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# Analysis

## Delaware Chancery Court Reaffirms the Business Judgment Rule's Protection Against Claims of Undue Risk Taking

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On February 24, 2009, in *In re Citigroup Inc. Shareholder Derivative Litigation*,[1] the Delaware Court of Chancery granted in substantial part a motion to dismiss shareholder derivative claims for failure to plead futility of pre-suit demand, premised upon, among other things, allegations that Citigroup's losses from exposure to the subprime lending market were incurred due to the directors' failure to monitor investment risk. Consistent with the *Caremark* [2] doctrine, the court held that the complaint failed to plead, with the particularity required by Delaware Chancery Rule 23.1, a claim for oversight liability—a claim ''rooted in concepts of bad faith,'' or scienter [3]—as it only alleged conclusorily that liability should ensue merely because Citigroup incurred substantial losses. The chancery court reasoned, ''[i]t is well established that the mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, and without more, is not a basis for personal director liability.'' [4]

Just two weeks earlier, the chancery court, in *American International Group Inc., Consolidated Derivative Litigation*,[5] denied a motion to dismiss claims for oversight liability, finding that the ''plaintiff-friendly standard of [Delaware Chancery] Rule 12(b)(6)'' had been satisfied because the complaint alleged that the defendant officers in *AIG* had permitted the company ''to engage in a diverse array of complex transactions that were, at bottom, deceptive.'' [6] In recognition of the *AIG* decision, the chancery court wrote in *Citigroup* that, ''[t]here are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk.'' [7]

These two decisions provide important guidance to financial institutions, other companies, and practitioners litigating shareholder derivative lawsuits that include claims for oversight liability, as they reaffirm that, under *Caremark*, directors and officers will not be liable for failure ''to predict the future and to properly evaluate business risk,'' provided that systems are in place and that there is no corresponding fraudulent or criminal conduct.[8]

This article first reviews the pre-*Citigroup* and *AIG* state of the *Caremark* doctrine. Next, this article examines the *Citigroup* and *AIG* decisions, and then discusses the guidance provided therein with respect to the *Caremark* doctrine.

### Overview of 'Caremark'

It has long been the view of the Delaware courts that ''absent cause for suspicion[,] there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.'' [9] That long-standing view was developed more fully by the chancery court's seminal opinion in *Caremark*.

The derivative claims in *Caremark* arose out of allegations that, due to the director's failure to establish proper oversight systems, certain individuals were able to cause the company to violate a federal law that ''prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients.'' [10] Briefly summarized, Caremark entered into agreements with certain physicians that prescribed or recommended Caremark services to Medicare recipients and other patients, which raised the specter of unlawful ''kickbacks.'' [11] Nonetheless, Caremark's directors were advised by counsel that these agreements complied with the law, and the company's predecessor developed a written guide to govern its employees in entering into these agreements, which was amended and revised with the passage of related regulations.[12] Still, regulators investigated, and indictments of the company and others followed. The company pled guilty and agreed to pay civil and criminal fines.[13] Multiple shareholder derivative lawsuits followed and, during the pendency of the defendants' motions to dismiss, the parties agreed to a settlement.

In approving the settlement, the chancery court found that the ''record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function.'' [14] The court then took the opportunity

*(continued on page 70)*

[1] 964 A.2d 106 (Del. Ch. 2009).
[2] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).
[3] 964 A.2d at 123.
[4] *Id.* at 130.
[5] 965 A.2d 763 (Del. Ch. 2009).
[6] *Id.* at 782.
[7] 964 A.2d at 131.
[8] *Id.*
[9] *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963).
[10] 698 A.2d at 961–62.
[11] *Id.* at 962.
[12] *Id.*
[13] *Id.* at 960.
[14] *Id.* at 971.

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*(continued from back page)*

to discuss in detail the parameters of the duty of oversight, beginning with the principle that liability may ''arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.'' [15] Accordingly, corporate fiduciaries should assure 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.[16]

That said, 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.'' [17] Furthermore, the sufficiency of a company's chosen reporting systems is assessed under the traditional business judgment rule, which, of course, incorporates a presumption that ''in making a business decision the directors of a corporation acted on an informed basis, . . . and in the honest belief that the action taken was in the best interests of the company [and its shareholders].'' [18]

While the *Caremark* doctrine is now firmly embedded in Delaware law, the case-by-case application results in some continuing uncertainty. For example, prior to the decisions in *Citigroup* and *AIG*, no reported decision had examined whether catastrophic losses by a company could be recouped from its corporate fiduciaries simply by blaming them for failing to oversee risk. As explained below, the decisive language in the *Citigroup* and *AIG* opinions goes a long way to settling that uncertainty.

## 'Citigroup,' Business Risk

In *Citigroup*, plaintiffs brought a shareholder derivative action against current and former directors and officers of Citigroup, alleging that the company incurred substantial losses in connection with investments in subprime securities because defendants failed to monitor ''excessive'' business risk.[19] Because plaintiffs did not make pre-suit demand on the board, the court considered whether, under the stringent pleading requirements of Chancery Rule 23.1, the complaint contained ''particularized facts that 'create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.' '' [20] Thus, the analysis came down to whether the complaint pled particularized facts sufficient to present the directors with a substantial chance of personal liability.

Inasmuch as that Citigroup's certificate of incorporation included a standard exculpatory provision that protected directors from personal liability, except for, among other things, breaches of the duties of loyalty or for acts involving bad faith or intentional misconduct, plaintiffs were required to ''plead particularized facts that demonstrate that the directors acted with scienter.'' [21] Plaintiffs alleged that several ''red flags'' existed—*e.g.*, the decline in the housing market since 2005 and the rise in foreclosure rates since 2006—that should have alerted Citigroup's corporate fiduciaries of the problems with such investments.[22] Plaintiffs also alleged that a majority of the directors should have been ''especially conscious of these red flags'' because of ''previous Enron related conduct,'' and were, as members of the Audit and Risk Management Committee, considered financial experts.[23]

Thus, plaintiffs limited their claims to oversight failure, and not to any particular transaction. To establish oversight liability in this context, ''[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.'' [24] The chancery court also recognized, however, that this obligation to ''implement and monitor a system of oversight . . . 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.'' [25]

Guided by these principles, the chancery court rejected plaintiffs' oversight liability claims because they were supported by only ''conclusory allegations'' and found that, in this context, pre-suit demand was not excused.[26] The court first acknowledged that Citigroup has procedures and controls in place designed to monitor risk, including a specific committee and charter provisions designed to assist the board in overseeing risk management.[27]

The chancery court then considered whether plaintiffs' list of so-called ''red flags'' constituted a sufficient pleading of bad faith on the part of the directors.[28] In concluding that bad faith was not pled, the chancery court reasoned that:

> plaintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them. . . . That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk.[29]

The court also found that plaintiffs failed to show how Citigroup's exposure to the financial scandals at Enron has any relevance to investments in subprime securities, and determined that ''expert'' directors are not held to a higher standard of care in the oversight context.[30] Therefore, the chancery court concluded that ''red flags'' like these are nothing more than ''evidence that the directors made bad business decisions.'' [31]

Thus, the chancery court reaffirmed that the business judgment rule protects directors from personal liability based upon investment decisions that turn out bad—or even really bad:

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[15] 698 A.2d at 967.
[16] *Id.* at 970.
[17] *Id.* at 971.
[18] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *see also Caremark*, 698 A.2d at 971.
[19] 964 A.2d at 131. Plaintiffs also alleged an unrelated claim for corporate waste, which we do not address herein.
[20] *Id.* at 120.
[21] *Id.* at 125.
[22] *Id.* at 112–14.
[23] *Id.* at 124.
[24] 964 A.2d at 123, 125.
[25] *Id.*
[26] *Id.* at 127.
[27] *Id.*
[28] *Id.*
[29] 964 A.2d at 128, 130.
[30] *Id.* at 128 n.63, 129.
[31] *Id.* at 128.

> In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got 'unlucky' in that a huge loss—the probability of which was very small—actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.[32]

## 'AIG,' Alleged Criminal Conduct

*AIG*, on the other hand, involved allegations of oversight lapses and certain affirmative acts by the defendants that, in the chancery court's judgment, were sufficient to deny dismissal at the pleading stage. In *AIG*, upon the motions to dismiss by two AIG fiduciaries, the court considered the sufficiency of allegations seeking to make AIG whole from substantial harm it suffered allegedly as a result of ''intentional misconduct by AIG's top managers.'' [33] The misconduct alleged includes, among other things, a ''fraudulent $500 million reinsurance transaction in which various AIG insiders staged an elaborate artificial transaction with defendant Gen Re Corporation''; and the use of ''secret offshore subsidiaries to mask AIG losses.'' [34]

Unlike in *Citigroup*, where the stringent pleading standard of Chancery Rule 23.1 applied, because AIG's special litigation committee took ''no position'' with respect to whether plaintiffs could go forward without making pre-suit demand, the court analyzed the complaint under the ''plaintiff-friendly lens required by Rule 12(b)(6).'' [35]

Using this lenient standard, the chancery court denied the defendants' motions to dismiss, finding that ''a plausible inference arises that [defendants] themselves inspired and oversaw a business strategy premised in substantial part on the use of improper accounting and other techniques designed to make AIG appear more prosperous than it in fact was.'' [36] The court continued:

> given that the Complaint pleads that [defendants] were able to implement several fraudulent schemes involving billions of dollars without detection by AIG's auditor, Audit Committee, or in-house lawyers, a fair inference arises that these defendants were conscious that the corporation had a deficient compliance structure. Indeed, a related inference arises that these defendants knew of improper conduct and failed to bring it to the attention of the full AIG board.[37]

In reviewing whether the complaint alleged facts that the two defendants ''knew AIG's internal controls were broken,'' the court rejected attempts to address this issue ''on a scheme-by-scheme analysis'' because the plaintiffs did not ''rest their monitoring, or *Caremark*, claim on the failure of AIG's internal controls in one discrete instance of serious wrongdoing.'' [38] Instead, using particularly punctuated language, the court found that the ''Complaint fairly supports the assertion that AIG's Inner Circle led a . . . criminal organization. The diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary.'' [39] While ''fully recogniz[ing] the difficulty of pleading a breach of the duty of loyalty based on a failure to monitor, even under a Rule 12(b)(6) standard,'' the court upheld the breach of fiduciary duty claims because the complaint alleged that the defendants had '' 'consciously failed to monitor or oversee [the company's internal controls] thus disabling themselves from being informed of risks or problems requiring their attention.' '' [40]

## Impact of 'Citigroup' and 'AIG'

The *Citigroup* and *AIG* decisions, together, may be seen as clarifying and reaffirming the *Caremark* doctrine that has provided guidance to boards of directors for a dozen years. As an initial matter, the *Caremark* doctrine, as discussed above, is quite difficult to permeate. Indeed, a claim against directors for breach of the duty of attention or care in connection with the on-going operation of the corporation's business is ''possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'' [41]

With this backdrop, the contours of the business judgment rule were made even clearer by the decisions in *Citigroup* and *AIG*. As the chancery court held in *Citigroup*, while juxtaposing its *AIG* decision, business decisions that result in losses to the company—even catastrophic losses—will not be second-guessed by the court provided that those losses are not the result of clearly actionable wrongdoing.[42] In other words, ''Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company,'' and the courts will not impose liability simply for failure to monitor ''excessive'' risk.[43]

A contrary result in *Citigroup* would have been both difficult to square with well-established jurisprudence under the business judgment rule and illogical. Indeed, as the chancery court acknowledged:

> [i]f 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.[44]

Furthermore, permitting such lawsuits to proceed would allow a judge or jury to second-guess business decisions, irrespective of whether they were made rationally and the corporate fiduciaries availed themselves of available, material information.

Thus, even where there may be purported indicators ''that one could point to and argue are evidence that the decision was wrong,'' as long as they are not coupled with any criminal wrongdoing, and reasonable and adequate risk management procedures are in place, financial institutions and practitioners should take comfort from the decisions in *Citigroup* and *AIG* that there still will be a ''presumption against an objective review of business decisions by judges.'' [45]

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[32] *Id.* at 126.
[33] 965 A.2d at 774. Other motions to dismiss were discussed, which we do not discuss herein.
[34] *Id.* at 775.
[35] *Id.* at 776, 778, 807–10.
[36] *Id.* at 777.
[37] *Id.*
[38] *Id.* at 799.
[39] 965 A.2d at 799.
[40] *Id.* (quoting *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).
[41] 698 A.2d at 967.
[42] *Citigroup*, 964 A.2d at 131.
[43] *Id.*
[44] *Id.*
[45] The court mused in *Citigroup* that the outcome might have been different had plaintiffs chosen not to ''rely on the 'group' accusation mode of pleading demand futility,'' and instead pursued ''individual allegations as to each of the director defendants.'' 964 A.2d at 121 n.36.

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