of competent jurisdiction that his action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation. . . .

7.5 The Board's Duty to Monitor: Losses "Caused" by Board Passivity

So far, we have discussed the possible liability of directors for failing to take reasonable care in making business decisions that lead to financial losses. We now turn to the related question: What is the scope of director liability for losses that arise not from business decisions but rather from causes that the board might arguably have deflected but did not? The business judgment rule protects boards *decisions.* In fact, however, the relatively few cases that actually impose liability on directors for breach of the duty of care are not cases in which a decision proved disastrously wrong, but cases, like the Enron collapse of 2001, in which directors simply failed to do anything under circumstances in which it is later determined that a reasonably alert person would have taken action.[17]

Directors' incentives are far less likely to be distorted by liability imposed for passive violations of the standard of care than for liability imposed for erroneous decisions. We should not be surprised that actual liability is more likely to arise from a failure to supervise or detect fraud than from an erroneous business decision. Nevertheless, given the disjunction between the scale of operations of many public corporations and the scale of the personal wealth of typical individual directors, the risk of liability for inactivity may still deter talented persons from serving on corporate boards. Despite this danger, the astonishingly rapid collapse of the Enron Corporation in 2001 suggested to many observers that boards may generally be too easily manipulated by company officers. As a corrective, some of these observers believe that the sharp prod of potential liability ought to be more in evidence. But liability for losses in these huge enterprises is a crude ex post method to force appropriate attention. Losses in the Enron case were in the many tens of billions of dollars. Liability for the smallest percentage of this loss would financially destroy corporate directors and would make board service to others desperately unappealing. How then are incentives for director attention to be created that do not deter service? We can, at least, say it cannot be done scientifically.

17. Recall that the earliest case we find is the 1741 decision *Sutton v. Charitable Hospitable Case*, noted above, in which the board was charged with failing to uncover a fraud. See also the often-cited U.S. Supreme Court case of *Briggs v. Spaulding*, 141 U.S. 132 (1891).

In this section, we review five cases dealing with directors who are charged with breaching their duty of care by not sufficiently monitoring the corporation and thus by not preventing a loss that the corporation incurred.

FRANCIS v. UNITED JERSEY BANK

432 A.2d 814 (N.J. 1981)

[Pritchard & Baird, Inc. was a reinsurance broker that arranged contracts between insurance companies that wrote large policies and other companies in order to share the risks of those policies. In this industry, the company that sells insurance to the client pays a portion of the premium to the reinsurance broker, who deducts its commission and forwards the balance to the reinsuring company. The broker thus handles large amounts of money as a fiduciary for its clients.

As of 1964, all the stock of Pritchard & Baird was owned by Charles Pritchard, Sr., one of the firm's founders, and his wife and two sons, Charles, Jr., and William. They were also the four directors. Charles, Sr., dominated the corporation until 1971, when he became ill and the two sons took over management of the business. Charles, Sr., died in 1973, leaving Mrs. Pritchard and the sons the only remaining directors.

Contrary to the industry practice, Pritchard & Baird did not segregate its operating funds from those of its clients, depositing all in the same account. From this account Charles, Sr., had drawn "loans" that correlated with corporate profits and were repaid at the end of each year. After his death, Charles, Jr., and William began to draw ever larger sums (still characterizing them as "loans") that greatly exceeded profits. They were able to do so by taking advantage of the "float" available to them during the period between the time they received a premium and the time they had to forward it (less commission) to the reinsurer.

By 1975, the corporation was bankrupt. This action was brought by the trustees in bankruptcy against Mrs. Pritchard and the bank as administrator of her husband's estate. As to Mrs. Pritchard, the principal claim was that she had been negligent in the conduct of her duties as a director of the corporation. She died during the pendency of the proceedings, and her executrix was substituted as defendant.]

THE FALL OF THE HOUSE OF PRITCHARD[18]

In the mid-1940s, Charles Pritchard, Sr., and George Baird founded one of the first domestic brokerages in the nascent American reinsurance industry. Roughly speaking, reinsurance insures primary insurers by spreading a risk of loss among multiple parties, so as to avoid the possibility of a catastrophic loss

18. This account comes from Reinier Kraakman & Jay Kesten, *The Story of Francis v. United Jersey Bank: When a Good Story Makes Bad Law*, Corporate Law Stories (2010). Citations to the trial court opinion and other sources are provided there.

for any one. Under the leadership of Charles Pritchard, Sr., Pritchard & Baird became one of America's largest and most prestigious reinsurance intermediaries. After Baird retired in 1964, the Pritchards became the firm's sole shareholders, senior officers, and directors. In 1968, the Prichard sons, Charles, Jr., and William, assumed sole responsibility for the management of the family firm due to the failing health of their father. Though they were well educated and raised in the family business, Charles, Jr., and William were cut from an altogether different cloth than their father. Where he was moderate, they were greedy; where he was conservative, they were risk-takers; and where he appears to have had integrity, they were unscrupulous.

For several years, the younger Pritchards financed their extravagant lifestyles by misappropriating more than $10 million held in trust by their reinsurance company. But eventually the brothers were discovered, forced into personal bankruptcy, and escaped lengthy prison sentences by a hair's breadth. Shortly thereafter, trustees — including Mr. Francis, the plaintiff in the civil case — were appointed to gather and administer the assets of the various estates. In April 1976, the bankruptcy court directed the trustees for Pritchard & Baird to bring suit against members of the Pritchard family to recover the more than $10 million of client funds misappropriated under the guise of "shareholder loans." Claims were initially filed against all three directors of the company, but the Pritchard brothers were dismissed from the case after being adjudicated bankrupt, leaving their mother — Lillian Pritchard, the only solvent director of Pritchard & Baird — as the main defendant in the case.

The trial court held that if Mrs. Pritchard "had paid the slightest attention to the affairs of the corporation, she would have known what was happening." Consequently, Mrs. Pritchard was found negligent, since "[h]ad she performed her duties with due care, she would readily have discovered the wrongdoing . . . and she could easily have taken effective steps to stop the wrongdoing." The court rejected the argument that Mrs. Pritchard should be absolved of liability because she was "a simple housewife . . . old and grief-stricken at the loss of her husband" (Charles, Sr., had died in 1973) who merely "served as a director as an accommodation to her husband and sons." Indeed, in an interesting rhetorical twist, Judge Stanton opined that accepting this argument would insult the "fundamental dignity and equality of women." Based on these findings, the trial court held Mrs. Pritchard liable for the more than $10 million of "loans" improperly paid to members of the Pritchard family at the direction of Charlie and Bill between 1970 and 1975. The decision was affirmed by a three-judge panel of the Appellate Division, and the New Jersey Supreme Court granted certification on the question of Mrs. Pritchard's liability as a director.

Pollock, J.:

The "loans" were reflected on financial statements that were prepared annually as of January 31, the end of the corporate fiscal year. Although an outside certified public accountant prepared the 1970 financial statement, the corporation prepared only internal financial statements from 1971-1975. In all instances, the statements were simple documents, consisting of three or four 8 ½ × 11 inch sheets. . . .

	Working Capital Deficit	*Shareholders Loans*	*Net Brokerage Income*
70	$ 389,022	$ 508,941	$ 807,229
71	NOT AVAILABLE	NOT AVAILABLE	NOT AVAILABLE
72	$ 1,684,298	$ 1,825,911	$1,546,263
73	$ 3,506,460	$ 3,700,542	$1,736,349
74	$ 6,939,007	$ 7,080,629	$ 876,182
75	$10,176,419	$10,298,039	$ 551,598

The statements of financial condition from 1970 forward demonstrated: Mrs. Pritchard was not active in the business of Pritchard & Baird and knew virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr. would "take the shirt off my back," Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation. . . .

After her husband died in December 1973, Mrs. Pritchard became incapacitated and was bedridden for a six-month period. She became listless at this time and started to drink rather heavily. Her physical condition deteriorated, and in 1978 she died. The trial court rejected testimony seeking to exonerate her because she "was old, was grief-stricken at the loss of her husband, sometimes consumed too much alcohol and was psychologically overborne by her sons." . . . That court found that she was competent to act and that the reason Mrs. Pritchard never knew what her sons "were doing was because she never made the slightest effort to discharge any of her responsibilities as a director of Pritchard & Baird." 162 N.J. Super. at 372. . . .

III

Individual liability of a corporate director for acts of the corporation is a prickly problem. Generally directors are accorded broad immunity and are not insurers of corporate activities. The problem is particularly nettlesome when a third party asserts that a director, because of nonfeasance, is liable for losses caused by acts of insiders, who in this case were officers, directors and shareholders. Determination of the liability of Mrs. Pritchard requires findings that she had a duty to the clients of Pritchard & Baird, that she breached that duty and that her breach was a proximate cause of their losses. . . .

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. . . . Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act." . . .

Directors are under a continuing obligation to keep informed about the activities of the corporation. . . . Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. Accordingly, a director is well advised to attend board meetings regularly. Indeed, a director who is absent from a board meeting is presumed to concur in action taken on a corporate matter, unless he files a "dissent with the secretary of the corporation within a reasonable time after learning of such action." N.J.S.A. 14A:6-13 (Supp. 1981-1982). . . .

While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements. In some circumstances, directors may be charged with assuring that bookkeeping methods conform to industry custom and usage. The extent of review, as well as the nature and frequency of financial statements, depends not only on the customs of the industry, but also on the nature of the corporation and the business in which it is engaged. Financial statements of some small corporations may be prepared internally and only on an annual basis; in a large publicly held corporation, the statements may be produced monthly or at some other regular interval. Adequate financial review normally would be more informal in a private corporation than in a publicly held corporation.

Of some relevance in this case is the circumstance that the financial records disclose the "shareholders' loans." Generally directors are immune from liability if, in good faith, they rely upon the opinion of counsel for the corporation or upon written reports setting forth financial data concerning the corporation and prepared by an independent public accountant or certified public accountant or firm of such accountants or upon financial statements, books of account or reports of the corporation represented to them to be correct by the president, the officer of the corporation having charge of its books of account, or the person presiding at a meeting of the board.

The review of financial statements, however, may give rise to a duty to inquire further into matters revealed by those statements. . . . Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign. . . .

[In this case, Mrs. Pritchard] should have realized [from those statements] that, as of January 31, 1970, her sons were withdrawing substantial trust funds under the guise of "Shareholders' Loans." The financial statements for each fiscal year commencing with that of January 31, 1970, disclosed that the working capital deficits and the "loans" were escalating in tandem. Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. . . .

Nonetheless, the negligence of Mrs. Pritchard does not result in liability unless it is a proximate cause of the loss. . . .

Cases involving nonfeasance present a much more difficult causation question than those in which the director has committed an affirmative act of negligence leading to the loss. Analysis in cases of negligent omissions calls for determination of the reasonable steps a director should have taken and whether that course of action would have averted the loss.

Usually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action. . . . Conversely, a director who votes for or concurs in certain actions may be "liable to the corporation for the benefit of its creditors or shareholders, to the extent of any injuries suffered by such persons, respectively, as a result of any such action." N.J.S.A. 14A:6-12 (Supp. 1981-1982). A director who is present at a board meeting is presumed to concur in corporate action taken at the meeting unless his dissent is entered in the minutes of the meeting or filed promptly after adjournment. N.J.S.A. 14:6-13. In many, if not most, instances an objecting director whose dissent is noted in accordance with N.J.S.A. 14:6-13 would be absolved after attempting to persuade fellow directors to follow a different course of action. . . .

In this case, the scope of Mrs. Pritchard's duties was determined by the precarious financial condition of Pritchard & Baird, its fiduciary relationship to its clients and the implied trust in which it held their funds. Thus viewed, the scope of her duties encompassed all reasonable action to stop the continuing conversion. Her duties extended beyond mere objection and resignation to reasonable attempts to prevent the misappropriation of the trust funds. . . .

A leading case discussing causation where the director's liability is predicated upon a negligent failure to act is *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924). In that case the court exonerated a figurehead director who served for eight months on a board that held one meeting after his election, a meeting he was forced to miss because of the death of his mother. Writing for the court, Judge Learned Hand distinguished a director who fails to prevent general mismanagement from one such as Mrs. Pritchard who failed to stop an illegal "loan":

> When the corporate funds have been illegally lent, it is a fair inference that a protest would have stopped the loan, and that the director's neglect caused the loss. But when a business fails from general mismanagement, business incapacity, or bad judgment, how is it possible to say that a single director could have made the company successful, or how much in dollars he could have saved? (*Id.* at 616-617) . . .

. . . The wrongdoing of her sons, although the immediate cause of [Pritchard & Baird's] loss, should not excuse Mrs. Pritchard from her negligence which also was a substantial factor contributing to the loss. . . . Her sons knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect. Her neglect of duty contributed to the climate of corruption; her failure to act contributed to the continuation of that corruption. . . .

Analysis . . . is especially difficult . . . where the allegation is that nonfeasance of a director is a proximate cause of damage to a third party. . . . Nonetheless, where it is reasonable to conclude that the failure to act would produce a particular result and that result has followed, causation may be inferred. We conclude that even if Mrs. Pritchard's mere objection had not stopped the depredations of her sons, her consultation with an attorney and the threat of suit would have deterred them. That conclusion flows as a matter of common sense and logic from the record. Whether in other situations a director has a duty to do more than protest and resign is best left to case-by-case determinations. In this case, we are satisfied that there was a duty to do more than object and resign. Consequently, we find that Mrs. Pritchard's negligence was a proximate cause of the misappropriations.

To conclude, by virtue of her office, Mrs. Pritchard had the power to prevent the losses sustained by the clients of Pritchard & Baird. With power comes responsibility. She had a duty to deter the depredation of the other insiders, her sons. She breached that duty and caused plaintiffs to sustain damages.

The judgment of the Appellate Division is affirmed.

NOTE

Although an odd case in some respects, *Francis* reflects the majority view that there is a minimum objective standard of care for directors — that directors cannot abandon their office but must make a good-faith attempt to do a proper job. The case law is divided on whether the minimum standard is the same for all directors or whether sophisticated directors (e.g., lawyers and investment bankers) ought to be held to a higher standard. The law is clear that all directors must satisfy the same legal standard of care, but the determination of liability is a director-by-director determination. A court may conclude that a reasonable engineer or investment banker serving on a board should have acted in certain circumstances while a reasonable person without that training and experience may not have done so. See *In Re Emerging Communications Inc. Shareholders Litigation* 2004 Del. Ch. LEXIS 70 (2004) (investment banker held liable for complicity in controllers breach of loyalty in buyout, while other directors with less knowledge found not liable).

QUESTIONS

1. What would have been the result if Mrs. Pritchard had spotted her sons' activities; if they had responded: "Don't worry, Mama. We were stealing, but we'll stop now and establish a segregated fund for our clients' moneys"; and if her sons had continued to steal as before but pacified their mother with a false financial statement?

2. Courts are reluctant to impose a duty on directors who suspect wrongful activity to do more than protest and resign. Ought the corporation law impose something tough, such as a whistle-blowing duty (i.e., to go to prosecutors or disclose to shareholders)?

In general, boards of public companies have a particular obligation to monitor their firm's financial performance, the integrity of its financial reporting, its compliance with the law, its management compensation, and its succession planning. Because of the large scale of modern public corporations, the board must monitor largely through reports from others, whether outside auditors, other professionals, or corporate officers. The board authorizes only the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, etc. The lesser decisions that are made by officers and employees within the interior of the organization can, however, vitally affect the welfare of the corporation. Recent business history has graphically demonstrated that the failure of appropriate controls can result in extraordinary losses to even very large public companies. Even before the Enron and WorldCom scandals, large losses following monitoring failures resulted in the displacement of senior management and much of the board of Salomon, Inc.;[19] the replacement of senior management of Kidder, Peabody;[20] and extensive financial loss and reputational injury to Prudential Insurance arising from misrepresentations in connection with the sale of limited partnership interests.[21] Financial disasters of this sort raise this question: What is the board's responsibility to assure that the corporation functions within the law to achieve its purposes?

GRAHAM v. ALLIS-CHALMERS MANUFACTURING CO.

188 A.2d 125 (Del. 1963)

WOLCOTT, J.:

This is a derivative action on behalf of Allis-Chalmers against its directors and four of its non-director employees. The complaint is based upon indictments of Allis-Chalmers and the four non-director employees named as defendants herein who, with the corporation, entered pleas of guilty to the indictments. The indictments, eight in number, charged violations of the Federal anti-trust laws. The suit seeks to recover damages which Allis-Chalmers is claimed to have suffered by reason of these violations.

The hearing and depositions produced no evidence that any director had any actual knowledge of the anti-trust activity, or had actual knowledge of any facts which should have put them on notice that anti-trust activity was being carried on by some of their company's employees. The plaintiffs, appellants here, thereupon shifted the theory of the case to the proposition that the directors are liable as a matter of law by reason of their failure to take action designed to learn of and prevent anti-trust activity on the part of any employees of Allis-Chalmers.

19. See, e.g., *Rotten at the Core*, Economist, Aug. 17, 1991, at 69-70; Mike McNamee et al., *The Judgment of Salomon: An Anticlimax*, Bus. Week, June 1, 1992, at 106.

20. See Terence P. Pare, *Jack Welch's Nightmare on Wall Street*, Fortune, Sept. 5, 1994, at 40-48.

21. Michael Schroeder & Leah N. Spiro, *Is George Ball's Luck Running Out?*, Bus. Week, Nov. 8, 1993, at 74-76.

By this appeal the plaintiffs seek to have us reverse the Vice Chancellor's ruling of non-liability of the defendant directors upon this theory. . . .

Allis-Chalmers is a manufacturer of a variety of electrical equipment. It employs in excess of 31,000 people, has a total of 24 plants, 145 sales offices, 5000 dealers and distributors, and its sales volume is in excess of $500,000,000 annually. The operations of the company are conducted by two groups, each of which is under the direction of a senior vice president. One of these groups is the Industries Group under the direction of Singleton, director defendant. This group is divided into five divisions. One of these, the Power Equipment Division, produced the products, the sale of which involved the anti-trust activities referred to in the indictments. The Power Equipment Division, presided over by McMullen, non-director defendant, contains ten departments, each of which is presided over by a manager or general manager.

The operating policy of Allis-Chalmers is to decentralize by the delegation of authority to the lowest possible management level capable of fulfilling the delegated responsibility. Thus, prices of products are ordinarily set by the particular department manager, except that if the product being priced is large and special, the department manager might confer with the general manager of the division. Products of a standard character involving repetitive manufacturing processes are sold out of a price list which is established by a price leader for the electrical equipment industry as a whole.

Annually, the Board of Directors reviews group and departmental profit goal budgets. On occasion, the Board considers general questions concerning price levels, but because of the complexity of the company's operations the Board does not participate in decisions fixing the prices of specific products.

The Board of Directors of fourteen members, four of whom are officers, meets once a month, October excepted, and considers a previously prepared agenda for the meeting. Supplied to the Directors at the meetings are financial and operating data relating to all phases of the company's activities. The Board meetings are customarily of several hours duration in which all the Directors participate actively. Apparently, the Board considers and decides matters concerning the general business policy of the company. By reason of the extent and complexity of the company's operations, it is not practicable for the Board to consider in detail specific problems of the various divisions.

The indictments to which Allis-Chalmers and the four non-director defendants pled guilty charge that the company and individual non-director defendants, commencing in 1956, conspired with other manufacturers and their employees to fix prices and to rig bids to private electric utilities and governmental agencies in violation of the anti-trust laws of the United States. None of the director defendants in this cause were named as defendants in the indictments. Indeed, the Federal Government acknowledged that it had uncovered no probative evidence which could lead to the conviction of the defendant directors.

The first actual knowledge the directors had of anti-trust violations by some of the company's employees was in the summer of 1959 from newspaper stories that the TVA proposed an investigation of identical bids. Singleton, in charge of the Industries Group of the company, investigated but unearthed nothing. Thereafter, in November of 1959, some of the company's employees were subpoenaed before the Grand Jury. Further investigation by the company's Legal Division gave reason to suspect the illegal activity and all of the subpoenaed employees were instructed to tell the whole truth.

Thereafter, on February 8, 1960, at the direction of the Board, a policy statement relating to anti-trust problems was issued, and the Legal Division commenced a series of meetings with all employees of the company in possible areas of anti-trust activity. The purpose and effect of these steps was to eliminate any possibility of further and future violations of the antitrust laws.

As we have pointed out, there is no evidence in the record that the defendant directors had actual knowledge of the illegal anti-trust actions of the company's employees. Plaintiffs, however, point to two FTC decrees of 1937 as warning to the directors that anti-trust activity by the company's employees had taken place in the past. It is argued that they were thus put on notice of their duty to ferret out such activity and to take active steps to insure that it would not be repeated.

The decrees in question were consent decrees entered in 1937 against Allis-Chalmers and nine others enjoining agreements to fix uniform prices on condensers and turbine generators. The decrees recited that they were consented to for the sole purpose of avoiding the trouble and expense of the proceeding.

The director defendants and now officers of the company either were employed in very subordinate capacities or had no connection with the company in 1937. At the time, copies of the decrees were circulated to the heads of concerned departments and were explained to the Managers Committee.

In 1943, Singleton, officer and director defendant, first learned of the decrees upon becoming Assistant Manager of the Steam Turbine Department, and consulted the company's General Counsel as to them. He investigated his department and learned the decrees were being complied with and, in any event, he concluded that the company had not in the first place been guilty of the practice enjoined.

Stevenson, officer and director defendant, first learned of the decrees in 1951 in a conversation with Singleton about their respective areas of the company's operations. He satisfied himself that the company was not then and in fact had not been guilty of quoting uniform prices. . . .

Scholl, officer and director defendant, learned of the decrees in 1956 in a discussion with Singleton on matters affecting the Industries Group. He was informed that no similar problem was then in existence in the company.

Under the circumstances, we think knowledge by three of the directors that in 1937 the company had consented to the entry of decrees enjoining it from doing something they had satisfied themselves it had never done, did not put the Board on notice of the possibility of future illegal price fixing.

Plaintiffs are thus forced to rely solely upon the legal proposition advanced by them that directors of a corporation, as a matter of law, are liable for losses suffered by their corporations by reason of their gross inattention to the common law duty of actively supervising and managing the corporate affairs. . . .

The precise charge made against these director defendants is that, even though they had no knowledge of any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end. However, the *Briggs* case expressly rejects such an idea. On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but 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.

The duties of the Allis-Chalmers Directors were fixed by the nature of the enterprise which employed in excess of 30,000 persons, and extended over a large geographical area. By force of necessity, the company's Directors could not know personally all the company's employees. The very magnitude of the enterprise required them to confine their control to the broad policy decisions. That they did this is clear from the record. . . .

In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.

Plaintiffs say these steps should have been taken long before, even in the absence of suspicion, but we think not, for we know of no rule of law which requires a corporate director to assume, with no justification whatsoever, that all corporate employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities.

We therefore affirm the Vice Chancellor's ruling. . . .

QUESTIONS

1. There is evidence that the exceptionally decentralized operating policy of Allis-Chalmers was accompanied by enormous pressure on the company's semiautonomous units to show steadily growing profits. If this was the management style approved by the Allis-Chalmers board, should there be any implications for the board's duty of care?

2. What function would imposing liability for breach of the duty of care serve in *Allis-Chalmers*? When might it be in the narrow economic interests of shareholders, and when might it not be in the interests of shareholders?

3. To the extent that one is tempted to impose liability on the board for purposes of enforcing the antitrust laws, what alternative enforcement strategies might be available? What about increasing penalties against the company itself?

State corporate law is not the only legal source of a director's duty of care. Securities law and the SEC also impose negligence-based duties on directors in a variety of contexts. *In the Matter of Michael Marchese*, below, is a particularly aggressive assertion of a breach in an outside director's duty to monitor a firm's financial statements. In the present regulatory environment, conventional wisdom has it that outside directors are at least as concerned about SEC enforcement actions as they are about shareholder suits under state law.

IN THE MATTER OF MICHAEL MARCHESE

Release Nos. 34-47732; AAER-1764; Administrative Proceeding File No. 3-11092 (April 24, 2003)

BACKGROUND

Respondent Marchese became an outside director of Chancellor in December 1996. He was an acquaintance of Brian Adley, who was Chancellor's controlling shareholder, chairman and chief executive officer. Chancellor reported in public filings that Marchese was a member of the company's audit committee from 1996 to May 1999. Marchese never reviewed Chancellor's accounting procedures or internal controls. He generally deferred to Adley when board action was required.

1. Chancellor Prematurely Consolidated an Acquired Subsidiary's Revenue

On August 10, 1998, Chancellor entered into a letter of intent to acquire MRB, a seller of used trucks. A final closing took place on January 29, 1999. When preparing its financial reports for 1998, Chancellor improperly designated August 1, 1998, as the MRB acquisition date for accounting purposes. Chancellor designated that date based on its claim that a preexisting written agreement between Chancellor and MRB gave Chancellor effective control of MRB's operations as of August 1, 1998. When Chancellor's auditors began the audit of Chancellor's year-end 1998 financial statements, they reviewed the agreement and informed Chancellor's management that it did not give Chancellor sufficient control of MRB during 1998 to justify consolidating the two companies' financial statements for accounting purposes. The auditors sent a memorandum to Adley and Marchese in February 1999 setting forth their position that GAAP required a 1999 consolidation date.

During February 1999, Adley directed Chancellor's acting CFO to create and backdate to August 1998 a purported amended management agreement with MRB to provide additional support to justify an August 1, 1998 acquisition date for accounting purposes. This document, however, did not cause the auditors to change their position with respect to the correct acquisition date.

ACCORDINGLY, IT IS ORDERED:

Pursuant to Section 21C of the Exchange Act, that Respondent Marchese shall cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and from causing any violations and any future violations of Sections 13(a), 13(b)(2)(A) and 13(B)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-1 promulgated thereunder.

By the Commission.

Jonathan G. Katz

Secretary

QUESTION

Ever since the enactment of the Securities Enforcement and Penny Stock Reform Act of 1990, SEC enforcement actions have been a powerful and frequently used weapon to secure compliance with the federal securities laws. The case against Michael Marchese generated a great deal of practitioner commentary. In the aftermath of the settlement, then-SEC enforcement director Stephen Cutler stated: "[W]e intend to continue following closely in our investigations on whether outside directors have lived up to their role as guardians of the shareholders they serve. As with the *Chancellor* case, we will exercise particular scrutiny in considering the role of directors in approving or acquiescing in transactions by company management."[22] Imagine that a public-company board of directors has asked you to advise them on the implications of the Chancellor case on their duty to monitor obligations. How would you advise them? More specifically, to what extent, if at all, does the SEC enforcement action against Marchese go beyond existing "red flag" doctrine under state corporate law?

NOTE ON THE FEDERAL ORGANIZATIONAL SENTENCING GUIDELINES

The United States has begun to sometimes treat lapses from statutory or administratively mandated standards of business conduct as criminal matters.[23] Federal statutory law has been a powerful engine of this movement. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),[24] for example, opens up potential civil and criminal liabilities for both corporations and "persons in charge," who may be officers or

22. Stephen M. Cutler, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program*. Speech at UCLA Law School, Los Angeles, California (Sept. 20, 2004).

23. E.g., Flom, *U.S. Prosecutors Take a Tough Line*, Fin.Times, Oct. 31, 1991, at 21.

24. 42 U.S.C.A. §§9601 et seq.

low-level employees.[25] The Resource Conservation and Recovery Act (RCRA) imposes criminal liability on "any person" who knowingly transports hazardous waste to an unpermitted facility or treats, stores, or disposes of any hazardous waste without a permit.[26] Similarly, the Clean Water Act[27] and the Clean Air Act include criminal penalties applicable to any "person" including "any responsible corporate officer"[28] who violates those Acts. Environmental laws are simply one category of substantive federal regulation in which the criminal law is deployed to promote corporate compliance with regulation. The Occupational Safety and Health Act (OSHA);[29] the Food, Drug, and Cosmetics Act;[30] the antitrust acts; the Foreign Corrupt Practices Act (FCPA);[31] and the acts regulating federally chartered or insured depository institutions[32] and securities markets[33] all authorize substantial civil or criminal fines against corporations and their officers or employees.

In 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission[34] adopted Organizational Sentencing Guidelines, which set forth a uniform sentencing structure for organizations convicted of federal criminal violations and provided for penalties that generally exceed those previously imposed on corporations.[35] The Guidelines offer powerful incentives for firms to put compliance programs in place, to report violations of law promptly, and to make voluntary remediation efforts. Under the Organizational Sentencing Guidelines, a convicted organization that has satisfied these conditions will receive a much lower fine. For example, the Guidelines will reduce the base fine of a fully compliant firm by up to 95 percent, while they quadruple the base fine of firms with the highest culpability rating.[36] Since the maximum base fine under the Guidelines is $72.5 million, the culpability score could cause a variation in a fine from $3.6 million to $290 million for the same offense, depending on the circumstances.

Designing corporate compliance programs has developed into a new legal subspecialty. The enormous potential fines at stake today make it less likely than it was in 1963 that a court construing the duties of corporate directors would pass over a board's failure to implement a legal compliance program as blithely as was done in *Allis-Chalmers*.

25. E.g., *United States v. Mexico Seed & Feed Co.*, 764 F. Supp. 565, *rev'd in part*, 980 F.2d 473 (8th Cir. 1992).

26. 42 U.S.C. §6928(d), (e).

27. 33 U.S.C. §§1319(c), 1362(5), 1321(b)(5) (specifically including "any responsible corporate officer").

28. 42 U.S.C. §§7602(e), 7413(c)(6).

29. 21 U.S.C. §333.

30. 21 U.S.C.A. §§301 et seq.

31. 15 U.S.C. §§78m et seq.

32. E.g., Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-429, 104 Stat. 931 (1990).

33. E.g., Securities Enforcement Remedies and Penny Stock Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

34. See Sentencing Reform Act of 1984, Pub. L. No. 98-473.

35. See United States Sentencing Commission, Guidelines Manual, ch. 8 (2008) (www.ussc.gov/2008guid/CHAP8.pdf).

36. Id. §8C2.4-2.6.

IN RE CAREMARK INTERNATIONAL INC. DERIVATIVE LITIGATION

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

ALLEN, C.:

Pending is a motion pursuant to Chancery Rule 23.1 to approve as fair and reasonable a proposed settlement of a consolidated derivative action on behalf of Caremark International, Inc. ("Caremark"). The suit involves claims that the members of Caremark's board of directors (the "Board") breached their fiduciary duty of care to Caremark in connection with alleged violations by Caremark employees of federal and state laws and regulations applicable to health care providers. As a result of the alleged violations, Caremark was subject to an extensive four year investigation. . . . In 1994 Caremark was charged in an indictment with multiple felonies. It thereafter entered into a number of agreements with the Department of Justice and others. Those agreements included a plea agreement in which Caremark pleaded guilty to a single felony of mail fraud and agreed to pay civil and criminal fines. Subsequently, Caremark agreed to make reimbursements to various private and public parties. In all, the payments that Caremark has been required to make total approximately $250 million.

This suit was filed in 1994, purporting to seek on behalf of the company recovery of these losses from the individual defendants who constitute the Board of Directors of Caremark.[1] The parties now propose that it be settled and, after notice to Caremark shareholders, a hearing on the fairness of the proposal was held on August 16, 1996.

A motion of this type requires the court to assess the strengths and weaknesses of the claims asserted in light of the discovery record and to evaluate the fairness and adequacy of the consideration offered to the corporation in exchange for the release of all claims made or arising from the facts alleged. . . .

Legally, evaluation of the central claim made entails consideration of the legal standard governing a board of directors' obligation to supervise or monitor corporate performance. For the reasons set forth below I conclude, in light of the discovery record, that there is a very low probability that it would be determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise. . . .

I. BACKGROUND

. . . I regard the following facts . . . as material. Caremark . . . was created in November 1992. . . . The business practices that created the problem pre-dated the spin-off. During the relevant period Caremark was involved in two main health care business segments, providing patient care and managed care services. . . .

1. Thirteen of the Directors have been members of the Board since November 30, 1992. Nancy Brinker joined the Board in October 1993.

A substantial part of the revenues generated by Caremark's businesses is derived from third party payments, insurers, and Medicare and Medicaid reimbursement programs. The latter source of payments is subject to the terms of the Anti-Referral Payments Law ("ARPL") which prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. From its inception, Caremark entered into a variety of agreements with hospitals, physicians, and health care providers for advice and services, as well as distribution agreements with drug manufacturers, as had its predecessor prior to 1992. Specifically, Caremark did have a practice of entering into contracts for services (e.g., consultation agreements and research grants) with physicians at least some of whom prescribed or recommended services or products that Caremark provided to Medicare recipients and other patients. Such contracts were not prohibited by the ARPL but they obviously raised a possibility of unlawful "kickbacks."

As early as 1989, Caremark's predecessor issued an internal "Guide to Contractual Relationships" ("Guide") to govern its employees in entering into contracts with physicians and hospitals. . . . Each version of the Guide stated as Caremark's and its predecessor's policy that no payments would be made in exchange for or to induce patient referrals. But what one might deem a prohibited quid pro quo was not always clear. Due to a scarcity of court decisions interpreting the ARPL, however, Caremark repeatedly publicly stated that there was uncertainty concerning Caremark's interpretation of the law. . . .

In August 1991, the HHS [Health and Human Service] Office of the Inspector General ("OIG") initiated an investigation of Caremark's predecessor. Caremark's predecessor was served with a subpoena requiring the production of documents, including contracts between Caremark's predecessor and physicians (Quality Service Agreements ("QSAs")). Under the QSAs, Caremark's predecessor appears to have paid physicians' fees for monitoring patients under Caremark's predecessor's care, including Medicare and Medicaid recipients. Sometimes apparently those monitoring patients were referring physicians, which raised ARPL concerns. . . .

The first action taken by management, as a result of the initiation of the OIG investigation, was an announcement that as of October 1, 1991, Caremark's predecessor would no longer pay management fees to physicians for services to Medicare and Medicaid patients. . . .

During this period, Caremark's Board took several additional steps . . . to assure compliance with company policies concerning the ARPL and the contractual forms in the Guide. In April 1992, Caremark published a fourth revised version of its Guide apparently designed to assure that its agreements either complied with the ARPL and regulations or excluded Medicare and Medicaid patients altogether. In addition, in September 1992, Caremark instituted a policy requiring its regional officers, Zone Presidents, to approve each contractual relationship entered into by Caremark with a physician.

Although there is evidence that inside and outside counsel had advised Caremark's directors that their contracts were in accord with the law, Caremark recognized that some uncertainty respecting the correct interpretation of the law existed. . . .

Throughout the period of the government investigations, Caremark had an internal audit plan designed to assure compliance with business and ethics policies. In addition, Caremark employed Price Waterhouse as its outside auditor. On February 8, 1993, the Ethics Committee of Caremark's Board received and reviewed an outside auditors report by Price Waterhouse which concluded that there were no material weaknesses in Caremark's control structure. Despite the positive findings of Price Waterhouse, however, on April 20, 1993, the Audit & Ethics Committee adopted a new internal audit charter requiring a comprehensive review of compliance policies and the compilation of an employee ethics handbook concerning such policies.

The Board appears to have been informed about this project and other efforts to assure compliance with the law. For example, Caremark's management reported to the Board that Caremark's sales force was receiving an ongoing education regarding the ARPL and the proper use of Caremark's form contracts which had been approved by in-house counsel. On July 27, 1993, the new ethics manual, expressly prohibiting payments in exchange for referrals and requiring employees to report all illegal conduct to a toll free confidential ethics hotline, was approved and allegedly disseminated.[5] The record suggests that Caremark continued these policies in subsequent years, causing employees to be given revised versions of the ethics manual and requiring them to participate in training sessions concerning compliance with the law. . . .

On August 4, 1994, a federal grand jury in Minnesota issued a 47-page indictment charging Caremark, two of its officers (not the firm's chief officer), an individual who had been a sales employee of Genentech, Inc., and David R. Brown, a physician practicing in Minneapolis, with violating the ARPL over a lengthy period. According to the indictment, over $1.1 million had been paid to Brown to induce him to distribute Protropin, a human growth hormone drug marketed by Caremark. . . .

In reaction to the Minnesota Indictment . . . [m]anagement reiterated the grounds for its view that the contracts were in compliance with law.

Subsequently, five stockholder derivative actions were filed in this court and consolidated into this action. . . .

On September 21, 1994, a federal grand jury in Columbus, Ohio issued another indictment alleging that an Ohio physician had defrauded the Medicare program by requesting and receiving $134,600 in exchange for referrals of patients whose medical costs were in part reimbursed by Medicare in violation of the ARPL. . . . Caremark was the health care provider who allegedly made such payments. . . .

5. Prior to the distribution of the new ethics manual, on March 12, 1993, Caremark's president had sent a letter to all senior, district, and branch managers restating Caremark's policies that no physician be paid for referrals, that the standard contract forms in the Guide were not to be modified, and that deviation from such policies would result in the immediate termination of employment.

II. LEGAL PRINCIPLES . . .

The complaint charges the director defendants with breach of their duty of attention or care in connection with the on-going operation of the corporation's business. The claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance. The complaint thus does not charge . . . loyalty-type problems. . . .

1. *Potential liability for directorial decisions:* Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." . . . What should be understood . . . is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. . . .
2. *Liability for failure to monitor:* The second class of cases in which director liability for inattention is theoretically possible entail circumstances in which a loss eventuates not from a decision, but from unconsidered inaction. Most of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention. . . . As the facts of this case graphically demonstrate, ordinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation. . . . [They] raise the question, what is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?

Modernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations. In 1991, pursuant to the Sentencing Reform Act of 1984, the United States Sentencing Commission adopted Organizational Sentencing Guidelines which impact importantly on the prospective effect these criminal sanctions might have on business corporations. The Guidelines set forth a uniform sentencing structure for organizations to be sentenced for violation of federal criminal statutes and provide for penalties that equal or often massively exceed those previously imposed on corporations. The Guidelines offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.

In 1963, the Delaware Supreme Court in *Graham v. Allis-Chalmers Mfg. Co.*, addressed the question of potential liability of board members for losses experienced by the corporation as a result of the corporation having violated the anti-trust laws of the United States. There was no claim in that case that the directors knew about the behavior of subordinate employees of the corporation that had resulted in the liability. Rather, as in this case, the claim asserted was that the directors ought to have known of it. . . . The Delaware Supreme Court concluded that, under the facts as they appeared, there was no basis to find that the directors had breached a duty to be informed of the ongoing operations of the firm. . . .

How does one generalize this holding today? Can it be said today, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that corporate information gathering and reporting systems exists which represents a good faith attempt to provide senior management and the Board with information respecting . . . compliance with applicable statutes and regulations? I certainly do not believe so. . . .

[I]n recent years the Delaware Supreme Court has made it clear — especially in its jurisprudence concerning takeovers . . . — the seriousness with which the corporation law views the role of the corporate board. Secondly, I note the elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under [DGCL] Section 141. . . . Thirdly, I note the potential impact of the federal organizational sentencing guidelines on any business organization. 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.

[I]t would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

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. . . . But 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 operations, so that it may satisfy its responsibility. . . .

III. ANALYSIS OF THIRD AMENDED COMPLAINT AND SETTLEMENT

A. The Claims

On balance, . . . I conclude that this settlement is fair and reasonable. In light of the fact that the Caremark Board already has a functioning committee charged with overseeing corporate compliance, the changes in corporate practice that are presented as consideration for the settlement do not impress one as very significant. Nonetheless, that consideration appears fully adequate to support dismissal of the derivative claims of director fault asserted, because those claims find no substantial evidentiary support in the record and quite likely were susceptible to a motion to dismiss in all events. . . .

2. *Failure to monitor:* Since it does appear that the Board was to some extent unaware of the activities that led to liability, I turn to a consideration of the other potential avenue to director liability that the pleadings take: director inattention or "negligence." Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, . . . only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability. . . .

Here the record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function. To the contrary, . . . the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts. If the directors did not know the specifics of the activities that led to the indictments, they cannot be faulted. . . .

NOTES FOLLOWING CAREMARK

Among the various provisions of the Sarbanes-Oxley Act of 2002, §404 requires that the CEO and the CFO of firms with securities regulated under the Securities Exchange Act of 1934 periodically certify that they have disclosed to the company's independent auditor all deficiencies in the design or operation, or any material weakness, of the firm's internal controls for financial reporting. Among all of the debate surrounding "SOX" (alternatively, "Sarbox"), §404 has generated the most discussion and controversy. Critics have complained that §404 compliance costs have far exceeded predictions, are irrationally high, and have pushed many companies, particularly smaller companies, out of the public markets.[37] More recently, it is noted that initial public offers of stock are, post SOX, moving to London, Hong Kong, and other financial centers and away from the New York Stock Exchange. Judging from public statements, §404 is not the only cause of this, but it is believed to be a very major part of the perceived problem. Proponents, on the other hand, argue that §404 forces companies to take a hard look at their control systems, which has long-term benefits that they suppose outweigh the costs. Since 2002, among companies with more than $1 billion in market capitalization, 2 percent have disclosed material weaknesses under §404.[38] Two stud-

37. Professors Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley present empirical evidence supporting the view that small U.S. public companies are more likely to go private due to the burdens imposed by Sarbanes-Oxley compliance. See Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (USC Center in Law, Economics & Organization Research Paper No. C05-12) (2006).

38. Christine Dunn, *Effective Controls, Clean Opinions Rule the Roost*, Compliance Week (June 2, 2006).

ies find that companies disclosing weaknesses under §404 suffer a 2 percent market-adjusted decline in their stock price, on average.[39]

In the event that a firm's internal controls fail to prevent a loss and the CEO *did not* identify any weakness in the control system to the auditors, cases such as *Kamin v. American Express Co.,* above, indicate that state law imposes little risk of directorial liability—unless, under *Caremark,* the board's failure to prevent a loss resulted from a systematic failure to attempt to control potential liabilities. Does §404 of Sarbanes-Oxley change that prediction in any way? What are the arguments, pro and con?

In 2005, the U.S. Supreme Court struck down the federal sentencing guidelines for individuals as a violation of a criminal defendant's Sixth Amendment right to a jury trial.[40] As a result, the federal sentencing guidelines are now advisory, not mandatory, with respect to individual criminal defendants. The status of the organizational sentencing guidelines remains murkier, however, because the extent to which Sixth Amendment jury trial rights extend to corporate defendants is not clear. Even if the organizational sentencing guidelines are deemed to be only advisory, a 2003 Department of Justice memorandum entitled "Principles of Federal Prosecution of Business Organizations" (a.k.a. the "Thompson Memo," after then-Deputy Attorney General Larry Thompson), eventually incorporated into the U.S. Attorney's Manual, directs U.S. Attorneys to consider the depth and quality of a company's compliance program in connection with charging decisions. As a result, the logic that underlies *Caremark* remains important under federal law as well.

Confirming this point, in 2006, the Delaware Supreme Court in *Stone v. Ritter* endorsed and clarified the *Caremark* standard, stating that: "We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." 911 A.2d 362 (Del. 2006).

The *Caremark* standard as clarified in *Stone v. Ritter* was put to the test in the following case. The particular issue before the court was whether demand was excused, a doctrine we examine in Chapter 9. However, the court's determination on this procedural question was guided by its assessment of the viability of the plaintiffs' substantive claims under *Caremark* and *Stone*.

39. Messod Daniel Beneish et al., *Internal Control Weaknesses and Information Uncertainty* (working paper Apr. 2006); Gus De Franco et al., *The Wealth Change and Redistribution Effects of Sarbanes-Oxley Internal Control Disclosures* (working paper Apr. 2005).

40. *United States v. Booker*, 543 U.S. 220 (2005).

IN RE CITIGROUP INC. SHAREHOLDER DERIVATIVE LITIGATION

2009 WL 481906 (Del. Ch. Feb. 24, 2009)

CHANDLER, Chancellor.

. . . Plaintiffs, shareholders of Citigroup, brought this action against current and former directors and officers of Citigroup, alleging, in essence, that the defendants breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced from problems in the subprime lending market and for failing to properly disclose Citigroup's exposure to subprime assets. Plaintiffs allege that there were extensive "red flags" that should have given defendants notice of the problems that were brewing in the real estate and credit markets and that defendants ignored these warnings in the pursuit of short term profits and at the expense of the Company's long term viability. . . . Plaintiffs allege that since as early as 2006, defendants have caused and allowed Citigroup to engage in subprime lending[2] that ultimately left the Company exposed to massive losses by late 2007.[3] Beginning in late 2005, house prices, which many believe were artificially inflated by speculation and easily available credit, began to plateau, and then deflate. Adjustable rate mortgages issued earlier in the decade began to reset, leaving many homeowners with significantly increased monthly payments. Defaults and foreclosures increased, and assets backed by income from residential mortgages began to decrease in value. By February 2007, subprime mortgage lenders began filing for bankruptcy and subprime mortgages packaged into securities began experiencing increasing levels of delinquency. In mid-2007, rating agencies downgraded bonds backed by subprime mortgages.

Much of Citigroup's exposure to the subprime lending market arose from its involvement with collateralized debt obligations ("CDOs") — repackaged pools of lower rated securities that Citigroup created by acquiring asset-backed securities, including residential mortgage-backed securities ("RMBSs"),[4] and then selling rights to the cash flows from the securities in classes, or tranches, with different levels of risk and return. Included with at least some of the CDOs created by Citigroup was a "liquidity put"—an option that allowed the purchasers of the CDOs to sell them back to Citigroup at original value. According to plaintiffs, Citigroup's alleged $55 billion subprime exposure was in two areas of the Company's Securities & Banking Unit. The first portion totaled $11.7 billion and included securities tied to subprime loans that were being held until they could be added to debt pools for investors. The second portion included $43 billion of super-senior securities, which are portions of CDOs backed in part by RMBS collateral.[5] By late 2007,

2. "Subprime" generally refers to borrowers who do not qualify for prime interest rates, typically due to weak credit histories, low credit scores, high debt-burden ratios, or high loan-to-value ratios.

3. These facts are drawn from the complaint and taken as true for purposes of the motion to dismiss.

4. RMBSs are securities whose cash flows come from residential debt such as mortgages.

5. Rights to cash flows from CDOs are divided into tranches rated by credit risk, whereby the senior tranches are paid before the junior tranches.

it was apparent that Citigroup faced significant losses on its subprime-related assets. . . .

Plaintiffs also allege that Citigroup was exposed to the subprime mortgage market through its use of SIVs [Structured Investment Vehicles]. Banks can create SIVs by borrowing cash (by selling commercial paper) and using the proceeds to purchase loans; in other words, the SIVs sell short-term debt and buy longer-term, higher yielding assets. According to plaintiffs, Citigroup's SIVs invested in riskier assets, such as home equity loans, rather than the low-risk assets traditionally used by SIVs.

The problems in the subprime market left Citigroup's SIVs unable to pay their investors. The SIVs held subprime mortgages that had decreased in value, and the normally liquid commercial paper market became illiquid. Because the SIVs could no longer meet their cash needs by attracting new investors, they had to sell assets at allegedly "fire sale" prices. In November 2007, Citigroup disclosed that it provided $7.6 billion of emergency financing to the seven SIVs the Company operated after they were unable to repay maturing debt. Ultimately, Citigroup was forced to bail out seven of its affiliated SIVs by bringing $49 billion in assets onto its balance sheet, notwithstanding that Citigroup previously represented that it would manage the SIVs on an arm's-length basis. . . .

Plaintiffs' theory of how the director defendants will face personal liability is a bit of a twist on the traditional *Caremark* claim. 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. . . . In contrast, plaintiffs' *Caremark* claims are based on defendants' alleged failure to properly monitor Citigroup's business risk, specifically its exposure to the subprime mortgage market. In their answering brief, plaintiffs allege that the director defendants are personally liable under *Caremark* for failing to "make a good faith attempt to follow the procedures put in place or fail[ing] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market." Plaintiffs point to so-called "red flags" that should have put defendants on notice of the problems in the subprime mortgage market and further allege that the board should have been especially conscious of these red flags because a majority of the directors (1) served on the Citigroup board during its previous Enron related conduct and (2) were members of the ARM [Audit and Risk Management] Committee and considered financial experts.

Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When 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 for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them — the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a "right" or "wrong" decision.

The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[51] The burden is on plaintiffs, the party challenging the directors' decision, to rebut this presumption. Thus, absent an allegation of interestedness or disloyalty to the corporation, 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. The standard of director liability under the business judgment rule "is predicated upon concepts of gross negligence."[53]

Additionally, Citigroup has adopted a provision in its certificate of incorporation pursuant to 8 Del. C. §102(b)(7) that exculpates directors from personal liability for violations of fiduciary duty, except for, among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Because the director defendants are "exculpated from liability for certain conduct, 'then a serious threat of liability may only be found to exist if the plaintiff pleads a non-exculpated claim against the directors based on particularized facts.'" [citations omitted] Here, plaintiffs have not alleged that the directors were interested in the transaction and instead root their theory of director personal liability in bad faith. . . .

Turning now specifically to plaintiffs' *Caremark* claims, one can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to §102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. A plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director consciously disregarded an obligation to be reasonably informed about the business and its risks or consciously disregarded the duty to monitor and oversee the business.

The Delaware Supreme Court made clear in *Stone* that directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight; however, this obligation does not eviscerate the core protections of the business judgment rule — protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and

51. *Aronson* [*v. Lewis*, 473 A.2d 805 (Del. 1984)], at 812.
53. Id.

the burden to show bad faith is even higher. . . . The presumption of the business judgment rule, the protection of an exculpatory §102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk. . . .

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law. . . .

Plaintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk. Plaintiffs admit that Citigroup established the ARM Committee and in 2004 amended the ARM Committee charter to include the fact that one of the purposes of the ARM Committee was to assist the board in fulfilling its oversight responsibility relating to policy standards and guidelines for risk assessment and risk management. The ARM Committee was also charged with, among other things, (1) discussing with management and independent auditors the annual audited financial statements, (2) reviewing with management an evaluation of Citigroup's internal control structure, and (3) discussing with management Citigroup's major credit, market, liquidity, and operational risk exposures and the steps taken by management to monitor and control such exposures, including Citigroup's risk assessment and risk management policies. According to plaintiffs' own allegations, the ARM Committee met eleven times in 2006 and twelve times in 2007. . . .[63]

The warning signs alleged by plaintiffs are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions. The "red flags" in the Complaint amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally. Plaintiffs fail to plead "particularized facts suggesting that the Board was presented with 'red flags' alerting it to potential misconduct" at the Company. That the director defendants knew of signs of a deterioration in the subprime mortgage market, or even signs suggesting that conditions could decline further, is not sufficient to show that the directors were or should have been aware of any wrongdoing at the Company or were

63. Directors with special expertise are not held to a higher standard of care in the oversight context simply because of their status as an expert. Directors of a committee charged with oversight of a company's risk have additional responsibilities to monitor such risk; however, such responsibility does not change the standard of director liability under *Caremark* and its progeny, which requires a showing of bad faith. Evaluating director action under the bad faith standard is a contextual and fact specific inquiry and what a director knows and understands is, of course, relevant to such an inquiry. Even accepting, however, that a majority of the directors were members of the ARM Committee and considered audit committee financial experts, plaintiffs have not alleged facts showing that they demonstrated a conscious disregard for duty, or any other conduct or omission that would constitute bad faith. Even directors who are experts are shielded from judicial second guessing of their business decisions by the business judgment rule.

consciously disregarding a duty somehow to prevent Citigroup from suffering losses. . . .

. . . Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. 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. Citigroup was in the business of taking on and managing investments and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.[78]

Instead of alleging facts that could demonstrate bad faith on the part of the directors, by presenting the Court with the so called "red flags," plaintiffs are inviting the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule. In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the "right" decision if they had been in the directors' position. This temptation, however, is one of the reasons for the presumption against an objective review of business decisions by judges, a presumption that is no less applicable when the losses to the Company are large. . . .

IV. CONCLUSION

Citigroup has suffered staggering losses, in part, as a result of the recent problems in the United States economy, particularly those in the subprime

78. If defendants had been able to predict the extent of the problems in the subprime mortgage market, then they would not only have been able to avoid losses, but presumably would have been able to make significant gains for Citigroup by taking positions that would have produced a return when the value of subprime securities dropped. Query: If the Court were to adopt plaintiffs' theory of the case — that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup's exposure to them — then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?

mortgage market. It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame someone and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.

QUESTIONS

1. How would you articulate the board's duty to monitor after *Citigroup*? Specifically, is it the case that directors of Delaware corporations bear no responsibility for monitoring business risk? Or, is it the case that boards bear at least some responsibility for monitoring business risk, but the "red flags" in *Citigroup* were not sufficiently particularized to allow the claim to proceed?

2. As a policy matter, does it make sense to draw a distinction between establishing a control system to detect employee misconduct and establishing a control system to properly evaluate business risk? Which category would seem to be more within a board's expertise? And which category would shareholders be more concerned about?

7.6 "Knowing" Violations of Law

In *Caremark*, the court says that directors have a duty to take reasonable steps to see that the corporation has in place an information and control structure designed to offer reasonable assurance that the corporation is in compliance with the law. But does that mean every aspect of our public policy should be deployed to this end? Specifically, in addition to the incentives provided in the federal Organizational Sentencing Guidelines above, should corporate law also command obedience to positive law? When we ask this question, are we necessarily asking whether shareholders should be able to sue directors to recover any loss the corporation may suffer (as in *Caremark*) by reason of a knowing violation of the law? Are there issues present in such a question in addition to whether we want augmented enforcement?