Delaware Chancery Court Revisits Oversight Liability and Corporate Waste

March 25, 2009

The Delaware Court of Chancery recently handed down what is likely to be an influential decision relating to oversight liability of directors and the doctrine of corporate waste. *In re Citigroup Shareholder Derivative Litigation*, C.A. No. 3338-CC, 2009 Del. Ch. LEXIS 25 (Feb. 24, 2009), involved claims brought by shareholders of Citigroup (the "Company") against current and former directors and officers of the Company, alleging various claims relating to the Company's subprime lending practices and investments that ultimately left the Company exposed to massive losses and also relating to excessive compensation practices. In the decision, the Court: (1) declined to hold directors in violation of their fiduciary duties for their alleged failure to monitor and manage the Company's subprime-market risk exposure in the face of publicly available warning signs; (2) declined to hold directors in violation of their fiduciary duties for the Company's alleged failure to disclose its exposure to subprime assets; and (3) allowed to go forward a claim relating to the size of the former chief executive officer's severance package, under the theory of corporate waste.

The *Citigroup* decision is expected to be influential for several reasons:

- The decision presents a detailed review of several areas of Delaware law, in particular the directors' duty of oversight.
- The Court's analysis is likely to have a significant impact on pending and future derivative suits arising out of the current economic crisis.
- The Court gave new vitality to the doctrine of corporate waste, which may engender additional derivative actions, particularly in light of the current climate of public scrutiny over the size of executive compensation.
- The decision is a clear sign that the Court will not allow established doctrines of Delaware law to be circumvented in order to assess liability on directors in the face of the current economic crisis.

Demand Futility

The Court first summarized the threshold issue of demand for a derivative action to proceed under Delaware law. Under the standard, a shareholder must either: (1) show that the directors wrongfully refused to bring suit, in response to a shareholder's pre-suit demand on the directors to do so; or (2) plead facts showing that demand upon the directors would have been futile.

Focusing on the second option, the Court next described the two tests used to analyze demand futility, both of which demonstrate the unwillingness of a court to set aside a board decision unless the plaintiff has shown some reason to doubt that the board will exercise its discretion impartially and in good faith. In the context of a claim arising out of board *action*, the test in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), requires a plaintiff to show demand futility by providing particularized factual allegations that create a reasonable doubt that (1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. In the context of a claim arising out of board *inaction*, the test in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), requires a plaintiff to show demand futility by providing particularized factual allegations that create a reasonable doubt that, as of the time the complaint is filed, the directors could have properly exercised its independent and disinterested business judgment in responding to a demand, particularly as a result of a substantial likelihood of director liability.

Oversight Liability

In their first claim, the *Citigroup* plaintiffs alleged that the defendants breached their fiduciary duties for failing to properly monitor and manage the Company's risk exposure in the subprime mortgage market in the face of public information indicating worsening conditions in the subprime and credit markets. Identifying this public information as "red flags," the plaintiffs claimed that the "red flags" should have put defendants on notice of the problems with the Company's subprime investments.

Since the claim related not to board action, but rather to a failure of the board to take action, the Court explained, the applicable analysis for demand futility was the *Rales*test. Accordingly, the plaintiffs alleged that the directors would be unable to exercise independent and disinterested business judgment in responding to a demand because they would face a substantial likelihood of personal liability for their lack of proper oversight that resulted in the overexposure of the Company to risk in the subprime market.

The plaintiffs derived their theory of "oversight" liability from the Court of Chancery's opinion in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (hence the reference to such claims as "*Caremark* claims"). The *Citigroup* Court explained that director oversight liability "was based on the concept of good faith, which . . . was embedded in the fiduciary duty of loyalty and did not constitute a freestanding fiduciary duty that could independently give rise to liability." The *Citigroup* Court explained that a finding of oversight liability, as explained in *Stone* *v. Ritter*, 911 A.2d 362 (Del. 2006), requires the directors to have either "(a) . . . utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." The Court further clarified that the plaintiffs must show that "the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious*disregard for their responsibilities" and that, in addition, "a showing of bad faith is a*necessary condition* to director oversight liability."

The Court characterized the plaintiffs' theory as "a bit of a twist on the traditional*Caremark* claim." Whereas a typical *Caremark* case involves liability for damages arising from a failure to properly monitor or oversee employee misconduct or violations of law, the *Citigroup* plaintiffs proposed to extend *Caremark* to reach directors' alleged failure to properly monitor the Company's *business risk*. The Court explained that it saw the plaintiffs' claims instead as an attempt to hold the defendants liable for making business decisions that, in hindsight, turned out poorly for the Company, and that the better analysis for such claims is under the Business Judgment Rule. The Court explained that it was "almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the 'right' business decision" partly due to "hindsight bias," which is "the tendency for people with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted."

Under the Business Judgment Rule, a court will not second-guess a business decision of the board of directors, absent evidence of gross negligence: "if the directors employed a rational process and considered all material information reasonably available" in making a business decision, the decision will stand. Although the Court initially seemed to indicate that it would apply this analysis in lieu of *Caremark*, the Court focused primarily on the *Caremark* requirement of proof of bad faith, which requires a plaintiff to "plead particularized facts that demonstrate that the directors acted with scienter." Although the Court suggested that a plaintiff could allege "particularized facts that show that a director*consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business," the Court explained that the plaintiffs faced an extremely high burden to state a claim for personal director liability for a failure to see the extent of a company's business risk.

The Court found the plaintiffs' factual allegations to be insufficient to demonstrate bad faith on the part of the defendants, determining that: (1) the warning signs alleged by the plaintiffs were "nothing more than signs of continuing deterioration in the subprime mortgage market" and, at best, evidence that the directors made bad business decisions; (2) at no point did the plaintiffs allege how the defendants' oversight mechanisms were inadequate or how the defendants knew of these inadequacies and consciously ignored them; (3) at no point did the plaintiffs explain what the defendants did or failed to do that would give rise to a violation of their fiduciary duties; and (4) the plaintiffs' allegations that the defendants must have seen and consciously ignored the warning signs or knowingly failed to monitor the Company's risk in accordance with their fiduciary duties were nothing more than "conclusory allegations."

The Court distinguished its holding from its recent decision in *American International Group, Inc. Consolidated Derivative Litigation*, C.A. No. 769-VCS, 2009 Del. Ch. LEXIS 15 (Del. Ch. Feb. 10, 2009), in which the factual allegations of failure to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct were sufficient to survive a motion to dismiss. The *Citigroup* Court, explaining that failing to predict business risk is fundamentally different from failing to oversee employee fraudulent or criminal conduct, stated that "oversight duties . . . are not designed to subject directors . . . to personal liability for failure to predict the future and to properly evaluate business risk." The Court queried:

If the Court were to adopt plaintiffs' theory of the case . . . then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags?

What remains unclear about the Court's holding is whether the theory of oversight liability will be available in cases not involving internal fraudulent and criminal action. At times, the Court indicated disfavor with extending the analysis to situations involving other aspects of director oversight. However, the Court indicated that there could be a set of facts under which liability could be found; and its holding seemed to hinge more on the plaintiffs' lack of factual allegations that had been pled to support the claim, than any concern it might have had with extending the duty of oversight beyond the context of fraudulent and criminal actions impacting the company. At a minimum, since the Court went to great length to distinguish the fraudulent and criminal nature of the actions at issue in the *AIG* case and to emphasize the dangers of judicial interference with business decisions, it appears that the Court is likely to tread lightly in extending oversight liability to novel contexts.

Disclosure

In their second claim, the plaintiffs alleged that the defendants breached their fiduciary duties for failing to properly disclose the Company's exposure to subprime assets. The Court explained the applicable legal standard for failure of duty of disclosure:

Even in the absence of a request for shareholder action, shareholders are entitled to honest communication from directors, given with complete candor and in good faith. When there is no request for shareholder action by the board, a shareholder plaintiff can demonstrate a breach of fiduciary duty by showing that the directors *deliberately* misinformed shareholders about the business of the corporation, either directly or by a public statement.

As with the oversight liability claim, the Court determined that the plaintiffs' disclosure claim did not satisfy the *Rales* test, due to the plaintiffs' failure to plead with particularity, relying again on conclusory allegations about what the defendants must have known in the face of "red flags." The Court explained that the plaintiffs failed to identify which disclosures were misleading and what the Company was obligated to disclose, what board involvement there was in the preparation of the disclosures that would implicate their liability, or that the defendants had any knowledge that any public statements were false or misleading, thereby failing to satisfy their obligation to prove that a disclosure violation was made in bad faith, knowingly or intentionally.

Corporate Waste

In the plaintiffs' third claim, they alleged that certain defendants were liable to the Company for corporate waste for, among other actions, approving a multimillion-dollar severance package for Charles Prince, the Company's former chief executive officer, upon his retirement in November 2007. Unlike the first two claims, the plaintiffs' claims for corporate waste related to board *action*. Consequently, the Court explained, the applicable analysis for demand futility was not the *Rales* test, but rather the second prong of the *Aronson* test. Accordingly, the plaintiffs alleged that the approval of the transactions at issue did not constitute a valid exercise of business judgment by the board.

The Court explained that to overcome the Business Judgment Rule in the context of a claim of corporate waste, the Court would analyze "whether there was 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." The Court further explained that a plaintiff "must allege particularized facts that lead to a reasonable inference that the . . . defendants authorized an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." Specific to executive compensation, the Court explained that, although directors have broad discretion to make executive compensation decisions, "there is an outer limit to the board's discretion to set executive compensation, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."

Applying this analysis, the Court allowed the claim relating to the Prince severance package to proceed, concluding that the plaintiffs alleged sufficient facts to raise a reasonable doubt as to whether the severance package satisfied the "so one sided" standard or whether the compensation awarded was beyond the "outer limit" of the board's discretion. The Court indicated that what remained to be considered was how much additional compensation Prince actually received and the real value, if any, of the various agreements and releases given by Prince as consideration for the severance package.

Impact

Even though the defendants in *Citigroup* were found not liable for failure to monitor the business risk of the Company, directors may want to ensure their companies have oversight procedures and controls that monitor activity that may result in major losses for the company, whether such activity is internal or external. At a minimum, such controls should monitor fraudulent and criminal activity by employees of the company. Moreover, directors may want to ensure that they receive meaningful information from company oversight systems and respond as appropriate. If effective oversight controls are in place and the directors reasonably monitor these controls systems, it is unlikely that directors will be held liable on a theory of oversight liability.

Relating to compensation, directors may want to consider the *Citigroup* case in the context of the current economic climate and, accordingly, should have a heightened sensitivity to granting what may be perceived as excessive compensation. Even though the standard of proof remains very high, the *Citigroup* decision is likely to leave open a window of opportunity for shareholders to bring claims relating to executive compensation and severance packages under the doctrine of corporate waste; directors may want to keep themselves apprised of developments in future cases. An increase in compensation-related claims is likely to follow.

For Further Information

If you have any questions regarding this Alert or would like more information, please contact any member of the Corporate Practice Group or the attorney in the firm with whom you are regularly in contact.