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Delaware Chancery Court Rejects Notion That A Director's Duty To Oversee A Corporation Encompasses Duty to Monitor Business Decisions

By Edward J. Sholinsky

The Delaware Chancery Court issued a strong reaffirmation of the business judgment rule in *In re Citigroup Inc. Shareholder Derivative Litigation*, No. 3338-CC. In *Citigroup*, the court rejected a novel theory that a director's duty to oversee a corporation requires the director to not only monitor for criminal and fraudulent conduct by employees, but also to monitor business decisions. The court held that a director's mere knowledge of deteriorating market conditions does not mean that the director was or should have been aware of the type of wrongdoing within the corporation that the director has a duty to monitor.

The plaintiffs in *Citigroup* brought a derivative action alleging that the defendant current and former directors breached their fiduciary duties by failing to "properly monitor and manage the risks the Company faced from problems in the subprime lending market" and by failing "to properly disclose Citigroup's exposure to subprime assets." Specifically, the plaintiffs alleged that, because the defendants were pursuing "short term profits and at the expense of the Company's long term viability," they disregarded "red flags" that should have alerted them to the problems developing in the real estate and credit markets. The plaintiffs also alleged that the defendants were liable to Citigroup for corporate waste because they allowed the corporation to 1) purchase $2.7 billion in subprime loans in 2007; 2) repurchase shares of the corporation in the first quarter of 2007 when the price of shares was artificially inflated; 3) enter into a multimillion dollar money and benefits package for former Citigroup CEO Charles Prince, who plaintiffs allege was largely responsible for the company's losses; and 4) invest in structured investment vehicles ("SIVs") that could not pay off maturing debt.

The plaintiffs' claims arose out of Citigroup's involvement in the subprime lending market beginning in 2006. Citigroup delved into collateralized debt obligations ("CDOs"), which were repackaged pools of lower rated securities that Citigroup created through the acquisition of asset-backed securities, including residential mortgage-backed securities. Citigroup sold the rights to the cash flow from the CDOs, but included in some of the sales a "liquidity put" that entitled the purchaser to sell the CDOs back to Citigroup at the original purchase price. Citigroup also invested in the subprime market through SIVs, which sold short term debt to buy longer term, higher yielding assets. The plaintiffs alleged that Citigroup's SIVs made investments that were much riskier than the investments in the industry standard SIVs.

The plaintiffs filed suit in Delaware – there is also companion litigation in New York – without making a pre-suit demand on Citigroup's directors. The plaintiffs argued that it would have been futile to make a demand because the individual directors were personally liable for failing to oversee and supervise the risks Citigroup was taking. According to plaintiffs, the business judgment rule would not insulate the directors from liability for breaching their oversight obligations because investing in the subprime market was not a valid exercise of business judgment. The court reasoned that the only way the plaintiffs could be excused from their obligation to make a pre-suit demand was to show that the directors did not act

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in good faith by failing repeatedly to oversee the company. That is, plaintiffs would need to show that "the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act."

The court noted that the plaintiffs' claim had "a bit of a twist" on the common claim that individual directors who breached their fiduciary duties are subject to personal liability. In the typical case, the alleged breach of fiduciary duty is premised on a failure to "properly monitor or oversee employee misconduct or violations of law." Here, however, the plaintiffs based their claims on the defendants' "failure to properly monitor Citigroup's *business risk*, specifically its exposure to the subprime mortgage market." The plaintiffs premised their claim in part on the theory that the defendant directors should have been especially sensitive to the "red flags" in the subprime market because they "served on the Citigroup board during its previous Enron related conduct."

The court rejected the plaintiffs' novel theory of personal liability. The court reasoned that the business judgment rule insulates directors from liability for making business decisions "on an informed basis, in good faith" when they have a belief the action is in the company's best interest. A director's oversight duty "does not eviscerate the core protections of the business judgment rule – protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly." The court held that a director's duty to oversee a corporation does not extend to business decisions that, in hindsight, turned out to be costly for the company. The court reasoned that the company's decision to participate in the sub-prime market despite warning signs suggesting that the market was weakening was a bad business decision, but not the kind of fraud or criminal misconduct for which directors have a duty to monitor. Directors have a duty to monitor for fraudulent or criminal conduct, not for bad business decisions. The defendants' involvement with prior debacles and scandals like the Enron situation does not change the analysis, the court stated, because those scandals did not relate to the subprime situation.

The *Citigroup* decision makes clear that directors cannot be held liable for failing to oversee business decisions that do not pan out. A contrary rule would render meaningless the business judgment rule, which allows management to make business decisions and take risks, even if they turn out badly, as long as those decisions are informed and made in good faith. It is only when a director knows or should have known of criminal or fraudulent conduct that the director can be held personally liable for breaching his oversight obligations. ◆

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