ASSESSING DELAWARE’S OVERSIGHT JURISPRUDENCE: A POLICY AND THEORY PERSPECTIVE

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ABSTRACT

The recent financial crisis has triggered a renewed emphasis on corporate directors’ duty to exercise oversight. In contrast to the area of discrete decision-making, where academics only rarely dispute the board’s almost complete insulation from liability, there is considerable resistance to the idea that oversight should be subject to equally strict limits to hold directors responsible. Yet, Delaware courts have made it clear that they continue to severely limit, and not expand, directors’ oversight liability, leading Delaware in the opposite direction than that which many of its critics would advocate.

Both policy and theoretical considerations, however, support Delaware’s decision to maintain strict limits on oversight liability. Such restraints protect directors’ ability to exercise independent business judgment, encourage risk taking and board service by qualified individuals, and prevent directors from assuming the role as insurers of business risks. In addition, limits on oversight liability reduce monitoring costs and promote efficient functioning of boards. Thus, as this Article argues, Delaware’s current solution works and strikes the correct balance between directors’ accountability and authority.
I. INTRODUCTION

From among an infinite number of useful things that a board of directors might reasonably have done . . . , the number that will not have been done by the most qualified, best-run, and most diligent board in the world will always be far greater than the number that were done.

Bayless Manning

CORPORATE crises have been rampant since the beginning of the millennium. In the last ten years, we have witnessed the burst of the dot-com bubble, the collapse of notable corporations such as Enron and WorldCom, and a financial crisis that harkens back to the depths of the Great Depression. Several commentators have attributed the rise of these crises, in part, to a lax oversight liability standard imposed on directors by the Delaware Chancery Court’s decision in Caremark and its progeny, with at

1. See, e.g., Daniel J. Morrissey, The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule, 86 O. R. L. REV. 973, 1012 (2007) (linking the options backdating controversy to boards’ disregard of oversight responsibilities and calling for a reassessment of liability standards); Elizabeth A. Nowicki, Director Inattention and Director Protection under Delaware General Corporation Law Section 102(b)(7): A Proposal for Legislative Reform, 33 DEL. J. CORP. L. 695, 695 (2008) (stating that “[m]any recent high-profile corporate scandals likely could have been prevented by a board of directors that was engaging, inquisitive, and giving its corporate charge due attention. The looting of WorldCom, the implosion of Enron, the irrational explosion of executive compensation, and stock option backdating all involved conduct that could have been detected and remedied by an attentive board of directors” and arguing for greater imposition of liability for inattentive conduct). See also Janet E. Kerr, Developments In Corporate Governance: The Duty Of Good Faith And Its Impact On Director Conduct, 13 GEO. MASON L. REV. 1037, 1038 (2006) (noting that “corporate debacles have led to an increase in the scrutiny of corporate directors and their fiduciary duties”); E. Norman Veasey, Policy and Legal Overview of Best Corporate Governance Principles, 56 SMU L. REV. 2135, 2136 (2003) (opining that “the main corporate governance failure in this period [of corporate scandals at the turn of the millennium] was the latitude and indifference of some boards of directors who were not pro-active in their oversight and strategic roles”). With regards to additional criticism of oversight in the wake of the recent financial crisis, see also infra notes 10 and 11 and accompanying text.

2. In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996). In Caremark, the court established that directors were required to put into place adequate information and reporting systems concerning their company’s compliance with applicable laws and its business performance. See infra Part II.A.
least one commentator referring to Caremark as “shameful and
disingenuous.”

The most recent financial crisis and its effects have triggered a renewed emphasis on the importance of board oversight and resulted in an increasing number of lawsuits against directors. After all, board passivity in oversight and, specifically, risk management programs is often viewed as one of the crisis’s contributing elements. In addition, while the financial crisis

3. Lawrence E. Mitchell, The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?, 48 VILL. L. REV. 1189, 1189 n.2 (2003). Professor Mitchell contends that in Caremark, “Chancellor Allen gave a great deal of lip service to Delaware’s standards of supervision and the extent to which they were met by Caremark’s cosmetic policies in a case in which it was obvious . . . that Caremark’s compensation system and management structure were set up in every way possible to create incentives for employees to disregard the Anti-Referral Payment Law and defraud the Medicare program.” Id. at 1203.


5. See Nees, supra note 4, at 237 n.160 (providing a list of subprime lending/credit crisis shareholder derivative suits alleging breaches of fiduciary duties, including oversight failures by directors). Most notably, claims related to exposure to the subprime lending market have met corporate oversight liability doctrine in the recent Delaware case of In re Citigroup Inc’ s Holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

6. See, e.g., Stephen M. Bainbridge, Caremark and Enterprise Risk Management, 34 J. CORP. L. 967, 968 (2009) (noting that the financial crisis revealed serious and systematic risk management failures); Michelle M. Harner, Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis, 5 J. BUS. & TECH. L. 45, 48–52 (2010) (observing that many financial and other firms limited the board’s role in risk management and stating that boards and senior management likely could have mitigated losses and the severity of the financial crisis if provided with more information); Pan, Duty to Monitor, supra note 4, at 718 (“The absence of adequate board oversight is partially to blame for the recent catastrophic losses suffered by Bear Stearns, Lehman Brothers, AIG, and Citigroup.”); Barry B. Burr, Shareholders See Victory in Obama Administration, PENSIONS & INVESTMENTS, Nov. 10, 2008, available at http://www.pionline.com/apps/pbcs.dll/article?AID=/20081110/PRINTSUB/31109932 (citing a deputy director of the Council of Institutional Investors as referring to the financial crisis as “a massive failure of oversight at all levels”); Ben W. Heineman, Boards Fail – A gain, Bus. Wk. Online, Sept. 26,
apparently did not involve blatant financial manipulation and illegal activities, a recent report has revealed that questionable accounting practices might have played a role in the collapse of Lehman Brothers. As a result, boards’ risk oversight as well as their responsibility to monitor legal compliance—classic Caremark territory—may come under renewed scrutiny.

Commentators have renewed their criticism of the Delaware courts’ approach to oversight. Some argue that the judicial interpretation of Caremark liability is encouraging boards to be ignorant of or fail to question officers’ aggressive risk taking. Others believe that the courts are skewing the balance between directors’ authority and their accountability to shareholders too far in favor of directorial autonomy. Thus, in contrast to the area of discrete decisionmaking, where the board’s almost complete insulation from liability is now only rarely disputed, there is considerable

7. See Brian R. Cheffins, Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? – The Case of the S&P 500, 65 BUS. LAW. 1, 28–30 (2009). Of course, this does not mean that there were no instances of managerial wrongdoing, as evidenced by several ongoing, and possibly future, lawsuits that could uncover illegal conduct. See id. (discussing civil and criminal proceedings against companies and executives that were initiated in connection with the financial crisis).


9. Yet, note that in the case of Lehman, the Bankruptcy Examiner’s Report did not find colorable claims that Lehman’s directors breached their fiduciary duty by failing to monitor the firm’s risk taking activities. See id. at 54–57, 190–95.

10. Pan, Duty to Monitor, supra note 4, at 718.

11. See, e.g., Nees, supra note 4, at 235 (arguing that “the fulcrum point between director authority and accountability has been pushed too far in favor of director authority”); J. Robert Brown, Delaware Courts and Exonerating the Board from Supervising Risk: In re Citigroup Derivative Litigation (Introduction), March 12, 2009, http://www.theracetothebottom.org/preemption-of-delaware-law/delaware-courts-and-exonerating-the-board-from-supervising-r-4.html (introducing a series of blog posts that criticize the Delaware Chancery Court’s Citigroup decision and call for imposition of stricter liability on directors).

12. See Leo E. Strine, Jr. et al., Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law, 98 GEO. L.J. 629, 636–37 & n.13 (2010) (citing several prominent corporate commentators for the proposition that a breach of the duty of care should not result in directors’ personal liability for monetary damages).
resistance to the idea that oversight should be subject to equally strict limits to hold directors responsible.

Yet, the increasing awareness of the importance of oversight and its popularity with plaintiffs are inversely proportional to the success rate of oversight liability claims in Delaware courts. Procedural and substantive hurdles continue to make it exceedingly difficult for plaintiffs to hold directors responsible under a theory of oversight liability. Today, a string of recent case law has made it clear that the judicial trend is to severely limit, not expand, directors' oversight liability, leading Delaware in the opposite direction from that which many of its critics would advocate.

Against this background, this Article will map and evaluate the various reasons Delaware courts have put forward to explain its director-friendly approach to oversight liability. It will argue that from a policy and theoretical perspective, Delaware is correct in maintaining strict limits on oversight liability. Such restraints protect directors' ability to exercise independent business judgment, encourage risk taking and board service by qualified individuals, and prevent directors from assuming the role as insurers of business risks. In addition, limits on oversight liability reduce monitoring costs and promote efficient functioning of boards.

Part II of this paper will explore the evolution of Delaware's oversight jurisprudence, tracing its origins and the shift of oversight from the duty of care to the duty of loyalty. This Part will also turn to the uncertainties that arose in the wake of the Delaware Supreme Court's decision in Stone v. Ritter, which complicated the law of oversight liability and seemed to open potential new avenues for plaintiffs to hold directors liable. Part III will describe how Delaware courts have reaffirmed in subsequent case law the strict limits on oversight liability. Part IV will examine the policy considerations that Delaware courts have adopted as justifications for strictly limiting oversight liability and discuss them in a broader theoretical context. Finally, Part V will put oversight liability into a broader perspective, arguing that despite the doctrinal shift to the duty of loyalty, oversight stays true to the policy goals that it shares with directors' liability outside the oversight context, which support strict limits on liability.

13. See infra Part III.
II. The Evolution of Delaware’s Oversight Liability

The concept of fiduciary oversight liability is a relatively new addition to state corporate law. Only in the iconic 1996 Caremark case\(^{15}\) did then-Chancellor Allen introduce a duty for directors to establish corporate information and reporting systems. Subsequently, these “Caremark duties” have rapidly evolved and become a fixture in the corporate litigator’s arsenal. Recently, in Stone,\(^{16}\) the Delaware Supreme Court once again weighed in and redefined the contours of Delaware’s oversight doctrine.

A. The Origins of Oversight

Traditional state corporate law has long confirmed that directors have a fiduciary duty to pay attention to the ongoing business and affairs of the corporation and to supervise management.\(^{17}\) Until the 1960s, however, Delaware had not directly addressed a critical issue in corporate governance: Are directors, as part of their fiduciary duties, obliged to maintain reporting systems that help the board learn of and prevent illegal activity by the corporation’s subordinates and ensure legal compliance?

When first faced with this question, the Delaware Supreme Court answered it in the negative. In Graham v. Allis-Chalmers Mfg. Co.,\(^{18}\) the court concluded that directors were not obliged to implement “a system of watchfulness.”\(^{19}\) Rather, only upon a failure to take action following an event that put them on notice—what today would be called a “red flag”\(^{20}\)—or by

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\(^{15}\) In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
\(^{16}\) 911 A.2d 362, 364 (Del. 2006).
\(^{17}\) See, e.g., Barnes v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924) (finding that directors are under an individual duty to keep themselves informed in some detail); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) (holding that directors are under a continuing obligation to keep themselves informed about the corporation’s activities); see also 2 Seymour D. Thompson, Corporations §§ 1276–81 (2d ed. 1909) (discussing directors’ liability for negligent ignorance and acts of subordinate officers under early case law).
\(^{18}\) 188 A.2d 125 (Del. 1963). The plaintiffs in Graham alleged that directors of Allis-Chalmers, a large manufacturer of electrical equipment, were liable for their failure to learn of and take steps to prevent violations of antitrust laws by company employees engaging in price fixing. Id. at 127.
\(^{19}\) Id. at 130.
recklessly\textsuperscript{21} confiding in an obviously untrustworthy employee could directors incur liability.\textsuperscript{22} As the court famously observed, "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."\textsuperscript{23}

Despite the shifting legal landscape,\textsuperscript{24} Graham remained the leading case on oversight liability (or, rather, the lack of it) for more than thirty years.\textsuperscript{25} This situation was about to change in 1996, however, when then-Chancellor Allen, reviewing the proposed settlement of a derivative action, seized the opportunity to discuss the legal standard governing directors' monitoring duties in his opinion in Caremark.\textsuperscript{26}

The suit underlying the proposed settlement involved claims that the directors of Caremark violated their duty to monitor the company in connection with illegal schemes by company employees.\textsuperscript{27} Chancellor Allen,

\textsuperscript{21} Despite the reference to recklessness, it is not clear which standard of review of the duty of care the court invoked. See Stephen M. Bainbridge, Corporation Law and Economics 293 n.30 (2002) (discussing the standard of review used in Graham and subsequent decisions); see also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 n.31 (Del. 1993) (criticizing Graham's reasonable person standard).

\textsuperscript{22} Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (relying in part on Briggs v. Spaulding, 141 U.S. 132 (1891)). In its analysis, the court specifically took into account the larger size and geographical extension of the company and the practical need to delegate tasks to non-director employees. Id.

\textsuperscript{23} For an approving discussion of Graham from a policy perspective, see Stephen M. Bainbridge et al., The Convergence of Good Faith and Oversight, 55 UCLA L. Rev. 559, 578 (2008) (analogizing Graham with the common law "dog bite" rule); see also Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461, 484–486 (1992).


\textsuperscript{25} See, e.g., In re Baxter Int'l, Inc. Shareholders Litig., 654 A.2d 1268, 1270–71 (Del. Ch. 1995); Rabkin v. Philip A. Hunt Chem. Corp., 1987 WL 28436, at *2 (Del. Ch. 1987). Another case, Seminarts v. Land, 662 A.2d 1350, 54–55 (Del. Ch. 1995) did not refer to Graham, but stated that in order to hold directors liable for failing to adequately supervise employees involved in wrongdoing; plaintiffs would "have to demonstrate that they were grossly negligent in failing to supervise these subordinates."

\textsuperscript{26} Id. at 906–66. Specifically, the plaintiffs alleged that Caremark's directors failed to supervise the conduct of company employees and to institute corrective measures, exposing Caremark to substantial fines and liability as a result of civil and criminal violations of various laws applicable to health care providers. Id. Overall, Caremark was, under its agreements with governmental agencies, required to make total payments of approximately $250 million. Id. at 961.
influenced by recent business scandals and troubled by passive and self-content boards, decided to go beyond simply approving the settlement and to issue an opinion that would induce directors to engage more actively in monitoring their companies. Allen held that boards, regardless of any notice of actual wrongdoing, have a duty to assure themselves that reasonably designed information and reporting systems exist that “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.”

While these duties were new and relatively expansive as compared to previous case law, Chancellor Allen formulated a narrow standard of review that severely constrained courts’ authority to hold directors liable for misguided compliance decisions. He opined that “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”

As Allen later explained, Caremark had, in fact, adopted a bifurcated liability standard. On the one hand, claims that directors failed to act would not

28. See id. at 968–69 (citing examples of business and financial scandals that invoked questions regarding boards’ role in overseeing legal compliance).
29. See Arlen, supra note 24, at 325, 339–40.
30. Caremark, 698 A.2d at 970. Stating the basis for his opinion, Allen pointed to cases evidencing the Delaware Supreme Court’s focus on the role of the corporate board, the essential role of relevant and timely information in exercising a board’s supervisory and monitoring function, and the potential impact of the Federal Sentencing Guidelines. See id. at 969–70. Today, Allen would presumably have also noted the Sarbanes-Oxley Act and its emphasis on internal control. See infra note 195 (discussing the potential impact of Sarbanes-Oxley on state oversight liability).
31. Nevertheless, corporate commentators had already, well before Caremark, posited that the law could expect directors to ensure that legal compliance and other reporting systems are in place. See Bayless Manning, The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality, 39 BUS. LAW. 1477, 1499 (1984); E. Norman Veasey & William E. Manning, Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model A: Standard of Care Compared with Delaware Law, 35 BUS. LAW. 919, 929–30 (1980);
33. Caremark, 698 A.2d at 971. Applying these criteria to the case before him, Allen concluded that the record did not indicate that the director defendants were guilty of a sustained failure to exercise their oversight function. On the contrary, he found that Caremark’s information systems seemed to represent a good faith attempt by the board to inform itself of relevant facts. Id.
be governed by a gross negligence standard, but by a bad faith standard that required evidence that director neglect was conscious and resulted from bad motives.\textsuperscript{34} On the other hand, claims that directors had adopted an inadequate compliance program would be subject to the business judgment rule and fall under the ambit of a company’s exculpatory charter provisions under Section 102(b)(7) of the Delaware General Corporate Law.\textsuperscript{35}

Allen also framed the duty to monitor in terms of “good faith.”\textsuperscript{36} Drawing from Judge Learned Hand’s opinion in \textit{Barnes v. Andrews}\textsuperscript{37}—wherein Hand observed that so long as directors “faithfully” devoted adequate attention to their company’s affairs, they would not be liable\textsuperscript{38}—Allen held that “the core element of any corporate law duty of care inquiry” is whether there was a “good faith effort to be informed and exercise judgment.”\textsuperscript{39}

Despite Allen’s use of “good faith” as a yardstick to measure directors’ exercise of their obligations,\textsuperscript{40} \textit{Caremark} is clear in treating oversight as a care-based duty.\textsuperscript{41} Nevertheless, the references to “good faith” in \textit{Caremark} would

\begin{itemize}
\item \textsuperscript{34} See Arlen, supra note 24, at 341 n.96. The language of \textit{Caremark} does not, by itself, clearly reveal that Allen intended to create this type of liability standard. Courts and academics often thought that under \textit{Caremark}, oversight cases involving director inaction would be subject to a gross negligence standard. See, e.g., In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 748–49 (Del. Ch. 2005), aff’d, 906 A.2d 27 (Del. 2006); Bainbridge et al., supra note 23, at 597, 599 (noting that \textit{Caremark} would allow courts to impose liability for grossly negligent board inaction).
\item \textsuperscript{35} See Arlen, supra note 24, at 341 n.96; In re \textit{Caremark Int’l Inc. Derivative Litig.}, 698 A.2d 959, 970 (Del. Ch. 1996) (“Obviously the level of detail that is appropriate for such an information system is a question of business judgment.”).
\item \textsuperscript{36} See \textit{Caremark}, 698 A.2d at 968–72.
\item \textsuperscript{37} 298 F. 614 (S.D.N.Y. 1924).
\item \textsuperscript{38} Barnes, 298 F. 614,618.
\item \textsuperscript{39} \textit{Caremark}, 698 A.2d at 968 (first emphasis added).
\item \textsuperscript{40} See Tara L. Dunn, The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-Of-Pocket After Disney IV?, 83 DENV. U. L. REV. 531, 564 (2005) (“\textit{Caremark} considered good faith as a component of directors’ duty of care”); see also Claire A. Hill & Brett H. McDonnell, Disney, Good Faith, and Structural Bias, 32 IOWA J. CORP. L. 833, 841 n.36 (2007) (stating that “[c]ontrary to prior characterizations of good faith as coming within the duty of loyalty,” in \textit{Caremark}, “good faith itself was seemingly characterized as falling within the duty of care” and noting that Chancellor Allen’s casebook includes \textit{Caremark} in the chapter on the duty of care).
\end{itemize}
later cause confusion about which category of fiduciary duty oversight should properly be attributed to.\textsuperscript{42}

B. The Shift to Loyalty

Caremark’s "good faith" language began to take on a life on its own in two now well-known decisions by the Delaware Chancery and the Delaware Supreme Court.

In Guttman v. Huang,\textsuperscript{43} Vice Chancellor Strine departed in two important ways from Caremark’s approach to oversight. Drawing from Caremark’s emphasis on “good faith,” Strine concluded that liability for directors is premised exclusively “on a showing that the directors were conscious of the fact that they were not doing their jobs.”\textsuperscript{44} He also found that Caremark articulated a standard of liability that requires a showing that the directors breached their duty of loyalty.\textsuperscript{45} For Strine, the Caremark court’s holding that a lack of good faith was “a necessary condition to liability”\textsuperscript{46} suggested that

\begin{quote}(observing that “the most cursory reading of Caremark demonstrates that Allen viewed oversight liability as a species of the duty of care” and citing specific language from Caremark); Bainbridge, supra note 6, at 975 (“The fiduciary duty at issue in the original Caremark opinion demonstrably was the duty of care”); 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”); Clark W. Furlow, Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware, 2009 UTAH L. REV. 1061, 1074 (2009) (stating that Caremark connected oversight to the duty of care); Claire A. Hill & Brett McDonnell, Stone v. Ritter and the Expanding Duty of Loyalty, 76 FORDHAM L. REV. 1769 (2007) (calling Caremark a “paradigmatic duty of care case”); Hillary A. Sale, Delaware’s Good Faith, 89 CORNELL L. REV. 456, 467 (2004) ("Caremark generated considerable discussion as a duty of due care case"); see also In re Abbott Labs. Derivative S’holders Litig., 325 F.3d 795, 805 (7th Cir. 2003) (describing Caremark as a duty of care case); McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001) (same). But see Strine et al., supra note 12, at 687 ("As a textual matter, we of course must admit that Caremark never firmly places this new liability standard [for oversight] within the broader rubric of the traditional duty of loyalty. But that is the clear import of the decision when it is read in context, as it must be, with Chancellor Allen’s prior related jurisprudence.").
\end{quote}
oversight liability invoked the duty of loyalty. As he noted, “[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.”

Nevertheless, post Guttman, the Chancery Court was not quick to adopt this new characterization of oversight liability. In subsequent cases, the Chancery Court either did not decide from which duty oversight flows or continued to treat it as part of the duty of care. However, in 2006, the Delaware Supreme Court took up the issue in Stone v. Ritter. Stone involved a shareholder derivative suit alleging that directors of AmSouth Bancorporation failed to implement reasonable legal compliance controls. Its facts provided the Court with the opportunity to address finally a “classic Caremark claim.”

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47. Guttman, 823 A.2d at 506 n.34 (relying in part on Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del.1993)); see also In re Gaylord Container Corp. Sholders Litig., 753 A.2d 462, 475 n. 41 (Del. Ch. 2000) (explaining that Technicolor (also known as Cede II) equated good faith with loyalty). By treating the duty of good faith as a subset of the duty of loyalty, Vice Chancellor Strine effectively rejected the concept of the “triad” that Technicolor had created. See Technicolor, 634 A.2d at 361. Strine subsequently explained his views on the nature of good faith in more detail in a broad co-authored article. See Strine et al., supra note 12. Interestingly, in an earlier article that appeared before Guttman, Strine already noted Caremark’s emphasis on good faith, but acknowledged that the opinion “is most often cited to emphasize the duty of directors to exercise due care in monitoring the corporation’s compliance with legal standards.” Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUS. LAW. 1371, 1386 (2002) (emphasis supplied). Moreover, in that article, Strine still characterized good faith as a “state of mind,” but not a duty. Id. For a thorough discussion of the role of good faith in the fiduciary duty framework, see also Julian Velasco, How Many Fiduciary Duties Are There in Corporate Law?, 83 S. CAL. L. REV. 1231 (2010).

48. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 971 n.16 (Del. Ch. 2003) (“The ‘duty to monitor’ is not a separate fiduciary duty, but rather stems from the core fiduciary duties of care and loyalty. . . . I need not, nor do I, decide from which duty the ‘duty to monitor’ flows in order to reach my conclusion.”), aff’d, 845 A.2d 1040 (Del. 2004); Canadian Commercial Workers Indus. Pension v. Alden, 2006 WL 456786, at *6 (Del. Ch. Feb. 22, 2006) (“The duty of oversight implicates both the duty of care and the duty of loyalty.”).

49. In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 750, 756 n.463 (Del. Ch. 2005) (discussing Caremark claims in the context of the duty of care and characterizing Caremark as “an extension, or rather, an example of, severe violations of the fiduciary duty of care”), aff’d, 906 A.2d 27 (Del. 2006).

50. 911 A.2d 362 (Del. 2006).

51. Specifically, shareholders of AmSouth Bancorporation alleged that the directors had failed to implement controls that would have informed them of breaches of federal anti-money-laundering regulations that caused AmSouth and its wholly owned subsidiary to pay of $50 million in governmental fines and penalties. Stone, 911 A.2d at 364-66.

52. Id. at 364. Prior to 2006, the Delaware Supreme Court had already approvingly cited parts of Caremark. See In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 n.111 (Del.
The Court made three important findings in Stone. First, in a partial victory for Chancellor Allen, it held “that Caremark articulates the necessary conditions predicate for director oversight liability.”53 To recover successfully in an oversight case, the Court explained, a plaintiff must show that:

(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.54

However, Stone went further than just confirming Caremark. In reality, Stone adopted Guttman’s version of Caremark, including the former’s focus on the lack of good faith and conscious disregard of directorial duties as a requirement for oversight liability.55 In line with Guttman,56 the Court also took the position that the fiduciary duty violated by director oversight is not the duty of care, but rather the duty of loyalty:

[The Caremark standard for so-called “oversight” liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent Disney decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct

53. Stone, 911 A.2d at 370.
54. Id.
55. See Bainbridge, supra note 6, at 975.
56. Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003) (“Caremark articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty.”).
giving rise to a violation of the fiduciary duty of care (i.e., gross negligence).\textsuperscript{57}

In addition, Stone's treatment of oversight liability as being dependent upon a failure to act in good faith—and relating good faith to the duty of loyalty—had yet another important doctrinal consequence: it effectively ended the idea of a “triad” of fiduciary duties established by the Court in Technicolor.\textsuperscript{58} Contrary to what some academics had come to believe—and embrace—\textsuperscript{59} the Court explained that the requirement to act in good faith did not establish an independent fiduciary duty or basis for direct imposition of liability.\textsuperscript{60} Rather, the Court characterized the duty to act in good faith as a “subsidiary element” of the duty of loyalty.\textsuperscript{61} Subsuming oversight and other

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\item \textsuperscript{57} Stone, 911 A.2d at 369.
\item \textsuperscript{58} Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (announcing that directors owe a “triad[ ]” of fiduciary duties consisting of good faith, loyalty, and due care); see also Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) (both referring to the “triad”). In contrast to the Delaware Supreme Court, the Chancery Court had always been reluctant to accept the idea of three separate fiduciary duties and tended to describe good faith as an aspect of loyalty. See, e.g., Gutman, 823 A.2d at 506; Nagy v. Bistricer, 770 A.2d 43, 48-49 n.2 (Del. Ch. 2000). For a discussion of these opposing views and the concept of “good faith” prior to Stone, see Christopher M. Bruner, Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law, 41 Wake Forest L. Rev. 1131, 1151-1172 (2006).
\item \textsuperscript{59} These academics regarded an independent duty of good faith as a desirable tool to limit the impact of DGCL § 102(b)(7) and hold directors liable for egregious misconduct that did not fall under the ambit of classic loyalty cases. See, e.g., Melvin A. Eisenberg, The Duty of Good Faith in Corporate Law, 31 Del. J. Corp. L. 1, 6-11, 27-31 (2006) (arguing that a separate duty of good faith has long been embodied in corporate statutes and case law and emphasizing the gap-filling function of a separate duty of good faith); Sale, supra note 41, at 494 (advocating a separate duty of good faith to address “those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts”). Leo Strine and his co-authors have recently argued that advocates of an independent duty of good faith “in a less-than-overt way” advanced the argument that directors should be liable for acts of gross negligence. Strine et al., supra note 12, at 696. However, “Sune v. Ritter made plain that opponents of § 102(b)(7) provisions had to make their case in forums other than courts, by pushing boards to amend charters to repeal exculpatory provisions or pushing the Delaware General Assembly to repeal § 102(b)(7).” Id.
\item \textsuperscript{60} Stone, 911 A.2d at 370 (“Although good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.”).
\item \textsuperscript{61} Id. (quoting Gutman, 823 A.2d at 506 n.34). Prior to Stone, the Delaware Supreme Court had expressly left open the question whether the duty of good faith is a duty that, like the
failures to act in good faith under the duty of loyalty also meant that the court had to accept an exceptionally broad notion of the duty of loyalty. Thus, loyalty breaches are per Stone “not limited to cases involving a financial or other cognizable fiduciary conflict of interest.”

C. The Post-Stone Uncertainties

Prior to Stone, Delaware cases applying Caremark had set a high bar for plaintiffs to succeed with claims alleging improper oversight. Stone, however, created a new state of uncertainty as to the extent of the liability risks directors would face.

Under both Stone and Caremark, boards that did not exercise any oversight at all would incur liability in cases where such lack of oversight was the result of a conscious breach of their duties. In these instances, Stone

62. Stone, 911 A.2d at 370. Traditionally, loyalty claims were limited to cases involving financial conflicts and self-dealing. See, e.g., Eisenberg, supra note 59, at 5 (“The standard of conduct under the duty of loyalty essentially requires a manager to act fairly when he acts in his own pecuniary self-interest or in the pecuniary interest of an associate or a family member.”). The duty of loyalty is often traced back to Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939), even though the language in Guth already appears to allow for a more expansive definition of loyalty beyond cases of conflict and self-interest. See id. at 510 (referring, inter alia, to a duty “to refrain from doing anything that would work injury to the corporation” and stating that “[t]he occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated”). For a discussion of the new and expanded understanding of the duty of loyalty in Delaware law, see Andrew S. Gold, The New Concept of Loyalty in Corporate Law, 43. U.C. DAVIS L. REV. 457, 457 (2009).

63. See, e.g., Rattner v. Bidzos, 2003 WL 22284323, at *12–13 (Del. Ch. Sept. 30, 2003); Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 971–72 (Del. Ch. 2003); David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, at *5–6 (Del. Ch. Feb. 13, 2006); Canadian Commercial Workers Indus. Pension v. Alden, 2006 WL 456786, at *6–8 (Del. Ch. Feb. 22, 2006); but d. Saito v. McCall, 2004 WL 3029876, at *6 (Del. Ch. Dec. 20, 2004) (concluding that plaintiffs had “barely” stated a Caremark claim by pleading specific facts demonstrating that directors should have been aware of certain accounting risks), aff’d, 870 A.2d 1192 (Del. 2005); McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001) (plaintiffs alleged sufficient facts to allow inference that directors were in conscious breach of their duty to stop fraudulent practices of employees); In re Abbott Labs. Derivative S’holders Litig., 293 F.3d 378, 390 (7th Cir. 2002) (plaintiffs pleaded with particularity that obvious danger signs pointing to federal violations were ignored).

64. See supra text accompanying notes 34 and 54.
probably introduced a more favorable standard for directors than Caremark, since Stone requires a scienter element by directors that was often thought not to be required by Caremark.\textsuperscript{65} However, commentators identified a critical difference between Stone and Caremark in the area of discrete board decisions.\textsuperscript{66} Under Caremark, directors engaging in decisions relating to oversight—for example, pertaining to the design of a corporate compliance program, whether or not to adopt certain internal controls, or regarding the response to warning signs—could benefit from certain protections. These included the business judgment rule,\textsuperscript{67} exculpation provisions,\textsuperscript{68} and indemnification.\textsuperscript{69}

Conversely, Stone had the potential to undermine these protections and to curtail director discretion in many instances. For example, with Stone's characterization of oversight liability as necessarily involving bad faith and a breach of the duty of loyalty,\textsuperscript{70} it was unclear whether oversight-related board decisions, even if made on a fully informed basis, would be protected by the

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\item Some courts and academics read Caremark as to allow for liability for grossly negligent inaction without there being any conscious disregard of known duties. See supra note 34.
\item See Bainbridge et al., supra note 23, at 599–603.
\item See In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996); Bainbridge et al., supra note 23, 601-02.
\item See Arlen, supra note 24, 341 n.96. DGCL § 102(b)(7) permits a corporation to include in its certificate of incorporation:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.

\textsc{Del. Code Ann.}, tit. 8, § 102(b)(7). For insightful background discussion on § 102(b)(7), see Strine et al., supra note 12, at 659–63.
\item DGCL § 145(b) allows indemnification for expenses in derivative suits and suits brought by the corporation if the director acted in good faith. See \textsc{Del. Code Ann.}, tit. 8, § 145(b). Under § 145(c), the corporation must indemnify a director who "has been successful on the merits or otherwise," without regard to whether the director acted in good faith or not. See \textsc{Del. Code Ann.}, tit. 8, § 145(c); see also Waltuch v. Conticommodity Servs., 88 F.3d 87, 96 (2d Cir. 1996).
\item See Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006); supra Part II.B.
\end{enumerate}
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business judgment rule. In addition, the re-characterization of oversight duties from care to loyalty meant that exculpatory charter provisions would no longer protect directors from Caremark-style claims. Likewise, after Stone, only directors who have been “successful on the merits or otherwise” in oversight litigation against them could be indemnified. Moreover, concerns surfaced that D&O insurance might not cover a director if found liable under Stone, since certain policies exclude from their coverage instances of directors’ disloyal or bad faith conduct. Because of these uncertainties, the direction that the emergent duty of oversight would take after Stone was difficult to predict. To be sure, Stone made it clear that it would only impose liability upon a showing that directors knowingly violated their fiduciary obligations. It also put an end to speculations that a freestanding “duty of good faith” could be used to increase directors’ liability for oversight.

71. See Bainbridge et al., supra note 23, at 603 (citing the possibility that oversight related decisions will not be protected by the business judgment rule after Stone); but cf. EDWARD BRODSKY & M. PATRICIA ADAMS, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES, AND LIABILITIES § 2:17 (2008) (stating that a conscious decision by the directors not to adopt a policy program remains a business judgment entitled to the protection of the rule). This potential disparity between Caremark and Stone has also led to a policy-based critique of the latter. Because Stone requires a showing that the directors knew they were not discharging their fiduciary obligations, a passive board which never considered implementing an internal control system could escape liability, whereas a board that after a careful cost-benefit analysis knowingly decided against implementing such a system could be held liable. See Bainbridge et al., supra note 23, at 599-603.


73. DEL. CODE ANN., tit. 8, § 145(c). Being “successful” under DGCL § 145(c) includes situations where the corporation pays to settle a lawsuit against the defendant director and the director is dismissed from a case without having to contribute to the settlement. See Waltuch v. Conticommodity Servs., 88 F.3d 87, 96 (2d Cir. 1996). DGCL § 145(b) does not authorize indemnification of expenses incurred by an unsuccessful director who did not act in good faith. See DEL. CODE ANN., tit. 8, § 145(b).

74. See Mark R. High, Disney Directors Survive A Tack on Magic Kingdom, 15 BUS. L. TODAY 18, 21 (2006) (suggesting that bad faith acts and duty of loyalty breaches are not covered by traditional D&O insurance policies); but cf. Bernard Black et al., outside Director Liability, 58 STANFORD L. REV. 1055, 1086-87 (2006) (noting that two common exclusions from coverage found in D&O insurance policies, deliberate fraud and personal profit exclusions, are considerably narrower than the good faith limitation on indemnification and will not be triggered by a “conscious disregard for one’s responsibilities”).

75. Stone, 911 A.2d at 370.

76. See supra notes 58–61 and accompanying text.
Nevertheless, the possible erosion of director protections continued to raise concern. Consequently, commentators pointed to Stone’s potential to expand the scope of director liability,\(^77\) predicted that good faith cases would get greater scrutiny than care cases and create liability risks,\(^78\) and highlighted the non-observance of red flags as a significant new source of potential personal liability.\(^79\)

In fact, in the first post-\(\text{Stone}\) decision that involved Caremark duties, the court imposed—probably for the first time in Delaware—liability on directors for oversight failures.\(^80\) In ATR-Kim Eng Financial Corp. v. Araneta,\(^81\) the Delaware Court of Chancery held that the directors breached their duty of loyalty by failing to monitor the conduct of a fellow director and majority shareholder who looted the company.\(^82\) The case was somewhat unusual in that internal controls were neither in place nor ever considered. Moreover, the two directors admitted that they were uninformed about the company’s affairs and never questioned their fellow director’s actions.\(^83\) The court concluded from the two directors’ behavior, however, that they consciously abandoned their duties,\(^84\) even though it was also possible to infer that they subjectively believed that no action on their part was necessary.\(^85\)

Thus, Araneta suggested that post-\(\text{Stone}\) courts could be inclined to find a knowing breach of duty even in instances where there is no clear evidence as to the directors’ actual state of mind. Combined with the erosion of protections for directors’ oversight-related decisions and hindsight evaluation of alleged “red flags,” oversight liability was poised to turn into a very substantial concern for directors.

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\(^77\) See, e.g., Bainbridge et al., supra note 23, at 597.
\(^78\) Hill & McDonnell, supra note 41, at 1796.
\(^80\) See Pan, Duty to Monitor, supra note 4, at 735; Nees, supra note 4, at 216 n.65.
\(^81\) 2006 WL 3783520 (Del. Ch. Dec. 21, 2006), aff’d, 930 A.2d 928 (Del. 2007).
\(^82\) Id. at *1.
\(^83\) Id. at *20.
\(^84\) Id. at *21.
\(^85\) Id. at *20. The testimony included the following statement by a defendant director: “Why should I ask him [the majority shareholder/director] all these questions? He’s telling me they have already agreed… It’s not like I’m going to go out there and check on him, doesn’t make sense.” Id.
III. REAFFIRMING THE STRICT LIMITS ON OVERSIGHT LIABILITY

An early test of whether Stone would lead to an increase in liability arose in the wake of an options backdating controversy that had affected numerous companies. In Desimone v. Barrows, a shareholder brought a derivative action against directors and officers regarding the improper backdating of stock options. The plaintiff contended that the directors were not informed of their firm’s backdating activity and that their ignorance resulted from an abdication of the duty to monitor their company’s legal compliance.

Finding that there was insufficient evidence demonstrating the board’s knowledge of inadequate internal controls and that it “chose to do nothing about the control deficiencies that it knew existed,” the court struck down the plaintiff’s oversight claim. In addition, the court emphasized that Stone’s good faith analysis would not allow plaintiffs to circumvent a corporation’s exculpation provision. The court explained that “[b]y reinforcing that a scienter-based standard applies to claims in the delicate monitoring context, Stone ensured that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded.”

The court also touched upon the question of whether Stone increased directors’ liability exposure in making oversight-related decisions. In this respect, Vice Chancellor Strine opined that Stone did not undercut “the discretion given to corporations to address law compliance in a manner that takes into account the precise circumstances facing the corporation.” Rather, Strine explained that he read Stone “as reaffirming the protection

86. Options backdating refers to an illegal practice where a company issues stock options to an executive on a given date, but fraudulently asserts that the options were actually issued earlier, in order to inflate the stock options’ value. See Desimone v. Barrows, 924 A.2d 908, 918 (Del. Ch. 2007) (explaining options backdating and similar practices).
87. 924 A.2d 908 (Del. Ch. 2007).
88. Desimone, 924 A.2d at 939.
89. Id. at 940. The court also reiterated Caremark’s oft-cited statement that oversight liability “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” Id. at 939 (quoting In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996)). See also Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006); Guttmann v. Huang, 823 A.2d 492, 505 n.33 (Del. Ch. 2003) (both quoting Caremark for the same proposition).
90. Desimone, 924 A.2d at 935 (citations omitted). Additionally, see Guttmann, 823 A.2d at 506, where Vice Chancellor Strine had already noted that “[f]unctionally, Caremark also matches the liability landscape for most corporate directors, who are insulated from monetary damage awards by exculpatory charter provisions.”
91. Desimone, 924 A.2d at 936 n.95.
given by Caremark to directors who make good faith judgments about how their corporations should address law compliance. . . .”  

Following Desimone, a string of Delaware cases further confirmed that Stone would not increase risks for directors, and possibly even result in stricter limits on oversight liability. For example, the Delaware Chancery Court reaffirmed that a breach of oversight duties would only lie where directors “consciously and intentionally disregarded their responsibilities” and in the transactional context, “a very extreme set of facts” would be required to sustain a successful oversight claim. Moreover, in response to claims that a board knowingly ignored warning signs, courts have found that red flags are only “useful when they are either waved in one’s face or displayed so that they are visible to the careful observer.”  

Very recent cases have also highlighted Delaware’s robust commitment to maintaining strict limits on oversight liability. For example, in In re Citigroup Inc. Shareholder Derivative Litigation, plaintiffs accused directors of breaching their oversight duties by failing to oversee adequately Citigroup’s exposure to the subprime lending market. In “a bit of a twist on the traditional Caremark claim,” plaintiffs did not base their complaint on a failure to detect
employee misconduct or non-compliance with laws, but rather on the theory that the directors did not properly monitor business risks.\textsuperscript{99}

Chancellor Chandler was unclear as to whether the plaintiffs had correctly characterized their claims as relating to oversight.\textsuperscript{100} Instead—and perhaps too hastily—\textsuperscript{101} he recast the plaintiffs’ claims as the “making of business decisions that, in hindsight, turned out poorly for the Company” or duty of care claims.\textsuperscript{102} In the end, the court dismissed the oversight claims, relying not so much on Stone’s substantive loyalty-based standard,\textsuperscript{103} but rather by evaluating the formal aspects of the process employed by the board of directors in making its decisions.\textsuperscript{104} Curiously, this type of analysis is

\begin{itemize}
  \item[99.] Id.
  \item[100.] See id. at 128 n.65 (“That plaintiffs are unable to point to specific wrongdoing within the Company that caused Citigroup’s losses from exposure to the subprime mortgage market further supports my hypothesis that this case is not truly a Caremark case, but rather a straightforward claim of breach of the fiduciary duty of care.”). In this regard, it is useful to recall that Chancellor Allen had stated in Caremark that internal control systems needed to allow the board “to reach informed judgments concerning both the corporation’s compliance with law and its business performance,” In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (emphasis added), and suggested that a failure to oversee business risks could form the basis of a Caremark claim. For a complete analysis of the application of Caremark to risk management, see Bainbridge, supra note 6 (arguing that Caremark claims may properly be brought in connection with failures in corporate risk management, but that in respect to these cases the bar needs to be set particularly high); but cf. Paul E. McGreal, Corporate Compliance Survey, 65 BUS. LAW. 193, 210 (2009) (stating that Citigroup made it clear that Caremark duties apply only to oversight of legal risks, not to business risks); Pan, Critical Assessment, supra note 4, at 5, 19–25 (reading Citigroup to hold that boards cannot be held liable for a failure to monitor business risks and arguing that this aspect of the holding is misguided); Steven M. Davidoff, Big Win in Delaware for Corporate Boards, N.Y. TIMES DEALBOOK, February 26, 2009, available at http://dealbook.blogs.nytimes.com (“Caremark is now a principle confined to oversight of fraud and wrongdoing.”).
  \item[101.] Pan, Duty to Monitor, supra note 4, at 739 (“When a board fails to follow-up on a past decision and ignores developments that may reveal a corporate strategy to be flawed, the outcome should be considered the result of unconsidered inaction. That is why Citigroup should be a duty to monitor case.”).
  \item[102.] Citigroup, 964 A.2d at 124 (“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.”).
  \item[103.] See id. at 123.
  \item[104.] The court did not actually inquire into the substance of what the defendant directors had done or had failed to do in order to ensure adequate risk management and monitoring.
typical for cases that allege breaches of the duty of care, not the duty of loyalty.

In *Citigroup*, Chancellor Chandler also repeatedly invoked the business judgment rule and its underlying policy considerations, noting that Stone "does not eviscerate the core protections of the business judgment rule." In addition, the Chancellor noted the "similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7)." The court concluded:

The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a Caremark claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.

Instead, it focused on formal aspects, such as whether an audit committee existed that was charged with overseeing risk management and how often that committee met. See Bainbridge, supra note 6, at 986 (observing that the *Citigroup* court's demands were "strikingly modest" and that "[t]he court did not drill down into the details of what the audit committee actually did with respect to risk management").

105. See *Citigroup*, 964 A.2d at 124–31. In particular, the court remarked that "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." Id. at 126. See also In re Dow Chem. Co. Derivative Litig., 2010 WL 66769, at *10 n.58 (Del. Ch. Jan. 11, 2010) ("The primary claim in *Citigroup* was that the directors failed to recognize the coming subprime business risk. The Court examined this claim under the business judgment rule. . . . ").

106. *Citigroup*, 964 A.2d at 125.

107. Id. *Citigroup* had in fact adopted an exculpatory provision in its certificate of incorporation. Id. at 124.

108. Id. at 125. In contrast, in In re Countrywide Fin. Corp. Derivative Litig., 554 F.Supp.2d 1044 (C.D. Cal. 2008), a federal court sitting in California held that demand under Delaware law was excused for derivative claims based on the defendant directors' alleged failure to exercise oversight. The court found that shareholders sufficiently pled facts raising a strong inference of directors' scienter with respect to the mortgage company's loan origination practices and the duties of board committees to monitor high-level indicators of financial performance and credit risk. See id. at 1077. The court cited "the Board's failure to regulate practices at the very core of Countrywide's business model" and contrasted these strong allegations with cases that involved the issuance of backdated stock options or oversight over specific accounting practices, implying that these latter cases did not involve equally important aspects of a company's business. Id. at 1082 n.42. The claims in this case were subsequently dismissed after plaintiffs lost standing due to a merger between Countrywide and Bank of America.
Following the line of reasoning in Citigroup, Delaware once again reaffirmed its strict approach to oversight liability in In re Dow Chemical Co. Derivative Litigation. In Dow, the plaintiffs alleged that directors failed to detect and prevent bribery, insider trading, and other misconduct that allegedly took place inside their company. Yet, the court found that plaintiffs had failed to show the existence of any “red flags” that would have indicated misconduct, or that the board had utterly failed to supervise corporate insiders.

Conversely, in In re American International Group, Inc., the Delaware Chancery Court demonstrated the stringent requirements that an oversight claim must meet in order to be successful, despite denying the defendant directors’ motions to dismiss. AIG represented a rare occurrence in Delaware case law in which Vice Chancellor Strine declined to grant a motion to dismiss a claim alleging the breach of the duty of oversight. Strine found that the pleadings supported the assertion that some of the defendants, inside directors of AIG, effectively led a “criminal organization” and that the defendants were directly involved in many instances of the alleged wrongful conduct. Consequently, the court held that the plaintiffs had pleaded a claim that the defendants breached their duty of loyalty by being implicated in fraudulent schemes, and—almost as a byproduct of the directors’ own improper acts—recognized a loyalty claim against the defendants for consciously tolerating inadequate internal controls and failing to monitor their subordinates’ legal compliance.

Delaware courts have also restricted oversight claims by narrowing the good faith prong of the duty of loyalty, which after Stone gained great importance for oversight liability. In Lyondell Chemical Co. v. Ryan, the court held that directors lack the necessary good faith if they not only knowingly, but also “completely,” fail to undertake their responsibilities. Following this reasoning, the slightest effort to exercise oversight should satisfy a

110. Id. at *13.
111. 965 A.2d 763, 799 (Del. Ch. 2009).
112. In doing so, Strine noted that the complaint contained “well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG.” AIG, 965 A.2d at 776.
113. Id. at 799.
114. Id. at 777, 797-99.
115. Id. at 798–99.
director’s obligations in this regard since this would not constitute a complete failure of board action. As a result, oversight claims are now restricted to instances when directors knowingly and completely fail to take action.

Overall, Delaware has made clear that Stone did not change the judiciary’s commitment to maintaining strict limits on Caremark-style oversight liability. As it stands now, plaintiffs continue to face a high burden to state a claim for directorial liability for failure to monitor, with possibly an even higher burden should these claims relate to oversight over business risks. In particular, the lesson from Citigroup and AIG is that even outside a narrow transactional context, an extreme set of facts is necessary in order to state a credible oversight claim.

IV. LIMITING OVERSIGHT LIABILITY

Caremark has famously declared oversight to be “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” As the preceding Part demonstrates, Delaware courts have proved Caremark right. Most importantly, the Delaware Supreme Court has made it clear in Stone that directors will only be liable for oversight failures if they knew they were not discharging their fiduciary obligations. Short of requiring intent to inflict actual harm, one can hardly imagine a more demanding liability standard.

118. In AIG, it was arguably due to the specific allegations of direct wrongdoing and criminal conduct by the defendants that plaintiffs were able to proceed past the motion to dismiss stage. See Lisa L. Casey, Twenty-Eight Words: Enforcing Corporate Fiduciary Duties through Criminal Prosecution of Honest Services Fraud, 35 Del. J. Corp. L. 1, 29 (2010) (reading Citigroup and AIG to suggest that “[u]nless public company executives managed a firm engaged in pervasive wrongdoing, or they appear to have committed some grievously dishonest and disloyal act themselves, the defendant directors and officers will not be adjudicated liable for breaching their state law fiduciary duties”). In addition, note that the court in AIG analyzed the complaint under the plaintiff-friendly standard required by Court of Chancery Rule 12(b)(6), whereas Citigroup was decided under the more stringent particularized pleading standard of Rule 23.1. See In re Citigroup Inc. S’holder Deriv. Litig., 964 A.2d 106, 130 n.75 (Del. Ch. 2009); see generally Edward P. Welch, Andrew J. Turezyn & Robert S. Saunders, Folk on the Delaware General Corporation Law 2009: Fundamentals § 327.4.2.2 (2009) (discussing the different pleading burdens under the two Rules).
Critics have expressed their discontent with what in their opinion has become an insufficient hands-off approach to directors’ liability. For example, one commentator has stated that freeing directors from liability for inattention that does not rise to the level of bad faith is preposterous, while another observer regards Stone’s oversight liability standard as directly linked to board ignorance and excessive corporate risk-taking.

In view of these criticisms, the question arises as to why Delaware has chosen to impose such strict limits on oversight liability. Accordingly, this Part will explore and evaluate the reasons behind Delaware’s decision to provide directors with strong protections from liability in the oversight context.

A. First Principles: Directors’ Liability and Its Limits

1. Shareholder Litigation and Accountability

Shareholder fiduciary duty litigation is commonly thought to serve two main goals, ex post compensation and, above all, ex ante deterrence. While in principle these goals are beneficial to shareholders, they must—as the discussion in this Part will show—necessarily be curbed in order to avoid negative effects on shareholders’ as well as directors’ wealth. For this reason, corporate law contains strict limits on directors’ personal liability. Indeed,

121. See supra notes 1, 10–11 and accompanying text.
122. Elizabeth A. Nowicki, A Director’s Good Faith, 55 BUFF. L. REV. 457, 532 (2007). Professor Nowicki contends that directors should also be liable for “lack of good faith,” i.e. behavior that does not rise to the level of “bad faith.” Especially in inattention-based fiduciary duty cases, Nowicki argues, shareholders should be allowed to point to the absence of affirmative good faith (as opposed to the existence of affirmative bad faith) to substantiate their claim. Id. at 528–33. The Delaware Supreme Court has held that in some contexts, there arguably may be a difference between “bad faith” and “failure to act in good faith.” Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 240 n.8 (Del. 2009). For the purposes of its Stone decision, however, the court did not draw a distinction between “good faith” and “bad faith.”
these limits have become so pronounced that the prospect of a lawsuit for fiduciary breaches, at least in Delaware courts, has arguably lost most of its deterrent effect and compensation has become unlikely.125

What justifies this status of directors’ low accountability to shareholders? In terms of liability for business decisions, a lower standard of director accountability flows from the justifications of the business judgment rule. The business judgment rule is “the first protection against a threat of sub-optimal risk acceptance”;126 that is, it mitigates the problem that the prospect of personal liability can cause directors, in authorizing corporate investments, to be more risk-averse than the interest of diversified shareholders would dictate.127 Stated more broadly, the business judgment rule serves to protect boards and their decisions from judicial second-guessing.128 In the corporate context, judges abstain from substituting their own business judgment over that of the directors whose decisions shareholders have challenged, thereby fostering risk-taking and preserving a board’s ability to engage in efficient decision-making.

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125. See, e.g., Casey, supra note 118, at 17 (“In practice, however, directors and officers seldom face civil liability for breaching their fiduciary duties, regardless of the forum in which shareholders bring suit and despite corporate law rhetoric emphasizing the importance of executives’ fiduciary responsibilities.”); James D. Cox, The Social Meaning of Shareholder Suits, 65 Brook. L. Rev. 3, 13–14 (1999) (discussing two studies that each conclude that the wealth effect of derivative suits is negligible); Ibrahim, supra note 124, at 954 (“[T]he conventional wisdom that holding directors to account provides minimal economic benefits to shareholders, with plaintiffs’ attorneys being the primary economic beneficiaries.”); Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1012 (1997) (noting that the assumption of direct deterrence in the corporate context is implausible). But see infra Part IV.B.3 (discussing deterrent effects of extra-legal mechanisms and behavioral theories).
127. Id. at 1052 (“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. But directors will tend to deviate from this rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss.”); see also Joy v. North, 692 F.2d 880, 885–86 (2d Cir. 1982).
128. See Joy, 692 F.2d at 886 (“[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later . . . since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.”).
decision-making. In a somewhat ironic and roundabout way, therefore, the 
business judgment rule protects shareholders from themselves, in that it 
allows boards to take risks that will ultimately benefit shareholders as a class. 
Similarly, DGCL Section 102(b)(7)—arguably the Delaware General 
Assembly’s most important contribution to the corporate liability 
framework—is also related to risk-taking and board authority. The 
Delaware Supreme Court’s decision in Smith v. Van Gorkom and the ensuing 
directors’ and officers’ insurance liability crisis triggered the need for 
exculpatory provisions and concerns for directors’ liability exposure and the 
shortage of qualified board candidates confirmed their necessity.

However, after the adoption of Section 102(b)(7), “stockholders usually 
approved charter amendments containing these [exculpatory] provisions 
because it freed up directors to take business risks without worrying about 
negligence lawsuits.”

Overall, the need to encourage risk-taking, protection from judicial 
second-guessing, and general concerns regarding directors’ liability exposure 
and their willingness to serve on boards are the main drivers behind 
limitations on directors’ personal liability for decisions and actions they take 
in their official capacities. In this respect, the business judgment rule and 
exculpatory charter provisions serve as important tools in the quest to 
establish a balance between board authority and accountability.

129. See, e.g., William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Realigning the Standard of 
Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny 
substantive policies justifying Delaware’s gross negligence standard for care breaches and 
the business judgment rule); see generally Stephen M. Bainbridge, The Business Judgment Rule 
judgment rule as abstention doctrine, as opposed to a standard of liability, and discussing 
director risk-taking, lack of judicial expertise, and the impact on boards’ internal dynamics 
as underlying rationales for the rule).

130. The statute permits shareholders to adopt a provision in the certificate of incorporation to 
limit or eliminate directors’ personal liability for monetary damages for due care 

131. 488 A.2d 858 (Del. 1985).


133. See E. Norman Veasey, Economic Rationale for Judicial Decisionmaking in Corporate Law, 53 

134. Malpiede, 780 A.2d at 1095; see also Veasey, supra note 133, at 693 (noting that institutional 
investors generally have supported these provisions).

135. Striking the balance between a board’s authority and its accountability is a central aspect 
of modern corporate law and lies at the heart of the director primacy theory advanced by 
Professor Bainbridge. See Stephen M. Bainbridge, The New Corporate
2. The Unique Nature of Oversight Liability

As we will see in the following subsections, the policy reasons for limiting directors’ liability for oversight are in large part analogous to those that justify restrictions in case of discrete business decisions. Naturally, this insight has not been lost on various observers. Prominent corporate lawyer Bayless Manning, for example, posited that, contrary to traditional formulations, “the principle of the business judgment rule must have equal application to things not done by the board as well as to things done by the board.” 136 More generally, another commentator opined that “the standard for wrongfulness for omissions should be the same as the standard of wrongfulness for deliberate decisions.” 137

However, limits on oversight liability should be even more justifiable than they are in the case of positive acts. This is because there are additional factors that courts have to take into account when called upon to adjudicate failures in what one court has called “the delicate monitoring context.” 138

For instance, oversight is unique in nature, in that there is no specific transaction—such as a merger or approval of a major commercial contract—which delineates the decision-making process and narrows the potential amount of information the board needs to consider. Therefore, the exercise of fiduciary duty of oversight is more challenging, open-ended, and difficult to grasp. Similarly, potential damages resulting from improper oversight are ex ante hard to predict and directors are likely in a weaker position to avoid (and insure against) oversight based claims than they are in a position to steer clear of lawsuits based on decisions involving specific business transactions.

In addition, the causal links between inadequate oversight and any losses allegedly incurred as a result thereof can be weak. For example, it will likely not be clear whether and to what extent stricter oversight by a board would have prevented or limited misconduct or non-compliance that occurred

Governess in Theory and Practice 11 (2008); Stephen M. Bainbridge, Director Primacy, The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547, 551, 573 (2003); see also E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, 403 (1997) (“The defining tension in corporate governance today is the tension between deference to directors’ decisions and the scope of judicial review.”).

136. Manning, supra note 31, at 1486.
within their firm. In retrospect, plaintiffs can construe almost every instance where a company has suffered losses to involve some sort of monitoring mistake or lack of attention. Indeed, one is reminded of Manning’s observation that “[f]rom among an infinite number of useful things that a board of directors might reasonably have done ..., the number that will not have been done by the most qualified, best-run, and most diligent board in the world will always be far greater than the number that were done.”

Finally, oversight cases differ from other scenarios of alleged fiduciary breaches in that there is less likelihood of the interests of directors and shareholders diverging. Unless a lack of oversight is part of a scheme to cover up improper activities that involve the directors themselves, as the plaintiffs allege in AIG, directors have no per se interest in “bad” oversight. Aside from perhaps saving the necessary time and effort to exercise proper oversight, directors do not personally benefit from neglecting their monitoring duties. Therefore, it makes sense for courts to be especially skeptical in assessing claims that allege directors’ conscious wrongdoing in oversight cases.

B. Deterrence, Risk-Taking, and Judicial Second-Guessing

1. Application to Oversight

Deterrence is traditionally one of the principal reasons for allowing shareholders to sue directors for fiduciary breaches. Yet, as we have already seen, overdeterrence is counterproductive, and courts are taking great pains to avoid it.

First, if exposed to excessively strict liability, directors may be less inclined to take on potentially lucrative but risky business opportunities. While this concern typically arises in connection with discrete board decisions, it extends with equal force to oversight liability. The paradigmatic case is Citigroup, where plaintiffs claimed failures in monitoring business risks. While these claims came in the form of Caremark claims, alleging omissions by the board, the court instead approached the allegations by treating them as an

139. Manning, supra note 31, at 1485.
140. See Hill & McDonnell, supra note 40, at 861 (noting that inattention cases tend to invoke issues of care rather than self-interest or conscious breaches of loyalty).
141. See supra note 124 and accompanying text.
142. See supra notes 126–127 and accompanying text.
attempt "to hold the director defendants personally liable for making (or allowing to be made) business decisions."143 By framing the issue as one that relates to (albeit unspecified) decisions—as opposed to failures to monitor the consequences of these decisions—the court was able to engage the traditional business judgment rule and its risk-taking rationale:

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, 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.144

Yet, the court could have also expressly extended the business judgment rule or its risk-taking rationale to apply to oversight, or, more broadly, omissions by the board.145 To be sure, taking a decision and monitoring its results are two different things. Still, in general, it does not make sense to insulate the decision itself from judicial review by applying the business judgment rule, but subsequently take away these protections when evaluating the consequences of the decision.

Granted, the notion of protecting risk-taking and preventing judicial second-guessing fits most easily when applied to scenarios such as the one in Citigroup, where the monitoring of business risks is at issue, but these policies also play a role in explaining the limits on liability in the context of traditional Caremark claims, which involve failures to detect illegal conduct by officers and other employees.

For example, assume that a board decides that adopting a compliance program designed to prevent certain illegal acts is not justifiable from a cost-

144. Id. at 126.
145. See supra notes 136–37 and accompanying text (citing, among others, Bayless Manning for the proposition that the business judgment rule should apply to "things not done" by boards).
benefit perspective, or that only a compliance program that is limited in scope is desirable. In a broader sense, such decisions constitute a form of risk-taking and are part of a company's (operational) risk management. If directors face overly strict liability, they could shy away from cost-benefit driven “risky” oversight decisions and overinvest in reporting and monitoring systems. From the perspective of diversified shareholders, this outcome is obviously undesirable.

Increased investments in internal control systems, driven by risk-averse boards, also translate into higher corporate expenditures—a concern that Chancellor Allen had in mind when he issued his opinion in Caremark. Of course, increased expenditures, as a consequence of the duty to exercise proactive oversight, are not by themselves a negative factor, as long as the investments in internal controls result in benefits that exceed their costs.

In many cases, it will not be efficient to try to fully eliminate all risks that are targeted by internal controls. Instead, a cost-efficient internal control system will allow for an “optimal level” of materialized risks, including illegal conduct by employees. Consequently, an efficient system of oversight liability should allow directors, when they believe it to be economically

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146. For example, a corporation can only target a limited number of laws with its compliance programs, and it would not be good policy to extend compliance efforts to laws that the corporation ex ante cannot reasonably expect to violate in view of its specific activities.

147. A firm’s operational risks include matters such legal compliance, accounting irregularities, etc. See Bainbridge, supra note 6, at 969. Typically, the board of directors will be responsible for assessing whether the company has established and implemented programs designed to address risk and compliance issues. In addition, it will oversee management’s efforts in the implementation of such programs. See American Bar Ass’n, Corporate Director’s Guidebook 27-28 (5th ed. 2007); Bainbridge, supra note 6, at 967-68.


149. See, e.g., Henry N. Butler & Larry E. Ribstein, The Sarbanes-Oxley Debacles: What We’ve Learned; How to Fix It 92 (2006) (explaining that monitoring measures are only cost-efficient up to the point that additional expenditures spent on monitoring avert greater losses in the future).

justified, to eliminate, limit or not adopt certain internal controls.\footnote{151} Delaware’s oversight jurisprudence implicitly acknowledges these considerations in recognizing that even rationally designed internal controls cannot guarantee absolute legal compliance.\footnote{152}

An additional effect of overdeterrence is that directors may be less willing to serve on boards.\footnote{153} Moreover, directors may ask for higher compensation in exchange for taking on added litigation exposure. An empirical study has found that an increase in litigation risks results in directors taking on fewer board appointments or exiting the directors’ labor market and that the replacements—even though in ready supply—require additional compensation.\footnote{154}

\footnote{151}{See Bainbridge et al., supra note 23, at 578. To be sure, opting-out of internal controls will usually not make sense in the important area of accounting. Maintaining precautions in that particular area is often relatively cost-efficient and not having such controls could hardly be justified, see id. at n.112, and could possibly be illegal. For example, federal laws such as the Foreign Corrupt Practices Act and the Sarbanes-Oxley Act mandate certain internal controls related to accounting and financial performance. Of course, boards will also need to take into account that the Federal Sentencing Guidelines, which allow a corporation to mitigate a potential fine if it can demonstrate that it had an effective ethics and compliance program in place prior to the crime. See United States Sentencing Commission, Guidelines Manual 517-18 (2009); see also Paula Desio, United States Sentencing Commission, An Overview of the Organizational Guidelines, available at http://www.ussc.gov/corp/ORGOVERVIEW.pdf. Note that the incentives provided by Federal Sentencing Guidelines also mean that internal controls to prevent criminal conduct may benefit the company even in case these controls fail. Conversely, as Professor Bainbridge points out, this is not the case for controls that monitor business risks. When risk management programs fail to detect and prevent risks, the fact that they were in place does by itself not offer any benefits. See Bainbridge, supra note 6, at 982.}

\footnote{152}{See Stone v. Ritter, 911 A.2d 362, 373 (Del. 2006) (noting that directors’ good faith exercise of oversight may not invariably prevent criminal acts by employees, or from causing the corporation to incur financial liability); In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (“[N]o rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations.”).}

\footnote{153}{Black et al., supra note 74, at 1140 (noting in the context of board service by outside directors that higher levels of liability risks could deter good candidates). But cf. Pan, Critical Assessment, supra note 4, at 36 (suggesting that directors that are driven away from board service in the face of a more stringent duty of oversight may be “those who either lack the qualifications to carry out the necessary monitoring responsibilities or who cannot devote the additional time and other resources demanded by a stronger duty to monitor”).}

\footnote{154}{See Eric Helland, The Impact of the Securities Litigation on the Directors’ Labor Market, draft working paper for UCLA workshop of October 3, 2008 (on file with author).}
Delaware courts, however, are well aware of these dangers. As Chancellor Allen already posited in Caremark:

[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.\textsuperscript{155}

Finally, for the same reasons that courts abstain from reviewing any other board decision—say, an investment in the development of a new product line—they should not review directors' decisions that relate to oversight. After all, oversight involves the design and implementation of internal controls and monitoring efforts, which are matters that affect the organizational and operational aspects of a corporation.\textsuperscript{156} Courts are not equipped to review and challenge these kinds of decisions as they not only require general business expertise, but also an intimate knowledge of a firm’s specific business drivers and its corporate culture.\textsuperscript{157} As a result, courts should leave these decisions to the board.\textsuperscript{158}

2. The Deterrent Effect of Legal Sanctions

Today, procedural and substantive obstacles for plaintiffs insulate directors to a large degree from personal liability.\textsuperscript{159} Absent conflicts of

\begin{flushleft}{155. Caremark, 698 A.2d at 971 (emphasis in original); see also Stone, 911 A.2d at 372; Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003) (both citing Caremark for the same proposition).}\\{156. See Arlen, supra note 24, at 340 n.93.}\\{157. See e.g., Bainbridge, supra note 129, at 119–21; but d. Geoffrey P. Miller, 2010 COLUM. BUS. L. REV. 319, 329–30 (2010) (challenging the view that judges lack the expertise to review managerial business decisions).}\\{158. See Arlen, supra note 24, 340 n.93 (noting that “[r]easonableness review of directors’ compliance decisions would be particularly troublesome because judges could not avoid making substantive business judgments since compliance program design and oversight involves trade-offs between centralized oversight and decentralized action affecting the fundamental structure and operation of the firm”).}\\{159. See, e.g., Casey, supra note 118, at 17–25 (discussing requirements for standing, pleading demand futility and non-exculpated claims, the business judgment rule, and exculpatory charter provisions).}\
\end{flushleft}
interest, fiduciary liability is rare and mostly confined to situations where directors act with "suspect" motives."\(^\text{160}\)

However, even if plaintiffs surmount the procedural and substantive hurdles to holding a director liable, the combined effects of indemnification, D&O insurance, and settlement incentives work in tandem to reduce the risk that directors will have to make out-of-pocket payments.\(^\text{161}\) Thus, in most cases, it is the corporation, not the directors, that ultimately bears the costs incurred in connection with an oversight lawsuit, either by settling the case on the directors’ behalf, by indemnifying the directors,\(^\text{162}\) and/or by having paid for the insurance premiums (and pay for future premiums) that cover directors in case of losses that were not indemnified.\(^\text{163}\)

In view of these realities, the threat of liability arising from litigation and legal sanctions could fail to have a sufficiently strong deterrent effect on directors. Consequently, we may need to question whether deterrence-based arguments in support of limiting directors’ oversight liability, as discussed in the preceding subsection,\(^\text{164}\) remain valid. The question thus becomes

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\(^{161}\) See Black et al., supra note 74, at 1139 (summarizing the results of their in-depth empirical study on outside directors’ liability risks). In a related paper, Professor Black and his co-authors condense their findings to state that the principal areas of out-of-pocket liability exposure for outside directors of U.S. public companies are (1) conduct that is not insurable and not indemnifiable, (2) conduct that is insurable but not indemnifiable, and (3) cases where the company is insolvent and insurance is inadequate. Bernard Black et al., Outside Director Liability: A Policy Analysis, 162 J. Inst’l & Theoretical Econ. 5, 12 (2006). See also John Armour et al., Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US, 6 J. Empirical Legal Stud. 687 (2009) (finding that, based on decisions in the United States between 2000–2007, only a small percentage of public companies faced lawsuits against directors alleging fiduciary duty breaches that were sufficiently contentious to result in a reported court opinion, and that a substantial fraction of these cases were dismissed).

\(^{162}\) In addition to indemnification pursuant to corporate law statutes, a director or officer may have additional indemnification rights under the corporation’s charter or bylaws, or under a contractual agreement with the corporation. See James A. Fanto, Directors’ and Officers’ Liability § 8:3.2 (2d ed., Release No. 2, Oct. 2007). Note, however, that “unsuccessful” directors can per Stone no longer be indemnified for expenses incurred in connection with oversight cases. See supra notes 69 and 73 and accompanying text.


\(^{164}\) Part IV.B.1.
whether it is still justified to defend protective devices for directors based on the need to encourage risk-taking.

As this Article argues, the need to avoid overdeterrence is still an integral element of oversight liability. This is true for at least four reasons. First, where a plaintiff demonstrates a director's conscious breach of duty, the director can face non-indemnifiable legal expenses. Second, where a plaintiff's lawsuit raises questions of bad faith or "fraudulent misconduct," liability insurance may not cover any damages for which the director is held liable. Third, as long as nominal liability rules continue to stipulate the prospect of personal liability, directors will be likely to have the impression that their personal assets are more exposed than they really are in terms of statistical probability. Finally, even if directors are typically not forced to make out-of-pocket payments after a court concludes that they were in breach of their fiduciary duties, such a verdict may result in substantial reputational costs. As a result, despite the low risks of out-of-pocket payments by directors, deterrence-based justifications for limiting directors' personal liability remain valid and the need to avoid overdeterrence remains.

3. The Role of Extra-Legal Mechanisms

A further concern related to deterrence lies on the other side of the spectrum. Here, not overdeterrence, but rather underdeterrence and the possible rise of "moral hazard" type problems is at issue. That is, if the threat of legal sanctions is too low, directors may act in a careless manner and

165. See supra notes 69–73 and accompanying text.
166. See supra note 74 and accompanying text.
167. In addition, the recent financial crisis has served as a reminder that "perfect storms," where outside directors will be forced to make out-of-pocket payments, are not as unlikely as it may seem, although these scenarios have been likened to "[d]eterrence by occasional lightning strike." Black et al., supra note 74, at 1140. Today, one could certainly imagine cases where D&O insurance is inadequate to cover losses incurred by oversight failures, or where the D&O insurer and/or the corporation that could provide indemnification payments become insolvent.
168. See Pan, Critical Assessment, supra note 4, at 40–41.
169. The problem has often been discussed in the context of insurance, which can create "moral hazard" by reducing an insured party's incentives to avoid risks which are covered by its insurance. See, e.g., KENNETH J. ARROW, ESSAYS IN THE THEORY OF RISK-BEARING 142 (1971); George L. Priest, The Current Insurance Crisis and Modern Tort Law, 96 YALE L.J. 1521, 1547 (1987).
fail to exercise meaningful oversight. Today, however, it is widely recognized that director behavior is not exclusively a function of the potential legal sanctions with which they are threatened. Instead, market pressures and other non-legal consequences—such as loss of employment, restrictions on future employment, and reputational risks—may serve as alternative monitoring devices and deter directors from engaging in improper acts.

Interestingly, one scholar has observed that Delaware fiduciary duty law itself relies, in large part, on the non-legal measures of public shaming or praise to constrain corporate managers. In the same vein, another

170. See, e.g., Black et al., supra note 161, at 6 (citing concerns that “if the prospect of liability is highly remote, outside directors could too readily slack off and fail to monitor management in a meaningful way”); Lisa M. Fairfax, Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability, 42 Hous. L. Rev. 393, 438–49 (2005) (suggesting that weak legal sanctions contribute to director misconduct); Nowicki, supra note 1, passim (proposing to introduce fiduciary liability across all classes of violations with a cap on the amount of damages a director can be held accountable for); Celia R. Taylor, The Inadequacy of Fiduciary Duty Why Corporate Managers Have Little to Fear and What Might Be Done About It, 85 Ohio L. Rev. 993, 994–95 (2006) (noting that current law allows corporate managers to “flaunt the notion of fiduciary duty” with very little risk of liability and tying this to “misdeeds of corporate managers such as Kenneth Lay, Bernie Ebbers, and Dennis Kozlowski”).

171. See, e.g., Bainbridge, supra note 135, at 171–73 (discussing directors’ reputational concerns); Black et al., supra note 74, at 1140 (noting that the limited deterrence provided by out-of-pocket liability is supplemented by market incentives, reputation, and other soft incentives, including the substantial nuisance of being sued); Black et al., supra note 161, at 16–19, (discussing incentives based on share ownership, reputation and future employment opportunities, and hassle associated with litigation, concluding that the low-risk status quo is warranted from a policy perspective where extra-legal mechanisms provide outside directors with incentives to be vigilant monitors); Rock, supra note 125, at 1011 (citing various market pressures as a potential source of deterrence); Bainbridge, supra note 135, at 567 (same). Conversely, commentators that advocate stricter legal sanctions for directors’ fiduciary breaches liability also question the efficacy of non-legal rules. See, e.g., Nees, supra note 4, at 236 (pointing to the recent financial crisis and finding that market-based incentives to act in accordance with oversight duties are, by themselves, inadequate to protect shareholder interests); Fairfax, supra note 170, at 456 (arguing that “extra-legal sanctions cannot be effective without the support of legal penalties” in preventing director misbehavior); Renee M. Jones, Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance, 92 Iowa L. Rev. 105 (2006) (observing that social norms cannot adequately constrain managerial conduct and calling for stricter accountability mechanisms); see also Arlen, supra note 24, at 326–27 (noting that Caremark and its commitment to abstain from regulating internal business judgments did not succeed in inducing directors to exercise the level of active oversight that federal authorities want).

commentator has suggested that shareholders suits not only deter through the
threat of legal sanctions, but also through social and reputational effects on
defendants. 173 In addition to these deterrent devices, pecuniary incentives
such as equity ownership may further stimulate directors and lead, inter alia,
to better oversight. 174

Some commentators also suggest that conduct by agents can be, to some
extent, self-controlled. Under these behavioral theories, a director obeys his
duties and acts in the best interest of shareholders because he wants to, not in
response to a perceived threat of legal liability. 175 For example, the reasoning
in Caremark reflects Chancellor Allen’s view that despite the employment of a
narrow “bad faith” standard of review in the case, imposing a duty to monitor
legal compliance would alter directors’ behavior through moral suasion and
impact on directors’ norms rather than by way of threat of legal sanctions. 176

Ideally, legal and non-legal rules should work in tandem. While liability
rules should, at the very least, deter intentional misconduct, alternative or
extra-legal monitoring devices should also dissuade improper behavior below
that level. Still, while legal and non-legal mechanisms can and do deter, they
will never— and should not be expected to— completely suppress corporate

173. Cox, supra note 125.
174. See Charles M. Elson & Christopher J. Gyves, In Re Caremark: Good Intentions, Unintended
175. See, e.g., Melvin A. Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. 1253
(1999) (examining the interrelation of social norms and corporate law, finding that
directors and other corporate actors are in significant part not motivated by the desire
to avoid liability, but by the prospect of financial gain and by social norms); Lynn A. Stout,
On the Proper Motives of Corporate Directors (Or, Why You Don’t Want to Invite Homo Economicus
to Join Your Board), 28 DEL. J. CORP. L. 1 (2003) (discussing altruistic theory in the context
of directors’ behavior); Michael B. Dorff, Softening Pharaoh’s Heart: Harnessing A altruistic
Theory and Behavioral Law and Economics to Rein in Executive Salaries, 51 BUFF. L. REV. 811,
857-77 (2003) (exploiting altruistic theory with a view to applying it to help resolve general
corporate governance problems).
176. See Arlen, supra note 24, at 342; see also Guttman v. Huang, 823 A.2d 492, 507 n.39 (Del.
Ch. 2003) (“Buried in this footnote is an alternative legal policy issue, which is whether
the Caremark loyalty-based standard provides the only basis of liability for a lack of
oversight claim, reducing a failure of care to a violation of expected director conduct
subjecting the directors to social shame and potential unseating at the polls, but not to
legal liability, irrespective of the existence of an exculpatory charter provision. That may
be a debatable proposition, but, as I understand it, the well-thought out Caremark decision
accurately reflects our law, strikes a sensible policy balance in this difficult area, and I
adhere to it.”).
misconduct.\textsuperscript{177} With these limitations in mind, it also becomes clear that we need to be careful before rushing to declare failures of corporate governance, be it the in face of corporate scandals or the recent financial crisis.\textsuperscript{178}

C. Risk-Shifting

In addition to deterrence and related considerations, a strong argument in favor of maintaining strict limits on directors’ oversight liability is a more fundamental one; to wit, the notion that risks arising out of a corporation’s ongoing business operations should be borne by the corporation and not be shifted to directors.

Oversight liability, like fiduciary liability in general, is intended, in part, to help shareholders and the corporation be compensated for losses in firm value caused by fiduciary breaches.\textsuperscript{179} This policy goal demands that tools are available that ensure that directors can be held liable. From the shareholders’ perspective, adding potentially wealthy directors’ assets to the pool available to them to recover from is particularly attractive. However, from the directors’ point of view, the potential for shareholder lawsuits poses a dangerous threat. In short, personal liability for directors arising from alleged oversight failures has the potential to shift the risk of legal non-compliance and—“under some set of facts”\textsuperscript{180}—general business risks from the corporation to the directors.

Since boards take, manage, and avoid business risks on behalf and for the benefit of the corporation and the shareholders, adverse outcomes should not lead to personal liability. As one court has noted, directors “are not insurers of corporate activities.”\textsuperscript{181} Liability rules should, therefore, severely restrict

\textsuperscript{177}See Strine, supra note 47, at 1402 (stressing investors’ responsibility to be attentive and noting that “the after-the-fact threat of federal and state law liability can never be an efficient or adequate method by which to ensure corporate integrity”); see also LUCIAN ARYE BECHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 53–58 (2004) (discussing the limits of market forces in correcting agency problems with regards to executive compensation).

\textsuperscript{178}See infra text accompanying note 216 (citing from a study that concludes that corporate governance did not fail during the financial crisis).

\textsuperscript{179}See supra note 124 and accompanying text.

\textsuperscript{180}In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009).

directors’ personal liability, given that a judgment against them or a settlement with an out-of-pocket payment component could easily prove to be ruinous and incommensurate with board fees.\textsuperscript{182} Put differently, the corporation’s asset partitioning function\textsuperscript{183} should be understood to protect directors’ personal assets from the reach of shareholders in most cases.\textsuperscript{184}

Furthermore, in Caremark, Chancellor Allen noted that if “shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors.”\textsuperscript{185} In other words,

\begin{itemize}
  \item[182.] Some advocates of increased director liability suggest that directors should face stricter liability, but that the amount they can be held liable for should be capped. See, e.g., Nowicki, supra note 1, at 712-18; Fairfax, supra note 170, at 454. However, besides practical problems (namely, how should the appropriate amount be determined in order for it (1) not be excessive, but (2) still incentivize plaintiffs to bring claims?), this Article argues that there should be no liability for oversight failures, even if capped, absent at least a conscious breach of fiduciary duty. Conversely, in cases of conscious breaches, there should be no cap on the amount of damages.
  \item[183.] Professors Hansmann and Kraakman have shown that the essential role of a legal entity is to provide for asset partitioning. Under their theory, organizational law serves to limit the extent to which creditors of an entity can have recourse against the personal assets of the owners or other beneficiaries of the entity, which includes the limited liability feature of most corporate entities. In addition, and more importantly, organizational law helps to shield the entity’s assets from claims of the creditors of the entity’s owners or managers. See Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale L.J. 387 (2000); see also Henry Hansman et. al, Law and the Rise of the Firm, 119 Harv. L. Rev. 1333 (2006).
  \item[184.] Conversely, in their model, Hansmann and Kraakman discuss asset partitioning with respect to directors only in view of claims by third party creditors, not shareholders. See Hansmann & Kraakman, supra note 183, at 398 (“The firm’s assets are not available to satisfy the manager’s personal obligations, and the manager’s personal assets are not available to satisfy the firm’s obligations.”).
  \item[185.] In re Caremark Int’l Inc. Derivative Litig, 698 A.2d 959, 968 (Del. Ch. 1996). The principle that shareholders to a certain degree voluntarily undertake the risk of bad business decisions by sub-par management is also one of the rationales that form the basis of the business judgment rule. See Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (“Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.”).
\end{itemize}
shareholders should lie in the beds they make for themselves. Judge Posner made a similar point in a case that dealt with a corporation’s charges against its auditors for failing to discover fraud by the corporation’s managers. Posner, like Allen, emphasized that shareholders share some of the responsibility in monitoring their corporation, be it directly or through the delegation of this task to the board of directors that they elect. However, Posner also introduced a distinction between management’s fraud “on behalf” of a corporation, such as breach of antitrust regulations or other conduct that (initially) benefits the firm, and fraud against it, such as diversion of funds from the corporation. In cases of fraud on behalf of the corporation, Posner opined, shareholders are to some extent “beneficiaries of the fraud” and should therefore not be allowed to escape all responsibility; that is they should be forced to bear at least part of the cost incurred after the fraud is uncovered.

Thus, in sum, to avoid undue risk-shifting, shareholders should only be able to hold directors personally responsible for oversight failures where special circumstances arise. These special circumstances are now, per Stone, correctly limited to the narrow category of conscious breaches of known duties.

186. In view of most shareholders’ rational apathy, this statement might seem too strong. Rational apathy refers to the notion that shareholders, based on a cost-benefit analysis, decide not to vote or at least not to vote in opposition to management. See e.g., Lisa M. Fairfax, The Future of Shareholder Democracy, 84 Ind. L.J. 1259, 1268–69 (2009). Whether and to which degree institutional shareholders are subject to rational apathy is subject of an ongoing debate. See e.g., BAINBRIDGE, supra note 135, 202–09; Stephen M. Bainbridge, Investor Aversion: Reshaping the Playing Field? (May, 2008), UCLA School of Law, Law & Economics Research Paper No. 08-12, available at http://ssrn.com/abstract=1130969 (advancing the view that rational apathy generally also extends to institutional shareholders). But cf. Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 590 (1990) (contending that rational apathy does not play a significant role in institutional shareholders’ voting). See also Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1253, 1274–83 (discussing increased activism by institutional investors).

187. Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982), cert. denied, 459 U.S. 880 (1982) (holding that fraud by a corporation’s managers could be used by corporation’s auditors against charges of failing to detect managerial misconduct).

188. Id. at 455–56.

189. Id. at 456.
D. The Role of Corporate Directors

A final problem with oversight liability is the effect that it could have in transforming the role of the board. Without strict limits, liability for oversight forces directors to dedicate more time to dealing with internal controls and to be more concerned with the details of a corporation’s business. The stricter the courts interpret oversight duties, and the less reliance on corporate officers and other employees they permit, the stronger such effects will be on boards. Increased board attention to matters of daily operations, instead of on high-level tasks, can also prove highly problematic. Expansive oversight liability may force boards to oversee and micro-manage details of the company’s daily business while losing sight of the strategic vision of the corporation on which they should focus.

In recognition of these circumstances, Delaware corporate law, as many other jurisdictions, allows directors to delegate a host of responsibilities to board committees, management, and others. Specifically, DGCL Section 141(e) provides that directors may rely on records of the corporation and upon information, opinions, reports or statements by board committees, officers, employees, and certain external advisors. While it is currently unclear whether or to what extent that provision is applicable in the oversight context, Stone rightly confirms that directors may delegate certain monitoring responsibilities to subordinates and, in exercising their oversight duties, rely on their periodic reports.

190. For example, one commentator has linked stronger scrutiny of directors’ actions by Delaware courts and the passage of Sarbanes-Oxley to overactivity of corporate boards, misallocation of human resources, slower decision-making, and potential undermining of management’s authority. See Peter B. Heller, Involvement Overboard: An Evaluation Of How And Why Corporate Boards Have Become Increasingly Active and the Problems the Activity Presents, 41 COLUM. J. L. & SOC. PROBS. 53 (2007).
191. The potential for a trend in this direction has already been identified in connection with the various tasks and implementation deadlines mandated by Sarbanes-Oxley Act and related reforms. See William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. PA. L. REV. 953, 960 (2003); see also Strine, supra note 47, at 1393 n.75 (stressing the need to set priorities for board focus).
194. See Stone v. Ritter, 911 A.2d 362, 372-73 (Del. 2006) ("[The KPMG Report’s] findings reflect that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for . . . monitoring compliance, and exercised oversight by relying on periodic reports from them. Although there ultimately may have been failures by employees to report deficiencies to the Board, there
V. RECONCILING POLICY AND DOCTRINE

As we have seen in the previous Part, Delaware’s restrictive approach to oversight is firmly grounded in policy and theory. Indeed, the justifications for limiting oversight liability can be attributable to those for limiting directors’ liability for business decisions. In fact, as Citigroup has highlighted, it is often difficult, if not arbitrary, to determine whether a discrete decision caused a loss—which would normally invoke the duty of

is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.”). Also, with respect to the board’s role in exercising oversight, the Business Roundtable Principles of Corporate Governance state:

Given the board’s oversight role, stockholders and other constituencies can reasonably expect that directors will exercise vigorous and diligent oversight over a corporation’s affairs. However, they should not expect the board to micromanage the corporation’s business by performing or duplicating the tasks of the CEO and the senior management team.

BUSINESS ROUND TABLE, PRINCIPLES OF CORPORATE GOVERNANCE 3–4 (2002).

195. In view of regulatory developments at the federal level, namely the Sarbanes-Oxley Act and its § 404, one could argue that state corporate law should put a greater emphasis on, or increase liability standards for, oversight that concerns the corporate accounting and reporting process. Indeed, while Sarbanes-Oxley § 404, by its plain language, places the responsibility for internal controls and procedures for financial reporting on the CEO and CFO, the SEC has clarified that the overall responsibility to oversee the design and maintenance of internal controls rests with the board of directors. See Regina F. Burch, “Unfit to Serve” Post Enron, 42 VA. U. L. REV. 1081, 1097 (2008); Fairfax, supra note 170, at 400–402 (noting that Sarbanes-Oxley imposes responsibilities on directors similar to the oversight responsibilities under state corporate fiduciary law). To be sure, the requirements imposed by Sarbanes-Oxley have offered benefits such as improvements in internal controls, streamlining of business procedures, and a substantial modernization of financial processes in many companies. See, e.g., Stephen M. Bainbridge, THE COMPLETE GUIDE TO SARBANES-OXLEY: UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS 249 (2007). Yet, Sarbanes-Oxley and its expansion of internal control liability has also been fraught with difficulties, leading to problems similar to the ones discussed in Part IV of this Article, including increased cost, deterrence problems, risk shifting, and a creeping change in the role of the board. See Butler & Rubinstein, supra note 149 (providing an in-depth critique of Sarbanes-Oxley). As a result, it would be imprudent to use Sarbanes-Oxley as a basis for a case for increased state oversight liability. In addition, as one observer has noted, weaknesses (if any) in state oversight liability in the area of accounting and reporting may not raise any serious policy concerns, since the federal securities laws already provide considerable litigation-driven incentives for directors of public companies to identify, disclose, and act upon weaknesses in financial reporting. See Hamermesh, supra note 160, at 285.
care—or omissions related to oversight caused a loss—which now would invoke the duty of loyalty. From the perspective of boards, of course, decision-making and oversight form part of only one duty—their “directorship duty” toward the company—and it is only lawyers and courts that pigeonhole acts and omissions into different fiduciary categories.

The artificiality associated with courts’ dissection of oversight from other roles that boards assume makes Guttman and Stone’s recasting of Caremark duties as loyalty-based even more puzzling. Why did the Delaware courts shift oversight to the duty of loyalty while, at the same time, introducing an exacting oversight liability standard that parallels the standard for assessing directors’ duty of care breaches under DGCL Section 102(b)(7)? A closer look at Guttman and Stone suggests that the reason was purely doctrinal and not an attempt to stray from Delaware’s established policy of respect for the principle of board authority.

196. In In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009), for example, the court regarded the losses that the bank had suffered as a result of prior business decisions, while plaintiffs’ contended that these losses were caused by the board’s failure to monitor. See supra text accompanying notes 100–104.

197. Various commentators have explored the idea that there could be but one fiduciary duty. See, e.g., Hill & McDonnell, supra note 40, at 855 (suggesting that care, good faith, and loyalty represent aspects of only one fiduciary duty, “the duty to actively pursue the best interests of the corporation”); Strine et al., supra note 12, at 635 (suggesting that “it is possible to conceive of there being only one core duty, that of loyalty”); see also Gold, supra note 62, at 487 (“Loyalty can thus incorporate due care as a feature of a broader duty to act in the interests of another.”); Sean J. Griffith, Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 DUKE L.J. 1, 39–43 (2005) (discussing interconnections between loyalty and care). Professor Johnson has provided this thoughtful observation:

Possibly, the positive reach of loyalty partially overlaps care, or perhaps loyalty is one component of the even richer-dimensioned and more fundamental concept of “care.” Stated differently, the more full-bodied the concept of loyalty is, the more likely that the philosophical boundary between loyalty and care is “fuzzy” rather than sharp. Corporate law’s binary liability scheme, however, as manifested in section 102(b)(7) and similar statutes in other states, contemplates no such ill-defined dividing line between the two duties. Supposedly, Delaware law is clear in that directors face no personal liability for breach of “care” claims, only for breach of “loyalty” claims. This tidy appraisal assumes a discreteness of meaning more hoped for than real.


198. See Citigroup, 964 A.2d at 125 (noting the similarity between the two liability standards).
On the one hand, Stone and Guttman over interpreted Caremark’s good faith language and injected it with new meaning. In effect, both cases stand for the proposition that a failure to act in good faith must necessarily result in, or, at least be accompanied by, a violation of the duty of loyalty. Consequently, Stone also defined the duty of loyalty to encompass cases where there is no fiduciary conflict of interest at issue, such as where a director consciously decides not to exercise his oversight duties. On the other hand, both Stone and Guttman did not mean to disrupt the authority/accountability equilibrium between board members and shareholders as established by prior case law.

199. See supra Part II.B.; see also McCall v. Scott, 250 F.3d 997, 1000 (6th Cir. 2001) (noting that “Delaware courts do not discuss a breach of the duty of care in terms of a mental state more culpable than gross negligence. Rather, allegations of intentional or reckless director misconduct are more commonly characterized as either a breach of the duty of loyalty or a breach of the duty of good faith”); Strine et al., supra note 12, at 634 (explaining that “our law has been clear that the duty of loyalty is implicated by all director actions, because all such actions must be undertaken in good faith to advance the corporation’s best interests and because directors owe an affirmative obligation to put in a good faith effort to responsibly carry out their duties.”). The proposition that an intentional violation of the duty of care must always implicate loyalty is, however, debatable. See In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 750, 756 n.463 (Del. Ch. 2005) (noting that “good faith” has both loyalty and care aspects); Official Comm. of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, 2004 WL 1949290, at *9 n.37 (Del. Ch. 2004) (suggesting that the Chancery Court’s holding in Disney can be conceptualized as a duty of care claim that is so egregious that it constitutes an absence of good faith); Bainbridge et al., supra note 23, at 597 n.241 (demonstrating that “a conscious disregard of a known duty” could be analyzed under the duty of care); Sale, supra note 41, at 484 (noting that one can act in bad faith “without being disloyal, at least as traditionally viewed”); David Rosenberg, Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach, 29 Del. J. Corp. L. 491, 515 (2004) (using a contractarian approach to argue that “good faith is an interpretive device which can be used to determine whether directors have adhered to their traditional fiduciary duties of loyalty and care”); Miller, supra note 137, at 922 (“To insist that any director who acts in bad faith also acts disloyally, but then explain that this is a distinct kind of disloyalty, different from the conflicts of interest that are the usual subject of loyalty inquiries under the business judgment rule, does not represent a doctrinal advance. It is a semantic accommodation that obfuscates rather than illuminates.”). Indeed, one might as well argue that “good faith” relates to an actor’s mens rea and accept that there can be “bad faith” or conscious breaches of the duty of care that do not implicate the duty of loyalty. See Furlow, supra note 41, at 1069 (“[U]nlike the duties of loyalty and care, ‘good faith’ does not define conduct. Rather, it defines the state of mind.”).


201. See Pan, Duty to Monitor, supra note 4, at 733 (“Stone, a decision that courts have interpreted as defining the appropriate scope of the duty to monitor, was in reality an attempt by the
Strine did not intend to undermine the practical effects of exculpatory charter provisions. This is confirmed by comments Strine made only months prior to his opinion in Gutman. In a 2002 article on the impacts of Enron, he predicted increased pressure on courts to examine whether directors carried out their duties in good faith. However, at the same time, he stressed the importance of the policy goals served by exculpatory charter provisions and cautioned courts to refrain from eroding these protections.

Similarly, the Stone court was well aware that framing oversight failures in terms of lack of good faith and disloyalty would not narrow the ambit of Section 102(b)(7) provisions, which already allowed for exceptions based on precisely these grounds. As the Stone court observed, “Caremark articulates the necessary conditions predicate for director oversight liability.” Thus, the language of the Court’s holding suggests that while it attempted to clarify the preconditions for oversight liability, it did not intend to adjust the already existing liability standard.

More importantly, although Stone created some uncertainties, holdings following that decision suggest that the net effect of Stone’s doctrinal changes...
on most directors' liability is zero. In part, this was because Stone's bad faith requirement to hold directors liable mirrored already existing exceptions to DGCL Section 102(b)(7) provisions and the business judgment rule. Moreover, despite the renewed emphasis on good faith in Stone, Gutman, and other cases, former Chief Justice Veasey's remarks seem particularly apt when he noted that "good faith has been in our law for decades and is not a new concept. Thus, it should not now have any more sharp edges than it has always had." Specifically, Citigroup demonstrated that in the area of oversight, like elsewhere, the Delaware judiciary's focus remains on process and procedure rather than after-the-fact examinations of substantive outcomes. Perhaps oddly, the fact that oversight is now per Stone a loyalty-based claim is not reflected in practice. As seen in Citigroup, plaintiffs are still required to overcome the presumption of the business judgment rule by pleading with

208. Directors not protected by exculpatory charter provisions could now even face less liability risks, since some courts had interpreted Caremark as to allow for liability for grossly negligent inaction. See also Bordonaro, supra note 41, at 1133 n.109 (discussing client memoranda issued by several large law firms that, overall, were of the opinion that Stone would leave liability standards unchanged); Gold, supra note 62, at 500–01 (noting that Stone will have a minimal effect on the board's actual liability risk). But see Appleby & Montaigne, supra note 41, at 457 (positing that the effect of Stone is to expose directors to a much higher level of oversight liability).

209. DGCL § 102(b)(7) does not permit eliminating personal liability for breaches of the duty of care if the underlying acts or omissions were not in good faith. Del. Code Ann., tit. 8, § 102(b)(7)(ii). Similarly, the business judgment rule only insulates a board decision from judicial review as long as, inter alia, directors act in good faith. See, e.g., Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).


211. See Sale, supra note 148, at 295–96 (pointing to Delaware's emphasis on process in the monitoring context). There have been proposals to introduce novel process-oriented approaches to judicial review of oversight claims. For example, Professor Tucker Nees suggests a five-prong test that would use "red flags" as a means to identify when a director consciously disregards his or her duties. This test to evaluate the existence of a red flag would consider: (1) the potential harm to the company, (2) the time to react, (3) the source of the red flag, (4) the frequency of the red flag, and (5) the availability of the information in forming the red flag. See Nees, supra note 4, at 239–46. Professor Miller, on the other hand, suggests a more complex approach where the board will ex ante by way of a resolution create a standard of what directors should know of the particular corporation. Courts would then ex post determine in an objective inquiry whether the individual directors have lived up to the rule the board has set. If the directors have not breached their duties of care, loyalty, or good faith, the court will review the omission under a rational business purpose standard. See Miller, supra note 137, at 943–45.
particularity facts sufficient to demonstrate a breach of directors’ oversight duties, including scienter, at the very outset of the case. Even in cases where the business judgment rule is today inapplicable, for example when there was unconsidered inaction, plaintiffs will still bear the burden of having to plead non-exculpated claims based on particularized facts alleging bad faith.

VI. CONCLUSION

The evolution of the duty of oversight under Delaware law has experienced a long path: from non-recognition of the board’s duty to exercise active oversight to adoption of such a duty and, finally, to the Delaware Supreme Court’s reframing of oversight in terms of good faith and loyalty. Despite uncertainties along the journey, it is clear today that plaintiffs continue to face an exceptionally high burden in successfully initiating oversight claims.

As this Article argues, Delaware has steered the duty of oversight to the correct final destination—one in which directors’ personal liability is strictly limited. Nevertheless, its classification of oversight as part of the duty of loyalty is in many ways unsatisfying from a doctrinal perspective. The simpler and cleaner solution to maintaining the protections of the business judgment rule and exculpatory clauses in relation to oversight claims would have been to continue to treat them as duty of care cases. Yet, from a practical standpoint, Delaware’s current solution works and, contrary to what many critics say, strikes the correct balance between directors’ accountability and authority.

212. See In re Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106, 125–26 (Del. Ch. 2009); Nees, supra note 4 (discussing the procedural effect of the business judgment rule in director oversight cases). In order to ease plaintiffs’ pleading burden, Professor Pan proposes to allow plaintiffs to demonstrate scienter on the part of directors by demonstrating facts that show a board’s deliberate recklessness, while the burden then would be on the board to provide evidence that it exercised its monitoring responsibilities in good faith. See Pan, Critical Assessment, supra note 4, at 32.

213. It has long been settled that the business judgment rule does not apply to an unconsidered failure to take action. See Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984); see also Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (the business judgment rule does not apply in cases “in which the corporate decision ... results from an obvious and prolonged failure to exercise oversight or supervision”).

The principles that justify strict limits on directors’ personal liability for oversight apply equally to claims involving catastrophic losses, such as those incurred in the wake of the recent financial crisis.\(^{215}\) In many ways, the financial crisis is an excellent “stress test” of whether the rules protecting boards will work when needed most. If Citigroup is any indication, Delaware’s rules have passed the test. Although, the outcome is painful and difficult to accept for many shareholders, it is correct as a matter of corporate law principles. Oversight liability is, thus, not in need of repair\(^{216}\) and neither the financial crisis nor other future corporate crises should lead Delaware to veer away from its current path.

\(^{215}\) See, e.g., Citigroup, 964 A.2d at 130 (stating that “[i]t is well established that the mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, and without more, is not a basis for personal director liability” and contrasting the allegations of failures to monitor business risk with the allegations of financial fraud in AIG).

\(^{216}\) As Professor Cheffin notes:

> Though the U.S. system of corporate governance did not perform optimally during its 2008 stress test, along key dimensions it performed tolerably well under very difficult conditions. The case for fundamental reform is thus not yet made out.

Cheffins, supra note 7, at 61.