential *Caremark* liability and therefore make "territorial adjustments" in determining the acceptable level of oversight.[226]

A. The Delaware Chancery Court's Holding is Consistent with Precedent

The *Hughes* court correctly applied the *Rales* test when it determined demand futility for two reasons: (1) the nature of the complaint itself and (2) the *Hughes* court's position was consistent with recent precedent regarding the situational applicability of the demand futility tests.[227] The Delaware Chancery Court also correctly rejected Kandi's claims that its oversight efforts were sufficient to meet its *Caremark* burden by reasonably inferring from the plaintiff's particularized facts—and grounded in prior precedent—that the board failed to provide meaningful oversight.[228]

1. The Court's Use of the Rales *Test in Determining Demand Futility is Consistent with the Nature of the Complaint and Precedent*

The Delaware Chancery Court spent a considerable amount of time determining the applicable demand futility test to apply to the facts at hand.[229] Ultimately, the court determined the correct test by focusing on the alleged

dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim." *Id.* at 39–40 (quoting *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009)).

222. C.A. No. 2019-0112-JTL, slip op. (Del. Ch. Apr. 27, 2020).

223. *Id.* at 37–38.

224. *See infra* Section IV.A.

225. *See infra* Section IV.B.

226. *See infra* Section IV.C.

227. *See infra* Section IV.A.1.

228. *See infra* Section IV.A.2.

229. Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 22–29 (Del. Ch. Apr. 27, 2020).

challenged actions[230] rather than the board's composition.[231] The court noted that the complaint was not alleging an "*Aronson*-style" suit—where the plaintiff was challenging a specific transaction or a particular decision—but rather was alleging that the harm caused by the directors' lack of financial oversight was a chronic issue.[232] This framing of chronic versus acute harm closely matches a core philosophical underpinning of *Caremark* liability—that "oversight" implies actions *over* time and not a specific action *in* time.[233] The court's holistic analysis in selecting the *Rales* test over the *Aronson* test further solidifies the court's reluctance to be dogmatically bound by factual technicalities in determining the applicable demand futility test.[234]

2. The Court's Caremark *Liability Holding is Consistent with Recent Precedent*

Caremark's core principle is that directors are liable if they failed to create or maintain board-level information-gathering systems.[235] While the bar of effort needed to satisfy this basic principle is not excruciatingly high,[236]

230. *Id.* at 28–29.

231. *Id.* The court openly admitted that the board composition alone should lead to an *Aronson* analysis. *Id.* at 28 ("Technically, because less than 'a majority of the directors making the decision have been replaced' . . . *Aronson* would govern." (alteration in original) (internal citation omitted)). *Id.*

232. *Id.* at 28–29.

233. *See* Marchand v. Barnhill, 212 A.3d 805, 822–24 (Del. 2019) (noting that the boards continual "lack of efforts" to ensure some form of oversight lead to a liability under *Caremark*); s*ee also* Wood v. Baum, 953 A.2d 136, 140 (Del. 2008) ("The . . . (*Rales*) test applies where the subject of a derivative suit is not *a business decision* of the Board but rather a violation of the Board's oversight *duties*.") (emphasis added).

234. *Hughes*, slip op. at 29 n.3 (citing eleven cases since 2017 where Delaware courts have held that the *Rales* test was applied for demand futility to director oversight claims). Some commentators have noted this preference towards the conceptually broader *Rales* test. DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 11.03(c)(4)(ii) (Matthew Bender & Co. ed., 2nd ed. 2020) ("[O]ne might argue that the current state of this area of the law is conceptually inverted . . . . Indeed, recent decisional law seems to be trending incrementally toward a recognition of and preference for the more efficient utility of the *Rales* analysis.").

235. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("[C]orporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist . . . that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow . . . the board . . . to reach informed judgments concerning both the corporation's compliance with law and its business performance."); Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (observing that directors face liability under *Caremark* if: "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.").

236. *See In re* Gen. Motors Co. Derivative Litig., No. 9627-VCG, 2015 WL 395872, at *15 (Del. Ch. June 26, 2015), *aff'd*, 133 A.3d 971 (Del. 2016) (holding that that by having "*some* oversight,"

the bottom-line effort is a showing of "good faith" by the directors.[237] Therefore companies facing *Caremark* liability routinely and successfully argue that their "good faith" attempts in taking "some" efforts to address their "risks"[238] shields them from *Caremark* liability.[239] Yet, Delaware courts have found that minimal efforts by boards to implement meaningful controls are not a panacea to avoid liability.[240]

Shareholders face an uphill statutory climb[241] in convincing the courts to reject the companies pleading of "good faith."[242] They must show, using "particularized facts," that the board-level controls were virtually meaningless.[243] But the court's holding that the board faced a "substantial likelihood of liability under *Caremark*" extends a recent trend of cases where the Chancery Court has rejected pleadings of "good faith" by more readily accepting reasonable inferences drawn from the plaintiff's well-plead "particularized facts."[244]

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albeit not detailed enough to bring to the board's attention the specific issue, can defeat arguments that the board "should have . . . had a *better* reporting system.").

237. *Marchand*, 212 A.3d at 821.

238. While the term "risks" is relatively all-encompassing unto itself, Delaware courts have narrowed the scope of applicable "risks" that boards must "make themselves aware of" to mean mostly "legal risks." *See supra* Section II.C.3. "Business risks" are generally covered by the business judgment rule. *Id.*

239. *In re* Gen. Motors Co., 2015 WL 395872, at *15.

240. *See, e.g.*, Rich ex rel. Fuqi Int'l, Inc. v. Yu Kwai Chong, 66 A.3d 963, 983 (Del. Ch. 2013) (concluding that despite the existence of an audit committee and independent auditor, the company "had no *meaningful* controls in place").

241. The Delaware Chancery Court is bound by the heightened pleading requirements of rule 23.1 where "conclusionary [sic] allegations of fact or law not supported by the allegations of specific fact may not be taken as true." Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988) *rev'd on other grounds*, Brehm v. Eisner, 746 A.2d 244 (Del. 2000); DEL. CH. CT. R. 23.1(a).

242. Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 27 (Del. Ch. Apr. 27, 2020).

243. *Id.* at 21 ("But once a plaintiff pleads particularized allegations, then the plaintiff is entitled to all 'reasonable inferences [that] logically flow from particularized facts alleged by the plaintiff.'" (alteration in original) (quoting Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004))).

244. *In re* Clovis Oncology, Inc. Derivative Litig., C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *1, *10, *13 (Del. Ch. Oct. 1, 2019); Marchand v. Barnhill, 212 A.3d 805, 824 (Del. 2019). These cases have prompted significant debate within the legal community about the difficulty of pleading a *Caremark* case. *E.g.*, Stephanie C. Evans & Alan J. Wilson, *Another Reminder from Delaware About the Duty of Oversight*, WILMERHALE (Oct. 28, 2019), https://www.wilmerhale.com/en/insights/blogs/focus-on-audit-committees-accounting-and-the-law/20191028-another-reminder-from-delaware-about-the-duty-of-oversight. Some practitioners do not read these cases as lowering *Caremark*'s pleading difficulty since the cases must still withstand later litigation phases. *Id.* Rather, these cases show a greater acceptance by the Delaware Chancery Court in making reasonable inferences in the plaintiffs' favor during the initial litigation phases. *Id.* It is worth noting that the defendants in *Marchand* and *In re Clovis*—the two *Caremark* cases to survive motions to dismiss immediately before *Hughes*—were monoline businesses. *Id.* Kandi, on the other hand, operates in the wider electric vehicle market and produces a range of products. *KNDI: NASDAQ GS Stock Quote*, BLOOMBERG (Feb. 8, 2021, 10:12 AM),

B. The Court's Holding Will Exacerbate Foreign Companies' Avoidance of Delaware Corporation Law

Delaware has long been heralded as the "de facto national corporate law[maker]" and the gold standard for corporate governance law.[245] This praise is not unjustly warranted, as Delaware has a triumvirate of business-friendly entities: courts with judges experienced in corporation law, a legislature attentive to business needs, and interested local groups.[246] However, recent avoidance by foreign-based firms has led some scholars to question Delaware's global prominence as the premier purveyor of corporate governance law.[247] For over twenty years, foreign corporations listed on American stock exchanges have dramatically shifted from incorporating in Delaware to incorporating in foreign nations.[248] This shift is paradoxical given both the rise of foreign corporations accessing American capital markets[249] and the presumption that company managers select incorporation locations that investors view positively.[250] While this drift is plausibly

https://www.bloomberg.com/quote/KNDI:US. Logically, monoline businesses are the simplest form of producers and therefore, risks in monoline businesses should be more apparent than other companies that delve into a larger number of products. The oversight standards announced in *Marchand*—and reinforced in *In re* Clovis—thus should be more stringent than multi-product or multi-field companies. However, this potential distinction in potential oversight standards for monoline and multi-line businesses is yet to be analyzed.

245. Marcel Kahan & Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 VAND. L. REV. 1573, 1574 (2005) (noting that Delaware "has long been viewed as the de facto national corporate law"); Goshen, *supra* note 18, at 426 ("Delaware . . . is widely recognized as the most significant jurisdiction for corporate-law purposes . . . .").

246. William J. Moon, *Delaware's New Competition*, 114 NW. U. L. REV. 1403, 1435, 1437–38 (2020).

247. William J. Moon, *Delaware's Global Competitiveness*, 106 IOWA L. REV. (forthcoming 2021) (manuscript at 27–35) (on file with author) (providing a detailed review of several potential explanations for Delaware's weakness in competing for foreign-based firms).

248. Moon, *supra* note 247, at 20 tbl.1 (showing that between 1985 and 2016 the ratio of Delaware to foreign-nation incorporation of American-listed foreign corporations shifted from roughly 2:1 to 1:5).

249. Stephen Grocer, *Chinese Companies Flocked to U.S. Markets in 2018. The Trade War May Have Had a Role*, N.Y. TIMES (Jan. 2, 2019), https://www.nytimes.com/2019/01/02/business/dealbook/trade-war-china-ipos.html; Evelyn Cheng, *Chinese Companies Are Leading the Global IPO Rush Amid a 'Flight from Uncertainty'*, CNBC (Oct. 27, 2020, 12:18 AM), https://www.cnbc.com/2020/10/27/chinese-companies-are-leading-the-global-ipo-rush-amid-a-flight-from-uncertainty.html.

250. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1420 (1989) ("The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the most money."); Brian Broughman et al., *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J.L. & ECON. 865, 866 (2014) (stating that "a firm wishing to attract investors from around the country may choose Delaware merely to provide a law that can be 'spoken' by all of its investors").

attributed to tax reduction objectives,[251] this idea misses an essential factor foreign-based firms consider: local business environments.[252]

Many foreign corporations only interact with the United States to access the world's largest capital markets and potentially opt into some available corporate governance rules.[253] Therefore, many of these foreign corporations conduct the vast majority of their business within their local, foreign markets.[254] These local markets can differ significantly from the general American market.[255] The differences in markets can lead to operational incompatibility between Delaware's corporate governance laws and local practices.[256] The *Hughes* holding both demonstrates the potential legal issues that can arise from operational incompatibility and provides a potential warning to managers of foreign companies that Delaware courts do not understand—or more accurately, do not account for—their particular business environments in litigation matters.[257]

The primary operational incompatibility apparent in *Hughes* was the corporate structure and governance style of Kandi.[258] Similar to several other U.S.-listed Chinese companies, Kandi is roughly structured as a corporate group.[259] These corporate groups routinely conduct intra-group transactions

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251. *See* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 276 (2010) ("In some circumstances, managers will opt to minimize taxes by choosing a tax haven or tax-friendly jurisdiction, even if that jurisdiction is suboptimal from the standpoint of corporate law."); Moon, *supra* note 246, at 1407 n.17, 1454 (providing an example of the tax implications of moving the location of incorporation from an American state to a tax haven).

252. *See infra* notes 253–256 and accompanying text.

253. Kandi Technologies Group is a perfect example. The company is publicly traded on the NASDAQ, incorporated in Delaware, but the majority of its business is in China. Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 4 (Del. Ch. Apr. 27, 2020); *Company Profile*, KANDI GROUP, http://ir.kandigroup.com/profile (last visited Feb. 8, 2021). As of 2016, the two primary states of incorporation for Chinese corporations listed in American stock markets were Delaware and Nevada. Moon, *supra* note 247, at 22 tbl.2.

254. *See, e.g.*, *Chinese Companies Listed on Major U.S. Stock Exchanges*, U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION 1, 3, 8, https://www.uscc.gov/sites/default/files/2020-10/Chinese_Companies_on_US_Stock_Exchanges_10-2020.pdf (Oct. 2, 2020) (listing several prominent Chinese companies, including Kandi, that are listed on U.S. exchanges but primarily do business in China).

255. Moon, *supra* note 247, at 50 ("That is, local market environments—shaped by an array of factors including government policies, regulatory laws, capital markets, business culture, and judicial infrastructure—affect the corporate law preferences of firms.").

256. Moon, *supra* note 247, at 51–52.

257. *See infra* notes 258–278 and accompanying text.

258. *See infra* notes 259–273 and accompanying text.

259. The term "corporate group" is a nebulous term, but a key characteristic of corporate groups is common ownership. Virginia Harper Ho, *Theories of Corporate Groups: Corporate Identity Reconceived*, 42 SETON HALL L. REV. 879, 886 (2012). Corporate groups in China—as well as other regions of the world such as Latin America, and Continental Europe—are a well-known phenomenon. Moon, *supra* note 247, at 39–40; Raymond Fisman & Yongxiang Wang, *Trading*

as a general means of economic efficiency.[260] Therefore, Xiaoming Hu's ownership of sizable portions[261] of both the company and the contracting service company is not—situationally—abnormal.[262] Vertical control is a relative rarity in the United States[263] and "self-deals" commonly form the basis for shareholder derivative litigation.[264] Therefore, the *Hughes* approach, in which the court did not consider how the challenged company typically conducts business, is problematic for foreign-based companies.[265] This approach potentially exposes foreign-based companies to massive future litigation costs.[266] Put succinctly, "Delaware's elaborate legal regime policing 'self-dealing' transactions clashes with China's contemporary market dynamics, where firms operating as corporate groups routinely

Favors Within Chinese Business Groups, 100 AM. ECON. REV. 429, 430 (2010) ("Most large Chinese firms belong[] to a business group . . . ."); Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 706 (2013) ("[B]usiness groups fostered by the political regime and deeply entwined with Chinese Communist Party leadership may be central to the developmental success of the regime.").

260. The term "economic efficiency" should be construed in the broadest possible terms. Transactions within groups decrease the transaction capital costs and overcome external structural weaknesses such as weak contract enforcement by judicial entities and weak capital markets. *See* Jens Dammann, *Related Party Transactions and Intragroup Transactions, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 218, 218 (Luca Enriques & Tobias Tröger eds., 2019); *see generally* Lisa A. Keister, *Interfirm Relations in China: Group Structure and Firm Performance in Business Groups*, 52 AM. BEHAV. SCIENTIST 1709 (2009) (describing the economic effects of using a corporate group structure in China).

261. Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 4 (Del. Ch. Apr. 27, 2020) ("Xiaoming Hu is the Company's CEO and chairman of its board of directors. He beneficially owns 28.4% of the Company. He also owns 13% of the Service Company.").

262. Ho, *supra* note 259, at 886.

263. *See* Lina M. Khan, Note, *Amazon's Antitrust Paradox*, 126 YALE L.J. 710, 731–36 (2017) (detailing some of the historical concerns regarding vertical integration).

264. Moon, *supra* note 247, at 55 ("[T]he United States is fairly unique in the world, in terms of the relative lack of self-dealing transactions and corporate groups.").

265. *Related Party Transactions Minority Shareholder and Rights*, OECD 9 (2012), https://www.oecd.org/daf/ca/50089215.pdf ("Around the world, company groups and concentrated ownership are normal, the exceptions being in the United Kingdom, the United States and Australia. Under such conditions, RPTs are mainly with the controlling shareholders and/or with members of a company group."). This analysis should not be read as an approval of self-dealing. As Professor Moon put it, "[t]he normative merits of self-dealing transactions are at best murky. After all, controlling shareholders can wield their power to expropriate minority shareholders by engaging in transactions that enrich themselves . . . . But the normative desirability of self-dealing transactions . . . depends on the web of regulatory laws and market conditions." Moon, *supra* note 247, at 44.

266. Shareholder litigation is a costly and timely endeavor. Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 85–86 (2011). This is not to say that shareholder derivative litigation is not a useful and protection mechanism to prevent abuses of managerial misconduct. Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1345–46 (1993).

engage in 'self-dealing' transactions as part of normal business."[267] This difference in typical business styles is a strong headwind in pushing foreign-based companies to jurisdictions that allow for such interconnected business structures.[268]

Moreover, in the United States, when directors have stakes on both ends of a business dealing, only the independent directors can cleanse the company's deal.[269] The demand for "independent directors" presents an issue for many Chinese companies, as management is routinely helmed by firm founders and socially connected directors.[270] Although the *Hughes* court does not cite *Marchand*'s analysis of the impact that social connections have on director independence,[271] it does analogize to *Marchand* in its oversight analysis.[272] Therefore, the *Hughes* court's reliance on *Marchand* as an analogous case does little to assuage potential concerns that foreign-corporation managers might have about how Delaware judges would view the directors' decisions.[273]

Hughes represents a potential turning point for Delaware's place as an international supplier of corporate governance law.[274] Foreign corporations

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267. Moon, *supra* note 247, at 36. "[T]he United States is fairly unique in the world, in terms of the relative lack of self-dealing transactions and corporate groups." *Id.* at 55.

268. Some jurisdictions like the British Virgin Islands require the court's permission before bringing a derivative suit and courts consider "the interests of the company taking account of the views of the company's directors on commercial matters" and "the costs of the proceedings in relation to the relief likely to be obtained." BVI Business Companies Act, 2004, §§ 184C (V.I.). Pleading thresholds in other jurisdictions are so high and recoveries so limited as to make derivative suits unappealing. *Breach of Duty by Director of a Cayman Fund – The Path to Investor Relief in the Cayman Islands vs New York*, MOURANT 4 (July 2017), https://www.mourant.com/file-library/media—-2016/2016-guides/breach-of-duty-by-director-of-a-cayman-fund.pdf.

269. When select directors are considered "interested" in a potential dealing—because of a personal, financial, or any other reason—only "disinterested" directors can approve, or "cleanse," the company's involvement in that deal. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); DEL. CODE ANN. tit. 8, § 144(a)(1) (2020); Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 905 (2011). Another way to "cleanse" these types of deals is via a shareholder's vote of approval. DEL. CODE ANN. tit. 8, § 144(a)(2) (2020).

270. Moon, *supra* note 247, at 45–46; Sang Yop Kang, *The Independent Director System in China: Weaknesses, Dilemmas, and Potential Silver Linings*, 9 TSINGHUA CHINA L. REV. 151, 153–54 (2017).

271. *Compare* Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019) ("[T]he fact that fellow directors are social acquaintances . . . does not, in itself, raise a fair inference of non-independence . . . . [A]ny realistic consideration of the question of independence must give weight to these important relationships and their natural effect on the ability of the parties to act impartially . . . ."), *with* Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 30–38 (Del. Ch. Apr. 27, 2020) (making no mention of *Marchand*'s social connections analysis).

272. *Hughes*, slip op. at 35–36.

273. *See* Moon, *supra* note 247, at 46 ("Given this reality, it is unlikely that Delaware courts will find appointed 'independent' directors in China to be truly independent.").

274. *See infra* notes 275–278 and accompanying text.

that look to *Hughes* see the possibility of costly, continuous, and seemingly unwarranted shareholder litigation based solely on a perceived animosity towards their typical business practices.[275] Therefore, Delaware will appear uninviting and, consequently, open the door for new nations to compete for these corporations' business.[276] This new competition—coupled with institutional investors' seeming acceptance of corporations incorporating in "lax" jurisdictions—further promotes a Delaware exodus.[277] Therefore, desires to maintain typical local business market practices will lead to foreign-corporations incorporating in more compatible jurisdictions.[278]

C. Delaware Courts, in Caremark *Liability Analyses, Should Allow for "Territorial Adjustments"*

Corporation law is big business in Delaware.[279] Moreover, the state government is aware of the outsized role of corporate franchise taxes on the state.[280] However, as more countries begin to offer competitive corporate law regimes[281] that protect directors and companies from costly shareholder

275. *See supra* notes 259–273 and accompanying text; *see* Moon, *supra* note 247, at 8–9 ("[I]f a corporation operates predominantly in China—where self-dealing transactions are routine, tolerated by local authorities, and constitute an important strategy to compete in certain sectors—that corporation would be averse to Delaware law . . . .") (footnote omitted); Erickson, *supra* note 266, at 85–86.

276. Moon, *supra* note 246, at 1409 ("[A] handful of foreign nation states are actively vying to gain a share of the American corporate law market.").

277. Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227, 231 (2018) ("[T]he rise of institutional investors has transformed the ownership of U.S. corporations. Institutional investors, such as investment managers and pension funds, now invest the overwhelming majority of capital in U.S. corporations and have the capability to determine corporations' choice of arrangements.") (footnote omitted); Moon, *supra note* 247, at 47, 49 ("Institutional investors in the United States thus far have not (successfully) demanded that Chinese firms incorporate in Delaware.").

278. Moon, *supra* note 247, at 49 (noting that the lack of institutional investor pressure on foreign-based firms to include "enhanced contractual safeguards" indicates that incorporation in non-Delaware jurisdictions—primarily Cayman Islands and the British Virgin Islands—is based more on "corporate governance rules that comport with local market conditions rather than facilitating fraud").

279. Moon, *supra* note 246, at 1429–30 ("Delaware's incorporation fee revenues, which are often heralded as the textbook case of legislative dependence on corporate charter fees, averaged 17% of the state's total tax revenue over the past several decades.").

280. *Governor's Budget Financial Summary and Charts*, DEL. OFF. OF MGMT. AND BUDGET, https://budget.delaware.gov/budget/fy2020/documents/operating/financial-summary.pdf (last visited Nov. 15, 2020) (estimating revenues from incorporation revenues to be 27.6% of all revenues for the fiscal year 2020).

281. While roughly three additional countries—Bermuda, the British Virgin Islands, and the Cayman Islands—might not seem like a significant jump in the number of competitors, it is worth noting that Delaware is not *earnestly* competing with other American states. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002) ("[T]he

derivative litigation,[282] Delaware corporation law risks diminishing in value.[283] Delaware's government seems aware of this potential calamity, as it routinely touts the benefits of its corporation laws for international businesses.[284] Therefore, if Delaware wishes to remain a leading supplier of corporate law to foreign firms listed in U.S. stock markets, something must change.[285]

The *Hughes* holding's warning signals indicate the best places for immediate adjustments: the treatment of the typical business operations in legally-weak jurisdictions and the unworkability of genuinely independent directors in several countries to cleanse self-dealings.[286] The courts possess greater institutional competency to handle independent adjustments based on a business's primary operating market given the analysis's fact-intensive nature.[287] In contrast, the legislature is the better institution to address self-dealings since these standards are primarily enumerated.[288]

Any potential amendments to self-dealing statutes are fraught with possible widespread policy concerns regarding shareholder protections.[289] Delaware's self-dealing statute offers several means to cleanse self-deals;[290] however, local business practices make these options relatively unworkable to many foreign-based companies.[291] While self-dealing can provide some potentially useful benefits,[292] loosening the restrictions would likely harm minority shareholders.[293] Moreover, America is unique in that corporate law

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very notion that states compete for incorporation[] is a myth. Other than Delaware, no state is engaged in significant efforts to attract incorporations of public companies.").

282. Erickson, *supra* note 266, at 86.

283. As companies avoid or—more alarmingly to the Delaware legislature—leave Delaware as their place of incorporation, the state both loses revenue and Delaware corporation law loses its allure as the "gold standard" of corporation law. *See supra* notes 245, 280 and accompanying text.

284. *Beyond the Borders: Delaware's Benefits for International Business*, DELAWARE, https://corplaw.delaware.gov/delawares-benefits-international-business/ (last visited Feb. 13, 2020).

285. *See infra* notes 296–344 and accompanying text.

286. *See supra* Section IV.B.

287. *See* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1078 (2000) ("Delaware chancery judges are known for their expertise in business matters, and the court has developed a reputation for its sophistication in corporate law.").

288. DEL. CODE ANN. tit. 8, § 144 (2020).

289. *See infra* notes 290–295 and accompanying text.

290. DEL. CODE ANN. tit. 8, §§ 144(a)(1)–(3) (2020).

291. *See supra* note 270 and accompanying text.

292. *See supra* note 260 and accompanying text.

293. Moon, *supra* note 247, at 44 ("[C]ontrolling shareholders can wield their power to expropriate minority shareholders by engaging in transactions that enrich themselves . . . . In its most perverse form, self-dealing is the legalized looting of minority shareholders."). Moreover, the controlling normative theory of business ethics in America is the shareholder (or stockholder)

is not handled by the federal government.[294] Therefore, given America's general animosity towards self-dealing, a loosening of these standards might prompt a federal reaction.[295] Consequently, since these related-party transactions might never be adequately cleansed, the number of *Caremark* suits foreign corporations could face will only continue to grow as a result.

Therefore, in *Caremark* liability analyses, I propose that Delaware courts allow for "territorial adjustments" in determining the acceptable level of oversight for companies that primarily do business in non-American markets.[296] This proposition leverages both the Delaware Court of Chancery's and the Delaware Supreme Court's business expertise,[297] and the fact-intensive nature of *Caremark* analyses[298] to achieve a potentially equitable and business-friendly approach.[299] The core of this proposition is not a rewriting or lowering of *Caremark*'s "bottom-line requirement,"[300] but rather a reconsidering of *Caremark*'s "good faith" effort standards by considering the sophistication of the business's underlying primary market.[301] *Caremark* liability is a fact-intensive judicially created concept; therefore, the addition of a territorial factor—which would also be a fact-intensive inquiry—is well within the court's institutional capabilities.[302]

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theory, which holds that a firm's primary responsibility is to its shareholders. H. Jeff Smith, *The Shareholders vs. Stakeholders Debate*, MIT SLOAN MGMT. REV. (July 15, 2003), https://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/. Therefore, judges would not likely view even cleansed deals favorably should they do significant damage to minority shareholders. *Id.*; Moon, *supra* note 247, at 44.

294. *See, e.g.*, Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REGULATION 26, 26 (2003) ("For over 200 years, corporate governance has been a matter for state law.").

295. Under the "'stockholder' theory," actions that harm stockholders are viewed as suspect. Smith, *supra* note 293. Therefore, if self-dealing was allowed to be more pervasive under America's leading provider of corporate governance law, then the potential harms would justify the federal government preempting such a potentially harmful piece of legislation. Chris Brummer, *Corporate Law Preemption in an Age of Global Capital Markets*, 81 S. CAL. L. REV. 1067, 1089 (2008) ("Delaware provides law in the shadow of the threat of federal intervention, and from this vantage point preemption serves as the primary discipline and motivation for efficient laws. Yet even here, the federal government cannot and does not monitor all of Delaware's lawmaking.") (footnote omitted); Bainbridge, *supra* note 294, at 26.

296. *See infra* notes 297–344 and accompanying text.

297. Fisch, *supra* note 287, at 1078.

298. *In re* Puda Coal, Inc. S'holders Litig., C.A. No. 6476-CS, 2013 Del. Ch. LEXIS 338, at *14–15 (Del. Ch. Feb. 6, 2013) (showing that analysis of liability under *Caremark* is a rigorous inquiry that will depend on the facts of the case).

299. *See infra* notes 318–320 and accompanying text.

300. Marchand v. Barnhill, 212 A.3d 805, 821 (Del. 2019).

301. *See infra* notes 313–320, and accompanying text.

302. *In re Puda Coal, Inc.*, 2013 Del. Ch. LEXIS 338, at *14–15; Stone v. Ritter, 911 A.2d 362, 364–65, 370 (Del. 2006) (accepting and defining the prongs of *Caremark* liability).

The *Hughes* decision is correct[303]—mainly due to the company's excessive *laissez-faire* concern for oversight.[304] The court rendered its decision at the motion to dismiss stage,[305] a stage that most *Caremark* cases rarely survive.[306] *Caremark* cases that survive a motion to dismiss typically present facts showing that a board—*in fact* or *in practice*—failed to either implement any board-level oversight or ignored some legal risk.[307] Both failings were present in *Hughes*.[308] Therefore, this suggestion is not a plea to overturn the *Hughes* holding.[309] Instead, this proposal addresses potential misgivings that future foreign-company directors—who try in good faith to attempt proper oversight—might have when considering incorporation in Delaware because of the *Hughes* holding.[310] A duology of cases presents the intellectual framework underpinning this proposal.[311]

In *In re General Motors Co. Derivative Litigation*,[312] the Delaware Chancery Court acknowledged that while boards may miss critical oversight risks within their companies, affirmative actions by the board to try and become aware of these risks represent "some oversight."[313] Moreover, the *General Motors* court noted that the plaintiff's arguments that the board "should have . . . had a *better* reporting system" carried little weight.[314] Likewise, in *In re Puda Coal, Inc. Stockholders Litigation*, the Delaware Chancery Court expressed that "[c]ompanies . . . should all try to be as law

303. *See supra* Section IV.A for a longer discussion of the *Hughes* decision in relation to standing precedent.

304. The court spent considerable time referencing the disconnect between the limited time the audit committee met and the critical work the board tasked the committee with doing. Hughes v. Hu, C.A. No. 2019-0112-JTL, slip op. at 9–16 (Del. Ch. Apr. 27, 2020). The court also stressed the seeming disregard the company had towards quickly addressing the critical accounting failures. *Id.* at 5, 14, 17.

305. *Id.* at 2.

306. Pollman, *supra* note 191, at 2036. *See supra* notes 254–260 and accompanying text.

307. Pollman, *supra* note 191, at 2036–37.

308. *Hughes*, slip op. at 5, 9–17. Had the audit committee spent more time—both in terms of literal total time and time of actual critical review—considering the financial reports or were more critical of management's ability to provide meaningful and accurate information to the committee, this case might not have survived the motion to dismiss. *Id.* at 35–36 (distinguishing the case at hand from *General Motors*, where the board had demonstrated "some oversight" and therefore were not violating *Caremark*).

309. *See infra* notes 313–320 and accompanying text.

310. *See infra* notes 313–320 and accompanying text.

311. *See infra* notes 290–298 and accompanying text.

312. *In re* Gen. Motors Co. Derivative Litig., No. 9627-VCG, 2015 WL 395872 (Del. Ch. June 26, 2015), *aff'd*, 133 A.3d 971 (Del. 2016).

313. *Id.* at *15 (noting that the creation of the "Finance and Risk Committee" and "Audit Committee" equated to positive actions undertaken by the board to become aware of potential risks).

314. *Id.* at *15 ("Plaintiffs concede that the Board was exercising *some* oversight, albeit not to the Plaintiffs' hindsight-driven satisfaction.").

compliant as [they] can."[315] The court noted that company oversight is—realistically—never perfect, and therefore the "reasonableness of peoples' efforts at compliance" is proportional to the risks and the business.[316] The *Puda Coal* court also provided an apt example of what directors for principally foreign-based companies—in this case, China—should do to meet *Caremark*'s "good faith" standard.[317] In particular, the court noted that directors should be physically located in and have the language skills to operate in the "environment in which the company is operating."[318] If courts require directors to have the skills to operate successfully within their business's specific operating environment, then, logically, the courts must be able to identify what a successful business operation looks like in non-American markets.[319] *General Motors* and *Puda Coal* together create a notion that, with regard to *Caremark* liability, directors operating in their unique markets must reasonably try to be "successful" and should not be held to overly punitive or U.S.-centric evaluations in hindsight.[320]

However, many practitioners might have concerns with judges "territorially adjusting" a company's acceptable level of oversight.[321] One potential concern of having judges consider the underlying primary business market while determining *Caremark* liability is that it would create two separate standards for businesses—based solely on the primary place of business. Essentially, one standard would be considered the "traditional," (and presumably stricter) standard for "American" companies,[322] and the other being a "territorially-adjusted," (and presumably more lenient) standard for "foreign" companies.[323] On its face, this bifurcated standard would

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315. *In re* Puda Coal, Inc. S'holders Litig., C.A. No. 6476-CS, 2013 Del. Ch. LEXIS 338, at *15 (Del. Ch. Feb. 6, 2013).

316. *Id.* at *15 ("[Y]ou can be at a company where it has a $25 billion market cap and it's assessed a $45 million regulatory penalty . . . . That proportionality comes into play in assessing Caremark and the reasonableness of peoples' efforts at compliance because you can't watch everybody everywhere.").

317. *Id.* at *14 (noting that "you better have your physical body in China an awful lot . . . have . . . a system of controls to make sure that you know that you actually own the assets . . . have the language skills to navigate the environment in which the company is operating . . . [and] retain[] accountants and lawyers who are fit to the task of maintaining a system of controls over a public company").

318. *Id.*

319. *Id.*

320. *See supra* notes 313–319 and accompanying text.

321. *See infra* notes 324, 331–333 and accompanying text.

322. In this context, "American" refers to those companies that do most of their business in the U.S. or U.S.-like markets and are therefore subject to present (i.e., "traditional") *Caremark* liability standard.

323. In this context "foreign" refers to those companies that do most of their business in non-U.S.-like markets and are therefore subject to a territorially adjusted *Caremark* liability standard.

potentially drive companies operating in "traditional" jurisdictions to "territorially-adjusted" jurisdictions,[324] thereby exacerbating the exact problem Delaware would try to avoid.[325] However, this interpretation misses the mark, as the division between "American" and "foreign" companies is not meant to be a "bright-line" rule based solely on a company's location, but a more comprehensive inquiry into how companies in that region conduct business in those markets.[326]

In practice, judicial consideration of a company's underlying business market would be comparable to the consideration of the company's industry when considering sufficient oversight, which the Delaware Chancery Court has routinely taken into consideration when considering "bad faith" in oversight.[327] As such, judicial consideration of a company's underlying business market would help courts better understand what oversight measures the challenged company attempted—or, in the case of *Hughes*, did not attempt[328]—and to better determine if the company missed the "red flags" that were either "waived [sic] in one's face or displayed so that they are visible to the careful observer."[329] Therefore, this new consideration—like the court's consideration of the company's industry—is a means of giving

324. The norm for corporate managers is to attempt to maximize shareholder value. Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TRANSACTIONS 221, 242 (2012). *But see* Afra Afsharipour, *Redefining Corporate Purpose: An International Perspective*, 40 SEATTLE U. L. REV. 465, 468 (2017) (noting that there are challenges to this norm). Therefore, similar to some tax reduction practices, managers might determine that reincorporating to the perceived "more lenient" jurisdiction would achieve greater shareholder value than remaining in the perceived "more stringent" jurisdiction. *See supra* note 251 and accompanying text.

325. *See supra* notes 279–280 and accompanying text.

326. For example, suppose the "market" in the fictional country of Luciland is highly similar to the American market, and the challenged company primarily does business there. In this case, it stands to reason that courts should view the company under a more "American-like" conception of typical "good faith," considering the typical business practices of that region. On the other hand, suppose the "market" in the fictional country of Elvisland is more lenient towards "self-dealings" in corporate groups, and the challenged company primarily does business there. In that case, the court should consider Elvisland's business realities when determining *Caremark* liability while also not forgetting the minimal requirements established under Delaware case law.

327. *In re* MetLife Inc., C.A. No. 2019-0452-SG, 2020 WL 4746635, at *14 (Del. Ch. Aug. 17, 2020) ("Regarding the second *Caremark* prong—at issue here—a plaintiff can establish a board's bad faith by showing that it saw red flags related to compliance with law and consciously disregarded those flags."). For example, in *Marchand*, the court was explicit in saying that the "red flags" were failings in being compliant with food safety requirements, which were "critical to the company's business operation." Marchand v. Barnhill, 212 A.3d 805, 816, 822 (Del. 2019). Here, operating within the business realities of the primary place of business would also be mission critical. *See supra* notes 317–319, and accompanying text.

328. *See supra* note 304 and accompanying text.

329. *In re* Clovis Oncology, Inc. Derivative Litig., C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *13 (Del. Ch. Oct. 1, 2019) (quoting Wood v. Baum, 953 A.2d 136, 143 (Del. 2008)).

context to, and not *alleviation from*, what constitutes "sustained or systemic failure[s]" of board oversight.[330]

Another potential criticism is that this "territorial-adjustment" consideration would not go far enough in assuaging foreign-corporation directors of potential litigation risks.[331] Although this criticism bears some weight—for if other jurisdictions can offer greater accommodations,[332] then why select Delaware corporation law at all[333]—it misses the critical benefit of incorporating in Delaware, which is access to the full complement of Delaware's case law and the courts that make it.[334]

When foreign corporations incorporate in the United States, they are typically buying into a suite of laws: state corporate law, federal securities laws, and various other business regulations.[335] The benefit of "buying" this suite—with Delaware corporate law being the first "product" in the bundle—versus shopping around for the best "deal"—is Delaware's extensive case law.[336] Because of its near-universal familiarity,[337] this large body of case law creates both predictability[338] and lowered transaction costs for

330. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (emphasis added) ("Generally where a claim of directorial liability for corporate loss is *predicated upon ignorance of liability creating activities* within the corporation . . . only a *sustained or systemic failure* of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability.") (emphasis added).

331. *See infra* notes 332–333 and accompanying text.

332. Here, "accommodations" especially refers to those accommodations offered by non-U.S. jurisdictions to potentially decrease the litigation risks from shareholder derivative suits. *See supra* note 268.

333. *See supra* note 268 and accompanying text.

334. *See infra* notes 335–345 and accompanying text.

335. Omari S. Simmons, *Delaware's Global Threat*, 41 J. CORP. L. 217, 224 (2015).

336. Jonathan G. Rohr, *Corporate Governance, Collective Action and Contractual Freedom: Justifying Delaware's New Restrictions on Private Ordering*, 41 DEL. J. CORP. L. 803, 817 (2017) ("The case law 'provides a pool of handy precedents, and the basis for obtaining almost instantaneously a legal opinion on any issue of Delaware law. These features of stability and predictability are desired by managers who need quick opinions on proposed activities.'") (quoting Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 274 (1985)). There are also other benefits to "buying" Delaware corporation law, such as "signaling" to potential investors. Brian J. Broughman & Darian M. Ibrahim, *Delaware's Familiarity*, 52 SAN DIEGO L. REV. 273, 299–300 (2015). But those benefits won't be discussed further in this Note.

337. As aptly described by Professors Broughman and Ibrahim, Delaware corporation law is the "lingua franca," or bridge language, of corporation law. Broughman & Ibrahim, *supra* note 336, at 277–78.

338. *Rohr*, *supra* note 336, at 817–18; Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 212 (2011) (""The judicial opinions that result from frequent litigation benefit all members of the Delaware network, because such opinions provide firms with interpretive guidance on matters of Delaware corporate law."").

corporations.[339] Therefore, leaving or avoiding Delaware corporation law because of fear of litigation might be both an overreaction to a solvable problem[340] and a needless avoidance of a potentially valuable good.[341]

A "territorial-adjustment" will not eliminate the potential for costly litigation; however, it will allow the courts to create specific case law that "rewards"[342] foreign-based companies that in "good faith" try to reach Delaware's standards and punishes those truly "bad-actors."[343] Moreover, this suggestion does not require eviscerating Delaware's established standards in corporate governance; instead, it merely proposes a discretionary supplement the court may use depending on the specific case.[344] Therefore, as courts adjudicate more cases using the "territorial-adjustment" consideration, foreign-based companies operating in "good faith" gain both protection from this new branch of case law while still having access to the full breadth of Delaware case law.[345]

The Delaware Chancery Court has both the expertise and ability to facilitate the fact-intensive inquiries necessary to consider a business's primary marketplace's sophistication.[346] Therefore, the court should consider "territorially-adjusting" what its *Caremark* good faith standard is on a case-by-case basis to account for the variety of corporate governance styles.[347]

339. Broughman & Ibrahim, *supra* note 336, at 300; Kahan & Kamar, *supra* note 281, at 725–26 (noting that although a competing state might "copy[]" Delaware's corporate code and instruct its judges to "interpret the code in light of Delaware precedent," that state would still not "deliver the same product that Delaware does").

340. *See infra* notes 342–345 and accompanying text.

341. Moon, *supra* note 247, at 7 n.23.

342. By "rewards," I mean both the creation of case law that, in essence, protects "good faith" actors from protracted litigation and the continued access to the broader Delaware case law in general.

343. The Delaware Chancery Court has dealt with some legitimately fraudulent foreign-based companies. Deutsch v. ZST Digital Networks, Inc., No. CV 8014-VCL, 2018 WL 3005822, at *1 (Del. Ch. June 14, 2018) (dealing with two senior corporate officers from a Delaware corporation—whom principally did business in China—that, upon voluntary delisting from the NASDAQ following the resignation of its auditors on claims of alleged obstruction, failed to comply with a default judgment entered on a stockholder's demand to inspect books and records). *See generally* David Graff & Shveta Kakar, *Chinese Companies "Going Dark": Finally Accountable to U.S. Hedge Funds and Other Shareholders*, HEDGE FUND L. REP. (Feb. 13, 2014), https://www.hflawreport.com/2547031/chinese-companies-going-dark—finally-accountable-to-u-s-hedge-funds-and-other-shareholders.thtml (explaining the practice and consequences of a publicly-traded company "going dark").

344. *See supra* notes 297–319 and accompanying text.

345. *See* Manesh, *supra* note 338, at 212 ("The judicial opinions that result from frequent litigation benefit all members of the Delaware network, because such opinions provide firms with interpretive guidance on matters of Delaware corporate law.").

346. Fisch, *supra* note 287, at 1078.

347. *See supra* notes 297–319 and accompanying text.

V. CONCLUSION

In *Hughes v. Hu*,[348] the Delaware Chancery Court noted that the Kandi board of directors did not implement nor maintain sufficient board-level oversight controls for the company's accounting practices or related-party transactions.[349] The court correctly held that the Kandi board of directors faced a substantial threat of liability under *Caremark* and denied the board's motion to dismiss the shareholder derivative suit.[350]

But the court's holding will likely exacerbate the current trend of foreign-based companies avoiding Delaware as their place of incorporation.[351] The decline in foreign-companies incorporating following *Hughes* will likely decrease Delaware franchise tax revenues,[352] and signal to other foreign-based companies that viable and attractive alternatives to Delaware's corporate governance rules are available.[353] Jurisdictions such as the British Virgin Islands and the Cayman Islands have already begun developing favorable legal protections for companies that operate in non-American markets by establishing specialized business courts, staffed with qualified business law jurists, aimed at resolving complex corporate law questions.[354]

Delaware precedent seems to create no room for the courts to consider non-American corporate governance styles when determining *Caremark* liability;[355] however, the *General Motors* and *Puda Coal* duology marks a dormant thinking within the Delaware Chancery Court that the "successful operation" of a company varies depending on the company's primary marketplace.[356] Therefore, in an effort to achieve a more equitable and business-friendly approach, Delaware courts should allow for "territorial

348. C.A. No. 2019-0112-JTL, slip op. (Del. Ch. Apr. 27, 2020).

349. *See supra* Section I.B.

350. *Hughes*, slip op. at 37–38.

351. Moon, *supra* note 247, at 20 tbl.1 (showing that between 1985 and 2016 the ratio of Delaware to Foreign-nation incorporation of American-listed foreign corporations shifted from roughly 2:1 to 1:5).

352. *Governor's Budget Financial Summary and Charts*, DEL. OFF. OF MGMT. AND BUDGET (last visited Feb. 13, 2020), https://budget.delaware.gov/budget/fy2020/documents/operating/financial-summary.pdf (estimating revenues from incorporation revenues to be 27.6% of all revenues for the fiscal year 2020).

353. *See supra* notes 268 & 278 and accompanying text.

354. *See supra* note 268; Moon, *supra* note 246, at 1423, 1437–43 (detailing the creation and effects of "specialized business courts in offshore jurisdictions that supply the judicial infrastructure necessary to handle complex corporate law disputes").

355. *See supra* Section IV.A.

356. *See supra* notes 313–319 and accompanying text.

adjustments" in determining the acceptable level of oversight for companies that primarily do business in non-American markets.[357]

357. *See supra* Section IV.C.