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Delaware Chancery Court Reaffirms Strength of Business Judgment Rule in Wake of Major Financial Crisis [¶7.1]

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An age-old fear among lawyers is the risk that cases with "bad facts" could result in the creation of "bad law." While the current global financial crisis has more than enough bad facts to go around, it is fortunate that the Delaware Chancery Court has indicated that it will look beyond these bad facts to the reality of the situation directors find themselves in and apply well-established law to claims of breach of fiduciary duty. In *In re Citigroup Inc. Shareholder Derivative Litigation*, one of the first cases to address the business judgment rule in the context of the financial crisis, the Delaware Chancery Court recently provided a strong reaffirmation of the business judgment rule that protects directors from the second-guessing of their decisions, even when such decisions lead to losses for shareholders.

The plaintiffs in the case alleged that the directors of Citigroup breached their fiduciary duties by making decisions, such as permitting the company to become extensively involved in collateralized debt obligations and structured investment vehicles, that resulted in massive losses. The plaintiffs further alleged that the board failed to exercise proper oversight of the company in the face of the declining subprime lending market by ignoring "red flags" in the market that should have caused the board to take action to minimize losses. The plaintiffs asserted that under these circumstances, the directors should not be entitled to the protection of the business judgment rule and should be

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personally liable for breach of their fiduciary duties. The business judgment rule is a presumption that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation.

In the *Citigroup* decision, the Delaware Chancery Court recognized that while the desire among shareholders to find someone to blame for their losses is understandable, the board's decisions had to be analyzed in the context of the existing law. It noted that the business judgment rule focuses on the board's decision-making process rather than on a substantive evaluation of the merits of the decision. Thus, the business judgment rule ''prevents judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available—a standard measured by concepts of gross negligence.''

The court emphasized that compliance with a director's duty of care can never be determined based on the content of a board decision that leads to a loss, but rather must focus on consideration of the good faith or rationality of the process employed. Citing its earlier decision in *In re Caremark Int'l Inc. Derivative Litig.*, the court explained: ''[W]hether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. . . . Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.''

The court further noted that the plaintiff shareholders essentially were attempting to hold the directors personally liable because they made or supported business decisions that, in hindsight, turned out badly for the company and failed to perceive the significance of negative information in the market. The shareholders claimed that this was evidence of the directors' bad faith. In response, the Chancery Court confirmed that a plaintiff can show bad faith only if a director *knowingly* violates a fiduciary duty in a *conscious disregard* for director duties. ''Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher.''

The court acknowledged that it is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the ''right'' business decision. ''Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a 'wrong' business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and . . . this Court will not abandon such bedrock principles of Delaware fiduciary duty law.''

In this case, the market decline and warning signs alleged by the plaintiffs were ''not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they were evidence that the directors made bad business decisions.'' But bad business decisions are not a breach of fiduciary duty under Delaware law. ''It is well established that the mere fact that a company

takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, and without more, is not a basis for personal director liability. That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate further is not an invitation for this Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk.''

The *Citigroup* decision is a clear indication from the Delaware Chancery Court that the business judgment rule is alive and well and that the Delaware judges are up to the task of closely analyzing facts and assessing them with a view to the real world in which directors work.[1] As long as directors are mindful of their fiduciary duties of care and loyalty and act in good faith in the best interests of the corporation, they should not have fear that their decisions will be second-guessed by the Delaware Chancery Court.[2]

1. As the court pointed out, the allegations in *Citigroup* were in marked contrast to the allegations in *American International Group, Inc. Consolidated Derivative Litig.*, where the Chancery Court refused to dismiss a complaint that contained specific allegations that the board of AIG failed to exercise reasonable oversight over pervasive and substantial financial fraud and criminal conduct.

2. The Chancery Court allowed to proceed one claim of corporate waste alleged by the plaintiffs based on the board's approval of a $68 million compensation package for Citigroup's CEO upon his retirement, noting that under Delaware law ''there is an outer limit'' to the board's discretion to set executive compensation and without more information there was reasonable doubt whether the compensation package was within the board's discretion or beyond the outer limit.

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