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CAREMARK AND ENTERPRISE RISK MANAGEMENT

by

STEPHEN M. BAINBRIDGE



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Caremark and Enterprise Risk Management

Stephen M. Bainbridge

UCLA School of Law
Box 951476
405 Hilgard Avenue
Los Angeles, California 90095-1476

bainbrid@law.ucla.edu.
310.206.1599

***Abstract*:** The financial crisis of 2008 revealed serious and widespread risk management failures throughout the business community. Shareholder losses attributable to absent or poorly implemented risk management programs are enormous.

Efforts to hold corporate boards of directors accountable for these failures likely will focus on so-called *Caremark* claims. The *Caremark* decision asserted that a board of directors has a duty to ensure that appropriate "information and reporting systems" are in place to provide the board and top management with "timely and accurate information." Although post-*Caremark* opinions and commentary have focused on law compliance programs, risk management programs do not differ in kind from the types of conduct that traditionally have been at issue in *Caremark*-type litigation.

Risk management failures do differ in degree from law violations or accounting irregularities. In particular, risk taking and risk management are inextricably intertwined. Efforts to hold directors accountable for risk management failures thus threaten to morph into holding directors liable for bad business outcomes. *Caremark* claims premised on risk management failures thus uniquely implicate the concerns that animate the business judgment rule's prohibition of judicial review of business decisions. As *Caremark* is the most difficult theory of liability in corporate law, risk management is the most difficult variant of *Caremark* claims.

Keywords: board of directors, risk management, enterprise risk management, oversight, Caremark

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Caremark and Enterprise Risk Management

Stephen M. Bainbridge*

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I. Introduction

Enterprise risk management is the process by which the board of directors and executives of a corporation define the firm's strategies and objectives so as "to strike an optimal balance between growth and return goals and related risks."[1] It encompasses determining an appetite for risk consistent with the interests of the firm's equity owners and identifying, preparing for, and responding to risks.[2]

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* William D. Warren Professor of Law, UCLA School of Law. I thank William Chandler and William Klein for their helpful comments. Any remaining errors are mine.

[1] Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management—Integrated Framework: Executive Summary 1 (2004), available at http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf [hereinafter COSO FRAMEWORK].

[2] *Id.* Because risk and return are positively correlated, a corporation inevitably must take risks to generate a positive rate of return. *See* WILLIAM A. KLEIN & JOHN C.

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Although primary responsibility for risk management rests with the corporation's top management team, the board of directors is responsible for ensuring that the corporation has established appropriate risk management programs and for overseeing management's implementation of such programs.[3]

The financial crisis of 2008 revealed serious risk management failures on an almost systemic basis throughout the business community.[4] Shareholder losses attributable to absent or poorly implemented risk management programs likely are enormous.[5] Will shareholders be able to recoup some of those losses by suing boards of directors of companies with lax risk management programs?

Shareholder suits bringing such claims principally implicate the analysis of oversight failures by the board of directors established by the *Caremark* decision and its progeny.[6] *Caremark* held that the board of directors has a duty to ensure that appropriate "information and reporting systems" are in place to provide the board and top management with "timely and accurate information."[7] Although post-*Caremark* opinions and commentary have focused on law compliance

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COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 45 (9th ed. 2004). Owners of the firm's equity stake will have the strongest appetite for risk because, as the company's residual claimants, they do not get paid until the claims of all other stakeholders have been satisfied. *Id.*

[3] *See* AMERICAN BAR ASSOCIATION COMMITTEE ON CORPORATION LAWS, CORPORATE DIRECTOR'S GUIDEBOOK 27-28 (5th ed. 2007) (setting out board obligations for risk management and compliance programs) [hereinafter ABA GUIDEBOOK].

[4] *See* Melanie Roller, *Reasonable Risk*, WALL ST. & TECH., Dec. 31, 2008, at 15 ("Poor risk management practices have been blamed for the credit crisis and ensuing global financial meltdown. Financial institutions and regulators suggest that risk previously was simply reported, rather than managed, and inaccurately assessed, causing banks to post billions of dollars in losses in 2008."); *Chiefs Admit "Lax" Practices Fed Crunch*, RISK MGMT., Aug. 2008, at 4 ("Risk chiefs and CEOs from many of the world's major financial institutions say lax risk management standards in the face of 'favourable market conditions' and strong competition was one of the primary reasons the credit crunch occurred.").

[5] In 2008, declining stock prices caused investors to lose $6.9 trillion. Renae Merle, *Wall Street's Final '08 Toll*, WASH. POST, Jan. 1, 2009, at A01.

[6] *See infra* Part IV.

[7] In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 970 (Del. Ch. 1996).

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programs,[8] the original *Caremark* decision contemplated a similar duty with respect to the corporation's "business performance."[9]

There is no doctrinal reason *Caremark* claims should not lie in cases in which the corporation suffered losses not due to a failure to comply with applicable laws but rather due to lax risk management.[10] Likewise there is no basis in the underlying policy concerns for limiting *Caremark* to cases involving lax law compliance. Risk management and law compliance differ only in degree and not in kind.[11] Even so, some of those differences matter. Accordingly, courts need to develop a modified regime for deciding *Caremark* claims not involving law compliance issues. This article concludes by outlining the relevant considerations.

II. Enterprise Risk Management

A. Overview

Enterprise risk management is the process by which a business organization anticipates, prevents, and responds to uncertainties associated with the organization's strategic objectives.[12] Put another way, risk management is the process by which business organizations proactively determine the types and levels of risk appropriate for achieving the organization's strategic goals.[13] In recent decades, increasing attention has been paid to the evolving standards of enterprise risk management "as financial theory has advanced, new technology has made modeling of risks more feasible, and innovation has helped to find better ways to mitigate risk."[14]

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[8] *See* Charles M. Elson & Christopher J. Gyves, *In re Caremark: Good Intentions, Unintended Consequences*, 39 WAKE FOREST L. REV. 691, 702 (2004) (noting "the heightened managerial and board focus on compliance systems that resulted from the increased prospect of director liability occasioned by *Caremark*").

[9] *Caremark*, 698 A.2d at 970.

[10] *See infra* Part III.

[11] *See infra* Part IV

[12] *See, e.g.*, GREGORY MONAHAN, ENTERPRISE RISK MANAGEMENT 12 (2008) (proposing "that risk management is defined as a methodology for managing risks associated with strategic objectives of an organization").

[13] *See, e.g.*, MICHEL CROUHY ET AL., THE ESSENTIALS OF RISK MANAGEMENT 1 (2006) ("Risk management is really about how firms actively select the level and type of risk that it is appropriate for them to assume.").

[14] Susan Schmidt Bies, *Director and Officer Responsibility: A Plan for Action*, 8 Fordham J. Corp. & Fin. L. 81, 82-83 (2003). For a brief history of business risk

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A large public corporation these days faces "a myriad of risks … ranging from complex financial risk to quality control regarding material manufactured in China."[15] In general, however, the risks corporations face can be broadly categorized as operational, market, and credit. Operational risk encompasses such concerns as "inadequate systems, management failure, faulty controls, fraud, and human error."[16] Related concerns include failure to comply with applicable legal rules, accounting irregularities, bad business models, and strategic planning errors.

Market risk can be broadly defined as changes in firm valuation linked to asset performance. For example, financial risk management views market risk as the expected variance of a portfolio's rate of return.[17] In contrast, the Basel Accords define market risk as "as the risks (a) 'in the trading book of debt and equity instruments and related off-balance-sheet contracts and (b) foreign exchange and commodities risks.'"[18] In either case, market risks are identified and evaluated by financial models that predict changes in prices, interest rates, liquidity, and foreign exchange rates.[19]

Credit risk is defined as the possibility that a change in the credit quality of a counterparty will affect the firm's value.[20] It thus includes not only the risk of default, but also such risks as the possibility a credit-rating agency might downgrade the counterparty's creditworthiness.[21] The financial crisis revealed that the existing models for measuring and predicting consumer credit risk are poorly developed.[22]

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management and the development of the enterprise risk management concept, see Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 Loy. U. CHI. L. J. 571, 577-86 (2008).

[15] Simkins & Ramirez, *supra* note 14, at 571.

[16] CROUHY ET AL., *supra* note 13, at 30-31.

[17] Turan G. Bali, *A Generalized Extreme Value Approach to Financial Risk Measurement*, 39 J. MONEY, CREDIT & BANKING 1613 (2007).

[18] W. Ronald Gard, *George Bailey in the Twenty-First Century: Are We Moving to the Postmodern Era in International Financial Regulation With Basel II?*, 8 TRANSACTIONS 161, 183 (2006). On Basel II, *see infra* notes 27-29 and accompanying text.

[19] Bies, *supra* note 14, at 83.

[20] CROUHY ET AL., *supra* note 13, at 29.

[21] *Id.*

[22] Bies, *supra* note 14, at 84.

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The tools for managing these risks *ex ante* include (1) avoiding risk by choosing to refrain from certain business activities, (2) transferring risk to third parties through hedging and insurance, (3) mitigating operational risk through preventive and responsive control measures, and (4) accepting that certain risks are necessary to generate the appropriate level of return.[23] Examples of such tools in action include the use of asset securitization and derivatives to hedge risk,[24] although they both also proved tempting devices for speculative excesses that contributed to the financial crisis. A rather different example, far removed from the complexities of modern financial instruments, is Microsoft's reliance on temporary workers.[25] It allows Microsoft to make quick operating changes in response to evolving operational risks.[26]

Best practices with respect to enterprise risk management are still evolving.[27] Indeed, while there are a number of widely used risk management frameworks, none has emerged as a dominant best practice. Basel II, for example, is a set of international regulatory guidelines for determining the minimum acceptable levels of capital financial institutions need to protect themselves from market, credit, and operating risk.[28] Despite having been designed for banks and similar financial firms, the Basel II framework has become extremely influential in the risk management industry generally.[29] Alternatively, many firms have adopted COSO's 2004 recommendations, even though they in fact provide "little guidance on how to design and execute an effective enterprise risk management framework."[30] The problem of choosing among competing proposed best practice regimes is compounded by—or, perhaps, attributable to—the fact that different

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[23] CROUHY ET AL., *supra* note 13, at 88. Meulbroek offers a slightly different typology: (1) modifying operations; (2) adjusting their capital structure; (3) hedging and related strategies using derivatives or other targeted financial instruments. Lisa Meulbroek, Integrated Risk Management for the Firm: A Senior Manager's Guide 2 (2002), http://ssrn.com/abstract=301331.

[24] Bies, *supra* note 14, at 83. Using derivatives as a risk management strategy is hardly new. The use of crop futures to manage agricultural risks, for example, dates back to the early 1800s. Simkins & Ramirez, *supra* note 14, at 578.

[25] Meulbroek, *supra* note 23, at 2.

[26] *Id.*

[27] *Id.*

[28] MONAHAN, *supra* note 12, at 122.

[29] CROUHY ET AL., *supra* note 13, at 55.

[30] MONAHAN, *supra* note 12, at 119.

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firms have different appetites for risk and face different types of risk, which means they have differing enterprise risk management needs.[31]

B. Risk Management and the Financial Crisis of 2008-2009

Risk management failures during the financial crisis took several different forms. At some firms, the problem was the absence of any system for managing risk. According to a 2002 survey of corporate directors, 43 percent said that their boards had either an ineffective risk management process or no process for identifying and managing risk at all.[32] According to the same survey, 36 percent of directors felt they had an incomplete understanding of the risks faced by their companies.[33]

A 2008 Towers Perrin survey of CFOs suggests that risk management remained underdeveloped when the financial crisis hit. Seventy-two percent of the respondents, for example, "expressed concern about their own companies' risk management practices and ability to meet strategic plans."[34] Instructively, 42% "foresaw more energized involvement by boards of directors in risk management policies, processes and systems,"[35] which implies that pre-crisis boards were inadequately engaged with risk management. This inference finds support in a 2006 observation that risk management was still "a work in progress at many boards."[36]

Among firms that had undertaken risk management programs prior to the crisis, many used a silo approach in which different types of risk were managed by different teams within the firm using different processes.[37] This sizeable group of firms thus failed to adopt an enterprise management approach in which all risk

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[31] *See* Simkins & Ramirez, *supra* note 14, at 592 (noting differences among firms).

[32] CAROLYN KAY BRANCATO & CHRISTIAN A. PLATH, CORPORATE GOVERNANCE HANDBOOK 2005 75 (2005). This finding is supported by a 2003 study, in which 45% of respondent directors said their firms had no risk management plan. Bies, *supra* note 14, at 86.

[33] BRANCATO & PLATH, *supra* note 32, at 75.

[34] Towers Perrin, *Financial Crisis Intensifies Interest in Risk Management Among CFOs* (Sept. 2008), available at http://www.towersperrin.com/tp/showdctmdoc.jsp?country=global&url=Master_Brand_2/USA/News/Spotlights/2008/Sept/2008_09_30_spotlight_cfo_survey.htm.

[35] *Id.*

[36] CROUHY ET AL., *supra* note 13, at 85.

[37] Simkins & Ramirez, *supra* note 14, at 581.

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areas are brought into a single, integrated, firm-wide process.[38] Indeed, according to a 2007 survey, only about 10% of respondent firms had adopted such a holistic approach to risk management.[39]

To be sure, some argue that even effective risk management programs could not have anticipated the financial crisis that struck in 2008. As the argument goes, risks fall into three broad categories: known problems, known unknowns, and unknown unknowns.[40] "There is a view that the financial crisis—while clearly a high-impact; rare-event risk—was unpredictable and possibly unmanageable, an unknown unknown."[41] In fact, however, there were warning signs of an approaching crisis in the housing market, including "easy home-mortgage credit terms combined with rapidly accelerating home prices and reportedly lax credit standards,"[42] which in turn signaled risks for the financial services industry and then the economy as a whole.

Evaluating such extremely low probability but very high magnitude risks is challenging because the outcomes associated with such risks do not follow a normal distribution.[43] Instead, they tend to have long or fat tails.[44] Because risk management is focused on extreme events, requiring one to quantify the probability and magnitude of severe loss events, an uncertainty generating such a fat- or long-tailed distribution poses "a severe problem for risk managers."[45] Indeed, there is considerable evidence that such risks are approached in "a sort of lax, undisciplined way" that results in them being "undermanaged before they

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[38] *See id.* at 581 (defining enterprise risk management).

[39] Simkins & Ramirez, *supra* note 14, at 584.

[40] Thomas L. Barton et al., *Managing an Unthinkable Event*, FIN. EXEC., Dec. 1, 2008, at 24.

[41] *Id.*

[42] *Id.*

[43] Bies, *supra* note 14, at 88.

[44] *Id.* A fat tail distribution has a mean and variance similar to the normal distribution but different probability masses at the tails. LINDA ALLEN ET AL., UNDERSTANDING MARKET, CREDIT, AND OPERATIONAL RISK: THE VALUE AT RISK APPROACH 25 (2004). As such the probability of an extreme outcome is higher in a fat tailed distribution than the normal distribution. *Id.* In a long tail distribution, a small number of high frequency outcomes is followed by a large set of low frequency outcomes that gradually tail off asymptotically. Outcomes at the far end of the tail thus have a very low probability of occurrence. ROBERT SANDY, STATISTICS FOR BUSINESS AND ECONOMICS 47 (1989).

[45] ALLEN ET AL., *supra* note 44, at 26.

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first occur and overmanaged afterward."[46] Nonetheless, "it is simply unacceptable to chalk such an event up to 'not manageable' and focus on the more predictable, tameable and probably less-severe risks."[47]

This conclusion is supported by the Towers Perrin CFO survey. Sixty two percent of respondents blamed "poor or lax risk management at financial institutions as a major contributor to the current financial mess," a higher figure than either the complexity of financial instruments or speculation (55% and 57%, respectively).[48] Accordingly, "more than half (55%) of the CFOs" surveyed planned "to put their risk management practices under a microscope" in an investigation that "will in many instances reach all levels of the organization, from the board down and from the shop floor up."[49] The question to which we now turn is whether prospective liability for breach of fiduciary duty will lend impetus to such investigations.

III. *Caremark* and Progeny

In 1994, Caremark International, Inc., a health care corporation, was indicted by the federal government for violating the Anti-Referral Payments Law.[50] This statute prohibited health care businesses from paying doctors and other providers for referring Medicare or Medicaid patients to the business.[51] According to the indictments and related civil suits brought by multiple federal agencies, certain Caremark business practices constituted just such illegal referral payments.

In mid-1995, Caremark settled the federal litigation by pleading guilty to one count of mail fraud, paying criminal fines, and also making a monetary settlement of the civil claims.[52] In early 1996, Caremark also settled private party lawsuits brought by insurance company payors who claimed damages arising out of

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[46] Barton et a., *supra* note 40.

[47] *Id.*

[48] Towers Perrin, supra note 34.

[49] *Id.*

[50] In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 961-62 (Del. Ch. 1996). Caremark previously had been a division of Baxter International, Inc. *Id.* at 961. In 1992, Caremark was spun off as an independent public corporation. *Id.* The conduct for which Caremark was indicted pre-dated the spin off, *id*., but that fact assumed little significance in the analysis.

[51] *Id*. at 961-62.

[52] *Id*. at 963-64.

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Caremark's allegedly improper business practices.[53] In all, Caremark paid approximately $250 million to resolve the various claims against it.[54]

Five shareholder derivative suits were brought against Caremark's board of directors, seeking to hold the board's members individually liable for the losses Caremark had suffered, which were consolidated into a single proceeding.[55] In May 1995, the derivative plaintiffs and the corporate defendants negotiated a settlement.[56] The latter were not obliged to make any monetary payment. Instead, Caremark and the individual defendants agreed to a seven-point plan designed to ensure that Caremark complied with the relevant federal statutes in the future.[57]

Under Delaware law, a proposed settlement of a shareholder derivative suit must be approved by the court.[58] Although judicial review often is perfunctory, at best,[59] in this instance Chancellor William Allen seized the opportunity to author a mini-treatise on the oversight responsibilities of boards of directors. Given the procedural posture of the case, Chancellor Allen's analysis of that issue was mere dicta, but the analysis nevertheless "morphed into what has come to be known as a *Caremark* claim, as federal and state courts, both within and outside Delaware, have recognized a cause of action against boards for failing to take minimal steps to achieve legal compliance."[60]

Chancellor Allen began by noting that the allegations in the case involved neither self-dealing by directors nor "the more difficult loyalty-type problems arising from cases of suspect director motivation, such as entrenchment or sale of control contexts."[61] Instead, the complaint alleged a breach by the directors of their duty of care through inattention.[62] Chancellor Allen then explained that:

> Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such

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[53] *Id.*

[54] *Id.* at 960-61.

[55] *Id.* at 964.

[56] *Id.* at 965.

[57] *See id.* at 966 (summarizing terms of the plan).

[58] DEL. CT. CH. R. 23.1.

[59] *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 381 (2002) (discussing comparable requirements under the Federal Rules of Civil Procedure and the Model Business Corporation Act).

[60] Paul E. McGreal, *Corporate Compliance Survey*, 64 BUS. LAW. 253, 272 (2008)

[61] *Caremark*, 698 A.2d at 967.

[62] *Id.*

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> liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.[63]

Plaintiffs' claims in this case fell into the second category.[64]

Chancellor Allen concluded that the board of directors' duty to be attentive to the business of the corporation "includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[65] He cited three reasons for so concluding. First, Delaware case law increasingly emphasized the critical role of the board.[66] Second, it is "elementary" that directors need to be informed in order to carry out their duties.[67] Third, the federal sentencing guidelines create incentives for corporations to adopt law compliance programs.[68]

A board's failure to comply with this obligation—even if negligent—is not sufficient for liability to be imposed. Instead, "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

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[63] *Id*.

[64] *Id.* at 971 (citation omitted).

[65] *Id.* at 970 (footnote omitted).

[66] *Id.* Allen took some pains to distinguish the Delaware Supreme Court's prior holding in Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963). In *Graham*, the firm had paid fines to settle federal antitrust charges of price fixing by mid-level employees. A shareholder thereafter sued the board of directors of for having failed to install a law compliance program to prevent antitrust violations. *Graham*, 188 A.2d at 128. The Delaware Supreme Court rejected plaintiff's claim, holding that directors are entitled to rely on the honesty of their subordinates until something occurs to put them on notice that illegal conduct is taking place. *Id*. at 130. Only if they are put on notice and then fail to act, or recklessly repose confidence in an obviously untrustworthy employee, may liability be imposed. *Id.* Allen contended that *Graham* should not be understood to mean "that a corporate board has no responsibility to assure that appropriate information and reporting systems are established by management …." *Caremark*, 698 A.2d at 969-70.

[67] *Caremark,* 698 A.2d at 970.

[68] *Id.* at 970; *see also id.* at 969 (describing guidelines).

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lack of good faith that is a necessary condition to liability."[69] As Chancellor Allen observed, this standard sets the liability bar "quite high."[70] Indeed, earlier in the opinion, he had noted that the claim at issue here is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[71]

As noted, the *Caremark* dicta fairly quickly became the leading standard of review for claims alleging breach of a board's oversight obligations.[72] In the process, however, the content of that standard changed significantly.

A critical shift in emphasis came in *Guttman v. Huang*.[73] Plaintiffs alleged that, *inter alia*, the board of directors had failed to "make sure that the company had in place a functioning system to guarantee compliance with legally mandated accounting standards …."[74] As is often true of *Caremark*'s progeny,[75] the procedural posture of the case was a motion to dismiss a shareholder derivative suit premised on a *Caremark* claim for failure to make pre-suit demand on the board of directors.[76] Even though the procedural posture did not permit the court to reach the merits of the *Caremark* claim, this lacuna matters little for our purposes because "the same facts that give rise to a colorable *Caremark* claim also may satisfy the [Delaware] test for demand excusal."[77]

The fiduciary duty at issue in the original *Caremark* opinion demonstrably was the duty of care.[78] "Indeed, Allen explicitly distinguished a board's failure to

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[69] *Id.* at 971.

[70] *Id.*

[71] *Id.* at 967.

[72] *See supra* text accompanying note 60.

[73] 823 A.2d 492 (Del. 2003).

[74] *Id.* at 497.

[75] See Eric Landau et al., *Revisiting Caremark and a Director's Duty to Monitor: The Chancery Court's Wake-Up Call to Directors*, 1418 PLI/CORP 37, 46 (2004) ("A large number of *Caremark* claims have been dismissed for failure to plead facts sufficient to excuse demand.").

[76] *See Guttman*, 823 A.2d at 493 (observing that "defendants have moved for dismissal for failure to make a demand"). On the demand requirement, see generally BAINBRIDGE, *supra* note 59, at 385-93.

[77] Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 496 (2006).

[78] *See* Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 596 (2008) (citing numerous passages from *Caremark*); Peter D. Bordonaro, Comment, *Good Faith: Set In Stone?*, 82 Tul. L. Rev. 1119, 1135 (2008) ("*Caremark* liability was originally based on a violation of the duty of care."). *See also* In

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monitor proactively corporate performance from charges of self-dealing and "loyalty type problems arising from cases of suspect director motivation."[79] In *Guttman*, however, Vice Chancellor Leo Strine ripped the *Caremark* claim from its original home in the duty of care and reinvented it as a duty of loyalty:

> Although the *Caremark* decision is rightly seen as a prod towards the greater exercise of care by directors in monitoring their corporations' compliance with legal standards, by its plain and intentional terms, the opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith.[80]

This passage "effectively transformed director oversight liability from a duty of care claim into a duty of loyalty claim."[81]

To be sure, *Guttman* did not result in directors facing a higher probability of liability. The business judgment rule, after all, has no more application to cases involving a breach of the duty of care through unconsidered inaction than it does to cases involving breach of the duty of loyalty.[82] So the change mattered little from that perspective.

Granted, by situating the *Caremark* claim within the duty of loyalty, Vice Chancellor Strine precluded the use of § 102(b)(7) exculpatory clauses in these cases.[83] Even so, he probably was correct that his holding effectively replicated "the liability landscape for most corporate directors, who are insulated from

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re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795, 805 (7th Cir. 2003) ("The plaintiffs in *In re Caremark Int'l Inc. Derivative Litigation*, charged the board of directors with a breach of their duty of attention or care in connection with the on-going operation of corporate business."); McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001) (noting that "allegations of gross negligence may state a claim for breach of the duty of care under *Caremark*"); In re Cray Inc., 431 F.Supp.2d 1114, (W.D. Wash. 2006) ("*Caremark* did not address demand futility, but only stated the liability standard for certain breaches of the duty of care.").

[79] Bainbridge et al., *supra* note 78, at 597.

[80] *Guttman*, 823 A.2d at 506.

[81] Bordonaro, *supra* note 78, at 1126.

[82] *See* BAINBRIDGE, *supra* note 59, at 291 (explaining that the business judgment "rule applies only where the board has exercised business judgment, while most oversight cases arise precisely because the board has failed to act").

[83] *See* Regina F. Burch, *"Unfit To Serve" Post-Enron*, 42 VAL. U. L. REV. 1081, 1094 (2008) ("*Caremark* claims are not precluded by the Delaware General Corporations Code, Section 102(b)(7)'s exculpatory charter provisions.").

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monetary damage awards by exculpatory charter provisions."[84] First, Vice Chancellor Strine emphasized that *Caremark* claims are difficult to prove.[85] Second, he premised liability "on a showing that the directors were conscious of the fact that they were not doing their jobs."[86] Mere unconscious inaction seemingly was no longer enough; instead, there must be proof of conscious disregard by the board for its duties. Put another way, "to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care."[87] Third, Vice Chancellor Strine quoted both Chancellor Allen's admonition that "only a sustained or systematic failure of the board to exercise oversight" would result in liability and Chancellor Allen's acknowledgement that this pegged the liability bar "quite high."[88] Given these high standards, Vice Chancellor Strine concluded, the plaintiffs had "not come close to pleading a *Caremark* claim."[89]

> Their conclusory complaint is empty of the kind of fact pleading that is critical to a *Caremark* claim, such as contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.[90]

Although *Caremark* seemed well-established by the time *Guttman* was decided, being widely followed both in the Delaware Chancery Court and in other states, the Delaware Supreme Court did not expressly endorse it until *Stone v. Ritter* in 2006.[91] Shareholders of AmSouth Bancorporation brought a derivative suit against the bank's board of directors alleging a *Caremark* claim arising out of an alleged failure by the board to ensure that the bank had an adequate compliance program in place to prevent and detect violations of the federal Bank Secrecy Act.[92]

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[84] *Guttman*, 823 A.2d at 506.

[85] *Id.* at 505-06.

[86] *Id.* at 506.

[87] Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007).

[88] *Guttman*, 823 A.2d at 506.

[89] *Id.*

[90] *Id.* at 506-07.

[91] Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[92] *Id.* at 365.

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The Delaware Supreme Court purported to confirm "that *Caremark* articulates the necessary conditions for assessing director oversight liability."[93] In fact, however, what *Stone* really confirmed was *Guttman*'s reinterpretation of *Caremark*.[94] For example, *Stone* held that *Caremark* "draws heavily on the concept of director failure to act in good faith."[95] The Court then quoted with approval *Guttman*'s conflation of good faith and loyalty: "The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty.'"[96]

Most important for present purposes, *Stone* confirmed *Guttman*'s emphasis on conscious disregard of the board's duties as being the touchstone of liability in *Caremark* cases:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard

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[93] *Id.*

[94] *See* Bordonaro, *supra* note 78, at 1136 ("Because the *Stone* decision adopted *Guttman* in several other contexts, it is not surprising that the *Stone* court also found the shift of directorial oversight liability from care to loyalty appropriate."). I have elsewhere argued that "*Stone*'s reinterpretation of *Caremark* failed both to advance a convincing explanation for why seemingly well-settled doctrine should be overturned and to set forth clearly the new rules of the game." Bainbridge et al., *supra* note 78, at 598.

[95] *Stone*, 911 A.2d at 369.

[96] *Id.* at 369-70 (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)). In *Stone*, the Delaware Supreme Court resolved the question of whether the obligation of directors to act in good faith is an independent fiduciary duty—part of "triad" of fiduciary duties along with care and loyalty—or rather a mere subset of one or both of those duties. The court concluded that the obligation to act in good faith is subsumed by the duty of loyalty, quoting *Guttman* for the proposition that "'[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.'" *Id.* at 370 (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)). For criticism of this holding, see Bainbridge et al., *supra* note 78, at 584-88.

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> for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[97]

The Supreme Court thereafter quoted *Caremark* for the proposition that "a claim that directors are subject to personal liability for employee failures is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'"[98] As had Vice Chancellor Strine in *Guttman*, the Supreme Court further quoted the passages from *Caremark* emphasizing the need for proof of a sustained or systematic failure by the board and the "quite high" bar to liability thereby established.[99]

The plaintiff was unable to clear that bar in *Stone*:

> With the benefit of hindsight, the plaintiffs' complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs' argument is a failure to recognize that the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both …. In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions "to assure a reasonable information and reporting system exists" and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.[100]

The cautionary approach to director liability thus confirmed by *Stone* will prove quite significant to our analysis of *Caremark* claims arising out of risk management failures.

IV. Do Enterprise Risk Management and Law Compliance Differ in Kind?

Cases in which plaintiffs have brought *Caremark* claims typically involve either law compliance or accounting irregularities.[101] The recent *Citigroup*

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[97] *Stone*, 911 A.2d at 370.

[98] *Id.* at 372.

[99] *Compare Stone*, 911 A.2d at 311 (quoting *Caremark*) with *Guttman*, 823 A.2d at 506 (same).

[100] *Stone*, 911 A.2d at 373.

[101] *See* In re Citigroup Inc. Shareholder Litig., 2009 WL 481906 at 10 (Del. Ch. 2009) ("In a typical Caremark case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law.").

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decision, however, nicely illustrates how plaintiffs will adapt *Caremark* claims in cases of risk management failure.[102]

Citigroup is a multinational financial services corporation. In the period prior to the financial crisis, Citigroup's Securities and Banking Unit began marketing collateralized debt obligations (CDOs).[103] This form of derivative security consists of "repackaged pools of lower rated securities that Citigroup created by acquiring asset-backed securities, including residential mortgage backed securities ("RMBSs"), and then selling rights to the cash flows from the securities in classes, or tranches, with different levels of risk and return."[104] In some cases, the CDO's terms included a so-called "liquidity put," which allowed the purchasers to resell the securities to Citigroup at their original cost.[105]

Eventually Citigroup had some $55 billion in exposure to the subprime mortgage market via these CDOs and other investments.[106] As a result, Citigroup faced all three types of enterprise risk. Market risk arose, for example, because changes in interest rates and housing prices could significantly affect the value of CDOs based on mortgage-backed securities. Credit risk arose, for example, because adverse changes in the credit quality of subprime mortgage-backed securities could lead to Citigroup's counterparties exercising their liquidity puts. Operational risk is pervasive in the context of derivative securities, potentially arising from "inadequate systems, management failure, faulty controls, fraud, and human error":[107]

> [In fact,] many of the large losses from derivative trading are the direct consequence of operational failures. Derivative trading is more prone to operational risk than cash transactions are because derivatives, by their nature, are leveraged transactions. The valuation of complex derivatives also creates considerable operational risk. Very tight controls are an absolute necessity if a firm is to avoid large losses.[108]

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[102] *See id.* (noting that "plaintiffs' Caremark claims are based on defendants' alleged failure to properly monitor Citigroup's *business risk*"; emphasis in original).

[103] *Id*. at *2.

[104] *Id.* "An asset-backed security is a financial instrument which, unlike a traditional security, is secured by a discrete pool of assets and not the credit and assets of a company." In re CFS-Related Securities Fraud Litigation, 256 F.Supp.2d 1227, 1233 (N.D. Okla. 2003).

[105] *Citigroup*, 2009 WL 481906 at *2.

[106] *Id.*

[107] CROUHY ET AL., *supra* note 13, at 30.

[108] *Id.* at 31.

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When the financial crisis hit and the subprime mortgage market collapsed, Citigroup in fact suffered very serious financial losses.[109]

The defendants were current and former directors and officers of Citigroup. Plaintiffs' claims against them included an argument "that the director defendants are personally liable under *Caremark* for failing to 'make a good faith attempt to follow the procedures put in place or fail[ing] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market.'"[110] Chancellor William Chandler seemingly was tempted simply to exclude these claims from *Caremark*'s ambit, observing that:

> Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them—the fiduciary duty of care and the business judgment rule.[111]

Later in the opinion, the court further observed that: "While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. … Oversight duties under Delaware law are not designed to subject directors … to personal liability for failure to … properly evaluate business risk."[112] On the other hand, the court elsewhere in the opinion stated that it might be possible for plaintiff to state such a claim "under some set of facts."[113]

In fact, risk management and law compliance are not "fundamentally different." First, there are no reasonable grounds in the *Caremark* opinion for limiting the obligations created therein to legal and accounting compliance. Granted, Chancellor Allen made much of the benefits law compliance programs

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[109] *See id.* at 2-3 (summarizing alleged losses between October 1, 2007, and July 18, 2008).

[110] *Id.* at *10.

[111] *Id.*

[112] *Id.* at *16.

[113] *Id.* at *13.

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offered corporations under the federal sentencing guidelines.[114] Yet, that was only one of the three justifications Chancellor Allen offered.[115] The necessity for the board to ensure that it is provided with sufficient information to carry out its obligations, which drove Chancellor Allen's other rationales, seems just as relevant to risk management as to legal and accounting compliance. Indeed, such a conclusion is at least implicit in Chancellor Allen's requirement that the board assure itself "that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments *concerning both the corporation's* compliance with law and its *business performance*."[116] Chancellor Allen thus obviously intended the *Caremark* duty to extend beyond mere law compliance to include such issues as business risk management.[117]

Second, the risk management role assigned to the board of directors by emergent corporate best practice guides is comparable to the role assigned boards with respect to law compliance and accounting controls. The Corporate Director's Guidebook, for example, conflates risk and compliance oversight into a single topic.**[118]** In addition, the Guidebook lists "compliance programs" as one of several examples of "typical risk management programs."**[119]** Likewise, Committee of Sponsoring Organizations of the Treadway Commission (COSO) lists "compliance with applicable laws and regulations" as one of four broad categories of enterprise risk management, along with ensuring that the corporation is pursuing appropriate strategic goals, making effective and efficient operational use of resources, and providing reliable disclosures.**[120]**

Third, the board's role in risk management of the board has been described as one of ensuring that the corporation has put into place an effective risk

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[114] *See supra* text accompanying note 68.

[115] *See supra* text accompanying notes 66-68.

[116] *Caremark*, 698 A.2d at 970.

[117] See Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 754 (2005) ("Although *Caremark* focused on the board's duty to root out illegal behavior, the case's rationale extends comfortably to the exercise of business judgment.").

[118] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 3, at 27.

[119] *Id.*

[120] COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY 3 (2004).

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management program with procedures "for identifying, assessing, and managing all types of risk, i.e. business risk, operational risk, market risk, liquidity risk, and credit risk."[121] The board's role thus includes "making sure that all the appropriate policies, methodologies, and infrastructure are in place."[122] Notice the rather precise parallel to how *Caremark* described the need for the board to ensure that effective reporting structures exist with respect to law compliance.

Finally, risk management failures raise concerns about board-management relations comparable to those raised by law compliance or accounting irregularities. It is probably rare that corporate officers commit accounting fraud or other violations of law solely out of disinterested concern for corporate profit maximization. Instead, most cases probably involve at least a substantial element of self-dealing. "Scott D. Sullivan knowingly continued to lead WorldCom's $11 billion accounting fraud," for example, "in order 'to preserve his $700,000 salary, $10 million bonus and stock options.'"[123]

The success of Sullivan's fraud, in fact, is an excellent example of an operational risk management failure. Even in the absence of actual self-dealing, moreover, management self-interest still may be a contributing factor to risk management failures. In particular, a corporation's failure to adopt effective enterprise risk management may often be attributable to resistance by the CEO and top management. Stock options and related pay-for-performance compensation schemes give management incentives to prefer high volatility.[124]

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[121] CROUHY ET AL., *supra* note 13, at 88.

[122] *Id.* at 89.

[123] Lisa H. Nicholson, *Sarbanes-Oxley's Purported Over-Criminalization Of Corporate Offenders*, 2 J. BUS. & TECH. L. 43, 53 (2007).

[124] Kurt A. Desender, The Influence of Board Composition on Enterprise Risk Management Implementation 5 (October 1, 2007), available at http://ssrn.com/abstract=1025982. In theory, stock options and other pay-for-performance compensation practices align manager and shareholder interests with respect to the risk-return calculation. In practice, however, the differing time horizons of managers and shareholders may give rise to conflicts of interest. Because shareholders have a long-term investment horizon, they would prefer risk-return policies that produce sustainable share price appreciation. In contrast, stock options may give management a short term investment horizon creating incentives "to push the share price up, but not necessarily in a sustainable way." CROUHY ET AL., *supra* note 13, at 87. A case study of executives of gold mining companies paid in stock options, for example, found that they took fewer measures to hedge obvious risks than did executives of firms with less volatile compensation. Danielle Blanchard & Georges Dionne, *Risk Management and Corporate Governments* 5-6 (September 2003).

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Because boards can use enterprise risk management not only to manage risk, but also as a monitoring device,[125] CEOs therefore may resist implementation or effective operation of risk management programs. In any case, the key point is that enterprise risk management can be understood as a form of agency cost control analogous to monitoring by independent directors or large shareholders, incentive compensation plans, auditing, law compliance programs, and internal controls.[126]

In sum, risk management does not differ in kind from legal compliance or accounting controls. The board of directors appropriately is charged with oversight over them all. *Caremark* claims thus appropriately lie with respect to each.

V. The Significant Differences in Degree

Although risk management does not differ in kind from law compliance and accounting internal controls, it does differ from them in degree. Some of these differences are significant enough to justify being factored into the *Caremark* analysis.

A. Risk Management is Still Evolving

Risk management is a young discipline.[127] Accordingly, as already noted, best practice with respect to enterprise risk management is still evolving.[128] In addition, as we have seen, the types of risk management programs that will be effective vary from firm to firm.[129] Devising effective enterprise risk management programs has been a particular challenge for the boards of directors of "complex risk-taking organizations such as banks, securities firms, insurance companies, and energy companies," all of played important roles in the financial crisis, precisely because it was a new board function requiring adaptation of new and evolving risk analytic disciplines.[130] This reality calls into question the extent to which the widespread risk management failures that have come to light in recent years should be blamed on board negligence.

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[125] *See* Desender, *supra* note 124, at 3 (noting that risk management provides boards with a tool for identifying and offsetting CEO risk-taking initiatives).

[126] *Id.* at 2.

[127] Bies, *supra* note 14, at 92.

[128] *See supra* text accompanying note 27-31; *see also* Simkins & Ramirez, *supra* note 14, at 592.

[129] *See supra* text accompanying note 31.

[130] CROUHY ET AL., *supra* note 13, at 85.

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If, in applying *Caremark* to risk management failures, courts are perceived as imposing liability on boards for failing to adopt some specific model of risk management, the evolutionary market processes by which optimal best practices emerge may be aborted. Accordingly, courts should be extremely leery about rendering opinions perceived as creating a roadmap for approaching risk management.

B. The Benefits of Risk Management Programs are Inherently Less Certain

At best, an effective risk management program can prevent risks from materializing and perhaps limit the impact of those that do materialize. In contrast, a law compliance program can not only "significantly reduce the incidence of violations of laws,"[131] it also can substantially "reduce or eliminate civil lawsuits, penalties, or prosecution" when violations do occur.[132] In other words, law compliance programs provide the additional benefit of mitigating or even eliminating sanctions for violations that fall through the program's cracks. The federal sentencing guidelines, for example, authorize courts to significantly reduce fine to be imposed on convicted corporations if the firm had appropriate and effective law compliance programs in place.[133] A downward adjustment is also available where the corporation discovers and voluntarily discloses a violation.[134] The potential payoff from effective law compliance programs is thus substantial.

C. Risk Management and Risk Taking are Inextricably Intermingled

Just because a firm has the ability to reduce risk does not mean that it should exercise that option. As the firm's residual claimants, shareholders do not get a return on their investment until all other claims on the corporation have been satisfied.[135] All else equal, shareholders therefore prefer high return projects.[136] Because risk and return are directly proportional, however, implementing that preference necessarily entails choosing risky projects.[137]

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[131] CORPORATE DIRECTOR'S GUIDEBOOK, *supra* note 3, at 28.

[132] *Id*.

[133] U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2008).

[134] *Id.* at § 8C2.5(g).

[135] MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 33 (1995).

[136] *See* KLEIN & COFFEE, *supra* note 2, at 46 (comparing creditor and shareholder risk preferences).

[137] *See id.* at 269 (explaining why "common shareholders might be better off with the riskier investment").

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Even though conventional finance theory assumes shareholders are risk averse,[138] rational shareholders still will have a high tolerance for risky corporate projects. First, the basic corporate law principle of limited liability substantially insulates shareholders from the downside risks of corporate activity.[139] The limited liability principle, of course, holds that shareholders of a corporation may not be held personally liable for debts incurred or torts committed by the firm.[140] Because shareholders thus do not put their personal assets at jeopardy, other than the amount initially invested, they effectively externalize some portion of the business' total risk exposure to creditors.

Accordingly, as Chancellor Allen explained in *Gagliardi v. Trifoods Int'l, Inc.*,[141] shareholders will want managers and directors to take risk:

> Shareholders can diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the highest risk adjusted rate of return first. Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.[142]

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[138] *Id.* at 245-46.

[139] Indeed, it is this very insulation that motivates critics of corporate limited liability. *See, e.g.*, Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1414-15 (1993) (arguing that: "Thanks to limited liability, shareholders can fund the activities of large corporations, receive dividends and capital gains on their investments, and yet remain immune to some of the costs of misconduct or misjudgment by their corporate agents."); Henry Hansmann and Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882 (1991) (arguing that limited liability, *inter alia*, creates an "incentive ... for the shareholder to direct the corporation to spend too little on precautions to avoid accidents").

[140] *See, e.g.*, MOD. BUS. CORP. ACT ANN. § 6.22 (1984 & supp) (stating that: "Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.").

[141] 683 A.2d 1049 (Del. Ch. 1996).

[142] *Id.* at 1052.

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As the federal Second Circuit explained in *Joy v. North*,[143] this understanding of shareholder risk preferences is an important part of the rationale for the business judgment rule:

> Although the rule has suffered under academic criticism, it is not without rational basis. ... [B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. ... Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. ... A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.[144]

Just as the business judgment rule insulates risk taking from judicial review, so *Caremark* should insulate risk management from judicial review.

Risk management necessarily overlaps with risk taking because the former entails making choices about how to select the optimal level of risk to maximize firm value.[145] Recall that there are only four basic ways of managing risk: avoiding it by avoiding risky activities, transferring it through insurance or hedging, mitigating it, and accepting it as unavoidable.[146] All of these overlap with risk taking. Operational risk management, for example, frequently entails making decisions about whether to engage in risky lines of business and, more generally, determining whether specific risks can be justified on a cost-benefit analysis basis.[147] As a result, it is becoming increasingly "difficult to draw a line between corporate governance and risk management."[148]

The fuzzy line between risk-taking and risk management is nicely illustrated by how corporations use derivatives. On the one hand, they can be used to hedge risk. On the other hand, they can be used as speculative investments. In many cases, they can be used as both simultaneously.

As Chancellor Chandler correctly recognized in *Citigroup*, *Caremark* claims premised on risk management failures thus uniquely implicate the core concerns

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[143] Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

[144] Id. at 886.

[145] Meulbroek, *supra* note 23, at 22.

[146] *See supra* text accompanying note 23.

[147] Meulbroek, *supra* note 23, at 26.

[148] CROUHY ET AL., *supra* note 13, at 87.

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animating the business judgment rule in a way typical *Caremark* claims do not.[149] Chancellor Chandler seemingly understood that risk management cannot be easily disentangled from risk taking, because it described plaintiffs' claim as "asking the Court to conclude … 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."[150] He declined to do so, explaining that "this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law."[151]

VI. Tweaking *Caremark*

Because risk management differs in degree from classic *Caremark* claims arising out of law compliance and accounting controls, courts need to be especially sensitive in applying *Caremark* to the former class of cases. This section offers several suggestions for how courts should tweak the *Caremark* standard in this context.

A *Caremark* claim can be prosecuted on any or all of three theories. First, plaintiff can argue the directors were interested in the relevant subject matter or were not independent of persons with such an interest.[152] This prong seems unlikely to be relevant to many risk management failure-based *Caremark* claims and, in any event, involves generic issues of corporate law largely independent of the *Caremark* framework. Accordingly, it is not pursued herein. Second, plaintiff might allege that the board failed "to assure the existence of reasonable information and reporting systems."[153] Third, plaintiff might allege that red flags were raised by such systems or otherwise that the directors ignored.[154] The next two sections take up the latter two theories seriatim.

A. An Utter Failure to Adopt Risk Management Programs

Under *Stone*, the initial question is whether the board "*utterly* failed to implement *any* reporting or information system or controls."[155] Where a

[149] *See supra* text accompanying note 111.

[150] *Citigroup*, 2009 WL 481906 at *15.

[151] *Id.* at *12.

[152] Shaev v. Armstrong, 2006 WL 4762860 * 4 (Del. Ch. 2006).

[153] *Id.*

[154] *Id.*

[155] *Stone*, 911 A.2d at 370 (emphasis supplied).

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Caremark claim is premised on accounting control failures, liability would arise if "the company *entirely* lacked an audit committee or other important supervisory structures, or that a formally constituted audit committee failed to meet."[156] Note the emphasis that a mere failure is not enough; there must be an utter or entire failure. This requirement follows inexorably from *Caremark*'s dictum that "the level of detail that is appropriate for [the requisite] information system is a question of business judgment."[157] Courts are not to second-guess a board's determination that the company's risk management programs are adequate.

Chancellor Chandler hewed closely to this principle in *Citigroup*, in a passage that is notable for its brevity:

> Plaintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk. Plaintiffs admit that Citigroup established the ARM Committee and in 2004 amended the ARM Committee charter to include the fact that one of the purposes of the ARM Committee was to assist the board in fulfilling its oversight responsibility relating to policy standards and guidelines for risk assessment and risk management. The ARM Committee was also charged with, among other things, (1) discussing with management and independent auditors the annual audited financial statements, (2) reviewing with management an evaluation of Citigroup's internal control structure, and (3) discussing with management Citigroup's major credit, market, liquidity, and operational risk exposures and the steps taken by management to monitor and control such exposures, including Citigroup's risk assessment and risk management policies. According to plaintiffs' own allegations, the ARM Committee met eleven times in 2006 and twelve times in 2007.[158]

The demands on the board implied by this passage are strikingly modest. The passage, after all, amounts to the following: the company had an audit committee, which on paper was charged with various risk management oversight obligations, and which met often, so the requisite utter failure cannot be demonstrated. The court did not drill down into the details of what the audit committee actually did with respect to risk management.

This judicial reticence is appropriate because substantive analysis of board decisions with respect to the nature, scope, and content of risk management programs are themselves business decisions of the sort protected by the business judgment rule. The levers a board can pull when supervising the company's risk

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[156] *Shaev*, 2006 WL 4762860 at * 4 (emphasis supplied).

[157] *Caremark*, 698 A.2d at 970.

[158] *Citigroup*, 2009 WL 481906 at *13.

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management include, for example, the human capital resources devoted to the task.[159] The board might ask such questions as: To whom do risk management officers report? How are they chosen? How much are they paid? How is their performance evaluated?[160] Personnel decisions like these are core business judgments protected from judicial review by the business judgment rule.[161] Likewise, managing operational risk by choosing among possible business activities[162] is a basic business judgment that should be protected by the rule.[163] Accordingly, in light of the inextricable intertwining of risk taking and risk management discussed in the preceding Part,[164] courts should be especially willing to accept any board effort to supervise risk management as adequate to satisfy their Caremark obligations.

B. Risk Management Red Flags

As noted, a board's failure to respond to red flags is a viable basis for a *Caremark* claim. Because *Caremark* requires "a sustained or systematic failure" on the board's part,[165] however, those red flags need to be "numerous, serious, directly in front of the directors, and indicative of a corporate-wide problem."[166] In addition, even if a sustained pattern on a board's part of overlooking red flags can be demonstrated, liability seemingly would not result. Recall that *Stone* requires the board to have "consciously failed to monitor," which requires "a

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[159] CROUHY ET AL., *supra* note 13, at 89.

[160] *Id.*

[161] *See* In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 762 (Del. Ch. 2005) (holding that "the decision to hire [the company's president] is one of business judgment, to which the presumptions of the business judgment rule apply"), *aff'd*, 906 A.2d 27 (Del. 2006).

[162] *See supra* text accompanying note 23 (noting that this is one of four basic risk management strategies).

[163] *See* David E. Brown, Jr., et al., Strategic Alliances: Why, How, and What To Watch For, 3 N.C. Banking Inst. 57, (1999) (noting that corporate decisions to acquire or dispose of lines of business, enter into alliances, license technology or products, and agree to associated restrictions on activities inconsistent with those decisions … will generally be accorded the protections of the 'business judgment rule'").

[164] *See supra* Part V.C.

[165] *See supra* text accompanying note 69.

[166] Burch, *supra* note 77, at 498.

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showing that the directors knew that they were not discharging their fiduciary obligations."[167]

The net effect of these requirements has been to confirm Chancellor Allen's assertion that *Caremark* set a high bar for liability.[168] In order to survive a motion to dismiss, *Caremark* claims have had to involve "clearly egregious behavior."[169] Because risk management differs in kind from legal compliance or accounting controls, it seems unlikely that many cases based on the former will involve sufficiently egregious misconduct for liability to be imposed.

The distinction between *Caremark* liability premised on a board's egregious failure to deal with criminality within the firm and a board's failure to manage business risks is nicely illustrated by a trio of federal cases. In *McCall v. Scott*,[170] the court concluded that the complaint alleged sufficient facts to permit the inference that the board of directors' sustained failure to act against corporate employees' systematic health care fraud amounted to intentional or reckless disregard of their fiduciary duties. The red flags in that case included (1) audit discrepancies between cost reports submitted to the government and internal reports; (2) improper acquisition practices in which at least one board member was personally involved; (3) a qui tam action against the corporation alleging widespread violations of federal law; (4) an extensive criminal investigation, which included raids on thirty-five company facilities in six different states; and (5) an investigation by the New York Times into the company's billing practices.[171]

In Re Abbott Laboratories Derivative Shareholders Litigation,[172] similarly involved numerous red flags that should have alerted the board to obvious violations of federal law. The FDA had conducted various investigations of Abbott over a six-year period, which included thirteen inspections of Abbot facilities.[173] The FDA sent four Warning Letters to Abbot, formally advising the firm that failure to correct certain violations could result in severe regulatory

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[167] *See supra* text accompanying note 97.

[168] *See supra* text accompanying note 70.

[169] Martin Lipton et al., *Risk Management and the Board of Directors* 2 (Nov. 2008), available at http://blogs.law.harvard.edu/corpgov/files/2008/11/risk-management-and-the-board-of-directors.pdf.

[170] 239 F.3d 808 (6th Cir.2001), amended on denial of rehearing by McCall v. Scott, 250 F.3d 997 (6th Cir.2001).

[171] *Id*. at 819-24.

[172] 293 F.3d 378 (7th Cir.2002).

[173] *Id*. at 382.

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action.[174] The chairman of the board had received several of these notices. No action was ever taken by the board of directors. Abbot ultimately was given "the largest penalty every imposed for a civil violation of FDA regulations."[175]

A board that is aware of a sustained pattern of serious regular violations has little justification for looking the other way. As we have seen, however, risk management presents a more complex problem. Whereas law compliance has something of an "either/or" aspect—you're either breaking the law or not—business risk management is inevitably intertwined with risk taking.[176]

Salsitz v. Nasser,[177] for example, involved a *Caremark* claim against the directors and officers of Ford Motor Co. for their alleged failure to adequately supervise management with respect to three corporate actions that allegedly exposed the company to significant losses: "(1) the decision from approximately 1982 to 1995 to mount a computerized ignition system, known as a thick film ignition ("TFI") switch, directly onto the engine block, despite the switch's propensity to fail and shut down the engine if overheated; (2) the decision ongoing from 1990 to 2000 to install Bridgestone/Firestone tires on Explorer vehicles, even though the tires made the Explorer prone to instability and rollovers; and (3) the prolonged failure to oversee and monitor the purchase of palladium, a precious metal used in certain Ford vehicles, which resulted in a costly write-down for excessive purchases."[178] The court emphasized that:

> The facts in this case are not analogous to those in *McCall* or *Abbott*. There are no allegations of criminal or civil investigations that plainly put the Board on notice of illegal behavior. Indeed, there is no indication in the complaint that Ford has ever been officially warned or sanctioned by NHTSA for any of its conduct in reaction to the tire debacle. Accordingly, the court concludes that insufficient facts have been set forth to indicate that Defendants ought to be personally liable for the resulting damages.[179]

The lesson seems to be that red flags involving illegal behavior or accounting irregularities are more likely to result in liability than risk management failures.[180]

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[174] *Id.*

[175] *Id*. at 384.

[176] *See supra* Part V.C.

[177] 208 F.R.D. 589 (E.D. Mich. 2002).

[178] *Id*. at 590.

[179] *Id*. at 599.

[180] *Cf. Citigroup*, 2009 WL 481906 at *16, where Chancellor Chandler contrasted the facts before it to those of American International Group, Inc. Consolidated Derivative

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This conclusion is supported by *Citigroup*, which recognized that allowing "plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk" threatened to undermine "the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions."[181] An institution that suffers a large loss because a certain risk materialized did not necessarily have a risk management failure. Yet, when such a loss occurs, there is a substantial risk that suing shareholders and reviewing judges will be unable to distinguish between competent and negligent management because bad outcomes often will be regarded, *ex post*, as having been foreseeable and, therefore, preventable *ex ante*.[182]

> It 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. … In 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. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the "right" decision if they had been in the directors' position.[183]

If liability results from bad outcomes, without regard to the *ex ante* quality of the decision and/or the decision-making process, however, managers will be discouraged from taking risks.[184] Accordingly, courts need to be particularly wary of the risk that they will confuse risk management and risk taking in hindsight.

Litigation, 2009 WL 366613 (Del.Ch. Feb. 10, 2009). In the latter case, in which a *Caremark* claim survived a motion to dismiss, there were credible and particularized allegations that the defendants "to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct." *Citigroup*, 2009 WL 481906 at *16 (emphasis in original). *See also id.* at *16 ("There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk.").

[181] *Citigroup*, 2009 WL 481906 at *15.

[182] *See* Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 799-805 (2001) (discussing empirical evidence that judicial decision making is tainted by the hindsight bias).

[183] *Citigroup*, 2009 WL 481906 at *12.

[184] *See* Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 ORE. L. REV. 587, 644 (1994) (suggesting that "retrospective evaluation of business decisions might discourage highly qualified people from serving on boards of directors").

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A related concern is that courts will be influenced by the systemic implications of the financial crisis. A Wachtell, Lipton client memorandum, for example, observes that: "In light of the focus on risk oversight in the current environment, however, boards should recognize the possibility that what constitutes a red flag and what constitutes conscious disregard may be evaluated in the future with heightened focus."[185] Yet, there is no meaningful difference between being biased by such systemic considerations and by hindsight with respect to a particular firm. Again, accordingly, courts need to be wary of such biases.[186]

The purported red flags identified by plaintiffs in *Citigroup* in fact consisted mainly of such systemic factors. Plaintiffs pointed, for example, to the decline in housing prices that started as early as 2005, a rise in foreclosure rates starting in 2006, substantial losses at some subprime lenders starting in 2006, and losses suffered by other major financial institutions.[187] As Chancellor Chandler noted, such allegations amounted "to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally."[188] "That the director defendants knew of signs of a deterioration in the subprime mortgage market, or even signs suggesting that conditions could decline further," the court explained, "is not sufficient to show that the directors … were consciously disregarding a duty somehow to prevent Citigroup from suffering losses."[189]

Even if plaintiffs had been able to allege particularized facts showing that materializing business risks exposed Citigroup to potentially enormous losses, moreover, their claim still might not have survived a motion to dismiss. "Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to

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[185] Lipton et al., *supra* note 169, at 2.

[186] Donald Langevoort makes the interesting point that Sarbanes-Oxley can be understood as being concerned less with less about investor protection than with preventing a recurrence of the social and economic dislocations caused by Enron and WorldCom debacles. Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1829-31 (2007). The effect has been to dampen risk taking. *Id.* at 1832-33. Whether or not such a result is socially desirable, these sort of macro social and economic concerns are more properly the subject of federal legislation than common law adjudication in a single state. Accordingly, Delaware courts should eschew the temptation to affect global changes in the architecture of corporate governance.

[187] *Citigroup*, 2009 WL 481906 at *13-14.

[188] *Id.* at *14.

[189] *Id.*

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properly evaluate business risk."[190] The inextricable intermeshing of managing risk and taking risks once again counsels against permitting *Caremark* claims to sound in connection with risk management failures absent egregious, firm-specific facts.

VII. Conclusion

In *Caremark*, Chancellor Allen opined that the oversight claims countenanced by that case would be perhaps the most difficult corporate law claim for plaintiffs to satisfy.[191] *Guttman* likewise emphasized that *Caremark* claims are difficult to prove.[192] *Stone* reiterated the same emphasis on creating a high liability bar.[193]

Risk management does not differ in kind from the more typical law compliance and accounting control cases in which *Caremark* claims have been brought in the past. Because risk management does differ in degree from such claims, however, particularly because it is inextricably intertwined with risk taking, the bar needs to be set particularly high with respect to such claims. If *Caremark* is the most difficult theory of liability in corporate law, risk management needs to be the most difficult variant of *Caremark* claims.

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[190] *Id.* at *16.

[191] *See supra* text accompanying note 71.

[192] *See supra* text accompanying note 85.

[193] *See supra* text accompanying note 95.

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