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Directors' Duty to Monitor: Experience in the Banking Sector—Part I

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This article analyzes the statutory, regulatory, and supervisory requirements for board oversight of banks and bank holding companies. In this first part of a two-part article, the author analyzes the monitoring duties of the directors of a bank holding company under Delaware corporate law. The second part of the article, which will appear in an upcoming issue of The Banking Law Journal, *discusses the regulatory and supervisory approaches that have been adopted by the bank regulatory authorities to board oversight at the level of both the bank and the bank holding company.*

The 2007–2009 financial crisis occasioned a fundamental re-assessment of regulatory and supervisory practices in the financial sector. Among the range of issues highlighted by the crisis was a perceived lack of effective risk management and governance processes at those large financial institutions that faltered and in some instances failed during the crisis. The perceived lack of effective risk management processes at some of the largest U.S. banking institutions was particularly notable because the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and the Office of the Comptroller of the Currency (the "OCC") have for many years examined and rated the management and the boards of directors of banking institutions based on the quality of their risk management processes and oversight.[1] One might have supposed that an investment banking institution like Bear Stearns or Lehman Brothers would not have adopted risk management processes as robust as those applicable to banking institutions.[2] The financial crisis, however, appeared to

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[1] *See, e.g.*, Bd. of Governors of the Fed. Reserve Sys., SR 95-51 (SUP), Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies (1995); Bd. of Governors of the Fed. Reserve Sys., SR 93-69 (FIS), Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations (1993). As used in this article, the term "banking institution" includes both a bank and a bank holding company.

[2] *See* Press Release, U.S. Sec. and Exch. Comm'n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), https://www.sec.gov/news/press/2008/2008-230.htm (stating that the consolidated supervised entities program for large

highlight significant deficiencies in the risk management and governance processes at a number of large banking institutions as well.[3]

CRITICISM OF BOARD OVERSIGHT

In the wake of the financial crisis, commentators asserted that the boards of directors and management of certain large financial institutions had failed in their risk management responsibilities. This view was expressed by international supervisors and other public sector observers.[4] Private commentators reached similar conclusions. One private commentator captured the thrust of these

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investment banks was "fundamentally flawed . . . because investment banks could opt in or out of supervision voluntarily."). *See also* OFFICE OF AUDITS, OFFICE OF INSPECTOR GENERAL, U.S. SEC. AND EXCH. COMM'N, REP. NO. 446-A, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM (2008) (examining in detail the deficiencies in the consolidated supervised entity program for large investment banking entities).

[3] *See* THE PRESIDENT'S WORKING GRP. ON FIN. MKTS., POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (2008), https://www.treasury.gov/press-center/press-releases/Pages/hp871.aspx; Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve Sys., Risk Management in Financial Institutions, Address at the Federal Reserve Bank of Chicago's Annual Conference on Bank Structure and Competition (May 15, 2008), http://www.federalreserve.gov/newsevents/speech/bernanke20080515a.htm.

[4] *See, e.g.,* SENIOR SUPERVISORS GROUP, RISK MANAGEMENT LESSONS FROM THE GLOBAL BANKING CRISIS OF 2008 4 (2009) ("[Risk management failures included an] unwillingness or inability of boards of directors and senior managers to articulate, measure, and adhere to a level of risk acceptable to the firm . . . . A key weakness in governance stemmed from what several senior managers admitted was a disparity between the risks that their firms took and those that their boards of directors perceived the firms to be taking."); ORG. FOR ECON. COOPERATION AND DEV., CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: KEY FINDINGS AND MAIN MESSAGES 31 (2009) ("Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management in what were widely regarded as institutions whose specialty it was to be masters of the issue."); BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE § I:6 (2010) ("[Corporate governance failures that came to light during the financial crisis] included, for example, insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank organizational structures and activities."); THE FIN. CRISIS INQUIRY COMM., THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xviii (2011) ("We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis."). *See also* SIR DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS 12 (2009) (recommending in light of governance failures at U.K. banks that board engagement in risk oversight be materially increased "with particular attention to the monitoring of risk and discussion leading to decisions on the entity's risk appetite and tolerance.").

views succinctly with his conclusion: "Boards Fail—Again."[5] Press commentary trumpeted the failure of board oversight.[6] Legal commentators criticized what they saw to be the weaknesses in corporate law regimes for imposing effective oversight responsibility on boards.[7]

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[5] Ben W. Heineman, Jr., *Boards Fail—Again*, BusinessWeek (Sept. 26, 2008), http://www.bloomberg.com/news/articles/2008-09-26/boards-fail-againbusinessweek-business-news-stock-market-and-financial-advice ("[I]t is clear that the boards of our major financial institutions did not understand the risks the entities were taking."). In reaching the conclusion that boards had failed again in their oversight, this commentator invoked the memory of Enron and earlier failures of oversight by boards of directors. *Id.* The earlier failures had also prompted pointed criticism of board oversight. *See, e.g.,* Jonathan R. Macey, Corporate Governance: Promises Kept, Promises Broken 80 (2008) ("The most important corporate governance lesson to be learned from Enron is that it is unwise to place too much trust and reliance on a company's board of directors."); E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles*, 56 SMU L. Rev. 2135, 2136 (2003) ("[T]he main corporate governance failure in this period [of Enron, WorldCom and similar scandals] was the lassitude and indifference of some boards of directors who were not pro-active in their oversight and strategic roles."); *see also* Frederick D. Lipman, *From Enron to Lehman Brothers: Lessons for Boards from Recent Corporate Governance Failures*, Director Notes (The Conference Board), March 2012, https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N6-12.pdf&type=subsite ("The board, and, in particular, the independent directors did not have the information required to properly perform their oversight duties, even though such information was known to various members of management.").

[6] *See., e.g.*, Francesco Guerra & Peter Thai Larsen, *Gone by the Board? Why Bank Directors Did Not Spot Credit Risks*, Fin. Times (June 25, 2008), http://www.ft.com/intl/cms/s/0/6e66fe18-42e8-11dd-81d0-0000779fd2ac.html ("Boards are supposed to be a company's backstop and they completely missed this crisis."); Paul Myners, Opinion, *Banking reform must begin in boardroom*, Fin. Times (April 24, 2008), http://www.ft.com/intl/cms/s/0/82d60c06-1212-11dd-9b49-0000779fd2ac.html#axzz45DCUA2Mm ("One of the credit crunch's recurrent motifs is that of bank directors who lack the expertise or rigour to govern their banks."); John Schnatter, Commentary, *Where Were the Boards?*, Wall St. J. (October 25, 2008), http://www.wsj.com/articles/SB122489049222968569 ("[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.").

[7] *See e.g.,* Renee M. Jones & Michelle Welsh, *Toward a Public Enforcement Model for Directors' Duty of Oversight*, 45 Vand. J. Transnat'l L. 343, 346 (2012) ("Public inquiries into the failure of Bear Stearns, Lehman Brothers, and Citigroup consistently portray directors as oblivious to the scope of the risks that their firms had undertaken. Directors remained blind to significant departures from approved risk management guidelines and failed to detect flaws in financial reporting practices that led to systematic underreporting of leverage and the concealment of devastating losses."); Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 Colum. Bus. L. Rev. 319, 320 (2010) ("[T]he fantasy that Delaware monitors director performance creates an unhealthy misconception that someone is minding the store."); Anne Tucker Nees, *Who's the Boss? Unmasking Oversight Liability Within the Corporate Power*

RESPONSES TO THE PERCEPTION OF INADEQUATE BOARD OVERSIGHT

The post-crisis response to the perceived deficiencies in board oversight of risk management processes has taken several forms. One form has been legislative action in the United States and in other jurisdictions to strengthen the legal requirements for board oversight. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has imposed several new statutory requirements on board governance of financial institutions.[8] In the United Kingdom, the Financial Services (Banking Reform) Act 2013 has taken an even more robust approach with respect to board responsibility. It imposes potential criminal liability on a director of a failed U.K bank if the conduct "falls far below what could reasonably be expected" of a person in the director's position.[9] Commentators in the U.S. have renewed their calls (as they had earlier following the Enron and similar

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Puzzle, 35 Del. J. Corp. L. 199, 202 (2010) ("[D]irector liability for failed oversight [is] a legal fiction absent a clear violation of law."); Eric J. Pan, *A Board's Duty to Monitor,* 54 N.Y.L. Sch. L. Rev. 717, 718 (2010) ("The absence of adequate board oversight is partially to blame for the recent catastrophic losses suffered by Bear Stearns, Lehman Brothers, AIG, and Citigroup."). There were some countervailing voices as well. *See, e.g.,* Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. Corp. L. 967, 982 (2009) ("[T]he recent widespread risk management failures perhaps resulted not so much from board negligence as from the uncertain and underdeveloped state of risk management practices."); Robert T. Miller, *Oversight Liability for Risk Management Failures at Financial Firms*, 84 S. Cal. L. Rev. 47, 48 (2010) ("[D]irector oversight liability has little or no role to play in improving risk-management practices at major financial firms."). For a more general reflection on corporate governance in the financial crisis, see Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 Bus. Law. 1 (2009) (arguing that the events of the financial crisis did not make the case for fundamental reform of corporate governance).

[8] The provision in the Dodd-Frank Act most relevant to the oversight responsibility of a board is section 165(h) (codified at 12 U.S.C. § 5365(h) (2012)), which, as implemented by the Federal Reserve Board, requires the establishment of (i) a separate risk committee of the board for bank holding companies with consolidated assets of $50 billion or more and (ii) a risk committee that may be combined with another committee such as the audit committee for publicly traded bank holding companies with consolidated assets of $10 billion to $50 billion. *See* 12 C.F.R. §§ 252.22 & 252.33 (2014). These and other Dodd-Frank Act requirements are discussed in Part II of this article.

[9] Financial Services (Banking Reform) Act 2013, c. 33, § 36(1)(c). The U.K. authorities are also in the process of implementing a Senior Managers and Certification Regime that includes a statutory duty of responsibility to be applied to senior managers, including the chairman of the board and the chairs of certain committees of the board. *See* HM Treasury, Senior Managers and Certification Regime: Extension to all FSMA Authorized Persons 11–12 (2015). The U.K. authorities also propose to extend the new regime to non-executive directors. *Id*. at 12.

scandals) for revisions to state corporate law, or federal law if necessary, to strengthen the oversight responsibility of directors.[10]

Another response from international bodies like the Basel Committee on Banking Supervision (the "Basel Committee") has been the promulgation of more explicit guidance on the supervisory expectations for board oversight of risk management processes in banking institutions.[11] Paralleling the work of international standard setters like the Basel Committee, private sector standard setters have expanded their guidance and articulation of best practices for boards of directors of corporations generally and financial institutions in particular.[12] Many commentators believe that these varied sources of guidance and best practices for director oversight responsibility are an important influence on director behavior.

But perhaps the most important (and generally unappreciated) influence on director oversight behavior in banking institutions is the comprehensive role played by the bank regulatory agencies in their supervision of banking institutions. The bank regulatory agencies supervise banking institutions based on an amalgam of statutes, regulations and supervisory guidance.[13] The bank

[10] For proposals to revise state corporate law, see sources cited *supra* note 7. For proposals to revise federal law, see, *e.g.*, Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 106 (2011) (proposing a federal fiduciary duty for directors to develop and monitor risk management oversight systems to address systemic risk); John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 75 (2014) (suggesting a federal fiduciary duty regime for directors of systemically important financial firms).

[11] *See* BASEL COMM. ON BANKING SUPERVISION, GUIDELINES: CORPORATE GOVERNANCE PRINCIPLES FOR BANKS (2015); BASEL COMM. ON BANKING SUPERVISION, *supra* note 4. *See also* ORG. FOR ECON. COOPERATION AND DEV., G20/OECD PRINCIPLES OF CORPORATE GOVERNANCE (2015).

[12] *See, e.g.,* AMER. BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK (6th ed. 2011) [hereinafter CORPORATE DIRECTOR'S GUIDEBOOK]; BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (2012); THE CONFERENCE BD., CORPORATE GOVERNANCE HANDBOOK: LEGAL STANDARDS AND BOARD PRACTICES (3rd ed. 2009); NAT'L ASS'N OF CORP. DIRS., KEY AGREED PRINCIPLES TO STRENGTHEN CORPORATE GOVERNANCE FOR U.S. PUBLICLY TRADED COMPANIES (2008).

Best practice standards for corporate governance have also been developed specifically for financial institutions. *See, e.g.,* GRP. OF THIRTY, TOWARD EFFECTIVE GOVERNANCE OF FINANCIAL INSTITUTIONS (2012). The Clearing House Association in 2012 issued detailed guidance specifically designed for U.S. banking institutions and has recently updated that guidance. *See* THE CLEARING HOUSE, GUIDING PRINCIPLES FOR ENHANCING U.S. BANKING ORGANIZATION CORPORATE GOVERNANCE (2015) [hereinafter CLEARING HOUSE GUIDING PRINCIPLES].

[13] *See* Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 DEL. J. CORP. L. 121, 126 (2011) ("Today, there is a complexity of laws and regulation affecting bank directors with no counterpart in general corporate law.").

regulatory agencies expect the board of directors to bear ultimate responsibility for the oversight of a banking institution based on these statutory, regulatory and supervisory requirements. The requirements are principally directed at the safe and sound operation of the banking institution in compliance with law.[14] Adding to the challenges for directors, the bank regulatory agencies maintain that directors of banking institutions are responsible to a broader set of stakeholders than just shareholders. The additional constituents include depositors (and indirectly the federal deposit insurance fund), creditors and the regulators themselves.[15] The expansive expectations that the bank regulators have traditionally held for the directors' oversight function appear to have been challenged by the events of the financial crisis.[16]

One of the responses of the bank regulators to the financial crisis has been to pronounce new "heightened" or "enhanced" standards for board oversight of large banking institutions, particularly for outside directors, the principal focus of this article.[17] Another response of the bank regulators has been to adopt additional regulations that require the board of directors to monitor specific

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[14] *See, e.g.,* Office of the Comptroller of the Currency, The Director's Book: The Role of a National Bank Director 19 (2010) ("[T]he board must oversee the bank to ensure that the bank operates in a safe and sound manner and complies with applicable laws and regulations.").

[15] *See, e.g.,* Basel Comm. on Banking Supervision, *supra* note 4, at 5 ("[I]n addition to their responsibilities to shareholders, banks also have a responsibility to their depositors and to other recognized stakeholders. The legal and regulatory system in a country determines the formal responsibilities a bank has to its shareholders, depositors and other relevant stakeholders."); Bd. of Governors of the Fed. Reserve Sys., Commercial Bank Examination Manual § 5000.1 (2013) ("The board of directors is responsible to the bank's depositors, other creditors, and shareholders for safeguarding their interests through the lawful, informed, efficient, and able administration of the institution."); Office of the Comptroller of the Currency, *supra* note 14, at 1 ("Directors of a national bank are accountable not only to their shareholders and depositors but also to their regulators."). In some instances, the regulators have described the responsibility to depositors as a fiduciary duty. *See, e.g.,* Office of the Comptroller of the Currency, Comptroller's Handbook: Management and Board Processes (Section 502), at 1 (1998) ("Bank directors have a fiduciary duty to shareholders and depositors.").

[16] *See, e.g.,* Paul L. Lee, *Risk Management and the Role of the Board of Directors: Regulatory Expectations and Shareholder Actions*, 125 Banking L.J. 679, 679 (2008) (noting that the complexities of large financial institutions challenged the regulators' expectations for board oversight during the financial crisis).

[17] *See, e.g.,* OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 79 Fed. Reg. 54518 (Sept. 11, 2014) (to be codified at 12 C.F.R. pt. 30 app. D); Bd. of Governors of the Fed. Reserve Sys., Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies, SR 14-1 (2014); & Consolidated Supervision Framework for Large Financial Institutions, SR 12-17 (2012).

activities and to approve various policies and procedures for risk management processes.[18] Both of these responses replicate approaches that the bank regulators used prior to the financial crisis. The breadth and intensity of the monitoring that the regulators expect by the board of directors, however, has markedly increased in the aftermath of the financial crisis. Concerns had been voiced even before the financial crisis that the enumeration of an increasing quota of policies and procedures that a board of directors was required to approve was placing an inappropriate burden on outside directors and in various instances imposing on outside directors responsibilities that were more appropriately in the domain of management.[19] These concerns are now being voiced even more frequently. Maintaining the appropriate distinction between the role of the board in its oversight function and the role of management in running a banking institution remains a significant challenge.

REGULATORY BURDEN ON DIRECTORS

A report issued by the American Association of Bank Directors in 2014, entitled *Bank Director Regulatory Burden Report*, makes the point that the accretion of statutes, regulations and supervisory guidance over many years has imposed an undue burden on directors. The report notes that there are at least 143 provisions in federal banking law or related statutes imposing duties on the directors of banking institutions.[20] The report also notes that there are at least 50 provisions in the OCC regulations, 38 provisions in Federal Deposit Insurance Corporation ("FDIC") regulations, and 37 provisions in Federal Reserve Board regulations imposing requirements on the boards of the respective banking institutions that they supervise.[21] Even more significantly, the report notes that there are 225 provisions in OCC guidance documents, 180 provisions in FDIC guidance documents, and 140 provisions in Federal Reserve Board guidance documents, imposing responsibilities on directors of

[18] *See, e.g.,* Enhanced Prudential Standards for Bank Holding Companies and Foreign Bank Organizations, 79 Fed. Reg. 17240 (March 27, 2014) (to be codified at 12 C.F.R. pt. 252).

[19] *See, e.g.*, Lee, *supra* note 16, at 685 (noting the longstanding private-sector concern that OCC Banking Circular 277 dealing with derivative activities had imposed on bank boards "a higher level of involvement in and responsibility for risk management processes than traditional norms of corporate governance would otherwise envision" and that "the role marked out for the board in Banking Circular 277 verged on management responsibility").

[20] DAVID BARIS & LOYAL HORSLEY, AMER. ASS'N OF BANK DIRS., BANK DIRECTOR REGULATORY BURDEN REPORT 16 (2014 ed.).

[21] *Id.*

the respective institutions that they supervise.[22] Most of the provisions in the guidance documents are directed to the oversight and monitoring activities of the board. For the largest bank holding companies with the most extensive range of financial activities, during the course of a single year there may be more than 200 matters requiring review and approval by the board or a committee of the board of the bank holding company or its principal bank subsidiary. The report expresses the initial concern that this growing composite of requirements places an undue burden on directors. The report expresses the ultimate concern that the threat of regulatory and personal liability is forcing bank boards to become "compliance" boards, leaving little time for business and strategic planning.[23] Other "wise" men and women have expressed similar concerns.[24]

A report issued by the Clearing House Association in May 2016, entitled *The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations*, takes an even more strategic approach to the analysis of board governance for large U.S. banking institutions.[25] The Clearing House report, in a fashion similar to the *Bank Director Regulatory Burden Report*, identifies in two appendices hundreds of legislative and regulatory requirements and guidance statements that call for matters to be addressed at the board level of banking institutions, including those that call for board review and approval of specific items. Even more helpfully, the Clearing House report includes a discussion of five recommended core functions for a board, distinguishing the board's core functions (including oversight) from the management's responsibility for the day-to-day operation of the banking organization. In recommending five core functions for a board, the report seeks to establish appropriate high-level organizational priorities to meet a board's fiduciary responsibilities and to ensure the safety and soundness of a banking organization. The Clearing House report addresses the expanding challenges that face the directors of banking institutions and provides a thoughtful approach to addressing these challenges. The Clearing House report provides critical guidance for banking institutions and regulators alike.

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[22] *Id.*

[23] *Id.* at 7.

[24] *See, e.g.,* GRP. OF THIRTY, *supra* note 12, at 13 ("Boards that permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk, and talent issues are making a critical mistake.").

[25] THE CLEARING HOUSE, THE ROLE OF THE BOARD OF DIRECTORS IN PROMOTING EFFECTIVE GOVERNANCE AND SAFETY AND SOUNDNESS FOR LARGE U.S. BANKING ORGANIZATIONS (2016).

THE THESES OF THIS ARTICLE

The purpose of this article is to assess the statutory, regulatory, and supervisory requirements for board oversight of banks and bank holding companies. This article offers several theses in respect of these requirements. The first thesis is that these statutory, regulatory and supervisory requirements can provide a potentially useful mechanism for assisting and enhancing a board's monitoring and oversight activities. Input from and dialogue with the bank regulatory agencies can provide an important source of information for a board. It also sets the stage for a useful dialectic between the board and the bank regulators.[26] Much of the information derived from the bank regulators will be firm specific, but the bank regulators may also be in a position to provide the board with horizontal insights based on their supervision of "peer" institutions. The statutory, regulatory and supervisory requirements can also provide a measure of discipline and accountability to board oversight that various commentators assert is not found in the general corporate context.

As a corollary, the existing regulatory and supervisory mechanisms generally make the likelihood that a board would be found to have violated its basic monitoring and oversight duties under applicable corporate law more remote. As discussed below, bank regulatory and supervisory requirements create a comprehensive and detailed framework for compliance and risk management systems that do not exist for most other types of corporations.[27] These statutory, regulatory and supervisory requirements are monitored by the bank regulatory agencies through reporting requirements, regular examinations and other surveillance techniques. The combination of the existence of these requirements and the monitoring of these requirements by the bank regulatory agencies means that the first test for director oversight liability under Delaware corporate law, *i.e.*, a sustained or systematic failure of the board to exercise oversight such as an utter failure to assure that any reporting system exists, will very rarely be met.[28]

The second test for director oversight liability under Delaware corporate law, *i.e.*, a conscious failure to monitor or oversee the operations of the corporation

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[26] *See* GRP. OF THIRTY, A NEW PARADIGM: FINANCIAL INSTITUTION BOARDS AND SUPERVISORS (2013) (providing a comprehensive discussion of the recommended course of dialogue and interaction between the boards of financial institutions and their supervisors).

[27] Securities firms are also subject to regulatory, supervisory and examination requirements from their regulators that are expanding and beginning to approach the scale of bank regulatory and supervisory requirements at least with respect to compliance systems.

[28] *See* discussion *infra*.

based on the reporting systems, will also very rarely be met.[29] Criticisms of a banking institution's systems for monitoring compliance and risk management processes may be made in an examination report prepared by the bank regulatory agency, but the examination report will expressly require those criticisms (styled as "matters requiring attention" or "matters requiring immediate attention") to be addressed by the institution under the oversight of its board of directors.[30] This external monitoring mechanism generally does not exist for other types of corporations. Moreover, in the case of significant criticisms, the bank regulatory agencies will often require the institution to retain an independent consultant to assist in addressing the compliance or risk management deficiencies.[31] While there may be cases of repeat criticisms in examination reports, it is unlikely as a practical matter that a criticism will go unaddressed for such a prolonged period as to constitute a "sustained" failure, the Delaware corporate law test for director oversight liability. Thus, there is a very *low* probability that a shareholder will be able to meet the very *high* hurdle for asserting a derivative claim under Delaware corporate law against the directors of a banking institution. The experience with the disposition of derivative actions against banking institutions both before and after the financial crisis confirms this hypothesis. As a practical matter, the regulatory expectations and requirements for board oversight of banking institutions substantially exceed the threshold for establishing director oversight liability under Delaware corporate law. The incremental level of protection against liability for the board of a banking institution flowing from the high regulatory standards for board monitoring, however, comes at a price: the scope of exercise of business judgment by the board is constrained by the multiple regulatory and supervisory provisions directing specific oversight activities for the board.

The second thesis is that the responsibility of the boards of the largest banks and bank holding companies is now being expanded by these regulatory and supervisory mechanisms to encompass the interests not only of shareholders and depositors, but also of the larger financial system. The full implications of this expanded scope of responsibility are not yet clear. One implication, however, is clear. The interests of shareholders in share buy-back and dividend programs are now being subordinated by regulatory and supervisory mechanisms such as the annual Comprehensive Capital Analysis and Review exercise (discussed in Part II of this article) to the larger yet indistinct interests of protecting the financial system.

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[29] *See* discussion *infra*.

[30] *See* discussion in Part II of this article.

[31] *See* discussion in Part II of this article.

The third thesis is that the expansion in director responsibility and the heightened intensity of expected director oversight may compromise the genuine efforts of directors to meet all of the supervisory expectations. The inexorable addition of new mandated areas for specific board oversight threatens to overload the board and diminish its ability to devote heightened attention to areas that it believes require such attention. The supervisory expectations for board oversight have in recent years acquired an increasing breadth and granularity. The complexity of modern risk management processes and the emergence of new threats, such as cybersecurity, make oversight by a board even more challenging than oversight of traditional banking activities.[32] In any event, little recurring judgment has been applied by the regulators in revisiting the breadth and granularity of these supervisory expectations or in prioritizing the supervisory expectations. Sound macro- and micro-supervisory policy requires the regulators to revisit the scope of their supervisory expectations and to prioritize those expectations. There are some initial signs that the bank regulators may be becoming sensitized to the need to revisit their approach to board oversight issues.[33]

To establish a base for the discussion of the monitoring duties of a director of a banking institution, Part I of this article analyzes a director's monitoring duties under the Delaware General Corporation Law. Virtually all large banks operate as wholly owned subsidiaries of bank holding companies. Shareholder recourse for a failure of director oversight is thus directed at the directors of the holding company. (Regulator recourse for a failure of director oversight can be directed at the directors of the bank subsidiary as well as at the directors of the holding company.) Many bank holding companies are chartered under Delaware law and the directors of these bank holding companies have been the frequent target of derivative actions asserting that the directors failed in their monitoring responsibilities in the lead-up to the financial crisis. Substantial case law thus exists explicating the duties of a director under Delaware law. Delaware

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[32] *See*, *e.g.*, Lisa M. Fairfax, *Managing Expectations: Does the Directors' Duty to Monitor Promise More than It Can Deliver?*, 10 U. St. Thomas L.J. 416, 418 (2012) ("[T]he size and complexity of the modern corporation may make it impractical for directors to successfully engage in oversight."). *See also* Robert F. Weber, *An Alternative Story of the Law and Regulation of Risk Management*, 15 U. Pa. J. Bus. L. 1005, 1073 (2013) ("The ever-expanding pretensions of control have in many respects advanced well beyond practical capabilities.").

[33] *See*, *e.g.*, Daniel K. Tarullo, Mem. of the Bd. of Governors of the Fed. Reserve Sys., Corporate Governance and Prudential Regulation, Address at the Association of American Law Schools 2014 Midyear Meeting (June 9, 2014), https://www.federalreserve.gov/newsevents/speech/tarullo20140609a.htm (noting that the regulators "should probably be somewhat more selective in creating the regulatory checklist for board compliance and regular consideration").

case law also influences the case law of other states. It is thus an appropriate and informative starting point for analysis.[34]

Part I discusses the development of the directors' duty to monitor by the Delaware courts. It then discusses the view of certain commentators that Delaware law provides for a "lax liability" regime (in some cases arguably a "no liability" regime) for board oversight responsibility. To evaluate the actual standards applicable to the directors of bank holding companies, Part I provides a detailed discussion of derivative actions mounted against bank holding companies both before and after the financial crisis. This discussion focuses on the distinction (as well as the possible interplay) between the corporate law standards for board oversight and the regulatory standards for board oversight. Part I also discusses the force of norms under Delaware law and the influence of best practice standards adopted by industry groups, including financial industry groups. Many commentators have argued that Delaware law is influential in establishing norms for director behavior even though the case law rarely finds directors liable for a failure to monitor. These commentators also argue that best practice standards adopted by industry groups have had a significant influence on directors and have resulted in more robust oversight by directors.

Part II of this article discusses the regulatory and supervisory approaches that have been adopted by the bank regulatory authorities to board oversight at the level of both the bank and the bank holding company. There are manifold elements in these regulatory and supervisory approaches. Federal banking statutes expressly dictate certain board oversight requirements for banks and bank holding companies and provide the federal banking authorities with administrative enforcement powers, such as the power to impose civil money penalties on officers and directors of banks and bank holding companies.[35] The FDIC also regularly pursues litigation against officers and directors of failed

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[34] The duties of the directors of a bank holding company are established by the state corporate law under which the company is chartered. The duties of the directors of a bank subsidiary of a holding company are established by the law under which the bank is chartered. National banks are chartered by the OCC under the National Bank Act. State banks are typically chartered by a state banking authority under the state banking law. State banks that are insured by the FDIC or that choose to become members of the Federal Reserve System are subject to additional statutory and regulatory requirements under federal law. The monitoring duties of directors of banks are discussed in Part II of this article.

[35] The administrative enforcement powers of the federal banking agencies include the power to impose civil money penalties on a director of a bank or bank holding company who knowingly violates any law or regulation, engages in any unsafe or unsound practice in the conduct of the affairs of the bank or breaches any fiduciary duty. 12 U.S.C. § 1818 (i)(2)(A)–(C) (2012).

banks to recover damages for the receivership estate of failed banks, generally based on claims of gross negligence. These various *ex post* mechanisms exert a significant *in terrorem* effect on directors.

In addition to these *ex post* mechanisms, the federal banking agencies also exert an important *ex ante* influence on the management and directors of banking institutions through their regular application of regulatory and supervisory measures to the operation of banking institutions and through their examination process. The federal banking authorities have, for example, adopted regulations that impose specific monitoring and oversight responsibilities on boards of directors. As indicated above, even more significantly, the federal banking authorities have issued an extensive body of supervisory "guidance" for director oversight of banks and bank holding companies. The guidance documents in many cases impose *de facto* oversight requirements on directors.[36] The failure to adhere to the guidance documents can lead to adverse regulatory and supervisory consequences for a banking institution, such as limiting its expansion possibilities or its ability to engage in new financial activities. These regulatory and supervisory consequences may be visible as a result of public enforcement orders issued by the bank regulatory agencies. Other consequences will be less visible if the enforcement action taken by the bank regulatory agency is confidential and nonpublic. In any event, it is in the joint interest of the management and the board of a banking institution that the board meet the regulators' expectations for effective board oversight. Part II provides an assessment of the regulatory and supervisory approaches to board oversight responsibilities and offers suggestions to refine the current regulatory and supervisory approaches building upon the recommendations contained in the 2016 Clearing House report.

THE DELAWARE CORPORATE LAW REGIME

The perceived failure of board oversight at certain large financial institutions in the lead-up to the financial crisis resulted in substantial adverse commentary.[37] Various legal commentators renewed their calls for changes to Delaware law to impose greater liability on boards for oversight failures. Similar (unavailing) calls had been made earlier in the decade in the aftermath of the corporate scandals involving companies such as Enron and WorldCom. One of the claims made in the earlier calls for reform was that there was no effective

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[36] *See* Lee, *supra* note 16, at 683 (discussing the rise of "prescriptive" guidance as a standard part of bank supervisory practice).

[37] *See* sources cited *supra* notes 4–6.

mechanism in Delaware law to enforce a director's duty of oversight.[38] Some commentators asserted that there was a *de facto* "no liability" regime under Delaware law for a failure of director oversight.[39] These commentators traced the "no liability" regime to a set of substantive and procedural elements in Delaware law, as further exacerbated in their view by the operation of the exculpation, indemnification, and director and officer insurance provisions in the Delaware General Corporation Law.[40] They asserted that the Delaware corporate law regime lacked a credible accountability mechanism for director fiduciary duty, including the monitoring duty of a director. Some of these commentators discount the argument that qualified individuals will be dissuaded from serving as directors out of a concern for potential personal liability or alternatively suggest that some form of liability cap could be devised to mitigate the concern with personal liability.[41] Other commentators have concluded that neither indemnification by the company nor director and officer liability insurance would fully protect directors against the prospect of personal liability on the large dollar claims that are now routinely asserted against

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[38] *See* sources cited *supra* note 7.

[39] *See, e.g.*, Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 Iowa L. Rev. 105, 108 (2006) ("A tradition of judicial deference has created a de facto 'no liability' rule which means that directors are rarely called upon to justify their actions.").

[40] *See, e.g.*, Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 Hous. L. Rev. 393, 394 (2005) (observing that "over the last twenty years, there has been a virtual elimination of legal liability—particularly in the form of financial penalties—for directors who breach their fiduciary duty of care"). S*ee also* Bernard Black et al., *Outside Director Liability*, 58 Stan. L. Rev. 1055, 1090 (2006) ("Establishing even nominal liability against an outside director for a duty of care breach is exceedingly difficult."); J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. Rich. L. Rev. 317, 345 (2004) ("[T]he standard employed by *Caremark* meant that directors would almost never be liable for a failure to monitor as a result of inadequate procedures."); Elizabeth A. Nowicki, *Director Inattention and Director Protection Under Delaware General Corporation Law Section 102(b)(7): A Proposal For Legislative Reform*, 33 Del. J. Corp. L. 695, 697 (2008) (arguing that "section 102(b)(7) [of Delaware General Corporation Law which authorizes a charter provision eliminating personal liability of a director for a breach of the duty of care other than for actions or omissions not in good faith or involving misconduct or a knowing violation of law] practically obliterates any credible threat of personal liability punishment for inattentive, distressed Delaware directors").

[41] *See, e.g.*, Fairfax, *supra* note 40 at 454 (suggesting ways to cap a director's liability "to reach a more optimal level of deterrence that would prevent instances of overdeterrence and make the cost of serving as a director more acceptable"); Nowicki, *supra* note 40, at 717 (proposing a cap on personal liability based on the amount of compensation paid to director by the company).

boards.[42] The Delaware courts have shown no interest in establishing a regime in which qualified individuals would be dissuaded from serving as directors because of the risk that something might go wrong and large personal liability for a mistake could be assessed. The failure to revise Delaware corporate law notwithstanding the recurring calls of various commentators also reflects a continuing legislative judgment that providing appropriate protection to directors is an essential element in attracting qualified individuals to board positions.

THE *CAREMARK* DUTY

The duty of directors to monitor the operations of a corporation has been the subject of frequent commentary by corporate practitioners and of regular homilies by Delaware courts since the duty was first articulated in 1996 in a case that has given its name to the duty, *In re Caremark International Inc. Derivative Litigation.*[43] This case involved the approval by the Court of Chancery of a settlement agreement for a derivative claim brought against the directors of Caremark International Inc. The claim alleged a breach of the board's duty of care for failing to discover and prevent employee activities that resulted in a felony plea by Caremark and the payment of almost $250 million in criminal and civil fines for violations of a Medicare anti-referral law. The Court of Chancery noted that no senior officers or directors were charged with wrongdoing in the government investigations. The Court of Chancery also noted that although there was evidence that both inside and outside counsel had advised Caremark's directors that Caremark's contracts were in accord with law, Caremark recognized that there was some uncertainty respecting the correct interpretation of the law.[44]

The Court of Chancery began its analysis of the underlying claim with the now oft-repeated observation that a claim against directors for a failure to monitor corporate operations "is possibly the most difficult theory in corpo-

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[42] *See, e.g.*, Black et al., *supra* note 40, at 1058–1059 (noting that "[f]ear of liability has for some time been a leading reason why potential candidates turn down board positions") (footnote omitted); Miller, *supra* note 7, at 332 (recognizing that the "[f]ear of overwhelming judgments against directors for a good decision gone wrong might deter people from serving on corporate boards") (footnote omitted). *See also* Jones, *supra* note 39, at 108 (concluding that one of the reasons for judicial and legislative deference to directors is the belief that "[t]he penalties that directors face for a breach of duty seem disproportionate in relation to the degree of wrongdoing").

[43] 698 A.2d 959 (Del. Ch. 1996).

[44] *Id.* at 963.

ration law upon which a plaintiff might hope to win a judgment."[45] With the memory of the scandals at Salomon Brothers and Kidder, Peabody still fresh in mind, the Court of Chancery asked what was the responsibility of a board with respect to the organization and monitoring of a corporation to assure that it functioned within the law. As to the basic question of the duty to monitor corporate operations, the Court of Chancery concluded that directors had a duty to

> assur[e] 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.[46]

The Court of Chancery further observed that the level of detail that is appropriate for such information and reporting systems would be a question of business judgment.[47]

The Court of Chancery then articulated the following test for liability for a breach of the duty of care arising out of a failure to monitor: "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."[48] The court recognized that this test for liability, requiring in effect a showing of bad faith by the directors, was "quite high", but asserted that a high test was beneficial to corporate shareholders as a class because it "makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors."[49] The court concluded that the record before it provided essentially no evidence of a sustained failure by the directors of Caremark in the exercise of their oversight responsibility. Quite to the contrary, from the record available to the court, the company's information systems appeared to represent a good faith attempt to be informed of relevant facts.

The position of the Court of Chancery in *Caremark* appeared to depart from the position that the Delaware Supreme Court had taken in a leading case,

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[45] *Id.* at 967.

[46] *Id.* at 970.

[47] *Id.*

[48] *Id.* at 971.

[49] *Id.*

Graham v. Allis-Chalmers Manufacturing Co., in 1963.[50] In *Graham*, the Delaware Supreme Court had declined to impose a duty on directors to monitor compliance by corporate employees in the absence of clear signs of wrongdoing. The Court of Chancery concluded that in light of intervening developments, the Delaware Supreme Court would not adopt so cribbed an interpretation of the duty of directors to have compliance programs in place.[51] As one of the intervening developments, the Court of Chancery cited the promulgation of the Organizational Sentencing Guidelines in 1991, which offered "powerful incentives" for corporations to have compliance programs in place.[52] Reliance on this development appeared to be based more on expediency than on principle.

There were other developments based on principle that the Court of Chancery might have cited as well. The American Law Institute (the "ALI") in its Principles of Corporate Governance, first released in 1992, had recommended that one of the basic functions of a board should be to "[o]versee the conduct of the corporation's business to evaluate whether the business is being properly managed."[53] The ALI commentary accompanying the Principles of Corporate Governance cited the American Bar Association (the "ABA") Corporate Director's Guidebook (as published in 1978) for the proposition that a "corporate director should be concerned that the corporation has programs looking toward compliance with applicable laws and regulations[] . . . and that [the corporation] maintains procedures for monitoring such compliance."[54] The ALI commentary also cited the 1990 Statement of the Business Roundtable on Corporate Governance and American Competitiveness, which listed as one of the five primary functions of a board to "[r]eview the adequacy of systems to comply with applicable laws/regulations."[55] The *Caremark* decision has been variously described as a "landmark" decision, "one of the most prominent Delaware opinions of all time," and one that "forever changed

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[50] *See* 188 A.2d 125 (1963).

[51] *See* 698 A.2d 959, 970.

[52] *See id*. at 969. The Organizational Sentencing Guidelines were issued by the U.S. Sentencing Commission pursuant to the Sentencing Reform Act of 1984. 18 U.S.C. §§ 3551–3656. The Guidelines provide for mitigation in the sentencing process for companies that have compliance programs in place to detect violations of law.

[53] AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02(a)(2) (1994).

[54] *Id.* § 3.02, cmt. (d).

[55] *Id.*

Delaware law."[56] In actuality, the *Caremark* decision was simply recognizing and endorsing what had already been established as the norm by the ALI, the ABA and the Business Roundtable.[57]

THE *STONE* RE-ARTICULATION

In 2006, the Delaware Supreme Court in *Stone ex rel. AmSouth Bancorporation v. Ritter*[58] confirmed and clarified the *Caremark* decision. The *Stone* decision is thus important in its own right. It is also important from the perspective of this article because it provides an opportunity to consider the interplay of corporate law duties with the regulatory requirements applicable to banking institutions. The case arose from a major compliance incident at AmSouth Bank, a wholly owned subsidiary of AmSouth Bancorporation. The incident involved the failure by AmSouth Bank to file certain suspicious activity reports ("SARs") as required by the Bank Secrecy Act (the "BSA") and the regulations issued thereunder.[59] As a result of the failure to file various SARs,

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[56] Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, in CORPORATE LAW STORIES 323, 331 (J. Mark Ramseyer, ed. 2009) (stating that *Caremark* "forever changed Delaware law"); Pan, *supra* note 7, at 719 (a "landmark" decision); Hillary A. Sale, *Monitoring* Caremark's *Good Faith*, 32 DEL. J. CORP. L. 719, 720–21 (2007) (noting that *Caremark* is destined to be "one of the most prominent Delaware opinions of all time").

[57] *See* H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L. 1 (2001) (providing a detailed discussion of the background of the *Caremark* decision, including the influence of the ALI and the ABA on the development of the duty to monitor). *See also* Arlen, *supra* note 56 (discussing the importance of the development of even a limited duty to monitor). Various commentators have nonetheless concluded that the *Caremark* standard is set too low. *See, e.g.,* Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FRBNY ECON. POL'Y REV. 91, 102–03 (2003) (arguing that the *Caremark* standard of a "sustained or systematic failure" is too low for banking institutions in particular).

[58] 911 A.2d 362 (Del. 2006).

[59] 31 U.S.C. § 5318(g). The Financial Crimes Enforcement Network ("FinCEN"), the federal agency with general rulemaking authority under the BSA, has issued a regulation implementing the BSA requirement for banks to file SARs. *See* 31 C.F.R. § 1020.320. This regulation was originally issued in 1996. The Federal Reserve Board in 1996 issued its own parallel regulation requiring state-member banks like AmSouth Bank to file SARs. *See* 12 C.F.R. § 208.62. The Federal Reserve Board regulation requires the management of the bank to promptly notify its board, or a committee of the board, of any SAR filed pursuant to the regulation. 12 C.F.R. § 208.62(h). The Federal Reserve Board had previously issued a regulation in 1987 requiring state-member banks to implement a program to monitor compliance with the BSA. *See* Procedures for Monitoring Bank Secrecy Act Compliance, 52 Fed. Reg. 2858 (Jan. 27, 1987). The latter regulation has since 1987 required the board of directors of each state-member

AmSouth Bancorporation and AmSouth Bank were required to pay $40 million in fines pursuant to a deferred prosecution agreement with a U.S. Attorney's office and $10 million in civil money penalties pursuant to separate regulatory orders from the Federal Reserve Board and FinCEN. The deferred prosecution agreement did not ascribe blame to the board or to any director and no regulatory action was taken against the directors. The FinCEN order, however, contained certain findings (which AmSouth neither admitted nor denied), including a finding that AmSouth's BSA compliance program "lacked adequate board and management oversight" and a finding that there were "systemic deficiencies" in the BSA compliance program.[60] In the proceeding before the Court of Chancery, the plaintiffs relied heavily on the findings in the FinCEN order, particularly the finding that the AmSouth BSA compliance program lacked adequate board and management oversight.[61]

The Court of Chancery dismissed the derivative claim for failure to meet the demand requirement of Delaware law, *i.e.,* the requirement that a shareholder either make a demand on the board itself to bring the claim or plead with particularity why a demand on the board should be excused as futile.[62] The Court of Chancery ruled that the plaintiffs, in merely restating in their complaint the FinCEN report finding that the BSA program lacked adequate board oversight, had failed to plead with particularity the facts underlying the FinCEN report's finding, and thus that the plaintiffs' pleading was simply conclusory.[63] The Court of Chancery noted that the plaintiffs had not pled any

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bank to approve a BSA compliance program for the member bank. *See* 12 C.F.R. § 208.63.

60 U.S. Dep't of the Treasury, Financial Crimes Enforcement Network, *In the Matter of AmSouth Bank: Assessment of Civil Money Penalty* (2004), *available at* http://www.sec.gov/Archives/edgar/data/3133/000089183604000358/ex_99-4.htm [hereinafter FinCEN Order].

61 *Stone v. Ritter*, No. Civ. A. 1570-N, 2006 Del. Ch. LEXIS 20, at *3–4 (Del. Ch. Jan. 26, 2006).

62 Delaware Chancery Rule 23.1 requires a shareholder plaintiff to allege with particularity the efforts, if any, made by the plaintiff to obtain action from the directors and the reason for plaintiff's failure to obtain the action or for not making the effort. The plaintiffs in *Stone* asserted that the demand on the board should be excused because the directors faced a substantial likelihood of liability for failing to implement adequate internal controls and thus were incapable of making an impartial decision whether to institute litigation against themselves. *Stone*, 2006 Del. Ch. LEXIS 20, at *5. The Delaware case law on demand futility requires that a derivative complaint plead particularized facts that support the conclusion that the directors face a substantial likelihood of liability on the claim. *See Rales v. Blasband*, 634 A.2d 927, 930 (Del. 1993); *Guttman v. Huang*, 823 A.2d 492, 501 (Del. Ch. 2003).

63 *Stone*, 2006 Del. Ch. LEXIS 20, at *4. Although the FinCEN Order did recite that the AmSouth Bank's BSA program lacked adequate board and management oversight, the FinCEN Order contained no discussion of the basis for that conclusion. The FinCEN Order did recite

facts showing that the board was aware AmSouth Bank's internal controls were inadequate and that the board chose to do nothing about the problems it allegedly knew existed.

The Delaware Supreme Court affirmed the dismissal by the Court of Chancery and in doing so provided an expanded articulation of the legal standards applicable to the director duty of oversight. The Delaware Supreme Court said that there are two bases for imposing director oversight liability under Delaware law:

> 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* (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.[64]

Under either prong of this test, the imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations, thus amounting to a "conscious disregard" of their responsibilities.[65]

The Court of Chancery observed in its decision that the plaintiffs had not pled the existence of any "red flags" that would have suggested that the AmSouth board was aware the internal controls were inadequate and chose to do nothing about the problems. On appeal, the Delaware Supreme Court ruled that in the absence of such "red flags," the good faith of the directors in meeting their oversight responsibility would be measured by the actions that directors had taken to assure that a reasonable information and reporting system existed. The Delaware Supreme Court found support for the proposition that the board had exercised its good faith in assuring that there was a reasonable information and reporting system in a report prepared by KPMG. KPMG had actually prepared the report pursuant to one of the requirements of the Federal Reserve

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that the internal reporting system to management was materially deficient and that, as a result, the board and senior management committees responsible for overseeing BSA compliance could not be effective. FinCEN Order, *supra* note 60, at 4. However, there was no statement in the FinCEN Order indicating that the board was aware of the deficiencies in the internal reporting system. The plaintiffs could not plead particularized facts supporting the conclusory determination about inadequate board oversight in the FinCEN Order because the FinCEN Order itself did not recite any facts relating to the board oversight.

64 *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). The Delaware Supreme Court also re-articulated the oversight duty as being part of the duty of loyalty, rather than the duty of care.

65 *See id.*

Board's enforcement order against AmSouth.[66] In the words of the Delaware Supreme Court, the findings of the KPMG report indicated that the AmSouth board had dedicated "considerable resources" to its compliance program and had put in place "numerous procedures and systems to attempt to ensure compliance" as part of a "longstanding BSA/AML compliance program."[67] The findings of the KPMG report, which was attached as an exhibit to the plaintiffs' complaint, thus served to refute the plaintiffs' assertion that the board of directors never took the necessary steps to attempt to ensure that a reasonable reporting system existed. The detailed findings in the KPMG report also presumably offset the conclusory findings of the FinCEN order.[68] In affirming the dismissal of the complaint, the Delaware Supreme Court reprised the observation made by the *Caremark* court that a claim against directors for failure of oversight is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[69] It is, if possible, an even more difficult theory to pursue with respect to directors of banking

[66] The Federal Reserve Board enforcement order, which was issued simultaneously with the announcement of the deferred prosecution agreement, required AmSouth Bancorporation to retain a qualified independent consultant to conduct a comprehensive review of AmSouth Bank's anti-money laundering ("AML") program and provide a report to the Federal Reserve Board on its review. *In the Matter of AmSouth Bancorporation and AmSouth Bank,* Cease and Desist Order and Assessment of a Civ. Money Penalty, No. 04-021-B-HC ¶ 1 (Oct. 12, 2004). The KPMG report was the product of the review conducted in response to the Federal Reserve Board order. The Federal Reserve Board order also directed the boards of AmSouth Bank and AmSouth Bancorporation to conduct a review of the governance and organization of AmSouth Bank's AML compliance program with a description of the specific actions that the boards proposed to take to strengthen the AML program. *Id.* ¶ 6.

[67] *Stone*, 911 A.2d at 371. The KPMG report described various departments and committees established by the board to oversee AmSouth's compliance with the BSA and to report violations to management and the board. *Id*. As explained in the KPMG report, AmSouth had "for years" maintained a BSA/AML Compliance Department to comply with the Federal Reserve Board regulation requiring such a BSA compliance program as discussed *supra* note 59. *Id*. AmSouth also had a Suspicious Activity Oversight Committee whose mission had been "for years" to oversee the BSA/AML compliance programs. *Id*. In the view of the Delaware Supreme Court, the KPMG report reflected that the directors had not only discharged their oversight responsibility to establish an information and reporting system, but they also proved that the system was designed to permit the directors to monitor AmSouth's ongoing compliance with the BSA. *Id*. at 371–72.

[68] The Delaware Supreme Court noted that the Federal Reserve Board enforcement order had required AmSouth "for the first time" to improve its AML program, thereby disposing of any inference that earlier concerns had been expressed by the Federal Reserve Board to AmSouth or its board about its AML program. *Id*. at 366.

[69] *Id.* at 372 (quoting *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 968 (Del. Ch. 1996)).

institutions that are subject to regulatorily prescribed requirements for compliance monitoring systems.

ENRON AND WORLDCOM RELATED CASES

The Enron and WorldCom scandals provided shareholders with multiple targets for derivative actions. The derivative actions against the directors of Enron and WorldCom enjoyed more success than the derivative actions lodged against corporations with one degree of separation from Enron or WorldCom. For example, the Delaware Supreme Court in *In re Citigroup Inc. Shareholders Litigation* affirmed a dismissal of a derivative complaint against the directors of Citigroup arising out of the involvement of Citibank, N.A. in various transactions with Enron.[70] The complaint alleged that the Citigroup directors knew or should have known about questionable Enron transactions and that the directors were responsible for a "sustained and systematic failure" to supervise the activities of their corporate subordinates.[71] The complaint alleged that there were red flags that should have put the directors on notice of potential "offensive conduct" with respect to the Enron relationship and of weaknesses in internal controls.[72] The Court of Chancery at oral argument elicited from plaintiffs' counsel an acknowledgement that the "red flags" consisted of a "series of internal corporate memoranda and e-mails disseminated at the level of Citigroup's operating subsidiaries."[73] The Court of Chancery concluded that there was "nothing in the [complaint] to suggest or permit the Court to infer that any of these documents ever came to the attention of" the board of directors of Citigroup or any committee of the board.[74]

The Court of Chancery contrasted the situation in the *Citigroup* case with the situation in a case in which the Seventh Circuit had applied Delaware law to a *Caremark* claim. That case, *In re Abbott Laboratories Derivative Shareholders Litigation,* involved a claim against the directors of Abbott Laboratories arising from a consent decree between Abbott Laboratories and the Food and Drug

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[70] *Rabinovitz v. Shapiro*, 839 A. 2d 666 (Del. 2003), *aff'g In re* Citigroup Inc. S'holders Litig., No. 19827, 2003 Del. Ch. LEXIS 61 (Del. Ch. June 5, 2003).

[71] *In re Citigroup*, 2003 Del. Ch. LEXIS 61, at *4.

[72] *Id.* at *7–8.

[73] *Id.*

[74] *Id.* The Court of Chancery observed that "'[r]ed flags' are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer." *Id.* (footnote omitted).

Administration (the "FDA").[75] The consent decree related to violations of FDA regulations spanning a six-year period. The plaintiffs alleged that the directors ignored "repeated red flags" raised by the FDA and reported in the media with respect to violations of the FDA regulations.[76] During the six-year period, the FDA had conducted 13 inspections of Abbott Laboratories and had issued four formal warning letters.[77] The plaintiffs alleged that the directors "were aware of the six-year history of noncompliance . . . with the FDA [regulations] and . . . had a duty to take necessary action to correct the [] problems."[78] The Seventh Circuit ruled that, in light of the "extensive paper trail" and "inferred awareness of the problems" by the board, there was a reasonable assumption that there was a "sustained and systematic failure of the board to exercise oversight."[79] This case provides an example of the application of regulatory warnings as potential red flags relevant to the pleading of a *Caremark* claim. Other federal courts have also been disposed to recognize red flags arising from prior regulatory actions as a sufficient basis to meet the demand futility requirements of Delaware law.[80] These particular federal courts have also been more inclined to draw inferences about what the directors might have known than the Delaware courts.

In *David B. Shaev Profit Sharing Account v. Armstrong*, the Delaware courts considered another derivative action brought against the directors of Citigroup, arising from the relationships between Citigroup and its clients, Enron and WorldCom.[81] Citigroup's activities with Enron and WorldCom resulted in multi-billion dollar settlements with the shareholders of Enron and WorldCom, a significant fine from the Securities and Exchange Commission (the "SEC"),

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[75] 325 F.3d 795 (7th Cir. 2003).

[76] *Id*. at 802.

[77] *Id.* at 799–800.

[78] *Id*. at 802.

[79] *Id*. at 809.

[80] *See, e.g.*, *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001) (holding that allegations of red flags, including an extensive federal investigation of Medicare fraud, were sufficient under Delaware law to excuse demand on the board). *See also* Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719, 733–43 (discussing the nature of the "red flags" in the *Abbott Laboratories* and *McCall* cases that led the courts to conclude that a demand on the board should be excused). *See also In re* Pfizer Inc. S'holder Deriv. Litig., 722 F. Supp. 2d 453 (S.D.N.Y. 2010) (holding that allegations of red flags relating to prior government enforcement actions for similar drug marketing activities were sufficient under Delaware law to excuse demand on the board).

[81] No. Civ. A. 1449-N, 2006 Del. Ch. LEXIS 33 (Del. Ch. Feb. 13, 2006), *aff'd*, 911 A.2d 802 (Del. 2006).

and regulatory actions from the OCC and the Federal Reserve Bank of New York.[82] The plaintiff in this derivative case "concede[d] that the [Citigroup directors] knew nothing about the challenged transactions, and had erected a full set of supervisory mechanisms to oversee the company" and to detect misconduct.[83] The plaintiff nonetheless argued that only a reckless indifference to duty could explain why the board remained ignorant of Citigroup's involvement with Enron and WorldCom. The Court of Chancery rejected this argument as relying on precisely the type of conclusory statements that do not meet the *Caremark* standard. The court observed that the complaint alleged "literally nothing to suggest that the defendants willfully or recklessly ignored information that would have led to the discovery of the misconduct at issue."[84] It noted in particular that the plaintiff had not alleged any particularized facts suggesting that the board had been presented with red flags alerting it to the potential misconduct with respect to Enron or WorldCom.[85] The opinion in this case provides an epitaph that is equally applicable to the many other *Caremark* complaints that have over the years failed to survive a motion to dismiss: "the most the complaint alleges is that some admittedly troubling things happened at Citigroup, that the directors had erected a full panoply of audit systems designed to detect such misconduct, that for some reason the system failed to work, and that damages to Citigroup ensued."[86]

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82 *See* Citigroup, Inc., Exchange Act Release No. 48230, 80 SEC Docket 2116 (July 28, 2003); Written Agreement Between Citibank, N.A. and Office of the Comptroller of the Currency, Enf't Action No. 2003-77 (July 28, 2003), http://www.occ.gov/static/enforcement-actions/ea2003-77.pdf; Written Agreement Between Citigroup, Inc. and Federal Reserve Bank of New York (July 28, 2003), http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20030728/attachment.pdf.

83 *Armstrong*, 2006 Del. Ch. LEXIS 33, at *16. The plaintiff's counsel acknowledged at oral argument that Citigroup had a "wide range of compliance systems in place" and that the directors "had no reason to believe that the []systems were not functioning in a basic sense." *Id.* at *18. The wide range of compliance systems at Citigroup were presumably in place to meet the requirements and expectations of the various regulatory authorities with supervisory responsibility over Citigroup and its subsidiaries. In response to Citigroup's activities with Enron, the OCC and the Federal Reserve Board as part of their enforcement actions required Citigroup to institute a new monitoring system for so-called "complex structured finance transactions." *See supra* note 82. Subsequently, the OCC, the Federal Reserve Board, the FDIC, and the SEC issued industry-wide guidance to banking institutions for enhanced monitoring procedures for complex structured finance transactions. *See* Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 72 Fed. Reg. 1372 (Jan. 11, 2007).

84 *Armstrong*, 2006 Del. Ch. LEXIS 33, at *3–4.

85 *Id.* at *18.

86 *Id.* at *4.

Even in an era marked by prominent corporate scandals like Enron and WorldCom, the Delaware courts adhered to a strict application of the requirements for *Caremark* claims.[87] The combination of the substantive requirement under Delaware law for *Caremark* liability (bad faith or a conscious disregard of responsibility) and the procedural requirement under Delaware law for satisfying demand futility (pleading particularized facts indicating such bad faith or conscious disregard of duty) has meant that few derivative actions asserting a *Caremark* claim have proceeded beyond the initial pleading stage in Delaware courts.[88]

RECENT DEVELOPMENTS

The Delaware courts continue to show caution in addressing *Caremark* claims. The recent decision in *In re General Motors Company Derivative Litigation* reflects that caution.[89] This case involved a derivative claim against the directors of General Motors for a corporate activity that in the words of the Court of Chancery had gone "terribly awry": the malfunction of ignition switches in General Motors cars.[90] The complaint asserted that the board should have had a system to be informed of serious car defects. A special investigation that was commissioned by General Motors after the ignition-switch problem became public in February 2014 concluded that the reporting system put in place by the General Motors board did not require that serious defects be reported to the board and that the board did not learn of the ignition-switch problem until General Motors announced the first of its recalls in February 2014.[91] The Court of Chancery noted that the complaint did not allege that the board was aware that its risk management system was not functioning as it should; in other words, there were no "red flags" or other bases

[87] Other courts applying Delaware law also dismissed derivative complaints asserting claims based on Enron-related transactions. *See, e.g.*, *Halpert Enters. Inc. v. Harrison*, 362 F. Supp. 2d 426 (S.D.N.Y. 2005) (dismissing derivative claim against the directors of JPMorgan Chase); *Simon v. Becherer,* 7 A.D. 3d 66 (N.Y. App. Div. 2004) (reversing judgment denying motion to dismiss derivative claim against the directors of JPMorgan Chase); *Fink v. Komansky*, No. 03CV0388 (GBD), 2004 U.S. Dist. LEXIS 24660 (S.D.N.Y. Dec. 8, 2004) (dismissing derivative claim against the directors of Merrill Lynch).

[88] For one of the rare occasions on which a *Caremark* claim has survived a motion to dismiss in the Delaware courts, see *In re Am. Int'l Group, Inc. v. Greenberg.*, 965 A.2d 763, 799 (Del. Ch. 2009) (holding that facts supporting an inference that certain officer-directors knew that the company's internal controls were inadequate would withstand a motion to dismiss).

[89] C.A. No. 9627-VCG, 2015 Del. Ch. LEXIS 179 (Del. Ch. June 26, 2015).

[90] *Id.* at *1–2.

[91] *Id.* at *7.

from which the court could infer knowledge by the board that the risk management system was inadequate.[92] According to the court, the complaint was asserting in effect that "[General Motors] *had* a system for reporting risk to the Board, but in the Plaintiffs' view it should have been a better system."[93] The court did suggest that the facts pled in the complaint might be sufficient to raise a reasonable doubt about whether the board's oversight was "free of negligence."[94] But applying the *Caremark* standard, the court concluded that even gross negligence in respect of board oversight would not imply a threat of director liability and hence that there was no basis for a finding of demand futility.[95] The *General Motors* decision is a fresh reminder, if any be needed, of the high hurdle for establishing oversight liability under Delaware law.[96]

THE DUTY TO MONITOR BUSINESS RISK

In its classic form, the *Caremark* standard has been applied to cases involving fraudulent accounting practices or other illegal activities by employees of a corporation. The onset of the financial crisis in 2007 with the attendant announcement of significant losses by many large financial companies provided the occasion for shareholders to attempt to apply the *Caremark* standard to alleged failures to monitor business risk. A derivative action mounted against the directors of Citigroup in 2007 based on subprime mortgage losses provided the first opportunity for a Delaware court to consider the application of the

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[92] *Id.* at *40.

[93] *Id.* at *46.

[94] *Id.* at *57.

[95] *Id.* Among the concluding thoughts in the opinion was the following: "Pleadings, even specific pleadings, indicating that directors did a poor job of overseeing risk in a poorly-managed corporation do not imply director bad faith." *Id* at *57–59 (footnote omitted).

[96] In several particularly egregious financial statement cases involving Delaware companies operating from China, the Delaware courts have allowed *Caremark* claims to survive motions to dismiss. *See*, *e.g.*, *In re* China Agritech, Inc. S'holder Deriv. Litig., C.A. No. 7163-VCL, 2013 Del. Ch. LEXIS 132, at *56 (Del. Ch. May 21, 2013) ("[L]ike those rare *Caremark* complaints that prior decisions have found adequate, the [c]omplaint supports [its] allegations with references to books and records obtained using Section 220[of the Delaware General Corporation Law] . . . ."); *Rich ex rel. Fuqi Int'l v. Chong*, 66 A.3d 963, 966 (Del. Ch. 2013) ("Notwithstanding the well-known difficulty of prevailing on a *Caremark* claim, the Plaintiff has pled facts that, assumed true, lead me to reasonably infer that the Fuqi directors knew that its internal controls were deficient, yet failed to act."); *cf.* Alexandra Stevenson & Matthew Goldstein, *A Bounty Hunter on Wall Street: Robert W. Seiden Represents American Investors Who Have Sued Chinese Companies, Saying They Were Duped*, N.Y. Times, Mar. 16, 2016, at B1 (discussing legal actions against nine Chinese-owned companies incorporated in the United States).

Caremark duty to the monitoring of business risk.[97] The plaintiffs asserted that various red flags relating to the subprime mortgage market should have put the Citigroup directors on notice of problems in that market and in Citigroup's own subprime mortgage holdings.[98] The Court of Chancery characterized the plaintiffs' claim of failure to monitor as an attempt "to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the [c]ompany."[99] The court worried about the risk of hindsight bias, particularly as applied to decisions about business risk: "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."[100] The court offered the further observation that "[b]usiness decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future."[101] The court was reluctant to venture into an area that might lead to second-guessing directors' oversight of business risk and thereby undermine the business judgment rule. The answer that the Delaware courts have traditionally applied to these kinds of challenges to director action is to focus the legal analysis on the directors' decision-making process rather than on a substantive evaluation of the merits of the directors' decision.[102]

For purposes of its analysis of the demand futility provisions of Delaware law, the Court of Chancery analyzed the claim against the directors as a *Caremark* claim. The demand futility pleading rules for a *Caremark* claim require particularized factual allegations of bad faith or conscious disregard of duty by the directors.[103] The court said that the only factual support that the plaintiffs had provided for their *Caremark* claim were "red flags" that amounted to nothing more than signs of continuing deterioration in the subprime mortgage market. Of these "red flags" the court said:

> That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they

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[97] *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106 (Del. Ch. 2009).

[98] *See id.* at 123–24.

[99] *Id.* at 124.

[100] *Id.* at 126.

[101] *Id.*

[102] *See id.* at 124.

[103] *See id.* at 127.

> did not properly evaluate business risk. What plaintiffs are asking the Court to conclude from the presence of these "red flags" is that the directors failed to see the extent of Citigroup's business risk and therefore made a "wrong" business decision by allowing Citigroup to be exposed to the subprime mortgage market.[104]

The court found that the plaintiffs' reliance on these "red flags" was insufficient to meet the pleading standard for a *Caremark* claim—in effect by applying the business judgment rule to the claim.[105]

Having found the plaintiffs' pleadings of a *Caremark* claim insufficient for purposes of the Delaware demand futility rule, the court returned to the issue whether *Caremark* should encompass a duty to monitor business risk in the first place. The court appeared to conclude that it should not. The court reasoned that there are significant differences between failing to monitor employee fraudulent or criminal behavior and failing to recognize the extent of a company's business risk. It observed that "[t]o impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors."[106] The court, however, left the door slightly ajar with language suggesting that "under some set of facts" it might be possible for a plaintiff to meet the burden for stating a *Caremark* claim relating to the monitoring of business risk.[107]

The *Citigroup* decision produced conflicting commentary. The corporate bar strongly endorsed the conclusion that monitoring business risk should not be encompassed under the *Caremark* duty.[108] They asserted that the business judgment rule required this outcome. As stated in the most reductionist form

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[104] *Id.* at 130.

[105] *Id.* at 129–30.

[106] *Id.* at 131. The court further observed with respect to the risk of hindsight bias that "[i]n any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong." *Id.*

[107] *Id.* at 126.

[108] *See, e.g.*, Mark J. Gentile & Joseph L. Christensen, In re Citigroup: *The Birth Announcement and Obituary of the Duty of Business Performance Oversight*, 3 BLOOMBERG LAW REPORTS—CORPORATE LAW, no. 19, 2009; Peter Atkins, Harv. L. Sch. F. on Corporate Governance and Fin. Reg., Directors' Duty of Oversight in a Meltdown (March 8, 2009), https://corpgov.law.harvard.edu/2009/03/08/directors-duty-of-oversight-in-a-meltdown/; Martin Lipton, Harv. L. Sch. F. on Corporate Governance and Fin. Reg., The Welcome Reaffirmation of the Business Judgment Protection (Feb. 27, 2009), https://corpgov.law.harvard.edu/2009/02/27/the-welcome-reaffirmation-of-the-business-judgment-protection/.

by corporate practitioners, "[e]ach decision directors make, whether discrete or not, about the manner in which the directors monitored business risk is a business decision."[109] Academic commentary was divided. Some experts argued that boards should not be excused from some level of monitoring business risk.[110] These commentators suggested, for example, that once the board had set a risk appetite for the company or for an important activity or product (which these commentators acknowledge would be protected by the business judgment rule), there should be a subsequent duty to monitor whether the employees were adhering to the risk appetite. As discussed in Part II of this article, this is the approach that the federal banking agencies take to board monitoring. Other scholars concluded that the *Citigroup* decision on balance represented the appropriate treatment of directors' responsibilities with respect to business risk.[111]

The Court of Chancery had another opportunity to consider a *Caremark* claim relating to the monitoring of business risk in *In re The Goldman Sachs Group Inc. Shareholder Litigation*.[112] The plaintiffs asserted various derivative claims, including a *Caremark* claim, based on an alleged failure by the directors to monitor legal and business risk presented by certain securities trading activities of Goldman Sachs. The plaintiffs claimed that the compensation system approved by the board had led management to pursue a high-risk business strategy that emphasized short-term profits to enhance their yearly bonuses at the expense of shareholder interests. This incentive system also allegedly led employees of Goldman Sachs to take positions that were in conflict with clients' interests to the detriment of the company's reputation. As an example of such conflicts, the complaint pointed to the Abacus transaction, which had resulted in an enforcement action and a $550 million penalty from

[109] Gentile & Christensen, *supra* note 108, at 3.

[110] *See, e.g.*, Claire Hill & Brett McDonnell, *Reconsidering Board Oversight Duties After the Financial Crisis*, 2013 U. Ill. L. Rev. 859 (2013); Renee M. Jones & Michelle Welsh, *Toward a Public Enforcement Model for Directors' Duty of Oversight*, 45 Vand. J. Transnat'l L. 343 (2012); Eric J. Pan, *Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 Fla. St. U. L. Rev. 209 (2011); Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on* In re Citigroup Inc. Shareholder Derivative Litigation, 23 McGeorge Pac. Global Bus. & Dev. L.J. 1 (2010); Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. Corp. L. 967 (2009).

[111] *See, e.g.*, Christine Hurt, *The Duty to Manage Risk*, 39 J. Corp. L. 253 (2014); Lisa M. Fairfax, *Managing Expectations: Does the Directors' Duty to Monitor Promise More than It Can Deliver?*, 10 U. St. Thomas L.J. 416 (2012); Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 Va. L. & Bus. Rev. 433 (2011); Robert T. Miller, *The Board's Duty to Monitor Risk After* Citigroup, 12 U. Pa. J. Bus. L. 1153 (2010).

[112] C.A. No. 5215-VCG, 2011 Del. Ch. LEXIS 151 (Del. Ch. Oct. 12, 2011).

the SEC for a failure by Goldman Sachs to make appropriate disclosures relating to the transaction. The complaint also cited three other transactions as examples of "disloyal or unethical trading practices." The Court of Chancery said that the pleading of "disloyal" or "unethical" transactions was not a sufficient pleading of wrongdoing or illegality to meet the *Caremark* standard. The Court of Chancery further said that the complaint did not allege as to those three transactions the disclosure problem that allegedly afflicted the Abacus transaction. The Court of Chancery concluded, however, that the Abacus transaction, even with its disclosure issue, did not on its own demonstrate a willful ignorance of red flags by the directors. In the words of the court, "[t]he single Abacus transaction without more is insufficient to provide a reasonable inference of bad faith on the part of the Director Defendants."[113]

The Court of Chancery then turned to the aspects of the complaint that asserted a *Caremark* claim based on the board's failure to monitor business risk. The Court of Chancery noted that the *Citigroup* decision had not definitely stated whether a *Caremark* duty includes a duty to monitor business risk as well as legal or compliance risk.[114] It quoted approvingly the language from the *Citigroup* decision that imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different from imposing a duty to monitor for fraud or illegal activity.[115] It also quoted the language from the *Citigroup* decision that the manner in which a company "evaluate[s] the trade-off between risk and return" is "[t]he essence of . . . business judgment."[116] It further observed that "[i]f an actionable duty to monitor business risk exists, it cannot encompass any substantive evaluation by a court of a board's determination of the appropriate amount of risk. Such decisions plainly involve business judgment."[117]

The Court of Chancery then reviewed the work of the audit committee of the Goldman Sachs board in overseeing the company's market, credit and other risks. The court observed that "[t]he Director Defendants exercised their business judgment in choosing and implementing a risk management system that they presumably believed would keep them reasonably informed of the company's business risks."[118] The court dismissed the *Caremark* claim for a

[113] *Id.* at *70.

[114] *Id* at *72.

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Id.* at *75.

failure to plead facts showing a substantial likelihood of liability on the part of the Director Defendants.[119]

The Court of Chancery has more recently had occasion to consider a derivative action against the directors of JPMorgan Chase, arising from the operation of the Chief Investment Office (the "CIO") of JPMorgan Chase and the activities of the so-called "London Whale."[120] The complaint alleged a "sustained and systematic" failure to establish and maintain proper control or oversight of the accounting and financial reporting polices related to the CIO.[121] The court dismissed the complaint on the grounds of collateral estoppel, arising from the dismissal of similar claims in actions previously filed in state and federal courts in New York (discussed below). In dismissing the complaint on estoppel grounds, the court observed that "[i]t is not entirely clear under what circumstances" a derivative claim could prevail on a theory of failure to monitor business risk.[122] The court then volunteered the view that "it is difficult to see how successful maintenance of [such a] derivative action can be consistent with this jurisdiction's model of corporate governance, short of circumstances that would support a waste claim."[123]

STATE AND FEDERAL DECISIONS IN NEW YORK

The question whether the *Caremark* duty extends to monitoring business risk has also occupied the attention of state and federal courts in New York. In *Security Police and Fire Professionals of America Retirement Fund v. Mack*, shareholders of Morgan Stanley sought to bring a derivative action against the directors of Morgan Stanley for failure of oversight with respect to the compensation paid to employees of Morgan Stanley.[124] The Appellate Division of the New York Supreme Court said that assuming *arguendo* the duty of oversight includes the duty to monitor business risk, the plaintiffs had failed to allege that the directors had "*consciously* failed to implement any sort of risk monitoring system or, having implemented such a system, *consciously* disre-

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[119] *Id.* at *77.

[120] *See* Asbestos Workers Local 42 Pension Fund v. Bammann, C.A. No. 9772-VCG, 2015 Del. Ch. LEXIS 142 (Del. Ch. May 21, 2015).

[121] *Id.* at *6.

[122] *Id.* at *43. The Court noted that the plaintiff cited no examples where a *Caremark* claim applied to business risk had successfully been maintained. *Id.*

[123] *Id.* at *43–44.

[124] 940 N.Y.S. 2d 609 (App. Div. 2012).

garded red flags."[125] It affirmed the dismissal of the complaint for failure to make a demand on the board.

The Appellate Division of the New York Supreme Court in *Wandel v. Dimon* has also recently affirmed the dismissal of a derivative claim against the directors of JPMorgan Chase, arising from the "London Whale" incident.[126] The Appellate Division relied in significant part on the reasoning in a decision from the Second Circuit dismissing a similar derivative claim arising from the "London Whale" incident in a case filed in the Southern District (discussed below).[127] New York courts applying Delaware law have regularly dismissed derivative claims, alleging a failure to monitor legal or business risk, based on the failure to plead particularized facts indicating that the board was aware of any of the alleged problems and failed to take action.[128]

A number of derivative actions filed in the Southern District of New York also involve *Caremark* claims, arising out of activities related to the financial crisis. *In re Goldman Sachs Mortgage Servicing Shareholder Derivative Litigation* involved a shareholder claim, alleging a failure by the board of Goldman Sachs to monitor various mortgage servicing activities.[129] The mortgage servicing activities at many companies became the subject of intense government scrutiny as residential mortgage foreclosures rose rapidly in the wake of the financial crisis.[130] Goldman acquired a mortgage servicing company (Litton Loan) in

[125] *Id.* at 614.

[126] 23 N.Y.S. 3d 200 (App. Div. 2016).

[127] *Id.* at 203–204 (citing *Wayne Cty. Empls.' Ret. Sys. v. Dimon*, 135 A.D.3d 515, 23 N.Y.S.3d 200 (2d Cir. 2015)).

[128] *See, e.g., City of Roseville Empls.' Ret. Sys. v. Dimon*, 2014 WL 7643004 (N.Y. Sup. Ct. Dec. 16, 2014), *aff'd*, 22 N.Y.S. 3d 850 (App. Div. 2016) (alleging a failure by the JPMorgan Chase board to oversee mortgage servicing activities); *Siegel v. JPMorgan Chase & Co*., 2012 N.Y. Misc. LEXIS 6101 (Sup. Ct. 2012), *aff'd*, 960 N.Y.S. 2d 104 (App. Div. 2013) (alleging a failure by the JPMorgan Chase board to oversee mortgage-backed securities activities); *Asbestos Workers Phila. Pension Fund v. Bell*, 990 N.Y.S. 2d 436 (Sup. Ct. 2014), *aff'd*, 137 A.D. 680 (App. Div. 2016) (alleging a failure by the JPMorgan Chase board to oversee mortgage-backed securities activities). *See also Cent. Laborers' Pension Fund v. Blankfein*, 971 N.Y.S. 2d 282 (App. Div. 2013) (noting that plaintiffs were not contesting the lower court decision that they had failed to plead particularized facts relating to their claim that the Goldman Sachs board had failed to oversee compensation).

[129] 42 F. Supp. 3d 473 (S.D.N.Y. 2012).

[130] *See, e.g.*, Press Release, Federal Reserve Board (April 13, 2011), announcing the issuance of consent cease and desist orders against 10 large banking organizations arising from deficient practices with respect to residential mortgage foreclosures, *available at* http://www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm.

2007, which it subsequently sold in September 2011.[131] In September 2011, the Federal Reserve Board entered into a consent cease and desist order with Goldman Sachs relating to alleged improper mortgage servicing activities, such as the robo-signing of foreclosure affidavits by Litton employees.[132] The plaintiffs posited that Goldman Sachs had a "robust" governance structure and so the board "must have been aware" that the Litton mortgage servicing business lacked adequate controls and that Litton employees were engaged in improper activities, such as "robo-signing."[133] The court noted that the plaintiffs' complaint alleged no red flags that would have alerted the Goldman Sachs board to the alleged "broken" controls in the Litton operations.[134] The court distinguished the case before it from the allegations in the *Abbott Laboratories* case and several other cases, which found that sufficient red flags were alleged to meet the pleading requirements for demand futility.[135]

In *Brautigam v. Rubin*, a shareholder sought to bring a claim against the directors of Citigroup for a failure to properly oversee the company's mortgage servicing operations.[136] In April 2011 the OCC announced that it had entered into consent orders with Citibank and seven other banks, including Bank of America, JPMorgan Chase Bank and Wells Fargo Bank, relating to mortgage servicing practices. Likewise in April 2011 the Federal Reserve Board announced that it had entered into consent orders with Citigroup and nine other bank holding companies relating to the mortgage servicing activities of their

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[131] *In re Goldman*, 42 F. Supp. 3d at 477.

[132] *The Goldman Sachs Group, Inc.*, Consent Order, Docket Nos. 11-112-B-HC & 11-112-B-SM (Sept. 1, 2011), http://www.federalreserve.gov/newsevents/press/enforcement/enf20110901f1.pdf. In the Consent Order, Goldman Sachs neither admitted nor denied the alleged shortcomings in the Litton mortgage servicing operations. The Consent Order required Goldman Sachs to implement various remedial measures with respect to any future mortgage servicing activities in which it might engage. It required the boards of Goldman Sachs and any servicing company that it might operate to submit a written plan "to establish strong board oversight of residential mortgage loan servicing, including the boards' oversight of risk management, internal audit, and compliance programs . . . ." *Id.* ¶ 9.

[133] *In re Goldman*, 42 F. Supp. 3d at 482.

[134] *Id.* at 483.

[135] *Id.* For example, plaintiffs' counsel conceded at oral argument that Litton comprised only a small percentage of Goldman Sachs' revenue in distinction to the situation in the case of *In re Countrywide Financial Corp. Derivative Litigation*, 554 F. Supp. 2d 1044 (C.D. Calif. 2008), where the challenged practices concerned "the very core of Countrywide's business model" and where the court was willing to infer that the directors must have known about the challenged practices in Countrywide's mortgage underwriting operations. *In re Goldman*, 42 F. Supp. 3d at 483 (quoting *In re Countrywide*, 554 F. Supp. 2d at 1082 n.42).

[136] 55 F. Supp. 3d 499 (S.D.N.Y. 2014).

subsidiaries. The shareholder complaint alleged various warnings that Citigroup had about its mortgage servicing operations, but the bulk of the warnings related to general deterioration in the housing market and Citigroup's exposure as an originator of subprime loans.[137] According to the complaint, however, there were also more specific red flags in the form of letters to Citigroup from certain regulatory bodies. The complaint referred to a February 2008 supervisory letter from the OCC summarizing its examination of director and management oversight at Citicorp for the second half of 2007 and referring to risk management failures at Citibank.[138] The complaint also referred to an April 2008 examination letter in which the Federal Reserve Board "criticized Citigroup's weak risk-management practices and internal-control failures."[139] However, as the court observed, the complaint did not allege that the criticism in these letters related to the specific risk management failures that were the subject of the derivative claim, *i.e.*, risk management failures in Citigroup's mortgage servicing business. A subsequent statement in the court's opinion recited that the 2008 letters from the OCC and the Federal Reserve Board related to risk management problems with Citigroup's structured credit

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[137] *Id.* at 502.

[138] *Id.*

[139] *Id.* Examination reports and letters such as those cited in the *Brautigam* complaint discussing the findings of an examination process constitute confidential supervisory information protected from disclosure by federal law, including a provision in the U.S. criminal code. *See* Office of the Comp. of the Currency, Fed. Deposit Ins. Corp., Bd. of Governors of the Fed. Reserve Sys. & Office of Thrift Supervision, *Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information* (Feb. 28, 2005), http://www.federalreserve.gov/boarddocs/srletters/2005/SR0504a1.pdf. Such information is also protected by a qualified privilege from discovery in private litigation. *See, e.g.*, *In re* Citigroup Bond Litig., No. 08 Civ. 9522(SHS), 2011 U.S. Dist. LEXIS 155715 (S.D.N.Y. Dec. 5, 2011) (permitting disclosure of certain documents given by Citigroup to the federal bank regulators as part of the supervisory process and denying disclosure of other documents under the qualified privilege for bank examination material). Shareholder plaintiffs will generally not have access to such supervisory information in pursuing derivative litigation. The examination reports and letters cited in the *Brautigam* complaint happened to be available on a public website as a result of the work of the Financial Crisis Inquiry Commission. The plaintiff thus was able to attach the examination reports as exhibits to its complaint in *Brautigam*. In contrast to examination reports, most enforcement actions by the bank regulatory agencies, such as written agreements, cease and desist orders, and civil money penalties, must be publicly disclosed (12 U.S.C. § 1818(u)(l)) and so are available to plaintiff shareholders to cite as potential red flags. However, public enforcement orders issued by the bank regulatory agencies generally do not include a recitation of particularized facts and instead rely on conclusory recitals that will likely not satisfy the pleading requirements under Delaware law.

products, not its mortgage servicing business.[140] The court said that these "red flags" did not support the claim for demand futility. Likewise, the court said that the regulatory settlements entered into by Citigroup relating to its mortgage services practices, such as the April 2011 consent orders with the OCC and the Federal Reserve Board, did not provide evidence that the board knew of the mortgage servicing deficiencies at the time of the original misconduct.[141]

Other business practices related to the financial crisis have also been the subject of derivative claims in the Southern District. For example, a district court dismissed a derivative action brought against the directors of American International Group, Inc. ("AIG"), alleging *inter alia* a breach of fiduciary duty for failure of adequate oversight over AIG's credit default swaps exposure.[142] The plaintiff shareholders argued that there were numerous "red flags" that provided the board with constructive knowledge of inadequacies in AIG's risk management of its credit default swaps exposure. The two red flags of greatest significance according to the complaint were multiple warnings from AIG's external auditor about material weaknesses in AIG's risk management and two warnings from AIG's primary federal regulator, the Office of Thrift Supervision (the "OTS"), specifically relating to AIG's risk management of its credit default swaps exposure.[143] The district court concluded that the directors who were aware of the auditor and OTS warnings were entitled to rely on the management's determination that the actions taken by AIG in response to those warnings under the supervision of the AIG audit committee were adequate.[144]

The Second Circuit has also dealt with other high-profile derivative claims, one of which was similar to the claim in the *Stone* case. In *Central Laborers' Pension Fund v. Dimon*, the plaintiff shareholders brought a derivative action against the directors of JPMorgan Chase, arising out of the Ponzi scheme orchestrated by Bernard Madoff.[145] The failure by JP Morgan Chase to file a timely SAR on the Madoff relationship resulted in a deferred prosecution

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140 *Brautigam*, 55 F. Supp. 3d at 507.

141 *Id.*

142 *In re* Am. Int'l Grp., Inc. Deriv. Litig., 700 F. Supp. 2d 419 (S.D.N.Y. 2010), *aff'd*, 415 F. App'x 285 (2d Cir. 2011) (summary order).

143 *Id.* at 427. Like the complaint in *Brautigam*, the complaint in the *AIG* case cited confidential examination reports relating to AIG that happened to be publicly available as a result of the work of the Financial Crisis Inquiry Commission.

144 *Id.* at 437.

145 2014 U.S. Dist. LEXIS 100874 (S.D.N.Y. July 23, 2014), *aff'd*, 638 F. App'x 34 (2d Cir. Jan. 6, 2016) (summary order).

agreement between JPMorgan Chase and the U.S. Attorney's Office and a $1.7 billion penalty payment by JPMorgan Chase. The derivative complaint alleged *inter alia* a failure by the board to ensure that the company maintained an effective internal control structure for filing SARs. The plaintiffs cited alleged red flags surrounding the Madoff relationship, but, as the district court observed, without showing that the outside directors had any knowledge of the red flags. The district court dismissed the complaint for a failure to plead particularized facts that would support a finding of a "dereliction of duty" or a "conscious disregard" of duty by the directors.[146] As in the *Stone* case, JPMorgan Chase and its bank subsidiaries were required to have extensive BSA and AML compliance and monitoring systems based on bank regulatory requirements. Thus, the plaintiffs could not allege that the directors had failed to establish any compliance or reporting system. They could only allege that the extensive existing systems at JPMorgan Chase were deficient, which the district court found to be a legally insufficient claim under the *Caremark* standard.

On appeal, the plaintiffs argued that under Delaware law the test for a *Caremark* claim is not whether the directors failed to assure that a company had *any* reporting system, but rather whether it had a *reasonable* system. The Second Circuit affirmed the conclusion of the district court that the test as stated in the *Stone* decision is the failure to provide for *any* system.[147] The Second Circuit found support for this conclusion both in the language of the *Stone* case and in the recent holding by the Court of Chancery in *In re General Motors Company Derivative Litigation*.[148] In the *General Motors* case the Court of Chancery dismissed a derivative action with the observation that "the Plaintiffs complain that GM could have, should have, had a *better* reporting system, but not that it had *no* such system."[149]

The Second Circuit also has had an opportunity to consider a derivative

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[146] *Cent. Laborers'*, 2014 U.S. Dist. LEXIS 100874, at *10.

[147] *Cent. Laborers',* 2016 U.S. App. LEXIS 48, at *12–13.

[148] *Id*. at *12–14 (quoting *In re* Gen. Motors Co. Deriv. Litig., No. 9627-VCG, 2015 Del. Ch. LEXIS 179, at *46–49 (Del. Ch. June 26, 2015), *aff'd*, No. 392, 2015, 133 A.3d 971 (Del. Feb. 11, 2016)).

[149] *In re Gen. Motors*, 2015 Del. Ch. LEXIS 179, at *49. In *Steinberg v. Dimon*, No. 14 Civ. 688(PAC), 2014 U.S. Dist. LEXIS 96838 (S.D.N.Y. July 16, 2014), another plaintiff shareholder sought to bring a derivative action against the directors of JPMorgan Chase, based on several legal and regulatory actions taken against JPMorgan, including the legal and regulatory actions arising from the Madoff matter. The district court found that the complaint failed to provide particularized facts demonstrating that any of the outside directors knew or should have known about any of the alleged red flags cited in the complaint relating to the various regulatory investigations. The complaint cited certain internal reports and communications referring to the

claim against JPMorgan Chase involving the "London Whale" incident. In *In re JPMorgan Chase & Co. Derivative Litigation*, the district court dismissed a derivative action against the directors of JPMorgan Chase for allegedly failing to monitor excessive risk in the CIO.[150] The district court observed that to satisfy the demand futility requirement under Delaware law, the complaint had to allege particularized facts showing that the directors consciously disregarded their duty to monitor the business. The district court further observed that because the derivative claim was premised on an alleged failure to monitor business risks, "their burden is even greater."[151] The district court ruled that the plaintiff had not pled sufficient facts to support its assertion that the board of JPMorgan Chase had consciously disregarded red flags regarding risk in the CIO. The JPMorgan Chase board consisted of one management director and ten independent directors. The district court specifically ruled that the plaintiff could not satisfy its burden of pleading that a majority of the board faced a substantial likelihood of personal liability by relying on allegations that a minority of the board, namely, the audit committee, was aware of certain information relating to the CIO. Moreover, as the district court noted, the information on the CIO available to the audit committee did not include specific information about the CIO trading strategy that led to the large losses.[152]

The plaintiff also cited as a red flag a 2010 OCC supervisory letter that was provided to the board.[153] The district court noted, however, that the OCC letter, which was provided to the board in summary form, only said that the CIO needed to better document investment policies and portfolio decisions in its portfolios. The district court concluded that these statements in the OCC supervisory letter did not put the board on notice of "facially improper business

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investigations, but did not allege that the board ever saw the documents. *Steinberg*, 2014 U.S. Dist. LEXIS 96838, at *11.

[150] 2014 U.S. Dist. LEXIS 46363 (S.D.N.Y. March 31, 2014), *aff'd sub nom*, *Wayne Cty. Emps.' Ret. System v. Dimon*, 629 F. App'x 14 (2d Cir. 2015) (summary order).

[151] *In re JPMorgan Chase*, 2014 U.S. Dist. LEXIS 46363, at *15.

[152] *Id.* at *20–21.

[153] *Id.* at *18. In its complaint the plaintiff quoted several phrases from the OCC supervisory letter that were extracted from an extensive report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs of the U.S. Senate relating to the CIO operations. *Id.*; *see* STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 113TH CONG., JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES 222–224 (2013). The Permanent Subcommittee CIO report included quotes and summaries of various supervisory communications between JPMorgan and the OCC. *See id.* As confidential supervisory information, these communications would not have been publicly available but for their incorporation into the Permanent Subcommittee report.

risks or illegal activity" in the CIO.[154] The plaintiff subsequently asked for reconsideration of the district court's decision, asserting that the decision did not adequately consider the settlements that JPMorgan Chase had reached with various regulators relating to the operations of the CIO.[155] The district court responded that the regulatory settlements did not contain any admissions with respect to the board's awareness of improper risk or illegal activities at the CIO.[156]

The Second Circuit affirmed the dismissal of the derivative action for failing to plead demand futility.[157] The Second Circuit began its analysis with the observation that the standard for pleading a *Caremark* claim is exacting, *i.e.*, a sustained or systematic failure to exercise oversight. It further observed that this "considerable threshold is raised when, as here, the claims involve a failure to monitor *business* risk, as opposed to legal risk."[158] The Second Circuit confirmed that a pleading will not satisfy the demand futility requirements for a *Caremark* claim by alleging that particular warnings reached a minority of the board. It then noted that the complaint had alleged that some warnings had reached a majority of the board, but that the most urgent of these warnings were "given in a single quarter in which an audit report was prepared and delivered, and the severe loss followed the audit report by a few days or a couple of weeks."[159] Hence, even if there were warning signs, "the warning signs were not received, let alone ignored, over a sustained period of time."[160] The Second Circuit thus ruled that the plaintiff had not pled a "sustained or systematic failure" of the board to exercise oversight.[161]

Similarly, in *Brautigam v. Dahlbach* the Second Circuit affirmed the dismissal of a derivative action against the directors of Goldman Sachs, alleging a failure of three inside directors and four outside directors to oversee Goldman Sachs'

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154 *In re JPMorgan Chase*, 2014 U.S. Dist. LEXIS 46363, at *18.

155 *In re* JPMorgan Chase & Co. Deriv. Litig., No. 12 Civ. 03878(GBD), 2014 U.S. Dist. LEXIS 106259, at *7 (S.D.N.Y. July 30, 2014). The settlements mentioned in the court's opinion were with the OCC, the Commodity Futures Trading Commission and the U.K. Financial Conduct Authority. In addition, JPMorgan Chase entered into settlements with the SEC and the Federal Reserve Board.

156 *Id.*

157 *Wayne Cty. Emps.' Ret. Sys. v. Dimon*, 629 F. App'x 14 (2d Cir. 2015) (summary order).

158 *Id.* at 15.

159 *Id.* at 16.

160 *Id.*

161 *Id.*

activities in the sale of collateralized debt obligations ("CDOs").[162] The district court noted that while the complaint specifically alleged that the three inside directors made or directly managed decisions relating to various "questionable" CDO transactions, it did not make any particularized pleadings that any of the four outside directors made decisions regarding the CDOs or had knowledge of any details of the Goldman transactions in question.[163] The district court rejected the argument that the four outside directors who were members of the Goldman audit and risk committees should be assumed to have known about the particular CDO transactions simply by virtue of their membership on these committees.[164]

The federal courts in the Southern District of New York appear to assume *arguendo* that a *Caremark* duty may extend to monitoring business risk, but they adopt the view reflected in the *Citicorp* and *Goldman* decisions above that the *Caremark* pleading threshold is raised when the claim involves a failure to monitor business risk.[165] Even the commentators who have criticized the

[162] 598 F. App'x 53 (2d Cir. 2015) (summary order), *aff'g*, *Brautigam v. Blankfein*, 8 F. Supp. 3d 395 (S.D.N.Y. 2014).

[163] *Brautigam v. Blankfein*, 8 F. Supp. 3d at 405.

[164] *Id*. at 405–06.

[165] The federal courts in the Southern District have regularly dismissed other derivative claims alleging board failures to monitor business risks. *See, e.g.*, *Louisiana Mun. Police Emps. Ret. Sys. v. Blankfein*, No. 08 Civ. 7605(LBS), 2009 U.S. Dist. LEXIS 42852 (S.D.N.Y. May 19, 2009). The complaint alleged that Goldman Sachs had manipulated the auction-rate securities ("ARS") market during 2007–2008. The court analogized the claim to the one in the *Citigroup* case, concluding that the claim was an attempt to base liability on a failure to monitor business risk related to the ARS market. The court concluded that the red flags alleged in the complaint amounted to nothing more than general signs of deterioration in the ARS market. The complaint did cite as one other red flag a 2006 settlement agreement between the SEC and Goldman Sachs relating to certain trading activities in the ARS market. The court found that the practices involved in the 2006 settlement were not relevant because the complaint relied on other practices not covered in the 2006 settlement. *See also Louisiana Mun. Police Emps. Ret. Sys. v. Pandit*, No. 08 Civ. 7389(LTS)(RLE), 2009 U.S. Dist. LEXIS 82308 (S.D.N.Y. Sept. 10, 2009). The complaint alleged that Citigroup had manipulated the ARS market. Citing both the *Citigroup* case and the similar claim against Goldman Sachs for alleged manipulation of the ARS market, the district court found that the red flags cited in the complaint were nothing more than signs of a general deterioration in the market and insufficient to create a substantial likelihood of liability under a *Caremark* standard. *See also In re* Bank of America Corp. Securities, Deriv. & Employee Retirement Income Security Act (ERISA) Litig., No. 09 MD 2058(PKC), 2013 U.S. Dist. LEXIS 59783 (S.D.N.Y. April 25, 2013) (dismissing *Caremark* claims for failure to plead specific facts indicating that the board had ignored red flags about Bank of America's subprime holdings); *Staehr v. Mack*, No. 07 Civ. 10368(DAB), 2011 U.S. Dist. LEXIS 36014, 2011 WL 1330856 (S.D.N.Y. March 31, 2011) (dismissing *Caremark* claims alleging failure of the Morgan

Citigroup decision for potentially excluding business risk from the *Caremark* duty approach the idea of applying *Caremark* to business risk cautiously. One commentator has opined that because there are significant differences between monitoring compliance risk and monitoring business risk, the bar for liability for failure to monitor business risk must be set "particularly high." He framed the issue in *Caremark*esque terms:

> If *Caremark* is the most difficult theory of liability in corporate law, risk management needs to be the most difficult variant of *Caremark* claims.[166]

Other commentators who support the idea of applying *Caremark* to monitoring business risk likewise assert that the chances of a director being held liable should be "even more infinitesimally small" in the business risk context than in the classic *Caremark* compliance context.[167] As discussed in Part II of this article, the bank regulatory agencies expect the directors of a banking institution to apply the same level of attention to the monitoring of business risk as compliance risk.

CORPORATE NORMS AND BEST PRACTICES

There are commentators, including some academic commentators, who do not lament the very high hurdle that exists under Delaware law for asserting a *Caremark* claim against directors for a failure to monitor. Instead, these commentators take comfort from the belief that legal, corporate and social norms, not the threat of personal liability, provide the incentives for directors to exercise appropriate oversight over the operations of a corporation.[168] This

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Stanley board to monitor subprime mortgage holdings for a failure to make a demand on the board); *In re* Citigroup Inc. S'holder Deriv. Litig., No. 07 Civ. 9841, 2009 U.S. Dist. LEXIS 75564 (S.D.N.Y. Aug. 25 2009) (dismissing a *Caremark* claim for failure to plead particularized facts in support of the allegation that the board failed to monitor subprime mortgage risk).

[166] Bainbridge, *supra* note 110, at 990. This commentator offered the following advice: "in light of the inextricable intertwining of risk taking and risk management . . . courts should be especially willing to accept any board efforts to supervise risk management as adequate to satisfy their *Caremark* obligations." *Id.* at 986 (footnote omitted).

[167] Hill & McDonnell, *supra* note 110, at 862.

[168] *See, e.g.,* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009 (1997); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 Colum. L. Rev. 1253 (1999); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. Pa. L. Rev. 1619 (2001); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. Pa. L. Rev. 1811 (2001); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundation of Corporate Law*, 149 U. Pa. L. Rev. 1735 (2001).

"norms" theory takes several forms. Some commentators suggest that opinions of the Delaware courts provide guidance to, and establish norms for, directors on their duties even in cases where the courts decline to find any liability.[169] The opinions of the Court of Chancery and the Supreme Court in the *Walt Disney* case are perhaps the prime exemplars of this theory.[170] One of the leading proponents of this view is the former Chief Justice of the Delaware Supreme Court, E. Norman Veasey. Reflecting on the role of the Delaware judiciary in the development of Delaware corporate law, he cites as one of the dominant features of Delaware case law that

> an opinion that raises questions or teaches without imposing liability may provide guidance to the corporate world to conform to best practices without the downside of actually imposing personal liability.[171]

He undoubtedly had in mind the teachings contained, among other places, in an opinion that he wrote in the *Disney* case.[172] As Chief Justice, he strongly endorsed the adoption of corporate best practices as reflected in the ABA's Corporate Director's Guidebook. In fact, he developed his own list of best practices for consideration by directors and legal practitioners.[173] It should be noted, however, that commentators differ in the weight that they accord judicial statements of "expectations" in influencing board conduct.[174]

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[169] *See, e.g.,* Rock, *supra* note 168, at 1016 (discussing the role of Delaware courts as "preachers" in corporate cases).

[170] *In re* The Walt Disney Co. Deriv. Litig., 907 A.2d 693 (Del. Ch. 2005); *In re* The Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

[171] E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399, 1406 (2005). *See also* E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa?*, 149 U. Pa. L. Rev. 2179 (2001) (suggesting that corporate law can shape good corporate practices and good corporate practices can inform corporate law).

[172] *See Brehm*, 746 A.2d at 249 (stating that the *Disney* board processes in question were "casual, if not sloppy and perfunctory" and "hardly paradigms of good corporate governance practices"). Apparently, Chancellor William Allen, the author of the *Caremark* decision, also hoped to exhort directors to more effective monitoring. *See* Arlen, *supra* note 56, at 339–42 (describing an interview with Chancellor Allen in which he explained that he believed that his dicta in the *Caremark* decision relating to the duty to monitor legal compliance "would alter directors' behavior through its moral suasion and associated impact on directors' norms").

[173] Veasey, *supra* note 171, at 1506–1508.

[174] *Compare* Blair & Stout, *supra* note 168, at 1797 ("When the Delaware Court of Chancery trumpets the importance of careful attention to fiduciary duties, directors and officers are likely to heed that call—even though they may have little or no external incentive for doing it.") *with* Jones, *supra* note 39, at 131 (asserting that the *Disney* litigation actually "demonstrates the

Another variant of the norms theory is that reputational concerns will lead directors to exercise heightened attention to their oversight responsibilities.[175] In the words of one commentator, directors "do not like to be made the object of public scorn and ridicule."[176] This commentator made this observation in a discussion of the *Disney* litigation. Commentators suggest that critical comments about directors' performance by the courts, the press and investor monitoring groups like the Council of Institutional Investors have a significant effect on how directors approach their service on boards.[177]

Still another variant of the norms theory suggests that social norms work to

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dubious nature of the claim that weak judicial exhortations positively influence board norms"). *See also* Arlen, *supra* note 56, at 326–27 ("*Caremark* did not succeed, however, in inducing directors to exercise the level of active oversight over legal compliance that federal authorities want. *Caremark's* oversight duty was not sufficiently specific to induce outside directors to actively oversee compliance program design and internal investigations . . . . The limitation of Delaware's approach became apparent at the turn of this century when the country again was rocked by corporate scandals. In response, Congress and the national exchanges injected themselves into corporate governance regulation through a variety of compliance-related mandates . . . .").

[175] Skeel, *supra* note 168, at 1860 ("[s]haming sanctions are unusually effective . . . because a director's reputation is her single most important asset"); Jonathan R. Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1134 (2005) ("[d]irectors do not like to be sued"); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1489 (2007) ("in light of the Delaware courts' reluctance to impose monetary liability on directors, the most significant independence-enhancing effect of litigation is probably through improving the operation of the reputation market rather than through the threat of monetary sanctions") (footnote omitted); Pan, *supra* note 110, at 246 (noting the nuisance cost to directors of being involved in derivative litigation and the more significant potential cost to their reputations).

[176] Macey, *supra* note 175, at 1134. In a subsequent work, this commentator has suggested that reputational concern may now be exerting less of an influence on corporate and individual behavior. *See* JONATHAN R. MACEY, THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET 96–98 (2013).

[177] *See, e.g.,* Skeel, *supra* note 168, at 1836–56 (discussing "shaming" of the directors by courts, the financial press and institutional investor groups); Eisenberg, *supra* note 168, at 1268–69 (discussing the effect of critical comments by the press and institutional investor groups on directors). One study designed to analyze whether the "labor" market "penalized" outside directors at poorly performing financial firms found no labor market reaction to poor firm performance in the form of lost directorship opportunities at other firms for the period covering 2006 through 2011. Steven M. Davidoff et al., *Do Outside Directors Face Labor Market Consequences? A Natural Experiment from the Financial Crisis*, 4 HARV. BUS. L. REV. 53 (2014). The authors of the study suggest that the results of the study are consistent with at least two theories. One theory is that the market views outside directors as largely inconsequential to firm performance and risk taking, particularly in the context of large complex financial firms. Alternatively, the results of the study are also consistent with the theory that shareholders and

encourage directors to be diligent in their oversight function.[178] With respect to directors' duties, one commentator believes that a change in the belief system of the business community has led to a norm requiring a higher level of care from directors.[179] It is likely that the belief system of the business community influenced (and was influenced by) the adoption of the ALI Principles and ABA Corporate Director's Guidebook, which expressly recognize the monitoring duty of a board.[180] Similarly, a report prepared by the Conference Board in 2006 chronicled the evolving view among directors themselves about their oversight responsibility.[181] The Conference Board report discussed how corporate boards were moving from their focus on internal controls in the immediate aftermath of the Sarbanes-Oxley Act to a more comprehensive enterprise-wide risk management framework and "toward integration of [that] framework with their historic strategic oversight responsibilities."[182] The report noted that an increasing number of directors acknowledged that they had to oversee business risk as part of their strategy-setting role.[183] The report also observed that a number of legal and regulatory developments were redefining directors' duties, citing the decisions in the *Caremark* and *Disney* cases and the best practices being developed in highly regulated industries such as banking.[184]

The revisions to the ABA Corporate Director's Guidebook (since its original publication in 1978) reflect an increasing emphasis on monitoring business risk as well as compliance risk. The 2007 edition of the Corporate Director's

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regulators may not be able to discipline outside directors despite the belief that outside directors can impact a firm's performance. *Id.* at 55.

[178] *See, e.g.,* Eisenberg, *supra* note 168, at 1268 ("it is difficult to avoid the conclusion that the level of directorial care is determined in significant part not by the threat of liability or the prospect of gain, but by social norms concerning the directorial role").

[179] Eisenberg, *supra* note 168, at 1278–82.

[180] *Id.* at 1280.

[181] THE CONFERENCE BOARD, THE ROLE OF U.S. CORPORATE BOARDS IN ENTERPRISE RISK MANAGEMENT (2006).

[182] *Id.* at 5. For the leading articulation of an enterprise-wide risk management framework, *see* COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N (COSO), ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY (2004), http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf. The COSO enterprise-wide risk management framework has gained broad acceptance in the corporate sector as an essential element of corporate governance. *See*, *e.g.*, Michelle M. Harner, *Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis*, 5 J. BUS. & TECH. L. 45 (2010); Bainbridge, *supra* note 108; Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571 (2008).

[183] THE CONFERENCE BOARD, *supra* note 181, at 5.

[184] *Id.* at 33–37.

Guidebook stated that the "board, or an appropriate committee, should receive periodic reports describing and assessing the corporation's programs for identifying financial, industry, and other business risks."[185] It further noted that a "full understanding of the controls and infrastructure for the prevention, mitigation, and remediation of risks allows a corporation to determine its risk/reward appetite and risk tolerance in various business areas and to manage those risks more effectively."[186] The 2007 edition further indicated that the board is responsible for "overseeing management's activities in assuring the corporation's compliance with legal requirements in the various jurisdictions in which the corporation does business," the original focus of the *Caremark* standard.[187]

The 2011 edition of the Corporate Director's Guidebook reflected further updating, based on insights from the financial crisis and the enactment of the Dodd-Frank Act. The 2011 edition noted that risk management is a "particularly salient issue for directors today and a significant part of the directors' duty of oversight of the business and affairs of the corporation" and that "the board must ensure that its risk management overview addresses not just legal and compliance issues, but also devotes time to strategy, product innovations, cyclical risks, and the like."[188] It also noted that the board "should determine [the corporation's] risk/reward appetite and risk tolerance in various business areas and oversee those risks effectively."[189] Thus, the "belief system" of the business community now appears to expect board monitoring of both compliance risk and business risk.

A high level of engagement and monitoring by the boards of banking institutions is also the expectation in the banking community. The Clearing House Guiding Principles reflect this high level of engagement and monitoring by directors. Section 4 of the Guiding Principles is directed to the oversight duties of the board and provides a specific list of areas that should be included in the oversight by the board of a bank or bank holding company.[190] Among the areas are:

- reviewing financial performance, capital adequacy and liquidity on a

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[185] CORPORATE DIRECTOR'S GUIDEBOOK (5th ed.), *reprinted in* 62 BUS. LAW. 1479, 1501 (2007).

[186] *Id.*

[187] *Id.*

[188] CORPORATE DIRECTOR'S GUIDEBOOK (6th ed.), *reprinted in* 66 BUS. LAW. 975, 998 (2011).

[189] *Id.*

[190] CLEARING HOUSE GUIDING PRINCIPLES, *supra* note 12, at 6–7.

regular basis;

- reviewing and approving the organization's strategic objectives and plans on a regular basis, and evaluating risk management and capital and liquidity planning in a manner consistent with these strategic objectives and plans;
- monitoring management performance in formulating and implementing the organization's strategic plans and overseeing key business policies and procedures established by management;
- setting the ethical "tone at the top" by overseeing the development and implementation of a code or codes of conduct applicable to directors and employees and that addresses treatment of breaches or lapses in ethical behavior, and approving appropriate corporate governance principles;
- promoting a culture of compliance with applicable laws and regulations, and overseeing management's establishment, implementation and operation of a compliance system, including internal and external audit processes, disclosure controls and procedures, and responses to compliance failures;
- understanding the organization's risk profile, reviewing the standards for the nature and level of risk the organization is willing to assume in light of the organization's capital and liquidity levels, approving capital plans and resolution plans, reviewing the organization's principal risk management policies and monitoring compliance with the foregoing; and
- performing other oversight duties and responsibilities required by statute, regulation or regulatory orders, including oversight of executive compensation programs, liquidity and stress testing.[191]

The highly articulated nature of the Clearing House Guiding Principles reflects the influence of the bank regulatory regime both in the references to regulations that require board approval of particular matters such as capital plans and resolution plans and in the references to setting a "tone at the top" and creating a "culture" of compliance. The best practices in the banking sector such as those reflected in the Clearing House Guiding Principles are at the forefront of corporate best practices.[192]

There are multiple sources of best practices for governance in the corporate

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[191] *Id.*

[192] *See, e.g.*, CONFERENCE BOARD, THE NEXT FRONTIER FOR BOARDS: OVERSIGHT OF RISK

sector generally and in the banking sector specifically. There is, however, at least one key difference between best practices for governance in the general corporate sector and best practices for governance in the banking sector. In the general corporate sector, best practices are merely aspirational.[193] In the banking sector, best practices may actually be enforceable through formal or informal actions by the bank regulators. The bank regulators play an important role monitoring the performance of the management and the board. The regulators' monitoring function can serve to make the directors more attentive to their oversight duty (although it is not clear that it can serve to make the directors more prescient in the exercise of that duty). The regulators' monitoring function and the regulators' expectations and requirements for board monitoring are the subject of Part II of this article, which will appear in an upcoming issue of *The Banking Law Journal*.

CULTURE (2015); ERNST & YOUNG, SHIFTING FOCUS: RISK CULTURE AT THE FOREFRONT OF BANKING (2014).

[193] *See Brehm v. Eisner*, 746 A.2d 244, 246 (Del. 2000) ("the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance").