ADDRESS

The Challenges for Directors in Piloting Through State and Federal Standards in the Maelstrom of Risk Management

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INTRODUCTION

As we all know, the world is trying to recover from two years of financial calamities and uncertainty that have roiled the financial markets and sovereign nations and cut deeply into the net worth of many investors. The "blame game" goes on in the media, the halls of the United States Congress, and the SEC. In the midst of the frenetic swirl, corporate directors, regulators, and courts are under unprecedented pressure.

I would like to address the federal and state contexts relating to the corporate-governance focus on business risk and the expectations laid at the doorstep of directors and officers of U.S. public companies. Specifically, I would like to look at the governance landscape through both a federal regulatory lens and a state judicial lens as it relates to risk assessment and risk management.

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1. The print version of the Address differs from the June 4, 2010, presentation. Significant legislative changes occurring in the months following the presentation are now mentioned. Citations and footnotes are added to assist the reader.

NEW FEDERAL LEGISLATION

Inside the Beltway in Washington, D.C., a massive piece of federal legislation has just been born. It is the Dodd-Frank Act, which has passed the Senate and House and was signed into law by the President on July 21, 2010. It is euphemistically titled "The Wall Street Reform and Consumer Protection Act of 2010."[2]

The final Act will have a sweeping regulatory effect on business, particularly banking, and will have some effect on corporate governance. Mercifully, that latter effect, in itself, will be only marginally intrusive, but nevertheless, it is a federal intrusion that is undesirable as a matter of principle. It will not, however, constitute a wholesale federal preemption of corporate law and corporate governance. The bottom line is that the Dodd-Frank Act does not alter or eliminate the protections traditionally provided to directors by the business judgment rule.

The governance provisions and the SEC implementation of the authority conferred on the Commission in the legislation will make life more challenging for directors. And it will strengthen the hand of activist investors. Particularly problematic is the broad authority conferred on the SEC to require mandatory proxy access[3] for investors to nominate directors on the company's proxy, under certain circumstances.

Except to note that corporate management, directors, and general counsel of many corporations will be impacted significantly as business works its way through the massive regulatory sweep of the legislation, I do not plan to discuss those complex regulatory provisions. What is outside the scope of my remarks today are the creation of a Consumer Financial Protection Bureau (within the Federal Reserve), the Financial Stability Oversight Council (composed of the heads of the various regulatory agencies including the Chairman of the SEC), the permanent status conferred on the Investor Advisory Committee established last year by the SEC, and the other myriad regulations dealing with heightening capital, the requirement of orderly wind-down plans of insolvent operations

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2. On July 15, 2010, the conference process was completed, and the Act was sent to the president for signature. H.R. 4173, 101st Cong. (as reported by the Committee of Conference, June 29, 2010); *see also* WEIL, GOTSHAL & MANGES LLP, FINANCIAL REGULATORY REFORM: AN OVERVIEW OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://www.weil.com/files/upload/Weil%20Dodd-Frank%20Overview.pdf (summarizing the Act's provisions); *Challenges of the Next Proxy Season: What to Expect from the Dodd-Frank Act and How to Begin to Prepare*, WEIL BRIEFING (July 22, 2010), *available at* http://www.weil.com/files/upload/NY_Briefing_Corp_Gov_FRR_Full_List_100723_FINAL_THREE_Weil%20Briefing_SEC_CG%20July_2010_v4.pdf.

3. Note that Delaware has already acted to enable proxy access by private ordering. Stockholders have always had the right, in Delaware at least, to have bylaw amendments proposed and voted on by the stockholders, including most recently proxy access. DEL. CODE ANN. tit. 8, §§ 112-13 (2009).

to fend off a "too-big-to-fail" scenario, and the regulations dealing with credit-rating agencies, hedge funds, issuers of securities products, derivatives, and swaps.

Those elaborate, detailed provisions that comprise most of the more than 2000-page Act are beyond the scope of this talk, which is about corporate governance and the responsibility of directors for risk management. Although the rhetoric about "excessive risk" has driven many congressional efforts, the taking of prudent risks by directors, acting in accord with their state law fiduciary duties of care and loyalty, is the engine of business strategy and is protected by the business judgment rule. The business judgment rule is alive and well, almost unharmed by this federal legislation, and it animates state internal corporate affairs law, as exemplified by Delaware court decisions.

Corporate governance and other matters relating to the internal corporate affairs of U.S. companies have historically been governed by the law of the state of incorporation.[4] To be sure, the Dodd-Frank Act, like the Sarbanes-Oxley Act did with respect to audit committee responsibilities and independence and audit committee and auditor independence requirements, includes provisions mandating certain actions and structures involving traditionally state law corporate governance matters. These include proxy access, say-on-pay and "golden parachute" votes, compensation committee composition and advisors, incentive compensation "clawback" policies, and special governance requirements for financial companies.[5] Moreover, directors also will need to oversee management's compliance with the panoply of new regulations imposed by the Act. Significantly, however, the Act's provisions concerning say-on-pay votes and compensation committee advisors expressly disclaim any intention "to create or imply any change to the fiduciary duties of directors" or "to affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of the duties of the compensation committee."[6] Other corporate governance proposals of some earlier bills, such as the attempted prohibition of staggered boards in the Schumer Bill, are not included in the Act.[7]

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4. Vantagepoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112 (Del. 2005).

5. WEIL, GOTSHAL & MANGES LLP, *supra* note 2.

6. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 101st Cong. §§ 951–52 (as reported by the Committee of Conference, June 29, 2010).

7. *SEC Disclosure and Corporate Governance, Congressional Watch: Senator Dodd Introduces Financial Stability Bill Calling for SEC Proxy Access Authority and Other Governance and Executive Compensation*, WEIL BRIEFING (May 24, 2010), *available at* http://www.weil.com/files/Publication/8abe68bb-7941-4e2e-af64-e3ad5702efee/Presentation/PublicationAttachment/419e2155-a01d-4955-a852-f0d9a1664561/Weil_Briefing_SEC_CG_2010_05_24.pdf; *see also* Holly J. Gregory, *Boards, Legis-*

There may or may not be merit to some of the non-corporate governance provisions. But let me say at the outset that, in my opinion, the corporate governance provisions in the Dodd-Frank Act are unnecessary. The financial meltdown of 2008–2009 was not, in my opinion, the result of a pervasive failure of good governance practices of the boards of the thousands of U.S. public companies.

Under Delaware law, many advances have been put in place in recent years, including majority voting (now the norm for most public companies) and proxy access under private ordering provisions of Delaware law. Indeed, it is the freedom of corporate private ordering, subject to fiduciary duties, that is the "genius of American corporate law."[8] The fundamental flaw of federalizing corporate law is that it is a "one-size-fits-all" regime for thousands of diverse public corporations, each of which has its own culture and business model.

To be sure, there have been some failures where directors were "asleep at the switch" and missed "red flags." That small minority of boards with bad practices is not, however, a justification for the across-the-board creation of these federal intrusions into internal corporate affairs, which traditionally (though not always) have been the exclusive province of the states. The Sarbanes-Oxley Act of 2002 intruded to some extent. And let me add that, in my opinion, state legislatures and state courts—led prominently by Delaware—have done a good job over the last century of enabling boards of directors to properly direct the management of the business and affairs of corporate America. That includes risk assessment and risk management. More about that later.

That said, however, the anger of the American public and the response in the media and in Congress have created a "drum beat" of rhetoric to "do something!" That drum beat has focused, in large part, on "excessive risk-taking" (largely in financial institutions) as a major culprit. This rhetoric has resulted in calls for the scalps of CEOs, CFOs, directors, and other players in American business, with a wide swath of blame for all and for the corporate structure in which these players function. So, corporate governance practices got erroneously swept up in the frenzy.

HISTORY

These federally-imposed corporate governance provisions will be somewhat problematic in practice, but they could be worse. Consider

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lators, Regulators: Setting the Right Expectations, PRAC. L. J., May 2010, at 12 (discussing roles of and appropriate expectations for boards).

8. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

this thumbnail sketch of the history of federalism and attempts at federalization in the area of corporate governance.

Federal and state courts have made it quite clear that Congress has not yet federalized internal corporate affairs, except in disclosure and some other areas.[9] Federal and state law have coexisted for many years, and internal corporate affairs remain the province of the state of incorporation. Federal law, dating from the securities legislation of 1933 and 1934 and going through the Williams Act of the 1980s, has long related primarily to disclosure issues.

There are concurrent applications of federal and state authority. And there is strictly federal law and strictly state law. Delaware has embraced this federalism model, and that phenomenon has led to the incorporation in Delaware of more than sixty percent of the Fortune 500 companies.

In the mid-1970s, Professor Cary of Columbia Law School, a former SEC Commissioner, said, "Delaware is leading the race to the bottom," and he wrote articles in the *Yale Law Journal* alleging that. He said, "this pygmy state" (Delaware) should not be dominating the corporate system and that federal minimum corporate standards were needed.[10]

At that time, there were some academic views that favored Cary's preference for federal minimum standards of corporation law. Many other people took quite a different view, saying the state system, particularly that of Delaware, is working, and that a one-size-fits-all federal system would not.

Ralph Winter, then a Yale law professor and later a judge of the United States Court of Appeals for the Second Circuit, articulated a very persuasive economic analysis. He concluded "that state corporate legal systems do protect shareholders and that state regulation is generally preferable to federal regulation."[11] "An expanded federal role," he said, "would . . . be counterproductive. At the federal level, there is no mechanism by which optimum legal rules governing the shareholder-corporation relation can be determined."[12] "Once federal legislation is

9. *See, e.g.*, Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90 (1991) (holding that federal court entertaining derivative action of company registered under Federal Investment Company Act of 1940 must apply demand futility exception defined by state of incorporation); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (absent clear congressional intent, federal courts should be reluctant to federalize and override state corporate laws); *see also* E. Norman Veasey, *What Would Madison Think? The Irony of the Twists and Turns of Federalism*, 34 DEL. J. CORP. L. 35, 41–42 (2009).

10. William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701, 705 (1974).

11. *See* RALPH K. WINTER, JR., GOVERNMENT AND THE CORPORATION 5 (1978); *see also* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

12. WINTER, *supra* note 11, at 44–46.

enacted," he said, "it will be very difficult to correct . . . [and] even the most demonstrably foolish rule will lead to calls for more rather than less regulation."[13] So, all that happened coming out of this academic debate was the American Law Institute (ALI) *Principles of Corporate Governance*, which is offered by the ALI as a template for state corporation law.[14]

We have had this fragile ecosystem of state and federal law in the corporate area, and it has been working. That view carried the day in the late twentieth century. But what would the future hold? In 2001, along came Enron, WorldCom, Tyco, the bursting of the technology bubble, and the loss of $7 trillion in market capitalization. That, of course, led to the Sarbanes-Oxley Act in 2002, an election year.

That Act resulted in some intrusion into the internal affairs of corporations, but I do not think it intrudes in many significant respects. Now if you analyze the things that it did that are properly in the federal lane, they seem to work: audit regulation, executive certification of financial statements, prohibition of insider trades during pension-fund blackout periods, enhanced criminal penalties, and additional disclosure requirements. But there are some provisions that are worrisome because they are clearly in the state lane: regulation of non-audit services, audit-committees' composition, executive bonuses, executive loans, and rules on lawyer conduct.[15]

So, many observers think that Sarbanes-Oxley might have been much worse, might have been much more intrusive. Moreover, aside from the high cost of Sarbanes-Oxley to small businesses, many people think that this law in the post-Enron environment has improved board conduct. And although many governance improvements, some stimulated by Delaware judges,[16] were happening before Enron and before Sarbanes-Oxley, I think Sarbanes-Oxley, with all of its warts, has not been overly harmful.

In the federalism area, we have to go back to something James Madison said nearly 235 years ago, in the context of the formulation of the U.S. Constitution, that is applicable to the federal-state tension in corporate law today. He said:

> [T]he federal and State governments are . . . constituted with different powers, and designed for different purposes. . . . [T]he ultimate

13. *Id.*

14. PRINCIPLES OF CORPORATE GOVERNANCE (1994).

15. E. Norman Veasey et al., *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law*, *in* 2 THE PRACTITIONER'S GUIDE TO THE SARBANES-OXLEY ACT V-5-1 (John J. Huber et al. eds., 2006); Veasey, *supra* note 9, at 47.

16. *See* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

> authority . . . will not depend merely on the comparative ambition . . . of the different governments . . . to enlarge its sphere of jurisdiction at the expense of the other . . . . [C]hange can only result from such manifest and irresistible proofs of a better administration . . . .[17]

I think that last sentence is worth repeating. "[C]hange can only result from such manifest and irresistible proofs of a better administration . . . ." So, will these federal corporate governance provisions make for a "better administration?" I think not.

This whole subject of federalism is fascinating, and it is particularly fascinating in the corporate area. My speculation on the future is that Congress may chip away, depending on the scandal or perceived scandal or need *du jour*. But I think it is unlikely in our lifetime that Congress will totally preempt state corporate law—I hope not, but it might!

These Dodd-Frank governance provisions and some of the provisions in the Sarbanes-Oxley Act violate principles of federalism and may be—to some extent—the "camel's nose in the tent" of federal intervention in some internal corporate affairs. But they do not, in themselves, represent a federal incorporation law or a sweeping imposition of massive "minimum federal standards" as proposed by Professor Cary in the 1970s.

The distinction between the academic debate of the '70s and the congressional activity of today is that then it was academics talking. They had no power to effect change. Today it is politicians who are talking, and those politicians in Congress have plenary power! In Dodd-Frank they have exercised that power, but with only limited effect on state corporation law.

That said, corporate directors need to be on guard that a "creeping federalization," such as that represented by Sarbanes-Oxley and Dodd-Frank, does not turn into a galloping federal takeover of corporate governance. That takeover, whether creeping or galloping, could come as a congressional paroxysm in the wake of future scandals. So, it behooves all of us to do what we can to encourage best corporate governance practices.

Thus, we turn to the subject of risk management as the general area where future scandals involving "excessive risk-taking" may fuel a politically-perceived need to venture more robustly in the federalization direction.

17. THE FEDERALIST NO. 46, at 315–17 (James Madison) (Jacob E. Cooke ed., 1961).

DELAWARE CORPORATE LAW ON THE DIRECTORS' DUTY OF OVERSIGHT

I have my friend Professor Stephen Bainbridge, of UCLA Law School, to thank for much of the articulation that follows.[18] In fact, I have paraphrased some of his prose. First, we start with enterprise risk management, which is the process that boards of directors and executives undertake in understanding and executing the firm's strategies and objectives so as "to strike an optimal balance between growth and return goals and related risks."[19]

Although risk management is the job of senior management, the board of directors is responsible for ensuring that the corporation has established appropriate risk-management systems, much as they must establish compliance systems. Moreover, the board must monitor management's implementation of risk-management systems, much as they must do in the compliance arena.

COMPLIANCE

Derivative suits asserting lack of proper oversight claims against boards of directors culminated in the 1996 *Caremark* decision. *Caremark* dicta stated that the board of directors has a duty to ensure that appropriate "information and reporting systems" are in place to provide the board and top management with "timely, accurate information."[20]

The *Caremark* decision led to corporate-governance paradigms of board monitoring of law and financial-compliance systems as part of the board's oversight duties. So, on the surface at least, board monitoring responsibility for compliance systems appears to be a first cousin to the board's duty to oversee risk management, although much of Professor Bainbridge's scholarly analysis demonstrates that the relationship between the board's role in compliance and the board's role in risk management is much more complicated than that.[21]

The risks that corporations face include operational, market, credit, and reputational risks. Operational risk concerns inadequate systems, human error, and sometimes downright fraud. Market risk includes firm activities and firm valuation linked to asset performance. Credit risk centers around change in the credit quality of a counterparty that could affect the value of the director's company. Reputational risk is constantly a worry because it may be the cause or the effect of the other risks. Just think of the catastrophe of the BP oil spill disaster that we see on

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18. Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967 (2009).

19. *Id.* at 967.

20. *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

21. Bainbridge, *supra* note 18, at 978–84.

television constantly. BP, for example, may be a demonstration of alleged operational risk failures that led inexorably to reputational meltdowns and incalculable economic and market capitalization losses.

As Professor Bainbridge observes, best practices with respect to risk management are still evolving. He notes that this evolution is a function of the fact that "different firms have different appetites for risk and face different types of risk, which means they have differing enterprise risk management needs."[22]

Because the taking of prudent risks is inherently the engine of corporate profit maximization, a risk-taking strategy is important. A car running in neutral doesn't go anywhere. But prudence in risk-taking, today more than ever, must be part of the calculus of best practices in the standard of conduct for directors as they carry out their fiduciary duties of care and loyalty.

I would like to pause for just a moment and set the framework of the corporate law of fiduciary duties and the exposure of directors to liability. The first focus is on the standards of conduct and the second focus is on the standards of liability.[23]

The standards of conduct are aspirational. What *should* a board do in carrying out its responsibility to direct the management of the business and affairs of the corporation? Clearly a board should strive for best practices of attention and uncompromising loyalty to the enterprise. You all have been subjected to presentations and literature on best practices, including the 2007 fifth edition of the *Corporate Director's Guidebook*[24] (now being updated to a sixth edition by the Committee on Corporate Laws), the NACD *Key Agreed Principles,*[25] and other works. But best practices do not define liability exposure.[26]

The standards of liability form the lens through which a court or regulator will evaluate director conduct when that conduct is challenged in a proceeding. In a derivative suit brought by a stockholder on behalf of the corporation against directors and officers, the court will determine—at the pleading stage or after trial—whether the facts pled or proven rebut the business judgment rule (which is a presumption of due care, good faith, and loyalty).[27]

22. *Id.* at 970.

23. *See, e.g.*, 2 MODEL BUS. CORP. ACT ANN. §§ 8.30, 8.31 (4th ed. 2008, Supp. 2009).

24. ABA COMMITTEE ON CORPORATE LAWS, CORPORATE DIRECTOR'S GUIDEBOOK (5th ed. 2007), *reprinted in* 62 BUS. LAW. 1479 (2007).

25. NAT'L ASS'N OF CORP. DIRECTORS, KEY AGREED PRINCIPLES TO STRENGTHEN CORPORATE GOVERNANCE FOR U.S. PUBLICLY TRADED CORPORATIONS (2008), *available at* https://secure.nacdonline.org/StaticContent/StaticPages/DM/NACDKeyAgreedPrinciples.pdf.

26. Brehm v. Eisner, 906 A.2d 27, 56–58 (Del. 2006).

27. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

The fiduciary duty of due care requires directors to study and consider all material information reasonably available in making a business decision.[28] The fiduciary duty of due care likewise applies to the board's oversight duties.

Both duties of due care (in decision-making and in oversight) are tested by a gross-negligence standard,[29] but ordinarily there can be no personal liability for damages against directors for lack of due care because of the widespread adoption of charter provisions implementing statutes permitting exculpation of monetary damages for breach of the duty of care.[30] This exoneration does not apply to officers in most states and it does not apply to either directors or officers who are found to have violated their duty of loyalty, including failure to act in good faith.[31]

The duty of loyalty requires that directors and officers act unconditionally in what they honestly believe to be the best interests of the corporation. They may not engage in any self-dealing or conduct themselves in a way that personally benefits them or their family or business associates at the expense of the corporation. Moreover—and this is a recent clarification of Delaware law—they must act in good faith to carry out their duty of loyalty. A lack of good faith is shown if directors *intentionally* violated positive law or *consciously* disregarded or violated a known duty in either decision-making or oversight.[32]

So, now I would like to focus on the board's duty of oversight. The *Caremark*[33] decision by Chancellor Allen is the logical genesis of the analysis. In 1994, the federal government indicted Caremark International, Inc., a healthcare corporation, for violating the Anti-Referral Payments Law. Caremark settled the federal litigation, paid fines, and settled civil claims, all for approximately $250 million.

Stockholders filed derivative suits in Delaware against Caremark's board of directors for the losses. These derivative suits were also settled, subject to court approval. Then-Chancellor William Allen in 1996 approved the settlement but also authored important dicta on the oversight responsibilities of boards of directors. And, as noted earlier, a board's oversight responsibilities may be enhanced as a result of the regulatory provisions in the Dodd-Frank Act.

These dicta have become enshrined as the key standards of liability under Delaware law in the oversight area and have, correspondingly,

28. *Id.*
29. *Id.*
30. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).
31. *Id.*
32. Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006); *Brehm*, 906 A.2d at 66–67.
33. *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).

framed best practices advice as the key standards of conduct in the area of compliance oversight. The issue I would like to visit with you today is the extent to which the *Caremark* line of cases on oversight and compliance are analogous in the context of risk assessment and risk management. The key *Caremark* dicta are that the directors' duty to be attentive

> includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.[34]

But, importantly, he added that "only 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." And he noted—significantly—that this standard sets the liability bar "quite high." He said such a claim is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[35]

Caremark became a well-established standard for the duty of oversight and was followed both in the Delaware Court of Chancery as well as in other states. But the Delaware Supreme Court did not expressly adopt it until ten years later in *Stone v. Ritter*,[36] a decision authored by Justice Randy Holland for the court. *Stone* was brought derivatively by stockholders of AmSouth Bancorporation against the board of directors, alleging a *Caremark* claim. The suit alleged that the board failed to ensure that the bank had an adequate compliance program in place to prevent and detect violations of the federal Bank Secrecy Act that had resulted in large fines arising out of a "Ponzi scheme" perpetrated by some rogue employees. This criminal activity was unknown to the directors in spite of the company's compliance and information system. The suit was dismissed for lack of a proper pleading of bad faith on the part of the directors.

Stone held that conscious disregard of the board's duties is the basis of liability in *Caremark* cases:

> We hold 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

34. *Id*. at 970.
35. *Id.* at 967.
36. 911 A.2d 362 (Del. 2006).

> (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 either case, imposition of liability requires a showing that the directors know that they were not discharging their fiduciary obligations. 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 in good faith.[37]

In *Stone*, the Supreme Court also confirmed the *Caremark* dictum that such an oversight claim "for employee failures is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'"[38] The plaintiff was unable to clear that hurdle in *Stone*:

> With the benefit of hindsight, the plaintiffs' complaint seeks to equate a bad outcome with bad faith. . . . In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.[39]

RISK MANAGEMENT

Caremark claims typically involve a failure of oversight of law compliance or accounting irregularities. A recent decision by Chancellor William Chandler in the *Citigroup* case demonstrates the (perhaps distant) kinship between the compliance/oversight calculus of *Caremark* and the standard of review in risk-management cases.[40]

As Professor Bainbridge notes, Citigroup faced at least three types of enterprise risk. Market risk related to the fact that changes in interest rates and housing prices affected the value of Collateral Debt Obligations (CDOs) based on mortgage-backed securities. Credit risk was implicated because of adverse changes in the credit quality of subprime mortgage-backed securities. Operational risk arose in the context of derivative securities.[41]

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37. *Id.* at 370.
38. *Id.* at 372 (quoting *Caremark*, 698 A.2d at 967).
39. *Id.* at 373.
40. *Bainbridge*, *supra* note 18, at 978 (citing *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 123 (Del. Ch. 2009)).
41. *Id.*

When the financial crisis hit and the subprime mortgage market collapsed, the risks materialized and Citigroup suffered very serious financial losses. Plaintiffs brought a derivative action charging the directors with a lack of good faith for knowingly disregarding a known risk because "red flags" foreshadowed these losses.

In dismissing the bulk of the allegations of the complaint,[42] Chancellor Chandler observed a key distinction between oversight and strategic decisions governed by the business judgment rule:

> 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—fiduciary duty of care and the business judgment rule.[43]

I agree with Professor Bainbridge that just as the business judgment rule insulates risk-taking from judicial review, so *Caremark* should insulate risk management from judicial review. Risk management necessarily overlaps with risk-taking because the former entails making choices about how to select the optimal level of risk to maximize firm value.

In connection with the current intense focus on risk, I would like to commend to your study the very recent report of the NACD Blue Ribbon Commission, entitled *Risk Governance: Balancing Risk and Reward*.[44] Here are just a few brief points from the report:

> **Understanding the Critical Link Between Strategy and Risk**
>
> Risk is not merely something to be avoided, mitigated, and minimized; risk is integral to strategy and essential for a business to succeed. Boards should encourage management to pursue prudent risks to generate sustainable corporate performance and value.

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42. A claim alleging that certain executive compensation arrangements constituted waste survived the motion to dismiss. *Citigroup*, 964 A.2d at 138.

43. *Id.* at 124.

44. NAT'L ASS'N OF CORP. DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMM'N, RISK GOVERNANCE: BALANCING RISK AND REWARD (2009).

The Role of the Board and Its Standing Committees

While there is no one-size-fits-all solution, the Commission believes that, as a general rule, the full board should have primary responsibility for risk oversight, with the board's standing committees supporting the board by addressing the risks inherent in their respective areas of oversight. It is rare that any one committee—such as the audit committee or a risk committee—would have the time, resources, and expertise to oversee the full range of risks facing a company. Moreover, the critical link between strategy and risk points to the need for the full board—rather than any one committee—to have responsibility for risk.

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While the *full board* likely does not have the time to consider each relevant risk in detail on an ongoing basis, it does have two basic responsibilities:

- To ensure that management has implemented an appropriate system to manage these risks, i.e., to identify, assess, mitigate, monitor, and communicate about these risks.
- To provide effective risk oversight through the board's committee structure and oversight processes.

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Appendix B: 25 Questions Every Director May Wish to Consider

Corporate profitability is driven by taking prudent risks after a well thought-out strategy is developed. . . . Maintaining the status quo is a choice, but not always the best one. . . .

In developing corporate strategy and a focus on risk, directors should probe management, advisors, and each other by asking at least the following twenty-five questions (though not necessarily in this order):

1. What are we aiming to accomplish, and how (corporate strategy)?
2. What alternative strategies have been considered/explored?
3. Do the directors receive risk material which adequately distills vast quantities of risk information into prioritized, actionable summaries? . . .

* * *

8. What could go wrong or derail our strategy? For example, could multiple problems arise simultaneously or sequentially (the "perfect storm")? . . .

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24. Has the board and have the appropriate committees reviewed the incentive structure with strategy and risks in mind?

Caremark and *Stone* require "a sustained or systematic failure"[45] on the board's part. But the failure to heed "red flags" does not necessarily translate into liability for lack of good faith. *Stone* requires the board to have "consciously failed to monitor," which requires "a showing that the directors knew that they were not discharging their fiduciary obligations."[46] As noted, directors by statute are permitted to be protected by the corporate charter from liability for claims of gross negligence.[47] To hold directors personally liable, a plaintiff must show a lack of good faith resulting in a violation not of the duty of care, but of the duty of loyalty.

The Chancellor in *Citigroup* would not allow "plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk."[48] He found that such a claim threatened to undermine "the well settled policy of Delaware law by inviting courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions."[49] Just because large losses happen as a result of risks that materialized does not necessarily prove a risk-management failure. To paraphrase Justice Holland in *Stone* and Chancellor Chandler in *Citigroup*, plaintiffs and courts may not use hindsight to equate a bad outcome with bad faith.

There is a concern that, when directors of Delaware corporations are sued in courts other than the Delaware Court of Chancery, judges in other jurisdictions applying Delaware law may find it difficult to distinguish between competent and negligent management when there are bad outcomes. They may inadvertently slip into a hindsight bias and find such outcomes to have been foreseeable and therefore preventable. "It 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."[50]

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45. *Caremark*, 698 A.2d at 971.
46. *Stone*, 911 A.2d at 370.
47. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).
48. *Citigroup*, 964 A.2d at 126.
49. *Id.*
50. *Id.*

I hope that a court outside of Delaware, following the Chancellor's decision in *Citigroup* in the context of a bad outcome, should be able to avoid conflating strategic and conscious risk-taking exercised in good faith with the directors' duties of oversight. Yet, there can be situations where directors fail to act in good faith to monitor the potential disastrous consequences of proper business judgment having gone bad for lack of controls or otherwise. The law relating to risk is still evolving, and the prevalent media/political condemnation of "excessive risk" may drive some bad results in litigation, just as it apparently has driven Congress to assume (erroneously in my view) that pervasive corporate governance failures caused the 2008–2009 financial meltdown.

CONCLUSION

I conclude by saying that director conduct in risk assessment and risk management will continue to be guided primarily by state law—for now. The limits of liability concerns for alleged lack of good faith by directors in risk cases are clear under Delaware decisions such as *Citigroup*, which properly puts risk-taking in the business judgment column. Monitoring a strategic risk and setting up proper controls may be the possible touchstones of liability. Nevertheless, some judges in the future might not perceive the correct analysis, so directors should continue to aspire to achieve best practices, such as those summarized in the NACD Blue Ribbon Report and the other sources I mentioned.