

# RECONSIDERING BOARD OVERSIGHT DUTIES AFTER THE FINANCIAL CRISIS\*

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*The financial crisis has yielded significant losses for shareholders, and for the greater society. Shareholder suits arguing that boards should have been more active monitors have failed. We argue here for an expansion of board monitoring duties. The crisis suggests that corporations may sometimes abuse the privilege of limited liability. Boards should be charged with monitoring for risks arising from corporations' operations and procedures (including their compensation practices) that might significantly harm both shareholders and society at large.*

## I. INTRODUCTION

A suit alleging a breach of fiduciary duty by reason of a board's failure to monitor has famously been characterized as one of the hardest for shareholders to win.<sup>1</sup> Indeed, this characterization follows logically and directly from the way in which fiduciary duties have come to be articulated. After *Stone v. Ritter*, the duty at issue in board monitoring would be the duty of good faith, now subsumed within the duty of loyalty.<sup>2</sup> A breach of the duty of good faith requires affirmative bad faith—in this context, an intentional failure to act, in conscious disregard of one's duty to act.<sup>3</sup> But conceptually, grammatically, and logically, most examples of “failures” that come readily to mind are passive, not active—hence the extreme difficulty plaintiffs have in prevailing.

The financial crisis helps make the case that boards should do more

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\* We thank Daniel Sokol and participants at the *In the Boardroom: Corporate Governance Meets The Real World* symposium for helpful comments.

1. See *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996); see also Robert T. Miller, *The Board's Duty to Monitor Risk After Citigroup*, 12 U. PA. J. BUS. L. 1153, 1163 (2010).

2. *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006); see also Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporate Law*, 4 VA. L. & BUS. REV. 333, 341 (2009).

3. See Hill & McDonnell, *supra* note 2, at 342, 343 n.37, 353.

monitoring. Corporate behavior in the crisis yielded enormous negative externalities for the greater society. Corporations were able and inclined to behave in a manner that imposed externalities because of a privilege the society, or more precisely the state, grants them: their owners get limited liability.<sup>4</sup> Given that privilege, and the fact that it can incentivize risky behavior that yields negative externalities, it seems appropriate that boards do more to prevent the abuse of the privilege. Indeed, they are well situated to do so. The risks at issue are also risks to shareholders: an economy of scope exists.

A motivating example involves compensation. Shareholders recently lost a lawsuit in which they argued that Goldman Sachs's compensation practices incentivized risky behavior, and that the directors, having put in place these practices, ought to have been monitoring to make sure the risks thus incentivized were appropriate.<sup>5</sup> We agree with the Goldman shareholders that directors should have been doing precisely this type of monitoring. We potentially part ways with the Goldman shareholders on the issue of liability: we think the board monitoring duty at issue may more realistically and perhaps even more desirably belong in what we and others have called the penumbra, as *Caremark*<sup>6</sup> duties themselves do. Boards should be encouraged to monitor for risks to the company and its shareholders that might also yield sizeable negative externalities, but the set of cases in which they should be liable for doing so is small, and should not encompass a case like *Goldman*. We have previously written on this mechanism of Delaware law, in which judges, in their opinions and in articles and speeches, and lawyer memos written to clients explaining Delaware law, significantly affect behavior, describing "duties" (like the *Caremark* duty) the breach of which would almost certainly not yield liability.<sup>7</sup> We think such a duty in this context would be a step forward—a way in which the crisis can improve corporate governance. Cases like *In re Citigroup Inc. Shareholder Derivative Litigation*,<sup>8</sup> in which plaintiffs lost a suit against directors for failing to monitor Citi's exposure to the subprime mortgage market, and *Goldman*, and indeed the financial crisis more broadly, raise the issue of whether corporate governance appropriately has as an aim minimizing harm to society. Our

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4. One of us is proposing, in an article and forthcoming book with a coauthor, that bankers in investment banks have some measure of personal liability for the negative externalities their banks may cause. Investment banks are now corporations; until a few decades ago, however, they were mostly organized as general partnerships, and their ability and incentive to impose externalities was thus significantly constrained. See Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1177 (2010).

5. *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. 5215-VCG, 2011 WL 4826104, at \*1-2, \*23 (Del. Ch. Oct. 12, 2011).

6. *In re Caremark*, 698 A.2d at 959.

7. See generally Hill & McDonnell, *supra* note 2; see also Lyman Johnson, *Counter-Narrative in Corporate Law: Saints and Sinners, Apostles and Epistles*, 2009 MICH. ST. L. REV. 847, 873; Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM. & MARY L. REV. 519 (2012).

8. 964 A.2d 106 (Del. Ch. 2009).

answer to this question is yes, within limits; our account and proposal here attempt to explain and justify this answer.

## II. LEGAL BACKGROUND

The leading cases defining the board oversight duty are *Caremark*<sup>9</sup> and *Stone v. Ritter*.<sup>10</sup> In *Caremark*, employees committed a series of violations of the Anti-Referral Payments Law.<sup>11</sup> The board was not aware of these violations and did not directly authorize them—if it had, the case would have involved the duty not to engage in knowing violations of the law.<sup>12</sup> Instead, the plaintiffs complained that the board did not take adequate steps to ensure that the corporation and its employees complied with the law.<sup>13</sup> Delaware Supreme Court precedent at the time held that the board was not responsible for illegal behavior by lower-level employees unless there had been red flags signaling cause for suspicion.<sup>14</sup> Chancellor Allen argued, however, that intervening developments had created a somewhat stronger duty. Even in the absence of red flags, boards have a duty “to assure that a corporate information and reporting system . . . exists.”<sup>15</sup> He grounded this conclusion on three factors:

Modern case law is increasingly serious about the role of the board;  
Information is essential to the supervisory and monitoring role of the board; and

The federal sentencing guidelines encourage a monitoring system.<sup>16</sup>

The duty to monitor in *Caremark* has limited bite, however. “[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system [exists]—will establish the lack of good faith that is a necessary condition to liability.”<sup>17</sup>

The Delaware Supreme Court affirmed *Caremark* as good law a decade later in *Stone*.<sup>18</sup> It caught some (indeed, perhaps, most) commentators and people in the corporate world off-guard by categorizing (1) *Caremark* as a case about the directors’ duty to act in good faith, and (2) the duty of good faith as part of the duty of loyalty, not the duty of care.<sup>19</sup> The court framed the duty to monitor as follows:

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9. *In re Caremark*, 698 A.2d at 959.
  10. 911 A.2d 362 (Del. 2006).
  11. *In re Caremark*, 698 A.2d at 961–62.
  12. *Id.* at 971.
  13. *Id.* at 961.
  14. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).
  15. *In re Caremark*, 698 A.2d at 970.
  16. *Id.* at 969.
  17. *Id.* at 971.
  18. *Stone v. Ritter*, 911 A.2d 362, 373 (Del. 2006).
  19. Claire A. Hill & Brett H. McDonnell, Essay, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1769 (2007).

We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.<sup>20</sup>

A critical question is whether the *Caremark* oversight duty extends beyond the monitoring of legal compliance risk to the monitoring of business risk more generally. In *Caremark* itself, Chancellor Allen seemed to suggest that it does. He said that the board should assure that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning *both* the corporation's compliance with law and its business performance.<sup>21</sup>

However, Delaware courts have not yet clearly held that the oversight duty extends beyond legal compliance.

The first case to most nearly confront the issue is one of the leading post-financial crisis cases, *In re Citigroup Inc. Shareholder Derivative Litigation*.<sup>22</sup> The plaintiffs claimed that the board had failed to adequately monitor Citigroup's exposure to the subprime lending market.<sup>23</sup> The court dismissed the case rather, well, dismissively, except (interestingly)<sup>24</sup> for a waste claim concerning the retiring CEO's compensation package. Chancellor Chandler was clearly quite reluctant to recognize a duty to monitor general business risk, fearing that such a duty would lead to judicial second-guessing of board decisions, precisely the sort of second-guessing that the business judgment rule is meant to block.<sup>25</sup> Based on such reasoning, he came very close to saying that there is no duty to monitor general business risk, although he perhaps did not quite go that far.<sup>26</sup> Some academic commentators have celebrated this reasoning.<sup>27</sup> However, even one of the most staunch defenders of board authority, Stephen Bainbridge, has acknowledged that legal compliance and general risk management do not differ in kind, and that there is no clear line between the oversight in *Caremark* and in *Citigroup*. (That being said, Bainbridge does maintain—as do we—that the chances of being held liable should be even more infinitesimally small in the *Citigroup* context

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20. *Stone*, 911 A.2d at 370.

21. *In re Caremark*, 698 A.2d at 970 (emphasis added); see Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 980 (2009).

22. 964 A.2d 106 (Del. Ch. 2009).

23. *Id.* at 114.

24. *Id.* at 138.

25. *Id.* at 131.

26. *See id.*

27. Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 100 (2010).

than they are in the *Caremark* context.<sup>28)</sup>

A second crisis-related case against a leading financial company also addressed the duty to monitor business risk. The plaintiffs in *In re Goldman Sachs Group, Inc. Shareholder Litigation*<sup>29</sup> claimed that the Goldman executive and employee compensation scheme was approved in bad faith because it was structured to encourage excessive risk and to divert assets to the employees. The plaintiffs also raised a *Caremark* board oversight claim.<sup>30</sup> After disposing of the compensation-setting claims, Vice-Chancellor Glasscock turned to the *Caremark* claim. Like us, he found *Citigroup* ambiguous as to whether any duty exists to monitor business risk.<sup>31</sup> He then, as in *Citigroup* but more explicitly so, evaded deciding the question by saying that insofar as there may be such a duty, it was not violated.<sup>32</sup>

As in *Citigroup*, the *Goldman Sachs* court stresses that it is not a violation of the board's duty to take on a high degree of risk.<sup>33</sup> However, the plaintiffs in *Goldman Sachs* made a more subtle claim: "According to the Plaintiffs, after the Director Defendants created Goldman's compensation structure, they had a duty to ensure protection from abuses by management, which were allegedly made more likely due to the form of that structure."<sup>34</sup> We argue below that this is a promising and important argument. Disappointingly, the court drops this point after stating it, never really responding to the argument.

As noted above, cases dealing with the monitoring of legal compliance by employees differ from those dealing with deliberate lawbreaking sanctioned by the board itself. The latter category is also of interest to us here, since it ties into our discussion of the role of externalities, and of interests other than the wealth of shareholders. Deliberate violation of the law would appear to violate the board's duty even where such violation is on net profitable. There are very few cases addressing this issue explicitly.<sup>35</sup> The leading case is *Miller v. AT&T*.<sup>36</sup> Dicta in Delaware suggest that directors do indeed violate their duty by sanctioning any sort of deliberate lawbreaking. Most significantly, in a key passage (later endorsed by the Delaware Supreme Court) setting out the contours of good faith in the *Disney* opinion, Chancellor Chandler said that 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*

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28. Bainbridge, *supra* note 21, at 981.

29. CA No. 5215-VCG, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011).

30. *Id.* at \*1–2. The plaintiffs also raised a waste claim.

31. *Id.* at \*21–22.

32. *Id.* at \*23.

33. *Id.* at \*22.

34. *Id.* at \*19.

35. Thomas A. Uebler, *Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. CORP. L. 199, 206 n.35 (2008).

36. 507 F.2d 759 (3d Cir. 1974).

*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.<sup>37</sup>

A tougher and less-settled question concerns the calculation of damages. Should the harm caused by the legal violation be offset by any gain created by it? Where a crime is actually profitable, this could lead to no damage remedy at all. The *Miller* court, following New York state court precedent, stated that to be cognizable as an element of damages, the loss caused by the violation must outweigh the gains it produced.<sup>38</sup> The American Law Institute, in contrast, suggests that such offsetting is not proper.<sup>39</sup>

As we discuss later, the appropriate damage measure may depend in part upon whether the underlying rationale supporting a duty not to violate the law is controlling agency costs within the corporation, or whether it also includes the goal of reducing significant negative externalities, such as costs associated with activities that society has decided to prohibit. Stated differently, do fiduciary duties run solely to shareholders or to other corporate stakeholders as well?<sup>40</sup> The debate is an active one. Many states have adopted corporate constituency statutes that provide that directors and officers may (and in one case, must) act on behalf of specified groups beyond just shareholders.<sup>41</sup> Delaware has no constituency statute. Delaware's case law is not entirely clear and consistent. In at least one type of situation, where the board has decided to put control of the corporation up for sale, its duty is focused solely upon receiving the best return for shareholders.<sup>42</sup> In other circumstances, though, the courts say that the board may consider the interests of other constituencies, although the consequences if those interests directly conflict with those of shareholders are not clear.<sup>43</sup> Where a corporation is nearing insolvency, it appears to have an explicit duty to consider the interests of one specific nonshareholder group, namely creditors,<sup>44</sup> although that group does not have standing to sue to enforce that duty.<sup>45</sup>

As we also discuss, the status of the oversight duty of boards may depend in part upon, and certainly interacts strongly with, related requirements under federal law. Financial companies face much more regulation concerning risk taking than do other corporations. Banks face probably the strictest regulation, being constantly monitored by examiners and graded on the safety and soundness of their operation. Insurance companies face extensive prudential regulation at the state level. Under new Rule 15c3-5,<sup>46</sup> certain broker-dealers are required to maintain a system of risk management control and supervisory procedures.

There are several provisions of the Dodd-Frank Act of particular interest for our discussion. All the provisions will become effective upon

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37. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005) (emphasis added); see also *Desimone v. Barrows*, 924 A.2d 908, 934 (Del. Ch. 2007); *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs., Inc.*, 854 A.2d 121, 131–32 (Del. Ch. 2004).

rule-making by the appropriate agency.<sup>47</sup> The main one is Section 165(h), which requires certain bank holding companies and certain non-bank financial companies to establish risk committees that will

- (A) be responsible for the oversight of the enterprise-wide risk management practices of the nonbank financial company supervised by the Board of Governors or bank holding company . . .
- (B) include such number of independent directors as the Board of Governors may determine appropriate, based on the nature of operations, size of assets, and other appropriate criteria related to the nonbank financial company supervised by the Board of Governors or a bank holding company . . . ; and
- (C) include at least 1 risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms.<sup>48</sup>

Other provisions of the Dodd-Frank Act of particular interest for our discussion will restrict compensation at certain financial institutions that would encourage inappropriate risk taking<sup>49</sup> and require certain “covered financial institutions” to provide extensive disclosure concerning incentive-based compensation sufficient to determine whether such compensation could lead to material financial loss for the institution.<sup>50</sup> Finally, bank examiners are now taking into account compensation and the incentives it creates in evaluating safety and soundness.<sup>51</sup>

Within federal securities law, nonfinancial companies also have some significant regulation of their risk management systems, although certainly less extensive than that facing financial companies. Under the Sarbanes-Oxley Act (SOX), public companies are required to have audit

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38. *Miller*, 507 F.2d at 763 n.5.

39. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.18(c) (1994); *see* Uebler, *supra* note 35, at 216–20.

40. For a good concise discussion, see Ian B. Lee, *The Role of the Public Interest in Corporate Law*, in THE RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 106 (Claire A. Hill & Brett H. McDonnell eds., 2012).

41. Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1228 (2004); *see also* Anthony Bisconti, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?*, 42 LOY. L.A. L. REV. 765, 780–86 (2009).

42. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 185 (Del. 1986).

43. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985).

44. *Credit Lyonnais Bank Nederland, N.V. v. Pathé Commc'n Corp.*, No. 12150, 1991 WL 277613, at \*1155–56 (Del. Ch. Dec. 30, 1991).

45. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007).

46. Risk Management Controls for Brokers or Dealers with Market Access, 17 C.F.R. § 240.15c3-5 (2010).

47. See, e.g., *Implementing the Dodd-Frank Act: The Federal Reserve Board's Role*, BOARD OF GOVERNORS OF THE FED. RES. SYS., [http://www.federalreserve.gov/newsevents/reform\\_milestones\\_proposed\\_rules\\_being\\_finalized.htm](http://www.federalreserve.gov/newsevents/reform_milestones_proposed_rules_being_finalized.htm) (last updated Dec. 5, 2012); *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Accomplishments*, U.S. SEC. AND EXCHANGE COMM'N, <http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml> (last updated Mar. 4, 2013).

48. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165(h)(3), 124 Stat. 1376, 1429–30 (2011) (to be codified at 12 U.S.C. § 5365).

committees composed of only independent directors.<sup>52</sup> The CEO and CFO must certify as to the company's internal controls,<sup>53</sup> and the outside auditor must also attest as to those controls.<sup>54</sup> Disclosure rules adopted in 2009 require companies to discuss the board's role in risk oversight and how compensation policies may affect risk management.<sup>55</sup>

With this as backdrop, we now turn to discussing how board monitoring duties fit within the broad spectrum of fiduciary duties.

### III. AN ENHANCED DUTY TO MONITOR

Fiduciary duties can be arrayed along a continuum of increasing judicial scrutiny. Traditional loyalty is at one end, and involves careful judicial scrutiny; traditional care is at the other, and involves enormous judicial deference in the form of the business judgment rule. These are the easier cases. There is a vast middle ground, in which the law has more difficulty. We have argued elsewhere that the taint of interest accounts for much of the middle ground.<sup>56</sup> Consider in this regard the doctrines concerning takeovers. Because entrenchment is a possibility, courts scrutinize far more than they would in cases raising the possibility of generic inattention. The taint of interest, broadly construed, also includes structural bias. Examples include reflexively rubber-stamping a decision to hire at above-market terms an executive the CEO selected and proposed, without much inquiry or negotiation on compensation.<sup>57</sup>

The middle ground also contains what we have called conduct involving illegality.<sup>58</sup> Where the board engages in such conduct, liability results. Where what is at issue is preventing illegal conduct by others, especially low-level others, *Caremark* and *Stone* set forth what a board must do to avoid liability—not much—and what it should do—rather more, abide by its *Caremark* duties.<sup>59</sup> The rationale supporting the board's duties regarding illegal conduct is not crystal clear, but the most intelligible construction includes harm to shareholders and harm to society.<sup>60</sup> In this it differs importantly from the canonical fiduciary duty rationale, which is harm to shareholders and more particularly, agency

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49. *Id.*; see also *id.* § 956, 124 Stat. at 1905–06 (to be codified at 12 U.S.C. § 5641).

50. *Id.* § 956, 124 Stat. at 1905–06.

51. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, COMMERCIAL BANK EXAMINATION MANUAL § 4008.1 (2010).

52. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (2002) (codified at 15 U.S.C. § 78j–1 (2006)).

53. *Id.* § 302, 116 Stat. at 777 (codified at 15 U.S.C. § 7241).

54. *Id.* § 404, 116 Stat. at 789 (codified at 15 U.S.C. § 7262).

55. Proxy Disclosure Enhancements, Securities Act Release No. 33-9089, Exchange Act Release No. 34-61175, 74 Fed. Reg. 68334, 68344, 68347 (Dec. 23, 2009).

56. Hill & McDonnell, *supra* note 19, at 1780–81.

57. *See id.*

58. *Id.* at 1784–86.

59. *Id.*

60. *Id.*

costs, where the agent-managers are benefiting themselves at the expense of the principal, the corporation (and its shareholders).<sup>61</sup> Indeed, some types of illegal conduct may benefit shareholders, at least monetarily: the bribe, to a foreign official, to get business that is either not detected, or elicits a fine smaller than the increased profits on account of the business obtained by means of the bribe. Let us consider various leading rationales for the *Caremark* duty to monitor legal compliance, and for each ask whether that rationale justifies broadening to a duty to monitor business risk generally.

#### A. *The Monitoring Board*

We start with the rationales that Chancellor Allen actually gives in *Caremark*. His first two reasons are closely related, focusing on modern cases emphasizing the board's role and on the need for information if the board is to fulfill that role.<sup>62</sup> If we look at board practices today, does the understanding of the duty to monitor stop at the monitoring of legal compliance? Hardly. Indeed, frequently it will be hard to even clearly distinguish monitoring aimed at legal compliance and other kinds of monitoring—there are important economies of scope in monitoring legal compliance, financial information required for, among other things, securities law compliance, and business risk more generally. Moreover, best practice today involves quite vigorous and widespread monitoring of the various risks that a business assumes. Increasingly, guidance as to how such monitoring should occur has been advanced under the label of “enterprise risk management.”<sup>63</sup> The leading authoritative guidance on enterprise risk management comes from the Committee of Sponsoring Organizations of the Treadway Commission (COSO).<sup>64</sup> Delaware case law often both draws upon and reinforces corporate best practices.<sup>65</sup> Today, those best practices clearly include intense efforts at enterprise risk management.

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61. *Id.* at 1784–85.

62. *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

63. Bainbridge, *supra* note 21, at 969; Michelle M. Harner, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323, 1328 (2010); Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J. L. REFORM 55, 58 (2011); Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571, 577 (2008).

64. COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMM'N, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY (2004) [hereinafter RISK MANAGEMENT], available at [http://www.coso.org/documents/COSO\\_ERM\\_ExecutiveSummary.pdf](http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf).

65. As our discussion above indicates, *Caremark* is a leading example. Another example would be Disney and executive compensation. See Hill & McDonnell, *supra* note 2, at 347–48.

### B. Sentencing Guidelines and Other Legal Guidance

The third rationale that Chancellor Allen gave in *Caremark* concerned the federal sentencing guidelines.<sup>66</sup> These guidelines give companies strong reason to put in place a legal compliance oversight program in order to reduce or eliminate organizational criminal liability for the acts of employees.<sup>67</sup> Do other areas of law today create a similar argument for more generalized board monitoring? We think so. For all public companies there are the SOX audit committee and internal control rules and the new disclosure rules on risk management discussed above.<sup>68</sup> For financial companies, there are a variety of stricter risk management requirements scattered throughout the rules of different areas of financial regulation.<sup>69</sup> For all companies, but particularly financial companies, a clear imperative exists to engage in a serious risk management program, or face a variety of possible sources of legal liability.

### C. Agency Costs

As noted above, we see agency costs and the potential of interested motivation and structural bias as central to the justification for most forms of judicial scrutiny stronger than the duty of care. Do such concerns justify the *Caremark* duty to monitor legal compliance, and if so, do they justify a more general monitoring duty? We have struggled with that question in the context of the duty to monitor legal compliance. We previously argued that:

[T]he directors' willingness to tolerate or engage in illegal conduct may be a proxy for their willingness to engage in conduct that more directly diverges with the shareholders' interests. Someone who sets out to break the law often displays stealth and a willingness to pursue a more parochial interest over a competing more general interest: their own personal interest over the interests of others, their family or friends' interests over that of strangers, or their corporations' interests over more general social welfare. Those very traits also characterize those prone to steal from their corporations.<sup>70</sup>

We do not think that particular agency cost argument applies in the context of oversight of business risk. However, in considering possible agency-controlling justifications for the *Caremark* duty, we previously advanced another argument which we think does apply:

Perhaps another justification for the *Caremark* line of cases is that internal control systems that monitor illegal behavior tend to overlap with internal control systems that monitor fraudulent behavior.

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66. *In re Caremark*, 698 A.2d at 970.

67. *Id.*

68. See *supra* notes 52–54.

69. See *supra* notes 47–49.

70. Hill & McDonnell, *supra* note 19, at 1784.

A board that leaves its corporation open to subordinates breaking the law is also likely to be vulnerable to top officers who choose to steal from the corporation.<sup>71</sup>

This argument does seem to generalize to monitoring business risk more broadly. As noted above, there are economies of scope in monitoring illegal behavior, financial information, and risk more generally. Indeed, top officers not infrequently have compensation packages that reward certain types of risk taking; these officers cause the corporation to take risks for which they would be rewarded, and try to conceal the risks taken by hindering board monitoring of risk more broadly. Stephen Bainbridge makes these two points well:

[A] corporation's failure to adopt effective enterprise risk management may often be attributable to resistance by the CEO and top management. Stock options and related pay-for-performance compensation schemes give management incentives to prefer high volatility. Because boards can use enterprise risk management not only to manage risk, but also as a monitoring device, CEOs may resist implementation or effective operation of risk management programs.<sup>72</sup>

More directly, monitoring of business risk will naturally help in reducing agency costs for employees below the board and top officer level. Indeed, such monitoring is one of the main functions of the modern board, and limiting agency costs below the board level is obviously critical to the profitable operation of a large corporation. That point is, however, just as obvious to boards and top officers as it is to courts and to us, indeed more so, so the question for courts and for us is whether limiting lower level agency costs is a compelling justification for imposing any sort of monitoring duty on the board, as opposed to simply letting the board decide how much monitoring, if any, is enough.

#### D. Externalities

Although agency arguments may justify both *Caremark* itself and its extension to a more general risk oversight duty, the fit is not great. The same is true for the duty to not deliberately violate the law. All of these duties fall close to the care end of the care/loyalty spectrum, and indeed, the chances of legal liability for violating these duties are slim, reflecting that fact.<sup>73</sup> We suspect, however, that other considerations also do and should influence the willingness of courts to impose some scrutiny in

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71. *Id.* at 1785; see also Mihir A. Desai & Dharmik Dharmapala, *Earnings Management, Corporate Tax Shelters, and Book-Tax Alignment*, 62 NAT'L TAX. J. 169, 183–84 (2009) (“This research points to an alternative view, emphasizing that tax avoidance demands obfuscatory actions that can be bundled with diversionary activities, including earnings manipulation, to advance the interests of managers rather than shareholders.”).

72. Bainbridge, *supra* note 21, at 981. (Yes, that Bainbridge. We were surprised too.)

73. Hill & McDonnell, *supra* note 19, at 1792.

these areas. We have made this point before with respect to conduct involving illegality:

[W]e may regard illegal acts as contrary to shareholders' interests notwithstanding that they might be in shareholders' pecuniary interests. Shareholders are also citizens, and insofar as laws advance the general social welfare, citizens care about that. A diversified shareholder with small stakes in any one corporation may well find that the public interest predominates over the corporate interest. The other possible account, rather less neat from a doctrinal perspective, is that, because corporations are chartered by the state, they owe a duty to the public, which may include the shareholders, not to act illegally.<sup>74</sup>

The rationale for imposing fiduciary duties on boards with respect to conduct involving illegality thus does not fit comfortably into the typical agency cost analysis. Rather, it considers harm to shareholders that may result from behavior that may or may not benefit the corporation's managers. It opens the door to consideration of harm to the public as well. One of our main points is this: the rationale applies equally well to risks from business activities—risks that are potentially exceedingly damaging.

We think the financial crisis helps make the case that board monitoring should extend to conduct potentially imposing significant harm on shareholders, especially where that conduct can also significantly harm third parties. In the financial crisis, corporate behavior caused appreciable harm to the greater society and harm to shareholders,<sup>75</sup> sometimes presenting with canonical agency costs and sometimes not. Illegality was part of the story, but ultimately not that important a part. Investment banks are among the corporations whose behavior caused the most harm. They have been charged with various types of illegal conduct in connection with the crisis, and investigations are continuing.<sup>76</sup> But the illegality, while not beside the point, is in fact not the point. There was considerable harm done simply by aggressive risk taking (including investing in complex and new financial instruments) and apparently shoddy due diligence (in structuring, selling, and also buying those instru-

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74. *Id.* at 1784–85; see also Anne Tucker, *The Citizen Shareholder: Modernizing the Agency Paradigm to Reflect How and Why a Majority of Americans Invest the Market*, 35 SEATTLE U. L. REV. 1299 (2012).

75. We assume for purposes of this discussion that we can fairly characterize corporate behavior in the financial crisis as “harming shareholders.” We acknowledge, of course, that it would not be fair to judge harm purely ex post: that a big risk that could enormously have benefited shareholders failed is not cognizable harm without more, we think. We therefore assume for purposes of this discussion that there is something more than simply symmetrically large risk that shareholders might ex ante choose with full information—perhaps a higher-level or lower-level employee compensation structure that encourages the risk taking and asymmetrically rewards it.

76. See, e.g., U.S. SECURITIES AND EXCHANGE COMM'N, <http://www.sec.gov> (last visited Mar. 5, 2013) (publishing many press releases on settlements with Citigroup, JP Morgan, Goldman Sachs and other banks).

ments).<sup>77</sup> To illustrate the point, consider two polar cases: the smart, corrupt executives who are bribed to overlook the low quality of mortgages they securitize, and the stupid, harried executives who simply do not notice. Same harm, vastly different liability to the SEC (and others).

Financial companies caused the greatest harm during the crisis because they posed the greatest systemic risk to the economy.<sup>78</sup> Financial companies have high leverage, and also typically have a mismatch between the maturity of their assets and liabilities.<sup>79</sup> This makes them subject to contagious panics. Their critical role in the key capitalist task of raising and allocating capital, as well as other key functions such as payment systems and the transmission of monetary policy, mean that financial crises usually wreak havoc on the general economy.<sup>80</sup> The much stronger legal regime for regulating risk and risk management by financial companies discussed above is legal recognition of this systemic risk. And the much greater legal restrictions on financial companies turn their monitoring issues into a conventional *Caremark* duty to monitor legal compliance. Even large nonfinancial companies, however, pose some degree of systemic risk. When speculative booms occur across the economy, many businesses shortsightedly take on high leverage and big risks without being fully aware that they are doing so.<sup>81</sup> Consider the extent to which the industries associated with housing, most notably construction, ramped up, and the results thereof.<sup>82</sup> This short-sighted risk taking sets the economy up for a big fall when the bubble bursts.<sup>83</sup> One way to justify the various securities law rules which mandate a degree of board risk management<sup>84</sup> is because of the systemic risk that predictably builds up during market booms. We recognize that this is not the conventional justification for such rules, but the financial crisis has brought to the fore concerns about systemic risk, and we believe that various elements of securities and corporate law can and should be conceptualized and adapted to help address those concerns.

We recognize that this is quite a broad treatment of systemic risk, and that it tends to elide the distinction between systemic risk and simple business risk and leverage. We do not want to push the point too far, but a Minskian understanding of how risk taking becomes contagious during speculative bubbles suggests the two are indeed not easy to disentangle<sup>85</sup>—there is no bright line dividing systemic and general business risk.

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77. Writing on these matters is voluminous. One excellent source is BETHANY MCLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS* (2010).

78. Brett McDonnell, *Don't Panic! Defending Cowardly Interventions During and After a Financial Crisis*, 116 PENN ST. L. REV. 1, 7–9 (2011).

79. *Id.*

80. *Id.*

81. HYMAN MINSKY, *STABILIZING AN UNSTABLE ECONOMY* 118 (1986).

82. McDonnell, *supra* note 78, at 9–11.

83. MINSKY, *supra* note 81, at 165–66.

84. See *supra* note 64 and accompanying text.

85. MINSKY, *supra* note 81, at 197–220.

We also note that the law already does recognize a duty to a corporation's creditors in the zone of insolvency, thereby acknowledging a built-in tendency of corporations focused on shareholder value to take on too much risk in some circumstances.<sup>86</sup> One way of making our point on systemic risk is to note that, particularly during a speculative bubble, the zone of insolvency can be much wider and more imminent than most people realize, and that when many companies hit the zone at once, society suffers. Society would benefit if corporate law could do a little to nudge boards away from that zone.

Thus, corporations taking on a variety of kinds of business risk without sufficient knowledge threaten both shareholders and society generally. Indeed, the threat is as great as the threat from corporations which flout the law. The doctrinal path is clear: to take seriously the court's suggestion in *Citigroup* that business risk be treated like illegality for purposes of *Caremark* duties.<sup>87</sup>

#### IV. WHAT SHOULD THE DUTY TO MONITOR BE?

What form should the duty to monitor for business risk take? The parameters of the duty should be informed by principles guiding fiduciary duty law generally. In particular, we are mindful of the courts' appropriate reluctance to micromanage business, embolden meritless litigation, and discourage people from joining boards because of the potential scope of liability. We thus think that the duty should be strongest where the potential harm is greatest and is easiest for the board to anticipate. Returning to *Goldman*, the directors themselves put in place the compensation system that motivated the harmful risk taking.<sup>88</sup> But they are far less chargeable with anticipating the extent of the harm.

Where are traditional agency costs in this analysis? Courts ought to give more scrutiny to cases where such agency costs might cause difficulties, either because such costs had the potential to cause harm, or because they had the potential to prevent directors from vigorously monitoring. Consider an example like *Goldman*, except where the problematic compensation incentives were to top management who effectively appointed and retained the officers.<sup>89</sup> In such a case, simply by reason of who got the compensation, we might want to look more closely at the decision to grant the compensation, and the decision not to monitor for the risk it might cause. But otherwise, we might be inclined to defer more to a board unless they should have anticipated (or did anticipate) large harms.

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86. See *supra* note 35 and accompanying text.

87. *In re Citigroup, Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009).

88. *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. 5215-VCG, 2001 WL 4826104, at \*3 (Del. Ch. Oct. 12, 2011).

89. See *id.*

Liability would only be imposed for cases at the end of the continuum, where the potential harm was great, and the directors did anticipate or should have anticipated it. But the penumbra would extend further, and would be where we expect our proposal to have the most effect. Boards would have what we will call here “*Goldman* duties”— to ask: “Do we adequately understand the risks we are exposing ourselves to? Is there something that the corporation is doing that might expose the corporation, its shareholders, its other stakeholders, and/or the greater society to risks we have not considered?” There is, after all, an economy of scope in making this inquiry, given that the board arguably is charged with making it anyway with respect purely to shareholder harms. As a matter of aspirational best practices, the directors might even be encouraged to ask about the corporation’s behavior that might have the potential to greatly harm the society whether or not it was to have a bad effect on shareholders. Here, we are particularly mindful that we may be asking for an inquiry that asks everything and nothing. Moreover, what sorts of harms might be cognizable in this context? Consider an analogy with illegality: apparently, the directors owe a duty to monitor for illegality even if the illegality offers a net pecuniary benefit to shareholders. Why not impose a like duty for risks of the sort we have been considering here? One answer is that something being illegal reflects a societal consensus that the behavior is disfavored; a broader duty may require an amorphous and costly inquiry where no such consensus exists. But we think this answer is not dispositive given what is at stake.

In any event, the mechanism would work mostly extra-legally, through norms. Indeed, we would expect that liability would virtually never occur under this approach. Courts occasionally might be willing, however, to allow a case on this theory to proceed beyond the inevitable motion to dismiss for failure to make demand (as indeed happened in *Citigroup*, albeit on the waste theory rather than the *Caremark* claim<sup>90</sup>). Such decisions allowing a case to continue would allow the courts to preach with just a hint of a hammer behind their words, and it would increase the settlement value of such cases, thereby providing some incentive to bring the cases so that Delaware judges can come to the pulpit in the first place.<sup>91</sup>

Let us tie this analysis more closely to the existing legal structure of *Caremark* duties, and ask in what ways a court applying our approach would have written an opinion different from that in *Goldman*. First, unlike the courts in *Goldman* and *Citigroup*, we would explicitly state that the *Caremark* oversight duty includes a duty to monitor business risk generally, not just the risk of breaking the law. We would stress that this

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90. See *In re Citigroup*, 964 A.2d at 139–40.

91. See E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1406 (2005).

duty does not proscribe taking on any particular risks, or any general level of risk. A corporation may take on as much risk as it likes. However, the board must take real effort to ensure that it understands what risks are being undertaken, and that those risks are consistent with the risk level that the board desires to undertake,<sup>92</sup> and that among the risks it has considered are risks to the greater society.

As articulated in *Stone*, directors can fail to meet their *Caremark* duty in two ways. One is by not implementing *some* system of information and control.<sup>93</sup> As we have noted, enterprise risk management systems are now standard practice for public corporations.<sup>94</sup> Any system in place, no matter how imperfectly designed will suffice. Some corporations, though, seem to have no enterprise risk management system in place.<sup>95</sup> These corporations will need to put a system in place, or risk facing liability.

Even if a corporation does have a system in place, the board may still be liable if it consciously fails to monitor or oversee its system of information and control.<sup>96</sup> We think courts should be less deferential than they are—less deferential than they were in *Goldman* or *Citigroup*—in making the determination that a board has or has not “consciously failed.” First, courts should look for evidence that the board, or its audit committee (or both), has spent *some* time reviewing information generated by its risk monitoring system, and reviewing that system itself. Guidance from the extensive enterprise risk management literature can tell courts what sort of questions boards should be asking, and what sorts of information they should be looking at.<sup>97</sup> Given the fairly large audit and risk management functions within both Goldman Sachs and Citigroup, it is highly doubtful that plaintiffs could succeed on these grounds; the value, again, would be in the encouragement that the directors go through the exercise of looking.

Beyond this, the board (in the first instance, and then the court if a suit is brought) should look for red flags that something has gone wrong within a company’s risk management system. These red flags should not be simply that some decisions led to big losses. Rather, one would look for signs of self-interested, disloyal behavior, or rather, behavior that has elements of disloyalty. There were at least two such signs in *Goldman*,

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92. PROTIVITI, BOARD RISK OVERSIGHT: A PROGRESS REPORT 1–2 (2010) [hereinafter BOARD RISK OVERSIGHT], available at <http://www.coso.org/documents/Board-Risk-Oversight-Survey-coso-protiviti.pdf>.

93. *Stone v. Ritter*, 911 A.2d 362, 373 (Del. 2006).

94. See *supra* note 64.

95. BOARD RISK OVERSIGHT, *supra* note 92, at 7.

96. *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). And here is where we particularly hope a penumbra that expanded the effective reach of the duty might emerge, motivating real efforts to become informed rather than focusing on limiting legal liability, perhaps even through willful or semi-willful blindness that would prevent “conscious” awareness of something the board should have been doing.

97. See BOARD RISK OVERSIGHT, *supra* note 92; RISK MANAGEMENT, *supra* note 64.

and the court does not adequately respond to either of them. One sign is the system of compensation at issue in the case, which created strong incentives for lower level employees to take on great risk.<sup>98</sup> Such compensation systems may well have played a major role in the financial crisis.<sup>99</sup> Having put such a system in place, the board should be on the lookout for behavior which may predictably follow. As long as the incentive problems are only at the lower level of an organization, we see this only as a yellow flag. So long as the board and top officers are themselves properly motivated, there is not much reason to distrust their judgment in carrying out that duty. However, high-risk-inducing compensation schemes at lower levels probably tend to mirror similar schemes at the highest levels of the organization. Where that is so—as it presumably was at Goldman itself, though it is not clear whether or not the plaintiffs alleged as much (they should have!)—then there is less reason to trust the board and top officers and the judgments they have made in setting compensation schemes and monitoring risk. Indeed, even if the higher-level managers’ compensation scheme is not mirroring the lower-level employee scheme, the higher level managers can presumably benefit from the lower level managers’ compensation-encouraged risky behavior.

The other bothersome sign of disloyal behavior in *Goldman* concerns an apparent tendency for the bank to engage in transactions in which their interests were at odds with those of their clients, and in which this was not clearly disclosed.<sup>100</sup> One notorious example is the Abacus deal. The court tries to minimize this as an isolated incident, but many believe that it represented a growing trend and a disturbing break with the company’s past.<sup>101</sup> Another example involves Citigroup, which entered into a \$285 million settlement with the SEC of allegations that it had structured and marketed a portfolio on which it took a short position, earning significant amounts for itself in profits and fees as its clients lost their entire investment.<sup>102</sup> This is quite problematic for several reasons: violating customers’ trust risked destroying important reputational capital, customers themselves are a corporate constituency who may matter to corporate law, and bankers who are willing to rip off customers are probably bankers who are willing to rip off shareholders too.

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98. See *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. 5215-VCG, 2011 WL 4826104, at \*3 (Del. Ch. Oct. 12, 2011).

99. McDonnell, *supra* note 78, at 11–12, 58–60.

100. *In re Goldman Sachs*, 2011 WL 4826104, at \*4–5, 20.

101. See MCLEAN & NOCERA, *supra* note 77, at 268–73.

102. Citigroup and the SEC settled for \$285 million; Judge Rakoff rejected the settlement, but the SEC and Citi appealed, and the Second Circuit stayed his rejection, clearly indicating that it supported the SEC practice. Congressional hearings on the subject were held, with most commentators supporting the SEC practice on the rationale that without it, no settlements would be made. See Claire A. Hill & Richard Painter, *Why S.E.C. Settlements Should Hold Senior Executives Liable*, N.Y. TIMES DEALBOOK (May 29, 2012, 11:28 AM), <http://dealbook.nytimes.com/2012/05/29/why-s-e-c-settlements-should-hold-senior-executives-liable/>.

These two red (or at least yellow) flags may conceivably have been enough to avoid dismissal and allow the case to continue—we think that is a close call. Absent more disturbing evidence revealed through discovery, we do not think the facts as presented would justify ultimately holding the defendants liable. The *Caremark* duty is indeed one of the most difficult for plaintiffs to win, and for good reason. Whether or not the court should have dismissed the case or allowed it to continue, though, we think there is one more way in which the *Goldman* and *Citigroup* courts went wrong: their rhetoric. These two companies were at the heart of the worst worldwide financial crisis since the Great Depression. Certainly at Citigroup,<sup>103</sup> those at the top do not seem to have been adequately aware of the risks posed by subprime-related asset-backed securities, and they did not ask questions about that risk that they really should have asked. A corporate culture of high risk taking, motivated and rewarded by huge bonuses that senior (and even junior) officers earned therefrom, seems to have prevailed throughout Wall Street, with these two firms among the leaders in defining that culture.

This all cried out for a good ol' Delaware sermon. That is a big part of what Delaware courts do. Even where they ultimately hold for the defendants, they moralize where behavior has fallen well short of best practice aspirations. That moralizing may help in spreading and reinforcing norms of proper board behavior.<sup>104</sup> *Goldman* and *Citigroup* both provided perfect opportunities to call out these defendants on what they did to their shareholders, their clients, the country, and indeed the whole world. Yet, there is little to nothing along those lines in either case. The *Citigroup* court in particular seems quite defensive rhetorically, repeatedly invoking the business judgment rule, almost as a magic talisman.<sup>105</sup> It is as if the Delaware courts were shocked by the tide of populist outrage which (quite rightly) has rolled across the United States, from all sides of the political spectrum, and felt that they should not pile on, and indeed, needed to defend the corporate system from which Delaware judges so benefit. If this narrative is even partly true, an enormous opportunity is being squandered. Part of Delaware's role in defending this system is forcefully calling to the attention of directors and officers areas in which they need to do their jobs better. Surely one clear lesson of the financial crisis is that risk management oversight is an area where boards, especially the boards of systemically significant financial companies like

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103. Indeed, there is evidence that Goldman saw the looming debacle of the subprime market earlier than most of its competitors and acted to limit its losses, yielding significant losses for some of its clients. See WILLIAM D. COHAN, MONEY AND POWER: HOW GOLDMAN SACHS CAME TO RULE THE WORLD 489–546 (2011).

104. Hill & McDonnell, *supra* note 2, at 354; Johnson, *supra* note 7, at 79–87; Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, 1016 (1997); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1663 (2001); Velasco, *supra* note 7, at 13.

105. See *In re Citigroup, Inc. S'holder Derivative Litig.*, 964 A.2d 106, 124–31 (Del. Ch. 2009).

Goldman Sachs and Citigroup, need to step up their game.

How does what we argue for relate to the risk committee to be mandated under Dodd-Frank? First, and most obviously, the committee is only mandated for certain types of financial firms.<sup>106</sup> Our proposal would apply to all types of firms. Second, even where the firm was required to have a risk committee, our proposal would serve as a helpful adjunct. A private remedy can supplement scarce government resources. The private bar's pursuit of companies that could be pursued by the SEC may be a mixed bag, but it is surely not unambiguously bad. But most importantly, what we seek as much as law on the books is law in action—the penumbra, or the norms, that very much influence the behavior of corporate actors. The risk committee requirement will be of a piece with our broader concern that boards focus more on risk, not just because of the steps firms will take to meet the requirement, but also because law will be thereby expressing its views as to, and making more salient, the board's and the firm's role in risk inquiries. It will thus complement the force of our proposal, which relies in significant part on the importance of what Delaware judges say as much as how they rule in their opinions.

## V. CONCLUSION

One of the canonical roles for boards is to monitor. So, why are duty to monitor lawsuits so hard to win? Put differently, why does the duty to monitor require as little as it does? One straightforward answer is that corporate law's well-known reluctance to micromanage business leads it to be very uncomfortable second-guessing business decisions; here, the micromanagement would have to go deeper, to second-guess something that was not done and perhaps should have been. The reluctance to micromanage is of course of a piece with a desire to limit meritless suits. Allowing suits for things that should have been done but were not might open the door wide indeed. Put differently, corporate law is most comfortable scrutinizing behavior that implicates conflicts of interest in straightforward ways. The duty to monitor smacks of inattention, a type of conduct the law feels far less comfortable overseeing. Thus, the doctrine as now articulated provides that when failure to monitor is actionable, it is because the failure is tantamount to an action—an intentional failure “to act in the face of a known duty to act, demonstrating a conscious disregard for [the board member’s] duties.”<sup>107</sup> Most failures that come to mind are passive, not active; thus, not surprisingly, a claim that a board breached its fiduciary duty by failing to monitor almost never succeeds.

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106. See *supra* notes 49–50 and accompanying text.

107. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006), quoted approvingly in *Stone v. Ritter*, 911 A.2d. 362, 369 (Del. 2006) and many other cases including *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. 5212-VCG, 2011 WL 4826104, at \*13 (Del. Ch. Oct. 12, 2011).

We think the duty should require more. One way to articulate why we think this is so arises from the financial crisis. Corporations behaved in ways that enormously harmed the greater society and their shareholders. They would not have behaved as they did but for the fact that corporate law grants owners limited liability.<sup>108</sup> It seems to us that the privilege of limited liability can be abused, and was, and that one way to limit its abuse is for directors to try to anticipate the abuses that might occur. This role for directors must of course be circumscribed lest they be left with an amorphous duty to look for *everything*. But we think the plaintiffs' articulation in the *Goldman* case describes the sort of thing directors should be doing. We do not believe that the directors in the case should have been liable for a breach of fiduciary duties for failing to monitor. But we do think that when they are or should be informed about a matter of importance to the company, whether or not they are making an affirmative decision, directors ought routinely to be asking themselves the questions: Might significant negative externalities result as well as potential harm to shareholders? If so, what should we be monitoring or overseeing to minimize the possibility of those externalities and harms? In the *Goldman* case, directors were aware of the compensation scheme they had adopted.<sup>109</sup> They were, or should have been, aware of the incentives it produced. Monitoring on a regular basis to see how those incentives had motivated behavior would have been appropriate and advisable. Should failure to do so trigger liability? Almost never, but we do think that monitoring in this manner is part of the board's duty. What should be the board be monitoring for? Business risk, broadly construed: risk of harm to the corporation and its shareholders, especially where accompanied by risk of harm to the society. The duty should be most acute where the board itself put in place an important contributor to the harm; it should, however, be present generally.

A final point: we think that to some extent, the narrow reach of the duty to monitor, especially its penumbra, is an infelicitous effect of language. "Loyalty" was made the umbrella characterization in *Stone* for breaches involving monitoring when the duty of good faith was subsumed under the duty of loyalty.<sup>110</sup> Breaching the duty of loyalty means that one is "disloyal." Breaching the duty of good faith has come to mean acting in affirmative bad faith. This is so certainly insofar as what is at issue is potential liability; the language characterizing the duty of good faith as requiring only an absence of affirmative bad faith has, we would argue, influenced the penumbra of law as well, the duties directors abide by even if liability could not attach for failing to do so. Law's traditional and appropriate reluctance in the business area to micromanage business decisions and give litigious plaintiffs fodder for meritless law-

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108. See Hill & Painter, *supra* note 4, at 1177.

109. *In re Goldman Sachs*, 2011 WL 4826104, at \*3, \* 13.

110. *Stone*, 911 A.2d at 369–70.

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suits has caused the duty to monitor to be more limited than we think it needs to be. Recent events have shown that even though treading into the murkier waters of risk oversight generally has, dare we say it, risks, it is necessary and advisable. The crisis serves as powerful evidence of the perils of doing too little.

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