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The Need for Increased Possibility of Director Liability: Refusal to Dismiss *In re Wells Fargo & Co. Shareholder Derivative Litigation*, a Step in the Right Direction

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THE NEED FOR INCREASED POSSIBILITY OF DIRECTOR LIABILITY: REFUSAL TO DISMISS *IN RE WELLS FARGO & CO. SHAREHOLDER DERIVATIVE LITIGATION*, A STEP IN THE RIGHT DIRECTION

Abstract: The frequency and magnitude of corporate scandals call into question the effectiveness of the current mechanism to police director misconduct. Presently, directors are rarely held personally liable for failing to fulfill their fiduciary duties. The combination of multiple judicial and statutory protections and the courts' hesitance to impose director liability shields directors and makes it difficult for shareholder plaintiffs to succeed on such claims. In fact, most claims are dismissed before courts have an opportunity to hear the merits of the case. This Note focuses on the oversight liability doctrine and argues that it is applied too narrowly, at least at the motion to dismiss stage, to deter director misconduct and encourage adequate oversight by directors. This Note uses the Wells Fargo corporate scandal and the directors' failure of oversight as a case study. In *In re Wells Fargo & Co. Shareholder Derivative Litigation*, the United States District Court for the Northern District of California denied the director defendants' motion to dismiss, allowing shareholder plaintiffs the opportunity to prove their claims against the directors. This Note argues that this rare decision is a positive step that sends a firm message to directors that they cannot disregard their duties and expect complete protection from liability.

INTRODUCTION

In September of 2016, Wells Fargo, the third largest bank in America, publicly admitted to creating at least 1.5 million fake bank accounts and issuing 565,000 unauthorized consumer credit cards.[1] For these practices, the bank

[1] Consolidated Amended Verified Stockholder Derivative Complaint ¶ 55, at 12, *In re* Wells Fargo & Co. S'holder Derivative Litig., 282 F. Supp. 3d 1074 (N.D. Cal. 2017), 2017 WL 1044785; Matt Egan, *Wells Fargo Victims Get Closer to Payback in $142 Million Settlement*, CNN (July 10, 2017), http://money.cnn.com/2017/07/10/investing/wells-fargo-fake-account-settlement/index.html [https://perma.cc/QJZ4-84DB] [hereinafter Egan, *$142 Million Settlement*]; Lisa Joyce, *Can Wells Fargo's Brand Survive Another Scandal?*, FIN. BRAND (Sept. 12, 2007), https://thefinancialbrand.com/67399/wells-fargo-brand-scandal-crisis [https://perma.cc/SL3V-XF92]; *see* Matt Egan, *5,300 Wells Fargo Employees Fired over 2 Million Phony Accounts*, CNN MONEY (Sept. 9, 2016), http://money.cnn.com/2016/09/08/investing/wells-fargo-created-phony-accounts-bank-fees/index.html [https:// perma.cc/EK65-PX2J] [hereinafter Egan, *2 Million Phony Accounts*] (describing the harm that Wells Fargo caused its customers and reporting that in a statement to the public, Wells Fargo took responsibility for the unwanted and unauthorized products). Wells Fargo is the "third largest bank in the United States by

was fined $185 million.[2] Additionally, in April of 2017, Wells Fargo agreed to settle a national class action suit against them for $142 million to compensate affected customers.[3] Wells Fargo had charged customers about $2.6 million in fines and fees for those unwanted accounts and credit cards.[4] At least between 2011 and 2015, Wells Fargo's demanding corporate culture and sales practices pushed employees to open these fake accounts without customer authorization in order to meet high sales quotas.[5] In fact, there is evidence that these practices reached as far back as 2002, and possibly even earlier.[6] The Wells Fargo Board of Directors ("the Board") received consistent warning signs, or "red

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assets" and the second largest in the world by "market capitalization." Complaint, *In re Wells Fargo & Co. S'holder Derivative Litig.*, *supra*, ¶ 69, at 14.

[2] Bill Chappell, *Wells Fargo Fined $185 Million Over Creation of Fake Accounts for Bonuses*, NPR (Sept. 8, 2016), https://www.npr.org/sections/thetwo-way/2016/09/08/493130449/wells-fargo-to-pay-around-190-million-over-fake-accounts-that-sparked-bonuses [https://perma.cc/B46R-JHV6]. The $185 million fine is made up of three separate fines. *Id.* Wells Fargo will pay $50 million to the City and County of Los Angeles and $35 million to the Office of the Comptroller of the Currency (OCC). *Id.*; *see* Proposed Stipulated Final Judgment ¶ 40, at 11, California v. Wells Fargo & Co., No. BC580778 (Cal. Super. Ct. Sept. 1, 2016) (judgment of $50 million in civil penalties approved). The remaining $100 million will be paid to the Consumer Financial Protection Bureau (CFPB). Wells Fargo Bank, N.A., CFPB No. 2016-CFPB-0015, at 17 (Sept. 8, 2017), https://files.consumerfinance.gov/f/documents/092016_cfpb_WFBconsentorder.pdf [https://perma.cc/Q7NT-J968]; Chappell, *supra*.

[3] Egan, *$142 Million Settlement*, *supra* note 1. The initial settlement was for $110 million; however, the settlement was increased to include customers who were affected by the fake bank accounts as far back as 2002. *Id.* The attorney's fees and other administrative costs will be the first expenses paid from the settlement, followed by "out-of-pocket losses" that customers suffered. *Id.* If what is left after these expenses are paid is less than $25 million, Wells Fargo has agreed to increase the settlement. *Id.* The remaining pool of money will be split between the customers depending on the type of account that was opened under their name, how many accounts were opened under their name, and how much of a financial loss they suffered. *Id.*

[4] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 55, at 12 (explaining that, of the fake accounts and unauthorized credit cards opened, about 115,000 of these accounts collectively produced about $2.6 million in fees).

[5] *See* INDEP. DIRS. OF THE BOARD OF WELLS FARGO & CO., SALES PRACTICE INVESTIGATION REPORT 4 (2017) [hereinafter BOARD INVESTIGATION REPORT], https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf [https://perma.cc/VV2Z-WCTT] (finding that strong culture and improper sales models led to an atmosphere that prompted "low quality sales" and "unethical behavior"); Egan, *$142 Million Settlement*, *supra* note 1 (stating that Wells Fargo admitted to illegal activity between 2011 and 2015); *infra* notes 127–128 and accompanying text.

[6] *See* Matt Egan, *Wells Fargo Scandal: Where Was the Board?*, CNN (Apr. 24, 2017), http://money.cnn.com/2017/04/24/investing/wells-fargo-scandal-board-annual-meeting/index.html [https://perma.cc/454R-2S74] [hereinafter Egan, *Where Was the Board?*] (reporting that the Wells Fargo Board had knowledge of sales violations though audit reports and examinations dating back to 2002, which they ignored); DEMOCRATIC STAFF OF THE COMM. ON FIN. SERVS., U.S. HOUSE OF REPRESENTATIVES, THE CASE FOR HOLDING MEGABANKS ACCOUNTABLE: AN EXAMINATION OF WELLS FARGO'S EGREGIOUS CONSUMER ABUSES 6 n.7, (2017), https://financialservices.house.gov/uploadedfiles/09.29.17_staff_report_final.pdf [https://perma.cc/BD47-QZTK] (stating that it is estimated that Wells Fargo and its subsidiaries have paid more than eleven billion dollars in fines for various kinds of violations since 2000).

flags," of such practices as early as 2005, but failed to act, allowing the fraud to escalate.[7]

On February 24, 2017, Wells Fargo shareholders filed a shareholder derivative law suit, naming the bank itself, executive officers, and directors as defendants.[8] The complaint alleged that defendants encouraged illegal practices by enforcing a competitive sales strategy and that defendants either were aware of or "consciously disregarded" the creation of unauthorized bank accounts by employees.[9] Plaintiffs alleged that directors failed to act in the bank's best interest and are therefore liable for violations of multiple provisions of the Securities Exchange Act of 1934, violations of state law, and breach of their fiduciary duties.[10]

Wells Fargo is one of a series of corporate scandals, in which directors and officers failed to adequately address widespread illegalities within the cor-

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[7] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 21, at 7 (alleging that directors "turned a blind eye" to red flags regarding illegal activity as early as 2007); Egan, *Where Was the Board?*, *supra* note 6 ("Wells Fargo's board of directors received 'regular' reports since 2005 warning that most of the bank's internal ethics hotline complaints and firings were linked to sales violations."); *infra* notes 146–161 and accompanying text.

[8] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶¶ 66–91, at 14–17 (naming all of the defendants who are subject to litigation). This Note focuses solely on the director defendants, who include: John G. Stumpf, John D. Baker II, Elaine L. Chao, John S. Chen, Lloyd H. Dean, Elizabeth A. Duke, Susan E. Engel, Enrique Hernandez, Donald M. James, Cynthia H. Milligan, Enrique Peña, James H. Quigley, Judith M. Runstad, Steven W. Sanger, Susan G. Swenson, and Suzanne M. Vautrinot. *Id.* ¶¶ 76–91, at 15–17. Timothy J. Sloan is listed as an officer defendant. *Id.* at 15. Shareholder derivative actions are suits brought by shareholders against directors or officers of a corporation alleging that they have caused harm to the company. WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 375 (5th ed. 2016). These actions allow shareholders to remedy harm or loss to the company on behalf of the corporation, specifically in situations where the company itself cannot or will not bring the lawsuit. WENJING CHEN, A COMPARATIVE STUDY OF FUNDING SHAREHOLDER LITIGATION 17 (2017). An example of this situation is when the company is controlled by the directors and officers who are causing the harm to the company. *Id.*

[9] Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 1, at 4; *see infra* notes 122–123 and accompanying text.

[10] Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 56, at 12. The Securities Exchange Act of 1934 governs the buying and selling of securities. *See* John E. Tracy & Alfred Brunson MacChesney, *Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1025 (1934) (explaining that the Securities Exchange Act of 1934 regulates stock exchanges). Additionally, the Act created the Securities and Exchange Commission (SEC) and gave it broad authority to regulate and oversee the securities industry. *The Law That Governs the Securities Industry*, SEC, https://www.sec.gov/answers/about-law sshtml.html [https://perma.cc/ES8N-QZE2]. Plaintiffs in the Wells Fargo suit asserted eleven causes of action: "(1) breach of fiduciary duty; (2) unjust enrichment; (3) breach of fiduciary duty for insider selling and misappropriation of information; (4) violation of § 14(a) of the Securities Exchange Act and SEC Rule 14a-9; (5) violations of § 10(b) of the Securities Exchange Act and SEC Rule 10b-5; (6) violation of § 20A of the Securities Exchange Act; (7) violations of § 29(b) of the Securities exchange act; (8) violation of § 25402 of the California Corporations Code; (9) violation of § 25403 of the California Corporations Code; (10) corporate waste; and (11) contribution and indemnification." *In re Wells Fargo & Co.*, 282 F. Supp. 3d at 1088 (summarizing the eleven causes of action that plaintiffs brought against defendants).

poration and failed to perform their required duties.[11] Conscious disregard of their duties by directors and officers affects not only the company itself, but also its consumers and potentially the larger economy.[12] The magnitude and reoccurrence of these types of scandals brings into question the effectiveness of judicial approaches to corporate governance, suggesting that there is no good mechanism to effectively police director misconduct.[13]

[11] *See infra* notes 162–176 and accompanying text. Two examples, among many, of other corporate scandals are those surrounding Enron and Equifax. *See* Sean Farrell, *The World's Biggest Accounting Scandals*, THE GUARDIAN (July 21, 2015), https://www.theguardian.com/business/2015/jul/21/the-worlds-biggest-accounting-scandals-toshiba-enron-olympus [https://perma.cc/W4WC-X4QD] (stating that the scandal at Enron was one of the largest accounting scandals); Hamza Shaban, *Equifax CEO Richard Smith Steps Down Amid Hacking Scandal*, WASH. POST (Sept. 26, 2017), https://www.washingtonpost.com/news/the-switch/wp/2017/09/26/equifax-ceo-retires-following-massive-data-breach [https://perma.cc/J4PX-BNCE] (describing the Equifax scandal). Enron was a company that traded energy. *See* MARK JICKLING, CONG. RESEARCH SERV., RS21135, THE ENRON COLLAPSE: AN OVERVIEW OF FINANCIAL ISSUES 2 (2003) https://www.everycrsreport.com/files/20040812_RS21135_d3ccc53ec06a45476370a0cd5255b99c69afea08.pdf [https://perma.cc/BU3J-ELRZ] (describing Enron's energy-trading business). The company made a series of bad investments that affected the financial condition of the company but hid the losses by falsifying its accounts instead of disclosing the situation to investors. *Id.* The losses were kept secret for about eighteen months, and when disclosed, the company quickly collapsed. *Id.* Similarly, Equifax is a "consumer credit reporting agency" that holds important consumer personal and financial information. *How Does Credit Reporting Work?*, EQUIFAX, https://help.equifax.com/s/article/How-does-credit-reporting-work [https://perma.cc/Q3G9-WSWU]; *Consumer Reporting Agency*, INVESTORWORDS, http://www.investorwords.com/1063/consumer_reporting_agency.html [https://perma.cc/Q47N-8R3F]. On September 7, 2017, Equifax announced that its database had been breached by hackers between May and July of 2017. *See* Elizabeth Weise, *A Timeline of Events Surrounding the Equifax Data Breach*, USA TODAY (Sept. 26, 2017), https://www.usatoday.com/story/tech/2017/09/26/timeline-events-surrounding-equifax-data-breach/703691001/ [https://perma.cc/F2P9-REF4] (describing the timeline of events of the Equifax scandal). This breach resulted in the hackers gaining access to confidential information belonging to 44% of the people of United States. *Id.* There is evidence that Equifax's CEO, Richard Smith, knew about the breach for weeks before informing the board of directors. Liz Moyer, *Equifax's Then-CEO Waited Three Weeks to Inform Board of Massive Data Breach, Testimony Says*, CNBC (Oct. 2, 2017), https://www.cnbc.com/2017/10/02/equifaxs-then-ceo-waited-three-weeks-to-inform-board-of-massive-data-breach-testimony-says.html [https://perma.cc/W43S-FFME].

[12] *See infra* notes 190–199 and accompanying text. Wells Fargo caused its customers significant financial losses. *See* Complaint ¶ 6, at 3, *California v. Wells Fargo & Co.*, No. BC580778 (Cal. Super. Ct. May 4, 2015) (alleging that Wells Fargo has: "(a) withdrawn money from customers' authorized accounts to pay for the fees assess by Wells Fargo on unauthorized accounts opened in customers' names; (b) placed customers into collections when the unauthorized withdrawals from customer accounts went unpaid; (c) placed derogatory information in credit reports when unauthorized fees went unpaid; (d) denied customers access to their funds while Wells Fargo stockpiled account applications; and (e) caused customers to purchase identity theft protection"). Financial losses to one company caused by these corporate scandals increase systemic risk—the threat of financial distress at one financial institution may lead to distress at other financial institutions. *See infra* notes 194–197 and accompanying text.

[13] *See infra* notes 17–19, 181–184 and accompanying text. Statutory approaches have perhaps been equally ineffective at policing director misconduct. *See* CHEN, *supra* note 8, at 30 (acknowledging that statutory rules on shareholder litigation are not necessarily effective); JICKLING, *supra* note 11 (stating that the collapse of large corporations such as Enron after corporate scandals suggests that there are weaknesses in the United States' current system of securities regulation).

Directors are bound by the oversight liability doctrine to, in good faith, attempt to implement and maintain an appropriate reporting or monitoring system.[14] Under this doctrine, directors are liable to their company when they fail to perform these duties up to a certain standard.[15] This Note argues that the judicial application of this doctrine is too narrow, at least at the motion to dismiss stage, and does not increase the risk of director liability adequately to deter bad behavior.[16] The reality is that directors are rarely held personally liable for their actions (or inactions).[17] Liability is usually only triggered in extreme circumstances.[18] In addition, directors almost never pay out of pocket for any type of litigation or settlement.[19] Reform of state corporate law and judicial

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[14] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996); *see infra* notes 46–61 and accompanying text.

[15] *In re Caremark*, 698 A.2d at 970 (requiring directors to have and adequately oversee a monitoring system for detecting misconduct); s*ee infra* notes 46–61 (discussing the *Caremark* ruling and standard).

[16] *See infra* notes 17–20, 76–120, 181–184, and accompanying text. Because Wells Fargo is incorporated in Delaware, as are many large corporations, this Note will only focus on Delaware corporate law and case law. Leslie Wayne, *How Delaware Thrives as a Corporate Tax Haven*, N.Y. TIMES (June 30, 2012), https://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html [https://perma.cc/9538-M25J]; *see* Wells Fargo & Co., Annual Report (Form 10-K) (Feb. 28, 2012), https://www.sec.gov/Archives/edgar/data/72971/000119312512084528/d280360d10k.htm [https://perma.cc/MS47-Z4L8]. Additionally, the majority of the cases regarding oversight liability claims are not decided on the merits because they are dismissed for failure to meet the demand requirements. Martin Petrin, *Assessing Delaware's Oversight Jurisprudence: A Policy and Theory Perspective*, 5 VA. L. & BUS. REV. 433, 452 n.93 (2011); *see infra* notes 99–100 (explaining the pre-litigation demand requirement that plaintiffs must meet before they can continue with their shareholder derivative action). This fact, however, does not impair the court's ability to set the standard and requirements for oversight liability, because a successful oversight liability claim would satisfy the demand requirement. Petrin, *supra*, at 452 n.93; *see infra* notes 99–100.

[17] *See* Gretchen Morgenson, *Sending Wells Fargo a Word of Warning*, N.Y. TIMES, Nov. 3, 2017, at BU1 (explaining that directors have protections against most legal liability).

[18] Brad S. Karp, *Analysis of Wells Fargo Shareholder Litigation*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Dec. 15, 2017), https://corpgov.law.harvard.edu/2017/12/15/analysis-of-wells-fargo-shareholder-litigation [https://perma.cc/6WWW-S9M9]; *see* Julian Velasco, *Fiduciary Duties and Fiduciary Outs*, 21 GEO. MASON L. REV. 157, 166–67 (2013) (acknowledging that director liability will be found only for "egregious breaches" of any fiduciary duty).

[19] *See* ALLEN & KRAAKMAN, *supra* note 8, at 422 (discussing the findings of a study on hundreds of shareholder suits, specifically that: in most of the cases settled, director and officer (D&O) insurance covered the majority of the settlement amount, and directors and officers never paid costs or expenses themselves). Both parties in shareholder suits have incentives to settle. *Id.* at 421. Pursuing a lawsuit is very expensive for plaintiffs, especially through discovery, and they risk losing all of the suit costs. *Id*. Regarding defendant directors, corporate statutes allow for indemnification, which authorizes the corporation to reimburse the director (or agent, employee, or officer) for reasonable expenses arising from a judicial proceeding including settlement payments (subject to certain limitations). DEL. CODE ANN. tit. 8, § 145(a) (2018); ALLEN & KRAAKMAN, *supra* note 8, at 421. Directors are incentivized to settle because if the case is fully litigated, they can only be indemnified by court authorization. ALLEN & KRAAKMAN, *supra* note 8, at 421. Additionally, directors have the protection of D&O insurance, which will cover the expenses and penalties from such litigation or settlement, so paying a settlement does not cost them money. *Id.* Losses that arise from fraud or self-dealing are typically excluded from D&O insurance if the case is litigated, while settlement allows this insurance

standards, specifically broadening the application of the oversight liability doctrine would send a stronger message to directors regarding the consequences of their decisions and hopefully prevent future scandals.[20]

This Note illustrates the tremendous obstacles that shareholder plaintiffs must overcome to be successful in lawsuits against directors or officers of a corporation under the current application of the oversight liability doctrine by the courts.[21] This Note examines *In re Wells Fargo & Co. Shareholder Derivative Litigation* and the Wells Fargo scandal as a whole to demonstrate how the current corporate governance system is lacking and show the importance of judicial reformation of the oversight liability doctrine.[22] Part I describes the evolution and current standard of the doctrine through case law and explains two important director protections from liability.[23] Part II discusses why it is so difficult to hold directors liable for breach of their fiduciary duties and considers the narrow interpretation of the oversight liability doctrine.[24] Part III focuses solely on Wells Fargo, the series of events that led to the creation of fake bank accounts, the red flags that repeatedly gave the directors warning of the fraudulent activity, and the directors' conscious disregard for their duty of oversight.[25] Finally, Part IV analyzes why it is important to the larger economy to broaden the application of director liability and provides judicial reforms that could move the courts in the right direction.[26]

I. OVERSIGHT LIABILITY DOCTRINE AND DIRECTOR PROTECTIONS

Corporations are required to be managed by a board of directors.[27] The relationship between a board of directors, the corporation, and its shareholders

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to cover the losses. *Id.* All corporations have D&O insurance policies, which are usually divided into two parts: (1) coverage to the corporation for the defense and indemnification of its officers and directors; and (2) coverage to directors and officers for situations where the indemnification is inapplicable. *Id.* at 422.

[20] *See* Morgenson, *supra* note 17 (explaining that the U.S. District Court in San Francisco's denial of the director defendants' motion to dismiss in *In re Wells Fargo & Co. S'holder Derivative Litig.* sent a strong message to directors of "be vigilant for bad behavior in your operations, or else"); *infra* notes 180, 200–216, and accompanying text.

[21] *See infra* notes 40–120 and accompanying text.

[22] *See infra* notes 121–199 and accompanying text.

[23] *See infra* notes 27–75 and accompanying text.

[24] *See infra* notes 76–120 and accompanying text.

[25] *See infra* notes 121–176 and accompanying text.

[26] *See infra* notes 177–217 and accompanying text.

[27] Lisa M. Fairfax, *Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692, 1692–93 (2011); *see, e.g.*, DEL. CODE ANN. tit. 8, § 141(a). Board members, also called directors, are appointed or elected by the corporation's shareholders. ALLEN & KRAAKMAN, *supra* note 8, at 163. Shareholders of a corporation have an ownership interest in the company, received in exchange for providing the company with capital. *Roles of Shareholders and Directors*, VENTURE CHOICE, http://www.venturechoice.com/articles/roles_of_share holders_and_directors.htm [https://perma.cc/Q9KG-QH67]. This ownership share gives shareholders

is a fiduciary one, which imposes certain duties upon directors.[28] Suing for breach of these duties is the shareholders' primary tool to supervise and control directors and officers of a corporation, because such breach can lead to the imposition of personal liability on the directors.[29] The Delaware courts have defined three core fiduciary duties: the duty of care, the duty of loyalty, and the duty of good faith.[30]

The duty of care requires that directors make fully informed decisions with the level of care that an "ordinarily careful and prudent" person would use in a similar situation and under similar circumstances.[31] The standard of review for breach of the duty of care is a finding of gross negligence.[32] Regard-

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the right to vote, the right to sue, and the right to sell their shares. ALLEN & KRAAKMAN, *supra* note 8, at 163. Although shareholders have these rights, they generally have no involvement in the management of the company. *Roles of Shareholders and Directors*, *supra*. Directors appoint officers to manage the business of the company and its "day-to-day operations," but monitor and supervise the officers' actions, as well as participate in the major decisions of the corporation. LATHAM & WATKINS LLP, AN OVERVIEW OF FIDUCIARY DUTIES 3 (2016), https://www.lw.com/admin/Upload/Documents/OilAndGasMandA/Governance/An_Overview_of_Fiduciary_Duties.pdf [https://perma.cc/9BGE-ZQC2]; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, Westlaw Practical Law Practice Note 6-382-1267 (2015). Within a corporation, the board of directors is said to have an "advisory or supervisory role." FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra*.

[28] Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239, 244, 258 (2009). A fiduciary is a person who has the responsibility to act for the benefit of another. *Fiduciary*, BLACK'S LAW DICTIONARY (10th ed. 2014).

[29] Alces, *supra* note 28, at 243. The threat of litigation can deter bad behavior. *Id.*

[30] Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); *see In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 745 (Del. Ch. 2005) (creating and announcing a duty of good faith for directors).

[31] Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 406 (2007); *see* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) (stating that the duty of care requires directors to act "in an informed and deliberate manner respecting the corporate merits of an issue before the board"); Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (explaining that directors have a duty to make "informed business judgment[s]" under the duty of care); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. Ch. 1963) (explaining that when managing affairs of the corporation, directors must act with care in the way that an "ordinarily careful and prudent" person would in a similar situation). The duty of care is centered around the process by which directors make decisions for the company, not the substance of the final decision itself. Alces, *supra* note 28, at 251; *see* Anne Tucker Nees, *Who's the Boss—Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 208–09 (2010) (stating that whether a director acted in compliance with the duty of care is a procedural question which looks at the information that the directors considered when making a decision and whether they considered alternatives and consequences of the decision).

[32] *See* Velasco, *supra* note 18, at 167 (explaining that although the standard of conduct for directors is a negligence standard, the courts will only find liability for breach of duty of care if there is proof of gross negligence). Standards of conduct are the rules that actors must follow when operating in a specific environment. *Id.* at 166. Standards of review are the criteria that judges apply when ruling on a particular issue. *Id.* A person negligently breaches a duty when (1) they behave differently than a reasonable person would in similar circumstances and (2) the breach causes harm. *Negligence*, BLACK'S LAW DICTIONARY (10th ed. 2014). Gross negligence is an extreme degree of negligence that is characterized by reckless disregard of one's duty to act like a reasonable prudent person. *Gross Negligence*, BLACK'S LAW DICTIONARY (10th ed. 2014).

ing the duties of loyalty and good faith, the latter is a subset of the former.[33] Under the duty of loyalty, directors must always, in good faith, act with and for the best interest of the company rather than for their own self-interest.[34] Good faith prohibits directors from acting in bad faith, which is acting with the intent to harm or to knowingly disregard their duties to the corporation.[35] Therefore, the standard of review for breach of the duty of loyalty requires knowingly acting against the best interest of the corporation.[36]

Claims brought for oversight failure can be brought under breach of the duty of care or the duty of loyalty, however the imposition of liability is limited by the business judgment rule and Delaware General Corporation Law (DGCL) section 102(b)(7).[37] Section A explains the oversight liability doctrine, its creation, and the evolution of the standard for finding liability.[38] Section B defines the business judgment rule and DGCL section 102(b)(7).[39]

A. Origins of Oversight Liability and Standards for Finding Director Liability

The oversight liability doctrine evolved through case law, being first directly addressed in 1963.[40] In *Graham v. Allis-Chalmers Manufacturing Co.*, employees of the electrical equipment manufacturer Allis-Chalmers violated

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[33] *See* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) (establishing that the duty of good faith is a condition or a requirement of the duty of loyalty). Courts previously viewed the duty of good faith as its own fiduciary duty, but have recently consolidated it with the duty of loyalty. *See* Petrin, *supra* note 16, at 446 (describing how the *Stone* court ended the "triad" of fiduciary duties).

[34] *See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (stating that directors are prohibited from using their power within the company to make decisions that further their own personal interests). Directors have a positive duty to protect corporate interests and a negative duty to not harm the company. *Id.* This demands that a director have "unselfish loyalty" to their corporation. *Id.*

[35] Nees, *supra* note 31, at 209.

[36] *See Stone*, 911 A.2d at 370 (establishing that "[w]here 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").

[37] *See* Nees, *supra* note 31, at 215–16 (arguing that, although claims for oversight liability can be brought as breaches of the duty of care, loyalty, or good faith, obstacles such as exculpatory provisions, the business judgment rule, and the merger of the duty of good faith into the duty of loyalty have restricted the imposition of liability and it is actually a "toothless tiger" for directors); *infra* notes 62–75, 86–102 and accompanying text; *see, e.g.*, *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d at 960 (bringing an oversight claim based on an alleged breach of the duty of care); Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 526, at 112 (alleging that directors breached their duties of loyalty and good faith).

[38] *See infra* notes 40–61 and accompanying text.

[39] *See infra* notes 62–75 and accompanying text.

[40] *See* Petrin, *supra* note 16, at 439 (stating that the court had not addressed the issue of whether maintaining a proper reporting system is part of the fiduciary duties that directors owe the corporation and its shareholders until *Graham*); *infra* notes 41–61 and accompanying text. *See generally Graham*, 188 A.2d at 130 (addressing plaintiffs' allegation that liability should be imposed on directors who caused loss to the corporation by their failure to manage the affairs of the corporation).

anti-trust laws, causing significant losses to the company.[41] Plaintiffs alleged that the directors of the corporation should have implemented a monitoring system, which would have alerted them to the misconduct by their employees.[42] Consequently, the Delaware Supreme Court addressed the issue of whether directors are required to implement adequate reporting systems or internal controls to prevent illegal activity without any prior cause for suspicion.[43] In declining to impose liability, the court held that directors are only required to implement such a monitoring system when something occurs to indicate illegal activity, but that prior to such an event, directors cannot be held liable for failing to have such a system.[44] This was the birth of the "red flag" doctrine, the "red flag" referring to a warning sign of illegalities, which triggers director liability.[45]

In re Caremark International Inc. Derivative Litigation expanded the concept of oversight liability and established the standard for finding such liability.[46] Caremark International was a health care provider whose employees violated the Anti-Referral Payments Law, resulting in both civil and criminal penalties for the corporation.[47] Plaintiffs brought an oversight claim, arguing that directors breached their duty of care and attention by allowing the viola-

[41] *Graham*, 188 A.2d at 127. The employees illegally fixed prices and falsified bids to private electric utility and governmental agencies. *Id*. at 128. There are three main federal anti-trust laws still in effect today: the Sherman Act, the Federal Trade Commission Act, and the Clayton Act. *The Anti-Trust Laws*, FED. TRADE COMM'N, https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/antitrust-laws [https://perma.cc/3RLC-AJ5X]. In general, these laws prohibit unlawful or unfair business practices, giving deference to the court in deciding which acts are specifically illegal. *Id.*

[42] *Graham*, 188 A.2d at 130. Plaintiffs initially alleged that directors had knowledge of the federal violations or that they should have known of such violations, based on knowledge of certain facts that would have put them on notice. *Id.* at 127. The court determined that there was no evidence that directors had knowledge of the illegal activity or had reason to be suspicious of such violations, leaving the plaintiffs with the latter argument. *Id.* at 129–30.

[43] *See id.* at 130 (addressing the plaintiffs' argument that the directors should have implemented a monitoring system to bring violations to their attention).

[44] *See id*. at 130–31 (stating that directors can rely on their managers', officers', and employees' honesty and that no duty to further investigate arises until the directors are given a reason to no longer rely on that honesty). The court considered the size of the company, noting that the directors could not possibly know all the employees on a personal level. *Id*. at 130.

[45] *See Graham*, 188 A.2d at 130 (establishing that an event that gives notice to directors of misconduct by employees followed by director inaction could lead to the imposition of liability); Petrin, *supra* note 16, at 439–40 (explaining how *Graham* established the "red flag" doctrine). The court held that the whether liability will be imposed on a director for losses due to failure to perform a duty will be determined by the circumstances. *Graham*, 188 A.2d at 130. For example, directors will be held liable if they recklessly confide in an employee who is clearly untrustworthy, refuse to perform their duties, or ignore obvious warning signs ("red flags") of misconduct. *Id*.

[46] *In re Caremark*, 698 A.2d at 971; *see infra* notes 47–51 and accompanying text.

[47] *See In re Caremark*, 698 A.2d at 960–62 (explaining that the employees allegedly violated a law that bars health care providers from paying "to induce the referral of Medicare or Medicaid patients," leading to significant negative consequences to the company).

tions to occur and continue, which led to significant losses for the company.[48] Although the court dismissed the derivative case brought against the directors, the court established that directors must, in good faith, attempt to implement an adequate reporting system or internal controls even in the absence of red flags, and failure to do so may lead to liability.[49] The standard for finding liability for this breach of a good faith duty to implement adequate reporting systems is only met by a "sustained or systematic failure of oversight" by the board.[50] "Utter failure" to establish such systems is necessary to show lack of good faith and impose liability, according to the court.[51]

In *Stone v. Ritter*, the Delaware Supreme Court further clarified the standard of the duty of oversight, combining the standards in *Graham* and *Caremark*.[52] In *Stone*, AmSouth employees violated federal anti-money laundering regulations, causing the corporation financial loss.[53] In bringing a derivative lawsuit against directors, plaintiff shareholders alleged a "classic *Caremark* claim"—that the board failed to, in good faith, implement an adequate moni-

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[48] *Id.* at 967. The violations caused the company a loss of about $250 million. *Id.* at 960.

[49] *Id.* at 970–71. The court rejected *Graham* and held that directors do not satisfy their obligation to be reasonably informed without ensuring that there is a system in place to inform them. *Id.* at 970. Nevertheless, the court conceded that directors' duty of good faith to be reasonably informed does not require them to collect comprehensive information on every aspect of the corporation. *Id.* at 971. Moreover, the court distinguished between two ways to claim breach of the duty of oversight. *Id.* at 967. The first way is to claim that losses occurred due to a negligent board decision. *Id.* The second arises from an "unconsidered failure of the board to act" in situations where the corporation would not have suffered the harm that it did if the board had acted. *Id.* When plaintiffs allege the latter, it is known as a *Caremark* claim and is subject to the standard laid out by the *Caremark* court for oversight liability. *See, e.g.*, *Stone*, 911 A.2d at 364 (stating that plaintiffs alleged a *Caremark* claim).

[50] *In re Caremark*, 698 A.2d at 971. Caremark International's incentive system encouraged kickback payments; however, even though the directors were benefiting, the court still ruled in their favor. Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481, 494 (2006).

[51] *In re Caremark*, 698 A.2d at 971. The court acknowledged that this is an extremely difficult standard of liability to meet; however, a more demanding liability standard might be beneficial to shareholders. *Id*. A less demanding standard may limit the pool of qualified applicants for board positions because of fear of liability. *Id.* Additionally, Delaware courts have acknowledged that holding directors liable would "cripple their ability to earn returns for investors by taking business risks." *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 109, 126 (Del. Ch. 2009). *Caremark* established three requirements that are necessary to show that directors breached their duty of care when they failed to control and monitor their employees: plaintiffs must (1) show that directors had knowledge of the misconduct or should have known that misconduct was occurring; (2) show failure by the directors to make a good faith attempt to prevent future misconduct or fix the current situation; and (3) show that the failure by the directors resulted in loss to the company. 698 A.2d at 971.

[52] *See Stone*, 911 A.2d at 370 (incorporating both *Graham*'s red flag doctrine and the duty to implement a system of reporting or monitoring from *Caremark*); *see also In re Caremark*, 698 A.2d at 970–71 (setting the standard for finding liability under the oversight doctrine).

[53] *Stone*, 911 A.2d at 365. AmSouth is incorporated in Delaware and had a bank as a subsidiary. *Id.* The employees violated the anti-money-laundering laws by failing to file Suspicious Activity Reports, which are required by law. *Id.* Such violations resulted in fines and penalties of about $50 million. *Id.*

toring system that would have alerted them of such violations.[54] The court, however, reaffirmed the Chancery Court's decision to dismiss the case because of evidence that the directors had exercised oversight by having reasonable reporting systems in place and taking steps to ensure compliance with the law.[55]

The Delaware Supreme Court clarified the two situations in which directors can be held liable under *Caremark* claims: (1) where directors completely fail to implement a monitoring system; or (2) where directors, with such a system in place, "consciously fail[] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[56] Both of these standards require directors to have knowledge of their own failure to fulfill their duties, which is a breach of the duty of good faith.[57] The *Stone* court took it one step further and established that a failure to act in good faith is a violation of directors' duty of loyalty.[58]

Together, these cases established the standard that the courts rely on in determining board member liability for breach of their oversight duty.[59] In summary, under the oversight liability doctrine, directors can be held liable for breach of this duty when they: (1) knowingly fail to put a monitoring system into place to monitor and oversee behavior of employees, (2) knowingly fail to oversee the operation of such a program or to take steps to ensure it continues to be effective, or (3) knowingly fail to investigate after they were put on no-

[54] *Id.* at 364, 370. The plaintiffs did not allege that the directors had knowledge of or should have had knowledge of the violations. *Id.* at. 364.

[55] *See id.* at 372–73 (relying on a report that showed that directors established a reporting system, approved additional policies and procedures, and oversaw periodic monitoring of employees to ensure that employees were acting in compliance with the laws). The court noted that the plaintiffs failed to recognize that a good faith attempt by directors to fulfill their oversight responsibilities may not always prevent employees from engaging in activities that are illegal or that cause the corporation financial loss. *Id.* at 373.

[56] *Id.* at 370. The court clarified that when there are no red flags, the only way that the duty of good faith can be breached is by failing to make sure that there is an adequate information system in place. *See id.* at 373 (quoting *In re Caremark*, 698 A.2d at 967–68, 971).

[57] *See id.* at 370 (establishing that "when 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").

[58] *Id.* The court established that breach of the duty of good faith alone cannot result in liability. *Id.* Only breaches of the duties of care and loyalty can result in director liability. *Id.* The duty of loyalty encompasses the duty of good faith. *Id.*

[59] *See id.* (clarifying the standard for finding oversight liability by combining *Graham*'s "red flag" doctrine and *Caremark*'s standard of the good faith requirement); *In re Caremark*, 698 A.2d at 971 (setting the standard for oversight liability); *Graham*, 188 A.2d at 130 (establishing the "red flag" doctrine"); *see, e.g.*, Desimone v. Barrows, 924 A.2d 908, 939–40 (Del. 2007) (relying on the *Caremark* and *Stone* standard to determine whether the court should impose oversight liability on defendant directors); *In re Citigroup*, 964 A.2d at 123–24 (analyzing the plaintiffs' *Caremark* claim).

tice by red flags, either actual or constructive.[60] All of these avenues for liability require a conscious disregard of their duties.[61]

B. Director Protections: The Business Judgment Rule and DGCL Section 102(b)(7)

Both the business judgment rule and DGCL section 102(b)(7) provide limitations on board member liability for breach of their fiduciary duties.[62] The business judgment rule is a judicially created protection which balances directors' fiduciary duties with their right to make decisions for their company.[63] Under this rule, when a decision by directors is questioned, the reviewing court will presume that the directors "acted on an informed basis, in good faith and in honest belief that the action was in the best interest of the company," unless shown otherwise.[64] The presumption allows directors and managers to appropriately engage in risky transactions without exposure to liability if those transactions or activities fail.[65] Because this rule revolves around the decision-making

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[60] Jeremy S. Piccini, *Director Liability, the Duty of Oversight, and the Need to Investigate*, 2011 BUS. L. TODAY 1, 2. At a minimum, in addition to implementing a monitoring system, directors must act in good faith to address violations of the law when they have direct knowledge of illegalities or knowledge of red flags. *Id.* Examples of red flags that put the directors on notice are: whistleblower complaints, letters or public notices, public suspicion, consumer complaints, related civil litigation claims, and other issues discovered by internal controls. *Id.* Whistleblowers are employees of a company who go above their superiors in order to address and bring out an issue or problem. *Whistleblower*, BLACK'S LAW DICTIONARY (10th ed. 2014).

[61] *Stone*, 911 A.2d at 370.

[62] *See infra* notes 63–75 and accompanying text.

[63] James L. Griffith, *Director Oversight Liability: Twenty-First Century Standards and Legislative Controls on Liability*, 20 DEL. J. CORP. L. 653, 658–59 (1995); *see* Aronson v. Lewis, 437 A.2d 805, 812 (Del. 1984) (stating the current interpretation of the business judgment rule); Zapata Corp. v. Maldonado, 430 A.2d 779,782 (Del. 1981) (acknowledging that the business judgment rule protects the decisions that directors make on behalf of the corporation and their managerial powers under DGCL section 141(a)). DEL. CODE ANN. tit. 8, § 141(a). Although the business judgment rule is a common-law rule, many state legislatures have codified the principles underlying this presumption. *See* Linsday C. Llewellyn, *Breaking Down the Business Judgment Rule*, 14 COM. & BUS. LITIG. 1, 2 (2013) (providing CAL. CORP. CODE § 309(a) as an example of a state statute that codifies the underlying principles of the business judgment rule).

[64] *Aronson*, 437 A.2d at 812. The business judgment rule only applies to directors who are disinterested, as opposed to interested. *Id.* An interested director is one who appears to be on both sides of a transaction, is involved in self-dealing, or gains personal benefit from the transaction at the expense of the corporation. *Id.*

[65] *In re Citigroup*, 964 A.2d at 125. Courts have recognized that they are not in the best position to "second-guess" decisions made by directors. Griffith, *supra* note 63, at 655; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 27. The business judgment rule discourages courts from hindsight evaluation of director decisions and from second-guessing the quality of those decisions. *In re Citigroup*, 964 A.2d at 126. This avoidance of second-guessing decisions is a fundamental, well-established principle of Delaware fiduciary law. *Id.*

process, it is mostly connected to the duty of care and the concept of gross negligence.[66]

The plaintiff shareholders have the burden of overcoming and rebutting the business judgment presumption.[67] To overcome this presumption, plaintiffs must show: (1) a conflict of interest (sometimes termed an "interested director"); (2) a failure to act in good faith; (3) a failure to exercise due care by not becoming fully informed when making decisions; (4) the absence of a rational business purpose for a decision or the abuse of discretion; or (5) the lack of a business decision (in other words, inaction because of inattention).[68]

Another widespread tool that directors use to escape liability is DGCL section 102(b)(7) (or its equivalent statute in other states), which authorizes an exculpatory provision in a corporation's certificate of incorporation.[69] Section 102(b)(7) allows corporations to write into their charter a provision that eliminates monetary director liability for violations of the duty of care, subject to certain limitations.[70] Directors cannot be exculpated for breaches of the duty of

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[66] *In re Citigroup*, 964 A.2d at 124 (explaining that the courts developed the duty of care and the business judgment rule, which focus on the process of the decision rather than its substance and merits); *Van Gorkom*, 488 A.2d at 872–73 (clarifying that the duty to "exercise an informed business judgment" falls under the duty of care); *Aronson*, 437 A.2d at 812 (establishing that the business judgment rule is based on the concept of gross negligence). If directors acted with the requisite care, the business judgment rule will apply and protect them. *See In re Citigroup*, 964 A.2d at 122 (explaining that the business judgment presumption protects directors who were well-informed and not grossly negligent in making the decision).

[67] *Aronson*, 437 A.2d at 812; *see* Griffith, *supra* note 63, at 660 (stating that the courts cannot impose liability unless the business judgment presumption has been rebutted and overcome by the plaintiff); *see, e.g.*, Gantler v. Stephens, 965 A.2d 695, 707 (Del. 2009) (concluding that plaintiffs provided sufficient facts to rebut and overcome the business judgment presumption where directors rejected a merger opportunity that was of benefit to the company).

[68] Griffith, *supra* note 63, at 660; *see* Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) (establishing that, in order to overcome the business judgment presumption, plaintiffs must prove that directors breached one of their required duties: the duty of care, the duty of loyalty, or the duty of good faith); *see also In re Citigroup*, 964 A.2d at 124 (stating that "absent an allegation of interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information"). The business judgment presumption can also be rebutted by proving that the directors' actions were fraudulent, illegal, or wasteful. Nees, *supra* note 31, at 226.

[69] DEL. CODE ANN. tit. 8, § 102(b)(7). In order to form a corporation, a company must file a certificate of incorporation, or "charter." ALLEN & KRAAKMAN, *supra* note 8, at 82–83. This document states the purpose of the corporation, its powers, and spells out all the special features the corporation has. *Id.* at 83. DEL. CODE ANN. tit. 8, § 102 states the information that must be included in the certificate of incorporation and information that may be included. DEL. CODE ANN. tit. 8, § 102(a)–(b). Every state has a law analogous to DGCL section 102(b)(7). Nees, *supra* note 31, at 218; *see, e.g.*, NEV. REV. STAT. § 78.037(2) (2015) (allowing corporations to limit the duties of directors by including an exculpatory provision to limit liability).

[70] DEL. CODE ANN. tit. 8, § 102(b)(7). This elimination does not apply to violations of the duty of loyalty and the duty of good faith, among other limitations. *Id.* Delaware law only extends this protection to directors; however, other states also extend the exculpatory protection to officers. Richard B.

loyalty, breaches of the duty of good faith, action or inaction involving intentional misconduct or knowing violation of the law, or transactions that improperly benefit the directors.[71]

In 1986, the Delaware legislature enacted DGCL section 102(b)(7) in response to the unusual holding from the Delaware Supreme Court in *Smith v. Van Gorkom*.[72] *Smith* was the first Delaware case to hold directors liable for breach of the duty of care as the result of a business decision.[73] State legislatures did not want this threat of liability to disincentivize capable and qualified directors from serving on boards, so Delaware and other states quickly created this statutory authority for exculpatory provisions.[74] Together, the business judgment rule and DGCL section 102(b)(7) (or its equivalent) protect directors from legal liability.[75]

II. THE NARROWING OF OVERSIGHT LIABILITY DOCTRINE AND THE INCREASED DIFFICULTY OF FINDING LIABILITY

The imposition of liability on directors under an oversight liability claim has been said to possibly be the "most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[76] Oversight liability claims can be brought under the duty of care or the duty of loyalty.[77] The distinction

Kapnick & Courtney A. Rosen, *The Exculpatory Clause Defense to Shareholder Derivative Claims*, 17 BUS. TORTS. J. 1, 1 (2010).

[71] *See* DEL. CODE ANN. tit. 8, § 102(b)(7)(i)–(iv) (listing the limitations on exculpatory provisions).

[72] *Smith*, 488 A.2d at 881; Kapnick & Rosen, *supra* note 70. The issue in *Smith* was whether the board's decision to approve a merger was an informed decision. 488 A.2d at 874. The plaintiffs contended that the Court of Chancery incorrectly applied the business judgment rule. *Id.* at 871.

[73] ALLEN & KRAAKMAN, *supra* note 8, at 246; *see Smith*, 488 A.2d at 881 (refusing to apply the business judgment rule and imposing liability because directors were grossly negligent by failing to make an informed business decision regarding a merger). The courts had occasionally imposed director liability for breach of the duty of care prior to *Smith*; however, those cases involved situations where directors failed to prevent fraud or other illegal activity. ALLEN & KRAAKMAN, *supra* note 8, at 246.

[74] Yaniv Grinstein & Stefano Rossi, *Good Monitoring, Bad Monitoring*, REV. FIN. 1719, 1722 (2016). DGCL section 102(b)(7) or its equivalent, like the demanding standard for oversight liability under *Caremark* and for the application of the business judgment rule, serves to protect directors from liability. *See* DEL. CODE ANN. tit. 8, § 102(b)(7); *supra* note 65 and accompanying text (discussing the function of the business judgment rule). Within ten years of the *Smith* decision and the implementation of section 102(b)(7), about forty other states implemented similar authority for such an exculpatory provision. ALLEN & KRAAKMAN, *supra* note 8, at 246.

[75] *See supra* notes 62–74 and accompanying text.

[76] *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 125 (Del. Ch. 2009) (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996)).

[77] *See In re Caremark*, 698 A.2d at 967 (explaining that oversight liability can be found based upon negligent director decisions or upon director inaction and a lack of attention that caused loss to the corporation—a *Caremark* claim); *see also* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (establishing that *Caremark* claims involving failure to act in good faith result in oversight liability only when there is a breach of the duty of loyalty); Okla. Firefighters Pension & Ret. Sys. v. Corbat, No.

between these two avenues for liability is significant because of the difference in standards of review for breach of these duties.[78] If the oversight liability claim alleges a breach of the duty of care, the standard of review is simply gross negligence and reckless disregard.[79] If the claim alleges a breach of the duty of loyalty (a *Caremark* claim), then plaintiffs must also prove that the directors acted in bad faith.[80] An oversight claim alleging a breach of the duty of loyalty is thus much more difficult to prove.[81]

Although it appears that these two duties provide plaintiffs with multiple avenues to show oversight liability, plaintiff success under either of these claims is rare and unlikely absent an obvious violation of the law.[82] This Part discusses the burdens and obstacles that plaintiffs encounter when attempting to prove an oversight liability claim.[83] Section A discusses the fate of the business judgment rule and exculpatory provisions permitted under DGCL section 102(b)(7) after the *Stone* decision and their application to and effect on over-

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CV 12151-VCG, 2017 WL 6452240, at *2 (Del. Ch. Dec. 18, 2017) (explaining that plaintiffs can bring oversight claims for breach of the duty of care or breach of the duty of loyalty).

[78] *See Stone*, 911 A.2d at 370 (establishing that proving bad faith is a requirement for finding breach of the duty of loyalty in an oversight claim); *cf.* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining that the standard for liability under the duty of care is gross negligence).

[79] *See Aronson*, 473 A.2d at 812 (affirming the gross-negligence standard for breach of the duty of care). Directors will be held liable if they act with "reckless indifference" toward the best interest of the corporation after being put on notice of possible illegal acts or other wrongdoings. *Okla. Firefighters Pension & Ret. Sys.*, 2017 WL 6452240, at *2.

[80] *Stone*, 911 A.2d at 369–70; *see In re Caremark*, 698 A.2d at 971 (setting the standard for what constitutes bad faith, which is required for the imposition of liability under the oversight liability doctrine). This bad-faith element either requires an "utter failure" to implement and maintain an adequate and reasonable reporting system, or, if such a system is in place and red flags are present, knowingly acting against the best interests of the corporation. *See In re Caremark*, 698 A.2d at 971 (establishing that an "utter failure to attempt to assure a reasonable information and reporting system exists" establishes breach of the duty of good faith); *see also Okla. Firefighters Pension & Ret. Sys.*, 2017 WL 6452240, at *2 (explaining that in bringing an oversight liability claim under breach of the duty of loyalty, the plaintiff must also show lack of good faith, which requires malintent).

[81] *See In re Caremark* 698 A.2d at 971 (acknowledging that showing a "sustained or systematic failure" to oversee is a very high standard); *see also In re Citigroup*, 964 A.2d at 125 (admitting that the burden on the plaintiff to prove bad faith is more difficult to meet than the burden to prove gross negligence).

[82] *See In re* Lear Corp. S'holder Litig., 967 A.2d 640, 653 (Del. Ch. 2008) (stating that the Delaware Supreme Court has held that liability for an oversight claim under the duty of loyalty can only be imposed if there is a "strong showing of misconduct"); Nees, *supra* note 31, at 215–16 (stating that the current oversight liability doctrine does not attach unless there is a clear violation of an additional law); *see, e.g.*, *In re Citigroup*, 964 A.2d at 123 (comparing the facts of the case, where there was no violation of the law, with those of a typical *Caremark* case, which involves a failure to monitor violations of the law, and declining to find oversight liability); *cf.* ATR-Kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N, 2006 WL 3783520, at *1 (Del. Ch. Dec. 21, 2006) (finding liability where members of the board failed to oversee and monitor another director who engaged in self-dealing), *aff'd*, 930 A.2d 928 (Del. 2007). *ATR-Kim* is one of the few examples of the imposition of liability for failure to oversee. Nees, *supra* note 31, at 216 n.65.

[83] *See infra* notes 86–120 and accompanying text.

sight liability claims.[84] Section B discusses the evolution in case law after *Stone* that narrowly applied the oversight liability doctrine, making it more difficult for plaintiffs to be successful on these claims.[85]

A. The Survival of DGCL Section 102(b)(7) and the Business Judgment Rule

Stone created some uncertainty as to whether future courts would broaden the ability to find directors liable or narrow it further.[86] One uncertainty was whether DGCL section 102(b)(7) and the business judgment rule would still apply in oversight liability cases.[87] Post-*Stone*, Delaware courts have made it very clear that directors are still protected by exculpatory provisions permitted under DGCL section 102(b)(7) and the business judgment rule.[88]

In *Desimone v. Barrows*, the court clarified that rather than eliminating the protections of exculpatory provisions permitted under DGCL section 102(b)(7), *Stone* actually ensured that such protections given to directors would not be eliminated, even at the motion to dismiss stage.[89] Because of this survival, if a corporation includes this exculpatory provision in its certificate of incorporation, the duty of care argument is eliminated for plaintiffs, and they must argue

[84] *See infra* notes 86–102 and accompanying text.

[85] *See infra* notes 103–120 and accompanying text.

[86] *See* Petrin, *supra* note 16, at 447–51 (explaining the questions that were left unanswered after the *Stone* decision); *see also* Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007) (stating that after *Stone*, there was a question of whether directors would be subject to increased liability through potential elimination of the knowledge requirement).

[87] Petrin, *supra* note 16, at 448–49. *Stone* held that director failure to oversee is a failure to act in good faith, which is a breach of the duty of loyalty. 911 A.2d at 370. Because the business judgment rule and DGCL section 102(b)(7) are significantly connected—mainly to the duty of care—it was uncertain whether these protections would still apply in oversight liability cases. *See* Petrin, *supra* note 16, at 448–49 (stating that because of the classification of failures of oversight as a breach of the duty of loyalty, it was unclear if directors would be protected by the business judgment rule, and concluding that because oversight fell under the duty of loyalty instead of the duty of care, directors would not be protected by DGCL section 102(b)(7)).

[88] *See Desimone*, 924 A.2d at 935 n.95 (reaffirming the protections that directors are entitled to under *Caremark* and stating that *Stone* did not weaken the discretion that directors are given to address issues of compliance with the law as they see fit).

[89] *See id.* at 935 (explaining that *Stone* reinforced the knowledge requirement and its application to oversight claims, and that by doing this, the court ensured protection of the exculpatory provision). In *Desimone*, defendant-directors allegedly allowed stock of the corporation to be granted to employees, whose option-grant date was backdated to the lowest trading price. *Id.* at 913. This fraudulent activity is known as backdating of stock options, and its appeal is that it increases the value of the stock option. Petrin, *supra* note 16, at 451 n.86. A stock option gives the holder of the stock the right (not the obligation) to sell or buy the contracted-for stock for a predetermined price within a set period of time. *Stock options*, BLACK'S LAW DICTIONARY (10th ed. 2014). Plaintiffs claimed that this was a breach of the directors' fiduciary duty and brought oversight liability claims under *Caremark*. *See Desimone*, 924 A.2d at 939–40 (explaining that the plaintiffs alleged that directors were unaware of the backdating due to their abandonment of their duty of oversight and monitoring). The defendants brought a motion to dismiss the case, and the court granted it. *Id.* at 908.

oversight liability under the non-exculpated breach of the duty of loyalty, which is a more difficult standard to meet.[90] In other words, absent a showing of bad faith, directors cannot be held liable for failure of oversight if an company has an exculpatory provision.[91] It is almost impossible to find liability for failure of oversight based on a breach of the duty of care due to the prevalence of this exculpatory provision.[92] Additionally, if corporations take advantage of this exculpatory provision, plaintiffs cannot rebut the business judgment presumption by showing breach of the duty of care, again making rebuttal more difficult.[93]

Moreover, in *In re Citigroup Inc. Shareholder Derivative Litigation*, the court acknowledged that a director's duty of oversight does not eliminate the protections that directors are given under the business judgment rule.[94] The

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[90] DEL. CODE ANN. tit. 8, § 102(b)(7) (2018); *see* Wood v. Baum, 953 A.2d 136, 141 (Del. 2008) (quoting Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch. 2003)) (stating that when directors are exculpated from liability for certain conduct, liability is only a significant threat if a plaintiff pleads a claim that is not exculpated in the certificate of incorporation); *Okla. Firefighters Pension & Ret. Sys.*, 2017 WL 6452240, at *2 (explaining that if directors are exculpated from liability for breach of the duty of care, a plaintiffs' only avenue for finding liability is proving that director inaction or failure to oversee was a breach of the duty of loyalty, which requires that directors knowingly acted against the best interest of the corporation in the presence of red flags); Nees, *supra* note 31, at 219 (explaining that this exculpatory provision eliminates liability for gross negligence and leaves plaintiffs to rely on showing breach of the duty of loyalty or good faith); *see, e.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 239 (Del. 2009) (finding that the exculpatory provision in Lyondell's certificate of incorporation eliminated liability for breach of the duty of care, leaving plaintiffs to contend that defendants should be held liable under the duty of loyalty).

[91] *See* John F. Savarese, *Failure-of-Oversight Claims Against Directors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 15, 2016), https://corpgov.law.harvard.edu/2016/01/15/failure-of-oversight-claims-against-directors [https://perma.cc/HKA4-ZMCS] (explaining the application of oversight liability doctrine in *Central Laborers' Pension Fund v. Dimon*, 638 F. App'x 34 (2d Cir. 2016) (summary order)); *see also Stone*, 911 A.2d at 369–70 (establishing that oversight liability falls under the duty of loyalty and reaffirming that breach of good faith is a condition of finding liability under the duty of loyalty) (quoting *Guttman*, 823 A.2d at 506).

[92] *See* Nees, *supra* note 31, at 218 n.72 (explaining that about 90% of corporations include an exculpatory provision in their certificate of incorporation that eliminates liability for breach of the duty of care). For those corporations that do not have an exculpatory provision, oversight liability claims can be brought under breach of the duty of care; however, the standard of review will be gross negligence, which although easier, is still a difficult one to prove. *See Okla. Firefighters Pension & Ret. Sys.*, 2017 WL 6452240, at *2; *see also In re Citigroup*, 964 A.2d at 125 (acknowledging the difficulty of the gross-negligence standard of review).

[93] *See, e.g.*, *Lear*, 967 A.2d at 647–48 (explaining that the plaintiffs must show that directors breached their duty of loyalty in order to rebut the business judgment presumption and survive the motion to dismiss because the defendants are protected by the exculpatory provision, eliminating liability for breach of the duty of care).

[94] *See In re Citigroup*, 964 A.2d at 125 (stating that the business judgment rule is in place to protect and encourage directors and managers to follow through with riskier transactions without the fear of liability if those investments or transactions fail); Peter Atkins, *Directors' Duty of Oversight in a Meltdown*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 8, 2009), https://corpgov.law.harvard.edu/2009/03/08/directors-duty-of-oversight-in-a-meltdown/ [https://perma.cc/G8CD-S673] (pointing out that the decision in *Citigroup* emphasizes the presence and survival of the busi-

continued application of the business judgment presumption in oversight liability claims is another significant obstacle that hinders plaintiffs from obtaining a judgment in their favor.[95] Plaintiffs can successfully rebut the presumption by proving that the directors' actions were fraudulent, illegal, wasteful, or that the directors breached a fiduciary duty.[96] Because of the nature of an oversight liability claim, courts are unlikely to see inaction or failure to oversee as fraudulent, illegal or wasteful, leaving plaintiffs with no option but to prove breach of a fiduciary duty.[97] Proving a breach of fiduciary duty is mostly limited to proving a breach of the duty of loyalty (which is harder to prove than a breach of the duty of care), because of the prevalence of exculpatory provisions in certificates of incorporation as permitted by DGCL section 102(b)(7) (or its local equivalent).[98]

The early procedural timing of the application of the business judgment rule adds an additional hurdle for plaintiffs.[99] The business judgment rule is

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ness judgment rule in shareholder litigation). The *Citigroup* court also acknowledged that the business judgment rule continues to apply regardless of how significant the corporation's losses were. *In re Citigroup*, 964 A.2d at 131. The *Citigroup* and *Desimone* holdings show the Delaware courts' commitment to keep the imposition of liability narrow, shielding directors from personal liability. Petrin, *supra* note 16, at 452.

[95] *See In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998) (affirming that "it is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment'" (quoting *Aronson*, 473 A.2d at 815)); *see also In re Citigroup*, 964 A.2d at 125 (admitting that the burden that the plaintiff has to rebut the business judgment presumption is high due to the challenge of proving gross negligence or bad faith).

[96] *See* Nees, *supra* note 31, at 226 (stating the ways in which the business judgment presumption can be rebutted); *see also supra* note 68 (describing the five ways that plaintiffs can rebut the business judgment presumption).

[97] *See* Nees, *supra* note 31, at 226–27 (explaining the unlikelihood of classifying failure to act as illegal, fraudulent, or wasteful). Failure to act will not likely be illegal unless there is failure to comply with some statute or regulation. *Id.* Inaction will not likely be classified as fraud absent some "false statement of material fact made with the intent to induce action." *Id.* at 227. Additionally, inaction will likely not be waste, because the test for waste is very strict, narrowly applied, and rarely used. *Id.* at 226 n.121. Regarding the waste argument, *Lewis v. Vogelstein* states that "waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which a reasonable person might be willing to trade . . . . [It is] a transfer of corporate assets that serves no corporate purpose; or for which no consideration is received." 699 A.2d 327, 336 (Del. Ch. 1997); *see* Nees, *supra* note 31, at 226 n.121 (*quoting Lewis*, 699 A.2d at 336).

[98] Nees, *supra* note 31, at 227; *see Okla. Firefighters Pension & Ret. Sys.*, 2017 WL 6452240, at *1–2 (explaining that plaintiffs must prove breach of the duty of loyalty in order to overcome the business judgment presumption where there is an exculpatory provision in the company's certificate of incorporation); *see, e.g.*, *Lear*, 967 A.2d at 647–48 (limiting the plaintiffs to arguing breach of the duty of loyalty to overcome the business judgment presumption due to an exculpatory provision eliminating liability for breach of the duty of care).

[99] *See* Nees, *supra* note 31, at 225 (arguing that plaintiffs are hindered by the difficulty of pleading and proving facts establishing breach of a fiduciary duty at the beginning of a case). In a shareholder derivative action, the shareholders are bringing a claim on behalf of the corporation. Carole F. Wilder, *The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits*, 5 PACE L. REV. 633, 633 (1985). Prior to commencing a shareholder

used as the standard for whether plaintiffs have satisfied the demand requirement necessary to commence a shareholder derivative action against directors.[100] The issue that plaintiffs encounter is that properly establishing a breach of a duty necessary to rebut the business judgment presumption requires extensive fact finding, which is more easily done in the discovery stage of the

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derivative action against directors, shareholders must first satisfy the demand requirement, which requires shareholders to demand that the board to bring the suit themselves. *Id.* at 635; *see* Hawes v. Oakland, 104 U.S. 450, 460–61 (1882) (establishing the demand requirement). This demand requirement ensures that shareholders tried everything they could within the corporation to address the issue prior to bringing an action that generally belongs to the corporation itself rather than to the shareholders. *Hawes*, 104 U.S. at 460–61. Every state requires that shareholders demand the board to bring the suit themselves before the shareholders can bring the suit on behalf of the corporation. Wilder, *supra* at 635 n.9. An exception to the demand requirement is the futility exception. *Id.* at 636. If the demand would have been "futile," plaintiffs are excused from making such a demand and can continue with bringing the lawsuit against the directors. *Id.*; *see* Cathedral Estates v. Taft Realty Corp., 228 F.2d 85, 88 (2d Cir. 1995) (stating that demand is excused if such demand "would be 'futile,' 'useless,' or 'unavailing'").

[100] *See* Bradley R. Aronstam & Irwin H. Warren, *Delaware's Business Judgment Rule and Varying Standards for Judicial Review for Assessing Director Conduct in M&A Transactions* 7 (Canadian Inst., 2007), http://www.ramllp.com/media/article/12_Canadian%20Institute%20Article.pdf [https://perma.cc/NSE6-CDBX] (explaining that, in addition to the substantive component of the business judgment rule, the rule also has a procedural component as the test for pre-litigation demand). The board's decision to reject demand is subject to the business judgment rule. *Id.* at 9. If demand is rejected, the plaintiff has the burden of rebutting the business judgment presumption at this early stage in the litigation. *See* Wilder, *supra* note 99, at 635 (explaining that the plaintiff has to show to the court that the board's decision to reject demand should not be respected). If the plaintiff fails to overcome the presumption, the case will be dismissed. *See id.* at 365–66 (stating that it is rare that courts allow cases to continue after demand has been rejected); *see also* Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990) (stating that "absent an abuse of discretion, if the requirements of the traditional business judgment rule are met, the board of directors' decision not to pursue the derivative claim will be respected the courts"). In determining whether the rejection of demand should be upheld, the courts will look at whether the rejection can be "attributed to any rational purpose," which is an easy standard to meet. Aronstam & Warren, *supra*, at 9–10. Therefore, most plaintiffs attempt to satisfy the futility exception instead of trying to show that the rejection did not have a rational purpose. *Id.* at 10. Excusing demand due to futility is also subject to a strict standard that revolves around the business judgment rule. *See* Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993) (stating the requirements for determining demand futility in situations where there is no business decision by the directors); *Aronson*, 473 A.2d at 814 (establishing the requirements for determining demand futility in situations where plaintiffs are challenging a director decision). For situations where shareholders are challenging a business decision made by the board, in order to be excused from making demand, the plaintiffs must show that the alleged facts create a reasonable doubt that: (1) the directors are disinterested and independent; and (2) the business decision is a result of a "valid exercise of business judgment." *Aronson*, 473 A.2d at 814. Where demand futility is being determined in the absence of a business decision (inaction by directors), in order to excuse demand, plaintiffs must show that their alleged facts "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Rales*, 634 A.2d at 934. Arguing demand futility is an essential component of a plaintiff's case, yet it imposes a very heavy burden on the plaintiff. *See* Aronstam & Warren, *supra*, at 11 (explaining that failure to successfully plead demand futility results in a dismissal before the court can address the merits of the case).

case.[101] Without sufficient facts in the pleading at the outset to show possible breach of a fiduciary duty, the court will likely dismiss the case.[102]

B. The Narrowed Application of Oversight Liability Doctrine

In addition to allowing the survival of indemnification as permitted by DGCL section 102(b)(7) and continuing to apply the business judgment presumption in oversight liability claims, the courts have narrowly interpreted the elements of oversight liability and strictly applied the doctrine, producing obstacles for plaintiffs.[103] *Stone* significantly narrowed the application of oversight liability by establishing that a *Caremark* claim falls under the duty of loyalty.[104] This eliminated the breach of the duty of care argument for *Caremark* claims (assuming that it is not already eliminated by an exculpatory provision in the particular case) and imposed a more challenging standard on plaintiffs, who now must prove bad faith, as is required to find liability under the duty of loyalty.[105] Additionally, *Stone* rejected the possibility of imposing

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[101] *See* Nees, *supra* note 31, at 228 (explaining that the procedural component of the business judgment rule is an obstacle for plaintiffs, because, although plaintiffs can request access to the corporation's books and records, the facts needed to prove the intent to cause harm or a conscious disregard of duty by the directors is more easily done during the deposition or discovery stage of the litigation); *see also Lear*, 967 A.2d at 640, 647 (holding that, at the motion to dismiss stage, the plaintiffs "cannot rely on conclusory allegations," but "must plead specific facts that support the inference that the Lear directors breached their fiduciary duty of loyalty"); *Aronson*, 473 A.2d at 815 (establishing that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases, a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists"). Discovery is the process where parties in a suit exchange information about their witnesses and their evidence. *Discovery*, ENCYCLOPAEDIA BRITANNICA, https://www.britannica.com/topic/discovery-law [https://perma.cc/2X2K-AGMT].

[102] *See* Wilder, *supra* note 99, at 648 (acknowledging that the application of the business judgment rule to the demand requirement has prevented most shareholder derivative suits from advancing past the pleading stage).

[103] *See infra* notes 104–120 and accompanying text.

[104] *See Stone*, 911 A.2d at 369–70 (establishing that failure to perform oversight duties under *Caremark* is a violation of the duty of loyalty).

[105] *See id.* (affirming that acting in good faith is a condition and requirement of the duty of loyalty and holding that, in order to prove bad faith, plaintiffs must show knowledge or "conscious disregard" of duties); *In re Caremark*, 698 A.2d at 971 (establishing that lack of good faith must be proven to impose liability for breach of the duty of loyalty). This standard has a knowledge requirement, which is very difficult to prove. *See In re Citigroup*, 964 A.2d at 123 (clarifying that to be successful on an oversight claim, plaintiffs must prove that the directors had knowledge that they were not following through with their required duties or that the directors showed "conscious disregard" for their duties and responsibilities); *Stone,* 911 A.2d at 370 (holding that in order to impose liability, plaintiffs must prove that directors knowingly disregarded their duties by failing to implement a reporting system or failing to act in the presence of red flags provided by the reporting system); *In re Caremark*, 698 A.2d at 971 (establishing the demanding test for liability in oversight claims: lack of good faith is only proven by showing a "sustained or systematic failure" to oversee). Moreover, the definition of good faith is not fully developed by the courts and within corporate law, making the application of the doctrine more difficult. *See In re Walt Disney Co.*, 906 A.2d at 63 (stating that, although the duty of good

liability by simply showing lack of good faith, eliminating yet another avenue.[106]

Subsequent courts have significantly hindered plaintiffs' ability to succeed in an oversight claim under the duty of loyalty.[107] It appears that liability will only be imposed in extreme circumstances where there is clear misconduct.[108] Moreover, in *Lyondell Chemical Co. v. Ryan*, the Supreme Court of Delaware narrowed the definition of bad faith with respect to oversight liability claims.[109] The case involved a merger between two companies: Lyondell Chemical Co. and Basell AF.[110] The plaintiffs contended that directors breached their duty of loyalty by employing defective negotiation methods and approving the merger on the basis of self-interest.[111] In recognizing a distinc-

faith has been discussed by scholars, it is still an under-developed area of corporate law and not completely addressed by courts).

[106] *See Stone*, 911 A.2d at 370 (holding that good faith is not an independent duty and that liability cannot be imposed under the duty of good faith alone). Unlike the duty of good faith, breach of the duty of care or loyalty can directly lead to the imposition of liability. *Id.*

[107] *See infra* notes 108–120 and accompanying text.

[108] *See Wood*, 953 A.2d at 143 (concluding that the plaintiffs failed to provide facts that proved that the director defendants "knew or should have been on notice" of employee misconduct or that directors allowed or engaged in such illegal conduct); *Lear*, 967 A.2d at 654–55 (stating that in a transactional context, only an extreme set of facts would show that directors consciously disregarded their duties, and acknowledging that there must be a "strong showing of misconduct" to impose liability for breach of the duty of loyalty for failing to act in good faith); Petrin, *supra* note 16, at 456 (explaining that case law shows that "an extreme set of facts is necessary in order to state a credible oversight claim" even outside the transactional context). In *Wood*, plaintiff shareholders alleged that the directors of MME Corporation breached their fiduciary duties by: (1) causing the company to improperly value assets and issue false financial statements, which is a violation of the law; (2) causing the company to make "improper charitable contributions;" (3) causing the company to engage in improper transactions in order to improve financial performance; and (4) failing to "institute, administer and maintain adequate accounting and reporting controls" which led to significant losses by the corporation. 953 A.2d at 139. The court dismissed the case because the plaintiffs failed to provide specific facts that proved that directors knowingly violated the law or that directors failed to properly fulfill their duty of oversight. *Id.* at 143. The court additionally acknowledged that "under Delaware law, red flags 'are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer.'" *Id.* In *Lear*, shareholders filed a suit against directors alleging that the directors breached their duty of loyalty and good faith because they agreed to a merger agreement knowing that the shareholders would disapprove of both the share price and the termination provision. 967 A.2d at 641, 647. The court ultimately held that the plaintiffs did not plead sufficient facts to prove conscious and intentional disregard of duties and breach of the duty of loyalty by the directors. *See id.* at 647–48 (establishing the standard of facts that plaintiffs had to show in order to survive the motion to dismiss and concluding that plaintiff's arguments were "unpersuasive").

[109] *See* 970 A.2d at 243–44 (holding that complete failure in director oversight responsibility is necessary to find a breach of the duty of loyalty).

[110] *Id.* at 237. Lyondell was a publicly traded chemical company and Basell was a private company in the business of polyolefin technology. *Id.*

[111] *Id.* at 239. The plaintiffs alleged that directors breached their duty of loyalty and care; however, because Lyondell had an exculpatory provision in its certificate of incorporation, the duty of care argument was eliminated. *Id.* The complaint contained five allegations: (1) a "grossly insufficient" merger price; (2) self-interested motivation to approve the merger on behalf of the directors; (3) defective negotiation practices; (4) approval of "unreasonable deal protection provisions"; and (5) omission

tion between inadequately carrying out one's duties and consciously disregarding those duties, the court concluded that liability could only be imposed where directors "knowingly and completely failed" in carrying out their duties, which was not the case here.[112] This interpretation of good faith can be interpreted to mean that directors only have to put in a minimal effort to fulfill their duties and still escape liability.[113]

Courts have also declined to apply the oversight liability doctrine and the *Caremark* standard in the context of "business risk."[114] In *In re Citigroup Inc. Shareholder Derivative Litigation*, Citigroup invested in the subprime mortgage market, which eventually led to significant losses by the corporation.[115] In their *Caremark* claim, plaintiffs contended that directors breached their fiduciary duties by failing to adequately monitor and control the risk that the corporation faced from exposure to the subprime mortgage market and by failing to disclose the losses that the corporation suffered.[116] Also, plaintiffs al-

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of material facts on the preliminary proxy statement. *Id.* Plaintiffs alleged that during the negotiations, directors did not push the buyer to see if they could get a better price or do a market check to see if the price they were getting was a fair one. *Id.* at 241.

[112] *Id.* at 243–44. The court clarified that failure by directors to take any specific steps is not enough to show a conscious disregard of their duties. *Id.* at 243. According to the court, there is a distinction between not adequately performing one's duties and consciously disregarding one's duties. *Id.* The court reasoned that decisions that directors make do not have to be perfect, but merely reasonable. *Id.* The court criticized the trial court's approach, and said that the question it should have asked was whether the directors "utterly failed to attempt to obtain the best sales price"—not whether they did everything they should have done to obtain it. *Id.* at 244. A 2016 case from the Second Circuit, *Central Laborers' Pension Fund*, supports this narrow definition by clarifying that oversight liability claims against directors require "allegations of conscious misconduct and cannot be predicated on after-the-fact challenges to the 'reasonableness of a corporation's controls.'" *See* Savarese, *supra* note 91 (citing *Central Laborers Pension Fund*, 638 F. App'x 34).

[113] *See* Petrin, *supra* note 16, at 455–56 (interpreting *Lyondell* and acknowledging that any reasonable effort, even a small one, to oversee would be enough to satisfy the directors' obligations under their fiduciary duties).

[114] *See In re Citigroup*, 964 A.2d at 126 (declining to impose liability for failure to properly anticipate business risk, even for a claim framed in a *Caremark* context).

[115] *Id.* at 112. Citigroup engaged in the subprime mortgage market as early as 2006 and began suffering losses in 2007. *Id.* The following were examples of the losses that plaintiffs alleged were attributed to engagement in the subprime mortgage market: a 57% decrease in Citigroup's net income; affiliate bailouts; a 40% decline in dividend disbursement; more than 6,000 layoffs of Citigroup employees; a quarterly loss of $9.83 billion in January of 2008; and an additional loss of $2.5 billion in the second quarter of that year. *Id.* at 113–14.

[116] *Id.* at 111. Plaintiffs alleged that under *Caremark*, directors were liable for failure to maintain proper reporting systems to alert them to potential risk. *Id.* at 123–24. Plaintiffs also brought a waste claim, alleging that Citigroup's directors are liable for corporate waste for: (1) allowing the company to buy subprime loans worth $2.7 billion; (2) allowing the company to buy its own shares in order to inflate the price; (3) approving a multi-million-dollar retirement benefit package to a former CEO who is considered to be responsible for losses suffered; and (4) allowing the company to engage in bad investments. *Id.* at 111–12.

leged there were multiple red flags providing notice of issues in the real estate market and that such red flags were ignored by directors.[117]

In analyzing the claims, the Delaware Chancery Court emphasized that there are substantial differences between failing to oversee employee violations of the law and failing to recognize a corporation's level of business risk.[118] The court declined to impose liability for the latter in order to prevent courts from second-guessing and evaluating the reasonableness of director decisions.[119] The court concluded that the alleged red flags did not evidence that the directors acted in bad faith by consciously disregarding their duties and ultimately dismissed the plaintiffs' *Caremark* claim.[120]

III. WELLS FARGO: "GAMING" AND THE "GR-EIGHT INITIATIVE"

Cross-selling, the practice of selling additional products to prospective or existing customers, is a profitable sales practice and is a major component of the Wells Fargo business model.[121] In the shareholder derivative lawsuit

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[117] *Id.* at 111. The plaintiffs alleged that directors ignored multiple red flags "in pursuit of short-term profits and at the expense of the Company's long-term viability." *Id.* The majority of the red flags that the plaintiffs alleged directors ignored were statements from public documents that illustrated and warned of the declining condition of financial markets, such as the subprime mortgage market. *Id.* at 114–15. A majority of the directors were members of the board during prior, Enron-related activity and were considered to be financial experts. *Id.* at 124. For these reasons, the plaintiffs alleged that the directors should have been "especially conscious" of the present red flags. *Id.* The court viewed the claim as shareholders trying to impose liability on directors for making decisions that, when looking back, did not turn out well for the corporation. *Id.*

[118] *Id.* at 131. The court compared the facts of the case with those of *American International Group, Inc. Consolidated Derivative Litigation*, 965 A.2d 763 (Del. Ch. 2009), where there was fraudulent and criminal conduct by employees and failure to oversee by directors. *Id.* at 130. The court also reaffirmed its past conclusion that the company suffering losses, even significant losses, alone was not enough to impose personal liability on directors. *Id.* at 130.

[119] *See id.* at 126 (stating that allowing personal liability for failing to evaluate business risk undermined the already established policy of protecting directors from courts making "hindsight evaluations" regarding the reasonableness of their business decisions). The court recognized that because of the nature of evaluating business risk, it is practically impossible for a court to make a determination on whether directors correctly evaluated the risk and made the "right" decision. *Id.* Even if directors correctly evaluate a business risk, there is still a chance that taking that risk could result in negative consequences. *Id.* It is completely possible that directors are merely unlucky. *Id.* The court did not want to diminish the directors' ability to take risks that make money for the company by imposing liability for failing to correctly evaluate a risk. *Id.* Additionally, the court reasoned that it is not the intention of the duty of oversight to impose liability on directors for "fail[ing] to predict the future and properly evaluate business risk." *Id.* at 131.

[120] *Id.* at 112, 128. The court dismissed the case because the plaintiffs failed to fulfill the demand requirement and were denied the futility exception. *Id.* at 112. The claim regarding corporate waste was not dismissed. *Id.* The court determined that the red flags, at most, proved that the directors may have made a bad business decision. *Id.* at 128.

[121] *See* WELLS FARGO & CO., WELLS FARGO & COMPANY ANNUAL REPORT 2014, at 44, 126, https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2014-annual-report.pdf [https://perma.cc/NA6T-AZXL] (stating that Wells Fargo's cross-selling strategy was "to increase the number of products [their] customers use by offering them all of the financial products

against Wells Fargo and its board of directors, plaintiffs brought an oversight liability claim alleging breach of the duties of loyalty and good faith in connection to cross-selling.[122] Plaintiffs claimed that directors breached their fiduciary duties by overseeing demanding sales quotas, allowing employees to open unauthorized accounts, ignoring red flags that put them on notice of the illegal activity, and having inadequate risk control systems.[123]

Section A details the culture that Wells Fargo directors and managers created within the corporation that led to employee illegal conduct.[124] Section B provides a timeline of when red flags appeared that put directors on notice of illegal activity.[125] Section C discusses when and how the Board responded to such red flags.[126]

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that satisfy their financial needs" and such practices are essential to Wells Fargo's business model); *see also* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 3, at 4 (claiming that defendant-directors stressed the fact that cross-selling was essential to the bank's financial condition). Cross-selling is a profitable sales practice because it encourages customers to remain loyal to their bank. *See* Matt Levine, *Wells Fargo Opened a Couple Million Fake Accounts*, BLOOMBERG VIEW (Sept. 9, 2016), https://www.bloomberg.com/view/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts [https://perma.cc/G9AQ-B5GM] (explaining that if customers have multiple accounts with one bank, they are more likely to want more high-profile products, such as mortgages); E. Scott Reckard, *Wells Fargo's Pressure-Cooker Sales Culture Comes at a Cost*, L.A. TIMES (Dec. 21, 2013), http://www.latimes.com/business/la-fi-wells-fargo-sale-pressure-20131222-story.html [https://perma.cc/88L5-KLME] (explaining that multiple products in the hands of one customer discourages the customer from switching banks). In 2014, defendant Carrie L. Tolstedt, the then-Senior Executive Vice President, Community Banking, commented: "the cross-sell model . . . drive[s] revenue." Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 4, at 5.

[122] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 526, at 112 (stating the claims that the plaintiffs brought against the directors and explaining the ways in which the directors breached their duties). The plaintiffs also argued that the defendants breached their duty of candor and reasonable inquiry. *Id.* Although arguing breach of the duty of care is an easier standard to meet, the plaintiffs were barred from arguing such a claim because Wells Fargo has an exculpatory provision in its certificate of incorporation, eliminating liability for breach of the duty of care. *See* Wells Fargo & Co., Restated Certificate of Incorporation of Wells Fargo & Company (Form 10-K, ex. 3a) (Feb. 28, 2012), https://www.sec.gov/Archives/edgar/data/72971/000119312512084528/d280360dex3a.htm [https://perma.cc/BQ47-ZS9L] (stating that directors will not be held monetarily liable for breach of their fiduciary duties except for situations under DEL. CODE ANN. tit. 8, § 174 ("Liability of directors for unlawful payment of dividend or unlawful stock purchase or redemption; exoneration from liability; contribution among directors; subrogation"), situations involving breaches of the duty of loyalty or good faith, and situations where a director receives an improper benefit from a transaction).

[123] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 526, at 112–13 (listing allegations of breach on the part of the directors). Additionally, the plaintiffs alleged that the directors breached their duties by: structuring the compensation policies which incentivized employees to engage in illegal activities and rewarding executives with bonuses for cross-selling; "allowing Wells Fargo insiders to conduct insider sales and dispositions of company stock while in the possession of material, adverse, non-public information"; allowing the repurchase of Wells Fargo shares that were artificially inflated; allowing for false public statements on cross-selling which artificially increased the Wells Fargo share price; and "engaging in abuse of control and gross mismanagement of Wells Fargo's assets and business through a failure to prevent the illicit account-creation scheme." *Id.*

[124] *See infra* notes 127–145 and accompanying text.

[125] *See infra* notes 146–161 and accompanying text.

[126] *See infra* notes 162–176 and accompanying text.

A. Pressures to Meet Demanding Quotas and the Logistics Behind "Gaming"

Former Wells Fargo Chief Executive Officer (CEO) and board member Dick Kovacevich created a sales initiative with the sales motto "Going for Gr-Eight" or "Eight is Great," referred to as the "Gr-Eight Initiative."[127] The goal of this sales model was for employees to sell at least eight Wells Fargo products to each customer.[128] This slogan and sales model continued within Wells Fargo even after Kovacevich was replaced by John Stumpf as CEO in 2007.[129] The "Gr-Eight Initiative" led to directors and officers imposing and enforcing demanding sales quotas regarding the number of products each employee had to sell each day.[130] Consequently, plaintiffs alleged that the pressures to meet the quotas was the driving force that led Wells Fargo bankers to open the unauthorized bank accounts and commit fraud.[131]

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[127] Bethany McLean, *How Wells Fargo's Cutthroat Corporate Culture Allegedly Drove Bankers to Fraud*, VANITY FAIR (2017), https://www.vanityfair.com/news/2017/05/wells-fargo-corporate-culture-fraud [https://perma.cc/GK9F-BKFS] [hereinafter McLean, *Cutthroat Corporate Culture*]. Kovacevich started this initiative in 1997 and when asked why "eight," he responded: "[i]t rhymes with GREAT!" *Id.* Kovacevich compared banking and selling money to operations at any other store trying to sell products. *See id.* (referring to an interview with Kovacevich in which Kovacevich implied that "bank branches were like 'stores,' and bankers were 'salespeople' whose job was to 'cross-sell,' which meant getting 'customers'—not 'clients,' but 'customers'—to buy as many products as possible"); Bethany McLean, *Is This Guy the Best Banker in America?*, FORTUNE (July 6, 1998), http://archive.fortune.com/magazines/fortune/fortune_archive/1998/07/06/244842/index.htm [https://perma.cc/ET6N-FLCL] [hereinafter McLean, *Is This Guy the Best Banker in America?*] (reporting that Kovacevich said that he sells money the same way that "Home Depot sells screwdrivers").

[128] Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶¶ 1–2, at 4; Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 4, at 2; McLean, *Cutthroat Corporate Culture*, *supra* note 127.

[129] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 3, at 4 (claiming that between 2011 and 2017, defendant-directors stressed the fact that cross-selling was and is essential to the bank's financial condition); WELLS FARGO & COMPANY ANNUAL REPORT 2014, *supra* note 121, at 126 (showing that cross-selling was still a major part of Wells Fargo business model in 2014); *Wells Fargo Names Stumpf CEO; Kovacevich Remains Chair*, CNBC (June 27, 2007), https://www.cnbc.com/id/19452417 [https://perma.cc/9TSQ-FTT6] (reporting that Stumpf will replace Kovacevich as CEO). Stumpf referred to Wells Fargo as "the king of cross-sell[ing]." Complaint, *In re Wells Fargo & Co.*, *supra* note 1, at ¶¶ 3–4. In addition to CEO, Stumpf held the following other positions within Wells Fargo: board of director member (2006–2016); Chairman of the Board (2010–2016); President (2005–2015); Chief Operating Officer (2005–2007); and other management and senior management positions. *Id.* ¶ 70, at 15.

[130] Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 2, at 4. Management encouraged the illegal activity by incentivizing employees with bonuses. Egan, *2 Million Phony Accounts*, *supra* note 1.

[131] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 2, at 4 (explaining that the strict quotas lead to significant amount of pressure on bankers to meet those quotas, driving employees to illegally open the unauthorized accounts); Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 5, at 2 (stating that the sales quotas were strictly enforced and were difficult to meet without engaging in fraudulent activity); Reckard, *supra* note 121 (reporting that an investigation found that the intense pressure to sell led to "ethical breaches, consumer complaints, and labor lawsuits").

The environment within any Wells Fargo bank was of high-stress for all employees and often described as a "pressure cooker".[132] Employees were trained to maximize cross-selling.[133] Management constantly monitored employees and threatened, demeaned, and berated them to compel them to make sales.[134] When target sales were not achieved for the day, employees were rep-

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[132] *See generally* Reckard, *supra* note 121 (referring to Wells Fargo as a "pressure-cooker" because of its intense environment). This pressure-filled environment had negative physical and emotional effects on Wells Fargo employees. *See* Stacy Cowley, *Voices from Wells Fargo: "I Thought I Was Having a Heart Attack,"* N.Y. TIMES: DEALBOOK (Oct. 20, 2016), https://www.nytimes.com/2016/10/21/business/dealbook/voices-from-wells-fargo-i-thought-i-was-having-a-heart-attack.html [https://perma.cc/6L4R-K7F6] [hereinafter Cowley, *I Thought I Was Having a Heart Attack*]. Wisconsin banker Angie Payden described the effects of her experience as a Wells Fargo banker:

> I started to have extreme physical stress-related symptoms as well as random panic attacks. At some point during that summer, the stress was so intense that I could no longer handle the pressure. On the banker's desk, in the bathroom, behind the teller line and in the vault, the store kept bottles of hand sanitizer. One morning, before meeting with a customer, in which I knew I was going to have to sell unneeded services, I had a panic attack. I went to the bathroom and took a drink of some hand sanitizer . . . . In late November 2012, I was completely addicted to hand sanitizer and drinking at least a bottle a day during by work day . . . . The recent news stories have reactivated my memories and P.T.S.D. I am now having nightmares and flashbacks of that time period. It was horrible.

Id. There are accounts of employees suffering anxiety attacks, and one employee even developed shingles as a result of the stress. *Id.*

[133] *See* Cowley, *I Thought I Was Having a Heart Attack*, *supra* note 132 (recounting banker Ashlie Storms's experience) ("We would have conference calls with regional presidents and managers coaching us on how to word our selling points so that the customer can't say no. I felt like a cheat. I started losing sleep and got nauseous every Sunday night over the start of the next work week."). A former branch manager from the Pacific Northwest stated: "It's all a manipulation. We are taught exactly how to sell multiple accounts." Reckard, *supra* note 121.

[134] Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 5, at 2, ¶ 24, at 6. Each branch reported its sales to district managers four times a day. *Id.* ¶ 5, at 2. One teller from an Illinois branch recounted:

> Every day, your supervisor would make you set a sales goal, follow up on reaching that sales goal and coach you on how to make those sales . . . . I believe my daily product sales goal was six a day. It didn't matter if you had 20 products one day, you still had to meet your goal every other day . . . . Even if a customer didn't want access to online banking, we were taught to force them into it.

Cowley, *I Thought I Was Having a Heart Attack*, *supra* note 132. Another banker from a Houston branch said:

> Managers kept a board right by the teller line where we would write how many people we had talked to, how many we had referred to a banker and how many sales were closed. At the end of the day, the manager would call out each teller in front of everybody and share their results. It was a frightening experience. If tellers did not have any sales on the board, you did not want to be that person . . . . Every morning I had to sit with my boss and go over the previous day and every single customer's relationship.

Id. Banker Julie Miller was fired from her job for not meeting the sales goals one year even though she was in the top 2% of managers in the country for sales. *Id*. She moved to a new branch where she rimanded and often obligated to attend meetings with management, where they were told to do "whatever it takes" to meet their sales goals for the day.[135] Additionally, some employees were required to work extra hours without compensation for not meeting the quotas, and many were threatened with losing their job.[136] As the civil complaint put it, "Wells Fargo put its employees between a rock and a hard place, forcing them to choose between keeping their jobs and opening unauthorized accounts."[137]

It was these pressures from management that pushed employees to their breaking points and led to the use of illegal sales practices, called "gaming".[138] There were multiple ways that employees created bank accounts for customers without their authorization or knowledge.[139] A common practice was "bundling," which involved product misrepresentation.[140] When selling products, employees told customers that certain products, for example a checking account, could not be purchased individually, but instead must be purchased with multiple other accounts or products.[141] Management encouraged this deception by training employees to sell these "bundles" or "packed accounts."[142]

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said that the management "would grill [employees] every day; it was nonstop badgering and berating. It was verbal and mental abuse." *Id.*

[135] Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 5, at 2. Sabrina Bertrand, a banker from Houston, stated, "I had managers in my face yelling at me . . . . They wanted you to open up dual checking accounts for people that couldn't even manage their original checking account." Matt Egan, *Workers Tell Wells Fargo Horror Stories*, CNN MONEY (Sept. 9, 2016), http://money.cnn.com/2016/09/09/investing/wells-fargo-phony-accounts-culture/index.html [https://perma.cc/54XK-PEKQ] [hereinafter Egan, *Wells Fargo Horror Stories*]. In order to meet sales quotas, employees would resort to opening up unnecessary accounts for their family members. *Id.* At one bank, employees convinced a homeless woman to open up six separate accounts, all resulting in fees. Reckard, *supra* note 121.

[136] Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 24, at 7. Florida branch manager Rita Murillo explained that when employees did not meet the sales quotas, they worked late and on weekends to make up for it, and anyone who was behind in sales after two months was fired. Reckard, *supra* note 121. Murillo recalled: "We were constantly told we would end up working for McDonald's . . . . If we did not make sales quotas . . . we had to stay for what felt like after-school detention, or report to a call session on Saturdays." *Id.* Another employee described the environment as a "'cutthroat' environment that caused employees to fear for their job and make 'bad ethical choices.'" Egan, *Wells Fargo Horror Stories*, *supra* note 135.

[137] Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 8, at 4.

[138] *See id.* ¶ 5, at 2 (alleging that the pressures within the culture at Wells Fargo banks led to managers and bankers to engage in "gaming"); McLean, *Cutthroat Corporate Culture*, *supra* note 127, at 5 (quoting a Wells Fargo investigator from 2004) ("Whether real or perceived, team members . . . feel they cannot make sales goals without gaming the system . . . . The incentive to cheat is based on the fear of losing their jobs.").

[139] *See* Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 7, at 3 (explaining the logistics behind three examples of gaming practices: "sandbagging," "bundling," and "pinning").

[140] *See id.* ¶ 29, at 7 (explaining the practice of "bundling" and how it involved lying to customers).

[141] *Id.* Employees also used "bundling" when customers confronted Wells Fargo about accounts that were opened in their name without their consent. *See id.* ¶ 30, at 8 (explaining that employees told customers that the additional accounts were automatically opened with the account or product that they originally purchased). Customers were also advised by employees to destroy the additional cards for the

Moreover, bankers would move money from existing customer accounts into new accounts in order to double the number of accounts opened under one customer's name.[143] Employees opened these new accounts using a practice called "pinning," which involved changing customers' Personal Identification Number (PIN) for their accounts without their knowledge or consent.[144] The opening of these accounts resulted in a significant amount of unjustified fees.[145]

B. Early Red Flags of Fraud

The creation of fake bank accounts and other illegal practices by Wells Fargo bankers and management began, at the latest, in 2002 and continued through at least 2015.[146] Former CEO Stumpf testified that he and the Board were not made aware of the illegal activity by employees until 2013.[147] Nonetheless, according to an investigation by the Office of the Comptroller of the Currency (OCC), the Board received red flags warning of the illegal practices

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fake accounts that they received; however, employees would not close those additional accounts and the credit profiles of customers would remain affected. *Id.* ¶ 31, at 8.

[142] *Id.* ¶ 29, at 7–8. Even though these products could be purchased alone, management told employees to lie to customers in order to convince them to purchase the additional "packed" account. *Id.* ¶ 29, at 7.

[143] Egan, *2 Million Phony Accounts*, *supra* note 1. Other gaming tactics that Wells Fargo engaged in included lying to customers by telling them that they would incur fees on one of their accounts until and unless they opened additional accounts; telling customers that accounts would not incur fees when in fact they would; and targeting individuals who did not have social security numbers because it is easier to open fraudulent accounts without one. Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 36, at 9.

[144] *See* Complaint, *California v. Wells Fargo*, *supra* note 12, ¶ 32, at 8 (alleging that bankers would change customer PINs to "0000," which allowed the banker to enroll the customer in online banking, which counted as a sale). Customers did not become aware of their change in PINs or the fact that they were being enrolled in other bank products because employees created fake email accounts to which information regarding the new accounts was sent. *See id.* (explaining that some fake email addresses included: 1234@wellsfargo.com or noname@wellsfargo.com).

[145] Egan, *2 Million Phony Accounts*, *supra* note 1. Wells Fargo employees created 565,434 such credit card accounts, and a sample of just fourteen thousand of those accounts resulted in over $400,000 in fees. *Id.*

[146] *See* THE CASE FOR HOLDING MEGABANKS ACCOUNTABLE, *supra* note 6, at 6, 8 (reporting that it is estimated that, since 2000, Wells Fargo and its subsidiaries have paid over $11 billion in fines for sales violations, and noting that the company had been fraudulently opening accounts since 2002, or perhaps even earlier); Geoff Colvin, *Inside Wells Fargo's Plan to Fix Its Culture Post-Scandal*, FORTUNE (June 11, 2017), http://fortune.com/2017/06/11/wells-fargo-scandal-culture [https://perma.cc/5GQY-SJKG] (stating that cases of "gaming" activities were reported in 2000 and increased as the years passed, with 1,469 reports in 2013); *supra* note 6 and accompanying text.

[147] Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 16, at 6. Stumpf's testimonies before the Senate Banking Committee and the House Financial Services Committee were inconsistent. *See id.* ¶ 258, at 48, ¶ 260, at 49 (reporting that before the Senate Banking Committee, Stumpf testified that the he and the Board became aware of the sales violations in 2013, but before the House Financial Services Committee, Stumpf said that the Board was made aware as early as 2011).

starting in 2005.[148] The Board failed to address the situation until 2016, when the scandal went public.[149]

The Board received multiple red flags that put them on notice of the illegality occurring within the bank's branches.[150] As early as 2005, the Board received reports informing them of "gaming" and sales violation complaints that were called into the "EthicsLine" by employees.[151] Employees also communicated directly to the Board and to Stumpf to notify them that sales violations were occurring.[152] Stumpf admitted that these reports and communications were coming in between 2011 and 2013; however, evidence suggests that the Board was directly notified years earlier.[153]

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148 *See* OFFICE OF THE COMPTROLLER OF CURRENCY, LESSONS LEARNED REVIEW OF SUPERVISION OF SALES PRACTICES AT WELLS FARGO 5 (2017), https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf [https://perma.cc/9ADR-TQGF] [hereinafter COMPTROLLER REPORT] (finding that the Board had received Audit & Security reports on a regular basis since 2005 informing them that the majority of the calls to the internal "EthicsLine" and employee firings were connected to sales violations). The plaintiff-shareholders alleged in their complaint that the Board repeatedly ignored red flags as early as 2007. Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 16, at 6. They also alleged that the Board encouraged the illegal practices. *See id.* ¶ 2, at 4 (explaining the incentives that the Board had to turn a blind eye to the red flags and to encourage the illegal activity). The Office of the Comptroller of Currency ("OCC") is Wells Fargo's federal regulator. *See Are All Commercial Banks Regulated and Supervised by the Federal Reserve System, or Just Major Commercial Banks?*, FED. RESERVE BANK OF S.F. (Nov. 2006, https://www.frbsf.org/education/publications/doctor-econ/2006/november/commercial-banks-regulation/ [https://perma.cc/GJ4J-8UMK] (stating that national banks are regulated by the OCC).

149 *See* Egan, *Where Was the Board?*, *supra* note 6 (stating that once the public became aware of the fraud that was occurring within the bank, the Board finally acted on the situation).

150 *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 16, at 6 (alleging that directors ignored the multiple red flags that were present); *infra* notes 151–161 and accompanying text.

151 COMPTROLLER REPORT, *supra* note 148, at 5; *see* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶¶ 197–202, at 40–41 (providing examples of employees who called the "EthicsLine" to report illegal sales practices). In their complaint, the shareholders allege that by at least 2008, the bank became aware of and began tracking these complaints. Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 23, at 8. These complaints were red flags that put the Board on notice regarding the illegal activity. *Id.* ¶ 208, at 42. The "EthicsLine" is a hotline that employees could call when they had concerns about ethics or compliance. *Id.* ¶ 151, at 32. The employees could report their concerns to an independent third party, who then reported back to the bank. *Id.* When a complaint is filed, a summary of the complaint is given to the bank's Office of Global Ethics to assess. *Id.* If there is an investigation, the bank's Audit & Examination Committee oversees it. *Id.* ¶ 153, at 33.

152 *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 196, at 40 (stating that in addition to using the "EthicsLine", employees contacted Stumpf directly through email or by letter to alert him to the misconduct). In 2011, former branch manager Rasheeda Kamar emailed Stumpf warning him that employees were opening unauthorized bank accounts. *Id.* ¶ 200, at 40. When asked about this communication during the Senate hearing, he responded that he did not remember. *Id.*

153 *See id.* ¶ 154, at 33 (recounting Stumpf's testimony regarding the calls to the "EthicsLine" and other ethics reports). In 2007, an employee sent letters to both the Board's Audit and Examination Committee and then-CEO Stumpf warning them that the "Gr-Eight Initiative" created a high-stress culture that was causing fraudulent activity. *Id.* ¶ 22, at 7. The letter warned: "Left unchecked, the inevitable outcome shall be one of professional and reputational damage, consumer fraud and shareholder lawsuits, coupled with regulator sanctions." *Id.* Stumpf testified that he was aware of an increase in reports regarding sales-practice violations in 2013. *Id.* ¶ 169, at 35.

Mass employee terminations and subsequent litigation, including wrongful termination suits and whistleblower complaints, were other red flags that shareholders alleged had put the Board on notice as early as 2008.[154] The number of terminations that occurred during the relevant "gaming" time period was colossal and such terminations were left uninvestigated by the Board.[155] By 2010, there were at least seven hundred cases of whistleblower complaints against Wells Fargo.[156] Whistleblower wins for employees are extremely uncommon, yet in early 2017, Wells Fargo admitted that some of the whistleblower claims against it may actually have merit.[157]

The 2013 Los Angeles Times investigation and article exposing the demanding sales quotas and illegal practices was yet another red flag according to shareholders.[158] Stumpf testified that he was aware of the article when it

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[154] *See id.* ¶ 24, at 8, ¶ 246, at 47 (alleging that the termination of 5,300 employees over the span of five years and wrongful termination suits brought as early as 2008 were major red flags that put the Board on notice of illegal activity); Piccini, *supra* note 60, at 2 (stating that whistleblower complaints are red flags that give notice). The shareholder complaint provided examples of employee litigation that was brought against Wells Fargo. Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶¶ 24–26, at 8. In 2008, a former Wells Fargo employee brought a whistleblower case against Wells Fargo and won. *Id.* ¶ 24, at 8. The court found that Wells Fargo violated whistleblower protection laws by firing the employee after he complained about the creation of fake accounts. *Id.* Additionally, in 2009, six former employees sued Wells Fargo for wrongful termination, claiming that they were fired for fraudulent activity that they were instructed by their manager to perform. *Id.* ¶ 25, at 8.

[155] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶¶ 246–147, at 47 (stating that Wells Fargo fired about one thousand employees for violations of sales practices in 2011 and totaled around 5,300 such firings during a five year period); Howell E. Jackson, *One Take on the Report of the Independent Directors of Wells Fargo: Vote the Bums Out*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Apr. 22, 2017), https://corpgov.law.harvard.edu/2017/04/22/one-take-on-the-report-of-the-independent-directors-of-wells-fargo-vote-the-bums-out [https://perma.cc/N9Q4-UUCU] (stating that the Board simply acknowledged the number of terminations and did nothing to investigate why they were happening). The reasons for which Wells Fargo employees were fired were usually inaccurate statements about employees. *See* Matt Egan, *Wells Fargo's Whistleblower Problem Worsens*, CNN MONEY (Apr. 6, 2017), http://money.cnn.com/2017/04/06/investing/wells-fargo-whistleblower-retaliation-osha/index.html [https://perma.cc/JH2H-72QF] [hereinafter Egan, *Wells Fargo's Whistleblower Problem Worsens*] (providing the example of the wrongful termination of Claudia Ponce de Leon, a Wells Fargo general manager, who warned her bosses about the creation of fake bank accounts, called the "EthicsLine," and was subsequently fired because "she drank too much"). Stumpf saw the termination of about 1,000 employees (1% of employees) per year between 2011 and 2016 as good news because it meant that 99% of the employees were not committing fraud. Colvin, *supra* note 146, at 8.

[156] COMPTROLLER REPORT, *supra* note 148, at 5.

[157] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 212, at 42 (acknowledging the difficulty of success under a whistleblower claim and stating that only 2% of these cases rule in favor of the employee); Egan, *Wells Fargo's Whistleblower Problem Worsens*, *supra* note 155 (reporting that current CEO Tim Sloan said: "A few cases out of the hundreds reviewed raised questions, and we are following up on each of them.").

[158] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶¶ 163–170, at 34–35 (alleging that the investigation and article put the Board on notice that fraudulent activity was prevalent within the corporation). *See generally* Reckard, *supra* note 121 (detailing the environment at Wells Fargo and how it led to employees committing fraud to meet demanding sales quotas).

came out and brought it to the attention of the Board, although this resulted in no further investigation by the Board.[159] Lastly, shareholders alleged that Wells Fargo's awareness that its behavior was the subject of federal investigations as far back as 2012 also put the Board on notice of illegality.[160] The complaint argued that, taken together, all of these red flags were enough to put the Board on notice and enough to show that the Board either knew or should have known that employees were engaging in fraudulent activity.[161]

C. The Board's Response to Red Flags

The Board failed to take action despite the presence of these red flags until 2016 when federal regulators announced a large settlement with the bank.[162] The shareholder complaint in the derivative suit pointed out that there were strong incentives for the Board to turn a blind eye to the illegal activity and even encourage it.[163] Cross-selling was fundamental to Wells Fargo's business model, and success in cross-selling was "central to its financial results and market participants' assessment of the company."[164] Financial growth led to an increase in the company's stock price, which resulted in significant increases to executive compensation.[165]

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[159] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 169, at 35 (citing to Well Fargo's written response to the Senate Banking Committee).

[160] *See id.* ¶ 171, at 35 (alleging that investigations by the OCC and FINRA were red flags that put the Board on notice). Wells Fargo was investigated by the OCC, the Consumer Finance Protection Bureau (CFPB) and the Financial Industry Regulatory Authority (FINRA) for misconduct between 2012 and 2014. *Id.* ¶¶ 183–185, at 38. The OCC began receiving complaints from customers about the creation of unauthorized bank accounts in 2012, and in 2014 it launched an investigation. *Id.* ¶ 183, at 38. Additionally, in 2013, the CFPB investigated whistleblower complaints filed against Wells Fargo, and in 2014, FINRA fined the bank for anti-money-laundering failures. *Id.* ¶¶ 184–185, at 38.

[161] *See id.* ¶ 49, at 11–12, ¶ 208, at 42, ¶ 245, at 46 (explaining the red flags and alleging that these red flags showed that defendants either knew or should have known that employees were creating illegal, unauthorized accounts for customers).

[162] THE CASE FOR HOLDING MEGABANKS ACCOUNTABLE, *supra* note 6, at 7–9; *see* Egan, *Where Was the Board?*, *supra* note 6 (stating that once the public became aware of the fraud that was occurring within the bank, the Board finally acted on the situation); *see also* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 16, at 6 (alleging that defendant directors had ignored red flags since 2007). In fact, the Senate Banking Committee's hearing found that the Board failed to implement internal controls or a "meaningful reporting system to adequately address significant and pervasive illegal practices." Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 15, at 6. Additionally, the hearing found that the illegal practices continued because the Board ignored them. *Id.*

[163] *See* Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 2, at 4 (pointing out that Wells Fargo's goal in stressing a demanding cross-selling strategy was "to show steady quarterly growth in the opening of customer accounts, maintain the Company's industry leadership in cross-selling, and most importantly, drive up the Bank's share price").

[164] *Id.* ¶ 2, at 4; *see* WELLS FARGO & COMPANY ANNUAL REPORT 2014, *supra* note 121, at 126 (stating that cross-selling is the "key to [Wells Fargo's] ability to grow revenue and earnings").

[165] Complaint, *In re Wells Fargo & Co.*, *supra* note 1, ¶ 2, at 4. Increases in the bank's stock price were caused by defendants falsifying or producing misleading statements regarding cross-selling. *Id.* ¶ 382, at 85. Defendants sold over $629 million of Wells Fargo stock at the artificially inflated price.

With the public announcement of the scandal, Stumpf resigned due to the allegations made against the bank.[166] Although Stumpf did not receive a severance package upon resignation and agreed to return $41 million from his compensation, it is reported that he still walked away with a pay package of about $133.1 million.[167] Timothy Sloan replaced Stumpf as CEO despite admitting that he became aware of the scandal in 2013.[168] Top executive Carrie Tolstedt also retired, returning $19 million yet walking away with $125 million.[169] In

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Id. Before stepping down from his position, Stumpf was the highest paid CEO in the banking industry. *Id.* ¶ 2, at 4. He received "tens of millions of dollars in salary and equity compensation every year." *Id.*

[166] Richard Gonzales, *Wells Fargo CEO John Stumpf Resigns Amid Scandal*, NPR (Oct. 12, 2016), https://www.npr.org/sections/thetwo-way/2016/10/12/497729371/wells-fargo-ceo-john-stumpf-resigns-amid-scandal [https://perma.cc/UC8V-HRCM]. Prior to resigning, Stumpf was questioned by Senator Elizabeth Warren at the Senate committee hearing. Berkeley Lovelace Jr. & Antonio Jose Vielma, *Sen. Elizabeth Warren on Wells Fargo CEO Stumpf: 'Gutless leadership,'* CNBC (Sept. 20, 2016), https://www.cnbc.com/2016/09/20/senator-warren-on-wells-fargo-ceo-gutless-leadership.html [https://perma.cc/B49A-F7M9]. Warren asked Stumpf why he had not resigned as CEO, returned any personal earnings he made while the scandal was going on, or fired any senior executives in light of the scandal. *Id.* Stumpf blamed lower level employees instead of placing the blame on those in charge or on the demanding cross-selling sales strategy. *Id.*; *see* Lucinda Shen, *Here's How Much Wells Fargo CEO John Stumpf Is Getting to Leave the Bank*, FORTUNE (Oct. 13, 2016), http://fortune.com/2016/10/13/wells-fargo-ceo-john-stumpfs-career-ends-with-133-million-payday [https://perma.cc/7753-XNAV] (reporting that Stumpf had denied that the culture and environment at the bank lead to the misconduct by employees and that he blamed the lower level employees). Stumpf told Congress that the scandal was not as severe as they perceived it to be. Shen, *supra*.

[167] Shen, *supra* note 166; *see* Jim Puzzanghera, *What Did Wells Fargo's New CEO Know About the Scandal? Senators Push for Answers*, L.A. TIMES (Oct. 20, 2016), http://www.latimes.com/business/la-fi-wells-fargo-elizabeth-warren-20161020-snap-story.html [https://perma.cc/C2DD-5QKN] (explaining that Stumpf will retire with more than $100 million in vested stock plus pension and 401(k) benefits over $24 million). A severance package is a compensation package offered to employees after their employment contract ends. *Severance Package*, BLACK'S LAW DICTIONARY (10th ed. 2014). The $41 million that Stumpf returned came from unvested stock awards. Puzzanghera, *supra*. Unvested stock is stock set aside by the company but not yet owed by the person receiving the stock until certain agreed upon conditions are met. Hunkar Ozyasar, *What Is an Unvested Stock?*, THE NEST, https://budgeting.thenest.com/unvested-stock-31525.html [https://perma.cc/V2KK-4YZ9]. Vested stock refers to shares that now are owned by the receiver and come with the right vote, sell and transfer. *Id.*

[168] Gonzales, *supra* note 166; *see* Puzzanghera, *supra* note 167 (stating that Sloan admitted to knowledge of the scandal as far back as 2013). Prior to replacing Stumpf as CEO, Sloan served as Wells Fargo's President and Chief Operating Officer (COO). Gonzales, *supra* note 166.

[169] Wilfred Frost & Dawn Giel, *Wells Fargo Board Slams Former CEO Stumpf and Tolstedt, Claws Back $75 Million*, CNBC (Apr. 10, 2017), https://www.cnbc.com/2017/04/10/wells-fargo-board-slams-stumpf-and-tolstedt-claws-back-millions.html [https://perma.cc/G5Y4-ATYL]; Renae Merle, *Wells Fargo Fired 5,300 Workers for Improper Sales Push. The Executive in Charge Is Retiring With $125 Million*, WASH. POST (Sept. 13, 2006), https://www.washingtonpost.com/news/wonk/wp/2016/09/13/wells-fargo-fired-5300-workers-for-illegal-sales-push-executive-in-charge-retiring-with-125-million [https://perma.cc/7L3C-BWYJ]. Tolstedt oversaw the community-banking division, which was subject to demanding sales quotas and goals. Merle, *supra*. Her retirement package included shares of Wells Fargo stock, options, and restricted shares. *Id.* Restricted shares are similar to unvested shares. *See What Are Restricted Shares?*, INVESTOPEDIA, https://www.investopedia.

2017, the Board "clawed back" an additional $28 million from Stumpf and an additional $47.3 million from Tolstedt.[170]

In late 2016 and early 2017, the Board conducted an investigation of all the allegations and events that occurred between 2011 and 2016 and compiled a report on its findings.[171] Although the report admitted that the Board should have acted earlier, this company-led investigative report was not particularly critical of the Board.[172] Rather, the report blamed the fraud and illegal activity on lower management and the decentralized system of governance within Wells Fargo.[173] On January 1, 2017, in the middle of the investigation and barely four months before the release of the report, Sloan finally changed the compensation system to focus on customer satisfaction and achievement of team goals, rather than product sales.[174] He also addressed the bank's structure by fully centralizing the risk and human resources functions.[175] Despite the

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com/ask/answers/061515/what-are-restricted-shares.asp [https://perma.cc/6USV-SU5D] (defining restricted shares as those that are not fully transferable until certain agreed upon conditions are met).

[170] Frost & Giel, *supra* note 169. Between 2011 and 2016, Stumpf made $286 million. *Id.* Stumpf surrendered only 24% of his salary due to the scandal. *Id.*

[171] *See generally* BOARD INVESTIGATION REPORT, *supra* note 5. The Board created an "oversight committee" to oversee the investigation. *Id.*; Guy Rolnick, *Wells Fargo and the Failure of Boards and Regulators*, PRO-MARKET (Apr. 25, 2017), https://promarket.org/wells-fargo-failure-boards-regulators [https://perma.cc/D59R-ZJXD]. This committee was made up of the four independent board members. Rolnick, *supra*. The committee hired Shearman & Sterling LLP to conduct the investigation. BOARD INVESTIGATION REPORT, *supra* note 5, at 2.

[172] *See* BOARD INVESTIGATION REPORT, *supra* note 5, at 16–17 (finding that the Board should have "moved toward the centralization of the risk function earlier than it did" and that Stumpf should have fired Tolstedt much earlier); *see also* Jackson, *supra* note 155, at 1 (stating that the report recognized the serious misconduct, but only discussed conduct by Stumpf and Tolstedt, who had already retired); Rolnick, *supra* note 171 (acknowledging that the report "largely exonerated" the Board members and placed blame on the management for failing to report the misconduct right away).

[173] *See* BOARD INVESTIGATION REPORT, *supra* note 5, at 4 (finding that the decentralized business model vested too much power in senior management, who ignored the illegal activity that was occurring, which led to the Board missing the red flags); *see also* Jackson, *supra* note 155, at 2 (recounting that the report placed the blame for the scandal on "delegation of too much managerial responsibility to operating units like Tolstedt's Community Bank"). The decentralized system at Wells Fargo meant that significant responsibility and oversight powers were pushed down to operating units. Jackson, *supra* note 155, at 2. The report explained that this allowed those in charge, like Tolstedt to prevent internal reports of issues from going up to the Board. *Id.* Still, scholars like Howell E. Jackson question why the Board did not investigate the risk that the decentralized system imposed on the company. *Id.*

[174] BOARD INVESTIGATION REPORT, *supra* note 5, at 2 (noting that the investigative committee was created in late September of 2016, and showing the date of the report as April 10, 2017); Colvin, *supra* note 146, at 9. Employees will no longer be evaluated on how many products they sell to the customers and this information will no longer be reported to shareholders. Colvin, *supra* note 146, at 9–10.

[175] Colvin, *supra* note 146, at 10. The leaders of these units will now report to the corporate chiefs. *Id.* Sloan "consolidated much of the vast risk-control bureaucracy into a new office of ethics, oversight, and integrity, accountable to the Board's risk committee." *Id.*

scandal, in April of 2017, the same month as the report's publication, Wells Fargo shareholders voted to re-elect all fifteen board members.[176]

IV. WELLS FARGO AND OVERSIGHT LIABILITY MOVING FORWARD

The director defendants of *In re Wells Fargo & Company Shareholder Derivative Litigation* filed a motion to dismiss the shareholder complaint for failing to plead demand futility.[177] On May 4, 2017, the court denied the defendants' motion to dismiss with respect to the majority of the claims, including the breach of fiduciary duties claim.[178] The court focused on the collective presence of seven specific red flags and held that "they support[ed] an inference that a majority of director defendants consciously disregarded their fiduciary duties despite knowledge regarding widespread illegal account-creation

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[176] BOARD INVESTIGATION REPORT, *supra* note 5, at 2; Stacy Cowley, *Wells Fargo Shareholders Tepidly Re-elect Bank's Directors*, N.Y. TIMES: DEALBOOK (Apr. 25, 2016), https://www.nytimes.com/2017/04/25/business/dealbook/wells-fargo-board.html [https://perma.cc/T6YL-JQQC] [hereinafter Cowley, *Shareholders Tepidly Re-elect*]. Some shareholders had the intention of removing at least some of the board members, but each board member had support from at least 53% of the shareholders, allowing re-election. Cowley, *Shareholders Tepidly Re-elect*, *supra*. In June of 2017, Senator Elizabeth Warren wrote a letter to Janet Yellen, Chair of the Board of Governors of the Federal Reserve System, asking the Federal Reserve to remove twelve Wells Fargo board members who served on the bank's Board during the scandal. Letter from Senator Elizabeth Warren to Janet Yellen, Chair, Fed. Reserve Bd. of Governors (June 19, 2017), https://www.warren.senate.gov/files/documents/2017-6-19_Warren_Ltr_to_Fed.pdf [https://perma.cc/4V8T-XRZ2]. In 2018, the Federal Reserve took action and ordered Wells Fargo not to grow its assets beyond their current value ($1.95 trillion) and to replace four members of the Board. Mark Calvey & Riley McDermid, *Wells Fargo Shares Plunge as Bank Hit by Fed with Growth Limit, Plans Removal of Four Directors*, S.F. BUS. TIMES (Feb. 12, 2018), https://www.bizjournals.com/sanfrancisco/news/2018/02/02/wells-fargo-bank-federal-reserve-scandal-wfc.html [https://perma.cc/TTS9-HQMF]. Wells Fargo predicted that this halt on financial growth would cost the bank about $400 million in profits. *Id.* In a statement, Janet Yellen said: "We cannot tolerate pervasive and persistent misconduct at any bank and the consumers harmed by Wells Fargo requires the firm to improve its governance and risk management processes, including strengthening the effectiveness of oversight by its board of directors." *Id.*

[177] *See generally* Wells Fargo & Co.'s Notice of Motion and Motion to Dismiss, *In re Wells Fargo & Co.*, 282 F. Supp. 3d 1074 (N.D. Cal. 2017) (No. 3:16-cv-05541). The motion to dismiss was first filed by nominal defendant Wells Fargo, and the director defendants joined in the motion thereafter. *In re* Wells Fargo & Co. S'holder Derivative Litig., 282 F. Supp. 3d 1074, 1081 n.1 (N.D. Cal. 2017). In order to be successful, plaintiffs must have proved that defendants had knowledge of illegal activity or that they were consciously disregarding their fiduciary duties, due to the exculpatory provision included in Wells Fargo's certificate of incorporation. *Id.* at 1107.

[178] *See In re Wells Fargo & Co.*, 282 F. Supp. 3d at 1088 (denying defendants' motion to dismiss because plaintiffs' allegations created a substantial likelihood that defendants consciously disregarded their fiduciary duties and will be liable for breach of those duties). The court granted the motion to dismiss for the claim brought under section 25403 of the California Corporations Code, because the section does not provide a private right of action. *Id.* This decision would have allowed the case to progress and given plaintiffs the opportunity to prove their claims; however, a $240 million settlement was reached in February of 2019. Morgenson, *supra* note 17; Jonathan Stempel & Dena Aubin, *Wells Fargo Officials Enter $240 Million Settlement Over Bogus Accounts*, REUTERS (Mar. 1, 2019, 8:54 AM), https://www.reuters.com/article/us-wells-fargo-settlement/wells-fargo-officials-enter-240-million-settlement-over-bogus-accounts-idUSKCN1QI4P3 [https://perma.cc/C7JE-MLKC].

activities, and therefore, that there is a substantial likelihood of director oversight liability," satisfying the *Caremark* standard.[179] This ruling sends a strong message to directors, that where they fail to act in the presence of knowledge of misconduct, the court might not rule in their favor, at least not at the motion to dismiss stage of the litigation.[180]

It is rare for the courts to find director liability or likelihood of director liability, and when they do, it is usually for cases that involve extraordinary circumstances.[181] As demonstrated by the Wells Fargo scandal, directors need to experience consequences for their mistakes to deter future misconduct.[182] Although the Board took some action in 2016 to address the issue and regulators imposed some consequences on Wells Fargo, these responses appear inade-

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[179] *In re Wells Fargo & Co.*, 282 F. Supp. 3d at 1088; *see* Karp, *supra* note 18 (explaining the court's standard for oversight liability and its conclusion that the plaintiffs' claims survived under the *Caremark* standard). The court specified the following seven red flags: (1) Stumpf's testimony regarding when he knew about the misconduct; (2) reports and other communications from employees to the Board alerting them about the misconduct; (3) various litigation against the company (4) the Los Angeles Times article exposing Wells Fargo's fraud; (5) other interventions by federal regulators; (6) the increase in employee terminations that occurred to silence the whistleblowers; and (7) the emphasis that Wells Fargo put on cross-selling and its importance to their financial reports. *In re Wells Fargo & Co.*, 282 F. Supp. 3d at 1088. The court focused on the number of red flags and extent that they were directly communicated to the Board. Karp, *supra* note 18. The court acknowledged that standing alone, any one of these red flags may be insignificant, because of the large size of Wells Fargo. *In re Wells Fargo & Co.*, 282 F. Supp. 3d at 1088. The court, however, looked at the facts collectively and not individually, and it concluded that the record supported the inference that defendant directors "consciously disregarded" their fiduciary duties while having knowledge of misconduct. *Id.*

[180] *See* Karp, *supra* note 18 (arguing that a court might not favor directors and rule that the directors "consciously disregarded" their duties when they fail to act in the presence of knowledge of misconduct within the corporation). Securities-law expert Lewis D. Lowenfels commented on this court's denial of the defendants' motion to dismiss:

> [This ruling] is a reminder that you can't just be a passive figurehead on a board and keep your fingers crossed that nothing will go wrong . . . . You have to be actively involved and cognizant of what's going on with respect to the company, or you could very well face liabilities.

See Morgenson, *supra* note 17 (quoting Lewis D. Lowenfels).

[181] Karp, *supra* note 18; *see In re* Lear Corp. S'holder Litig., 967 A.2d 640, 653 (Del. Ch. 2008) (stating that the Delaware Supreme Court has established that liability will be imposed only where there is a "strong showing of misconduct"); Nees, *supra* note 31, at 215–16 (explaining that oversight liability is rarely a threat to directors unless there is a clear violation of a law); Velasco, *supra* note 18, at 166–67 (acknowledging that liability will only be imposed for "more egregious breaches"). The fact that the court in *In re Wells Fargo & Co.* denied the motion to dismiss does not mean that future courts will do the same. Karp, *supra* note 18. It is possible that the allegations against Wells Fargo are so unique that the decision might be limited only to its uncommon set of facts. *Id.*

[182] *See* Egan, *Where Was the Board?*, *supra* note 6 (quoting New York City Comptroller Scott Stringer who said: "This scandal was the result of a serious oversight failure by Wells Fargo's board, and the directors responsible need to be held accountable"); *see also* Mark Thoma, *Explainer: "What Is Moral Hazard"?*, CBS NEWS (Nov. 22, 2013), https://www.cbsnews.com/news/explainer-moral-hazard [https://perma.cc/8XA5-PYKB] (arguing that, in order to decrease risk-taking and misconduct by directors, they need to be held liable and responsible for their actions).

quate to deter this kind of wrongdoing in the future because directors and officers were not sufficiently punished.[183] The actions that the Board took were inadequate, even hollow, and the actions taken by regulators were severely criticized as insufficient, and there therefore needs to be more enforcement on the judicial end in order to deter misconduct.[184]

The court's rare decision in *In re Wells Fargo & Co. Shareholder Derivative Litigation* at the motion to dismiss stage is a step in the right direction in order to deter director failure of oversight, however plaintiffs must still carry a significant burden to prove their claims.[185] Moreover, it is likely parties to such litigation will settle before trial, as has occurred in the Wells Fargo case, and settlement amounts are typically covered by director and officer ("D&O") insurance.[186] Because of significant director protections, the application of the

[183] *See* Michael Hiltzik, *The Wells Fargo Board Is Still Getting a Pass for Failure*, L.A. TIMES (Feb. 6, 2018), http://www.latimes.com/business/hiltzik/la-fi-hiltzik-wells-fargo-20180206-story.html [https://perma.cc/9SML-LEHQ] (reporting that the former Secretary of the Department of the Treasury, Lawrence Summers, believes that the Wells Fargo board of directors are "getting off too easy" for their role in the scandal); Thoma, *supra* note 182 (explaining that minimizing protections against liability and accountability will incentivize directors and other decision makers to decrease risk-taking and wrongdoing).

[184] *See* COMPTROLLER REPORT, *supra* note 148, at 4 (finding that the OCC failed to act in a timely and effective manner after receiving complaints regarding sales practice violations); Hiltzik, *supra* note 183 (asking why only four directors are being fired, and why Sloan, who had management responsibilities during the scandal, is not being fired as well); Lawrence H. Summers, *Lawrence Summers: Wells Fargo's Board Members Are Getting off Too Easy*, WASH. POST (Feb. 6, 2018), https://www.washingtonpost.com/news/wonk/wp/2018/02/06/lawrence-summers-wells-fargos-board-members-are-getting-off-too-easy [https://perma.cc/53FV-HFPS] (asking why the four directors who are being fired are not being named, and why they are not being "asked to resign effective immediately with an element of humiliation"); Kurt Walters, *Regulators Must Finish the Job of Penalizing Wells Fargo*, AM. BANKER (Nov. 22, 2017), https://www.americanbanker.com/opinion/regulators-must-finish-the-job-of-penalizing-wells-fargo [https://perma.cc/C3DK-ZBLR] (pointing out that the Federal Deposit Insurance Corporation (FDIC) has not begun to investigate whether Wells Fargo deserves to keep its federal-deposit-insurance privilege even though the OCC found that it engaged in "unsafe and unsound practices"). The Board's actions in response to the scandal appeared forced and mechanical, and the consequences appeared to be more of a simple slap on the wrist than serious punishment. *See* Cowley, *Shareholders Tepidly Re-elect*, *supra* note 176 (reporting that despite the scandal, all fifteen board members were re-elected by shareholders); Puzzanghera, *supra* note 167 (reporting that Sloan was appointed as CEO even though he admitted to being aware of the creation of illegal bank accounts as early as 2013); Rolnick, *supra* note 171 (acknowledging that the Board's investigation report placed little, if any, blame on the directors for the scandal); Shen, *supra* note 166 (reporting that Stumpf will retire with a significant amount of money, even after the claw backs).

[185] *See* Nees, *supra* note 31, at 215 (arguing that the prevalence of the exculpatory provision, the courts' interpretations of the oversight liability doctrine and good faith, and the prominent presence of the business judgment rule present obstacles to plaintiff success in bringing oversight liability claims); Morgenson, *supra* note 17 (stating that the court's unusual decision in *In re Wells Fargo & Co. Shareholder Derivative Litigation* will hopefully send a clear message to directors that they must perform adequate oversight to avoid liability).

[186] *See* ALLEN & KRAAKMAN, *supra* note 8, at 421–22 (explaining the incentives that both parties have to settle and the high likelihood of D&O insurance coverage on any possible settlement or litiga-

oversight liability doctrine should be expanded in order to deny more motions to dismiss and send a message that courts will not tolerate director misconduct any longer.[187] Section A analyzes the importance of finding director liability and deterring future misconduct.[188] Section B provides possible ways for courts to expand the oversight liability doctrine.[189]

A. The Importance of Expanding the Application of Oversight Liability to Deter Future Misconduct

Narrow judicial application of oversight liability only provides directors with another shield against personal liability, on top of exculpatory provisions, the business judgment rule, indemnification, and D&O insurance.[190] Such protections create moral hazard and the possibility of problematic excessive risk-taking.[191] These concerns are heightened when the corporation is a financial institution with additional government protections, such as Wells Fargo.[192] The risk of failing to monitor internal controls or business risks of a financial insti-

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tion expenses); Stempel & Aubin, *supra* note 178 (reporting the $240 million settlement of the Wells Fargo litigation in February of 2019).

[187] *See* Nees, *supra* note 31, at 215–16 (arguing that the current judicial approach to oversight liability is a "toothless tiger" and poses no threat to directors, warranting change); Karp, *supra* note 18 (stating that denials of motions to dismiss in oversight liability claims threaten and remind directors that where they consciously disregard their duties, the court might not grant the motion).

[188] *See infra* notes 190–199 and accompanying text.

[189] *See infra* notes 200–217 and accompanying text.

[190] *See* Nees, *supra* note 31, at 215–16 (arguing that the narrow interpretation of the oversight liability doctrine that is currently used poses minimal threat of director liability).

[191] *See* Steven L. Schwarcz, *Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility*, 102 MINN. L. REV. 761, 761 (2017) (defining the moral-hazard problem: when people are protected from liability or other negative consequences of their decisions they are inclined to take more risks, which could lead to excessive risk-taking); Thoma, *supra* note 182 (describing how protections against losses alter an individual's behavior). It is important to note that shareholders want directors to take certain amounts of risks, because that is how they produce returns. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009).

[192] *See* Schwarcz, *supra* note 191, at 761–62 (stating that excessive risk-taking by financial institutions was allegedly the cause of the 2008 Financial Crisis and continues to be a threat to our economy); *Who Is the FDIC?*, FDIC, https://www.fdic.gov/about/learn/symbol [https://perma.cc/22QW-7N7J] (explaining that the FDIC insures bank and thrift deposits of up to $250,000 per person, per account in case the bank fails and cannot meet deposit withdrawal demands). Certain financial institutions are "too big to fail," and will be subject to government bailouts in order to save the rest of the economy. Thoma, *supra* note 182. The government bears the loss of the mistakes of the financial institutions. *Id.* The government is willing to bail out "too big to fail" financial institutions because of systemic risk. James Bullard et al., *Systemic Risk and the Financial Crisis: A Primer*, FED. RES. BANK ST. LOUIS REV., Sept./Oct. 2009, 403, 403, https://files.stlouisfed.org/files/htdocs/publications/review/09/09/part1/Bullard.pdf [https://perma.cc/CKJ5-YR5Z]. This protection incentivizes them to make riskier decisions and investments, which increases the chances of a bail out. Thoma, *supra* note 182.

tution is especially dangerous because of the significant effect that failure of these institutions can have on the economy.[193]

Systemic risk is the threat that failure of one institution will create a domino effect, causing financial distress within other institutions and jeopardizing the entire financial system.[194] Failure of one financial institution significantly increases this risk.[195] Corporate governance scandals, especially at the third largest financial institution in the United States, thus threaten the entire economy because of the financial distress caused by the scandals.[196] Wells Fargo is a "too big to fail" bank that is incentivized to engage in increased risk-taking, and if it fails, it has the potential to cause another economic crisis.[197] Because of the potential detrimental effects of these corporate scandals, courts should

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[193] *See* Petrin, *supra* note 16, at 455–56 (explaining that due to current judicial interpretation, directors have a decreased incentive to properly exercise their oversight duty because only a "complete" failure of oversight will result in liability); Robert Lenzner, *The Ten Reasons Why There Will Be Another Systemic Financial Crisis*, FORBES (Dec. 8, 2014), https://www.forbes.com/sites/robertlenzner/2014/12/08/the-ten-reasons-why-there-will-be-another-systemic-financial-crisis [https://perma.cc/V2BS-TJ36] (opining that the next financial crisis will likely involve banks that are "too big to fail").

[194] *See Systemic Risk*, INVESTOPEDIA, https://www.investopedia.com/terms/s/systemic-risk.asp [https://perma.cc/7HQF-49HT] (defining systemic risk as the threat than an event can trigger the downfall of the United States' economy).

[195] *See* Bullard et al., *supra* note 192, at 404 (arguing that it only takes the failure of one financial institution to threaten the entire financial system). There are three reasons why the failure of one financial institution increases systemic risk. *Id.* at 408–09. First of all, the financial system is interconnected. *Id.* at 408; *see* Lenzner, *supra* note 193 (describing the financial system as a "fragile and complex network of financial relationships that has built into it a tendency for periodic disturbances that can produce 'huge unanticipated changes,' which at times spin out of control into a catastrophe as took place in 2008"). Both commercial and investment banks lend and trade to each other. Bullard et al., *supra* note 192, at 408. Second, financial institutions are highly leveraged, meaning that a significant amount of their assets come from issuing debt rather than selling equity in the corporation. *Id.* at 409. Third, the nature of the banking and financial business requires institutions to hold illiquid long-term assets and liquid short-term debt. *Id.* This makes these institutions subject to bank runs, which occur when depositors "run" to the bank to withdraw their money in response to uncertainty. *See id.* (describing the effects of depositors suddenly withdrawing their money from the banks). These runs threaten to cause the insolvency of the financial institution and increases systemic risk. *See id.* (stating that mass deposit withdrawals threaten the liquidity of the institution).

[196] *See* Ely Razin, *What Effect Will the Wells Fargo Fake Accounts Have on the Bank's Commercial Lending?*, FORBES (Oct. 27, 2016), https://www.forbes.com/sites/elyrazin/2016/10/27/what-effect-will-the-wells-fargo-fake-accounts-scandal-have-on-the-banks-commercial-lending [https://perma.cc/R64H-2C6W] (estimating that Wells Fargo could lose about $99 billion in deposits and $4 billion in revenue after the scandal). Scandals such as this one cause customers to lose faith in their bank, leading to them pulling their deposits to ensure the safety of their money. *See id.* (citing a study that found that 14% of Wells Fargo customers have already decided to change banks and 30% are "actively exploring" other banks to switch to).

[197] Joyce, *supra* note 1; *see* Schwarcz, *supra* note 191, at 761–62 (stating that "excessive risk-taking . . . is regarded as a continuing threat that can misallocate resources, increase public costs by necessitating government bailouts, and even cause other economic collapse"); Lenzner, *supra* note 193 (predicting that the next economic crisis will involve banks that are "too big to fail"); Thoma, *supra* note 182 (explaining that "too big to fail" institutions will likely receive government bail outs in case of failure, which increases moral hazard and incentives to take risks, threatening the economy).

be more lenient with their application of the oversight liability doctrine, at least at the motion to dismiss stage, to increase the chance of director liability and minimize excessive risk-taking.[198] Within both financial and non-financial institutions, an increase in the ability to find liability for failure to oversee internal controls or business risk can act as a check on the moral hazard created by all of these protections.[199]

B. Reforms to Oversight Liability Doctrine

The application of oversight liability could be expanded in a few ways to allow more cases to progress beyond the motion to dismiss stage of litigation and achieve a higher probability of imposing liability.[200] First, plaintiffs should be allowed to plead breach of the duty of care in order to overcome the business judgment rule at the procedural motion to dismiss stage, regardless of whether defendants have the protections of an exculpatory clause as permitted by DGCL section 102(b)(7).[201] Continuing to apply exculpatory clauses at such early stages of litigation eliminates an avenue for plaintiffs to show director liability.[202] If allowed to argue the easier standard of breach of duty of care at the motion to dismiss stage, plaintiffs would have a better chance of advanc-

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[198] *See* Thoma, *supra* note 182 (stating that the way to decrease moral hazard is to hold decision makers responsible for their actions or inactions and to make them suffer the consequences of their decisions). With all the protections in place for directors and officers, there are minimal incentives to be cautious with investment and really oversee risk. *See id.* (stating that government bail outs do not incentivize a decrease in excessive risk-taking).

[199] *See id.* (acknowledging that making directors deal with the consequences of their decisions will minimize the moral hazard created by multiple protections against liability).

[200] *See infra* notes 201–217 and accompanying text.

[201] *See* Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007) (explaining that *Stone* reinforced the knowledge requirement and its application to oversight claims, and by doing this, the court ensured protection of the exculpatory provision for breach of the duty of care even at the motion to dismiss stage of litigation); *see, e.g.*, *In re Lear Corp.*, 967 A.2d at 647–48 (providing an example where plaintiffs could not argue breach of the duty of care at the motion to dismiss stage in order to overcome the business judgment presumption because of the presence of an exculpatory provision); *see also* Nees, *supra* note 31, at 225, 228 (explaining that the procedural timing of the business judgment rule at the motion-to-dismiss stage requires plaintiffs to plead specific facts, which is extremely difficult to accomplish due to the unavailability of extensive fact finding at that stage in the litigation).

[202] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2018) (allowing corporations to write exculpatory provisions in their certificates of incorporation, eliminating liability for breach of the duty of care); *Desimone*, 924 A.2d at 908, 935 (clarifying that exculpatory provisions protect directors at the motion to dismiss stage of the litigation); *see also* Wood v. Baum, 953 A.2d 136, 141 (Del. 2008) (stating that when directors are exculpated from liability for certain conduct, liability is only a significant threat if plaintiffs plead a claim that is not exculpated in the certificate of incorporation) (quoting Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch. 2003)); Nees, *supra* note 31, at 219 (explaining that this exculpatory provision eliminates liability for gross negligence and leaves the plaintiff to rely on showing breach of the duty of loyalty or good faith); *see, e.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 239 (Del. 2009) (forcing plaintiffs to solely plead breach of the duty of loyalty due to the bar on breach of the duty of care claims created by the exculpatory provision in the company's certificate of incorporation).

ing through this stage and would have more time and resources to gather all facts needed in order to prove breach of loyalty and good faith when the court hears the case on the merits.[203] An alternative suggestion would be to prohibit defendants from filing a motion to dismiss until after discovery and adequate fact-finding, to allow plaintiffs to gather sufficient facts to effectively prove their claim.[204]

Second, the oversight doctrine could be expanded by widening the criteria to find "bad faith" stated in *Lyondell Chemical Co. v. Ryan*, which allow a finding of bad faith only if directors have knowledge of their required duties and completely fail to execute them.[205] Under the current interpretation, minimal effort by directors to fulfill duties will satisfy the standard of good faith because such effort does not constitute complete failure.[206] The requirement of complete failure could be widened to significant, considerable, or notable failure.[207]

Another possible expansion of oversight liability would be to separate breach of the duty of loyalty from the requirement for bad faith.[208] For corporations that have eliminated liability for breach of the duty of care in their certificate of incorporation, the current application disallows a finding of liability without a finding of bad faith.[209] Separation would facilitate the finding of lia-

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[203] *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996) (acknowledging that the available claim, breach of the duty of loyalty, is a high standard to meet); Nees, *supra* note 31, at 228 (explaining that the business judgment standard may lead to dismissal of the case before plaintiffs access necessary discovery to prove a breach of the duty of loyalty); *see also In re Citigroup*, 964 A.2d at 125 (admitting that the burden on the plaintiff to prove bad faith is greater than the burden to prove gross negligence).

[204] *See* Nees, *supra* note 31, at 228 (explaining how the business judgment rule at the motion-to-dismiss stage requires plaintiffs to plead specific facts, but noting that pleading specific facts to show breach of the duty of loyalty is extremely difficult without extensive fact-finding, which is available in discovery); *see, e.g.*, *In re Lear Corp.*, 967 A.2d at 647–48 (holding that plaintiffs did not plead sufficient specific facts to prove that defendants breached their duty of loyalty and dismissing the claim).

[205] 970 A.2d at 243–44.

[206] *See* Petrin, *supra* note 16, at 455–56 (interpreting *Lyondell Chemical* and acknowledging that any reasonable effort, even a minimal one, to oversee would be enough to satisfy the director's obligations under the fiduciary duties).

[207] *See Lyondell Chem.*, 970 A.2d at 243–44 (concluding that liability could only be imposed where directors "knowingly and completely failed" in carrying out their duties, which had not occurred in that case).

[208] *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (establishing that good faith is a subset of the duty of loyalty and that breach of good faith alone cannot result in liability directly, only indirectly); Nees, *supra* note 31, at 224 (arguing that the collapse of the duty of good faith into the duty of loyalty narrows the ability for plaintiffs to prove liability and makes oversight liability a "toothless tiger").

[209] DEL. CODE ANN. tit. 8, § 102(b)(7); *see Wood*, 953 A.2d at 141 (stating that when directors are exculpated from liability for certain conduct, liability is only possible if the plaintiffs plead a claim that is not or cannot be exculpated in the certificate of incorporation, such as breach of the duty of loyalty); *Stone*, 911 A.2d at 369–70 (confirming the *Caremark* standard that finding breach of the duty of good faith is a requirement for imposing liability for breach of the duty of loyalty); *In re Caremark*, 698 A.2d at 971 (establishing that a finding of bad faith is required to find directors liable under a *Caremark* claim).

bility under breach of the duty of loyalty by eliminating the requirement to show knowledge of and conscious disregard of duties, as is necessary to show bad faith.[210] Additionally, separation would add another avenue for bringing a claim by re-establishing good faith as an independent duty.[211]

Expanding application of *Caremark* oversight claims to encompass failures to evaluate business risk is another way to discourage director misconduct by expanding liability.[212] The Delaware court rejected such an expansion in *In re Citigroup Inc. Shareholder Derivative Litigation*, relying on the policy of preventing the courts from second-guessing director decisions.[213] Applying oversight liability to the evaluation of business risk would make directors more cautious in their investments and decisions in order to avoid significant losses to the corporation.[214]

Lastly, in cases where there is no exculpatory provision and oversight liability is able to be brought under breach of the duty of care, a way to expand the application of liability would be to close the gap between the standard of conduct and the standard of review.[215] The standard of review should be low-

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[210] *See Stone*, 911 A.2d at 370 (explaining that failure to act in good faith, a condition of finding liability under breach of the duty of loyalty, is proven by showing that directors consciously disregarded their responsibilities and that they had knowledge that they were disregarding their duties); *see also In re Citigroup*, 964 A.2d at 125 (acknowledging that proving bad faith places a very high burden on the plaintiff).

[211] *See Stone*, 911 A.2d at 370 (establishing that the duty of good faith is not an independent duty and can only lead to liability indirectly).

[212] *See In re Citigroup*, 964 A.2d at 125, 140 (affirming that the business judgment rule, DGCL section 102(b)(7), and the difficulty of being successful on a *Caremark* claim work together to place an "extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk," and dismissing the *Caremark* claim that was brought for failure to oversee business risk); *see also* Thoma, *supra* note 182 (explaining that one way to decrease excessive risk-taking is to hold the risk takers liable and responsible for the consequences of their investments).

[213] *In re Citigroup*, 964 A.2d at 126, 131 (concluding that allowing oversight liability for failure to monitor and evaluate excessive risk would allow the courts to make a "hindsight evaluation" of the decisions directors make, contradictory to the business judgment rule and "bedrock principles of Delaware fiduciary duty law").

[214] *See* Thoma, *supra* note 182 (explaining that one way to decrease excessive risk-taking is to hold the risk takers liable for the consequences of their investments); *see also In re Citigroup*, 964 A.2d at 126 (stating that the court did not want to "cripple [director's] ability to earn returns for investors by taking business risks"); Schwarcz, *supra* note 191 (stating that protections from liability create moral hazard).

[215] *See* Velasco, *supra* note 18, at 167 (explaining that the standard of conduct that directors are held to is ordinary care and negligence while the standard of review is gross negligence); *see also* Okla. Firefighters Pension & Ret. Sys. v. Corbat, No. CV 12151-VCG, 2017 WL 6452240, at *2 (Del. Ch. Dec. 18, 2017) (clarifying that, absent an exculpatory provision, an oversight claim can be brought as a breach of the duty of care); Nees, *supra* note 31, at 220 n.87 (questioning whether there should be an emphasis on closing the gap between the standard of conduct and the standard of review for the duty of care in order to prevent second-guessing by the courts).

ered to a negligence standard to match the standard of conduct.[216] This would make directors who negligently failed to create a system of internal controls or negligently ignored red flags liable for breach of the duty of oversight.[217]

CONCLUSION

As this Note explains, it is important for courts to send a strong message to directors that, if they fail in their fiduciary duties, they will potentially be held liable. Directors have significant and numerous protections already in place for them. These protections increase moral hazard and incentivize excessive risk-taking (or risky inaction). The court's decision to deny the defendant directors' motion to dismiss in *In re Wells Fargo & Co. Shareholder Derivative Litigation* is a step in the right direction, alerting directors that such misconduct is unacceptable. Subsequent courts should expand the application of oversight liability, at least at the motion to dismiss stage, to instill the slightest bit of fear in directors and deter them from engaging in wrongdoing that will cause significant harm to their corporation.

CLAUDIA A. RESTREPO

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[216] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (affirming that the standard for liability under the duty of care is gross negligence); Velasco, *supra* note 18, at 167 (explaining that although the standard of conduct for directors is a negligence standard, the courts will only find liability for breach of the duty of care if there is proof of gross negligence). Directors will be held liable if they act with "reckless indifference" toward the best interest of the corporation after being put on notice of possible illegal acts or other wrongdoings. *Okla. Firefighters Pension & Ret. Sys.*, 2017 WL 6452240, at *2.

[217] *See Aronson*, 437 A.2d at 812 (stating that directors will be liable under the duty of care if they acted with gross negligence, rather than negligence); *see also Stone*, 911 A.2d at 370 (explaining that liability is found when directors completely failed to implement a monitoring system or when, with such a system in place, directors ignored red flags that put them on notice of possible risks or problems).