Maybe There Is More Than One Reason They Call It a Derivative Lawsuit – The Implicit Corporate Duty to Hedge

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Abstract

Derivatives became the primary scapegoat after the financial markets crashed in 2008 and many large investment banks collapsed in the aftermath. Derivatives were thought to be far too risky and not transparent, even though derivatives were originally contrived in order to mitigate risk. Contrary to popular opinion, if used properly, derivatives are very effective in the mitigation of price changes, currency exchange, and interest rate risk. Moreover, the current regulatory landscape encourages the use of derivatives to hedge risk.

The current financial environment encompasses the widespread use and acceptance of products that allow hedging to be a common trade practice. The failure to use such financial products in order to hedge risks or to acknowledge hedging opportunities that can add to the profitability of the corporation may be a violation of a corporate fiduciary’s duty to hedge risk.

This Article seeks to determine whether, under existing case law, there is an implicit corporate duty for corporate directors to educate themselves on the use of derivatives in order to hedge risk. Further, this Article asserts that United States law implies a corporate duty to hedge risk within the umbrella duty of care. Finally, this Article maintains that a corporate director should take prudent action to invoke the protections of the business judgment rule, consult with experts in the field, and delegate risk management to those individuals who may be more qualified to assess corporate risk.

I. Introduction

The 2008 market collapse marked a watershed moment in the history of derivative instruments. Bear Sterns, Lehman Brothers, and AIG’s holding company were all overleveraged with credit default swaps.1 When the market went against them, three of the largest investment banks in the world collapsed.2

In the aftermath of the Great Recession, derivatives had become synonymous with risk. Even Warren Buffet referred to credit default swaps as

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2. *Id.*
“financial weapons of mass destruction.” Further, J.P. Morgan’s recent and well publicized $2 billion dollar loss was attributed to credit default swaps.

Originally, derivatives were developed out of a need to hedge risk, and, if used properly, effectively mitigate price changes and currency exchange and interest rate risk. Moreover, the current regulatory landscape encourages the use of derivatives to hedge risk.

This Article seeks to determine whether, under existing case law, there is an implicit corporate duty for directors to utilize hedging strategy. In other words, are corporate fiduciaries required to educate themselves regarding the use of derivatives to hedge the risks of a corporation?

To answer this question, this Article is divided as follows. Part II examines the development of risk management tools and the increased demand to hold corporate fiduciaries accountable. Part III asserts that current U.S. law implies a corporate fiduciary duty to hedge. Couched in federal statutes are concessions to reduce the cost of mitigating risk. Further, hedging not only mitigates risk, but it adds value to the corporation. Existing case law regards the duty to hedge as an outgrowth of the duty of care, which requires that corporate fiduciaries have all material information reasonably available to make an informed decision. Furthermore, the reasonably informed director must take prudent action to invoke the protections of the business judgment rule. This section concludes by pointing out that directors also have an implied duty to consult experts or delegate risk management to those adequately skilled to perform their duty. However, corporate fiduciaries have a duty to monitor delegates, and, thus, delegation does not sever the corporate fiduciary from liability. Part IV presents a general conclusion.

II. Risky Business

A. The Ripple Effect

“All of life is the management of risk not it’s elimination.” Indeed, risk is the ever-present adversary that challenges every fiduciary in the business world. Currency exchange and interest rate volatility create risks for multinational corporations, fluctuating oil and gas prices affect the bottom line of airline companies, and the ebbs and flows of commodity prices impact manufacturers. The prosperity of market participants is always at the mercy of variations in the financial market, as well as the regulatory landscape. The ever-changing nature of the market presents the challenge of unpredictable outcomes (i.e., how to hedge risk).

7. Id. at 986–87.
8. Id. at 986.
9. Id.
Most analysts agree “that the financial environment is riskier today than . . . in the past.”\textsuperscript{10} However, the ability to manage risk has not remained stagnant.\textsuperscript{11} One commentator notes that “[t]he saving grace of this riskier financial environment has been the spawning of financial innovation.”\textsuperscript{12} In other words, “[f]inancial innovation is a demand-driven phenomenon that always has been fueled by market risk.”\textsuperscript{13} When markets are not overly volatile, “simple, conservative investments satisfy the market.”\textsuperscript{14} However, as markets face greater volatility and less certainty, “the market always responds with a proliferation of risk management instruments.”\textsuperscript{15}

Financial innovation provides the contemporary fiduciary with sophisticated risk management instruments to better evaluate and manage risk.\textsuperscript{16} The availability of such risk management instruments allows fiduciaries to regularly deal with price uncertainty, and, thus, hedge risk exposure.\textsuperscript{17}

Indeed, hedging has become the standard rather than the exception in global markets. A 2009 survey conducted by the International Swaps and Derivatives Association showed that over ninety-four percent of the world’s Fortune 500 companies use derivatives to hedge business and financial risk, including ninety-two percent of the U.S. companies surveyed.\textsuperscript{18}

The widespread use and acceptance of such products evinces that hedging is a common trade practice and suggests an implicit duty to hedge. As one top airline executive commented, “If we don’t hedge jet fuel price risk, we are speculating. \textit{It is our fiduciary duty to try and hedge this risk.}”\textsuperscript{19}

Labor jet fuel is the second largest operating expense for airlines.\textsuperscript{20} Ever-changing fuel prices present a major challenge for airlines because of their highly volatile nature.\textsuperscript{21} Further, given the highly competitive nature of the business, airlines are unable to simply pass the costs onto customers.\textsuperscript{22} Thus, if airlines can hedge risks associated with the cost of fuel they can more accurately estimate budgets and forecast earnings.\textsuperscript{23} For a corporation, profitability as well as survival depends on mitigating risk and controlling price uncertainty.

\textsuperscript{10} Borkus, supra note 5 (quoting CHARLES W. SMITHSON & CLIFFORD W. SMITH, JR., MANAGING FINANCIAL RISK: A GUIDE TO DERIVATIVE PRODUCTS, FINANCIAL ENGINEERING, AND VALUE MAXIMIZATION 2 (1995)).
\textsuperscript{11} Borkus, supra note 5, at 147.
\textsuperscript{12} Id.
\textsuperscript{13} Id. at 146–48. “The volatility of the 1970s created an environment of price uncertainty with severe changes in foreign exchange rates, interest rates, and commodity prices.” Id.
\textsuperscript{14} Id. at 147.
\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} Id.
\textsuperscript{19} Dave Carter, Dan Rogers, & Betty Simkins, Fuel Hedging in the Airline Industry: The Case of Southwest Airlines, *1 (quoting Scott Topping, Director of Corporate Finance for Southwest Airlines) (emphasis added).
\textsuperscript{20} Id.
\textsuperscript{21} Id.
\textsuperscript{22} Id. at 3.
\textsuperscript{23} Id. at 1.
B. The Growing Demand for Accountability

Amplified risk in the global financial markets has resulted in increasing pressure on corporate fiduciaries to implement appropriate hedging strategies. The contemporary corporate fiduciary is now expected to remain well-informed as to the nature of the risk inherent in the markets, the availability of the products to hedge the risk, and the feasibility of implementing hedging strategies to manage corporate risk. Before the advent of financial derivative products, “a corporate fiduciary could blame . . . poor results on the movement of the dollar or unforeseen interest rate changes or commodity price shocks.” Because of the limitations in hedging instruments to insure against price uncertainty, shareholders had to accept the response.

However, with the development of financial derivative products and the availability of risk management tools, such a response quickly became unacceptable. Additionally, corporate shareholders are better informed and increasingly more sophisticated. Therefore, they expect corporate management to hedge company assets against negative price movements. As a result, shareholders—individual, corporate and institutional—now hold their fiduciaries accountable for hedging against all forms of price uncertainty.

The concept of risk management is more than a bank or corporation buying hedges; it is the idea of protecting the dollar value of the business. Corporate fiduciaries have a general duty to understand how to protect the dollar value of the business. The positive impact that risk management disclosure has had upon a company’s net cash flows further evidences this point. Therefore, implicit in a corporate fiduciary’s duty to protect the dollar value of the business is the duty to hedge insurable risks.

III. A Duty to Hedge Emerges

A. The Legal Framework

1. Hedging Adds Value

As a general principle, a corporation is primarily organized to create value for its shareholders. Implicit to this principle is protecting the dollar value of a business. To a corporate fiduciary, protecting a corporation’s dollar value is analogous to a trustee’s duty to protect the trust corpus—it is the cornerstone of the fiduciary duty.

24. Id. at 148 (citing SMITHSON & SMITH, MANAGING FINANCIAL RISK 65).
25. Carter, Rogers, & Simkins, supra note 19, at 148.
26. Id. (quoting Edgeward & Eller at 1045).
27. Id. (citing SMITHSON & SMITH, MANAGING FINANCIAL RISK 65).
28. Id.
29. Id.
30. Id.
However, hedging does more than protect the dollar value of a business. Empirical evidence shows that the value of firms that hedge currency risk, on average, is higher by about five percent. This hedging premium is statistically and economically significant. With a median market value of about $4 billion, this translates into an average value added of almost $200 million for firms using foreign currency derivatives to hedge price uncertainty—a very large effect.

In the case of fuel hedging among U.S. airlines, empirical evidence shows an even higher hedging premium of about fourteen. This is because the financial risk associated with volatile fuel prices is economically very significant for airlines. Hedging adds value to a corporation by “decreasing taxes . . . [and the] expected costs associated with financial distress . . . [and] avoiding the errors in the investment decision that are induced by conflicts between bondholders and shareholders.” Moreover, hedging allows firms, particularly airlines, to expand operations when times are bad for the industry, thereby alleviating the problem of underinvestment.

As noted above, hedging can also reduce tax exposure. Code § 1221(a)(7) provides an exception to capital asset treatment for qualifying “hedging transactions.” “Hedging transactions” are defined as:

[A]ny transaction entered into by a taxpayer in the normal course of its trade or business primarily to manage risks of interest rate or price changes, or currency fluctuations with respect to ordinary property that is held, or to be held, by the taxpayer, or to manage risks of interest rate, price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred, or to be incurred by the taxpayer.

Furthermore, the Treasury has the authority to issue regulations extending the definition of “hedging transactions” to the management of other risks.

As a result, the Financial Accounting Standards Board (the “FASB”) promulgated accounting and disclosure standards for a corporation’s use of derivatives to hedge. The FASB is designated by the Securities and Exchange Commission “to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.”

35. Id.
37. Id.
38. SMITHSON & SMITH, supra note 24, at 505–06.
39. Carter, Rogers, & Simkins, supra note 36.
41. Id.
Hedging also adds to a business’s value by reducing the probability of a firm’s financial distress.44 For example, where a volatile firm provides service agreements and warranties to its customers, consumers will place less value on those service agreements and warranties and will be more likely to turn to competitors.45 Reducing the risk of financial distress increases consumers’ valuation of its service agreements and warranties, and this perceived increase in value is reflected in the cash flows to the firm and in the price consumers are willing to pay for the product.46

Last, hedging also reduces underinvestment risk. When a corporation is in financial distress, shareholders become reluctant to provide additional equity for even attractive, value-adding projects because part of the added value will go to lenders or bondholders.47 Hedged cash flows, thus, reduce the tension between shareholders and bondholders by providing firms the liquidity needed to expand operations in economic downturns.48

As suggested by the above, shares in a corporation with less risk exposure trade at a premium. This is because investors have two basic objectives: (i) they seek high returns; and (ii) they want those returns to be “dependable, stable, [and] not subject to uncertainty.”49 Because hedging guards against risk exposure, increases shareholder value, and increases the dollar value of a firm, fiduciaries have a fiduciary duty to hedge.

2. Hedging Is Statutorily Accepted and Encouraged

Regulators are fully aware of the hedging activities of corporations, and federal statutes reflect a favorable approach to the use of derivatives to hedge risk.50 In addition to the U.S. tax code, the Wall Street Reform and Consumer Protection Act of 2009 (hereafter, and better known as “the Dodd-Frank Act”)51 and the Employee Retirement Security Act of 1974 (hereafter “ERISA”)52 are glaring examples of how U.S. federal statutes encourage derivative hedging strategies.

The Dodd-Frank Act, enacted following one of the worst financial downturns in history, excludes from registration any firm “whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures within its organization.”53 The Dodd-Frank Act also provides an

45. Id.
46. Id.
48. Id.
50. See generally Treas. Reg. 26 U.S.C. §1.1221-2(b); Internal Revenue Code § 1221 (b)(2).
53. Dodd–Frank Act § 721 (to be codified at 7 U.S.C. 1a(33)(D)) (note that the exemption does not extend to treatment as a major securities-based swap participant).
exception to its clearing mandate for non-financial businesses using “swaps to hedge or mitigate commercial risk.”

Additionally, section 716 of the Dodd-Frank Act, popularly known as the Volker Rule, creates a general prohibition against insured depository institutions acting as major swap participants. However, the Volker Rule does not apply if insured depository institutions limit their activities to “[h]edging and other similar risk mitigating activities directly related to the insured depository institution’s activities.”

While the Dodd-Frank Act generally creates stringent rules for the use of derivatives, it exempts and excludes hedging activities. Thus, by design, the Dodd-Frank Act encourages the use of derivatives to hedge risk.

Similarly, Employee Retirement Income Security Act Regulations (“ERISA”), enacted during a period of volatile exchange rates and “oil price shocks,” include provisions that encourage (if not induce) hedging. ERISA imposes on trustees of pension and employee benefit trusts a duty of prudent investing, and requires consideration of the role that each investment plays in the context of the portfolio as a whole. Trustees are neither restricted nor obligated to use specific types of investments or investment strategies. In other words, the use of derivatives in pension plans is no longer imprudent per se. Consistent with modern portfolio theory, federal courts look at the complete portfolio rather than investments in isolation in ERISA litigation.

Furthermore, ERISA also repealed the prior rule against delegation of investment responsibilities in response to the growing complexity of managing...
financial assets and the need for trustees to rely on delegation to professionals to discharge their obligations. Given the bifurcation of derivatives and securities regulations and the complexity of derivatives, the ability to delegate strongly appears to encourage the use of derivatives as hedging instruments.

3. The Duty to Hedge Is Grounded in the Business Judgment Rule

While the above demonstrates the prudence of hedging, the corporate duty to hedge is ultimately grounded in the business judgment rule. Under current U.S. law, plaintiff-shareholders seeking to hold corporate fiduciaries liable are faced with overcoming the “business judgment rule”.

a. The Business Judgment Rule

The business judgment rule provides that in the absence of fraud, illegality, self-dealing, or other misconduct:

[D]irectors of a corporation . . . are clothed with [the] presumption, which the law accords to them, of being [motivated] in their conduct by a bona fide regard to the interest of the corporation whose affairs the stockholders have committed to their charge.

In other words:

[Because] it is both the duty and the right of the board of directors to manage the affairs of the corporation, courts will defer to business decisions made by the board of directors, as long as in making those decisions the directors complied with their fiduciary duties of loyalty, due care and good faith.

The rule is designed to shield faithful directors who have otherwise adhered to their fiduciary duties but made honest errors of judgment.

The business judgment rule is multi-faceted and has procedural and substantive implications. On one hand, the rule generally creates “a presumption in favor of [the corporate fiduciary’s] actions.” Thus, the burden is on the plaintiff-shareholder to prove that the director breached one of its three fiduciary duties: due care, good faith, or loyalty. Failing to do so, a plaintiff “is not entitled to any remedy unless the transaction constitutes waste . . . [in other words] the

65. RALPH C. FERRERA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 5.01 (1996); see generally Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the rule presumes informed business decisions).
66. Aronson, 473 A.2d at 812.
68. Id. at 872; Aronson, 473 A.2d at 812. Although the business judgment rule has generally been applied as a tripartite test (whether a corporate fiduciary breach the duty of due care, loyalty or good faith), the Delaware Supreme Court more recently construed good faith as a “subsidiary element” of the duty of loyalty. See also Stone v. Ritter, 911 A.2d 362 (Del. 2006).
exchange was so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”

Substantively, the rule creates affirmative duties in the corporate fiduciaries while shielding them from liability if the shareholder fails to rebut the presumption. It should be noted that in some jurisdictions the rule is construed as providing an affirmative defense to directors. In other words, the rule “provides a safe harbor that makes both directors and their actions unassailable if certain prerequisites have been met.”

In the context of litigation, the rule is a means for conserving judicial resources and promoting judicial efficiency, thereby permitting courts to avoid being mired down in rehashing decisions that are inherently subjective and ill-suited for judges, as opposed to business men and women. Finally, the rule is the law’s implementation of broad economic policy, built upon economic freedom and the encouragement of informed risk taking.

4. The Duty of Care

The fiduciary duty of care requires directors to take an active and direct role in the decision-making process. The fiduciary duty of due care also requires that directors of a corporation both: (i) “use that amount of care which ordinarily careful and prudent men would use in similar circumstances” and (ii) “consider all material information reasonably available.” Liability for a breach of the duty of care can arise in two contexts:

First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or “negligent.” Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.

The first class of cases is subject to review under the business judgment rule. To invoke the rule’s protections in the context of a duty of care, “directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.” When determining whether a breach occurred, courts look to objective facts including the amount of time available to directors to prepare for the meeting, the extent of the directors’ preparation for

70. Id.
71. Branson, supra note 67, at 632.
72. Id.
73. Id.
74. Id.
76. In re Disney, 907 A.2d at 749.
80. Aronson, 473 A.2d at 880 (citing Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch. 1974)) (one and a half days’ notice is insufficient).
the meeting,81 time spent by the directors at the meeting,82 the type and quality of the advice available to the directors,83 the directors' participation in the meeting,84 and the documents the directors reviewed.85

If a company's “directors individually and the board collectively” failed to inform themselves “fully and in a deliberate manner,” then they “lose the protection of the business judgment rule” and the court is “required to scrutinize the challenged transaction under an entire fairness86 standard of review.”87 In this regard, gross negligence is the proper standard for determining whether a business judgment reached by a board of directors was an informed one.88

As for the second class of cases, where a loss results from director inaction, the protections of the business judgment rule do not apply.89 Under such circumstances, a “sustained or systematic failure” of a director to exercise reasonable oversight constitutes a breach of the director’s duty of care.90

5. The Duty of Loyalty

Traditionally, a breach of the duty of loyalty occurred where “a director [took] for herself something which should otherwise belong to the corporation.”91 Corporate fiduciaries have an affirmative duty to act in the interest of the corporation and its shareholders, and thus are to refrain from self-dealing and usurpation of corporate opportunities without informed consent of the corporation.92

To allege a breach of the duty of loyalty based on actions or omissions of the Board, the Plaintiff must “plead facts demonstrating that a majority of a board that approved the transaction in dispute was interested and/or lacked independence.” To show that a director was interested, it is usually necessary to show that the director was on both sides of a transaction or received a benefit not received by the shareholders.93

81. Cede, 634 A.2d at 371 (holding that the directors' failure to inform themselves of all reasonably available material information to the decision at hand was a violation of the duty of care).
82. Smith v. Van Gorkom, 488 A.2d 858, 874 (2002) (holding that the two–hour meeting was insufficient to satisfy the duty of care).
83. Sealy Mattress Co. v. Sealy, Inc. 532 A.2d 1324, 1337 (Del. Ch. 1987) (holding that a business decision made without expert advice violated the duty of care).
84. Id. (directors' failure to consider facts relevant to the merger violated the duty of care).
85. Van Gorkom, 488 A.2d at 874 (directors' failure to review merger documents violated the duty of care).
86. In order to satisfy an entire fairness review of a challenged transaction, a board must demonstrate that its transaction was the product of both fair dealing and produces a fair price to shareholders. See generally Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). This analysis is not necessarily bifurcated, and reviewing courts may blur the line with the outcome of one prong influencing the outcome of the other. Id. at 711.
89. Disney, 907 A.2d at 748.
90. Id. at 750 (citing In re Caremark Int'l Inc. v. Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996)).
91. Claire A. Hill & Brett H. McDonnell, Stone v. Ritter and the Expanding Duty of Loyalty, 76 FORDHAM L. REV. 1769, 1795 (2007) (laying forth the notion that the duty of loyalty is “an obligation of devotion” to the corporation including more than simply not enriching oneself at the company’s expense).
93. Continuing Creditors' Comm. of Star Telecomms, Inc v. Edgecomb, 385 F. Supp. 2d 449, 460 (D. Del. 2004); see also Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) ("[A] director is considered interested where he or she will receive a personal financial benefit from, a transaction that is not equally shared by the stockholders.").
However, the Delaware Supreme Court’s recent decision in *Stone v. Ritter* clarified that, under Delaware law, any act made in bad faith is also disloyal. 94

The fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.

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Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. 95

Thus, there is no “triad” of separate fiduciary duties: when a director acts in bad faith he has also violated his duty of loyalty. 96 Put another way, knowing breaches of any duty, including knowing breaches of the duty of care, are henceforth disloyal.97

6. Good Faith

A fiduciary breaches the duty of good faith when, among other things, he takes, or fails to take any action that demonstrates a “faithlessness or lack of true devotion to the interests of the corporation and its shareholders.” 98 The fiduciary duty of good faith; and, thus, the duty of loyalty are breached:

Where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. 99

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95. *Id.*: see also *Morris v. Zelch* (*In re Reg. Diagnostics LLC*), 372 B.R. 3, 30 (N.D. Ohio 2007) (holding that “under Delaware law a claim for breach of the duty of loyalty can be premised on a failure to act in good faith”); *Alberts v. Tuft* (*In re Greater Se. Cnty. Hosp. Corp. I*), 353 B.R. 324, 344 (Bankr. D.D.C. 2006) (“[M]aking a decision that is not in the corporation’s best interests—abdicating one’s directorial duties—is a breach of the fiduciary duty to act in good faith, . . . which is just another permutation of the fiduciary’s duty of loyalty.”) (emphasis added) (citing *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 65–68 (Del. 2006)); *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (“A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”). Stone thus explicitly affirms Strine’s assertion in *Guttman* that, “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.” *Stone*, 911 A.2d at 370. The terminology here is rather confusing because the opinion also explicitly affirms Guttman’s definition of good faith as a “subsidiary element,” i.e., a condition, of the fundamental duty of loyalty.” *Stone*, 911 A.2d at 370, citing Guttman. At the same time, however, *Stone* expands the meaning of disloyalty to include acts for which the director did not have a “good faith belief that her actions are in the corporation’s best interest.” *Stone*, 911 A.2d at 370. While the court narrows the definition of bad faith so that it becomes merely a subset of disloyalty, it expands the definition of disloyalty to include acts that earlier might have simply met the definition of bad faith but not necessarily disloyalty in the sense of being self-serv ing.

96. *In re Bridgeport Holdings, Inc.*, et al., 388 B.R. 548, 577; 2008 Bankr. LEXIS 1586 ** 35 (citing Desimore v. Barrows, 924 A.2d 908, 933 (Del. Ch. 2007)).

97. *In re Bridgeport Holdings, Inc.*, 388 B.R. at 577; *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. Ch. 2007) (citing *Stone* for this proposition).

In other words, a director acts disloyally, under Delaware law, if he does not believe in good faith that his actions are in the best interests of the corporation. “[T]he reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation’s best interest does not make it faithful, as opposed to faithless.” Therefore, bad faith, and hence disloyalty, is not limited merely to actions which plainly benefit the director at the expense of the corporation but include any of a number of “moral failings.”

Bad faith can be the result of “any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation,” including greed, “hatred, lust, envy, revenge . . . shame or pride”. Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a systematic or sustained shirking of duty.

Thus, the faithless director knows that he is acting against the best interests of the corporation due to a “moral failing.” While ignorance, alone, is probably not enough to constitute a breach of bad faith, “ignorance attributable to any of the moral failings previously listed could constitute bad faith.” “Deliberate indifference and inaction in the face of a duty to act is . . . conduct that is clearly disloyal to the corporation.”

The duty of good faith, includes a duty to monitor, and makes actionable situations in which “(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 thus disabling themselves from being informed of risks or problems requiring their attention”. The “imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.” Therefore, plaintiffs must plead “particularized facts . . . that [the directors] had ‘actual or constructive knowledge’ that their conduct was legally improper.”

B. Legal Precedent Shows That Corporate Fiduciaries Have a Duty to Hedge

Unlike the corresponding duty to diversify, the duty to hedge, at this moment, does not enjoy a rich history of common law precedent. First, as noted above, corporations are already hedging. Second, the media’s portrayal of derivatives as high risk instruments has resulted in a “blame the product” mentality. Third, exculpatory and indemnification clauses were thought to limit
liability and, thus, until, recent clarification, deterred lawsuits\textsuperscript{109} and induced settlements.\textsuperscript{110}

According to commentators, the duty to hedge is an outgrowth of the duty of care.\textsuperscript{111} However, a breach of the duty of care was believed to be non-actionable if a corporate fiduciary had an exculpatory clause in her contract. After Stone, however, certain breaches of the duty of care, such as a knowing breach, will not enjoy the protection of the business judgment rule because they breach the duty of loyalty as well.\textsuperscript{112}

By subsuming good faith into the duty of loyalty . . . Stone extends the domain of the duty of loyalty to cases in which the defendant received no financial benefit . . . [and thus,] liability for acts in bad faith . . . will look a lot more like that imposed in cases involving a breach of the duty of care than the duty of loyalty.\textsuperscript{113}

This is significant because some jurisdictions, like Delaware, provide for the indemnification of directors and officers for litigation expenses under specified circumstances.\textsuperscript{114} Yet indemnification statutes specifically limit certain indemnification provisions to persons who “acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.”\textsuperscript{115} Thus, directors and officers “can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.”\textsuperscript{116} As a result, the duty of care, and, thus, the duty to hedge, again has teeth.

1. Development of the Fiduciary Responsibility Structure

In the seminal case of Smith v. Van Gorkom,\textsuperscript{117} some of the directors there conducted a “preliminary study” in which they simply crunched numbers

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\footnote{109. See Nancy E. Barton, Dennis J. Block, & Stephen A. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 167–72 (5th ed. 1998) (identifying only twelve modern cases as finding actionable director negligence without a concurrent breach of loyalty or a conflict of interest).}
\footnote{110. See e.g., Charal Inv. Co. v. Rockefeller, Fed. Sec. L. Rep. (CCH) 98, 979, at 93,761 (Del. Ch. Nov. 7, 1995); Axler v. Wagner, No. 94-CV-3097 (E.D. Pa.) (settled out of court); In re Piper Funds, Inc. Institutional Gov't Income Portfolio Litig., 71 F.3d 298, 300 (8th Cir. 1995) (involving a class action suit that alleged negligent misrepresentations, breach of fiduciary duty, and violations of the federal securities laws, which settled for $70 million); Smith v. Citron, (C.D. Cal.) (consisting of a class action that alleged the defendants recklessly gambled with public money by investing in high-risk, volatile derivatives which were excessively leveraged and not adequately hedged against loss).}
\footnote{111. See Adams & Runkle, supra note 65; see generally Borkus, supra note 5; George Crawford, A Fiduciary Duty to Use Derivatives, 1 Stan. J.L. Bus. & Fin. 307 (1995).}
\footnote{112. Further, in the wake of Disney V and Stone, courts must reevaluate the scope of the protections granted by 102(b)(7). Focusing on the language of the law itself (and not its widely accepted paraphrase), it appears that 102(b)(7) allows waivers of liability for most breaches of duty of care but not those breaches of that duty that might be considered disloyal according the Delaware Supreme Court’s definition in Stone. It is entirely possible then, after Stone, that a 102(b)(7) waiver would no longer protect directors for the authorization of a risky project where the directors deliberately ignored the relationship between the chances of success of the project and its rewards for the corporation.}
\footnote{113. Bainbridge et al. at 585. Including as disloyalty acts that do not benefit the director does indeed make the duty of good faith look a lot like the duty of care. Essentially, Stone’s duty of loyalty includes breaches of the duty of care in bad faith.}
\footnote{114. Del. Corp. § 145}
\footnote{115. Id.}
\footnote{116. Id.}
\footnote{117. Smith v. Van Gorkom, 488 A.2d 858, 858 (Del. 1985).}
\end{footnotes}
This preliminary study became the basis of a “fair price” for the company’s stock. The Van Gorkom court pointed out that this method of calculation does not necessarily yield the best price; therefore, the business judgment rule did not protect the directors who had failed to inform themselves of all material information reasonably available prior to making a business decision.

The Supreme Court of Delaware reasoned that the duty of care requires directors to inform themselves of all material information reasonably available to them, which includes alternatives, before making a business decision. The Van Gorkom Court held that the board of directors was grossly negligent where they failed to act with informed, reasonable deliberation in agreeing to a merger proposal.

Similarly, in Paramount Communications, Inc. v. QVC Network Inc., directors conditionally agreed to a tender offer made by Viacom. However, Paramount subsequently entered into a “no shop” agreement with Viacom, providing that it would not consider or accept other offers without self-imposed liability. As a result, Paramount refused to consider a more lucrative unsolicited offer tendered by QVC. The Paramount Court held that Paramount’s directors had an obligation to search for the best value reasonably available to the stockholders, including all subsequent offers, and, thus, violated their fiduciary duties since Paramount was required to act on an informed basis and to secure the best value reasonably available to the stockholders.

As in Van Gorkom, Paramount’s directors had a duty to become fully informed on the alternatives available. The Paramount Court found that Paramount’s directors’ process was not reasonable, and the result achieved for the shareholders was unreasonable under the circumstances.

Although the plaintiffs were corporations tendering merger offers and not shareholders, the Delaware Supreme Court’s decision indicates that this case would have met all of the necessary requirements to overcome the business judgment rule. Additionally, the court indicated that Paramount’s justification for its actions would not have met the entire fairness standard.

In 1992, the Indiana Court of Appeals addressed the issue of a duty to hedge head-on in Brane v. Roth. In Brane, the shareholders of a commercial grain cooperative brought an action against the co-op’s directors for failure to hedge

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118. Id.
119. Id.
120. Id. at 875–76.
121. Id. at 872.
122. Id. at 881.
123. Paramount Commc’ns, Inc. v. QVC Network, Inc. 637 A.2d 34, 45 (Del. 1994).
124. Id. at 50.
125. Id.
126. Id.
127. Id.
128. Id. at 49.
130. Id. at 49.
131. Id.
132. Id.
against commodity price risk. The co-op’s gross profit had fallen continuously for four years. Following substantial losses in the third year, the co-op’s accountant recommended hedging in the grain market to minimize future losses. Directors gave the authority to hedge to an inexperienced manager, and the manager only hedged $20,050.00 of the co-op’s $7.3 million in total grain sales. The Brane court determined that the directors could have mitigated the losses by using derivatives to hedge against price risk, and held that “the directors breached their duty by their failure to . . . become aware of the essentials of hedging to be able to monitor the business which was a proximate cause of the co-op’s losses.”

Generally, when corporate executives make decisions based upon good faith and honest judgment, they avoid judicial scrutiny under the business judgment rule. However, the Brane court reasoned that the fiduciaries were not protected under the business judgment rule presumption because they failed to inform themselves of and implement the hedging tools commonly available to grain market participants. Brane was at least partially decided along similar reasoning to that in Van Gorkom and Paramount Communications.

Moreover, the Brane court went a step further and reasoned that there were material issues, as well, because the corporation derived ninety percent of its income from long grain positions. Thus, hedging was a reasonable business expectation in the grain co-op business and reasonable managers would have protected against commodity price uncertainty.

The Brane decision unambiguously establishes a precedent for a fiduciary duty to hedge risk. Interestingly, the Brane Court is attentive to the fact that the co-op derived nearly all of its profits from one source, suggesting that diluting the risk through diversification might have changed the outcome. If dilution of risk would indeed have changed the outcome, the case would have favored the issue of materiality while also maintaining a consistency with trust law and its acceptance of modern portfolio theory. Nonetheless, the Brane Court highlights that grain hedging was a common trade practice, and, thus, a reasonable business expectation.

134. Id. at 589.
135. Id.
136. Id.
137. Id.
139. Id.
140. Id. at 592. “To invoke the [business judgment] rule’s protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.” Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); see also W & W Equip. Co. v. Mink, 568 N.E.2d 564, 575 (Ind. Ct. App. 1991) (stating that “a director cannot take action blindly and later avoid the consequences by saying he was not aware of the effect of the action”).
141. “Long” as used here means to “have ownership of the underlying commodity: thus, the commodity owner possesses the insurable property and a position in a futures contract or an option on a futures contract can be taken to shift the commodity price risk to another legal entity.” Borkus, supra note 5, at 114. “This is no different from purchasing insurance on a house and shifting the liability to the insurance company.” Id.
143. Id.
144. RESTATEMENT (THIRD) OF TRUSTS § 227(b) cmt. f(3) (providing that “diversification is fundamental to the management of risk and is therefore a pervasive consideration in prudent investment management . . . the duty to diversify ordinarily applies even within a portion of a trust portfolio that is limited to assets of a particular type or having special characteristics”); see also Harry M. Markowitz, Portfolio Selection, 7 J. FIN. 77 (1952) (theory for which Markowitz received the 1990 Nobel Prize in Economic Science).
Shortly after Brane, George Crawford published an influential article, *A Fiduciary Duty to Use Derivatives*,145 in which Crawford posits a situation where the case for using derivatives was so overwhelming that a failure to use them would be tantamount to imprudence. Specifically, Crawford describes a situation in which a bank, acting as trustee, would incur liability where it failed to use derivatives to hedge an under-diversified portfolio.146 Two years later, Crawford’s hypothesis would be tested in *Levy v. Bessemer Trust Co.*147

In *Levy*, a post *Brane* case, a federal district court denied a defendant’s motion to dismiss finding that a trust fiduciary has a duty to be informed of risk management tools and hedging techniques.148 Levy, a client of a financial management and investment advisory service sued the firm, Bessemer Trust Company (“BTC”), “for negligence, gross negligence, negligent misrepresentation, breach of fiduciary duty, breach of the duty to supervise, breach of contract, and fraud.”149 The *Levy* court refused to dismiss the action finding that Levy adequately pled all causes of action but breach of contract.150

The facts in *Levy* are analogous to those in *Brane*. Similar to the co-op deriving most of its profits from grain, Levy’s portfolio comprised mostly of one company’s stock with restrictions on his ability to sell.151 BTC specifically represented to Levy that the company had “special expertise in providing financial services and investment advice to high net-worth individuals” and managing equity positions.152

Like *Brane*, Levy recognized his risk exposure, and in numerous conversations with BTC account representatives, stressed the importance of hedging.153 BTC replied that due to the restrictions on the stock’s ownership, there was no “immediate protection from downward price movement.”154 Six months after hiring BTC, Levy, unsatisfied with BTC’s response, sought further advice.155 A Paine Webber representative recommended a “European options collar”, a combination put and call option. Levy eventually closed his account with BTC and reopened it with Paine Webber.156 Unfortunately, by the time Levy had fired BTC and hired Paine Webber to enter the transaction, his price floor was $24.75 per share and capped at $31.90 per share.157 If BTC had entered into this type of transaction for Levy six months earlier, his stock price would have a floor of $33.33 per share and a ceiling of $44.00 per share.158

145. Crawford, supra note 111.
146. Id.
148. Id.
149. Id. at *2
150. Id. at *3–6.
151. Id. at *1. “The stock certificate prohibited [Levy] from trading the Shares for a period of one year from issuance.” Id. Levy informed BTC that his stock certificate contained a liquidation contingency. Id. at *1–2.
152. Id. at *5.
153. Id. at *1–2.
154. Id. at *1 (noting that BTC employees and management claimed they were not aware of the option strategies available to hedge Levy’s position).
155. Id. at *2–4.
156. Id. (noting that Paine Webber account executives hedged Levy’s investment against further price depreciation).
157. Id. at *2.
158. Id. at *2.
The Levy’s Court found a material question of fact in the pleadings for breach of the fiduciary duty for a failure to hedge to supervise the hedge.\footnote{Id. at *4.} The Levy court further found a material issue with BTC’s alleged breach to Levy as an investment advisor. BTC provided “erroneous investment information . . . [and] made misrepresentations to induce [Levy] to maintain his account with BTC . . . .”\footnote{Id.} If BTC had properly advised Levy, he could have hedged the equity shares and avoided losses.

While Levy involves a trustee, it is not without its utility in the corporate fiduciary context:

The Levy court’s decision that the trustee breached a duty to hedge is analogous to a corporate fiduciary’s duty to protect a business . . . a trust fiduciary also has an implicit duty to hedge against insurable risks, especially given the availability of information regarding modern financial management techniques. A trustee also has a duty to protect trust corpus and the beneficiaries’ entitlements, which is similar to a corporate duty to protect the dollar value of a business. This duty implicitly requires that a trustee be informed of risk management tools and hedging techniques.\footnote{Borkus, supra note 5, at 155–57.}

Simply stating the trust and corporate fiduciary standards is hardly an easy task, but Brane and Levy both illustrate to some extent their symbiotic relationship. In addition to the difference between the standards in theory and the standards in practice, a difference in terminology can mask the fundamental similarities. It is common to reference the twin fiduciary duties of loyalty and care. However, the corporate duty of loyalty arises from the director’s duty to act “in a manner the director reasonably believes to be in the best interests of the corporation,”\footnote{Model Bus. Corp. Act § 8.30(a)(3).} and the duty of care arises from the director’s obligation to act “with the care an ordinarily prudent person in a like position would exercise under similar circumstances;”\footnote{Id. § 8.30(a)(2).} overlaying both duties is the duty to act “in good faith.”\footnote{Id. § 8.30(a)(1).}

A trustee owes beneficiaries the duty of loyalty\footnote{Unif. Trust Code § 802.} and the duty of prudence\footnote{Id. § 804.} (and the duty of impartiality among the beneficiaries).\footnote{Id. § 803.} Importantly, a trustee’s duty of loyalty is grounded in a duty to “administer the trust solely in the interests of the beneficiaries.”\footnote{Id. § 802(a).} Acting in the interest of beneficiaries is really no different from acting “in the best interests of the corporation,” and, thus, Levy’s rules are every bit as applicable to the corporate fiduciary as they are to trustees.

By contrast, courts will not impose liability on fiduciaries engaged in bona fide hedging strategies. For example, in Laborers National Pension Fund v. Northern Trust Quantitative Advisors,\footnote{Laborers Nat’l Pension Fund v. N. Trust Quantitative Advisors, 173 F.3d 313 (5th Cir. 1999).} the Fifth Circuit reversed a district court determination that the defendant-bank’s purchase of interest-only

\footnotesize{\begin{itemize}
  \item Id. at *4.
  \item Id.
  \item Borkus, supra note 5, at 155–57.
  \item Model Bus. Corp. Act § 8.30(a)(3).
  \item Id. § 8.30(a)(2).
  \item Id. § 8.30(a)(1).
  \item Unif. Trust Code § 802.
  \item Id. § 804.
  \item Id. § 803.
  \item Id. § 802(a).
  \item Laborers Nat’l Pension Fund v. N. Trust Quantitative Advisors, 173 F.3d 313 (5th Cir. 1999).
\end{itemize}}
mortgage-backed securities ("IO")\textsuperscript{170} was not a prudent investment for a pension fund.\textsuperscript{171}

The Laborers National Pension Fund (the "Fund") sued the defendant-bank for breach of fiduciary duties alleging violations under ERISA.\textsuperscript{172} The lower court determined that the defendant-bank ignored the Fund’s investment requirements because IOs were inconsistent investments for the Fund, and, thus, a prudent fund manager would not invest in an IO.\textsuperscript{173} The lower court also found expert testimony supporting investment in IOs unpersuasive.\textsuperscript{174}

The Fifth Circuit held that the district court’s decision was erroneous because modern portfolio theory under ERISA requires that investments not be viewed in isolation.\textsuperscript{175} The Fifth Circuit found no reasonable basis for the lower court’s decision when the applicable law was correctly applied to the present set of facts.\textsuperscript{176}

The court ultimately held, inter alia, that the IO purchase was a hedge designed to protect the portfolio\textsuperscript{177} and that the investment was a reasonable portfolio addition, which acted as insurance against potential economic turmoil.\textsuperscript{178} The court found that defendant-bank provided adequate testimony that the IO investment was prudent and that the defendant-bank’s expert had properly analyzed the IO hedge.\textsuperscript{179}

While the Fifth Circuit in Laborers National refused to hold a fiduciary liable for his “good faith” use of hedging instruments, it also provides a precedent, that under ERISA, there is a duty to hedge. Fiduciary duties with respect to plan investments are grounded in a prudent investment process, with an emphasis placed on an “appropriate consideration”\textsuperscript{180} and a “reasoned decision-making process”\textsuperscript{181} given to investments and investment courses of action involved.\textsuperscript{182} The Fifth Circuit reasoned:

In determining compliance with ERISA’s prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper

\textsuperscript{170} Id. An IO is a right to receive a portion of the interest paid on by a homebuyer against a mortgage payments made on mortgage loans by a pool of homeowners. Each IO is paid from the stream of interest on mortgage loans. Thus, prepayment of mortgage loans by members of the pool tends to diminish or extinguish the yield on the related IO. The rate at which mortgages are paid off increases more than expected if interest rates on mortgage loans decline unexpectedly prompting an unanticipated higher number of homeowners to refinance. Given these characteristics, IOs can result in significantly greater price and yield volatility than traditional debt securities. \textit{See} Olkey v. Hyperion 1999 Term Trust, Inc., 98 F.3d 2, 6 (2d Cir. 1996), \textit{cert. denied}, 520 U.S. 1264, 117 S. Ct. 2433, 138 L. Ed. 2d 194 (1997). In addition, however, IOs can serve as a hedge to prevent significant losses in value due to interest rate changes because IOs generally increase as interest rates rise and mortgage-backed securities generally decline as interest rates rise. \textit{Id.} at 3–4.

\textsuperscript{171} Laborers Nat’l Pension Fund, 173 F.3d at 314–16.

\textsuperscript{172} Id. at 316–17.

\textsuperscript{173} Id.

\textsuperscript{174} Id. at 322.

\textsuperscript{175} Laborers Nat’l Pension Fund v. N. Trust Quantitative Advisors, 173 F.3d 313, 322 (5th Cir. 1999).

\textsuperscript{176} Id.

\textsuperscript{177} Id.

\textsuperscript{178} Id. at 321.

\textsuperscript{179} Id.

\textsuperscript{180} Reg. 2550.404a-1.

\textsuperscript{181} \textit{DiFelice} v. U.S. Airways, Inc., 497 F.3d 410, 421 (4th Cir. 2007).

\textsuperscript{182} It should be noted that although Reg. 2550 404a-1 is provided as a “safe harbor” or nonexclusive means of satisfying prudence requirements, courts have looked to its provisions for guidance in determining whether investment actions were “prudent.” \textit{See also} Cal. Ironworkers Field Pension Trust v. Loomis Sayles & Co., 259 F.3d 1036, 1044 (9th Cir. 2001).
Implicit Corporate Duty to Hedge

methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions. “[The ERISA] test of prudence is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed.” Thus, the appropriate inquiry is whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.183

However, ERISA prudence requirements broadly cover all aspects of the plan investment process, extending far beyond initial decisions to enter into investments. Under the “prudence rule” the “appropriate consideration” requirement applies to both “investment[s]” and “investment course[s] of action;” and an “investment course of action” is defined as “any series or program of investments or actions related to a fiduciary’s performance of his investment duties.”184 The Fifth Circuit found that:

Investments in derivatives are subject to the fiduciary responsibility rules in the same manner as are any other plan investments. In determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan’s investment policy, what role the particular derivative plays in the plan’s portfolio, and the plan’s potential exposure to losses.

* * *

Plan fiduciaries have a duty to determine the appropriate methodology used to evaluate market risk and the information that must be collected to do so. Among other things, this would include, where appropriate, stress simulation models showing the projected performance of the derivatives and of the plan's portfolio under market conditions. Stress simulations are particularly important because assumptions that may be valid for normal markets may not be valid in abnormal markets, resulting in significant losses.185

Furthermore, courts have recognized an ongoing “duty to monitor” investments, notwithstanding delegation of management authority to third parties.186 As demonstrated by Laborers National, applicable law generally holds that the prudent investment process is reviewed from the standpoint of experts and in light of available industry standards. Courts hold that the ERISA prudent person standard is applied from the perspective of “a prudent fiduciary with experience dealing with a similar enterprise.”187 Where fiduciaries lack expertise

184. Dept. of Labor Reg. 2550.404a-1(c)(2).
185. Id. (citing the Dept. of Labor Letter of Guidance and Statement on Derivatives).
186. See generally Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998) (holding that Defendants failed to monitor the fund’s solvency and adjust levels and Defendants failed to utilize due care in selecting and monitoring the fund's service providers and in reviewing the performance of trustees); see generally Harley v. Minn. Mining & Mfg. Co., 42 F. Supp. 2d 898 (D. Minn. 1999) (holding that the trustees’ delegation of responsibility to an investment advisor did not relieve the trustees of their fiduciary obligation to monitor investments).
in a specific area being considered, court hold that they have an affirmative duty to seek out such expertise.\textsuperscript{188}

Additionally, in review of whether a fiduciary’s methods employed and information reviewed satisfy ERISA prudence requirements, courts look to prevailing industry methods and standards—for example, the stress stimulation model in \textit{Laborer’s National}.\textsuperscript{189} This model essentially means that although standards for ERISA prudence requirements may be reviewed by attorneys and litigated in courtrooms, they are ultimately determined by the investment industry and its experts.\textsuperscript{190}

Finally, courts routinely look to trust law for guidance when analyzing ERISA claims (to the extent not inconsistent with ERISA).\textsuperscript{191} As noted above, the common law of trusts already provides precedent for fiduciary liability in duty to hedge cases—\textit{Brane} and \textit{Levy}.

Based upon the foregoing, a wholesale rejection of hedging strategies would certainly constitute a failure to give “appropriate consideration”, and as indicated above, a lack of expertise would provide no defense against such a claim. Thus, at a minimum, ERISA fiduciaries must give “good faith” consideration to hedging strategies.

While \textit{Laborers National}, by analogy, supports a corporate duty to hedge, it is important to point out a few differences between corporate and trust fiduciaries. It is commonly stated that ERISA fiduciaries have a higher duty under the law than corporate fiduciaries.\textsuperscript{192} This is because ERISA fiduciaries, unlike their corporate counterparts, are unable to invoke the business judgment rule for protection.\textsuperscript{193}

As of this Article, the business judgment rule has not been directly applied in a similar case. Likewise, courts have not answered the question of how shareholders might shift their burden of proof back to directors by demonstrating a breach of duty for losses under similar circumstances.

In another ERISA case, \textit{Gilbert v. EMG Advisors},\textsuperscript{194} the court, highlighting that the ERISA fiduciary duties were the highest known to the law, held that an investment manager had breached his fiduciary duties for failing to be informed of all material information before investing certain assets belonging to a

\begin{itemize}
  \item Cal. Ironworkers v. Loomis Sayles & Co., 259 F.3d 1036, 1044 (9th Cir. 2001) (analyzing “appropriate consideration” under DOL Reg. 2550.404a-1). The district court found more persuasive Loomis’ evidence that the Bloomberg system was the tool prevalently used in the industry and that only a few portfolio managers were using OAS analysis, and it made factual findings to that effect. \textit{Id.; see also DiFelice v. U.S. Airways,} 436 F. Supp. 2d (E.D.V.A., 2006) (“In the present context, this means that U.S. Airways was required to act pursuant to the standards of the investment industry . . .”).
  \item See generally \textit{Laborers Nat’l Pension Fund v. N. Trust Quantitative Advisors}, 173 F.3d 313, 313–14 (5th Cir. 1999).
  \item \textit{See Cal. Ironworkers}, 259 F.3d at 1047 (citing Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000)) (“The common law of trusts is incorporated into analysis of ERISA claims unless inconsistent with the statute’s language, structure or purpose.”).
  \item \textit{Gilbert v. EMG Advisors}, 1999 WL 160382, at *1 (9th Cir. Mar. 17, 2004).
  \item 1999 WL 160382, at *1.
\end{itemize}
Implicit Corporate Duty to Hedge

retirement fund in a complex derivatives scheme.\textsuperscript{195} Unlike \textit{Laborer’s National}, the defendants in \textit{Gilbert} did not act on an informed basis.

The above provides the general framework for a corporate fiduciary duty to hedge. While the \textit{Brane} decision addressed the issue of whether there is a corporate fiduciary duty to hedge, it left open the question of \textit{when} the decision not to hedge becomes a breach of duty.

C. Determining Elements of a Breach of the Duty to Hedge

In \textit{A Trust Fiduciary’s Duty to Implement Capital Preservation Strategies using Financial Derivative Techniques}\textsuperscript{196} Randall Borkus asserts that “[w]hen determining a breach of the duty to hedge, a court should ask whether the information is material [and thus] there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision.”\textsuperscript{197} In the corporate fiduciary context, “the fact that management fails to hedge an ordinarily hedgeable risk appears on its face to be information that an investor would find material to the decision of whether or not to invest.”\textsuperscript{198} Thus, the \textit{Brane} decision:

\begin{quote}
[C]an be interpreted as a benchmark for setting a reasonable corporate fiduciary duty to hedge that protects shareholders from negligent managers who fail to stay reasonably informed about common industry risk management practices. . . . Therefore, a reasonable principal would view a fiduciary's decision not to insure the buildings as a material breach of the duty to hedge against an insurable loss.\textsuperscript{199}
\end{quote}

The key to determining whether a breach of the duty to hedge has occurred is whether a corporate fiduciary has fulfilled his duty to be informed about material risks and any available hedging and risk management strategies. In other words, a corporate fiduciary must, at a minimum, pay attention to information regarding material risks and options to mitigate such risk. Thereafter, if a corporate fiduciary acts imprudently or fails to act where he has a known duty to act, he will be held liable.\textsuperscript{200}

\begin{enumerate}
\item \textit{Fiduciaries in the “Stone” Age}
\end{enumerate}

In the time since \textit{Brane}, \textit{Levy}, and \textit{National Laborer’s} “good faith” jurisprudence has evolved over a series of Delaware Supreme Court cases. While the cases mostly involved a corporate fiduciary’s duty to monitor, the reasoning can easily apply to situations in which directors choose—or choose not—to take affirmative risks on behalf of the corporation.

\textsuperscript{195} Id.
\textsuperscript{196} Borkus, supra note 5, at 127.
\textsuperscript{197} Id. at 151.
\textsuperscript{198} Id.
\textsuperscript{199} Id.
\textsuperscript{200} Barton, supra note 109, at 40–43 (stating that the protections of the rule will not apply when the director or officer is interested, did not actually make a decision, made an uninformed decision, or was grossly negligent); see also Miller v. Schreyer, 683 N.Y.S.2d 51, 54 (N.Y. App. Div. 1999) (explaining that “where the wrong alleged is inaction of the board rather than a conscious decision . . . the business judgment rule is inapplicable”).

Vol. 1, Fall 2012
By clarifying the definition of good faith in Stone, the Delaware Supreme Court invites the opportunity to re-evaluate the way that the business judgment rule addresses risk-taking by corporate fiduciaries. As Stone established, it is not good faith, “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation.” Therefore, deliberately failing to pay attention to the risks of pursuing a new idea or to the risks of an investment in a highly uncertain financial instrument would be bad faith and would therefore fall outside the protections of the business judgment rule.

Stone introduces a higher threshold—only knowingly careless conduct becomes disloyal conduct and, thus, bad faith. Thus, courts may now impose liability for knowing failures to pay attention when authorizing affirmative risks, or failing to hedge them. Under the Stone formulation of “good faith” directors who have indeed acted disloyally—by failing either to pay attention or to engage in any kind of business judgment at all—lose the protections afforded under the business judgment rule.

According to Steven Bainbridge, et al., when designing oversight and compliance programs, directors inevitably must take risks that may or may not turn out to benefit the company. Weighing the costs and benefits of certain safeguards against rules violations, a board might decide that the safeguards are simply not worth the price given the likelihood of a potential violation and the gravity of the harm it would do. According to Bainbridge et al., assuming that the directors arrived at the decision not to implement the safeguards in good faith, they would plainly be protected under the business judgment rule.

Seen in this light, the decision to assume a risk by not implementing a costly safeguard is therefore not different from the decision to take a risk by pursuing, for example, a new and untested technology, or to invest in financial instruments backed by sub-prime loans; at least they are not different regarding the way a court should evaluate the good faith of the corporate authorities who chose to take the risk in the first place. The decision to not implement a safeguard (i.e., the decision to not hedge) can only be arrived at in good faith by finding that it is not in the company's best interest.

Finally, corporate fiduciaries, like trust fiduciaries, have a duty to consult experts and delegate hedging strategies to those with the skill to implement such safeguards.

202. Still, the threshold might very well allow adjudication of claims against corporate directors who approved investment in mortgage-backed securities where the directors plainly did not take care to ensure that the nature of risk involved was understood. Clearly this is one significant component of the meltdown of 2008. See, e.g., Saul Hansell, How Wall Street Lied to Its Computers, N.Y. TIMES (Sept. 18, 2008), http://bits.blogs.nytimes.com/2008/09/18/how-wall-streets-quants-lied-to-their-computers/ (describing how Wall Street investment firms "continued to trade very complex securities concocted by their most creative bankers even though their risk management systems weren't able to understand the details of what they owned"); see also Eric Dash & Julie Creswell, Citigroup Saw No Red Flags Even as It Made Bolder Bets, N.Y. TIMES, Nov. 23, 2008, at 1.
203. Bainbridge et al. at 600–01.
204. Id. at 601.
205. Id. (“After all, a decision not to act does not differ from a decision to take action. Accordingly, the thrust of Allen’s opinion [in Caremark] suggests that the business judgment rule ought to protect directors who rationally elect against adopting a compliance program after weighing the costs against the benefits.”).
strategies.\textsuperscript{206} As noted above, liability, however, does not terminate at delegation.\textsuperscript{207}

2. A Few Words on the Duty of Oversight and Vigilance

Under the \textit{Caremark} standard, a director breaches the duty to be vigilant by “utterly fail[ing] to implement any reporting or information system or controls” or “having implemented such system or controls, consciously fail[ing] to monitor or oversee its operations.”\textsuperscript{208} Most notably, the court identified a scienter requirement to prove a breach of the duty to monitor, stating “imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”\textsuperscript{209}

In the wake of the $2 billion in losses to J.P. Morgan, CEO Jamie Dimon claimed J.P. Morgan made a “terrible, egregious mistake” as it tried to hedge corporate bonds it held through a series of derivatives that led to significant paper losses that continue to grow.\textsuperscript{210} In a conference call disclosing the loss, Dimon said that the bank’s trading strategy was “poorly reviewed, poorly executed and poorly monitored.”\textsuperscript{211}

In his recent article, \textit{Corporate Control: Regulators Need to Regulate}, Richard Leblanc looks at the widespread corporate malfeasance and mismanagement, including recent events at UBS, allegedly involving rogue trader Kweku Adoboli, concluding:

Risk management, corporate governance and banking reforms to date have been wholly inadequate . . . most corporate directors simply do not understand complex derivative products, and we are demanding too much of them in expecting otherwise. . . . Current and former CEOs may not understand derivatives, and there is evidence that CEOs do not make better directors.\textsuperscript{212}

Leblanc’s observations are both alarming and obvious. The widespread, haphazard use of derivative instruments in the current “too big to fail” economy coupled with gross mismanagement\textsuperscript{213} has already lead to a global economic meltdown.\textsuperscript{214} Given the apparent willingness of CEOs to repeat their mistakes, at what point does it

\textsuperscript{206} Sealy Mattress Co. v. Sealy, Inc. 532 A.2d 1324, 1337 (Del. Ch. 1987) (holding that decision made without expert advice violated the duty of care); see also The Group of Thirty Global Study Group, \textit{DERIVATIVES: PRACTICES & PRINCIPLES} 1 (1993) (recommending that top management obtain an extensive understanding of hedging and derivatives use before agreeing to implement strategies for their use for risk management purposes).

\textsuperscript{207} McMullin v. Beran, 765 A.2d 910, 916–20, 924 (Del. 2000) (finding that directors of subsidiary were not entitled to business judgment rule protection because they delegated their decision to a parent corporation when they themselves “had an ultimate statutory duty and fiduciary responsibility to make an informed and independent decision”).

\textsuperscript{208} Id.

\textsuperscript{209} \textit{See} Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (emphasis added). In re-formulating the \textit{Caremark} standard the court borrowed language from the definition of good faith, specifically the use of the word “conscious”, first set forth by Chancellor Chandler in \textit{Disney II} as a “conscious disregard of for one’s responsibilities” (emphasis added). Thus, there is an explicit connection between the duty to monitor standard set forth in \textit{Caremark} and the duty of good faith standard set forth in the \textit{Disney} cases.


\textsuperscript{211} Id.


\textsuperscript{213} Id. (stating “[g]ross mismanagement” might be too kind).

\textsuperscript{214} Id.
become actionable?

Three recent opinions provide a glimpse at how courts will address shareholder claims in which directors breached their fiduciary duties in managing risk in the future—*American International Group, Inc. Consolidated Derivative Litigation*,215 *In re Citigroup Inc. Shareholder Derivative Litigation*,216 and *In re Countrywide Financial Corp. Derivative Litigation*.217 These cases arose from the fallout of the 2008 subprime mortgage crisis. In each, shareholders brought derivative actions against members of the board of directors, attempting to hold them personally responsible for failing to fulfill their oversight obligations.

In *AIG*, Delaware Supreme Court Vice-Chancellor Strine allowed plaintiffs to proceed with a shareholder derivative lawsuit against AIG’s directors for knowingly failing to stop certain fraudulent schemes carried out by the company’s management.218 Citing *Stone*, Strine noted that “directors can be held liable where they ‘consciously failed to monitor or oversee [the company’s internal controls] thus disabling themselves from being informed of risks or problems requiring their attention.’”219 Such a failure, Strine explicitly states, can constitute a breach of the duty of loyalty.220 Strine’s decision is a clear affirmation that *Stone’s* extension of the definition of disloyalty includes knowing breaches of the duty of care by directors by failings in their oversight function.

In *Citigroup*, shareholders sued Citigroup’s directors for failing to adequately “monitor the risk” to which the company had subjected itself in the months leading up to the subprime mortgage meltdown.221 The plaintiffs claimed that Citigroup directors ignored glaring “red flags” that suggested an imminent collapse in the sub-prime mortgage market.222 Overly mindful of traditional theory for the business judgment rule, Chancellor Chandler concluded that the plaintiff’s allegations were insufficient to state a claim under *Caremark*.223 Chandler reasoned that Delaware law requires something more than evidence of wrong decision-making to rebut the presumptions of the business judgment rule.224 Warning signs, Chandler writes, “are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they are evidence that the directors made bad business decisions.”225 *Citigroup* clearly requires a conscious failure to evaluate risk at all and not simply a “failure to predict the future.”226

Distinguishing the allegations in *Citigroup* from those in *AIG*, Chandler found that the AIG plaintiffs alleged that the directors knowingly failed to prevent wrongdoing.227 If those allegations are true, a persuasive case for bad faith exists. In *Citigroup*, however, the directors merely made a wrong decision by ignoring the

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219. *Id.* at 24 (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).
220. *Id.*
222. *Id.* at 128.
223. *Id.* at 126.
224. *Id.* at 126.
225. *Id.* at 125.
226. *Id.* at 127.
red flags that indicated a downturn in the economy.

Fearing the risk of “hindsight bias,” Chandler posits that the failure of the Citigroup directors to foresee the extent of the sub-prime mortgage crisis is not evidence of bad faith, but bad judgment. To hold Citigroup directors personally liable would require evidence of a knowing and deliberate failure to evaluate the risks of the company’s policies, not a mere failure to predict the future.228

However, in Countrywide, demand was excused as futile where shareholders sued Countrywide’s directors for (i) approving an increase in the origination of non-conforming loans; (ii) extension of loans in contravention of company underwriting standards; and (iii) a failure to maintain appropriate reserves and allowances to offset the company’s riskier loan portfolio.229 In Countrywide, directors approved a series of high risk business practices, which resulted in the price of Countrywide stock falling from $45.00 per share to $5.00 per share between February 2007 and January 2008.230

The plaintiffs successfully argued that the Countrywide’s directors violated Section 10(b) of the Securities and Exchange Act of 1934,231 as well as their duty to monitor under Delaware law. Unlike the Delaware Supreme Court in Citibank, the federal court applied the “core business operations theory, to infer knowledge of the directors by virtue of the fact the directors served on key board committees “charged with oversight of Countrywide’s risk exposures, investment portfolio, and loan loss reserves. . . . As such, they were in a position to recognize the significance of these red flags, and, accordingly, investigate the extent to which underwriting standards had been abandoned.”232 In other words, the directors should have known, or were at least reckless in not knowing, because it was their job to know.

The court was persuaded by the plaintiffs’ allegation that the failure of the board to prevent the violation of the company underwriting standards “simply does not square with the specific and comprehensive monitoring duties assigned to the members of the Board.”233 The Federal court concluded that the directors failed to act in the face of glaringly obvious “red flags.”234

Specifically, the federal court took notice of a public report issued by a coalition of banking regulators condemning the type of lending practice engaged in by Countrywide and competing lenders were reporting distress during the same period.235 Countrywide excused demand because plaintiffs pointed to specific “red flags of such prominence that [defendants] must necessarily have examined and considered them in the course of their committee oversight duties.”236

JP Morgan CEO Jaime Dimon’s comments earlier in this section seem ready to be entered into evidence for a breach of the duty to monitor and thus a breach

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228. Id. at 127.
230. Id.
231. Section 10(B) of the Securities Exchange Act, as amended, codified at 15 U.S.C. § 78j(b), provides in relevant part that: “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”
233. Id. at 1066.
234. Id.
235. Id. at 1082.
236. Id.
of the duty of loyalty. However, under *Citibank*, it seems doubtful that an action would even survive summary judgment. If true, this would indeed be a disappointment. The business judgment rule is designed to protect and encourage informed decision making, not reckless gambles.

*AIG, Citibank, and Countrywide* perhaps raise more questions than they answer. First, what is the proper measure of scienter? Chancellor Chandler’s formulation sets the bar too high for the duty to have any real meaning. However, will the “core business operations theory” find application outside of federal securities cases?

Next, does the duty to monitor apply to actions outside of illegal acts? Chandler distinguished wrong decisions from wrong acts. Thus, the duty to monitor seems to be limited to traditional “bad faith” cases.

Finally, what effect do the cases above have on the duty to hedge? While directors can be held liable for a knowing failure to hedge firm risk, at what point does allowing an inadequate hedging strategy to continue rise to the level of a conscious failure to oversee its operations?

Chandler’s *Citibank* opinion does, however, illustrate how the duty to hedge fits right into traditional business judgment rule theory. The business judgment rule is premised in part on informed decision making, including the decision to assume risk. The duty to hedge does not hinder informed risk taking. Being properly informed requires an understanding of material risk, and hedging options. It is only where it is imprudent to not hedge firm risk that the duty has been breached and the fiduciary has acted disloyal.

**D. “A Hedge or Not a Hedge, That Is the Question”**

– Senator Robert Menendez (D-N.J.)

By way of example, J.P. Morgan’s recent $2 billion loss is the latest symptom of the U.S. corporate malfeasance pandemic. Management, starting with J.P. Morgan’s CEO Jamie Dimon, claim that the loss was due to a complex hedging strategy involving hard-to-value instruments and embedded risk that eluded the best and brightest minds at the bank until it was too late.

Calling J.P. Morgan’s losing bet a hedge is analogous to claiming that John Dillinger simply made a series of bank withdrawals:

The trade was a simple bet on the difference, or “spread,” between the price of a group of bonds and an index based on those bonds. In theory, those two prices should be about the same. In practice, they may vary due to factors such as the relative liquidity of the bonds and the index. At a certain point, the J.P. Morgan trader, known as the “Whale,” took a view that the index was expensive and the bonds were cheap. In effect, by selling the index and buying the bonds, the whale would own the spread. As the spread comes back to normal, the whale reaps enormous profits and finally unwinds the trade by selling what he bought and buying what he sold at better prices.

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238. *Id.*

239. *Id.*

Vol. 1, Fall 2012 54
Unfortunately, the voluminous size of the trade proved fatal.\textsuperscript{240} Other market participants, notably hedge funds, intentionally widened the spread.\textsuperscript{241} They knew that if they “inflict[ed] enough pain on the Whale in the form of daily mark-to-market losses, he [would] eventually have to get out of the trade by selling it back.”\textsuperscript{242} Forced out of the trade, the Whale sold at a loss of $2 billion dollars.\textsuperscript{243}

E. “Context Is the Key – From That Comes the Understanding of Everything”

– Kenneth Noland

The recent crisis in the financial sector has put pressure on both legislatures and courts to increase protections for investors while holding those responsible for the crisis accountable. Further, the demand for accountability is fueled by the fact that as the global economy fell precipitously, executive compensation experienced a golden era. The following section looks briefly at the current environment and its impact on fiduciary jurisprudence and the duty to hedge.

1. The Dimon Club

While their respective companies collapsed, corporate officers pocketed millions. For example, Richard Fuld, former CEO of Lehman Brothers, collected roughly $480 million in compensation in the years leading up to the bank's collapse in 2008.\textsuperscript{244} Bank of America received $25 billion in “bail out” money in 2008, and an additional $20 billion in 2009, yet former CEO Kenneth Lewis left with about $83 million in pension and insurance benefits, stock, and other compensation.\textsuperscript{245} In 2008, the same year that Citigroup accepted a $45 billion government bailout, former CEO Vikram Pandit took home a benefits package worth $38.2 million.\textsuperscript{246} In July of 2008, Martin Sullivan retired from the collapsing offices of AIG, with a $47 million stock and benefits package; a few months later AIG was approved for $85 billion in government bailout funds.\textsuperscript{247} Lloyd Blankfein, CEO of the recently indicted Goldman Sachs, was reportedly paid over $70 million in 2008 alone.\textsuperscript{248} That same year, Goldman Sachs received $10 billion in “bail out” funding leading many to question the rationale behind Blankfein’s massive compensation.\textsuperscript{249}

By 2009, Goldman Sachs had been charged with subprime mortgage fraud by the SEC, which alleged that the organization deliberately marketed bad loans

\begin{itemize}
  \item \textsuperscript{240} Id.
  \item \textsuperscript{241} Id.
  \item \textsuperscript{242} Id.
  \item \textsuperscript{243} Id.
  \item \textsuperscript{244} Jonathan Sihan, \textit{Former Lehman Brothers Boss Attached Over Wall Street Excesses}, DAILY TELEGRAPH (Oct. 7, 2008), http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3147479/Former-Lehman-Brothers-boss-attached-over-Wall-Street-excesses.html.
  \item \textsuperscript{245} Dan Fitzpatrick, \textit{Retirement Benefits for BofA’s Lewis: $83 Million}, W. ST. J. (Feb. 27, 2010), http://online.wsj.com/article/SB10001424052748704625004575089742035330432.html.
  \item \textsuperscript{249} Id.
\end{itemize}
in a deceptive manner. Blankfein settled with the SEC in July for $550 million.

J.P. Morgan Chase CEO Jamie Dimon received a $28 million bonus package in late 2007 despite J.P. Morgan Chase being in such poor financial shape that it needed a $25 billion government bailout less than a year later. In 2009, Dimon received another $16 million in bonuses.

2. Expansion

In response, the SEC filed suit against several organizations and Congress enacted sweeping financial reform legislation imposing new duties on certain types of advisers and authorizes the SEC to enact new rules imposing additional duties. Neither of these actions can restore the loss in shareholder equity. While suing corporations appears to impose liability on those at the helm, it generally harms shareholders. Additionally, post hoc regulation does little shareholder value, plus it increases transaction costs—costs that are generally passed on to the consumer.

Like regulators, courts appear to be moving, slowly, in the direction of expanding the concept of fiduciary duties. For example, courts have often held as a matter of law that hedge fund advisers owe no fiduciary duties to individual investors in a hedge fund, but only to the fund itself. The rule was reflected in the 2006 case Goldstein v. SEC in which the D.C. Circuit struck down an SEC rule requiring hedge funds to register with the SEC based on the number of investors in the fund. Analyzing the client-adviser relationship under both prior SEC interpretations and Supreme Court precedent dating back to 1985, it announced that “[t]he adviser owes fiduciary duties only to the fund, not to the fund’s investors.”

In the intervening years, hedge fund advisors sued by fund investors for breach of fiduciary duties regularly invoke the principles described in Goldstein to have such claims dismissed on the pleadings for failure to state a claim recognized by law.

However, a recent Sixth Circuit case, United States v. Lay, is demonstrative of small but increasing willingness of the courts to impose additional duties on advisers. In Lay, an investment by the Ohio Bureau of Workers’ Compensation in a hedge fund, gave rise to a criminal claim of investment adviser fraud. The adviser argued that the jury could not, under Goldstein, have concluded that the adviser owed a fiduciary duty to the Bureau because his only duties were to the fund and not to the individual investors.

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253. Id.
255. Id. at 881.
256. United States v. Lay, 612 F.3d 440 (6th Cir. 2010).
257. Id.
258. Id.

Vol. 1, Fall 2012 56
The Sixth Circuit disagreed, holding that “Lay’s categorical argument to the contrary is primarily based upon reading too much into the holding of the District of Columbia Circuit in Goldstein.”259 “Goldstein,” the court held, “did not stand for the proposition that no hedge fund adviser could create a client relationship with an investor, but rather held only that the SEC had ‘not justified treating all investors in hedge funds as clients.’”260

The Sixth Circuit concluded that the jury should have been afforded the opportunity to consider various factors that could have resulted in a fiduciary duty being established with the hedge fund investor. The Sixth Circuit cited the fact that the fund had only a single investor in attendance in the fund, that it had meetings with the hedge fund adviser regarding its investment indicating an active role in the investment, and had a previous relationship with the hedge fund manager as a financial adviser.261 While Lay does not announce a full-blown reversal of Goldstein, it does indicate an increased willingness to consider a hedge fund manager as a fiduciary to the fund investor in certain circumstances, and tempers the bright-line rule other courts have extracted from that case.

Similarly, a Connecticut state court faced with a fiduciary duty claim against a Bernard “Bernie” Madoff related feeder fund recently came to a similar conclusion in Retirement Program for Employees of Town of Fairfield v. Madoff.262 There, the investment adviser for the feeder fund invoked Goldstein to argue that the limited partners did not have standing to make a fiduciary duty claim against it.263 As in Lay, the court found the adviser’s previous relationship with the investor significant and permitted the limited partners to assert the claim against the adviser.264 As the effects of the financial crisis percolate through the courts, one can expect further development, and likely expansion, of fiduciary duties owed by advisers to hedge fund and other investors.

**IV. Conclusion**

“[F]iduciary law plays a significant role in ensuring the continued efficacy of the web of human interdependency by governing the conduct of fiduciaries holding power over others.”265

Operating in an environment in which it is known that risky decisions often end in failure, corporate directors act imprudently *per se* where they fail to consider and/or act on information to hedge on behalf of the company. Furthermore, the holding in Stone makes it clear that directors cannot choose a risky course of action knowing that the decision is a bad one or knowing they have not taken care to evaluate whether or not the risks involved will benefit the corporation.266 In Benjamin Cordozo’s oft-quoted words:

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259. Id. at 446.
260. Id. at 446–47.
261. Id. at 446.
263. Id. at *12.
264. Id. at *14–15.
Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A [fiduciary] 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 condition that is unbending and inveterate. Uncompromising rigidity had been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.267

Only with rigorous attention to the duty a fiduciary owes a company and the imposition of the requirement that such fiduciaries never divide loyalty as Cardozo has described above will the global economy recover from the damage inflicted upon it by the bad faith risk takers of the early years of the twenty-first century. Continued vigilance will diminish such wrongdoing through transparent and expanded application of the fiduciary duties owed by a company’s caretakers.