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In re Citigroup: The Birth Announcement and Obituary of the Duty of Business Performance Oversight (Back to Top)

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Introduction

The Court of Chancery in *In re Citigroup Inc. Shareholder Derivative Litigation*,[1] acknowledged for the first time that a duty to oversee business risk exists under Delaware law and *Caremark* specifically, but the life of that duty was short. It may live on doctrinally, but in practice, *Citigroup* has made it extraordinarily difficult for a plaintiff to prevail on such a theory, more difficult even than an ordinary *Caremark* claim, which is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[2]

The plaintiffs in *Citigroup* alleged violations of a duty of oversight based on a "failure to properly monitor Citigroup's *business risk*, specifically its exposure to the subprime mortgage market."[3] Until *Citigroup*, Delaware courts had not had occasion to directly address whether a duty to monitor business risk existed under *Caremark*.[4] While *Caremark*'s progeny helped to clarify the board's duty to ensure the proper functioning of the corporation's legal and regulatory compliance oversight systems, none had squarely addressed the scope of the board's duty to oversee the corporation's business risk or performance.[5] This is surprising given that *Caremark* itself referenced the board's duty to implement reporting systems "concerning *both* the corporation's compliance with law *and its business performance*."[6] In this article, I discuss the broader duty to oversee business performance of which the oversight of business risk at issue in *Citigroup* is a part. This article first discusses the framework created by *Caremark* and its progeny and then discusses *Citigroup* and its impact.

Caremark *and Progeny*

Caremark

Caremark is often considered a landmark Delaware decision because it allowed stockholders to hold directors liable for breach of the fiduciary duty of loyalty if they could "show[] that the directors were conscious of the fact that they were not doing their jobs."[7] Prior to *Caremark*, exculpatory charter provisions adopted pursuant to Section 102(b)(7) of the Delaware General Corporation Law presented an almost insurmountable barrier to plaintiffs bringing such claims.[8] *Caremark* made room for allegations that a board had been so consciously deficient in monitoring the corporation and its employees that its failure amounted to action not in good faith, a fundamentally disloyal act.[9] Because actions not in good faith are not exculpable under Section 102(b)(7), complaints that satisfied *Caremark* pleading requirements might survive a motion to dismiss, whereas, prior to *Caremark*, exculpatory clauses would have stymied them. In other words, "from the sphere of actions that was once classified as grossly negligent conduct that gives rise to a violation of the duty of care, the court has carved out one specific type of conduct -- the intentional dereliction of duty or the conscious disregard for one's responsibilities -- and redefined it as bad faith conduct, which results in a breach of the duty of loyalty."[10] The difference in potential damages makes it more attractive to bring a claim under *Caremark* than under a pure duty of care theory. This attractiveness has provided strong economic incentive to conflate violations of the duty of care with non-exculpated violations of the duty of good faith.

The directors in *Caremark* were accused of violating their fiduciary duty of care.[11] The company had been indicted for violating various federal regulations in connection with Caremark's patient care business. It reached a settlement with the federal government and state governments at a price of approximately $170 million. In addition, the Caremark board approved a $98.5 million settlement with private insurers. Plaintiffs alleged that the Caremark board failed to properly oversee the conduct that ultimately led to these settlements and in doing so violated their fiduciary duty of care. Plaintiffs had reached a settlement of their own and the court, in evaluating the settlement's fairness and adequacy,[12] focused on the intersection of the duty of care and the directors' good faith discharge of their "supervisory and monitoring role."[13]

Caremark recast the "supervisory and monitoring role under Section 141 of the Delaware General Corporation Law."[14] The Delaware courts had previously recognized the duty to supervise and monitor in *Graham v. Allis-Chalmers Mfg. Co*.,[15] but the *Graham* court construed the duty as a latent one until there was "cause for suspicion."[16] The *Caremark* court reinterpreted that duty in light of intervening events, such as the *Smith v. Van Gorkom*[17] decision and implementation of the federal organizational sentencing guidelines,[18] and found that the duty to monitor required directors to "attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."[19] "[A] sustained or systematic failure of the board to exercise oversight—such as an utter failure of the board to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[20] This was a more active requirement than existed under *Graham.* In addition, *Caremark* interpreted *Graham* to require a still more active inquiry when there was "cause for suspicion," or red flags.[21]

Caremark *Progeny*

The subsequent cases applying *Caremark* principally involved inadequate oversight of the corporation's legal, regulatory or accounting compliance systems.[22] *Guttman v. Huang*[23] involved accusations that the board had allowed the financial statements to be prepared without "ensur[ing] that the resulting statements had integrity and met legal standards."[24] *Saito v. McCall*[25] also involved allegations of improper accounting practices while *Desimone v. Barrows*[26] dealt with improper accounting practices, but in relation to stock option backdating which also implicated securities and tax laws and regulations. More recently, the Court of Chancery dealt with a motion to dismiss the allegations of massive fraud and assorted criminal conduct in *American International Group, Inc. v. Greenberg.*[27]

Before *Citigroup*, the closest a Delaware court came to discussing liability for failure to oversee ongoing "business performance" risk was a statement from *Shaev v. Armstrong*.[28] There the court implied in *dicta* that an allegation "that the board failed to ask questions about risks the company was undertaking" would state a cause of action under *Caremark*.[29] Similarly, in *Canadian Commercial Workers Indus. Pension Plan v. Alden*,[30] the Court of Chancery entertained a complaint that alleged that directors and officers had "'failed to follow the policies and procedures or standard industry practices to investigate the creditworthiness of the proposed borrowers'" and "'failed to perform their oversight responsibility to ensure that borrowers were paying the amounts due to [Case Financial] on time and in full.'"[31] The court found the complaint fatally deficient in specifics, but the court did not reject the premise outright that these allegations, which concerned a mix of substantive business practice and compliance with company policies, could form the basis of a *Caremark* claim. In *Globis Partners, L.P. v. Plumtree Software, Inc.*,[32] the plaintiffs alleged that "directors had to know" that the company had breached a contract and incurred liability.[33] Although this conclusory complaint was also dismissed, the Vice Chancellor again did not challenge the premise that this type of claim, which did not involve a compliance issue, could be brought under *Caremark*.[34]

Stone v. Ritter: *Supreme Court Approval of* Caremark

In *Stone v. Ritter*,[35] the Supreme Court of Delaware approved the *Caremark* standard and clarified the doctrine of good faith as it relates to the duty of oversight. The fact pattern of *Stone v. Ritter* was similar to that of *Caremark*. The claim in *Stone v. Ritter* was that the board should be held liable for the failure of bank employees to file suspicious activity reports.[36] These failures ultimately led to approximately $50 million of fines and civil penalties.[37] The Supreme Court of Delaware held that to show bad faith in the oversight context, a plaintiff must prove either that "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[38] *Stone v. Ritter* accomplished at least two things relevant to a duty of business performance oversight. First, it made clear that bad faith requires knowing or conscious disregard for corporate well-being. Second, it broke down the *Caremark* monitoring duty into two phases. A board must establish a system for bringing important information to its attention and then it must follow through and maintain an ongoing engagement with that system. In addition, the directors continue to have a duty to investigate yet more proactively when the information system (or other circumstances) raises red flags, a duty first laid out in *Graham*. In each instance (establishment, ongoing engagement and red flag investigation), the board is faced with a known duty to act and failure to act is a violation of the duty of loyalty.[39]

In re Citigroup: *Biography of a Fiduciary Duty*

Chancellor Chandler begins his analysis of the issue of whether there is a duty of business risk oversight under *Caremark* with a recap of the framework discussed above, putting emphasis on the fact that violations of the oversight duty entail *knowing* or *conscious* disregard of one's responsibilities.[40] Plaintiffs alleged that the Citigroup directors failed to "'make a good faith attempt to follow the procedures put in place or . . . to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market.'"[41] Further, the plaintiffs alleged the existence of various red flags that "should have put defendants on notice of the problems in the subprime mortgage market."[42] In essence, plaintiffs alleged, albeit conclusorily, failures in the establishment of the monitoring system, in maintaining an ongoing engagement with the system and an improper response to red flags.

Chancellor Chandler held that "[w]hile it may be possible for a plaintiff to meet the burden under some set of facts" the plaintiffs in *Citigroup* had fallen far short.[43] Looking at the substance of the allegations, the Chancellor saw what "appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company."[44] These types of claims, which could at worst only be violations of the duty of care,[45] are properly addressed by the business judgment rule and the law on the duty of care and, for reasons familiar to all, the court is not in a good position to reassess business decisions. "Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors."[46] With that, the court reintroduced business judgment rule analysis into oversight claims, at least those involving business performance.[47] Each decision directors make, whether discrete or not, about the manner in which the directors monitored business risk is a business decision. This is true not only for businesses like Citigroup whose stock in trade is risk itself, but just as clearly for businesses that sell other goods and services. The farmer must know how to produce a crop, but also how to manage weather risk. Claims based on violations of a duty to oversee business performance are thus fundamentally different from claims that the directors failed to properly oversee legal and regulatory compliance. This result rescues the body of corporate fiduciary law from the uncomfortable fate of being swallowed by one of its parts -- the duty of good faith. Had claims that were essentially based on violations of the duty of care been validated by the mere fact that they were framed as *Caremark* claims, the duty of care, Section 102(b)(7) exculpation, and the business judgment rule would have become hopelessly secondary.

The logic of *Caremark* does not translate well to oversight of business performance. Fundamentally, the job description of a director is to oversee business performance. Only a conscious failure to do one's job as a director,[48] a conscious failure to oversee the business that one is charged, qua director, with overseeing would constitute a breach of the duty to oversee business performance. Since the very job of a director is to oversee the business, it makes little sense to overlay an additional duty of business performance oversight through *Caremark*. The three aspects of *Caremark* (implementation of monitoring system, ongoing engagement, and red flag investigation) are a useful framework to consider whether directors were doing their jobs, but so long as the directors are not consciously abdicating their duties in those respects, good faith is not implicated.

Citigroup's *Impact: Establishment and Engagement with the Business Performance Oversight System*

Citigroup makes clear that the specific features of a particular board's method of doing its job, including how deep the business monitoring system must plumb or how "granular" it must be[49] is a business judgment unique to that corporation's particular business.[50] So long as the board's determination in this regard is made in good faith, the size of the losses incurred for their mistakes is immaterial to whether the directors fulfilled their business performance oversight duties.[51] Having admitted that Citigroup had a system in place to monitor business performance, the only way forward for the plaintiffs would have been to allege that there were deficiencies so gross as to indicate bad faith, that the defendants were aware of those deficiencies and consciously ignored them or that the directors in bad faith utterly failed to maintain an ongoing engagement with the system.[52] Chancellor Chandler noted that the mandate of the Audit and Risk Management Committee included management of the very type of risk that plaintiffs claimed was not overseen in good faith and that the Committee met frequently.[53] This was more than enough to show that the directors were doing their jobs in good faith.

While the mere size of a loss occurring because of inadequate oversight will not make the danger of liability any greater,[54] it is still somewhat unclear what impact a complete failure to account for a specific type of risk would have. The boards in *Stone v. Ritter* and *Citigroup* were found to have fulfilled their duties in good faith, but the systems the board established in each case were directed toward the specific danger that eventually surfaced. How tightly or broadly a court would characterize the purpose of the existing oversight system as compared to the source of the eventual loss could change the outcome of a *Citigroup*-type claim. If a risk surfaced for which the board took no account, but which was so obvious (even taking hindsight bias into account)[55] that the failure to even think about the risk indicates the directors were utterly failing to do their jobs to such an extent that bad faith is the only explanation, then perhaps *Caremark*-like liability would attach. The examples of such utter failures would have to be so egregious that they are more likely to appear in comic strips than a business context.[56] To truly be blindsided even after implementing in good faith a system to monitor business performance may be worthy of blame, but not of liability.[57] It merely shows that there were few "Cromwells" in this Civil War.[58]

Citigroup's *Impact: What Constitutes a Red Flag?*

The oversight system is intended to detect problems, known as red or other shaded flags. Once the red flags are detected by the oversight system (or detected outside the oversight system), the duty of the directors changes from one of oversight to one of active investigation. It is only when a board does nothing in response to a red flag that it can incur liability. *Citigroup* emphasizes that red flags are not simply bad news.[59] It is not clear precisely what a red flag is, but one plausible definition is that a red flag is information that alone or in combination with other known information presents the board with an immediately known duty to act. Under this definition, news that is accretively bad is unlikely to present a red flag because each drip only adds a drop to the bucket with little warning of the deluge on its way.[60]

Conclusion

Citigroup stands for the proposition that a claim of a violation of business performance oversight would have to actually be such and not a care claim dressed up in red flags. Such a claim must allege that directors either completely failed to set up a system to oversee the performance of the corporation, completely failed to engage with that system on an ongoing basis, or intentionally ignored a red flag, a particular piece of information that gave rise to an immediately known duty to act. Delaware corporate law has always taken pains to stay out of directors' collective way in making good faith business decisions so that the full power of the limited liability corporation can be harnessed to create societal wealth. This works in both directions. The court will stay out of the way of directors when the corporation's fortunes are rising and it will not step in when those fortunes nosedive. Delaware corporate law at its best is capable of remedying unfairness between and among the corporation's capital participants and their fiduciaries. It can do very little directly to ensure corporations run their businesses in substantively better ways. In the same way, it is not tooled to recover losses on behalf of stockholders when the directors and officers who made those mistakes made them honestly.

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[1] 964 A.2d 106 (Del. Ch. 2009).
[2] *Id.* at 125 (citing *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)).
[3] *Id.* at 123 (emphasis original).
[4] Statements from the podium rather than the bench by other members of the Delaware judiciary indicate that they had considered the possibility of business performance oversight claims under *Caremark* before *Citigroup*. Elizabeth Bennett, *Holland Leads Delegation to Present Delaware Model in Asia*, DEL. L. WKLY., Dec. 24, 2008, at 3, 5 (referencing discussions concerning duty of oversight as laid out in *Stone v. Ritter* in context of Wall Street meltdown); Video: *Views from the Delaware Bench and Keynote Debate: What to expect next?* (Video of International Corporate Governance Network Mid-Year Event), *available at* http://www.icgn.org/conferences/2008/delaware/videos.php; Francis G.X. Pileggi, Delaware Corporate Governance – Views from the Bench, Delaware Litigation Blog, December 10, 2008, *available at* http://www.delawarelitigation.com/2008/12/articles/commentary/delaware-corporate-governanceviews-from-the-bench/ (providing summary of the statements of the panel including the statements regarding *Caremark*).
[5] *See, e.g.*, Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, NYU Law and Economics Research Paper No. 08-57, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1304272; Stephen Bainbridge, *et al.*, *The Convergence of Good Faith and Oversight*, UCLA School of Law, Law-Econ Research Paper No. 07-09, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1006097; Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004); Hillary Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719 (2007); Hillary Sale, *Good Faith's Procedure and Substance*, In re Caremark International Inc., Derivative Litigation, in THE ICONIC CASES IN CORPORATE LAW (Jonathan Macey ed. 2008).
[6] 698 A.2d 959, 970 (emphasis added). "Thus, the reporting system must be timely and accurate, it must contain legal compliance and business performance information, and the information must flow to the

board in the ordinary course of business." Stephany Watson, *Fostering Positive Corporate Culture in the Post-Enron Era*, 6 TRANSACTIONS: TENN. J. BUS. L. 7, 20 (2004). "Thus, *Caremark* identified a duty for directors to put internal controls in place to reach informed judgments regarding a business's compliance with law and regarding business performance." Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 494 (2006).

[7] *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).

[8] *See* Sale, *Good Faith's Procedure and Substance*, *supra* note 5, at 1.

[9] *Id.* (noting that a *Caremark* claim "requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith").

[10] *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008).

[11] *Caremark*, 698 A.2d at 960, ("The suit involves claims that the members of Caremark's board of directors (the "Board") breached their fiduciary duty of care . . . .").

[12] *Id.* at 961.

[13] *Id.* at 970.

[14] *Id.*

[15] 188 A.2d 125 (1963).

[16] *Id.* at 130.

[17] 488 A.2d 858 (Del. 1985).

[18] *Caremark*, 698 A.2d at 970.

[19] *Id.*

[20] *Id.* at 971.

[21] *Caremark*, 698 A.2d at 969 (quoting *Graham*).

[22] *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 653 (Del. Ch. 2008) ("The line of cases running from *Graham v. Allis-Chalmers* to *Caremark* to *Guttman* to *Stone v. Ritter* dealt in large measure with what is arguably the hardest question in corporation law: what is the standard of liability to apply to independent directors with no motive to injure the corporation when they are accused of indolence in monitoring the corporation's compliance with its *legal responsibilities*?") (emphasis added, citations omitted).

[23] 823 A.2d 492 (Del. Ch. 2003).

[24] *Id.* at 506.

[25] 30 Del. J. Corp. L. 650 (Del. Ch. Dec. 20, 2004). *See also*, *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 971 (2003) (rejecting a claim that directors had a duty to "monitor the personal affairs of an officer or director").

[26] 924 A.2d 908, 933-935 (Del. Ch. 2007).

[27] 965 A.2d 763 (Del. Ch. 2009).

[28] 31 Del. J. Corp. L. 1139 (Del. Ch. Feb. 13, 2006).

[29] *Id.* at 1147.

[30] 31 Del. J. Corp. L. 1070 (Del. Ch. Feb. 22, 2006).

[31] *Id.* at 1080 (quoting complaint).

[32] C.A. No. 1577-VCP, slip op. at 17 (Del. Ch. Nov. 30, 2007).

[33] *Id.*

[34] *Id.* at 18.

[35] 911 A.2d 362 (Del. 2006).

[36] *Id.* at 365.

[37] *Id.*

[38] *Id.* at 370.

[39] *See In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006) (quoting *In re Walt Disney Deriv. Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005)).

[40] *Citigroup*, 964 A.2d at 123.

[41] *Id.* at 124 (quoting Plaintiffs' Answering Brief at 2).

[42] *Id.*

[43] *Id.* at 126.

[44] *Id.* at 124; *cf. David B. Shaev Profit Sharing Account v. Armstrong*, 31 Del. J. Corp. L. 1139, 1146 (Del. Ch. Feb. 13, 2006) ("[T]he one thing that is emphatically not a *Caremark* claim is the bald allegation that directors bear liability where a concededly well-constituted oversight mechanism, having received no specific indications of misconduct failed to discover fraud.").
[45] *See also Lyondell Chemical Co. v. Ryan*, No. 401, 2008, 2009 BL 76364 (Del. Mar. 25, 2009).
[46] *Citigroup*, 964 A.2d at 131.
[47] *Cf.* Stephen Bainbridge, *Stone v. Ritter: Directors Caremark Oversight Duties*, Business Associations Blog, *available at* http://www.businessassociationsblog.com/lawandbusiness/comments/stone_v_ritter_directors_caremark_oversight_duties/ (Jan. 3, 2007).
[48] 8 Del. C. § 141(a).
[49] *See* Ken Brown and David Enrich, *Rubin, Under Fire, Defends His Role at Citi*, WALL ST. J., Nov. 29, 2008, *available at* http://online.wsj.com/article/SB122791795940965645.html ("'The board can't run the risk book of a company,' [Robert Rubin, director of Citigroup] said. 'The board as a whole is not going to have a granular knowledge' of operations.").
[50] *See Caremark*, 698 A.2d at 970 ("Obviously the level of detail that is appropriate for such an information system is a question of business judgment.").
[51] As Chancellor Allen remarked in *Caremark*, "it could never be assumed that an adequate information system would be a system that prevented all losses. *Id.*; *see also Stone v. Ritter*, 911 A.2d at 371 ("The fact of [AmSouth's incurring the largest] losses [of this kind], however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible.").
[52] *Citigroup*, 964 A.2d at 127.
[53] *Id*.
[54] "[T]he mere fact that a company takes on business risk and suffers losses -- even catastrophic losses -- does not evidence misconduct, and without more, is not a basis for personal director liability." *Id.* at 130.
[55] *Id.* at 124.
[56] *See In re Lear Corp. S'holder Litig.*, 967 A.2d at 654-55 (Del. Ch. 2008) ("In the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.").
[57] *See* Joe Nocera, *Risk Management*, N.Y. TIMES MAGAZINE, Jan. 2, 2009 (chronicling the failure of the VAR risk model to predict the financial crisis).
[58] *Caremark*, 698 A.2d at 968 ("'While he may not have been the Cromwell for that Civil War, [the director] did not engage to play such a role.'") (quoting *Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924) (Learned Hand, J.)).
[59] *See Citigroup*, 964 A.2d at 135.
[60] *Id.* ("The 'red flags' in the Complaint amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally.").