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Monitoring the **Duty to Monitor**

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THE SIGNIFICANT LOSSES suffered by investors during the recent financial crisis have again left many shareholders clamoring to find someone responsible. Where were the directors who were supposed to be watching over the company? What did they know? What should they have known?

Obviously, directors should not be liable for losses resulting from changes in general economic conditions, but what about the boards of mortgage companies and financial institutions that had a business model tied to market risk. Most individuals that invest in the U.S. capital markets would likely be surprised to hear that the board's duty to monitor may not include monitoring such risk. In fact, just last month the Delaware Court of Chancery would go no further than to say "this Court has not definitively stated whether a Board's *Caremark* [oversight] duties include a duty to monitor business risk."[1]

This article explores whether the directors' fiduciary duty of oversight is robust enough to provide investors with any level of assurance worth relying on, whether market trends or industry "red flags" ever create an obligation on the part of directors to take action or whether the only remedy available to investors in these situations is to replace the board.

If the mortgage crisis is behind us, plenty of potential red flags remain out there for directors to trip over. For example, it has been widely reported that the SEC and the U.S. Department of Justice are investigating fraud and misleading financial statements in Chinese companies listed on U.S. exchanges, with particular emphasis on companies that have gone public through reverse mergers.[2] One estimate is that more than one-third of these companies may have misleading financial statements. As a result, the stock prices of Chinese listed companies have collapsed. Do directors have a duty to monitor and react to trends that raise obvious concerns that are industry "red flags," but not specific to the individual company? And if so, what is the appropriate penalty for the board's failure to act? "Sine poena nulla lex." ("No law without punishment.").[3]

Fiduciary Duties Generally

The duty to monitor arose out of the general fiduciary duties of directors. Under Delaware law, directors have fiduciary duties to the corporation and its stockholders that include the duty of care and the duty of loyalty.[4] The duty of care requires directors to act with the care that a person in a similar position would reasonably believe appropriate when making decisions or acting on behalf of the corporation under similar circumstances. This duty requires directors to inform themselves "of all material information reasonably available to them"[5] before they make a business decision.

The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its stockholders, rather than for their own interest. Earlier jurisprudence discussed a separate "duty of good faith" requiring directors to act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. The Delaware Supreme Court, in *In re The Walt Disney Company Derivative Litigation*,[6] described the requisite conduct for establishing a breach of the duty of good faith as "qualitatively more culpable than gross negligence,"[7] but did not decide whether such duty was a duty independent of the duties of care and loyalty. Five months later, in *Stone v. Ritter*, the same court rejected the notion of a separate duty and found the duty of good faith to be a subsidiary element of the duty of loyalty.[8]

Typically, absent a transaction involving financial self-interest, courts are reluctant to probe the subjective state of mind of directors, i.e., their "good faith," and have been reluctant to find that a director has breached the duty of loyalty. Finding bad faith is a rarely met threshold that requires proof of "fiduciary conduct motivated by an actual intent to do harm" or an "intentional dereliction of duty, [and] a conscious disregard for one's responsibilities."[9] Examples of conduct amounting to bad faith include "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[10]

Absent a conflict of interest, claims of breaches of duty of care by a board are subject to the judicial review standard known as the "*business judgment rule*."[11] The business judgment rule provides "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."[12] The focus of the judicial inquiry is on the process rather than the substance of the board's decision-making. The protection provided by the business judgment rule was designed to allow directors to pursue transactions, including risky transactions, without the specter of being second-guessed by others who have the benefit of hindsight bias or being held personally liable if those decisions turn out poorly.

Furthermore, most Delaware corporations have adopted a provision in their certificates of incorporation pursuant to §102(b)(7) of the Delaware General Corporation Law (DGCL)[13] that allows for exculpation of directors from personal liability for violations of fiduciary duty, except for, among other things, breaches of the duty of loyalty, actions or omissions not in good faith[14] or actions involving internal misconduct or knowing violations of law. The combination of the deferential business judgment rule and §102(b)(7) provisions makes it extremely difficult to hold directors liable for a breach of fiduciary duty absent a showing of self-dealing.

Without the protection generally provided by the business judgment rule and §102(b)(7), it would be difficult to find quality directors to serve on public boards and, if found, such directors would need to be paid substantially higher

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amounts to compensate them for their increased risk.[15] However, the broad exculpation provided by §102(b)(7) also calls into question whether fiduciary duties provide meaningful oversight protection for investors, given directors' lack of personal liability.

Duty of Oversight

In its 1996 decision,[16] *In re Caremark International Inc. Derivative Litigation*,[17] the Delaware Court of Chancery held that losses allegedly resulting not from board decisions (which are subject to the business judgment rule), but instead from *unconsidered inaction*, could trigger director liability for a failure to monitor.

The underlying wrong in *Caremark* was the company's payment of illegal kickbacks. The case emphasized that timely information about potential issues or "red flags" was essential in order for the board to perform its supervisory and monitoring role.[18] The court held that the duty of care required corporate directors to "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."[19] Such a system would presumably allow the board to react so as to protect the interests of the corporation and shareholders. However, the court limited the duty by holding that "only a sustained or systematic failure of the Board to exercise oversight—such as an *utter failure* to attempt to ensure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[20]

This limited duty to monitor was confirmed by the Delaware Supreme Court 10 years later in *Stone v. Ritter*.[21] The action against the directors was based on their failure to adequately monitor the corporation's compliance with federal banking laws and regulations. The complaint was dismissed since the court found that the plaintiffs failed to allege facts that demonstrated that the directors were aware that the corporation's controls were inadequate but chose to do nothing about these deficiencies. The court set out the necessary conditions for director oversight liability as follows:

(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.[22]

Imposing liability under *Stone* requires a showing that the directors knew they were not discharging their fiduciary obligations. Once a monitoring system is in place, *Stone* indicates that a director's oversight liability can be established by evidence that the directors deliberately ignored "red flags" as to potential issues. Unlike *Caremark*, *Stone* construed the duty to monitor as part of the duty of loyalty rather than the duty of care, thus removing monitoring failures from §102(b)(7) exculpation. However, by effectively adding an element of scienter as a requirement to establish a breach of the duty of loyalty, *Stone* made it virtually impossible for plaintiffs to show that directors breached their duty.

Following *Stone*, Delaware courts continued to tighten the standard upon which directors could be held liable for oversight claims. Red flags recognized by Delaware courts to potentially impose director liability have been found *only* in cases involving illegal company activity, extreme instances of employee fraud, or other violations of law. Red flags related to business risks or market trends, no matter how damaging they may be to the company, have never been found by a published Delaware court opinion to implicate a director's duty of oversight. Some of the recent cases addressing oversight claims, many of which arose out of the mortgage crisis, are discussed briefly below.

> The **business judgment rule** provides "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**."

In a 2009 Delaware Court of Chancery case styled as a *Caremark* claim, *In re Citigroup Shareholder Derivative Litigation*,[23] the plaintiffs claimed that the public reports and statements reflecting worsening conditions in the financial markets, in particular with respect to subprime mortgages, should have served as "red flags" to the Citigroup directors who breached their duty to properly monitor the business risks involved. The court rejected the plaintiffs' claims and pointed out that the alleged "red flags" were "little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally"; they were "not evidence that directors consciously disregarded their duties"[24] as required by *Stone*.

The court distinguished its holding from that of *Caremark* and *Stone* by highlighting how those two cases involved the alleged failure to monitor internal employee *misconduct* or *violations of law*, rather than business risk. Here, however, the most that the plaintiffs had demonstrated was that directors made bad business decisions; but such decisions were protected by the business judgment rule. The restrictiveness of the court's language implies that the Delaware judiciary is likely to limit the finding of oversight liability to the most extreme instances of bad faith. One can question whether the same outcome would have been reached if the duty of care (instead of just loyalty) had been part of the analysis.

AIG and Countrywide

Despite cases where the plaintiffs' pleading was held sufficient to implicate the board's duty of oversight, the sphere of facts that establish liability has been limited to the point that a board need have little or no concern, or at least no financial concern, about its duty to monitor the company's performance, except in a case that involved actual or constructive fraud or other illegal activity.

Meanwhile, reputational risk alone has proven to be no real deterrent. In *American International Group v. Greenberg, et al.*,[25] the Delaware Court of Chancery found that two of the director defendants *knowingly* tolerated inadequate controls and *knowingly* failed to monitor their subordinates' compliance with the law. In this case, the directors had direct control over the corporate operations involved in the commission of illegal acts. The defendants involved were not only directors, but also senior officers of the corporation, and the corporate divisions involved were under their supervision. The facts in this case prompted the court to describe the defendants as having led a "criminal organization." This court's holding, however, offers little hope for future plaintiffs, since the alleged wrongdoing was so widespread and egregious and involved violations of law, effectively implying scienter on the part of the implicated directors.

In *In re Countrywide Financial Corporation Derivative Litigation*,[26] the U.S. District Court for the Central District of California, in considering a motion to dismiss, found that allegations of Countrywide's rampant disregard of underwriting standards and the directors' failure to take any action in the face of company-specific red flags could potentially establish the requisite inference of scienter or at least deliberate recklessness. The court determined that directors who served on key board committees charged with overseeing Countrywide's risk exposures, investment portfolios, and loan loss reserves, "were in a position to recognize the significance of these red flags, and, accordingly, investigate the extent to which underwriting standards had been abandoned."[27] As the court in *Staehr v. Mack* later explained,[28] the red flags identified in *Countrywide* were "of such prominence that individual defendants must necessarily have examined and considered them in the course of their committee oversight duties." Because loan origination was at the core of Countrywide's business, and because the company's culture encouraged unchecked deviation from underwriting standards, this case turned in a direction contrary to that of *Citigroup*.

Although the plaintiffs' claims in *Countrywide* were dismissed due to loss of standing, the analysis of the district court suggests that future plaintiffs may find some success in oversight claims involving a failure to supervise normal business activity without alleging a failure of oversight relating to employees committing illegal acts. Notably, the standard of scienter applied by the district court included deliberate recklessness. Such a standard is recognized under federal securities litigation under §10(b), but it is broader than the generally recognized standard under Delaware law in oversight claims.

Delaware court decisions to date suggest that directors' requirement to take action is triggered only in instances where the company's internal operations raise red flags, and generally only in instances where the failure to investigate involves red flags that concern fraudulent or criminal conduct rather than business risk. Delaware courts have declined to find that general external forces, such as those in the global marketplace, constitute the kind of red flags that establish proof of an intentional failure to act in the face of a known duty to act. Given the precedent in Delaware, practitioners have questioned whether the Chancery Court would have come to a different conclusion, even in the context of a motion to dismiss, in considering the *Countrywide* facts.[29]

The SEC's Investigation

Has the SEC's announced investigation of numerous Chinese companies created a red flag? Does the duty of oversight require action by independent directors of other Chinese companies who are not currently under investigation by the SEC?

This question is dependent on three others:

(1) Is the Delaware standard universally accepted or are other states going to be more aggressive in protecting shareholders rather than directors?

(2) Has the duty of oversight law in Delaware settled in the right place, or does *Countrywide* indicate that the pendulum has started to swing toward "more shareholder protection"?

(3) Given the types of alleged activity being investigated by the SEC, are the boards of Chinese companies, and more particularly the independent audit committees, more squarely in the area where courts will reach to find scienter given the audit committees specific charge to monitor the financial reporting of these companies?

The SEC's current investigation of these companies involves misrepresentations in financial statements that could involve fraudulent or criminal misconduct. Such areas have been found to be within even the most restrictive view of oversight liability. As the *Citigroup* court noted, the failure to monitor fraudulent or criminal misconduct within the company is different from the failure to monitor business risk.

Although *Caremark* and its progeny, particularly *Citigroup*, indicate that external market-based risks do not give rise to red flags sufficient to impose oversight liability, the external events in such cases related solely to business risk. In contrast, the red flags raised by the investigation of Chinese companies involve potential fraud and illegal deviation from accounting standards. Following the direction of the *Countrywide* court in broadening the scope of the duty to monitor, it remains possible that given the right set of facts, a court may find that evidence of systemic fraud and illegal activity in various Chinese companies has created a market-based red flag for directors of other similarly situated companies. Given the widespread nature of the trend, a duty to act may be created, and ignoring such a duty may be found to constitute a failure to monitor.

Accordingly, prudence mandates that directors of similarly situated companies consider that these trends could be "red flags" that should require directors to take appropriate action. Such actions could include reviewing the effectiveness of information and reporting systems and, if necessary, increasing monitoring to provide more robust early warning systems, as well as considering whether conducting a targeted internal investigation into particular areas may be warranted to ensure that the shareholders' interests are protected.

Although the duty to monitor may provide far less protection than investors may have expected, the potential remains for this duty to expand (both in the areas of business risk and in the area of market-based illegal activity trends), especially if a court is presented a set of facts such as the widespread illegal activities like those currently being investigated by the SEC.

1. *In re The Goldman Sachs Group. Inc. Shareholder Litigation*, C.A. No. 5215-VCG at 60 (Del. Ch. Oct. 12, 2011).

2. Speech of Commissioner Aguilar, April 4, 2011.

3. Since ancient Roman times it has been recognized that a law without a meaningful penalty would just be ignored.

4. See *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 795 (Del. Ch. 2005).

5. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

6. 906 A.2d 27 (Del. 2006).

7. Id. at 66.

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

9. *Disney*, 906 A.2d 27 at 66.

10. Id. at 67.

11. See *Disney*, 907 A.2d at 747.

12. *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 125 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

13. Section 102(b)(7) was enacted in response to the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*, which found directors personally liable for a breach of the duty of care based on their gross negligence.

14. The inclusion in §102(b)(7) of "actions or omissions not in good faith" as a separate item from the "duty of loyalty" does raise a question as to *Stone*'s finding that the duty of good faith is a subsidiary element of the duty of loyalty.

15. See generally Martin Petrin, "Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective," 5 Va. L. & Bus. Rev. 433 (2011). The fear of chilling service of quality directors begs the question of whether due to the tremendous losses suffered, shareholders might be better off increasing director compensation and not adopting §102(b)(7) exculpation provisions in charters.

16. The *Caremark* decision, in part, was interpreting the 1963 Delaware Supreme Court case *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. Supr. 1963).

17. 698 A.2d 959 (Del. Ch. 1996).

18. See Id. at 970.

19. Id. at 970.

20. Id. at 971.

21. 911 A.2d 362 (Del. 2006).

22. Id. at 370.

23. *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (2009).

24. Id. at 128.

25. 965 A.2d 763 (Del. Ch. 2009).

26. 554 F. Supp. 2d 1044 (C.D. Cal. 2008).

27. Id. at 1060.

28. 2011 WL 1330856 (S.D.N.Y.) at 8.

29. See Eric J. Pan, "The Duty to Monitor Under Delaware Law: From *Caremark* to *Citigroup*," The Conference Board (February 2010).