KEEPING THE BOARDROOM HONEST: FIDUCIARY DUTIES, INFORMATION ASYMMETRY, AND REGULATING CORPORATE BEHAVIOR IN MORTGAGE-BACKED SECURITIES TRANSACTIONS

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> *People will do things in a boardroom that they would never do as an individual. Group decisions, no personal liability.*[1]

> *[A] stockholder is not powerless to challenge director action which results in harm to the corporation. The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management.*[2]

I. INTRODUCTION

CountyLine Bank (the Bank) is a publicly traded company organized under the laws of Delaware that, among other typical market activities of a commercial bank, is a residential-property mortgage lender.[3] The Bank is composed of an eight-member board: two are officers in the corporation, two are inside directors whose primary income derives from the salary they are paid by

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1. *Richard Schaden Quotes*, http://thinkexist.com/quotes/richard_schaden/ (accessed May 3, 2014). Richard Schaden is an attorney, engineer, former C.E.O., and co-founder of Quiznos Sandwich Restaurants. Beyond the Edge, *Richard F. Schaden*, http://www.beyond-the-edge.com/richard-f-schaden-2/ (accessed May 3, 2014).

2. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled in part on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

3. Michael Corkery, *A Toxic Subprime Mortgage Bond's Legacy Lives on: Story of CWABS 2006-7—Its Borrowers, Investors and Others Touched by It—Is Financial Crisis Seen from Inside*, Wall Street Journal, (available at http://online.wsj.com/article/SB10001424127887323423804579024612669517406.html) (describing the fate of investors and residential property owners tied to a mortgage bond originated by Countrywide Financial Corp.).

the Bank, and the remaining directors are outside directors who receive a "modest" annual retainer fee by the Bank but are employed as officers and outside directors for other companies.[4] Beginning in the early part of the century, the Bank began approving tens of thousands of residential mortgage loans[5] and structuring these loans in a number of ways to increase profitability and loan approval.[6] Some of the Bank's loan officers and their supervisors reported to some of the board members that the company's underwriting guidelines were ignored during the loan approval process.[7]

Larry Investor is a long-term stockholder in CountyLine. The few hundred shares of stock Larry owns are held in a portfolio, which he intends to use to fund his retirement. Larry hears a report[8] that the directors and officers of the corporation granted tens of thousands of residential property loans to borrowers whose lack of creditworthiness was undeniable.[9] The report goes on to say that the chief executive officer, loan officer, and chief financial officer heavily invested the company in similar high-risk loans granted by other entities that were pooled for investing in a process called securitization to create mortgage-backed securities

4. *See Smith v. Van Gorkom*, 488 A.2d 858, 867–868 (Del. 1985), *overruled in part on other grounds*, *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (describing a common structure of a corporate board).

5. *See* Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073, 1073 (2009) (noting that in 2006, mere months prior to the beginning of the subprime loan crisis, "the total value of outstanding subprime loans [was] over a trillion dollars").

6. Kristen David Adams, *Homeownership: American Dream or Illusion of Empowerment?* 60 S.C. L. Rev. 573, 600–601 (2009) (explaining that in the wake of the housing boom, creative lending strategies encouraged by the government allowed mortgage lenders to structure loans in ways that made homeownership seem like an affordable option to consumers).

7. *See e.g. In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1060, 1065 (C.D. Cal. 2008) (finding that the directors had a responsibility to oversee the operations and ensure that the company's policies and underwriting guidelines were being observed).

8. *See generally* Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 Iowa L. Rev. 49, 73–74 (2011) (stating that the United States Securities and Exchange Commission's (SEC) investigations and SEC 10b-5 class-action lawsuits typically precede derivative actions because of statements made by the management regarding the company's stability).

9. *See e.g. In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d at 1053 (stating that the plaintiffs alleged that the corporate managers ignored the company's internal procedures and loan guidelines).

(MBS).[10] The Bank had done this several hundred (maybe even several thousand) times and with no regard for the quality of these investments.[11] As the loans in the investment pool began faltering—either because of default or because of early payoff—the Bank continued to invest in these MBS, and the chief executive officer (C.E.O.), loan officer, and chief financial officer (C.F.O.) continued making quarterly bonuses based on the unprecedented growth of the Bank's portfolio (which is now dominated by MBS).[12] The report concludes that the Bank is in danger of suffering the same fate as its major market competitor who went into closure and receivership by the Federal Deposit Insurance Corporation (FDIC) after investing heavily in MBS.[13]

Outraged that the Bank's management was able to profit[14] through what he thinks is reckless, if not deliberately self-serving decision-making, Larry files a derivative action[15] on behalf of the corporation against the directors and officers. The complaint alleges that: (1) the board members should have known that these investments were being approved without adequate information as to how they would perform, and, consequently, the

10. *See* Sec. & Exch. Comm'n, *Mortgage-Backed Securities*, http://www.sec.gov/answers/mortgagesecurities.htm (modified July 23, 2010) (providing a basic definition of mortgage-backed securities).

11. *See e.g. In re Goldman Sachs Mortg. Servicing S'holder Derivative Litig.*, 2012 WL 3293506 at *2 (S.D.N.Y. Aug. 14, 2012) (stating that the "[p]laintiffs allege[d] that Goldman knew that loans underlying the [Residential Mortgage-Backed Security (RMBS)] it sold were troubled and falsely represented that the loans complied with particular underwriting standards").

12. *See e.g. Kellmer v. Raines*, 674 F.3d 848, 849 (D.C. Cir. 2012) (stating that the shareholders brought actions against Fannie Mae based on accounting irregularities when the company declared an unprecedented growth in profits following its investment in MBS).

13. *See* FDIC, *Failed Bank List*, http://www.fdic.gov/bank/individual/failed/banklist.html (last updated May 2, 2014) (providing a list of banks that have failed since October 1, 2000 and the acquiring institutions).

14. *See* Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits*, 2009 Wis. L. Rev. 243, 247 (2009) (explaining that both SEC actions and 10b-5 class-action suits are typically paid from the corporate coffers even though the former are designed to punish the corporation and the latter to compensate the shareholders).

15. *Grimes v. Donald*, 673 A.2d 1207, 1213 (Del. 1996), *overruled in part on other grounds*, *Brehm*, 746 A.2d 244. Shareholders can file either direct or derivative actions. *Id.* Direct and derivative claims are distinguished by the wrongs alleged and the remedies available. *Id.* Specifically, in a direct action, the stockholder is suing for some wrong that he or she suffered that is unique from harm suffered by other stockholders. *Id.* The relief serves to personally compensate the stockholder and comes from the corporate coffers. *Id.* A derivative action is brought on behalf of the corporation by a stockholder, and it is the corporation that is compensated by wrongs committed by the officers or directors. *Id.*

Bank paid a premium for low-performing investments; (2) the board breached its duty to the corporation by failing to inform of the nature of these investments; and (3) the board breached its duty by approving bonuses to the corporate officers based on its investments in these underperforming MBS.[16]

The directors claimed to be just as surprised as anyone else about the investments' failure and filed a motion to dismiss the derivative action.[17] The court summarily issued an order granting the motion. The news reports quote the order, which emphasized that "under the business judgment rule (BJR),[18] corporate directors are presumed to have acted in compliance with their fiduciary duties" and that "shareholders challenging this presumption must offer evidence that the directors lacked a good-faith belief that they were acting in the best interest of the corporation."[19] One article goes on to quote the order's admonition of the complaint: "It is well-established law that allegations need to be pleaded with specificity regarding the breach of duty, as liability cannot be imposed under these facts simply because a bad business decision was made."[20] Ultimately, the court concluded that demand[21] was not excused.[22] The article displays a

16. These types of allegations were typical of derivative claims filed based on similar facts. *See In re Goldman Sachs Group, Inc. S'holder Litig.*, 2011 WL 4826104 at *4 (Del. Ch. Oct. 12, 2011) (noting that the plaintiffs alleged, among other things, that the Audit Committee comprised of at least some of the directors failed to make a good-faith assessment of the risk because the directors' interests diverged with those of shareholders).

17. *See In re Am. Int'l Group, Inc. Derivative Litig.*, 700 F. Supp. 2d 419, 438–439 (S.D.N.Y. 2010) (stating that insufficient proof exists to demonstrate that the directors had knowledge of the impending losses based on MBS).

18. Del. Code. tit. 8, § 141(a) (2013). The "fundamental principle" of the BJR—divided management and ownership of corporations—is codified in Title 8, Section 141(a) of the Delaware Code. *Van Gorkom*, 488 A.2d at 872. "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." Del. Code tit. 8, § 141(a). The BJR is further discussed in Part II, *infra*.

19. For examples of cases in which courts have similarly ruled, see *In re Goldman Sachs Mortgage Servicing Shareholder Derivative Litigation*, 2012 WL 3293506 at *9 (concluding that the allegations of false and misleading statements as to the robustness of the loans compromising the MBS were insufficient because the defendants could not point to any disclosures that could be characterized as misleading); *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 126–127 (Del. Ch. 2009) (expressing concern about challenging a "well settled policy of Delaware law" by allowing courts to second-guess business decisions by evaluating the decisions' consequences).

20. *See In re Goldman Sachs Mortg. Servicing S'holder Derivative Litig.*, 2012 WL 3293506 at *9; *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d at 126.

21. *See Aronson*, 473 A.2d at 811 (stating that demand must be made on a board in order to give it the opportunity to rectify the situation that is the source of the

picture of the C.E.O. and his attorney; the caption underneath explains that the "Former C.E.O. of CountyLine Bank, N.A. who was in charge of the department that over-invested in mortgage-loan trusts left with a hundred-million dollar golden parachute[23] after receiving millions of dollars in short-term performance bonuses."[24] In order to avoid going into closure and receivership, like so many of its competitors, CountyLine accepts government assistance in the form of Troubled Asset Relief Program (TARP) funds.[25] Larry loses his long-term investment—along with all of the other shareholders—the company's coffers are depleted, and the directors and officers who enabled, if not placed, CountyLine in such a precarious position left with huge bonuses; however, "borrowers, lenders, neighborhoods, and cities, [lost trillions of dollars] not to mention broader effects on the U.S. and world economies."[26]

United States courts in Delaware and elsewhere have dismissed claims similar to the one described in the hypothetical above based on similar reasoning.[27] The derivative action is subject to dismissal for failure to state a cause of action because

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shareholders' complaints). Directorial independence from the owners to make business decisions, including the decision to file suit, is the reason that demand must either be made on the board prior to filing a derivative action or be shown through particularized facts that demand is excused because it would be futile. *Id.*; *see also Rales v. Blasband*, 634 A.2d 927, 930 (Del. 1993). Making demand on a board, however, can be fatal to the derivative action and subsequent claims. *See Grimes*, 673 A.2d at 1210 (finding that because demand was made and denied, the plaintiffs were precluded from claiming that demand was futile in subsequent claims).

22. *Aronson*, 473 A.2d at 814. Demand is excused when "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.*

23. "Golden parachutes" are "termination agreements providing substantial bonuses and other benefits for managers and certain directors upon a change in control of a company." *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 n. 5 (Del. 1985).

24. *See e.g.* Claire Suddath, *Biggest Golden Parachutes, Big Spenders, Stanley O'Neil*, http://content.time.com/time/specials/packages/article/0,28804,1848501_1848500_1848459,00.html (accessed May 2, 2014) (stating that the "former CEO and Chairman of the Board of Merrill Lynch & Co. Inc. left the company in 2007 with a whopping $161.5 million" and noting that "his departure coincided with a quarterly loss of $2.3 billion (the largest in the company's ninety-three-year history)").

25. The New York Times, *Chart: The Rescue Plan, The Largest Recipients*, http://www.nytimes.com/imagepages/2008/10/13/business/20081014_BAILOUT1_GRAPHIC.html (Oct. 13, 2008).

26. Bar-Gill, *supra* n. 5, at 1073.

27. *In re Goldman Sachs Mortg. Servicing S'holder Derivative Litig.*, 2012 WL 3293506 at *9; *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d at 126–127.

the shareholder does not have sufficient facts at his or her disposal to plead specifically. The corporation that potentially has the information the shareholder needs has the case dismissed before the discovery phase. Consequently, this "information asymmetry" is unresolved in the traditional derivative suit. The directors and officers of corporations are under a duty to act with a good-faith belief that their actions are in the best interest of the corporation.[28] But when short-term incentive packages combine with a remote chance of personal liability, the benefits of ignoring fiduciary duties[29] to the corporation and its owners outweigh the costs. Moreover, the complexity of certain transactions, such as MBS, makes it almost impossible to allege with any particularity that the board members or officers of a corporation either collectively or individually failed to act with a good-faith belief that the board's decision was in the best interest of the corporation.[30] The derivative action theoretically enables shareholders to force managers to comply with their fiduciary duties, but liability-limiting doctrines have made derivative actions ineffectual in imposing personal liability.[31]

Accordingly, what is needed is a method of regulation that more effectively deters much of the short-sighted behavior that led to the current financial crisis by making executives accountable to shareholders for a breach of fiduciary duty.[32] This Article proposes a regulatory scheme based on disclosures that would unravel these complex transactions in order to promote meaningful decision-making in the boardroom while providing

28. Clark W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware*, 2009 Utah L. Rev. 1061, 1066–1067 (2009).

29. *See* Anne Tucker Nees, *Who's the Boss? Unmasking Oversight Liability within the Corporate Power Puzzle*, 35 Del. J. Corp. L. 199, 213, 219–223 (2010) (arguing that balance is needed between directorial independence and the duties owed to the corporation so that the fiduciaries do not turn a "blind eye" to their responsibilities); Janice Kay McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-up Call for Reforming Executive Compensation*, 12 U. Pa. J. Bus. L. 131, 139 (2009) (stating that in approving risky loans "loan officers and their superiors had no financial incentive to screen applicants, including applicants' income documentation, credit history, credit worthiness, or long-term ability to repay").

30. *See infra* pt. II.

31. Nees, *supra* n. 29, at 205. "A quarter-century shift away from director accountability has created a narrow and virtually unenforceable standard for director oversight liability in shareholder derivative suits absent clear violations of the law." *Id.*

32. McClendon, *supra* n. 29, at 173, 178 (providing that the focus on short-term gains that became so pervasive in American corporate culture can be resolved through federal regulation).

shareholders with an effective tool to hold directors liable if they breach their duties to the corporation.[33]

Part I of this Article explains the unique circumstances of the secondary mortgage market that make mandatory disclosures necessary and why regulation of the secondary mortgage market is relevant to the primary mortgage market. Part II details the current limitations on the liability of directors that make the need for supplemental federal legislation necessary. Part III discusses the proposed federal legislation and how it would resolve the information asymmetry problem. Part III also discusses the disclosures in the context of directorial personal liability in light of the current landscape of American corporate law. Part IV contains a draft of the proposed legislation.[34] The Conclusion briefly discusses how Larry Investor's derivative action in the Introduction's hypothetical might benefit from the proposed legislation.

II. BACKGROUND

Between 2008 and 2011, an estimated 348 banks have gone into closure and receivership by the FDIC,[35] many of which

33. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (noting that there must be a good-faith belief that the information and reporting system that exists is adequate and that noncompliance with the legal standards for these systems may, "at least in theory," render the board members liable to the corporation for noncompliance). This form of regulation is in line with traditional notions of directors' and officers' fiduciary duties. *See generally Van Gorkom*, 488 A.2d at 872 (noting that "[u]nder the business judgment rule there is no protection for directors who have made 'an unintelligent or unadvised judgment'" (quoting *Mitchell v. Highland-Western Glass Co.*, 167 A. 831, 833 (Del. Ch. 1933))); *Aronson*, 473 A.2d at 812 (stating that the presumption under the BJR is that directors have "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

34. The proposed legislation is designed to: (1) remove the complexity from these transactions so that a board of directors can, presuming the consequences are unintentional, focus on complying with its fiduciary duties; (2) allow shareholders to have information at the outset of an alleged breach of fiduciary duty to overcome the presumption of the business judgment rule; and (3) attach personal liability to such a breach so that the directors have added incentives to make decisions with the best interest of the corporation in mind while at the same time removing any aspect of personal gain that may be associated with approving transactions that directors do not believe in good faith will benefit the company. In this way, this form of legislation could be adopted to regulate corporate behavior regarding other complex business decisions.

35. Kevin LaCroix, *Number of Bank Failures Finally Starting to Decline?* http://www.lexisnexis.com/legalnewsroom/banking/b/banking-finance/archive/2011/04/07/number-of-bank-failures-finally-starting-to-decline.aspx (posted Apr. 7, 2011 11:30 a.m.); *see* FDIC, *Failed Bank List*, *supra* n. 13.

resulted from the subprime mortgage and MBS markets.[36] In the wake of the banking crisis, experts have advocated for stronger disclosures from lenders to borrowers[37] under the Truth-in-Lending Act, emphasizing the "least sophisticated consumer" standard of the Federal Fair Debt Collection Practices Act in an effort to diminish predatory lending practices.[38] Relatively little attention has been paid, however, to the staggering number of securities fraud class-action lawsuits brought by stockholders and parallel derivative suits.[39] By and large, these suits have been unsuccessful.[40]

While the Securities and Exchange Act (the Act) allows stockholders to bring actions under a theory of fraud, and derivative actions provide a mechanism to enforce managers' fiduciary duties, stockholders have rarely been successful in these actions because of certain hurdles derived from corporate law that are present in the Act.[41] Specifically, these lawsuits are susceptible to dismissal for failure to state a cause of action because the alleged behavior of corporate directors and officers does not rise to the level of bad faith of corporate directors and officers.[42] Conse-

36. McClendon, *supra* n. 29, at 147 (noting that "[f]rom 2003 to 2007, U.S. subprime mortgages increased 292 percent, from $332 billion to $1.3 trillion, and most of that activity was due to the private sector's entrance into the subprime secondary market").

37. *See generally* Daniel Lamb, *A Specter Is Haunting the Financial Industry—The Specter of the Global Financial Crisis: A Comment on the Imminent Expansion of Consumer Financial Protection in the United States, the United Kingdom, and the European Union*, 31 J. Nat'l Ass'n Admin. L. Jud. 213, 222 (2011); Katherine L. Lewis, *Rebuilding a House of Cards: Envisioning Sustainable Federal Housing Policy*, 35 Wash. U. J.L. & Policy 473, 479–480 (2011).

38. *See generally* Debra Pogrund Stark & Jessica M. Choplin, *A Cognitive and Social Psychological Analysis of Disclosure Laws and Call for Mortgage Counseling to Prevent Predatory Lending*, 16 Psychol. Pub. Policy & L. 85, 85 (2010); Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. Banking Inst. 111, 111 (2002); Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. Cin. L. Rev. 1471, 1471 (2005).

39. 27 *Sec. Lit. Forms and Analysis* § 1:11 (WL current through Dec. 2013).

40. Erickson, *supra* n. 8, at 54 (providing that derivative lawsuits are consistently outperformed by government investigations and securities class actions).

41. *See e.g. In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326 (S.D.N.Y. 2011) (concluding that the stockholders failed to state a cause of action because they did not properly allege scienter). The BJR is embodied in section 10(b) of the Securities and Exchange Act which calls for a strong inference of fraudulent intent or scienter. 15 U.S.C. § 78(j) (2006).

42. For example, in two recent lawsuits, *In re Goldman Sachs Mortgage Servicing Shareholder Derivative Litigation*, 2012 WL 3293506 at *10, and *In re American International Group, Inc. Derivative Litigation*, 700 F. Supp. 2d at 441, shareholders were unsuccessful in maintaining actions against the corporations they held stock in for breach of

quently, these suits often utilize what is referred to as "puzzle pleading"[43] in an attempt to allege a cause of action that would overcome the BJR.[44]

If we accept the proposition that banks are "too big to fail"[45] and the idea that one of the principal goals of the law is to promote efficient behavior,[46] then some form of additional regulation is necessary. Part of the issue with regulation and enforcement mechanisms until now is that: (1) successor-in-interest entities are often not subject to liability for any wrongdoing by the originating entity;[47] and (2) none of these laws attempt to regulate the behavior of the agents of the corporation whose short-sighted business decisions are responsible for the damage suffered by the corporation, its shareholders, or the economy as a whole.[48] Hence, the corporations are still provided with TARP funds under the Emergency Economic Stabilization Act of 2008,[49]

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fiduciary duty based on claims that the officers and directors should not have invested in mortgage-backed securities because the allegations did not overcome some aspect of the BJR.

43. *See* Jonathan N. Eisenberg, *Litigating Securities Class Actions Volume 1*, Ch. 9, § 9.04(e) (Lexis Nexis 2012) (defining "puzzle pleading" as a "complaint [which] merely repeats numerous public statements about a company" without the requisite specificity to state a cause of action).

44. *See* Fed. R. Civ. P. 23.1(b)(3)(A), (B) (requiring that plaintiffs allege particularized sets of facts that would tend to show that the decision could not be supported as one rationally related to a business purpose); Del. Code tit. 8, § 141 (2012) (emphasizing the dependence of corporate directors in the management of a corporation); *Aronson*, 473 A.2d at 814 (stating that demand is only excused if particular facts are alleged that create a reasonable doubt that the defendants' complied with their fiduciary duties).

45. FDIC, *An Examination of the Banking Crises of the 1980s and Early 1990s: Continental Illinois and "Too Big to Fail,"* 247–252 (available at http://www.fdic.gov/bank/historical/history/235_258.pdf) (accessed May 3, 2014) (explaining that the concept of "too big to fail" arose in the late 1980s with the first major wave of government bailouts to banks based on the idea that banks were so important to our economy that if they failed, the economy would utterly collapse).

46. *See generally* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 Cal. L. Rev. 1051, 1054 (2000).

47. For example, under Florida law, a creditor who proves "status as holder of a note underlying a mortgage [has offered] proof of purchase of the debt, and the previous ownership history of the note and mortgage is irrelevant." *In re Balderama*, 451 B.R. 185, 190–191 (Bankr. M.D. Fla. 2011).

48. *See* McClendon, *supra* n. 29, at 169 (noting that TARP's restrictions on executive compensation did not alter the short-term compensation incentives that contributed to the economic downfall).

49. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 Minn. L. Rev. 373, 374 (2008) [hereinafter Schwarcz, *Protecting Financial Markets*] (comparing government reactions to the financial crisis to doctors that treat "a patient by focusing on curing symptoms, not the underlying disease" because the

and the corporate officers, arguably, are rewarded for taking unjustified risks at the expense of the corporation[50] with lawsuits being paid out or settled with the already damaged corporation's funds.[51] The lawsuits that do not settle are subject to dismissal based on liability-limiting doctrines in corporate law.[52] As one commentator has pointed out, it seems somewhat odd that American corporate law has such a broad concept of fiduciary duties[53] but provides such a narrow avenue for shareholders to enforce liability based on the breach of those duties.[54]

The next three sections of Part II discuss aspects of MBS and the current legal landscape of directorial liability in order to highlight the need for the proposed legislation. The first section underscores the importance of regulating the secondary mortgage

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government gave support to the banks but not the failing markets that were affecting the banks).

50. *See* Paul Kiel, *Biggest Financial Crisis Bailout Fails*, http://www.huffingtonpost.com/2012/09/06/financial-bailout-wallstreet_n_1861853.html (posted Sept. 6, 2012, 2:45 p.m. EDT) (discussing the effect of TARP funds on banks that were destined to fail); Gary Strauss, *CEOs' Golden Parachute Exit Packages Pass $100 Million*, http://www.usatoday.com/money/companies/management/story/2011-11-07/100-million-dollar-chairmen/51116304/1, USA Today (updated Nov. 8, 2011, 5:57 p.m.)

51. *See* Mitchell, *supra* n. 14, at 247 (stating that because damages in class-action lawsuits are almost always paid by the corporation or its insurer, and not the culpable managers, derivative actions are not effective deterrents); *see e.g. In re Fannie Mae 2008 Sec. Litig.*, 891 F. Supp. 2d 458, 477 (S.D.N.Y. 2012) (finding that "[w]hen the defendant is a corporate entity, the law imputes the state of mind of the employees or agents who made the statement(s) to the corporation") (quoting *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 543 (S.D.N.Y. 2011)); Att'ys Gen. on the Exec. Comm., *About the Settlement*, http://www.nationalmortgagesettlement.com/about (accessed May 3, 2014) (detailing how the State's Attorneys General reached a $25 billion settlement with five of the largest servicers of mortgages in the United States).

52. *See generally* Nees, *supra* n. 29, at 202–205 (providing that the primacy of directorial discretion in American corporate law is highlighted by judicial doctrines that limit liability).

53. As Benjamin Cardozo, then Chief Justice of the New York Court of Appeals, famously wrote of fiduciary duties in *Meinhard v. Salmon*, "[j]oint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. . . . A trustee is held to something stricter than the morals of the market place. Not honesty alone, but *the punctilio of an honor the most sensitive*, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate." 164 N.E. 545, 546 (N.Y. 1928) (emphasis added). Note that Chief Justice Cardozo begins talking about partners in joint ventures and then starts talking about trustees; this makes sense in light of the fact that corporate fiduciary duties sprang from the common law treatment of trustees' fiduciary duties. *See generally Maldonado v. Flynn*, 413 A.2d 1251, 1261 (Del. Ch. 1980), *rev'd sub nom.*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

54. Nees, *supra* n. 29, at 202 (indicating that there is a disconnect between the high level of accountability that corporate directors have to their shareholders and liability-limiting doctrines such as the business judgment rule).

market in order to preserve and benefit companies, investors, and the national economy. Next, the complexity of MBS is discussed to emphasize the particular need for disclosures in these transactions. Lastly, the current framework of director liability is discussed to understand how the proposed legislation affects directorial liability.

A. Why Focus on the Secondary Mortgage Market?

Criticisms of the primary residential mortgage market and its effects on the economy center on poor lending practices by originating lenders, including the companies' failures to observe their own underwriting guidelines.[55] As a result, many commentators have suggested direct regulation of the primary mortgage market.[56] Certainly the rise in subprime lending can be attributed to the desire for homeownership in the United States, the federal government's role as a proponent of homeownership, and the creation and structuring of many different types of home loans that made homeownership seem like an affordable, if not attainable, option for many borrowers.[57] Scholars and litigants have suggested that the adoption of increasingly lax underwriting standards in contravention of the lenders' policies and guidelines must have, at the very least, raised some red flags to the loan originators that the likelihood of default, and, therefore, the risk

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55. *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d at 1044 (detailing the derivative plaintiffs' allegations that the defendant–directors failed to pay heed to the red flags and ignored the company's internal procedures and loan guidelines); Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build up to the Financial Crisis*, 63 U. Miami L. Rev. 1111, 1121 (2009) (arguing that the private MBS market gave private entities the incentive to ignore internal underwriting guidelines).

56. *See supra* nn. 37–38 and accompanying text.

57. *See* Adams, *Homeownership*, *supra* n. 6, at 597–601 (stipulating that borrowers' desire of homeownership, government proponents of homeownership because of perceived benefits, and lenders' creative loan structuring in order to target lower income households propelled the conditions that produced the housing bubble); Kristen David Adams, *Do We Need a Right to Housing?* 9 Nev. L. J. 275, 317–320 (2009) [hereinafter Adams, *Do We Need a Right to Housing?*] (arguing that despite Americans' preference for homeownership and the place of importance that it occupies in the popular imagination, homeownership can prove disastrous for financially vulnerable members of society); McClendon, *supra* n. 29, at 140, 143–147 (stating that the federal government created various programs and agencies to protect and promote homeownership based on its perceived benefits and that federal deregulation of the mortgage market contributed to the excessively risky loans that were granted to under-qualified borrowers).

to these companies, was extraordinarily high.[58] Undoubtedly, corporate greed and short-term incentive packages contributed greatly to the de facto adoption of subprime residential mortgage loans as the norm for many of these lenders.[59] Even when corporate incentives are tied to short-term productivity goals, that alone cannot explain the millions of risky subprime home loans that were granted before the housing bubble burst.[60]

Perhaps not a mere coincidence, at the same time that subprime home loans saw an unprecedented increase, MBS started becoming a very attractive investment option.[61] Consequently, the originating lenders made these risky loans and had a ready market to dump the riskiest and least attractive of these

58. *See Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust ex rel. Fed. Nat'l Mortg. Ass'n v. Raines*, 534 F.3d 779, 789 (D.C. Cir. 2008) (alleging that the directors failed to account for the high level of risk that MBS investments represented at the company); *In re Goldman Sachs Mortg. Servicing S'holder Derivative Litig.*, 2012 WL 3293506 at *2 (detailing counts in the complaint alleging "that Goldman knew that loans underlying the RMBS it sold were troubled and falsely represented that the loans complied with particular underwriting standards," and they bought credit default swaps betting that the loans they undersigned would default, creating a conflict of interest); *In re Citigroup Inc. S'holder Derivative Litig.*, 788 F. Supp. 2d 211, 212 (S.D.N.Y. 2011) (claiming that Citigroup breached its duties of care, loyalty, and good faith by substantially investing in high-risk loans and failing to disclose the true risk involved in these investments to its shareholders); *In re Am. Int'l Group, Inc. Derivative Litig.*, 700 F. Supp. 2d at 438–439 (alleging that the directors failed to disclose material information regarding the performance of the subprime loans that were securitized and bought by the corporation); *In re Goldman Sachs Group, Inc. S'holder Litig.*, 2011 WL 4826104 at *4 (alleging the Audit Committee comprised of at least some of the directors was in charge of overseeing the risk in Goldman's portfolio but failed to make a good faith assessment of the risk because the directors' interests diverged with those of shareholders); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d at 114 (claiming that the directors failed to make a good-faith assessment of the risks of investing in securities backed by subprime mortgages).

59. McClendon, *supra* n. 29, at 139 (noting that "commercial bank and mortgage company loan officers received bonuses for the quantity of loans, not the quality" and "had no financial incentive to screen applicants" for creditworthiness).

60. Dennis, *supra* n. 55, at 1120 (stating that private MBS gave the private entities a way to get rid of their riskiest loans, providing them with an incentive to lower their underwriting guidelines); *see also* Elizabeth Devine, *The Collapse of an Empire? Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 Fordham J. Corp. & Fin. & L. 177, 186 (2011) (arguing that the rating agencies contributed to the problem by giving MBS investment-grade ratings, allowing originators to get rid of their worst loans).

61. Dennis, *supra* n. 55, at 1114, 1122 (arguing that the nationally recognized rating agencies overestimated the performance of MBS and underestimated the risks involved because they wanted the profits generated from referrals); McClendon, *supra* n. 29, at 142–143, 146–147 (explaining that the investment-grade ratings that were given to many MBS propelled investment).

loans so that they did not have to internalize any of the risks.[62] Because the players in the primary residential mortgage lending market were able to easily liquidate their assets and grant new loans, many of these companies saw historic increases in profits that caused them to disregard their own underwriting guidelines that were spurred by short-term incentive packages.[63] In other words, the originating lenders continued to grant these loans and get rid of them through "investment grade"[64] MBS, thereby externalizing much of the risk until the bubble burst, and they were forced to take massive losses by internalizing the risks that they created.[65] Additionally, it is the role of the secondary mortgage market that allowed the unsound lending practices of

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62. Essentially the argument goes: the originating entities continued to grant subprime residential mortgage loans because they had a ready market to "dump" these loans on in the form of MBS investment; the MBS market was growing exponentially because credit agencies continually overrated the loans and underrated the risk; nationally recognized credit rating agencies continually gave MBS investment-grade ratings because they were profiting tremendously from the securitizing entities' referrals; and they kept receiving referrals because the ratings were high, which generated a high-level of investment. Dennis, *supra* n. 55, at 1136–1140. *See* Devine, *supra* n. 60, at 178, 186 (providing that rating agencies contributed to the problem to the extent that the AAA-rated investments in MBS were actually junk, allowing originators to get rid of their worst loans to a market of eager investors who were relying on these ratings); Steven L. Schwarcz, *Marginalizing Risk*, 89 Wash. U. L. Rev. 487, 506 (2012) [hereinafter Schwarcz, *Marginalizing Risk*]. Investors in private entity MBS looked almost exclusively to rating companies in order to determine whether the mortgages pooled in securitized trusts would generate income, making the rating agencies de facto gatekeepers of private-label MBS. Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 1 U. Ill. L. Rev. 1, 12–14 (2004) [hereinafter Schwarcz, *Rethinking the Disclosure Paradigm*] (arguing that investors' overreliance on credit rating agencies occurred because MBS are complex transactions); Dennis, *supra* n. 55, at 1121–1122.

63. For example, the 2012 Fannie Mae litigation was based, in part, on accounting irregularities based on losses in the MBS market after an unprecedented growth in profits was declared so that company executives could meet short-term goals that would trigger their compensation packages. *Kellmer*, 674 F.3d at 849. Corporate waste based on executive compensation is commonly pled in derivative suits for failure of oversight. *See generally In re Countrywide Litig.*, 554 F. Supp. 2d at 1056; *In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 443–446; *Brehm*, 746 A.2d at 244; *In re Goldman Sachs Litig.*, 2011 WL 4826104 at **3–5; McClendon, *supra* n. 29, at 134 (noting that "multi-million dollar bonuses were [paid to executives] primarily related to past MBS originations or sales that produced short-term corporate gains").

64. "Investment grade" securities are rated from AAA to BBB. Dennis, *supra* n. 55, at 1140 n. 167.

65. *Id.* at 1121 (stating that because private MBS did not have to comport with the strict standards of the government-sponsored enterprises (GSEs), the private MBS market provided entities a way to get rid of their riskiest loans). Additionally, the private MBS market provided residential mortgage lenders with an incentive to lower their underwriting guidelines while the loan investors "lack[ed] the information that the lender ha[d] that would indicate whether or not a borrower [was] likely to default." *Id.*

many players in the primary market to spill over into other unrelated markets, exacerbating the effects of the economic crisis.[66] As a result of the undeniable and perhaps dominant role that the secondary mortgage market played in the housing crisis,[67] it seems appropriate to regulate that market just as much, if not more, than the primary residential loan mortgage market.[68] MBS should not be altogether banned because, to put it simply, not all MBS are bad, and they can be great investment options.[69] MBS do pose a unique problem to would-be regulators, however, because these are complex transactions that are neither easily understood nor easily summarized.[70]

B. The Complexity of Mortgage-Backed Securities

Securities and Exchange Commission (SEC) Rule 10b-5[71] is a major enforcement mechanism for the SEC and prohibits a corporation from making material misstatements or omissions connected with the sale or purchase of a security.[72] This Article, although concerned with shareholder derivative suits, makes several references to the SEC Rule, mostly in connection with shareholders' parallel claims in derivative suits that often piggyback on actions brought by the SEC or shareholder class-action securities claims.[73] Rule 10b-5 is relevant in this Section

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66. *Id.*

67. *Supra* nn. 59–60.

68. *Supra* n. 60 (providing that the consequence of regulating the secondary market is that lenders in the primary market will be forced to internalize the risk of the loans that they create if they do not conform to underwriting standards).

69. For a discussion on the reasons that banning structured transactions would be socially detrimental, see note 62 at 21–23.

70. In addition to the problems discussed above, many of the special-purpose entities created to manage these MBS in the form of Real Estate Mortgage Investment Conduits were run by directors and officers of the originating entities, causing what some perceive as a conflict of interest in light of the originating lender's desire to be rid of the low performing loans and the investor's desire to invest in a pool of securitized loans that will perform well. Schwarcz, *Rethinking the Disclosure Paradigm*, *supra* n. 62, at 20, 30–32.

71. 17 C.F.R. § 240.10b-5 (2013).

72. *See id.* (prohibiting parties from making "any untrue statement of a material fact or to omit to state a material fact" in connection with the purchase or sale of securities); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152 (1972) (affirming the circuit court's opinion to the "extent that it held that . . . the record reveals a misstatement of a material fact, within the proscription of Rule 10b-5(2)"); *S.E.C. v. Mudd*, 885 F. Supp. 2d 654, 669 (S.D.N.Y. Aug. 10, 2012) (stating that if the alleged omissions are viewed as being material to investors, they could support a claim under 17 C.F.R. § 240.10b–5).

73. *See infra* pt. II (discussing that the concepts of disclosure and misleading statements and many of the factual and legal arguments made in the SEC actions are

insofar as many of the claims for false and misleading statements in connection with the sale or purchase of securities by the government are successful whereas historically these claims have failed in derivative suits[74] because of "puzzle pleading"[75] caused, in part, by the complexity of these transactions. Resolving the complexity problem through disclosures serves two purposes. First, disclosures would provide directors and shareholders with additional insight into the MBS, facilitating compliance with the fiduciary duties. Second, derivative plaintiffs would have evidence that would allow them to plead with particularity facts that could create a reasonable doubt as to directors' entitlement to protection under the BJR.

1. Disclosures to Reduce Information Asymmetry

One of the major problems with the MBS investments was a failure of information.[76] Professor Steven L. Schwarcz has written a series of articles that focus on the failure of the information systems in place as a force contributing to the economic crisis.[77] Central to his analysis of MBS, Professor Schwarcz points out that

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equally applicable in derivative suits, despite the fact that the parties play different roles in each of these actions).

74. Jessica Erickson, *Corporate Misconduct and the Perfect Storm of Shareholder Litigation*, 84 Notre Dame L. Rev. 75, 79–80 (2008) (explaining that some commentators fail to see the difference between derivative lawsuits and securities class actions because they often involve the same parties, albeit in different roles, and facts supporting securities fraud claims (e.g., material misstatements about the condition of the company) will often be used to support derivative actions). Professor Erickson argues in her ABA-funded study, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 Iowa L. Rev. 49, 51–53, 62–66, 73–75; *see supra* n. 8, that derivative actions are inefficient in deterring corporate wrongdoers because these suits often piggyback on other forms of deterrent litigation such as suits arising out of government investigations, SEC actions, and securities class actions but are often settled out of court with corporate funds.

75. *See supra* n. 43 and accompanying text (discussing "puzzle pleading").

76. Dennis, *supra* n. 55, at 1121. "This information asymmetry allows lenders the opportunity to profit from the origination of low quality loans, the risks of which are born by investors." Investors in private-entity MBS looked almost exclusively to rating companies to determine whether the mortgages pooled in securitized trusts would generate income (e.g., not default), making the rating agencies "de facto gatekeepers" of private-label MBS. *Id.* at 1122. Yet, the AAA–C ratings may be insufficient to appreciate the performance or risk of investing in private MBS. *Id.* at 1115–1116.

77. Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 Wis. L. Rev. 815, 818–821 (2012) [hereinafter Schwarcz, *Controlling Financial Chaos*]; Schwarcz, *Marginalizing Risk*, *supra* n. 62, at 496–497; Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 3 Utah L. Rev. 1109, 1110 (2008) [hereinafter Schwarcz, *Disclosure's Failure*]; Schwarcz, *Protecting Financial Markets*, *supra* n. 49, at 3754; Schwarcz, *Rethinking the Disclosure Paradigm*, *supra* n. 62, at 4–5.

the complexity of these transactions contributed to the deficiency of information available.[78] Further, because these transactions are complex,[79] many of the investors in MBS may have been complacent about doing their due diligence and over-relied on rating agencies.[80]

Many rating agencies gave asset-backed securities secured by subprime home loans investment grade ratings.[81] Professor Schwarcz advocates for stronger disclosures in the secondary mortgage market in order to reduce the information asymmetry between the buyers and sellers of MBS.[82] This Article does not assume that the buyers and investors of MBS were unaware of the risks inherent in these types of investments.[83] Moreover, because this Article deals primarily with derivative actions relating to breach of fiduciary duties, it takes the position that because many of the participants in the secondary mortgage market were also originators of loans, there was some awareness that these investments would eventually falter.[84] So, unlike Professor Schwarcz, who argues disclosures should be used to remedy information asymmetry between decision-makers in a transaction,

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78. Schwarcz, *Controlling Financial Chaos*, *supra* n. 77, at 818–821; Schwarcz, *Marginalizing Risk*, *supra* n. 62, at 496–497; Schwarcz, *Disclosure's Failure*, *supra* n. 77, at 1113–1115; Schwarcz, *Rethinking the Disclosure Paradigm*, *supra* n. 62, at 12–13. *See also* Dennis, *supra* n. 55, at 1116–1118 (arguing that AAA–C ratings may be insufficient to appreciate the performance or risk of investing in private MBS).

79. The focus on MBS as complex transactions is because of the number of loans pooled and the numerous factors that would go into determining the strength of these investments, but the individual subprime loan contract also contains many complex features that contribute to the complexity of MBS. Bar-Gill, *supra* n. 5, at 1121–1123.

80. *Supra* nn. 53–56 and accompanying text. It is interesting to note that one of the arguments forwarded by the derivative plaintiffs in the 2011 Goldman Sachs litigation was that the credit rating agencies were beholden to Goldman Sachs. *In re Goldman Sachs Litig.*, 2011 WL 4826104 at **3–5. Professor Schwarcz's article, *Marginalizing Risk*, *supra* n. 62 at 504–506, specifically addresses the likelihood of information failures when risk is dispersed among many parties based on transaction costs and the belief that someone more heavily invested must have studied the investment thoroughly. Therefore, many investors are content that they have done sufficient research after a cursory review of the ratings granted to a security by a private agency such as Moody's or S&P. *Id.* at 496–497.

81. *Supra* nn. 58–62.

82. Schwarcz, *Rethinking the Disclosure Paradigm*, *supra* n. 62, at 18–31.

83. Nees, *supra* n. 29, at 2013 (pointing out that the perception of lack of oversight that resulted from the failure of investments in MBS and CDOs was highlighted by corporate directors' claims that they were blindsided by the failure of these investments).

84. *See e.g. In re Goldman Sachs Litig.*, 2012 WL 3293506 at *2 (stating that the plaintiffs alleged that the corporate directors and officers bought credit default swaps on the loans and MBS that they created, betting that the loans they undersigned would default and create a conflict of interest).

this Article advocates for disclosures for the purposes of regulating corporate behavior. Increased disclosure requirements promote ethical compliance among board members and officers in addition to reducing information asymmetry between parties in a transaction.

It has been proposed that nationally recognized rating agencies should be required, through regulation, to disclose the information that was used in deriving the rating.[85] However, the information is often too complex for the average investor to understand, and the transaction costs associated with unwinding the information in these disclosures would make investing for many individuals, to put it simply not worth it.[86] Because MBS involve the credit of hundreds of borrowers whose finances, assets, earning potential, credit and bankruptcy history, and neighborhood and properties values vary drastically, it is difficult to assess the returns on these investments using traditional investment assessment tools.[87] Therefore, the entities that participate heavily in the secondary mortgage market through MBS should be primarily responsible for creating and deciphering the content of these disclosures. Additionally, executives, as part of their supervisory responsibilities to the organizations that employ them, should be charged with ensuring that the disclosures comply with federal laws. A failure to monitor these systems in assessing the risk of a given investment in MBS would call into question the directors' duty of loyalty.

2. *Disclosures to Eliminate "Puzzle Pleading"*

Many of the derivative claims that corporate directors breached their fiduciary duties in connection with the purchase of MBS are backed by allegations that the directors made misrepresentations or misstatements as to the performance of MBS or the condition of the company[88] after investing heavily in

85. Dennis, *supra* n. 55, at 1145.
86. Schwarcz, *Marginalizing Risk*, *supra* n. 62, at 504–505.
87. Schwarcz, *Disclosure's Failure*, *supra* n. 77, at 1114.
88. *In re Oxford Health Plans, Inc.*, 192 F.R.D. 111, 117 (S.D.N.Y. 2000) (stating "violations of the law concerning the dissemination of false and misleading financial statements cannot be deemed to be the product of a valid exercise of business judgment, and therefore protected from a demand futility allegation by the case law").

these securities.[89] These claims are sometimes couched in terms of negligent management of the company, which is nonactionable in the vast majority of cases,[90] but also include allegations of corporate waste because of employee compensation. Facts about exorbitant compensation packages could reflect plaintiff's desire to have the courts conclude that directors and officers had improper motives spurred by personal interest. An improper action spurred by personal interest is not protected by the BJR and, therefore, is actionable.[91] However, courts seem to separate the facts associated with these distinct claims and tend to rule that: (1) the directors' decisions to invest in MBS were within their directorial discretion; and (2) employee compensation[92] was

89. *Kellmer*, 674 F.3d at 849 (tracking the allegations in the complaint regarding the directors' approval of accounting irregularities in order to hide losses suffered in the MBS market); *In re Countrywide Litig.*, 554 F. Supp. 2d at 1053–1054 (alleging that various statements by Angelo Mozilo, an inside director, regarding the strength and flexibility of Countrywide's business model constituted a breach of fiduciary duty when he knew that the company had overinvested in MBS like other companies that were failing); *In re Goldman Sachs Litig.*, 2012 WL 3293506 at *2 (indicating, as a central theme of the complaint, that the "[p]laintiffs allege[d] that Goldman knew that loans underlying the RMBS it sold were troubled and falsely represented that the loans complied with particular underwriting standards"); *In re Fannie Mae 2008 Securities Litig.*, 2012 WL 3758537 at *18 (S.D.N.Y. Aug. 30, 2012) (finding that allegations that Goldman Sachs failed to disclose material information that would reveal that Fannie Mae's subprime loans were overvalued so that Fannie Mae could liquidate its assets by selling these loans on the secondary mortgage market did not state a claim for market manipulation because Goldman Sachs had "no independent duty to make such disclosures"); *In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 438–439 (denying the plaintiffs' claims that the directors breached their duty of loyalty by intentionally failing to disclose material information about underperforming MBS); *In re Citigroup Litig.*, 964 A.2d at 132 (holding that the failure to disclose material information regarding the vulnerability of the mortgages assigned to SPVs was also not a violation of the duty of good faith).

90. *See infra* pt. II.

91. *See generally In re Citigroup Litig.*, 788 F. Supp. 2d at 212, 215–216 (providing that the demand would be excused when the derivative plaintiffs could demonstrate that the board had an improper motive or was otherwise not disinterested).

92. *Brehm v. Eisner* is one of the most well-known cases regarding employee compensation. 746 A.2d at 244, 251. In that case, shareholders brought a derivative action claiming that the board breached its fiduciary duties to the corporation by approving a five-year employment compensation package for Michael Ovitz that included "a base salary of $1 million per year, a discretionary bonus, and two sets of stock options . . . that collectively would enable Ovitz to purchase 5 million shares of Disney common stock" but that would offer him substantially more compensation if he had been terminated without cause. *Id.* at 250. In regard to the allegations against the "old board" regarding the approval of the compensation package, the shareholders alleged that the employment contract was unilaterally negotiated by Ovitz's successor and best friend, Michael Eisner, and that the board either failed to review the contract thoroughly or approved the golden parachute that firing Ovitz would trigger, thereby failing to act in the best interest of the corporation in violation of their duty of loyalty. *Id.* at 251–252. Ultimately, the court ruled that employee compensation was a business decision within the sound discretion of the

also a business decision protected by the BJR.[93] Undoubtedly, oversight liability claims for failure to institute information and reporting systems often touch on the notion that the directors informed neither themselves nor the shareholders through appropriate disclosures.[94] The desired effect of the disclosures this Article proposes is that by reducing the information asymmetry in these transactions, directors can make more informed decisions regarding complex investment, and shareholders can ensure that such compliance has been met or file suit to force compliance. The disclosures also provide a paper trail that along with other facts, such as meeting minutes, price paid, and losses to the corporation, could overcome the pleading requirements and other liability-limiting mechanisms in American corporate law.

C. The Current Landscape of the Law Governing Director Liability

Director liability is founded on a breach of one of the three traditional fiduciary duties[95] that directors serve to the company and its owners.[96] These fiduciary duties can be enforced, or the

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board and that the board's reliance on its expert was sufficient to guarantee that there was no violation of corporate fiduciary duty of loyalty. *Id.* at 262.

93. *In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 443–446 (denying plaintiff's claims of waste based on three compensation packages given to employees that the shareholders claimed were responsible for the deteriorated economic state of the company); *In re Goldman Sachs Litig.*, 2011 WL 4826104 at **3–5 (denying relief for allegations that the directors failed in their duty of oversight and committed corporate waste by approving the employee compensation of three individuals responsible for company losses); *but see In re Countrywide Litig.*, 554 F. Supp. 2d at 1064–1065 (finding that plaintiffs pled sufficient facts to support an inference of scienter regarding the directors' alleged violation of fiduciary duties by approving certain investments and committing corporate waste in granting a director's stock repurchase option and awarding him compensation). It is logical for shareholders to include allegations of extreme executive compensation when lodging complaints in order to overcome the BJR presumption by presenting a theory of liability based on the duty of loyalty. But it seems like a fallacy to allow the very same individuals who made these companies so vulnerable to become personally enriched by their acts and not accountable to anyone. *See* McClendon, *supra* n. 29, at 159 (stating that after receiving TARP funds, "AIG then paid out $165 million in retention bonuses to executives at AIG FP, the division that engaged in the MBS transactions that brought AIG to the brink of disaster").

94. *See e.g. In re Goldman Sachs Litig.*, 2012 WL 3293506 at **8, 10 (finding that plaintiffs were unable to point to the disclosures that were alleged to be misleading); *In re Fannie Mae Litig.*, 891 F. Supp. 2d at 486 (concluding that the defendants had no independent duty to make the disclosures).

95. Furlow, *supra* n. 28, at 1066 (explaining that the three traditional fiduciary duties that officers owe the corporations they serve are the duties of loyalty, care, and good faith).

96. *Id.* at 1065–1066.

damages resulting from a breach of these duties can be sought through either a direct or derivative action.[97] This Article concerns itself with directors' duties to the corporation.[98] In order to comply with their fiduciary duties, the directors must be independent and disinterested in the transactions that they approve,[99] but more applicable to the issues of MBS regulation is the duty of directors to avail themselves of material information reasonably available to them prior to approving a transaction.[100] Personal liability for breach of fiduciary duties based on hasty, uninformed decision-making is not a new concept in American corporate law.[101] While most managerial decisions are protected by the BJR, "there is no protection for directors who have made 'an unintelligent or unadvised judgment.'"[102] This theory of liability was first founded on the breach of the duty of care theory[103] but is now limited to review under a breach of the duty of loyalty under a theory of failure of oversight liability.[104] To understand the current framework of oversight liability, it is necessary to understand

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97. *Grimes*, 673 A.2d at 1213. The distinction between direct and derivative claims hinges on the differences between the wrongs alleged and the remedies available. *Id.* Specifically, in a direct action, the stockholder is suing for some wrong that he or she suffered that is unique from harm suffered by other stockholders. *Id.* The relief serves to personally compensate the stockholder and comes from the corporate coffers. *Id.* A derivative action is brought on behalf of the corporation by a stockholder, and it is the corporation that is compensated by wrongs committed by the officers or directors. *Id.*

98. By way of comparison, some examples of the duties owed to the owners of the corporation by the management include the right to inspect the company's books, records, and papers, *Holdsworth v. Goodall-Sanford, Inc.*, 55 A.2d 130, 132 (Me. 1947), the right to be fully informed of material information before casting a shareholder vote, *Stroud v. Grace*, 606 A.2d 75, 85 (Del. 1992), and the duty to maximize the company's value at sale once the corporation has initiated an active bidding process, *Revlon*, 506 A.2d at 182.

99. *Aronson*, 473 A.2d at 814.

100. *Id.* at 812. "The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves prior to making a business decision, of all material information reasonably available to them." *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812).

101. *See Lutz v. Boas*, 171 A.2d 381, 395–396 (Del. Ch. 1961) (holding that directors of a company managing a mutual fund were personally liable for losses to the corporation for "almost automatic approval" of an agreement in derogation of their fiduciary duties).

102. *Van Gorkom*, 488 A.2d at 872 (quoting *Mitchell v. Highland-Western Glass*, 167 A. at 833. The *Van Gorkom* court went on to say that, "[a] director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders." 488 A.2d at 872 (citing *Lutz*, 171 A.2d at 381).

103. *Van Gorkom*, 488 A.2d at 872–873; *Lutz*, 171 A.2d at 395–396.

104. Nees, *supra* n. 29, at 204–205; Furlow, *supra* n. 28, at 1066–1067; *see In re Walt Disney Litig.*, 906 A.2d 27, 64–65 (Del. 2006) (noting that a shared distinction exists "between the duties to exercise due care and to act in good faith").

how the BJR and exculpatory clauses have changed the landscape of directorial liability in American corporate law.

1. The Shield That Is the Business Judgment Rule and 102(B)(7)

> *The business judgment rule, as consistently reiterated by the Delaware Supreme Court, stands as an almost impenetrable barrier to the plaintiffs.*[105]

The BJR protects directors from personal liability to the corporation unless the derivative plaintiffs can prove through particularized facts that the directors breached one of their fiduciary duties or failed to be reasonably informed about material facts prior to entering a transaction or undertaking a decision.[106] This presumption is not easily overcome, and many lawsuits are dismissed for failing to plead with specificity, facts that would ultimately show a violation of fiduciary duty.[107] Arguably, the BJR serves many purposes; two are relevant to this discussion: first, it prevents shareholders disgruntled with the results of their investment from going on a "fishing expedition";[108] second, the BJR isolates directors' decisions from judicial scrutiny

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105. *Sullivan v. Hammer*, 1990 WL 114223, 1631-1632 (Del. Ch. Aug. 7, 1990).

106. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967–968 (Del. Ch. 1996) (stating that the BJR could be overcome if the plaintiffs proved that the directors lacked good faith in exercising their supervisory functions, thereby breaching the duty of loyalty); *In re Citigroup Litig.*, 964 A.2d at 111, 126–127, 140 (stating that in order to overcome the BJR, plaintiffs must allege with specificity that the directors breached the duty of loyalty by doing nothing in the face of a known duty to act); *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 367–369 (Del. 2006) (providing that in order to survive dismissal, the derivative plaintiffs in oversight liability suits must show bad-faith conduct in violation of the duty of loyalty); Furlow, *supra* n. 28, at 1083 (dictating that in order to overcome the presumption made by the business judgment rule, "a plaintiff must prove the decision was made in violation of the directors' fiduciary duties"); Erickson, *supra* n. 74, at 84–92 (pointing out that the BJR standard in derivative suits is similar to those in securities class actions, scienter, because they both involve a conscious dereliction of a known duty).

107. Nees, *supra* n. 29, at 227–232 (stating that many derivative suits are dismissed in the prediscovery phase because of the requirement that plaintiffs plead with particularity that the directors have violated a fiduciary duty). *But cf. Maldonado*, 413 A.2d at 1256 (noting that the BJR "requires utmost loyalty to the corporation and its interests and does not protect fraudulent, illegal, or reckless decisions by the directors").

108. *Seinfeld v. Verizon Commc'n, Inc.*, 909 A.2d 117, 123 (Del. 2006). In this way, the BJR allows the courts to dismiss complaints based on vague allegations of wrongdoing prior to the discovery phase of litigation. *Id.*

and second-guessing with the benefit of hindsight.[109] This second function is significant as a central theme in American corporate law: by dividing ownership and management functions of a corporation, we allow directors to take greater risks while spreading those risks among many investors.[110]

Working in conjunction with the BJR is the exculpatory clause—commonly referred to as the 102(b)(7) clause.[111] Delaware Code Title 8, Section 102(b)(7) came into play after the *Van Gorkom* case.[112] The Delaware legislature reacted quickly to the *Van Gorkom* case to enact 102(b)(7), as the case's effects were felt almost immediately.[113] As a result of the statute, a corporation may place an exculpatory clause in its Articles of Incorporation that shields directors from personal liability for breach of fiduciary duty, except in cases of a breach of the duty of loyalty, failure to act in good faith,[114] intentional misconduct, or knowing violations of the law. All fifty states have adopted statutes similar to 102(b)(7), and exculpatory clauses have become nearly ubiquitous in company charters of incorporation.[115]

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109. In many of the cases brought under a theory of oversight liability, courts have discussed the issue of the judiciary not being well equipped to second-guess directors' business decisions. *In re Citigroup Litig.*, 964 A.2d at 126 (stating that a "well settled policy of Delaware law" is that courts will not second-guess business decisions by evaluating their consequences).

110. *See In re Citigroup Litig.*, 964 A.2d at 126 (providing that directors are employed to make decisions regarding the risk and return of investments that courts are reluctant to review); Schwarcz, *Marginalizing Risk*, *supra* n. 62, at 493–494 (dictating that one of the hallmarks of the corporation is spreading ownership among many investors so that risk will not be borne by relatively few individuals).

111. "A provision *eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty* as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's *duty of loyalty* to the corporation or its stockholders; (ii) for acts or omissions *not in good faith or which involve intentional misconduct or a knowing violation of law*." Del. Code tit. 8, § 102(b)(7) (emphasis added).

112. *Smith v. Van Gorkom*, 488 A.2d at 863, held that the director of a corporation was "grossly negligent" in carrying out his duties to the corporation and could not, as a result, avail himself of the protection of the BJR. In the wake of the *Van Gorkom*, insurance policies protecting directorial actions became prohibitively expensive and many corporate directors resigned. Janet E. Kerr, *The Financial Meltdown of 2008 and the Government's Intervention: Much Needed Relief or Major Erosion of American Corporate Law? The Continuing Story of Bank of America, Citigroup, and General Motors*, 85 St. John's L. Rev. 49, 83 (2011).

113. *Id.* After the Delaware Supreme Court rendered the opinion, it was reported that many companies' board members resigned fearing personal liability, and insurance policies for directors became scarce. *Id.*

114. *Id.*; Furlow, *supra* n. 28, at 1062.

115. Nees, *supra* n. 29, at 218.

The combined effects of the BJR and 102(b)(7) exculpation clauses are that nothing short of allegations of a knowing violation of law or a breach of the duty of loyalty, pleaded with particularized facts at the outset of an action, will survive dismissal.[116] It follows that the large number of unsuccessful derivative actions based on material misstatements in violation of the directors' fiduciary duties are attributable to courts finding that: (1) such decisions are attributable to the business judgment of the directors; (2) the decisions are not actionable under a theory of breach of due care because of the presence of an exculpatory clause; (3) the pleading requirements are not met because the plaintiffs cannot show at the outset of the case that the directors did not have a good-faith belief that they were acting in the best interest of the corporation; and (4) there is no framework of analysis for bad-faith business decisions that do not result in a violation of the law without contravening the principles of the BJR.[117] With the de facto disappearance of the duty of

116. *See generally In re Goldman Sachs Litig.*, 2011 WL 4826104 at *12 (stating that because the company's charter contained an exculpatory clause, the plaintiffs would have to show through particularized pleadings that there was bad-faith conduct, namely that there was an intentional dereliction of a known duty or a conscious disregard for a duty); *In re Citigroup Litig.*, 964 A.2d at 124 (providing that the plaintiffs could only succeed on a theory that the directors breached their duty of loyalty or failed to exercise a decision in good faith that was violative of the law because the corporate charter included an exculpatory provision as defined under Title 8, Section 102(b)(7) of the Delaware Code). This is particularly problematic because the duty of loyalty and failure to act in good faith have been said to be much more difficult to prove than a breach of the duty of care. *See* Nees, *supra* n. 29, at 219–222 (pointing out that the presence of an exculpatory clause in a corporation's articles makes the claim much more difficult to prove because a showing of bad faith or conscious disregard for the duty must be shown instead of a mere showing that the directors failed to act reasonably).

117. *Raines*, 534 F.3d at 791 (concluding that the alleged red flags were insufficient to create the likelihood of substantial liability for the directors); *In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 438–439 (holding that the pleadings were legally insufficient to hold the directors liable for failure to disclose material information regarding the performance of the subprime loans because plaintiffs did not show that the directors deliberately misinformed the shareholders); *In re Citigroup Litig.*, 964 A.2d at 124 (holding that the plaintiffs failed to rebut the BJR because they were unable to demonstrate through particularized and specific pleading of facts that the decision to invest in MBS was not a "product of a rational process and the directors availed themselves of all material and reasonably available information"); *see* Nees, *supra* n. 29, at 228–232 (stating that many derivative suits are dismissed in the prediscovery phase because of the requirement that plaintiffs plead with particularity that the directors have violated a fiduciary duty). This is the reason that so many derivative actions piggyback on other lawsuits aimed at directorial decision-making—then they can show that there was a violation of law that exposed the company to liability. Erickson, *supra* n. 8, at 55.

care, the underlying breaches alleged in derivative actions are limited to the two remaining fiduciary duties.

2. The Duty of Loyalty & Good Faith

Classic configurations of corporate fiduciary duty proclaim that directors and officers have three distinct fiduciary duties that form a triad: the duty of care, the duty of loyalty, and the duty of good faith.[118] The duty of care has disappeared almost entirely from the landscape of corporate fiduciary responsibility as a result of exculpation clauses and judicial reluctance to substitute its own discretion with the benefit of hindsight.[119] The duty of care provides that the directors must perform their managerial or supervisory functions with a reasonable amount of care.[120] Reviewing board decisions for negligence inevitably entails second-guessing the directors' exercise of discretion through the lens of its consequences in contradiction to the BJR.[121] Because derivative actions must overcome the BJR and will often have to contend with 102(b)(7) exculpation clauses, they are often brought under theories of breach of the duty of loyalty and breach of the duty of good faith.[122]

Further, Delaware caselaw, starting with *Stone*,[123] provides that the "duty of good faith" is a component of the duty of loyalty.

118. Nees, *supra* n. 29, at 208–209; Furlow, *supra* n. 28, at 1063.

119. *Supra* n. 111 for the relevant text of Del. Code tit. 8 § 102(b)(7). *See also* Nees, *supra* n. 29, at 219 (stating that as a result of exculpatory clauses, a showing of bad faith on the part of directors is necessary in order to impose liability); Furlow, *supra* n. 28, at 1062–1063 (noting that it is significant that Delaware law has not properly defined "good faith" because Title 8, Section 102(b)(7) of the Delaware Code provides that a corporation can include a provision in its Articles of Incorporation that shields directors from liability for breaching fiduciary duties except the duty of loyalty and decisions that a lack of good-faith basis or involve a knowing violation of the law).

120. Furlow, *supra* n. 28, at 1066.

121. *Aronson*, 473 A.2d at 812. The *Aronson* court noted that "demand futility is inextricably bound to issues of business judgment." *Id.* The court went on to say that to be protected by the BJR, directors must be disinterested and seek to inform themselves using information that is reasonably available to them. *Id.* at 812.

122. *See* Kerr, *supra* n. 111, at 75–77 (noting that board members are shielded from potential liability by the BJR, exculpatory clauses, and the fact that shareholder derivative suits are rarely successful).

123. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369–370 (Del. 2006) (stipulating that good faith underpins a successful *Caremark* liability suit as the allegations must show that the directors breached the duty of loyalty by failing to have a good-faith belief that their actions were in the best interest of the corporation). Professor Furlow proposes that good faith should not be approached as an independent fiduciary duty as it "describes the state of mind of a director who is acting in accordance with her

Proponents of this view argue that the duty of good faith simply asks whether the directors held a good-faith belief that the action was in the best interest of the company.[124] Consequently, the duty of loyalty has become paramount when it comes to derivative actions. However, this does not mean that concepts of good faith are irrelevant to directors carrying out their duties to the corporation because evidence that tends to show bad-faith behavior is usually relevant to show that one or more of the directors has violated the duty of loyalty.[125] Oversight liability, such as this Article proposes, for failing to consider material information contained in disclosures can only attach if a breach of the duty of loyalty is found. In order to distinguish actions that allege this failure of oversight on a theory of breach of the duty of care actions from those that result in a breach of the duty of loyalty, Delaware courts have expressed a number of criteria centered around BJR concepts to limit liability.

3. Oversight Liability and the Rise of Caremark[126] *Suits*

Oversight liability is widely regarded as being one of the toughest theories of director liability that can be raised in a derivative action.[127] As mentioned above, American corporate law jurisprudence has several built-in mechanisms, including the BJR doctrine and 102(b)(7) exculpation clauses, that express

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duty of loyalty" whereas the "[t]he duty of loyalty defines *what* the directors are seeking to accomplish—i.e., the best interests of the corporation" and "[t]he duty of care defines *how* [directors] are to pursue that goal—i.e., by using 'that amount of care which ordinarily careful and prudent men would use in similar circumstances.'" Furlow, *supra* n. 28, at 1063, 1069–1070 (quoting *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 729 (Del. Ch. 2005) (quoting *Graham v. Allis-Chambers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963)). *See* Kerr, *supra* n. 112, at 81–82 (stating that the duty of good faith is sometimes described as a "sub-category" to the duty of loyalty).

124. Furlow, *supra* n. 28, at 1063.

125. *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d at 967–970 (explaining that to comply with the duty of loyalty, directors must have a good-faith belief that their actions are in the best interest of the corporation); *Stone*, 911 A.2d at 369–370 (stating that liability for failure of oversight is premised on the breach of the duty of loyalty by showing bad-faith conduct through evidence of a director's conscious disregard for his or her responsibilities); Furlow, *supra* n. 28, at 1066–1067, 1071–1072 (defining good faith as an absence of bad faith and explaining that a decision made in bad faith is a violation of the duty of loyalty).

126. Under *Caremark*, the standard is that "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations." *Stone*, 911 A.2d at 370.

127. *In re Caremark*, 698 A.2d at 967.

judicial and legislative reluctance to second-guess board members' business decisions simply because in hindsight they should have decided differently.[128] Courts have noted, in what *Stone* refers to as *Caremark* and its progeny, that no single theory of liability seems more intrusive on the directors' business judgment than oversight liability.[129] As in other derivative suits, courts are reluctant to substitute their views for the directors' business judgments when an after-the-fact event has proved that the directors could have made a better decision. However, the current state of oversight litigation is dominated by cases that emphasize a qualitative difference between oversight liability based on systems designed to detect illegal activity and liability based on a failure to assess risk.[130] The possible reasons for this judicial preference are discussed below. Whatever the source of the preference for oversight liability claims based on alleged failures of systems that detect criminal activity, it is illustrative of courts' general apprehension toward *Caremark* suits.[131]

As a result of this apprehension, *Caremark* and its progeny have established several limitations on these actions: (1) these suits can only be established through evidence of a "sustained or systemic failure" to exercise oversight duties so as to bring into question the directors' duty of loyalty;[132] (2) the plaintiffs must be

128. *See* Kerr, *supra* n. 112, at 75–77 (noting that board members are shielded from potential liability by the business judgment rule, exculpatory clauses, and the limited success of shareholder derivative suits).

129. In adopting the *Caremark* standard for oversight litigation, the Delaware Supreme Court explained that because a derivative action invades the board's discretion to decide what is in the best interest of the corporation, demand must either be made or shown to be futile. *Stone*, 911 A.2d at 367, 369–370. The court went on to explain that director liability for failure of oversight especially invades the directors' discretion. *Id.* at 369–370.

130. The Delaware Court of Chancery in *In re Goldman Sachs Group, Inc. Shareholder Litigation*, 2011 WL 4826104 (Del. Ch. 2011), has, perhaps, gone the farthest when it held that because none of the activities alleged as the bases of the *Caremark* claim are not illegal per se the directors cannot be liable for failure of oversight. *Id.* at **19–20. The language in other opinions does not seem to go as far. For example, in *In re Citigroup Inc. Shareholder Derivative Litigation*, the court denied the plaintiffs' claims based on the directors' approval of underperforming MBS because a misstatement is actionable as a breach of duty only when it is "made knowingly or in bad faith." 964 A.2d at 106.

131. While the duty of loyalty requires the board to pursue the best interests of the corporation (e.g., profits), it also requires it to do so within the confines of the law. Furlow, *supra* n. 28, at 1073, 1082. Consequently, failure to monitor for illegal activity that exposes the corporation to liability can never be said to be the product of a rational business decision.

132. *See e.g. Raines*, 534 F.3d at 789 (outlining the "red flags" plaintiffs pled were sufficient to put the directors on notice); *In re Goldman Sachs Litig.*, 2012 WL 3293506 at *8 (discussing "red flags"); *In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 435 (holding

able to demonstrate through particularized pleadings that there were "red flags" present that tend to show that the directors demonstrated a conscious disregard for a known duty showing that their failure to act was not in good faith;[133] and (3) the courts will only review the processes that the directors employed.[134] These three limitations accomplish the goals of the BJR in at least two ways.

First, the limitations direct the litigants' attentions to the duty of loyalty to the exclusion of arguments that the directors were negligent in implementing or monitoring the processes.[135] Because any argument couched in terms of negligence would necessarily question the business decisions of the board in its supervisory role, oversight liability cannot attach absent bad-faith conduct.[136] Second, the three limitations focus the pleadings and judicial review on the facts that were present at time of the board's alleged acts or omissions that form the basis for the failure-of-oversight claim.[137] This focus furthers the goals of the BJR by removing from the analysis, as much as possible, arguments regarding the adverse consequences that ensued.[138] The

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that the alleged "red flags" based on general market conditions were insufficient to place the directors on notice for the purposes of a *Caremark* claim); *In re Citigroup Litig.*, 964 A.2d at 126–127 (discussing the quality of the alleged "red flags"); *In re Caremark*, 698 A.2d at 971. In *Stone*, the Delaware Supreme Court made *Caremark* the rule of the land and reaffirmed the "sustained or systemic failure" standard. 911 A.2d at 370. Now, oversight liability cases either discuss whether there was a sustained or systemic failure or the quantity and quality of "red flags"—which in my opinion are looking for the same type of evidence. *In re Countrywide Litig.*, 554 F. Supp. 2d at 1077 (discussing "sustained or systemic failure").

133. The presence of sufficient red flags to place the directors on notice goes to proving that: (1) there was a "sustained or systemic failure"; and (2) that the directors failed "to act in the face of a known duty to act." *In re Countrywide*, 554 F. Supp. 2d at 1077 (quoting *Stone*, 911 A.2d at 369).

134. *In re Caremark*, 698 A.2d at 967–968.

135. The *Caremark* standard for director liability resulting from failure of oversight "draws heavily upon the concept of director failure to act in good faith" and is a higher standard than mere negligence or even gross negligence. *Stone*, 911 A.2d at 369.

136. Furlow, *supra* n. 28, at 1068.

137. Although oversight liability focuses on the processes—an analysis usually associated with the duty of care—the end result of this analysis asks whether the failure to implement or adequately monitor these processes was an act taken in good faith. *In re Caremark*, 698 A.2d at 967–968.

138. In failure of oversight claims, plaintiffs have to rebut the presumption that the decision was a "product of a rational process and the directors availed themselves of all material and reasonably available information." *In re Citigroup Litig.*, 964 A.2d at 124. *See generally In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 435 (stating that a plaintiff cannot succeed on a *Caremark* claim simply by alleging that market conditions created "red flags" that the directors should have picked up on in exercising their business

end result of all of this is that *Caremark* suits are based on either a failure to implement reporting or information systems or a conscious disregard for the duty to monitor these systems in the face of numerous red flags that triggered the duty to act.[139] Further, the failure to act under these circumstances cannot be supported as a valid business decision when considering directors' duty of loyalty.[140] If these limitations and standards seem convoluted and overlapping, it is because they are essentially trying to achieve the same BJR-type goals. Facts that support or fail one of these judicially created standards will often support or fail the others in the same way by applying very similar reasoning.[141]

As a result of these liability-limiting doctrines and *Caremark* caselaw, the basis for most successful *Caremark* suits usually involves a failure to monitor the company and its agents for fraudulent or illegal activity.[142] But failure to monitor for illegal activity is not, at this point, the only plausible theory of recovery in oversight liability cases.[143] The emphasis on illegal activity, therefore, is just another way that the BJR has worked its way into the law of derivative actions because liability will not be imposed unless the board acted with a conscious disregard for its duty to supervise in a way that cannot be justified as a valid

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judgment); *In re Citigroup Litig.*, 964 A.2d at 126–127 (denying the claim based on "red flags" that mostly dealt with market conditions such as the rise of foreclosures, the impact of the burst of the housing bubble on MBS, and losses reported by companies similarly situated to Citigroup). *But see In re Countrywide Litig.*, 554 F. Supp. 2d at 1055 (denying the defendants' motion to dismiss because the plaintiffs' allegations based on "red flags" particular to the goings-on within the company and general market conditions were sufficient to raise an inference of scienter in connection to the purchase of high-risk MBS).

139. Nees, *supra* n. 29, at 205–207, 239.

140. *Id.*; Furlow, *supra* n. 28, at 1066–1067 (stating that, under Delaware law, directors who ignore "red flags" violate the duty of loyalty because they cannot in good faith claim that they acted in the best interest of the corporation).

141. *See supra* nn. 105–109.

142. *See generally In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 438–439; *In re Goldman Sachs Litig.*, 2011 WL 4826104 at *22; *In re Citigroup Litig.*, 964 A.2d at 124.

143. Personal liability can be imposed on the directors if it is shown that they deliberately misinformed the shareholders regarding underperforming assets, such as subprime loans, *In re American International Group Litigation*, 700 F. Supp. 2d at 438–439, or if the entity had an "independent duty to make such disclosures," *In re Fannie Mae Litigation*, 891 F. Supp. 2d at 486. Likewise, liability could attach if the decision was not a "product of a rational process and the directors [failed to] avail[ ] themselves of all material and reasonably available information" in reaching their decision. *In re Citigroup Litig.*, 964 A.2d at 124.

business decision.[144] In the wake of massive economic losses, and perhaps motivated by a desire to hold someone responsible,[145] shareholders have argued oversight liability using an assortment of factual scenarios. Some of these scenarios appear to be an effort to convolute the quantity and quality of the alleged red flags with the disastrous results of poor decision-making in order to make the board decision seem unsupportable as a valid exercise of discretion.[146]

4. Why Limit Oversight Liability to Illegal Activity?

In cases in which the failure of oversight results in a violation of the law, there is a workable standard by which to analyze the sufficiency of the processes: whether they were designed to adequately monitor for violations of the law. When the answer is that the information systems in place were not adequately designed to detect illegal activity, the board has been negligent. To rise to the level of bad faith and ultimately result in a judicial determination that the directors violated their duty of loyalty, the failure of the system (in this case implementation of a system) must be "sustained or systemic" in a way that cannot be reconciled with the duty of loyalty.[147] In order to be sustained or

144. Furlow, *supra* n. 28, at 1074 (emphasizing that illegal activity, no matter how profitable, cannot be justifiable); Nees, *supra* n. 29, at 235 (arguing that the pendulum in favor of director authority has swung too far in their favor, and the derivative suit should be utilized as a mechanism to balance directorial discretion to run the corporation with their fiduciary duties to the owner-shareholders).

145. McClendon, *supra* n. 29, at 138 (detailing how news stories "placed the blame squarely at the feet of unscrupulous industry executives who took millions in incentive-based compensation before and after releasing record losses to the public").

146. For example, in *Raines*, 534 F.3d at 789, the plaintiffs alleged that the red flags consisted of: "(1) a $200 million audit difference originating in 1998 [which the court decided was okay because the board met with an outside auditor that agreed with the treatment of the expenses and deferring them for future years, *id.* at 789]; (2) a whistleblower's complaints that Fannie Mae was improperly manipulating earnings [the court decided this was fine because an audit committee met and reviewed the allegations made by the whistleblower and were satisfied with the result of the investigation, *id.* at 790]; (3) signs that Fannie Mae management was using improper hedge accounting practices [the court said that because the complaint alleged that the board's committee "should have known," the allegations were insufficient to impose liability, *id.* at 790]; and (4) sister company Freddie Mac's disclosure in 2003 that it had understated profits [the court found that the directors met to discuss the Freddie Mac situation and were assured by the company's financial officers that Fannie Mae was not vulnerable in the same manner as Freddie Mac, *id.* at 791]."

147. *In re Countrywide Litig.*, 554 F. Supp. 2d at 1077; *In re Citigroup Litig.*, 964 A.2d at 122–123; *In re Caremark*, 698 A.2d at 971.

systemic, there must have been "red flags" that would have placed the directors on notice.[148] To put it simply, allowing illegal activity to occur can never be justified as a valid business decision.[149] By limiting oversight liability to cases in which the plaintiffs can show a failure of systems designed to detect illegal activity, courts are not in danger of running afoul of BJR principles.

Nevertheless, liability for failure to implement or adequately monitor other types of systems is possible under the current framework of *Caremark* litigation.[150] In order to impose oversight liability for the failure to monitor excessive risk-taking behavior, a system is needed that tracks "red flags" by documenting the information available to directors at the time the decision was made and the processes utilized in reaching their decision to take that risk.[151] Implementing a process to track investment decisions in MBS seems especially appropriate because: (1) these types of asset-backed securitized transactions are very complex and thus require fuller disclosure;[152] (2) the market has failed to monitor itself;[153] (3) many executives claim to have been blindsided by the failure of MBS, and thus these types of investments require

148. *In re Countrywide Litig.*, 554 F. Supp. 2d at 1053; *Stone*, 911 A.2d at 370; *In re Citigroup Litig.*, 964 A.2d at 127–128.

149. Furlow, *supra* n. 28, at 1073.

150. *In re Fannie Mae*, 891 F. Supp. 2d at 486; *In re Am. Int'l Group Litig.*, 700 F. Supp. 2d at 438–439; *In re Citigroup Litig.*, 964 A.2d at 124.

151. Professor Nees proposes the use of a five-factor test articulated by the court in *In re Citigroup Inc. Shareholders Litigation*, 2003 WL 21384599 at *2 (Del. Ch. June 5, 2003), that is independent of the narrow confines of whether the systems were designed to detect illegal activity: "(1) the potential harm to the company, (2) the time [directors had] to react, (3) the source of the red flag, (4) [the] frequency [of the red flag], and (5) the availability of [relevant] information [to the directors]." Nees, *supra* n. 29, at 258.

152. Schwarcz, *Controlling Financial Chaos*, *supra* n. 77, at 818–821; Schwarcz, *Marginalizing Risk*, *supra* n. 62, at 496–497; Schwarcz, *Disclosure's Failure*, *supra* n. 77, at 1114; Schwarcz, *Rethinking the Disclosure Paradigm*, *supra* n. 62, at 11–14; *see also* Dennis, *supra* n. 55, at 1116, 1119, 1121 (arguing that AAA–C ratings may be insufficient to appreciate the performance or risk of investing in private MBS).

153. Dennis, *supra* n. 55, at 1132–1133 (arguing that the reputational-market theory failed as a regulator of rating agencies); Nees, *supra* n. 29, at 214 (stating that because market incentives have been unsuccessful at curbing excessive risk-taking, derivative actions are appropriate in certain circumstances as shareholders have a right to "encourage and enforce complying behavior" that is in the best interest of the corporation); Schwarcz, *Disclosure's Failure*, *supra* n. 77, at 1122 (providing that investors are likely to consider their own needs well before the needs of the market, making disclosures by themselves ineffective at protecting the market).

better monitoring systems;[154] (4) the banking sector is so crucial to the economy that more regulation is justified;[155] and (5) by broadening the concept of personal liability for failure of oversight—even if not much—the incentives created by short-term performance compensation packages will be removed.[156]

III. SOLUTIONS

A. Oversight Liability Based on Federally Mandated Investment Risk Disclosures

Setting up a framework for analysis based on federally required disclosures as part of the information systems utilized by all companies operating in the secondary mortgage market would be in line with *Caremark* and its progeny. Because these disclosures would be legally required, they would be subject to federally mandated standards, which would provide guidance to the judiciary. The principle purpose of these standards would be to reduce information asymmetry so that the risk of the investment or purchase of MBS would be known to officers, directors, and shareholders. However, these disclosures could also form the basis of a colorable cause of action for oversight liability that would allow shareholders in certain circumstances to plead facts with particularity that would overcome the BJR presumption and 102(b)(7) exculpation clauses.[157]

Full and fair disclosure has been a principal method of reducing information asymmetry in a number of contexts, including executive compensation,[158] environmental impact of a company's actions,[159] public reports about a company's activities in

154. Nees, *supra* n. 29, at 201 (pointing out that the perception of lack of oversight that resulted from the failure of investments in MBS and CDOs was highlighted by corporate directors' claims that they were blindsided by the failure of these investments).

155. *Supra* pt. II (discussing the banking sector and why more regulation is justified).

156. McClendon, *supra* n. 29, at 134–136 (providing that huge bonuses given to executives for producing short-term gains caused them to ignore the companies' standards and grant increasingly riskier loans).

157. *See* Schwarcz, *Disclosure's Failure*, *supra* n. 77, at 1122 (providing that investors are likely to consider their own needs well before the needs of the market, making *disclosures by themselves* ineffective at protecting the market).

158. 15 U.S.C. § 78n-1 (2011).

159. Since 1989, Rule 10b-5 has required companies to include in the quarterly 10-Q or annual 10-K reports full and fair disclosure of the corporations' environmental costs under Regulation S-K, 17 C.F.R. Section 229. Elizabeth Glass Geltman, *The Pendulum Swings*

trade-in securities,[160] and in the sale or purchase of securities.[161] It is probably not an overstatement to say that the principal method employed by the Securities and Exchange Act of 1934 is full and fair disclosure.[162]

The purpose of disclosures is to eliminate asymmetrical information in business transactions. This purpose is particularly useful in securities exchanges in which the buyer of securities would have almost no way of knowing what the seller knows about the transaction.[163] MBS are often so complex that the prospectus—or pooling and servicing agreements—are often hundreds of pages long.[164] Moreover, those entities that participate in the secondary mortgage market and are heavily invested in MBS and those that originate loans that are securitized and pooled for investment should have small teams of financial analysts creating and unwinding these disclosures for the benefit of board members who, with the company's officers, must decide whether to continue investing in MBSs.[165] The ultimate purpose of disclosures is to bring market prices in line with the quality of the investments because markets will not compensate for insufficient disclosure in a world of complexity.[166]

Because the disclosures would reduce information asymmetry between the directors and shareholders, derivative claims

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Back: Why the SEC Should Rethink Its Policies on Disclosure of Environmental Liabilities, 5 Vill. Envt'l. L.J. 323, 393 (1994).

160. 15 U.S.C. § 78m(stating that all companies that register securities with the SEC are required to file 10-K reports at least once per year).

161. 15 U.S.C. § 78(j) (stating that the enabling legislation for SEC Rule 10b-5 disclosure requirements).

162. The "'[f]undamental purpose' of [this chapter is] implementing a 'philosophy of full disclosure[,]' [and] once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." *Cole v. Schenley Indus., Inc.*, 563 F.2d 35, 44 (2d. Cir. 1977). "Congress designed [this chapter] to promote the full and fair disclosure of information concerning securities so that the public would be protected from the fraudulent schemes of securities salesmen." *Anspach v. Bestline Prods., Inc.*, 382 F. Supp. 1083, 1086 (N.D. Cal. 1974).

163. The purpose of this chapter is "[t]o substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *Spilker v. Shayne Laboratories, Inc.*, 520 F.2d 523, 525 (9th Cir. 1975) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

164. Schwarcz, *Disclosure's Failure*, *supra* n. 77, at 1110.

165. *See id.* at 1114 (pointing out that structured transactions are complex—often too complex for a single individual to decipher alone—and while entities investing in these securities should have a team of analysts working on unwinding the disclosures, they often do not but should hire these experts to the extent that the benefits exceed the costs).

166. Schwarcz, *Rethinking the Disclosure Paradigm*, *supra* n. 62, at 6–7, 23.

based on failure of oversight for certain risks would not rely on puzzle pleadings heavily based on general market conditions. If the directors failed to implement an information system that would produce disclosures detailed enough to apprise them of the risks of investing in a particular set of MBS, oversight liability could ensue under the current framework of *Caremark* suits. Likewise, oversight liability could attach if suitable disclosures were produced—that is, the disclosures are deemed legally sufficient—but the surrounding facts present at the time of the transaction, such as price, other market indicators, or the amount of time spent in the boardroom, show that little heed was paid to the contents of the disclosures. The quantity and quality of the red flags produced by the information in the disclosures would indicate whether the failure to monitor was systemic or sustained.[167] Just as in the current framework of successful *Caremark* suits, either of these two activities would be sufficient to overcome the BJR by offering a particular set of facts that show that the directors' decisions violated the duty of loyalty because the act or omission could not have been supported by a good faith belief that it was in the best interest of the corporation.

Further, the disclosures would provide the red flags that trigger directors' duty to act. As the Delaware Court of Chancery held in *Caremark* and the Delaware Supreme Court later approved in *Stone*, the duty to monitor is not limited to circumstances in which directors have a suspicion that the reporting and information systems are inadequate.[168] Consequently, the duty to monitor these investments through the federally required disclosures is not suspended because of a belief by the board members that the reporting and information systems are adequate to monitor risky investments. In conformity with the BJR, oversight liability based on these disclosures would focus on the

167. Direct knowledge of circumstances is not necessary in order to prove that a director has conscious disregard for a known duty that amounts to bad faith. *In re Citigroup Litig.*, 964 A.2d at 125 (stating that "[a] plaintiff can thus plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties" (emphasis in the original)); Andrew C. W. Lund, *Opting out of Good Faith*, 37 Fla. St. U. L. Rev. 393, 431–432 (2010) (explaining that a conscious disregard for a duty does not require proof of knowledge).

168. *Stone*, 911 A.2d at 368 (affirming the same finding by the Court of Chancery in *Caremark*, 698 A.2d at 969–970).

processes and not on the adverse results.[169] The relevant period for review of acts and omissions would be between the time that the disclosures were presented to the board and the time that the transaction was completed.[170]

B. Regulation through the Threat of Litigation

Derivative actions are often confused with securities class-action suits.[171] The goal in a securities class-action is to have the corporation pay investors for losses the investors claim to have suffered because of deceptive or fraudulent statements or omissions that the corporation may have made in connection with a certain investment.[172] Derivative actions, on the other hand, seek to compensate the corporation for losses that it suffered because of the directors' or corporate officers' failure to perform one or more of their fiduciary duties by holding those individuals personally liable to the corporation.[173] Although these two types of claims aim to accomplish different goals, they share some similarities: like most litigation, they serve a public and private purpose.[174]

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169. This approach is in line with precedent because it imposes an "independent duty to make [ ] disclosures," *In re Fannie Mae Litigation*, 891 F. Supp. 2d at 486, and the failure to create the appropriate disclosures would be an act that deliberately misinformed the shareholders regarding underperforming assets, *In re American International Group Litigation*, 700 F. Supp. 2d at 438–439, in addition to violating federal law. Moreover, whether the directors' decision to invest in a set of MBS was a "product of a rational process [through which] the directors availed themselves of all material and reasonably available information," *In re Citigroup Litigation*, 964 A.2d at 124, could be evidenced by their consideration of the information contained in the disclosures.

170. The transaction costs to the corporation could, for example, be greatly reduced if officers relied on the opinions of experts who could utilize all of the information required in the disclosures to assess risk perhaps using an algorithm similar to those used by the insurance industry to assess risk. By relying in good faith on expert opinions, the directors could be shielded from liability. *Brehm*, 746 A.2d at 262.

171. Erickson, *supra* n. 8, at 79–80.

172. *Id.*

173. In fact, there seems to be a perception that securities class actions and derivative claims are coextensive—that is, that the money lost in the securities litigation can be recouped by the corporation through the derivative claim. *Id.* at 79.

174. *See id.* (arguing that derivative actions underperform as deterrents). There is some indication that the derivative suit is outperformed by other actions in deterring certain corporate behaviors. *Id.* at 76–78. However, the derivative suit could be an effective regulatory device but has been rendered all but useless by "[a] quarter-century shift away from director accountability [that] has created a narrow and virtually unenforceable standard for director oversight liability in shareholder derivative suits absent clear violations of the law." Nees, *supra* n. 29, at 205.

Class-action securities lawsuits serve the purpose of having the corporation compensate the investors for false statements that its officers made in connection with the securities that prompted investors to invest funds in the securities.[175] Additionally, it serves the public purpose of ensuring that the corporation, through its officers, complies with the SEC regulations that form the basis of 10b-5. Likewise, derivative actions serve the private purpose of compensating the corporation for its losses resulting from officers' breaches of fiduciary duties and serve the public purpose of ensuring that officers comply with their fiduciary duties[176] Arguably, the public-purpose component is less obvious in derivative actions,[177] but has become an increasing topic of public discussion as the failure of the housing sector has bled into other unrelated markets.[178] The public purpose component of corporate fiduciary duties gains even more strength as many corporations are bailed out by public funds[179] and the compensation of corporate officers has become a part of the public debate regarding the state of the national economy.[180]

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175. 15 U.S.C. § 78j (2009); *S.E.C. v. Mudd*, 885 F. Supp. 2d at 661.

176. *See* Nees, *supra* n. 29, at 214 (noting that because market incentives have been unsuccessful at curbing excessive risk-taking, derivative actions would seem to offer the proper balance between directors' discretion in running the corporation and their duties to the owners of the corporations by allowing the shareholders in certain circumstances to "encourage and enforce complying behavior" that is in the best interest of the corporation).

177. Because damages in class-action lawsuits are almost always paid by the corporation or its insurer, not by the culpable managers, it is not an effective deterrent. Mitchell, *supra* n. 14, at 247.

178. Schwarcz, *Marginalizing Risk*, *supra* n. 62, at 501–503 (detailing how documented losses by financial institutions heavily invested in MBS caused other markets unrelated to mortgage lending and MBS investments to falter).

179. Kerr, *supra* n. 112, at 50–51 (stating that Congress enacted the Emergency Economic Stabilization Act of 2008 and created the Troubled Asset Relief Program in an effort to stabilize the economy and to hedge off further damage); McClendon, *supra* n. 29, at 159 (stating that after receiving TARP funds, "AIG then paid out $165 million in retention bonuses to executives at AIG FP, the division that engaged in the MBS transactions that brought AIG to the brink of disaster").

180. "Much of the blame for the MBS-generated global financial crisis and the ensuing recession was placed on financial industry executives who took millions of dollars in bonuses for short-term corporate gains. In 2007, two of the top-ten highest paid CEOs work[ed] in the financial industry: John Thain, Merrill Lynch CEO, received $83 million; and Lloyd Blankfein, Goldman Sachs CEO, received $54 million. In 2008, there was more of the same, with Lloyd Blankfein receiving $42.9 million and James Dimon, JPMorgan Chase CEO, receiving $35.7 million." McClendon, *supra* n. 29, at 134.

Regulation through litigation is a well-established concept in the landscape of American law.[181] Private grievances gain a public component when the harm is widespread and damaging enough to raise public awareness of its ills.[182] This public component is arguably present in many types of civil actions because one of the purposes of litigation is to promote efficient behavior.[183] In light of the massive losses by what many believe is the reckless risk-taking of directors, officers, and other agents in charge of managing corporations, it seems that the law has failed to promote efficiency in that sector. But corporate decision-makers were provided many incentives to increase the short-term earnings of the companies that employed them without regard for the dangers that they were creating.[184] Because failure of oversight liability is founded on a theory of breach of the duty of loyalty, Delaware law prohibits indemnification of the director found liable under these circumstances.[185] Moreover, the remote chance of personal liability did not weigh in adequately when they were

181. For example, various provisions of the Fair Debt Collection Practices Act allow a debtor to bring a private action against a violating debt collector under a theory of strict liability. *See* 15 U.S.C. §§ 1692(d), 1692(e), 1692(j), 1692(k) (2011).

182. W. Kip Viscusi, *Regulation through Litigation*, 1–7 (W. Kip Viscusi ed., AEI-Brookings Joint Center for Regulatory Studies 2002).

183. *See generally* Richard A. Posner, *The Economic Approach to Law*, 53 Tex. L. Rev. 757 (1974–1975) (detailing how economic analysis of litigation involving certain market players has influenced legal policy). *See also* Bar-Gill, *supra* n. 5, at 1073, 1139–1140, 1150–1151 (arguing that "a better understanding of the market failure that produced [ ] inefficient [subprime loan] contracts should inform the ongoing efforts to reform the regulations governing the subprime market"). Some classic examples of private concerns becoming so great that they gain a public component include asbestos and carcinogens from tobacco products. *See generally* W. Kip Viscusi, *Risk Equity*, 29 J. Leg. Stud. 843, 851 (2000) (detailing how public pressures because of these private concerns propelled lawmakers to act). *See also* W. Kip Viscusi, *Toward a Diminished Role for Tort Liability: Social Insurance, Government Regulation, and Contemporary Risks to Health and Safety*, 6 Yale J. on Reg. 65, 65–67 (1989) (arguing that the role of private tort litigation should give way to market and legislative forms of regulation as the complained of injuries gain a public component).

184. *Supra* nn. 25–26 and accompanying text.

185. Del. Code tit. 8, § 145(b) (2013) (providing that a corporation has the discretion to indemnify an unsuccessful director or officer litigant unless the individual did not have a good-faith belief that he or she was acting in the best interest of the corporation). Additionally, indemnification will probably not be indemnified by the typical Director and Officer Insurance Policy (D&O insurance) because a claim that results in a judicial decree that the insured acted dishonestly is excluded under such policies. Perry S. Granof, *Directors' and Officers' Liability Insurance* in *Doing Business in Washington State: A Guide for Foreign Business and Investment*, 225–226 (Randy J. Aliment & Williams Kastner, eds., Int'l Practice Section Washington State Bar, 2010) (available at http://www.granofinternational.com/documents/guide_foreign_business_investment.pdf).

assessing the personal risks of the actions they had been taking.[186] Therefore, to adequately ensure that the private and public interests of having officers comply with their fiduciary duties are well-balanced and adequately promote efficiency,[187] derivative litigation should be expanded—albeit not much and within the current framework of corporate law—to allow shareholders to file suit and get to the discovery stage of litigation.[188]

IV. THE PROPOSED LEGISLATION[189]

RESIDENTIAL REAL ESTATE MORTGAGE-BACKED SECURITIES DISCLOSURE ACT

Purpose: *To provide substantial disclosures to purchasers of mortgage-backed securities and investors in the secondary mortgage market. Congress finds that due to the complexity of these transactions and the propensity for many underperforming assets to be pooled and securitized for sale and investment in the secondary mortgage market, stronger disclosures are required to adequately apprise investors of how these investments are likely to perform given the assets in each individual pool.*

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186. Liability-limiting doctrines such as the BJR and the presence of exculpatory clauses make director liability an illusory concept in relation to the broad duties directors owe to the corporation. Nees, *supra* n. 29, at 210. As the state of the law stands, fiduciary duties seem aspirational, if not farcical, which is a far cry from Cardozo's "punctilio of an honor the most sensitive." *Meinhard*, 164 N.E. at 546.

187. The proposed scheme would not pose difficulties for directors to comply with the fiduciary duties. By simply considering the information in an adequately prepared disclosure, the directors would be in compliance. *See e.g. Moran v. Households Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (determining that the directors had complied with their fiduciary duties because they had been given and considered a notebook that provided a summary of the aspects of the challenged transaction).

188. This is Professor Nees's argument, but while her focus is on establishing a standard that defines the red flags, Nees, *supra* n. 29, at 207, this Article focuses on bridging the gap between information failures or deliberate misinformation regarding excessive risk taking and *Caremark* liability suits. While the corporate directors can, "in good faith, decide not to pursue a remedy on behalf of the corporation," this is not a right of the directors once the suit has been instituted, and it is subject to judicial review. *Maldonado*, 413 A.2d at 1262.

189. The proposed legislation must be enacted at the federal level so that it can be applied uniformly and not avoided by simply moving to a state that has not adopted the legislative scheme.

(A) REQUIRED DISCLOSURES—Any Seller of mortgage-backed securities whose market activities comprise of more than [DOLLAR AMOUNT], or whose trade in these securities exceeds [PERCENTAGE] of said company's interest, shall be required to produce disclosures that conform with the requirements of subsection (C), which shall be delivered or otherwise made available to potential Investors and Purchasers no less than [NUMBER OF DAYS] days before the securitized mortgage loans are made available for sale and investment.

  (1) Each asset securitized and pooled for investment shall be subjected to the requirements of subsection (C);

  (2) The Seller's special purpose entity shall be responsible for assuring the adequacy of the disclosures;

  (3) The Seller of mortgage-backed securities shall give the buyer [NUMBER OF DAYS] days to review the disclosures and reach an independent assessment as to the investment's performance before holding a sale or closing the date for investments;

  (4) The Seller of securities under this section are required to inform the Buyer of material changes that would affect any portion of the disclosures under subsection (C) before holding a sale or closing the date for investments.

(B) REQUIREMENT TO CONDUCT A THOROUGH ANALYSIS OF THE DISCLOSURES—Any Buyer of mortgage-backed securities whose market activities in these investments comprise of more than [DOLLAR AMOUNT], or whose trade in securities exceeds [PERCENTAGE] of said company's portfolio, shall be required to employ analysts to analyze the disclosures under subsection (C). The analysts shall provide a report to the board of directors [NUMBER OF DAYS]

days before the securitized mortgage loans are made available for sale and investment.

(1) The number of analysts employed by the buyer of mortgage-backed securities shall be of a number sufficient to analyze the data and create a report within the time tables of this Section;[190]

(2) The analysts described under this subsection shall evaluate the disclosures provided by the Seller of the mortgage-backed securities and prepare a report based on the independent evaluation of the likely performance of these securities;

(3) The analysts shall produce a report for the board's review that describes the strength of the securities and likely market performance;

(4) The report shall suggest a price point at which the investment in the pool of securities correlates with the risk associated with investing in the securities based on the analysts' independent findings;

(5) Directors who rely in good faith on the representations of their experts are exempt from liability under subsection (F).[191]

(C) CONTENTS—All of the information required under this subsection shall be subject to general accounting principles.

(1) For each individual loan that will be securitized and pooled for investment:

(a) Loan application;

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190. This would vary with the amount of market activity that a company has in these types of investments.

191. *See* Del. Code tit. 8, § 141(e) (providing that directors and mangers "shall . . . be fully protected" if they rely in good faith on the corporation's documents and the opinions of its experts); *see also Brehm*, 746 A.2d at 261–262 (finding that ultimately the corporations' fiduciaries did not breach any duty because they relied in good faith on the opinion of an outside expert).

(b) Truth-in-Lending Act Disclosure Statement;

(c) Interest rate and any variable features of loan extended to the borrower;

(d) Loan amount;

(e) Income-to-debt ratio at origination without figuring in assets or equity in the home;

(f) Credit report of the borrower pulled [NUMBER OF DAYS] days prior to origination;

(g) Outstanding principal balance;

(h) Whether the loan is a negative amortization loan;

(i) Life of the loan history;

(j) Bankruptcy filings by the mortgagor;

(k) Likelihood of loan prepayment;

(l) History of default on the loan.

(2) For each pool of securitized mortgages:

(a) Written assessment of how the different mortgages will perform together as one investment;

(b) Chart diagramming the risk of the collective expected performance of the mortgages pooled into a single investment;

(c) Breakdown into categories by accepted market terms of the structuring of the loans that are to comprise the securitized mortgages and the percentage of each that will comprise the portfolio;

i. For each category of loan structuring [RISK]:

1. Total number of payments that were delinquent from the time the loans were incepted until the date of analysis [giving fifteen days for analyzing];

2. Average number of late payments per loan category;
3. Expected return per loan category.

ii. Chart(s) relaying the following characteristics of loans made in each category [PERFORMANCE]:

1. Total number of loans;
2. Total number of dollars outstanding;
3. Rate of return;
4. Average interest rate for the category of loan.

(D) LIABILITY FOR NOT CONFORMING WITH THIS ACT—Failure to conform to this action may result in the nonconforming entity, its board members, and its officers being subject to liability under this and other Sections of the Securities and Exchange Act of 1934.

(1) Government enforcement—Any purchaser or seller that fails to conform with the provisions of the Act will be subject to liability for any or all of the following:

(a) Strict liability of $1,000.00 per violation;

(b) Liability under 15 U.S.C. Section 78(j) (17 C.F.R. § 240.10b-5).

(2) Purchaser Standing—Purchasers of mortgage-backed securities shall have standing to file an action against the seller for failure to comply with subsection (C) of this Statute.

(3) Shareholder Standing—Shareholders of purchasing entities shall have standing to file actions for violations of any applicable provision of this Section against the directors and officers of the corporation if:

(a) The shareholder(s) bringing the derivative action held stock in the purchasing corporation at the time the transaction was completed; and

(b) The shareholder(s) bringing the derivative action can demonstrate that the purchasing entity did not have sufficient resources in place to complete the analysis required under this Act and did not complete an analysis sufficient to satisfy the requirements of this Act; OR

(c) Having had the processes and resources in place to conduct the analysis required under this subsection, the board members either:

i. Failed to adequately consider the contents of the disclosures in reaching the decision to purchase the securities; or

ii. Did not rely on the statements made by the company's financial analysts in good faith.

(4) Attorneys' Fees—The prevailing Shareholder or Purchaser of investments in mortgage-backed securities under this Section shall be entitled to attorneys' fees subject to judicial review for reasonableness.

(E) JUDICIAL REVIEW OF BOARD ACTIONS—Judicial review of board action shall be subject to the limitations imposed by other provisions of this Act and general principles governing corporate law.

V. CONCLUSION

The introductory scenario demonstrates how Larry Investor's derivative action could benefit from this Article's proposed legis-

lation.[192] First, Larry's complaint relied on the SEC investigation, 10b-5 class-action claims, and reports on general market conditions in order to plead that the directors had violated the duty of loyalty. Larry was attempting to use circumstantial evidence to create an inference that the directors could not have acted with a good faith belief in their decision to invest in MBS. The court summarily dismissed the complaint because the pleadings seemed to challenge the transactions as bad business decisions rather than a violation of the duty of loyalty—a challenge that would need to focus on the quality of the decision making process. If this Article's proposed legislation was in effect and Larry was afforded the benefit of the proposed disclosures, Larry would be able to discern the quality of the loans and their expected performance as a single investment. Second, using the information on the quality of the investment, Larry could determine a price point at which the loans were valued at the time of the board's decision. This would allow Larry to determine if the Board overpaid for the investment at the time it was made in addition to whether the disclosures were properly created, considered, and applied in the decision-making process.[193] Lastly, Larry could utilize the meeting minutes to show that the Board either did not consider the information in the disclosures or allotted an inadequate amount of time to approve the transaction.

Limiting itself to the contents of the complaint, the court concludes that the derivative action states a cause of action for breach of fiduciary duty based on the directors' failure to consider information material to the challenged transaction. In its opinion, the court emphasizes that the disclosures should have raised various red flags to the directors regarding the quality of the investments.[194] Being under a legal obligation to create, unwind,

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192. Although this Article focuses on MBS, this form of regulation through personal liability founded on disclosures could be applied to other types of complex transactions that suffer from similar information failures.

193. To overcome the BJR absent a showing that the directors ignored the information in the disclosures, Larry would likely need to show that the price paid was bordering on exorbitant in relation to the quality of the investment.

194. The plaintiffs in *In re Countrywide Litigation* made similar allegations against Countrywide as the hypothetical plaintiff, Larry Investor, made in the Introduction. 554 F. Supp. 2d at 1055. In that case, the court found that one of the major red flags was the increase in negative amortization loans and summarily denied the defendants' motion to dismiss, except as to one of the defendants. *Id.* at 1083. Like the paper trail created by the negative amortization loans, the MBS disclosures would create a paper trail upon which

and consider the information in the disclosures, the court can only conclude that the directors demonstrated a conscious disregard for their duties such as "an intentional failure to 'act in the face of a known duty to act.'"[195] The court concludes that through the "particularized facts alleged, a reasonable doubt is created that: (1) the directors [were] disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[196] Consequently, demand is excused, the motion to dismiss is denied, and Larry is able to make discovery requests in order to prove the case.

Justice Cardozo described a heightened requisite standard of behavior for trustees as "[n]ot honesty alone, but the punctilio of an honor the most sensitive."[197] Reinvigorating derivative actions—especially in complex transactions like MBS *because* corporate managers can hide behind the complexity of such transactions—would make Justice Cardozo's words regain significance as a guiding principle of fiduciary duties in American corporate law.[198]

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the court could conclude that there is reasonable doubt as to whether the directors had a good-faith belief that the decision was in the best interest of the company.

195. *In re Countrywide Litig.*, 554 F. Supp. 2d at 1077 (quoting *Stone*, 911 A.2d at 369) (internal quotations omitted). Recall that direct knowledge of circumstances is not necessary in order to prove that a director has conscious disregard for a known duty so as to amount to bad faith. Lund, *supra* n. 166.

196. *Aronson*, 473 A.2d at 814.

197. *Meinhard*, 164 N.E. at 546.

198. In an age when corporations are so essential to the stability of our economy and, by extension, our lives, this Author thinks that this can only be a good thing.