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IN DISMISSING DERIVATIVE CLAIMS AGAINST CITIGROUP'S DIRECTORS, DELAWARE COURT OF CHANCERY DISCUSSES BOARD'S DUTY TO MONITOR AND MANAGE RISK

But Court Allows Corporate Waste Claim based on Severance Agreement with Former CEO to Proceed

When called upon to analyze stockholder claims that directors of a Delaware corporation failed to exercise proper oversight over management, the courts turn to the oft-cited opinion of former Chancellor William Allen in *In re Caremark Int'l Inc. Derivative Litigation*.[1] In the course of determining that the Caremark directors violated their fiduciary duties by failing to monitor properly corporate officers engaged in ongoing violations of Federal law, Chancellor Allen, in a "reassessment" of the traditional "red flag" standard established by the Delaware Supreme Court's holding in *Graham v. Allis-Chalmers Manufacturing Company*,[2] held that boards of directors must have systems in place designed to detect potential wrongdoing. The Chancellor set a high bar for plaintiffs attacking a corporation that has implemented such measures, requiring "a sustained or systematic failure of the board to exercise oversight." Chancellor Allen characterized this standard as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

Recently, the Delaware Court of Chancery applied *Caremark* in analyzing the alleged failure of Citigroup directors "to properly monitor and manage the risks the

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[1] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[2] *Graham v. Allis-Chalmers Manufacturing Company,* 188 A.2d 125 (Del. 1963). In *Graham*, the Court articulated the "red flag" standard by holding that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."

Company faced from problems in the subprime lending market."[3] Dismissing the plaintiff stockholders' *Caremark* claims, the Court refused to engage in a hindsight evaluation of the directors' conduct that could impose obligations on directors that would "eviscerate the core protections of the business judgment rule — protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly."

The Court's decision in *Citigroup* provides useful distinctions from another recent case arising from the current financial crisis — claims brought against former executive officers of American International Group.[4] In that case, the Court of Chancery allowed a stockholder derivative claim under *Caremark* to proceed against AIG executives (two of whom served on AIG's board) who "allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct" at that troubled company. Contrasting the allegations in *Citigroup*, the Court observed that "[w]hile it may be tempting to say that directors have the same duties to monitor and oversee business risk" as they do "to intervene and prevent frauds or other wrongdoing," "imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different." These distinctions help to clarify the parameters of the duty to monitor under *Caremark*, as well as the high degree of difficulty plaintiffs face in successfully pursuing such a claim against directors of a Delaware corporation, at least when there has been no fraudulent or illegal conduct.

Although the *Citigroup* Court dismissed all of plaintiffs' other claims, the Court refused to dismiss their claim of corporate waste based on the terms of a severance package granted by the Citigroup board to the departing CEO. In allowing this claim to proceed, the Court gave voice to the current movement to rein in, and restructure the incentives underlying, executive compensation, noting that "there is an outer limit to a board's discretion to set executive compensation."

Factual Background

As we know all too well by now, Citigroup has sustained massive losses from, among other things, its involvement with collateralized debt obligations and mortgage backed securities, much of which arose from the subprime residential lending market. By late 2007, these losses led to a precipitous drop in the price of Citigroup stock, a 57% decline in net income from Citigroup's 2006 results, significant write-downs and the ousting of Citigroup's then CEO, Charles Prince.

In the wake of these events, disappointed stockholders filed derivative lawsuits both in New York[5] and in Delaware claiming, among other things, that the defendant Citigroup directors violated their fiduciary duties under *Caremark* by failing to monitor and manage adequately Citigroup's exposure to its investments in the subprime mortgage market, despite many "red flags" indicating serious problems with these investments. The "red flags" cited by plaintiffs included negative economic reports regarding the housing market and credit

[3] *In re Citigroup Inc. S'holder Derivative Litig.*, C.A. No. 3338-CC (Del. Ch. 2009).
[4] *Am. Int'l Group, Inc. v. Greenberg*, C.A. No. 769-VCS (Del. Ch. 2009).
[5] In the Delaware action, the Court denied defendants' motion to dismiss or stay in favor of the New York action, finding that — unlike the situation in previous litigation involving the collapse of Bear Stearns — allowing the Delaware action to proceed would not "result in overwhelming hardship." For a further discussion of the *Bear Stearns* litigation, *see* our Client Alert entitled "NY State Court Decision Relating to Bear Stearns Takeover Should Provide Comfort to Corporate Directors Forced to Take Action in Unstable Markets" (December 29, 2008).

markets in general, bankruptcies of subprime lenders and (some would argue long overdue) downgrades of subprime residential mortgage-backed securities by the rating agencies. Plaintiffs claimed that these "red flags" should have put the defendant directors on alert that they had a duty to mitigate Citigroup's risk in this market. The plaintiffs also complained of several instances of corporate waste on the part of the Citigroup board, including approval of the former CEO's severance package.

Chancellor Chandler granted the defendant directors' motion to dismiss the *Caremark* claim.[6] However, while dismissing all of the other corporate waste claims, the Chancellor allowed plaintiffs' claim of corporate waste relating to the CEO severance package to proceed.

Caremark Claims

The Court's Analysis

At the outset, the Court noted the key distinction discussed in *Caremark* between the standards for imposing director liability in the case of (1) "a *board decision* that results in a loss because that decision was ill advised or 'negligent'" *versus* (2) "*an unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss." The *former* is governed by the business judgment rule, under which courts will not second guess the decision of the directors so long as "the directors employed a rational process and considered all material information reasonably available." The *latter*, a claim based on directors' "failure to monitor," requires the "sustained or systematic failure of the board to exercise oversight" found in *Caremark* as a predicate for "establish[ing] the lack of good faith that is a necessary condition to liability."[7]

Although the claims of the *Citigroup* plaintiffs fell into the latter category, the Court noted "a bit of a twist on the traditional *Caremark* claim," which typically arises from "a failure to properly monitor or oversee employee misconduct or violations of law." The *Citigroup* plaintiffs did not allege any such misconduct or violations of law, but instead grounded their purported *Caremark* claims on defendants' alleged failure to properly monitor Citigroup's business risk "by ignoring various 'red flags' that should have put the defendants on notice of the problems in the subprime mortgage market."

Next, the Court noted that because "a showing of bad faith is a *necessary condition* to director oversight liability" under *Caremark*, a plaintiff must prove "that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act." According to the Court, plaintiffs can satisfy their burden under *Caremark* "by, for example, properly alleging particularized facts that show that the 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."

[6] Consistent with this ruling, the Court also dismissed plaintiffs' claims against the defendant directors "for failing to disclose Citigroup's exposure to subprime assets." The Court based this ruling on, among other factors, its finding that "the Complaint does not sufficiently allege that the director defendants had any knowledge that any disclosures or omissions were false or misleading or that the director defendants acted in bad faith in not adequately informing themselves."
[7] Consistent with other recent Delaware decisions, the Court observed that the concept of good faith is "embedded in the fiduciary duty of loyalty" and does not constitute "a freestanding fiduciary duty that could independently give rise to liability." *See* our Client Alert entitled "Recent Delaware Decisions Temper Concerns Arising From *Ryan v. Lyondell* Discussion of Director Liability Under DGCL Section 102(b)(7)" (September 11, 2008).

Applying these principles to the claims against the Citigroup directors, the Court determined that "[p]laintiffs fail to plead any particularized factual allegations that raise a reasonable doubt that the defendant directors acted in good faith." Instead, the Court found that plaintiffs' claims represented only "conclusory allegations … not sufficient to state a claim for failure of oversight." In the Court's view, the "red flags" relied on by plaintiffs were not "evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidenced that the directors made bad business decisions." Moreover, the Court observed that the "plaintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them. Rather, plaintiffs seem to hope that the Court will accept the conclusion that because the Company suffered large losses, and because a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses." The Court refused to take this leap of faith, noting that such "conclusory allegations are exactly the kinds of allegations that *do not state a claim* for relief under *Caremark*." [emphasis added]

While the Court had little difficulty in determining that the plaintiffs had not established bad faith conduct on the part of the Citigroup directors sufficient to establish liability under *Caremark*, one powerful passage in the opinion demonstrates that the Court believed that the facts before it were inapplicable to, and did not warrant, a *Caremark* analysis:

> "Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left 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. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them — the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a 'right' or 'wrong' decision."

Directors should take comfort from the Court's observation that the business judgment rule was more applicable to the Citigroup directors conduct than the *Caremark* standard.

AIG Litigation Comparison

Comparing the *Citigroup* holding to the recent decision of the Court of Chancery in *American International Group* provides an even clearer picture of the type and level of director oversight duty envisioned by Delaware courts. In *American International Group*, the Court refused to dismiss a *Caremark* claim against top AIG executives (two of whom also served on AIG's board) accused of overseeing fraudulent schemes at the divisional level so rampant that the Court found that the plaintiffs' complaint "fairly supports the assertion that AIG's Inner Circle led a — and I use this term with knowledge of its strength — criminal organization." The *Citigroup* Court saw a difference between the circumstances facing AIG and Citigroup, however, observing that

there are "significant differences between failure to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk." The former failure, according to the Court, touches upon a corporation's obligation to have "oversight programs [in place that] allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct." The latter failure, by contrast, "would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors,[8] to *personal liability* for failure to predict the future and to properly evaluate business risk."

Conclusion

Caremark claims, while very difficult to prove, are significant because they can expose directors to the risk of personal liability. Because such claims are premised on bad faith conduct constituting a breach of the duty of loyalty, directors found to be liable under *Caremark*, *a fortiori*, are not afforded protection under charter provisions adopted under Section 102(b)(7) of the Delaware General Corporation Law.[9] Nevertheless, as reiterated by Chancellor Chandler in *Citigroup*, the touchstone of Delaware corporate law that "[i]t is 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," continues to afford directors of Delaware corporations the protection necessary to allow them to carry out their duties without fear of liability should their decisions prove to have been poorly made. The Court further points out that "this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law."

As with the recent decisions involving the shotgun weddings of Bear Stearns and Wachovia,[10] the dismissal of the *Caremark* claims in the *Citigroup* derivative litigation should provide a measure of comfort to directors of corporations who have suffered through the current financial crisis and recession. If they can establish that they acted with due care and in a disinterested manner, regardless of how clever plaintiffs' counsel dress up their claims, the business judgment rule should be the standard that courts apply to the directors' conduct. Putting this in perspective in the current environment, the *Citigroup* Court observed that:

> "It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable."

[8] The Court went on, in a lengthy footnote, to explain that directors "with special expertise are not held to a higher standard of care in the oversight context," and those who sit on committees with oversight responsibility over a company's risk profile, such as audit and risk management committees, "have additional responsibilities to monitor such risk … [but] such responsibility does not change the standard of director liability under *Caremark* and its progeny, which require a showing of bad faith."

[9] For a further discussion of the relationship between duty of loyalty claims and Section 102(b)(7), *see* our Client Alert discussed in note 7 above.

[10] *See* our Client Alert discussed in note 5 above.

Addendum on Corporate Waste and Executive Compensation

The only claim that the *Citigroup* Court permitted to go forward was plaintiffs' charge that the directors engaged in corporate waste by approving a multi-million dollar severance and benefit package for Citigroup's former CEO Charles Prince, who had left the company in late 2007 amid allegations that he shared much of the responsibility for Citigroup's woes. In exchange for Prince's entering into non-compete, non-disparagement and non-solicitation agreements, as well as a release of claims against Citigroup, the board approved a severance package that included payment of $68 million in salary, bonus and accumulated stockholdings upon his departure from Citigroup, as well as use of an office, an administrative assistant and a car and driver for the lesser of five years or until he commenced full-time employment with another organization.

According to the Court, in order to state a claim for corporate waste, a plaintiff must meet "stringent requirements" and "allege particularized facts that lead to a reasonable inference that the director 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.'" In addition, recognizing that "[t]he directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions," plaintiffs must overcome a "general presumption of good faith" by demonstrating 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."

Despite this high bar, the Court determined that the Citigroup plaintiffs' allegations established "a reasonable doubt" as to whether the CEO departure package constituted waste under Delaware law. In so ruling, the Court made it clear that "the discretion of directors in setting executive compensation is not unlimited" and recognized that "'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.'"

Notably, as recently as 2006, the Delaware Supreme Court upheld the dismissal of a claim of corporate waste brought against the Walt Disney board of directors in connection with Michael Ovitz's $130 million severance package.[11] Mr. Ovitz received his package when he left Disney, after a highly-publicized falling out with then-CEO Michael Eisner, only 14 months after having been recruited by Mr. Eisner. The *Citigroup* Court's granting of a green light to the corporate waste claims over Mr. Prince's severance arrangement probably does not reflect a change in Delaware law. However, the *Citigroup* decision, together with the Court's admonition that "the discretion of directors in setting executive compensation is not unlimited," certainly does reflect the heightened scrutiny now being paid to executive compensation by disappointed investors, Federal and state governments and regulators and the public at large. Going forward, as the calls for companies to make executive compensation more transparent and less dependent on risky business decisions intensify, boards will be required, more than ever before, to justify their executive compensation decisions not only to stockholders, but to courts as well.[12]

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[11] *See In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd* 906 A.2d 27 (Del. 2006).
[12] For instance, starting in the 2009 proxy season, commentators have suggested that companies include in the Compensation Discussion and Analysis section of their proxy statement a risk assessment statement as to whether their compensation programs are designed so that executives are not encouraged to take excessive risks.

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