WHO'S THE BOSS? UNMASKING OVERSIGHT LIABILITY 
WITHIN THE CORPORATE POWER PUZZLE 

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This article explores the competing interests between director 
authority and accountability within the doctrinal developments under- 
pinning the arguments for and against director oversight liability. 

The historic losses suffered by companies entangled in the web of 
subprime mortgages, collateralized debt holdings, and the ensuing credit 
crisis have brought the role of corporate directors as risk managers under 
renewed public scrutiny. Directors' authority and their accountability to 
shareholders are two critical pieces to striking the appropriate balance 
among the roles, rights, and responsibilities of directors, officers, share- 
holders, and other corporate constituencies who operate within the cor- 
porate power puzzle. Numerous shareholder derivative suits brought in the 
wake of such losses allege, among other claims, that directors breached 
their fiduciary duties by failing to provide adequate oversight of their 
companies' high-risk investments. Despite being a frequently pled claim, 
director oversight liability is somewhat of a legal myth be-cause previous 
court language hinging liability on the presence of ignored "red flags" 
remains largely unexamined, undefined, and inapplicable to such cases. 
This article proposes an alternative judicial approach to analyzing director 
oversight liability by articulating a five-pronged, process-oriented test to 
define "red flags" and, thus, director oversight liability. By articulating a 
test for oversight liability that avoids the substantive review and second- 
guessing of board decisions disfavored in corporate law, this article 
advocates that an appropriate balance between director authority and 
accountability be struck. 

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I. INTRODUCTION

When things end in disaster—whether it is a team that never achieved its potential, a transaction that was stymied, a bad group project, or a case that imploded in the courtroom—whatever the situation, there is usually one question asked: who was in charge here? After the burst of the housing
bubble in 2007, the credit crisis of 2008, and the turbulent markets of 2009, many investors were asking the same question.1

Corporate claims of unknown risks with investment vehicles, a failure of corporate boards to grasp the extent to which their companies were leveraged on mortgage-backed securities, and an inability to forecast the unsustainability of the housing market underscored the sentiment of absent leadership.2 While average investors sincerely bemoaned their unanticipated portfolio losses, they sensed that corporate directors—like professional athletes who missed the game-winning shot—were paid the big bucks to get it right. They believed it was directors' job to see trouble coming, and to do so early enough to change course and ward off the astronomical losses recorded by some of the biggest and seemingly safest companies in our economy.3

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1Graham Bowley & Jenny Anderson, Where Did the Buck Stop at Merrill?, N.Y. TIMES, Nov. 4, 2007, at 3.1 (discussing who is to blame for Merrill's $8.4 billion write-down, "the biggest known loss in Wall Street history"); see also Jenny Anderson & Charles Duhigg, Flirting with Disaster, N.Y. TIMES, Sept. 21, 2008, at B1 (describing the difficulties facing Wall Street investment bank leaders as they "navigat[e] [the] uncharted waters" of the financial crisis (quoting Jeffrey A. Sonnenfeld, Professor, Yale School of Management)).


As markets crash and retirement dreams fade away, media and the public are full of outrage at everyone from mortgage brokers and Wall Street CEOs to real estate investors to experts who failed to predict the crisis was coming. Congress hauls the most prominent executives before tough committee hearings, while political candidates blame each other. Pundits proffer lists of the mustache-twirling villains who caused the whole thing.

Id.

In a sense investors were correct; state law bestows upon corporate directors the sole authority over a broad range of management issues including issuing stock, declaring dividends, and setting fiscal policy. That authority, coupled with directors' fiduciary duties of loyalty (and its derivative duties of good faith and oversight) and care, obligates directors to perform such functions with a certain level of accountability to shareholders. However, liability for breaching such duties is limited by familiar concepts such as the business judgment rule and other doctrinal developments, making director liability for failed oversight a legal fiction absent a clear violation of law.6 Obviously, our story contains a different chapter.

In the aftermath of the financial crisis, when markets recover and stability is on the horizon, the question still remains: who is actually in charge in corporate America? In the complex corporate power puzzle,7

Predicts First Loss Since 2003, N.Y. TIMES, Mar. 21, 2008, at C6 ("Credit Suisse ... post[ed] its first quarterly loss since 2003 ... The bank said it would write off $2.65 billion for the fourth quarter of 2007 and the first three months of 2008."); Ronald D. White & Walter Hamilton, Stocks, Oil Fall on Dim Outlook, L.A. TIMES, Nov. 12, 2008, at C1 ("Financial stocks briefly fell to new lows as investors braced for another round of steep writes-offs by banks on their mortgage-related holdings.").

See, e.g., MODEL BUS. CORP. ACT § 8.01(c) (2008) ("In the case of a public corporation, the board's oversight responsibilities include attention to: (1) business performance and plans; (2) major risks to which the corporation is or may be exposed ... "); see also DEL. CODE ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors ... ").

See, e.g., MODEL BUS. CORP. ACT § 8.30(a) (2008) ("Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.").


Every corporation is composed of shareholders, officers, and directors. In closely-held corporations the same person(s) may fill all three roles. In larger corporations and certainly publicly held ones, these three groups are differentiated in terms of power/control, risks/rewards, and long/short-term interests. Each component—shareholders, officers, and directors—plays vital, but separate, roles in the corporate structure. Yet, corporations act as a single entity, and are treated as such under the eyes of the law. These pieces, when put together, form a single, cohesive picture. See, e.g., Linda L. Berger, What Is the Sound of a Corporation Speaking? How the Cognitive Theory of Metaphor Can Help Lawyers Shape the Law, 2 J. ASSN LEGAL WRITING DIRECTORS 169, 181-83 (2004) (analyzing the different entity theories legal scholarship and the courts utilize to conceptualize the corporation as a single entity).

The rights, responsibilities, and roles of shareholders, officers, and directors within the corporate structure are thus three pieces within the corporate power puzzle. Understanding how these pieces are distinct within a corporation and which one, if any, is ultimately responsible for the actions of the corporation is critical to articulating standards of legal liability for directors. In addition, the relationships between these pieces are dependent upon the circumstances (e.g., shareholder voting rights are triggered only in certain events), and therefore change in accordance with the underlying circumstance creating not a two-dimensional puzzle, but a Rubik's-cube-like puzzle with multiples sides and pieces that must be aligned as one to get the correct picture. Thinking of these three roles and their duties as fitting together to form a Rubik's-cube puzzle is one
directors are one of the constituencies in charge, and have tremendous authority to steer the direction of the corporation. Directors' authority is underscored by courts' reluctance to second-guess their decisions and by theories arguing that boards need to be free (if not encouraged) to take entrepreneurial risk. When successful, corporate boards gladly take credit. When unsuccessful, or even worse, catastrophically disastrous, directors want to avoid blame and liability for these risks. Similarly, many investors are happy to have boards run the companies in which they invest with little more than a glance at their quarterly 401(k) statements. However, when companies "too big to fail" are suddenly on the brink of doing just that, and the market is down 30%, investors want to know what their directors are doing and hold them personally accountable for the investors' losses.

Asking "who's the boss" is another way of evaluating where blame should be placed. Within corporations, answering that question is critical to determining when directors should have absolute authority and when they should be accountable to shareholders. Discerning this fine balancing point between the two competing interests of director accountability and director authority has been a long-standing, although elusive, goal of corporate law.

way to conceptualize the distinct, but interdependent roles of each and the inherent tension in balancing them.

An inexhaustive list of constituencies with control in a corporation include officers (managers), shareholders (owners), and creditors. Compare Bowley & Anderson, supra note 1 ("[A]nalysts are quick to point out that no major corporation is a one-man operation. They ... wonder to what extent accountability for effective oversight of financial strategies and gambits reach[es] beyond the chief executive's suite and into the boardroom."). and Janet McFarland, Jarislowsky Blames Financial Mess on Lax Governance Rules, THE GLOBE & MAIL (TORONTO), Oct. 24, 2008, at B12 (highlighting the opinion of Stephen Jarislowsky, founder of Montreal investment firm Jarislowsky Fraser Ltd. and prominent Canadian "guru" on corporate governance, who argues that [corporate] "boards have enormous responsibility for [the financial crisis]", with Jack Welch & Suzy Welch, Of Boards and Blame, BUS. WK., Jan. 26, 2009, at 102 (arguing that the norms governing the leadership role of corporate boards are more responsible for the financial crisis than the behavior of any specific board of directors).

See In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (demonstrating a reluctance to second-guess "the content of the board decision" because a contrary approach "would, in the long-run, be injurious to investor interests" (emphasis omitted)); STEPHEN M. BAINBRIDGE, CORPORATE LAW 105 (2d ed. 2009) ("[T]he business judgment rule ... encourages directors to take risks. [I]t avoids ... 'stifling innovation and venturesome business activity.'") (quoting E. Norman Veasey, An Economic Rationale for Judicial Decisionmaking in Corporate Law, 53 BUS. LAW. 681, 694 (1998))).


Some corporate law scholars believe a principal-agency relationship exists between directors and shareholders:
Director accountability arguably peaked with *Smith v. Van Gorkom*, a 1985 Delaware Supreme Court case that has been followed by an increasingly laissez-faire approach to director oversight. Recent economic events may prompt a shift in public attention and judicial focus toward encouraging and enhancing director oversight within the corporate power puzzle.

Oversight liability—directors' liability for failing to oversee the corporation in accordance with the fiduciary duty of loyalty, which requires "good faith"—raises difficult questions because it engages in analysis close to the forbidden "second-guessing" by courts that could discourage entrepreneurial risk taking. On the other hand, the notion that all allegations of

Whenever one person (the principal) entrusts another (the agent) with authority to act, a classic agency problem is presented. The principal delegates certain authority to the agent to act on the principal's behalf. The principal, however, also wants the ability to hold the agent accountable if the agent fails to complete the assigned tasks or exceeds the authority given by the principal. For a principal to hold an agent accountable, the principal first must know what the agent has done and also must have the ability to impose adverse consequences on the agent. Thus, measures to assure accountability require mechanisms for transmission of information as well as enforcement. The classic agency problem becomes more complex in the corporate context, but the tension between authority and accountability remains.


3488 A.2d 858, 864 (Del. 1985) (holding individual directors liable for breaching their duties of care when they approved a low-dollar merger transaction after limited deliberation).


*In re Caremark*, 698 A.2d at 967.

"A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." The business judgment rule is a recognition of that statutory precept. The rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Therefore, the judgment of a properly functioning board will not be second-guessed and "[a]bsent an abuse of discretion, that judgment will be respected by the courts."

Orman v. Cullman, 794 A.2d 5, 19-20 (Del. Ch. 2002) (quoting Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984)); see also *In re Citigroup S'holder Deriv. Litig.*, No. 07 Civ. 9841, 2009 WL 2610746, at *5 (S.D.N.Y. Aug. 25, 2009) (holding that the claimed breach of director oversight for failing to monitor business risks was an attempt "to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company") (quoting *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009)).
failed oversight are beyond the purview of the shareholders and the courts is equally counterintuitive and potentially undesirable as it negates the notion of balance, opting instead to allocate total authority to directors over shareholders' investments.\textsuperscript{15}

A quarter-century shift away from director accountability has created a narrow and virtually unenforceable standard for director oversight liability in shareholder derivative suits absent clear violations of the law. In the 1996 Caremark case, the Delaware Court of Chancery opined that directors could be liable for failed oversight if a plaintiff could show that directors knew or should have known that violations of law were occurring yet failed to take good faith steps to prevent or remedy the situation that proximately caused the complained-of losses.\textsuperscript{16} Caremark has been interpreted to condition liability upon the failure to implement reporting and monitoring systems, or once having implemented such systems or controls, failing to monitor and react to the information compiled from such systems—in other words ignoring "red flags" that should have prompted director action.\textsuperscript{17}

In theory, directors face potential liability for failed oversight. But in practice it is viewed as an unworkable and virtually meaningless standard where liability exists only within a very narrow procedural footing. Plaintiffs' lawyers have unsuccessfully applied the Caremark dicta to claims of director oversight liability for failing to monitor "business risks."\textsuperscript{18} Such claims have been quickly dismissed for engaging in second-guessing of business decisions, leaving the standard of oversight liability largely unexamined and undefined outside of the context of clear violations of law.\textsuperscript{19}

\textsuperscript{15}See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1934) (analyzing the threats associated with the separation of ownership and control and the concentration of economic power). Note too that a breach of oversight claim may be pled as a breach of the duty of care; however, the prevalence of exculpatory provisions eliminating director liability for duty of care breaches means that in practice a successful claim of breached director oversight must be pled as a breach of the duty of loyalty. See infra notes 71-77.

\textsuperscript{16}In re Caremark, 698 A.2d at 967-70. Written in the context of a settlement approval, the Caremark decision evaluated whether directors had breached their duties of care by failing to monitor employees who violated various state and federal laws regarding health care provider payments, resulting in significant criminal and civil fines. \textit{id.} at 960-66.

\textsuperscript{17}Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (outlining the elements of director oversight liability established in Caremark).


\textsuperscript{19}See, e.g., In re Citigroup, 2009 WL 2610746, at *5 (dismissing plaintiff's claims for oversight liability based upon a theory of mismanaged "business risks"); In re Citigroup, 964 A.2d at 125 (stating that the combined effect of the business judgment rule, director exculpation, and the burden of establishing a Caremark claim "place an extremely high burden on a plaintiff to state a claim for personal director liability").
The obstacles to meaningfully examine director oversight liability are (1) the prevalence of exculpatory provisions in charter documents, (2) the recent interpretation by the Delaware Supreme Court of the duty of good faith, and (3) the role of the business judgment rule in shareholder derivative suits. Reviewing failed oversight within the corporate power puzzle is further complicated by the failure of the courts to define "red flags." Despite the procedural hurdles described above, the failure of director oversight claims may be attributable to the lack of a clearly articulated liability test under this theory rather than a wholesale incompatibility of such claims with the doctrinal developments of director liability and the business judgment rule.

This uncertain standard does not serve directors who still must defend against shareholder derivative suits alleging failed oversight even if no ultimate liability is assigned. In addition, executing duties without defined parameters promotes inefficiency in the boardroom. Shareholders (and courts), meanwhile, lack meaningful tools to review allegations of failed oversight and assess liability where appropriate. It could also be argued that the absence of substantive standards to assess liability sets the stage for reckless corporate behavior. Acknowledging that solutions for the oversight conundrum within the corporate power puzzle will arise from multiple sources, including regulations, this article argues that director oversight liability should be expanded beyond the original Caremark applications. Oversight liability for failing to monitor "business risks" is an underdeveloped concept that has been met with hostility from the courts.

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20See infra Part III.B.
21See infra Part III.C; see also Scarlett, supra note 11, at 83 ("The business judgment standard could be implemented as a procedural or a substantive mechanism. At times, the business judgment rule has been seen as substantive and other times procedural.").
22But see ATR-kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N, 2006 WL 3783520, at *19-21 (Del. Ch. Dec. 21, 2006) (finding directors to have acted in bad faith when they "consciously abandoned any attempt to perform their duties").
23Another view is that greed pushed Wall Street to take such dangerous risks. Steverman & Bogoslaw, supra note 2.
Wall Street bankers were taking home a lot of money by making these gambles.
The chief executive of Lehman, Richard Fuld Jr., for example, earned $34.4 million in 2007.

....

The whole system—from mortgage brokers to Wall Street risk managers—seemed tilted toward making short-term risks while ignoring long-term obligations. The most damning evidence is that most of the people at the top of the banks didn't really understand how those credit default swaps and other instruments worked.

Id.

24See In re Citigroup, 964 A.2d at 131.
While it may be tempting to say that directors have the same duties [of oversight]
Utilizing a revised doctrinal approach that relies upon well-articulated standards giving life to *Caremark*'s concept of red flags, however, hinges liability upon failed processes, instead of the hindsight-benefited determination of poor business decisions. Such a proposed *Caremark* claim appropriately frames oversight liability as a balancing tool allowing director authority while still promoting accountability to shareholders in limited circumstances where directors acted with a conscious disregard of their duties.\(^{25}\)

In keeping with the standards of corporate law that respect the traditional decision making authority of the board of directors,\(^{26}\) courts should adopt a five-factor, process-oriented approach that identifies red flags triggering a director's duty to act under *Caremark*. The proposed standard is articulated under the current procedural and substantive doctrine of director oversight liability and emphasizes an analysis of the factual components of the directorial decision making process, rather than second-guessing the substance of boardroom decisions.\(^{27}\) The five factors are (1) the potential harm to the company, (2) the time directors had to react, (3) the particular source of the red flag, (4) the frequency of the red flag, and (5) the availability of relevant information to the directors.

Part II of this article addresses the history of shareholder derivative suits and the theoretical framework for the debate regarding the tensions to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk.

*Id.*

\(^{25}\)Earlier market downturns similarly raised concerns over the extent to which directors should inject themselves in the day-to-day management of corporations:

After every market crisis—from the collapse of commercial real estate in the late 1980s to the implosion of the technology bubble in 2000 and the demise of Fortune 500 companies like Enron and WorldCom—there has been public hand-wringing over how much involvement directors should have in acting as a check against management. Case law, lawyers say, has affirmed that directors have to be informed and make sure that obvious red flags are not ignored.


\(^{26}\)See, e.g., MODEL BUS. CORP. ACT § 8.01(b) (2008) ("All corporate powers shall be exercised by or under the authority of the board of directors . . . ").

\(^{27}\)See, e.g., Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 69 (Del. Ch. 2008) (citing *In re Caremark Int'l* Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996)) ("The notion that judges should chew over the complicated calculus made by incumbent boards considering whether to add to the management slate candidates . . . seems to run against many of the sound reasons for the business judgment rule.").
between director authority and director accountability. Part III describes how the standard of director oversight liability has narrowed as a result of the confluence of three elements and shifted towards director authority. Part IV proposes an alternative approach to evaluating director oversight liability that strikes the appropriate balance between director authority and accountability in oversight cases. Part V applies the proposed red flags test to three recent Delaware cases alleging failed oversight duties to demonstrate the effect of the proposed standard.

II. DIRECTOR LIABILITY AND SHAREHOLDER DERIVATIVE SUITS—
TWO PIECES TO THE CORPORATE POWER PUZZLE

As with many doctrines, director oversight liability is an evolving standard.28 Its evolution resembles a swinging pendulum between the competing interests of director accountability and authority, two pieces to the corporate power puzzle.29 At one end of the spectrum, the duties of care, loyalty, and good faith are enforced to maintain director accountability.30 At the other end is the pressing need to facilitate directors' autonomy, risk-taking, and entrepreneurial spirit.

A. Director Fiduciary Duties

Directors owe three fiduciary duties to the shareholders and to the corporation. The duty of care requires that directors and officers make corporate decisions that are informed, well reasoned, and serve a rational business purpose.31 Compliance with the duty of care is often a procedural

29See Stephen M. Bainbridge et al., The Convergence of Good Faith and Oversight, 55 UCLA L. REV. 559, 567-68 (2008) (discussing the competing values of accountability and authority); see also Bainbridge, supra note 13, at 773 (arguing that the Unocal standard strikes the appropriate balance between director authority and accountability).
30Cf. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (stating that although good faith is not an independent fiduciary duty, a failure to act in good faith, like violations of the duties of care and loyalty, may result in liability).
31See, e.g., Smith v. Van Gorkom, 488 A.2d 858, 871 (Del. 1985) (finding directors liable for not making informed and deliberate decisions); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."); NL Indus., Inc. v. Maxxam, Inc. (In re MAXXAM, Inc.), 659 A.2d 760, 771 (Del. Ch. 1995) (stating that a transaction would be upheld under a claimed breach of fiduciary duty of care or loyalty if attributable to "any rational business purpose" (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993))).
question, asking whether the directors considered certain information, including alternatives to, and consequences of, corporate actions. The duty of loyalty requires that the "best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." The duty of loyalty prevents a fiduciary from abusing his or her position within the corporation to advance personal interests above corporate interests. To satisfy the duty of loyalty, the fiduciary must be both independent and disinterested in a transaction. The duty of good faith, something akin to honesty, disallows bad faith, which is the intent to do harm or to consciously disregard one's duties. The duty of good faith is considered a subset of the duty of loyalty. Within these three broad categories of fiduciary duties are certain actions that trigger liability, including failed oversight, which is analyzed under the duty of loyalty.

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32See Ann M. Scarlett, Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals, 60 FLA. L. REV. 589, 611 (2008) (discussing Delaware courts' focus on "the process that the board used to reach the decision" when analyzing a duty of care claim).


Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

Id.

35See, e.g., In re LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 178-79 (Del. Ch. 2005) (finding that allegations of a lack of director independence required that the defendants' motion to dismiss on the basis of an exculpatory provision be denied). See generally Donald C. Clarke, Three Concepts of the Independent Director, 32 DEL. J. CORP. L. 73 (2007) (differentiating between independent, outside, and disinterested directors and defining their respective roles).

36See, e.g., Brehm v. Eisner, 746 A.2d 244, 257-58 (Del. 2000) (affirming dismissal of breach of loyalty claims based upon evidence of lack of personal benefit to director who approved the transaction); see also Clarke, supra note 35, at 102-08 (discussing definitions of "disinterested" directors); Scarlett, supra note 32, at 616 (providing scenarios where a director is "interested").

37In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 63 (Del. 2006); see also Scarlett, supra note 32, at 619-24 (identifying the duty of good faith as "perhaps the most elusive of the fiduciary duties").
Together, the fiduciary duties establish the standards for director conduct. Logically, individual director liability is based on an alleged failure to carry out these duties. But various interpretations of director liability for breached fiduciary duties reveal tension between the scope of the standards of conduct and when legal liability actually attaches.\(^{38}\) Currently, the scope of potential director liability is narrower than the standards of conduct to fulfill fiduciary duties, especially within the context of oversight liability.\(^{39}\) Both the fiduciary duties and the appropriate scope of liability are subject to much debate about their proper definitions, analysis, application, and harmonization. For example, in 1985, the Delaware Supreme Court decided the landmark case of *Smith v. Van Gorkom*,\(^{40}\) swinging the pendulum of director liability towards accountability by imposing individual liability on directors for failing to execute their duties of care.\(^{41}\) *Van Gorkom* triggered a backlash in corporate law over the fear that it would chill the American entrepreneurial spirit within the boardroom.\(^{42}\) This backlash set in motion a shift in the opposite direction towards director authority, where the pendulum hangs today.\(^{43}\)

\(^{38}\) *Compare* Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985) (holding directors liable for breached fiduciary duties), with *In re Walt Disney Co.*, 906 A.2d at 62 (rejecting claim that directors acted in bad faith).

\(^{39}\) *See* Scarlett, *supra* note 32, at 609 (arguing that the Delaware courts have developed two standards for directors' behavior: "the best corporate practices that directors should comply with when making decisions and the lower legal liability standard that directors will be judged against in litigation").

\(^{40}\) 488 A.2d 858.

\(^{41}\) *Id.* at 881.


\(^{43}\) *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 358-59 (Del. 1993).

The Chancellor's rationale for subordinating the due care element of the business judgment rule, as applied to an arms-length, third-party transaction, was a belief that the rule, unless modified, would lead to draconian results. The Chancellor left no doubt that he was referring to this Court's decision in *Smith v. Van Gorkom*. . . . He stated, "In all, plaintiff contends that this case presents a compelling case for another administration of the discipline applied by the Delaware Supreme Court . . . ."

*Id.; see also* Bainbridge et al., *supra* note 29, at 570.

In sum, we observe throughout corporate law rules that recognize the need to strike a balance between authority and accountability but nevertheless are biased toward deference to the board's authority rather than accountability. Courts leave corporate decisionmaking to the board of directors and refuse to intervene when the board simply makes an inferior business decision.

*Id.*
B. Opposing Interests: Director Authority and Accountability

The debate over director liability within the corporate power puzzle is historic and meets at the intersection of the competing interests of authority and accountability. This debate is central to one of the salient features of modern American corporations: the strict distinction between the roles, rights, and responsibilities of company owners (the shareholders) and managers (the directors and officers). When ownership and control are separated, courts and legislatures must ensure that the interests of company owners and managers are sufficiently aligned to both protect shareholders and provide incentives for profitable management.

The debate is framed by the tension between a director's engagement in entrepreneurial risk taking to grow shareholder investments and company value, and a director's responsibility to preserve those investments and sustain company value. Stephen Bainbridge, for example, argues that if the balance is skewed too far towards accountability, talented managers will be driven from the boardroom and the economy will be stifled as a result.

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44See generally BERLE & MEANS, supra note 15 (analyzing how corporate governance disrupts traditional notions of property and ownership). The division of ownership from control is a cornerstone of our economy. See id. at 1. This division facilitates our modern markets because companies can raise tremendous amounts of working capital, disburse risks, and, it is argued, make rational market decisions based upon access to superior information and expertise. See id. at 1-9. This strict distinction manifests itself in several ways, but the most common example is in the business judgment rule: the inability of shareholders or courts to second-guess the managerial decisions of directors and officers. See id. at 66-69 (noting that investors' wealth "is determined . . . [partly] by the actions of the individuals in command of the enterprise—individuals over whom the typical owner has no control"); cf. Melvin A. Eisenberg, The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm, 24 J. CORP. L. 819, 825 (1999) (proposing that corporations and their shares are not personal property to be owned, but rather should be viewed as a nexus of contracts).

45See Bainbridge, supra note 13, at 785 ("Given that the 'separation of ownership from control produces a condition where the interests of owner and of the ultimate manager may, and often do, diverge,' shareholders will require mechanisms to hold directors accountable for failing—whether through oversight or intent—to comply with that norm." (quoting BERLE & MEANS, supra note 15, at 6)).

46See Bainbridge et al., supra note 29, at 567-68 (2008) (discussing the competing values of accountability and authority).


[A] corporation that evaluates managerial performance almost exclusively in terms of shareholder value will inevitably produce a board in composition and function quite different from a corporation in which managers are charged with trying to balance and in some way maximize total stakeholder value. As a positive matter, in competitive global capital and product markets, the shareholder value objective
On the other hand, Adolf Berle and Gardiner Means argue that inadequate protection for the shareholder and shareholder investment will result if risk is always preferred over responsibility.48

Another way to analyze this debate is to contrast the corporate governance structure under a director primacy model—emphasizing the centralized control and management assigned to the directors and officers—with the structure created under a shareholder primacy model—emphasizing the role and rights of shareholders. Under the former, centralized control with the board of directors is justified by the argument that directors have superior expertise and better access to information about the corporation, and are responsive to the needs of the company and its markets.49 That model is premised, in part, upon the observation that where there is dispersed ownership, shareholders often have diversified portfolios, a small ownership share in the company, insufficient corporate or industry information to make "rational" decisions, and no efficient means to organize other shareholders to make effective "control" decisions.50 In contrast, the shareholder primacy

is likely to be of greater importance and therefore will drive the conception of the board.

48See BERLE & MEANS, supra note 15, at 120-24 (arguing that management may often have interests adverse to those of the corporation's owners and the desire to maximize personal profit may adversely impact management's decisions). But see Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 547, 561-63 (2003) (criticizing Berle and Mean's managerialism approach for not distinguishing between directors and officers).

In publicly traded companies with dispersed ownership, the interests of management do not fully overlap with those of shareholders, and management thus cannot be automatically counted on to take actions that would serve shareholder interest. As a result, agency costs that reduce shareholder value might arise. Without adequate constraints and incentives, management might divert resources through excessive pay, self-dealing, or other means; reject beneficial acquisition offers to maintain its independence and private benefits of control; over-invest and engage in empire-building; and so forth. Adequate governance arrangements, however, can provide constraints and incentives that reduce deviations from shareholder-value maximization.

Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 833, 850 (2005); see also Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. CORP. L. 1, 7 (2002) (asserting that public corporations involve agency costs because the appointed managers do not watch over the shareholders' investments as if they were their own); Joseph William Singer, Normative Methods for Lawyers, 56 UCLA L. REV. 899, 927 (2009) (criticizing the law and economics analysis of the appropriate balance between shareholder and management rights, which "turn[s] . . . attention away from legal doctrine and moral principles, [and] . . . us[e] cost-benefit analysis . . . to identify rules that maximize social welfare").

49See Bainbridge, supra note 48, at 562-63 (explaining the development of the director primacy model).

50See Bainbridge, supra note 13, at 782-83 (summarizing the problems with shareholders exercising managerial control, including dispersed ownership and the lack of incentives to gather
model urges that shareholders play a more meaningful and active role in managing the corporation and should, at a minimum, have mechanisms to recoup corporate losses caused by breaching directors.51

On the other end, market-based theories argue that the market alone creates sufficient disincentives for non-complying director behavior.52 A market-theory approach assumes that the free market, if left unrestrained, will strike the appropriate balance between accountability and authority within the corporate power puzzle.53 It also assumes that judicial and governmental interference are unwanted and unproductive because they impair the ability of the market to provide sufficient profit incentives for appropriate director behavior.54

This article argues for a middle ground approach—one that centralizes control with directors, but also recognizes the need to empower shareholders with certain tools designed to encourage and enforce director compliance with their duties. One such tool could be an articulated standard for liability that encompasses failed directorial oversight. The test proposed in this article does not discount the market incentives that exist, such as a manager's reputation, bonus compensation tied to stock performance, and stock ownership.55 Such incentives cannot be ignored, and they act as a first line

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51See, e.g., Bebchuk, supra note 48, at 850-51. Bebchuk proposes increased shareholder control over certain "game-ending" decisions as a counterweight to the inherent bias of managers to maintain the corporation or execute policies that benefit themselves, but not shareholders as a whole. Id. at 896-97. Bebchuk further argues that shareholder weakness results from "legal rules that insulate management from shareholder intervention." Id. at 842. As a result, he proposes a redistribution of shareholder power in "rules-of-the-game" decisions (such as choosing a state of incorporation). Id. at 868-69. Currently, shareholders only vote after the board approves such changes in limited "game changing" scenarios when after the fact they must approve certain board decisions, such as mergers, other end-of-the-game decisions, and downsizing decisions. See id. at 862. In these scenarios, the shareholder has veto power to prevent something from happening, but cannot make something happen. Id. In contrast, Bebchuk calls for increased shareholder control over scenarios that irrevocably affect shareholders' investments. Id. at 896; see also BERLE & MEANS, supra note 15, at 84-88 (describing the fallacy of shareholder control as illustrated by the election of directors).

52See Bainbridge, supra note 48, at 567 ("[M]arket constraints, including the capital, product, and employment market forces, already encourage directors and managers to exercise care in their business decisions. Thus, judicial intervention in cases dealing with poor business judgment would prove redundant and undermine the board's decisionmaking discretion." (footnote omitted)).


54Bainbridge, supra note 48, at 567 ("[J]udicial intervention in cases dealing with poor business judgment would prove redundant and undermine the board's decisionmaking discretion." (citation omitted)).

55See Bainbridge, supra note 13, at 826 ("[T]he tenure and reputation of outside board members are determined by the performance of the top inside managers, which gives independent directors further incentives to be vigilant in overseeing management's conduct.").
of defense against corporate mismanagement. In light of the inability of those incentives to curb significant failures of oversight, however, legal reinforcement is necessary to achieve the appropriate balance between accountability and authority within the corporate power puzzle.

Shareholder derivative actions are particularly well suited to this task.\textsuperscript{56} A shareholder derivative suit is an exception to the strict division of power between owners and managers.\textsuperscript{57} Derivative actions recognize that shareholders have some influence over—or right to control—their investment, and can be an effective mechanism for shareholders to hold directors and managers liable in limited circumstances, typically those involving director self-dealing or self-interested transactions.\textsuperscript{58}

This article argues that there is a limited and appropriate role for shareholder derivative suits in maintaining the correct balance between accountability and authority in the director oversight context. Market incentives alone have been unsuccessful in curbing directorial shirking of over-sight duties; thus, the shareholder derivative suit emerges as an important tool to encourage and enforce complying behavior.\textsuperscript{59} The role that derivative suits can play in this context is necessarily limited, however, given the statutory and doctrinal developments of the last quarter-century that have emphasized director authority over accountability, including recent case law dismissing oversight liability claims.\textsuperscript{60} Nonetheless, it is possible to

\textsuperscript{56}A shareholder derivative suit is a form of a corporate class action where a shareholder sues the wrongdoers, frequently the corporation's own directors and officers, on behalf of the corporation (and all other shareholders) and where any recovery flows to the corporation rather than to the individual plaintiff(s). See, e.g., Sternberg v. O'Neil, 550 A.2d 1105, 1124 (Del.1988) ("In a shareholder's derivative suit, the shareholder sues on behalf of the corporation for harm done to the corporation. Therefore, the damages recovered in the suit are paid to the corporation."); Kenneth B. Davis, Jr., The Forgotten Derivative Suit, 61 VAND. L. REV. 387, 437 (2008) ("Derivative litigation performs the task of translating the abstract concepts of fiduciary obligations, good faith, and fairness into the specific limits on the insiders' ability to favor themselves.").

\textsuperscript{57}The decision to litigate is a business decision that, unless the precise requirements of a shareholder derivative suit are present, only a board of directors can make. See, e.g., Womble v. Dixon, 585 F. Supp. 728, 731-32 (E.D. Va. 1983), aff'd in part and vacated in part, 752 F.2d 80 (4th Cir. 1984).

\textsuperscript{58}See Bainbridge, supra note 48, at 568 ("Courts recognize that market forces may fail to sufficiently constrain self-interested behavior among directors and managers .... Hence, courts actively intervene to review alleged breaches of director loyalty." (footnote omitted)); Kinney, supra note 11, at 172 ("The controversial derivative action allows a shareholder to bring suit against wrongdoers on behalf of a corporation. Examples of actionable injuries to corporations include illegal activities of employees and outright self-dealing on the part of managers or directors." (footnote omitted)). But see Davis, supra note 56, at 415-17 (critiquing shareholder derivative suits).

\textsuperscript{59}See Davis, supra note 56, at 436-37 (demonstrating how derivative suits give substance to the "abstract concepts of fiduciary [duties]").

\textsuperscript{60}In re Citigroup Inc. S'holder Deriv. Litig., No. 07 Civ. 9841, 2009 WL 2610746, at *13
construct a workable doctrinal standard out of the existing rubric of oversight liability first articulated in Caremark, which authorized liability for the failure to act in the face of red flags. Such a standard would strike a better balance between accountability and authority than currently exists.

III. THE TOOTHLESS TIGER: THE CURRENT STATE OF DIRECTOR OVERSIGHT LIABILITY

Despite the existence of the three categories of directors' fiduciary duties, in practice, plaintiffs may only pursue oversight liability under one: the duty of loyalty. A derivative suit challenging director oversight could be cast as a breach of the duty of care, loyalty, or good faith; however, under the current, narrow standard of liability, such a claim may only be brought under the duty of loyalty, which impacts how such claims are litigated and decided. The narrowing of the standard of oversight liability is a result of a confluence of the following three elements: (1) the prevalence of exculpatory provisions, (2) Delaware's recent interpretations of the duty of good faith, and (3) the role of the business judgment rule in shareholder derivative suits.

Keeping the framework of the debate in mind—the tensions between accountability and authority—we now turn to the evolution of the doctrine in setting the pendulum where it currently hangs. While the narrowing of the standard of liability pushes the pendulum towards director authority, it is ultimately the lack of an articulated definition of oversight liability within the narrowed standard that weakens and impairs the balance within the corporate power puzzle. The current doctrinal approach has created a

(S.D.N.Y. Aug. 25, 2009) (dismissing claims of failed director oversight); In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 139-40 (Del. Ch. 2009) (dismissing claims of failed director oversight); see also Bainbridge, supra note 48, at 570-71 (identifying the relationship between limited shareholder rights and director primacy).


62 In theory, a plaintiff could cast an oversight claim (e.g., director X failed to oversee the sale of a corporate subsidiary) as a breach of the duty of care (e.g., director X failed to review the reports before voting, did not consult with counsel, and did not deliberate), a breach of the duty of good faith (e.g., director X knew that an alternative purchaser was willing to pay more for the subsidiary, but choose not to pursue that option), or as a breach of the duty of loyalty (e.g., director X oversaw the sale of the subsidiary to a company owned by her, but not disclosed to the board).

63 This article only discusses the erosion of liability and does not implicate any erosion of the three distinct duties and standards of conduct. The fiduciary duties owed by directors and officers are fixed in both statutory and case law and have not changed; however, this article explores how the standards of liability arising under those duties have changed. For a discussion of the gap between the stated fiduciary duties (the standards) and the liability available under the three fiduciary duties, see Scarlett, supra note 32, at 609-24.

64 In sum, we observe throughout corporate law rules that recognize the need to strike a balance between authority and accountability but nevertheless are biased toward deference to the board's authority rather than accountability. Bainbridge et al., supra note 29, at 570.
"toothless tiger"—an eviscerated standard that in practice rarely poses any meaningful threat of liability absent a violation of law—warranting a revision to the standard of oversight liability.65

A. Exculpatory Provisions Eliminate Director Oversight Liability Under the Duty of Care

The first contributing factor to the narrowing scope of director oversight liability is the introduction, and later prevalence, of a powerful director authority tool: the exculpatory provision. Exculpatory provisions are statutory opt-in rules that allow a corporation to adopt charter language limiting director liability only to instances involving a breach of the duty of good faith or loyalty, and eliminating liability for a breach arising under the duty of care.66 Exculpatory language originated in section 102(b)(7) of the

65 C.F. ATR-kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N, 2006 WL 3783520 (Del. Ch. Dec. 21, 2006). In an opinion written by Vice Chancellor Strine, the Delaware Court of Chancery held two nonfeasance directors—directors who failed to perform an act which they should have—liable for breaching their duties of loyalty to the corporation for failed oversight. Id. at *1-2. In this case, which is the single example of failed oversight leading to liability, the CEO, who owned 90% of the corporation, transferred key assets to his family members totaling over $35 million, leeching the corporation of all assets. Id. at *1. The two "uninterested" directors ultimately held liable were found by the court to be "stooges" of the CEO, seeking to please him and trusting his actions and recommendations without any independent research, verification, or inquiry. Id. The court held that "[s]uch behavior . . . reflects a conscious decision to approach one's role in a faithless manner by acting as a tool of a particular stockholder rather than an independent and impartial fiduciary." Id. The nonfeasance directors were held liable for a failure to implement information and reporting systems. Id. at *19-20.

Put in plain terms, it is no safe harbor to claim that one was a paid stooge for a controlling stockholder. [The directors] voluntarily assumed the fiduciary roles of directors . . . For them to say that they never bothered to check whether the [corporation] retained its primary assets and never took any steps to recover the [missing assets] once they realized that those assets were gone is not a defense. To the contrary, it is a confession that they consciously abandoned any attempt to perform their duties independently and impartially, as they were required to do by law. Their behavior was not the product of a lapse in attention or judgment; it was the product of a willingness to serve the needs of their employer . . . even when that meant intentionally abandoning the important obligations they had taken on to the [corporation] and its [shareholders].

Id. at *21.

66 E.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2006). Delaware law allows corporations to adopt

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; (iii) under § 174 of this title;
Delaware corporate code, which was adopted in 1986 in response to Smith v. Van Gorkom.67

In Van Gorkom, the Delaware Supreme Court held individual directors liable for breaching their respective duties of care when they approved a merger transaction after only two hours of deliberation and without having read the merger agreement or engaging in any sale-appropriate preparations.68 In response to Van Gorkom, directors' and officers' insurance policies became scarce and expensive.69 Additionally,


or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.


68Smith v. Van Gorkom, 488 A.2d 858, 864, 869 (Del. 1985). The Delaware Supreme Court held that the decision of the TransUnion board of directors to approve the merger was not the result of an informed business judgment, that the board's efforts to later amend the merger agreement and take curative measures were not effective, and that the board breached its duty of candor by failing to disclose material facts to the shareholders. The Delaware Supreme Court conceptualized the duty of care as the duty of directors to inform themselves of all material information reasonably available to them. Id. at 864, 873-91. TransUnion was faced with a unique tax posture and was researching its options to maximize its tax credits within its railroad car leasing business, including a potential buyout. Id. at 864-65. On September 13, 1980, Van Gorkom, chairman and CEO of TransUnion, contacted a corporate takeover specialist to discuss a potential buyout at a proposed share price of $55, which was based solely on Van Gorkom's personal valuation. Id. at 866. This meeting, and those that followed over the next week, triggered a fast-moving buyout negotiation; a formal three-day purchase proposal at $55 per share was submitted to the board on September 18. Id. at 866-67. On September 20, the board held a meeting to discuss the purchase proposal, of which only two directors plus Van Gorkom were even previously aware. Id. at 868-69. During this meeting, the board received a twenty-minute presentation on the proposal, was not given the merger agreement to review, and ultimately decided to approve the transaction and put it to a shareholder vote after only two hours of deliberation. Id. at 869. The final merger agreement was signed later that night by Van Gorkom at an event for the Chicago Lyric Opera without him, or any other corporate representative, having read the actual documents. Id. at 868-69. After amendments to the merger agreement and time to test the share price on the market, the merger closed in January. Id. at 870. The Delaware Supreme Court held that the directors did not inform themselves prior to approving the merger and breached their duties of care by engaging in grossly negligent decision making; they had no sound valuation model, no real market test of the share price, and sought no independent fairness opinion of the offer. Id. at 874, 884-88.

69See, e.g., Lee, supra note 42, at 240-41 (discussing the post-Van Gorkom "violent swing in the insurance markets making directors' and officers' liability insurance . . . painfully expensive or simply unavailable"). This article proposes a standard under which directors would incur director oversight liability when a plaintiff is able to establish a conscious disregard of duties based upon a
some independent directors fled the boardroom, which in turn “sent lobbyists scurrying to state legislative bodies seeking statutory remedies.” The result was the creation of exculpatory provisions.

As is typical with corporate law, what originated in Delaware was replicated throughout the country. Now all fifty states' corporate codes authorize an exculpatory provision. Such provisions are commonplace, having been adopted by most public corporations. As such, while exculpatory provisions are not a statutory default rule, they operate like one in practice. process-oriented review. See infra Part IV. The proposed standard may, like the decision in Van Gorkom, impact, or at least have a perceived impact upon D&O insurance premiums. The obvious concern is that expanded liability standards (although this author would argue that it is not expanded liability so much as defined liability) would increase such premiums. On the other hand, however, liability standards serve three functions: (1) to punish non-complying behavior, (2) make the aggrieved shareholders and corporation whole, and (3) encourage complying behavior. The third goal, encouraging complying director behavior, should reduce corporate liability and result in no impact upon D&O insurance.

The impact of legal policy upon D&O insurance may not be an appropriate legal concern, but it is certainly a valid business concern. For example, in the recent AIG $115 million settlement of derivative claims, the majority of the settlement ($85.5 million) was paid by AIG's D&O insurance carriers. Kevin LaCroix, About the AIG Derivative Settlement, D&O DIARY, Sept. 11, 2008, http://www.dandodiary.com/2008/09/articles/shareholders-derivative-litiga/about-the-aig-derivative-settlement/.

Lee, supra note 42, at 241. As with concerns over D&O insurance, critics of the standard proposed by the article may argue that, like Van Gorkom, it would drive talent from the boardroom. But the standard proposed in this article is a process-oriented review that should decrease second-guessing about complying behavior and clearly establish liability standards; a known risk is an avoidable one. Additionally, this article advocates for a reemphasis on the involvement of inside directors on the board. See infra note 188 and accompanying text. Such board members, when kept in a minority, have the ability to bring inside corporate knowledge to the board, which marries the operations of management with the oversight of the board of directors. See Lee, supra note 42, at 258-59. Oversight without knowledge of the inner workings of a corporation has the potential to cause inaccuracies and abuse. Id.

See, e.g., NEV. REV. STAT. § 78.037(2) (2008) (authorizing exculpatory provisions as an optional articles of incorporation provision); N.C. GEN. STAT. ANN. § 55A-2-02(b)(4) (West 2007) (authorizing provisions in the articles of incorporation limiting director liability for certain breaches of fiduciary duty not involving bad faith or interested-director transactions).


Out of one hundred "Fortune 500" companies, ninety-eight of the stock corporations that incorporated in jurisdictions allowing for exculpatory charter provisions have adopted such provisions. In addition, every one of the Delaware corporations in this sample had adopted such a provision.

Furthermore, out of a sample of one hundred small- and mid-capitalization companies, all but one (a Delaware corporation) of those incorporated in a jurisdiction authorizing exculpatory charter provisions have included such a
Once a corporation adopts exculpatory language in its articles of incorporation, a director may not be held liable for breaching his or her duty of care regardless of fault or the resulting harm.\textsuperscript{74} Exculpatory provisions eliminate liability for gross negligence or recklessness, and, consequently, require a shareholder plaintiff to prove a breach of a director's duty of good faith or loyalty in order to recover on behalf of the corporation.\textsuperscript{75} A duty of care violation requires a lower showing of fault to establish liability, and is a particularly potent tool to the shareholder claiming failed oversight because he or she would only have to prove that a reasonable director would have taken certain preparatory or decision making measures.\textsuperscript{76} In contrast, an oversight claim brought under the duty of loyalty or good faith requires a plaintiff to prove that a director took (or failed to take) a certain action in bad faith against the corporation or with a conscious disregard of a duty.\textsuperscript{77}

The settlement reached in \textit{Teachers' Retirement System of Louisiana v. Aidinoff}\textsuperscript{78} illustrates the effect of an exculpatory provision in a director oversight case. In this suit against American International Group (AIG), the complaining shareholder challenged hundreds of millions of dollars in commission payments from AIG to Starr, a company wholly owned and controlled by AIG's top executives and directors.\textsuperscript{79} Starr, however, performed no discernable, discrete services for AIG, nor did it have its own employees or overhead expenses.\textsuperscript{80} The shareholder plaintiff brought claims against the self-interested directors and officers, as well as other directors on AIG's board (the nonfeasance directors) who knew of the "sham" transactions yet voted to approve the renewal of these contracts.\textsuperscript{81}

The nonfeasance directors who turned a blind eye to these abuses were alleged to have breached their duties of care by failing to provide adequate oversight of the contracts process.\textsuperscript{82} The complaint also alleged

\begin{itemize}
\item\textsuperscript{73} See Romano, \textit{supra} note 72, at 1160-61.
\item\textsuperscript{74} E.g., \textit{Del. Code Ann. tit. 8, § 102(b)(7)} (2006) (permitting exculpatory provisions that relate to directors' but not the officers' breach of the duty of care).
\item\textsuperscript{75} See, e.g., \textit{id.}
\item\textsuperscript{76} See Taylor, \textit{supra} note 72, at 1022 (arguing "process review [of directors' decisions has] largely supplanted substantive review" in the duty of care context).
\item\textsuperscript{77} See \textit{id. at} 1014 (stating that, despite efforts to limit the impact the duty of loyalty, it "continue[s] to impose meaningful restraints on directorial behavior").
\item\textsuperscript{78} 900 A.2d 654 (Del. Ch. 2006). The case settled in September 2008 for $115 million, a record Delaware shareholder derivative suit settlement amount. LaCroix, \textit{supra} note 69.
\item\textsuperscript{79} Aidinoff, 900 A.2d at 658.
\item\textsuperscript{80} \textit{Id. at} 662.
\item\textsuperscript{81} \textit{Id. at} 658.
\item\textsuperscript{82} \textit{Id. at} 660.
\end{itemize}
that the nonfeasance directors' complicity was motivated, in part, by a hope that one day they too would be invited to invest in Starr, which was known as the AIG Billionaires' Club.83 The case settled for $115 million, because the directors who owned Starr were engaging in blatantly self-dealing transactions.84 While the self-interested directors were more culpable,85 the sham contracts could not have been effectuated without the complicity of the nonfeasance directors. These directors had an obligation to act in the shareholders' best interests by implementing reporting programs and hiring the appropriate personnel to oversee the contract process, and arguably failed to do so. But because AIG's charter contained an exculpatory provision which would have ultimately prevented liability against the nonfeasance directors, the shareholder plaintiff struck a deal with the Special Litigation Committee86 dismissing the oversight claims against them.87 Therefore, the nonfeasance directors faced no liability; the plaintiff's case against them was

83 Aidinoff, 900 A.2d at 658, 662, 664. With the alleged motivations of the nonfeasance directors, it is plausible that shareholders could have also brought a claim for breach of the duty of good faith or loyalty, which they did not.
85 The vast amount of the settlement will be paid by AIG's D&O insurance carriers (approximately $85.5 million), with the bulk of the remainder to be paid by Starr, the company controlled by the self-dealing directors and officer. Stipulation of Settlement § II.A.1, Teachers' Ret. Sys. of La. v. Greenberg, No. 20106-VCS (Del. Ch. Ct. Sept. 30, 2008), 2008 WL 4452190 [hereinafter Greenberg Settlement]. Aside from $1.25 million to be funded by director Thomas Tizzio, no money was to be paid by the directors themselves. Id.; see also Mark A. Hofmann, Greenberg, Others Settle over AIG payments to Starr, BUS. INS., Sept. 11, 2008, http://www.businessinsurance.com/article/20080911/NEWS/200013902 (noting that Greenberg himself was not responsible for any payments). The settlement also provided that

[i]t is expressly understood and agreed that neither this Stipulation or any act or omission in connection therewith, is intended or shall be deemed or argued to be evidence or to constitute an admission by: (i) the Defendants, or any of them, or the Company, as to the validity of any claims, defense, other issues raised, or which might be or might have been raised, in the Derivative Action or in any other action, or to be evidence of or constitute an admission of any wrongdoing or liability by any of them, and each of them expressly denies any such wrongdoing or liability; or (ii) TRSL as to the informing of any claim or the validity of any defense.

Greenberg Settlement, supra, § VI.
86 See infra Part III.C.2.
87 See Aidinoff, 900 A.2d at 668 (characterizing plaintiffs' decision to dismiss, in light of the exculpatory provision, as "pragmatic"). If the role of the board is to provide management that is protected from secondary review, one might ask whether there should be greater emphasis on making the standard of liability more closely related to the standard of conduct. See Scarlett, supra note 32, at 611 (suggesting that one problem with shareholder derivative suits and the doctrine of director liability is the disparity between the standards of directorial conduct (fiduciary duties) and the scope of liability).
flawed from the outset due to the nature of the claim (oversight), the breached duty under which it was pleaded (care), and the presence of the exculpatory provision.\footnote{In *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009), the Delaware Supreme Court reviewed the Delaware Court of Chancery's denial of directors' motion for summary judgment on oversight liability claims and discussed the role of exculpatory provisions. \textit{Id.} at 237, 239. Even though the trial court found that the shareholder plaintiffs "might be able to prevail at trial on a claim that the Lyondell directors breached their duty of care" in approving the merger transaction, the exculpatory provision in Lyondell's charter protected the directors from personal liability for such breaches, thus rendering the claim inconsequential. \textit{Id.} at 239. To plead a non-exculpable breach of oversight liability, plaintiffs must plead that the directors acted in bad faith with either intent to harm or an intentional dereliction of duty. \textit{Id.} at 240.}

Exculpatory provisions eliminate director liability for duty of care cases;\footnote{Exculpatory provisions have a similar effect on director oversight liability claims. Turning now specifically to plaintiffs' Caremark claims, one can see a 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 \textsection{}102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. \textit{In re Citigroup Inc. Shareholder Deriv. Litig.}, 964 A.2d 106, 125 (Del. Ch. 2009). \textit{In re Citigroup}, the court granted the director defendants' motion to dismiss because the plaintiffs failed to plead a non-exculpable breach of loyalty claim. \textit{Id.} at 132. Because the director defendants are "exculpated from liability for certain conduct, . . . liability may only be found to exist if the plaintiff pleads a} evidence of even gross negligence is insufficient to hold a director...
liable.\textsuperscript{90} Nothing short of evidence that the nonfeasance directors acted with the intent to harm the shareholders or in the face of a conflict of interest could have cured the plaintiff's claims. Thus, when an exculpatory provision is in place, an actionable claim for director oversight must be cast as a breach of the duty of good faith or loyalty.


The second factor contributing to the narrowing of the doctrine for director oversight liability is Delaware's recent interpretations of the duty of good faith. These cases examine the relationship between the duties of good faith and loyalty.\textsuperscript{91}

In the landmark Disney cases in both the Delaware Court of Chancery and the Delaware Supreme Court from 1998 through 2006,\textsuperscript{92} the Delaware courts addressed the role of the duty of good faith in shareholder derivative suits. The Disney litigation involved the termination of then-CEO Michael Ovitz after only fourteen months of service, entitling him to a golden parachute worth approximately $130 million.\textsuperscript{93} The resulting shareholder derivative litigation was brought against Ovitz, Michael Eisner, who was the

\textit{non-exculpated} claim against the directors based on particularized facts." \textit{Id.} at 124-25 (internal quotation marks omitted) (quoting Wood v. Baum, 953 A.2d 136, 141 (Del. 2008)).

\textsuperscript{90}Gross negligence without more, however, cannot constitute bad faith sufficient to be a \textit{non-exculpable} fiduciary duty breach. \textit{Lyondell}, 970 A.2d at 240 (quoting \textit{In re Walt Disney Co. Deriv. Litig.}, 906 A.2d 27, 64-66 (Del. 2006)).

\textsuperscript{91}See Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[B]ecause a showing of bad faith conduct . . . is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.").

\textsuperscript{92}The procedural history of the Disney cases is as follows: the Delaware Court of Chancery dismissed the original shareholder complaint brought against Ovitz and the Disney directors regarding Ovitz's $140 million severance package. \textit{In re Walt Disney Co. Deriv. Litig.}, 731 A.2d 342, 350, 380 (Del. Ch. 1998). On appeal, the Delaware Supreme Court affirmed the dismissal in part, reversed the dismissal in part, and granted plaintiffs an opportunity to replead the action in the Court of Chancery. \textit{Brehm v. Eisner}, 746 A.2d 244, 248 (Del. 2000). The Court of Chancery then denied defendants' motion to dismiss the repleaded complaint. \textit{In re Walt Disney Co. Deriv. Litig.}, 825 A.2d 275, 278 (Del. Ch. 2003). Defendants moved for summary judgment on the repleaded complaint after completing discovery, and defendants' motion was granted in part and denied in part. \textit{In re Walt Disney Co. Deriv. Litig.}, No. Civ. A.15452, 2004 WL 2050138, at *1 (Del. Ch. Sept. 10, 2004). The case was finally tried before Chancellor Chandler in a thirty-seven-day trial between October 2004 and January 2005. \textit{In re Walt Disney Co. Deriv. Litig.}, 907 A.2d 693, 697 (Del. Ch. 2005). Chancellor Chandler issued an epic eighty-six-page decision in August 2005, finding that the director defendants neither breached their fiduciary duties nor committed corporate waste. \textit{Id.} at 697, 779. That decision was appealed to the Delaware Supreme Court, which affirmed the trial court, thus ending the Disney litigation. \textit{In re Walt Disney Co. Deriv. Litig.}, 906 A.2d 27, 75 (Del. 2006).

\textsuperscript{93}In re Walt Disney Co., 906 A.2d at 35.
president, and the other Disney directors for breaching their duties of good faith and loyalty to the shareholders.\textsuperscript{94}

Disney initiated an executive succession search following the unexpected death of its CEO and declining health of Eisner, its second in command.\textsuperscript{95} Eisner recruited his friend Michael Ovitz, a successful Hollywood talent agent and manager and controlling partner in a very successful, privately-held talent agency.\textsuperscript{96} To induce Ovitz to sell his lucrative business interests (earning him approximately $20-25 million per year) Eisner negotiated a series of "downside protection[s]" for Ovitz in case the Disney employment arrangement did not work out for the long term.\textsuperscript{97} Once Ovitz joined the Disney team, however, he found that his personal friendship with Eisner did not translate into a successful working relationship.\textsuperscript{98} Less than a year after joining the company, with the help of other members of Disney's board, Eisner began plotting Ovitz's termination.\textsuperscript{99} The board concluded that Ovitz could not be terminated "for cause."\textsuperscript{100} Thus, the board pursued Ovitz's termination "without cause," resulting in the golden parachute payment worth $130 million.\textsuperscript{101} A shareholder derivative suit ensued alleging that the directors breached their duty of good faith in negotiating the provision and firing Ovitz under circumstances that triggered it.\textsuperscript{102}

In evaluating the Disney directors' possible liability, the Delaware Supreme Court affirmed the Court of Chancery's reasoning that a breach of the duty of good faith could be an actionable, stand-alone claim.\textsuperscript{103} The court held that a good faith breach amounting to an "'intentional dereliction of duty, a conscious disregard for one's responsibilities,'" or a "'[d]eliberate indifference and inaction in the face of a duty to act'" could result in director liability.\textsuperscript{104} Ultimately, the court found that Eisner and the remaining Disney directors breached their duty of care for failing to negotiate the golden parachute provision during their deliberations over Ovitz's termination.\textsuperscript{105}
directors were not liable under the facts of the case, but the decision opened
the door for the duty of good faith to be a stand-alone, actionable claim.\textsuperscript{105}

That door, however, was quickly and affirmatively shut in \textit{Stone v. Ritter},\textsuperscript{106} another 2006 Delaware Supreme Court case involving shareholder
derivative claims alleging insufficient director oversight. In \textit{Stone}, the
plaintiff brought suit against fifteen directors of AmSouth and AmSouth
Bank who paid $50 million in fines and civil penalties for failing to comply
with the reporting provisions of the Banking Secrecy Act and anti-money
laundering statutes after learning of a Ponzi scheme effectuated by its
employees.\textsuperscript{107}

The Delaware Supreme Court in \textit{Stone} held that a director's duty to act
in good faith is a subsidiary element of the duty to act loyally.\textsuperscript{108} "It follows
that because a showing of bad faith conduct . . . is essential to establish
director oversight liability, the fiduciary duty violated by that conduct is the
duty of loyalty."\textsuperscript{109} Citing \textit{Caremark},\textsuperscript{110} the Delaware Supreme Court opined
that liability for failed oversight required that the directors either "utterly
failed to implement any reporting or information system or controls; or . . .
having implemented such a system or controls, consciously failed to monitor
or oversee its operations."\textsuperscript{111}

Excusatory provisions that eliminate liability for negligence and
gross negligence (i.e., the duty of care), combined with the assumption of the
duty of good faith under the liability standard for the duty of loyalty, narrow
the standard of liability for director oversight. The result is while directors
have three fiduciary duties—the duties of care, good faith, and loyalty—the

\textsuperscript{105} Prior to the \textit{Disney} cases, the duty of good faith was a recognized fiduciary duty
(standard of conduct), but rarely served as the sole basis for liability. For a discussion of the
evolving doctrine of the duty of good faith, see Bainbridge et al., \textit{supra} note 29, at 604 (concluding
that in the balance between authority and accountability, it is "uncertain the extent to which a good
faith requirement tips that balance toward accountability").

\textsuperscript{106} 911 A.2d 362, 364-65 (Del. 2006).

\textsuperscript{107} Id. at 365. The shareholders alleged that the directors breached their fiduciary duties of
good faith because the company's existing Bank Secrecy Act compliance program was inadequate.
See id. at 366. Citing \textit{Caremark}, the Court of Chancery dismissed the complaint for a failure to
establish a systematic or sustained failure of board oversight. Id. at 370-71.

\textsuperscript{108} Id. at 370. "The failure to act in good faith may result in liability because the requirement
to act in good faith 'is a subsidiary element[,] i.e., a condition, 'of the fundamental duty of loyalty.'"
\textit{Id.} at 369-70 (quoting Gutman \textit{v} Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

\textsuperscript{109} Id. at 370.

\textsuperscript{110} \textit{Compare In re Caremark} Intl Inc. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996)
(stating that failed director oversight is a breach of the duty of care), \textit{with Stone}, 911 A.2d at 370
(stating that the breach for failed oversight claim pertains to good faith and loyalty).

\textsuperscript{111} \textit{Stone}, 911 A.2d at 370 (emphasis omitted).
three standards of conduct are essentially collapsed into one actionable standard: the duty of loyalty.\footnote{Liability for breaching oversight duties requires a showing that the directors knew that they were not discharging their fiduciary obligations. "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." \textit{In re Citigroup Inc. S'holder Deriv. Litig.}, 964 A.2d 106, 123 (Del. Ch. 2009). \footnote{Id.; see also McCullough v. Scott, 239 F.3d 808, 819 ("Thus, we find the district court erred in concluding that only intentional conduct would escape the protection of the [exculpatory] provision adopted in Columbia's Restated Certificate of Incorporation."); \textit{In re Citigroup}, 964 A.2d at 126 ("A plaintiff can thus plead bad faith by alleging with particularity that a director knowingly violated a fiduciary duty or failed to act in violation of a known duty to act, demonstrating a conscious disregard for her duties." (emphasis omitted)).}

"Thus, to establish oversight liability a plaintiff must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities, such as by failing to act in the face of a known duty to act. The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a necessary condition to director oversight liability."\footnote{See \textit{id}.
\footnote{See \textit{In re Citigroup}, 964 A.2d at 125 (outlining this procedural requirement, which}}

After \textit{Stone}, plaintiffs must cast director oversight liability claims as a breach of the duty of loyalty.\footnote{\textit{See id.}}

C. The Role of the Business Judgment Rule
Under a Single Standard of Liability in Director Oversight Cases

The role of the business judgment rule in shareholder derivative suits, especially those suits alleging failed oversight, exaggerates the effect of the collapse of the three duties into a single standard of oversight liability. Oversight liability is doctrinally limited to cases claiming a breach of the duty of loyalty.\footnote{\textit{See \textit{id.}}}

The procedural effect of the business judgment rule exacerbates the narrowed standard by requiring the plaintiff to plead facts sufficient to demonstrate a breach of the duty of loyalty at the very outset of the case.\footnote{\textit{See \textit{id.}}}

The combined effect of the doctrinal limitations and the
procedural obstacles further narrows the scope of director oversight liability, pushing the pendulum towards authority.117

1. Rebutting the Business Judgment Rule  
and the Need to Demonstrate a Likely Breach of Fiduciary Duty

The business judgment rule118 prevents a court from second-guessing the decisions made in the boardroom by presuming them to be undertaken in compliance with the directors' fiduciary duties. This presumption can be rebutted if a plaintiff pleads with particularity that the directors' actions were fraudulent, illegal, wasteful, or that the directors likely breached a fiduciary duty.119 But directors and their decisions will be protected by the business judgment rule if the plaintiff fails to rebut the presumption.120

In failed oversight cases, a director's failure to act will not likely amount to a fraudulent or illegal act because the directors' collective inaction is typically under review.121 The failure to act will rarely be an "illegal" act

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117 See id. ("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 ... ").

118 Id. at 124 ("The business judgment rule 'is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))).

119 See id. at 124-25; see also Scarlett, supra note 32, at 622 ("Plaintiffs may also rebut the business judgment rule presumption by showing that the directors failed to make a decision or that the directors' conduct was fraudulent, illegal, or wasteful. It is axiomatic that the business judgment rule applies only to scenarios involving a 'business judgment.'").

120 In re Citigroup, 964 A.2d at 125; see also Scarlett, supra note 32, at 604.

121 An argument can be made that failed oversight amounts to corporate waste. The test for corporate waste is a stringent standard. A plaintiff must plead facts that no ordinary person of "sound business judgment could view the benefits received in the transaction as a fair exchange for the consideration paid by the corporation." In re Lear Corp. S'holder Litig., 967 A.2d 640, 656 (Del. Ch. 2008) (citation omitted); see also Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. ... [It is] a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift.  

Id.

However, waste is a rarely used and relatively undefined area of corporate law that does not pose a meaningful option for plaintiffs at this time. See generally Frank P. VanderPloeg, Legal Standards for Adoption of Executive Compensation Programs and Contracts, in 833 TAX LAW AND PRACTICE 167 (PLI Tax Law and Estate Planning, Course Handbook Series No. 14, 322, 2008) (discussing corporate waste as a mechanism to rebut the business judgment rule and characterizing such claims as difficult). See also Steiner v. Meyerson, No. 13,139, 1995 WL 441999, at *1 (Del.
absent instances such as a failure to comply with a statutory (e.g., payroll taxes) or regulatory (e.g., the SEC) regime.\textsuperscript{122} Similarly, inaction would rarely constitute grounds for fraud,\textsuperscript{123} which requires a false statement of material fact made with intent to induce action.\textsuperscript{124} Thus, to rebut the business judgment rule in oversight cases, a shareholder will likely have to demonstrate that the directors’ failed oversight breached a fiduciary duty. But to do that a shareholder plaintiff must plead with particularity\textsuperscript{125} that the board breached the duty of loyalty for failed oversight.

\textsuperscript{122}See, e.g., Stone v. Ritter, 911 A.2d 362, 365 (Del. 2006) (invoking shareholders that alleged breach of fiduciary duty for failure to comply with the Banking Secrecy Act and money-laundering statutes); In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959, 961-62 (Del. Ch. 1996) (invoking shareholders that alleged breach of fiduciary duty for failure to comply with the Anti-Referral Payments Law and Department of Health and Human Services regulations).

\textsuperscript{123}See Stephenson v. Capano Dev., Inc., 462 A.2d 1069, 1074 (Del. 1983) ("[O]ne is equally culpable of fraud who by omission fails to reveal that which it is his duty to disclose in order to prevent statements actually made from being misleading.").

\textsuperscript{124}Vice Chancellor Lamb describes the Delaware fraud standard:

Common law fraud in Delaware requires: 1) the existence of a false representation, usually one of fact, made by the defendant; 2) the defendant had knowledge or belief that the representation was false, or made the representation with requisite indifference to the truth; 3) the defendant had the intent to induce the plaintiff to act or refrain from acting; 4) the plaintiff acted or did not act in justifiable reliance on the representation; and 5) the plaintiff suffered damages as a result of such reliance. In addition to overt representations, fraud may also occur through deliberate concealment of material facts, or by silence in the face of a duty to speak. To state a claim for equitable fraud under Delaware law, a plaintiff must "satisfy all the elements of common-law fraud with the exception that plaintiff need not demonstrate that the misstatement or omission was made knowingly or recklessly."


\textsuperscript{125}See, e.g., 2 AM. LAW INST., PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.04 (1994) [hereinafter ALI PRINCIPLES OF CORP. GOVERNANCE] ("The complaint shall plead with particularity facts that, if true, raise a significant prospect that the transaction or conduct complained of did not meet the applicable requirements of [the director's fiduciary duties] . . . "). Additionally, when a plaintiff is pleading demand excuse, the demand futility allegations must be pleaded with particularity. Therefore, if a plaintiff is pleading a likely breach of fiduciary duty of loyalty as grounds for demand futility, then such allegations must be
Pleading particularized facts establishing a breach of the duty of loyalty at the outset of a case, before discovery, is a significant procedural hurdle for plaintiffs. While plaintiffs can make section 220 demands (shareholder right to access books and corporate records), demonstrating intent to harm or a conscious disregard of one's duties may require the type of investigation that is best suited for depositions and other forms of traditional discovery rather than relying upon the corporate records and board meeting minutes. The procedural impediment posed by the business judgment rule, therefore, further narrows the scope of director oversight liability.

pleaded with particularity. See FED. R. CIV. P. 23.1(b) (2009) ("The [shareholder derivative action] complaint must be verified and must: . . . (3) state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.").

See infra notes 128-38 and accompanying text for a discussion of the demand excuse standards and pleading requirements in Delaware as articulated in Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

See also the following state statutes for similar particularity pleading requirements for demand excuse: ALASKA STAT. § 10.06.435(d) (2008); ARK. CODE ANN. § 4-27-740(b) (2001); CAL. CORP. CODE § 800(b)(2) (West 1990); 805 ILL. COMP. STAT. ANN. 5/7.80(b) (West 2004); IND. CODE ANN. § 23-1-32-2 (LexisNexis 2008); KAN. STAT. ANN. § 60-223a (2005); K.Y. REV. STAT. ANN. § 271B.7-400(2) (West 2006 & Supp. 2008); LA. CODE CIV. PROC. ANN. art. 615(2) (1999); N.Y. BUS. CORP. LAW § 626(c) (McKinney 2003); OR. REV. STAT. § 60.261(2) (2007); TENN. CODE ANN. § 48-17-401(b) (2002 & Supp. 2008); WASH. REV. CODE ANN. § 23B.07.400(2) (LexisNexis 2006); MINN. R. CIV. P. 23.09 (2006); N.J. R. CT. 4:32-3 (2010); N.M. R. CIV. P.1-023.1 (2003).

Note that nineteen states are "universal" demand states that do not recognize the demand excuse or futility exception, and that use almost identical statutory language. Compare ARIZ. REV. STAT. ANN. §§ 10-742 (2004); COLO. REV. STAT. ANN. § 7-80-714 (West 2006); GA. CODE ANN. §§ 14-2-742 (2003); IDAHO CODE ANN. §§ 30-1-742 (2005); IOWA CODE ANN. § 490.742 (West 2009); MASS. GEN. LAWS ANN. ch. 156D, § 7.42 (West 2005); MISS. CODE ANN. § 79-4-7.42 (West 1999); MONT. CODE ANN. § 35-1-543 (2007); NEB. REV. STAT. ANN. § 21-2072 (LexisNexis 2008); NEV. REV. STAT. § 41.520 (2007); N.H. REV. ST. ANN. § 293-A:7.42 (1999); N.C. GEN. STAT. §§ 55-7-42 (2007); 42 PA. CONS. STAT. ANN. § 1506 (West 2002); R.I. GEN. LAWS § 7-1.2-711(c) (Supp. 2008); S.D. CODIFIED LAWS § 47-1A-742 (2007); UTAH CODE ANN. § 16-6a-612(3) (Supp. 2009); VA. CODE ANN. § 13.1-672.1(B) (2006 & Supp. 2008); WISC. STAT. ANN. § 180.0742 (West 2002); WYO. STAT. ANN. § 17-16-742 (2009), with MODEL BUS. CORP. ACT § 7.42 (2008) (requiring that a demand be made upon the board of directors and that the shareholder wait to commence the derivative action until 90 days have expired or the demand is rejected).

See generally DEL. CODE ANN. tit. 8, § 220 (2006); Stephen A. Radin, The New Stage of Corporate Governance Litigation: Section 220 Demands—Reprise, 28 CARDOZO L. REV. 1287 (2006) (discussing the role that section 220 inspection rights can have in helping plaintiffs satisfy the particularity requirements to plead demand futility).

The business judgment rule acts in this context as it is intended. As the business judgment rule presumes that directors act in compliance with their fiduciary duties, which can only be rebutted by demonstrating fraud, abuse, or the likely breach of fiduciary duty, the business judgment rule serves to limit directors' exposure to liability. BAINBRIDGE, supra note 9, at 109-10.
2. Demand Requirements and Special Litigation Committees in Director Oversight Cases

In addition to the presumption of compliant behavior, plaintiffs face more procedural hurdles to an oversight liability suit with demand requirements and Special Litigation Committees. Because shareholder derivative suits are claims brought on behalf of the corporation, the plaintiff must either make a demand upon the corporation or demonstrate why such a demand is excused. Courts will excuse demand if it would be futile; but the burden is on the plaintiff to demonstrate that the business judgment rule does not apply to the challenged transaction.

The Delaware Supreme Court announced the standard for demand excuse in Aronson v. Lewis. A shareholder plaintiff is excused from making a pre-suit demand if he or she creates a reasonable doubt that either the directors were disinterested or independent, or that the complained-of

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To make a demand a shareholder generally must send a letter or draft complaint or other comparable communication to the board of directors, although some state statutes and Federal Rule 23.1 do allow a demand to be made on someone other than the board if that party is of "comparable authority."

Id. 129 The demand requirement forces a shareholder to seek an 'intracorporate resolution' . . . [because] it provides a mechanism for a corporation to resolve shareholder claims without the need for judicial intervention." Jeffrey S. Facter, Fashioning a Coherent Demand Rule for Derivative Litigation in California, 40 SANTA CLARA L. REV. 379, 384 (2000); see also In re Sonus Networks, Inc. S'holder Deriv. Litig., 499 F.3d 47, 66 (1st Cir. 2007).

Delaware law requires that in a case such as this, in which the directors are accused of nonfeasance rather than misfeasance, a would-be derivative plaintiff either must make demand on the board to bring the suit or else must allege particular facts which "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

Id. (emphasis and footnote omitted) (quoting Stone v. Ritter, 911 A.2d 362, 366-67 (Del. 2006)). Whether or not a plaintiff must make a demand or may plead demand excuse depends upon the state of incorporation of the nominally named corporate defendant. See Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108-09 (1991) (holding that courts must abide by the procedural rules of the state of incorporation in derivative suits because demand-related rules are substantive).

130 Scarlett, supra note 32, at 597 (citing FED. R. CIV. P. 23.1). "Consequently, if a shareholder files suit without making a demand on the board, the shareholder must show that demand should be excused as futile by pleading particular facts sufficient to rebut the presumption of the business judgment rule." Id.

131 473 A.2d 805, 811-12 (Del. 1984); see also Brehm v. Eisner, 746 A.2d 244, 253 (Del. 2000) (clarifying that the standard of review of the court of chancery's dismissal of a derivative suit for failure to plead demand futility is de novo, not abuse of discretion).
transaction was otherwise the product of a valid business judgment.\textsuperscript{132} "Thus, under the second prong of Aronson, a plaintiff may proceed with a suit against a disinterested and independent board if the plaintiff pleads particularized facts sufficient to rebut the presumption of the business judgment rule by alleging a breach of fiduciary duty."\textsuperscript{133}

In Rales v. Blasband,\textsuperscript{134} however, the Delaware Supreme Court articulated an alternative to the business judgment rule in demand-excite cases involving claims of nonfeasance.\textsuperscript{135} Under Rales, a court that would otherwise be analyzing demand futility under the Aronson test and the business judgment rule must instead determine whether the board that would have received the demand could have acted impartially and without improper considerations: "a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."\textsuperscript{136} The Delaware Court of Chancery evaluated

\textsuperscript{132}Aronson, 473 A.2d at 814. The court in Aronson enunciated a conjunctive standard for demand excuse; however, in Brehm, the court affirmed the standard but characterized it as disjunctive. See Brehm, 746 A.2d at 253.

\textsuperscript{133}McPadden v. Sidhu (I2 Technologies), 964 A.2d 1262, 1269-70 (Del. Ch. 2008). A court's examination of the merits under the demand excused litigation, however, may impact the analysis (or at least provide incentive for a court to find against the company if the court suspects actual wrongdoing). In Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981), the Delaware Supreme Court established a rule to review SLC recommendations in the context of demand-excused litigation. It expanded the court's power in examining a special litigation committee recommendation to include a "substantive judgment . . . balanc[ing] . . . many factors—ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal." Id. (citation omitted). In Delaware, the court may apply its own "independent business judgment" in determining whether the motion should be granted. Id. at 789. Compare this with the New York approach where the court will only review the independence and good faith of directors making the recommendations and the thoroughness of the investigation. See Auerbach v. Bennet, 393 N.E.2d 994, 996 (N.Y. 1979) ("[T]he court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued . . . "). Delaware takes a less strict approach to the special litigation committee review, but many states strictly adhere to the standard established in Auerbach, recognizing only clear violations of interest and independence. For example, in St. Clair Shores General Employees Retirement System v. Eibeler, No. 06 Civ. 688(SWK), 2008 WL 2941174 (S.D.N.Y. July 30, 2008), the district court dismissed derivative claims upon the special litigation committee's recommendation and motion to dismiss. Id. at *1. The court found that the directors were all independent, disinterested, and that the special litigation committee acted in good faith. Id. at *6-7. Furthermore, the directors had a reasonable basis for their conclusion that litigation was not in the best interest of the corporation. Id. at *15-16.

\textsuperscript{134}634 A.2d 927 (Del. 1993).

\textsuperscript{135}See id. at 933 ("Where there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application.").

\textsuperscript{136}Id. at 934.
demand excuse under the *Rales* standard in the 2009 Citigroup shareholder derivative case, which alleged failure of oversight duties arising from the company's heavy losses resulting from the subprime mortgage fallout, the bursting of the housing bubble, and the subsequent economic downturn.\(^{137}\) Likewise, in most oversight liability cases, demand will be excused if a plaintiff can satisfy the *Rales* test.\(^{138}\)

States with universal demand rules, modeled after the MCBA and the ALI/ABA standards, require shareholders to make a demand in every case.\(^{139}\) Neither the *Aronson* nor the *Rales* tests are applicable in those states, regardless of the nature of the claims involved (direct breach or nonfeasance). Rather, at the demand stage, a corporate board may reject a shareholder's demand by a vote of the majority of the disinterested directors finding that the suit is not in the corporation's best interest.\(^{140}\) The decision to reject a shareholder's demand is also protected by the business judgment rule, because the decision to litigate is ultimately a business decision.\(^{141}\) As

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\(^{138}\) *Rales* articulates a standard for demand excuse in instances of *unconsidered action*. *See* *Rales*, 634 A.2d at 933 (identifying the "absence of board action" as requiring a "departure ... from the standards set forth in *Aronson*"). As discussed above, however, director oversight liability (nonfeasance) will only be actionable if such action (or inaction) was the result of intent to harm or a conscious disregard of the board's duties to the corporation. *See supra* notes 113-14 and accompanying text. Therefore, if a court concludes that the *Rales* standard applies, a shareholder plaintiff complaining of failed director oversight could not prevail under the duty of loyalty prong, which requires intent to harm or a conscious disregard; the concepts of unconsidered action and conscious disregard are inconsistent. *Cf. In re Citigroup*, 964 A.2d at 122 (applying the *Rales* demand futility standard to plaintiffs' *Caremark* claims of failed oversight liability). Nonetheless, the court in *Citigroup* granted the director defendants' motion to dismiss, finding that the plaintiffs "failed to state a *Caremark* claim sufficient to excuse demand based on a theory that the directors did not fulfill their oversight obligations by failing to monitor the business risk of the company." *Id.* at 126.

In order for a plaintiff to successfully plead a derivative action for failed oversight, the complaint must demonstrate that the actions amounted to a breach of the duty of loyalty and therefore should not qualify under the *Rales* standard applied to unconsidered action. *See* Bainbridge, * supra* note 48, at 602 (arguing for broad application of the business judgment rule). *Rales*, therefore, should be inapplicable to the context discussed herein and should not exempt demand excuse oversight claims from review under the business judgment rule. This is the subject of a forthcoming article.

\(^{139}\) *See supra* note 125 and accompanying text; *see also* ALI PRINCIPLES OF CORP. GOVERNANCE, * supra* note 125, § 7.03 cmt. e (identifying three reasons to eliminate the demand futility exception: (1) eliminate threshold litigation about demand excuse, (2) provide a low-cost gatekeeper function, (3) present a clearer, more unified standard).

\(^{140}\) E.g., ALI PRINCIPLES OF CORP. GOVERNANCE, * supra* note 125, § 7.04(a)(2).

\(^{141}\) More specifically, whether or not a corporation benefits from bringing litigation is a business decision. For example, on a contract for $100,000 worth of goods, a corporation suffering a breach amounting to $10,000 may choose not to sue because the costs of litigation outweigh any possible recovery or to preserve the business relationship. *See* Zapata Corp. v. Maldonado, 430
with the underlying decision being challenged, the complaining shareholder continuing with his or her suit must, to overcome a company-brought motion to dismiss, plead particularized facts that, if true, raise a significant prospect that (1) the demand refusal statements were inaccurate, (2) the underlying transaction or conduct was not protected by the business judgment rule, or (3) in rejecting the demand the board could not have determined that rejection was in the best interests of the corporation.142

Whether in a universal demand jurisdiction after the demand rejection stage or in a demand-excuse jurisdiction after the complaint has been filed, the company has an opportunity to oppose or control a derivative suit by forming a special litigation committee (SLC).143 A board-formed SLC, which can make decisions that are binding upon the corporation,144 investigates the claims raised by the shareholder and then can usually take one of three options, or some combination thereof: (1) take control of the litigation (the board pursues the claims), (2) settle the claims with the shareholder, or (3) move to dismiss the litigation.145 Under the Delaware

A.2d 779, 788 (Del. 1981) (noting that the decision to litigate is motivated by various business and legal concerns).

An interesting element to demand rejection is that the directors named in the lawsuit are often those making the decision whether or not to pursue litigation on behalf of the corporation. "A director may be found to be independent even if the director was elected by the alleged wrongdoers, was named in the suit, or approved of the wrong but did not personally benefit from it." Kinney, supra note 11, at 183. Compare Julian Velasco, Structural Bias and the Need for Substantive Review, 82 WASH. U. L.Q. 821, 821 (2004) (discussing structural bias and proposing a standard of "moderate review of the substance of directors' decisions" in cases involving structural bias), with Minor Myers, The Decisions of Corporate Special Litigation Committees: An Empirical Investigation, 84 IND. L.J. 1309, 1320 (2009) (finding that in 30% of cases, special litigation committees settled the derivative claim and that the special litigation committee moved to dismiss the entire case in 60% of cases).

142 ALI PRINCIPLES OF CORP. GOVERNANCE, supra note 125, § 7.04(a)(2)(A)-(C).

143 The corporation may oppose a shareholder derivative action through the creation of a special litigation committee even though demand was never made upon the company. See Zapata, 430 A.2d at 785 ("Even though demand was not made in this case and the initial decision of whether to litigate was not placed before the board, Zapata's board, it seems to us, retained all of its corporate power concerning litigation decisions.").

144 For example, section 141 of the Delaware General Corporation Law authorizes the delegation of board power to a committee. DEL. CODE ANN tit. 8, § 141(c)(2) (2006) ("The board of directors may designate 1 or more committees, . . . [a]ny such committee . . . shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation . . . "). Committee authority, however, does not extend to certain corporate acts such as actions requiring stockholder approval or changes to the bylaws. Id.

145 On the other hand, in demand-excuse regimes, "[a] second hurdle faces some shareholder-plaintiffs—the possibility that [an SLC], composed of independent and disinterested directors, will move to dismiss the action based on the SLC's recommendation that continuing the litigation would not be in the corporation's best interests." Scarlett, supra note 32, at 598. The recommendations of a special litigation committee are typically afforded business judgment rule protections in all states except Iowa. See, e.g., Miller v. Register & Tribune Syndicate, Inc., 336
approach, as articulated in *Zapata Corp. v. Maldonado*, the court first evaluates the good faith and independence of the committee in its investigation, as well as the reasonableness of the information on which it relied.\(^{146}\) Second, the court may, at its discretion, apply its own independent business judgment to determine whether the committee's decision is valid.\(^{147}\) An alternative approach, articulated by the New York Court of Appeals in *Auerbach v. Bennett*, precludes the reviewing court from making any substantive evaluation of the SLC decision, and instead limits the review to the procedures of the SLC.\(^{148}\)

Demand, particularized pleadings at the outset of the case, the presumption of the business judgment rule, demand-excuse tests, and the role of an SLC all pose significant procedural obstacles for a shareholder plaintiff bringing a derivative suit for failed oversight. These procedural hurdles, combined with the doctrinal collapse of the three fiduciary duties into a single standard under the duty of loyalty, create a very narrow scope of

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\(^{146}\) *Zapata*, 430 A.2d at 789.


oversight liability, which serves director authority.\textsuperscript{149} The threshold that a plaintiff must surpass in order to rebut the business judgment rule presumption at the outset of the case is heightened by the collapse of the fiduciary duties into a single, actionable standard under the duty of loyalty. In order to rebut the business judgment rule, the shareholder plaintiff must demonstrate a likely breach of a fiduciary duty—which can only be pleaded as a breach of the duty of loyalty in oversight cases where an exculpatory provision exists. Therefore, the plaintiff must plead with particularity at the outset of its case that a director-defendant acted with either intent to harm the corporation or a conscious disregard of his or her duties, both very high thresholds.

Understanding the narrow scope of director oversight liability provides one example of how director authority is favored over accountability.\textsuperscript{150} The narrowness of the standard is not the main problem;\textsuperscript{151} rather, it is that the standard of liability within this narrow context remains unarticulated. The courts' treatment of oversight liability, in effect, makes it a threat without any enforcement mechanism—a toothless tiger.

What actions (or lack thereof) result in a breach of the duty of loyalty has not yet been conclusively answered by courts.\textsuperscript{152} At one end of the

\textsuperscript{149}\textit{In re} Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 125 (Del. Ch. 2009) ("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.").

\textsuperscript{150}See, e.g., \textit{id.} at 126 (establishing arguments against recognizing plaintiff's claims for director liability for a failure to monitor business risk).

Risk has been defined as the chance that a return on an investment will be different that [sic] expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses—and particularly financial institutions—make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.

\textit{Id.}

\textsuperscript{151}The narrowness of the standard is itself problematic, especially in the context of exculpatory provisions where gross negligence is shielded from review. Although exculpatory provisions are shareholder-ratified provisions adopted into the charter, they are not shareholder-friendly provisions. Investors are shackled by the choices either they or earlier generations made, depending on the age of the investor. The marketplace provides no real alternative to this provision for the average investor as most publicly-traded corporations contain exculpatory provisions. See Hamermesh, \textit{supra} note 72, at 490 (demonstrating the near ubiquity of exculpatory provisions in Delaware corporations).

\textsuperscript{152}For the evolution of Delaware's standard for liability under the duty of loyalty, see generally Stone v. Ritter, 911 A.2d 362 (Del. 2006); \textit{In re} Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006); \textit{In re Lear Corp. S'holder Litig.}, 967 A.2d 640 (Del. Ch. 2008); McPadden v. Sidhu
spectrum, Caremark established that violations of the law and absent or ignored reporting systems are sufficient to hinge oversight liability. Recent subprime shareholder derivative suits occupy the other end of the spectrum, establishing that alleged failures to oversee "business risks" are insufficient to trigger oversight liability.153 The doctrinal developments of duty of loyalty liability in Caremark and Stone end with the enunciation that liability could be found where a director consciously disregards his or her duties, but provide little indication of how that standard will be applied or how a court will determine whether or not one's duties were "consciously" disregarded.154 The standards for establishing a breach of the duty of loyalty in oversight cases (intent to harm or conscious disregard) remains largely untested and undefined.155 The absence of an articulated standard within the narrow scope of liability further pulls the pendulum towards director authority and leaves shareholders without meaningful accountability tools. This goes beyond merely preventing courts from second-guessing directorial decisions, and, in effect, shields oversight responsibilities from judicial review and shareholder enforcement. Without articulated standards defining the narrow scope of oversight liability, the balance between accountability and authority is skewed towards authority without a counterbalance of accountability.

IV. UNMASKING DIRECTOR OVERSIGHT LIABILITY
—A PROPOSED STANDARD

As a result of the doctrinal and procedural obstacles to enforcing director compliance with fiduciary duties of oversight beyond fidelity to the law, the fulcrum point between director authority and accountability has been pushed too far in favor of director authority. The derivative suit is a shareholder's tool that should be available to counterbalance director authority within the corporate power puzzle.


154 See Stone, 911 A.2d at 370 (finding liability when "directors fail to act in the face of a known duty to act"); In re Caremark, 698 A.2d at 967 (finding liability from "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss" (emphasis omitted)).

155 See Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242-43 (Del. 2009) ("[T]here is no single blueprint that a board must follow to fulfill its duties." (quoting Barkan v. Amsted Indus., 567 A.2d 1279, 1286 (Del. 1989)); see also In re Citigroup, 964 A.2d at 125; In re Lear, 967 A.2d at 648 (requiring plaintiffs to demonstrate that the directors "somehow act[ed] in bad faith"); i2 Technologies, 964 A.2d at 1263 ("[W]hat must be shown for bad faith conduct has not yet been completely defined . . . .").
Market-based incentives to act in accordance with oversight duties alone are inadequate. Proponents of this approach argued that directors had sufficient market incentives such as reputation, stock ownership, etc., to compel complying behavior.\textsuperscript{156} But the stunning upset of the financial system and markets in 2008, which continued in 2009, warrants a reevaluation of that argument. Former Federal Reserve Chairman Alan Greenspan conceded in his October 2008 testimony before Congress that he was wrong in assuming that the market alone can provide adequate incentives to protect shareholder investments.\textsuperscript{157} Even if one disagrees and believes that the markets do provide sufficient incentives, this debate has nonetheless been revived; the assumptions of the market theory should be reargued, if not reassessed, in light of these new developments. Market-based incentives act as the primary defense against director misconduct; however, these defenses cannot, by themselves, adequately protect shareholder interests. Take the AIG/Starr example, where directors, who arguably failed to fulfill their oversight duties, approved sham contracts that siphoned millions in AIG profits away from the company and its shareholders and into a subsidiary owed by AIG's top management.\textsuperscript{158} Certain failures to execute oversight duties should be actionable and result in liability. Any such standard, however, must be carved out in a manner that respects the general division of authority between the directors and the shareholders within the corporate power puzzle.

\textsuperscript{156} "Corporate directors operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. A variety of market forces provide important constraints. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents." Bainbridge, supra note 13, at 785. Professor Bainbridge also writes:

Top corporate managers do not get ahead by being associated with sub-par performance in the product markets. Indeed, as between shareholders and managers, it is the latter who have the greatest incentives to ensure the firm's success. Shareholders can and should hold diversified portfolios, so that the failure of an individual firm will not greatly decrease their total wealth. Managers, on the other hand, cannot diversify their firm-specific human capital (or their general human capital, for that matter). If the firm fails on their watch, it is the top management team that suffers the principal losses.

\textit{Id.} at 827 (footnote omitted).


\textsuperscript{158} See supra notes 78-83 and accompanying text.
In response to the subprime mortgage crisis, over twenty-five shareholder derivative suits have been filed, the majority of which allege, among other claims, a failure of director oversight. As a result, it is likely that courts will have a well-timed opportunity to reevaluate director oversight liability and define it more clearly. While courts have dismissed early cases, evaluating the claims under the five-factor test proposed in this article would provide a consistently-applied analysis that would strike the right balance between director authority and shareholder accountability.

Taking the example of the recently filed subprime shareholder derivative suits, it is unlikely that plaintiffs can demonstrate oversight liability under the narrow scope of the doctrine in light of the procedural barriers and the absence of clear standards defining it as well as the court's justified hostility towards reviewing mismanagement of "business risks." Without an enforceable standard of oversight liability, however, the playing field tilts too sharply in favor of director authority. For example, an AIG shareholder filed a derivative suit in September 2008, the day after the

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159 It is important to note that shareholder derivative suits are always post hoc. The courts experience increases in shareholder derivative litigation after bad events, such as the slew of derivative actions over stock option backdating and Enron-type accounting scandals. See, e.g., Kevin LaCroix, The List: Options Backdating Settlements, Dismissals and Denials, D&O DIARY, Oct. 28, 2007, http://www.dandodiary.com/2007/10/articles/options-backdating/the-list-options-backdating-settlements-dismissals-and-denials/index.html (tracking the over 150 options backdating lawsuits).


161 See In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 125 (Del. Ch. 2009) (stating the Delaware standard for liability for "bad faith conduct").

162 See, e.g., id. (dismissing director oversight liability claims).

163 See supra Parts III-A-B.
government announced its $85 billion bailout of the company. The shareholder-plaintiff pleaded demand excuse and alleged a failure of director oversight. Because AIG has an exculpatory provision, the shareholder-plaintiff must plead with particularity that the directors acted with a conscious disregard of their duties or with intent to harm the shareholders in order to rebut the business judgment rule and demonstrate demand excuse. As discussed above, however, the standard necessary to demonstrate that an oversight failure amounts to a breach of fiduciary duty is unclear.

The Delaware courts in Caremark and Stone, the prominent decisions addressing oversight liability, provide some initial guidance to structuring an analytical approach within the narrow scope of oversight liability. In those cases, we see that the necessary conditions for director oversight liability are either that (1) "the directors utterly failed to implement any reporting or information systems or controls; or" (2) once having implemented such systems, the directors "consciously failed to monitor or oversee its operations." Public companies subject to regulatory and reporting regimes such as Sarbanes-Oxley, the Securities Act of 1933, and the Securities Exchange Act of 1934 will almost always be able to demonstrate that they have some

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164 The federal bailout was increased to $153 billion in November 2008 after the federal bailout plan was revised. Cheque Mate: How AIG got Uncle Sam over a Barrel, ECNOMONIST, Nov. 15, 2008, at 88-90.

165 The Individual Defendants . . . violated and breached their fiduciary duties of care, loyalty, reasonably inquiry, oversight, good faith and supervision. Each of the Individual Defendants had actual or constructive knowledge that they had caused the Company to improperly misrepresent the Company's business prospects and financial results." AIG Complaint, supra note 160, at 53. The shareholder-plaintiff also alleged that the directors failed to properly consider the interests of the Company [sic] and its public shareholders by failing to conduct proper supervision, paying out $3.7 billion to repurchase the Company stock, paying bonuses to certain of its executive officers and incurring potentially hundreds of millions of dollars of legal liability and/or legal costs to defend defendants' unlawful actions.

Id. at 54.

166 See Teachers' Ret. Sys. of La.v. Aidinoff, 900 A.2d 654, 668 (Del. Ch. 2006) ("AIG's charter contain[s] an exculpatory provision exempting directors from monetary liability for fiduciary breaches of the duty of care."")

167 See supra notes 119-27 and accompanying text.

168 See supra note 110 and accompanying text.

169 See In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996). Note that Caremark originally discussed the standard of director liability in duty of care cases. Id. Stone, however, applied the reasoning in a duty of loyalty context, which requires a higher standard of culpability (i.e., something more than gross negligence). See Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("Because a showing of bad faith conduct, in the sense described in . . . Caremark, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.")

168 Stone, 911 A.2d at 370 (emphasis omitted).
form of reporting or information systems in place; therefore, a shareholder-plaintiff (in a public company at least) will almost never be able to establish liability on the first prong of Caremark. The focal point for director oversight cases, thus, should be on the second prong, which discusses a conscious disregard of directorial duties. In contemplating what would constitute a conscious disregard, the Stone and the Caremark courts referred to "red flags" alerting the directors that certain managerial action is required.\textsuperscript{171} The Delaware courts have described a red flag as "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."\textsuperscript{172}

Using red flags as a means to identify when a director consciously disregards his or her duties creates a workable standard within the existing doctrine of oversight liability.\textsuperscript{173} A fact-intensive test to evaluate the existence of a red flag should consider the following: (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.\textsuperscript{174} By focusing on these elements to establish a conscious disregard,

\textsuperscript{171}"Under Delaware law, 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.'" Wood v. Baum, 953 A.2d 136, 143 (Del. 2008) (quoting In re Citigroup Inc. Shareholder Litig., No. 19827, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003)). In Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125 (Del. 1963), the Delaware Supreme Court first visited the theory of director liability for a failure of oversight duties. Id. at 127. Shareholders brought that case after subordinate employees engaged in unlawful price fixing with a competitor that resulted in the company's guilty plea to a violation of the Sherman Act and a series of resulting corporate losses. Id. at 128. Shareholders attempted to hold the directors liable for failure to be aware of and able to stop or prevent the price fixing. Id. at 127; see also Miller, supra note 121, at 934-37 (discussing the "ad hoc" approach taken in Graham, which provided the foundation for Chancellor Allen to refine his approach to director oversight liability in Caremark and Stone).

\textsuperscript{172}In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006). "[Director oversight liability] can be more narrowly interpreted as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." In re Caremark, 698 A.2d at 969 (summarizing the holding in Graham).

Note the author is proposing a standard within the existing legal framework. To incorporate this test, no doctrinal revision is necessary nor are any laws or regulations required. Rather, a court could simply incorporate the five-factor test proposed in this article into an analysis of director oversight liability pleaded as a breach of the duty of loyalty.


Instead of alleging facts that could demonstrate bad faith on the part of the directors, by presenting the Court with the so called "red flags," plaintiffs are inviting the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule. In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that
a court would avoid finding liability for a mere mismanagement of "business risk" and strike the correct balance between director authority and shareholder accountability.\textsuperscript{175}

The potential harm factor evaluates whether the risk of harm is substantial in light of the company's assets. Both the magnitude of the harm and its probability are components of this prong.\textsuperscript{176} For example, this element takes into account whether directors received a red flag regarding a $10 billion loss or a quarterly loss of $450 million to Bear Stearns.\textsuperscript{177} In terms of magnitude, a court would look not only to the dollar amount of the loss, but also to the percentage of the company that the loss represents, or the projected impact of that loss on future operations or viability of the company. Similarly, this prong takes into account the probability of the loss materializing when determining whether it should be classified as a red flag or not. A determination of the probability of the risk materializing will evaluate the type of forecast involved with the information (e.g., imminent, likely, etc.). Evaluating the potential harm to the company by looking to both the magnitude and probability shields directors from liability for petty

\textsuperscript{175}In re Citigroup S'holder Deriv. Litig., No. 07 Civ. 9841, 2009 WL 2610746, at *5-6 (S.D.N.Y. Aug. 25, 2009) (dismissing allegations of director oversight liability for failure to monitor "business risks"); In re Citigroup, 964 A.2d at 126-27 (dismissing allegations of director oversight liability on the same basis).

\textsuperscript{176}Measuring risk in terms of magnitude and probability is a common test used in securities fraud claims. See, e.g., Lormand v. US Unwired, Inc., 565 F.3d 228, 248 (5th Cir. 2009) ("The omission of a known risk, its probability of materialization, and its anticipated magnitude, are usually material to any disclosure discussing the prospective result from a future course of action."). Tort law also utilizes the relationship between magnitude and probability of risk to determine whether a duty existed. See, e.g., Satterfield v. Breeding Insulation Co., 266 S.W.3d 347, 365 (Tenn. 2008) (incorporating "the foreseeable probability of the harm or injury" and "the possible magnitude of the potential harm or injury" as two elements in the unreasonable and foreseeable risk analysis of torts); cf. BAINBRIDGE, supra note 9, at 108 (discussing the inverse relationship between tort and corporate law in the assignment of risk).

\textsuperscript{177}The shareholder plaintiff in this case alleged that

during the Relevant Period, the Company's value has declined more than $10 billion from its peak in February 2007, quarterly net income for the period ended in August 2007 sank 61% to $171.3 million, or $1.16 a share, from the year-earlier period and revenue fell to $1.3 billion from $2.13 billion last year.

Complaint at 3-4. Cohen v. Bear Stearns Co. (In re Bear Stearns Co. S'holder Deriv. Litig.), No. 07-CV-10453 (S.D.N.Y. filed Nov. 19, 2007). "By their allegations alleged herein, Individual Defendants, either directly or through aiding and abetting, abandoned and abdicated their responsibilities and fiduciary duties with regard to prudently managing the assets and business of Bear Stearns in a manner consistent with the operations of a publicly held corporation." Id. at 43.
complaints, insignificant losses, and unlikely risks, and instead focuses a court's attention on the information that should have put a reasonable director on notice that action (i.e., exercise of management duties) was required in order to prevent a substantial and likely loss.

The second factor, reaction time, also evaluates how the board exercised its duties, rather than the substantive decision that was made. The element borrows from tort law where the duty of care owed by a reasonable person in unforeseeable emergency circumstances incorporates the exigency of the situation.178 Similarly, courts should accept a broader range of director actions as complying with their fiduciary duties when responding to "corporate emergencies."179 Responsiveness is critical to director control as well as to shareholder protection.180 Whether or not a board took action and how it executed its oversight duties should be informed by the context in which those managerial decisions took place. Careful corporate planning and decisions should be made in all corporate settings, but in a traditional business judgment rule approach, such exacting standards are relaxed when the board is responding to the immediate and changing needs of the corporation.181 Incorporating the temporal aspect of the board's action or inaction

178See, e.g., RESTATEMENT (THIRD) OF TORTS §§ 29, 32 (Proposed Final Draft No.1 2005) (discussing the liability limitations upon rescuers responding to persons placed in imminent and serious harm through the negligent acts of third parties); Annotation, Liability for Death of, or Injury to, One Seeking to Rescue Another, 158 A.L.R. 189, 190 (1945) (stating that a rescuer, even if acting negligently, is not liable for harm done to the rescue during the rescue when placed in imminent and serious peril through the negligence of a third party).

179The author defines corporate emergencies as unplanned-for and unforeseen (not merely ignored) corporate events that pose significant potential threats to a corporation and its shareholders. This approach is consistent with Delaware law:

Likewise, a managerial commitment to timely decision making is likely to have systemic benefits but occasionally result in certain decisions being made that, with more time, might have come out differently. Courts should therefore be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith.

In re Lear Corp. S'holder Litig., 967 A.2d 640, 654 (Del. Ch. 2008).

180See Bainbridge, supra note 13, at 828 (arguing that Unocal illustrates the appropriate balance in the tensions between director authority and accountability).

181The Delaware courts have at least twice addressed the issue of corporate emergencies relaxing the standard of care required of directors. See In re NVF Co. Litig., No. 9050, 1989 WL 146237, at *7 (Del. Ch. Nov. 22, 1989), reprinted in 16 DEL. J. CORP. L. 361, 377-78 (1991) (evaluating whether circumstances regarding a defaulted loan constituted a corporate crisis sufficient to relax the duty of care standard). "While an emergency situation does not excuse the duty of care, it could be a factor in determining whether the directors in question have breached their duty." Id., reprinted in 16 DEL. J. CORP. L. at 378; see also Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1984) (finding that the directors' conduct did not satisfy their duty of care absent the "exigency of a crisis or emergency").
under review formalizes the totality-of-the-circumstances-like analysis in which courts often engage.\textsuperscript{182} For example, the due diligence of a board required to negotiate for a three-day merger offer is less than that required for a strategic company-initiated subsidiary sale.\textsuperscript{183} The court should adopt a similar sliding scale approach with regard to director oversight liability.

The third factor, the source of the red flag, is also a fact-specific, process-oriented approach. Under this prong, a court evaluates the directors' sources of information under a totality of the circumstances evaluation.\textsuperscript{184} Categories of sources of corporate information would include, but not be limited to, internal/external, direct/indirect, verifiable/opinion, and preliminary assessment/conclusion. For example, whether the source of the red flag was a financial analyst writing for the \textit{New York Times} about the overall health of a company's stock or an internal report that showed undercapitalization, over-valuation, and over-exposure to risk would be probative to a court's analysis of red flags. Under this approach, inside reports could be given more weight under some circumstances (e.g., evidence of internal control and auditing problems), and outside sources could be given more weight under other scenarios (e.g., evidence of corporate corruption or self-dealing). For instance, internal reports regarding undercapitalization of debt instruments, revenue projections, and other specific aspects of a corporation's health to which those "inside" (i.e., officers, employees, and directors) would have the greatest access to the most accurate information could carry more weight than external reports regarding these same metrics. Conversely, with legislative action, enforcement policies of regulatory agencies, and other potentially business-critical elements that are external to the

\textsuperscript{182}The totality of circumstances test as a mode of legal reasoning is a concept that is utilized in many different fields, all of which employ it as short hand for a fact-specific rather than a bright-line test. See, e.g., \textit{3 BANKR. SERVICE LAW. Ed.} § 27:1810 (2009) (describing the totality of circumstances test in deciding whether a debtor is entitled to undue hardship discharge of student loan obligations as "open-ended" and that the court has "broad latitude to consider any evidence that is relevant to [the] debtor's situation"); \textsc{black's law dictionary} 1628 (9th ed. 2009) (describing the totality of circumstances test in determining "the reliability of...hearsay evidence" as "focusing on the entire situation"); Robert B. McKinney & Mary Anne Pazanowski, \textit{Defamation and Privacy, in Ohio Jurisprudence} § 9 (3d ed. 2009) ("The totality of circumstances test...is fluid; every case must be analyzed on its own facts and the weight to be accorded to each of the four factors may vary depending upon the circumstances."); Sarah M. Knight, Note, United States v. Andrus: \textit{Password Protect Your Roommate, Not Your Computer}, 26 J. MARSHALL J. COMPUTER & INFO. L. 183, 184 n.7 (2008) ("The totality of circumstances test is an objective inquiry....").

\textsuperscript{183}But cf. \textit{in re WorldCom, Inc. Sec. Litig.}, 346 F. Supp. 2d 628, 669-71 (S.D.N.Y. 2004) (noting that underwriters' due diligence requirements under section 11 of the Securities Act are the same regardless of timing pressures).

\textsuperscript{184}See supra note 182 and accompanying text.
corporation, external reports would typically be given increased weight.\textsuperscript{185} Under this prong of the proposed test, the appropriate inquiry is not just the source itself, but what the source reveals about the reported information and whether it would convey the appropriate message of required action.

The fourth prong, frequency, assists a court in determining whether a director's failure to act was "conscious." Repeated exposure to and knowledge of a risk or problem increases the likelihood that a failure to act in

\textsuperscript{185}The Delaware Court of Chancery in \textit{In re Citigroup Shareholder Derivative Litigation}, 964 A.2d 106 (Del. Ch. 2009), rejected the following "red flags" plaintiffs claimed established a failure of directors to monitor business risks: (1) a 2005 article in the \textit{New York Times} regarding a potential burst in the housing bubble, (2) a 2007 bankruptcy filing by a subprime mortgage lender and a subsequent article regarding its business model, (3) Feddie Mac's 2007 announcement to refinance up to $20 billion of subprime loans, (4) a downgrade in rating by Standard & Poor's and Moody's of subprime backed bonds, (5) a 2007 bankruptcy filing by two Bear Sterns subprime mortgage-invested hedge funds, (6) a 2007 AIG warning regarding spreading subprime defaults, and (7) a reduction by Standard & Poor's in the credit rating of mortgage backed securities. \textit{Id.} at 115. These red flags were external to the company and did not specifically address Citigroup's investments or business models. Rather, these red flags were generalized statements and predictions about the future of a large segment of the financial and housing industries. These red flags amounted to little more than market-projected trends that rightfully were found not to give rise to a duty of the Citigroup directors to act. Sufficiently pled allegations of red flags, under the test proposed above, could have included internal reports regarding undercapitalization, increasing default rates upon Citigroup investments that matched or outpaced industry predictions, credit downgrades of Citigroup and its investment subsidiaries or bankruptcy filings by Citigroup subsidiaries. Something more than the business news headlines must be required to demonstrate red flags sufficient to give rise to potential director liability for failed oversight. "The only factual support plaintiffs provide for this conclusion are 'red flags' that actually amount to nothing more than signs of continuing deterioration in the subprime mortgage market. These types of conclusory allegations are exactly the kinds of allegations that do not state a claim for relief under Caremark." \textit{Id.} at 130.

On the other hand, in \textit{McCall v. Scott}, 239 F.3d 808 (6th Cir. 2001), the Sixth Circuit held that plaintiffs' allegations of red flags obtained from internal audit report demonstrated unmistakable signs that improper practices were being employed throughout the corporation... [including] discrepancies between cost reports submitted to the government and secret reserve reports; improper inclusion of money spent on physician recruitment, marketing, and advertisement with claims for patient care reimbursement; improper shifting of costs from inpatient to outpatient services to get higher reimbursement rates; and extra fees paid to referring physicians...[and] statistical evidence of widespread illegal 'upcoding' in the form of consistently above-average reimbursements... . . . Plaintiffs alleged that the directors knew that such a rate of growth was not realistically attainable absent fraud. \textit{Id.} at 820. The red flags were internal sources containing information regarding the company's specific and current practices. \textit{Id.} Additionally, the allegations claimed that such information was known to the directors who had repeated access to the information and sufficient time to react. \textit{Id.} at 823-24. It should be noted, too, that the claims in \textit{McCall} arise from a hospital corporation and have similarities to the underlying claims in \textit{Caremark}, which are absent in \textit{In re Citigroup} and other derivative actions arising from the subprime mortgage crisis.
response to it would constitute a "conscious disregard." Similarly, the fifth prong evaluates whether the information contained in the red flag was readily available to the board of directors. This prong could facilitate a finding that the directors acted with a conscious disregard even if, for example, the "flag" was not raised frequently, but could have been—or more importantly should have been—as a part of regular reporting and monitoring functions, because the information was readily available to the board. Additionally, any duty of care analysis does not just ask what the directors subjectively knew, but evaluates what a reasonable director in their position would have known. This fifth prong acts as a disincentive for directors to shield themselves from liability with willful ignorance. The fourth and the fifth prongs work together to promote and encourage an informed and engaged board of directors.

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186 See Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006) ("A failure to act in good faith may be shown . . . where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." (quoting In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006)).

187 See, e.g., Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[T]he directors'] duties are those of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts of the particular case."); see also BAINBRIDGE, supra note 9, at 96 ("The duty of care requires corporate directors to exercise 'that amount of care which ordinarily careful and prudent men would use in similar circumstances.'" (quoting Graham, 188 A.2d at 130)).

188 Additionally, boards should be comprised of a mix of independent as well as inside directors. Nasdaq Best Practices require that a majority of the board be comprised of independent directors. NASDAQ, Inc., Stock Market Rules § 5605(b)(2) (2009), available at http://www.nasdaq.cchwallstreet.com; accord NYSE, Inc., Listed Company Manual § 303A.01 (2009), available at http://www.nysemanual.nyse.com/LLM/Sections. The traditional corporate law model has focused on the cleansing power of the independent director. See Teachers' Ret. Sys. of La. v. Aidinoff, 900 A.2d 654, 669 (Del. Ch. 2006) ("The informed approval of a conflict transaction by an independent board majority remains an important cleansing devise under our law and can insulate the resulting decision from fairness review under the appropriate circumstances."); see also Clarke, supra note 35, at 84 (stating that independent directors "serve as a check on management") and have "no need or inclination to stay in the good graces of management"); Gordon, supra note 47, at 1493-99 (discussing the evolution and role of independence in corporate governance including special committees, lead director meetings, and nomination committees); Donald C. Langevoort, Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty, 83 WASH. U. L.Q. 1017, 1018-19 (2005) (arguing that independent directors "add value as a form of shareholder protection" but still more oversight is required). However, having inside directors serve on a board prevents the board from claiming a "head in the sand" approach. And, as Berle and Means theorized, it is the officers who have the best access to information and their finger on the pulse of the corporation. See BERLE & MEANS, supra note 15, at 229-33; see also Bainbridge, supra note 13, at 862 (implying that it is corporate managers (officers) who ultimately control the corporation, not the directors). The dual roles of inside directors (officers who also serve as directors) should prevent a board from declaring ignorance and seeking a liability shield as a result. See, e.g., Stephen M. Bainbridge & Christina J. Johnson, Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307, 2004 MICH.
The proposed red flag standard would not promote a culture of ignorance in order to avoid liability by rewarding directors who do nothing to know the state of the corporation. First, the Caremark standard states that a complete absence of information and reporting systems could constitute a failure of the duty to oversee. Second, as discussed above, regulatory requirements such as Sarbanes-Oxley and others enforced by the SEC require that some reporting and information systems (e.g., audit controls) be in place. Thus, directors may not shield themselves entirely from liability through ignorance because they are statutorily required to have some knowledge of the company.

In order to demonstrate to a court that a red flag existed, a plaintiff would not necessarily have to plead all five factors. Rather, a court evaluating the complaint will weigh the totality of the facts and circumstances alleged under these five factors, along with any other relevant information, to perform a procedural review of red flags. If a court finds that

ST. L. REV. 299, 305 (explaining that Sarbanes-Oxley "constitute[s] a substantial effort to shift the balance of power from management to the independent directors"); Ribstein, supra note 48, at 12 (stating that independent board committees can help reveal appropriate information to the board of directors and shareholders alike). The knowledge of the officer or inside director also should be imputed to the board. This provides incentives for the outside or independent directors to overcome their knowledge gaps and actively engage in their monitoring roles. Also, the statutorily defined roles of independent directors as found in Sarbanes-Oxley, for example, ensures that the independent directors still play a meaningful role in the corporation and serve as a check against self-dealing. See id.

Professor Bainbridge analogized the Graham opinion to the one-bite rule for animals in torts, where an owner of an animal is not liable in tort for an injury resulting from a bite unless the animal has bitten before, which should have put the owner on notice of the need to take additional safety precautions. See Bainbridge, supra note 48, at 557-78. The Graham opinion, the genesis of the red flags language in Caremark, held that directors are entitled to rely on the assumption that their subordinates are working honestly and in compliance with the law until something (or someone) gives them notice otherwise. Graham, 188 A.2d at 130-31.


Justice Holland describes the scope of bad faith conduct:

"A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient."

Stone, 911 A.2d at 369 (emphasis added) (quoting In re Walt Disney Co., 906 A.2d at 67).
red flags existed (or were likely to have existed), the plaintiff will be able to proceed with his or her case under the duty of loyalty, having pleaded sufficient facts to establish a likely breach of fiduciary duty, rather than have the case thrown out at the motion to dismiss stage. This test creates a fact-specific inquiry that remains true to the traditional business judgment rule approach and is mindful of striking an appropriate balance between accountability and authority. A court, in evaluating whether a red flag existed, would be able to make such a determination by focusing solely on the process taken by the board and the information available to it rather than evaluating the substantive decision made by the board. This fact-specific approach fits within the existing doctrinal framework and offers a solution to the default deference to director authority that is created in the absence of articulated standards of oversight liability. It also respects and recognizes that directors, not courts or shareholders, are in the best position to make corporate decisions. This test promotes appropriate behavior and punishes only egregious inaction in order to strike the appropriate balance between director authority and accountability. Similarly, the test does not promote judicial interference; rather, it requires director decisions and management by encouraging corporate monitoring, knowledge, engagement, and action benefiting both the short- and long-term health of the company.

V. CASE STUDIES—SHIFTS IN THE CORPORATE POWER PUZZLE

Several recent Delaware Court of Chancery opinions illustrate the narrowing scope of oversight liability and the associated deference to authority: i2 Technologies, Lear, and Lyondell. These cases also illustrate how the proposed five-factor test articulates a standard for oversight liability that strikes the appropriate balance between authority and accountability. In two of the three cases, the result under the proposed test is the same as was reached under the current doctrine, demonstrating that the proposed test is narrow in scope and application, but important in establishing an equilibrium between director authority and shareholder accountability within the corporate power puzzle.

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192 See, e.g., McCall v. Scott, 239 F.3d 808, 819-20 (6th Cir. 2001) (finding demand excuse for fiduciary duty claims based in part on allegations that the directors failed to act in the face of "red flags"); In re Am. Intl Group, Inc., 965 A.2d 763, 777 (Del. Ch. 2009) (denying defendants' motions to dismiss failed director oversight claim where the pleadings gave rise to the "fair inference that defendants knew that AIG's internal controls and compliance efforts were inadequate").
A. McPadden v. Sidhu (i2 Technologies)

The first, *i2Technologies*, is a case where the plaintiff alleged that the board of directors breached its duty of oversight during the sale of a subsidiary. The board initiated the sale process after learning of a competitor's interest in the company. It appointed Mr. Dubreville, the president of the subsidiary, to be in charge of the subsidiary's sale with the knowledge that Dubreville was interested in purchasing the subsidiary himself. Despite having this knowledge, the board exercised "little to no oversight" over the sale process. Dubreville oversaw the sale process, but failed to contact competitors to bid on the subsidiary, and he relied on outdated and low-dollar financial projections to value the subsidiary. In addition, he submitted only three bids to the board, one of which was his own, and the other two were allegedly sham bids. Ultimately, Dubreville purchased the subsidiary for $3 million and sold it five months later for $25 million to a competitor who was originally interested in purchasing the subsidiary.

In the *i2Technologies* suit, the complaining shareholder sued the self-dealing officer, Dubreville, as well as the board members who failed to adequately oversee the sale process. The shareholder-plaintiff, however, did not make a pre-suit demand upon the board and argued demand futility. In evaluating demand excuse, the court held that the plaintiff had not rebutted the business judgment rule for purposes of demand excuse because *i2 Technologies* had an exculpatory provision; therefore, there could be no director liability for duty of care claims. Additionally, the court held that the plaintiff failed to plead with particularity that the nonfeasance directors acted with either intent to harm or a conscious disregard of their duties in order for the oversight claim to be cast as a breach of the duty of loyalty. The result is that the directors knew of Dubreville's conflict yet failed to act in the shareholders' best interest by appointing him to be in charge of the sale and approving his bid without sufficient inquiry into the process.

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194Id. at 1265.
195Id. at 1266-67.
196Id. at 1271.
197*i2 Technologies*, 964 A.2d at 1267.
198Id.
199Id. at 1263.
200Id. at 1264.
201*i2 Technologies*, 964 A.2d at 1270.
202Id. at 1275.
203Id.
204See id. at 1271.
Regardless, because of the narrow scope of oversight liability and the preference for director authority in this context, the case against the nonfeasance directors was dismissed.\textsuperscript{205}

Under the proposed test, however, the shareholder derivative complaint in \textit{i2 Technologies} would survive the motion to dismiss by rebutting the business judgment rule with a finding of red flags. The facts of the \textit{i2 Technologies} case demonstrate (1) a high potential harm to the company, (2) sufficient time to react to the planned-for corporate event, (3) reliable internal sources providing notice of the red flag, (4) frequent and repeated exposure to the red flag, and (5) access to the necessary information in order to evaluate the red flag. The ultimate harm to \textit{i2 Technologies} was the loss of over $20 million resulting from the sale of the subsidiary at $3 million to the officer overseeing the sale process, who later resold the subsidiary for over $2.5 million.\textsuperscript{206} The board of directors, after deciding to sell the subsidiary, had four months to complete the sale process; thus, the board was not operating under a corporate emergency.\textsuperscript{207} The sources of the red flags in this case were both internal and reliable. At the December 2004 board meeting, when the board decided to sell the subsidiary and appointed Dubreville to conduct the sale, "Dubreville had already discussed with i2 the possibility of leading a management buyout of [the subsidiary]."\textsuperscript{208} Dubreville himself was the source of the information—an officer of the company, the person charged with the sale, and an offeror for the subsidiary. Finally, the board of directors had several opportunities to discuss the possible conflict of interest when the proposed management buyout was discussed at three separate board meetings in February, March, and April of 2005.\textsuperscript{209}

The facts of \textit{i2 Technologies} satisfy all five elements of the proposed process-oriented review of red flags. The facts of the case show that red flags had been raised, and that the directors' failure to oversee the sale process constituted a conscious disregard of their duties sufficient to demonstrate a likely breach of a fiduciary duty (i.e., loyalty/good faith) in order to rebut the business judgment rule. The board could have selected another officer to conduct the sale, but instead chose Dubreville. The board had

\footnotesize{\textsuperscript{205}See \textit{i2 Technologies}, 964 A.2d at 1275. Note that because exculpatory provisions cover only directors, Dubreville, as an officer of \textit{i2 Technologies}, faced liability for breaching both his fiduciary duties of care and loyalty. \textit{Id.} at 1275-76.}

\footnotesize{\textsuperscript{206}Id. at 1263.}

\footnotesize{\textsuperscript{207}See \textit{id.} at 1266-67. The board of directors decided to sell the subsidiary in December 2004 and signed the letter of intent with Dubreville, the officer and buyer, on April 22, 2005. \textit{Id.}}

\footnotesize{\textsuperscript{208}Id. at 1271.}

\footnotesize{\textsuperscript{209}i2 Technologies, 964 A.2d at 1266-67.}
notice of the red flag from the most reliable source (Dubreville himself), had plenty of time to respond, and yet failed to do so even after considering the conflict of interest on several occasions. Under the proposed test, the plaintiff in *i2 Technologies* could have proceeded against the nonfeasance directors and for wrongs that amounted to more than mismanagement of business risks. The result would be director liability for failing to engage in conduct that satisfies a process-oriented, fact-specific review of their actions (and inaction), an approach that does not engage in the type of judicial second-guessing that is disfavored in corporate law. Additionally, it strikes the appropriate balance between authority and accountability within the corporate power puzzle.

B. *In re* Lear Corp. Shareholder Litigation

*In re Lear Corp. Shareholder Litigation* provides another recent example of director oversight liability. The plaintiff alleged that the board approved a merger plan with the belief that the shareholders would reject it, which they did, resulting in a no-vote termination fee of $25 million. The shareholders brought a derivative suit alleging a failure of the directors' oversight duties. Because Lear had an exculpation clause precluding a duty of care claim, the complaining shareholder was required to plead with particularity that the defendant directors "breached their duty of loyalty by making a bad faith decision to approve the merger for reasons inimical to the interests of the corporation and its stockholders." To satisfy the demand futility test, the shareholder relied upon the second prong of *Aronson*, arguing that the transaction was not the product of a valid exercise of business judgment—in other words, that the board members breached their fiduciary duties of care in approving it. The exculpatory provision, however, required that the plaintiff plead a non-exculpated claim that the directors breached their fiduciary duty of loyalty by acting in bad faith.

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211967 A.2d 640 (Del. Ch. 2008).

212Id. at 641.

213Id. Plaintiffs also alleged that the director defendants breached their *Revlon* duties, which requires directors when selling corporate assets "to take reasonable steps to obtain the highest price reasonably available." Id. at 643 (citing *Revlon*, Inc. v. *MacAndrews & Forbes* Holdings, Inc., 506 A.2d 173 (Del. 1986)).

214Id. at 641.

215In re Lear, 967 A.2d at 647-48.
against the best interests of the corporation.\textsuperscript{216} The claims ultimately failed because the court found that the board used an adequate process to approve the merger.\textsuperscript{217} Vice Chancellor Strine held that there was no evidence that the board knew that the shareholders would vote down the merger, although it was aware of at least one institutional investor with concerns.\textsuperscript{218} The court concluded its opinion by observing that one of the "hardest" questions in corporate law is defining the standard of liability to apply to independent directors charged with nonfeasance.\textsuperscript{219} The court then reaffirmed that independent directors will be culpable in the monitoring context only if their lack of oversight rises to the level of a breached duty of loyalty by a "sustained or systematic failure . . . to exercise oversight" or where directors "were conscious of the fact that they were not doing their jobs [as monitors]."\textsuperscript{220}

The facts of \textit{Lear}, analyzed under the proposed test, produce a different result than \textit{i2 Technologies} because no red flags existed. Applying the proposed test reaches the same result as the Delaware Court of Chancery.

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\textsuperscript{216}Id. at 648.
\textsuperscript{217}Id. at 641. Such procedures included employing reputable financial and legal experts, creating a special committee of independent directors, implementing a forty-five-day go-shop provision, and negotiating an increased share price after the board became aware of shareholder resistance to the proposed merger. \textit{See id.} at 644-47.
\textsuperscript{218}Id. at 651.
\textsuperscript{219}In re \textit{Lear}, 967 A.2d at 653. Vice Chancellor Strine continued by stating: The line of cases running from \textit{Graham v. Allis-Chalmers} to \textit{Caremark} to \textit{Guttmann} to \textit{Stone v. Ritter} dealt in large measure with what is arguably the hardest question in corporation law: what is the standard of liability to apply to independent directors with no motive to injure the corporation when they are accused of indolence in monitoring the corporation's compliance with its legal responsibilities? . . . But it must be answered because one of the central justifications for the use of independent directors is that they are well positioned to oversee management, particularly by monitoring the processes used by the corporation to accurately account for its financial affairs and comply with applicable laws. . . . Although everyone has off days, \textit{fidelity to one's duty is inconsistent with persistent shirking and conscious inattention to duty}. For this reason, \textit{Caremark} and its progeny have held that directors can be held culpable in the monitoring context if they breach their duty of loyalty by "a sustained or systematic failure . . . to exercise oversight," or "were conscious of the fact that they were not doing their jobs [as monitors]." More generally, our Supreme Court has held that to hold a disinterested director liable for a breach of the fiduciary duty of loyalty for acting in bad faith a strong showing of misconduct must be made[,] . . . such as intentionally acting "with a purpose other than that of advancing the best interests of the corporation," acting "with the intent to violate applicable positive law," or "intentionally fail[ing] to act in the face of a known duty to act." \textit{Id.} at 653-54 (emphasis added and footnotes omitted) (quoting \textit{In re Walt Disney Co. Deriv. Litig.}, 906 A.2d 27, 67 (Del. 2006); \textit{Guttmann v. Huang}, 823 A.2d 492, 506 (Del. Ch. 2003); \textit{In re Caremark Int'l Inc. Deriv. Litig.}, 698 A.2d 959, 971 (Del. Ch. 1996)).
\textsuperscript{220}Id. at 653 (quoting \textit{Guttmann}, 823 A.2d at 506; \textit{In re Caremark}, 698 A.2d at 971).
In *Lear*, the shareholder plaintiffs complained that the board of directors breached their fiduciary duties by approving a termination fee of $25 million in exchange for a $1.25/share increase when the board knew that the shareholders would not approve the merger.\(^{221}\) Under the facts of *Lear*, the potential harm was significant in magnitude—a $25 million termination fee—but the probability that it would materialize was insufficient. After concern from the board that the shareholders would not approve the merger, the shareholder vote was delayed beyond the initial forty-five day go-shop provision.\(^{222}\) During the following ten days, Lear's CEO negotiated with the buyer for better terms to encourage shareholder approval.\(^{223}\) Ultimately, the merger price was increased by $1.25 per share in exchange for Lear's offer of a $25 million termination fee.\(^{224}\) While the board had several months to investigate the merger, the termination fee of which the plaintiff complained was negotiated in the last ten days of the deal, after a delayed shareholder vote and threats of killing the deal.\(^{225}\) The termination fee was not an original deal term, but was the result of the board's need for emergency action to save the deal by securing shareholder approval.\(^{226}\) Thus, the board should be entitled to more leniency from a reviewing court because the decision was made under a corporate emergency.

Additionally, the source of the red flag in *Lear* was external and was not as reliable as it was in *i2 Technologies*. The *Lear* board first learned of shareholder concern over the merger terms from its advisors who had met with the company's largest shareholders, just days before the originally scheduled shareholder vote.\(^{227}\) As the additional deal terms were being renegotiated, shareholders, including one of the plaintiffs in the case, communicated to the board that a price increase of at least $1.00 would be sufficient to approve the merger.\(^{228}\) Acting on this information, the ultimate share increase of $1.25 was negotiated in exchange for the challenged termination fee.\(^{229}\) Before the board's approval of the revised terms, it became aware that ISS, a proxy voting advisory service, was concerned about the lack of stub equity in the deal, but the board directed ISS to talk to

\(^{221}\) *Id.* at 641.
\(^{222}\) *Id.* at 644-45.
\(^{223}\) *In re Lear*, 967 A.2d at 645.
\(^{224}\) *Id.* at 646.
\(^{225}\) *Id.* at 645-46.
\(^{226}\) See *id*.
\(^{227}\) *Id.* at 644-45.
\(^{228}\) *Id.* at 645.
\(^{229}\) *Id.* at 645-46.
the buyer regarding its absence. 230 Believing that shareholder support was likely secured (thus a low probability of paying the $25 million termination fee), the board approved the merger. 231 In sum, red flags were not repeatedly raised outside of the ten-day window between the delayed shareholder vote and the board's approval of the revised merger terms. Additionally, the sources of information regarding the red flags in this case were not concrete, were external to the company, and were not readily available to the directors.

In Lear, we see the need for deference to director authority and how judicial second-guessing could chill entrepreneurial risk in the boardroom. Boards do not have to make good decisions all of the time or accurately calculate the risks involved in any one decision; however, boards are required to perform their oversight duties in a reasonable manner in the best interests of the shareholders and the corporation. In Lear, we see that the board learned of shareholder opposition, took steps to alleviate it, negotiated more favorable terms, and voted to approve the merger after receiving some shareholder information that new terms would be acceptable to objecting shareholders. Lear does not present the case of an absentee board that was not responsive to the needs of the corporation and the shareholders. Quite to the contrary, the directors in Lear took decisive action in the face of the initial red flag (inadequate proxy support) and did not have conclusive evidence or substantial reason (low probability) to believe that the shareholders would reject the revised merger terms. The plaintiffs' failed oversight claims (i.e., bad faith) alleged that the directors approved a merger they knew was "almost certain not to be approved," 232 which was not supported by the facts. 233 At best, the directors in Lear were forced to make a close call—a difficult business decision—the very kind which should be protected by the business judgment rule and not rebutted by a finding of red flags. 234 This case illustrates the positive aspects of the business judgment rule and that such restraint in assessing liability is appropriate when the facts

230 Id. at 646.
231 In re Lear, 967 A.2d at 646.
232 Id. at 653.
233 See id. ("[The plaintiffs] plead no particularized facts that support these inflammatory and conclusory charges of wrongdoing.").
234 Vice Chancellor Strine states:
It would be inconsistent with the business judgment rule for this court to sustain a complaint grounded in the concept that directors act disloyally if they adopt a merger agreement in good faith simply because stockholders might (?), were likely (?), or were almost certain (?) to reject it. This sort of speculative second-guessing may be good fun for sports talk shows or political pundits, but it is not the stuff of which duty of loyalty case law is made.

Id. at 655.
of the case do not constitute directorial abuse and intentional disregard of known duties to act. While the result in *Lear* under the proposed test is the same as the court reached, articulating a five-factor, fact-based analysis in order to reach that conclusion lends credibility to the decision by making it appear less ad-hoc or value-driven and more defensible on appeal.\(^{235}\) Additionally, adopting the proposed test would add consistency to the body of law analyzing director oversight cases, and would inform the conduct of future board members (and their counsel).

C. *Lyondell Chemical Co. v. Ryan*

*Lyondell Chemical Co. v. Ryan*\(^{236}\) provides a third and final example of oversight liability claims. The Delaware Court of Chancery denied the director defendants' motion for summary judgment, but was reversed by the Delaware Supreme Court, which found that the directors had not breached their duty of loyalty for failure of oversight.\(^{237}\) *Lyondell* is a shareholder derivative suit that challenged a $13 billion cash-for-shares merger transaction.\(^{238}\) The acquiring company obtained a right to purchase Lyondell shares and made an unsolicited offer to merge.\(^{239}\) Negotiations stalled while the acquirer pursued an alternative target simultaneously, but quickly resumed with an offer of $48 per share, which represented a substantial premium over market.\(^{240}\) Thereafter, negotiations proceeded on an accelerated track over the next six days and were principally overseen by the CEOs of the two companies.\(^{241}\) At a subsequent special meeting, the board reviewed the proposed merger agreement, received the recommendation of Deutsche Bank, their independent financial advisor, and voted to approve the

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Scholars cite the need for uniformity and stability as mandating stare decisis, and assign the responsibility for maintaining the law's uniformity to the appellate courts. Nevertheless, the judiciary is a culture of comity, and the same desire for uniformity (and, to a lesser extent, stability) motivates judges to consider decisions from the trial courts.


\(^{237}\) *Id.* at 235.

\(^{238}\) *Id.* at 237.

\(^{239}\) *Id.* at 239.

\(^{240}\) *Id.* at 237.

\(^{241}\) *Id.* at 238.
merger. Ryan brought the suit alleging that the board's approval process was fatally flawed by its rushed nature and failure to comply with Revlon duties to maximize shareholder value. Ryan's claims were essentially that the board failed to oversee the merger negotiations in violation of its duty of oversight.

The Delaware Court of Chancery found that the negotiation process was inadequate, the deal protections for the acquirer too onerous, and the board's decision to "disregard the possibility of conducting even a discrete and targeted market check to pitch a sale of the entire Company or the possibility of breaking it up into more valuable parts," a potential breach of oversight. The Delaware Supreme Court reversed the Court of Chancery in a unanimous opinion written by Justice Berger on an interlocutory appeal.

The Delaware Supreme Court noted that the trial court record demonstrated likelihood that the director defendants breached their duty of care in overseeing the sale process, but that Lyondell's exculpatory charter provision protected the directors from personal liability for such claims. Liability in Lyondell turned on whether the directors' failure "also implicate[d] their duty of loyalty." Thus, the "sole issue" before the court in Lyondell was "whether the directors [were] entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith." Ultimately the Delaware Supreme Court reversed the denial of summary judgment on the grounds that the trial court imposed Revlon

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242 Id. at 238-39.
244 Lyondell, 970 A.2d at 239.
245 See id. at 241-42 (describing the interplay between the directors' duties under Revlon and their more general oversight responsibilities).
247 Lyondell, 970 A.2d at 237 ("The Court of Chancery decided that 'unexplained inaction' permits a reasonable inference that the directors may have consciously disregarded their fiduciary duties. . . . There is no evidence, however, from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty.").
248 Id. at 239.
249 Id.
250 Id. at 239-40.
251 Lyondell, 970 A.2d at 244. The court held that the trial court record contained "several undisputed facts" that would have warranted summary judgment in favor of the director defendants. [T]The directors were "active, sophisticated, and generally aware of the value of the Company and the conditions of the markets in which the Company operated." They had reason to believe that no other bidders would emerge, given the price Basell had offered and the limited universe of companies that might be interested
duties before they were triggered, interpreted Revlon duties as requiring compliance with certain procedural sale elements, and "equated an arguably imperfect attempt to carry out Revlon [sic] duties with a knowing disregard of one's duties that constitutes bad faith." Noting that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties," the court stated that "[o]nly if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty." Analyzing Lyondell under the proposed standard yields the same result as the Delaware Supreme Court reached. As in Lear, the facts of Lyondell do not demonstrate the existence of red flags that should have triggered a duty for the board to take certain actions. The primary allegation of failed oversight related to the director defendants' failure to execute their Revlon duties. The potential harm in this case is difficult to measure because it is the loss of a potential (and purely speculative) per share price increase. The record is clear, though, that Lyondell received no other bids even though the market had knowledge of the potential merger after the acquirer filed a

in acquiring Lyondell's unique assets. Smith negotiated the price up from $40 to $48 per share—a price that Deutsche Bank opined was fair. Finally, no other acquiror expressed interest during the four months between the merger announcement and the stockholder vote.

Id. at 241 (quoting Ryan, 2008 WL 2923427, at *13, reprinted in 34 DEL. J. CORP. L. at 356).

252 See id. at 242.

The problem with the trial court's analysis is that Revlon duties do not arise simply because a company is "in play." The duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control. . . . The time for action under Revlon did not begin until . . . the directors began negotiating the sale of Lyondell.

Id. (footnotes omitted).

253 See id. at 243.

The Lyondell directors did not conduct an auction or a market check, and they did not satisfy the trial court that they had the "impeccable" market knowledge that the court believed was necessary to excuse their failure to pursue one of the first two alternatives. As a result, the Court of Chancery was unable to conclude that the directors had met their burden under Revlon. In evaluating the totality of the circumstances, even on this limited record, we would be inclined to hold otherwise.

Id. at 241. Justice Berger describes the efforts of the directors to secure a higher price: The Court of Chancery focused on the directors' two months of inaction, when it should have focused on the one week during which they considered Basell's offer. During that one week, the directors met several times; their CEO tried to negotiate better terms; they evaluated Lyondell's value, the price offered and the likelihood of obtaining a better price; and then the directors approved the merger.

Id. at 242.

254 Id. at 241. Lyondell, 970 A.2d at 243-44.
Schedule 13D.\textsuperscript{256} Deutsche Bank, Lyondell's independent financial advisor, projected $51.50 per share as the very top price range of a valuation,\textsuperscript{257} making a top estimate of harm to be approximately $3.00 per share (or an additional $948 million).\textsuperscript{258} Even though the board knew about the acquirer's interest in the company, the merger negotiations did not begin until July 10th and concluded on the 16th.\textsuperscript{259} The board had a scant six days to assess the offer, comply with Revlon duties, and complete the transaction—they were operating in the context of a corporate emergency.

Looking to the third, fourth, and fifth factors which all relate to notice, the most telling part of the analysis emerges because the board had no clear source of information indicating that the $48 per share was not a top premium offer.\textsuperscript{260} The argument evident in the Court of Chancery's reasoning is that Revlon duties in a sale transaction create a de facto red flag that cannot be ignored by the board without violating the duty of loyalty. The Delaware Supreme Court concluded, however, that the Revlon duties were not ignored, but had been satisfied because the directors were "active, sophisticated, and generally aware of the value of the Company";\textsuperscript{261} that there were no other viable bidders within their niche market; and that their independent financial advisors endorsed the offer price as "fair."\textsuperscript{262} While


\textsuperscript{257}Id. at *8, reprinted in 34 DEL. J. CORP. L. at 346.

\textsuperscript{258}See id. (stating that the share's actual value was $48.00, which represents a $3.50 difference between actual and projected values).

\textsuperscript{259}Id. at *5-8, reprinted in 34 DEL. J. CORP. L. at 342-46.

\textsuperscript{260}The plaintiff primarily complains that the board did not have enough information to properly evaluate the offer. The lack of information, rather than the disregard of known information, is more accurately a duty of care allegation, rather than a duty of loyalty via oversight duties allegation. The court explains:

In substance, Ryan complains about the process employed by the Board in agreeing to sell the Company to Basell. Those complaints relate primarily to the Board's fiduciary duty of care, and on summary judgment the Court cannot conclude that Ryan would be unable to prove a breach of that duty at trial. If he only succeeded in that endeavor, however, the Lyondell stockholders would not be entitled to money damages, the only remedy now otherwise available, because Lyondell had an exculpatory charter provision adopted in accordance with 8 Del. C. § 102(b)(7). Accordingly, Ryan can only prevail on his Revlon claims by overcoming the protection afforded to the Board by Lyondell's exculpatory charter provision; in other words, because the Board was independent and not impermissibly motivated by self-interest, Ryan must demonstrate that the Board either failed to act in good faith in approving the Merger or otherwise acted disloyally.


\textsuperscript{262}Id. at 238.
the board met to discuss the merger on four separate occasions, such discussions did not include any reliable or readily available sources of information indicating that the offer price was inadequate or required market tests. Without these crucial prongs of information, a Caremark, red-flag analysis is not appropriate in this case. Had the Lyondell board been faced with conflicting valuation reports, alternative offers, or other reason to doubt the validity of the negotiation process, then the analysis would be different. As it stands, the plaintiff in Lyondell predominantly stated a breach of the duty of care, which was exculpated.

As demonstrated in this section, the proposed red flag standard does not attempt to expand director oversight liability, but instead articulates the circumstances under which it arises and should be enforced. The proposed test should provide guidance to courts faced with claims of director oversight liability in shareholder derivative suits arising from the market turbulence of 2008 and 2009, as well as help discourage meritless strike suits.

VI. CONCLUSION

Shareholder derivative suits are one mechanism to enforce and encourage compliant director behavior. The confluence of exculpatory provisions, the collapse of the duty of good faith and loyalty into a single liability standard, and the role of the business judgment rule in shareholder derivative suits has created an environment in which virtually no oversight claims could survive a motion to dismiss. The current doctrine of oversight liability, looking at the substantive and procedural footing, is skewed so far towards director authority that it is an eviscerated and meaningless tool of accountability. Reevaluating oversight liability and establishing a process-oriented test within the existing fiduciary duty and derivative suit frameworks appropriately sets the fulcrum point between authority and accountability within the corporate power puzzle. By focusing on red flags to define when directors display a conscious disregard of their oversight duties, shareholders can have a limited, but meaningful, enforcement tool and participate in the corporate power puzzle while still respecting the ultimate authority of the board to make business decisions. A process-oriented approach also keeps mere failures to monitor business risks outside of the purview of oversight liability, instead focusing judicial attention on facts establishing failure to act in the face of a known duty.

263 See id. at 244 ("[The directors] were generally aware of the value of their company and they knew the chemical company market.").
As the subprime shareholder derivative suits work their way through the system, courts have a well-timed opportunity to explore, define, and consistently apply an analytical framework to allegations of oversight liability. Courts should seize upon this opportunity to clarify director oversight liability under the proposed five-factor test to determine red flags. By looking at (1) the potential harm to the company, (2) the time to react, (3) the source of the red flag, (4) its frequency, and (5) the availability of the information, a court faced with a director oversight claim will be able to determine whether the directors acted with a conscious disregard of their duties in the face of red flags sufficient to establish oversight liability under the duty of loyalty. This approach is narrow in scope, but important in establishing an equilibrium between director authority and shareholder accountability within the corporate power puzzle.