DELAWARE CHANCERY COURT REFUSES TO HOLD CITIGROUP'S DIRECTORS PERSONALLY LIABLE FOR FAILING TO MONITOR RISKS ASSOCIATED WITH CITIGROUP'S SUBPRIME EXPOSURE

On February 24, 2009, Chancellor William B. Chandler III of the Delaware Chancery Court issued a noteworthy ruling dismissing breach of fiduciary duty claims asserted against the board of directors of Citigroup Inc. *See In re Citigroup Inc. Shareholder Derivative Litigation,* Civ. A. No. 3338-CC (Del. Ch. Feb. 24, 2009). Shareholders had commenced a derivative action – that is, an action purportedly on behalf of the corporation – against the directors of Citigroup asserting that the directors had breached their duties by failing to monitor and manage risks associated with Citigroup's exposure to subprime assets, and allowing Citigroup to engage in highly risky credit transactions that exposed Citigroup to massive losses by late 2007. According to the action, the director defendants had failed to take heed of numerous "red flags" (mainly public) that showed worsening conditions in the financial markets, including the subprime and credit markets. Separately, plaintiffs asserted claims for breach of fiduciary duty based upon disclosure violations, and for corporate waste. All claims, except one asserting that the board committed corporate waste by approving a large severance package with former CEO Charles Prince, were dismissed.

Under Delaware law, before a derivative action by shareholders can proceed, shareholders must show either (i) that demand on the board of directors was made and was wrongfully refused; or (ii) that making such a demand would have been futile. Plaintiffs asserted that demand was futile in this case because the directors faced substantial personal liability for Citigroup's financial problems by virtue of their failure to monitor and manage the risks Citigroup faced from problems in the subprime lending market. These types of "oversight" claims, which are generally quite difficult to establish, are known as "Caremark" claims, after the Delaware Chancery Court's decision in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

The argument was soundly rejected. In a strongly worded opinion, Chancellor Chandler found that the "failure to oversee" claims were just another way of saying the directors should be held personally liable "for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company." The Court made it crystal clear that Delaware law does not permit that kind of "judicial second-guessing" of directors' business decisions – even decisions that turn out to have catastrophic results – as long as those decisions were not made in bad faith. "Business decision-makers must operate in the real world," the Court observed, "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."

The Court contrasted its holding to a decision issued by the Court two weeks prior in *American International Group, Inc. Consolidated Derivative Litigation*, C.A. No. 769-VCS, 2009 Del. Ch. LEXIS 15 (Del. Ch. Feb. 10, 2009), in which the Court refused to dismiss claims commenced against the executives of AIG. Chancellor Chandler stated: "[u]nlike the allegations in this case, the defendants in AIG allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct." There are "significant differences," the Court noted, "between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk."

The Court concluded by noting that "[i]t is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by directors and officers of Delaware corporations. The law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law."

The *Citigroup* opinion is an important, welcome, and timely reminder that in these turbulent economic times, the Delaware Chancery Court – one of the nation's premier commercial courts – will continue to apply settled principles of corporate law to shareholder and commercial disputes. There have been, and will continue to be, many attempts by shareholders (and others) in this challenging economic environment to seek to impose liability on directors for engaging in business decisions that, with the benefit of hindsight, turn out to be unprofitable, unwise, or worse. Short of showing that the directors consciously disregarded their obligation to be reasonably informed about the business and its risks, or otherwise allowed pervasive fraudulent and criminal conduct to occur, such claims will be difficult to sustain.

* * * * * * * * * * * * * * *

If you have any questions about this alert, or would like a copy of the *Citigroup* opinion, please call or email Tariq Mundiya (212-728-8565, tmundiya@willkie.com), Mary Eaton (212-728-8626, meaton@willkie.com), or the Willkie Farr attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6009. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

February 25, 2009

Copyright © 2009 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.