

12-31-2014

The Duty to Manage Risk

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Recommended Citation

A. Christine Hurt, ??? ???? ?? ?????? ????, 39 J. CORP. L. 253 (2014).

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The Duty to Manage Risk

Christine Hurt*

I. INTRODUCTION	253
II. BAD CORPORATE BEHAVIOR AS SECURITIES FRAUD	260
<i>A. Federal Enforcement: Nondisclosure of Excessive Risk as Securities Fraud ..</i>	261
<i>B. Shareholder Securities Litigation: Nondisclosure of Excessive Risk as Securities Fraud</i>	264
III. EXCESSIVE RISK AS A BREACH OF FIDUCIARY DUTY	269
<i>A. The Duty of Care</i>	270
1. <i>Background</i>	270
2. <i>Successful (Delaware) Duty of Care Cases</i>	273
3. <i>Section 102(b)(7)</i>	274
<i>B. Excessive Risk and the Duty of Care</i>	275
<i>C. Excessive Risk, Compensation, and Waste</i>	276
IV. THE DUTY OF LOYALTY	279
<i>A. The Duty of Oversight</i>	279
<i>B. Excessive Risk as a Breach of the Duty of Oversight</i>	280
<i>C. Excessive Risk Claims in the Southern District of New York</i>	284
<i>D. The Theoretical Possibility of a Duty to Monitor Risk</i>	285
1. <i>Oversight + Securities Fraud</i>	287
2. <i>Red Flags + Failure to Act</i>	287
V. A NEW DUTY?	288
<i>A. Duty to Manage Risk Is Inconsistent with Fiduciary Duty Law</i>	289
<i>B. Duty to Manage Risk Would Be Inherently Unmanageable</i>	289
<i>C. Duty to Manage Risk as a Disclosure Duty</i>	291
VI. CONCLUSION	292

I. INTRODUCTION

To the bewilderment of many, the 2008 financial crisis resulted in few criminal prosecutions of the corporate executives whose actions, individually or collectively, caused so much harm to so many investors, employees, taxpayers, and homeowners.¹

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1. See, e.g., BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS 362 (2010) (“People also felt that a great crime had been committed, yet there was not

Following the 2001 accounting scandals, the “perp walk” became a frequent occurrence, with high-profile prosecutions ending in high-stakes sentences for high-flying corporate executives such as Bernard Ebbers,² Martin Grass,³ Richard Scrushy,⁴ Ken Lay,⁵ and Jeff Skilling.⁶ These cathartic rituals were all but absent from the 2008 financial crisis,⁷ a fact bemoaned by many U.S. citizens⁸ who suffered more widely and acutely from the

going to be a great punishment.”); Gretchen Morgenson & Louise Story, *In Financial Crisis, No Prosecutions of Top Figures*, N.Y. TIMES, Apr. 14, 2011, at A1 (“[W]hy, in the aftermath of a financial mess that generated hundreds of billions in losses, have no high-profile participants in the disaster been prosecuted?”).

2. United States v. Ebbers, 458 F.3d 110, 129 (2d Cir. 2006) (sentencing WorldCom’s CEO Bernard Ebbers to 25 years in prison plus three years of supervised release for securities fraud).

3. Rite-Aid’s former CEO Martin Grass pleaded guilty to Counts 1 and 33 of the indictment for accounting fraud, conspiracy to commit accounting fraud, and conspiracy to obstruct justice in exchange for a sentence of eight years. Though the trial judge originally rejected the deal as too lenient, the government argued that the plea on the eve of trial should be considered “timely” cooperation. See generally Government’s Sentencing Memorandum, United States v. Grass, No. 1:CR-02-146-01, 2004 WL 905611 (M.D. Pa. Apr. 7, 2004) (outlining the rationale behind Grass’ sentencing).

4. Richard Scrushy was originally indicted on multiple charges of conspiracy, accounting fraud, securities fraud, and money laundering for acts that occurred while serving as the CEO and Chairman of the Board of HealthSouth Corp., but was acquitted of all counts in June 2005. See Dan Morse et al., *HealthSouth’s Scrushy Is Acquitted: Outcome Shows Challenges for Sarbanes–Oxley Act; SEC Suit Still Ahead*, WALL ST. J., June 29, 2005, at A1 (detailing the jurors’ rationale for acquitting Scrushy). However, federal prosecutors indicted Scrushy later that year on charges of bribery, conspiracy, and mail fraud in connection with Scrushy’s selection for the Alabama hospital regulatory board. Scrushy was convicted on all counts in June 2006 and served almost all of his six year, ten month sentence before being released in 2012.

5. Ken Lay, the former CEO of Enron Corp., was convicted in May 2006 of five counts of securities fraud, wire fraud, and conspiracy to commit securities and wire fraud. See United States v. Causey, No. H-04-25, 2006 WL 1444908, at *1–2 (S.D. Tex. May 25, 2006) (detailing the jury verdict for Lay). In July 2006, before a sentencing hearing in that case, Lay suffered a heart attack and died, resulting in an appealed verdict that was not heard and therefore vacated and dismissed. United States v. Lay, 456 F. Supp. 2d 869, 870 (S.D. Tex. 2006).

6. Jeffrey Skilling, President of Enron Corp., was convicted in May 2006 of 28 counts of securities fraud, wire fraud, conspiracy to commit securities and wire fraud, false statements, and insider trading. United States v. Skilling, No. H-04-25, 2006 WL 1444909, at *1–6 (S.D. Tex. May 25, 2006). Skilling was later sentenced to 24 years and four months in prison and ordered to provide \$45 million in restitution to victims. However, while Skilling began his prison sentence in 2006, his appeals continued. See United States v. Skilling, 504 F.3d 529 (5th Cir. 2009), *aff’g in part and vacating in part sentence and remanding to U.S. Dist. Lexis 76981* (S.D. Tex. 2006), *aff’d in part and vacated in part sub nom. Skilling v. United States*, 130 S. Ct. 2896 (2010), *decision reached on appeal*, 638 F.3d 480 (5th Cir. 2011), *cert. denied*, 132 S. Ct. 1905 (2012) (affirming verdict but remanding for resentencing). In May 2013, Skilling and the prosecution entered into a resentencing agreement whereby Skilling waived all further appeals of either his conviction or sentence in return for a recommendation of a reduction in sentence. United States v. Skilling, No. 4:04CR00025, 2013 WL 1897838, at *1–4 (S.D. Tex. May 8, 2013). In June 2013, Skilling was resentenced to 14 years in prison. Peter Latman, *Ex-Enron Chief’s Sentence Is Cut by 10 Years, to 14*, N.Y. TIMES, June 22, 2013, at B2.

7. The Justice Department chose not to prosecute Angelo Mozilo, former chief executive of Countrywide Financial, even though the Securities and Exchange Commission (SEC) had filed a civil enforcement action against him and his firm for securities fraud relating to the financial crisis. E. Scott Reckard, *Criminal Probe Dropped Against Countrywide CEO Angelo Mozilo*, WASH. POST (Feb. 19, 2011), http://www.washingtonpost.com/business/criminal-probe-against-countrywide-ceo-ends/2011/02/18/ABrbObJ_story.html.

8. See ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM AND THEMSELVES* (2009) (recounting the political pressure against “bailouts” and “moral hazard” that fashioned the government response to the failures of Lehman Brothers and American International Group (AIG)).

actions of Countrywide Financial, Lehman Brothers, AIG, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of America, and Citigroup than from the actions of Enron or WorldCom.⁹

At the beginning of the decade, leaders who presided over the largest firm failures, such as Enron and WorldCom, went down with their ships both in terms of their careers and their freedoms, but following the corporate failures at the end of the decade, the leaders of AIG,¹⁰ Lehman Brothers,¹¹ Bear Stearns,¹² Wachovia,¹³ and others would not

9. For example, the WorldCom accounting scandal involved inflating financial statements by \$3.8 billion. In 2008, Citigroup lost \$27.68 billion, and its market capitalization decreased by \$250 billion between March 2007 and March 2009. Moreover, the Financial Crisis Inquiry Commission (FCIC) concluded that the 2008 crisis caused \$11 trillion in household wealth to vanish. See FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xxi–xv (2011) [hereinafter FCIC REPORT] (stating the results of the FCIC's findings on the current financial and economic crisis in the United States).

10. The failures of AIG became symbolic of the financial crisis, most notably for receiving an \$85 billion credit facility with the United States Federal Reserve Bank in September 2008 in return for an equity position, popularly known as the AIG Bailout. Prior to 2005, Maurice "Hank" Greenberg was the CEO of AIG, and Martin Sullivan held the post from 2005 until June 2008. Though both leaders must bear some blame for the downfall of AIG, neither was charged with any violation of law and both are currently chief executive officers of other companies. Greenberg, whose CEO reign was ended by a pre-crisis investigation by New York Attorney General Eliot Spitzer, a \$725 million settlement of a securities fraud lawsuit, and a \$90 million settlement of a shareholder derivative suit, is currently the CEO of C.V. Starr & Co. Inc., a company founded by one of the founders of AIG. See Mary Williams Walsh, *Ex-A.I.G. Chief Is Back, Luring Talent from Rescued Firm*, N.Y. TIMES, Oct. 26, 2009, at A1 (quoting industry players as saying that Greenberg was starting "AIG 2"); see also *In re Am. Int'l Grp., Inc. Consol. Deriv. Litig.*, 965 A.2d 763, 799 (Del. Ch. 2009) (denying the motion to dismiss against Greenberg and other officers, stating, "The Complaint fairly supports the assertion that AIG's Inner Circle was a—and I use this term with knowledge of its strength—criminal organization"). Sullivan served as chief executive officer of Willis Global Solutions until 2013, when he left to join Antares Managing Agency as non-executive chairman. See *Ex-AIG CEO Sullivan Joins Antares*, CARRIER MGMT. (July 12, 2013), available at <http://www.carriermanagement.com/news/2013/07/12/109532.htm>.

11. Richard Fuld was the CEO of Lehman Brothers from 1994 until it filed for bankruptcy protection in September 2008. Of all the executives involved in the financial crisis, Fuld has fared the worst as far as his professional reputation. In October 2008, he was served a subpoena to appear in front of a federal grand jury. See Ben White, *Investigators Said To Take Closer Look at Lehman*, N.Y. TIMES, Oct. 17, 2008, at B1 (reporting that prosecutors might be comparing statements to analysts, private investors, and the public leading up to disclosure of huge losses in 2008). However, no criminal charges were filed against him. Though both DOJ and SEC investigations have not led to any charges against him to date, Fuld's career has not rebounded. See Rolfe Winkler, *Fuld Disclosure*, WALL ST. J. OVERHEARD (Mar. 25, 2013, 3:58 PM), <http://blogs.wsj.com/overheard/2013/03/25/fuld-disclosure/> (reporting that Fuld was listed as a consultant in an SEC filing for GlyEco, Inc., but his connection with the firm was listed as a potential negative risk factor). Recently, the SEC ended its investigation into Lehman Brothers without any indictments. See Ben Prottess & Susanne Craig, *Inside the End of the U.S. Bid to Get Lehman*, N.Y. TIMES, Sept. 9, 2013, at A1 ("[T]he continued absence of parallel criminal cases against top executives reflects the challenge of white-collar investigations in which prosecutors struggle to pinpoint where risky dealings cross the line into illegality.")

12. Bear Stearns was the first financial firm to fail in 2008 and was sold to J.P. Morgan Chase in March of that year at a price per share propped up by an emergency loan from the U.S. government. See Amanda Alix, *Jimmy Cayne: Architect or Victim of the Bear Stearns Debacle?*, MOTLEY FOOL (Mar. 15, 2013), <http://www.fool.com/investing/general/2013/03/15/jimmy-cayne-architect-or-victim-of-the-bear-stearn.aspx> (noting that other executives of Bear Stearns remain in the financial sector in high-profile positions). James Cayne was the CEO for the 15 years leading up to the fall of Bear Stearns, and has not reappeared in the financial sector. *Id.*

13. Wachovia, a North Carolina-based bank holding company, did not file for bankruptcy but was sold to

face prosecutions, only public outcry and some reputational effects.¹⁴ The leaders of those financial firms that survived after receiving TARP funds, though their shareholders suffered tremendous losses, have retained their positions and their wealth.¹⁵ Though the 2001 scandals involved intentional behavior that violated state and federal laws, particularly the federal securities laws, prosecutors have made few colorable allegations of intentional violations of existing statutory law against various actors involved in the 2008¹⁶ financial crisis.¹⁷ The behavior at the heart of the financial crisis involved no obviously intentional violations of criminal laws or other regulations, but did involve risky trading practices surrounding mortgage-related derivatives.¹⁸

Wells Fargo in a controversial acquisition brokered by the U.S. Government, which shut out potential acquirer Citigroup in October 2008. CEO G. Kennedy Thompson had been forced to resign in June 2008, but continues to participate in the finance industry in the private equity world and by serving on various corporate boards.

14. See Morgenson & Story, *supra* note 1 (stating that no collective government has emerged since the crisis to criminally prosecute top figures in the financial crisis).

15. Lloyd Blankfein, for example, has been the CEO of Goldman Sachs since May 2006. Goldman received \$10 billion of TARP money and benefitted from governmental efforts to prop up AIG, a counterparty, though it repaid the \$10 billion with a positive return on the investment. Jonathan G. Katz, *Who Benefited From the Bailout?*, 95 MINN. L. REV. 1568, 1579 (2011). Blankfein remains at the helm of Goldman, and received \$21 million in salary and bonuses in 2012. Ben Protes, *Blankfein Is Awarded \$13.3 Million in Stock*, N.Y. TIMES, Jan. 19, 2013, at B3. Even Vikram S. Pandit, the CEO of Citigroup, which suffered larger losses for a longer period of time and accepted \$45 million in TARP funds, remained in that role until October 2012. See Gretchen Morgenson, *Citi's Torch Has Passed. Now Find a Knife*, N.Y. TIMES, Oct. 20, 2012, www.nytimes.com/2012/10/21/business/citigroups-torch-has-passed-now-find-a-knife.html?_r0 (stating that Citigroup must be broken up so it is not a burden to tax payers, or it must be allowed to suffer the consequences of its actions). Jamie Dimon, CEO of J.P. Morgan Chase since December 2005, received 70% of the shareholder vote in 2013 against a shareholder resolution that would have split the roles of CEO and Chairman of the Board, thereby providing Dimon with a mandate for his dual role. See Jessica Silver-Greenberg, *After a Vote, Dimon Moves to Mend Bank's Fences*, N.Y. TIMES DEALBOOK (May 23, 2013, 8:21 PM), http://dealbook.nytimes.com/2013/05/22/dimon-after-winning-support-moves-to-mend-banks-fences/?_r=0 (stating Dimon had won a shareholder vote to remain as CEO and Chairman and was working to improve the bank's culture).

16. The cases involving backdating of stock options for executives preceded the 2008 financial crisis and are not discussed here; though, arguably, the prosecutions were not as pervasive as the practice of backdating. See Peter Latman, *Backdating Scandal Ends with a Whimper*, N.Y. TIMES DEALBOOK (Nov. 11, 2013, 9:38 PM), <http://dealbook.nytimes.com/2010/11/11/backdating-scandal-ends-with-a-whimper/> (stating that the courts did not see stock option backdating as a major financial problem).

17. Another theory as to the dearth of prosecutions since 2008 is that bringing a criminal case against an energy or telecom company that is bankrupt has fewer collateral consequences than bringing the same case against a systemically significant financial institution interconnected in the U.S. economy. See Mark Gongloff, *Eric Holder Admits Some Banks Are Just Too Big To Prosecute*, HUFFINGTON POST (Mar. 6, 2013, 3:29 PM), http://www.huffingtonpost.com/2013/03/06/eric-holder-banks-too-big_n_2821741.html (internal quotations omitted) (quoting Attorney General Holder as saying in testimony to the Senate Judiciary Committee that "I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy."); Mark Gongloff, *Eric Holder: Actually I Meant to Say No Banks Are Too Big to Jail*, HUFFINGTON POST (May 14, 2013, 3:19 PM), http://www.huffingtonpost.com/2013/05/15/eric-holder-too-big-to-jail_n_3280694.html (noting that although Attorney General Holder claimed others had misconstrued his prior statement, no bank had been criminally charged regarding the financial crisis).

18. For example, here is a description of the root cause of Lehman Brothers' demise from the report of the court-appointed examiner in its bankruptcy case:

In 2006, Lehman made the deliberate decision to embark upon an aggressive growth strategy, to

Criminal law, however, rarely applies to actions that result from poor judgment, leaving risky, or negligent, acts that cause harm to the civil torts system.¹⁹ Arguably, the overwhelming majority of actions that combined to impair the U.S. economy were not criminal. In most cases, the independent and unrelated actors who caused the financial crisis did not intend to cause harm; they made poor decisions or took “excessive” risks.²⁰ What has understandably angered the investing community, workers, and homeowners in the wake of the financial crisis has been the otherwise-legal risk taking climates at financial firms that encouraged traders and other employees to use firm assets to take risky investment positions—originating, holding, or purchasing residential mortgage-backed securities (RMBS); selling credit default swaps (CDS) related to RMBS; purchasing or selling collateralized debt obligations (CDOs) related to RMBS; or some combination thereof. Continuing to invest, even heavily, in these types of securities in the face of negative financial forecasts was not illegal,²¹ nor was being highly leveraged. Unfortunately, state and federal laws are not good at criminalizing foolishness, even foolishness involving other people’s money.

Historically, civil liability for extremely poor judgment, whether negligent or grossly negligent, has filled gaps that criminal law leaves behind. Actions without evil intent should arguably not be punished by the criminal law, but many of these same actions should give rise to civil liability to compensate the injured and deter future bad conduct. Without any type of criminal retribution for wrongdoers, shareholders of the foolhardy financial firms could theoretically bring civil lawsuits against the officers and directors of their firms for poor decision making. These corporate actors made bad decisions that not only affected the economy as a whole, but also lost substantial sums of money belonging to the corporation and thus its shareholders, to whom those actors owe fiduciary duties. Therefore, one could argue that, in the months leading up to the financial crisis, many boards of directors breached their duties to those shareholders to manage

take on significantly greater risk, and to substantially increase leverage on its capital. In 2007, as the sub-prime residential mortgage business progressed from problem to crisis, Lehman was slow to recognize the developing storm and its spillover effect upon commercial real estate and other business lines. Rather than pull back, Lehman made the conscious decision to “double down,” hoping to profit from a counter-cyclical strategy. As it did so, Lehman significantly and repeatedly exceeded its own internal risk limits and controls.

Report of Anton R. Valukas, Examiner, at 4, *In re Lehman Bros. Holdings Inc.*, 469 B.R. 415 (No. 08-13555(JMP)) (Bankr. S.D.N.Y. 2012), available at <http://online.wsj.com/public/resources/documents/LehmanVol1.pdf> [hereinafter *Lehman Report*].

19. The distinction between intentional acts and negligent acts is blurry, however, and U.S. law often criminalizes reckless acts or acts that have a high disregard for the potential harm to others. See John C. Coffee, Jr., *Does “Unlawful” Mean “Criminal”?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 193 (1991) (“[T]he dominant development in substantive federal criminal law over the last decade has been the disappearance of any clearly definable line between civil and criminal law.”); see also Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 363, 369 (2008) (arguing that though corporate law had recently seen an “overcriminalization” trend in expanding the definition and prosecution of corporate acts as wrongful, a concurrent trend made the civil enforcement of these wrongful acts by shareholders very difficult).

20. This Article does not explore criminal actions that may have occurred during the crisis, such as mortgage fraud, foreclosure fraud, or “robo-signing.”

21. For a discussion of the law regulating financial derivatives, see generally Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011).

their firms responsibly. This argument stems from, and is bolstered by, the astounding losses of many firms, particularly financial firms. Specifically the numerous actions of firm employees taking on “excessive” risk at the outset proved devastatingly unwise, even stupid.²² The concept of a new duty to manage risk provides a glimmer of hope that those at fault—corporate boards and officers—may be forced to compensate the firms for the “house money” that they lost at the Wall Street casino. Going forward, the argument continues, the existence of such a duty may have a deterrent effect on future boards, which may demand stricter internal systems for monitoring firm risk.

However, the existing corporate law scheme for challenging poor judgment does not leave much room for a cause of action based on mismanaging risk, even financial risk within financial firms. This corporate law reality is not a quirk of history, but the product of design; corporate law specifically anticipates and rejects claims based on poor judgment.²³ Though personal injury law embraces the theory of liability for simple negligence, corporate law in most states emphatically does not, preferring to rely on the market for capital and the market for labor to discipline poor or even mediocre management.²⁴ In other words, shareholders can sell shares of companies that are poorly managed, and companies can fire poorly performing managers; imposing liability through a shareholder suit is the least efficient way to discipline management. State law derivative actions do allow for directors and officers to be liable for grossly negligent decisions, conflicts of interest, and actions taken in bad faith.²⁵ Because of various

22. For a discussion of the law regulating financial derivatives, see generally Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011). monitoring duties); Alec Orenstein, *A Modified Caremark Standard To Protect Shareholders of Financial Firms from Poor Risk Management*, 86 N.Y.U. L. REV. 766 (2011) (endorsing a standard that allows the courts to look at the steps management took, if any, to prevent their firm from being over-exposed to risk).

23. See STEPHEN M. BAINBRIDGE, *CORPORATE LAW* 96 (2d ed. 2009) (quoting *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1983)) (internal quotation marks omitted) (“While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. . . . Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment.”); Fred S. McChesney, *The “Trans Union” Case: Smith v. Van Gorkom*, in *THE ICONIC CASES IN CORPORATE LAW* 231–40 (Macey ed., 2008) (“It bears emphasis, too, that the relevant state law [in *Van Gorkom*] (Delaware) requires not just negligence by a director but *gross* negligence.”).

24. See BAINBRIDGE, *supra* note 23, at 104 (stating that “market forces encourage directors to make such decisions carefully”). Theoretically, shareholders have the ability to replace directors by exercising their statutory right to vote in director elections. However, in publicly held corporations, the ability of any individual shareholder to oust a director is illusory. See generally Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (finding that for firms with a market capitalization of more than \$200 million, shareholder challenges to management-chosen director nominees occurred on average at two companies per year in the United States).

25. These duties historically were seen as the duty of care, loyalty, and good faith. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995) (“This court held that to rebut the presumption [of the business judgment rule], a shareholder plaintiff assumes the burden of providing evidence that the *board* of directors, in reaching *its* challenged decision, breached any *one* of *its* triad of fiduciary duties: good faith, loyalty or due care.”). However, in recent years the Delaware Supreme Court has interpreted this “triad” as merely two duties: the duty of care and the duty of loyalty, which encompass both conflicts of interest and bad faith derelictions of the board’s supervisory duties. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“[A]lthough good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing Only the latter two duties, where violated,

doctrinal protections to preserve the judgment of directors and officers, however, most notably the business judgment rule,²⁶ absent a claim of a conflict of interest or obvious bad faith, shareholders rarely prevail in claims that directors breached fiduciary duties to the corporation.²⁷

These impediments within corporate fiduciary duty law notwithstanding, several lawsuits have attempted to prevail on fiduciary duty claims, with predictably little success. Not to be stymied, some scholars have argued for courts to recognize this new duty (or a new component of an existing duty).²⁸ To do so, courts are urged to analyze board decisions either under a framework of how reasonable managers make decisions that impact overall firm risk (duty of care) or a framework of how reasonable managers monitor internal systems designed to manage firm risk (duty of loyalty).²⁹ In addition, in these and similar lawsuits, litigants have alleged breaches of the fiduciary duties relating to board decisions approving incentive compensation plans that encouraged excessive risk taking or approving large compensation packages for those who engaged in excessive risk taking.³⁰ Relatedly, some litigants have made other attempts to create a cause of action under federal securities law for failing to disclose excessive risk taking.³¹

This Article argues that not only does a duty to manage financial risk not exist within the prevailing corporate law framework of fiduciary duties, but also that recognizing a separate duty to manage financial risk³² would be imprudent.³³ Breaches

may directly result in liability.”); *see also* Joan MacCleod Heminway, *Martha's (and Steve's) Good Faith: An Officer's Duty of Loyalty at the Intersection of Good Faith and Candor*, 11 *TRANSACTIONS: TENN. J. BUS. L.* 111, 113 (2009) (“With due respect to the Delaware Supreme Court, the law regarding the duty of good faith has been all over the map throughout the past 20 years.”).

26. For a complete discussion of the business judgment rule, its policy foundations, and its mechanisms, *see generally* BAINBRIDGE, *supra* note 23, at 96–102.

27. *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 *VAND. L. REV.* 1747, 1786 (presenting findings of an empirical study of derivative cases in Delaware showing that of all successful suits, only one did not allege a managerial conflict of interest).

28. *See* Hill & McDonnell, *supra* note 22, at 878 (proffering a limited argument for a duty to monitor that would “[a]lmost never” impose business risk but would require the board to do more than is currently legally required).

29. *See, e.g., In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 130–31 (Del. Ch. 2009) (discussing the meaning of “reasonable” oversight); *In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1080–82 (C.D. Cal. 2008) (discussing breach of duty of care allegation based on lack of oversight by company directors).

30. *See, e.g., In re Goldman Sachs Grp., Inc. S'holder Litig.*, Civil Action No. 5215-VCG, 2011 WL 4826104, at *3–5 (Del. Ch. Oct. 12, 2011) (alleging breach of fiduciary duties because of a compensation structure that encouraged management to make overly risky business decisions); *In re Am. Int'l Grp., Inc. Deriv. Litig.*, 700 F. Supp. 2d 419, 427–28, 431 (S.D.N.Y. 2010) (applying Delaware law to a question about employees' incentives to make overly risky business decisions).

31. *See, e.g., In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1146–47, 1053–54 (C.D. Cal. 2008) (alleging failure to adequately disclose riskiness of subprime mortgages); *In re Citigroup Inc. Sec. Litig.*, 753 F. Supp. 2d 206, 212 (S.D.N.Y. 2010) (deciding a case in which the managers allegedly knowingly misrepresented the risks the company faced); *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 353–55 (S.D.N.Y. 2011) (discussing allegations that the company made misstatements about underwriting standards and credit risk management).

32. In this Article, the term “financial risk” is primarily used to refer to investment risk of firms that purchase and sell financial products for their own accounts, but it is also used to describe liquidity risk, prepayment risk and credit risk. *See* Orenstein, *supra* note 22, at 778 (distinguishing these types of financial risks from “operational risk,” which involves typical *Caremark* risks of wrongdoing and illegal actions within a

of this duty would be identifiable only in hindsight, and such a duty would require courts to resolve questions best left to individual firms and their shareholders. For example, courts would have to determine what amount of risk taking is excessive for a given firm at the point of time the decision was made, and whether lack of risk taking would still be actionable as a failure to manage risk. Theoretically, the duty to manage financial risk would also encompass failures to take risks, making risk-averse firms also susceptible to breach of duty claims. Furthermore, a duty to manage risk would seem to encompass not only financial risks, but also other sorts of risks, such as business risk, litigation risk, political risk, environmental risk, tort risk, and disaster risk.

This Article does not seek to rehash the arguments about the causes of the 2008 financial crisis. Though many may disagree over which factors were primary or contributing, most commentators agree that the economy was harmed by “excessive borrowing, risky investments and lack of transparency” at systemically important financial institutions, “collapsing mortgage lending standards,” the holding of over-the-counter derivatives by financial institutions, and conflicts of credit rating agencies.³⁴ This Article reviews the litigation that emanated from the financial crisis in which shareholders of financial institutions attempted to gain legal redress from those actions that not only were contributing factors of the financial crisis, but also caused shareholder wealth to vanish. Part II analyzes attempts to hold financial firms liable under federal securities fraud for misstating the amount and character of the risks to which they exposed corporate assets. Part III transitions away from federal remedies to state law fiduciary duty derivative actions, including actions in which shareholders allege a breach of the duty of care and waste. This Part analyzes the current state of the law of the duty of care under the business judgment rule given the existence of permissive exculpation clause statutes. Part IV continues the discussion of fiduciary duties, but focuses on the duty of loyalty, and in particular, the duty of oversight. This Part explores all of the case law based on allegations that financial firms breached their duty of oversight by failing to monitor firm risk. Finally, in Part V, this Article considers whether a new duty to monitor risk, either as an extension of the duty of oversight or as a new duty, would fulfill goals of holding boards accountable while also maximizing shareholder value. The Conclusion in Part VI summarizes why imposing a broader duty of oversight to manage financial risk would inevitably become unmanageable.

II. BAD CORPORATE BEHAVIOR AS SECURITIES FRAUD

Corporate directors and officers may feel the effects of their bad behavior in a number of ways. The first and most immediate, of course, is in the market for capital. Among publicly held corporations, capital flows fairly easily based on the public’s knowledge of management competencies. When firms announce new products, changes

firm). The term “financial risk” is not intended here to encompass business risks.

33. This Article does not address concerns with the mechanism by which these claims are brought—the shareholder derivative lawsuit. Other commentators have written about the challenges for shareholders as well as the agency problems endemic in derivative lawsuits. This Article is mainly concerned with the legal doctrine of the substantive claims, not the procedural efficiency of the manner in which they are brought.

34. See FCIC REPORT, *supra* note 9, at xxiii–xxv (listing the FCIC’s conclusions as to the causes of the financial crisis).

in leadership, or financial data, shares of that firm will be bought or sold based on the perception of whether those choices are wise or those facts reflect the work of skillful managers. Unsatisfied shareholders will take their investment capital elsewhere or, if their stakes are sufficiently large, demand new management.³⁵ However, if the behavior of directors and officers is more than misdirected and actually violates laws, then state or federal prosecutors have the authority to charge firms criminally or civilly.

A. Federal Enforcement: Nondisclosure of Excessive Risk as Securities Fraud

For firms subject to federal securities laws, both the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) have the ability to prosecute firms for violations of certain provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.³⁶ Though neither act seeks to regulate corporate decision making or create an obligation for directors or officers to act prudently or reasonably,³⁷ both acts create various disclosure duties to ensure accurate reporting of financial facts and internal affairs to the investing public.³⁸ Therefore, if a firm is underperforming but continues to paint a rosy picture for investors, this misrepresentation is actionable by federal authorities, both civilly³⁹ and criminally.⁴⁰ In addition, several important antifraud provisions of the securities acts are actionable by investors through private litigation,⁴¹ resulting in numerous class action securities fraud lawsuits filed by shareholders each

35. See, e.g., Stephanie Clifford, *J.C. Penney Ousts Chief of 17 Months*, N.Y. TIMES, Apr. 9, 2013, at B1 (reporting that CEO Ron Johnson was asked to step down after causing the department store chain to lose hundreds of millions of dollars each quarter due to an unpopular, “no sales, no coupons” campaign).

36. 15 U.S.C. § 78u-2 (2012).

37. The first draft of the Securities Act, written by Huston Thompson, would have created a mechanism whereby the federal government would approve the merits of proposed offerings by issuers; this concept was rejected in favor of a disclosure regime. LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 12 (4th ed. 2011).

38. See, e.g., 15 U.S.C. § 77k (2012) (Civil Liabilities on Account of False Registration Statement); *id.* § 77l (Civil Liabilities Arising in Connection With Prospectuses and Communications); *id.* § 78j (Manipulative and Deceptive Devices); *id.* § 78ff (creating liability for “any person who willfully violates any provision of this chapter”).

39. See *id.* § 77k (Civil Liabilities on Account of False Registration Statement); 15 U.S.C. § 77l (Civil Liabilities Arising in Connection With Prospectuses and Communications); *id.* § 78ff (creating liability for “any person who willfully violates any provision of this chapter”).

40. See *id.* § 78u (“The [Securities and Exchange] Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.”).

41. Some provisions, such as Section 11 of the Securities Act, specifically provide for private rights of action. See 15 U.S.C. § 77k (providing that “any person acquiring such security” sold under a fraudulent registration statement may sue listed categories of defendants involved in the preparation of such registration statement). Though the antifraud provision found in Section 10 of the Exchange Act does not provide for such lawsuits, courts began to recognize in 1946 a private right of action for investors when firms make fraudulent misstatements or omissions in other documents and situations. See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 52 (2005) (detailing the rise of the Rule 10b-5 securities fraud lawsuit). Perceived abuses of class action securities fraud lawsuits led to the passage in 1995 of the Private Securities Litigation Reform Act. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. § 78u-4 (2012)).

year.⁴²

The 2002 accounting scandals resulted in numerous government prosecutions and private lawsuits for violations of the securities laws by firms that misrepresented their financial conditions to investors.⁴³ In 2002, President George W. Bush announced the creation of the Corporate Fraud Task Force (CFTF), which included the Enron Task Force.⁴⁴ At the end of the CFTF's existence, the CFTF took credit for 1300 convictions, including guilty pleas, stemming from the 2001 accounting scandals.⁴⁵ Many of these convictions were for violations of the antifraud provisions of the securities laws.⁴⁶

In contrast, the 2008 financial crisis resulted in very few investigations,⁴⁷ fewer prosecutions, and even fewer convictions.⁴⁸ Though President Barack Obama established the Financial Fraud Enforcement Task Force (FFETF) in 2009, it was given the broad charge to "build upon efforts already underway to combat mortgage, securities and corporate fraud" both to find those accountable for the financial crisis and to "prevent another meltdown."⁴⁹ Compared with the CFTF, the FFETF has not significantly pursued players and activities that caused the widespread harm of the 2008 financial crisis.⁵⁰

42. See CORNERSTONE RES., SECURITIES CLASS ACTION FILINGS: 2012 YEAR IN REVIEW 1 (2013), available at http://securities.stanford.edu/clearinghouse_research/2012_YIR/Cornerstone_Research_Securities_Class_Action_Filings_2012_YIR.pdf (finding 152 securities fraud class action filings in 2012, compared with 188 in 2011).

43. The failures of numerous large companies in late 2001 and 2002, and the frauds the failures exposed, harmed numerous groups of stakeholders, including retirement funds and employees who lost jobs. See DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 172–73 (2005) (describing the impact of the bankruptcies of Enron and WorldCom).

44. See Alice Fisher et al., *Encouraging Corporate Responsibility Through Criminal Enforcement*, in 3 THE PRACTITIONER'S GUIDE TO THE SARBANES–OXLEY ACT, at VII-1-1 (John J. Huber et al. eds., 2006) (discussing the effectiveness of imposing criminal liabilities on corporations).

45. See CORP. FRAUD TASK FORCE, REPORT TO THE PRESIDENT iii (2008) (discussing the result of a series of prosecutions).

46. See *Fact Sheet: President's Corporate Fraud Task Force Marks Five Years of Ensuring Corporate Integrity*, DEPARTMENT OF JUSTICE (July 17, 2007), http://www.justice.gov/opa/pr/2007/July/07_odag_507.html.

47. Following the September 2008 bankruptcy of Lehman Brothers, the Bankruptcy Court ordered a report, authored by Anton Valukas, which suggested that Lehman had engaged in materially misleading accounting practices. See Lehman Report, *supra* note 18, at 7–8 ("Lehman did not disclose its use—or the significant magnitude of its use—of [accounting technique] Repo 105 to the Government, to the rating agencies, to its investors, or to its own Board of Directors. Lehman's auditors, Ernst & Young, were aware of but did not question Lehman's use and nondisclosure of the Repo 105 accounting transactions."). However, to date, no criminal charges have been filed against anyone connected with Lehman Brothers. See Joshua Gallu, *SEC Staff Ends Probe of Lehman Without Finding Fraud*, BLOOMBERG (May 24, 2012, 10:30 PM), <http://www.bloomberg.com/news/2012-05-24/sec-staff-said-to-end-lehman-probe-without-recommending-action.html> (citing leaked internal memo from the SEC stating "[t]he staff has concluded its investigation and determined that charges will likely not be recommended").

48. The most high-profile prosecution was of Angelo Mozilo, the CEO of Countrywide Financial Corp.; the SEC settled and the DOJ dropped its criminal investigation. Reckard, *supra* note 7.

49. Press Release, Dep't of Justice, President Obama Establishes Interagency Financial Fraud Enforcement Task Force (Nov. 17, 2009), available at <http://www.justice.gov/opa/pr/2009/November/09-opa-1243.html>.

50. The FFETF has not submitted a report on its activities since its first-year report. FIN. FRAUD ENFORCEMENT TASK FORCE, FIRST-YEAR REPORT 2010 (2011), available at <http://www.stopfraud.gov/docs/FFETF-Report-LR.pdf>. However, the activities of the task force seem more focused on combatting frauds that are the result of the financial crisis, such as mortgage foreclosure fraud and

Though the SEC has attempted civil enforcement actions against several big players in the crisis, many of its successes are for isolated fraudulent activities that took place *during* the crisis and not for activities that may have contributed to the crisis.⁵¹ The FFETF does not list any statistics about investigations or convictions stemming from the financial crisis,⁵² but the SEC website reports that, as of July 15, 2013, the SEC had civilly charged 157 entities and individuals in connection with the financial crisis, including 66 corporate officers, resulting in \$1.53 billion in penalties.⁵³

However, shortly after the financial industry's meltdown in Fall 2008, the federal government did investigate incomplete disclosures of firm-specific risk⁵⁴ by a few notable firms. However, the SEC brought these cases as civil enforcement actions, not as criminal actions. For example, the SEC charged Countrywide officers Angelo Mozilo (CEO), David Sambol (COO), and Eric Sieracki (CFO) with securities fraud for failure to disclose to investors the liberalization of the firm's underwriting policies in the years leading up to its demise.⁵⁵ In addition, the SEC included charges of insider trading against Angelo Mozilo for establishing a Rule 10b-5(1) sales plan for his shares while possessing negative nonpublic information about the company.⁵⁶ Mozilo settled these charges for \$22.5 million in fines and \$45 million in disgorgement.⁵⁷ Sambol's settlement amounted to \$5.5 million, and Sieracki's to \$130,000.⁵⁸ Though Mozilo's large payout was touted as a success for the SEC and as proof of a high probability that the SEC would have been successful at trial, the DOJ did not move forward with a criminal investigation into the same alleged activities.⁵⁹ One of the other few successful

TARP-related fraud, and not alleged frauds that may have created the financial crisis. *See id.* at 3.3–3.4 (naming the five working groups, including the Mortgage Fraud Working Group, the Recovery Act Fraud Working Group, the Rescue Fraud Working Group, and the Non-Discrimination Working Group).

51. *See, e.g., SEC Enforcement Actions Addressing Misconduct That Led to or Arose from the Financial Crisis*, SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/enf-actions-fc.shtml> (last visited Sept. 30, 2013) [hereinafter *SEC Enforcement Actions*] (listing actions against investment banks that concealed “risks, terms, and improper pricing in CDOs and other complex structured products” from purchasers of proprietary products they marketed and sold).

52. *See Department of Justice Accomplishments*, U. S. DEP'T OF JUSTICE, <http://www.justice.gov/accomplishments> (last visited Sept. 30, 2013) (reporting generally that “Task Force members have charged a record number of mortgage-fraud-related cases” and “[t]he Department has prosecuted some of the most significant financial crimes”).

53. *See SEC Enforcement Actions*, *supra* note 51 (outlining the remedies sought relating to the 2008 financial crisis).

54. *See* Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1212 (arguing that “[o]ngoing risk disclosure at many financial institutions was of low quality, and their shareholders suffered considerable losses when the undisclosed risks came to pass,” but not asserting that disclosures were intentionally false).

55. *See* Complaint at 2–3, Sec. & Exch. Comm'n v. Mozilo, No. 09CV03994, 2009 WL 1549287 (C.D. Cal. June 4, 2009) (alleging that the three most senior executives of Countrywide hid unprecedented expansion of the company's underwriting guidelines).

56. *Id.* at 43.

57. *Id.*

58. Press Release, Sec. & Exch. Comm'n, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2010), *available at* <http://www.sec.gov/news/press/2010/2010-197.htm>.

59. *See* Gretchen Morgenson, *Case on Mortgage Official Is Said To Be Dropped*, N.Y. TIMES, Feb. 20, 2011, at A20 (“The conclusion by prosecutors that Mr. Mozilo, 72, did not engage in criminal conduct while

enforcement actions was filed against former CFO Gary Crittenden and former head of investor relations Arthur Tildesley, Jr. of Citigroup, Inc. for making “misleading statements in earnings calls and public filings about the extent of [Citigroup’s] holdings of assets backed by subprime mortgages.”⁶⁰ Ultimately, Citigroup settled these charges for \$75 million in fines, and the two executives settled for \$100,000 and \$80,000, respectively—comparatively miniscule fines given the \$40 billion exposure that was not disclosed.⁶¹ Because of the weakness of the settlement, no criminal charges were filed on these same facts.⁶²

B. Shareholder Securities Litigation: Nondisclosure of Excessive Risk as Securities Fraud

Regardless of whether federal or state actors bring actions against firms for securities fraud, shareholders in those firms have the right to seek redress in the courts for material misstatements or omissions.⁶³ To package a case in which a firm has engaged in excessively risky behaviors into a federal securities fraud case,⁶⁴ shareholders must be able to allege that firm actors made false statements of facts (or omissions of facts) about the behaviors in question. If firms make full and transparent disclosures of risky

directing Countrywide will likely fuel broad concerns that few high-level executives of financial companies are being held accountable for the actions that led to the financial crisis of 2008.”)

60. Press Release, Sec. & Exch. Comm’n, SEC Charges Citigroup and Two Executives for Misleading Investors About Exposure to Subprime Mortgage Assets (July 29, 2010), available at <http://www.sec.gov/news/press/2010/2010-136.htm>.

61. See *id.* (“Citigroup had more than \$40 billion of additional subprime exposure in these categories, which it didn’t disclose until November 2007 after a decline in their value.”).

62. Citigroup was and is a defendant in a wide array of cases stemming from its role in the financial crisis, which included disclosures it made in packaging residential-mortgage-backed securities and selling collateralized debt obligations. Citigroup settled criminal charges with the DOJ regarding its certification of RMBS for insurance provided by the federal government. See, e.g., *Citigroup to Pay \$158 Million in Mortgage Fraud Settlement*, N.Y. TIMES, Feb. 15, 2012, at B4 (reporting that Citigroup’s mortgage unit fraudulently misled the government into insuring risky mortgage loans). The most controversial case against Citigroup resulted in U.S. District Court Judge Jed S. Rakoff rejecting a \$285 million settlement with the SEC on the grounds that Citigroup, a “recidivist,” neither admitted nor denied any of the allegations in return for a fine that amounted to “pocket change.” See U.S. Sec. & Exch. Comm’n v. Citigroup Global Markets, Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011) (“[A] consent judgment that does not involve any admissions and that results in only very modest penalties is just as frequently viewed, particularly in the business community, as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies.”); Edward Wyatt, *Judge Blocks Citigroup Settlement with S.E.C.*, N.Y. TIMES, Nov. 28, 2011, at A1 (holding that the settlement was not “fair, reasonable, adequate and in the public interest” as required by law). That decision was appealed, and oral argument was held on February 8, 2013.

63. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 753 (1975) (“Sections 11 and 12 of the 1933 Act provide express civil remedies for misrepresentations and omissions in registration statements and prospectuses filed under the Act . . .”); *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512, 514–15 (E.D. Pa. 1946) (denying a corporation’s motion to dismiss a claim to recover damages for fraudulently inducing plaintiffs to sell their stock).

64. Shareholders also have the option of bringing a state law fiduciary duty claim of failure to disclose. See *Staehr v. Mack*, No. 07 Civ. 10368(DAB), 2011 WL 1330856, at *3 (S.D.N.Y. Mar. 31, 2011) (claiming the Morgan Stanley directors “breached their fiduciary duties in connection with Morgan Stanley’s failure to disclose its exposure to the subprime mortgage market and the false statements it provided to the market about the Company’s financial prospects”).

investments, then the securities laws have done their job; investors can decide whether to invest based on full knowledge of the risks entailed. However, if firms misstate their levels of exposure to risky investments, current and prospective investors may buy or hold shares without adequate information, and that misstatement may cause any losses that ensue. As a threshold matter, the shareholders must be able to pinpoint specific statements that are false or misleading or require further explanation.⁶⁵ Even then, shareholders face certain challenges to these claims, namely that the risks that were omitted or downplayed must not be publicly known risks⁶⁶ and must be material.⁶⁷ Finally, the statements must not be too general to be verified opinion⁶⁸ or mere puffery.⁶⁹

The most successful securities fraud lawsuit relating to the financial crisis, but also one of the very few, was brought in the Central District of California against certain individual officers and directors of Countrywide Financial.⁷⁰ In the California case, shareholders alleged that Countrywide's disclosure documents, filed with the SEC before 2007, contained fraudulent statements about the company's underwriting practices and portfolio of mortgage products.⁷¹ To survive a motion to dismiss, plaintiffs had to overcome certain pleading obstacles, including meeting the burden of proof on such elements as falsity, materiality, scienter, and loss causation.⁷² In other words, statements

65. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478–79 (1977) (refusing to find a viable Rule 10b-5 cause of action in a merger transaction challenged as “unfair” when no disclosure was challenged as false, stating that Section 10(b) of the Securities Exchange Act “did not seek to regulate transactions which constitute no more than internal corporate mismanagement”).

66. See *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989) (holding that inaccurate statements about the length of delays regarding proposed nuclear reactors were not actionable, stating, “[j]ust as a firm needn’t disclose that 50% of all new products vanish from the market within a short time, so Commonwealth Edison needn’t disclose the hazards of its [nuclear reactor] business, hazards apparent to all serious observers and most casual ones”).

67. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (stating that a fact is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”).

68. However, if the opinion necessarily implies facts that the speaker knows are untrue, then that statement of belief can be actionable. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1087 (1991) (upholding action against board of directors that misstated reasons for merger).

69. See *Longman v. Food Lion, Inc.*, 197 F.3d 675, 684–85 (4th Cir. 1999) (holding that Food Lion's statements that it had “some of the best benefits in the supermarket industry” and “clean and conveniently located stores” were not material misstatements even though an exposé showed two stores engaging in unsanitary practices and illegal labor practices).

70. *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1154–56 (C.D. Cal. 2008) (listing claims against 50 Countrywide defendants of violations of Section 11 of the 1933 Act for registration materials relating to debt securities and one class of equity securities and violations of 10b-5 and Section 20 of the 1934 Act).

71. See *id.* at 1153 (giving examples of false statements alleged in the consolidated complaint).

72. Notably, Section 11 claims have fewer elements that plaintiffs must plead and prove than Rule 10b-5 fraud claims; most notably, Section 11 plaintiffs do not have to prove scienter and loss causation. See *id.* at 1162 (internal citations omitted) (“Defendants are liable for innocent or negligent material misstatements or omissions, subject to a few affirmative defenses.”); *id.* at 1170 (“Loss causation is not a § 11 element. Rather, § 11(e) makes the absence of loss causation (or “negative causation”) an affirmative defense to reduce or avoid liability.”). The Rule 10b-5 fraud claims not only have additional elements, but plaintiffs also face heightened pleading standards under the Private Securities Litigation Reform Act (PSLRA). See *id.* at 1184 (“A plaintiff must prove the following elements in connection with the purchase or sale: (1) a material [(‘materiality’)] (2) misrepresentation or omission [(‘falsity’)] (3) made with scienter [(‘scienter’)] (4) on which plaintiff relied

about defendants' exposure to subprime risk would have to be specific enough to be falsifiable and not mere marketing statements; the speaker, whether an officer or the corporation, would have to know the statement was false or be reckless as to its falsity, and the false statements, rather than the declining stock market, would have to have caused the plaintiff to lose money. Though these burdens can be sufficiently onerous to end most private securities litigation,⁷³ plaintiffs prevailed against the defendants' 2008 motion to dismiss. The court refused to dismiss important parts of the complaint against directors and officers, even though many of the allegedly false statements were as generic as claims that their mortgages were "high quality" and that their underwriting standards were "consistent" and designed to reveal fraud.⁷⁴ Normally, such types of phrases are considered immaterial for purposes of securities fraud because investors recognize them as "puffery."⁷⁵ However, the court distinguished the Countrywide claims because the statements regarded "essential operations" of an issuer that is solely a mortgage originator,⁷⁶ even though the statements "would not be actionable in the vast majority of cases . . ."⁷⁷ Therefore, though some claims were dismissed on both procedural and substantive grounds against some defendants,⁷⁸ many important claims were allowed to stand against the company, former CEO Angelo Mozilo,⁷⁹ and other former officers.⁸⁰

['reliance']), (5) suffering an economic loss [('loss')] (6) caused by the misrepresentation or omission [('loss causation')]."). Under Federal Rule of Civil Procedure 9(b), facts alleging fraud must be pled with particularity, but the PSLRA requires facts relating to securities fraud claims to meet an even higher standard. See *In re Countrywide*, 588 F. Supp. 2d at 1185 (quoting 15 U.S.C. 78u-4(b)(1)) ("The complaint must (1) explain why the statement is false or misleading, and (2) if alleged on information and belief, the complaint must 'state with particularity all facts on which that belief is formed.'"). See also 15 U.S.C. § 78u-4(b)(1) (laying out the requirements for a misleading statement or omission).

73. See Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L. ECON. & ORG. 598, 602 (2007) (reporting that pre-PSLRA period fraud resulted in positive settlement in an amount greater than nuisance value; however, in the post-PSLRA period, the author predicts only 28.7% of the cases would have had a non-nuisance outcome).

74. See *In re Countrywide*, 588 F. Supp. 2d at 1153-54 (alteration in original) (giving as examples disclosures that stated "proprietary underwriting systems . . . improve the consistency of underwriting standards, assess collateral adequacy and help to prevent fraud" and referring to "quality control proves" and "underwriting standards" in the context of a company that had all but abandoned any underwriting standards previously articulated). Another area of misleading statements cited were references to Countrywide's portfolio as "prime" and "nonprime," which did not conform to industry definitions, and which were not defined in disclosure materials until 2007, giving the impression that Countrywide had a very small exposure to the subprime market when nearly all of its mortgages were subprime. See *id.* at 1154 (quoting a Countrywide rep as stating that "over 90% of Countrywide loan origination volume is prime quality").

75. See *id.* at 1144 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479) (acknowledging that "[t]he federal securities laws do not create liability for poor business judgment or failed operations").

76. See *id.* (noting that "[c]ore mortgage-related operations accounted for the vast majority of Countrywide's earnings during the class period—93% of fiscal year ('FY') 2006 pretax earnings").

77. See *id.* (explaining that "Countrywide's practices so departed from its public statements that even 'high-quality' became materially false or misleading").

78. See *In re Countrywide*, 588 F. Supp. 2d at 1205 (stating that all claims under Rule 10b-5 against the auditor, KPMG, were dismissed without prejudice, and all Section 11 claims except for one were also dismissed).

79. See *id.* at 1192-94 (comparing Mozilo's public statements about Countrywide's "very, very good solid subprime business" with contemporaneous internal statements).

80. Twenty months later, in August 2010, Countrywide and its defendant officers settled this shareholder securities fraud lawsuit for \$600 million. See *\$600 Million Countrywide Settlement*, N.Y. TIMES, Aug. 3, 2008,

Unfortunately for potential shareholder plaintiffs, the 2008 private securities fraud case against Countrywide has rarely been followed.⁸¹ Particularly in the Southern District of New York, which has the highest caseload of federal securities fraud cases among the federal district courts, the *Countrywide* decision has not ushered in a new era of successful securities fraud cases against financial institutions that touted the soundness of their portfolios.⁸² In fact, the Southern District of New York dismissed complaints against Wachovia under the traditional theory that claiming to have “conservative” or “sound” underwriting standards was mere puffery⁸³ and also that the plaintiffs failed to allege scienter as to the falsity of these general statements.⁸⁴ Because investors understand puffery to be mere marketing language or gloss, such statements are not

at B5 (reporting that the settlement was the largest payout to come out of the subprime crisis to date). This shareholder settlement occurred shortly before the settlement in the SEC enforcement action. E. Scott Reckard, *Countrywide Agrees To Pay \$600 Million To Settle Shareholder Lawsuits*, L.A. TIMES (Aug. 2, 2010), <http://articles.latimes.com/2010/aug/02/business/la-fi-countrywide-20100803>.

81. See, e.g., *Local 295/Local 851 IBT Emp'r Grp. Pension Trust & Welfare Fund v. Fifth Third Bancorp*, 731 F. Supp. 2d 689, 706 (S.D. Ohio 2010) (following *Countrywide* and holding that a company's misleading statements about the soundness of its underwriting standards, loan portfolio, and loan loss reserves are material); *In re Washington Mutual, Inc. Sec., Deriv. & ERISA Litig.*, 259 F.R.D. 490, 506 (W.D. Wash. 2009) (“If WaMu's lending environment was fraught with such extreme departure from any plausible conception of “standards,” a statement that the Company followed underwriting standards to manage or mitigate credit risk would mislead a reasonable investor.”) However, the *Washington Mutual* court did not answer the second question of whether the plaintiffs had adequately alleged scienter as to statements about underwriting standards, denying the motion to dismiss as to Section 11 claims, but granting plaintiffs leave to submit a more definite statement about scienter as to Rule 10b-5 claims. *In re Washington Mutual*, 259 F.R.D. at 503, 509.

82. See, e.g., *In re Sec. Capital Assurance, Ltd. Sec. Litig.*, 729 F. Supp. 2d 569, 580, 603 (S.D.N.Y. 2010) (dismissing complaint in its entirety because it failed to adequately allege scienter and materiality regarding statements that underwriting was “disciplined” and “conservative”). The court seemed fairly unsympathetic to plaintiffs. See *id.* at 597 (reiterating that securities fraud actions cannot be premised on “allegations of mismanagement” or “optimistic statements or puffery”). See *id.* Even as to the few statements it agreed were material and falsifiable, the court dismissed on the basis of loss causation, reflecting the harsh reality that securities fraud plaintiffs have numerous obstacles to overcome on the way to trial. See *id.* at 598–602 (“Defendants submit that Plaintiffs have not demonstrated that their alleged misrepresentations were the proximate cause of Plaintiffs' losses, because the price of SCA's stock declined steadily over the course of the Class Period . . .”).

83. See *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 354 (S.D.N.Y. 2011) (concluding Wachovia's “conservative underwriting standards” were puffery and generally not actionable); *In re New Century*, 588 F. Supp. 2d 1206, 1225 (C.D. Cal. 2008) (citing authority from the Central District of California that “misrepresentations concerning the quality of a company's underwriting are actionable under the securities laws”). In *Wachovia*, the Southern District emphasized that in the Second Circuit, those statements were not “sufficiently specific to cause a reasonable investor to rely upon them.” *Id.* at 376 (citing *ECA v. J.P. Morgan Chase Co.*, 593 F.3d 187, 206 (2d Cir. 2009)).

84. See *id.* at 344 (“Assuming *arguendo* that these statements are actionable, Plaintiffs still fail to raise an inference that Defendants knew or should have known the contrary facts at the time of the challenged statements.”). The court explained that such an inference arises when the company affirmatively decides to lower underwriting standards while still publicly touting them at their prior strength. *Id.* This case was settled for \$75 million while being appealed to the Second Circuit. *In re Wachovia Equity Sec. Litig.*, No. 08 Civ. 6172(RTS), 2012 WL 2774969, at *12 (S.D.N.Y. June 12, 2012). In approving the settlement, the court remarked, “Given the history of this case, including the fact that the court previously dismissed the Second Amended Complaint in its entirety, the Court has little difficulty concluding that Plaintiffs would face substantial hurdles in establishing liability and damages in this action.” *Id.* at *5.

actionable as fraudulent misstatements.⁸⁵ In a similar case brought in the Southern District against Citigroup, the court dismissed claims based on statements made by the issuer about its mortgage portfolio based on lack of scienter—there was insufficient proof that high-ranking officials knew anything about individual mortgages or groups of mortgages.⁸⁶ In addition, statements that Citigroup was “well-positioned” and a “pillar of strength” were neither material nor actionable; these were merely “expressions of ‘puffery and corporate optimism.’”⁸⁷ The *Countrywide* decision may be seen as a product of its time and geography. When the housing bubble burst, the State of California was one of the hardest hit areas in the United States. Given the fact that Countrywide was so involved in the mortgage industry in California, the courts there, even federal courts, would naturally be interested in ensuring that the firm did not escape public retribution for its acts, which had such ruinous consequences. However, even in the Central District of California, the court has distinguished its own *Countrywide* case, characterizing the firm as one who touted underwriting practices when it had abandoned them entirely so as not to have any, not as a firm that misled investors as to the quality of those existing practices.⁸⁸ The lasting impact of *Countrywide* may be limited to cases involving issuers that have one line of business and make statements—even generalized statements, regarding that business model that are fundamentally untrue where this disconnect is common knowledge within the company. This interpretation of *Countrywide* was followed in a Southern District of New York case involving an issuer making absolute statements, such as “we have zero in subprime,” and stating false loan-to-value (LTV) data.⁸⁹

85. See *Dunn v. Borta*, 369 F.3d 421, 431 (4th Cir. 2004) (“[T]he judiciary has long distinguished between mere puffing statements utilizing opinion and exaggeration to pitch a sale, on the one hand, and factual statements that constitute fraudulent misrepresentations, on the other.”); David A. Hoffman, *The Best Puffery Article Ever*, 91 IOWA L. REV. 1395, 1406 (2006) (explaining that puffery often consists of “vague statements of corporate optimism” that is not important to reasonable investors).

86. See *In re Citigroup Inc. Sec. Litig.*, 753 F. Supp. 2d 206, 245 (S.D.N.Y. 2010) (“Plaintiffs cannot rely on assertions that the information presented by confidential witnesses was known or common knowledge within the company; these assertions are too vague and conclusory to support a finding that defendants knew they were making false statements or made those statements with reckless disregard for their truth or falsity.”). *But see id.* at 237–38 (allowing certain claims related to the risk presented by CDOs to proceed).

87. *Id.* at 248.

88. *N.Y. State Teachers’ Ret. Sys. v. Fremont Gen. Corp.*, No. 2:07-cv-5756-FMC-FFMx, 2009 WL 3112574, at *8 (C.D. Cal. 2009) (dismissing complaint against mortgage company that claimed it “play[ed] at the upper end of [the subprime] spectrum” and was a “good, sound originator” on the basis of both falsity and scienter). This court distinguished the *Countrywide* case from 2008 because Countrywide Financial had abandoned its underwriting practices, rather than merely describing them in overly positive terms. *See id.* at *10 (quoting *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 145, 1159 (C.D. Cal. 2008) (“This argument [based on *Countrywide*] ignores the fact that Fremont never held itself out to be anything other than a sub-prime lender; in contrast, *Countrywide* involved allegations of a lender’s ‘systematic shift from sound underwriting’ to ‘the point of nearly abandoning’ its underwriting guidelines over the course of less than three years.”)).

89. See *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 191 (S.D.N.Y. 2010) (holding that the “glaring disparity” between the issuer’s statements and its actual practices was not mere puffery).

III. EXCESSIVE RISK AS A BREACH OF FIDUCIARY DUTY

The crux of the financial crisis securities fraud cases was that management was making very risky⁹⁰ decisions with corporate assets: maintaining high levels of leverage; originating loans that deviated from accepted underwriting criteria; establishing bonus plans for mortgage brokers predicated on originating loans; purchasing RMBS and CDOs for the firm's portfolio; entering into CDS based on RMBS or CDOs; and creating incentive compensation plans that led employees and high-ranking officers to take even riskier positions, even as signs in the marketplace looked like red flags. The securities fraud cases tried, mostly unsuccessfully, to shoehorn complaints of this poor assessment of risk into complaints of fraudulent misstatements of current levels of firm risk. However, complaints by shareholders as to management decisions, if not the articulation to the public of the state of those decisions, are generally the province of state corporate governance law, not federal securities law.⁹¹ As the shareholders in the securities fraud lawsuits were told, "[a]llegations of mismanagement, even where a plaintiff claims that it would not have invested in an entity had it known of the management issues, are insufficient to support a securities fraud claim"⁹² If allegations of mismanagement, particularly gross mismanagement with dire consequences, do not rise to the level of a criminal indictment or even civil sanctions under securities fraud statutes, then shareholders must turn to state fiduciary duty law for redress.⁹³

Under state corporate law, directors and officers are agents of the corporation who owe the firm fiduciary duties. The majority of claims against corporate actors fall under the categories of the duty of care and the duty of loyalty.⁹⁴ However, though they are oft-articulated, they are seldom violated as a matter of law.⁹⁵ This practical result is not a

90. Both these lawsuits and this Article use the terms "risk" and "risky" fairly loosely. Some of these "risky" decisions were decisions with a known statistical risk, while others were decisions with uncertain statistical risk. See Lynn A. Stout, *Uncertainty, Dangerous Optimism, and Speculation: An Inquiry into Some Limits of Democratic Governance*, 97 CORNELL L. REV. 1177, 1179–80 (2011–12) (explaining the difference between "risk" and "uncertainty"). Likewise, some decisions with an accepted statistical risk may have been premised upon statistical models that were flawed or outdated. For purposes of this Article, these decisions will generally be treated similarly.

91. See generally Robert B. Thompson & Hilary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003) (describing the traditional separation of state corporate governance law and federal securities law, and the trend toward federal corporate governance through disclosure requirements).

92. Sec. Capital Assurance, Ltd. Sec. Litig., 729 F. Supp. 2d 569, 597 (S.D.N.Y. 2010) (quoting *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 375 (S.D.N.Y. 2004)).

93. See D. Gordon Smith, *Doctrines of Last Resort*, in REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY: ON THE EMPIRICAL AND THE LYRICAL 426, 427 (2013) (describing fiduciary duty as a "doctrine of last resort . . . activated only when all other potentially applicable commands from constitutions, statutes, regulations, ordinances, common law decisions, and contracts have been exhausted").

94. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) ("Although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing Only the latter two duties, where violated, may directly result in liability"); see generally Robert B. Thompson, *The Short, But Interesting Life of Good Faith as an Independent Liability Rule*, 55 N.Y.L. SCH. L. REV. 543 (2010–11).

95. See Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 240 (2009) (declaring with regard to the doctrine of corporate fiduciary duties, "the emperor wears no clothes").

result of happenstance; courts, particularly the Delaware courts, have emphasized that directors should be subject to suit over their decisions only rarely, and liability for directors should be imposed even less often.⁹⁶

A. The Duty of Care

To the uninitiated, the actions at the heart of the financial crisis seem like textbook cases of breaches of the duty of care, as articulated in both the common law of agency⁹⁷ and foundational corporate law cases.⁹⁸ The agents of financial firms, lower-level employees, officers, and perhaps directors, made decisions that arguably were not made with particular “care, competence and diligence,” at least given the disastrous results.⁹⁹ However, the legal avenue with the least probability of success for imposing liability on directors and officers at such firms is a lawsuit alleging a breach of the duty of care.¹⁰⁰

1. Background

The types of decisions regarding the purchase and sale of risky securities and derivative contracts are acts with a significant risk of loss. In other areas of the law, these acts would be characterized as negligent, or as creating an unreasonable risk of loss or harm.¹⁰¹ On its face, the duty of care would seem to encompass negligent decisions and also, therefore, negligent decisions regarding firm risk. However, nothing could be further from the judicial reality of duty of care claims.

As anyone who has taken a basic business entities course knows, this duty is subject to something called the business judgment rule.¹⁰² The business judgment rule is not

96. See Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1312 (2008) (recognizing that Delaware chancellors are “too smart” to let fiduciary duty law result in “seriously wrong-headed outcomes”).

97. See RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006) (“[A]n agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances.”).

98. See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (“[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances.”).

99. See FCIC Report, *supra* note 9, at 7–8 (describing a line of bad decisions beginning with loan officers that fueled the mortgage crisis as one actor pushed the risk of a poor decision to the next in line).

100. In cases brought alleging that directors breached a duty to manage risk, the complaints do not pigeonhole this duty into the duty of care or loyalty, at least not in those words. See *In re Citigroup Inc. S'holder Derivative Litig.*, No. 07 Civ. 9841, 2009 WL 2610746, at *5 (S.D.N.Y. Aug. 25, 2009) (“The theory of relief on which the claim rests is not immediately apparent.”). It is then up to the court to decipher whether the language of the complaint states a claim under the duty of care, the duty of loyalty, or both. Generally, if a claim points to a specific director decision or numerous decisions, then that decision will be examined under the duty of care unless it a conflicted transaction under the duty of loyalty. If the claim points to activities of the firm that were not subject to a director decision, then the court will interpret this as an oversight claim under the duty of loyalty.

101. See Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1157 (2013) (noting that though “[t]he duty of care is dressed in the language of torts, . . . directors are not held to a negligence standard for business losses”).

102. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004) (“The business judgment rule commonly is understood today as a standard of liability by which courts review the decisions of the board of directors. . . . I argue that the rule is better understood as a doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting

exactly a rule or a defense, but it works like a presumption in any lawsuit alleging a breach of fiduciary duty in connection with any decision of the board.¹⁰³ The business judgment rule presumes that the board acted in good faith, in the best interests of the corporation, and after informing itself and engaging in deliberation.¹⁰⁴ To overcome this presumption, a successful plaintiff would have to prove bad faith, a conflict of interest, or gross negligence.¹⁰⁵ Needless to say, the business judgment rule screens out most claims of breach of the duty of care because plaintiffs cannot meet this burden.

Not only are due care claims met with a presumption that defendants exercised due care, but state law also allows for articles of incorporation to “exculpate” directors from liability for breaches of the duty of due care,¹⁰⁶ making this cause of action essentially a dead letter.¹⁰⁷ Even if shareholders could prove that firms’ decisions with regard to risk were grossly negligent, the directors may still be insulated from liability by charter. Given the procedural hurdles of the shareholder derivative lawsuit, the presence of an exculpation clause may result not only in directors ultimately facing no liability for a judgment, but also in the case ending on a motion to dismiss.¹⁰⁸ Of course, maintaining the rhetoric of a duty of care while simultaneously undercutting its strength with the

preconditions for review are satisfied.”). Whether the business judgment rule is a deferential standard of review of director decisions, a presumption that director decisions are made with due care, in good faith, and in the interest of the corporation, or a rule of abstention, the end result is that most directors’ decisions are insulated from substantive review, regardless of their catastrophic effects. See Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 250 (2009) (“Incompetent managers with bad judgment are not subject to personal liability for their failings.”).

103. See Bainbridge, *supra* note 102, at 87 (stating that the rule created a presumption against judicial review); S. Samuel Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111–12 (1979) (articulating the business judgment rule and stating that courts presume that directors’ conduct warrants protection under the rule). Though this Article focuses on the duties of directors, officers of a corporation owe the same duties to the corporation as directors. Officers also enjoy the presumption afforded by the business judgment rule.

104. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (describing the business judgment rule).

105. See Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 11 (2005) (“If the shareholder plaintiff cannot plead facts sufficient to overcome the business judgment rule’s substantive standards, the rule will apply, with the typical effect that the board wins, the shareholder loses, and the court stays out of it.”).

106. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2011) (allowing corporations to limit liability of directors in their charter for breaches not involving a breach of the duty of loyalty, bad faith, or illegal or wrongful conduct); N.Y. BUS. CORP. § 402(b)(1) (allowing corporations to limit liability of directors in their charter for breaches not involving bad faith, intentional misconduct, knowing violations of law, or personal financial gain).

107. See Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 652 (2006) (“The combined effect of the business judgment rule and director exculpation provisions is to limit most fiduciary duty claims to breaches of the duty of loyalty, that is, manager self-dealing.”).

108. Briefly, shareholders in a derivative action are required to make a demand on the board of directors that they sue themselves on behalf of the corporation before proceeding with the lawsuit. See, e.g., DEL. CH. CT. R. 23.1. However, shareholders can show demand futility by showing that the directors are not independent and disinterested or that the action was not “the product of a valid exercise of business judgment.” See *Aronson*, 473 A.2d at 814. One way to show interestedness is to show that the majority of the directors would be subject to personal liability should the lawsuit be successful. Therefore, even a well-pled claim of gross negligence would not subject a majority of the directors to personal liability in the presence of an exculpation clause, making it impossible for a derivative plaintiff to plead demand futility on the grounds that the directors are conflicted.

business judgment rule seems both convoluted and illogical.¹⁰⁹ The traditional argument for limiting the enforcement of this duty with the business judgment rule, and against claims that corporate boards were negligent, is that shareholders would prefer boards to be risk-seeking instead of risk-averse.¹¹⁰ Particularly in the passive-investor context, shareholders are hypothesized to be perfectly diversified. Therefore, diversified shareholders with many different investments that presumably hedge against systemic risk both assume and hope that boards will not be overly conservative with corporate assets.¹¹¹ A few mistakes along the way are preferable to flat growth and few profits over the long term. As Chancellor William Allen explained in *Gagliardi v. Trifoods International, Inc.*:

Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any “upside” gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on “negligence”, “inattention”, “waste”, etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders’ economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.¹¹²

A second argument for the business judgment rule is that courts are in a very poor position to second-guess the business decisions that boards make,¹¹³ particularly in

109. The existence of the business judgment rule has been described as reflecting the tension between honoring the “authority” of the directors while ensuring “accountability.” See Griffith, *supra* note 105, at 12 (describing corporate law’s goal of balance); Bainbridge, *supra* note 102, at 103 (discussing directors’ dual roles). The balance in that equation definitely seems to tip toward “authority.”

110. See Rhee, *supra* note 101, at 1156 (restating the argument that the purpose of tort negligence is to spread losses, but the purpose of the corporate duty of care is to incentivize risk taking).

111. See *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (reasoning that because shareholders can diversify their investments, “it is in [shareholders’] economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the *highest risk adjusted rate of return first*”).

112. *Id.*

113. In the area of tort law, juries second-guess alleged negligent actors all the time, whether the actors are acting as tugboat operators, bargees, landlords, road construction workers, drivers, pharmaceutical companies, or crane operators. Defendants and plaintiffs are free to offer expert testimony as to how reasonable actors in particular fields operate, and jurors are generally free to hold defendants to higher or lower standards than custom recommends. The main exception to this practice is in the area of medical malpractice, where expert testimony as to the standard of care of a reasonable physician is generally held to be binding on the jury.

hindsight.¹¹⁴ Relatedly, if all business decisions that turned out to be bad were actionable in court, corporations might spend corporate time and resources defending lawsuits, depleting shareholder profits. If management continually makes poor decisions, shareholders can sell their shares far more easily than they can file a lawsuit.

The countervailing argument is that insulation from mistakes may go too far.¹¹⁵ The prospect of accountability can have the healthy effect of deterring almost-egregious mistakes and incentivizing thoughtful decision-making processes. However, the past 30 years of duty of care litigation, at least in Delaware, reflects legislators' and courts' willingness to say that shareholders accept the possibility of director mistakes except in the most glaring instances.

2. Successful (Delaware) Duty of Care Cases

When asked to cite a successful duty of care case in Delaware, corporate lawyers would almost certainly name *Smith v. Van Gorkom*.¹¹⁶ Though the Delaware Supreme Court ultimately held that the board of directors was grossly negligent in approving an acquisition of Trans Union Corporation by a group led by Jay Pritzker, the success of the case may be in how precisely it communicated to other boards how to avoid the same fate.¹¹⁷ Though the court held that the board violated its duty of care by not reaching an "informed business judgment," it did not weigh in on the correctness of the board's decision, solidifying the notion that the duty of care is a process duty.¹¹⁸ Courts will look not to the substance of decisions, but to whether boards were rational in their decision-making processes. In other words, had the board spent time and resources acquiring quality information, then the board would not have been liable for the same decision, however poor the result.¹¹⁹

114. If a decision turns out to be profitable, presumably no lawsuit would follow. Therefore, only unprofitable decisions will ever be brought before a court under the claim of a breach of the duty of due care.

115. See Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 404 (2007) (noting the lack of empirical data on whether judges would make mistakes judging directors' decisions, whether directors would be more risk-averse given more judicial scrutiny, and whether shareholder wealth would be maximized with more judicial scrutiny).

116. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

117. See Jonathan R. Macey, *Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW. U. L. REV. 607, 607 (2002) (arguing that the Trans Union board was unfairly punished for the sloppy actions of the CEO and that even though "the decision may have dramatically improved the quality of deliberations in corporate boardrooms, the imposition of liability on the defendants in the case seems profoundly unjust").

118. *Van Gorkom*, 488 A.2d at 893 (holding that the directors breached their fiduciary duties because they failed to go through the process of "inform[ing] themselves of all information reasonably available"). The *Van Gorkom* facts include the following: Chairman and CEO Van Gorkom had a few casual conversations with senior management regarding the possibility of a leveraged buyout before meeting with Pritzker and suggesting such a leveraged buyout at \$55 per share, which Pritzker immediately accepted. *Id.* at 865–67. Van Gorkom then presented the agreement to the board during a one-hour meeting, at which no director reviewed the actual agreement but agreed to terms favorable to Pritzker. *Id.* at 866–70. Efforts at subsequent meetings to lessen these favorable terms had little effect, and the board made no additional effort to directly receive any independent valuations or advice. *Id.*

119. Had the board's decision gone against the weight of the information it assessed, there would be an argument that the board either did not act in good faith—losing the benefit of the business judgment rule—or

Though the *Van Gorkom* decision understandably created agitation among corporate boards,¹²⁰ the case did not bring forth a noticeable change in the number of cases in Delaware imposing liability on boards for breaches of the duty of care.¹²¹ In the years that followed, boards ensured that they spent adequate time deliberating important decisions, consulted with several expensive valuation, legal, and accounting specialists, and documented these efforts.¹²² Consequently, the Delaware courts have rewarded these practices by upholding board decisions that were arrived at with due care.¹²³ In fact, the Delaware Supreme Court has been loath to hold that a board, even a board that acts similarly to a *Van Gorkom* board, has violated its duty of care.¹²⁴

3. Section 102(b)(7)

Though the panic caused by *Van Gorkom* would prove unwarranted, the Delaware legislature responded to the case with Section 102(b)(7), which allows corporations, in their articles of incorporation, to “carve out” certain breaches of fiduciary duty for which directors will not be personally liable.¹²⁵ This provision does not, however, allow articles to limit liability “[f]or any breach of the director’s duty of loyalty,”¹²⁶ “[f]or acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law,”¹²⁷ or “[f]or any transaction from which the director derived an improper personal benefit.”¹²⁸ The glaring and obvious breach that is left over, and thus

that the board’s deliberative process was grossly negligent in ignoring the information.

120. See Lloyd L. Drury, III, *What’s the Cost of a Free Pass? A Call for the Re-Assessment of Statutes that Allow for the Elimination of Personal Liability for Directors*, 9 TRANSACTIONS: TENN. J. BUS. L. 99, 107 (2007) (describing the uncertainty following *Van Gorkom* as to whether the decision signaled greater liability for directors).

121. Henry N. Butler, *Smith v. Van Gorkom, Jurisdictional Competition, and the Role of Random Mutations in the Evolution of Corporate Law*, 45 WASHBURN L.J. 267, 280–81 (2006) (“For purposes of the duty of care and the business judgment rule, *Van Gorkom* is dead, and the business judgment rule is alive and well.”).

122. See *id.* (explaining the changes in corporate governance resulting from the *Van Gorkom* decision).

123. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 479 (2000) (“*Van Gorkom*’s greatest vice is that it conveys the inaccurate impression that claims for money damages against corporate managers for failure of attention constitute a common and viable form of litigation. . . . *Van Gorkom* represents the reality of litigation regarding a breach of the duty of care only slightly better than a unicorn represents the animal kingdom.”).

124. See *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 56 (2006) (establishing that director behavior may be far short of best practices, but not subject the board to liability, and reasoning, “[r]egrettably, the committee’s informational and decision making process used here was not so tidy. That is one reason why the chancellor found that although the committee’s process did not fall below the level required for a proper exercise of due care, it did fall short of what best practices would have counseled”); Butler, *supra* note 121, at 280 (arguing that by upholding the Disney directors’ actions regarding CEO Michael Ovitz’s pay package, the Delaware Supreme Court effectively reversed *Smith v. Van Gorkom*).

125. See Butler, *supra* note 121, at 274 (“Delaware had to adapt to the Delaware Supreme Court’s mistake or potentially lose market dominance.”).

126. DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (2011).

127. *Id.* § 102(b)(7)(ii).

128. *Id.* § 102(b)(7)(iv). The Model Business Corporation Act has a similar provision, which allows for articles of incorporation to eliminate or limit director liability except in the case of “a financial benefit received by a director to which he is not entitled, an intentional infliction of harm on the corporation or the shareholders,” or “an intentional violation of criminal law.” MODEL BUS. CORP. ACT § 2.02(b)(4)(A)–(B) & (D)

fair game for limiting director liability, is the duty of care. Therefore, with so many corporations adopting these provisions, few parties bring duty of care claims because very few claims succeed, and even those that do lack economic value.¹²⁹

Because of these obstacles, shareholders of financial firms necessarily became creative in their claims against these firms for breaches of fiduciary duty following the 2008 financial crisis. For breaches of the duty of care, the shareholders had to point to specific decisions made by the boards of directors. Shareholder plaintiffs were required to show that these decisions were not only grossly negligent (to overcome the business judgment rule), but also in bad faith (to overcome any applicable exculpation clause).

B. Excessive Risk and the Duty of Care

For the reasons stated above, few cases arising out of the financial crisis articulated the mistakes of boards of directors as breaches of the duty of care.¹³⁰ In *In re Goldman Sachs Group, Inc.*,¹³¹ shareholders challenged the decision of the board of directors to approve a compensation scheme that was in place leading up to the financial crisis as both grossly negligent and waste.¹³² The Delaware Chancery Court noted that because Goldman's charter contained an exculpation clause, to prevail on a motion to dismiss for demand futility, plaintiffs were required to "plead particularized facts that demonstrate . . . 'intentional dereliction of duty' or 'a conscious disregard' for their responsibilities, amounting to bad faith."¹³³ This court emphasized that these failures of good faith are "qualitatively different from, and more culpable than" gross negligence; i.e., different from *grossly* gross negligence. The court found that no facts gave rise to an inference that the board was either not adequately informed or was not acting in good

(2010). Neither statute allows for limiting liability for approving unlawful dividends. See Hamermesh, *supra* note 123, at 490 (offering data that shows that virtually all corporations that are incorporated in jurisdictions that allow exculpatory clauses adopt them).

129. See *In re Walt Disney*, 906 A.2d at 27 (discussing the duty of care claim). Plaintiff-appellees brought what was essentially a duty of care claim against the Walt Disney board of directors for approving the hiring and compensation package of Michael Ovitz. Both in the complaint and at appellant arguments, plaintiffs attempted an end-run around Section 102(b)(7) in several ways. Because neither the trial court nor the appellate court found gross negligence to rebut the business judgment rule, these arguments were moot. See *id.* at 46 n.37 (discussing the difficulties of bringing a duty of care claim). See also Hamermesh, *supra* note 123, at 479 ("Exculpatory charter provisions adopted pursuant to statutes, almost universally enacted since *Van Gorkom*, have rendered the damages claim for breach of the duty of care essentially non-existent."); Charles Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 583 (2002) ("Delaware's quick enactment of section 102(b)(7) reversed much of the substantive liability impact of the decision in *Van Gorkom*, so that directors today doing what the Trans Union directors did would not be subject to liability for damages.").

130. See *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Stumpf*, No. C 11-2369 SI, 2012 WL 424557, at *8 (N.D. Cal. Feb. 9, 2012) (dismissing claim for "gross mismanagement" and "abuse of control," holding that these claims are merely a "repackaging" of claims for breach of the duty of care); *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 114 n.6 (Del. Ch. 2009) (explaining that it was treating the complaint's claim for "reckless and gross mismanagement" as a claim for a breach of fiduciary duty).

131. *In re Goldman Sachs Grp., Inc. S'holder Litig.*, Civil Action No. 5215-VCG, 2011 WL 4826104 (Del. Ch. Sept. 7, 2011).

132. See *infra* Part III (discussing waste).

133. *In re Goldman Sachs*, 2011 WL 4826104, at *12 (quoting *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 693, 755 (Del. Ch. 2005)).

faith.¹³⁴ Other duty of care claims were similarly unsuccessful.¹³⁵

C. Excessive Risk, Compensation, and Waste

Another way to attempt to plead an essentially “grossly gross negligence” case is to allege waste.¹³⁶ The claim that an action of the board of directors constitutes waste is a claim that the board breached its duty of care to the corporation by taking an action with corporate assets that is not in the best interest of the corporation.¹³⁷ A showing that an excessive expenditure had no corresponding benefit to the corporation would constitute waste and rebut the business judgment rule.¹³⁸ Perhaps not surprisingly given the courts’ deference to board decisions generally, courts rarely agree with shareholder claims of waste.¹³⁹ To succeed, a plaintiff would have to prove that the corporation received essentially no benefit from the expenditure.¹⁴⁰ In essence, a corporation would have to

134. See *id.* at *16 (“At most, the Plaintiffs’ allegations suggest that there were other metrics not considered by the board that might have produced better results. The business judgment rule, however, only requires the board to *reasonably* inform itself, it does not require perfection or the consideration of every conceivable alternative.”).

135. See *In re Goldman Sachs Mortg. Servicing S’holder Deriv. Litig.*, No. 11 Civ. 4544(WHP), 2012 WL 3293506, at *10 (S.D.N.Y. Aug. 14, 2012) (applying Delaware law and dismissing claims that “(1) exiting TARP early; (2) causing Goldman to issue false or misleading RMBS registration statements; and (3) selling Litton without repairing its broken controls” were either in bad faith or without adequate information).

136. To allege waste may be to allege actions that are not examined within the purview of the business judgment rule or that are examined to rebut the business judgment rule. Either way, boards do not have discretion to commit waste. However, very few actions will constitute waste. See Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts’ Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 622–23 (2008) (describing waste as both something to rebut the business judgment rule and something outside the rule).

137. Though the duty of care is largely an inquiry into the rationality of the process behind board decisions, the claim of “waste” can be described as one that arises from an “irrational” decision, not a poorly judged decision. See *Sinclair Oil Corp. v. Levine*, 280 A.2d 717, 720 (Del. 1971) (discussing the argument that a board’s decision will not be disturbed if it can “be attributed to any rational business purpose”). The claim of waste can also be described as a vestige of the now anachronistic doctrine of *ultra vires*, which held that corporations could not take actions outside of their narrow corporate charters, including gifts and other wasteful acts. Now, corporations have broad corporate purposes to do any lawful acts, leaving the waste doctrine in a strange nether land. See *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 897 (Del. Ch. 1999) (asserting that the doctrine of waste has little application today).

138. See *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001) (“To prevail on a waste claim . . . , the plaintiff must overcome the general presumption of good faith by showing that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.”); *Sample v. Morgan*, 914 A.2d 647, 669 (Del. Ch. 2007) (“The doctrine of waste is a residual protection for stockholders that polices the outer boundaries of the broad field of discretion afforded directors by the business judgment rule.”).

139. See, e.g., *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006) (rejecting the claim that payment of a \$130 million severance payout to CEO Michael Ovitz after 14 months of employment constituted waste); *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1992) (rejecting the claim of Occidental Petroleum Corporation shareholders that approval of an expenditure of \$50 million to construct a building to be leased to the Armand Hammer Museum of Art and Cultural Center free of charge to house the extensive art collection of CEO Armand Hammer constituted waste); *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1055 (Del. Ch. 1996) (rejecting a shareholder’s claims that the corporation overpaid for, among other things, a new logo and the company that manufactured “Steak-umms”).

140. See *Harbor Fin. Partners*, 751 A.2d at 892 (quoting *Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979)) (stating that a successful plaintiff must “allege facts showing that ‘no person of ordinary sound business

virtually throw millions of dollars out a conference room window;¹⁴¹ if any reasonable person would have approved the expenditure, then it is not wasteful.¹⁴²

Though waste would not seem the most obvious claim against a corporation that suffered huge financial losses that were not the result of voluntary expenditures, some high-profile cases from the financial crisis made this argument either instead of or in addition to a duty of care claim. These cases built on a widespread concern over executive compensation, particularly compensation paid to actors at financial firms that both incurred losses and wreaked havoc on the U.S. economy.¹⁴³ These cases contend that the board of directors affirmatively created a compensation scheme for executives and others that resulted in large payouts to those who caused huge losses.¹⁴⁴ Therefore, the argument goes, the compensation schemes were wasteful.¹⁴⁵ Another route to the same result is to allege that the directors created a compensation scheme that incentivized traders to take high levels of risk.¹⁴⁶ Other cases involve large severance packages to

judgment' 'could view the benefits received in the transaction as 'a fair exchange'"); *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) ("Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.").

141. *Seinfeld v. Slager*, Civil Action No. 6462-VCG, 2012 WL 2501105, at *6 (Del. Ch. June 29, 2012) ("A plaintiff, as here, alleging waste arising from the decision of an independent board concerning employee compensation has set himself a Herculean, and perhaps Sisyphean, task.").

142. *See Harbor Fin. Partners*, 751 A.2d at 892 (quoting *Steiner v. Meyerson*, Civ. A. No. 13139, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995)) ("Put another way, if, under the facts pled in the complaint, 'any reasonable person might conclude that the deal made sense, then the judicial inquiry ends.'").

143. *See FCIC REPORT*, *supra* note 9, at 64 ("Many major financial institutions created asymmetric compensation packages that paid employees enormous sums for short-term success, even if these same decisions resulted in significant long-term losses or failure for investors and taxpayers."); Christine Hurt, *Regulating Compensation*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 21, 24 (2011) (discussing the post-crisis movement to regulate executive compensation as a renewal of older "pay without performance" movements energized by the financial crisis); Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 204–09 (2009) (describing in detail the skewed incentives of an asset manager who is rewarded for profits, but not terminated for losses).

144. *In re Goldman Sachs Grp., Inc. S'holder Litig.*, Civil Action No. 5215-VCG, 2011 WL 4826104, at *16 (Del. Ch. Oct. 12, 2011) ("The Plaintiffs' waste allegations revolve around three premises: that Goldman's pay per employee is significantly higher than its peers, that Goldman's compensation ratios should be compared to hedge funds and other shareholder funds to reflect Goldman's increasing reliance on proprietary trading as opposed to traditional investment banking services, and that Goldman's earnings and related compensation are only the result of risk taking."); *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Stumpf*, No. C 11–2369 SI, 2012 WL 424557, at *8 (N.D. Cal. 2012) (applying Delaware law and dismissing claims against Wells Fargo directors for waste in paying bonuses to employees involved in "robo-signing" scandal).

145. Another group of claims involved stock repurchases at high values prior to the financial crisis. Plaintiffs argued that the board knew that the subprime exposure would eventually lead to stock devaluation, making the billion-dollar repurchases wasteful. *See Stachr v. Mack*, No. 07 Civ. 10368(DAB), 2011 WL 1330856, at *9 (S.D.N.Y. Mar. 31, 2011) (applying Delaware law and dismissing claim that repurchase was wasteful on various grounds, including the theory that by repurchasing shares, the board sent a signal to the market that the shares were undervalued, which may have been "in the Company's best interests at the time it was made"); *In re Am. Int'l Grp., Inc. Deriv. Litig.*, 700 F. Supp. 2d 419, 427 (S.D.N.Y. 2010) (applying Delaware law and dismissing claim that 2007 \$7 billion repurchase was not actionable, though the Company purchased shares at \$61 and sold "shortly thereafter" at \$38).

146. *See In re Goldman Sachs*, 2011 WL 4826104, at *19 ("The Plaintiffs specifically contend that the Director Defendants created a compensation structure that caused management's interests to diverge from the stockholders' interests. As a result, management took risks which eventually led to unethical behavior and illegal conduct that exposed Goldman to financial liability."). *See also infra* Part IV.B (discussing oversight

fired leaders who steered the financial firms into ruin.¹⁴⁷

Generally, courts have not been receptive to these waste claims,¹⁴⁸ even in cases involving failed firms.¹⁴⁹ Courts in Delaware have routinely held that executive compensation is within the purview of the board of directors and not subject to claims questioning the judgment of the board in setting salary and bonus structures.¹⁵⁰ However, in the Citigroup Delaware derivative litigation,¹⁵¹ a waste claim was added to the main claim of failure to monitor excessive financial risk.¹⁵² Plaintiffs had complained about the board of directors approving a letter agreement in late 2007 that gave outgoing CEO Charles O. Prince \$68 million and ongoing administrative support, including an assistant and a car and driver.¹⁵³ The plaintiffs argued that this payment, with seemingly little if any consideration, was to “a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of dollars of losses at Citigroup.”¹⁵⁴ In dismissing the oversight claims, Vice Chancellor Laster did not dismiss the waste claim, holding that plaintiffs met the demand futility test and that “there [was] a reasonable doubt as to whether the letter agreement [met] the admittedly stringent ‘so one sided’ standard or whether the letter agreement awarded compensation that [was] beyond the ‘outer limit’ described by the Delaware Supreme Court.”¹⁵⁵ However, this case was dismissed in 2012 without compensation to any plaintiff or plaintiff’s attorney.¹⁵⁶ This voluntary dismissal seems to imply that the plaintiffs doubted whether the claim had any value at all, particularly given Citigroup’s 102(b)(7) exculpation clause in its charter, which may have applied to a waste claim,¹⁵⁷ unless the claim was characterized as being in “bad faith.”¹⁵⁸

claim).

147. See, e.g., *In re Am. Int’l Grp.*, 700 F. Supp. 2d at 446 (dismissing claims of waste premised on severance packages and retention bonuses paid at AIG); *In re Citigroup Inc. S’holder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009) (refusing to dismiss the one claim of waste regarding the severance package to former CEO Charles Prince for failure to make a demand when demand would have been futile). Though payment for past consideration is generally disfavored, courts in other contexts have found that bonuses at retirement and other noncontractual payments at termination may incentivize other employees to stay at the company or attract new employees. See *Seinfeld v. Slager*, Civil Action No. 6462-VCG, 2012 WL 2501105, at *7 (Del. Ch. 2012) (“The Plaintiff’s complaint is void of allegations which, if true, would lead to the conclusion that the retirement bonus, though retroactive and not required by prior contract, constituted waste.”).

148. See, e.g., *In re Goldman Sachs*, 2011 WL 4826104, at *17–18 (dismissing waste claims regarding compensation); *Stahr*, 2011 WL 1330856, at * 9 (dismissing waste claim regarding stock repurchases).

149. See, e.g., *In re Am. Int’l Grp.*, 700 F. Supp. 2d at 443 (dismissing complaint alleging waste regarding the firing of its CEO with severance and the compensation of his replacement).

150. See *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (reasoning that “the size and structure of executive compensation are inherently matters of judgment”).

151. See *infra* Part IV.B (discussing the oversight claims against the board of directors that were dismissed).

152. See *In re Citigroup*, 964 A.2d at 138–39.

153. *Id.* at 138

154. See *id.* (describing huge losses suffered by Citigroup under the departing CEO).

155. See *id.* (reasoning that without knowing what the company received in return via a side agreement that contained various releases, a non-compete clause, a non-disparagement clause, and a non-solicitation agreement, reasonable doubt existed, taking plaintiffs allegations as true).

156. *In re Citigroup, Inc. S’holder Derivative Litig.*, No. 3338-VCG, 2012 WL 628347 (Del. Ch. Feb. 23, 2012).

157. See Answer at 30–31, *In re Citigroup S’holder Derivative Litig.*, No. 3338-CC, 2009 WL 4821755 (Del. Ch. Mar. 31, 2009) (asserting both the business judgment rule and Citigroup’s 102(b)(7) exculpation clause as affirmative defenses).

Other than this short-lived victory, compensation waste claims against firms that suffered in the financial crisis have not been successful.

IV. THE DUTY OF LOYALTY

A. The Duty of Oversight

The duty of loyalty historically has been applied to situations in which an agent has discretion as to how to employ a resource belonging to a principal and must be constrained not to employ that resource for the agent's own gain. In other words, the agent must not self-deal.¹⁵⁹ In corporate law, the duty of loyalty is traditionally described as encompassing the duty of noncompetition, the duty of confidentiality, and the duty against self-dealing, including the duty not to usurp corporate opportunities.¹⁶⁰

In *In re Caremark International Inc. Derivative Litigation*,¹⁶¹ the Delaware courts recognized a claim for breach of fiduciary duty against directors who fail to properly engage in oversight of firm employees who themselves engaged in problematic activities.¹⁶² Though the board of directors does not affirmatively vote on the behavior in question in such a case, the board is tasked with monitoring or supervising firm employees. The *Caremark* court explained that a successful oversight claim would adequately allege and prove that the board failed to put in place mechanisms to ferret out the specific bad behavior in the face of "red flags."¹⁶³ However, the board would not breach the duty if the board had no reason to know that problematic behavior could occur and that some sort of controls were necessary.¹⁶⁴ A breaching board is one that refuses to

158. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011) (disallowing limitations of liability for, among other things, breaches of the duty of loyalty and breaches "not in good faith").

159. See D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1404-05 (2002) (describing opportunism in the fiduciary relationship).

160. See Alces, *supra* note 102, at 249 (noting that self-dealing must be monetary in nature to warrant court intervention and "[c]ourts tolerate all kinds of self-interested behavior by directors who use their position for personal, though non-monetary, advantage"); D. Gordon Smith & Jordan C. Lee, *Discretion*, 75 OHIO ST. L.J. (forthcoming 2014), available at papers.ssrn.com/so13/papers.cfm?abstract_id=2238287## (describing loyalty as refraining from self-interested behavior).

161. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). Thirty years earlier, the Delaware Supreme Court held that a board could not be liable for employees' illegal or wrongful misconduct unless the directors "ignored either willfully or through inattention obvious danger signs of employee wrongdoing." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). *Caremark* lowers this very high threshold for liability. See Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 81-82 (2011) ("Under *Graham*, directors' liability rested on whether the board was aware of wrongdoing or misconduct and failed to address the prohibited activities.").

162. Notably, this claim was recognized in *Caremark*, but the claim was unsuccessful. Though the firm became subject to substantial civil damages relating to alleged Medicare and Medicaid fraud perpetrated by its employees, the court held that the board satisfied its duty by having a monitoring system in place. *In re Caremark*, 698 A.2d at 971-72. The court speculated that "only a sustained or systematic failure of a director to exercise reasonable oversight" would constitute a breach of duty. *Id.* at 971.

163. See *id.* at 969 (interpreting *Graham* "as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf").

164. See *South v. Baker*, 62 A.3d 1, 13-20 (Del. Ch. 2012) (dismissing an oversight complaint against a company with three serious mining accidents in a year because plaintiffs could not allege facts that the directors

act in the face of a duty to act.¹⁶⁵ However, a failure to act cannot be inferred from a bad outcome or significant financial liability.¹⁶⁶ In addition, if the board has a mechanism in place, but the mechanism fails, this alone would not constitute a breach of the oversight duty.¹⁶⁷

Though the *Caremark* court did not specify whether this “oversight” duty was part of the duty of care or the duty of loyalty, the Delaware Supreme Court eventually situated this duty into the duty of loyalty.¹⁶⁸ Though this evolving interpretation may seem unexpected, this judicial turn saves the oversight cause of action from extinction. If oversight cases involved breaches of the duty of care, then these cases would disappear in the presence of 102(b)(7) exculpation clauses.¹⁶⁹ However, because oversight cases allege a breach of the duty of loyalty, which cannot be exculpated, parties will continue to bring these cases and have a chance of surviving a demand hearing in the derivative context.¹⁷⁰

B. Excessive Risk as a Breach of the Duty of Oversight

Because of both the business judgment rule and 102(b)(7) exculpation provisions, the most promising legal theory for the duty to manage risk is that it is part of the oversight duty. In other words, the duty to manage risk is really the duty to oversee those who are tasked with managing risk. This also makes sense given that few of the

knew of the mining accidents; rejecting the argument that directors must have known). In dismissing the complaint as to the plaintiffs in front of him, but not all possible plaintiffs, Vice Chancellor Laster emphasized the importance of specific facts and not just presumptions arising from the existence of three accidents in one year:

Like any simplistic bright-line rule, a three-incidents-in-a-year test would be easy to administer. And concededly the number three has a lot going for it. Three Graces. Three Fates. Three wishes from the djinni in Aladdin’s lamp. It’s the number of licks it takes to get to the center of a Tootsie Pop, and for fans of *Schoolhouse Rock*, it will always be a magic number. But three mining accidents in a year does not support a reasonable inference of board involvement, much less bad faith, conscious wrongdoing, or knowing indifference on the part of a board of directors, particularly where the incidents appear unrelated. In a large corporation engaged in a dangerous business, three incidents could readily happen in a single year because of decisions made and actions taken sufficiently deep in the organization for the board not to have been involved.

Id. at 18.

165. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation of good faith.”).

166. See *id.* at 372 (explaining that oversight duty analysis does not, with the ability of hindsight, equate a bad outcome with bad faith).

167. See *id.* (explaining that a satisfactory oversight process may not guarantee that no employee will violate criminal laws or incur a substantial financial liability, or both).

168. *Id.*

169. See *Johnson*, *supra* note 161, at 83–86 (discussing the uncertainty after *Caremark* as to whether an oversight claim was a duty of care claim subject to 102(b)(7) exculpation clauses, a new kind of duty of care claim not subject to 102(b)(7) exculpation clauses because it involves bad faith, or something else).

170. To prove that demand on the board of directors is futile, derivative plaintiffs must show that a majority of the board is not disinterested. If a director faces the possibility of liability, then the director is interested. If, however, the director faces no possibility of liability from the claim alleged because of an exculpation clause, then the director is disinterested. *Aronson v. Lewis*, 473 A.2d 805, 817 (Del. 1984).

financially devastating trading decisions, if any, were approved by boards of directors.¹⁷¹ Therefore, most lawsuits that have attempted to hold directors liable for excessive risk taking by firm employees have situated this problem within the duty of oversight.¹⁷² Though directors and executive officers did not make any decisions about specific trades, investments, or sales of derivative products, the agents that they supervised did. Therefore, one could argue that these defendants created an environment in which excessive risk taking was encouraged and rewarded, without putting in place mechanisms to monitor firm-wide positions for excessive and undiversified risk. However, these plaintiffs have also met significant doctrinal hurdles.¹⁷³ Though the duty of oversight is not subject to the business judgment rule or exculpation clauses, it “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”¹⁷⁴ The initial set of hurdles is factual. First, the board of directors must not have any type of risk-management system in place,¹⁷⁵ but must be on notice of the problem because of the existence of “red flags.”¹⁷⁶ These facts are not easily alleged,¹⁷⁷ particularly against a modern corporation with various levels of board and executive committees.¹⁷⁸

171. See *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 122–23 (Del. Ch. 2009) (explaining how oversight cases do not involve an analysis of the content of a director decision because no such decision of the directors was made).

172. *Id.* at 131 (dismissing complaint by shareholders of Citigroup alleging a *Caremark* claim for failure to monitor risk and observing that “[o]versight 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”).

173. See *id.* at 125 n.159: (quoting *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)) (internal quotation marks omitted) (“Director liability based on the duty of oversight is possibly the most difficult theory in corporate law upon which a plaintiff may hope to win a judgment.”).

174. *In re Caremark*, 698 A.2d at 967.

175. *In re Citigroup Inc. S’holder Derivative Litig.*, No. 07 Civ. 9841, 2009 WL 2610746, at *6 (S.D.N.Y. Aug. 25, 2009) (applying Delaware Law, and stating that the board had a system in place in its “Audit & Risk Management Committee”).

176. *In re Goldman Sachs Mortg. Servicing S’holder Derivative Litig.*, No. 11 Civ. 4544(WHP), 2012 WL 3293506, at *6–7 (S.D.N.Y. Aug. 14, 2012) (distinguishing an earlier case brought by Countrywide shareholders in California on the basis that no red flags existed in this case); *In re Am. Int’l Grp. Derivative Litig.*, 700 F. Supp. 2d 419, 437 (S.D.N.Y. 2010) (“General warnings about difficulties in a sector of the financial markets, however, were insufficient to have put [the directors] on notice of any risk particular to AIG.”).

177. See *In re China Agritech, Inc. S’holder Derivative Litig.*, C.A. No. 7163-VCL, 2013 WL 2181514, at *20 (Del. Ch. Feb. 21, 2013) (reflecting the court’s skepticism toward oversight claims, remarking on “the parade of hastily filed *Caremark* complaints that Delaware courts have dismissed” and “those rare *Caremark* complaints that prior decisions have found adequate”).

178. For example, even Countrywide Financial had an Audit Committee, a Credit Committee, a Finance Committee, a Compensation Committee, and an Operations and Public Policy Committee, in addition to others. See *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1052 (C.D. Cal. 2008) (stating the obligations of an Audit and Ethics Committee). Citigroup also had an Audit and Risk Management Committee. See *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 127 (Del. Ch. 2009) (“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.”); see also Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L. Q. 487, 503 (2003) (arguing that after *Caremark*, boards overreacted to the negligible risk of personal liability by

Second, plaintiffs must convince the court that *Caremark* claims apply not only to a duty to monitor against wrongful misconduct, but also to a duty to monitor against poorly strategized conduct. Breaches of the duty of oversight have typically been associated with illegal conduct on the part of firm actors that subject a firm to government fines and penalties.¹⁷⁹ In fact, *Caremark* itself was a case in which employees of the firm were successfully investigated for fraud under federal programs such as Medicaid and Medicare.¹⁸⁰ Courts have been hesitant to extend *Caremark* claims from the criminal wrongdoing context to the mismanagement context.¹⁸¹ Individual directors and officers would be liable to shareholders for their own decisions to engage in illegal misconduct. Therefore, turning a blind eye to the possibility of illegal misconduct in the face of red flags seems appropriately actionable by shareholders. However, given the business judgment rule, individual directors and officers are not liable to shareholders for their own negligent conduct. Accordingly, courts are extremely reluctant to create an oversight duty where no primary duty exists.

Again, plaintiffs won a victory against Countrywide Financial in the same consolidated cases that gave them a victory in the securities fraud context, though this victory would prove ephemeral. In the Central District of California, the federal district court denied a motion by various Countrywide defendants to dismiss shareholders' oversight claims in a derivative suit filed in the state where Countrywide was headquartered.¹⁸² Applying Delaware law, the court held that "red flags" existed because directors and officers knew that deviations from underwriting policies occurred in almost all loan originations and knew of the increase in mortgage delinquencies in the market.¹⁸³ However, the claims of the shareholders in that case would soon be extinguished by

implementing internal compliance structures to deter organizational misconduct).

179. See, e.g., *In re China Agritech, Inc.*, 2013 WL 2181514, at *19–22 (noting a failure to have an acting audit committee to monitor fraud); *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 362 (Del. 2006) (noting a failure to monitor compliance with Federal Bank Secrecy Act); *Guttman v. Jen-Hsun Huang*, 823 A.2d 492, 494 (Del. Ch. 2003) (involving an action regarding a failure to monitor securities fraud).

180. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 963 (Del. Ch. 1996).

181. Notably, in the shareholder lawsuit filed against AIG in 2004, Delaware Chancellor Leo Strine refused to dismiss a complaint alleging a breach of the duty of oversight based on the fact that officers "knowingly tolerat[ed] inadequate internal controls and knowingly fail[ed] to monitor their subordinates' compliance with legal duties" in the context of widespread securities fraud that he compared to a criminal enterprise. *In re Am. Int'l Grp., Inc. Consol.*, 965 A.2d 763, 798–99 (Del. Ch. 2009). This conduct subjected AIG to investigations by state and federal authorities and the imposition of steep fines. See Paritosh Bansal & Steve Eder, *AIG to Pay \$725 Million to Settle Fraud Case*, REUTERS (July 16, 2010), <http://www.reuters.com/assets/print?aid=USTRE66F5JO20100716> (noting that this amount was in addition to a \$115 million settlement with individual AIG defendants). The derivative case was eventually settled for \$90 million. See Victor Li, *AIG Derivative Suit Against Greenberg Settles for \$90 Million*, LAW.COM (Aug. 31, 2010), http://www.law.com/jsp/article.jsp?id=1202471287313&AIG_Derivative_Suit_Against_Greenberg_Settles_for_90_Million&slreturn=20130701174019.

182. *In re Countrywide*, 554 F. Supp. 2d at 1074.

183. The Countrywide opinion covers both securities fraud claims and oversight claims and seems to allow the analysis of the existence of securities fraud claims as proof of the existence of a properly alleged oversight claim in disallowing a motion to dismiss. See *id.* at 1077 ("The finding of a strong inference of at least deliberate recklessness . . . applies equally to the analysis of the failure of oversight claims. Because Plaintiffs have stated a claim under this theory, the Court denies Defendant's Motion to Dismiss for all Defendants except Dougherty and Snyder.").

operation of law when Bank of America (B of A) acquired Countrywide.¹⁸⁴ In a case brought by Countrywide shareholders in Delaware, alleging that B of A's acquisition price was too low because it did not value those extinguished derivative claims of the shareholders, the Delaware Court of Chancery signaled its disfavor with those claims. Rejecting plaintiffs' assertion that the extinguished claims were worth \$2 billion, the court stated "[t]here is little reason to doubt" that the "remaining allegations of fiduciary duty violations centered on process or oversight" are of "negligible value."¹⁸⁵

The Court of Chancery's evaluation of the value of the *Countrywide* oversight claim has been consistent with its treatment of similar oversight claims arising out of the failure of financial firms to effectively monitor risk leading up to the financial crisis. In fact, one month before its opinion in the *Countrywide* case, the Court of Chancery dismissed claims premised on risk oversight against Citigroup Inc.¹⁸⁶ The Chancery Court pointedly remarked that the *Citigroup* plaintiffs were not alleging a failure to monitor "employee misconduct or violations of law" but "Citigroup's *business risk*, specifically its exposure to the subprime mortgage market."¹⁸⁷ The Court characterized the complaint as attempting to create a breach of oversight duty out of a breach of the duty of care, which would be subject to the business judgment rule and not hold directors liable "because they failed to fully recognize the risk posed by subprime securities."¹⁸⁸ The court further reminded plaintiffs that the business judgment rule requires the court to look to whether the decision-making process was in good faith and rational, but "whether a judge or jury considering the matter after the fact believes a decision substantively wrong or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability."¹⁸⁹ The Delaware Chancery Court remained unmoved against similar claims against Goldman Sachs as well.¹⁹⁰

184. Bank of America agreed to purchase Countrywide in a stock-for-stock acquisition in early 2008. See Gretchen Morgenson & Eric Dash, *Bank of America to Buy Countrywide*, N.Y. TIMES (Jan. 11, 2008), http://www.nytimes.com/2008/01/11/business/worldbusiness/11ihn-bofa.3.9157464.html?_r=0 (valuing the deal at \$4 billion, \$500 million less than the market capitalization of Countrywide). However, this acquisition has proven to be extremely troublesome for B of A. See Ben Protess, *Tallying the Costs of Bank of America's Countrywide Nightmare*, N.Y. TIMES DEALBOOK (Oct. 25, 2012, 5:19 PM), <http://dealbook.nytimes.com/2012/10/25/tallying-the-costs-of-bank-of-americas-countrywide-nightmare/> (calculating the current costs of payouts for various allegations against Countrywide's lending practices at over \$40 billion).

185. *In re Countrywide Corp. S'holders Litig.*, C.A. No. 3464-VCN, 2009 WL 846019, at *14 (Del. Ch. Mar. 31, 2009).

186. See *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 136 (Del. Ch. 2009) (ruling that shareholders failed to adequately demonstrate that demand was futile regarding breach of fiduciary duty claims as well as claims of waste). This derivative lawsuit appeared before the court on a motion to dismiss on the grounds that the shareholders did not make a pre-suit demand on the board of directors to sue (themselves) on behalf of the corporation under Delaware Rule 23.1. The standard of review then is whether demand would have been futile given particularized factual allegations that raise a reasonable doubt that the directors are disinterested and independent. See *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984) (establishing a standard for when a stockholder's demand can be excused as futile). Directors would not be disinterested if they faced personal liability from the claim; in other words, the question almost becomes whether the claim has a colorable chance at being successful against the majority of the directors. The *Citigroup* court said "no", at least as to the oversight claims.

187. *In re Citigroup*, 964 A.2d at 123.

188. *Id.* at 124.

189. *Id.* at 122.

190. See *In re Goldman Sachs Group, Inc. S'holder Litig.*, Civil Action No. 5215-VCG, 2011 WL

In the *Goldman* case, plaintiffs attempted a slightly different approach than the unsuccessful *Caremark* claim in *Citigroup*. Among other things, plaintiffs alleged that the board failed to oversee actions that exacerbated business risk, but also that the board failed to supervise “unethical trading practices,” including the so-called “Abacus” transaction.¹⁹¹ The court was not persuaded, stating that “‘disloyal and unethical trading practices’ are not sufficient pleadings of wrongdoing or illegality necessary to establish a *Caremark* claim.”¹⁹² Furthermore, even though the Abacus transaction resulted in a hefty civil settlement with the SEC, the court did not seem willing to find the “red flag” necessary for a breach of oversight duty from a “unique,” “single transaction.”¹⁹³ Though the court did not hold that a *Caremark* claim could never arise from business risk alone, the court did not leave much room for parties to plead such a claim, suggesting that claims centered on “[t]he manner in which a company ‘evaluate[s] the trade-off between risk and return’” would always be protected by the business judgment rule.¹⁹⁴ Vice-Chancellor Glasscock left open only the following situation:

The plaintiff would essentially have to show that the board *consciously* failed to implement any sort of risk monitoring system or, having implemented such a system, *consciously* disregarded red flags signaling that the company’s employees were taking facially improper, and not just *ex-post* ill-advised or even bone-headed, business risks. Such bad-faith indifference would be formidably difficult to prove.¹⁹⁵

C. Excessive Risk Claims in the Southern District of New York

As part of an arguably growing trend, shareholders of Delaware corporations are bringing derivative cases against boards of directors in other jurisdictions.¹⁹⁶

4826104, at *22 (Del. Ch. Oct. 12, 2011) (holding that stockholders’ derivative action did not sufficiently claim a breach of duty by corporate directors to oversee the corporation’s business risk).

191. *Id.* at 19–21. The Abacus transaction involved the creation and sale of a collateralized debt obligation by Goldman “with input from the hedge fund founder John Paulson,” who then later took a short position in the same CDO, with Goldman’s knowledge. After an SEC investigation, Goldman settled in 2010, paying \$550 million in disgorgement and fines. See Press Release, Sec. & Exch. Comm’n, *Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO* (July 15, 2010), available at <http://www.sec.gov/news/press/2010/2010-123.htm>. This widely reported transaction led to Section 913 of the Dodd–Frank Act, which required the SEC to consider imposing fiduciary duties on brokers in similar transactions.

192. *In re Goldman*, 2011 WL 4826104, at *20.

193. See *id.* at *21 (explaining that “[t]he single Abacus transaction without more is insufficient to provide a reasonable inference of bad faith on the part of the Director Defendants”).

194. *Id.* at *22 (quoting *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 126 (Del. Ch. 2009)).

195. *Id.* at *22 n.217.

196. See Sean J. Griffith & Alexandra D. Lahav, *The Market for Preclusion in Merger Litigation*, 66 VAND. L. REV. 1053, 1068 (2013) (summarizing the scholarship as finding that many cases are brought in Delaware and other jurisdictions simultaneously or in one of a few other jurisdictions); see also John Armour et al., *Delaware’s Balancing Act*, 87 IND. L.J. 1345, 1345 (2012) (stating that “a majority of shareholder suits involving Delaware companies are being brought and decided elsewhere”); Matthew D. Cain & Steven M. Davidoff, *A Great Game: The Dynamics of State Competition and Litigation* 29 (Jan. 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984758 (“[W]e find that attorneys respond to incentives by selecting states which have previously made more favorable decisions.”).

Accordingly, shareholders attempted the same post-crisis claims in other jurisdictions, notably the Southern District of New York. Of course, other jurisdictions have to apply Delaware law to fiduciary duty claims against corporations incorporated in Delaware, but as happened in the *Countrywide* California litigation, some variations in applying Delaware law to the facts may occur. However, plaintiffs attempting to pioneer a risk-oversight duty were not successful in the Southern District of New York, either.¹⁹⁷ At least regarding Delaware law, any duty to monitor risk is only theoretical,¹⁹⁸ if it exists at all.¹⁹⁹

D. The Theoretical Possibility of a Duty to Monitor Risk

Whatever glimmer of possibility remains for a successful oversight claim involving excessive business risks is vanishingly small. Oversight claims in general are extremely hard to plead; claims involving poor business decisions seem to be impossible to plead without much more.²⁰⁰ Therefore, a claim of failure to monitor poor business decisions seems like the product of multiplying a very tiny fraction by an even smaller fraction,

197. *In re* Goldman Sachs Mortg. Servicing S'holder Deriv. Litig., No. 11 Civ. 4544(WHP), 2012 WL 3293506, at *6 (S.D.N.Y. Aug. 14, 2012) (distinguishing this case from the *Countrywide* opinion on the basis that no red flags existed in this case proving that directors and officers knew of a specific problem and ignored it); *Staehr v. Mack*, No. 07 Civ. 10368(DAB), 2011 WL 1330856, at *8 (S.D.N.Y. Mar. 31, 2011) (dismissing an oversight claim for failing to monitor false disclosures related to subprime exposure, distinguishing *Countrywide* on the basis of "no red flags"); see also *La. Mun. Police Emps. Ret. Sys. v. Pandit*, No. 08 Civ. 7839(LTS)(ALE), 2009 WL 2902587, at *12 (S.D.N.Y. Sept. 10, 2009) (dismissing a derivative action alleging breach of oversight duty relating to auction rate securities market); *In re* Citigroup Inc. S'holder Deriv. Litig., No. 07 Civ. 9841, 2009 WL 2610746, at *5-6 (S.D.N.Y. Aug. 25, 2009) (dismissing derivative action alleging breach of duty for "allowing" Citigroup to invest in RMBS and related securities as the same oversight claim dismissed earlier in the Delaware Citigroup litigation); *La. Mun. Police Emps. Ret. Sys. v. Blankfein*, No. 08 Civ. 7605(LBS), 2009 WL 1422868, at *5 (S.D.N.Y. May 19, 2009) (dismissing a derivative action alleging breach of oversight duty relating to auction rate securities market).

198. See *In re* Goldman Sachs Grp., Inc. S'holder Litig., Civil Action No. 5215-VCG, 2011 WL 4826104, at *22 n.217 ("While a valid claim against a board of directors in a hierarchical corporation for failure to monitor risk undertaken by corporate employees is a theoretical possibility, it would be, appropriately, a difficult cause of action on which to prevail.").

199. Of course, not all corporations are incorporated in Delaware and subject to Delaware law. Other states may not prove as hostile to these oversight claims. *FDIC v. Spangler*, 836 F. Supp. 2d 778, 789-90 (N.D. Ill. 2011).

200. Professors Hill and McDonnell do not seem to argue that courts should impose liability on the Citigroup and Goldman boards for the oversight duties at issue in the Delaware cases, but they do seem to wish for a more robust *Caremark* doctrine that would have allowed the claims to survive until trial, where other facts may have been revealed. See Hill & McDonnell, *supra* note 22, at 876 (concluding that even when Delaware courts hold for defendants, they reinforce norms of proper board behavior, something that neither case did, perhaps because neither survived long enough). In addition, the authors wish that the Delaware courts, at the end of the presentation of all the evidence, could have given a "good ol' Delaware sermon" in the vein of *Van Gorkom* or *Walt Disney*, in which judges spill a lot of judicial ink telling current and future directors exactly how not to make decisions, whether or not liability is imposed. See, e.g., *In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 736 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("Thus, as of December 12, [CEO] Ovitz was officially terminated without cause. Up to this point, however, the Disney board had never met in order to vote on, or even discuss, the termination at a full session, and few if any directors did an independent investigation of whether Ovitz could be terminated for cause. As a result, the Disney directors had been taken for a wild ride, and most of it was in the dark.").

approaching zero.²⁰¹

As the duty of care cases make clear, courts will not second-guess corporate actors' business decisions. The policy reasons for this well-settled maxim of corporate law underlie the business judgment rule and are discussed in Part II. One of the two most compelling arguments is that judges are not well-suited by education, profession, or situation to second-guess decisions made at an earlier time after the result of that decision is apparent.²⁰² Thus, the business judgment rule attempts to insulate those decisions from an uninformed evaluator with hindsight bias. The other oft-stated reason for the business judgment rule is that diversified shareholders prefer their directors to be risk-seeking, not risk-averse.²⁰³ Risk-seeking directors will prefer projects with higher rewards, potentially benefitting residual claimants with limited liability. If directors could be sued for the projects that failed, then shareholders would have two bites at every project apple. However, that design would leave directors choosing only low-risk or no-risk projects, creating little benefit for shareholders. In addition, others have argued that if more lawsuits were allowed for everyday business decisions, qualified directors would not expose themselves to personal liability by serving in the capacity of director, particularly that of outside director.²⁰⁴ A similar argument has been made for having significant hurdles for *Caremark* oversight claims—qualified individuals will be more likely to serve as directors.²⁰⁵

However, the decisions at the core of the failure to monitor risk claim are the very types of decisions that corporate law has wanted to keep insulated from shareholder complaints and judicial hindsight bias. Had boards of directors made these decisions, they would be protected by the business judgment rule and not subject to shareholder claims of a breach of the duty of care, unless the decisions were grossly negligent. Additionally, even if the decisions were grossly negligent, directors would not be subject to personal liability under an exculpation clause. In these financial crisis cases, the directors are

201. One might wonder why the Delaware courts have left the question open at all regarding this theoretical oversight duty. Perhaps Vice-Chancellor Glasscock did not want to foreclose a cause of action without the Delaware Supreme Court having a case in front of them. On the other hand, some scholars have posited that Delaware courts are responsive to the competition for charters and litigation, and so may not want to push case law so definitively as to push shareholder attorneys to file in other jurisdictions. See Matthew D. Cain & Steven M. Davidoff, *Delaware's Competitive Reach*, 9 J. EMPIRICAL L. STUD. 92, 95 (2012) (implying that both legal practitioners and the judiciary respond to competition for cases, stating "Delaware's edge in the market for corporate law may be dependent on its ability to produce law that is attractive to merging corporations").

202. See Mark Roe, *Corporate Short-Termism in the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 991 (2013) ("Consider that the judicial deference embedded in the business judgment rule is based in large measure on the presumption that judges are poorly positioned to make, or to second-guess, boardroom business decisions.").

203. See Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301, 347 (2013) ("It is clearly in the shareholders' interests that courts should assess the duty of care in this way, for otherwise the directors would act in a more risk-averse way than diversified shareholders would desire.").

204. See *Air Line Pilots Ass'n, Int'l v. UAL Corp.*, 717 F. Supp. 575, 582 (N.D. Ill. 1989) (articulating the theory of encouraging board service as a justification for the business judgment rule).

205. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) ("[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.").

charged with failing to monitor poor business decisions that corporate law has put out of the reach of shareholder lawsuits. At least under the existing framework of the duty to monitor, claiming an actionable oversight duty to monitor others' unactionable negligence seems illogical.²⁰⁶

1. Oversight + Securities Fraud

Within the existing framework, one type of successful claim could look similar to the rare, but not quite mythological, successful oversight claim.²⁰⁷ The easier type of claim would be one based on false statements relating to risk exposure. Securities fraud is unlawful and subjects the corporation to fines and shareholder liability; failure to monitor unlawful conduct is a traditional oversight claim.²⁰⁸ This type of traditional oversight claim is difficult to plead; if the statements are made by individual officers and are not part of an SEC filing the directors approved, then the board of directors would have to see warning signs that the false statements were being made and do nothing to correct them. Even then, the false statements regarding risk exposure would have to be actionable under federal securities law, which has been difficult for plaintiff shareholders to prove regarding most qualitative statements about risk exposure.

2. Red Flags + Failure to Act

The second type of claim, the failure of oversight of financial risks without fraud or wrongful conduct²⁰⁹ that Vice Chancellor Glasscock describes,²¹⁰ may approach the mythological. For this type of oversight claim, the board of directors must either have intentionally failed to put in place a risk monitoring system in the face of evidence that one was necessary or have a risk monitoring system but intentionally ignore any form of flashing lights or sirens that system produces.²¹¹ A modern, publicly held corporation in the United States that faces any type of financial risk²¹² will almost certainly have a monitoring system in place.²¹³ If financial risks are small or improbable, then a risk-

206. *In re Goldman Sachs*, 2011 WL 4826104, at *22 (“If an actionable duty to monitor business risk exists, it cannot encompass any substantial evaluation by a court of a board’s determination of the appropriate amount of risk. Such decisions plainly involve business judgment.”).

207. See Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 968 (2009) (“There is no doctrinal reason that Caremark claims should not lie in cases in which the corporation suffered losses, not due to a failure to comply with applicable laws, but rather due to lax risk management.”).

208. *In re Am. Int’l Grp., Inc. Consol. Deriv. Litig.*, 965 A.2d 763, 798–99 (Del. Ch. 2009).

209. See Bainbridge, *supra* note 207, at 968 (“[T]here is no basis in the underlying policy concerns for limiting Caremark to cases involving lax law compliance.”).

210. See *In re Goldman Sachs*, 2011 WL 4826104, at *22 n.217 (describing how a plaintiff would prove an oversight claim).

211. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369 (Del. 2006) (stating that the Caremark standard of oversight liability draws heavily on the failure of a director to act in good faith).

212. See Johnson, *supra* note 161, at 66 (describing the evolution of “enterprise-wide risk management” methods at financial institutions); but see Bainbridge, *supra* note 207, at 970–71 (citing a 2002 survey of corporate directors in which 43% of respondents “said that their boards had either an ineffective risk management process or no process for identifying and managing risk at all”).

213. Two recent Delaware Court of Chancery decisions that denied motions to dismiss in oversight cases involved (non-financial firm) companies based in China that gained access to the U.S. capital markets through reverse mergers and did not appear to have working audit systems in place to guard against accounting and

monitoring system would not be required, and a board would not be acting in bad faith by not implementing one. Once the board has put a system in place, the board would have to intentionally abandon it.²¹⁴ Hypothetically, a board might form a risk management committee that never meets²¹⁵ or put controls in place regarding limits on particular financial products in certain sectors that are routinely waived or ignored.²¹⁶ However, the decisions of such a committee regarding levels of risk would not create a cause of action against the board, as long as the process for setting limits and controls was rational.²¹⁷ In the 2008 financial crisis, many people across numerous firms with sophisticated players and internal structures made similar decisions.²¹⁸ Proving that each or any of those decisions was made in bad faith, the product of an irrational process or of no process would be nearly impossible.

V. A NEW DUTY?

Regardless of the unwillingness of Delaware law to recognize a duty to monitor risk within the existing duties of care and loyalty, other states may decide differently, either applying law from one of the other states to a corporation incorporated there or interpreting Delaware law differently. Legislatures or the authors of the Model Business Corporation Act²¹⁹ could amend corporation statutes, including a new duty alongside the

other frauds. *See In re China Agritech, Inc. S'holder Deriv. Litig.*, C.A. No. 7163-VCL, 2013 WL 2181514, at *20 (Del. Ch. May 21, 2013) (inferring bad faith of Audit Committee when, among other things, the company did not respond to a books and records request under Section 220 of the Delaware General Law); *Rich ex rel. Fuqi Int'l v. Chong*, 66 A.3d 963, 983 (Del. Ch. 2013) (“The board of directors may have had regular meetings, and an Audit Committee may have existed, but there does not seem to have been any regulation of the company’s operations in China.”). In these cases, the court could not find evidence that Audit Committees, required of listed U.S. companies, served any purpose in attempting to prevent the various frauds that were perpetrated by the respective issuers. *Rich*, 66 A.3d at 982. Other red flags were common, including problems with outside auditors. *In re China Agritech*, 2013 WL 2181514, at *9.

214. The closest set of litigated facts to this non-ideal would be the facts of the California *Countrywide* decision. *See In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1058–64 (holding that an oversight claim was supported by facts alleging that the company “abandoned” underwriting standards at the same time that board members received monthly reports of defaults, delinquencies, and negative amortizations). In other cases, courts can point to the existence of committees and their continued operations as evidence that the board has fulfilled its duty. *See generally Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007) (analyzing in detail oversight claims with respect to backdating stock options).

215. In *China Agritech*, the Audit Committee did not meet. *See In re China Agritech*, 2013 WL 2181514, at *12. In *Rich*, the company stopped paying the Audit Committee’s investigators. *Rich*, 66 A.3d at 972.

216. Another twist on the excessive compensation claim is the claim that directors breached their duty by approving compensation plans that had the effect of incentivizing excessive risk taking. These claims have also been dismissed as an effort to repackage unsuccessful oversight-of-risk-taking cases into (also unsuccessful) oversight-of-compensation cases. *See Am. Int'l Grp., Inc. Deriv. Litig.*, 700 F. Supp. 2d 419, 445 (S.D.N.Y. 2010) (stating that the directors’ decision to offer a compensation package largely consisting of stock and stock options to the board chairman was protected by the business judgment rule from a claim of waste of corporate assets).

217. *See Lisa M. Fairfax, Sue on Pay: Say on Pay’s Impact on Directors’ Fiduciary Duties*, 55 ARIZ. L. REV. 1, 30 (2013) (“So long as the process is sufficient, courts will not probe the substance of the decision, even if the decision can be viewed as a poor one or a mistake.”).

218. *See Langevoort, supra* note 54, at 1222–23 (discussing two theories of the cause of the excessively risky trading decisions at the heart of the crisis: behavioral biases and moral hazard, but not irrationality).

219. *See* MODEL BUS. CORP. ACT § 8.30 (2010) (containing a fairly statutory description of director

traditional ones. Delaware courts could change course. Or, as has been the case in recent years, the federal government could step in if regulators believe that state law is lacking in its regulation of corporate governance.²²⁰ However, doctrinal and federalism issues aside, the creation of a mechanism for review of management activities in the area of risk management seems incredibly unwise on a number of axes.

A. Duty to Manage Risk Is Inconsistent with Fiduciary Duty Law

Not only does current state fiduciary law not allow for a duty to manage risk, but such a duty is also inconsistent with existing duties and limitations. In limiting the duty of care through the business judgment rule, courts and legislatures have expressed a disinterest in, and even an opposition to, judicial interference with internal business decisions. Expanding the reach of the duty of loyalty to encompass monitoring employees' decisions involving financial risk is inconsistent with the existence of the business judgment rule. To the extent that the investment community wishes for courts to impose liability, at a minimum, for grossly negligent decisions regarding risk, exculpation clauses would need to be prohibited or required to be amended to allow for liability for gross management of business risk without a showing of bad faith or lack of a legitimate business purpose.

Fiduciary duties create boundaries around agents' discretion in situations that seem objectively against the principal's interest either because of the agent's bad motivations, self-interest, or purposeful neglect. Firm employees do not generally have interests adverse to the firm when they expose the firm to financial risk because of risky proprietary decisions. Employees took these decisions with the anticipation, whether well-reasoned or not, of profits for the firm.

B. Duty to Manage Risk Would Be Inherently Unmanageable

Assuming a duty to manage risk existed, courts would have to have some criteria for assessing whether that duty was met²²¹ other than the end results of various projects and enterprises.²²² Because courts have the benefit of hindsight, many decisions that seem

"standards of conduct").

220. Beginning with the Sarbanes–Oxley Act of 2002 (SOX), commentators have shown concern that the federal government was encroaching on corporate governance, an area historically left to state control. Both SOX and the Dodd–Frank Act contain provisions empowering the SEC to promulgate rules to empower shareholders in the areas of increased disclosure, proxy access, and executive compensation. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)) (amending regulations related to executive compensation); *id.* § 971 (codified as amended at 15 U.S.C. § 78n(a) (2012)) (amending regulations related to proxy access). Conceivably, the SEC could mandate structures or disclosure of risk-monitoring mechanisms, as it has done with disclosure of any connection between executive compensation and inappropriate risk. Alternatively, Congress could create a federal fiduciary duty to oversee risk management. *See Johnson, supra* note 161, at 106 (discussing downsides of such duty and possible attempts by the Federal Reserve to ensure that systemically important financial institutions (SIFIs) have risk management policies).

221. *See* Wulf A. Kaal & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1438 (2010) (admitting the controversy over "whether there is any such thing as excessive risk, and if so, how excessive risk is to be defined").

222. *See id.* at 1449 ("In most cultural settings, risk taking is not viewed as excessive simply because the

defensible at one time period seem indefensible at a later time period.²²³ No decision is risk-free, whether it involves purchasing assets, selling or purchasing derivatives, or acting as a market maker. No decision will result in profit 100% of the time, and various levels of profits will have various probabilities of occurring.²²⁴ In addition, even if a project had a 95% chance of being profitable, 5% of the time it would not be, and shareholders would still bring failure to monitor claims. If the decision is judged under an objective, reasonable person standard,²²⁵ then the duty to monitor becomes nothing more than the duty of due care.

Also, just as individuals have different appetites for risk, so do firms. If a firm's management is comfortable with high levels of risk taking, then there is nothing inherently incompetent, unethical, or illegal about that. Shareholders sort themselves into low- or high-risk firms or industries. Of course, problems arise when a firm or industry moves from being a low-risk firm to a higher-risk one, as firms such as commercial banks and mortgage lenders did leading up to 2008. Firms can move from being innovators to being static, but shareholders are in a better position to monitor their managers than courts after the fact. If excessive risk-taking harms anyone, it is the shareholder. If risk taking is firm-specific, then risk-taking discipline should be left to the market.

Some risky behavior, such as illegal behavior, has external consequences but internal rewards. Courts have recognized an oversight duty to ferret out illegal activity because firms might not have an incentive to do so; illegal activity might increase profits, not cause losses. However, firms should have ample incentive to monitor risk taking because poor risk management leads to immediate losses. The demonization of risk taking occurred during the financial crisis when a number of firms were creating systemic risk by being high-risk at the same time and in the same direction. However, these firms felt the losses in tandem with the market.²²⁶

Additionally, a duty to monitor risk implies, rightly or wrongly, that there is an optimal amount of risk, at least for a specific firm. Perhaps this amount varies from firm to firm, time to time, or industry to industry, but at any moment there is a perfect amount of risk, or perhaps an acceptable band of risk.²²⁷ If so, then shareholders should be able

risk did not pan out and somebody lost money.”).

223. One notable case in point is the *Walt Disney* litigation. The idea that a group of directors voted to approve a pay package that would pay a fired, and by all accounts lackluster, CEO \$140 million for 14 months' work seems ridiculous. However, as the court pointed out, at the time the employment agreement with Michael Ovitz was negotiated and signed, Disney was attempting to recruit one of Hollywood's most successful agents, whose own business paid him over \$20 million a year, and get him to try a new career in the middle of his life. To encourage Ovitz to take this risk, Disney created a compensation package designed to guarantee Ovitz the equivalent of five years' salary and bonus. However, the effect was that when Ovitz was fired so early in his contract, the per-month severance package seemed astronomical. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 51 (Del. 2006).

224. See Bainbridge, *supra* note 207, at 971 (“Evaluating such extremely low probability, but very high magnitude, risks is challenging because the outcomes associated with such risks do not follow a normal distribution.”).

225. See Kaal & Painter, *supra* note 221, at 1450 (discussing the prudent person standard for monitoring risk).

226. This statement is not intended to overlook the fact that many financial firms have recaptured profits much sooner than homeowners who lost their homes or their jobs have recovered.

227. See Karl S. Okamoto & Douglas O. Edwards, *Risk Taking*, 32 CARDOZO L. REV. 159, 163 (“[A]ssuming that compensation-related regulations could be rightly calibrated to reduce risk-taking incentives,

to bring an action not only for exceeding the acceptable band of risk, but also for not meeting it.²²⁸ Perhaps during a particularly auspicious economic time, when many investments have high rates of return, an institution might opt for the least risky, least rewarding projects. If a duty to manage risk exists, then that duty should encompass taking relevant and appropriate risks as well. This hardly seems like a breach of duty, but logically it would have to be. If courts can determine how much risk is too much risk, then courts would also be able to determine how much risk is too little.

Finally, the financial crisis litigation focused on financial risks taken by primarily financial firms. However, a duty to monitor or manage risk would necessarily encompass other sorts of risks at all firms.²²⁹ Firms might be liable for not being able to predict consumer tastes (leading to excessive business risk)²³⁰ or being able to predict global events (leading to excessive political risk).²³¹ Firms might not be able to predict litigation risk arising from licenses or patents. The numerous everyday decisions that firms make may all be characterized as decisions made under uncertainty involving some type of risk.²³² Some theory of the duty to monitor financial risk from proprietary trading or market making would have to articulate why that kind of financial risk is either more worthy of or more capable of being enforced by shareholders through the court system. Otherwise, as the courts have warned, a duty to manage risk inevitably comes full circle, becoming like all other exercises of business judgment.

C. Duty to Manage Risk as a Disclosure Duty

Given adequate information, shareholders should be able to choose between firms that have significant amounts of financial risk, such as particular kinds of financial institutions not subject to additional layers of regulation that apply to commercial banks. Within a group of firms, shareholders should be able to choose between firms that are risk-seeking and firms that are more conservative. In a perfect world, shareholders should have been able to choose between investing in mortgage lenders that focused on

we fail to see how regulators could set a fulcrum point for determining *when* risk taking becomes socially undesirable. Because the prevailing view seeks to address the question of financial stability via the reduction of excessive risk taking, ‘excessive’ should be defined.”).

228. See Bainbridge, *supra* note 207 at 982–83 (“Just because a firm has the ability to reduce risk does not mean that it should All else equal, shareholders therefore prefer high return projects.”).

229. *But see* Orenstein, *supra* note 22, at 789 (arguing for a *Caremark* duty to monitor risk in financial firms only because financial firm managers are incentivized to take on and allow excessive risk at their highly leveraged firms, unlike naturally risk-averse managers at nonfinancial firms).

230. The attempt to extend early victories by the *Countrywide* plaintiffs has already gone in this direction, though unsuccessfully. See *In re Las Vegas Sands Corp. Deriv. Litig.*, Nos. A576669, A580258, A582074, slip op. at 14, 2009 WL 6038660 (D. Nev. Nov. 4, 2009) (holding that there is no oversight duty to manage business risks).

231. See Perry E. Wallace, *Climate Change, Fiduciary Duty, and Corporate Disclosure: Are Things Heating Up in the Boardroom?*, 26 VA. ENVTL. L.J. 293, 333 (2008) (arguing that extending fiduciary duty, particularly oversight duties, to addressing climate change “is not entirely out of the question” and “will become increasingly more relevant with the accelerating pace of scientific knowledge about climate change”).

232. See Bainbridge, *supra* note 207, at 988 (citing to a pre-*Countrywide* decision dismissing a *Caremark* claim against Ford Motor Co. for various decisions regarding parts and design of vehicles); see also Salsitz v. Nasser, 208 F.R.D. 589, 589 (E.D. Mich. 2002) (dismissing claims involving specific director decisions under the business judgment rule and claims involving business decisions that directors were not involved in under *Caremark*).

subprime mortgage products and lenders that specialized in conforming mortgages with strict lending criteria. However, as we have seen with lawsuits involving Countrywide Financial and other firms, disclosures of business products and financial assets are not particularly clear for the average investor.²³³ Moreover, if a shareholder invests in a very large enterprise, such as Citigroup or another bank holding company, sorting out the various types of financial risks in disclosure documents would be beyond most investors' time and attention.

One alternative to a new fiduciary duty would be to enhance the quality and readability of disclosures regarding financial risk.²³⁴ The SEC could issue regulations that would mandate different kinds of disclosures, perhaps creating standard ways of presenting financial information.²³⁵ However, as with any additional mandatory disclosure,²³⁶ more information may not necessarily be helpful information.²³⁷ For many firms, the information regarding financial risk was publicly disclosed, but the reader would have had to interpret the information as signaling large amounts of risk.²³⁸ Or, courts could follow *Countrywide* and hold issuers liable for federal securities fraud for misleading qualitative statements such as "conservative" and "quality." This route would be more investor-friendly, but would also be over-inclusive and lead to many more securities fraud lawsuits.

VI. CONCLUSION

Shareholders, consumers, homeowners, borrowers, employees, and other citizens were harmed, in some cases substantially, by the business practices of individuals at various financial firms leading up to the 2008 financial crisis. After other financial crises, including the 2001 accounting fraud scandals, the public was treated to the catharsis of criminal prosecutions or even large civil judgments and settlements, but this rarely happened after the 2008 crisis. Instead, financial firms that incurred large losses on behalf of their shareholders repeatedly withstood those shareholders' attempts at legal redress.

233. See Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1110 (2008) ("Most, if not all, of the risks giving rise to the collapse of the market for securities backed by subprime mortgages were disclosed, yet the disclosure was insufficient, in part because complexity made the risks very difficult to understand.").

234. See Kaal & Painter, *supra* note 221, at 1473 (positing that allowing company managers to take risks, even firm-ending risks, with the benefit of the business judgment rule, may be preferable because a strict disclosure regime provides the incentive for directors to monitor and disclose risk).

235. See Robert Bartlett, *Making Banks Transparent*, 65 VAND. L. REV. 293, 295–96 (2012) (discussing proposals to increase disclosure of financial firms so market participants can make better investment decisions following the financial crisis).

236. The Dodd–Frank Act required the SEC to adopt rules mandating specific disclosures related to asset-backed securities, just one of many types of financial products; see 17 C.F.R. § 240.15Ga-1 (2011) (discussing repurchases and replacement relating to asset-backed securities). See also Joan MacLeod Heminway, *The SEC's New Line-Item Disclosure Rules for Asset-Backed Securities: MOTS or TMI?*, 35 HAMLINE L. REV. 385, 385–90 (2012) (discussing SEC disclosure rules).

237. See Kaal & Painter, *supra* note 221, at 1470 (discussing the conundrum that, though U.S. disclosure requirements are quite strict, managers are able to hide material facts about complex financial transactions in mandatory disclosures).

238. See Steven M. Davidoff & Claire A. Hall, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 599–629 (2013) (discussing security disclosure in the aftermath of the 2008 financial crisis).

Shareholders were turned away from the courthouse door in cases involving federal securities law claims and claims of breaches of state law fiduciary duties. Scholars and commentators have focused on one area of fiduciary duty that seemed to fit: a claim that the board of directors of a firm failed to exercise its oversight duty to monitor firm-wide financial risk. However, this claim was also unsuccessful in the courts as judges viewed the duty to monitor risk as repackaging the duty of care, which is significantly shielded from judicial review. Therefore, shareholders were left without a cause of action for admittedly “boneheaded” decisions of managers in light of changing economic circumstances.

This Article argues that the failure of the duty to monitor risk is not a bad development, but a logical and reasoned one. To say that shareholders, and by extension, courts, should not second-guess business decisions of boards of directors that are the result of a rational process, but to say that shareholders can second-guess the supervision of boards of those same decisions is inconsistent with decades of corporate governance jurisprudence. To make room for this duty within the duty of oversight or to create a separate duty to monitor financial risk would have the consequence of opening a side door to the questioning of all kinds of legal business decisions that have within them an element of business risk, political risk, currency risk, environmental risk, or legal risk. Though the oversight duty had been cabined to holding directors responsible for the crimes and wrongful acts they should have known were being perpetuated by firm employees, the duty to monitor risk would subject legal but risky actions to judicial scrutiny. This eventuality would, in effect, reduce the business judgment rule to a nullity.

Financial firms, particularly those firms that are not subject to banking regulation, will have a level of financial risk in their portfolios. Investors who choose to participate in this sector can sort themselves into firms with riskier or steadier focuses and endeavors. Of course, this type of market sorting is only possible with quality information in the market about the portfolios of these firms. Regulators’ ability to improve the amount and readability of the information disclosed through additional mandatory disclosures, however, is a contestable point. Developing more consistent securities fraud jurisprudence surrounding qualitative statements by financial firms as to their conservative strategies, soundness, and high-quality portfolios may be more helpful to investors who focus on textual statements rather than lengthy quantitative disclosures. However, eroding existing doctrines of puffery in disclosure statements could subject issuers to liability for such statements as “we have a great line of products” when a particular product does not sell. Unfortunately, equity investing is risky, though the law attempts to decrease certain risks, such as the risk of fraud or self-dealing. Some risks, however, the law has chosen to let remain, such as the risks of mismanagement and management mistake.²³⁹ Financial risk seems to fall within this category.

239. See Kaal & Painter, *supra* note 221, at 1448 (“Risk taking can be intentional or unintentional. Examples of intentional and sometimes ill-informed risk taking include investments in risky real estate deals in the 1980s and the purchase of some CDOs and other mortgage-backed securities by investment banks and institutional investors prior to the 2008 credit crisis. Examples of unintentional risk taking include miscalculations in valuation models or algorithmic trading. While unintentional risk taking can impose additional costs on the institutions that incur it because of the added element of surprise, both intentional and unintentional risk taking can be costly, and sometimes more costly than the benefits derived there from.”).
