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Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine

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RETHINKING THE BOARD'S DUTY TO MONITOR: A CRITICAL ASSESSMENT OF THE DELAWARE DOCTRINE

ERIC J. PAN

I. INTRODUCTION

The duty to monitor sits at the crossroads between the two fundamental fiduciary duties of corporations law: the duty of care and the duty of loyalty. Much of corporations law focuses on what directors should do when they make decisions for the corporation. The duty of care tells them to act with “the care of an ordinarily prudent person in the same or similar circumstances.” 1 The duty of loyalty tells them to “exercise [their] institutional power . . . in a good-faith effort to advance the interests of the company.” 2 Both duties tell directors to protect the interests of the corporation.

The difficult question is whether the board breaches any of its fiduciary duties when its inattention or inaction leads to harm to the corporation. The duty to monitor addresses this question by imposing liability on directors for failing to respond to signs of wrongdoing, illegality, or other harmful activities. Because the duty to monitor imposes liability based on what the board failed to do, it is difficult to define the scope of liability. 3 A natural dilemma exists in evaluating

1. WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 240 (3d ed. 2009); see also REVISED MODEL BUS. CORP. ACT § 8.30 (1985); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (1994).
2. ALLEN ET AL., supra note 1, at 295.
3. See In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (describing the duty to monitor as “a board decision that results in a loss because that decision was ill advised or ‘negligent’ ” and “an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss”).
a director’s level of care or loyalty based purely on the fact that there was an absence of action by such director. Unless the director’s failure to act was the product of deliberation (which takes the matter outside of the scope of the duty to monitor), no records, witnesses, or other readily available pieces of evidence will be available to inform a court whether the board’s failure to act was an act of carelessness or disloyalty. As a result, when adjudicating claims alleging inattention or inaction by a board, a court faces the uncomfortable task of exercising its own independent judgment that the board should have done something instead of remaining still and silent.

At the same time, the duty to monitor serves as the best means the law has to ensure that directors are attentive and vigilant against the occurrence of harm to the corporation. To the extent we believe and expect a board to perform a substantial role in managing the corporation—as opposed to serving merely as review and approval bodies for the wants and wishes of officers—it is appropriate to hold boards to a high monitoring standard. Ideally, little should affect the corporation without the knowledge, consent, or consideration of the board.

This Article criticizes the Delaware doctrine of the duty to monitor. Delaware courts have defined too narrowly the scope of the duty and have made it undesirably difficult for plaintiffs to bring forward duty to monitor claims. As it is currently conceived, the duty to monitor rewards ignorance and passivity by directors, imposing little obligation on them to take an active interest in the corporation’s business. By limiting the scope of the duty only to cases of wrongdoing and illegality, the doctrine encourages directors to focus on legal compliance at the expense of business performance—an odd result when boards are usually stocked with persons touted for their business, not legal, acumen. The focus on legal compliance also encourages government authorities to criminalize a broader scope of corporate activities, as this is the only way to ensure directors follow desirable corporate governance practices.

In addition, by requiring plaintiffs to plead a high degree of specificity as to what the directors knew of possible harm to the corporation, the doctrine incentivizes directors to avoid asking questions or otherwise making efforts to uncover possible red flags. Such efforts serve only to increase the number of occasions when directors may find themselves forced to act to satisfy their duty to monitor or to produce paper trails enabling plaintiffs to bring forward additional

duty to monitor claims. The doctrine instead encourages directors to rouse themselves only when red flags are thrown up by existing internal control systems, like the drunk who only looks for his lost keys under the street lamp because that is where the light is.

This Article sets forth four objections to how Delaware courts have defined directors’ duty to monitor. First, the Delaware doctrine is inconsistent with the role of the board in the corporation. Boards serve both a monitoring and managerial role in the corporation, and the duty to monitor should provide the proper incentives for boards to fulfill this preferred role.

Second, the Delaware doctrine is wrong to excuse boards from monitoring business risk. Rather, boards should be held responsible for business as well as legal outcomes, and courts should shift the burden onto them to show that they have made the effort to be informed and to respond to developments producing such outcomes.

Third, the recasting of the duty to monitor as a claim of bad faith conduct has imposed an unreasonable burden on plaintiffs to bring forward meritorious duty to monitor claims. In an attempt to respect the Delaware courts’ desire to cast the duty to monitor as part of the duty of loyalty, this Article argues that Delaware courts could ease the burden on plaintiffs by making clear that the definition of scienter includes demonstration of recklessness and treating a director’s failure to monitor as a rebuttable presumption. Such changes would be faithful to the reasoning of Caremark while still respecting the Delaware Supreme Court’s conception of the duty to monitor as part of the good faith and loyalty framework.

Fourth, Delaware courts have not provided adequate guidance as to when the duty to monitor should apply. The current doctrine emphasizes board action only in the face of a red flag but leaves ambiguous the board’s duty to monitor in the aftermath of a past decision. Courts should note that a board’s responsibility does not end at the moment of voting but includes ensuring that its decisions remain appropriate over time and in the best interests of the corporation. These changes reinforce the fact that Delaware courts cannot shy away from reviewing cases where a board’s failure to monitor results in harmful business outcomes.

This Article recognizes a common objection to any set of reforms aimed at strengthening the scope of fiduciary duties: directors enjoy numerous protections against personal liability. Even though indemnification and director and officer insurance shield them from personal liability, directors face very real reputational costs if they fail to meet their fiduciary obligations and will look to judges for guidance regarding their responsibilities. Therefore, this Article concludes that expansion of the scope of the duty to monitor will have a real effect on directors’ behavior toward risk management and managerial oversight.
II. THE DELAWARE DOCTRINE OF THE DUTY TO MONITOR

In an earlier article, I analyzed in detail the cases that have given meaning to the duty to monitor under Delaware law—an analysis that this Article now builds upon to frame a series of objections to the doctrine. The four cases that have defined Delaware’s duty to monitor are: *Graham v. Allis-Chalmers Manufacturing Co.*, *In re Caremark International Inc. Derivative Litigation*, *Stone v. Ritter*, and *In re Citigroup Inc. Shareholder Derivative Litigation*. *Graham* introduced the notion that boards have a duty to act when they become aware of wrongdoing (i.e., red flags). *Caremark* explained why boards have an obligation not only to act in the face of obvious signs of wrongdoing but also to be informed of, and to watch for, wrongdoing. *Stone* defined breach of the duty to monitor as an act of bad faith and therefore a breach of the duty of loyalty. Finally, *Citigroup* effectively has closed the door on duty to monitor claims pertaining to boards’ failure to monitor business risk.

The duty to monitor depends on two elements: what efforts the board must take to detect possible harm, and what types of possible harm require board action. The current standard for assessing what efforts must be taken by the board is whether the board “utterly fail[s] to implement any reporting or information system or controls” or if “having implemented such . . . system[s] or controls, consciously fail[s] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.” Courts have recognized a breach of a duty to monitor only when board inaction or inattention leads to wrongful acts or violations of law. Courts have never found a breach of the duty to monitor in cases involving business harm to the corporation in the absence of wrongful acts or violations of the law.

The path by which the Delaware courts developed their understanding of the duty to monitor is not a straight one. In the *Caremark* decision, Chancellor Allen provided a rationale for a quite ex-

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6. 188 A.2d 125 (Del. 1963).
8. 911 A.2d 362 (Del. 2006).
11. *Caremark*, 698 A.2d at 967. Hillary Sale has called *Caremark* “one of the most prominent Delaware opinions of all time.” Hillary A. Sale, Monitoring *Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719, 719-20 (2007). Because Chancellor William Allen’s opinion in *Caremark* remains the most complete exploration by a Delaware court of the meaning of the duty to monitor, duty to monitor claims are often referred to as “Caremark claims.”
13. See *Citigroup*, 964 A.2d at 126.
15. See, e.g., *Graham*, 188 A.2d at 130.
expansive duty to monitor—a duty that would require boards to be attentive to a broad range of legal and business harms to the corporation. According to Chancellor Allen, a board’s duty to monitor stems from the “seriousness” of its role in the management of the corporation. Such a serious role logically should mean that directors bear ultimate responsibility for preventing harm to the corporation and that directors’ ignorance of, or unfamiliarity with, any such harm would signify a failure to meet such responsibilities. Chancellor Allen also believed that having monitoring systems in place was essential to boards meeting their supervisory and monitoring role, and that this obligation to continuously collect “relevant and timely information” (and by implication, review such information) stems not only from a fiduciary obligation but from section 141 of the Delaware General Corporation Law—the statutory provision stating that the corporation shall be managed at the direction of the board. Ignorance cannot be the natural state of the board. As a decisionmaker and consumer of information, the board must make efforts to be informed and cannot avoid being held accountable for any developments that may affect the corporation’s performance.

Furthermore, in discussing the rationale for the duty to monitor, Chancellor Allen noted that the board’s responsibility to be informed was to prevent not only legal harm but also business harm. Boards must assure themselves that they have in place an information and reporting system that permits the board to make “informed judgments concerning both the corporation’s compliance with law and its business performance.” Thus, the duty to monitor should extend to harm resulting from illegal or wrongful acts and also business developments. Chancellor Allen, however, ultimately did not address in his decision the problem of failure to monitor business performance. He limited his analysis of the duty to monitor to “losses caused by non-compliance with applicable legal standards,” as the facts of the Caremark case pertained only to the failure of the board to prevent legal violations by employees. After Caremark, Delaware courts have declined to embrace fully Chancellor Allen’s rationale for the duty to monitor and instead have recognized the applicability of the duty to monitor in only a range of cases involving wrongdoing and illegality.

Ten years later in Stone, the Delaware Supreme Court revised the Caremark standard: first, by equating the duty to monitor with the

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16. Caremark, 698 A.2d at 970.
17. Id. (emphasis omitted).
18. Id. at 968-69.
19. Id. at 970.
20. Id.
duty of good faith; second, by subsuming the duty of good faith into the duty of loyalty (Chancellor Allen considered the duty to monitor to be part of the duty of care) and third, by requiring plaintiffs to meet a high standard of scienter to prove directors acted in bad faith. The Stone formulation of the duty to monitor standard is captured in the paragraph:

Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

22. Id. at 369-70.
23. See Caremark, 698 A.2d at 967-68.
24. Ambiguous drafting of section 102(b)(7) and references to a duty of good faith in earlier Delaware cases gave the impression that good faith was either an independent fiduciary duty that stood alongside the duties of care and loyalty or represented a means of measuring the degree of success that a fiduciary achieved in meeting her duty of care. In previous cases, the Delaware Supreme Court appeared to recognize that the duty of good faith, along with the duties of care and loyalty, formed a “triad” of fiduciary duties. See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (defining a triad of fiduciary duties to consist of the duty of good faith, duty of loyalty, and duty of care). The Delaware Supreme Court frequently re-emphasized the existence of this triad of fiduciary duties. See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998). For many commentators, recognition of an independent duty of good faith was desirable in order to hold directors and officers accountable for certain acts that did not constitute classic cases of disloyalty but were so egregious that they should be beyond section 102(b)(7) exculpation. See generally Melvin A. Eisenberg, The Duty of Good Faith in Corporate Law, 31 Del. J. Corp. L. 1 (2006); Hillary A. Sale, Delaware’s Good Faith, 89 Cornell L. Rev. 456 (2004) [hereinafter Sale, Delaware’s Good Faith].
25. The court identified a scienter requirement to prove a breach of the duty to monitor, stating “imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.” Stone, 911 A.2d at 370 (citing with approval Guttmann v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003)); see also Wood v. Baum, 953 A.2d 136, 141 (Del. 2008) (“Where, as here, directors are exculpated from liability except for claims based on ‘fraudulent,’ ‘illegal’ or ‘bad faith’ conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter . . . .”); Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007). In order to show scienter, plaintiffs must “plead particularized facts . . . that [the directors] had ‘actual or constructive knowledge’ that their conduct was legally improper.” Wood, 953 A.2d at 141; see also Guttmann, 823 A.2d at 506 (“The Caremark standard premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.”).
26. Stone, 911 A.2d at 370 (second emphasis added) (footnotes omitted).
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The Delaware Supreme Court’s decision made it more difficult for plaintiffs to bring duty to monitor claims. The court placed the burden on the plaintiff to demonstrate a director’s scienter in failing to act in the face of red flags. The lack of clarity from the Delaware courts as to how plaintiffs can meet this requirement in the absence of board deliberation undermined the effectiveness of the duty to monitor.

Finally, the recent Citigroup decision has narrowed the substantive limits of the duty to monitor. In this case, Chancellor Chandler considered a shareholder derivative suit against the Citigroup board for failing to prevent losses incurred by the bank holding company from its substantial investments in mortgage-backed securities. These investments resulted in near catastrophic losses for Citigroup, producing great losses to shareholders and forcing the bank to submit to two federal government bailouts. The plaintiffs argued that the Citigroup board failed to oversee the corporation’s exposure to the mortgage-backed securities market and ignored several red flags that warned the board of the deteriorating subprime mortgage market.

Chancellor Chandler rejected the plaintiffs’ claims. He decided that a claim to hold directors responsible for failing to prevent business harm would undermine the business judgment rule. The purpose of the business judgment rule is “to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly.” Chancellor Chandler appears to believe that failing to monitor business risk is the same as deciding to assume a business risk—a questionable assertion. Chancellor Chandler is understandably concerned that any evaluation by a court of the board’s responsiveness to busi-
ness risk would mean judging the merits of the board’s actions after the fact. As he noted, courts must be careful to avoid the danger of hindsight bias (i.e., “the tendency for [someone] with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted”). Chancellor Chandler narrowed the duty to monitor by ruling that, except in the most extreme cases, which he left unspecified, a board should never be held liable for failing to monitor business risk.

Since Stone, Delaware courts have often dismissed several plaintiffs’ attempts to argue that directors face a substantial likelihood of personal liability from duty to monitor claims. In dismissing the claims, the courts have either focused on whether plaintiffs have “pled sufficient facts to meet the scienter requirement or, in the case of Citigroup, have excused the board from having any monitoring” duty.

III. RETHINKING THE DUTY TO MONITOR

There are four objections to the Delaware courts’ treatment of the duty to monitor. First, a broader duty to monitor is crucial to enforcing the board’s proper role as monitor and manager of the corporation. Implicit in the Delaware recognition of a weak duty to monitor is the assumption that boards do not play an active role in the management of the corporation and, therefore, should not be expected to have knowledge of harmful events except in the occasional cases where passive monitoring systems may detect such events. Such an assumption is inconsistent with the appropriate role of the board in the corporation. Boards should serve both a monitoring and managerial role in the corporation, and the duty to monitor should provide the proper incentives for boards to fulfill this preferred role.

Second, Delaware courts are wrong to excuse boards from managing business risk and understanding the likelihood of harm to the corporation’s business. Rather, boards should be held responsible for business as well as legal outcomes. Courts should shift the burden

33. See id. at 124 n.50. Having the court give in to hindsight bias would make boards overly cautious and hypersensitive to hazardous activity, encouraging overinvestment in monitoring.  
34. See id. at 126 (“In this case, plaintiffs allege that the defendants are liable for failing to properly monitor the risk that Citigroup faced from subprime securities. While it may be possible for a plaintiff to meet the burden under some set of facts, plaintiffs in this case have failed to state a Caremark claim sufficient to excuse demand based on a theory that the directors did not fulfill their oversight obligations by failing to monitor the business risk of the company.” (emphasis added)).  
35. See id. at 124, 129-31.  
36. See Pan, supra note 5, at 733-34.  
37. See id. at 734.
onto directors to show that they made an effort to be informed and to respond to developments leading to such outcomes.

Third, the recasting of the duty to monitor as a claim of bad faith conduct imposes an unreasonable burden on plaintiffs to bring forward meritorious duty to monitor claims. This Article argues that Delaware courts could lower the burden on plaintiffs by adopting a definition of scienter that includes demonstration of recklessness (or at least deliberate recklessness) and treating a director’s failure to monitor as a rebuttable presumption. Such a change would be faithful to the reasoning of *Caremark* while still respecting the Delaware Supreme Court’s conception of the duty to monitor as part of the good faith and loyalty framework.

Fourth, the current doctrine leaves ambiguous the board’s duty to monitor in the aftermath of a past decision. Courts should note that a board’s responsibility does not end when it votes on an issue but includes ensuring that its decisions remain appropriate over time and in the best interests of the corporation. Recognizing the appropriate scope of the board’s responsibilities means Delaware courts cannot shy away from reviewing those cases where a board decision may lay the condition for harmful business outcomes. It is important for Delaware courts to clarify the boundary line between business judgment and failure to monitor.

A. Board as Monitor and Manager

Boards play two complementary roles. First, they monitor the performance of officers. They are elected representatives of the shareholders and responsible for the appointment of the CEO and other officers. They also serve as managers. They participate in the corporate decisionmaking process, working with the CEO in setting strategy. Given their importance in monitoring and contributing to management, courts should have high expectations for what boards can and should be able to do to oversee the risks of the corporation.

The authority of boards is absolute. Section 141(a) of the Delaware General Corporation Law is representative of the general rule in U.S. corporation law that, “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided . . . in its certificate of incorporation.”38 While the law grants boards the sole power to manage the

corporation, boards in practice delegate most management responsibility to officers.  

If boards are not supposed to be either full-time managers or corporate owners, what is their proper role? To the extent the concentration of managerial authority in the hands of a group of professional officers undermines shareholder value, boards must assume an active role in the management of the corporation, limiting the power of the officers. Boards should act as monitors, collecting and evaluating information about the performance of officers and the effectiveness of corporate strategy. Boards also must act as managers, offering advice concerning or, if necessary, dictating corporate strategy. These roles are not separable. A board cannot carry out its managerial role without first collecting information about corporate operations through its monitoring activities. Nor can the board fulfill its monitoring role without having the ability to affect corporate strategy and respond to negative developments.

Agency theory and resource dependency theory explain why boards operate as both monitors and managers. Agency theory assumes that managers, if given the opportunity, will pursue their personal interests at the expense of those of the shareholders. Consequently, efforts must be made to align the interests of managers and shareholders. Such pressure on managers can come from external and internal sources. For example, the market for corporate control provides outside pressure on managers. Managerial underperfor-

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39. See Robert C. Clark, Corporate Law 106-08 (1986) (noting that while the board is supposed to supervise the entire business, the actual amount of work performed by the board is actually much more modest). Under Delaware law, officers are the creation of the board. The board appoints officers as it sees fit and gives officers their power. Even the chief executive officer depends on the board for her authority to conduct business on behalf of the corporation. Title 8, section 142 of the Delaware Code states “[e]very corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors . . . .” Del. Code Ann. tit. 8, § 142 (West, Westlaw through 2010 legislation); see also Grimes v. Donald, No. CIV. A. 13358, slip op. at 8 (Del. Ch. Jan. 11, 1995), aff’d, 673 A.2d 1207 (Del. 1996) (“A fundamental precept of Delaware corporation law is that it is the board of directors, and neither shareholders nor managers, that has ultimate responsibility for the management of the enterprise. Of course, given the large, complex organizations through which modern, multifunction business corporations often operate, the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance.” (internal citations omitted)); Oliver E. Williamson, Corporate Boards of Directors: In Principle and in Practice, 24 J.L. Econ. & Org. 247, 259 (2008) (enumerating the benefits of delegation from the board to officers).


mance makes a corporation more attractive to takeover attempts. Incentive-based compensation offers internal pressure. Awarding equity allows managers to benefit from the maximization of shareholder value.\(^{42}\)

The most important mechanisms to address the agency problem, however, are those that facilitate direct monitoring of managers by shareholders. For example, much emphasis in recent years has been given to the role of institutional investors in monitoring managers.\(^{43}\) As the largest shareholders, institutional investors are in the best position to overcome the collective action problem and defend shareholder interests. Others have argued for better access by shareholders to proxy statements,\(^{44}\) requirements that directors receive majority support from

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shareholders, and approval by shareholders of executive compensation, and rights for shareholders to propose charter amendments.

Having shareholders monitor managers, however, is problematic. Shareholders’ authority stems primarily from their power to elect members of the board, but this power is limited. Shareholders must rely on boards to exercise appropriate control over officers. If boards fail to do so, shareholders’ only recourse is to elect new directors. This option presumes that shareholders have alternative candidates. Often, candidates nominated by the CEO dominate board elections, and current rules make it expensive for shareholders to propose their own candidates. Therefore, any increase in the influence of shareholders over managers depends on boards’ willingness to more aggressively monitor the performance of officers. A more robust duty to monitor for boards helps resolve this agency problem.

According to resource dependency theory, directors provide valuable resources to the corporation. Directors, who are selected for their skills, experience, and connections, contribute personal capital to the corporation whether by providing strategic advice to officers, identifying new business opportunities, assisting in government relations, or establishing new relationships. A board consisting of former regulatory officials, financial institution executives, or lawyers would give the corporation access to information about regulatory processes, to financial credit, or legal advice. Directors use their personal relat-

48. See Benjamin E. Hermelin & Michael S. Weisbach, Endogenously Chosen Boards of Directors and Their Monitoring of the CEO, 88 Am. Econ. Rev. 96, 96 (1998). Hermelin and Weisbach also cite the study conducted by Harry and Linda DeAngelo finding that when dissident shareholders challenge the officers’ recommended directors, the shareholders only succeed in winning a board seat one-third of the time. See Harry DeAngelo & Linda DeAngelo, Proxy Contests and the Governance of Publicly Held Corporations, 23 J. Fin. Econ. 29, 30 (1989).
tionships, skills, and reputation to advance the corporation’s interests. Directors also draw upon their experience and expertise to make valuable cognitive contributions to corporate decisionmaking. For resource dependency theory to hold true, the CEO must work closely with the board to exploit these valuable resources. Likewise, in order for the board to be useful to the corporation, the board must be intimately familiar with the objectives and operations of the corporation. This need is particularly true in situations where the director provides value to the corporation by drawing upon her experience and decisionmaking skills to help plan corporate strategy.

These theories suggest that the proper role of the board is that of both monitor and manager, and empirical studies have shown that these two roles are pursued in practice. Under agency theory, the board is valued for its ability to keep officers in check so that they work in the interests of shareholders. Resource dependency theory, on the other hand, places a premium on a board’s ability to add value as part of the decisionmaking and strategic planning process.

Two objections are commonly made to this depiction of the board as monitor and manager. The first objection comes from those who believe boards are controlled by the powerful CEO and offer little check on executive authority. Studies by Myles Mace and by Jay Lorsch and Elizabeth MacIver famously depicted the board as the junior partner to the CEO. The CEO’s dominance of the board is a result of a variety of factors. Officers have a monopoly on inside information. Directors have to rely on the officers to keep them informed. Officers are professional managers who are employed full-time by the corporation. Directors often have a more diverse range of backgrounds and spend only a fraction of their time on board business. The CEO and other officers frequently have seats on the board and, therefore, can exert direct control over board decisions. This power of the CEO over the board is frequently reflected by the fact that the CEO also serves as chairman of the board. Even if the board

52. See Violina P. Rindova, What Corporate Boards Have to Do with Strategy: A Cognitive Perspective, 36 J. MGMT. STUD. 953 (1999). Rindova observes that among the many contributions that boards make to strategic planning, boards contribute their diverse experience which serves a valuable source of knowledge from which management can draw upon to make superior decisions. Id. at 960.


is not composed of corporate insiders, the CEO often controls the nomination of new directors, making it more likely that the board will be compliant and receptive to the views of the CEO. Not surprisingly, this image of the board shaped by Mace, Lorsch and MacIver, and others has encouraged the belief that directors are incapable and ill-equipped to provide effective oversight of officers.56

Corporate governance reform efforts over the past twenty years, however, have sought to address many of these problems. There has developed a strong view as to corporate governance best practices designed to promote board independence and to enable the board to challenge decisions of the CEO.57 Some of these practices have been made mandatory for public companies under federal securities law and stock exchange listing rules.58 Such practices include: requiring a majority of directors to be independent;59 creating audit, compensation, and nominating committees composed of independent directors;60 having boards hold executive sessions outside the presence of officers;61 and separating the positions of CEO and


59. See E. Norman Veasey, Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa?, 149 U. PA. L. REV. 2179, 2184 (“Although independence of directors may not necessarily guarantee the best economic return to stockholders, I think the better view, generally, is that a worthwhile goal is to have a significant majority of independent directors on the board. Independence offers to investors some assurance that the governance process has integrity.”).

60. See Anil Shivdasani & David Yermack, CEO Involvement in the Selection of New Board Members: An Empirical Analysis, 54 J. FIN. 1829 (1999) (finding that when the CEO serves on the nominating committee or where there is no nominating committee the board consists of fewer independent directors and stock price reaction to independent director appointments is lower).

As many companies have put into place these reforms, boards of U.S. corporations have assumed a much more active role in monitoring the performance of the corporation. Many directors accept their role as monitors and have sought to increase the degree to which they oversee officers.

A second objection is that the monitoring and managing roles of the board are inherently inconsistent. The argument is that boards which are involved in the management of the corporation lose the objectivity they need to be effective managerial monitors or, alternatively, have a harmful, adversarial relationship with management. This argument implies that to the extent we want boards to be suppliers of “board capital” to management, we cannot expect them to be effective monitors. But in reality, boards carry out both functions, and the degree to which a board acts as monitor or manager depends on the special characteristics of the corporation. Furthermore, the

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63. See, e.g., William R. Boulton, The Evolving Board: A Look at the Board's Changing Roles and Information Needs, 3 ACAD. MGMT. REV. 827, 828 (1978) (observing from forty-five interviews with CEOs and directors of seven large U.S. companies that “[t]he changing of the board's role is seen as a process of evolution in which the board moves beyond providing basic legitimacy for the corporation to more actively auditing the results of corporate performance and, finally, to playing an involved role of questioning the viability of the firm’s long-term direction and success.”); Paul W. MacAvoy & Ira M. Millstein, The Active Board of Directors and Its Effect on the Performance of the Large Publicly Traded Corporation, 11 J. APP. CORP. FIN. 8, 8-11 (1999); see also Eisenberg, Board of Directors, supra note 57, at 238-39 (describing the “monitoring model of the board [as] almost universally accepted”).

64. See Holmstrom & Kaplan, supra note 61, at 15 (citing a survey of 2,000 directors in the United States conducted before the passage of the Sarbanes-Oxley Act reporting that the directors “consistently favored more monitoring than was the practice on the boards on which they served”).


67. See Fisch, supra note 65, at 282-89; see also Renée B. Adams, What do Boards do? Evidence from Board Committee and Director Compensation Data (Mar. 13, 2003) (un-
skills that enable boards to play a role in management are also the skills that make boards better monitors.68 Boards would have a better understanding of the business and, therefore, would be in a better position to identify inefficiencies and undesirable risks. Boards also require a requisite amount of managerial experience to evaluate properly the performance of officers. Stronger legal rules, such as the one argued for by this Article, that push directors to be better informed and remain cognizant of their ultimate responsibilities to the shareholders should help ensure that directors are not captured by the CEO and fail to be vigilant monitors. Thus, concerns that the managerial board model conflicts with a monitoring board model should be rejected.

A more robust duty to monitor will improve board effectiveness as monitor and manager. The proposed corporate governance reforms, discussed above, focus on the board’s independence from the CEO. Promoting board independence, however, assumes that if the CEO’s influence over the board is curbed, the board will naturally become a better monitor,69 but empirical evidence does not support this assumption.70 While these reforms may make it easier for boards to be more vigorous monitors, they do not provide a convincing explanation for why boards actually would want to take on the headaches of challenging the CEO.71 One reform designed to better align the interests

published working paper], available at http://ssrn.com/abstract=397401 (finding that boards of diversified firms spend more time monitoring while boards of growing firms spend more time on strategic planning). Donald Langevoort has argued that the ideal board structure may consist of a combination of monitoring and managerial directors accompanied by one of two directors who serve as mediators. See Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Geo. L.J. 797, 815 (2001) [hereinafter Langevoort, The Human Nature of Corporate Boards].


69. See Hermalin & Weisbach, supra note 48, at 97. But see Langevoort, The Human Nature of Corporate Boards, supra note 67, at 807 (noting how overconfident outside directors, unchecked by inside directors, may result in biased decisionmaking).


71. Victor Brudney notes that there is no reason why one should assume that independent directors desire to be serious monitors. Brudney, supra note 65, at 609-16. Charles Yablon, however, argues that the power of CEOs has actually decreased over the past twenty years. Charles M. Yablon, Is the Market for CEOs Rational?, 4 N.Y.U. J. L. & Bus. 89, 123-27 (2007). He notes that the average tenure of CEOs at U.S. corporations has decreased and there has been an increased rate of firing of CEOs. Id. at 123.
of boards with shareholders in improving shareholder value is to give directors stock options. In theory, a share of the corporation’s equity will motivate directors to take a greater interest in the activities of the corporation and “crack the whip” when officers fail to perform.\textsuperscript{72} But equity compensation is a blunt instrument to ensure greater board attention.\textsuperscript{73} Alternatively, reformers hope that increasing the threat of removal by activist shareholders will spur directors to act more in the interests of shareholders. Here too, the threat of removal seems to be a suboptimal corporate governance strategy, as incumbent directors continue to enjoy strong advantages in winning reelection.\textsuperscript{74}

Incredibly, the role of fiduciary duties in motivating directors to be better monitors is absent from the debate.\textsuperscript{75} The misalignment of interests between shareholders and boards, and the high transaction costs associated with the use of shareholder voting and incentive compensation packages to motivate directors produce a textbook case for the use of fiduciary duties, especially the duty to monitor.\textsuperscript{76} If, as argued in this Article, current fiduciary obligations on directors are inadequate to ensure effective monitoring, the legislature and courts should recognize a more robust duty to monitor.

\textbf{B. A Broader Scope: Monitoring of Business Risk}

The duty to monitor should demand boards keep themselves informed and participate in the management of the corporation in situations where we have the greatest concerns about officers’ ability to protect shareholders’ interests. Factors to consider would be the likelihood that officers will make an error or otherwise be careless resulting in harm to the corporation and the magnitude of the potential harm to the corporation. One reason why we may question officers’


Recent psychological research suggests that bonuses and other high monetary rewards can actually adversely affect performance by forcing employees to focus too narrowly on their bonus objectives. See Dan Ariely, Uri Gneezy, George Loewenstein & Nina Mazar, Large Stakes and Big Mistakes, 76 REV. ECON. STUD. 451 (2009).


\textsuperscript{75} Many dismiss the role of fiduciary duties because of the various limitations on directors’ personal liability for fiduciary breaches. Such objections will be addressed later in this Article. See infra text accompanying notes 153-55 and Part V.

ability to work without board oversight is that they lack the appropriate objectivity. Likewise, we expect greater board oversight for activities that may have a disproportionate impact on the health of the corporation.

The duty to monitor would be more effective if courts held boards responsible for overseeing business risk and the implementation of business decisions. Limiting the duty to monitor only to wrongful and illegal acts leaves out other acts, which may not be illegal but are still harmful to the corporation. Such acts are generally harmful because they represent assumption of risk that may be considered by a deliberative board as excessive.

The difficulty with extending the duty to monitor to require board oversight of business risk is how such a duty would be enforced. A court considering claims that the board failed to monitor business risk would be tempted to substitute its business judgment for that of the board's. Chancellor Chandler raised this objection in the Citigroup decision.

It is difficult, however, to see how a court considering a board's failure to consider business risk would be rejecting the business judgment of a board in favor of its own. First, a duty to monitor claim would not exist unless the board failed to exercise any business judgment. The purpose of the duty is to ensure that boards are vigilant and informed enough to be in a position where they can exercise their business judgment. Furthermore, enforcement of the duty to monitor only requires a court to consider a class of outcomes that are harmful enough to the corporation to justify liability for oversight failure. Appropriate outcomes should include those that result in corporate insolvency or otherwise threaten the corporation's ability to continue to operate as a going concern.

The distinction between liability for directorial decisions and liability for failure to monitor is one of process and substance. When the board makes a decision, directors enjoy the full protection of the business judgment rule, provided that they make a good faith effort to be informed and to exercise appropriate judgment. The process by which a board makes its decision is of paramount concern, and this is

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78. In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009) (“To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions.”).

79. Id. at 124.
the only focus of a court’s inquiry. The substantive outcome of the decision is ignored entirely. Success or failure is the responsibility of the board, and its decision will not be second-guessed by the court. Presumably a board that has made a bad decision will find itself subject to the ire of the shareholders at the next annual meeting.

When the board fails to act, on the other hand, a court becomes involved because of the substantive outcome of this failure to act. Committing illegal acts that result in criminal or civil penalties, for example, is a substantively bad outcome for the company. The existence of this bad outcome results in a lawsuit and becomes the basis for deciding a duty to monitor claim (i.e., that the board should have prevented the outcome). At that point, the court must consider whether the board was in a position to prevent or stop the illegal act. This is ultimately an inquiry into the process followed by the board in monitoring the activities of the corporation. This process is laid out in the Caremark standard.82

This requirement that courts consider the substantive outcome of a board’s inaction naturally limits the scope and application of the duty to monitor. Courts will be uncomfortable in assessing whether a company is doing well or poorly as a business. A duty to monitor claim, however, can only be considered if a court concludes that the board’s failure to act produced a bad outcome for the company. In order to get around their natural aversion to making such judgments, judges need to seek out defined categories of outcomes where they feel comfortable applying a duty to monitor analysis. Because judges are experts in law, the obvious category is violations of law. Therefore, it is not surprising that Delaware courts have limited duty to monitor claims to illegal acts. But there is no reason why courts must constrain themselves to this narrow set of outcomes, especially since judges retain the ability to excuse boards from liability by concluding that they did have in place reasonable monitoring systems or did make good faith efforts to prevent harm to the corporation. Judges can and should be willing to take on cases involving a more expansive list of bad outcomes that will lead them to apply a duty to monitor analysis. This list would include, for example, performance failures by the company that threaten the solvency of the company but do not involve illegal acts.

80. See Lynn A. Stout, In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule, 96 NW. U. L. REV. 675, 675-76 (2002); see also Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (noting that the merits of a business decision are considered separately from the process used to reach that decision).

81. Brehm, 746 A.2d at 264 (“Due care in the decisionmaking context is process due care only.”).

Such a stance would be consistent with the reasoning of Graham and Caremark. In supporting a sharper interpretation of Graham, Chancellor Allen argued that for boards to meet their obligation to be reasonably informed concerning the corporation they need to:

assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board... to reach informed judgments concerning both the corporation’s compliance with law and its business performance.83

It is logical that systematic monitoring is a task that must be undertaken not only to ensure legal compliance but also successful (or at least nondisastrous) business results. As Chancellor Allen himself noted, “[d]irectors are not specialists like lawyers... [but rather] general advisors of the business...”84 If directors are equipped to perform any type of monitoring, it must be of the business performance of the corporation. Courts should enforce this duty by more aggressively applying the duty to monitor.

In order for boards to be effective monitors of business risk, they must be independent, have adequate resources, and possess comprehensive information. Recent corporate governance reforms have sought to address the problem of board independence. Boards also have sought to secure additional resources to carry out their duties. For instance, boards can, and frequently do, hire their own financial advisors, legal counsel, and accounting firms to assist them.85 Corporations can also impose more exacting requirements on new board members, just as Citigroup did when it began looking for directors with “expertise in finance and investments.”86 Collection of information, however, is subject to a board’s ability to compel the CEO to share relevant and timely information. While a more robust duty to monitor may motivate boards to supervise officers more aggressively, the key prerequisite must be boards’ ability to obtain comprehensive, accurate, and timely information about corporate operations and related risks.87

83. Id. at 970 (emphasis added); see Bainbridge, Caremark and Risk Management, supra note 77, at 18 (“Chancellor Allen thus obviously intended the Caremark duty to extend beyond mere law compliance to include such issues as business risk management.”).
84. Caremark, 698 A.2d at 968.
85. See, e.g., Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18788 (Apr. 16, 2003) (codified at 17 C.F.R. pts. 228, 229, 240, 249 & 274) (requiring public companies to grant their audit committees the authority to engage independent counsel and other advisors, as such committees deem necessary to carry out their duties).
87. See Eisenberg, Board of Directors, supra note 57, at 244-46; see also Fama & Jensen, supra note 49, at 314.
In the previous section, this Article noted the gap in perception of boards’ ability to serve as monitors and the necessity of boards to play a more active monitoring role. There is also a gap in perception of boards having enough information to perform their monitoring role and the actual extent to which corporations have systems in place that provide boards with the information they need to be effective monitors. 88 Internal control and information reporting systems are expensive in both time and money. 89 Monitoring systems that feel invasive to officers also may breed distrust, distract, and inhibit risk taking. 90 Despite these costs, U.S. public corporations have invested heavily in recent years in internal control and information reporting systems, expanding significantly the scope of these systems.

The history of internal control and information reporting systems, especially the internal control requirements for financial reporting imposed by the Sarbanes-Oxley Act of 2002, has been described extensively elsewhere. 91 What is of greater interest is how internal control and information reporting systems have advanced since Sarbanes-Oxley. The evolving recommendations of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) 92 provide insight into the scope of internal control and information reporting systems adopted by U.S. public corporations. COSO has issued several reports that build upon its original 1992 report Internal Control—Integrated Framework. 93 The 1992 report laid out an inter-

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88. See Hillary A. Sale, Monitoring Caremark’s Good Faith, 32 DEL. J. CORP. L. 719, 724 (2007) (“Monitoring systems are . . . within the directors’ purview. They must approve and oversee them. . . . Thus, the systems are key to the role of directors and, once established, allow directors to focus on other strategic decisions.”).


90. See id.

91. See, e.g., Eisenberg, Board of Directors, supra note 57, at 240-44; Lisa M. Fairfax, Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act, 55 RUTGERS L. REV. 1, 56-57 (2002); Langevoort, Internal Controls After Sarbanes-Oxley, supra note 89, at 954-57.

92. COSO is sponsored by the five leading U.S. accounting associations: American Institute of Certified Public Accountants (AICPA), American Accounting Association (AAA), Financial Executives International (FEI), Institute of Internal Auditors (IIA), and Institute of Management Accountants (IMA). COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM’N, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY FRAMEWORK iii (2004) [hereinafter 1 COSO 2004 REPORT].

93. COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM’N, AICPA, INTERNAL CONTROL—INTEGRATED FRAMEWORK (1992) [hereinafter COSO 1992 REPORT]; see also Eisenberg, Board of Directors, supra note 57, at 244 (describing the 1992 COSO report as the definite treatment of internal controls of its time); Langevoort, Internal Controls After Sarbanes-Oxley, supra note 89, at 955 (noting that the SEC recognized the 1992 COSO report as the only suitable framework for internal controls, making the report the de facto standard); Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36636, 36641 (June 18, 2003) (codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270 & 274) (recognizing the COSO framework).
nal control framework to achieve “[e]ffectiveness and efficiency of operations[,] [r]eliability of financial reporting[,] [a]nd [c]ompliance with applicable laws and regulations.” The focus on legal compliance and accuracy of financial reporting is consistent with the scope of Delaware’s duty to monitor which is limited to the prevention of illegal acts. In 2004, COSO issued Enterprise Risk Management—Integrated Framework where COSO recommended internal control and information reporting systems to identify, assess, and manage “enterprise risk.” Enterprise risk management consists of reducing operational surprises and losses, seizing opportunities to improve corporate value, and improving deployment of capital—capabilities to “help management achieve the entity’s performance and profitability targets and prevent loss of resources.” What is striking about the COSO guidance on enterprise risk is that it recasts internal controls as being a tool to manage business risk, a task that goes far beyond what is required of the information reporting systems mandated by Delaware courts. Furthermore, COSO reaffirms boards’ role in overseeing enterprise risk management systems and to rely not only on reports from officers but also to draw upon internal and external auditors and other resources.

U.S. companies have embraced enterprise risk management. In a 2005-2006 survey of corporate directors, The Conference Board and McKinsey & Co. found that an increasing number of directors considered overseeing business risk as their responsibility and that contemplation of business risk is part of “every conversation they have about strategy.” In a 2002 survey, McKinsey found that almost half of the directors surveyed (200 directors representing over 500 boards) described their procedures to consider enterprise risk as “non-

94. See COSO 1992 REPORT, supra note 93, at 9.
96. See 1 COSO 2004 REPORT, supra note 92, at 3.
97. See 1 COSO 2004 REPORT, supra note 92, at 109-12, app. C (explaining how “enterprise risk management is broader than internal control”); MATTEO TONELLO, EMERGING GOVERNANCE PRACTICE IN ENTERPRISE RISK MANAGEMENT 17 (2007), available at http://ssrn.com/abstract=963221 (“The Sarbanes-Oxley Act’s impact on internal control is narrowly focused on managing the risk of fraud and ensuring accurate financial reporting. [Enterprise risk management], on the other hand, encompasses a wider array of the business risks the corporation is exposed to, including strategic and operational risks.”). It is helpful to note that the concept of enterprise risk management includes using risk measurement techniques such as Value-at-Risk (VaR). See GREGORY MONAHAN, ENTERPRISE RISK MANAGEMENT: A METHODOLOGY FOR ACHIEVING STRATEGIC OBJECTIVES 22-45 (2008). VaR is commonly used to measure potential losses on trading activities. See Kimberly D. Krawiec, The Return of the Rogue, 51 ARIZ. L. REV. 127, 149-50 (2009).
98. 1 COSO 2004 REPORT, supra note 92, at 83-84.
The survey also found “that non-financial risks received only ‘anecdotal treatment’ ” in board deliberations. By 2005-2006, boards of large U.S. public companies assumed much greater command of enterprise risk management with nearly 90% of surveyed directors (127 directors) stating they believed that they approached a full or very good understanding of their corporations’ risks. More significantly, the survey found evidence that directors distinguished between business risk and accuracy of financial information, and that they placed a higher priority on managing business risk. The survey results suggest that by 2005-2006 most directors of large U.S. corporations understood the need for internal control and information reporting systems that go beyond the requirements of the Sarbanes-Oxley Act.

Surveyed directors also described the division of responsibilities in the largest corporations concerning enterprise risk management. While directors generally believe that enterprise risk management is the responsibility of the CEO, all surveyed directors agreed that their role consisted of both overseeing the process of risk management and having oversight for corporate strategy. This result highlights how in practice directors have embraced their role as both monitor and manager.

The COSO recommendations and the survey results of The Conference Board and McKinsey indicate that board oversight exceeds the minimum requirements set by the Delaware courts. Boards recognize that they are expected and often prepared to monitor a broader range of corporate activities, and they consider it their responsibility to manage all risks that may have a material impact on corporate performance. Delaware courts should take heed of these recent trends to acknowledge expectations shared by shareholders and directors alike that boards have a duty to monitor all business risks.

C. Inferring Scienter: A Board’s Failure to Act in Good Faith as a Rebuttable Presumption

Since Stone when the Delaware Supreme Court declared that a board’s duty to monitor was part of its duty to act in good faith, Delaware courts have required plaintiffs to plead facts that demonstrate

100. Id. at 15.
101. Id.
102. Id. at 16.
103. See id. at 17. (53.3 percent of the surveyed directors believed strategic risk posed the greatest threat to their firms, “while only 15.7 percent indicated ‘financial risk’ as their key concern.”).
104. Id. at 23.
scienter. Delaware courts have described the scienter requirement to mean that plaintiffs need to show that directors knew that they were failing to fulfill their monitoring duties. It is not enough to show that directors had the opportunity to spot wrongdoing or illegal conduct, nor is it enough to show that the directors were or should have been in a position to see such conduct. Instead, plaintiffs must present facts to suggest that the directors acted with a “culpable state of mind.” It is this culpable state of mind that lies at the heart of the meaning of bad faith—a conscious disregard for one’s responsibilities. This requirement, however, is difficult for plaintiffs to meet. Rarely do plaintiffs have access to documents or other sources of evidence that reveal with particularity the defendants’ state of mind, especially at the pleading stage. Instead plaintiffs must convince the court to infer scienter from the board’s actions.

Scienter poses a particular problem in the context of the duty to monitor. Plaintiffs must attempt to show that a board failed to act in good faith by virtue of its lack of action. In such a case, what would serve as evidence of a culpable state of mind? Vice Chancellor Strine has suggested that culpability can be inferred by showing persistent indolence. The logic is that a board may fail to monitor so persistently that the only reasonable explanation for its behavior is that it intended to evade its monitoring duty. However, what does it mean

107. See, e.g., Wood v. Baum, 953 A.2d 136, 141 (Del. 2008) (“[A] plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter, i.e., that they had ‘actual or constructive knowledge’ that their conduct was legally improper.”); Desimone, 924 A.2d at 940 (“Thus, in order to state a viable Caremark claim . . . a plaintiff must plead the existence of facts suggesting that the board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed.”); Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (“[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”).
108. See, e.g., Desimone, 924 A.2d at 940.
109. Id. at 931.
110. Because there will not be any discovery at the time of pleading, plaintiffs will have limited access to materials that enable them to plead with particularity. Delaware courts have acknowledged this difficulty but have suggested a books and records request as a suitable mechanism for procuring information. Wood, 953 A.2d at 144 n.25 (“[F]ailure to make a books and records demand rendered plaintiff ‘unable to plead any facts about what the . . . board did, when they did it, what they discussed, what conclusions they reached, and why the board did or did not do anything’ . . . .” (citing Desimone, 924 A.2d at 951)); Beam v. Stewart, 845 A.2d 1040, 1057 n.52 (Del. 2004) (“[P]laintiff should pursue a books and records inspection in order to secure the facts necessary to support an allegation of demand futility if the factual allegations would otherwise fall short.”).
111. Desimone, 924 A.2d at 935 (“Caremark itself encouraged directors to act with reasonable diligence, but plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director—bad faith—because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation’s officers had developed and were implementing a prudent approach to ensuring law compliance.”).
to fail to monitor persistently? On one hand, there is the failure to put into place an internal control and information reporting system. The absence of a monitoring system would seem to be a clear case of failing to monitor. But what if the board has put in place some system? Caremark stated that the board had to have in place a “reasonably designed” system.\textsuperscript{112} Thus, plaintiffs would need to show that the directors knew that their system was not reasonably designed—a very difficult task to prove and one that cannot be easily inferred from the board’s behavior.

The more fruitful line of attack for plaintiffs would be to show that even with a monitoring system in place, the board ignored or failed to react to information reported by the system. In other words, the monitoring system brought to the board’s attention certain red flags, and the board failed to act in the face of such red flags. This line of argument poses two burdens on plaintiffs. First, they must tell the court which red flags the board should have seen. Plaintiffs have attempted to point to well-publicized news commentary or market trends as evidence of red flags, but courts have rejected these red flags as being too broad.\textsuperscript{113} Second, they must show that the red flags actually came to the directors’ attention and that they ignored them. This is also difficult to demonstrate. In recent cases, courts have rejected plaintiffs’ attempts to infer that directors saw the red flags because they either served on certain key board committees or had executed certain transaction documents.\textsuperscript{114}

It is difficult to avoid the fact that the duty to monitor as articulated in Caremark does not actually require the presence of scienter (as defined by recent Delaware court cases) but rather supports broader applicability. In Caremark, Chancellor Allen viewed a board’s liability as stemming from an “unconsidered failure of the board to act.”\textsuperscript{115} After all, the purpose of the duty is to ensure that the board does not allow itself to be caught off-guard. Chancellor Allen would have considered the Caremark directors to have breached their duty of care if the plaintiffs could show that the directors knew of the wrongdoing or “should have known that violations of law were occurring.”\textsuperscript{116} This language implies some objective standard of diligence. The purpose of the standard was to avoid the “head in the sand” behavior that Graham rewarded. Caremark, however, accepted the notion that a board should be held responsible only for knowing that

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  \item \textsuperscript{112} See In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).
  \item \textsuperscript{113} See, e.g., In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 128 (Del. Ch. 2009).
  \item \textsuperscript{114} See Wood, 953 A.2d at 142-43 (noting that it is not enough that the board approved an improper transaction or served on particular board committee as neither provides proof of the directors’ state of mind).
  \item \textsuperscript{115} Caremark, 698 A.2d at 967 (emphasis omitted).
  \item \textsuperscript{116} Id. at 971 (emphasis added).
\end{itemize}
which would be detected by a monitoring system slightly more competent than an “utter failure”—a low threshold indeed.\footnote{117. See, e.g., Jonathan R. Macey & Maureen O’Hara, *The Corporate Governance of Banks*, 9 ECON. POL’Y REV. 91, 102-03 (2003) (arguing that the *Caremark* standard is too low for the banking industry because bank directors have a continuing obligation to develop and maintain detailed and elaborate systems for monitoring and oversight).}

Given that the first part of the *Caremark* standard is about ensuring that boards have in place some type of minimally adequate monitoring system, scienter is not a factor that should be taken into consideration. If anything, the scienter requirement undermines the first part of the *Caremark* test because it will only serve to excuse those directors who fail to have in place a reasonable information reporting system but just did not realize that fact. The scienter element brings back the “head in the sand” effect of *Graham*, taking what was already an extremely easy test for directors and turning it into a meaningless one. An incurious board would always avoid liability. In addition, it turns on its head Chancellor Allen’s purpose for recognizing some oversight liability, which was “to act as a stimulus to good faith performance of duty by such directors.”\footnote{118. *Caremark*, 698 A.2d at 971.} In this respect, good faith means having directors pursue their duties diligently, not that they only need to make minimal efforts and “go through the motions” of collecting information.

Actual knowledge also is inconsistent with the second part of the *Caremark* standard. After a red flag is identified, a board’s liability does not stem merely from the failure to act on the red flag, but rather from the failure to act due to a conscious decision or a failure to recognize or react to the obvious danger. A conscious decision by the board to ignore the red flag, however, is a business decision and like all business decisions should be reviewed by the court with deference under the business judgment rule. It is only when the failure to act stems from board inattention or omission that a claim can be made that the board violated its duty to monitor.

Thus, the scienter requirement does not fit comfortably with a duty that results from a lack of deliberation by the board. The scienter requirement forces plaintiffs to undermine their own claims because they will have to produce particularized facts that the board recognized a red flag, which undoubtedly will reveal that the board exercised its business judgment in deciding how to react to the red flag. It is important to note that a valid business decision could be the decision to ignore a red flag. As a result, the only types of cases where there could be a successful duty to monitor claim (provided that a monitoring system was present) is a situation where the business judgment rule or section 102(b)(7) exculpation would not have provided protection to begin with, which is the conduct of wrongful or
illegal acts. Such a framework prevents the duty to monitor from being applied in other contexts.

Is there another way to define scienter such that plaintiffs do not have to show actual knowledge of a problem by the board? The federal district court decision in *Countrywide* offers an alternative: Delaware courts could adopt the definition of scienter as applied by federal courts in deciding section 10(b) and rule 10b-5 securities fraud cases.\(^\text{119}\) The vast majority of federal circuits have interpreted scienter to include recklessness.\(^\text{120}\) The accepted understanding of recklessness is “highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care”\(^\text{121}\) or, in the opinion of one circuit, “carelessness approaching indifference.”\(^\text{122}\) Such a standard requires an objective determination by the court of the defendant’s state of mind.\(^\text{123}\) For example, the court might make such a determination by asking if the defendant complied with applicable rules and corporate governance standards.\(^\text{124}\) Accepting recklessness as part of scienter invites courts to second guess the action (or inaction) of the defendant to decide if the defendant really did act in good faith. Whereas Delaware courts’ understanding of scienter requires plaintiffs to plead facts that show the defendant’s state of mind, recklessness sets aside the question of what was the defendant’s actual state of mind in favor of an inference of scienter based upon the defendant’s actions.\(^\text{125}\) The Ninth Circuit has adopted an even more refined formulation of the standard of scienter; it requires plaintiffs to plead evi-

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119. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (deciding that there must be an allegation of scienter for a cause of action under section 10(b) of the 1934 Securities Exchange Act and rule 10b-5).
124. Sale, Delaware’s Good Faith, supra note 24, at 490 (discussing the implications of the federal recklessness standards on the Delaware duty of good faith).
125. See, e.g., Geoffrey P. Miller, Pleading After Tellabs, 2009 Wis. L. Rev. 507, 515 (2009) (“As with any mental state, scienter cannot be established by direct evidence, but only circumstantially.”); see also Milich, supra note 123, at 187-91. Milich describes this understanding of scienter as the “disjunctive approach” where recklessness is determined independently of intent. Id. at 187. As noted by Milich, Oliver Wendell Holmes advocated the disjunctive approach: “[I]t means that the law, applying a general objective standard, determines that, if a man makes his statement on . . . [grossly insufficient] data, he is liable, whatever was the state of his mind, and although he individually may have been perfectly free of wickedness in making it.” Id. at 188 (quoting Oliver Wendell Holmes, The Common Law 108 (1963 ed.) (emphasis omitted)). Milich notes that most federal courts followed the disjunctive approach in their application of recklessness. Id. at 191-92.
Deliberate recklessness implies that courts should still seek evidence of the defendant's state of mind. Delaware courts may find deliberate recklessness as a possible middle ground for incorporating recklessness into its understanding of scienter.

To illustrate how a deliberate recklessness standard broadens the scope of the duty to monitor, consider *In re Countrywide Financial Corp. Derivative Litigation*. *Countrywide* was a decision of the U.S. District Court of the Central District of California concerning director violations of section 10(b) of the Securities Exchange Act of 1934 and the Delaware duty to monitor. The plaintiffs sought to hold certain directors responsible for approving an increase in the origination of non-conforming loans, extending in contravention of company underwriting standards, and failing to maintain appropriate reserves and allowances to offset the company's riskier loan portfolio. Like the Citigroup board, the Countrywide board approved a strategy and set of business practices that exposed the firm to greater risk.

*Countrywide* presents an interesting case because it is a duty to monitor case decided by a federal court. Furthermore, the federal court was deciding the monitoring claims alongside the section 10(b) claims. The court applied the Ninth Circuit standard of "deliberate recklessness." In applying this standard, the district court made more aggressive inferences of the board's scienter beyond what would have been made by any Delaware court. Evidence of deliberate recklessness implies that courts should still seek evidence of the defendant's state of mind. Delaware courts may find deliberate recklessness as a possible middle ground for incorporating recklessness into its understanding of scienter.

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126. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974, 976-77 (citing *Hollinger*, 914 F.2d at 1569) (9th Cir. 1999). Despite being the only circuit to require "deliberate recklessness" to prove scienter, the Ninth Circuit, like the rest of the federal circuits, has agreed that Congress did not change the scienter standard in the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (1995) when it imposed the requirement that every complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (2006).

127. In a recent case, *SEC v. Platforms Wireless Int'l Corp.*, however, the Ninth Circuit appeared to open the door to applying a scienter standard much closer to the less burdensome recklessness standard accepted in other federal circuits. 617 F.3d 1072 (9th Cir. 2010). While it affirmed the deliberate recklessness standard, it permitted plaintiffs to pass summary judgment by an objective evaluation of the defendant's mental state as opposed to a subjective evaluation of the defendant's actual state of mind. *See id.* at 1093-94.


129. *See id.* at 1057-71, 1077-83.

130. *Id.* at 1050-52.

131. *Id.* at 1057.
lessness included statements of fourteen low-level employees (out of 50,000 employees) describing the deterioration of Countrywide’s underwriting standards.\textsuperscript{132} Even though the plaintiffs could not show that the directors had any contact with these employees or that concerns raised by the employees ever reached the directors, the court concluded that the defendants must have known about what was happening because the underwriting practices were so pervasive across the corporation.\textsuperscript{133} Other evidence of deliberate recklessness was the fact that the defendants served on key board committees responsible for monitoring Countrywide’s financial statements.\textsuperscript{134} The plaintiffs convinced the court that the financial impact of the problematic loans constituted red flags that must have been seen by any director who was on a board committee tasked with preparing or reviewing the corporation’s financial statements.\textsuperscript{135} Again, the court did not require plaintiffs to show that the defendants actually had knowledge of these red flags or proof that such red flags were brought to the attention of the defendants. The \textit{Countrywide} decision shows that recognition of recklessness shifts the understanding of scienter away from what the defendants actually did know toward what they should have known or were in a position to know.

With its reliance on objective criteria to judge a board’s behavior, the deliberate recklessness standard looks suspiciously like gross negligence, and this poses a problem under Delaware law. Gross negligence has long been considered under Delaware law as a breach of the duty of care exculpated by section 102(b)(7). But, as noted by Chancellor Chandler, Delaware’s gross negligence standard has shown some elasticity over the past few years.\textsuperscript{136} Before the Delaware Supreme Court explained the meaning of the duty of good faith in \textit{Brehm} and \textit{Stone}, Delaware courts defined gross negligence as “reck-
less indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”

Since then, good faith has become separated from the original definition of gross negligence to mean “intentional dereliction of duty or conscious disregard for one’s responsibilities,” and gross negligence in turn is now defined as “reckless indifference or actions without the bound of reason.” Of course, these definitions offer little guidance in the abstract. Only through consideration of actual cases will the distinction between gross negligence and good faith be fully understood. The challenge will be to incorporate the standard of deliberate recklessness into scienter in such a way that directors will not be found liable for only grossly negligent behavior.

One solution is to make a plaintiff’s claim of bad faith for a failure to monitor a rebuttable presumption. Plaintiffs should be allowed to demonstrate scienter by pleading facts that show a board’s deliberate recklessness. The burden then should be on the board to rebut the plaintiff’s case by providing evidence that it did carry out its monitoring responsibilities in good faith. This can mean demonstrating to the court the manner in which the board ensured that a reasonable monitoring system was put into place, the extent to which the board considered the findings of such monitoring system, and the exercise of its business judgment in considering red flags identified by the system.

We expect boards to act in good faith, and we must consider the difficulty of determining if a board has acted in good faith when we are trying to discern the board’s state of mind from the absence of its action. Our hope is that boards make good faith efforts to oversee corporate activities and prevent the occurrence of harmful events. The current standard, however, presumes that boards are monitoring in good faith—a questionable presumption given long-standing concerns about board independence and qualifications. Turning good faith into a rebuttable presumption will encourage boards to take affirmative steps to exert monitoring efforts. More importantly, a rebuttable presumption allows a court still to consider a director’s state of mind without imposing a near impossible burden on the plaintiff. It becomes the job of the defendant to explain how his recklessness does not constitute culpable conduct.

138. See, e.g., id.
139. See Sale, Delaware’s Good Faith, supra note 24, at 491.
D. Monitoring After a Business Decision

In addition to addressing the question of what the duty to monitor should apply to (i.e., legal and business risks), courts also should re-think when the duty to monitor should apply. Chancellor Allen was very firm in Caremark to distinguish between “liability for directorial decisions” and “liability for failure to monitor.”

Chancellor Allen did not address a third situation where the board has made a decision—a decision that exposes the company to extensive business risk—and the board does not follow up on the decision and monitor its effects. What makes this situation different from the directorial decision situation contemplated by Chancellor Allen is that some decisions do not have immediate effect on the corporation and that these decisions are based upon assumptions made in the face of great uncertainty. In other words, decisions are subject to dynamic conditions. What may be considered initially an appropriate decision for the corporation may become a reckless and harmful decision as facts become known and conditions change. Arguably, these so-called “decisions subject to change” are the types of decisions more commonly made by boards than the types of decisions where there is immediate effect because boards tend to be involved more often in the setting of long-term corporate strategy rather than in the making of day-to-day decisions.

The Citigroup case is such an example. The Citigroup board made a business decision to expose the firm to greater trading risks in order to achieve higher profits. After the decision was made, however, the board relied on management to implement the strategy and did not inform itself of the manner in which the strategy was being implemented. Two years later, the board became aware for the first time that the activities of the firm stemming from its original decision had produced losses that threatened the solvency of the firm. Extending business judgment rule protection to the board for its early 2005 decision would be inappropriate given the length of time that had passed since the initial decision and the fact that conditions had changed so dramatically in that period. The Citigroup situation also raises the question of implementation. A trading strategy approved by the board was implemented in a manner where excessive risk was

140. In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 967-68 (Del. Ch. 1996). Chancellor Allen did not believe that the duty of monitor plays into board decisions because most corporate decisions do not involve the board. The board is only involved in the most significant corporate acts. See id.
143. Id.
taken on by the firm without the board’s knowledge.\textsuperscript{144} Failure of the board to ensure that there is proper implementation of corporate strategy is a form of board inaction and, therefore, a breach of the duty to monitor.

One can anticipate the counter-argument that the Citigroup situation is a unique case because the financial crisis was an improbable event. The financial crisis caught many financial institutions off-guard and is considered by many as a tail event, albeit a fat tail event.\textsuperscript{145} To hold boards liable for failing to anticipate improbable events would result in overinvestment in monitoring. But the fact of the matter is that there are many occasions where boards make decisions in the face of uncertainty and where follow-up monitoring by the board after the initial decision is desirable.\textsuperscript{146} To illustrate, consider a different example, one that does not relate to the circumstances of the financial crisis. A company finds itself struggling against fierce domestic and foreign competition. In order to save the company, the board authorizes management to develop a new product that, if successful, would revolutionize the market and restore the company’s position as a market leader. This project would require the devotion of a substantial amount of the company’s resources, and its failure would likely leave the company too financially weakened to ever again be a serious competitor, forcing the dissolution or sale of the company. Such a scenario broadly describes any “bet the company” decision by a board, whether it was Boeing’s decision in the 1960s to build the 747 jumbo jet\textsuperscript{147} or General Motors’ plan to build the battery-powered Chevrolet Volt.\textsuperscript{148} These decisions go to the heart of the board’s role as monitor and manager. Because of the signifi-

\textsuperscript{144} The board relied entirely on company employees. One director said, “There is no way you would know what was going on with a risk book unless you’re directly involved with the trading arena. . . . We had highly experienced, highly qualified people running the operation.” Nelson D. Schwartz & Eric Dash, \textit{Where Was the Wise Man?}, \textit{N.Y. Times}, Apr. 27, 2008, at 1.

\textsuperscript{145} \textit{See, e.g.}, Nassim Nicholas Taleb, \textit{The Black Swan: The Impact of the Highly Improbable} (2007) (popularizing the notion that the interconnectedness of global financial institutions made them more susceptible to market events that lay outside regular expectations).

\textsuperscript{146} \textit{See, e.g.}, Andrew, \textit{supra} note 53, at 32 (“If the review process leads the board to approve corporate actions, the board must stand behind its assent. This support entails sharing with the CEO the risks of the decisions it approves, and the board should not approve decisions until it is fully willing to accept those risks.”).

\textsuperscript{147} Eugene Rodgers, \textit{Flying High: The Story of Boeing and the Rise of the Jet-Liner Industry} 288 (1996) (“Although the 747 in its mature years helped Boeing to the pinnacle of financial success, the trauma of its birth nearly destroyed the company.”).

\textsuperscript{148} Jonathan Rauch, \textit{Electro-Shock Therapy: with the Chevy Volt, General Motors—Battered, Struggling for Profitability, Fed Up with Being Eclipsed by Toyota and the Prius—Is Out to Reinvent the Automobile, and Itself}, \textit{The Atlantic Monthly}, July-Aug. 2008, at 84 (“Can GM pull this off? Whenever I asked this question inside the company, I got one or another version of the same answer: ‘Failure is not an option.’ . . . [E]everyone agreed that failure on the Volt, real or perceived, would be a severe setback.”).
cance of the project to the corporation’s ability to survive and the risk of the project, the board’s role should not end, nor should the board’s liability be extinguished, at the time the decision is made. Rather, we would expect that an informed board would revisit its initial decision and decide whether such project or strategy should be continued, modified, or terminated.149

Again, the primary burden placed by the duty to monitor on the board is to be informed and to follow a process to consider such information and evaluate relevant risks. A board’s judgment to defer to the CEO or to accept great business risk is a board’s prerogative and should not be questioned by a court. For example, as dreadful as the outcome may have been for the shareholders of Citigroup, the Citigroup board would have clearly met its duty to monitor—even the more robust duty suggested by this Article—if the board had shown itself to be informed of the risks being taken by the firm. With this in mind, courts should recognize that this monitoring duty applies to a broader range of cases than that contemplated by the current doctrine.

IV. IN DEFENSE OF A MORE ROBUST DUTY TO MONITOR

A more robust duty to monitor that would include holding boards liable for monitoring business risks and require follow-up monitoring by boards would raise several concerns. The first concern is that such a standard would invite, if not require, judges to substitute their business judgment for that of the board. Such a role for judges would go against the basic principles of the business judgment rule. Judges would be evaluating the performance of directors with the benefit of perfect hindsight.150 It would be too tempting for judges to determine that the board missed obvious red flags and therefore breached its duty to monitor. As stated earlier, however, the duty to monitor does not ask nor want a court to second guess the judgment of the board. The duty to monitor only applies when there is evidence that the board, as a result of its complacency, failed to keep itself informed of the potential legal and business risks facing the corporation. Furthermore, the types of business risk that this Article suggests should be covered by the duty to monitor are those risks which might threaten the solvency of the corporation or otherwise prevent the corporation from continuing as a going concern. The duty to monitor does not require courts to replace boards. Instead, courts should only

149. One would need to be careful to avoid the problem of overcommitment where a board would resist recognizing evidence that their initial decision may have been wrong. See Langevoort, The Human Nature of Corporate Boards, supra note 67, at 811.
consider the procedures pursuant to which the board acted to keep itself informed and evaluate any response by the board to red flags.

A second concern is that a more robust duty to monitor would substantially increase the amount of potential personal liability directors will face. It is easy to recall the howls of protest from corporate directors across the United States that followed *Smith v. Van Gorkom* when the Delaware Supreme Court decided that the Trans Union board members breached their duty of care.151 Greater liability produces two unwelcome outcomes. First, boards will become overly cautious and avoid the taking of risks that benefit shareholders—shareholders whose appetite for risk is actually greater because of their ability to diversify risk across a portfolio of companies.152 Second, the higher threat of liability will deter qualified candidates from agreeing to serve on boards.153

It is difficult to refute entirely these concerns in the abstract. It is possible that there may be risk averse directors who will overreact to the possibility of liability and act in the manner stated above.154 But the relevant path of inquiry should be whether the duty to monitor suggested in this Article would require directors to do anything more than what shareholders would require them to do anyway. In other words, it is not clear that the actual amount of personal liability faced by a director would require a greater amount of effort than what a diligent director already expends. Even in its strongest form, the duty to monitor requires boards to invest in internal control and information reporting systems that would collect and deliver information about possible legal and business risks. The standard suggested by this Article continues to follow the *Caremark* standard that the board’s duty is to attempt in good faith to have a reasonable information reporting system in place. As Chancellor Allen indicated, and this Article agrees, this standard is not a difficult one for directors to meet and should not deter any qualified director from serving on a board.155 The second part of the standard is the burden on the board if such systems do report business and legal risks. The burden


154. Langevoort, *The Human Nature of Corporate Boards*, supra note 67, at 823-25 (arguing that corporate executives often have an incorrect impression of the actual risk of liability and overestimate such risk); Veasey, *supra* note 59, at 2186.

is actually extremely modest. So long as the board is willing to consider in good faith the relevant risks, it has met the burden.

If the duty to monitor does drive away certain persons from serving on boards, overall, this effect may be a desirable one. Those persons who will be most sensitive to the demands of the duty to monitor will be those who either lack the qualifications to carry out the necessary monitoring responsibilities or who cannot devote the additional time and other resources demanded by a stronger duty to monitor. Citigroup’s call for director candidates with experience in finance and investments was an admission that its board lacked the necessary expertise to effectively understand the firm’s risk.156 It is also reasonable to assume that boards that permit certain harm to the corporation to occur as a result of their complacency are often composed of persons who lack the time, interest, or motivation to fulfill their appropriate oversight role. If the effect of a more robust duty to monitor is that such persons do not wish to serve on boards, then we should applaud the end result.

A third concern is that the duty to monitor, as advocated in this Article, will usurp the board’s discretion in determining the appropriate degree of monitoring and inhibit risk-taking. We do not want the duty to monitor to prevent corporations from conducting certain activities that may actually benefit the company and its shareholders.157 In other words, the board may conclude it is in the best interest of the corporation for it to expose itself to extreme amounts of business risk.158 Furthermore, the board should decide on its own how much it wishes to invest in an internal control and information reporting system.159 Such systems are expensive in both management and employee time and money.160 Thus, boards should be permitted to limit their investment in internal control and information reporting systems if they conclude that corporate resources would be better spent elsewhere.

With respect to the first part of the concern, the ability of the board to decide on the level of risk it wishes to assume remains untouched. In fact, boards will have more flexibility to decide on the ap-

156. Citigroup Director Search, supra note 86 (advertising that “the Board is actively seeking new directors who meet the criteria . . . with a particular emphasis on expertise in finance and investments”); see also Eric Dash, Dean of Harvard Business School May Join Citigroup’s Board, N.Y. TIMES, July 9, 2008, at C2 (noting that none of Citigroup’s independent directors, except for a recent addition to the board, had substantial finance experience).

157. See CLARK, supra note 39, at 132-33.

158. See, e.g., id.

159. See id.

appropriate level of business risk than they currently have in deciding when it is acceptable for the company to take on legal risk given the prohibition against the conduct of illegal activities by a corporation.\textsuperscript{161} The more serious criticism is that the duty to monitor prevents boards from deciding how much they wish to invest in monitoring systems. This criticism is valid. A more robust duty to monitor would require directors to put into place more extensive information reporting systems to detect possible legal violations, ensure the accuracy of financial information, and manage business risk. But the power of this criticism assumes that boards in the current environment already invest the optimal amount in monitoring systems. If we believe that boards, in the absence of an effective duty to monitor, generally under-invest in monitoring systems, then the revised standard may be correcting erroneous practice.\textsuperscript{162} The fact is that we do not have evidence to know if the types of systems required to meet a tougher duty to monitor actually represent an appropriate level of investment or an over-investment in such systems. As noted by this Article, a duty to monitor including business risk tracks accepted risk management practice in large U.S. public companies.

The fourth concern is that the duty to monitor is unnecessary. Shareholders do not need the protection afforded by the duty to monitor, as they can protect themselves through owning a diversified portfolio of investments or exiting from companies that they feel are improperly managed. Alternatively, shareholders can ensure efficient director oversight through their power to elect members of the board. The strength of such criticism depends on how much faith one puts in the ability of shareholders to collect the information needed to rebalance their investment portfolios appropriately and influence the corporation’s governance. By all accounts, one would have to be quite optimistic to believe that shareholders can protect themselves sufficiently without the assistance of fiduciary duties, such as a duty to monitor. The duty to monitor is partially based upon the belief that directors will not have the necessary information to conduct appropriate oversight without the implementation of a reasonable monitoring system. If this assumption is correct, it is highly unlikely that

\textsuperscript{161} See, e.g., Metro Commc’n Corp. BVI v. Advanced Mobilecomm Techs., Inc., 854 A.2d 121, 131 (Del. Ch. 2004) (“Under Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity.”); see also S. Samuel Arsht, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93, 129-30 (1979) (“Bad faith may preclude the application of the business judgment defense where directors knowingly [sic] violate a statute or comparable expression of public policy, even if such a violation is undertaken in the corporation’s best interests.”).

\textsuperscript{162} Langevoort, Internal Controls After Sarbanes-Oxley, supra note 89, at 958 (noting that “[s]enior managers might choose to under-invest in monitoring the activities of subordinates for a variety of selfish reasons”).
shareholders will be on equal footing to make the appropriate evaluations. And in order to give shareholders the necessary information there would need to be additional requirements through federal securities law. Furthermore, shareholders, especially diverse shareholders of public companies, have difficulty exerting influence on management. Many of the corporate governance initiatives in vogue today are attempting to give shareholders a bigger voice in the management of the corporation, but it would be a mistake to assume that the board should not serve as the primary monitor of the corporation's activities.

V. DUTY TO MONITOR’S EFFECT ON DIRECTOR BEHAVIOR: DIRECTOR LIABILITY AND CORPORATE NORMS

What is the point of making the duty to monitor more robust if directors never face out-of-pocket liability? The fact that outside directors almost always escape personal liability for fiduciary breaches overshadows any proposal to intensify fiduciary obligations. Delaware, like most states, offers a variety of mechanisms to shield directors from personal liability and having to pay out-of-pocket expenses. Section 102(b)(7) allows corporations to exculpate directors’ liability for duty of care violations. Section 145 of the Delaware General Corporation Law permits corporations to indemnify directors for all settlements or judgments and cover their legal expenses. Section 145 also empowers corporations to purchase directors’ and officers’ (D&O) insurance for its board members. Unlike section 102(b)(7) exculpation and indemnification, there are no statutory limits on the coverage of D&O insurance. Even though the terms of most policies will not cover insurance claims for suits based upon deliberate fraud or personal profit, these exclusions are narrower than the good faith

163. See Sale, Independent Directors, supra note 68, at 1380 (noting that the absence of substantive state review has led to reliance on federal securities law, the need for additional disclosure, and the hope that investors and other market participants will engage in substantive review of a company’s corporate activities). There are also limitations on the ability of shareholders to obtain information from the corporation in “real time.” Delaware courts have acknowledged the difficulty of managers sharing information with shareholders because of the need to maintain secrecy (see Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 290 (Del. Ch. 1989)) or the complexity of the information (see Chesapeake Corp. v. Shore, 771 A.2d 293, 332 (Del. Ch. 2000)).


165. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).

166. DEL. CODE ANN. tit. 8, § 145 (2010). Indemnification is conditioned on directors having acted in good faith and “in a manner [they] reasonably believed to be in or not opposed to the best interests of the corporation.” Id. § 145(a).

167. Id. § 145(g).
exclusions under section 102(b)(7) and indemnification. The fact of
the matter is that a well-designed D&O insurance policy will cover
all damages or settlement payments resulting from an action against
a director for violating her duty to monitor. Given that almost all
public companies pay for D&O insurance, directors have little to fear
for their personal wealth from violating their duty to monitor.

In their seminal and exhaustive study of outside director liability,
Bernard Black, Brian Cheffins, and Michael Klausner scoured almost
4000 cases and several hundred settlements and judgments and
found that the risk of personal liability to outside directors is effect-
ively nonexistent. Black, et al. found only thirteen cases where
directors of public companies had to make personal payments (either
as part of judgments or settlements) in the course of twenty-five
years (1980-2005) of securities class action suits, SEC enforcement
actions, and shareholder derivative suits. Only three of the thir-
teen cases pertained to fiduciary duty breaches. Significantly, per-
sonal liability in almost all of these cases would have been avoided
with properly designed D&O insurance policies.

The absence of personal liability raises legitimate questions about
the purpose of imposing on boards more demanding fiduciary duties.
More robust duties may increase the likelihood of lawsuits, but even
then directors will remain untouched. In the meantime, corporations
will bear the cost of litigation, settlements, judgments, and D&O
insurance premiums.

Focusing on out-of-pocket payments, however, understates the
case for how recognizing a more robust duty to monitor will change
director behavior. When accused of fiduciary breaches, directors face
costs that go beyond their direct pecuniary interests. Most obviously,
directors bear the nuisance of having to participate in legal proceed-
ings, especially the commitment of personal time. The more signifi-
cant cost, however, is to a director’s reputation. If the claim is suc-
cessful, the director may be forced to resign or fail to be re-elected at
the next board election. In addition, the continuing presence of di-

169. See id. at 1064-76.
170. See id. at 1055.
171. See id. at 1070-74. One of three cases was Smith v. Van Gorkom, 488 A.2d 858
(Del. 2009), which inspired the passage of section 102(b)(7). See Strine, et al., supra note
151, at 42.
172. Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on
But see Anup Agrawal, Jeffrey F. Jaffe & Jonathan M. Karpoff, Management Turnover and
Governance Changes Following the Revelation of Fraud, 17 J.L. ECON. 309, 311 (1999)
(finding no association between occurrence of corporate fraud and subsequent managerial
or board turnover).
rectors who have been sued also increases the probability of future
lawsuits as these directors develop a reputation for being weak moni-
tors.173 A successful claim also makes a director less attractive as a
candidate to serve on other boards. In outlining their theory on the
separation of ownership and control, Eugene Fama and Michael Jen-
sen described a market for outside directors where outside directors
compete for open board positions.174 More respected directors would
receive more board invitations. Therefore, serving on multiple boards
would be a marker of the director’s quality and prestige. Several
studies support the existence of this market, finding a correlation
between corporate performance and additional board seats.175 The
study by Fich and Shivdasani, for example, found that outside direc-
tors experience a significant decline in the number of opportunities to
join other boards after the discovery of financial fraud.176 Outside di-
rectors face an especially strong reputational hit because they bear
greater responsibility for monitoring fraud. Consequently, reputa-
tional costs are real, and directors have the incentive to meet their
fiduciary obligations to the fullest extent possible.

Delaware courts’ ability to change board behavior, however, does
not come only from its power to mete out punishment. It also comes
from their power to define and change prevailing corporate govern-
ance norms. Judges achieve this through detailed commentary in
their judicial opinions, speeches, and articles about the expected du-
ties and responsibilities of directors and officers—what Claire Hill
and Brett McDonnell have called the “penumbra of Delaware corpo-
rate law.”177 Delaware judges’ influence on U.S. corporate law is high

173. Eliezer N. Fich & Anil Shivdasani, Financial Fraud, Director Reputation, and
175. Yermack, supra note 72, at 2281-2304 (estimating that the total pay-performance
sensitivity for fifth year outside directors to be 11 cents per $1,000 change in shareholder
wealth, of which the likelihood of obtaining new directorships constitutes 4.3 cents or 40% 
of the director’s total performance incentives); see also Stephen P. Ferris, Murali Jagannathan & A.C. Pritchard, Too Busy to Mind the Business? Monitoring by Directors with Mul-
tiple Board Appointments, 58 J. Fin. 1087, 1088 (2003); Suraj Srinivasan, Consequences of
Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements
and Audit Committee Members, 43 J. Acct. Res. 291, 292 (2005). But see Eric Helland,
Reputational Penalties and the Merits of Class-Action Securities Litigation, 49 J.L. & Econ.
365, 366 (2006) (finding little evidence of a negative reputational effect associated with
allegations of fraud except in the case of the largest shareholder class actions suits).
176. See Fich & Shivdasani, supra note 173.
177. Claire Hill & Brett McDonnell, Executive Compensation and the Optimal Penum-
bra of Delaware Corporation Law, 4 VA. L. & Bus. Rev. 333, 354 (2009). Others have also
commented on how decisions and commentary by judges change board behavior. See Margaret M. Blair & Lynn A. Stout, Director Accountability and the Mediating Role of the Cor-
Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1016 (1987); Edward B. Rock
& Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing
because they frequently interact with the bar and are not shy to provide guidance on expected corporate governance practices. These pronouncements, and the responses from the bar, shareholder activists, academics, and corporate leaders, produce a rich body of commentary that help shape the legal and business community’s understanding of best practices of corporate governance. It also is a means by which Delaware courts can clarify the meaning of various legal standards, including the scope and application of the duty to monitor.

These norms in turn affect the culture of the corporate board. Greater exhortations from Delaware courts for boards to engage in more robust monitoring of business risks and the implementation of past business decisions will shape the composition of boards and how boards go about their business. Board nominating committees will search for directors who have good reputations as monitors and possess relevant expertise and qualifications. Directors themselves will adjust their own expectations regarding the amount of time and effort they will need to spend on their positions. D&O insurance providers, who keenly observe the culture of corporate boards, will note changes and may reward the more proactive boards with lower D&O insurance premiums. Thus, it is within the Delaware courts’ power to make meaningful changes in how boards fulfill their duty to monitor.

VI. CONCLUSION

Risk management is a corporate governance problem. Officers and employees of the corporation make decisions every day that put the corporation at risk. A careful balance must be struck between encouraging risk-taking by these officers and employees—to take chances to grow the business and exploit new opportunities—and the need for control and supervision to ensure that risks are taken in an appropriate and reasoned manner. The recent catastrophic losses suffered by our large financial institutions remind us that there are downside risks that need to be managed and spur us to ask whether our corporate governance laws have struck the right balance.


Courts, especially the Delaware courts, play a crucial role in adjusting this balance. Courts need to be more aware of the expectations of shareholders, regulators, and even the directors themselves about how risks should be taken and managed. Courts should study the director-officer relationship and recognize how important it is for boards to make the effort to collect the right type of information about the corporation and be prepared to second-guess the risk perceptions of the officers.181 Strengthening the fiduciary duty to monitor is crucial to this task.182 The board’s duty to monitor should be especially great when the corporation takes risks that may threaten its survival. Often these are the times when the CEO is most likely to take extreme risks to the detriment of the enterprise.183

It must be noted that if Delaware courts do nothing and the duty to monitor continues to languish, the federal government will likely fill the void, imposing new rules to force boards to be better informed and manage business risks.184 Already in most areas of corporate law,
federal law has imposed more stringent requirements on public companies than those set by state courts and legislatures, preempting in many cases the applicability of state corporate law.185 Delaware has an interest in ensuring that it protects its role as the leading corporate law jurisdiction and take the lead on defining a meaningful monitoring duty.186

Fortunately, Delaware courts have tremendous influence over prevailing corporate governance practices. 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. Courts now should begin speaking out about the importance of a board’s duty to monitor and to back up their exhortations by expanding the scope and application of the duty in future cases.

185. Thompson & Sale, supra note 184, at 861 (noting that one of the few areas where state corporate law continues to govern exclusively is corporate decisions pertaining to change of control and self-dealing transactions).