

# NOTES

## A MODIFIED CAREMARK STANDARD TO PROTECT SHAREHOLDERS OF FINANCIAL FIRMS FROM POOR RISK MANAGEMENT

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*The recent collapse of the world financial system exposed excessive risk taking at many of the largest financial services firms. However, when shareholders of Citigroup sued the board of directors alleging that the board failed to adequately monitor the firm's risk exposure, the Delaware Chancery Court dismissed the suit under the famous Caremark case. Caremark held that a board's failure to monitor will not result in liability unless there was a failure to implement a monitoring system or a "sustained or systematic" failure to use that monitoring system. This deferential standard is premised on an assumption that managers are risk averse and the law should encourage risk taking. However, certain characteristics of financial firms make such firms more prone to risk taking and more susceptible to catastrophic losses resulting from that risk taking than other firms. In this Note, I argue that Caremark should be reworked in cases involving managers of financial firms in order to deter the excessive risk taking that caused such massive losses to shareholders of these firms recently. This standard should take the form of a gross negligence standard that allows the court to take a close look at whether management took the necessary steps to prevent their firm from being exposed to excessive risk.*

### INTRODUCTION

Of all the major players in the recent financial crisis, perhaps none more than Citigroup exemplifies the dangerous game the financial industry played during the last decade. Throughout the 2000s, Citigroup—like many other financial firms—made massive, risky bets on securitized home mortgages.<sup>1</sup> Citigroup's (and other firms') risk models were unable to predict the possibility of a downturn in housing

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<sup>1</sup> See Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 53 (2009) (explaining Citigroup's involvement in housing market and noting that, by 2007, Citigroup "owned about \$43 billion in mortgage-related assets").

prices that would undermine the value of these financial products.<sup>2</sup> When such a downturn came, Citigroup's shareholders lost more than \$220 billion.<sup>3</sup>

Much discussion of the recent crisis has focused on regulatory changes needed to protect the public from a recurrence of financial catastrophe.<sup>4</sup> Such changes are not the subject of this Note. Instead, I tackle the related, but separate, issue of whether directors of financial firms should be liable to their shareholders for failures to monitor financial risk. This issue surfaced in the latter half of 2007 when Citigroup shareholders sued the board of directors, alleging that the board failed to live up to its corporate-law duty to monitor risk.<sup>5</sup> The plaintiffs argued that such a duty is found in the Delaware Chancery Court opinion of *In re Caremark International Inc. Derivative Litigation*,<sup>6</sup> the famous progenitor of the "Caremark duty," which requires managers and directors to monitor their employees' actions. Though *Caremark* imposes upon management a duty to monitor, liability for failing to live up to this duty will not attach unless management fails to implement a monitoring system or, if such a system is implemented, engages in a "sustained or systematic" failure to use that monitoring system.<sup>7</sup> While a typical *Caremark* claim focuses on managers who failed to sniff out employee fraud or theft,<sup>8</sup> the plaintiffs in *Citigroup* argued that *Caremark* also includes a duty to monitor employee risk taking. In *Citigroup*, the Delaware Chancery Court dismissed the complaint against the directors,<sup>9</sup> finding that even if there was a *Caremark* duty to monitor risk,<sup>10</sup> plaintiffs had failed to allege facts sufficient to establish liability.<sup>11</sup>

Professor Stephen Bainbridge, commenting on the *Citigroup* decision, has argued that *Caremark* duties should include an obligation to monitor risk and that it would be incorrect to read *Citigroup* as

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<sup>2</sup> *Id.*

<sup>3</sup> Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1.

<sup>4</sup> See, e.g., Moran, *supra* note 1, at 93–102 (proposing regulatory changes).

<sup>5</sup> See *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 123–24 (Del. Ch. 2009).

<sup>6</sup> 698 A.2d 959 (Del. Ch. 1996); *Citigroup*, 964 A.2d at 121 ("Plaintiffs' argument is based on a theory of director liability famously articulated by former-Chancellor Allen in *In re Caremark*.").

<sup>7</sup> 698 A.2d at 971.

<sup>8</sup> See *infra* notes 39–41 and accompanying text (explaining typical *Caremark* claims).

<sup>9</sup> *Citigroup*, 964 A.2d at 139–40.

<sup>10</sup> *But see* Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 979 (2009) (pointing out conflicting language in *Citigroup* case that can be read to imply that there is no duty to monitor risk).

<sup>11</sup> See *infra* Part I.D (discussing *Citigroup*).

holding that such a duty does not exist under *Caremark*.<sup>12</sup> However, Bainbridge argued that liability for failing to live up to this duty should be especially difficult to establish because risk monitoring is a young discipline and notoriously imperfect.<sup>13</sup> I do not dispute this as a general matter. However, I argue that liability for failure to monitor financial risk should be easier to establish against directors and officers of financial firms<sup>14</sup> as compared to firms in other industries.<sup>15</sup> Specifically, I argue that factors unique to the financial industry undermine the traditional rationales for limiting managerial liability for failures to monitor in this context.<sup>16</sup> These factors include the incentives of various players within financial firms, such firms' enormous leverage<sup>17</sup> ratios, and shareholders' inability to be accurately informed of financial firms' risk taking. Moreover, as I explain in

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<sup>12</sup> See generally Bainbridge, *supra* note 10. Bainbridge is not the only one to make this argument. See, e.g., ERIC J. PAN, THE CONFERENCE BOARD, THE DUTY TO MONITOR UNDER DELAWARE LAW: FROM *CAREMARK* TO *CITIGROUP* 13 (2010) (“*Citigroup* should be a duty to monitor case.”).

<sup>13</sup> Bainbridge, *supra* note 10, at 982.

<sup>14</sup> The term “financial firm” has an elusive definition. I use it here to refer to firms whose business model is based, at least in large part, around trading and investing in securities either for their own profit—so-called “proprietary trading”—or on behalf of clients. This obviously includes investment banks but might also include some insurance companies (or at least certain subdivisions of such companies) as well. See Part II.B.2 for a full discussion of characteristics that define a “financial firm.”

<sup>15</sup> “Risk monitoring” or “risk management” in this Note means the practice of overseeing and managing risks associated with a firm’s investments and assets such as liquidity risk, investment risk, prepayment risk, and credit risk. See *infra* notes 81–88 and accompanying text (explaining different types of risk). While directors and officers are certainly responsible for managing all types of risk, this Note focuses on the management of risks associated with the firm’s investments and assets. See *infra* note 151 (noting this limitation on argument).

<sup>16</sup> The argument that directors and officers of financial firms should be held to a stricter standard has been made only sporadically in the past and is thus bound to be controversial. The only commentators to argue that traditional corporate-law fiduciary duties should be altered in the financial industry have focused exclusively on banks, basing their arguments on the need to protect depositors. See Jonathan R. Macey & Maureen O’Hara, *The Corporate Governance of Banks*, FED. RES. BANK N.Y. ECON. POL’Y REV., Apr. 2003, at 92 (“[T]he scope of the duties and obligations of corporate officers and directors should be expanded in the special case of banks. Specifically, directors and officers of banks should be charged with a heightened duty to ensure the safety and soundness of these enterprises.”); Patricia A. McCoy, *A Political Economy of the BJR in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1, 3 (1996) [hereinafter McCoy, *Political Economy*] (arguing that historically courts have curtailed business judgment rule’s (BJR) protections of bank directors out of concerns about “asset substitution,” the incentive for shareholders to substitute risky high-rate-of-return investments for low-risk ones, contrary to depositors’ interests); Patricia A. McCoy, *The Notional BJR in Banking*, 44 CATH. U. L. REV. 1031, 1032 (1995) [hereinafter McCoy, *Notional BJR*] (arguing that courts have “second-guessed decisions of bank directors on the merits in negligence cases for the past hundred years”).

<sup>17</sup> See *infra* Part II.B.2 (defining leverage).

detail, there are numerous reasons why private law, in the form of shareholder derivative suits, and public law, in the form of government regulation, are not stand-ins for one another. Each has different goals and effects and should be utilized in a complementary manner when attempting to rein in excessive risk taking in the financial industry. While I certainly agree that regulation is needed to protect the public, it is not sufficient to protect shareholders. In other words, while both public and private law solutions are needed to meet public and private concerns, respectively, this Note tackles only the private law concerns.

In Part I, I introduce the duty to monitor and its policy justifications, as well as the justifications for the high bar to liability for failure to live up to this duty. Next, I take a close look at the *Citigroup* case and explore how it fits into the doctrine. In Part II, I begin by explaining what “risk” and “risk management” entail with respect to the duty to monitor. I then argue that circumstances unique to the financial industry undermine the policy rationale that supports the deferential liability standard of *Caremark* and conclude that a stricter standard is needed when analyzing risk-monitoring claims against managers of financial firms. In Part III, I propose a new standard for failure-to-monitor claims against managers of financial firms. In so doing, I note certain features of risk management that courts should consider when applying this higher standard.

## I

### TRADITIONAL POLICY JUSTIFICATIONS FOR LIMITING MANAGERS’ LIABILITY FOR FAILURES TO MONITOR

In order to understand why the law has been traditionally reluctant to impose liability on management for failures to monitor, it is necessary to understand why courts generally defer to managerial decisions. As fiduciaries, directors and officers<sup>18</sup> are duty-bound to act with “the care of an ordinarily prudent person in the same or similar circumstances”—the duty of care.<sup>19</sup> While the duty of care appears to hold corporate managers to a typical negligence standard, corporate

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<sup>18</sup> I will refer to directors and officers using the umbrella term “managers” throughout this Note. “Manager” simply means any fiduciary of the shareholders that is charged with managing the corporation.

<sup>19</sup> WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 239–40 (3d ed. 2009); see also 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) [hereinafter AM. LAW INST.] (expressing common conception of duty of care in similar terms). Note that this duty is a personal one—theoretically at least, the manager is personally liable for any breach of the duty.

law has evolved to shield managers from liability resulting from purely negligent behavior through the so-called business judgment rule (BJR). The BJR stands for the proposition that a financially disinterested manager who makes a corporate decision will not be liable for breaching the duty of care—regardless of how poor that decision turned out to be in hindsight—as long as the manager was duly informed and acting in good faith.<sup>20</sup>

### A. *The Justifications for the Business Judgment Rule*

The policy underlying this liability shield arises from the unique relationship between a corporation's directors and its shareholders. The BJR serves to increase shareholder wealth by acknowledging that it is in the shareholders' best interest for corporations to take risks.<sup>21</sup> Shareholders can diversify their investments through capital markets and thus want managers to take risks to the extent necessary to maximize returns.<sup>22</sup> On the other hand, managers, even without the looming specter of liability, have an incentive to avoid risk because they "cannot diversify the value of their human capital."<sup>23</sup> Managers, unlike shareholders, often dedicate their entire professional lives to one firm. And managers, even with incentive pay, typically have only a very small proportionate ownership of the firm and therefore enjoy a small proportion of any profit.<sup>24</sup> If managers were subject to joint and several liability for any imprudent decision that they made, timidity would plague the corporate boardroom to the detriment of shareholder wealth.<sup>25</sup> In other words, for most firms, shareholders

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<sup>20</sup> ALLEN ET AL., *supra* note 19, at 253; MODEL BUS. CORP. ACT § 8.30 (2005); AM. LAW INST., *supra* note 19, § 4.01(c); AM. BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 25–26 (5th ed. 2007); *see also In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009) ("[T]he business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information."); *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 813 (Sup. Ct. 1976) ("It is not enough to allege . . . that the directors made an imprudent decision . . .").

<sup>21</sup> *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 93 (1991) (arguing that BJR represents "recognition that investors' wealth would be lower if managers' decisions were routinely subjected to strict judicial review").

<sup>22</sup> *See id.* at 99–100 (explaining diversification rationale); *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (same).

<sup>23</sup> EASTERBROOK & FISCHEL, *supra* note 21, at 99.

<sup>24</sup> *Gagliardi*, 683 A.2d at 1052.

<sup>25</sup> EASTERBROOK & FISCHEL, *supra* note 21, at 99–100 ("Managers especially want to avoid risk because they cannot diversify the value of their human capital. Shareholders, however, readily diversify risk through capital markets. They want managers to take the projects with the highest mean returns, which may entail high risk. (No pain, no gain.) Exposure to liability causes managers' incentives to diverge from the path of wealth maximization.").

need to be protected, not from excessive risk, but from excessive tentativeness. The BJR avoids this problem by allowing managers to make risky decisions—at least where they are disinterested, duly informed, and acting in good faith—without concern for personal liability.

### B. Caremark and the Duty To Monitor

It is “well settled that the duty of care requires directors to pay ongoing attention to the business and affairs of the corporation.”<sup>26</sup> Yet, as its name suggests, the BJR only protects actual “business judgments,” i.e., conscious decisions made by managers. Hence, a failure to monitor employees’ conduct—where managers have made no decision—is not protected by the BJR.<sup>27</sup> The duty to monitor and its attendant liability scheme were formulated in the landmark case of *In re Caremark International Inc. Derivative Litigation*.<sup>28</sup> Caremark was a pharmaceutical company that paid more than \$250 million in fines and reimbursements for violating the Anti-Referral Payments Law.<sup>29</sup> Plaintiff shareholders brought a derivative action claiming that the directors had breached their duty of care by failing to monitor adequately the employees who had committed the offenses.<sup>30</sup> Chancellor Allen first indicated that the BJR did not apply to director oversight cases.<sup>31</sup> Then, he explained that, in the modern corporate structure, “business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation.”<sup>32</sup> Without a duty to monitor, managers have less incentive to stamp out employee misconduct, especially when such conduct has the effect of increasing corporate profits in the short term as it did in *Caremark*.<sup>33</sup> For this reason, the Chancery Court agreed with the plaintiffs that there was a duty to monitor.

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<sup>26</sup> Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 561 (2008).

<sup>27</sup> See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 748 (Del. Ch. 2005) (finding that BJR does not apply “in instances where the directors have not exercised business judgment, that is, in the event of director inaction”); ALLEN ET AL., *supra* note 19, at 261 (“The business judgment rule protects boards that have made *decisions*.”); Bainbridge et al., *supra* note 26, at 575 (citing *Disney* for proposition that BJR does not protect director inaction).

<sup>28</sup> 698 A.2d 959 (Del. Ch. 1996).

<sup>29</sup> 42 U.S.C. § 1320a-7b; *Caremark*, 698 A.2d at 960–61, 963–64.

<sup>30</sup> *Caremark*, 698 A.2d at 967.

<sup>31</sup> See *id.* at 967–70 (distinguishing between liability arising from board *decision* and board *inattention*, noting BJR applies to former, and ignoring BJR in analyzing latter).

<sup>32</sup> *Id.* at 968.

<sup>33</sup> The Caremark employees’ goal in making payments to providers in violation of the Anti-Referral Payments Law was to get providers to prescribe Caremark’s products more

However, the court limited its holding by stating that, once management implemented a monitoring system, only a “sustained or systematic” failure to monitor would result in liability.<sup>34</sup> The Delaware Supreme Court has since narrowed the scope of liability by clarifying that *Caremark* liability depends on a showing of bad faith: Unless directors “utterly failed to implement any reporting or information system or controls,” or, having done so, “consciously failed to monitor or oversee its operations,” *Caremark* liability is not established.<sup>35</sup> Thus, Chancellor Allen aptly described the plaintiffs’ claim as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”<sup>36</sup> In explaining why the standard was so lenient as to directors, Chancellor Allen relied on *Gagliardi v. Trifoods International, Inc.*,<sup>37</sup> a case in which he explained the rationale for the BJR.<sup>38</sup> It is clear, then, that the policy justification that underlies the BJR also provides the rationale for the high bar to liability for *Caremark* claims: Shareholder wealth is enhanced by encouraging managers to take risks.<sup>39</sup>

### C. Duty To Monitor What?

Plaintiffs bringing *Caremark* claims typically argue that the defendant directors failed to adequately monitor employees in order to prevent accounting irregularities<sup>40</sup> or violations of law.<sup>41</sup> However, language in the *Caremark* opinion is not so limited. It describes the duty to monitor as including oversight of “both the corporation’s compliance with law *and its business performance*.”<sup>42</sup> The board is required to institute a monitoring system that would provide senior management with “information respecting material acts, events or

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often, thus leading to more revenue. *See id.* at 962 (stating that *Caremark*’s practice of contracting for services with physicians who prescribed *Caremark* products raised possibility of “unlawful kickbacks”).

<sup>34</sup> *Id.* at 971.

<sup>35</sup> *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (emphasis added).

<sup>36</sup> *Caremark*, 698 A.2d at 967.

<sup>37</sup> *Id.* (citing *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996)).

<sup>38</sup> *See supra* note 21–25 and accompanying text (discussing rationale for BJR).

<sup>39</sup> Note that while *Caremark* is a Delaware case, its reach is very broad, and most states have the equivalent of a “*Caremark* claim.” *See* Bainbridge, *supra* note 10, at 976 (arguing that *Caremark* is “widely followed both in the Delaware Chancery Court and in other states”). Thus, while this Note focuses on Delaware corporate law, the analysis is applicable to corporate law in many other states.

<sup>40</sup> *See, e.g.*, *Guttman v. Huang*, 823 A.2d 492, 493 (Del. Ch. 2003).

<sup>41</sup> *See, e.g.*, *Stone v. Ritter*, 911 A.2d 362, 365 (Del. 2006); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 127 (Del. 1963); *Caremark*, 698 A.2d at 960; *see also* Bainbridge, *supra* note 10, at 978 (“*Caremark* claims typically involve either law compliance or accounting irregularities.”).

<sup>42</sup> *Caremark*, 698 A.2d at 970 (emphasis added).

conditions within the corporation, *including* compliance with applicable statutes and regulations.”<sup>43</sup> The plain upshot of such language is that the monitoring system’s function goes beyond detecting violations of law or fraud. Yet Chancellor Allen left the question of what else must be monitored for another day.

At least some courts have seemed receptive to the idea that *Caremark* duties include a duty to monitor risk, though they have not found managers liable on such claims. In *Salsitz v. Nasser*,<sup>44</sup> the plaintiffs claimed that the directors of the Ford Motor Company failed to adequately monitor employees who had purchased a large stockpile of precious metals ostensibly to hedge against future price increases. Unfortunately, the hedging strategy failed and resulted in significant losses to the company.<sup>45</sup> Though the court applied the *Caremark* standard to adjudicate this claim, it ultimately ruled that the allegations were insufficient to show a “sustained and systematic” failure of oversight.<sup>46</sup> More recently, other courts have seemed inclined to read *Caremark* as imposing a duty on managers to monitor employees’ risk taking.<sup>47</sup>

## D. *In re* Citigroup

### 1. Background

In 1998, Citicorp merged with Traveler’s Group, Inc. to form the largest provider of financial services in the world.<sup>48</sup> During the first decade of the twenty-first century, Citigroup became more aggressive in its proprietary trading<sup>49</sup> and, by 2005, was heavily involved in the subprime mortgage market.<sup>50</sup> Citigroup faced massive exposure to the

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<sup>43</sup> *Id.* at 969 (emphasis added).

<sup>44</sup> 208 F.R.D. 589 (E.D. Mich. 2002).

<sup>45</sup> *Id.* at 599.

<sup>46</sup> *Id.*

<sup>47</sup> *See, e.g.*, La. Mun. Police Empl. Ret. Sys. v. Blankfein, No. 08 Civ. 7605 (LBS), slip op. at 8 (S.D.N.Y. May 19, 2009) (“Unlike the traditional *Caremark* claim in which liability arises from a failure to monitor or oversee appropriately employee misconduct or violations of law, the allegations in the Complaint attempt to base liability on a failure to monitor business risk related to the ARS market.”); *In re* Countrywide Fin. Corp. Derivative Litig., 554 F. Supp. 2d 1044, 1081 (C.D. Cal. 2008) (finding Board members have duty to monitor excessive risk taking).

<sup>48</sup> Timothy L. O’Brien & Joseph B. Treaster, *A \$70 Billion Pact*, N.Y. TIMES, Apr. 7, 1998, at A1.

<sup>49</sup> As noted *supra* note 14, proprietary trading is trading done by a financial institution for its own profit rather than in its capacity as an asset manager investing clients’ money.

<sup>50</sup> *See* Dash & Creswell, *supra* note 3 (describing Citigroup’s exposure to subprime mortgage market). Subprime mortgages are real estate loans made to riskier borrowers at higher interest rates. *See* RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 370–73 (4th ed. 2009) (discussing predatory lending and subprime mortgage crisis).

risks of the coming housing crash through its involvement in the market for mortgage-backed collateralized debt obligations (CDOs).<sup>51</sup> Between 2003 and 2005, Citigroup ramped up its issuances of the mortgage-backed CDOs from \$6.28 billion to over \$20 billion, thereby becoming an industry leader in the sale of these financial products.<sup>52</sup> Many of the CDOs that Citigroup had packaged and sold came with a “liquidity put,” which was an option for the purchaser of the CDO to sell it back to Citigroup for a certain predetermined price.<sup>53</sup> Much of the risk of the CDOs losing value was seemingly moved off Citigroup’s balance sheet with the use of “special investment vehicles” (SIVs).<sup>54</sup> While these SIVs were nominally separate entities, Citigroup later bailed them out to the tune of \$49 billion.<sup>55</sup>

As the housing bubble began to pop in the latter half of 2007, and home mortgage borrowers started to default in record numbers, Citigroup found itself with approximately \$43 billion in exposure to subprime mortgages.<sup>56</sup> This exposure was a result of losses suffered by the SIVs that still held the CDOs that were rapidly losing value. Citigroup held a board meeting in September of that year at which CEO Charles O. Prince III asked the head of the banking division, Thomas G. Maheras, whether the company was in danger of experiencing massive losses.<sup>57</sup> Maheras replied that the company was in good shape, but less than a month later Citigroup announced that it was writing down \$1.4 billion.<sup>58</sup> In January 2008, Citigroup took an

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<sup>51</sup> Moran, *supra* note 1, at 53. CDOs are constructed from pools of fixed-income assets such as home mortgages. *Id.* at 38–39. Financial firms such as Citigroup package pools of these assets and divide them into tranches. *Id.* at 39. The tranches are then categorized from senior to junior based on their priority of repayment, with interests in super-senior CDOs being paid out before those in junior ones. *Id.* The firm sells the CDO as a security to investors, often combined with default insurance. *Id.*

<sup>52</sup> *Id.* at 53; Dash & Creswell, *supra* note 3.

<sup>53</sup> *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 113 (Del. Ch. 2009).

<sup>54</sup> *See id.* at 114 (“Ultimately, Citigroup was forced to bail out seven of its affiliated SIVs by bringing \$49 billion in assets onto its balance sheet, notwithstanding that Citigroup previously represented that it would manage the SIVs on an arms-length basis.”). SIVs (also known as Special Purpose Entities) are separate corporate entities whose only assets are packaged debt instruments and are often used in the securitization process. *See* Kristin N. Johnson, *From Diagnosing the Dilemma to Divining a Cure: Post-Crisis Regulation of Financial Markets*, 40 SETON HALL L. REV. 1299, 1305–06 (2010) (explaining SIVs and their use).

<sup>55</sup> *Citigroup*, 964 A.2d at 114.

<sup>56</sup> Moran, *supra* note 1, at 53.

<sup>57</sup> Dash & Creswell, *supra* note 3.

<sup>58</sup> *Citigroup*, 964 A.2d at 113. When a firm writes down an asset, it downwardly adjusts the asset’s value on the firm’s balance sheet and transfers the difference to a loss account to reflect a change in the market value of the asset. BLACK’S LAW DICTIONARY 1748 (9th ed. 2009).

additional write-down of \$18.1 billion.<sup>59</sup> In the end, the losses amounted to approximately \$65 billion.<sup>60</sup> By late 2008, the value of the company's stock had decreased from \$244 billion to just \$20.5 billion.<sup>61</sup>

On November 9, 2007, a class of Citigroup shareholders filed a complaint in the Delaware Court of Chancery alleging that the Citigroup directors failed to monitor and rein in the risk exposure described above.<sup>62</sup> Plaintiffs pointed to more than fifty “red flags,” which they claimed should have alerted the directors to the company's risk exposure well before the September 2007 meeting.<sup>63</sup>

While plaintiffs claimed a breach of fiduciary duty for failing to monitor risk, there was no claim that Citigroup lacked a risk monitoring system.<sup>64</sup> In fact, plaintiffs admitted that the Citigroup board had established the Audit and Risk Management Committee (ARMC) and in 2004, gave it the responsibility to “assist the board in fulfilling its oversight responsibility relating to policy standards and guidelines for risk assessment and risk management.”<sup>65</sup> Instead, plaintiffs' only claim was that the ARMC failed to see the writing on the wall—the numerous “red flags” identified in the complaint—that the housing bubble was about to burst. Indeed, plaintiffs failed to make any claim that there was a “sustained or systematic” or “conscious” failure to oversee risk. Instead, plaintiffs pointed to other players in the financial industry that were able to heed the warnings and profit from the downturn.<sup>66</sup> Thus, the only support for the plaintiffs' argument derived from the outcome: They argued that the fact that the company had experienced losses should have been sufficient to establish liability.

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<sup>59</sup> *Citigroup*, 964 A.2d at 113.

<sup>60</sup> Dash & Creswell, *supra* note 3.

<sup>61</sup> *Id.*

<sup>62</sup> Derivative Complaint ¶ 115, *Citigroup*, 964 A.2d 106 (No. 3338-CC), 2007 WL 5208459; *Citigroup*, 964 A.2d at 114.

<sup>63</sup> These included a May 27, 2005 article by *New York Times* contributor Paul Krugman arguing that the housing market was “approaching the final, feverish stages of a speculative bubble”; the closings of two of the largest wholesale subprime lenders in the country, Ameriquest Mortgage and ResMae Mortgage, in May 2006 and February 2007, respectively; Standard & Poor's and Moody's downgrading of bonds backed by subprime mortgages in July 2007; and the August 2007 collapse of two Bear Stearns-managed hedge funds that invested heavily in subprime mortgages. Consolidated Second Amended Derivative Complaint ¶¶ 73–74, *Citigroup*, 964 A.2d at 115 (C.A. No. 3338-CC), 2008 WL 3910741; *Citigroup*, 964 A.2d at 115.

<sup>64</sup> *Citigroup*, 964 A.2d at 127 (“Plaintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk.”).

<sup>65</sup> *Id.*

<sup>66</sup> Consolidated Second Amended Complaint, *supra* note 63, ¶ 78.

## 2. *The Decision*

On February 24, 2009, the Delaware Chancery Court dismissed the suit against the defendant directors. As Professor Stephen Bainbridge has noted, Chancellor William Chandler's opinion is notable for its dual nature, at once dismissing the claim under the BJR as a challenge to a conscious business decision and also dismissing it under *Caremark*.<sup>67</sup> For instance, Chancellor Chandler declared that “[w]hile it may be tempting to say that directors have the same duties to monitor and oversee business risk [as they do to monitor criminal and fraudulent employee behavior], imposing *Caremark*-type duties on directors to monitor business risk is *fundamentally different*.”<sup>68</sup> This seemed to imply that *Caremark* did not contain a duty to monitor risk, and that a failure-to-monitor-risk claim was properly analyzed under the BJR.

Elsewhere in the opinion, though, the court proceeded to analyze the claim under the *Caremark* framework, looking for a “bad faith” failure to oversee risk. “[P]laintiffs’ allegations do not even specify how the board’s oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them.”<sup>69</sup> Therefore, *Citigroup*—if it was indeed analyzed under *Caremark*—was rightly decided under the law as it stands now. The parties agreed that there was a risk-monitoring system in place, and plaintiffs never pointed to any evidence that there was a conscious failure to monitor risk.<sup>70</sup> However, the fact that *Citigroup* was rightly decided raises a more important question: Is the law, as it stands now, sufficient to protect shareholders of financial firms from excessive risk taking?

## II

### POLICY JUSTIFICATIONS FOR EXPANDING FINANCIAL FIRM MANAGERS’ LIABILITY FOR FAILURES TO MONITOR RISK

As Stephen Bainbridge has argued, directors’ duty to monitor business risk does not differ in kind from their duty to monitor the firm’s compliance with the law.<sup>71</sup> Thus, a better reading of the Chancery Court’s opinion in *Citigroup* would be as an application of

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<sup>67</sup> Bainbridge, *supra* note 10, at 979–80.

<sup>68</sup> *Citigroup*, 964 A.2d at 131 (emphasis added).

<sup>69</sup> *Id.* at 128.

<sup>70</sup> See *supra* notes 64–65 and accompanying text.

<sup>71</sup> Bainbridge, *supra* note 10, at 979–81; see also PAN, *supra* note 12, at 13 (questioning whether it makes sense to distinguish between monitoring business risk and monitoring legal risk).

*Caremark* rather than of the BJR. There are two reasons for this: First, language in *Caremark* specifically envisions a duty that goes beyond monitoring law compliance or irregularities in accounting procedures.<sup>72</sup> Second, the focus of Bainbridge's piece, is that "risk management does not differ in kind from law compliance or accounting controls . . . [because t]he board of directors appropriately is charged with oversight over them all."<sup>73</sup> Thus, the duty to monitor the risk at issue in *Citigroup* should be recognized as a subset of the *Caremark* duty to monitor.

Though Bainbridge presents a convincing argument that *Caremark* should include a duty to monitor risk,<sup>74</sup> he argues that the lenient standard found in *Caremark* is the proper framework under which to analyze a claim of inadequate risk management.<sup>75</sup> He argues that since risk management is still evolving, courts should be wary of mandating any specific "roadmap for approaching risk management."<sup>76</sup> Further, he argues that risk-management systems are less effective than law compliance monitoring systems and that, because risk is a necessary part of any business model, we must accept that risk-management systems will sometimes "fail"—that is, allow losses—even when they are working properly.<sup>77</sup> Thus, Bainbridge advocates an even more deferential liability standard for the duty to monitor risk than for the duty to monitor law compliance.<sup>78</sup>

Bainbridge has a strong argument that shareholders are better off with a *Caremark* standard that is deferential to management, at least in most industries. The financial industry, however, is unique. Recall how the justifications for the lenient standard set out in *Caremark* are the same as those that underlie the BJR:<sup>79</sup> Investors are better off when managers can take risks without the looming threat of judicial second-guessing.<sup>80</sup> If this rationale does not have the same force in the context of the financial industry—that is, if the nature of risk taking in

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<sup>72</sup> *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969–70 (Del. Ch. 1996).

<sup>73</sup> Bainbridge, *supra* note 10, at 981.

<sup>74</sup> Other scholars have made similar arguments. For example, Eric Pan argues that, although the current Delaware doctrine does not include a duty to monitor risk, it should. See Eric J. Pan, *A Board's Duty To Monitor*, 54 N.Y.L. SCH. L. REV. 717, 740 (2010).

<sup>75</sup> Bainbridge, *supra* note 10, at 984 ("Just as the business judgment rule insulates risk taking from judicial review, so *Caremark* should insulate risk management from judicial review.").

<sup>76</sup> *Id.* at 982.

<sup>77</sup> *Id.* at 982–83.

<sup>78</sup> *Id.* at 985 ("[C]ourts need to be especially sensitive in applying *Caremark* to [risk management] cases.").

<sup>79</sup> See *supra* notes 37–39 and accompanying text (noting that both business judgment rule and *Caremark* standard encourage managers to take risks).

<sup>80</sup> See *supra* Part I.A (discussing policy justifications for business judgment rule).

the financial industry is qualitatively different than in other industries—the doctrine must adapt to that reality.

### A. Risk Monitoring in the Financial Industry

I briefly pause here to untangle two issues. First, a word about what I mean by “risk”: There are many different types of risk to which a business might find itself exposed.<sup>81</sup> One type is operational risk, which is defined by the Basel Committee on Banking Supervision as the “risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events.”<sup>82</sup> Operational risk can be further subdivided into smaller categories, most notably security risk (risk of employee malfeasance)<sup>83</sup> and property risk (risk of fire, burglary, or some other event that destroys property).<sup>84</sup> A second type of risk revolves around a firm’s assets and investments. This type includes liquidity risk (risk that a firm’s assets may not easily be converted into cash);<sup>85</sup> investment risk (risk that cash flows from an investment might be less than anticipated);<sup>86</sup> prepayment risk (risk that a debtor, by paying off a loan early, would deprive the lender of its expected, and possibly above-market, rate of return);<sup>87</sup> and credit risk (risk that a debtor will be unable to repay obligation).<sup>88</sup> Theoretically, *Caremark* requires managers to monitor all types of risk, but most *Caremark* claims have focused on different types of operational risk, namely, security risks involving employee fraud or theft.<sup>89</sup> By contrast, the subject of this Note is the monitoring of risks surrounding a firm’s investments and assets.

Second, what does it mean for financial firms to “monitor” these types of financial risk?<sup>90</sup> As financial firms began to trade increasingly exotic securities in the 1980s, a need for more advanced methods of

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<sup>81</sup> See generally JIHAD S. NADER, *THE MANAGER’S CONCISE GUIDE TO RISK* (2002) (cataloguing and exploring many different types of risk).

<sup>82</sup> BASEL COMM. ON BANKING SUPERVISION, *CONSULTATIVE DOCUMENT: OPERATIONAL RISK 2* (2001), available at <http://www.bis.org/publ/bcbsca07.pdf>.

<sup>83</sup> NADER, *supra* note 81, at 92–98.

<sup>84</sup> *Id.* at 87–88.

<sup>85</sup> *Id.* at 66–73.

<sup>86</sup> *Id.* at 63.

<sup>87</sup> *Id.* at 6–7 (otherwise referred to as “call risk”).

<sup>88</sup> *Id.* at 13–16.

<sup>89</sup> See *supra* Part I.C (discussing *Caremark* claims).

<sup>90</sup> One should keep in mind that the risk management divisions at most large financial firms are central to the functioning of those firms. Financial firms are in the risk-taking business. Thus, most decisions made within the firm are made with the quantitative analysts in mind. In fact, David Shirreff points out that, given the rise in complexity of financial products and risk management as a whole, some observers believe that it is “only a matter [of] time” before the “firm-wide risk manager” will be the typical CEO of a major financial institution. DAVID SHIRREFF, *DEALING WITH FINANCIAL RISK* 64, 72 (2004). This

analyzing the risks inherent in those instruments emerged.<sup>91</sup> Around the same time, advances in computing power enabled quantitative analysts, called “quants,” at financial firms to use computers to determine the likelihood of events taking place under certain circumstances.<sup>92</sup> At least when properly understood, the models have enabled better comprehension of the risks associated with complex financial instruments, which has, in turn, led to greater use of those products and the efficient diffusion of risk.<sup>93</sup> Thus, parties may take on the exact amount of risk that they are willing or able to accept, which lowers the cost of capital generally.<sup>94</sup>

Unfortunately, the models are not without their flaws. Their intricacies are difficult, if not impossible, to understand without training in computer science, mathematics, and statistics. Thus, the results of these simulations must be quantified into an easily understood metric that aggregates all of the risk faced by a particular trader, division, or even the entire firm. The primary metric used is known as “Value at Risk” (VaR).<sup>95</sup> VaR is a mathematical formula that essentially puts a dollar figure on risk exposure. If a certain trader has \$10 million of weekly VaR, that means that there is a 99% chance<sup>96</sup> that the trader’s portfolio will not lose more than \$10 million in the next week.<sup>97</sup> VaR is widely used and understood by managers, shareholders, and regulators alike, mostly due to its ability to distill a large amount of complex information into a single number.<sup>98</sup> In fact, the Basel and Basel II Accords, which are international banking supervision agreements, both recognize the utility of VaR as a vehicle for expressing risk.<sup>99</sup>

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Note is concerned with firms that break the mold and, contrary to this emerging industry practice, fail to take risk management seriously.

<sup>91</sup> See RICCARDO REBONATO, *PLIGHT OF THE FORTUNE TELLERS: WHY WE NEED TO MANAGE FINANCIAL RISK DIFFERENTLY* 119–27 (2007).

<sup>92</sup> See *id.* at 127–31 (2007) (describing risk modeling).

<sup>93</sup> See *id.* at xviii (describing International Monetary Fund’s view that “risk, in general, becomes less ‘toxic’ the more it can be dispersed”).

<sup>94</sup> See Virginia Harper Ho, “*Enlightened Shareholder Value*”: *Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 83 (2010) (“Better . . . risk management may also benefit the firm by lowering the cost of capital.”). See generally Mark P. Sharfman & Chitru S. Fernando, *Environmental Risk Management and the Cost of Capital*, 29 STRATEGIC MGMT. J. 569 (2008) (demonstrating empirically that environmental risk management can reduce cost of capital).

<sup>95</sup> Joe Nocera, *Risk Mismanagement*, N.Y. TIMES MAG., Jan. 4, 2009, at 24, 26 (explaining VaR).

<sup>96</sup> Depending on the model, the percentage can be anywhere from 95% to 99% to 99.99%.

<sup>97</sup> See Nocera, *supra* note 95, at 26.

<sup>98</sup> *Id.*

<sup>99</sup> See BASEL COMM. ON BANKING SUPERVISION, *INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS* 38 (2004), available at <http://>

However, VaR has its problems. Intriguingly, those problems stem from the same characteristic that makes VaR so useful. By simplifying so much information into one number, the qualifications, assumptions, and complexities of the models are lost.<sup>100</sup> Therefore, in order for upper-level management to utilize VaR honestly and intelligently, management must take time and effort to understand the limits of VaR. Furthermore, there are alternatives that fill in the gaps left by VaR that should be used by management to fully understand the risk exposure of the firm.

Thus, “risk monitoring” in this context means the collection and processing of information that is incorporated into the risk models, as well as using the information gleaned from these models to manage a firm’s risk exposure. Effective risk monitoring requires an understanding of the shortcomings of the models, which, in turn, means that senior management must be engaged in an honest, continuing dialogue with the “quants” about the risk position of the firm. Specific steps toward effective risk management are discussed in more detail in Part III.B.

### *B. How Financial Firms Are Different*

There is a qualitative difference between managing risk-taking activities at a financial firm such as Citigroup and doing so at firms in other industries. First, managers and employees of financial firms have unique incentives to take on risk due to the moral hazard<sup>101</sup> that exists for individual traders and upper-level management at financial firms. Second, financial firms are more leveraged than other types of firms. This magnifies the potential consequences of risky positions, thus necessitating strong risk management and oversight. Third, and perhaps most importantly, the complex nature of the modern financial system makes it difficult for shareholders of financial firms to understand the risks that those firms are taking. As a result, shareholders are unable to discount accurately the value of financial firms based on those firms’ risk exposure.

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[www.federalreserve.gov/boarddocs/press/bcreg/2004/20040626/attachment.pdf](http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040626/attachment.pdf) (permitting banks “to use a VaR models approach”).

<sup>100</sup> See *infra* notes 126–28 (discussing how VaR can be abused by those seeking to hide risk by taking on risks that do not show up in VaR calculations).

<sup>101</sup> Moral hazard is the phenomenon of someone who is insulated from the downside of risk behaving differently than if they were exposed to the full extent of risk. For a full explanation of moral hazard, see NADER, *supra* note 81, at 71–72.

## 1. Risk at the Trading Desks

### a. The Unique Incentive Structures of Financial Firms Push Traders Toward Excessive Risk Taking

In order to understand how financial firms are prone to taking on excessive risk, it is important to understand the incentives created by their compensation structure. Most traders at financial firms are paid via two metrics: a standard base salary that is relatively low compared to their total compensation and a profit-based bonus or incentive payment that typically constitutes a majority of their pay.<sup>102</sup> This means that traders share in the profits that they make for clients—or, in the case of proprietary trading, the profits that they make for the firm—but do not suffer the losses.<sup>103</sup> In other words, traders are playing with other people’s money, a problem that some have dubbed the “no skin in the game” problem.<sup>104</sup>

Thus, traders are incentivized by their salary structure to take very large risks. Because the downside is limited, a trader will take on greater risk in order to increase the potential upside.<sup>105</sup> This risk

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<sup>102</sup> See James Dow, *What Is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation*, MONETARY & ECON. STUD., Dec. 2000, at 16 (explaining nature of trader compensation).

<sup>103</sup> *Id.*

<sup>104</sup> Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 188 (2009); see also SHIRREFF, *supra* note 90, at 2 (“[I]n financial markets most risktakers are risking other people’s money, not their own.”). This structure can be thought of as an option contract, whereby the trader’s bonus is “in the money” whenever they make profits from their trade. See *id.* at 17 (describing option contracts); Dow, *supra* note 102, at 16 (describing traders’ incentive compensation as “option-like”).

In this way, one may notice a distinction between managers, who are generally risk-averse due in part to their large investment in human capital in the firm, see *supra* note 23 and accompanying text, and lower-level traders, who are often less personally invested in the overall health of the firm. Traders’ lack of interest in the long-term success of the firm has been identified as a problem with the incentive schemes of many firms. See *infra* note 120 and accompanying text (describing difficulty of tying trader compensation to long-term firm performance).

<sup>105</sup> For instance, Karl Okamoto gives the simple example of a trader—whose bonus is 20% of profits—faced with a decision to make either a relatively safe trade that will most likely have a 5% return on investment or an aggressive, risky trade that has the possibility of a 25% return, but also the strong possibility of loss. Okamoto, *supra* note 104, at 205. Because she does not share in the loss, the trader has a strong incentive to take on the more risky trade: 20% of a 25% return is substantially more than 20% of a 5% return. *Id.*

Of course, even if she bears none of the loss, she will get nothing from an unprofitable trade. For this reason, it is still possible that the trader in the hypothetical above will want to take the safe investment rather than the risky one. To give a clear example, suppose the safe trade is guaranteed to pay 5% whereas the risky one has only a 1% chance of paying 25%. The expected value to the trader (who makes 20% of profits, and thus makes nothing when the trade loses money) is actually greater with the safe trade, even though she does not bear any of the loss that would occur if she took the risky trade. However, her not sharing in the loss means that she will take the risky trade *more often* than she would if she

often exceeds the risk that most investors would take with their own money<sup>106</sup> and theoretically exceeds the risk that most shareholders would approve if they were running the firm.<sup>107</sup> Particularly egregious examples of this phenomenon are “rogue” traders such as Jerome Kerviel and Nick Leeson.<sup>108</sup> Kerviel, a junior asset manager for Société Générale at their proprietary trading desk, lost his firm over \$7 billion through unauthorized, excessively risky trades.<sup>109</sup> Leeson almost singlehandedly caused the Barings Bank collapse.<sup>110</sup> While certainly anomalies, these two traders nonetheless exemplify the corrupting influence that the incentive pay structure at financial firms can have on individual traders.<sup>111</sup> But it gets worse. As the positions<sup>112</sup> of individual traders sink below the level required to earn a bonus (or keep one’s job), the motivation to take increasingly large and unwarranted risk grows.<sup>113</sup> This effect has been termed “gambling for resurrection,”<sup>114</sup> or “get-evenitis.”<sup>115</sup>

The incentive structure at financial firms thus creates a culture that values short-term profits at the expense of future stability.<sup>116</sup> This

did bear the loss. Thus, “while losses impose some costs on the asset manager, they are less than those borne by the client [or, in the proprietary trading context, the firm] because none of the asset manager’s money is at risk. Therefore, absent some other constraints, the asset manager can be expected to take more risk than the client [or firm] normally would.” *Id.* at 206.

<sup>106</sup> *Id.*

<sup>107</sup> See *infra* notes 142–46 (describing apparent shareholder interest in reduced risk).

<sup>108</sup> See SHIRREFF, *supra* note 90, at 3, 42 (describing various banks’ huge losses caused by traders); Okamoto, *supra* note 104, at 208 (citing both as “[e]xtreme examples” of rogue traders who caused massive losses); see also Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 128 n.2 (2009) (citing instances of massive losses blamed on rogue traders).

<sup>109</sup> Krawiec, *supra* note 108, at 128. A securities class action arising out of Kerviel’s actions filed in U.S. District Court for the Southern District of New York was recently dismissed. *In re Société Générale Sec. Litig.*, No. 08 Civ. 2495(RMB), 2010 WL 3910286 (S.D.N.Y. Sept. 29, 2010).

<sup>110</sup> See W.P. Hogan, *The Barings Collapse: Explanations and Implications* 8–11, 42 (Univ. of Sydney Working Papers in Econ., Paper No. 235, 1996) (describing Leeson’s activities as causing and hiding massive losses, but concluding that “ultimate responsibility for the collapse of Barings Plc lay with its board and management”).

<sup>111</sup> See Okamoto, *supra* note 104, at 208 (“In hindsight, it comes as little surprise when, given the chance, each created for themselves extremely valuable options by taking enormous risk.”).

<sup>112</sup> By position, I refer simply to the value of assets held in the trader’s portfolio.

<sup>113</sup> See Dow, *supra* note 102, at 16 (explaining phenomenon whereby traders take on greater and greater risks to chase losses).

<sup>114</sup> *Id.*

<sup>115</sup> HERSH SHEFRIN, *BEYOND GREED AND FEAR* 24 (2000); see also SHIRREFF, *supra* note 104, at 28–29 (describing this effect as “gambler’s ruin”).

<sup>116</sup> See James A. Fanto, *The Role of Financial Regulation in Private Financial Firms: Risk Management and the Limitations of the Market Model*, 3 BROOK. J. CORP. FIN. & COM. L. 29, 47 (2008) (“Wall Street has become a place of short-term rewards and compen-

culture can also find its roots in the “either produce or get out” attitude that predominates in many top financial firms.<sup>117</sup> But why would managers set up the incentives this way? Obviously, some incentive pay is a good thing. Shareholders want to align the interests of the traders with those of the firm—making money. However, a balance must be struck between incentivizing traders to make money for the firm and making sure that, in so doing, they are not exposing the firm to too much risk. One possible compromise is to tie compensation to the long-term success of the firm, but, as James Fanto explains, this solution is unlikely to work for two reasons.<sup>118</sup> First, it is unclear how such a compensation system would work in many contexts.<sup>119</sup> Second, the compensation of traders and financial professionals cannot be tied to the long-term performance of the firm because many traders do not stay at one firm for long enough to make such a structure effective.<sup>120</sup>

Instead, in current practice, management relies on risk monitoring systems to keep traders in check.<sup>121</sup> Management adjusts bonuses to reflect the amount of risk exposure at each trading desk

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sation for short-term results . . . .”); Dennis K. Berman, *Grim Reaper of Jobs Stalks the Street*, WALL ST. J., Mar. 11, 2008 at C1 (discussing relationship between volatile employment statistics and risky investment behavior on Wall Street); Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys., Speech at the Global Association of Risk Management Professionals Annual Risk Convention: Improving Risk Management in Light of Recent Market Events (Feb. 25, 2008), available at <http://www.federalreserve.gov/newsevents/speech/kroszner20080225a.htm> (“In trading and certain other activities, there is a tendency for business-line heads or individual employees to focus on their short-term compensation and not think about the long-term risks that their activities create for the firm.”); see also SHIRREFF, *supra* note 104, at 50 (showing how options trading, especially with longer time horizons, allows traders to increase their current profit-and-loss account by taking imprudent risks that expose firms to massive long-term risk).

<sup>117</sup> Fanto, *supra* note 116, at 47; see Dow, *supra* note 102, at 16 (explaining that traders’ incentives to take risk increase with possibility that they may be “sacked”).

<sup>118</sup> Fanto, *supra* note 116, at 49.

<sup>119</sup> *Id.* (“It is not clear how deferred compensation would be structured in many situations, such as prime brokerage, and what length of time would qualify as ‘long term.’ Moreover, it is doubtful that the compensation of many financial professionals can be tied to the long-term performance of the firm when firms want the flexibility to end employment relationships without paying prohibitively for the privilege. In addition, aligning the interests of agents and the firm does not adequately address the macroeconomic harms from financial activities, such as systemic risk, since they do not likely even figure in the financial firm’s calculus in the first place.”).

<sup>120</sup> *Id.* But see generally Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term* (Yale Law Sch. John M. Olin Ctr. for Studies in Law, Econ., and Pub. Policy, Research Paper No. 374, 2009), available at <http://ssrn.com/abstract=1336978> (proposing that executive incentive compensation consist only of restricted stock and restricted stock options that cannot be sold or that do not vest until two to four years after executive leaves company).

<sup>121</sup> See Okamoto, *supra* note 104, at 208–09 (explaining that firms try to “counterbalance[] the inherent incentive to take excessive risk by erecting a ‘regulated’ environment”).

and imposes limits on the amount of risk to which traders can expose the firm. However, this in turn creates an incentive for traders to hide risk.<sup>122</sup> As discussed above, most firms quantify the risk that an individual trader takes on in terms of VaR.<sup>123</sup> The firm then ties the trader's compensation to VaR by discounting trading profits by the amount of risk to which the trader exposed the firm. The trader's incentives are then affected not only by the amount of profits made on investments but also by the riskiness of those investments. But traders can game this system.<sup>124</sup> A trader does this by "stuffing risk into the tails"<sup>125</sup>—that is, taking risks that do not show up in the VaR model because there is a less than one percent chance of their occurrence.<sup>126</sup> Such a position usually involves an "asymmetric risk position[ ]" wherein the chance of the loss is low, but the magnitude, should loss occur, is enormous.<sup>127</sup> A notable tool for stuffing risk into the tails is the now-infamous credit default swap—"essentially insurance that a [borrower will not] default" on a loan.<sup>128</sup> Firms themselves can also

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<sup>122</sup> See *id.* at 209–11 (explaining "incentive to understate risk" present where someone who has incentive to take on risk is confronted with risk management controls). As Okamoto explains, a similar effect could be observed during the recent financial crisis when mortgage loan originators understated the risks of those loans to the firms that securitized them, who in turn understated the risks to credit rating agencies. *Id.* Neil Shah explains a different aspect of this problem, pointing out that hedge funds price assets in ways that ignore fundamental risks. Neil Shah, *Can Wall Street Be Trusted To Value Risky CDOs?*, REUTERS, Jul. 13, 2007.

<sup>123</sup> See *supra* Part II.A (discussing VaR).

<sup>124</sup> See, e.g., SHIRREFF, *supra* note 104, at 69 (discussing gaming behavior on behalf of traders and highlighting importance of risk-adjusted incentive compensation structures).

<sup>125</sup> Nocera, *supra* note 95, at 46. The origin of this expression makes sense if one views all potential outcomes of a particular trade as falling along a bell curve. The least likely outcomes are spread out at the extreme ends of the curve—the "tails." Thus, when a trader is exposed to risks of extremely unlikely occurrences, he or she is "stuffing risk into the tails" of the distribution.

<sup>126</sup> See *id.* (discussing problem of manipulating VaR through use of credit-default swaps with less than one percent likelihood of large losses). For a discussion of ways in which mutual funds strategically frame risk in order to capitalize on investors' cognitive limitations, see SHEFRIN, *supra* note 115, at 170–74.

<sup>127</sup> Nocera, *supra* note 95, at 46; see also Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 179–80 (2009) (explaining how traders may take "asymmetric risk positions" involving small possibility of large losses to game VaR models).

<sup>128</sup> Nocera, *supra* note 95, at 46. Of course, the utility of a credit-default swap for stuffing risk into the tails is dependent on the likelihood of models ascertaining the risk of default. In the recent housing bubble, some traders found credit-default swaps useful to stuff risks into the tails because the event that would have led to default and thereby the obligation to pay on the credit-default swap—the housing crash—was deemed to be so unlikely that it was not calculated in the VaR.

hide risk by moving riskier investments to nominally separate companies that the firm must later bail out if the investments fail.<sup>129</sup>

b. Government Bailouts and Insurance Provide Traders with a (False) Sense of Invincibility

Moral hazard problems do not end with the pay structures at financial firms. Government guarantees of the financial system disincentivize traders at financial firms from conducting appropriate due diligence when doing business with other large financial firms. Though this guarantee may not be official policy, many perceive that certain banks are simply “too big to fail.” Much has been written about how the government’s role as lender of last resort to failing financial institutions creates moral hazard in the industry.<sup>130</sup> Because a trader dealing with a counterparty<sup>131</sup> that is a large financial institution thinks that the government implicitly guarantees that counterparty’s obligations, the trader has less incentive to investigate the risk that the particular counterparty will fail.<sup>132</sup> However, this underlying assumption is not always borne out: The government’s failure to rescue Lehman Brothers at the height of the crisis in September 2008 demonstrates the riskiness of assuming that large counterparties will be bailed out<sup>133</sup> and exemplifies the harm to financial firms’ shareholders if the expected bailout does not materialize.<sup>134</sup> It is possible to argue

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<sup>129</sup> See *supra* notes 53–55 and accompanying text (describing how Citigroup did this using SIVs).

<sup>130</sup> See, e.g., Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1633 (2008) (“If a firm is perceived to be ‘too big to fail,’ the problem that arises is moral hazard.”); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1375 (2009) (“Moreover, the moral hazard of institutions that are ‘too big to fail’ vastly increased as a result of this crisis.”).

<sup>131</sup> A counterparty is the party on the other side of any financial transaction.

<sup>132</sup> See McCoy et al., *supra* note 130, at 1370 (noting that “[c]ounterparty risk” had to have been considered by those market participants who bought credit-default swaps—essentially betting against housing market, but also relying on sellers of credit-default swaps to remain solvent—but such buyers must also have realized that AAA-rated sellers of credit-default swaps were “too big to fail”); see also ERIK BANKS, RISK AND FINANCIAL CATASTROPHE 60 (2009) (describing moral hazard effect of “too big to fail”).

<sup>133</sup> See RUSSELL ROBERTS, MERCATUS CTR., GAMBLING WITH OTHER PEOPLE’S MONEY 12 (May 2010), available at <http://mercatus.org/sites/default/files/publication/RUSS-final.pdf> (“[I]nvestors expected Lehman to be rescued as Bear was in the case of a Lehman collapse.”); Michael Boskin, *Investors Want Clarity Before They Take Risks*, WALL ST. J., Jan. 23, 2009, at A15 (discussing confusion arising out of government actions, including government’s failure to rescue Lehman).

<sup>134</sup> Jeff Miller, *Lehman: The Counterparty Risk*, SEEKING ALPHA (Sept. 15, 2008), <http://seekingalpha.com/article/95413-lehman-the-counterparty-risk> (explaining risk exposure of Lehman Brothers’ counterparties).

that although the idea that some institutions are “too big to fail” creates moral hazard problems, it is accompanied by strict government regulation. Thus, government oversight counteracts any increase in incentives toward risky behavior. However, as is discussed more fully below, the goals of regulators do not always align with the goals of investors, and regulators may not always be as effective as shareholders in policing management. Government regulation will never adequately replace strong corporate governance.

## 2. *The Financial Industry Is Built on Leverage*

Leveraged investing is the practice of using debt to finance investment.<sup>135</sup> In essence, one borrows money, invests it, and keeps the profit (after paying creditors back). In this way, it is possible to make money without needing a large capital base. However, leverage acts as a “magnifying glass, expanding small profit opportunities into larger ones, but also expanding small losses into larger losses.”<sup>136</sup> The financial industry uses leverage more than other industries. For example, in the typical commercial bank model, a bank will use depositors’ money (debt) to finance loans to borrowers (investment).<sup>137</sup>

While every business uses debt to finance its investments, no other industry relies on leveraged investments to the same extent as the financial industry.<sup>138</sup> Further, with the advent of derivatives,<sup>139</sup> as

<sup>135</sup> See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 8 (10th ed. 2007) (explaining fundamentals of leveraged investments).

<sup>136</sup> Nicholas Chan, Mila Getmansky, Shane M. Haas & Andrew W. Lo, *Systemic Risk and Hedge Funds* 37 (Nat’l Bureau of Econ. Research, Working Paper No. 11200, 2005).

<sup>137</sup> See LLOYD B. THOMAS, *MONEY, BANKING AND FINANCIAL MARKETS* 204 (2006) (“Banks earn profits principally by obtaining funds at relatively low interest rates and then lending the funds or investing in securities at higher interest rates.”); Macey et al., *supra* note 16, at 102 (arguing that “banks’ highly leveraged condition . . . supports the argument that bank directors should owe fiduciary duties to fixed claimants as well as to equity claimants”); McCoy, *Political Economy*, *supra* note 16, at 19 (“The banking sector, of course, is the archetype of a highly leveraged industry . . . .”); see also RICHARD SCOTT CARNELL ET AL., *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 45 (4th ed. 2009) (“Banks use much greater leverage than industrial firms.”).

<sup>138</sup> The financial industry’s pervasive use of the “carry trade” strategy is illustrative of its general practice of highly leveraged investing. See Okamoto, *supra* note 104, at 187. As Okamoto explains, “[c]arry trade refers generally to the strategy of taking low-cost borrowings and investing them in higher-yielding assets in order to capture the ‘spread,’ or ‘carry,’ created.” *Id.* This strategy is pervasive throughout the industry: “It is exactly what banks traditionally do for a living. It is the logic behind Collateralized Debt Obligations (CDOs), Special Investment Vehicles (SIVs), and even the economics of the current government bailout.” *Id.*; see also SHEFRIN, *supra* note 115, at 190 (explaining use of leverage by municipal bond fund companies).

<sup>139</sup> The fact that parties now can easily establish a long or short position in an asset using derivatives—without having to purchase or sell the asset itself—has caused an explosion in the prevalence of leveraged investing, as it allows anyone to bet as much on an asset

well as entities that are themselves highly leveraged such as hedge funds,<sup>140</sup> the financial industry has seen a recent explosion in the use of leverage.<sup>141</sup> Because of the systematic use of leverage, financial firms are more exposed to small fluctuations in the market. This makes strong risk-management oversight more important for financial firms than for other firms because a small mistake in managing risk in the financial industry can have consequences that are far more devastating than the consequences of similar mistakes in other, less leveraged industries.

### 3. *Financial Firms' Complexity and Ability To Hide Risk Make Market-Based Solutions Ineffective*

These two observations—that financial firms take on more risk than other firms and that they are more heavily leveraged—are troubling. But, perhaps, shareholders *know* that investing in financial firms is risky, and yet they still do so because the reward of high profits outweighs the risk of loss to a rational investor.<sup>142</sup> Such an argument rests on an assumption that investors have access to perfect information regarding the risks of their investment.<sup>143</sup> Commentators have debated the merits of this assumption for years,<sup>144</sup> but if it has any weakness, it lies at the center of the financial industry. Because of the

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moving up or down as he or she is willing to borrow. See BANKS, *supra* note 132, at 62–63 (describing how derivative contracts have been used to increase leverage).

<sup>140</sup> Hedge funds are private corporate entities that use sophisticated investment strategies such as leveraged, long, short, and derivative positions to aggressively pursue return on investments. Thierry Olivier Desmet, *Understanding Hedge Fund Adviser Regulation*, 4 HASTINGS BUS. L.J. 1, 2–3 (2008).

<sup>141</sup> See BANKS, *supra* note 132, at 62–63 (describing recent expansion of leverage in financial system).

<sup>142</sup> See, e.g., Nicholas Calcina Howson, *When “Good” Corporate Governance Makes “Bad” (Financial) Firms: The Global Crisis and the Limits of Private Law*, 108 MICH. L. REV. FIRST IMPRESSIONS 44, 48–49 (2009) (arguing that shareholders actually push for riskier investing as demonstrated by various banks' experience before and after recent crisis).

<sup>143</sup> This assumption is essentially the “strong” form of the “efficient capital markets” hypothesis, which argues that capital markets perfectly distribute information to all participants through the pricing of securities. See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 98–101 (4th ed. 2004) (discussing efficient capital markets hypothesis).

<sup>144</sup> See *id.* (pointing out disagreements among scholars and practitioners regarding efficient capital markets hypothesis). Many have argued that the efficient capital markets hypothesis runs counter to some well-recognized trading strategies and enforcement actions. See, e.g., *id.* at 100 (“[I]f the strong form of market efficiency were true, then a lot of effort has been misspent recently prosecuting individuals for insider trading.”). For a detailed discussion of the implications of real-world trading strategies for the efficient capital markets hypothesis, see Elizabeth Chorvat, *You Can't Take It with You: Behavioral Finance and Corporate Expatriations*, 37 U.C. DAVIS L. REV. 453, 480–84 (2003).

complex nature of the risks that financial firms take,<sup>145</sup> information asymmetry renders investors unable to gauge the risks of individual firms accurately.<sup>146</sup>

Furthermore, recall how some traders attempt to hide risk when given the opportunity.<sup>147</sup> Doing so hides risk not only from management, but also from investors. Firms themselves can also hide risk from investors, as Citigroup did using SIVs.<sup>148</sup> In an idealized market, investors would discount the value of the firm by the amount of risk the firm was taking on and would diversify their portfolios based on what *kinds* of risk the firm was taking on. However, if traders are hiding the risk exposure at their desks, and the firm is hiding its overall risk exposure, then investors do not have the information necessary to accurately discount or diversify their investment. Relying on market forces alone is therefore inadequate. Because investors cannot protect themselves from excessive risk in financial firms, courts should step in to force managers to monitor risk aggressively.<sup>149</sup>

### *C. Implications for Judicial Review of Financial Firms' Risk Management*

#### *1. Caremark Should Be Modified When Applied to Financial Firms*

Put simply, *Caremark's* liability standard is based on the idea that shareholders are better off where every failure to monitor the company does not automatically expose management to liability. If a risk-

<sup>145</sup> For a discussion of how the complexity of modern financial products played a role in the recent crisis, see *infra* note 202 and accompanying text.

<sup>146</sup> See REBONATO, *supra* note 91, at 110–14 (explaining this informational asymmetry). As Rebonato argues, this explains the phenomenon, seen repeatedly in capital markets, of investors' preference for "stable earnings." *Id.* at 112. This preference runs counter to traditional theory, which supposes that investors know all the risks of an investment, in which case the stability of any one investment is unimportant because investors can manage the diversification of all their investments as they see fit. *Id.*

<sup>147</sup> See Okamoto, *supra* note 104, at 209–11 (explaining "[i]ncentive to [u]nderstate [r]isk"); see also *supra* notes 121–28 and accompanying text (discussing tendency to hide risk).

<sup>148</sup> See *supra* text accompanying notes 53–55.

<sup>149</sup> There is also the possibility that investors, knowing that many financial firms' risk exposure is unknowable, discount the value of all financial firms equally. This is inefficient because it discourages investment in firms that manage risk well, which in turn discourages firms from making the effort to manage risk well. Thus, a heightened *Caremark* duty that provides investors with assurances that traders are not hiding risk and that there are people within the firm who are able to understand the complex nature of modern, risky financial products would not only protect investors, but would also help the financial industry—and the economy—as a whole. Similar justifications underlie the mandatory disclosure regime in federal securities regulation: Investors value disclosure and such a regime increases value generally. See Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1028–34 (2000) (discussing traditional justifications for mandatory disclosure regime).

management system exists, the *Caremark* standard is satisfied without inquiry into the system's effectiveness or robustness. This standard comes as a tradeoff whereby management does not have to scrutinize every decision made within the bowels of the firm (if, for example, they determine that to do so would be cost prohibitive), and courts do not get to second-guess management whenever something goes wrong. For the majority of firms, this tradeoff is in the best interest of shareholders. Most managers have a tendency to take too little risk, and the current *Caremark* liability standard works to counteract this tendency. However, by contrast, traders at financial firms are incentivized to take on excessive risk, and their managers tend to allow excessive risk to go unnoticed through a failure to understand that risk.<sup>150</sup> Further, financial firms are leveraged much more than other firms, meaning that small lapses in managing risk can be catastrophic. Finally, certain features of the financial industry make it impossible for shareholders to discount appropriately their investments in financial firms to account for each firm's riskiness or to otherwise protect themselves. Thus, *Caremark* should be modified to allow courts to conduct a detailed inquiry into the adequacy of the risk-management systems at financial firms.<sup>151</sup>

Of course, the financial industry is already heavily regulated by federal and state governments, especially with regard to the appropriate levels of risk.<sup>152</sup> Thus, it might be argued that private enforcement of risk management is wholly unnecessary because shareholders are already protected from excessive risk by stringent government regulations.<sup>153</sup> This is wrong for a number of reasons. First, the goals of government regulators do not always align with those of private

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<sup>150</sup> See *infra* notes 201–03 and accompanying text (discussing need for managers who understand financial risk).

<sup>151</sup> Note that this argument does not apply to every *Caremark* claim that a shareholder might bring against the managers of a financial firm. Instead, the argument is limited to claims of failure to monitor risks associated with a firm's investments and assets—such as liquidity risk, credit risk, and investment risk—because what makes financial firms different in my analysis is their unique exposure to these kinds of risk. Thus, nothing in this Note would argue against the typical *Caremark* standard being applied to monitoring operational risk (for example, a criminal act by a third party causing losses at the firm). The incentives to avoid operational risk are the same at financial firms as at any other kind of firm.

<sup>152</sup> See generally Nicholas Grabar, *Global Capital Markets & the U.S. Securities Laws 2010: Strategies for the Changing Regulatory Environment*, 1807 PLI/CORP. 329 (2010) (outlining financial regulation in United States).

<sup>153</sup> See, e.g., Howson, *supra* note 142, at 50 (“The global financial crisis of 2008–2009 should teach us once again—at least with respect to financial institutions—that we are well advised to enhance prudential regulation by public authorities, over and above the intuitively appealing but wrongheaded desire for ‘better’ or more vigorously enforced corporate governance.”).

shareholders. A good example of this is the prevalence of high leverage ratios in the financial industry.<sup>154</sup> A government regulator seeking to promote stable capital markets would clamp down on excessive leverage because a financial firm suffering large losses would—as we saw with Lehman Brothers in the fall of 2008—harm the financial system as a whole.<sup>155</sup> However, shareholders prefer that firms in which they invest have large leverage ratios, even if pervasively high leverage undermines the stability of the financial system at large.<sup>156</sup> There are a number of reasons for this. First, the tax treatment of debt is better than that of equity because firms can deduct interest payments to creditors but not dividends paid to shareholders.<sup>157</sup>

Second, leverage puts more of the firm's creditors' money at risk and less of the shareholders'.<sup>158</sup> As Karl Okamoto points out, using highly leveraged investing “is a great way to make money, *assuming you can manage the risk*.”<sup>159</sup> Thus, instead of simply limiting the amount of leverage available to firms—as government regulators have done—it is in the shareholders' best interest to allow the firm to use a large amount of leverage, but ensure that the firm manages its risk properly.

Third, government regulation does not provide investors with a remedy when managers at firms take on excessive risk. This is prob-

<sup>154</sup> See *supra* Part II.B.2 (discussing use of leverage in financial industry).

<sup>155</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act does this by creating the Financial Stability Oversight Council and empowering it to make recommendations to the Federal Reserve regarding leverage ratios. See 12 U.S.C.A. § 5321(a) (West 2010) (creating Financial Stability Oversight Council); *id.* § 5322(a)(2)(I) (empowering Council to make recommendations); see also *The Basel III Leverage Ratio Is a Raw Measure, but Could Supplement Risk-Based Capital Metrics*, STANDARD & POOR'S (Apr. 15, 2010), <http://www.bis.org/publ/bcbs165/splr.pdf> (explaining Basel Committee's attempt to rein in high leverage ratios across financial industry).

<sup>156</sup> See John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 27 (1986) (explaining how increasing firm's leverage sends positive signal to shareholders).

<sup>157</sup> See Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1059–64 (2000) (describing different tax treatment of interest payments and dividends).

<sup>158</sup> On the other hand, the Modigliani-Miller Theorem posits that, under certain conditions, the firm's capital structure is irrelevant to equityholders. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). However, as some have recently pointed out, because the Modigliani-Miller Theorem assumes fully informed investors, no taxes, and risk-free debt, there will be times when increasing leverage will be in the equityholders' best interest. See, e.g., Linda Schmid Klein et al., *Debt vs. Equity and Asymmetric Information: A Review*, 37 THE FIN. REV. 317, 319 (2002) (pointing out that Modigliani and Miller never actually say that capital structure is “irrelevant” to firm value and discussing situations in which equity financing would be less desirable than debt financing).

<sup>159</sup> Okamoto, *supra* note 104, at 187 (emphasis added).

lematic for two reasons: One, it prevents investors from being made whole, and, two, it fails to harness the power of private suits to hold managers personally accountable to shareholders for violations of their fiduciary duties. As to the former, penalties imposed by government regulators in the financial industry are typically paid directly to the United States Treasury rather than to victims.<sup>160</sup> While the Fair Fund provision of the Sarbanes-Oxley Act allows penalties to be paid to injured investors,<sup>161</sup> this provision applies only to suits brought under the securities laws, which do not cover breaches of the fiduciary duty of care. In order for shareholders of firms to be made whole when managers breach their fiduciary duties, shareholders must be allowed to bring private suits.<sup>162</sup>

As to the second point regarding managers' accountability, while managers are protected by other means from unlimited personal liability for breaches of their fiduciary duties,<sup>163</sup> the threat of such liability, coupled with the ordeal of defending a suit, will force managers to take it upon themselves personally to ensure that they meet their fiduciary duties. By contrast, government regulators often punish the firm itself, rather than individuals, for violating risk-based regulation. And even when regulators punish individual actors, regulators usually focus on individuals who are specifically responsible for managing risk rather than on general managers.<sup>164</sup> However, as every single board

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<sup>160</sup> See, e.g., 15 U.S.C. § 77t(d)(3)(A) (2006) ("A penalty imposed under this section shall be payable into the Treasury of the United States . . ."); see also John Marshall Cook, Comment, *The Securities Enforcement and Penny Stock Reform Act of 1990: The Cost of Flexibility*, 6 ADMIN. L.J. AM. U. 359, 372 n.96 (1992) (listing examples of fines for securities violations paid to U.S. Treasury).

<sup>161</sup> Sarbanes-Oxley Act of 2002 § 308, Pub. L. No. 107-204, 116 Stat. 745, 784 (codified as amended at 15 U.S.C. § 7246(a) (2006)).

<sup>162</sup> Of course, shareholders will not always be able to collect the entirety of their losses due to management's excessive risk taking, as such losses are likely to be enormous. However, because many directors and officers of major corporations are insured against liability for such suits, shareholders have a real opportunity to collect much of their losses from insurance claims.

<sup>163</sup> See *infra* notes 213–14 and accompanying text (discussing insurance and indemnity for directors and officers under Delaware law).

<sup>164</sup> For instance, the FDIC can bring cease and desist orders against banks for improper risk management and force the bank to hire more qualified individuals. 12 U.S.C. § 1818(b)(6)(B) (2006). However, this is a prospective action in an attempt to shore up the bank's risk management practices. *Id.* § 1818(b)(6) (laying out "affirmative action to correct conditions resulting from violations or practices"). Further, if the FDIC wishes to remove a manager, it must prove: (1) that the manager violated a law or written order or agreement, engaged in an unsafe or unsound practice, or breached a fiduciary duty; (2) that the violation, unsafe or unsound practice, or breach of fiduciary duty caused harm to the bank; and (3) that the manager engaged in an act of personal dishonesty or demonstrated "willful or continuing disregard . . . for the safety and soundness" of the bank. *Id.* § 1818(e). Similar requirements exist for the imposition of civil money penalties. *Id.* § 1818(i). It is therefore difficult for the FDIC to bring an action against a board member

member is charged with overseeing the risk position of the firm, each individual in such a position of responsibility should be made to feel as though he or she is personally accountable for ensuring that the firm's risk exposure is carefully monitored. By allowing shareholders to sue all such managers for failing to monitor risk, we can ensure that these actors take risk management seriously.

Perhaps a regulatory solution similar to Sarbanes-Oxley should be pursued in this context. In other words, instead of changing *Caremark*, a federal law might be enacted to allow shareholders to be compensated through agency enforcement actions that hold each manager personally accountable for the monitoring of the firm's risk. There are two problems with this proposal, however. First, relying on regulators to enforce risk-management requirements on behalf of shareholders would force regulators to shift their focus from protecting the economy at large to protecting shareholders' interests. These interests may not always align. For example, while shareholders may prefer higher leverage ratios, such ratios may breed excessive risk in the financial system. Regulation seems ill-suited to the task of ensuring that managers engage in the optimal amount of risk from the shareholders' perspective. Thus, regulators should protect the economy, and the *Caremark* standard should be modified so that shareholders can protect themselves.

Second, even if the goals of shareholders and regulators were aligned, government regulators might not pursue risk-management failures with the same vigor as would plaintiffs (or their attorneys). This is because regulators are prone to "capture."<sup>165</sup> When a regulator is "captured" by a special interest—in this case, financial firms that are pushing for excessive risk or less restrictive risk-monitoring requirements—the regulator will often fail to discharge its mission fully. Regulatory capture is prevalent in the financial industry.<sup>166</sup> Thus, allowing shareholders to play an active role in protecting their

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for a simple breach of that board member's *Caremark* duties without proof of dishonesty or "willful or continuing disregard."

<sup>165</sup> Regulatory "capture" occurs when powerful actors in a regulated industry influence regulators of that industry to do things that favor them over other actors. See William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 214 (1997) (describing public choice theory's definition of "capture").

<sup>166</sup> See Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In re Citigroup Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 113, 153 (2010) ("Specifically, banking and other regulatory regimes are subject to industry capture resulting, among other factors, from the revolving door phenomenon of individuals moving from the regulated private sector to regulatory agencies and back to the regulated private sector again, and from campaign contributions to elected officials from the regulated firms.").

own interests would better prevent managers at financial firms from taking undue risk with shareholders' money while government regulators conveniently looked the other way.

## 2. *What Is a Financial Firm?*

In order to modify the *Caremark* standard with respect to suits brought against managers of a "financial firm," a court will have to determine whether any given company is such a firm. While in the majority of cases this question would present no great difficulty, some would pose line-drawing problems. As some commentators have recently demonstrated, it is difficult to come up with a strict definition of a financial institution without either leaving out major players in the financial industry, or conversely, including almost every company in the world.<sup>167</sup> One starting place might be the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>168</sup> which defines "nonbank financial compan[ies]"<sup>169</sup> as any company that is "predominately engaged in financial activities."<sup>170</sup> That term is defined in section 102(a)(6) to mean any company that derives 85% of its assets from activities that are "financial in nature" as that term is defined in section 4(k) of the Bank Holding Company Act of 1956.<sup>171</sup> However, limiting application of the heightened *Caremark* liability standard according to the rigid definition in the Dodd-Frank Act might mean that many firms with the incentive, leverage, and complexity problems described above could slip through the cracks. For instance, if only 83% of a firm's assets were derived from activities that are financial in nature, it might still present the same problems—for *Caremark* purposes—as one with 87% of its assets derived from such activities.

Therefore, rather than draw a bright line between financial firms and other types of firms, it would be more useful if courts would inquire on a case-by-case basis into whether the particular firm is sub-

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<sup>167</sup> See, e.g., Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167, 176 (1999) (describing similar problem in defining "Financial Institutions").

<sup>168</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of 12 U.S.C.A.) (West 2010).

<sup>169</sup> *Id.* § 5311(a)(4). While a traditional bank that does little more than accept deposits and give out loans is highly leveraged, it may not have the other attributes discussed above (risk-encouraging incentives and complexity) that distinguish "financial firms" for *Caremark* purposes. Thus, while the Dodd-Frank Act assumes that traditional banks are subject to heightened regulation, for the purposes of *Caremark*, a more nuanced assessment is more appropriate. See *infra* note 172 and accompanying text (discussing nuanced assessment).

<sup>170</sup> 12 U.S.C.A. § 5311(a)(4)(B)(ii) (West 2010).

<sup>171</sup> *Id.* § 1843(k).

ject to the problems outlined above. A court would therefore ask the following questions: (1) Do employees (and traders in particular) have incentives to take higher-than-optimal risks with the firm's money? (2) Is leveraged investing a central part of the firm's business plan? (3) Does the firm deal with complex and opaque financial products? Because the majority of cases would be relatively straightforward (as in *Citigroup*), this standard does not pose any serious judicial economy concerns. Further, the necessity of having such a flexible definition becomes apparent when one considers isolated divisions of nonfinancial firms that deal in financial services, such as the financial products division at AIG, an insurance company.<sup>172</sup>

While ascertaining the definition of "financial firm" in a way that resembles a totality-of-the-circumstances test might invite arguments of unpredictability, such a concern is not acute in this context. First, for the vast majority of cases, the question of whether the firm involved is a financial firm would be answered easily. Citigroup clearly is a financial firm; Caremark clearly is not. Second, even if a firm such as AIG exists in the limited gray area between financial and nonfinancial firms, the standard described below would only push the firm to institute well-functioning risk-management procedures—something the firm should have in place in the first instance. In other words, the conduct standard would be no different in that managers would still be required to monitor risk.<sup>173</sup> All that would change is that the court would take a closer look to see if the manager has actually done so. Finally, there is little concern for unwarranted liability being imposed because, as explained below, a new standard would inquire only into the process of risk management at the firm.<sup>174</sup> As long as the firm has a robust risk-management division, managers would not be unfairly held liable for a bad outcome. This means that managers are responsible only for that which is within their control—the makeup of the risk-management system.

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<sup>172</sup> See Gretchen Morgenson, *Behind Biggest Insurer's Crisis, a Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1 (describing AIG's Financial Products division's role in collapse of AIG). Thus, while parts of AIG may not be subject to the concerns outlined above, if an investor sued the board under *Caremark* for failing to oversee risk at a division of the firm that *was* subject to those concerns, a court should use the heightened standard described later in this piece. On the other hand, if the suit was about risk management in a division that was not subject to those concerns, a court should use the traditional *Caremark* standard.

<sup>173</sup> *Caremark* arguably requires managers to monitor risk, and managers of financial firms will continue to have to do so under this standard. See *supra* Part I.B (discussing *Caremark* and the duty to monitor risk).

<sup>174</sup> See *infra* notes 196–207 and accompanying text.

## III

REPLACING “SUSTAINED OR SYSTEMATIC FAILURE” WITH  
“GROSSLY NEGLIGENT PROCESS”

The argument above—that financial firms are uniquely vulnerable to excess (and unmonitored) financial risk and its consequences—is borne out by the most recent financial crisis. For instance, consider Washington Mutual (WaMu). Beginning in the mid-1990s, WaMu was at the forefront of the subprime mortgage lending business.<sup>175</sup> As its competition with Countrywide, another subprime lender, increased, WaMu began making riskier home loans.<sup>176</sup> However, the firm’s internal risk-management controls were an afterthought at best:<sup>177</sup> An internal memo from 2005 informed WaMu’s risk-management staff that they needed to “shift [their] ways of thinking” from being a “regulatory burden” to instead act as a “customer service” whose goal was simply to help the company grow.<sup>178</sup> As one senior credit-risk officer said, “[t]hey weren’t going to have risk management get in the way of what they wanted to do, which was basically lend the customers more money.”<sup>179</sup> This behavior fits the pattern predicted above. WaMu’s employees had little incentive to curb their risk taking given their incentives to pursue short-term growth and focus on keeping up with Countrywide. When WaMu collapsed under the weight of its ill-considered lending practices, its demise was the biggest bank failure in history.<sup>180</sup>

Citigroup was also the target of claims of lackluster risk management. In fact, the Federal Reserve rebuked Citigroup for poor risk controls.<sup>181</sup> Critics argued that there was lax oversight reaching to the highest levels of the bank.<sup>182</sup> They pointed out that this was most likely due to the perverse incentives of managers at the bank and the close ties between those managers and the risk oversight division.<sup>183</sup> Citigroup and WaMu stand in direct contrast to firms like Goldman

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<sup>175</sup> See Drew DeSilver, *Doomed WaMu—Reckless Strategies Inside the Collapse*, SEATTLE TIMES, Oct. 25, 2009, at A1 (describing WaMu’s rise and fall).

<sup>176</sup> *Id.*

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> Eric Dash & Andrew Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at A1 (“Washington Mutual, with \$307 billion in assets, is by far the biggest bank failure in history . . .”).

<sup>181</sup> Dash & Creswell, *supra* note 3.

<sup>182</sup> *Id.*

<sup>183</sup> *Id.* (“Because of longstanding ties that clouded their judgment, the very people charged with overseeing deal makers eager to increase short-term earnings—and executives’ multimillion-dollar bonuses—failed to rein them in, these insiders say.”).

Sachs, which used a strong risk-management division to navigate the recent crisis.<sup>184</sup>

### A. *A Modified Caremark Standard*

When determining whether to impose liability, a court applying *Caremark* as it stands now asks only two questions: First, does a risk-management system exist? Second, was there a “sustained or systematic” or “conscious failure” to use it? Because of the deference to managers implicit in the current standard, managers like those presiding over Citigroup and WaMu before and during the recent crisis can rest easy knowing that any failure to properly manage risk is unlikely to expose them to liability. However, as demonstrated above, shareholders need protection from financial firms’ natural tendency to hide and ignore excessive risk.<sup>185</sup> Shareholders should be able to look to courts for such protection in the form of a *Caremark* standard that is less deferential to managers who institute defective risk-management systems. This standard should take the form of gross negligence: Managers who are grossly negligent in setting up and maintaining the firm’s risk-management process should be liable to shareholders.<sup>186</sup>

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<sup>184</sup> *Risk Management and the Residential Mortgage Market*, GOLDMAN SACHS, 5–11 (Apr. 23, 2010), <http://www.goldmansachs.com/our-firm/on-the-issues/risk-man-doc.pdf>. Though obviously self-serving, this report published by Goldman Sachs is unlikely to be materially misleading given Goldman’s status as a reporting issuer subject to both (perhaps uniquely intense) oversight by the SEC and second-guessing by the securities plaintiffs’ bar.

<sup>185</sup> Banks have regularly been subject to a greater degree of judicial second-guessing in the past. *See, e.g.*, *FDIC v. Robertson*, No. 87-2623-S, 1989 U.S. Dist. LEXIS 9292, at \*17 (D. Kan. July 24, 1989) (holding bank director liable for loan issued to new business that had “no proven track record of profitability”); *Bailey v. O’Neil*, 122 S.W. 503, 505–06 (Ark. 1909) (holding directors liable for loaning nearly half of bank’s assets to one local businessman). While these cases do not focus directly on the BJR or *Caremark*, they do serve as evidence that courts are less reluctant to defer to management in the financial industry. *See* Macey & O’Hara, *supra* note 16, 99–101 (describing duty of care applied to banking directors); McCoy, *Notional BJR*, *supra* note 16, at 1032 (“[C]ourts have second-guessed decisions of bank directors on the merits in negligence cases for the past 100 years.”). Further, although the rationale for these cases was based on debtholder rights (i.e., the right of depositors to be protected against a bank’s taking undue risk with depositors’ money), the principles underlying these holdings are the same as those upon which the arguments in this Note rest. Thus, far from a radical departure from the existing law, this Note simply argues for an alignment of the existing doctrine with the policy that underlies that doctrine.

<sup>186</sup> Abandoning the “sustained or systematic” or “conscious failure” language in favor of a gross negligence standard might change the issue in *Caremark* back into one of the duty of care, thus triggering section 102(b)(7) of Delaware General Corporation Law. *See* *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) (categorizing *Caremark* liability, because of its “sustained or systematic” requirement, as constituting bad faith and therefore as non-

But what does gross negligence mean in this context? Clearly, *Caremark*'s first inquiry would remain—there needs to be some risk-management system present. However, the second question would be replaced by a robust inquiry into the precise workings of such a system, searching for elements known to be crucial to effective risk-management systems. This gross negligence standard would be similar to the one found in the famous Delaware case of *Smith v. Van Gorkom*.<sup>187</sup> In that case, the Delaware Supreme Court found that the directors had breached their duty of care in voting to accept a take-over bid without fully informing themselves of the nature of the bid and competing bids. While the court continued to maintain that “a board acting within the ambit of the [BJR] faces no ultimate liability,” it held that for the BJR to protect the board's decisions, the board must fully inform itself of all material considerations or risk liability for a violation of the duty of care.<sup>188</sup> Thus, the gross negligence standard focuses on the process by which decisions get made and whether managers are fully informed prior to making those decisions. Similarly, in deciding whether managers would be liable for grossly negligent risk management, a court should look to the process by which the firm manages risk, focusing on whether managers are fully informed about the risk position of the firm.

Still, while the primary rationale for *Caremark*'s low-liability standard—inducing managers to take risk—does not apply with equal force to financial firms,<sup>189</sup> there are other reasons to be wary of exposing corporate directors and officers to increased liability. The most often cited is a fear that exposure to excessive liability could dissuade the most qualified individuals from serving as directors and officers of firms.<sup>190</sup> Further, there is always the risk of hindsight bias clouding the court's judgment, making ex post liability unfair and socially damaging.<sup>191</sup> The hindsight bias concern is particularly troubling in this context because the process of risk management is imper-

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indemnifiable breach of duty of loyalty). This issue and its implications are discussed below. See *infra* notes 215–17 and accompanying text.

<sup>187</sup> 488 A.2d 858 (Del. 1985), *overruled on other grounds* by *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

<sup>188</sup> *Id.* at 881.

<sup>189</sup> See *supra* Part II.C (arguing that *Caremark* should be modified when applied to financial firms).

<sup>190</sup> See ALLEN ET AL., *supra* note 19, at 261 (“[T]he risk of liability for inactivity may still deter talented persons from serving on corporate boards.”).

<sup>191</sup> See Jennifer Arlen & Renier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 732 (1997) (describing hindsight bias as “the fallacy that misconduct must have been likely to be detected because it was in fact detected”).

fect;<sup>192</sup> a firm that has a well-functioning risk-management system might nonetheless suffer losses simply because of the inherent limitations of risk modeling.<sup>193</sup> Risk management, at its most fundamental, is an effort to predict the future. Risk managers attempt to match statistical models to past events and extrapolate the likelihood of future events from those models. But this method is “deeply rooted in the assumption that outcomes are continuous”<sup>194</sup>—for example, that future events are always similar to past events—an assumption that the recent crisis has shown to be mistaken. To overcome this problem, risk managers often brainstorm different scenarios that may impact the firm.<sup>195</sup> This can be useful, but it clearly cannot predict every future event.<sup>196</sup> At best, risk management is an imperfect science. Thus, boards and officers should not be held liable every time the firm experiences losses. Rather, in applying *Caremark* to financial firms, courts should seek only to ensure that there is a system that allows managers to understand the models’ limitations and usefulness.

In other words, exposing a manager to liability based solely on the occurrence of loss would expose her to liability for something that she might not have had any power to prevent. Thus, the gross negligence standard must be focused on the process of risk management rather than the actual outcome. In this way, I am not arguing for a radical departure from the current law: *Caremark* and the BJR have always focused on process rather than outcome.<sup>197</sup>

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<sup>192</sup> See generally NASSIM NICHOLAS TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* (2007) (dubbing catastrophe that nobody sees coming as “black swan” and arguing that risk modeling’s inherent inability to predict major events in history makes risk models worse than useless).

<sup>193</sup> See REBONATO, *supra* note 91, at 17 (“One of the points that I make in this book is that the very high percentiles of loss distributions (i.e., roughly speaking, the probability of extremely unlikely losses) *cannot* be estimated in a reliable and robust way.”).

<sup>194</sup> SHIRREFF, *supra* note 90, at 105.

<sup>195</sup> See REBONATO, *supra* note 91, at 244–48 (describing this practice as “scenario analysis”).

<sup>196</sup> It is for this reason that some have argued convincingly that a major cause of this crisis, and its attendant losses for shareholders, was the over-reliance on risk modeling. See, e.g., Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL’Y 807, 821 (2010) (“The models assumed a life of their own, and ordinary judgment and common sense were forgotten.”). Cf. TALEB, *supra* note 192 (arguing *before* crisis that risk modeling’s inherent inability to predict major events in history makes risk models worse than useless).

<sup>197</sup> See KLEIN & COFFEE, JR., *supra* note 135, at 157 (“Under the majority formulation, any business judgment is immune from judicial review only if the directors first followed adequate *procedures* in reaching it.” (emphasis added)); see also *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (imposing duty to monitor); *Smith v. Van Gorkom*, 488 A.2d 858, 876–77 (Del. 1985) (focusing on information that board pos-

### B. *Elements of a Successful Risk-Management Regime*

In limiting their inquiry to the process of risk management at financial firms, courts should take note of certain elements of effective risk management that are well-known and found consistently throughout the literature. These elements were synthesized by a consortium of financial regulators from France, Germany, Switzerland, the United Kingdom, and the United States (known as the Senior Supervisors Group) in their March 2008 report.<sup>198</sup> The report focused on the successes and failures of risk management in the prior year and highlighted tactics that firms used to avoid substantial losses. Drawing on this report, there are five considerations that courts should take in to account in evaluating a financial firm's risk-management system.

First, courts should consider the degree to which firms have developed and utilized more than one method of risk management.<sup>199</sup> Having multiple risk-management procedures ensures that risks that slip through the cracks of certain risk measures are picked up by others. Second, the people who implement those methods must be independent and the board must listen to them. Thus, a court should inquire as to whether managers repeatedly ignored warnings from risk management. Firms need "people within the institution who—to paraphrase a former Federal Reserve Chairman—know when to take away the punch bowl."<sup>200</sup> Third, for risk management to be effective, firm managers must be able to understand the information presented by the risk managers,<sup>201</sup> especially as complex financial products

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sessed rather than substantive decision), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

<sup>198</sup> SENIOR SUPERVISORS GROUP, OBSERVATIONS ON RISK MANAGEMENT PRACTICES DURING THE RECENT MARKET TURBULENCE (Mar. 6, 2008), *available at* [http://www.newyorkfed.org/newsevents/news/banking/2008/SSG\\_Risk\\_Mgt\\_doc\\_final.pdf](http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf).

<sup>199</sup> *Id.* at 4; *see also* STANDARD & POOR'S, ENTERPRISE RISK MANAGEMENT FOR FINANCIAL INSTITUTIONS 20–25 (Nov. 2005), *available at* [http://www.mgt.ncsu.edu/erm/documents/sp\\_erm\\_busdevbk.pdf](http://www.mgt.ncsu.edu/erm/documents/sp_erm_busdevbk.pdf) (outlining best practices for risk management, including use of multiple tools in addition to VaR); GOLDMAN SACHS, RISK MANAGEMENT AND THE RESIDENTIAL MORTGAGE MARKET 5–11 (Apr. 23, 2010), *available at* <http://www.goldmansachs.com/our-firm/on-the-issues/risk-man-doc.pdf> (explaining different approaches Goldman Sachs used to monitor risk during mortgage crisis).

<sup>200</sup> Kroszner, *supra* note 116.

<sup>201</sup> Joe Nocera cites this as one of the major issues going forward after the recent economic crisis. Nocera, *supra* note 95, at 50. Nocera describes the ubiquitous use of VaR in the financial industry. He argues that boards relied too heavily on VaR without understanding its limitations. *Id.*; *see supra* notes 95–100 and accompanying text for a discussion of VaR. Chief among these limitations is the fact that it ignores extreme events. Directors who did not understand the nuances of the models "forgot that the VaR number was only meant to describe what happened 99 percent of the time. That \$50 million wasn't just the most you could lose 99 percent of the time. It was the least you could lose 1 percent of the time." Nocera, *supra* note 95, at 50.

increasingly play a central role in the financial industry.<sup>202</sup> This requirement may have already snuck its way into Delaware corporate law, as the *Citigroup* court mentioned multiple times that the Audit Risk Management Committee (ARMC) was filled with financial experts.<sup>203</sup> Fourth, information on risk exposure should be shared interdepartmentally within the firm. As the Senior Supervisors Group report stated, firms that were the best at managing risk “relied on information from many parts of their businesses and communicated that information both up to senior management and across businesses.”<sup>204</sup> Finally, an effective risk-management regime should be focused on keeping senior management up to date on developments in the firm’s risk exposure. Again, the court in *Citigroup* seemed to understand this need as well: Chancellor Chandler pointed out that the ARMC “met eleven times in 2006 and twelve times in 2007.”<sup>205</sup>

Of course, the argument that courts should scrutinize a financial firm’s risk-management process assumes that there are cases where such firms have suffered losses as a result of deficient risk-management processes. In other words, I am assuming that firms can do better at managing risk—otherwise, a stricter standard will have no practical effect. However, this assumption is reasonable given that some financial firms weathered the recent crisis better than others.<sup>206</sup>

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<sup>202</sup> Many commentators suggest that these products were the main causes of the crisis, in part because senior management did not understand how they worked and the risks involved. See, e.g., William L. Rutledge, *Transmittal Letter*, in SENIOR SUPERVISORS GROUP, *supra* note 198 (“[S]ome firms made strategic decisions to retain large exposures to super-senior tranches of collateralized debt obligations that far exceeded the firms’ understanding of the risks inherent in such instruments . . . .”); *id.* at 8 (“The senior management teams at some of the firms that felt most comfortable with the risks they faced and that generally avoided significant unexpected losses had prior experience in capital markets.”); Nocera, *supra* note 95, at 50 (describing managers’ lack of understanding of VaR); Andrew W. Lo, Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008, Written Testimony Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform, 27 (Nov. 13, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1301217](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217) (pointing out that “idealized relationship” between “quants,” who come from “technically sophisticated disciplines such as mathematics, physics, and computer science,” and senior management is a “fantasy”).

<sup>203</sup> See *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 112, 127 (Del. Ch. 2009).

<sup>204</sup> SENIOR SUPERVISORS GROUP, *supra* note 198, at 9.

<sup>205</sup> *Citigroup*, 964 A.2d at 127.

<sup>206</sup> See, e.g., GOLDMAN SACHS, *supra* note 199, at 5–11 (pointing to strong risk management practices as reason for success during recent crisis). Cf. Karl S. Okamoto & Douglas O. Edwards, *Risk Taking*, 32 CARDOZO L. REV. 159, 217 (2010) (“[T]here is evidence suggesting that better risk management and a stronger risk culture that empowers risk managers to speak as equals with risk takers leads to better risk outcomes.”).

### C. *Practical Implications of a Modified Standard*

It is unclear whether *Citigroup* would have come out differently had the court used this gross negligence standard. The plaintiffs' argument revolved around an unforeseen outcome. Plaintiffs limited their argument to "red flags" that purportedly should have alerted the risk managers to impending financial trouble. Plaintiffs seemed to argue that liability should stem solely from management's failure to act in the face of such "red flags." This is wrong,<sup>207</sup> as it is entirely possible that a firm's well-functioning risk-management system would see those "red flags," decide that the risk was not excessive, and press on. The fact that such a firm later suffers losses has no bearing on the question of whether the risk-management system was adequate. As shown above, risk models and risk managers are imperfect and an isolated failure does not mean that the system was deficient.<sup>208</sup>

Rather, under the gross negligence standard formulated in this Note, the plaintiffs should have focused on the structure of the risk-management system. This would mean asking the following questions: whether there were multiple metrics used to analyze risk, whether the people in charge of risk management were invited to have serious discussions with the firm's management, whether there were financial experts on the firm's ARMC, whether risk information was shared across departments, and how often the ARMC met.<sup>209</sup> Plaintiffs did not focus on any of these questions; thus, the court was correct in dismissing their claim even under my proposed standard.

While the *Citigroup* court was not given an opportunity to decide whether Citigroup's managers were grossly negligent in monitoring risk, such a standard would enable a court to look at problems that were found at firms such as WaMu with a keen eye. The internal memo at WaMu that urged the risk-management division to shift from

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<sup>207</sup> Thus, Chancellor Chandler was correct when he stated in *Citigroup* that the plaintiffs' argument, that the directors "must be found liable because Citigroup experienced losses as a result of exposure to the subprime mortgage market," was not a valid claim under *Caremark. Citigroup*, 964 A.2d at 129–30.

<sup>208</sup> See *supra* notes 191–96 and accompanying text. It is important to emphasize that nothing in this Note is meant to suggest that the BJR should be applied differently to financial firms. High leverage ratios, risky trades, and complex dealings undermine only the ability of managers to monitor the firm's risk exposure, not their ability to make well-reasoned conscious "business judgments."

<sup>209</sup> This is not to say that all "red flags" are irrelevant. A plaintiff that is able to show some defect in the structure of a risk management system might also point to some "red flags" as indirect evidence that the system was inadequate. Such an argument, though, relies on a court to infer an inadequate system from the system's failure—something that my discussion of "outcome" cautions against absent some direct proof that the system was faulty. See *supra* notes 196–97 and accompanying text.

a “regulatory burden” to a “customer service” focus<sup>210</sup> would certainly be evidence that there were major problems with the process of managing risk. While it has not been decided,<sup>211</sup> it is very likely that the *Caremark* claim (under the current standard) would fail: Instructing the risk managers to have a customer service focus probably would not be enough on its own to show a “sustained or systematic” failure. However, a court applying a gross negligence standard could interpret the memo described above as showing that the risk managers were far from independent. This might be sufficient for a finding of liability.<sup>212</sup> Thus, the circumstances leading to the fall of WaMu present a set of facts that probably would not have resulted in liability under *Caremark* as it stands now but may have been sufficient to show gross negligence under a modified *Caremark* standard.

In analyzing the practical implications of this argument, it is significant that *Caremark* and the BJR are not the only methods by which courts limit the fears of managerial liability. Delaware law allows for extensive indemnity payments<sup>213</sup> and liability insurance.<sup>214</sup> Further, section 102(b)(7) of the Delaware General Corporation Law allows a corporation in its charter to absolve directors of liability for all actions taken in good faith.<sup>215</sup> Violations of *Caremark* duties are currently categorized as bad faith—and therefore not covered by section 102(b)(7)—because the “sustained or systematic” language means that any failure to fulfill *Caremark* duties must be so egregious that it could not be in good faith.<sup>216</sup> However, if the *Caremark* standard were altered in the financial context to resemble that of gross negligence, section 102(b)(7) might protect managers of some firms from personal liability because one might be able to violate a negligence standard while still acting in good faith. Even if this were the case, though, a heightened liability standard would not lack power: A finding that a manager has breached her fiduciary duty has a profound

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<sup>210</sup> See *supra* note 178 and accompanying text (describing memo).

<sup>211</sup> WaMu was the subject of significant shareholder litigation, but it focused mainly on violations of the securities laws rather than on *Caremark* duties. See, e.g., *In re Washington Mutual, Inc. Sec. Litig.*, 694 F. Supp. 2d 1192 (W.D. Wash. 2009) (largely denying motions to dismiss securities fraud class action claims). Perhaps this is, in part, due to the cold reception that the *Caremark* claim for failure to monitor risk received from the Delaware Court of Chancery in *Citigroup*.

<sup>212</sup> Not that the absence of any one element of good risk management would automatically trigger liability; however, a court, after looking at all the evidence, could determine that liability was appropriate if even one element was seriously deficient.

<sup>213</sup> DEL. CODE ANN. tit. 8, § 145(a) (2001 & Supp. 2010).

<sup>214</sup> *Id.* § 145(g).

<sup>215</sup> *Id.* § 102(b)(7) (Supp. 2010).

<sup>216</sup> See *Stone v. Ritter*, 911 A.2d 362, 367–70 (Del. 2006) (examining failure to act in good faith in relation to section 102(b)(7)).

effect on managers' behavior due to the strong signals of disapproval that it can send, even if actual liability never results.<sup>217</sup> That is, managers pay attention to what the law demands of them even if they may ultimately be protected from liability.

#### CONCLUSION

The recent financial crisis has shone a light on an area of the law that has failed to live up to its task of protecting shareholders. The incentives in the financial industry to ignore risk, and the dangers to shareholders of doing so, have increased exponentially in recent decades, especially with the proliferation of complex financial products. In light of this, it is clear that the traditional *Caremark* liability standard—with its immense deference to managers—is inadequate to ensure that financial firms take risk management seriously.

A new standard is needed. Instead of *Caremark's* deferential “sustained or systematic failure” standard, courts should find managers of financial firms liable if management was grossly negligent in establishing and overseeing an effective risk-management system. In so doing, courts would be taking an important step toward protecting investors from excessive risk in the financial industry.

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<sup>217</sup> See PAN, *supra* note 12, at 14 (“Delaware courts have tremendous influence over prevailing corporate governance standards. Opinions and commentary by judges develop and define norms and best practices that affect director behavior, often more so than the threat of legal liability.” (citations omitted)).

