

# Protecting Directors Against Liability in Light of the *In re Citigroup Inc. Shareholder Derivative Litig.* Decision<sup>1</sup>

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Activist shareholders and legal commentators are responding to the current global economic crisis with calls for changes in Delaware law that would subject directors to enhanced accountability through greater personal liability. Although Delaware jurists state that the business judgment rule is alive and well, the recent spate of cases initiated in response to the current crisis bear watching. With over 50% of all publicly-traded companies, and more than 60% of Fortune 500 companies incorporated in Delaware, actions like the one brought against the directors of Citigroup seeking damages for the directors' alleged failure to properly monitor and manage the company's exposure to losses in the subprime market, could have far reaching implications.

The Delaware Chancery Court recently dismissed these oversight claims against Citigroup's directors, saying that failure to fully recognize the extent of the company's subprime risk was not, without more, a basis for personal liability.<sup>2</sup> Nevertheless, in light of the heightened risks facing most corporations in this time of economic uncertainty and calls for increasing governmental regulation, it is crucial that boards proactively exercise their oversight responsibilities, particularly enterprise and financial risk management.

## *Director Liability under Current Law*

Directors, as fiduciaries, are obligated to act in the best interests of the corporation and its shareholders. Under Delaware law, directors are charged with a duty of care, a duty of loyalty and a duty to act in good faith. This means directors must act on an informed basis, in the best interests of the corporation and free from conflicts of interest.

Directors are generally protected by the business judgment rule, which presumes that directors have met these standards, as well as by procedural protections permitted by many state laws.<sup>3</sup> However, if a majority of the directors were conflicted, did not act in good faith, relied on a grossly negligent information gathering system, or made a decision that was irrational, then the directors must show that their action was fair to the corporation and its shareholders -- a demanding standard, which puts the board in a difficult defensive position.

Recent lawsuits arising out of the economic crisis challenge directors' oversight of management. Under current Delaware law, directors will not be held personally liable for breach of oversight duties unless they ignored known "red flags" by failing to implement reporting systems or controls or, having implemented such systems, consciously failed to exercise proper oversight of them.<sup>4</sup>

In *Citigroup*, the Delaware Chancery Court addressed the distinction between directors' oversight duties and business judgment in the context of the current crisis. The plaintiffs alleged that the directors' lack of oversight caused the company to be "exposed to massive losses" tied to subprime mortgages despite "extensive 'red flags.'"<sup>5</sup> However, the only red flags identified were reports of problems in the subprime market and economy generally; no particularized facts suggesting potential misconduct at Citigroup were alleged.<sup>6</sup> The court concluded that plaintiffs' claims were not truly for failure of management oversight, but failure to recognize the extent of the company's business risk -- a form of business judgment.<sup>7</sup>

In light of the protection of the business judgment rule and the exculpatory provisions set forth in the Citigroup charter, the court reaffirmed that directors will not be personally liable for such claims unless plaintiffs can show particularized facts demonstrating bad faith -- namely, that the directors consciously disregarded their obligation to be reasonably informed about the company's business and its risks or consciously disregarded their duty to monitor and oversee the

company's business. Knowledge of a deterioration in the subprime mortgage market was not, by itself, sufficient.

Given the extreme facts of the current economic crisis, directors would be well served to take steps beyond what is required under this deferential standard. Had there been allegations of employee wrongdoing such as illegal or fraudulent conduct, the outcome in *Citigroup* might have been different. Further, courts in other jurisdictions applying Delaware law have allowed oversight claims to proceed.<sup>8</sup>

#### *Evolving Nature of Best Practices - Oversight Liability*

The Delaware courts strongly encourage directors to employ best practices of corporate governance, as understood at the time the board acts.<sup>9</sup> In the current economic crisis, increased government regulation can be expected to require increased director scrutiny of enterprise and financial risk management, thus affecting best practices.<sup>10</sup>

#### *Liability under Federal Securities Laws and Other Contexts*

Importantly, the business judgment rule does not apply to transactions involving a sale of control or breakup of a company, which receive a higher level of scrutiny. In the context of a corporation found to be insolvent, directors also face potential liability to creditors as well as shareholders, which has been the subject of extensive guidance from the Delaware courts.

Directors also face a threat of personal liability under Federal securities laws for material misstatements and omissions in registration statements used to sell corporate securities, unless the directors exercised appropriate due diligence.

#### *Steps Directors Can Take to Shield Themselves from Liability*

Today's directors will be judged for the manner in which they exercise management oversight during this economic crisis. Directors in the current environment should implement the following best practices.<sup>11</sup>

##### *Understand the Business*

Effective oversight requires knowing the business. Directors should understand the company's products, sources of profitability and expense, and fundamental business model. They should make sure they are getting information from multiple sources, both internal and external. The Nominating Committee should consider only nominating directors who have a solid understanding of the company's products and fundamentals.

##### *Understand the Company's Major Risks*

Understanding the company's enterprise risks, its financial risks and its risk management systems or controls is essential to oversight in today's environment. Directors should understand the potential impact of particular risks on the company's profitability and the assumptions underlying financial projections. They should participate in setting appropriate risk tolerance levels and ensure that the company's compensation system rewards behaviors that comply with the company's goals.

##### *Adhere to Board Procedures and Record Keeping*

Directors should attend and actively participate in all meetings, review materials in advance, and ask challenging questions. Decisions should be documented and minutes prepared with the involvement of the general counsel, and promptly circulated and reviewed.

### *Evaluate Board Structure*

Directors should consider appointing a non-executive Chairman, establishing an independent risk committee, and establishing direct communication with the general counsel.

### *Review Regulatory Filings*

Directors should exercise due diligence by reviewing all SEC filings and material disclosures with general counsel, accountants and other independent experts to ensure accuracy and quality of procedures used.

### *Understand the Company's Shareholders*

Directors should understand the company's large shareholders, including their investment objectives (which may conflict), and respond to their communications.

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<sup>2</sup> *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009). This decision is likely to be appealed by the plaintiffs to the Delaware Supreme Court. A decision on appeal may yield further guidance to directors on the legal standard to be applied in the context of current market conditions – which are changing rapidly and pose new challenges for directors and officers of Delaware corporations.

<sup>3</sup> Delaware General Corporations Law § 102(b)(7) permits a Delaware corporation to eliminate personal liability of directors for monetary damages for breach of fiduciary duty unless the director's acts or omissions were not taken in good faith or involve a breach of the duty of loyalty. The vast majority of Delaware corporations have such a provision in their charter. Many other states permit similar exculpation provisions.

<sup>4</sup> See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996).

<sup>5</sup> *In re Citigroup*, 964 A.2d at 111-12.

<sup>6</sup> *In re Citigroup*, 964 A.2d at 114-15, 128.

<sup>7</sup> *In re Citigroup*, 964 A.2d at 124.

<sup>8</sup> See *In re Countrywide Financial Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1060, 1077, 1080-82 (C.D. Calif. 2008) (denying motion to dismiss oversight claims where members of board committees tasked with risk oversight allegedly had actual knowledge of particular red flags showing problems with mortgage loans generated by company and failure to comply with underwriting standards without taking corrective action) (applying Delaware law).

<sup>9</sup> See *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

<sup>10</sup> See, e.g., Zachary A. Goldfarb, SEC to Examine Boards' Role in Financial Crisis, WASHINGTON POST, Feb. 20, 2009, at D1; Edmund L. Andrews, Fed Chairman Calls for a Regulator to Rein In Entities 'Too Big to Fail', NEW YORK TIMES, March 11, 2009, at B5; David Leonhardt, The Looting of America's Coffers, NEW YORK TIMES, March 11, 2009, at B1.

<sup>11</sup> See also *Highlights from the 5th Annual Audit Committee Issues Conference: Setting the 2009 Agenda* (February 2009), published by KPMG LLP.