

January 2010

## A Board's Duty to Monitor

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### Recommended Citation

Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717 (2009-2010).

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ERIC J. PAN

## A Board's Duty to Monitor

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## A BOARD'S DUTY TO MONITOR

### I. INTRODUCTION

One of the most difficult questions in corporate law is whether the board of directors has a duty to prevent harm to the corporation. Delaware courts have refrained from holding boards of directors responsible for harmful outcomes that do not involve wrongful or illegal acts.<sup>1</sup> By doing so, however, Delaware courts have encouraged boards to be uninformed of aggressive risk-taking by officers. Sometimes this risk-taking has detrimental effects on shareholders. The absence of adequate board oversight is partially to blame for the recent catastrophic losses suffered by Bear Stearns, Lehman Brothers, AIG, and Citigroup.

For example, at the height of the housing-price bubble in early 2005, Citigroup's board decided that more of the firm's capital should be invested in securities and derivatives that promised higher returns.<sup>2</sup> Investments in mortgage products proved especially lucrative. When the housing-price bubble began deflating in 2007, Citigroup faced enormous losses. By October 2007, Citigroup wrote down \$1.4 billion of its finance commitments.<sup>3</sup> Citigroup eventually disclosed owning approximately \$306 billion in troubled assets and reported losses of over \$65 billion.<sup>4</sup> In late 2008, the firm submitted to two government rescue packages, and its shareholders bore heavy losses.<sup>5</sup>

Six months after initially disclosing its financial problems, Citigroup announced it was seeking new directors who possessed "expertise in finance and investments."<sup>6</sup> The tacit admission that the then-current board members did not possess the skills to fully understand the firm's financial and investment decisions prompts the

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1. This paper focuses on the duty to monitor in Delaware because it is the state of incorporation of most U.S. public companies. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & Econ. 383, 391 (2003) (providing statistics of most popular jurisdictions of incorporation for U.S. companies).
  2. Ken Brown & David Enrich, *Rubin, Under Fire, Defends His Role at Citi*, WALL ST. J., Nov. 29, 2008, at A1; Eric Dash & Julie Creswell, *Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, at A1.
  3. Citigroup Inc., Current Report (Form 8-K), at Ex. 99.1 (Oct. 1, 2007).
  4. Citigroup Inc., Current Report (Form 8-K), at Ex. 99.1 (Nov. 26, 2008); Dash & Creswell, *supra* note 2.
  5. See Citigroup Inc., Current Report (Form 8-K) (Nov. 26, 2008) (announcing \$40 billion capital benefit provided by U.S. Treasury Department, Federal Reserve Board and Federal Deposit Insurance Corporation); Citigroup Inc., Current Report (Form 8-K) (Oct. 30, 2008) (announcing sale of \$25 billion in preferred stock and warrants to the U.S. Treasury Department); see also David Einrich, et al., *U.S. Agrees to Rescue Struggling Citigroup*, WALL ST. J., Nov. 24, 2008, at A1. Citigroup's share price fell eighty-six percent between December 31, 2004, and December 31, 2008. On December 31, 2004, Citigroup's stock was trading at \$48.18 per share. On December 31, 2008, Citigroup's stock was trading at \$6.71 per share. Yahoo Finance, Historical Prices for Citigroup, Inc., <http://finance.yahoo.com/q/hp?s=C&a=11&b=31&c=2004&d=11&e=31&f=2008&g=d&z=66&y=990> (last visited Mar. 11, 2010).
  6. Citigroup Director Search, <http://www.citigroup.com/citi/corporategovernance/directorsearch.htm> (last visited Mar. 1, 2010); see also Eric Dash, *Dean of Harvard Business School May Join Citigroup's Board*, N.Y. TIMES, July 9, 2008, at C2 (noting that, except for a recent addition to the board, none of Citigroup's independent directors had substantial finance experience).

question: Did the board do its job?<sup>7</sup> The answer depends on whether one believes the board had a duty to understand and monitor the firm's investments.

Some notable business commentators argued that the boards of Citigroup and similarly devastated firms breached their duty to monitor.<sup>8</sup> These critics accused the boards of violating a "clear-cut fiduciary responsibility to provide oversight."<sup>9</sup> If the boards had understood and monitored the firm's investments and other risk-taking activities, perhaps the catastrophic losses suffered by these firms could have been prevented. Delaware courts, however, have taken a different view. In *In re Citigroup Inc. Shareholder Derivative Litigation*, the Delaware Court of Chancery dismissed an attempt to hold the Citigroup board liable for the firm's losses, finding that the board did not breach any of its fiduciary obligations.<sup>10</sup>

Why did the court excuse the Citigroup board? The court applied a fiduciary standard set by two landmark Delaware decisions: the 1996 Court of Chancery decision *In re Caremark International, Inc. Derivative Litigation*, which established the basic duties of the board to monitor corporate acts;<sup>11</sup> and the 2006 Delaware Supreme Court decision *Stone v. Ritter*, which reconceived the *Caremark* duties to be consistent with the duty of good faith and loyalty.<sup>12</sup> Per *Stone*, directors breach their duty to monitor when they either "utterly fail[] to implement any reporting or information system or controls" or if "having implemented such systems or controls, consciously fail[] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."<sup>13</sup> This standard poses three challenges for plaintiffs. First, they must show scienter—that the board acted with actual or constructive knowledge that its inaction would harm the corporation. Second, the board is responsible only for preventing wrongful or illegal acts. The board has no responsibility to prevent acts that are legal, but that lead to harmful

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7. See Paul L. Lee, *Risk Management and the Role of the Board of Directors: Regulatory Expectations and Shareholder Actions*, 125 *BANKING L.J.* 679, 680 (2008) (predicting that shareholder litigants "will seek to charge the boards of directors in derivative actions with a failure to monitor and oversee the risk management processes for those [financial] institutions that have announced large losses.").
  8. See, e.g., Paul Myners, Comment, *Banking Reform Must Begin in Boardroom*, *FIN. TIMES*, Apr. 24, 2008 ("[B]oard members should never forget that the most vital part of their job is to challenge executives."); John Schnatter, Editorial, *Where Were the Boards?*, *WALL ST. J.*, Oct. 25, 2008, at A11 ("[Boards of directors] have a clear-cut fiduciary responsibility to provide oversight. . . . Behind the CEO of every Freddie Mac, Bear Stearns or Lehman Brothers who led their company down a path toward financial ruin, there was a board of directors that sat by silently and let it happen."); Review & Outlook, *Citi's Taxpayer Parachute: Why are Robert Rubin and Other Directors Still Employed?*, *WALL ST. J.*, Nov. 25, 2008, at A14 ("'Citi never sleeps,' says the bank's advertising slogan. But its directors apparently do. . . . Such a record of persistent failure suggests a larger—you might even call it 'systemic'—management problem. . . .").
  9. Schnatter, *supra* note 8.
  10. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).
  11. *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).
  12. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).
  13. *Id.* at 370.

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business results. Third, they cannot seek to hold boards responsible for monitoring the outcomes of previous board decisions.

This article explains how Delaware courts have defined a board's duty to monitor. In addition to reviewing the foundational cases that define the Delaware duty to monitor, this article also reviews several recent Delaware cases involving plaintiff shareholders challenging a board's failure to prevent harm to the corporation. These cases, applying the *Stone* standard, reveal that the Delaware approach to the duty to monitor does not require boards to play a role in managing risk or otherwise monitor corporate activities that may result in harm to a corporation's business. Such a weak fiduciary standard places Delaware jurisprudence in conflict with recent calls for boards to play a more active role in risk management.<sup>14</sup>

## II. THE FIDUCIARY DUTY TO MONITOR

The duty to monitor is an obligation to prevent harm to the corporation. The board may breach its duty when harm occurs due to the board's inattention or inaction.<sup>15</sup> The scope of the duty depends on two elements: the care that must be taken by the board to detect possible harm, and the types of harm that require board intervention.

Subjecting a board to liability for any harm to the corporation due to its inattention or inaction may cause a board to become risk averse, which could harm shareholders in two ways. First, the board may overinvest in monitoring and control mechanisms to limit the degree of risk assumed by the corporation. Second, the board may reject shareholder-enhancing business decisions that involve greater risk. Recognizing the chilling effect that the threat of legal liability may have on a board's business judgment, Delaware courts have sought to limit the scope of the duty to monitor. The current standard for breach of the duty to monitor exposes directors to possible

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14. *E.g.*, COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK 6–7 (2004) (“The board should ensure it is apprised of the most significant risks, along with actions management is taking and how it is ensuring effective enterprise risk management. The board should consider seeking input from internal auditors, external auditors, and others.”), *available at* [http://www.coso.org/Publications/ERM/COSO\\_ERM\\_ExecutiveSummary.pdf](http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf); SENIOR SUPERVISORS GROUP, RISK MANAGEMENT LESSONS FROM THE GLOBAL BANKING CRISIS OF 2008 22–23 (2009) (noting board direction and senior management oversight as areas for firms to improve risk management), *available at* [http://www.newyorkfed.org/news-events/news/banking/2009/SSG\\_report.pdf](http://www.newyorkfed.org/news-events/news/banking/2009/SSG_report.pdf). The Committee of Sponsoring Organizations of the Treadway Commission is a private organization sponsored by the five leading U.S. accounting associations (American Institute of Certified Public Accountants (AICPA), American Accounting Association (AAA), Financial Executives International (FEI), Institute of Internal Auditors (IIA), and Institute of Management Accountants (IMA)) that provides guidance on corporate governance and internal controls. COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, *supra*. The Senior Supervisors Group expresses the views of financial supervisors from the U.S. Federal Reserve Board, French Banking Commission, German Financial Supervisory Agency, Japanese Financial Services Agency, Swiss Financial Market Supervisory Authority, and U.K. Financial Services Authority. SENIOR SUPERVISORS GROUP, *supra*.

15. *See* WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 261–62 (3d ed. 2009).

liability if they fail to act in the face of a red flag or when inaction leads to legal violations.<sup>16</sup>

This article explores how Delaware courts developed these limits and whether the limits are appropriate. The three cases that established the duty to monitor are *Graham v. Allis-Chalmers*, *Caremark*, and *Stone*. *Graham* held that a board has a duty to act when it becomes aware of illegal or wrongful activities.<sup>17</sup> *Caremark* explained why a board has an obligation not only to act in the face of obvious signs of wrongdoing, but also to be informed and be vigilant for wrongdoing.<sup>18</sup> *Stone* limited the *Caremark* standard by incorporating the duty to monitor into the duty of good faith and loyalty.<sup>19</sup> Thus, a board's liability for failing to monitor is conditioned upon proof of scienter, a key element to finding lack of good faith.

An examination of these core cases and their progeny illustrates that the link between the duty to monitor and the duty of good faith and loyalty is a tortured one.

#### A. *Graham v. Allis-Chalmers Manufacturing Co.: Beware of Red Flags*

*Graham v. Allis-Chalmers Manufacturing Co.* was the first Delaware case to recognize a board's duty to prevent corporate misconduct.<sup>20</sup> Allis-Chalmers's shareholders sued the board for failing to stop employees from violating federal antitrust law.<sup>21</sup> The Delaware Supreme Court rejected the claim, noting that the board was entitled to depend on the "honesty and integrity" of the corporation's employees.<sup>22</sup> However, the court acknowledged a fiduciary duty to monitor and made three basic points about the duty. First, the court subsumed the duty to monitor within the duty of care, which arises from a board's control over the management of a corporation.<sup>23</sup>

Second, the court defined the duty as a passive duty. Citing for support the nineteenth century U.S. Supreme Court decision *Briggs v. Spaulding*,<sup>24</sup> the Delaware

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16. See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 971 (Del. Ch. 2003); *In re Baxter Int'l*, 654 A.2d 1268, 1270–71 (Del. Ch. 1995).

17. 188 A.2d 125 (Del. 1963).

18. 698 A.2d 959 (Del. Ch. 1996).

19. *Stone*, 911 A.2d 362 (Del. 2006).

20. 188 A.2d 125 (Del. 1963).

21. *Id.* at 127.

22. *Id.* at 130.

23. *Id.* ("[The directors'] duties are those of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts of the particular case.")

24. 141 U.S. 132 (1891). In *Briggs*, the receiver of the First National Bank of Buffalo sued the directors of the bank for failing to pay adequate attention to the affairs of the bank; specifically, the receiver alleged that the directors failed to hold meetings, appoint any committees of examination, make examinations in person into the conduct and management of the affairs of the bank, or supervise executive officers. The suit alleged that the failure to supervise permitted misconduct by management that contributed to

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Supreme Court ruled that boards were responsible for halting misconduct only if “something occurs to put them on suspicion that something is wrong.”<sup>25</sup> Boards did not have an obligation to watch for misconduct. Instead, boards would be liable only if they “ignored either willfully or through inattention *obvious* danger signs of employee wrongdoing.”<sup>26</sup> The court further refused to impose any “duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing.”<sup>27</sup> Rather, the court decided that the monitoring duty should be defined by what boards could not help but see, as opposed to what they should have seen if they had made a reasonable effort at monitoring.<sup>28</sup> Consequently, *Graham* gave boards little incentive to monitor.<sup>29</sup> A board that made an effort to be better informed would only expose itself to potential liability.

Third, boards only have a duty to stop corporate actions that are illegal. The description of the board's duty as exercising appropriate control could have justified a broader application of the duty. The court, however, did not consider whether a board's duty extended to preventing bad business outcomes or other harmful results not involving violations of the law. It was within this doctrinal framework that the Delaware Court of Chancery reconsidered the duty to monitor thirty-three years later in *Caremark*.

### B. *In re Caremark International, Inc. Derivative Litigation: A Duty to Monitor*

Chancellor William Allen's opinion in *In re Caremark International, Inc. Derivative Litigation* remains the most complete exploration by a Delaware court of the meaning

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the bank's downfall. *Id.* at 135–37. The Supreme Court determined that directors exercised ordinary care and prudence and exercised reasonable supervision over the bank's managers. While the managers may have been guilty of mismanagement, the Court concluded that the board's failure to know of (and, therefore, to prevent) such acts of wrongdoing was not the result of “gross inattention.” *Id.* at 165–66.

25. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

26. *Id.* (emphasis added). Such obvious signs constitute “red flags” that demand board action. See *In re Citigroup Inc. S'holders Litig.*, No. 19827, 2003 WL 21384599, at \*2 (Del. Ch. Jun. 5, 2003) (“Red flags’ are only useful when they are either waved in one’s face or displayed so that they are visible to the careful observer.”).

27. *Graham*, 188 A.2d at 130.

28. *Id.*

If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either *willfully or through inattention obvious danger signs of employee wrongdoing*, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.

*Id.* (emphasis added).

29. The board could either signal to company employees not to present any troubling information or, alternatively, employees of the company could withhold information from the board to protect the board from possible liability. See generally John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977).

of the duty to monitor,<sup>30</sup> so much so that duty to monitor claims are often referred to today as “*Caremark* claims.”<sup>31</sup> *Caremark* originated from a federal investigation of Caremark International employees who made illegal payments to physicians in exchange for patient referrals.<sup>32</sup> Caremark paid out approximately \$250 million to settle the charges.<sup>33</sup> In approving the derivative settlement, Allen took the opportunity to discuss whether the Caremark board had breached its duty to monitor by allowing the violations to occur.

Allen believed that boards have an obligation to invest in monitoring systems to identify legal violations. No longer could boards blissfully assume that the corporation was operating in complete compliance with the law. A board has 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.”<sup>34</sup> Finding a violation of this duty, however, would not be easy: the board must have failed to provide reasonable oversight in a “sustained or systematic” fashion.<sup>35</sup> A sustained or systematic failure of oversight would include an “utter failure” by the board to make certain that a reasonable information-reporting system was functioning.<sup>36</sup> Actual failure to prevent wrongdoing, however, does not in itself mean that the system was unreasonable or that the board utterly failed in ensuring that a reasonable system was in place. The court would need to consider both the design of the system and the board’s role in reviewing the design of the system.<sup>37</sup>

In *Caremark*, the company ran training programs and distributed ethics manuals to its employees.<sup>38</sup> The board also reviewed the company’s legal compliance systems even after outside auditors found no material weaknesses in the systems.<sup>39</sup> Allen concluded that the board had made a good faith attempt to ensure compliance with the law.<sup>40</sup>

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30. *In re Caremark*, 698 A.2d 959 (Del. Ch. 1996).

31. *E.g.*, *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009); *In re Career Educ. Corp. Derivative Litig.*, C.A. No. 1398-VCP, 2007 WL 2875202, at \*5–7 (Del. Ch. Sept. 28, 2007). Hillary Sale has called *Caremark* “one of the most prominent Delaware opinions of all time.” Hillary A. Sale, *Monitoring Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719, 719–20 (2007).

32. *In re Caremark*, 698 A.2d at 962.

33. *Id.* at 960–61.

34. *Id.* at 970.

35. *Id.* at 971.

36. *Id.*

37. *Id.* at 970.

38. *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 963 (Del. Ch. 1996).

39. *Id.*

40. *Id.* at 971–72.



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The burden on boards to put into place information-reporting systems went beyond what *Graham* contemplated, raising the question whether Allen ignored the earlier Delaware Supreme Court decision. But Allen questioned whether, thirty-three years after *Graham*, the Delaware Supreme Court still would believe that boards could justify not making some effort to ensure it collected information “respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations.”<sup>41</sup> He offered three reasons why *Graham* should be reinterpreted and, in doing so, provided the rationale for a more substantial duty to monitor.

First, Allen noted that since *Graham*, the Delaware Supreme Court had recognized the “seriousness” of boards’ role in the management of corporations.<sup>42</sup> He specifically cited to the Delaware Supreme Court’s decisions in *Smith v. Van Gorkom*<sup>43</sup> and *Paramount Communications v. QVC Network, Inc.*<sup>44</sup> as evidence of this change.<sup>45</sup> In *Van Gorkom* and *QVC*, Delaware courts held boards to a higher standard of review, requiring boards to demonstrate that they engaged in reasonable investigation and deliberation before approving certain corporate transactions.<sup>46</sup>

Second, Allen argued that information-reporting systems are essential to boards fulfilling their supervisory and monitoring role under section 141 of the Delaware General Corporation Law (“DGCL”)—the statutory provision stating that the corporation shall be managed by the direction of the board.<sup>47</sup> Allen’s linking of the operation of information-reporting systems to DGCL section 141 is consistent with the notion that a board can only manage the corporation if it has a means of collecting information.

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41. *Id.* at 969.

42. *Id.* at 970.

43. 488 A.2d 858 (Del. 1985).

44. 637 A.2d 34 (Del. 1994).

45. *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996). In *Van Gorkom*, the Delaware Supreme Court found the board to be grossly negligent and without the protection of the business judgment rule when it approved the sale of the corporation without a substantial inquiry into the terms of the offer. 488 A.2d at 874. In *QVC*, the Delaware Supreme Court decided that the board breached its duty under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), by failing to obtain the best price for the company in a change of control transaction. *QVC*, 637 A.2d at 51.

46. See generally *Van Gorkom*, 488 A.2d 858; *QVC*, 637 A.2d 34.

47. *In re Caremark*, 698 A.2d at 970. DGCL section 141(a) states:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a) (2001).

Caremark was a complex enterprise. It had 7000 employees divided into ninety different branches and a decentralized management structure.<sup>48</sup> The complexity of the firm made it difficult for Caremark's board to monitor all aspects of the firm without an information-reporting system.<sup>49</sup> Thus, *Caremark* represented a shift in how Delaware courts viewed the role of corporate boards: boards would be subject to a more literal interpretation of DGCL section 141 and be held responsible for the actions of corporate officers and employees.<sup>50</sup>

Third, Allen believed that any rational board would install an information-reporting system to take advantage of the benefits offered corporations under the federal organizational sentencing guidelines.<sup>51</sup> Pursuant to the guidelines, a judge may decide to lower a fine on a corporation for unlawful acts if she determines that the corporation had in place an "effective program to prevent and detect violations of law."<sup>52</sup> Consequently, the guidelines "offer powerful incentives for corporations today to have in place compliance programs."<sup>53</sup>

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48. *In re Caremark*, 698 A.2d at 962.

49. It is worth noting that the Delaware Supreme Court did not apply the same reasoning in *Graham*. Allis-Chalmers also was an extremely complex company, if not more so than Caremark. Allis-Chalmers had over 30,000 employees with operations across the United States. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). In that case, the Delaware Supreme Court considered the enormity of Allis-Chalmers' operations not to impose a duty on the board to put into place a system to monitor the vast corporate enterprise but rather to justify the board relying to a greater extent on the honesty and responsiveness of the company's management and employees. *Graham*, 188 A.2d at 130.

By force of necessity, the company's Directors could not know personally all the company's employees. The very magnitude of the enterprise required them to confine their control to the broad policy decisions. That they did this is clear from the record. At the meetings of the Board in which all Directors participated, these questions were considered and decided on the basis of summaries, reports and corporate records. These they were entitled to rely on, not only, we think, under general principles of the common law, but by reason of 8 *Del.C. § 141(f)* as well, which in terms fully protects a director who relies on such in the performance of his duties.

*Graham*, 188 A.2d at 130.

50. The need for information systems is even greater today as corporations continue to grow in size and complexity. See, e.g., PETER T. MUCHLINSKI, *MULTINATIONAL ENTERPRISES AND THE LAW* 58 (2d ed. 2007) (discussing complexity of modern U.S. corporations).

51. *In re Caremark*, 698 A.2d at 970.

52. U.S. SENTENCING GUIDELINES MANUAL § 8C4.11 (2009).

53. *In re Caremark*, 698 A.2d at 969; see also Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 703 (2002) (describing the incentive that corporations have under the guidelines to implement compliance programs). Even after the U.S. Supreme Court in *United States v. Booker*, 543 U.S. 220 (2005), declared aspects of the sentencing guidelines unconstitutional, the sentencing guidelines remain very influential. See Paul Fiorelli & Ann Marie Tracey, *Why Comply? Organizational Guidelines Offer a Safe Harbor in the Storm*, 32 J. CORP. L. 467, 475-78 (2007) ("Even if the logic and the holding of the Supreme Court in *Booker* also applies to corporations, organizations should still consider compliance and ethics programs to be good investments."). The impact of the sentencing guidelines also plays a bigger role in the pre-charge stage of corporate prosecutions when prosecutors negotiate deferred and non-prosecution agreements to corporations in return for governance reform. See Peter J. Henning, *The Organizational Guidelines: R.I.P.?*, 116 YALE L.J. POCKET PART 312, 312-14 (2007). The U.S. Attorneys' Manual continues to

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Prior to *Caremark*, Delaware courts expected little board involvement in the day-to-day work of the corporation, looking to the board only in the case of fundamental or self-dealing transactions. Pre-*Caremark* case law, during which time the *Graham* decision was the controlling law, perpetuated a CEO-centric model of corporate governance with little obligation on boards to supervise officers and employees. *Caremark* gave more substance to the duty to monitor.<sup>54</sup> Taken to its logical extension, *Caremark* placed the burden on boards both to establish and evaluate the adequacy of its internal control and information-reporting systems and to consider the legal and economic environment of the corporation. At least that is how companies and their legal advisers responded to *Caremark* until the Delaware courts limited the duty to monitor in *Stone v. Ritter*.<sup>55</sup>

### C. *Reconceiving the Duty to Monitor as part of the Duty of Good Faith and Loyalty*

The Delaware Supreme Court's response to the Chancery Court's *Caremark* decision came ten years later in *Stone v. Ritter*. Although the court adopted Chancellor Allen's reasoning in *Caremark* (including his reinterpretation of *Graham*), it cut back the scope of the *Caremark* standard by redefining the duty to monitor as part of the duty of good faith and loyalty.<sup>56</sup> Thus, *Stone* effectively limited the scope of the duty to monitor.

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direct prosecutors to take into account "the existence and effectiveness of the corporation's pre-existing compliance program." U.S. Attorneys' Manual 9-28.300(A)(5) (2008), available at [http://www.justice.gov/usao/eousa/foia\\_reading\\_room/usam/title9/28mcrm.htm](http://www.justice.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm). The SEC also rewards corporations that seek out and report wrongdoing. The SEC policy, articulated in the Seaboard Report, grants corporations better enforcement treatment for, among other things, self-reporting misconduct. See Report of the Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001).

54. See Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 266–67 (1997) (citing *Caremark* to support the statement: "Courts have embraced the model of an activist board and are indicating their willingness to impose liability on directors who fail to research, investigate, and ask challenging questions. No longer can independent directors rubber-stamp management recommendations without mastering the financial details of proposed transactions.").
55. See, e.g., Eric Landau, Shawn Harpen & Krisel A. Massey, *Revisiting Caremark and a Director's Duty to Monitor: The Chancery Court's Wake-up Call to Directors*, 1418 PLI/CORP 37, 54 (2004) ("While *Caremark* may not have had the wide-ranging impact envisioned by some, and may actually have been overtaken by rules and regulations imposed by Congress, the SEC and self-regulatory organizations, it still has served a wake-up call to corporate America[,] emphasiz[ing] the need for increased monitoring of corporate affairs to catch problems before they get out of hand . . ."); Sherrie McAvoy & Carole L. Basri, *After Caremark: Personal Liability for Director's Failure to Implement Corporate Compliance Programs and the Need for Self-Assessment*, 1057 PLI/CORP 35, 37 (1998) ("Failure of directors to promote adequate corporate programs within the corporation could lead to personal liability for losses due to such failure to provide appropriate corporate compliance programs. This concept of liability expands the director's responsibility beyond the traditional obligations of the duty of care and the countervailing concept of the business judgment rule.").
56. *Stone v. Ritter*, 911 A.2d 362, 368–70 (Del. 2006).

The *Stone* court limited the duty to monitor in three ways: first, the court equated the duty to monitor with the duty of good faith;<sup>57</sup> second, the court subsumed the duty of good faith into the duty of loyalty (Allen considered the duty to monitor to be part of the duty of care<sup>58</sup>);<sup>59</sup> and third, the court interpreted scienter as an element of bad faith.<sup>60</sup> While re-categorization of the duty to monitor as part of the duty of loyalty removed monitoring failures from DGCL section 102(b)(7) exculpation, re-characterization also made it more difficult to show that directors breached their duty to monitor.<sup>61</sup>

To understand why the Delaware Supreme Court limited the duty to monitor, it is necessary first to examine the Delaware courts' earlier struggle to define the duty of good faith. While the Delaware Supreme Court finally agreed upon a formulation of the meaning of good faith in the *Disney* cases,<sup>62</sup> the court failed to answer all questions about the status of good faith relative to the duties of care and loyalty. This doctrinal uncertainty ultimately led the Delaware Supreme Court to apply its new formulation of good faith to a *Caremark* claim in *Stone*.

57. *Id.*

58. *In re Caremark*, 698 A.2d at 967.

59. *Stone*, 911 A.2d at 369–70.

60. *Id.* at 370 (“[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. . . . a conscious disregard for their responsibilities.”). In later cases, the Delaware courts have confirmed the scienter element. *See, e.g., Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008) (“Where, as here, directors are exculpated from liability except for claims based on ‘fraudulent,’ ‘illegal’ or ‘bad faith’ conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter . . .”).

61. DGCL section 102(b)(7) states:

[T]he certificate of incorporation may also contain any or all of the following matters: . . . (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). A similar provision exists in the Model Business Corporation Act. *See* MODEL BUS. CORP. ACT § 2.02(b)(4) (2006).

62. The Delaware Supreme Court extended itself to examine the issue because it recognized the confusion generated by the term good faith. *See Brehm v. Eisner*, 906 A.2d 27, 64 (Del. 2006) (“Because of the increased recognition of the importance of good faith, some conceptual guidance to the corporate community may be helpful.”).

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### 1. *The Disney Cases and the Meaning of Good Faith*

In the *Disney* cases, shareholders sued the Walt Disney Company board of directors for its handling of the hiring and firing of Disney President Michael Ovitz.<sup>63</sup> After serving little more than one year at Disney, Mr. Ovitz received salary, stock options, and severance totaling approximately \$140 million.<sup>64</sup>

The plaintiffs argued that the board did not exercise an appropriate degree of care and diligence in approving the various transactions between the company and Mr. Ovitz.<sup>65</sup> At trial it became clear that, despite the importance of his position and the amount of compensation and severance he received, most of the Disney directors had little involvement in either the negotiation of Mr. Ovitz's employment or the terms of his departure.<sup>66</sup>

Disney, however, had a DGCL section 102(b)(7) exculpatory provision in its certificate of incorporation.<sup>67</sup> To bypass DGCL section 102(b)(7), plaintiffs argued that the board handled Mr. Ovitz's employment not in good faith.<sup>68</sup> However, at the time there was not a clear understanding in Delaware law as to the meaning of good

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63. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998) (dismissal of original complaint); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (partial reversal of dismissal); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (refusal of motion to dismiss) [hereinafter *Disney I*]; *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005) (decision on the merits) [hereinafter *Disney II*]; *Brehm v. Eisner*, 906 A.2d 27 (Del. 2006) (affirmation of lower court decision).

64. *Disney I*, 825 A.2d at 278–79.

65. *Id.* at 278.

66. The decision recounts in great detail the facts of the board's involvement in the hiring and termination of Mr. Ovitz. The court recognized that only three members of the board were involved in negotiating the details of Mr. Ovitz's employment agreement. *Disney II*, 907 A.2d at 702–09. Likewise, the board allowed Michael Eisner to negotiate almost all of the terms of Mr. Ovitz's termination. *Id.* at 724–40.

67. *Disney I*, 825 A.2d at 286. The Delaware legislature added DGCL section 102(b)(7) in 1986 in response to the decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the only case where a Delaware court held directors liable for breach of the duty of care. The legislative synopsis of the 1986 amendment stated:

Section 102(b)(7) and the amendments in Section 145 represent a legislative response to recent changes in the market for directors' liability insurance . . . . Recent changes in that market, including the unavailability of the traditional policies . . . have threatened the quality and stability of the governance of Delaware corporations because directors, have become unwilling, and in many instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions. The amendments are intended to allow Delaware corporations to provide substitute protection, in various forms, to their directors and to limit director liability under certain circumstances.

1 FOLK ON DELAWARE GENERAL CORPORATION LAW § 102.15 n.53 (5th ed. 2008). R. Franklin Balotti, one of the drafters of the text of DGCL section 102(b)(7), later explained that the exception for acts not in good faith was part of a "belts and suspenders" approach to ensure that the section did not shield a director from liability for acts beyond duty of care violations. Leo Strine, Lawrence Hamermesh, R. Franklin Balotti & Jeffrey Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law* (Feb. 26, 2009) GEO. L.J. (forthcoming) (manuscript at 40–44) (Widener Law School Legal Studies Research Paper No. 09-13; Harvard Law and Economics Discussion Paper No. 630), available at <http://ssrn.com/abstract=1349971>.

68. *Disney I*, 825 A.2d at 278.

faith. Ambiguous drafting of DGCL section 102(b)(7) and references to a duty of good faith in earlier Delaware cases gave the impression that good faith was either an independent fiduciary duty that stood alongside the duties of care and loyalty or was a means of measuring the degree of success that a fiduciary achieved in meeting her duty of care. Previous Delaware cases appeared to recognize a “triad” of fiduciary duties consisting of the duties of good faith, care, and loyalty.<sup>69</sup> For many commentators, recognition of an independent duty of good faith was desirable in order to hold directors and officers accountable for certain acts that did not constitute classic cases of disloyalty, but were so egregious that they should be beyond DGCL section 102(b)(7) exculpation.<sup>70</sup> Despite efforts to the contrary, the meaning and status of the duty of good faith remained elusive.<sup>71</sup>

In *Disney I* and *Disney II*, Chancellor William B. Chandler III attempted to define bad faith as an “intentional dereliction of duty, a conscious disregard for one’s responsibilities.”<sup>72</sup> He further stated that directors act in bad faith when they “consciously and intentionally disregard[] their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”<sup>73</sup>

The Delaware Supreme Court reviewed Chandler’s formulations. In *Brehm v. Eisner*, the final *Disney* case, the Delaware Supreme Court considered three possible categories of bad faith. The first category of bad faith conduct is conduct with intent to do harm.<sup>74</sup> There was no question that such conduct constituted bad faith.<sup>75</sup> A second category is gross negligence without intent to do harm.<sup>76</sup> As gross negligence was well understood as a violation of the duty of care,<sup>77</sup> the court reasoned that gross

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69. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (“The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith.”); *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) (“The director’s fiduciary duty both to the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty.”); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“[A] shareholder plaintiff assumes the burden of providing evidence that directors . . . breached any one of the *triads* of their fiduciary duty—good faith, loyalty, or due care.” (emphasis added)).
70. See, e.g., Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456 (2004).
71. See generally Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005).
72. *Disney II*, 907 A.2d 693, 755 (Del. Ch. 2005). The Delaware Supreme Court concluded that both definitions were substantively the same definition (i.e., intentional dereliction of duty, a conscious disregard for one’s responsibilities). See *Brehm v. Eisner*, 906 A.2d 27, 63 (Del. 2006) (“Both formulations [of bad faith] express the same concept, although in slightly different language.”).
73. *Disney I*, 825 A.2d at 289.
74. *Brehm v. Eisner*, 906 A.2d 27, 64 (Del. 2006).
75. *Id.* (“That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic.”).
76. *Id.*
77. See *McPadden v. Sidhu*, 964 A.2d 1262, 1273–74 (Del. Ch. 2008) (“Delaware’s current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason.” (citing *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 65, 67)).

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negligence could not be bad faith since a director either was protected from personal liability for acts of gross negligence by DGCL section 102(b)(7), or enjoyed indemnification for such acts under DGCL section 145.<sup>78</sup> The tough case is the third category, “which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence.”<sup>79</sup> In the Delaware Supreme Court’s view, Chandler’s definition of bad faith—intentional dereliction of duty, a conscious disregard for one’s responsibilities—fit this last category.<sup>80</sup>

In trying to distinguish between the duty of good faith and duty of care, the Delaware Supreme Court defined bad faith in terms of an extremely severe form of carelessness (i.e., greater than gross negligence):

Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is *qualitatively more culpable than gross negligence*, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.<sup>81</sup>

What the court did not resolve was whether the duty of good faith was independent of both the duties of care and loyalty, or, alternatively, whether good faith was an egregious duty of care violation. The court expressly refrained from addressing the issue.<sup>82</sup>

In adopting Chandler’s definition of lack of good faith (“intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties”), the Delaware Supreme Court noted that its understanding of good faith was consistent with earlier decisions. The court particularly zeroed in on *Caremark*’s reference to good faith: “a sustained or systematic failure of the board to exercise

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78. *Brehm*, 906 A.2d at 66 (“There is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.”); *see also, e.g.*, *Rothenberg v. Santa Fe Pac. Corp.*, Civ. A. No. 11749, 1992 WL 111206, at \*4 (Del. Ch. May 18, 1992) (noting that DGCL section 102(b)(7) protects directors from liability for gross negligence). Invocation of DGCL section 102(b)(7) in the face of a duty of care claim would be grounds for immediate dismissal of the claim. *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223–24 (Del. 1999). DGCL section 145 authorizes corporations to indemnify officers and directors against any expenses (and, in some cases, judgment costs) incurred by such persons in defending themselves against lawsuits concerning their corporate service. DEL. CODE ANN. tit 8, § 145 (2001).

79. *Brehm*, 906 A.2d at 66.

80. *Id.* at 66–67.

81. *Id.* at 66 (emphasis added). The Delaware Supreme Court also quoted with approval Chandler’s earlier description of good faith, a description that further gave the impression that good faith was distinct from care and loyalty: “The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.” *Id.* at 67.

82. *Id.* at 67 n.112.

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.”<sup>83</sup> Thus, the *Brehm* court reinterpreted *Caremark*, a case originally decided on duty of care grounds, as a case about the duty of good faith.

## 2. *Stone v. Ritter*

In deciding *Stone* less than five months after *Brehm*,<sup>84</sup> the Delaware Supreme Court grasped the opportunity to settle once and for all the meaning of the duty of good faith. Since *Stone* involved a *Caremark* claim, it also represented the first opportunity for the court to opine on the duty to monitor standard since *Graham* and *Caremark*.

*Stone* was a derivative suit brought by shareholders of AmSouth Bancorporation against the board for allowing employees to violate reporting requirements under various banking and anti-money-laundering regulations.<sup>85</sup> As AmSouth’s certificate of incorporation included a DGCL section 102(b)(7) exculpatory provision, plaintiffs attempted to characterize the failure to monitor as an act of bad faith.<sup>86</sup> The Delaware Supreme Court rejected that claim.<sup>87</sup> The company had in place a comprehensive information-reporting system designed by the board.<sup>88</sup> Even though the program proved to be flawed, the court found that the board pursued its monitoring responsibilities in good faith.<sup>89</sup>

In holding that the AmSouth directors pursued their monitoring responsibilities in good faith, the Delaware Supreme Court first upheld Chancellor Allen’s interpretation of *Graham*—eliminating any doubt that Allen’s decision in *Caremark*

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83. *Id.* at 67 n.111 (quoting *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 963 (Del. Ch. 1996)) (emphasis added). The Delaware Supreme Court refused to answer the question whether a violation of the duty of good faith could serve as an independent basis for directors’ liability, leaving unanswered whether good faith really is a third legal duty of a triad of fiduciary duties. *Id.* at 67 n.112.

84. The Delaware Supreme Court delivered its opinion in *Brehm*, 906 A.2d 27, on June 8, 2006 and delivered its opinion in *Stone*, 911 A.2d 362, on November 6, 2006.

85. Prosecutors uncovered AmSouth’s reporting failures when they discovered AmSouth custodial accounts being used in a Ponzi scheme. *Stone*, 911 A.2d at 365. As a result, AmSouth Bancorporation and its subsidiary, AmSouth Bank, had to pay \$50 million in fines and civil penalties. *Id.* Regulators also ordered AmSouth to improve its compliance programs. *Id.* at 366. The Delaware Supreme Court recognized the derivative complaint as a “classic *Caremark* claim.” *Id.* at 364.

86. *Stone v. Ritter*, No. Civ.A. 1570-N, 2006 WL 302558, at \*2 (Del. Ch. Jan. 26, 2006) (referring to the plaintiffs argument in the answering brief that demand should be excused because the board failed to make a good faith attempt to fulfill its fiduciary duties); see also *Stone*, 911 A.2d at 367 (“Critical to this demand excused argument is the fact that the directors’ potential personal liability depends upon whether or not their conduct can be excused by the section 102(b)(7) provision contained in the AmSouth certificate of incorporation.”).

87. *Stone*, 911 A.2d at 373.

88. *Id.* at 371–73.

89. *Id.* at 372–73.



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was not good law.<sup>90</sup> Even though *Graham* did not expressly require the board to make an effort to be informed of the activities of the corporation, the court agreed with Allen that boards had a duty to be reasonably informed and to ensure that corporate information-reporting systems were in place.<sup>91</sup>

The court also made clear, however, that the failure of a board to meet its *Caremark* duty was a failure to act in good faith (as opposed to a violation of the duty of care, as determined by Allen).<sup>92</sup> Furthermore, the court declared that the duty of good faith was a subsidiary element of the duty of loyalty.<sup>93</sup> Whereas in *Brehm* the duty of good faith appeared to be a non-exculpable violation of the duty of care, the court in *Stone* flatly rejected this notion and the notion that the duty of good faith was independent from the duties of care and loyalty, ending the doctrinal debate about the existence of a triad of fiduciary duties.<sup>94</sup>

In interpreting the duty to monitor, the Delaware Supreme Court relied heavily on the reasoning of Vice Chancellor Leo Strine in *Guttman v. Huang*.<sup>95</sup> In *Guttman*, Strine considered a *Caremark* claim where a group of shareholders accused the board of failing to ensure accurate financial reporting.<sup>96</sup> Even though Strine recognized that “by its plain and intentional terms” the *Caremark* standard for the duty to monitor was about the exercise of care by directors, he recast *Caremark* as a case about the duty of loyalty and the responsibility of directors to meet their duties in good faith.<sup>97</sup> In his opinion, good faith was an essential element of the duty of loyalty—i.e., it is impossible for a director to act in bad faith and still be considered to have acted loyally to the corporation.<sup>98</sup> Consequently, Strine argued that *Caremark*, despite its intent to encourage boards to exercise greater care, in fact set a standard that “requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith.”<sup>99</sup>

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90. *Id.* at 370 (“We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability . . .”).

91. *Id.* at 369.

92. *Id.* (“[T]he *Caremark* standard for so-called ‘oversight’ liability draws heavily upon the concept of director failure to act in good faith.”).

93. *Stone v. Ritter*, 911 A.2d 362, 368 (Del. 2006).

94. *Id.* at 370.

95. *See id.* at 370 (citing *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003)).

96. *Guttman v. Huang*, 823 A.2d 492, 505–06 (Del. Ch. 2003).

97. *Id.* at 506.

98. *Id.* at 506 n.34. Strine further argued that the Delaware legislature should redraft DGCL section 102(b)(7) to make disloyal conduct the only exception to liability exculpation, eliminating once and for all any notion that good faith and legality of action were different from the duty of loyalty. *See id.*

99. *Id.* at 506. *See generally* Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 *FORDHAM L. REV.* 1769 (2007) (commenting on the awkward fit of the duty of good faith within the duty of loyalty). It is interesting to note that despite his strongly argued assertion that a breach of the duty to monitor is a breach of the duty of loyalty, Strine still recognized the connection between the duty to monitor and the duty of care even after deciding *Guttman*. *See Teachers’ Ret. Sys. of La. v. Aidinoff*, 900 A.2d 654, 668 (Del. Ch. 2006) (“[T]he most difficult task of all: demonstrating

Building upon Strine's analysis in *Guttman*, the Delaware Supreme Court in *Stone* reformulated the *Caremark* standard as a two-part test where liability stems either from (a) "utterly fail[ing] to implement any reporting or information system or controls" or (b) if "having implemented such system or controls, consciously fail[ing] to monitor or oversee its operations."<sup>100</sup> Most notably, the court identified a scienter requirement to prove a breach of the duty to monitor, stating, "imposition of liability requires a showing that the directors *knew* that they were not discharging their fiduciary obligations."<sup>101</sup> In order to show scienter, plaintiffs must plead "particularized facts . . . that [the directors] had 'actual or constructive knowledge' that their conduct was legally improper."<sup>102</sup> The court left unanswered how difficult it would be to satisfy that requirement.

In sum, *Stone*, a decision that courts have interpreted as defining the appropriate scope of the duty to monitor, was in reality an attempt by the Delaware Supreme Court to end doctrinal confusion about the meaning of the duty of good faith and loyalty. However, because of its treatment by lower courts as a duty to monitor case, the decision, while clarifying one area of law, undermined the impact that the duty to monitor has on boards' willingness to exercise oversight of corporate activities and places Delaware out of step with popular calls for more vigorous risk management by corporate boards.

#### D. Duty to Monitor After *Stone v. Ritter*

In the few years since *Stone*, courts have considered a handful of duty to monitor cases, providing some data points to consider how well the post-*Stone* standard encourages monitoring efforts by boards. In almost all cases, the courts reviewed duty to monitor claims as part of motions to dismiss, usually in the context of plaintiffs arguing demand futility<sup>103</sup> by showing that directors faced a substantial likelihood of

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that the outside directors had breached their duty of care, not as a result of trying to do their job . . . but because the directors' level of indolence was so extreme that it arose to a conscious decision to take the salary of a director while intentionally failing to discharge one's fiduciary obligations.").

100. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (emphasis added). In reformulating the *Caremark* standard, the court borrowed language from the definition of good faith—specifically the use of the word "conscious"—first set forth by Chancellor Chandler in *Disney II* as a "conscious disregard for one's responsibilities." *Disney II*, 907 A.2d 693, 755 (Del. Ch. 2005). Thus, there is an explicit connection between the duty to monitor standard set forth in *Caremark* and the duty of good faith standard set forth in the *Disney* cases.
101. *Stone*, 911 A.2d at 370 (citing *Guttman*, 833 A.2d at 506) (emphasis added); see also *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008) ("Where, as here, directors are exculpated from liability except for claims based on 'fraudulent,' 'illegal' or 'bad faith' conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter . . ."); *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) (discussing a "scienter-based standard" in a monitoring context).
102. *Wood*, 953 A.2d at 141 (citation omitted); see also *Guttman*, 823 A.2d at 506 ("[The *Caremark* standard] premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.").
103. To initiate a derivative suit, a plaintiff makes a demand on the board to bring forward a claim on behalf of the corporation. A plaintiff may attempt to bring forward a derivative claim without the board's

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personal liability from the claims.<sup>104</sup> In only one case did the parties fully litigate the merits of a duty to monitor claim. All other post-*Stone* cases either have focused on whether plaintiffs pled sufficient facts to meet the scienter requirement or, in the case of *Citigroup*, excuse the board from monitoring business risk.

In several cases, plaintiffs have had difficulty demonstrating scienter. For example, *Desimone v. Barrows* concerned a derivative action against the directors of Sycamore Networks, Inc. for allowing the backdating of stock options.<sup>105</sup> The plaintiff argued that the granting of the backdated stock options by certain officers was “an abdication of the board’s duty to monitor the corporation’s compliance with applicable laws and regulations.”<sup>106</sup> In order to make a successful duty to monitor claim, however, Vice Chancellor Strine noted that the plaintiff had to plead the existence of facts suggesting both that the board actually *knew* that the internal controls of the corporation were inadequate in detecting the backdating, and that the board chose to ignore the inadequacies.<sup>107</sup> The plaintiff could not do so. The best evidence of scienter the plaintiff could produce was the existence of an internal memorandum describing the backdating activities.<sup>108</sup> The memorandum did not impress Strine, who noted that the plaintiff failed to show that the board knew of the contents of the memorandum.<sup>109</sup>

The plaintiff in *Desimone* gave Strine very little evidence with which to evaluate the possible merits of the claim. The plaintiff sloppily prepared his pleading, making little effort to collect the necessary facts to support his assertions.<sup>110</sup> Nonetheless, Strine’s discussion of the duty to monitor claim indicated what he expected the plaintiff to plead. The focus of the duty is on what the directors knew as opposed to what they should have known. Thus, the plaintiff could have succeeded only if he presented facts that demonstrated that the board actually knew of the deficiencies in its monitoring system or of the backdated stock options.<sup>111</sup>

In another case, *Wood v. Baum*, the Delaware Supreme Court considered a duty to monitor claim against the board of directors of a limited liability company for failing to

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consent by claiming demand futility if the claim pertains to a board decision and the plaintiff can demonstrate a reasonable doubt that (i) the directors could be disinterested and independent or (ii) the challenged transaction was otherwise the product of a valid exercise of business judgment. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). If the claim does not pertain to a board decision, the plaintiff must only demonstrate a reasonable doubt that the board of directors could be disinterested and independent in considering the demand. *Rales v. Blasband*, 634 A.2d 927, 933–34 (Del. 1993).

104. *Aronson*, 473 A.2d at 814–15.

105. 924 A.2d 908 (Del. Ch. 2007).

106. *Id.* at 939.

107. *Id.* at 940; *see also id.* at 942 (regarding potential liability of members of the audit committee).

108. *Id.* at 940.

109. *Id.*

110. *Id.* at 917–18 (describing the effort plaintiff put into his pleading as insubstantial).

111. *See Desimone v. Barrows*, 924 A.2d 908, 940 (Del. Ch. 2007).

maintain adequate accounting and financial-reporting controls.<sup>112</sup> As in *Desimone*, the court concluded that the plaintiff failed to establish that the directors *knowingly* participated in the illegal acts.<sup>113</sup> The court rejected the plaintiff's argument that the directors had actual knowledge of the illegal acts because they either signed the publicly filed documents that contained misstatements, approved the transactions that later proved to be improper, or served on the audit committee that failed to catch the questionable accounting practices.<sup>114</sup> The court affirmed that the directors' lack of good faith could not be inferred based upon what they should have known or the many opportunities they had to discover the wrongful actions, but rather could only be inferred upon evidence that they knew of, or participated in, the illegal acts.<sup>115</sup>

In three other cases, courts looked favorably on duty to monitor claims, but offered limited guidance to plaintiffs. *ATR-Kim Eng Financial Corp. v. Araneta* is the only case in which parties fully litigated a duty to monitor claim.<sup>116</sup> The case involved a joint venture between ATR and Carlos Araneta in which Araneta controlled ninety percent of the joint venture company.<sup>117</sup> ATR accused Araneta, who was chairman of the joint venture's three-person board, of transferring key assets from the joint venture to his family members, leaving ATR with only a ten percent stake in a worthless company.<sup>118</sup> The plaintiffs alleged that the other two directors breached their duty to monitor by permitting Araneta to transfer the joint venture's assets.<sup>119</sup> Vice Chancellor Strine called them "stooges for Araneta."<sup>120</sup> They did not hold board meetings, they did not question changes made to the company name, they allowed themselves to be removed from the board without explanation, and they possessed little knowledge of the company's activities.<sup>121</sup>

Describing *Araneta* as a *Caremark* claim is awkward. In citing to *Caremark*, however, Strine characterized the defendants' failure to carry out their basic board responsibilities as a failure to implement a reporting system.<sup>122</sup> But the *Araneta* case had nothing to do with a reporting system. It had to do with board members who showed themselves to be incapable of independent thought, judgment, or initiative. *Araneta* was about an extreme set of facts, leaving unanswered whether the duty to

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112. 953 A.2d 136, 139 (Del. 2008). The appeal followed a dismissal of the complaint by the Court of Chancery. *Id.* at 140.

113. *Id.* at 142. As in *Desimone*, the court criticized the plaintiff in *Wood* for not conducting a sufficient factual investigation to plead sufficient facts to support his monitoring claim. *Id.* at 143.

114. *Id.* at 142–43.

115. *Id.* at 143–44.

116. No. CIV.A. 489-N, 2006 WL 3783520 (Del. Ch. Dec. 21, 2006).

117. *Id.* at \*1.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* at \*20.

122. *Araneta*, 2006 WL 3783520, at \*19.

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monitor has any impact on directors who are more careful in carrying out their basic responsibilities.

Another case, *American International Group v. Greenberg*, focused on a series of fraudulent schemes perpetrated by AIG officers.<sup>123</sup> Vice Chancellor Strine decided that two of the defendants, who served as directors and officers of the company, “knowingly tolerat[ed] inadequate internal controls and knowingly fail[ed] to monitor their subordinates’ compliance with legal duties.”<sup>124</sup> Strine inferred defendants’ knowledge from their positions in the company (“top dog[s]”<sup>125</sup>), making it unlikely that illegal transactions could have been conducted without their knowledge.<sup>126</sup>

Although the plaintiffs provided no evidence that the defendants had direct knowledge of the fraudulent transactions, Strine was willing to draw such inferences for two reasons. First, he was horrified by the magnitude and consistency of the fraudulent conduct carried out by the corporation, going so far as to describe the defendants as being part of a “criminal organization.”<sup>127</sup> It was unbelievable to him that such extensive fraud could take place without some knowledge by the defendants.

Second, the defendants were not only directors but also senior officers of the corporation.<sup>128</sup> In discussing each defendant’s role in the corporation, Strine noted that the defendants directly controlled the corporate divisions involved in the fraud and illegal activities.<sup>129</sup> Not surprisingly, the strength of the control made it easier for the court to infer the existence of knowledge. Such inference would be unlikely in the case of outside directors, who do not commonly exercise such control. Given the unusual facts of the *AIG* case, Strine’s willingness to enforce the duty to monitor by drawing inferences of directors’ knowledge of wrongdoing will likely not be repeated in many other cases.

The other case to excuse demand for a *Caremark* claim was *In re Countrywide Financial Corp. Derivative Litigation*.<sup>130</sup> *Countrywide* was a decision of the U.S. District Court of the Central District of California.<sup>131</sup> The plaintiffs in *Countrywide* sought to hold various directors of Countrywide Financial responsible for approving an increase in the origination of non-conforming loans, extension of loans in contravention of company underwriting standards, and a failure to maintain

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123. 965 A.2d 763 (Del. Ch. 2009).

124. *Id.* at 799.

125. *Id.* at 797.

126. *Id.* at 796–99.

127. *Id.* at 798–99.

128. *Id.* at 774.

129. *E.g., Amer. Int’l Group*, 965 A.2d at 797 (“Similarly, given Matthews’s sensitive position and overall power and influence within AIG, I cannot assume at this stage in the litigation that AIG Financial Products, a subsidiary under Matthews’s supervision, took part in a scheme to collude with competitors in rigging markets without Matthews knowing about it.”).

130. 554 F. Supp. 2d 1044 (C.D. Cal. 2008).

131. *Id.*

appropriate reserves and allowances to offset the company's riskier loan portfolio.<sup>132</sup> Like the Citigroup board, the Countrywide board approved a strategy and a set of business practices that exposed the firm to greater risk.<sup>133</sup>

The plaintiffs argued that the Countrywide directors violated section 10(b) of the Securities Exchange Act of 1934 as well as their duty to monitor under Delaware law.<sup>134</sup> Scierter is an element of both claims, but the scierter standard in federal securities law is broader than that of Delaware fiduciary law.<sup>135</sup> Most federal courts have held, as the court in *Countrywide* did, that recklessness constitutes scierter for purposes of Exchange Act section 10(b) and SEC rule 10b-5 liability.<sup>136</sup> A showing of reckless indifference alone, however, is insufficient to satisfy the scierter requirement to show lack of good faith under Delaware law.<sup>137</sup> The court in *Countrywide* did not acknowledge any possible difference and applied the same scierter standard in evaluating both the federal and state law claims.<sup>138</sup>

The effect of the court's application of the broader federal standard of scierter is apparent in how the court evaluated the plaintiffs' duty to monitor claim. Rather than demanding that the plaintiffs present facts demonstrating actual knowledge by the directors of the wrongful acts conducted by the officers and employees of the company, the court instead inferred directors' knowledge from their positions on at least one of the key board committees "charged with oversight of Countrywide's risk exposures, investment portfolio, and loan loss reserves. As such, they were in a position to recognize the significance of these red flags, and, accordingly, investigate the extent to which underwriting standards had been abandoned."<sup>139</sup> In short, the court held that because it was their job to know, the directors should have known of the violations, or were at least reckless in not knowing. The court was convinced that the board's failure to prevent the violation of the company's underwriting standards "simply d[id] not square with the specific and comprehensive monitoring duties assigned to the members of the Board."<sup>140</sup>

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132. *Id.* at 1050–51.

133. *Id.*

134. *Id.* at 1056.

135. *Id.* at 1056–57.

136. JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 673–74 (6th ed. 2009); *In re Countrywide Derivative Litig.*, 554 F. Supp. 2d 1044, 1057 (C.D. Cal. 2008).

137. *E.g.*, *McPadden v. Sidhu*, 964 A.2d 1262, 1274–75 (Del. Ch. 2008).

138. *In re Countrywide*, 554 F.Supp. 2d at 1077 ("Thus, the standard for holding a director liable for a failure of monitoring is a 'scierter'-based one. The finding of a strong inference of at least deliberate recklessness in [the discussion of scierter under Section 10(b)], applies equally to the analysis of the failure of oversight claims." (citation omitted)).

139. *Id.* at 1062 (footnote omitted). The court specifically identified the relevant board committees to be the Audit & Ethics Committee, the Credit Committee, the Finance Committee, and the Operations & Public Policy Committee. *Id.* at 1062 n.13.

140. *Id.* at 1065 ("The purpose of the [Board] Committee system is to monitor the operation, financial performance, and risk position of the Company."). The court in *Countrywide* also cited for support the First Circuit decision in *Miss. Pub. Employees' Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 90–91 (1st

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Also striking is that the federal court was willing to conclude that the directors failed to act in the face of red flags because there was a public report condemning the type of lending practice engaged in by Countrywide, and because competing lenders reported distress during the same period.<sup>141</sup> Such events are analogous to the events that took place prior to the near failure of Citigroup, where both well-publicized concerns about the soundness of the mortgage securities and housing markets, as well as reports of losses mounting at competing financial institutions existed.<sup>142</sup> The federal court was happy to make inferences in the absence of actual evidence of knowledge in order to uphold a duty to monitor claim that likely would not have survived a Delaware court.

The most important recent case was *In Re Citigroup, Inc. Shareholder Derivative Litigation*, which illustrated the substantive limits of the duty to monitor.<sup>143</sup> The plaintiffs in *Citigroup* argued that the board failed to adequately oversee and manage the corporation's risk exposure and ignored several red flags that warned of the deteriorating subprime mortgage market.<sup>144</sup>

Chancellor Chandler rejected the plaintiffs' claims on two grounds. First, a board should not be held liable for failure to monitor business risk.<sup>145</sup> Chandler held that Delaware's duty to monitor required only that a board implement oversight programs to monitor corporate activities for fraud or illegal conduct, and that to extend the duty to monitor to business risk would encroach on a board's business judgment.<sup>146</sup>

Second, a board cannot be held liable for making business decisions that later prove to have been unwise.<sup>147</sup> Expanding the duty to monitor to hold boards responsible for bad business outcomes would place the court in the inappropriate position of second guessing the business judgment of the board.<sup>148</sup> Doing so would undermine the purpose of the business judgment rule, which is "to allow corporate managers and directors to pursue risky transactions without the specter of being held

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Cir. 2008). *In re Countrywide*, 554 F. Supp. 2d at 1065. In *Boston Scientific*, the federal court not only inferred scienter, but also inferred the existence of a highly effective internal control and information-reporting system because the company operated in a highly regulated industry. *Boston Scientific*, 523 F.3d at 90–91. Such leaps of logic would be unheard of in a Delaware court.

141. See *In re Countrywide*, 554 F. Supp. 2d at 1082.

142. See *supra* Part I.

143. 964 A.2d 106 (Del. Ch. 2009).

144. *Id.* at 114–15, 126–27.

145. *Id.* at 124–26. Chandler suggested that it is possible, under some set of facts, that directors may breach their duty to monitor by failing to monitor the corporation's business risk, but Chandler offered no example of when such a situation would occur. See *id.* at 126. He admitted that the presumption of the business judgment rule, the protection of DGCL section 102(b)(7), and the difficulty in proving a *Caremark* claim place "an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk." *Id.* at 125.

146. *Id.* at 129–31.

147. *Id.* at 130.

148. *Id.* at 124–26.

personally liable if those decisions turn out poorly.”<sup>149</sup> In addition, evaluating the board’s success at monitoring business risk would mean judging the merits of a business decision after the fact. Chandler noted that such an evaluation would unleash the dangers of hindsight bias (i.e., “the tendency for [someone] with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted”).<sup>150</sup>

Chandler’s reasoning raises questions about the internal consistency of the duty to monitor. First, it is unclear why business risk should be treated differently from legal risk. Both types of risk are part of managing the business enterprise.<sup>151</sup> It seems fantastic that the duty to monitor requires boards to ensure corporate legal compliance but also incentivizes boards to take no responsibility for the business results of the company—a complete disregard for the principle that the corporation shall be managed by or under the direction of the board.

Second, Chandler justified not extending the duty to monitor to include business risk by concluding that extending the duty would undermine the protection of the business judgment rule. His reasoning, however, indicates an overly narrow interpretation of the duty to monitor. The duty to monitor, as noted by Chancellor Allen in *Caremark*, pertains to unconsidered inaction—action that does not result from a decision of the board.<sup>152</sup> In *Citigroup*, the board made a decision that ultimately led to investment losses that threatened the firm’s solvency. The plaintiffs, however, sought to characterize the board’s behavior as a failure to monitor because the board did not appear to monitor the progress of the investment strategy after its original authorization. Thus, contrary to Chandler’s holding, the issue was not whether the board exercised good business judgment—that is not for a court to decide—but whether the board exercised *any* judgment since the original decision. When a board fails to follow up on a past decision and ignores developments that may reveal a corporate strategy to be flawed, the outcome should be considered the result of unconsidered inaction. That is why *Citigroup* should have been a duty to monitor case.

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149. *In re Citigroup Inc. S’holders Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2008); see also *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (“It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”).

150. *In re Citigroup*, 964 A.2d at 124, n.50 (citation omitted).

151. See *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996):

In light of these developments, it would . . . be a mistake to conclude that [the] Supreme Court’s statement in *Grabam* concerning “espionage” means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves 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.

*Id.* (emphasis added).

152. *Id.* at 968.



### III. CONCLUSION

Risk management is a corporate governance problem. Corporate officers and employees make decisions every day that put the corporation at risk. A careful balance must be struck between encouraging officers and employees to take chances to grow the business and exploit new opportunities, and the need for control and supervision by the board to ensure that risks are taken in an appropriate and reasoned manner. The catastrophic losses recently suffered by several large financial institutions remind us that there are downside risks that need to be managed and spur us to ask whether our corporate governance laws have struck the right balance.

Courts, especially the Delaware courts, play a crucial role in adjusting this balance. Courts need to be better aware of the expectations of shareholders, regulators, and directors themselves about how risks should be taken and managed. Courts should study the director-officer relationship and recognize how important it is for boards to make the effort to collect the right type of information about the corporation and be prepared to question and probe the risk perceptions of the officers.<sup>153</sup> Strengthening the fiduciary duty to monitor is crucial to that task.<sup>154</sup>

Delaware courts have tremendous influence over prevailing corporate governance practices.<sup>155</sup> Opinions and commentary by judges develop and define norms and best practices that affect director behavior, often more so than the threat of legal liability.<sup>156</sup> Judges should begin speaking out about the importance of a board's duty to monitor and to back up their exhortations by expanding the scope and application of the duty to monitor in future cases.

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153. See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 803 (2001) (noting that officers' risk perceptions tend to be tainted by an optimistic bias).

154. The recognition of the importance of the board to serve as monitor and the failure of securities law to ensure that boards are kept fully informed of the operations of the corporation have driven others also to look to fiduciary duties to force internal disclosure of information. Donald Langevoort, for example, argues for the enforcement of a "duty of candor" on executive officers to report information upward to the board. See Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1190 (2003).

155. See Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333, 354 (2009). Others have also commented on how decisions and commentary by judges change board behavior. See Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 442 (2001); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1695-96 (2001); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997).

156. See, e.g., Myron T. Steele & J.W. Verret, *Delaware's Guidance: Ensuring Equity for the Modern Witenagemot*, 2 VA. L. & BUS. REV. 189 (2007) (analyzing the influence of Delaware judges' extrajudicial activities on corporate law and norms); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A retrospective of Some Key Developments*, 153 U. PA. L. REV. 1399, 1404, 1407 (2005) (arguing that "judges have had a substantial role in shaping best practices in corporate governance" and "speeches and articles by Delaware judges are often helpful in guiding boards and their counsel in the direction of best practices").