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Delaware's Duty of Oversight—Directors Prevail in the *Citigroup* Subprime Litigation

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On February 24, the Delaware Chancery Court issued a decision that strongly reaffirms the protections granted to corporate directors under Delaware law. The decision provides reassurance that, even if corporate directors make decisions that—in hindsight—turn out poorly, their judgment will not be second-guessed by the courts, provided they acted in good faith. The case also makes clear that corporate boards that implement and oversee a corporate compliance system will be fully protected under Delaware law against fiduciary duty claims alleging a breach of the board's duty of oversight.

Factual and Procedural Background of *Citigroup*

The claims in *In re Citigroup Inc. Shareholder Derivative Litigation*,[1] arose out of significant losses experienced by Citigroup on its subprime mortgage-related assets as the financial markets, including the subprime and credit markets, deteriorated in 2007 and 2008. Beginning in October 2007, Citigroup announced a series of asset write-downs totaling more than $25 billion, resulting in losses that the court characterized as "staggering."[2]

Without making a demand on the Citigroup board of directors, the plaintiffs, a group of Citigroup shareholders, commenced a derivative suit in Delaware Chancery Court against the 13 then-current members of the Citigroup board, several former directors, and a number of former and current officers and senior management of Citigroup.[3] The plaintiffs asserted claims for breach of fiduciary duty for "(1) failing to adequately oversee and manage Citigroup's exposure to the prob-

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lems in the subprime mortgage market, even in the face of alleged 'red flags' and (2) failing to ensure that the Company's financial reporting and other disclosures were thorough and accurate."[4] The plaintiffs also asserted a claim for corporate waste against certain of the defendants for (1) allowing the company to purchase $2.7 billion in subprime loans; (2) allowing the company to invest in "structured investment vehicles" (SIVs) that held subprime assets; (3) authorizing and not suspending Citigroup's share repurchase program, which allegedly resulted in the company buying its own shares at artificially inflated prices; and (4) approving a lucrative compensation package for the company's departing CEO, who was allegedly responsible for many of the company's problems.

The defendants moved to dismiss the complaint pursuant to Delaware Chancery Court Rule 23.1, contending that the plaintiffs failed to plead demand futility with the particularity required by Delaware law.[5] The plaintiffs argued that demand was excused because Citigroup's directors were unable to exercise disinterested business judgment in responding to a demand,[6] because "their failure of oversight subjects them to a substantial likelihood of personal liability."[7] As the court held, however, "demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is 'so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"[8]

The Legal Framework

The court began its analysis with a thorough explanation of the *Caremark* theory of director liability, in which "directors are alleged to be liable for a failure to monitor liability creating activities."[9] The *Caremark* court had held that alleging a breach of fiduciary duty based on a failure to monitor "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," and 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."[10] In *Citigroup*, Chancellor William B. Chandler III noted that the Delaware Supreme Court had approved the *Caremark* standard in *Stone v. Ritter*,[11] and he summarized the stringent requirements of that test as follows:

> **Thus, to establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act. The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a *necessary condition* to director oversight liability.[12]**

Chancellor Chandler went on to note, however, that the plaintiffs' theory in *Citigroup* presented "a bit of a twist on the traditional *Caremark* claim," which typically involves an allegation that the defendants are liable for failing to properly oversee employee misconduct or violations of law.[13] In *Citigroup*, by contrast, the plaintiffs claimed that the defendants failed to properly monitor Citigroup's business risk. Thus, the court seemed to question whether *Caremark* was the sole framework for analysis, because it appeared that the plaintiffs were seeking to hold the defendants liable "for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company."[14] These claims, the court observed, are considered under the traditional doctrines of the fiduciary duty of care and the business judgment rule—under which the court "focus[es] on the decision-making process rather than on a substantive evaluation of the merits of the decision."[15]

Throughout the opinion, the court repeatedly emphasized the policies underlying the business judgment rule, which, among other things, is "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."[16] Chancellor Chandler's sophisticated understanding of how businesses operate in the

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real world, and the impact that legal rules might have on businesses, is worth quoting at length:

- "The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses—and particularly financial institutions—make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected."[17]

- "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."[18]

- "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."[19]

- "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."[20]

The court held that, even though the complaint was framed under a *Caremark* theory, it was important to keep in mind these "bedrock principles of Delaware fiduciary duty law."[21]

The court also observed that Citigroup, as permitted by 8 Del. C. § 102(b)(7), had adopted a provision in its certificate of incorporation exculpating directors from personal liability for breaches 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.[22] Under Delaware Supreme Court precedent, where an exculpation provision exists, a plaintiff arguing that demand is excused because of a substantial likelihood of director liability must plead "particularized facts that demonstrate that the directors acted with scienter, *i.e.*, that they had 'actual or constructive knowledge' that their conduct was legally improper."[23] "A plaintiff can thus plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties."[24]

Chancellor Chandler noted that there is a "similarity" between the *Caremark* standard for assessing oversight liability and the standard for assessing compliance with the duty of care when the company has adopted an exculpatory provision under § 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.**[25]

Summing up, the court held that "[t]he 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

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director liability for a failure to see the extent of a company's business risk."[26]

Applying the Law to the Facts

The court held that the plaintiffs had failed to plead demand futility based on the alleged exposure of the directors to liability for failure to properly monitor Citigroup's risk from subprime-related assets.

The court characterized the plaintiffs' allegations as "essentially … a claim that Citigroup suffered large losses and that there were certain warning signs that could or should have put defendants on notice of the business risks related to Citigroup's investments in subprime assets. Plaintiffs then conclude that because defendants failed to prevent the Company's losses associated with certain business risks, they must have consciously ignored these warning signs or knowingly failed to monitor the Company's risk in accordance with their fiduciary duties."[27] As should be apparent from Chancellor Chandler's explanation of the business judgment rule and the need to allow business managers to take risks without fear of second-guessing by courts, discussed above, he found the plaintiffs' arguments to be nothing more than "conclusory allegations" and "ipse dixit syllogisms," which failed to constitute the required particularized factual allegations of the directors' bad faith.[28]

The "red flags" identified by the plaintiffs consisted, in the court's view, principally of statements in public documents that "reflect worsening conditions in the financial markets, including the subprime and credit markets, and the effects those worsening conditions had on market participants."[29] Knowledge of such "warning signs" did not amount to a conscious disregard of the directors' duties:

> **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 consciously disregarding a duty somehow to prevent Citigroup from suffering losses.[30]**

The plaintiffs conceded that Citigroup had "procedures and controls in place that were designed to monitor risk," including an "Audit and Risk Management Committee" (ARM Committee) established to assist the board in overseeing policies and guidelines for risk assessment and risk management.[31] The ARM Committee was charged with specific duties and responsibilities to communicate with management and the auditors concerning financial statement issues, to evaluate the company's internal control structure, and to discuss major credit, market, liquidity and operational risks. The ARM Committee met 11 times in 2006, and 12 times in 2007. Based on these facts, the court held that the plaintiffs had failed to show that the director defendants did not make a good faith effort to comply with the company's oversight procedures. The court also held that directors who served on the ARM Committee, or other directors with financial expertise, were not subject to a higher standard of care simply because of such status.[32] Similarly, the court held that there was no higher standard imposed on directors who were involved in Citigroup's prior "debacle" with Enron Corp., which involved entirely unrelated circumstances.[33]

Chancellor Chandler distinguished the allegations in *Citigroup* from those in a recent decision by Vice Chancellor Leo E. Strine, Jr. in *American International Group, Inc. Consolidated Derivative Litigation*.[34] In *AIG*, the court held that the complaint stated a claim for relief under Rule 12(b)(6),[35] based on allegations of "pervasive *fraudulent* and *criminal* conduct" that were known to the senior management of AIG.[36] The *Citigroup* court observed 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"; Citigroup was, after all, "in the business of taking on and managing investment and other business risks."[37] Thus, the business judgment rule was implicated in *Citigroup* in a way that it was not in *AIG*.

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In addition to finding the failure to monitor claim inadequate to plead demand futility, the court also held that the plaintiffs had not pled with particularity facts supporting their contention that the defendants made or allowed to be made false statements with knowledge or in bad faith.[38] The court also dismissed all but one of the plaintiffs' waste claims, holding that, based on the plaintiffs' well-pleaded allegations, "there is a reasonable doubt" as to whether the former CEO's compensation package was "so one-sided" or otherwise beyond the "outer limit" permitted under Delaware law.[39] Accordingly, as to that claim alone, demand was excused.

Lessons and Implications of *Citigroup*

Clearly, the *Citigroup* decision is a significant victory for corporate directors, and a reaffirmation of the deference that their judgments must be accorded. Especially in an economic environment where the board's evaluations of "business risks" are, more and more frequently, being second-guessed, it should be of some comfort that, at least in connection with fiduciary duty claims, the Delaware Chancery Court will be reluctant to allow shareholders to bring derivative suits challenging judgments made in good faith by directors. Chancellor Chandler's well-articulated explanation of the reasons for the business judgment rule and the "raincoat" protections of Section 102(b)(7) should be influential for other courts that may look to Delaware for corporate law guidance.

Nevertheless, directors should not take *too* much comfort. The primary ground for the *Citigroup* decision was the plaintiffs' inability to plead any concrete facts suggesting that the Citigroup directors acted in bad faith or consciously disregarded their duties. Repeatedly, the court stressed 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."[40] Yet, the evaluation of a board's duty of oversight often is partly reflective of the "best practices" environment within which the board operates. Particularly in light of the recent credit crisis, boards are taking on more and more responsibilities in the area of risk management and enhancing their oversight functions. Moreover, as the federal government launches new initiatives for "systemic risk" management for regulated entities—and creates a new national systemic risk regulator—it is conceivable that new standards will develop that will create moral imperatives for non-regulated entities to adopt similar standards, and raise the bar for corporate boards generally in connection with their oversight duties and responsibilities. In the current environment, therefore, it is doubly important for boards to ensure that their companies have reliable mechanisms for assessing risk.

In sum, while *Citigroup* represents a "win" for directors, and a persuasive precedent for other courts to follow, directors should continue to take proactive steps to monitor corporate compliance and pay heed to their duties of oversight under Delaware law.

NOTES

1. *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009).
2. *Citigroup*, 964 A.2d at 131.
3. A related derivative suit was filed in the United States District Court for the Southern District of New York. Before deciding the defendants' motion to dismiss for failure to make pre-suit demand, the Delaware court denied the defendants' motion to dismiss or stay the Delaware action in favor of the New York action. *Citigroup* at 116-19.
4. *Citigroup*, 964 A.2d at 114.
5. *Citigroup*, 964 A.2d at 120 ("Where, as here, a plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the board would have been futile.").
6. This is the standard for showing demand futility where the subject of the derivative suit is board inaction, rather than a specific decision of the board. *See Rales v. Blasband*, 634 A.2d 927, 934, Fed. Sec. L. Rep. (CCH) P 98821 (Del. 1993). The plaintiffs also argued that, with respect to their corporate waste claim, the board's approval of the challenged transactions did not constitute a valid exercise of business judgment. *See Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (rejected

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on other grounds by, Kamen v. Kemper Financial Services, Inc., 908 F.2d 1338, Fed. Sec. L. Rep. (CCH) P 95363, 17 Fed. R. Serv. 3d 224 (7th Cir. 1990)) and (overruled on other grounds by, Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).
7. *Citigroup*, 964 A.2d at 121.
8. *Citigroup*, 964 A.2d at 121 (quoting *Aronson*, 473 A.2d at 815).
9. *Citigroup*, 964 A.2d at 122 (citing *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996)).
10. *Caremark*, 698 A.2d at 967, 971.
11. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006).
12. *Citigroup*, 964 A.2d at 123 (footnote omitted).
13. *Citigroup*, 964 A.2d at 123.
14. *Citigroup*, 964 A.2d at 124.
15. *Citigroup*, 964 A.2d at 124.
16. *Citigroup*, 964 A.2d at 125.
17. *Citigroup*, 964 A.2d at 126.
18. *Citigroup*, 964 A.2d at 131.
19. *Citigroup*, 964 A.2d at 126.
20. *Citigroup*, 964 A.2d at 139.
21. *Citigroup*, 964 A.2d at 126.
22. *Citigroup*, 964 A.2d at 124.
23. *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008).
24. *Citigroup*, 964 A.2d at 125.
25. *Citigroup*, 964 A.2d at 125.
26. *Citigroup*, 964 A.2d at 125.
27. *Citigroup*, 964 A.2d at 126-27.
28. *Citigroup*, 964 A.2d at 127, 129.
29. *Citigroup*, 964 A.2d at 114-115.
30. *Citigroup*, 964 A.2d at 128.
31. *Citigroup*, 964 A.2d at 127.
32. *Citigroup*, 964 A.2d at 128 n.63; *see also Citigroup*, 964 A.2d at 135 ("director liability is not measured by the aspirational standard established by the internal documents detailing a company's oversight system"). This holding echoes Chancellor Chandler's earlier decision in the *Disney* litigation, where he wrote: "This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices, any more than a common-law court deciding a medical malpractice dispute can impose a standard of liability based on ideal—rather than competent or standard—medical treatment practices, lest the average medical practitioner be found inevitably derelict." *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 697 35 Employee Benefits Cas. (BNA) 1705 (Del. Ch. 2005), judgment aff'd, 906 A.2d 27, 37 Employee Benefits Cas. (BNA) 2756 (Del. 2006).
33. *Citigroup*, 964 A.2d at 129. The court left open the question of whether directors who were involved in prior *related* circumstances might be expected to be more sensitive to warning signs.
34. *In re American Intern. Group, Inc.*, 965 A.2d 763 (Del. Ch. 2009).
35. In *Citigroup*, Chancellor Chandler noted that Rule 12(b)(6) imposed a "plaintiff-friendly standard," in contrast to the "particularized pleading standard" of Rule 23.1 that was applicable in *Citigroup*. 964 A.2d at 130 n.75.
36. *Citigroup*, 964 A.2d at 130.
37. *Citigroup*, 964 A.2d at 131.
38. *Citigroup*, 964 A.2d at 135.
39. *Citigroup*, 964 A.2d at 138.
40. *Citigroup*, 964 A.2d at 130.

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