A failure to monitor business risk may not be good for business, but in the eyes of the law it beats a failure to monitor legal risk.

Citigroup and AIG have both been laid low by the credit crisis, generating critical headlines, requiring federal bailouts, and inspiring talk of a new wave of regulation. Citigroup directors recently escaped liability when two influential courts dismissed shareholder derivative claims based on the directors’ alleged failure to monitor the business-risk profile of the company.

In contrast, AIG directors were unable—at least at the pleading stage—to escape shareholder derivative claims for their role in the crisis. The critical difference is that the claims against AIG were not predicated on allegations that the directors failed to monitor business risk, but that AIG directors and officers failed to adequately monitor legal risk, i.e., the monitoring of compliance with governing law, rules, and regulations.

Background—Duty to Monitor

While directors are charged with the obligation to manage the affairs of a corporation, the actual day-to-day management of the corporation is typically delegated to corporate officers. Nevertheless, directors’ oversight responsibility dictates that they have in place systems and controls to monitor the corporation’s compliance with applicable laws, rules, and regulations. Although historically the province of state law, federal law and regulations are playing an ever increasing role in director responsibilities, as are private entities, such as the stock exchanges and rating agencies. The potential consequences for breaching these obligations: liability for the corporation and personal financial liability for the director.

The Delaware Chancery Court was the first court to articulate a director’s and board’s duty of oversight in In re Caremark International Inc. Derivative Litigation. Plaintiffs’ claims in Caremark were predicated on the allegation that the directors had failed to monitor Caremark’s operations, i.e., liability premised on “unconsidered inaction,” as opposed to an affirmative board decision to act or not act. The court explained that the duty to monitor includes the board’s ability “[t]o assure itself that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”

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The court set a high standard for imposing liability on a failure-to-monitor theory: “[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”

The Delaware Supreme Court later approved of the Caremark oversight liability standard and explained that “oversight” liability is characterized by a lack of good faith. The court ruled that “Caremark articulates the necessary conditions predicate for director oversight liability: (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.” In both cases liability is predicated on a “showing that the directors knew that they were not discharging their fiduciary obligations.”

Dispelling any notion that the duty to monitor would apply only to directors, the Delaware Supreme Court has also recently confirmed that directors’ and officers’ duties of care and loyalty are identical.

No Violation of the Duty to Monitor

Two influential courts, the Delaware Chancery Court and the United States District Court for the Southern District of New York, recently declined to impose Caremark liability for a failure to monitor business risk, as opposed to a failure to monitor for wrongdoing or illegal conduct.

In In re Citigroup Inc. Shareholder Derivative Litigation, the Delaware Chancery Court rejected the plaintiff’s attempt to hold directors liable for their failure to monitor the corporation’s compliance with law and its business performance."
business risks associated with the bank’s exposure to the subprime mortgage market. The court, hostile at times to such an argument, refused to extend Caremark liability to the purported failure to monitor business risks: “While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing Caremark-type duties on directors to monitor business risk is fundamentally different.”

“Directors who engage in significant wrongdoing, such that their activity resembles a ‘criminal operation,’ will be liable under a Caremark theory of failure to monitor because their involvement in the wrongdoing demonstrates that they knew the company’s internal controls were inadequate and could be easily bypassed.”

Companies, the court noted, are in the business of balancing risk and return. Courts are not. “To impose oversight liability on the 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. Oversight duties under Delaware law are not designed to subject directors…to personal liability for failure to predict the future and to properly evaluate business risk.” The court noted that taking plaintiff’s theory to its logical conclusion would mean that defendants could be found similarly liable for their failure to predict the subprime mortgage meltdown and profit from it. The court ultimately dismissed the Caremark counts, finding that the derivative plaintiff had failed to establish the extremely high burden of showing bad faith—the necessary element to establish that 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.

The court cited a number of factors in support of its decision. For instance, Citigroup had a number of procedures and controls in place to monitor and evaluate risk, and the plaintiffs did not attempt to show how these procedures were inadequate or had been consciously ignored by the defendants. Furthermore, the plaintiff had rested its theory, for the most part, on “red flags,” which should have alerted the directors of pending Citigroup losses. But the court rejected this argument, finding that the “red flags” were merely signs of the deteriorating economic condition, rather than evidence that would support a finding of liability. In other words, the red flags failed to demonstrate that the directors had been aware of wrongdoing at Citigroup or that they were consciously disregarding their duties to Citigroup.

The Southern District of New York also declined to impose Caremark liability for a failure to monitor business risks in In re Citigroup Shareholder Derivative Litigation. There, the Caremark claims alleged against Citigroup directors were similar to those raised in the Delaware action. The Southern District relied on the reasoning of the Delaware case in rejecting the plaintiff shareholder’s claim that the Citigroup directors had acted in bad faith by failing to act as the economic downturn approached.

Notably, neither court ruled out the possibility that under some set of facts directors could possibly be held liable for their failure to monitor a company’s business risk. Thus companies should expect that this claim will continue to be alleged, especially by plaintiffs seeking damages stemming from the economic downturn. But plaintiffs will face significant hurdles and defenses to such a claim. As the Delaware Chancery Court has reasoned: “To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting the Court to perform a hindsight evaluation of the reasonableness or prudence of directors’ business decisions.”

Conduct Breaching the Duty to Monitor

In contrast to the Citigroup decisions, the plaintiffs in derivative litigation against officers and directors of AIG were permitted by the Delaware Chancery Court to proceed beyond the pleading stage. Rather than basing claims on the failure to monitor business risk, the plaintiffs in AIG asserted a more classic theory—that the directors failed to adequately monitor compliance with governing law, rules, and regulations. Generally, cases permitting plaintiffs to proceed on Caremark claims fall into two categories: (1) egregious behavior by directors evidencing their knowledge of inadequate internal controls and (2) failure to develop and implement compliance systems.

Egregious Behavior

Directors who engage in significant wrongdoing, such that their activity resembles a “criminal operation,” will be liable under a Caremark theory of failure to monitor because their involvement in the wrongdoing demonstrates that they knew the company’s internal controls were inadequate and could be easily bypassed.

In AIG the purported scheme alleged in the complaint included: misstating the company’s financial performance to deceive investors; engaging in various “schemes” to avoid taxes; and conspiring with others to rig markets and competitive auctions. The defendants argued, however, that the complaint was not properly pled in that the alleged facts did not show their involvement in the schemes. The court disagreed, finding that the complaint set out sufficient facts to survive a motion to dismiss and to demonstrate that the defendants would have been
involved in, monitored, or supervised the transactions at issue because of their positions within the company and their financial experience.29

The court found that the “[c]omplaint fairly supports the assertion that AIG’s Inner Circle led a…criminal organization.”30 The court acknowledged that “[a] cosmic wrong may have been done to the Inner Circle Defendants, whose members were victimized by a large number of lower level employees who, despite good faith efforts at oversight and the use of internal controls by the Inner Circle Defendants, were able to avoid detection and engage in widespread financial fraud.”31 However, at the motion to dismiss stage of the proceedings, “the pleading of direct involvement by…the Inner Circle Defendants in many of the specific alleged wrongs gives rise to a fair inference that the defendants knew that AIG’s internal controls and compliance efforts were inadequate.”32 Therefore the court declined defendants’ motion to dismiss the complaint, finding that plaintiffs had made out a breach of loyalty claim against the defendants for “knowingly tolerating inadequate internal controls and knowingly failing to monitor their subordinates’ compliance with legal duties.”33

No Controls

A complete lack of an internal control or monitoring system is a basis for imposing liability—even in the absence of any allegation that the director or officer in question participated in, approved of, or profited from the wrongdoing.34 In this context, a director’s lack of knowledge of the wrongdoing is not an excuse but, in essence, a confession of the failure to comply with oversight duties.35

Other Delaware cases have set out examples of the type of conduct that could serve as a predicate for a Caremark claim:

• lack of an audit committee or other important supervisory structures;

• the failure of the company’s audit committee to meet;

• the existence of an audit committee that rarely met and devoted patently inadequate time to its work;

• the failure of the board or audit committee to investigate notice of serious improprieties or misconduct; or

• the board or audit committee learned of irregularities and encouraged their continuation.36

Conclusion

Despite the Citigroup rulings, there is ample reason for corporations to have robust and up-to-date compliance programs. Such programs are mandated by federal laws and regulations, as well as by a variety of private entities, such as the New York Stock Exchange and NASDAQ.37 A strong compliance program will contribute to the defenses of Caremark claims leveled against directors and officers. Finally, if regulators or prosecutors take action as a result of wrongdoing, the existence of a well-functioning compliance program may reduce fines and sanctions.38

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Endnotes


4. See, e.g., NYSE Listed Company Manual § 303A.07(c)(i)(A) (requiring audit committee charters to address committee’s involvement with the listed company’s financial statements and the listed company’s compliance with legal and regulatory requirements); NASDAQ Listing R. 5610 (“Each Company shall adopt a code of conduct applicable to all directors, officers and employees….’’); FINRA Rules R. 3130(b) (“Each member shall have its chief executive officer…certify annually…that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations.”).

5. 698 A.2d 959, 970 (Del. Ch. 1996).

6. Id.

7. Id. at 971. The duty to monitor is also included within the oversight responsibilities listed by the Model Business Corporation Act for boards of public companies. Model Bus. Corp. Act § 8.01(c). Those responsibilities include the supervision of “policies and practices to foster the corporation’s compliance with law and ethical conduct,” “the effectiveness of the corporation’s internal controls,” and “arrangements for providing adequate and timely information to directors.” Id.


9. Id.

10. Id. at 370.


13. 964 A.2d 106 (Del. Ch. 2009).
14. Id. at 131.
15. Id.
16. Id. n.78.
17. Id. at 123, 126.
18. Id. at 127–28.
19. Id. at 128.
21. Id.
22. Id. at *6-7. Directors will also not be liable under Caremark for failing to monitor the personal affairs of a senior executive, even where the executive is as closely associated with the company as Martha Stewart was with Martha Stewart Living Omnimedia, Inc. Beam v. Stewart, 833 A.2d 961, 971–72 (Del. Ch. 2003). In Beam, a derivative action was filed against various directors of Martha Stewart Living Omnimedia, Inc. based, in part, on their failure to monitor Martha Stewart’s personal, financial, and legal affairs. Id. at 970-71. These allegations stemmed from Martha Stewart’s alleged trading of stock of ImClone Systems, Inc. on inside information. The court easily dismissed plaintiff’s claim as a “patently unreasonable” extension of the board’s oversight responsibilities. Id. at 971–72.
23. See, e.g., In re Citigroup, 964 A.2d at 125, 126.
25. In re Citigroup, 964 A.2d at 126.
27. Id.
28. Id. at 775.
29. Id. at 797–99.
30. Id. at 799.
31. Id. at 777.
32. Id. at 777.
33. Id. at 799. The court in the AIG case analyzed the complaint under the traditional and plaintiff-friendly pleading standard of rule 12(b)(6), rather than the more difficult particularized pleading standard of rule 23.1 because of the unique procedural posture of the case. Am. Int’l Group, 965 A.2d at 778. The AIG board had created a special litigation committee to determine what action the corporation should take with respect to the derivative complaint, and vested full authority in the special committee, including whether to pursue the claims set out in the derivative complaint or whether to have them dismissed. Following its investigation the special committee decided to “remain neutral” with respect to the relevant defendants. Therefore, any demand on the board would have been futile and was excused. As such, defendants’ motion to dismiss was evaluated under rule 12(b)(6). Compare Del. Ct. Ch. R. 12(b)(6), with id. R. 23.1(a).
35. Id.
37. See supra notes 4–5.
38. See supra note 4.

Donald A Corbett is a partner at Dickstein Shapiro LLP and Daniel Roque is an associate at the firm.