THE BUSINESS JUDGMENT RULE AND THE DIVERSIFIED INVESTOR: ENCOURAGING RISK IN FINANCIAL INSTITUTIONS

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ABSTRACT

The realm of corporate law has applied modern financial portfolio theory to support the insulation of corporate decision makers from liability in order to encourage risk taking, primarily using the Business Judgment Rule. This is done in the name of the diversified investor, who desires corporate decision makers take more risks than they would without a guarantee of protection. Encouraging more profitable risk taking, even at the risk of firm specific losses, is supposedly beneficial to diversified investors because they care about the return of their entire portfolio, normally reflecting the whole market, but corporate decision makers want to minimize potential liability resulting from their firm's losses.

However, the Great Recession has taught valuable lessons about the nature of risk in the finance and banking sector. Despite the unique danger of contagion, when one firm's demise impacts the market as a whole ("too big to fail"), the theory of diversification is being misappropriated to encourage risk-taking in the financial sector, often applied to the very firms and behavior that contributed to the crisis. Thus, the Business Judgment Rule is applied in the name of the diversified investor, yet when used to encourage risk taking in firms whose failures would actually have market wide impact, creates market volatility especially dangerous to a diversified investor. This article takes a detailed look at the concrete mechanics of diversification and risk taking and how these concepts coexist with the protection of the Business Judgment Rule and if that relationship is truly desirable.

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INTRODUCTION

In an interview after his tenure as Federal Reserve Chairman, Ben Bernanke claimed that the accountability of decision makers for their excessive risk-taking at the financial firms that caused the financial crisis of 2008 was not strict enough.[1] In Bernanke's opinion, the way to change how a corporation views risk, and thus protect the economy, boils down to the liability of the individuals within the corporation that make the decisions on what ventures the corporation pursues. While Bernanke's comments related to criminal sanctions, his remarks reveal two important principles for the post-crisis world that are applicable across corporate law. First, that potential personal liability for decision makers will directly impact how their corporations seek to manage risk, and second, that in certain sectors of the market, the very nature of risk can differ from the traditional notions of risk, sometimes threatening the economy of the entire nation. The convergence of these two principles is strongest when considering why corporate law, through the Business Judgment Rule, incentivizes risk-taking across all sectors of the market, seemingly ignoring evidence that while it is to the benefit of investors in some scenarios, it can be a detriment to investors in others. Evidence suggests that whether the encouragement of risk-taking is desirable depends on the nature of risk (and thus, its consequences), which can differ between industries.[2] It is this distinction, that the nature of risk is not static, which

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[1] Susan Page, *Ben Bernanke: More execs should have gone to jail for causing Great Recession*, USA TODAY (Nov. 13, 2015), http://www.usatoday.com/story/news/politics/2015/10/04/ben-bernanke-execs-jail-great-recession-federal-reserve/72959402/.

[2] *See* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 53-53 (2014).

reveals the problem with application of the Business Judgment Rule to firms involved in the financial collapse. It seems that modern courts have not recognized the dynamic nature of risk-taking and have been improperly motivated to apply the protection of the Business Judgment Rule.

Understanding why the Business Judgment Rule should be proscribed from protecting certain corporate decision makers requires an education starting at square one. To begin, like Bernanke's statements implied, when one has something to lose from the outcome of a decision, the standard for approving that decision is different than it would have been had the decision maker had no possibility of loss. This basic principle weaves its way through the fabric of almost every discipline, and corporate law is no different; liability in a basic sense functions as a mechanism for influencing individuals' actions. The second proposition of Bernanke's statement, that the nature and consequences of risk-taking is not equal in every situation, is less intuitive. However, after the Great Recession of 2008 many Americans are familiar with the gist of that concept. During and after the economic downturn, regulators, scholars, business leaders, and everyday investors tried to unpack the causes of the crisis.[3] In the end, excessive risk-taking by interconnected financial institutions motivated only to maximize profit and compensation[4] is often cited as the biggest contributor to the Great Recession.[5] It turns out that when corporations in the financial sector reach a certain size, the success or failure of that corporation can have market-wide effects.[6] To inquire further into the combination of liability's incentives for decision making and the analysis of risk-taking by decision makers, one must consider the Business Judgment Rule.

The Business Judgment Rule is a staple of any study of modern business law. In its most basic sense, the Business Judgment Rule shields decision makers from liability to shareholders as long as their decisions do not overtly implicate self-dealing.[7] The rationales for the Business Judgment Rule have long been the basis for many a judicial safeguard of decision makers from liability to shareholders and are quite diverse, ranging from incentivizing talented leadership to offer their services, to the reservation decision making to the expertise of executives rather than judges. One rationale for the Business Judgment Rule is particularly important after the crisis: the encouragement of risk to align decision

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[3] *See* Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 DEL. J. CORP. L. 121, 121 (2011).

[4] *See* Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 924 (2010) (internal citations omitted).

[5] *See, e.g.* Murphy, *supra* note 4, at 122-123; Zvi Bodie, Alex Kane, & Alan J. Marcus, Investments 18-23 (9th ed. 2011).

[6] *See* Armour & Gordon, *supra* note 3, at 53.

[7] *See, e.g.* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

maker incentives with diversified shareholder preferences. This rationale uniquely implicates both our understanding of decision maker liability to shareholders and our understanding of the impact of corporate risk-taking after the crisis. In fact, the logic of this justification actually suggests that in situations like the 2008 crisis, the Business Judgment Rule's protections might be a bane rather than a boon.

The conventionally accepted view of this rationale, discussed *infra* Part II, is that the Business Judgment Rule guides decision making by aligning the divergent risk preferences of corporate decision makers and shareholders: two groups who normally prefer different risks. In a brief summary, modern shareholders, it is said, diversify their holdings to minimize the impact any one corporation can have on their portfolio and, as a result, prefer that corporations pursue the highest risk adjusted returns, even if there is a possibility of bankruptcy for the corporation. Corporate decision makers, however, prefer to avoid risks that endanger their corporation because decision makers are incapable of diversifying away potential losses associated with their corporation. The Business Judgment Rule offers decision makers a safeguard from liability associated with the possible poor outcomes of those risky decisions, which in turn encourages the decision makers to be less averse to risk and thus more willing to take the risks and aim for the returns that diversified shareholders want. It's at this point that the flaw in this rationale resulting from the possible differences in the nature of risk between market sectors appears. In short, the events of 2008 have taught market participants, including diversified investors, some important lessons about the nature of risk in the financial sector. These lessons suggest that incentivizing decision makers to take risks regardless of the impact on the corporations' health in order to maximize return may not be desirable for a diversified investor when those corporations operate in the financial services industry.

This article will first focus on how exactly the Business Judgment Rule's rationale based on the unique preferences of diversified investors supports (or opposes) the Business Judgment Rule's impact on decision making and risk-taking in the context of the traditional view of risk and the post-2008 view of risk. In order to weigh the alleged benefits derived from the Business Judgment Rule, traditional rationales, as well as the rationale of diversified investor preferences, must be analyzed and understood. It will become clear that, in most instances, all the traditional rationales for the Business Judgment Rule exist in harmony and support the general effects of the rule. However, the discussion will then analyze how the rationale of risk encouragement for diversified investor works differently in the financial services industry, where the nature of risk is changed enough to challenge the desirability of that rationale. An in-depth inquiry into the mechanics of diversification, shareholder and decision maker preferences, and the unique traits of the financial services industry that change the nature of risk will be

required to facilitate the discussion. This discussion will include why lessons learned from 2008 provide reason to believe that, in the financial services industry, the risk encouragement rationale for the Business Judgment Rule actually opposes the traditional rationales and suggests a different treatment of decision making than the Business Judgment Rule provides. Finally, a look at litigation arising after the 2008 crisis will demonstrate that courts have erroneously applied the Business Judgment Rule by failing to understand the distinctions between the nature of risk in financial services industry.

PART I: THE TRADITIONAL FOUNDATIONS OF THE BUSINESS JUDGMENT RULE

The earliest forms of the Business Judgment Rule have been a facet of corporate law for almost two hundred years.[8] However, for such a pervasive legal rule, the Business Judgment Rule is surprisingly amorphous. While there is no single formulation of the Business Judgment Rule, the various iterations of the rule generally differ only in terms, not substance. The Delaware formulation is widely known and states that the Business Judgment Rule is:

> [A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts[, with t]he burden [being] on the party challenging the decision to establish facts rebutting the presumption.[9]

The Business Judgment Rule has had the practical effect of almost guaranteeing that shareholders may not successfully challenge director decision making[10], often articulated with exceptions for blatant evidence of gross negligence or self-dealing. It can be invoked in different situations and may differ in application based on the scenario.[11] In general, the Business Judgment Rule acts as either a general abstention doctrine or as a substantive standard.[12] In the first scenario, the Business Judgment Rule warns against judicial scrutiny of business decisions as long as there is not sufficient proof of a conflict of interest on the part of the decision maker.[13] The second scenario is triggered when there is

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[8] Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 613 (1987).
[9] Aronson, 473 F.3d at 812 (citations omitted).
[10] Joy v. North, 692 F.2d 880, 885 (2d. Cir. 1982).
[11] *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 287-88 (1994).
[12] *See id.*
[13] *Id.*

a supposed breach of the Duty of Care, and in such situations the Business Judgment Rule often acts as the source for the standard the court will measure the decision makers' actions against.[14] However, in either situation, the Business Judgment Rule functions as a means of placing corporate decision-makers beyond the reach of attempts to impose personal liability.

The idea that corporate decision makers can be liable for their decisions results from the notion that decision makers owe a duty to some class other than themselves. The question of corporate decision makers' duty was the defining question of corporate law during the 20th century.[15] It is now established that those operating the firm owe their duty to the shareholders. The Business Judgment Rule, then, is an attempt to define how this fiduciary relationship should exist in practice. The Business Judgement Rule falls into the realm of corporate governance[16] as a relationship device between shareholders and firm decision makers, whether directors or officers.[17] Although governance mechanisms are meant to regulate the relationships of actors *within* a corporation, governance rules greatly impact the world *outside* of the corporation, influencing everything from normal corporate operations to corporate social responsibility.[18] Some have argued that governance practices may be the main factor behind some of the largest failures during the 2008 banking crisis.[19] Indeed, the Business Judgment Rule and its protection of decision makers from shareholder scrutiny, and the resultant shareholder/decision-maker relationship can have nationwide economic impacts.[20]

The often-insurmountable protection provided by the Business Judgment Rule is viewed as a positive aspect of corporate law by some, and as an unfortunate development by others.[21] Some argue that this development results in greater efficiency by allowing a centralized decision-maker control of corporate

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[14] Although when invoked as a standard of care, the standard derived is not always clear. *See id.* at 295.

[15] *See generally* Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

[16] Stephen M. Bainbridge, *Director Primacy: the Means and End of Corporate Governance*, 97 NW. U. L. REV. 547, 601 (2003).

[17] There has been some discussion of whether the Business Judgment Rule applies to both directors and officers equally. In this paper it is assumed that the Business Judgment Rule shields any disinterested decision maker, whether director or officer, from liability to shareholders based on risk-taking decisions. *See generally* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005); Gregory Scott Crespi, *Should the Business Judgment Rule Apply to Corporate Officers, and Does it Matter?*, 31 OKLA. CITY U. L. REV. 237 (2006).

[18] *See* Bainbridge, *supra* note 17 at 580-82.

[19] *See* Fisch, *supra* note 5, at 923; Armour *supra* 3 at 50; Murphy *supra* 4 at 122-123.

[20] *See* Armour & Gordon, *supra* note 3, at 53.

[21] *Compare* Bainbridge, *supra* note 17, at 602-03 *with,* Gevurtz, *supra* note 12, at 289.

decision without interference from the often diverse, conflicted shareholders.[22] Opponents have argued the Business Judgment Rule's removal of liability makes little sense in relation to other areas of law, such as torts, where negligence is not presumed beyond the reach of recovery.[23] Additionally, courts have cited the "managerial prerogatives" arising from corporate charter that advocate for shareholder abrogation as a matter of long-standing tradition and law.[24] Regardless of whether the effects are desirable or not, it is obvious that this barrier between directors and shareholders is a centerpiece of the corporate relationship.

A rule so pervasive must stand on strong grounds. Rulings applying the Business Judgment Rule have been supported by a number of rationales throughout the years. Foundational to many of these rationales is the concept of the hindsight bias a reviewer may suffer when confronted with review of a business decision.[25] As most decisions that come to court are challenged due to a negative outcome, judicial reviewers may be at risk of inferring negative performance on the part of the decision maker more often than they should.[26] Obviously this is problematic because many business decisions result in less than desirable outcomes, perhaps by no fault of the decision maker responsible. Fear of this bias is an important underlying component of most rationales supporting the Business Judgment Rule as abstention doctrine. The rationales of acquiring and retaining talented managers, the difficulty of judicial review of business decisions, and the encouragement of risk-taking for diversified shareholders, all in some part rely on the notion that unsupported inferences are dangerous. The Business Judgment Rule is said to function as a counterbalance to the bias that links poor outcomes with poor performance by supporting non-review of prior business decisions.

While it is appealing to support the Business Judgment Rule as a backstop against unfair inferences drawn against unlucky decision makers, there is some reason to believe it may not be necessary. According to one commentator: "[s]tating that directors will be immune from liability so long as they act with due care . . . and comply with their fiduciary duties . . . is simply saying that directors will not be liable for their decisions unless there is a reason for holding them liable."[27] In other words, the Business Judgment Rule provides no more guidance than traditional legal thinking surrounding how courts should approach alleged

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[22] *See* Bainbridge, *supra* note 17, at 602-03.
[23] *See* Gevurtz, *supra* note 12 at 311.
[24] Aronson, 473 A.2d at 812.
[25] *See, e.g.,* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: a Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 at 265-266.
[26] *See id.*
[27] Gevurtz, *supra* note 12 at 290-91.

negligent or intentional decisions. The bias of inferring bad acts from bad outcomes is present in almost every courtroom and is normally adequately addressed by jury instructions or the elements of the law being applied.[28]

However, there are other espoused justifications for the Business Judgment Rule. One of the most well-known justifications for the Business Judgment Rule is the claim that judicial review is naturally ill-suited to analyze the quality of business decisions.[29] Most arguments in this camp center on either the lack of judicial expertise or the uniqueness of business decisions as "intuitive."[30] Because businesses deal in such diverse fields, the experienced leaders in that field have expertise at the time of decision-making that judges simply lack.[31] These business decisions are made in relation to "a long future, for expected competition, for a continuing as well as an immediately profitable venture" that are best left to "capable management," because "judges are not business experts."[32] Furthermore, the Business Judgment Rule could be seen as a "shortcut" that allows judges to easily decide cases they would have otherwise struggled with and potentially decided incorrectly, wasting precious judicial resources.[33] [34] In the words of Seventh Circuit Judge Eric Posner:

> A . . . reason for skepticism regarding courts' ability to determine obligations . . . is that courts have trouble understanding the simplest of business relationships. This is not surprising. Judges must be generalists, but they usually have narrow backgrounds in a particular field of the law. Moreover, they often owe their positions to political connections, not to merit. Their frequent failure to understand transactions is well-documented . . . Even when judges do not misunderstand basic ideas . . . [j]udges' reasoning can be evaluated only against the canned facts described in the opinion, which themselves are the result of a factfinding process that does not inspire confidence. Parties can reasonably believe that—given the varying sophistication of trial judges, lawyers, and juries, the accidents of discovery, the varying credibility of witnesses, the vagueness of the law, and so on—the chance of winning a breach-of-contract suit is pretty much random. Skepticism about the quality of judicial decisionmaking is reflected in many legal doctrines, including the business

[28] *See id.* at 306.
[29] *See e.g.,* Joy v. North, 692 F.2d 880, 886 (2d. Cir. 1982).
[30] *See* Gevurtz *supra* note 12 at 308.
[31] Dodge v. Ford Motor Co., 170 N.W. 668, 684 (1919).
[32] *Id.*
[33] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 118 (2004).
[34] *Id.*

> judgment rule in corporate law, which restrains courts from second-guessing managers and directors . . .[35]"[36]

It is often explained that the circumstances of business decisions are "not easily reconstructed in the courtroom."[37] Business decisions, it is said, lack objective norms to guide decision-making and, as a result, each business decision is unique and relies more on intuition than most other decisions that rely more on defined decision-making processes.[38] In other words, business decisions are a unique intuitive "swamp," almost impossible to navigate and fairly review in hindsight without falling prey to the inference bias.[39]

While this rationale has widespread appeal due to its simplicity, it has been called into question. One of the main critiques is that a judge's lack of expertise can be, and in many cases is, overcome by certain mechanisms in the judicial process, such as expert witnesses.[40] For instance, judicial review of medical negligence is not precluded just because most judges are not trained in the field of medicine. This argument is also bolstered because some decision makers, such as outside directors, are a part of the corporate system not due to expertise or knowledge in the corporation's industry or operations, but due to their leadership skills, prestige, or connections, among other traits. Because these decision makers may not possess any expertise at all, the judicial system should not hesitate to review their decisions. The system is often not troubled at all to review very specialized fields, such as medicine, engineering product liability or any number of the other routinely reviewed professions.[41] In the end, "this justification is problematic at best, because it would apply equally to a large number of cases outside of the corporate law area where negligence liability is routinely imposed."[42]

As far as the "uniqueness" of business decisions, some have argued that although some business decisions are "more art than science," there are objective standards and norms that guide almost every scenario in business.[43] In fact, the very existence of formal business education and extensive academia belies the

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[35] Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Juror Error*, 94 NW. U. L. REV. 749, 758 (2000) (internal citations omitted).
[36] *Id.*
[37] Joy, 692 F.2d at 886.
[38] *See id.*
[39] *See* Gevutrz, *supra* note 12 at 309.
[40] *See* Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 581 (2000).
[41] *Id.*
[42] Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization: the Case of the Busienss Judgment Rule*, 77 CHI.-KENT L. REV. 179, 196 (2001) (internal citations omitted).
[43] *See* Gevurtz, *supra* note 12 at 308 n.92.

notion that business decisions are ethereal enough to avoid judicial review.[44] Even if business decisions are uniquely intuitive and lack some objective standard, a critic may suggest that a decision maker's actions could still be measured against what a typical, prudent director would have done in the same circumstances, relying on her own intuition.[45] Through such inquiry, courts could develop meaningful standards for decision-maker conduct, even in the aspects of their roles that are intuitive.[46]

A second justification for the Business Judgment Rule is the existence of compensation incentives for corporate decision makers as an alternative to liability incentives. This rationale relies on the fact that compensation, rather than liability, for decision makers who act appropriately can provide incentives for proper decision-making.[47] If providing benefits for decision makers minimizes the occurrences of undesirable decision making, then liability rules are unnecessary, and the Business Judgment Rule should be applied to foreclose the imposition of extra potential liability.[48] Proponents of the use of compensation mechanisms point to the fact that liability penalties often are obtained from the corporation itself rather than the directors and thus harm the corporation.[49] This is the result of a number of phenomena.

First, corporations often indemnify their decision makers, which means that payment comes from the corporation, and this indemnification often uses insurance policies.[50] Recovery in a derivative suit often results in a loop where the damages simply go from the corporation back to the corporation, less transaction fees.[51] When liability is imposed and decision makers are indemnified through insurance, the cost of the director and officer insurance policies increases for all corporations, thus harming the corporation at issue in the recovery suit.[52] Second, if decision makers know that there is potential personal liability, then the cost of acquiring and retaining decision makers will be higher to the corporation to account for the potential liability the decision makers must bear.[53] Third, when decision makers are asked to bear the risk of poor decision making, that risk is transferred from the group that already bears that risk, the shareholders.[54] Shareholders are able to manage that risk much more efficiently due to limited personal liability and diversification tactics that are not available to management,

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44 *See* Gevurtz, *supra* note 12 at 308.
45 *See* Davis, *supra* note 41 at 583.
46 *See id.*
47 *See* Gevurtz, *supra* note 12, at 317.
48 *See* Fischel & Bradley, *supra* note 26, at 284.
49 *See id.* at 285.
50 *See id.*
51 *See* Gevurtz, *supra* note 12, at 317.
52 *See id.*
53 *See* Fischel & Bradley, *supra* note 26, at 285.
54 *See id.*

and transferring risk from shareholders to managers results in an inefficiency that imposes costs on the corporation system.[55]

Opponents of the rationale of compensation versus liability do not generally dispute the reasoning, but more often believe the justification is not strong enough to support the effects of the Business Judgment Rule.[56] For instance, some commentators argue that the utility of compensation versus liability is present in many arenas that still maintain liability rules, such as automobile injury torts.[57] Even with the same group of actors—the insurance company, the feasor, and the injured—liability rules are still seen as necessary by the law. Apart from this rationale's failure to distinguish between traditional torts and corporate law, some other commentators question the utility of compensation. Some see the link between compensation mechanics, normally tied to share price, and sound business leadership, consisting of proper decision making, as too inconsistently linked to provide incentive.[58]

Another widely discussed rationale for the Business Judgment Rule is the argument that, should a greater extent of potential personal liability be imposed, many prospective decision makers could be dissuaded from participation in the corporation.[59] Within this group of talent, there may have been otherwise more suitable and capable decision makers.[60] This concern stems beyond just the Business Judgment Rule. In fact, it has been noted that after the Business Judgment Rule was overcome in the notable *Van Gorkom*[61] Delaware Supreme Court decision, many states enacted statutes meant to shield directors so as not to lose talented individuals from the market.[62] Part of the critique to this justification has already been touched on; the plethora of insurance policies, shield statutes, and corporate indemnifications serve the purpose of reducing director liability. In fact, shortly after *Van Gorkom*, Delaware itself enacted § 102(b)(7), allowing corporate charters to limit monetary liability of directors for *Van Gorkom* style situations.[63] Nevertheless, imposition of liability as deterrence to talented

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[55] *See id.*

[56] *See* Gevurtz, *supra* note 12, at 318-19.

[57] *See id.*

[58] *Cf.* Gevurtz, *supra* note 12, at 319-20. Gevurtz notes that the link between decision maker actions, the outcome of those decisions, and the resulting effect on stock price, if any, is often not strong enough to infer what the consequence of a decision was in reality.

[59] *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990).

[60] *See* Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 27-28 (1987).

[61] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[62] Edward Brodsky & M. Patricia Adamski, The Law of Corporate Officers and Directors: Rights, Duties & Liabilities, § 2:15 (2015), Westlaw (database updated Oct. 2015).

[63] Del. Code Ann. tit. 8, § 102(b)(7) (West 2015).

decision makers remains an important concept in understanding the Business Judgment Rule.

The Business Judgment Rule, as such a long-standing, thoroughly discussed, and often a controversial doctrine, has impact beyond the recently discussed justifications. Commentators have spent years discussing the costs, benefits, and consequences of the Business Judgment Rule in many different contexts. The purpose of highlighting some of the most foundational justifications for the Business Judgment Rule and their weaknesses is to emphasize that, although long-standing, deeply entrenched and comprehensively accepted by courts, the Rule's justifications are balanced delicately enough on the peak between cost and benefit to provide doubt as to its utility. This is important to keep in mind while moving into the final discussed rationale, and the focus of this paper, the Business Judgment Rule's benefit of aligning the interests of managers and diversified shareholders by encouraging risk-taking. Traditionally, this rationale has both proponents and detractors, like the rationales before it. However, and more importantly, this rationale is actually a potentially devastating pretense for invoking the Business Judgment Rule for certain decision makers post-2008, namely those employed in the financial services industry. In essence, while this rationale has balanced on the peak with the others, ambiguously weighing the scales of cost and benefit, it seems that in the context of the financial industry, the encouragement of risk-taking by the Business Judgment Rule is a danger that has not been recognized by courts.

PART II: DIVERSIFICATION AS UNDERSTOOD BY THE COURTS: HOW THE DIVERSIFIED INVESTOR BENEFITS FROM THE BUSINESS JUDGMENT RULE'S ENCOURAGEMENT OF RISK

As far as jurists are concerned, the justification for the Business Judgment Rule derived from the realities of diversification relies on a few premises and requires a few logical inferences.[64] First, it is assumed that rational investors diversify their holdings.[65] This is because rational investors are risk averse,

[64] While there are certain models that dominate conventional understanding of portfolio theory and security pricing, the fields of economics or finance have not developed total consensus regarding many concepts. Reading commentary provided by lawyers and judges, however, often gives an impression of scientific certainty regarding matters of economics and finance. There is a good deal of room in both fields to entertain a myriad of investing techniques, security valuation models, and portfolio management tactics, perhaps much more room that most jurists appreciate; even the hallowed CAPM "does not fully withstand empirical analysis." Bodie, Kane, & Marcus, *supra* 6 at 280, 298. However, this paper's commentary on diversification will make the assumptions common within the reasoning that has been supplied in legal arenas such as the Delaware state courts and certain federal appellate courts.

[65] *See, e.g.,* Joy 692 F.2d at 886 (implying decision maker duties do not extend to the undiversified and thus "courts need not bend over backwards to give special protection to

meaning that investors are not willing to partake in investments that do not offer premiums for the risks that they take. In other words, risk repels investors unless there is appropriate return to compensate that risk.[66] Risk, itself often a misunderstood term, means that there is a possibility of more than one outcome to an investment scenario.[67] Risk associated with a corporation's stock is generally thought of as two different types, firm-specific risk and market risk.[68] Market risk influences a broad subset of the economy, while firm-specific risks encapsulate risks associated with the corporation alone.[69] Because investors want to minimize the presence of risk while maintaining as high returns as possible, investors can choose to own the stock of multiple companies. This strategy, known as diversification, can reduce the presence of risks associated with single corporations. An oft cited statistic in the literature regarding how diversification impacts the relationship between shareholder and decision maker is that over 90% of company specific risk associated with a stock may be eliminated with proper diversification.[70]

How is such reduction accomplished? One traditional explanation relies on the Capital Asset Pricing Model, known colloquially as the CAPM.[71] The CAPM posits that the expected return of an asset may be measured in relation to the market itself. For stocks, the expected return is reflected in the price of the stock, effectively allowing one to say that the CAPM prices stocks in relation to the market. The stock price's relation to the market is quantified within the CAPM as the stock's beta (β).[72] The beta gives an investor a common ground against which to measure the volatility, or risk, of individual stocks. This measurement separates risk associated with the firm (firm-specific risk) and risk associated with the entire market. Once this is understood, an investor may take advantage of this relational link between different stocks in order to methodically construct a portfolio where stock price movement associated with firm-specific risk can be expected to, in general, offset each other. This offset leads to a portfolio with less risk than a portfolio without such an offset because now negative returns and positive returns, in relation to the market, will cancel each

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shareholders who refuse to reduce the volatility of risk by not diversifying"); Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 430 (1998).

[66] Zvi Bodie, Alex Kane, & Alan J. Marcus, Investments 162 (9th ed. 2011).

[67] *Id.* at 129, 132.

[68] *See, e.g., Id*. at 295-296; Letsou, *supra* note 43, at 206; Booth, *supra* note 66, at 442.

[69] Bodie, Kane, & Marcus, *supra* note 67, at 295.

[70] *See* Booth, *supra* note 66, at 443-44; Letsou, *supra* note 43, at 206.

[71] $E(r_e) = r_f + \beta[E(r_m) - r_f]$ is the most familiar form of the CAPM. Bodie, Kane, & Marcus, *supra* note 67, at 287.

[72] *Id*. at 282.

other out.[73] This is advantageous because although returns in relation to the market cancel each other out, the portfolio captures the return of the market itself.

In practice, a portfolio manager or investor can alter a variety of inputs and bend the CAPM's guidance to construct portfolios with varying degrees of diversification to suit an individual's goals and risk aversion.[74] To make matters more involved, portfolios often include assets other than stocks, such as bonds or commodities futures. Such flexibility leads to the principle that investors can easily adjust their portfolios to account for risks associated with a single corporation which may affect the investor's overall holding very little, especially if offset due to diversification. However, as is implicit in the CAPM, investors cannot diversify risks associated with the market as a whole, only to the risks captured by the firm-specific beta. As a result, diversified investors develop a unique risk preference.

Because investors can achieve almost total indifference to firm-specific risk, a diversified investor will prefer that firm decision makers pursue profitable opportunities in spite of risk of failure, due to the investor's ability to offset that firm-specific risk with another stock in her portfolio with an opposite beta. Thus, the risks offset each other, and the expected return becomes more stable; in other words, losers and winners will offset each other to provide a statistically predictable return.[75] This means that when a corporate decision maker is faced with choosing between two projects, the diversified investor will prefer the manager to pursue the project that has higher risk adjusted return with indifference to the possibility that the firm itself could suffer.[76] This is notable because traditional undiversified investors would care a great deal about the risk of firm failure. In short, a diversified investor would choose the higher risk adjusted return and simply counterbalance any firm-specific risk (chance of firm failure) with their portfolio while undiversified parties prefer decision making to be influenced by firm-specific risk.

A very important thing to remember after understanding that a diversified investor will prefer firm-specific risk over market risk is that the diversified investor will still require the decision makers adhere to prudent valuation of the opportunity and only pursue it if is offers a positive Internal Rate of Return (IRR) or Net Present Value (NPV). These metrics provide a quantifiable measurement for whether an opportunity will have an expected return that outweighs any expected costs, accounting for the time value of money. Consider a simple example: investment #1 costs $1.00 to pursue and has a 50% chance of returning $4.00 instantly and a 50% chance of returning $0 instantly (a loss of the initial

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[73] *Id.* at 197.
[74] *Id.*
[75] *See* Booth, *supra* note 66, at 442.
[76] *Id.*

$1.00), and thus has an expected return is $1.50,[77] making the investment worthwhile (an expected return great than the cost). The NPV and IRR formulae account for the cost of capital, the $1.00 in our above example, in order to address investment schemes more complicated than our example, with payments occurring in the future. The takeaway from this is that although diversified investors prefer risk-taking in order to generate returns, they prefer profitable risk, i.e. returns that are adjusted for risk through NPV or IRR.[78] They also do so with the knowledge that the $1.00 lost could cause the failure of the firm.

It is understood that investors prefer risk to generate return and it is understood that diversified investors prefer high-risk adjusted returns regardless of firm-specific risk, which will be offset in their portfolio. Where does the Business Judgment Rule fit into this equation? The Business Judgment Rule, it is said, provides a haven for decision makers that fundamentally shift their interest closer to the unique preferences of the diversified investor discussed above. Managers, unlike modern shareholders, cannot mitigate the impact risky decisions will have on their corporation.[79] Possibilities of firm failure for decision makers entail a number of considerations:

> Why do directors care about the firm's cost of capital and the risk of firm failure? First, there are reputational costs to firm failure. Second, to the extent that directors invest in firm-specific human capital, that investment will be lost if the directors lose their positions following a firm failure or takeover. Third, stock-based director compensation, which has become increasingly common, aligns the board's direct financial interests with the ongoing success of the firm. Fourth, director socialization inculcates effort and cooperation norms. Fifth, there is self-esteem—the pride in doing a job well—which some theorists regard as the basis for norm compliance.[80]

It follows, then, that if decision makers are confronted with a decision to take on an opportunity in order to secure high-risk adjusted return, but at some risk to the corporation's solvency, or an opportunity to secure a smaller risk

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[77] The expected return (r) of an asset is the probability-weighted average of all possible return scenarios.
(r) = ($4.00 x .50) + (-$1.00 x .50) = $1.50. *See* Bodie, Kane, & Marcus, *supra* note 67, at 239-240.
[78] *See, e.g.,* Armour & Gordon, *supra* note 3, at 53.
[79] *See* Fischel & Bradley, *supra* note 26 at 265-66; Booth, *supra* note 66 at 447.
[80] Bainbridge, *supra* note 17, at 580 (internal citations omitted). Although Professor Bainbridge is speaking about directors specifically rather than decision makers generally, all considerations put forth arguably apply to both managers and directors, the decision makers on the opposite side of the Business Judgment Rule from shareholders.

adjusted return with little risk to the corporation's solvency, management will likely be averse to the notion of jeopardizing the firm and will pursue the safer investment. It has been shown, however, that a diversified investor would disregard the danger to the corporation's solvency as it is likely offset within their portfolio. Thus, as long as the danger to the corporation is firm-specific risk the diversified shareholder's preference will be the higher risk adjusted return. This puts the interests of the diversified shareholder at odds with the interest of decision makers, because although "[a] diversified stockholder can afford to win some and lose some, [m]anagement cannot. [Decision makers] stand[] to lose the most if the corporation fails."[81]

How does the Business Judgment Rule remedy this situation? According to the Second Circuit in *Joy v. North*,[82] the Business Judgment Rule relieves some of the pressure that causes decision makers to avoid taking risks that could be to the benefit of shareholders. That pressure, of course, is personal liability for decision makers to shareholder derivative suits resulting from losses generated by taking risks. As Chancellor Allen of the Delaware Court of Chancery put it, this pressure normally results in a "stupefying disjunction between risk and reward for corporate directors [that] threatens undesirable effects,"[83] particularly a lack of risk-taking to the chagrin of diversified investors. According to Judge Winters, who authored the opinion in *Joy*, the Business Judgement Rule combats judicial intervention that "penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally."[84] In other words, the Business Judgment Rule encourages risk-taking, and it does so with the permission, and the ostensible delight, of diversified shareholders who display "voluntariness in undertaking the risk of bad business decisions."[85] This basis for the Business Judgment Rule, then, uses the diversified investor's disregard of firm-specific risk as reason to guard decision makers from fallout based on decisions to take risks, even those that endanger the health of the firm.

Traditional critiques of the diversified shareholder rationale of the Business Judgment Rule are quite numerous. Generally, although diversified shareholders may prefer riskier ventures than decision makers, the Business Judgment Rule protects decision makers when there are poor outcomes, even if the risks of poor outcomes were not voluntarily assumed by shareholders. While it may be true that shareholders voluntarily, and indeed actively, seek risky ventures, some have argued that the Business Judgment Rule as applied by cases such as *Joy* mischaracterize the risks sought.[86] While shareholders do accept risk

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[81] Booth, *supra* note 66, at 430.
[82] *See* Joy, 692 F.2d at 885-86.
[83] Gagliardi v. TriFood Intern., Inc., 683 A.2d 1049, 1052 (1996).
[84] Joy, 692 F.2d at 886.
[85] *Id.* at 885.
[86] *See* Letsou, *supra* note 43 at 201.

as a necessity for receiving returns, shareholders arguably agree to assume general business risk, not risk of negligent mismanagement. One commenter describes the mischaracterization:

> [s]hareholders agree to take the risk of bad outcomes that may follow from good capital investment decisions (i.e., those that have an expected return sufficient to compensate for market risk); but they do not agree to take the risk of bad decisions (i.e., those that could not be justified, on an ex ante basis, by the net present value rule).[87]

It turns out that the Business Judgment Rule, as a difficult hurdle to jump, often places decision makers out of reach for both kinds of decisions.

Some commenters have also noted that, even if the logic of diversification supports the Business Judgment Rule by benefiting the diversified, encouraging risk-taking may harm constituencies such as bondholders and preferred stockholders as well as employees, businesses within the same supply chain as the corporation at issue, and the community.[88] Also harmed by imputing the protection of diversification to every investor are the undiversified. While diversification may be the norm, there is no doubt that some still pursue undiversified strategies. Applying modern portfolio theory's diversification model to the fiduciary duty paradigm that was created before shareholders could be characterized as diversified creates a conflict by precluding recovery for undiversified shareholders simply because the Business Judgment Rule serves diversified investor interests.[89] This is effectively a judicial endorsement of a single investment tactic,[90] albeit a popular one, when many valid strategies exist, especially when examining the nature of the investor, which could be a hedge fund, a mutual fund, an individual investor, etc.

As was the case with prior Business Judgment Rule justifications, some critics have noted the lack of any meaningful distinction between corporate law and other areas of law.[91] Critics are not satisfied with the fact that the Business Judgment Rule provides a hurdle for judicial intervention when a decision maker causes a loss, yet for breaches of contract, torts involving illegal trade practices, and other actions that harm the corporation, and thus the shareholder, the judicial system allows suits for recovery even though shareholders have likely diversified

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87 *Id.*

88 *See* Booth, *supra* note 66 at 446-47.

89 Modern portfolio theory was suggested in 1952 by Harry Markowitz twelve years before the CAPM, Bodie, Kane, & Marcus, *supra* note 67, at 280, and the modern notions of diversification adopted by cases such as Joy, 692 F.2d at 885. The Fiduciary Duty discussion was in full swing a few decades earlier. *See generally* Berle, *supra* note 16; Dodd, *supra* note 16.

90 *See* Gevurtz, *supra* note 13, at 316.

91 *See id.*

such risks as they are generally firm-specific.[92] If those effects are defended on the grounds that the Business Judgment Rule addresses considerations unique to shareholder derivative actions against decision makers, then it is likely more helpful to avoid the Business Judgment Rule and reform derivative suits directly.[93]

A. The Unique Nature of Risk in the Financial Sector and How the Logic of the Business Judgment Rule Fails

In addition to these traditional critiques, there is another criticism that has cast doubt on the desirability of encouraging risk, through the Business Judgment Rule, on the basis of diversified shareholder risk preferences. As discussed, the position of those applying the Business Judgment Rule as a measure for protecting diversified investors rely on the notion that diversified portfolios are indifferent to firm-specific risk, i.e. that such shareholders gladly risk the health of a corporation in order to pursue high-risk adjusted returns. Also entailed in such a position is a recognition that diversified portfolios are mostly comprised of market risk. Thus, the idea that encouraging risk is beneficial to shareholders relies on a distinct delineation of the two types of risk, firm-specific risk and market risk. This is where the universality of the risk encouragement rationale comes into doubt.

The problem arises when using the Business Judgment Rule to encourage risk-taking in the financial services industry. The banking collapses and bailouts of 2008 have shown that firm-specific risk, when causing the failure of certain banks, has the capability to cause market risk across the industry, or even the economy ("too big to fail"). If this is the case, then it turns out that encouraging risk with no regard to corporate health, under the auspices of serving diversified shareholder portfolios, may actually increase market risk, the type of risk most detrimental to the diversified shareholder. This unique potential for the creation of market risk out of firm specific failures, known as contagion,[94] provides the basis for an argument that the Business Judgment Rule should not provide protection for financial industry decision makers for the purpose of encouraging risk.[95] However, it seems that courts dealing with the aftermath of the crisis have not recognized the unique nature of risk in the financial sector and have explicitly

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[92] *See id.*
[93] *See id.* at 316-17.
[94] *See* Armour & Gordon, *supra* note 3, at 40.
[95] *See* Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, FRBNY ECONOMIC POLICY REVIEW, April 2003, at 95 (noting that "a public interest dimension to the banking [industry] that vitiates the exclusive claims that . . . shareholders typically bring to the attention of directors").

supported application of the Business Judgment Rule to contagion-causing firms with the notion that encouraging risk is still desirable.[96]

The unique dangers associated with the failure of a bank are the result of the natural composition a bank must maintain to carry on its business.[97] Banks often operate by carefully financing high-risk, highly illiquid loans with low-risk, highly liquid deposits, which leaves banks "structurally vulnerable, even fragile."[98] Additionally, the period leading up to the crisis saw many institutions augmenting deposit funding with short term, low yield debt when seeking long term high yield opportunities.[99] Thus, sudden increases in demand for liquid assets or a decrease in the value of the bank's liquid assets can force a bank into insolvency.[100] This structural vulnerability characterizes not just traditional banks, but any financial service firm that finances long-term, high-risk assets with short-term, low-risk debt.[101] The danger of contagion arises when an industry of structurally vulnerable firms rely heavily on each other for liquidity, payments, or financing, which can make the shutdown of one large bank a market-wide concern.[102] Because the shutdown of one bank or financial institution can cause a chain reaction in similarly invested firms, one institution's firm-specific risk of failure has the possibility of contributing to market risk.[103]

These connections were demonstrated in 2008 when waves of highly leveraged firms were forced to sell assets to "de-lever," which in turn caused the value of those assets to lower, forcing even more sales, in a dangerous cycle.[104] Furthermore, many institutions hedged these assets, usually Collateralized Debt Obligations (CDO) of bundled residential home mortgages, with Credit Default Swaps (CDS), financial instruments that found general use as insurance against default of the CDO.[105] As the rush for liquidity and the plummet in CDO value picked up speed, institutions over exposed by issuing CDS were unable to meet the calls of those using the CDS as hedges.[106] One striking example is AIG, who sold over $400 billion of CDS on subprime mortgage CDOs.[107] This presented danger to the market, as the collapse of one CDS issuing firm could affect a

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[96] *See in re* Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106, 126 (Del. Ch. 2009)
[97] *See* Armour & Gordon, *supra* note 3, at 40.
[98] *Id.* (citing Jeffery N. Gordon & Christopher Muller, *Confronting the Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. REG. 151).
[99] Bodie, Kane & Marcus, *supra* note 67 at 20.
[100] *See* Armour & Gordon, *supra* note 3, at 40 (citing Xavier Freixas, et al., Microeconomics of Banking, (2nd ed. 2008).
[101] *See* Armour & Gordon, *supra* note 3, at 40.
[102] *See id.* at 54.
[103] *See id.*
[104] Bodie, Kane & Marcus, *supra* note 67 at 20.
[105] *Id.*
[106] *Id.*
[107] *Id*.

multitude of other firms relying on the CDS to offset their own over-exposures.[108] The interconnectedness and risk taking was so high that some firms, such as Lehman Brothers and Merrill Lynch, were believed to have debt ratios as high as 30:1 (97% levered).[109] As seen in the discussion of why the presence of a diversified investor can support the encouragement of risk, *supra* Part II, the current understanding of a diversified investor-friendly Business Judgment Rule relies on an assumption of unrelated firm-specific and market risk, holding that the diversified investor does not care about one firm's failure.[110] Thus, a system of governance (i.e. the Business Judgment Rule) that advocates for the highest risk-adjusted return with no regard for firm-specific failure is highly inappropriate for the financial services industry.

Interestingly, courts have shown some interest, albeit very sporadically, in distinguishing decision makers of banks and financial instructions from decision makers of other corporations.[111] Normally this occurs after contagion-style events or when confidence in the financial sector is shaken.[112] In 1997, however, the Supreme Court made it clear that "[t]here is no federal common law that would create a general standard of care applicable to [financial institution decision makers]" as distinct from other corporate decision makers.[113] In crafting this decision, the Supreme Court left in the States' hands the standard of care decision makers in financial intuitions must exercise.[114] Over the decades some state courts have suggested that the law recognizes the difference between the consequences of actions by decision makers in financial institutions versus decision makers of other corporations, supporting to a more probing inquiry than should be applied to other decision makers. Some examples include *Litwin v. Allen*,[115] where the court believed that "[u]ndoubtedly, a director of a bank is held to stricter accountability than the director of an ordinary business corporation," and *Francis v. United Jersey Bank*,[116] where the court found that, in determining the standard by which to judge decision makers for United Jersey Bank, "more specific duties flow" from the general standard that encompasses decision makers from other corporations.

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[108] *Id.*

[109] *Id.*

[110] *See* Joy at 886 ("In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others.").

[111] *See* Macey, *supra* note 96, at 100.

[112] *Id.*

[113] Atherton v. F.D.I.C., 519 U.S. 213, 226 (1997).

[114] *See id.* at 227.

[115] Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940).

[116] Francis v. New Jersey Bank, 432 A.2d 814, 821 (1981).

B. Contagion in 2008 and the Modern Use of the Business Judgment Rule

It is important to look at the empirical evidence of contagion that suggests a closer scrutiny of risk-taking in tandem with the past judicial recognitions of the duty that decision makers of financial institutions have to guard the health of their corporation together to realize the danger the Business Judgment Rule's incentive for risk-taking presents to the economy. As the post-2008 world knows, the danger posed by improper governance is not one in the abstract. Accounts of governance failures leading up to and during the crisis paint a picture of decision makers' practices that will make prime future examples for corporate law textbooks. Bear Stearns, a former landmark investment and brokerage firm that is now a name mainly remember for being associated with the crisis,[117] was described as having corporate governance practices "straight out of the 1920's."[118] The list of offenses is long.

> Bear's board of directors met just six times a year, leaving primary oversight of the company to Bear's all-insider executive committee. Bear did not create a finance and risk committee until January 2007, just a year before its failure. Two members of Bear's audit committee served on the audit committees of five and six other companies, respectively, yet the board determined that, based upon their "wealth of financial experience," this service did not "impair their ability to effectively serve on the Company's Audit Committee."[119]

Critics summed up the failures by describing the board as "another one of these all male clubs that acts like a throwback to black and white movies."[120] While Bear Stearns may have been the posterchild for shaky governance methods that led to the crisis of 2008, it was not the only corporation operating with questionable decision makers at the helm.

Citigroup Inc. engaged in what many called excessive risk-taking which led to Citigroup becoming the world's largest issuer of collateralized debt obligations,[121] often decried as the risky assets that stimulated the crisis when housing (a common collateral asset) prices plummeted. During the crisis, Citigroup received almost $50 billion in aid and many of their assets were

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[117] *See* Elizabeth Hester, *Bear Stearns Brand Fades Two Years After Collapse*, Bloomberg, Jan. 8, 2010.

[118] *See* Fisch, *supra* note 26, at 923 (internal citations omitted).

[119] *Id*. (internal citations to Bear Stearns 2007 proxy statement omitted).

[120] *Id*.

[121] *Id*. (citing John C. Coffee, Jr, *What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis*, 9 J. Corp. L. Stud. 1, 17 n.54 (2009)).

guaranteed by the federal government to bolster market sentiment.[122] The fact that the federal government found it necessary to grant Citigroup bailout financing and to guarantee Citigroup's assets shows that Citigroup is a corporation that was involved a contagion-style situation. After all, the bailout intended to combat the "too big to fail" problem, a problem named for the fact that some financial firms become so important to the system that allowing them to fail would drastically damage the market.[123] The "too big to fail" problem precisely showcases the blurring between firm-specific risk and market risk that occurs in the financial sector. One of the primary assumptions necessary in justifying the Business Judgment Rule's encouragement of risk-taking, the isolation of firm-specific risk and market risk, does not hold true in Citigroup's case. Therefore, Business Judgment Rule should not be applied for the purpose of encouraging risk. Unfortunately, this was not the case when Citigroup derivative litigation reached the Delaware Court of Chancery.[124]

Before analyzing the *Citigroup* opinion there are two important things to remember. First, the governance model advanced by the Business Judgment Rule has a number of rationalizations, discussed *supra* Part I. Even if the Business Judgment Rule's rationale based on beneficially encouraging risk-taking does not hold true in the financial sector, other rationales benefits could arguably still allow for efficient imposition of the Business Judgment Rule. For instance, proponents of the Business Judgment Rule who argue the impropriety of judicial review of business decisions based on lack of judicial expertise, *supra* Part I, may maintain that cases in the financial industry, often involving complicated lending schemes, security bundles, and international economics, may be even more difficult for jurists to adequately address. Additionally, those who argue business decisions lack objective standards could further argue that the appropriateness of investment decisions depends heavily on the individual goals and risk aversion of investors,[125] making objective standards even harder to find. Proponents of compensation versus liability, *supra* Part I, could contend that the utility difference between the two methods of deterrence still operate effectively in the financial industry. Finally, those that argue the Business Judgment Rule prevents talented decision makers from leaving the market for fear of personal liability, *supra* Part I, could allege that if decision makers in financial institutions must indeed exercise more caution when taking risks, ensuring the most competent individuals retain decision making roles could be of utmost importance. In short,

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[122] Citigroup*: Eye on the Bailout*, PPROPPUBLICA, propublica.org., https://projects.propublica.org/bailout/entities/96-citigroup (last visited Dec. 2, 2016).
[123] Patrick Gillespie, Fed Ends 'Too Big to Fail' Lending to Collapsing Banks, money.cnn.com (Nov. 30, 2015) http://money.cnn.com/2015/11/30/news/economy/fed-adopts-rule-to-end-too-big-to-fail/ (last visited Dec. 5, 2016).
[124] *See* Citigroup, 964 A.2d. at 126.
[125] *See* Bodie, Kane, & Marcus, *supra* note 67, at 160, 163, 196.

the battle for and against the Business Judgment Rule has been a long one and the analysis for or against the Business Judgment Rule's justifications is simply another attempt to tip the scales.

Second, the argument that the Business Judgment Rule should not be invoked for the purpose of encouraging risk as the cost of the corporation's wellbeing is not a statement about how excessive risk-taking and contagion should be regulated by internal means, such as corporate governance, or external means, such as regulation. Many scholars have ably commented on what methods should combat externalities in the financial sector.[126] Instead, this paper merely inquires whether the defense of the Business Judgment Rule, relying on supposed benefit to diversified shareholders who prefer risk-adjusted returns at all costs, holds true in the financial industry. If it does not, as discussed *supra* Section A, then cases such as *Citigroup* misunderstand the nature of firm-specific and market specific risk and thus misapply the Business Judgment Rule when offering its protections for the express purpose of encouraging risk.

C. Citigroup: Using the Business Judgment Rule to Defend the Risk-Taking Associated with Contagion

The Delaware Court of the Chancery in 2009 decided *In re Citigroup Inc. Derivative Litigation*[127] as Duty of Care and waste claims[128] resulting from the directors' and officers'[129] alleged failure to adequately manage the bank's exposure to the subprime crisis and for choosing to repurchase shares.[130] Chancellor Chandler, author of the opinion, however, recharacterized the plaintiff's claims from monitoring, Duty of Care claims, to simple business judgment claims by stating:

> Although these claims are framed by plaintiffs as Caremark claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to *hold the director defendants personally liable for making (or allowing to be made)*

[126] *See* Armour & Gordon, *supra* note 3, at 44 for a discussion on the merits of external versus internal mechanisms for containing contagion-style externalities.
[127] *In re* Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106 at 106, 126 (Del. Ch. 2009).
[128] *See id.* at 111.
[129] *See id.* at 112.
[130] *See id.* at 111.

> *business decisions* that, in hindsight, turned out poorly for the Company.[131]

By framing the Duty of Care claims as business decisions, Chancellor Chandler was able to invoke both uses of the Business Judgment Rule, as a standard for measuring decision maker conduct, and as a general abstention from judicial review.[132] Thus, Chancellor Chandler was able to rely on the Business Judgment Rule's traditional rationales for general abstention from judicial review before deviling into decision maker conduct in light of the Business Judgment Rule as a substantive standard.[133] In supporting judicial abstention, Chancellor Chandler first briefly touched on "hindsight bias"[134] and claimed that by allowing the court to look into the decision makers' failure to monitor, the court would "undermin[e] the well settled policy of Delaware law . . . [by] evaluat[ing] . . . business decisions."[135]

Chancellor Chandler then turned to the topic of risk. To support the "well settled policy" of not interfering with business decisions, Chancellor Chandler explains that "[b]usinesses—and *particularly financial institutions*—make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return."[136] Chancellor Chandler goes as far to say that the Business Judgment Rule was "designed to prevent" claims that could "impose liability on directors for making a 'wrong' business decision [and] cripple their ability to earn returns for investors by taking business risks."[137] Here Chancellor Chandler suggests that even when a complaint is under the *Caremark*[138] Duty of Care, a court cannot "abandon such bedrock principles of Delaware fiduciary duty law" by discouraging risk-taking.[139]

Chancellor Chandler's express invocation of the diversified investor's preference for encouraged risk-taking is a prime example of courts not understanding the nature of risk when applied to financial institutions and banks. Chancellor Chandler was dealing with one of the banks most culpable for the contagion of 2008,[140] yet still applied the Business Judgment Rule expressly to encourage risk taking to benefit investors.[141] Although the traditional Business Judgment Rule encourages firm-specific risk, Citigroup, as evidenced by their

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131 *Id.* at 124 (emphasis added).
132 *See, e.g.,* Gevurtz, *supra* note 12, at 288.
133 Citigroup 964 A.2d at 124.
134 *Id.* at 124, 126.
135 *Id.* at 126.
136 *Id.* at 126 (emphasis added).
137 *Id.* at 126.
138 *In re* Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).
139 *Citigroup*, 964 A.2d at 126.
140 *See* Fisch, *supra* note 26, at 924.
141 Citigroup, 964 A.2d at 126.

receipt of bailout funds, was a financial firm capable of drastically affecting market risk by failing, thus severely harming diversified investors. As mentioned earlier, perhaps the Business Judgment Rule was warranted on other grounds, such as judicial lack of expertise or compensation utility. However, Chancellor Chandler's application of the Business Judgment Rule did not rely on justifications other than the encouragement of risk-taking as desired by investors.[142] Even the Chancellor's use of the "hindsight bias" was offered in conjunction with second guessing of risk assessment by decision makers.[143] The final evidence of a misunderstanding of the reasons for encouraging risk was the Chancellor's express comments that financial institutions in particular should get a pass when taking on risk.[144]

CONCLUSION

The world post-2008 has learned valuable lessons about the nature of risk with financial institutions. After evaluating the causes of the collapse, many have concluded that decision makers and decision making parameters are improperly incentivized. The Business Judgment Rule, which is a governance mechanism, attempts to provide a strong incentive to incur risks in return for reward to the benefit of modern, rational, diversified shareholders. After 2008, there is doubt about whether such incentives are desirable for investors in the financial sector due to the unique nature of risk and the danger of contagion. However, courts dealing with the aftermath of 2008 have chosen to encourage risk-taking in the very firms often seen as causing the crisis due to excessive risk-taking. While the Business Judgment Rule stands on many grounds, a new look at the nature of risk in the financial sector and the interest of the diversified shareholder may alter the calculus that determines its utility and continued use as a means of risk encouragement.

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[142] *Id.*

[143] *Id.*

[144] *Id.* at 126 ("[b]usinesses—and *particularly financial institutions*—make returns by taking on risk") (emphasis added).