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# MARKET MANIPULATION AND A DIRECTORS FIDUCIARY DUTY OF CARE[1]

## I. INTRODUCTION

Market manipulation of emerging or small cap companies is pervasive on Wall Street and according to the SEC has increased over 37% in the last decade.[2] The nature and scope of market manipulation schemes is limited only by the creativity and audacity of their perpetrators.[3] While the substance and mechanics of market manipulation schemes may differ, the objective is the same - to inject false information into the marketplace that artificially affects the price of the target companies securities by "interfering with the natural interplay of the forces of supply and demand."[4] The proliferation of market manipulation schemes has created challenging risk-management and best practice issues for the directors of targeted companies, which require directors to continuously assess the nature and scope of their fiduciary duty of care.

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[1] This article has been written by Alan M. Pollack, Esq., a partner in the law firm of Warshaw Burstein, LLP. The opinion expressed in this article is not intended as legal advice to the management of any corporation. Officers or directors who are contemplating taking legal action in response to their company being a target of a market manipulation scheme or who discover that their company has violated securities laws and regulations, should consult with their own attorneys.

[2] *See* Money Morning Magazine, July 8, 2015 article at p.1 by Abby Higgs, *Four Notorious Cases of Stock Manipulation.*

[3] These schemes include, among many others, naked short-selling; spoofing; insider trading cases, and the unlawful use of fully paid for customer shares held in segregated accounts.

[4] *See Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 130 (2d Cir. 2011).

## II. THE ANATOMY OF A MARKET MANIPULATION SCHEME

Market manipulation schemes that target emerging or small cap companies frequently follow predictable patterns of conduct. These schemes will often start with extensive blogs, tweets and message board comments that are written by anonymous authors or authors who use pseudonyms to proclaim without substantiation that the targeted companies' technologies are flawed; their products defective; their management incompetent or corrupt; and/or their financial statements and projections false and misleading. The comments that are made on social media typically are unrelenting and are intended to contradict or minimize positive public announcements concerning product development, earnings, acquisitions or executive hirings, that are published by the targeted company. These unsubstantiated claims pervade the marketplace. It is not uncommon for the SEC or FINRA to learn of these unsubstantiated claims, commence an administrative investigation that frequently leads to the filing of civil class actions against the company, which inevitably will cause the company to expend enormous time, effort and financial resources to defend.

The confluence of these factors sends a signal – albeit an inaccurate one - to the market that the shares of the targeted company are overvalued and should be sold. As investors sell their shares, a "snow-ball" effect is created causing more shareholders to "pile-on" and sell their holdings. The sudden increase in the supply of shares in the marketplace, in the absence of a countervailing increase in demand, causes the share price of the targeted company to decline precipitously. When share prices decline because manipulators are knowingly and intentionally injecting false information into the marketplace, a fraud on the market has been perpetrated. This raises challenging issues of corporate governance for the company's directors to consider: does the company have an effective monitoring and reporting system in place to timely provide

management with sufficient information to determine the cause of the manipulation scheme, the identity of the manipulators, and what remedial action, if any, should be taken to preserve the value of shareholder equity when their company is the target of a manipulation scheme.

## III. A DIRECTORS DUTY TO MONITOR AND OVERSEE

The risk oversight function of a company's board of directors is critically important and constantly evolving. Boards play an important role in overseeing and monitoring whether their company is in compliance with federal and state securities laws and regulations, stock exchange requirements, state fiduciary duties and industry best practice standards. Shareholders have the right to expect that the boards of directors of the companies in which they invest will monitor and oversee internal compliance with applicable securities laws. Shareholders also have the right to expect that company boards of directors will design and implement effective measures to protect the value of their investments from external stock manipulation schemes in the marketplace. [5]

Both the law and practical considerations restrict outside directors from being involved in the day-to-day management of their companies or monitoring daily whether their company is the target of a market manipulation scheme. In order to assist corporate management in determining if their company's stock price is being manipulated, boards have routinely retained market surveillance consultants and proxy advisory firms to track market participants, share ownership, and trading patterns. Such companies will provide directors with sophisticated analytics, monitoring strategies, and integrated solutions to assist corporate management in ascertaining and responding to nefarious market manipulation schemes. Increased oversight and monitoring

[5] *See In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del Ch. 2009).

of whether a company's share price is being manipulated has increasingly become a mandatory part of today's best practices and an integral part of a director's fiduciary duty of care.

## IV. THE EVOLUTION OF A DIRECTORS DUTY OF CARE

Delaware is the state where most companies are incorporated and, therefore has taken the lead in defining the national legal standard of care that directors owe to their companies on whose boards they sit. Risk management is a governance issue that is squarely within the oversight responsibility of the board of directors.

A director's fiduciary duty of care to monitor corporate operations and business risks, arises from the seminal decision of the Delaware Chancery Court in *In Re Caremark Intern, Inc. Derv. Lit.* [6] In *Caremark*, the company and several of its employees were indicted for violating the Anti-Referral Payment Law, which prohibits healthcare providers from paying any form of remuneration to induce the referral of Medicare or Medicare patients. The criminal case was resolved when Caremark pleaded guilty to a single count of mail fraud and agreed to pay civil and criminal fines and reimburse approximately $250 million to various public and private parties. Thereafter, shareholder derivative actions were commenced seeking recovery of these payments from the company's board of directors, for breaching their duty of care by failing to monitor whether the corporation had operated within the law. Plaintiffs claimed that the directors should have known of the company's unlawful conduct, and they would have been under a duty to bring the company into compliance with the law and thus avoid incurring the $250 million in fines and restitution. [7]

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

[7] *In re Caremark Intern*, 698 A.2d at 971.

In its examination of plaintiffs' claim, the court in *Caremark* distinguished between two director liability standards: (1) "a board decision that results in a loss because that decision was ill advised or 'negligent'" and (2) "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." *Id.* at 967. In connection with the first standard of liability concerning board decisions that resulted in a corporate loss, the *Caremark* court concluded that the business judgment rule typically applied, "assuming the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational." *Id.* The *Caremark* court emphasized that the process - and not the substance of the board's decision – was the determinative factor under this standard and as long as the process employed "was either rational or employed in a good faith effort to advance corporate interests," the business judgment rule applied. *Id.*

The second type of potential director liability the *Caremark* court considered concerned "circumstances in which a loss eventuates not from a decision but, from unconsidered inaction. *Id.* at 968. The court in *Caremark* reasoned that although officers and directors were not guarantors of the internal operations of their companies, a director must make a "good faith effort" to oversee the company's internal operations. The court concluded that "it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operation, so that it may satisfy its responsibility." *Id.* at 970. While *Caremark* recognized a director's duty to monitor the company's internal operations, it imposed a high burden of proof to sustain such a claim. The court concluded that only "a sustained or systematic failure of the board to exercise oversight --

such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability." *Id.* at 971.

In *Stone v. Ritter*, 911[8] the Supreme Court of Delaware reaffirmed the holding in *Caremark* in the context of a motion to dismiss a shareholders' derivative action that alleged violation of the directors' duty of good faith regarding banking law violations. In its determination that the complaint was properly dismissed, the *Stone* court held that the following elements were necessary to support a claim for director oversight liability: "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Id.* at 370. The Delaware Supreme Court concluded that "[i]n either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id.* Since a reasonable reporting system existed, the court concluded that the plaintiffs had failed to establish a lack of good faith necessary to impose liability on the board.

In *In re Citigroup Inc. S'holder Derivative Litig.*,[9] the Delaware Court of Chancery addressed whether plaintiffs' *Caremark* claims could be maintained against individual directors for their alleged failure to properly monitor Citigroup's business risk, specifically its exposure to the subprime mortgage market. According to plaintiffs' complaint, the directors failed, among

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[8] *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del 2006).

[9] *See In re Citigroup Inc.*, 964 A.2d at 123.

other things "to adequately oversee and manage Citigroup's exposure to the problems in the subprime mortgage market, even in the face of alleged 'red flags.'" *Id.* at 114. The court declined to extend the *Caremark* duty to monitor to plaintiffs' claims alleging a failure to assess the subprime mortgage risk. In dismissing plaintiffs' claim, the *Citigroup* court relied on the presumption inherent in the business judgment rule "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* at 124. In the absence of any allegation of self-interest, disloyalty to the corporation or bad faith, the *Citigroup* court held that the business judgment rule "prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information." *Id.*

In the twenty years that have followed *Caremark*, Delaware courts regularly have dismissed shareholder derivative suits that allege a total failure of oversight by the board. However, in recent years, Delaware courts have emphasized that a director's *Caremark* duty of care required both the adoption and active monitoring of oversight systems.

In *Marchand v. Barnhill*, [10] the Delaware Supreme Court reversed the dismissal of a complaint against the board of Blue Bell Creameries USA, Inc., one of the country's largest ice cream manufacturers. The complaint was brought by a stockholder after Blue Bell suffered a listeria outbreak in 2015 resulting in a recall of the company's products, a shutdown of plant operations, mass lay-offs and a liquidity crisis that forced the company to accept a dilutive private equity investment. *Id.* at 807.

[10] *See Marchand v. Barnhill*, 212 A.3d 805 (Del 2019).

In reversing the dismissal by the Chancery Court, the Delaware Supreme Court in *Marchand* applied the standard articulated in *Caremark* and *Stone v. Ritter* to determine whether the directors acted in bad faith. The *Marchand* court observed that "[b]ad faith is established under *Caremark* when 'the directors [completely] fail[] to implement any reporting or information system or controls[,] or . . . having implemented such a system or controls, consciously fail[] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." *Id.* at 821, quoting *Stone v. Ritter*,[11] In order to "satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it." *Id.* Using the books and records of the company, the court held that plaintiff adequately alleged that before the listeria outbreak, "no system of board-level compliance monitoring and reporting existed at Blue Bell." *Id.* at 822. The court concluded that the fact that Blue Bell nominally complied with FDA regulations was insufficient to support an inference that the board implemented a system to monitor food safety at the board level. *Id.* at 823. This "dearth of any board-level effort at monitoring" the company's risk management supported an inference that the directors had breached their oversight obligations. To "satisfy their duty of loyalty," the court held, "directors must make a good faith effort to implement an oversight system and then monitor it" themselves. *Id.*

In October 2019, the court in *In Re Clovis Oncology, Inc. Derivative Litigation* further extended the practical reach of Caremark when it upheld claims against directors for failing to accurately report drug testing results. Shareholders brought a derivative action against the board of directors claiming that the board breached its fiduciary duties by disregarding "red flags" that reports of the efficacy of the drugs performance in clinical trials were inflated. The Delaware

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[11] *See Stone ex rel.*, 911 A.2d at 370.

Court of Chancery held that duty-to-monitor claims required a showing of scienter, *i.e.* evidence that the directors either knew that they were violating their duty or recklessly avoided their duty but did not require the plaintiff to allege particular facts showing such knowledge. Instead, the court reasoned that the board consisted of "experts" who "should have understood" the problem and addressed it. Both *Marchand* and *Clovis* serve as important reminders that boards must actively participate in both establishing procedures and monitoring compliance with these procedures in order to avoid *Caremark* exposure.

## V. **CONCLUSION**

While directors are neither guarantors of their company's success, nor required to be aware of or involved in every aspect of their company's daily operations, they are considered the "eyes and ears" of their company's shareholders, and owe a fiduciary duty of care to the shareholders to design and implement systems that monitor and report financial, regulatory and legal issues to the company's management that may adversely impact a company's operations. The take-away from *Caremark* and its progeny is that good corporate governance necessitates implementation of effective internal controls and risk management systems. In furtherance of their risk management oversight responsibilities, directors may consider hiring outside shareholders intelligence consultants to assist in monitoring their company's stock price in the marketplace, in the event their company becomes the target of a stock manipulation scheme. As the "eyes and ears" of shareholders concerning risk management, directors cannot turn a blind eye or deaf ear to "red flags" or consciously fail to take remedial action, when it becomes apparent that their company is the target of a market manipulation scheme, without exposing themselves and their companies to time consuming and expensive litigation for breaching their fiduciary duty of care. It has been stated by State Street and other institutional investors that,

"good corporate governance necessitates the existence of effective internal controls and risk management systems, which should be governed by the board." A board's failure to oversee and monitor material risks facing the company, adopt effective reporting systems or engage outside consultants to assist them in discharging their duty, may threaten shareholder value and expose the company to considerable legal liability.