

Default Swaps and Director Oversight: Lessons from AIG

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Tests of board effectiveness include the way in which the members of the board as a whole work together under the chairman, whose role in corporate governance is fundamental, and their collective ability to provide both the leadership and the checks and balances which effective governance demands.¹

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1. COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE, THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE ¶ 4.2, at 19 (Gee Publishing 1992), [hereinafter THE CADBURY REPORT] available at http://www.econsense.de/_CSR_INFO_POOL/_CORP_GOVERNANCE/images/cadbury_report.pdf.

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I. INTRODUCTION

The recent events at American International Group, Inc. (AIG) are significant from the perspective of corporate governance. They raise important questions about the contemporary model of governance, which is based on management by the executives and oversight by the directors. To facilitate effective monitoring by the directors, the recent decades have seen an increased emphasis on directors' independence.² In addition, there is the requirement of extensive disclosures under U.S. securities law.³ The theory is that these mechanisms would ensure transparency and accountability and, in turn, promote the good governance of public corporations.⁴

Referring to AIG's statutory disclosures, media reports, and the statements of its senior executives, this Article traces the credit derivatives business of the company that led to its implosion. The experience with AIG and other financial corporations in the credit crisis offers valuable clues on shaping corporate governance policies for the future, particularly in fine-tuning the concept of monitoring boards. The AIG episode illustrates the limitations of the current “bare-bones” governance model that stops with placing the directors under a largely undefined duty to monitor. The concern of corporate theory is essentially with whom the directors will monitor, and very little about *what* they should monitor.⁵

2. See generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1471 (2007) (explaining the increase in independent directors and demonstrating the benefits of this shift).

3. The basic requirement for corporations is to publish quarterly and annual reports. Securities Exchange Act of 1934, 15 U.S.C. § 78a, § 13 (2006). The Sarbanes–Oxley Act of 2002 mandates current, or real-time, reports by public companies about “material changes in the financial condition or operations.” Pub. L. No. 107-204, § 409, 116 Stat. 745, 791 (2002).

4. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 8 (Aspen 2004).

5. This tendency can be traced to the “agency” problem in corporations, which economic theory stresses. The function of the directors is understood as keeping a watch on corporate resources and checking the executives from appropriating them. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

Without a clear definition of the functional responsibilities of the directors, it is not possible to come to conclusions about the oversight of AIG's default swaps business. The following are some major conclusions drawn in this Article from the case-study of AIG:

- a. The recent emphasis on the monitoring role of boards and director independence can potentially impede effective *business* oversight by the directors.
- b. The broad-brush standard of care applicable to directors, obfuscated by the business judgment rule, indemnity, and professional insurance, further undermines board oversight and directorial accountability.

To learn from the experience and to make board oversight more efficient, this Article proposes the following:

- a. A clear definition of the role of corporate boards and guidance on the mix of executive and non-management directors; and
- b. Developing a standard of care that balances the imperatives of accountability for the directors of public corporations with the need for affording them protection.

These measures would streamline the functioning of corporate boards and potentially improve the efficacy of director oversight. The result, hopefully, would be fewer instances of governance failures of the variety seen recently in the credit crisis.

This Article is divided into five Parts. Credit default swaps were at the center of the debacle at AIG, and Part I provides an overview of these instruments and their characteristics. Part II traces the credit derivatives business of AIG from 2002, when the company made the first reference to default swaps in its statutory report until 2007 when it reported a loss of over \$11 billion from the business, sparking the meltdown. Part III examines the governance structure of AIG and its credit derivatives business from the perspective of contemporary corporate theory. Part IV discusses the issues highlighted in the case-study—namely, board composition and functions and directors' duty of care.

Part V concludes with proposals for better articulation of the functions of boards, regulatory guidance on the mix of executive and outside directors and an effective standard of care for the directors of public corporations. These measures would strengthen the law's role in corporate governance that began recently with the Sarbanes–Oxley Act of 2002,⁶ and its requirements of audit committees and independent directors. The conclusion advocates an interdisciplinary approach to reform that promotes convergence between management theory and corporate theory.

II. CREDIT DEFAULT SWAPS

In the annual report for 2007, AIG reported “an unrealized market valuation loss of \$11.5 billion on [the] super senior credit default swap portfolio” held by its subsidiary, AIG Financial Products.⁷ This triggered a meltdown and ended AIG's life as an independent and successful company.⁸ This Part provides a brief overview of credit default swaps, which proved to be the undoing of AIG.

6. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

7. AMERICAN INTERNATIONAL GROUP, INC., 2007 ANNUAL REPORT 36–37 (2008) [hereinafter AIG, 2007 ANNUAL REPORT], available at http://www.ezodproxy.com/AIG/2008/AR2007/images/AIG_AR2007.pdf.

8. Edmund L. Andrews, Michael J. de la Merced & Mary Williams Walsh, *Fed's \$85 Billion Loan Rescues Insurer*, N.Y. TIMES, Sept. 16, 2008 at A1, available at <http://www.nytimes.com/2008/09/17/business/17insure.html> (last visited May 8, 2010).

A. Default Swaps—Their Origin

Collateralized Debt Obligations (CDOs) and Credit Default Swaps (CDSs) are the major credit derivatives devised by the financial industry in the last two decades.⁹ Between the two, credit default swaps—which are similar in principle to credit insurance—were the causal factor in the AIG debacle.¹⁰ In turn, it was AIG's stature as an insurance company that generated significant volumes in its default swaps business.¹¹

Default swaps are issued towards consolidated pools of debt securities, designated as CDOs.¹² The idea of pooling risky and safe debt as CDOs and marketing them among investors came, apparently, from Drexel Burnham Lambert, the now defunct investment banking firm.¹³ This was in 1987. It represented the first step towards CDOs, which soon gave rise to CDSs.

The financial instruments, designated as derivatives, have been constantly in the news in the last two decades. They were dogged by controversy derivatives from the beginning. In the early 1990s, efforts were made in the U.S. Congress to understand the risks in these derivatives.¹⁴ Regulatory interest in credit derivatives continued later in the 1990s as well.¹⁵ It was only in the recent years that the idea of consolidated debt, or CDOs, really took off. The growth in their popularity can be attributed to two significant innovations—credit rating and default swaps.

The debt securities comprising CDO pools could range from residential mortgages to automobile loans and credit card balances. Getting them rated by professional rating agencies would provide independent assessment of the credit risk in them. With such independent assessment, it would be easier to market the derivatives among investors. The theory is that chances of default by the borrowers would be low in CDOs that have

9. For a comprehensive discussion of collateralized debt obligations and credit default swaps, see JANET M. TAVAKOLI, *STRUCTURED FINANCE AND COLLATERALIZED DEBT OBLIGATIONS: NEW DEVELOPMENTS IN CASH AND SYNTHETIC SECURITIZATION* (John Wiley & Sons 2008).

10. This is the general business understanding. See, e.g., PIMCO, *Bond Basics* (June 2006), available at <http://www.pimco.com/LeftNav/Bond+Basics/2006/Credit+Default+Swaps+06-01-2006.htm> (describing credit default swaps by PIMCO, a large bond fund manager).

11. See, e.g., Gretchen Morgenson, *Behind Biggest Insurer's Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

12. For a summary of the relationship between CDO and CDS, see P.M. Vasudev, *Credit Derivatives and Risk Management: Corporate Governance in the Sarbanes-Oxley World*, 2009 J. BUS. L. 331.

13. Darryl Robert Schoon, *Headwaters of Disaster*, *Gold-Eagle*, Aug. 1, 2007, http://www.gold-eagle.com/editorials_05/schoon073107.html.

14. In 1992, Rep. Edward J. Markey directed the U.S. General Accounting Office (GAO) to study the risk in derivatives. GAO, which published its report in 1994, found major gaps and weaknesses in the regulatory oversight of derivatives. Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html>. In the same year—1994—George Soros, in his testimony to the Banking Committee of the U.S. House of Representatives, described derivatives as “esoteric” and expressed doubt whether their characteristics and implications could be understood even by sophisticated investors. EDWARD CHANCELLOR, *DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION* 334 (Farrar, Straus & Giroux 1999).

15. Brooksley Born, who headed the U.S. Commodity Futures Trading Commission, campaigned in the late 1990s for the regulation of derivatives. Manuel Roig-Franzia, *Credit Crisis Cassandra*, WASH. POST, May 26, 2009 at C01, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108.html>. But she was foiled by Alan Greenspan, then the chairman of the Federal Reserve, among others.

been professionally assessed.¹⁶

The other innovation—default swaps—would guarantee payment by the seller of the swaps in the unlikely event of default by the borrowers. When a large insurance company provides default swaps, as AIG did,¹⁷ it can be interpreted as near-complete elimination of the risk in CDOs. These are, apparently, the assumptions on which the actors in the financial market based their calculations for their credit derivatives business.

In substance, there is little distinction between default swaps and credit insurance,¹⁸ which is a longstanding feature of the insurance industry landscape.¹⁹ Understood in these terms, credit default swaps are quite innocuous. They are merely a variant of credit insurance, which offers protection to lenders against the risk of default by the borrowers. However, a number of *other* features that have been added to default swaps deprive them of their simple character as instruments that offer protection against credit risk. The process by which default swaps turned into instruments of speculation is outlined below.

B. Default Swaps—From Protection Against Risk to Speculation

A series of market developments have carried default swaps away from their simple conception as instruments that offer protection against credit risk. These include the neglect of insurable interest in the default swaps framework, the rise of synthetic CDOs, and the sale of multiple swaps for a single underlying pool of debt. The following is an account of the process by which default swaps were transformed from their position as risk protection devices into instruments of speculation and agents of instability.

1. Insurable Interest

Insurance is always about future events and uncertainty. Hence, an element of speculation is inherent in insurance.²⁰ The law of insurance, as it has developed, steered insurance contracts away from their speculative foundation and shaped them as instruments for protection against risk. A number of rules have been developed to undermine speculation and promote the integrity and legitimacy of insurance contracts.²¹ These rules stress the character of insurance as a device for protection against risk and weaken the speculative element.

Principal among the rules is the requirement that persons seeking insurance coverage must have “insurable interest” in the subject of insurance.²² The concept of

16. For an account of the risks in credit derivatives and the rating of debt securities, see Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007). See also Raghuram Rajan, Has Financial Development Made the World Riskier?, Address at Symposium sponsored by the Federal Reserve Bank of Kansas City (2005), available at <http://www.kansascityfed.org/PUBLICAT/SYMPOS/2005/PDF/Rajan2005.pdf>.

17. It is significant that the default swaps business of AIG was not done in its insurance unit. It was handled in the financial products unit. This has been disclosed in the reports of AIG. See *infra* note 54. The implications of this are discussed later in the article.

18. PIMCO, *supra* note 10.

19. For an account of the contrast between default swaps and insurance, see generally Ari J. Brandes, *A Better Way to Understand the Speculative Use of Credit Default Swaps*, 14 STAN. J. L. BUS. & FIN. 263 (2009).

20. This was pointed out by Lord Mansfield in *Carter v. Boehm*, 97 Eng. Rep. 1162, 1164 (1766).

21. See generally JEFFREY W. STEMPER, STEMPER ON INSURANCE CONTRACTS (3d ed. Aspen 2007).

22. For an explanation of insurable interest, see *id.* at 1–21 to 1–32.

insurable interest requires the holder of a policy to have substantial economic interest in the subject of insurance. For example, the interest that the owner of a house property has in the safety and security of the building would be insurable.

Default swaps were originally devised as instruments that offered protection to lenders against default by borrowers.²³ In their case, the insurable interest would be with the lenders or in persons claiming under them, such as assignees or transferees of the debt. The lenders or persons claiming under them would carry the economic risk of default by the borrower and would obtain protection against the risk that they actually carry. This is the legitimacy in credit insurance contracts.

It is apparent from the decision of the U.S. Court of Appeals for the Second Circuit in *Aon Financial Products, Inc. v. Société Générale*²⁴ that, in the world of credit derivatives as it has developed in the recent years, insurable interest was not a major consideration. The element of insurance in default swaps was gradually undermined. Instead, the notion that they were “hedged” gained traction, and this played a role in their proliferation. As a result insurable interest, which is the underpinning of insurance contracts, did not have a significant place in the default swaps framework.

The habits of thought that emerged in the recent years can be clearly seen in the judgment in *Aon Financial Products, Inc. v. Société Générale*.²⁵ The court cited with approval the following submission made by International Swaps and Derivatives Association (ISDA): “[Default swap agreements] do not, and are not meant to, indemnify the buyer of protection against loss. Rather, [these] contracts allow parties to hedge risk by buying and selling risks at different prices and with varying degrees of correlation.”²⁶ The eagerness of ISDA to avoid the stringent regulation applicable to the insurance industry is understandable, and this explains the submission it made to the court as amicus.²⁷ The decision, rendered in the pre-AIG world, does not seriously consider the similarity in the principle of default swaps and insurance. However, there is evidence that the insurance element was not completely ignored in the financial industry.²⁸

2. Synthetic CDO

Originally, CDOs were used as instruments to transfer loans from the books of the lending institutions to the Special Purpose Entities (SPEs) created for the purpose.²⁹ The portfolio of debt would be transferred to the SPE, and investors would buy slices or “tranches” of the debt pools from the SPE. This variety of CDO, known as a “balance sheet CDO,” would actually transfer the risk from the lender to the SPE. The originating lenders would normally retain the most risky part of the pool, which was termed “toxic

23. See PIMCO, *supra* note 10 (explaining credit default swaps).

24. *Aon Fin. Prods., Inc. v. Société Générale*, 476 F.3d 90 (2d Cir. 2007).

25. *Id.*

26. *Id.* at 96.

27. While the motive of ISDA is clear, the meaning of its submission is not equally so. The words “hedge” and “varying correlation” in the second part of the submission extracted above are not quite lucid in conveying the meaning. Such ambiguity has been a major issue with derivative instruments.

28. See, e.g., PIMCO, *supra* note 10.

29. The discussion of CDO here is based on TAVAKOLI, *supra* note 9.

waste.”³⁰ This feature of CDO was presented among the investors as a selling point.

In a balance sheet CDO, the SPE would be fully funded as investors paid for the debt portfolio transferred to the SPE. In return, the SPE would receive the cash flows from the underlying debt portfolio, both interest receipts and repayments of the principal. This cash flow would be the return for the investors who bought slices of the CDO. To facilitate marketing of CDOs among the investors as “risk-free,” default swaps were purchased by the SPE.³¹

This model was reasonably stable, as it had built-in protection against defaults. If the borrowers committed default, the loss would be borne by the SPE, which had already paid off the originating lender. No fresh payments would be required from any “counterparty,” as the parties to the transactions were termed, in the event of default by the borrowers. However, this simple state of affairs did not last long. Soon, financial innovation led to the development of “synthetic” CDOs that were only partly-funded. In the synthetic model, an originating lender would retain the loans with itself and the SPE would not be fully-funded.³² Instead, the SPE would purchase default swaps for the benefit of the lender in consideration of the lender making over the principal and interest receipts from the underlying portfolio to the SPE. In 1997, J.P. Morgan launched BISTRO, the first synthetic CDO that had a funding of just \$700 million against the underlying debt portfolio of \$10 billion.³³

The BISTRO model demonstrates that in synthetic CDOs, investors would pay for the default swaps purchased by the SPE. The development of this variety of CDO paved the way for multiple swaps which are discussed a little later. Obviously, in synthetic CDOs, the financial commitment of the investors was much lower—indeed, insignificant. Considering the element of insurance in default swaps, important questions would arise about the swaps issued for this variety of CDO. Neither the SPE that bought the swaps nor the investors who paid for them would have substantial economic interest in the reference portfolio covered by the swaps. The investors would not stand to lose anything other than their marginal contribution to the CDO in the event of default. In effect, the credit risk in the CDO was now transferred to the seller of the swap. This was an important step in the transition of default swaps into instruments of speculation.

3. Multiple Swaps for Debt Securities

Derivatives reached their peak in 2007. At this peak, the amount of outstanding swaps has been estimated at \$62.2 trillion.³⁴ This amount, which is truly staggering, was

30. The term was used by Sir Howard Davies. See Jill Treanor, *Barclays 'toxic waste' row with German bank settled*, THE GUARDIAN (U.K.), Feb. 15, 2005. Davies was the chairman of the Financial Services Authority (U.K.) from 1997 to 2003.

31. See example, Darrell Duffie, *Innovations in Credit Risk Transfer: Implications for Financial Stability* 8-9 (Bank for Int'l Settlements, Working Paper No. 255, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1165484. Duffie pointed out that among the loans sold by the banks, the percentage was higher for loans with credit rating.

32. See generally J.P. MORGAN & RISKMETRICS GROUP, THE J.P. MORGAN GUIDE TO CREDIT DERIVATIVES 77-78 (Risk Publications 1997), available at http://www.investinginbonds.com/assets/files/Intro_to_Credit_Derivatives.pdf (explaining the BISTRO structure).

33. *Id.*

34. *Credit Derivatives: The Great Untangling*, ECONOMIST, Nov. 6, 2008, at 12.

most likely in excess of the underlying debt, which suggests the possibility of multiple swaps for the portfolios. In other words, a number of default swaps were issued for a single debt obligation. Michael Gibson has pointed out, “[a]s the credit derivative market has grown, it has become common for the notional amount of CDS outstanding referencing a particular issuer to be larger than the face value of the issuer’s bonds outstanding.”³⁵ This fact clearly points towards multiple swaps for debt securities.³⁶ Such multiple swaps would, obviously, be speculative. It is quite obvious that there would be little at stake for the purchaser of a default swap who does not have substantial economic interest in the underlying debt or the credit risk it carries. The buyer would not have a legitimate economic relationship with the debt covered by the swap.

It is difficult to see how the buyers of multiple swaps can have any direct return from the debt. The position is quite clear with balance sheet CDOs where the investors would be assigned the cash flows from the underlying debt securities. But it is not equally so in synthetic CDOs, as evident from the BISTRO CDO promoted by J.P. Morgan discussed earlier. The character of synthetic CDOs requires closer investigation. In any event, it is a self-evident fact that a debt portfolio can only have one cash flow and that can only be assigned once, presumably to the person who purchased the first swap for it. By definition, the buyers of subsequent swaps for a given pool of debt cannot derive any direct returns out of the cash flows originating from the pool.

Logically for the purchasers of subsequent swaps, their only outgo would be the premium they paid for the swaps. Having made this payment, they would essentially bet on default in the underlying debt. The holders of multiple swaps would stand to benefit in the event of default. Indeed, it is equally clear, that they would have a vested interest in default, because without it the cost of the swap would be a write-off for them. Thus, multiple swaps for CDOs complete the transition of default swaps from their conception as hedges against risk into instruments of pure financial speculation.

4. Credit Events and Escalating Exposure

Another important feature of swap agreements is the obligation they impose on the seller of swaps to provide additional collateral on decline in the market value of debts covered by the swap. Swap agreements would, like insurance contracts, define the events that trigger the obligations of the provider.³⁷ Normally, the “credit events” defined in swap agreements include default by the borrower or the borrower filing for bankruptcy. Debt restructuring by the borrower may also qualify as a credit event.³⁸

When a credit event occurs, the swap seller must make a settlement, which could be either cash or physical. In a cash settlement, the swap seller must pay the difference between the par value of the debt security and its present value determined in the manner specified in the contract. When the swap agreement provides for physical settlement, the

35. Michael S. Gibson, *Credit Derivatives and Risk Management*, 92 *ECON. REV.* 25, 39 (2007).

36. There does not appear to be much information on this, and more detailed empirical research is needed before definitive conclusions can be drawn.

37. GEOFF CHAPLIN, *CREDIT DERIVATIVES: RISK MANAGEMENT, TRADING AND INVESTING* 61 (John Wiley & Sons 2005).

38. *Id.*

seller must purchase the debt security at par.³⁹

Other than making settlements on default, often the swap seller must provide collateral when the market value of the debt portfolio declines. This makes default swaps more risky and onerous than regular insurance contracts. AIG offers a good example of this condition in default swap contracts. In its filing for 2007, AIG explained the situation arising from its obligation to post collateral:

AIG's liquidity may be adversely affected by requirements to post collateral. Certain of the credit default swaps written by AIGFP contain collateral posting requirements. The amount of collateral required to be posted for most of these transactions is determined based on the value of the security or loan referenced in the documentation for the credit default swap. Continued declines in the values of these referenced securities or loans will increase the amount of collateral AIGFP must post which could impair AIG's liquidity.⁴⁰

The obligation of the swap seller to provide collateral when there is a fall in the market price of underlying debt security can be serious, as events at AIG have shown. Fluctuations in the market price of CDOs would trigger the liability of swap sellers to furnish collateral. An element of instability is inherent in the price of securities in financial markets.⁴¹ With CDOs, the difficulty is compounded by the fact that they were traded in the unregulated over-the-counter markets. Illiquidity in the market can itself lead to fall in the market price, and this would place the swap sellers under pressure to provide collateral.⁴² This occurs irrespective of any "credit event" caused by the acts or omissions of the borrower, which is evident from the experience of AIG.

The special features of default swaps, discussed above, have carried them away from their original role as instruments of protection against risk and effectively converted them into devices for speculation.⁴³ These features stress the difference between default swaps and regular insurance, although the essential nature of default swaps substantially continue. The additional features undermined the risk protection character of default swaps. Consistent with this, the other safeguards in insurance contracts, such as the

39. *Id.*

40. American International Group, Inc., Annual Report (Form 10-K), at 17 (Feb. 28, 2008) [hereinafter AIG, 2007 FORM 10-K], available at http://www.ezodproxy.com/AIG/2008/AR2007/images/AIG_10K2007.pdf. This was the first reference by AIG to this feature of the default swaps it had sold, and it appeared in the report for 2007 when the independent auditor, PriceWaterhouseCoopers, made adverse comments on the subject. The analysis of AIG's disclosures, in Part II below, suggests that these risks were not adequately appreciated by the company until then.

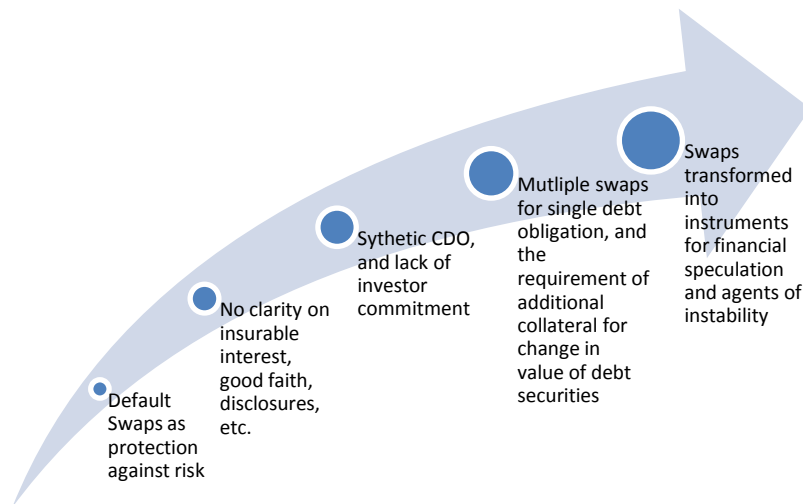
41. See generally CHARLES P. KINDLEBERGER & ROBERT ALBIER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (5th ed. Wiley 2005) (arguing that "displacement," or "some outside event that changes horizons, expectations, profit opportunities, [and] behavior," causes erratic behavior in the markets).

42. Martin Sullivan, who was the CEO of AIG, referred to this fact in his recent testimony before Congress. *The Causes and Effects of the AIG Bailout Before the H. Comm. On Oversight and Gov't Reform*, 105th Cong. (2008) (testimony of Martin Sullivan, former CEO, AIG) [hereinafter *Bailout Hearings*], available at <http://oversight.house.gov/images/stories/documents/20081007101236.pdf>. For further discussion see *infra* Part III.B.2.

43. A retort here could be, "So what?" A major strand in economic discourse in the recent decades has been in praise of speculation. However, the perils of financial speculation are evident from recent events, in particular the AIG episode which is the subject of this article. Responsible governance, which is advocated here, would be undermined by speculative business practices and the instability those practices carry.

requirement of utmost good faith or *uberrimae fides*⁴⁴ and full disclosure by the insured become irrelevant in the default swaps framework. Indeed, it is debatable how far the purchasers of swaps in synthetic CDOs, let alone the purchasers of multiple swaps, would have any meaningful knowledge of the underlying debt and the credit risk in it. Apparently, the entire system depended on the rating given by the credit rating agencies. The transformation of default swaps from instruments of protection into tools of speculation is shown in the diagram below.

Figure 1: Default Swaps—Transformation from Risk Protection to Speculation⁴⁵



With AIG, the issue is the extent to which the company was aware of the characteristic default swaps and appreciated their complexities. This is discussed in Part III below.

III. DEFAULT SWAPS BUSINESS AT AIG, 2002–07

In their seminal article on agency costs, Michael C. Jensen and William H. Meckling referred to a corporation as a “black box.”⁴⁶ Securities regulation attempts to force these black boxes open, at least in part, by requiring corporations to make a number of disclosures.⁴⁷ Over the last several decades, the nature and range of disclosures required under securities regulation have expanded, and as a result, a significant database of

44. For a recent statement of the requirement of utmost good faith in insurance contracts, see *New Hampshire Ins. Co. v. C'Est Moi, Inc.*, 519 F.3d 937 (9th Cir. 2008).

45. The development of Credit Default Swaps, shown in the figure, explains how a relatively minor element acts as the starting point and sets in motion a larger process—with consequences that have little connection to the original conception.

46. Jensen & Meckling, *supra* note 5, at 306.

47. For an account of the adoption of the informational regime in United States, see generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION* (Houghton Mifflin 1982).

information about public corporations is now available.⁴⁸

This part traces the credit derivatives business of AIG. It has two sub-parts. Part III.A provides an analytical account of the development of credit derivatives business from 2002 until 2007. It looks at how the company understood default swaps and dealt with this business. Part III.B examines the economic justification for AIG's credit derivatives business, in terms of its contribution to profits and the volume of risk the company assumed for earning these profits. The financial results of the credit derivatives business of AIG were mixed—losses in three of the six years. This raises the question as to whether the profits justified the significant quantum of risk the company assumed.

A. Disclosures and Statements on Credit Derivatives, 2002–07

A forensic account of the business processes in AIG with respect to its credit derivatives business—an account acceptable to a court investigating the issue—would require an examination of the minutes of the meetings of directors and their committees, as well as an examination of their internal communications and examinations of witnesses.⁴⁹ These are beyond the scope of this Article, whose goal is more modest. The limited effort here is to examine the events at AIG against the background of current corporate theory—namely, management by executives and oversight by the directors,⁵⁰ and the idea that transparency would promote good governance.⁵¹

2002 is the earliest year in which credit default swaps appeared in AIG's statutory filings, and this is adopted as the base year for analysis. The swaps business reached a climax in 2007 when the company reported a loss of \$11.5 billion in this line. In these six years, AIG made a number of disclosures and statements about the business in its annual reports and statutory filings, including the financial results of the business.

Among the disclosures that corporations must make under securities law, “management’s discussion and analysis of financial condition and results of operations” is significant.⁵² In particular, managements must make “quantitative and qualitative disclosures about market risk.”⁵³ The filings and reports of AIG from 2002 provide some information on how the company dealt with default swaps and the risk in those swaps.

48. “[T]he recurrent theme throughout [securities] statutes [is] disclosure, again disclosure and still more disclosure.” LOSS & SELIGMAN, *supra* note 4, at 8.

49. That would require an exercise like the Senate inquiry into the role of Enron directors in the collapse of the company. PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENT AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70 (2d Sess. 2002) [hereinafter ENRON REPORT], available at <http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf>.

50. See, e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE 24, 58 (2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf> (describing the role of the board in corporate governance).

51. Louis Brandeis, who later became a justice of the United States Supreme Court, was an influential figure in promoting the principle of transparency and the adoption of the informational regime in the 1930s. Brandeis' description of sunlight as the best disinfectant became a classic. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY ch. IV (1914), available at <http://www.law.louisville.edu/library/collections/brandeis/node/191> (discussing the benefits of publicity in corporate governance).

52. Regulation S-K, 17 C.F.R. § 229.303 (2009).

53. *Id.* § 305.

1. 2002

AIG's default swaps business was handled by its subsidiary, AIG Financial Products Corp. (AIGFP), based in London, UK. The company explained the nature of the business:

AIGFP enters into credit derivative transactions in the ordinary course of its business. The majority of AIGFP's credit derivatives require AIGFP to provide credit protection on a designated portfolio of loans or debt securities. AIGFP provides such credit protection on a "second loss" basis, under which AIGFP's payment obligations arise only after credit losses in the designated portfolio exceed a specified threshold amount or level of "first losses." The threshold amount of credit losses that must be realized before AIGFP has any payment obligation is negotiated by AIGFP for each transaction to provide that the likelihood of any payment obligation by AIGFP under each transaction is remote, even in severe recessionary market scenarios.⁵⁴

AIG was, thus, clear about the nature of the transaction—namely, providing protection against credit risk. The element of insurance is implicit in this description, but there is no explanation for why the business was handled in the Financial Services group and not in the insurance arm. AIG described the management structure of its Financial Services unit:

The senior management of AIG defines the policies and establishes general operating parameters for AIGFP AIG's senior management has established various oversight committees to review the various financial market, operational and credit issues of AIGFP The senior managements of AIGFP . . . report[s] the results of [its] . . . operations to and review future strategies with AIG's senior management.⁵⁵

These statements are quite general, and it is not clear if any special attention was paid to the new business—credit derivatives. There is no indication of whether the directors of AIG were involved in the decision to start the business, or were even aware of the fact that the company had gotten into it.

Interestingly, AIG had a committee specifically to deal with derivatives risk management—the Derivatives Review Committee.⁵⁶ This was not a committee of directors. It does not figure among the committees of the board, which are discussed in Part IV below. The Derivatives Review Committee, which apparently consisted of company executives, did not look into the credit derivatives business of AIGFP, which was treated as independent.⁵⁷ This is clear from the following:

AIG's Derivatives Review Committee provides an independent review of any proposed derivative transaction. The committee examines, among other things, the nature and purpose of the derivative transaction, its potential credit

54. American International Group, Inc., Annual Report (Form 10-K), at 98–99 (Mar. 31, 2003) [hereinafter AIG, 2002 Form 10-K], available at <http://www.sec.gov/Archives/edgar/data/5272/000095012303003570/y65998e10vk.txt> (discussing AIG's financial services).

55. *Id.* at 50.

56. *Id.* at 57.

57. *Id.*

exposure, if any, and the estimated benefits. *This committee does not review those derivative transactions entered into by AIGFP and AIGTG for their own accounts.*⁵⁸

In any event, AIG was alive to the risk in the default swaps sold by the Financial Products unit. It stated:

AIGFP is exposed to credit risk. If its securities available for sale portfolio were to suffer significant default and the collateral held declined significantly in value with no replacement or the credit default swap counterparty failed to perform, AIGFP could have a liquidity strain. AIG guarantees AIGFP's debt and, as a result, is responsible for all of AIGFP's obligations.⁵⁹

More specifically on the risk in default swaps, AIG stated:

In many cases, the credit risk associated with a designated portfolio is tranching into different layers of risk, which are then analyzed and rated by the credit rating agencies. *Typically*, there will be an equity layer covering the first credit losses in respect of the portfolio up to a specified percentage of the total portfolio, and then successive layers that are rated, generally a BBB rated layer, an A rated layer, an AA rated layer and an AAA rated layer. *In transactions that are rated*, the risk layer or tranche that is immediately junior to the threshold level above which AIGFP's payment obligation would arise is rated AAA by the rating agencies. For that reason, the risk layer assumed by AIGFP with respect to the designated portfolio in these transactions is often called the "super senior" risk layer, defined as the layer of credit risk senior to a risk layer that has been rated AAA by the credit rating agencies or if the transaction is not rated, equivalent thereto. For example, in a transaction with an equity layer covering credit losses from 0 to 2 percent of the total portfolio, a BBB rated layer covering credit losses from 2 to 4 percent, an A rated layer from 4 to 6 percent, an AA rated layer from 6 to 8 percent and an AAA rated layer from 8 to 11 percent, AIGFP would cover credit losses arising in respect of the portfolio that exceed an 11 percent first loss threshold amount, and thereby bear risk that is senior to the 8 to 11 percent AAA rated risk layer.⁶⁰

The emphasized words indicate that not *all* the default swaps sold by AIG were for debt portfolios that credit rating agencies had rated. There is no clarity on this. The statement, made above, that AIG's liability for payment will arise only after default in the first 11% of the portfolio, is significant. It does not contemplate the possibility of simultaneous defaults in different tranches. This stance also fails to consider AIG's obligation to provide collateral in the event of any fall in the market value of underlying securities.⁶¹ As seen earlier, AIG disclosed this obligation only in the filing for 2007. It is not clear if AIG was, in fact, alive to this possibility in 2002. In any event, it provided the following reassurance in 2002:

58. *Id.* (emphasis added).

59. AIG, 2002 Form 10-K, *supra* note 54, at 50.

60. *Id.* at 56 (emphasis added).

61. AIG, 2007 FORM 10-K, *supra* note 40.

AIGFP continually monitors the underlying portfolios to determine whether the credit loss experience for any particular portfolio has caused the likelihood of AIGFP having a payment obligation under the transaction to be greater than super senior risk. AIGFP maintains the ability opportunistically to hedge specific securities in a portfolio thereby further limiting its exposure to loss and has hedged outstanding transactions in this manner on occasion. AIGFP has never had a payment obligation under these credit derivatives transactions. *Furthermore, based on portfolio credit losses experienced to date under all outstanding transactions, no transaction has experienced credit losses in an amount that has made the likelihood of AIGFP having to make a payment, in AIGFP's view, to be greater than remote, even in severe recessionary market scenarios.* At December 31, 2002 the notional amount with respect to AIGFP's credit derivative portfolio was \$125.7 billion.⁶²

The statement that AIG had not made any payment during 2002 towards the default swaps is significant. This, perhaps, provided the confidence for selling larger volumes of swaps in the following years.

2. 2003

AIG, by and large, reiterated the disclosures it made for the previous year. These disclosures included the statement that the company had never had a payment obligation towards its credit derivatives transactions.⁶³ AIG formed the "Capital Markets" unit in 2003, and the credit derivatives business became a part of this unit.⁶⁴ Originally AIG reported \$1845 million revenue and \$1086 million profit from its Capital Markets unit,⁶⁵ and the following statement reflected the mood in the company about this business unit: "Capital Market activities were the primary reason for the growth in operating income in 2003 and to a lesser extent in 2002."⁶⁶ Significantly, AIG provided substantially more details about non-credit derivatives that included "all interest rate, currency, commodity and equity swaps, options, swaptions and forward commitments, futures and forward contracts."⁶⁷ The disclosures on non-credit derivatives were more expansive and their standard was higher than those for credit derivatives.⁶⁸ The company explained the nature of the credit risk in non-credit derivatives:

AIGFP utilizes various credit enhancements, including letters of credit,

62. AIG, 2002 Form 10-K, *supra* note 54, at 57 (emphasis added). AIG was in the practice of disclosing the notional amounts for its credit derivatives. From \$125 billion in 2002, this figure climbed to almost \$562 billion by 2007. The issues regarding notional amounts are discussed *infra* Part III.B.

63. American International Group, Annual Report (Form 10-K), at 106 (Mar. 15, 2004) [hereinafter AIG, 2003 Form 10-K], available at <http://www.sec.gov/Archives/edgar/data/5272/000095012304003302/y92059e10vk.htm>.

64. *Id.* at 36.

65. *Id.* at 37. The revenue was later revised to \$595 million and the profit turned to a loss of \$188 million, as shown in Table 2. *Infra* tbl. 2. The significant revisions: revenue to less than a third of the original figure and the profit of over a billion dollars turning into a loss of \$188 million. *Id.* This underscores the problems with financial reporting at AIG in the post-Enron, Sarbanes-Oxley world.

66. AIG, 2003 Form 10-K, *supra* note 63, at 37

67. *Id.* at 107.

68. *Id.* at 65-66, 106-07.

guarantees, collateral, credit triggers, credit derivatives and margin agreements to reduce the credit exposure relating to these derivative financial instruments. AIGFP requires credit enhancements in connection with specific transactions based on, among other things, the creditworthiness of the counterparties and the transaction's size and maturity.⁶⁹

AIG quantified the "fair value" of the non-credit derivatives portfolio at \$17.38 billion for 2002 and \$21.6 billion for 2003, and stated that these sums represented "the maximum potential loss" to the company.⁷⁰ There are references to the practice of "evaluat[ing] the creditworthiness of its counterparties" and obtaining approval from the Credit Risk Committee for "particularly credit intensive transactions."⁷¹ AIG then presented the credit ratings and industry breakdown of the counterparties for non-credit derivatives in two tables.⁷²

Similar details were not provided for credit derivatives, although the "notional amount" for this segment, at \$203 billion, was impressive.⁷³ AIG apparently made no efforts to quantify the maximum potential loss from the credit derivatives segment. Nor is there any reference to procedures like seeking approval from the Credit Risk Committee or monitoring of risk by the Derivatives Review Committee.

3. 2004

The general tone of disclosures about credit derivatives in 2004 is similar to the earlier two years, except for the following:

- a. There is no affirmation that AIG did not have any demands for payment.
- b. AIG admitted that some of the credit derivative transactions were not rated by credit rating agencies, but added that it "applies the same risk criteria for setting the threshold level for its obligations."⁷⁴

As with 2003, counterparty and the credit rating breakdowns for counterparties were only provided for non-credit derivatives.⁷⁵

4. 2005

This was by far the most successful year for the Capital Markets unit, which handled AIG's credit derivatives business. In this year, the unit's income leapt to \$2.66 billion from \$662 million in the previous year.⁷⁶ There is, however, no significant variation in

69. *Id.* at 107.

70. *Id.*

71. AIG, 2003 Form 10-K, *supra* note 63, at 107. This Committee was again, apparently, not a committee of the board of directors.

72. *Id.*

73. *Id.* at 106. AIG's disclosures on the "notional amounts" for default swaps are discussed *infra* Part III.B.

74. American International Group, Inc., Annual Report (Form 10-K), at 180 (May 27, 2005) [hereinafter AIG, 2004 Form 10-K], available at <http://www.sec.gov/Archives/edgar/data/5272/000095012305006884/y03319e10vk.htm>.

75. *Id.* at 181.

76. American International Group, Inc., Annual Report (Form 10-K), at 52 (Mar. 16, 2006) [hereinafter AIG, 2005 Form 10-K], available at http://media.corporate-ir.net/media_files/irol/76/76115/10K_06.pdf.

the disclosures on credit derivatives except that the company stated again, after a break of one year, that “it has never had a payment obligation under these credit derivative transactions.”⁷⁷

5. 2006

There are no material variations in AIG’s disclosures on credit derivatives for 2006—a year in which the Capital Markets business lost \$873 million.⁷⁸ The statements on issues such as management structure, the nature of the credit risk and management of risk continued along the lines of the earlier years, except that AIG was silent on whether it made any payments during 2006 towards the default swaps it sold.⁷⁹ Apparently, the loss did not make a significant impact on AIG’s management. The annual report states that the company “has created a specialized business, distinguishing itself as a provider of super senior investment grade credit protection and a unique credit-oriented asset manager.”⁸⁰

In 2006, AIG completed five years of reporting on the default swaps business. In the next year—2007—the company reported a loss of \$11.5 billion in this business, setting off the meltdown.⁸¹ The disclosures made in the five years from 2002 to 2006 were quite innocuous. They hardly explained the implications and risks of credit derivatives, which brought the company to the brink of collapse. If these disclosures were to guide investors, it is questionable how far they could have been warned about the events that unfolded in the next two years—2007 and 2008—in which investors almost lost their investments.⁸² This raises questions about the adequacy of disclosure as the governing principle of regulation of public corporations.

6. 2007

This was the momentous year for the default swaps business of AIG—the year in which the company reported a loss of \$11.5 billion from the business.⁸³ Understandably, the default swaps business had a prominent position both in the annual report and the statutory filing. Despite the loss, AIG asserted more than once in its annual report:

Based upon its most current analysis, AIG believes any losses that are realized over time on the super senior credit default swap portfolio of AIGFP will not be material to AIG’s overall financial condition, although it is possible realized

77. *Id.* at 128.

78. American International Group, Inc., Annual Report (Form 10-K), at 63 (Mar. 1, 2007) [hereinafter AIG, 2006 Form 10-K], available at <http://www.sec.gov/Archives/edgar/data/5272/000095012307003026/y27490e10vk.htm>.

79. *Id.* at 94–95.

80. AMERICAN INTERNATIONAL GROUP, INC., 2006 ANNUAL REPORT 34 (2007), available at http://www.ezonlinedocuments.com/aig/2007/annual/images/AIG_AR2006.pdf.

81. AIG, 2007 ANNUAL REPORT, *supra* note 7, at 1.

82. AIG shares, which have a par value of \$2.50, touched a low of 33 cents in March 2009, and have since recovered to about \$40 at this writing in April 2010. AIG share prices available at <http://finance.yahoo.com/q/hp?s=AIG> (last visited May 8, 2010). In understanding this recovery, we must consider the financial assistance the U.S. government provided to prevent the collapse of the company.

83. AIG, 2007 ANNUAL REPORT, *supra* note 7, at 1.

losses could be material to AIG's consolidated results of operations for an individual reporting period.⁸⁴

The statement makes it clear that AIG treated the loss in the default swaps business merely as a temporary setback, and the company was optimistic about its future. This is also evident from the passage below, which is significant for another reason. It has a direct reference to the element of insurance in default swaps and the complementary nature of the relationship between these two businesses of AIG:

The Financial Services group recorded an operating loss of \$9.52 billion for 2007 primarily due to the unrealized market valuation losses related to the AIGFP super senior credit default swap portfolio. We continue to believe that AIGFP will not realize significant losses from this derivative business, which insures against the default of certain securities. Since its creation, AIGFP has been a strong performer and is an important component of AIG's diverse portfolio of businesses.

We continue to see good potential across all product segments of our Financial Services group. Together, they diversify our revenues and complement our core insurance operations.⁸⁵

The statements in the annual reports extracted above were positive and optimistic, but the mood is quite different in the statutory filing. The statutory report described the credit market environment in the following terms:

Credit Market Environment

AIG's businesses may continue to be adversely affected by the current disruption in the global credit markets and repricing of credit risk. During the second half of 2007, disruption in the global credit markets, coupled with the repricing of credit risk, and the U.S. housing market deterioration created increasingly difficult conditions in the financial markets. These conditions have resulted in greater volatility, less liquidity, widening of credit spreads and a lack of price transparency in certain markets. These conditions continue to adversely affect Mortgage Guaranty's results of operations and the fair value of the AIGFP super senior credit default swap portfolio and contribute to higher levels of finance receivables delinquencies at AGF and to the severe and rapid decline in the fair value of certain investment securities, particularly those backed by U.S. residential mortgage loans. It is difficult to predict how long these conditions will exist and how AIG's markets, products and businesses will continue to be adversely affected. Accordingly, these conditions could adversely affect AIG's consolidated financial condition or results of operations in future periods. In addition, litigation and regulatory or governmental investigations and inquiries have been commenced against AIG related to these events and AIG may become subject to further litigation and regulatory or governmental scrutiny as a result of these events.⁸⁶

84. *Id.* at 37.

85. *Id.* at 7.

86. AIG, 2007 Form 10-K, *supra* note 40, at 16.

The mood in the statutory filing is quite somber, and this account is at variance with the hope and confidence exhibited in the annual report.⁸⁷ After expressing these cautious views about the credit market environment, AIG made the following statements about risk management.

Risk Management

AIG is exposed to a number of significant risks, and AIG's risk management processes and controls may not be fully effective in mitigating AIG's risk exposures in all market conditions and to all types of risk. The major risks to which AIG is exposed include: credit risk, market risk, operational risk, liquidity risk and insurance risk. AIG has devoted significant resources to the development and implementation of risk management processes and controls across AIG's operations, including by establishing review and oversight committees to monitor risks, setting limits and identifying risk mitigating strategies and techniques. Nonetheless, these procedures may not be fully effective in mitigating risk exposure in all market conditions, some of which change rapidly and severely. A failure of AIG's risk management processes or the ineffectiveness of AIG's risk mitigating strategies and techniques could adversely affect, perhaps materially, AIG's consolidated results of operations, liquidity or financial condition, result in regulatory action or litigation or damage AIG's reputation.⁸⁸

There was no similar discussion in the Form 10-K for the earlier years. This suggests that the company made these statements only after it had to declare a loss of \$11.5 billion in the default swaps business. The discussion is, however, quite bland. The references to "review and oversight committees to monitor risks [and] setting limits" to risk are not materially different from the perfunctory discussion of the management structure of the Financial Services division in the filing for 2002, which has been extracted earlier.⁸⁹

AIG provided the following breakup of the notional amount and "unrealized market valuation loss" in its credit default swap portfolio:

87. This is yet another issue with the informational regime. Some companies tend to make significantly different statements in their statutory filings and other documents, such as annual reports, to the shareholders and media releases. See generally P.M. Vasudev, *Stock Market, Corporations and Their Regulation: A Few Glimpses into Reality*, 5 ICFAI J. BEHAV. FIN. 28 (2008), available at <http://ssrn.com/abstract=1012938> (examining statutory reports and other communications of Enron, Sycamore networks, and Amazon.com).

88. AIG, 2007 Form 10-K, *supra* note 40, at 16.

89. See *supra* notes 54–62 and accompanying text (discussing AIGFP's handling of credit derivatives and the attendant risk exposure).

Table 1: AIG's Credit Default Swap Portfolio at December 31, 2007⁹⁰

	Notional Amount (\$ Billion)	Unrealized Market Valuation Loss (\$ Billion)
Corporate loans and prime residential mortgages	379	-
Corporate debt/Collateralized Loan Obligations (CLO)	70	0.23
Multi-sector CDO	78	11.25
Total	527	11.48

Referring to the corporate loans and prime residential mortgages (\$379 billion), AIG stated that it

represents derivatives written for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation. . . . AIG expects that the majority of these transactions will be terminated within the next 12 to 18 months by AIGFP's counterparties as they implement models compliant with the new Basel II Accord.⁹¹

For the first time, the word "subprime" entered the filing of AIG. The company stated that "[a]pproximately \$61.4 billion in notional amount of the multi-sector CDO pools include some exposure to U.S. subprime mortgages."⁹² There was no reference to subprime mortgages in the earlier years. It is difficult to reconcile this amount of \$61.4 billion with the assistance of \$170 billion reportedly provided by the U.S. government.⁹³

There are a few other important issues with the default swaps business of AIG—namely, its estimate of losses and its understanding of the obligations under the swap agreements.

- i. Estimation of Losses: AIG, as noted above, estimated the subprime component in its default swap basket at \$61.4 billion.⁹⁴ But the assistance provided by the federal government since September 2008 is reported to be over \$170 billion.⁹⁵ This indicates that the loss in default swaps business went beyond the subprime exposure estimated by AIG. Quite possibly, AIG faced substantial liability from multiple swaps for debt obligations explained earlier.
- ii. Valuation of Credit Derivatives and Posting Collateral: For the first time in 2007, AIG disclosed the difficulties in the valuation of credit derivatives.⁹⁶ This was the trigger for the company's obligation to furnish collateral, and a major factor in its

90. AIG, 2007 Form 10-K, *supra* note 40, at 122. AIG did not report any unrealized market valuation loss in the "Corporate loans and prime residential mortgages" segment of its Credit Default Swap portfolio.

91. *Id.*

92. *Id.*

93. Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After \$170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009, <http://nytimes.com/2009/03/15/business/15AIG.html>.

94. AIG, 2007 Form 10-K, *supra* note 40 at 122.

95. *Id.* at 90.

96. *Id.* at 123.

meltdown.⁹⁷ The following statements of AIG on the subject are significant:

The valuation of the super senior credit derivatives has become increasingly challenging given the limitation on the availability of market observable information due to the lack of trading and price transparency in the structured finance market, particularly in the fourth quarter of 2007.

....

AIGFP's valuation methodologies for the super senior credit default swap portfolio *have evolved in response to the deteriorating market conditions* and the lack of sufficient market observable information. AIG has sought to calibrate the model to market information and to review the assumptions of the model on a regular basis.⁹⁸

This indicates that AIG had not paid serious attention to these issues earlier. It had not considered the potential obligations and logistical issues, such as valuation of securities, at the time of entering into the default swap transactions.⁹⁹ The lack of clarity on these issues is further illustrated by the following statements:

AIGFP also considered the valuation of the super senior CDO securities provided by third parties, including counterparties to these transactions, and made adjustments as necessary.

....

AIG is aware that valuation estimates made by certain of the counterparties with respect to certain super senior credit default swaps or the underlying reference CDO securities, for purposes of determining the amount of collateral required to be posted by AIGFP in connection with such instruments, differ significantly from AIGFP's estimates. AIGFP has been able to successfully resolve some of the differences, including in certain cases entering into compromise collateral arrangements, some of which are for specified periods of time. AIGFP is also in discussions with other counterparties to resolve such valuation differences.¹⁰⁰

AIG's disclosures on default swaps from 2002 to 2007 are valuable for the information they provide on the business model used in the company. The loss of \$11.5 billion that AIG reported in February 2008 in its default swaps business represented about 12% of the shareholders' equity, which was \$95.8 billion in that year.¹⁰¹ As 2008 progressed, AIG's slide quickened and its collapse has been prevented by financial assistance from the U.S. government.¹⁰²

97. *Id.*

98. *Id.* (emphasis added).

99. This highlights the truth in Warren Buffett's famous description of derivatives as "financial weapons of mass destruction," and his warning that they "carry dangers that, while now latent, are potentially lethal." Letter from Warren E. Buffet, Chairman of the Board, Berkshire Hathaway, Inc., to Shareholders of Berkshire Hathaway Inc. 14 (Feb. 21, 2003), available at <http://www.berkshirehathaway.com/letters/2002pdf.pdf>.

100. AIG, 2007 Form 10-K, *supra* note 40, at 123–24.

101. *Id.* at 131 (displaying the consolidated balance sheet for 2007).

102. Recently, Ben Bernanke explained that the decision to bail out AIG was meant to "protect our financial system and to avoid a much more severe crisis in our global economy." *\$60b Bailout is for Everyone:*

B. Credit Default Swaps: The Economic Justification

AIG assumed considerable risk in its default swaps business. Ultimately, the risk proved to be unmanageable, and the question is whether it was justified in the economic sense. To answer this question, the risk must be measured against the profits the company earned from the business. The following table provides the revenue and income of AIG as a whole and those of its Capital Markets operations since 2002:¹⁰³

Table 2: AIG Capital Market Operations, 2002-07
Position in the Overall Business Picture¹⁰⁴

	Capital Markets Revenue (\$ million)	AIG Total Revenue (\$ million)	Capital Markets Revenue as % of Total Revenue	Capital Markets Income (\$ million)	AIG Total Net Income (\$ million)	Capital Markets Income as % of Total Net Income
2002	1,577	66,171	2.38	890	5,729	15.53
2003	595	79,421	0.75	-188	8,108	-2.32
2004	1,278	97,666	1.31	662	9,839	6.73
2005	3,260	108,781	3.00	2,661	10,477	25.40
2006	-186	113,387	-0.16	-873	14,048	-6.21
2007	-9,979	110,064	-9.07	-10,557	6,200	-170.27

Obviously the Capital Markets Operations (CMO), which included default swaps, were not very significant in terms of their contribution to the revenues. At the peak in 2005, AIG derived just three percent of its revenue from CMO. In three out of the six years, CMO ran up losses, and in 2007, the loss was truly phenomenal. However in the other three years in which it made profits, CMO's contribution to AIG's income was disproportionately large. In 2002, the (restated) income from CMO represented over 15% of the total income, although the division's share of the total revenue was just over 2%. The figures for 2005 are even more impressive. With just three percent share in the total revenue, the CMO unit brought in over a quarter of the company's profits.

In terms of profitability, the Capital Market operations of AIG were, at best, erratic. Significant volatility characterized the business, and the correlation between revenue and

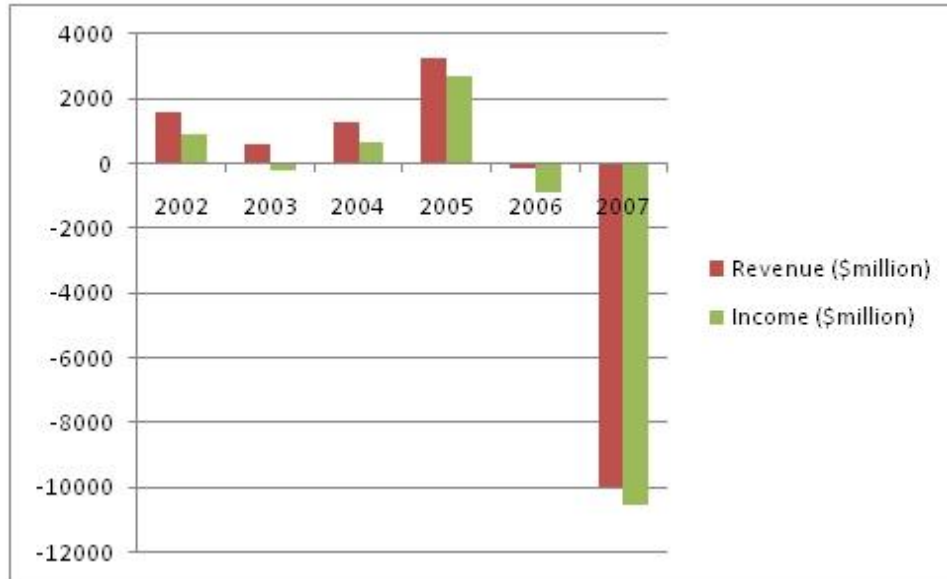
Bernanke, NEW ZEALAND HERALD, Mar. 5, 2009, at B2, available at http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10560021&pnum=0.

103. AIG restated its financials for 2004 and 2005. The figures for 2005 and 2006 have also been revised in the AIG, 2007 Form 10-K, *supra* note 40, although there is no formal reference to restatement. The repeated restatements, coming as they did in the Sarbanes-Oxley era, point to the governance problems in AIG. The figures in Table 2 are the latest provided by the company.

104. Data presented here is based on AIG's Annual Statutory Reports of Form 10-K for the respective years. AIG, 2002 Form 10-K, *supra* note 54; AIG, 2003 Form 10-K, *supra* note 63; AIG, 2004 Form 10-K, *supra* note 74; AIG, 2005 Form 10-K, *supra* note 76; AIG, 2006 Form 10-K, *supra* note 78; AIG, 2007 Form 10-K, *supra* note 40.

income has been erratic as the following graph shows:

Chart 1: AIG Capital Market Operations
Revenue and Income Pattern, 2002–07¹⁰⁵



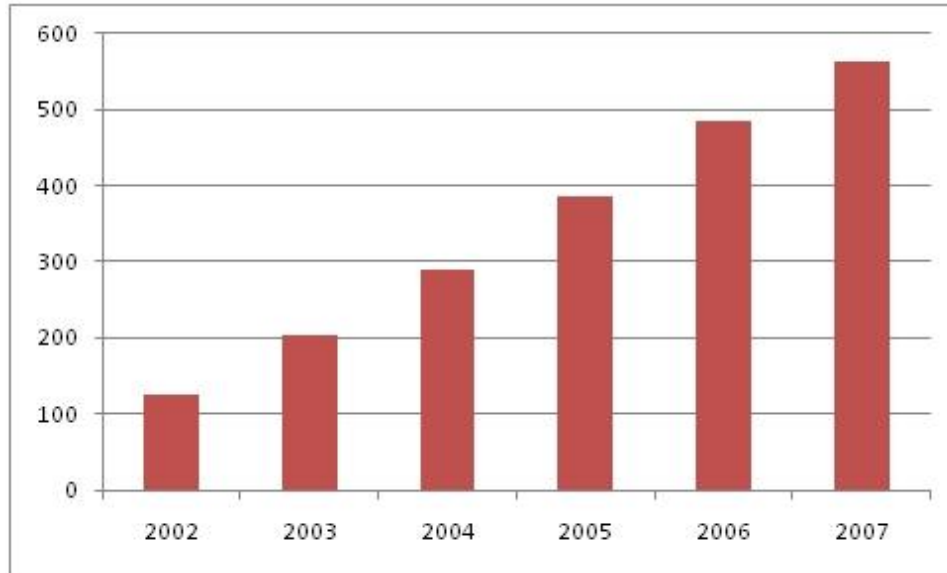
There is hardly any pattern in the relationship between revenue and income, as evident from the following analysis. During the three profitable years, the profits ranged from a (relative) low of 56% of the revenue in 2002 to a high of almost 82% in 2005. The losses incurred in the remaining three years, totaling \$11.62 billion, were 2.75 times the aggregate profit of \$4.21 billion earned in the other three profitable years. The instability in the business is obvious, and in an ideal world it must have set the alarm bells ringing in the company.

That AIG assumed significant risk in its default swap business is merely stating the obvious. As shown in the chart below, the “notional amounts” AIG disclosed for credit derivatives climbed year after year, which points to the constant expansion of the business. The notional amount grew from \$125 billion in 2002 to almost \$562 billion in 2007, as shown in Chart 2.¹⁰⁶ This is a staggering sum—even for a company that finished 2006 with shareholders’ equity of over \$101 billion.¹⁰⁷

105. The chart is based on data from Table 2, *supra* note 104.

106. See *supra* note 104 and accompanying table (detailing the values of AIG’s Capital Markets operations).

107. AIG, 2006 Form 10-K, *supra* note 78, at 103 (displaying the consolidated balance sheet for 2006).

Chart 2: Notional Amounts for Credit Derivatives, 2002-07 (\$ billion)¹⁰⁸

The ups-and-downs in the revenue and income from credit derivatives, seen in Table 2,¹⁰⁹ are not reflected in the notional amounts reported for default swaps. AIG explained “notional amounts” as follows:

The notional amounts used to express the extent of AIGFP’s and AIGTG’s involvement in swap transactions represent a standard of measurement of the volume of AIGFP’s and AIGTG’s swaps business. Notional amount is not a quantification of market risk or credit risk and it may not necessarily be recorded on the balance sheet. Notional amounts represent those amounts used to calculate contractual cash flows to be exchanged and are not paid or received, except for certain contracts such as currency swaps.¹¹⁰

AIG continued to state each year that the “[n]otional amount is not a quantification of market risk or credit.”¹¹¹ However, the reference to “amounts used to calculate contractual cash flows to be exchanged” is quite ambiguous.¹¹² It is not clear if the words

108. The notional amount figures are taken from the statutory annual reports of AIG in Form 10-K for the respective years. AIG, 2002 Form 10-K, *supra* note 54; AIG 2003 Form 10-K, *supra* note 63; AIG 2004 Form 10-K, *supra* note 74; AIG, 2005 Form 10-K, *supra* note 76; AIG, 2006 Form 10-K, *supra* note 78; AIG, 2007 Form 10-K, *supra* note 40.

109. See *supra* note 104 and accompanying table (detailing the values of AIG’s Capital Markets operations).

110. AIG, 2007 Form 10-K, *supra* note 40, at 162.

111. *Id.*

112. AIG, 2002 Form 10-K, *supra* note 54, at 56.

that follow—namely, “are not paid or received”—would apply only *if* all goes well.¹¹³ In other words, would there be no payments or receipts only if the borrowers do not default or there is no fall in the market value of the debt securities? The description of notional amounts is less than lucid. It makes an interesting comparison with the detailed and comprehensive information that AIG has provided for non-credit derivatives, discussed earlier.¹¹⁴

Viewed from the perspective of economic justification, the exposure that AIG assumed under default swaps is questionable. It would be difficult to argue that economic benefit, actual or perceived, provided sufficient justification for the enormous liability that AIG assumed in its credit derivatives business. The credit derivatives business never earned significant profits, relatively speaking. The only exception was in 2005 when it shored up the bottom line of the company.¹¹⁵ But the volume of risk was disproportionate to the benefit.

Are these conclusions merely the products of 20/20 hindsight? Or could they have been known at the time when AIG made and implemented the decisions? What was the level of seriousness and responsibility in decision-making at AIG for its default swaps business? To what extent were the directors of AIG involved in the business decisions? To find answers to these questions, Part IV looks at the governance structure at AIG, its decision-making processes, and its risk-management mechanisms.

IV. CORPORATE GOVERNANCE AT AIG—A REVIEW

In recent decades, the idea has been prominent that good governance ought not to be an issue for public policy or regulation.¹¹⁶ Rather, it should be the internal concern of individual corporations.¹¹⁷ The discussion that follows assesses the events at AIG by this standard. It is quite appropriate considering that AIG had a state-of-the-art governance structure—with independent directors, audit committees, et al., and a stated commitment to “be an outstanding corporate citizen and promote responsible and sustainable business practices.”¹¹⁸

A. Corporate Governance and the Structure at AIG

Myriad factors influence business governance. These include legal regulations, stock exchange rules, corporate governance codes, and the ethical environment prevailing in a society.¹¹⁹ The figure below explains the structure of corporate governance.

113. *Id.*

114. See *supra* notes 63–73 and accompanying text (examining AIG’s 2003 disclosures).

115. See *supra* note 104 and accompanying table (detailing the values of AIG’s Capital Markets operations).

116. For a rather extreme version of this approach, see Frank Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1416–21 (1989) (arguing that the role of statutes is to provide no more than a set of default rules for corporations).

117. See, e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 50 (including the independence of directors as one of many desirable qualities of corporate governance).

118. AMERICAN INTERNATIONAL GROUP, CORPORATE RESPONSIBILITY STATEMENT (2008), available at <http://ir.aigcorporate.com/phoenix.zhtml?c=76115&p=irol-govresponsibilityhome>.

119. See JOHN FARRAR, CORPORATE GOVERNANCE: THEORIES, PRINCIPLES AND PRACTICE 4 (3d ed. Oxford Univ. Press 2008).

Figure 2: The Structure of Corporate Governance¹²⁰

Among these, the law of corporations occupies a core position. It has traditionally vested management powers in the board of directors, who—nominally at least—were elected by the shareholders. However, in the real-world model as it has existed in the last several decades, the business and affairs of the corporations were actually managed by full-time executives.¹²¹ Writers such as William Douglas (1940) and Myles Mace (1970) complained that the directors played no meaningful role¹²² and were under the control of the executives, in particular the powerful CEOs of corporations.¹²³ There was also growing uneasiness about the unchecked powers of corporate managers.¹²⁴

In this milieu, corporate theory developed the idea that the boards would monitor the managers. This management structure, articulated by Melvin A. Eisenberg in 1976,¹²⁵ also found considerable support among the law and economics scholars.¹²⁶ It is now, more or less, the accepted norm in the governance of public corporations.¹²⁷ Corporate

120. *Id.*

121. See generally ALFRED D. CHANDLER, *VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (Belknap Press 1977).

122. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1307 (1934).

123. See generally MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* 191 (Harvard Bus. Sch. 1970) (interviewing CEOs and board members to discern their own views of their respective governance roles).

124. See, e.g., J.K. GALBRAITH, *THE NEW INDUSTRIAL STATE* (Hamish Hamilton 1967).

125. MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* (Little, Brown, and Co. 1976).

126. See, e.g., Jensen & Meckling, *supra* note 5, at 308–10 (describing the managers as agents of the corporation).

127. See, e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 50 (explaining how good monitoring by boards is an important part of sound corporate governance).

law endorses the concept of supervisory boards by authorizing the directors to delegate many of their powers to corporate executives.¹²⁸

In 1970 Myles Mace,¹²⁹ and before him, in 1932 Adolf A. Berle and Gardiner C. Means,¹³⁰ wrote about powerful and entrenched managements who dominated boards. Mace pointed out that the small number of outsiders on the boards of public corporations was, in fact, handpicked by the managers, who could count on the support of the outside directors. This reality was inconsistent with the notion that the directors' task was to monitor the managers. To oversee the managers, and do so effectively, the directors must be "independent."¹³¹ This was the next step in the development of corporate theory.¹³² Director independence is stressed in the stock exchange rules that impose mandatory governance standards on listed companies.¹³³ Among these is the rule that a majority of the board of directors of listed companies must be independent directors.¹³⁴ Jeffrey Gordon has found that in the recent decades, there has been a significant increase in the presence of independent directors on the boards of public companies.¹³⁵ Gordon has described the "dramatic shift" in favor of independent directors in large public companies and has estimated that their percentage rose from 22% in 1950 to 74% in 2005.¹³⁶

The Sarbanes–Oxley Act, enacted in the aftermath of the scandals at Enron and WorldCom—among others—also promoted the idea of independent directors.¹³⁷ The Sarbanes–Oxley Act goes beyond mere disclosure and makes what, in the traditional sense, would be considered an intrusion into corporate governance: dictating the composition of the boards of public corporations.¹³⁸ Boards must now have independent directors, or rather, audit committees consisting of independent directors.¹³⁹

AIG, as noted, had a state-of-the-art governance structure that was based on the principles outlined above. It adopted the model of executive management and monitoring by the board, and it has placed an emphasis on director independence. The chart below shows that in the recent years, the AIG board has had a full complement of independent directors, and the managers have become a small minority.

128. *See, e.g.*, DEL. CODE ANN., tit. 8, § 141 (2006).

129. *See generally* MACE, *supra* note 123.

130. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (MacMillan 1947) (1932).

131. *See, e.g.*, the definition of director independence in the Sarbanes–Oxley Act of 2002. Pub. L. 107-204, § 301, 116 Stat. 744, 775–77 (2002).

132. Recent developments on independent directors can also be traced to William O. Douglas, who mooted the idea of "public interest directors" for corporations. WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE* 52–53 (1940). However, the idea of independent directors has existed in Anglo-American business enterprises since early nineteenth century. *See* GEORGE HERBERTON EVANS, JR., *BRITISH CORPORATION FINANCE 1775-1850: A STUDY OF PREFERENCE SHARES* Chs. I and II (John Hopkins Press 1936).

133. *See, e.g.*, NYSE Euronext, Listed Company Manual, § 303A.00 (2002), *available at* <http://nysemanual.nyse.com/lcm/> (describing corporate governance standards).

134. *Id.* at § 303A.01. The tests of independence are provided in § 303A.02.

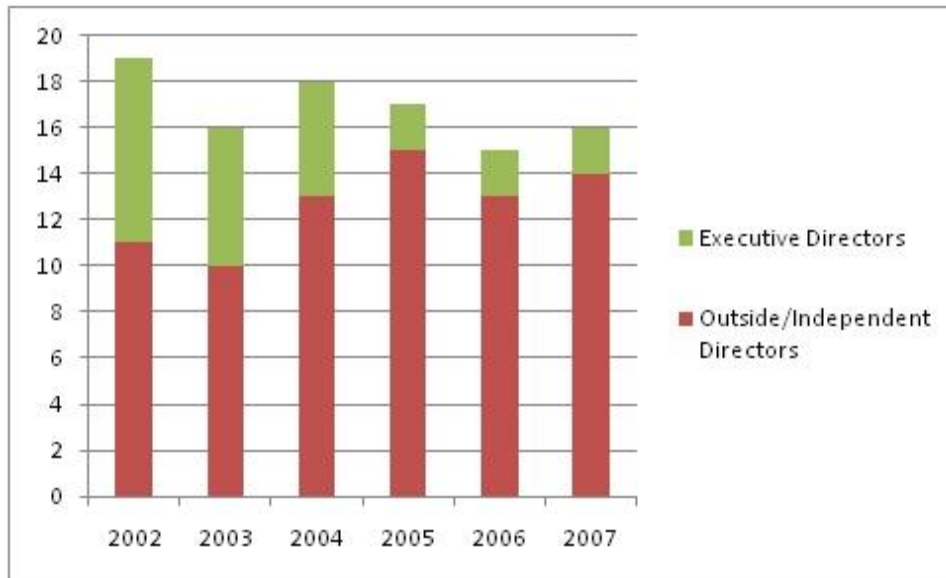
135. Jeffrey Gordon, *supra* note 2, at 1468.

136. *Id.* at 1471.

137. Sarbanes–Oxley Act of 2002. Pub. L. 107-204, § 301, 116 Stat. 744, 775–77 (2002).

138. *Id.*

139. *Id.*

Chart 3: AIG Board Composition, 2002–07¹⁴⁰

As can be seen, the contingent of independent directors at AIG has been quite large. The number of executive directors has declined from a high of eight in 2002 to two by 2005. It has since stayed there. Indeed, the company has not maintained the 2-to-1 ratio between outside/independent directors and executive directors, which is the norm stated in its Corporate Governance Guidelines.¹⁴¹ In doing so, AIG has moved closer to the ideal recently in economic theory—having just one inside director, the CEO.¹⁴²

According to AIG, the size of its board is determined to “facilitate substantive discussions by the whole Board in which each director can participate meaningfully.”¹⁴³ The company also stresses the “value of diversity of experience and views among Board members.”¹⁴⁴ Reflecting this, the directors of AIG have ranged from a banker and a former chief accountant of the SEC to a professor of economics and a former U.S. ambassador to the United Nations.¹⁴⁵

140. This data is based on the information from the American International Group’s Annual Statutory Reports (Form 10-K) for the respective years. AIG, 2002 Form 10-K, *supra* note 54; AIG 2003 Form 10-K, *supra* note 63; AIG 2004 Form 10-K, *supra* note 74; AIG, 2005 Form 10-K, *supra* note 76; AIG, 2006 Form 10-K, *supra* note 78; AIG, 2007 Form 10-K, *supra* note 40.

141. AMERICAN INTERNATIONAL GROUP, CORPORATE GOVERNANCE GUIDELINES (2008), available at http://www.aigcorporate.com/corpgovernance/AIGCorporatenance_GuidelineJuly_2009_revision091709.pdf. These charters are a requirement under the New York Stock Exchange Listed Company Manual. NYSE Euronext, *supra* note 133, § 303A.04–07.

142. Michael C. Jensen, et al., *Remuneration: Where We’ve Been, How We Got to Here, What Are the Problems, and How to Fix Them* 55 (Har. Bus. Sch., Research Working Paper No. 04-28), available at <http://ssrn.com/abstract=561305>.

143. AMERICAN INTERNATIONAL GROUP, CORPORATE GOVERNANCE GUIDELINES, *supra* note 141, at 1.

144. *Id.*

145. AIG, 2007 Form 10-K, *supra* note 40, at 206–07.

AIG's Corporate Governance Guidelines recognize the principle of management by executives and oversight by the board:

The business of AIG is conducted by management under the oversight of the Board. The roles of the Board and management are related, but distinct. AIG's business strategy is developed and implemented under the leadership and direction of the Chief Executive Officer by its officers and other employees. . . . In performing its general oversight function, *the Board reviews and assesses AIG's strategic and business planning as well as management's approach to addressing significant risks and challenges facing AIG.* . . . [T]he Board reviews and discusses reports regularly submitted to the Board by management with respect to AIG's performance, as well as significant events, issues and risks that may affect AIG's business or financial performance. . . . [T]he Board and its members will maintain frequent, active and open communication and discussions with the Chief Executive Officer and the management of AIG.¹⁴⁶

In this model, the default swaps business would likely qualify as "business strategy," which the CEO and his team would "develop and implement."¹⁴⁷ As a part of its general oversight function, the board would review and assess the strategic business plan, especially for identifying significant risks and challenges. This two-tier governance structure envisages that the CEO and his team would develop a business strategy, which would then be assessed and reviewed by the board of directors.

Risk management has emerged as an important subject in recent years, largely due to the uncertainties arising from the interlinking of economies worldwide and the volatility that is built into the financial systems.¹⁴⁸ The Organisation for Economic Cooperation and Development (OECD) has identified eight "key functions" of corporate boards that stress, among other things, risk management policy:

An area of increasing importance for boards and which is closely related to corporate strategy is risk policy. Such policy will involve specifying the types and degree of risk that a company is willing to accept in pursuit of its goals. It is thus a crucial guideline for management that must manage risks to meet the company's desired risk profile.¹⁴⁹

Risk management also receives considerable attention in the governance framework at AIG. As in other large companies, the board of the company had, at the material time, a number of committees.¹⁵⁰ Among these, two had risk management as a part of their function—the Audit Committee and the Finance Committee. The Audit Committee charter has the following among its "Other Duties and Responsibilities":

The Committee shall discuss the guidelines and policies governing the process

146. AMERICAN INTERNATIONAL GROUP, CORPORATE GOVERNANCE GUIDELINES, *supra* note 141, at 1 (emphasis added).

147. *Id.*

148. See generally MICHAEL POWER, THE RISK MANAGEMENT OF EVERYTHING: RETHINKING THE POLITICS OF UNCERTAINTY (Demos 2004).

149. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 50, at 60.

150. The New York Stock Exchange Listed Company Manual requires the existence of some board committees. NYSE, Inc., *supra* note 133.

by which senior management of AIG and the relevant operations of AIG assess and manage AIG's exposure to risk, as well as AIG's major financial risk exposures, and the steps management has taken to monitor and control such exposures. The Committee is not the sole body responsible for oversight of AIG's risk assessment and management. AIG manages and assesses its risk through multiple mechanisms other than the oversight of the Committee, including the oversight of other committees of the Board.¹⁵¹

The Finance Committee has a more direct role in risk management. Its "Duties and Responsibilities" include the following:

Management shall review with the Committee, as the Committee may deem appropriate, reports concerning AIG's exposures to market, liquidity, credit and operational risks in so far as those exposures relate to financial, transactional and other matters considered by the Committee as part of its duties and responsibilities under this Charter.¹⁵²

The board of directors would meet a minimum of six times each year, and its committees met at least four times a year.¹⁵³ These systemic provisions are, quite obviously, meant to ensure that the board and its committees have sufficient opportunity and time for performing the tasks assigned to them. Thus, AIG had the institutional arrangements and mechanisms prescribed in contemporary corporate theory. These are meant to promote the good governance of the company and proper management of risk.

B. Lifting the Corporate Veil

1. The Role of Joseph Cassano

To understand the handling of the default swaps business in AIG and the role of the board, it is necessary to identify the specific actors in the company. Media reports have named Joseph J. Cassano, then President of AIG Financial Products Corp., as the man behind AIG's default swaps business.¹⁵⁴ Gretchen Morgenson has cited AIG employees who stated that Cassano, an investment banker, ran the financial services unit of the company "with almost complete autonomy, and with an iron hand."¹⁵⁵

Obviously, the insurance arm of AIG had no role in its default swaps business. Still, AIG's reputation as the world's leading insurance company was an important factor in the sale of the swaps, whose principle is similar to that of credit insurance. Robert Arvanitis, CEO of Risk Finance Advisors, observed: "It is beyond shocking that this small operation could blow up the holding company. . . . They found a quick way to

151. AMERICAN INTERNATIONAL GROUP, AUDIT COMMITTEE CHARTER (2008), available at http://media.corporate-ir.net/media_files/irol/76/76115/Audit_Committee_Charter_032509.pdf.

152. *Id.*

153. AMERICAN INTERNATIONAL GROUP, CORPORATE GOVERNANCE GUIDELINES, *supra* note 141, at 5.

154. *See, e.g.*, Gretchen Morgenson, *supra* note 11; Robert Lenzer, *Why Wasn't AIG Hedged?*, FORBES, Sept. 28, 2008, available at http://www.forbes.com/2008/09/28/croesus-aig-credit-biz-cx_rl_0928croesus.html; Sharon Churcher & Ian Gallagher, *The Man Blamed for Bringing the World's Biggest Insurer AIG to the Brink of Ruin*, DAILY MAIL, Sept. 21, 2008, available at <http://www.dailymail.co.uk/news/article-1058841/The-man-blamed-bringing-worlds-biggest-insurer-AIG-brink-ruin.html>.

155. Gretchen Morgenson, *supra* note 11.

make a fast buck on derivatives based on A.I.G.'s solid credit rating and strong balance sheet. But it all got out of control."¹⁵⁶ Insurance is the core business of AIG. The company has vast experience in the field and in handling the associated risk. AIG's procedure for new insurance products and its standard precautions for risk management make an interesting comparison with derivatives, which have been discussed earlier. The following is AIG's description of its risk modeling for insurance products:

AIG's multiple insurance businesses are conducted on a global basis exposing AIG to a wide variety of risks with different time horizons. These risks are managed throughout the organization, both centrally and locally, through a number of procedures, including (i) pre-launch approval of product design, development and distribution; (ii) underwriting approval processes and authorities; (iii) exposure limits with ongoing monitoring; (iv) modeling and reporting of aggregations and limit concentrations and multiple levels (policy, line of business, product group, country, individual/group, correlation and catastrophic risk events); (v) compliance with financial reporting and capital solvency targets; (vi) extensive use of reinsurance both internal and third-party; and (vii) review and establishment of reserves.¹⁵⁷

Clearly AIG pays serious attention to risk, which is basic to its insurance business. The statutory report has a lengthy discussion about insurance risk, which is not relevant for the purpose of this Article.¹⁵⁸ It is eloquent proof of AIG's expertise and experience in managing insurance risk. AIG's approach towards default swaps was, in comparison, quite perfunctory as seen in the disclosures extracted in Part III.A. This suggests a lack of clear understanding of the product and its risks, which is natural considering that credit derivatives are a new line of business. The absence of a past record and detailed information about the risk ought to have made AIG more cautious.

According to the information available, Joseph St. Denis, an internal auditor, raised the earliest alarm to AIG's default swaps in September 2007.¹⁵⁹ St. Denis was concerned about the collateral that the company had been asked to furnish under the terms of its swap contracts.¹⁶⁰ It was reported that Joseph Cassano, an investment banker who had earlier worked for Drexel Burnham Lambert, was unhappy with St. Denis's queries and excluded him from the process of valuation of the derivatives.¹⁶¹ According to St. Denis, he brought these developments to the attention of Michael Roemer who was AIG's chief auditor, but that made little difference.¹⁶²

This incident points towards lack of proper appreciation within AIG of the nature of

156. *Id.*

157. AIG, 2007 Form 10-K, *supra* note 40, at 118.

158. Insurance is a regulated business, and AIG must maintain a "gross loss reserve" and report it annually. See the discussion about risk management for the general insurance business in the company's statutory report. AIG, 2007 Form 10-K, *supra* note 40, at 47-62. The estimation of these reserves and their maintenance are regulated in order to ensure that insurance providers can discharge their insurance obligations.

159. Liam Plevin & Amir Efrati, *Documents Show AIG Knew of Problems with Valuations*, WALL ST. J., Oct. 11, 2008, at B1.

160. *Id.*

161. *Id.*

162. Ilaina Jonas & Jan Paschal, *AIG Knew of Potential Problems in Valuing Swaps: Report*, REUTERS, Oct. 12, 2008, available at <http://www.reuters.com/article/idUSTRE49B2WW20081013>.

the risk in default swaps. As noted earlier, the business was done in the “Financial Services” unit of the company, rather than its insurance arm, despite the similarity in principle.¹⁶³ The swaps business was, according to reports, started and run by Cassano.¹⁶⁴ It is not clear whether Cassano had significant experience in insurance business or how he understood the risk in credit derivatives.

2. Oversight by CEO/Senior Management

The next level of oversight occurred under the CEO/Senior Management responsible for business strategy. Maurice Greenberg, the longstanding CEO of AIG, held the office until March 2005.¹⁶⁵ Martin Sullivan succeeded him and held the position until June 2008.¹⁶⁶ Greenberg did not attend the congressional hearing inquiring into AIG’s practices, but submitted a prepared testimony. He is reported to have stated that, “[w]hen I left AIG, the company operated in 130 countries and employed 92,000 people. . . . Today, the company we built up over almost four decades has been virtually destroyed.”¹⁶⁷ By late 2007, as noted, concerns had been raised about default swaps—first by internal auditor Joseph St. Denis and then by independent auditor PricewaterhouseCoopers (PwC).¹⁶⁸ At an investor conference held on December 5, 2007, Sullivan stated that “we are confident in our marks and the reasonableness of our valuation methods.”¹⁶⁹ Martin Sullivan’s testimony to Congress in October 2008 is in a similar vein.¹⁷⁰ It did not focus on any internal failures at AIG. Starting with a reference to the “global financial tsunami,” Sullivan focused on external factors.¹⁷¹ Describing himself as “an insurance man all [his] life,” Sullivan spoke about the “many factors . . . at play” such as “lending and borrowing practices, illiquid markets, the absence of credit, loss of investor confidence, and even accounting rules.”¹⁷² With regard to accounting rule FAS 157,¹⁷³ which requires “mark-to-market” valuation of assets, Sullivan stated that “in the unprecedented credit crisis which began in the summer of 2007, FAS 157 had, in my opinion, unintended consequences. In a distressed market where assets cannot be readily sold, companies are forced to declare the value of those assets at fire-sale

163. AIG, 2002 Form 10-K, *supra* note 54 and accompanying text.

164. Morgenson, *supra* note 11.

165. Jenny Anderson, *Greenberg and A.I.G. Sever Ties*, N.Y. TIMES, Mar. 29, 2005, at C1.

166. Jonathan D. Glater, *With Shares Battered, A.I.G. Ousts Leader*, N.Y. TIMES, June 16, 2008, at C1.

167. Andrew Taylor, *AIG Execs’ Retreat After Bailout Angers Lawmakers*, USA TODAY, Oct. 7, 2008, available at http://www.usatoday.com/money/economy/2008-10-07-3811831325_x.htm. Greenberg’s attitude towards the default swaps business in a more recent interview that he gave—in June 2009—is not very different. Neil Weinberg, *Hank Greenberg Blasts Government Dismantling of AIG*, FORBES, June 4, 2009, available at <http://www.forbes.com/2009/06/04/aig-hank-greenberg-personal-finance-financial-crisis.html>.

168. Plevin & Efrati, *supra* note 159.

169. *Id.*

170. *Bailout Hearings*, *supra* note 42 (testimony of Martin Sullivan).

171. *Id.*

172. *Id.* at 2.

173. FINANCIAL ACCOUNTING BOARD OF THE FINANCIAL ACCOUNTING FOUNDATION, STATEMENT OF ACCOUNTING FINANCIAL STANDARDS NO. 157—FAIR VALUE MEASUREMENTS (Sept. 2006) available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818754924&blobheader=application%2Fpdf>.

prices.¹⁷⁴ Martin Sullivan presented this among the reasons for the unrealized market valuation losses of AIG.¹⁷⁵ FAS 157, which came into effect on January 1, 2008, cannot explain the loss of over \$11 billion that AIG suffered in its default swap portfolio in 2007. The loss was, presumably, due to the occurrence of the credit events specified in the derivatives contracts of AIG and its obligations under those contracts.

The testimony made no reference to subprime mortgages or the risk-modeling of default swaps in AIG. Sullivan stated:

The underlying bonds were very highly rated, and the risk of default was viewed as extremely remote. The credit default swap business had, since its inception in the late 1990s, generated a reliable and steady source of income for AIG-FP. In fact, AIG-FP intended to retain its derivative interest in these highly rated bonds until they reached maturity.¹⁷⁶

3. Board Committees—Their Level of Involvement

Risk management, as noted earlier, is included among the responsibilities of the Audit and Finance Committees of the board of directors.¹⁷⁷ According to Plevin and Efrati, the committee considered the question of valuation of default swaps in January 2008.¹⁷⁸ It is not clear if this was after the independent auditor PwC raised the issue before certifying the financial statements for 2007 on February 28, 2008.¹⁷⁹

4. Monitoring by the Board of Directors

At the next level, the board of directors would “act as advisors and counselors to the Chief Executive Officer and senior management and oversee management’s performance on behalf the shareholders.”¹⁸⁰ This is, broadly, the brief of AIG’s board. It is quite adequate as a statement of principle, but major difficulties arise when it is applied to specific questions—such as the board’s involvement in the default swaps business. With the information available, it is not possible to determine whether the default swaps business was, in fact, considered by the board. This makes it superfluous to raise questions about the board’s reaction or any guidance that it might have given the management about the business and its risks. The corporate “black box” is, here, really and truly black.

Large corporations with multiple business divisions and global operations, such as AIG, are complex organisms. The directors have control, at least *de jure*, over the corporations and are responsible for their well-being. AIG started dealing in default swaps in the late 1990s.¹⁸¹ The responsibility of its directors for the swaps business must be examined from this perspective.

The statute under which AIG is organized—Delaware General Corporation Law—is

174. *Bailout Hearings*, *supra* note 42, at 4 (testimony of Martin Sullivan).

175. AIG, 2007 ANNUAL REPORT, *supra* note 7.

176. *Bailout Hearings*, *supra* note 42, at 4.

177. *See supra* notes 149–53 and accompanying text.

178. Plevin & Efrati, *supra* note 159.

179. AIG, 2007 Form 10-K, *supra* note 40, at 129.

180. AMERICAN INTERNATIONAL GROUP, CORPORATE GOVERNANCE GUIDELINES, *supra* note 141, at 1.

181. *Bailout Hearings*, *supra* note 42, at 4 (testimony of Martin Sullivan).

minimally intrusive. It vests management powers in the directors, and leaves them free to delegate most of their powers.¹⁸² The various governance codes that have been developed in the recent decades are supposed to fill this gap and provide guidance to corporations in devising their management structure.¹⁸³ In addition, most corporations have their own governance charters.

The prescriptions in codes such as *OECD Principles of Corporate Governance*¹⁸⁴ or AIG's own Corporate Governance Guidelines¹⁸⁵ stop with broad statements of principles. They avoid more detailed delineation of responsibilities. The Corporate Governance Project of American Law Institute (ALI) commented on the failure of state corporate statutes to "provide[] realistic guidance as to . . . the board's core functions."¹⁸⁶ The ALI Project embarked on this venture, and came up with a list of five core functions, which include: "(2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed" and "(3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions."¹⁸⁷ These elaborations of directors' functions are an improvement over the *OECD Principles* and AIG's charter. However, ALI principles also do not spell out the functional responsibilities of the directors of public corporations or their involvement in specific vital decisions such as starting a new business. This lack of clarity in the governance framework impedes effective monitoring of *business* by the directors. The issues with the prevailing theory of director oversight are explored in Part V.

V. DIRECTOR OVERSIGHT—THE ISSUES WITH CORPORATE THEORY

There has been renewed interest in directors, their role, and their efficacy since the corporate scandals that erupted at the turn of the century.¹⁸⁸ The senate inquiry into the role of Enron directors was quite extensive.¹⁸⁹ After examining over a million pages of documents and interviewing many directors, the inquiry leveled serious charges against the Enron board.¹⁹⁰ The AIG episode, once again, reveals the limitations of the current framework of corporate governance. It presents an opportunity to test important tenets of corporate theory—namely, the monitoring role of boards, notions about director independence, and the degree of care that directors are expected to exercise.

182. DEL. CODE ANN. tit. 8, § 141 (2010).

183. A comprehensive database of corporate governance codes developed in various jurisdictions is maintained by European Corporate Governance Institute, Index of Codes, http://www.ecgi.org/codes/all_codes.php (last visited Apr. 12, 2010).

184. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 50.

185. AMERICAN INTERNATIONAL GROUP, CORPORATE GOVERNANCE GUIDELINES, *supra* note 141.

186. DOUGLAS M. BRANSON, CORPORATE GOVERNANCE 265 (Michie 1993) (quoting ALI CORP. GOV. PROJ., cmt. to § 4.01(a), at 190).

187. *Id.* (quoting ALI CORP. GOV. PROJ. § 3.02(a)).

188. *See, e.g.*, PAUL W. MACAVOY & IRA M. MILLSTEIN, THE RECURRENT CRISIS IN CORPORATE GOVERNANCE (Stanford Bus. Books 2003) (discussing corporate scandals and providing a new approach for measuring the efficacy of corporate governance).

189. ENRON REPORT, *supra* note 49.

190. *Id.* at 3.

A. Boards—A Case for Expanding Their “Service” Function

Management theory has identified the following as the functions of corporate boards:¹⁹¹

- a. Control function, which describes the monitoring task of the directors in corporate and economic theory;¹⁹²
- b. Service function that is related to corporate business operations—evaluation of business plans or advice on strategy;¹⁹³ and
- c. The resource dependence function in which the directors act as corporate ambassadors to the external world—the government, consumers, investors and other groups.¹⁹⁴

Among these functions, it is the monitoring or control function that has received maximum attention in the reform efforts of the recent decades.¹⁹⁵ This trend can be traced to the milieu in which the reformative ideas were developed. CEOs and insider-dominated boards exercised near-complete control over powerful and wealthy corporations.¹⁹⁶ This was the breeding ground for the “agency costs” theory and the idea that managerial power had to be curbed.¹⁹⁷ It was, generally, an era of growth and prosperity that took corporate wealth almost for granted. In this environment, the theorists mostly confined their focus on (a) restricting the managers’ power to deal with the wealth, and (b) ensuring that it was used for the shareholders’ benefit.¹⁹⁸ Directors were presented as the instrument to achieve these goals.¹⁹⁹

These ideas lent an adversarial flavor to corporate boards. They pitted, at least in theory, the CEOs and managers on one side and the directors on the other.²⁰⁰ Quite naturally, there was considerable emphasis on director “independence” and the absence of any relationship between directors and the corporations or their managers.²⁰¹ This

191. See generally Jonathan L. Johnson et al., *Boards of Directors: A Review and Research Agenda*, 22 J. MGMT. 409 (1996) (discussing the roles and influence of corporate boards).

192. *Id.*

193. *Id.*

194. *Id.*

195. Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781, 786 (2003).

196. This situation was viewed with alarm across the political spectrum. On the one side, there were scholars such as John K. Galbraith, *supra* note 124, and activists like Ralph Nader, Mark Green and Joel Seligman. RALPH NADER et al., *TAMING THE GIANT CORPORATION* (Norton 1976). On the other, there was the emerging genre of libertarians, led by Milton Friedman, who also railed against corporate power. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, available at <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>. Friedman’s much-cited article, *The Social Responsibility of Business Is to Increase Its Profits*, in fact targeted the practice of corporations to make charitable donations. *Id.* According to Friedman, this was abuse of power by the managers who, he argued, were the stewards of shareholders’ wealth. *Id.*

197. See e.g., Jensen & Meckling, *supra* note 5 (using agency costs to analyze managerial behavior and ownership structure).

198. *Id.*

199. *Id.*

200. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 811–14 (2001).

201. See Jeffrey N. Gordon, *supra* note 2, at 1478 (arguing that director independence is increased if directors have no relationship with the corporation other than acting as a director).

thought process led to the requirement in the New York Stock Exchange Listing Rules that a majority of the directors be independent.²⁰²

The policing role of the directors received primacy.²⁰³ The focus on monitoring resulted in the weakening of the directors' "service" function, or their involvement in business operations and strategy. AIG operated in this world of what I would term "soft norms." The effectiveness of its directors in their service function must be assessed by the outcome.

There are two issues with the weakening of the service function of directors. It stresses the importance of a clearly articulated role for the directors. In a competitive environment, in which business growth and profitability cannot be taken for granted, corporate governance would no longer be merely a case of allocation of wealth or resources—whether between the managers and the shareholders, or among more constituencies such as employees, the community and so on. Here, policing would not be the only predominant function of the directors. Business issues such as product quality, innovation, and the ability to offer competitive prices must equally command the directors' attention at all times, on an ongoing basis. Exaggerated focus on the sharing of spoils would, over time, undermine business competitiveness and pose a risk to the very survival of the corporation.

The second issue is about whether an adversarial flavor should inform the relationship between the board—in particular the outside directors—and the managers, or whether there must *also* be a complementary element. It is about the place of trust and cooperation in the equation. A framework that lays equal stress on the service function of boards, as it does on the monitoring function, would promote a more cooperative culture that is beneficial to the corporation and its shareholders and other stakeholders. That would encourage the directors to pay greater attention to business issues, and facilitate corporations to derive greater benefits from the depth and range of skills that boards usually have.

Recently in Canada, the Saucier Committee on corporate governance advocated greater board involvement with the business and strategy of public corporations.

[T]he board's responsibility goes beyond the "adoption of a strategic planning process." The board should be responsible for contributing to the development of strategic direction and approving a strategic plan that takes into account an identification of business opportunities and business risks. It should oversee and monitor management's systems for managing business risk. And it should regularly review, with management, the strategic environment, the emergence of new opportunities and risks, and the implications for the strategic direction of the company.²⁰⁴

202. For criticism of this requirement, see Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, (UCLA School of Law, Research Paper No. 02-15, 2002), available at http://www.ssrn.com/abstract_id=317121.

203. Donald Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 80 (2007) (stating that outside directors "primarily function[] as a substitute for external regulation").

204. CHARTERED ACCOUNTANTS OF CANADA, TORONTO STOCK EXCHANGE: JOINT COMMITTEE ON CORPORATE GOVERNANCE, BEYOND COMPLIANCE: BUILDING A GOVERNANCE CULTURE 23 (2001), available at http://www.ecgi.org/codes/documents/beyond_compliance.pdf.

The experience with AIG highlights the service role of the directors. There is a strong case for its inclusion in the growing body of mandatory governance standards for public corporations.

B. Board Composition and Director Independence

Independent directors, as noted earlier, had their origin in the complaint that the boards of public corporations were dominated by their powerful CEOs and other managers who owed loyalty to the CEOs.²⁰⁵ As a result, the boards were mostly nothing but groups of insiders. The outsiders on the board, who were quite small in number, were equally loyal to the CEO and his team of managers.

Starting from here, corporate theory stressed that the directors must be “independent.”²⁰⁶ This conception of director independence is quite simple—it is merely concerned with the absence of any direct relationship between the Non-Management Directors (NMDs) and the companies.²⁰⁷ This principle informs the definition of director independence in New York Stock Exchange Listing Rules²⁰⁸ and the Sarbanes–Oxley Act.²⁰⁹

Recently, a recommendation has been made that the CEO must be the only executive on the board.²¹⁰ This represents a rather extreme form of the adversarialism discussed earlier. The idea, apparently, is to convert board meetings into a form of inquisition where the lone CEO will be vigorously questioned by a group of outside directors. While the measure could be theoretically effective in achieving this, its consequences for the board culture and the service function would be serious. Warren Buffett has provided insightful comments on the deficiencies in the current emphasis in the concept of director independence.²¹¹

In AIG’s case, NMDs have been in a large majority in the recent years while it was active in the credit derivatives business.²¹² AIG came quite close to attaining the questionable ideal of having just one executive director on its board.²¹³ This is despite the fact that the company *has* a 2-to-1 norm for non-executive and executive directors. This recognizes the importance of executive directors and the company-specific business

205. See, e.g., MACE, *supra* note 123.

206. See generally Jeffrey Gordon, *supra* note 2.

207. The word “independent” is rather inadequate, as it does not capture the underlying dynamics. Donald C. Clarke has made a more nuanced classification, which begins with the omnibus term, “Non-Management Directors” (NMD), to refer to external directors. Clarke, *supra* note 203, at 80–81. Within this broad group, Clarke has identified different classes, such as “independent,” “outside,” and “disinterested.” *Id.*

208. NYSE, Inc., *supra* notes 133–34.

209. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775 (2002).

210. Jensen, et al., *supra* note 142, at 10. This recommendation contrasts with the earlier view of Michael Jensen & Eugene Fama that they would “expect the board of a large open corporation to include several of the organization’s top managers.” Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 314 (1983).

211. Letter from Warrant Buffett, *supra* note 99, at 17.

212. See AIG’s Annual Statutory Reports of Form 10-K for the respective years. AIG, 2002 Form 10-K, *supra* note 54; AIG, 2003 Form 10-K, *supra* note 63; AIG, 2004 Form 10-K, *supra* note 74; AIG, 2005 Form 10-K, *supra* note 76; AIG, 2006 Form 10-K, *supra* note 78; AIG, 2007 Form 10-K, *supra* note 40.

213. See *supra* note 140 and accompanying chart (illustrating the composition of AIG’s Board of Directors from 2002–07).

knowledge they would bring to the board.²¹⁴ But AIG abandoned this principle, and executive directors became a minority of 2 in a board of 15 and 16 directors in the crucial years of 2006 and 2007, respectively.²¹⁵

There is a considerable body of literature that questions the value of NMDs to corporations. A 1998 study concluded that there was no relationship between board structure and corporate performance.²¹⁶ A more recent study has presented evidence that suggests that board independence has no correlation to long-term financial performance of corporations; indeed, it may harm the performance.²¹⁷

Despite the emphasis on the principle of director independence, there is no certainty that NMDs are truly “independent,” and whether the club atmosphere in corporate boards that Myles Mace pointed out continues substantially.²¹⁸ Recently Lauren Cohen et al. found that factors such as studying at the same academic institution as the CEO or CFO of a corporation continue to be relevant in the appointment of independent directors. This raises questions about the ability of directors selected on these criteria to play the monitoring role that corporate theory assigns them.

The AIG episode underscores the need to refine the ideas about board composition, outside directors, and intra-board relationships.²¹⁹ It is important that the governance standards require a judicious mix of inside directors and NMDs, and streamline the relationship between the two groups. Director independence of the variety stressed in the Sarbanes–Oxley Act is unlikely to be effective in promoting the healthy and responsible governance of public corporations.²²⁰

C. The Standard of Care

A plea made in this article is for treating directors as the guardians of corporate interests. If the directors are to be recognized as the guardians of corporations,²²¹ then it would be axiomatic that they must exercise proper care in performing their functions. They must apply reasonable care on an ongoing basis. This issue would be particularly relevant for the service function of the directors—their involvement in corporate business strategy and providing expert advice to managers.

214. The importance of balancing executive and outside directors was stressed by THE CADBURY REPORT, *supra* note 1, ¶ 4.1.

215. See *supra* note 140 and accompanying chart (illustrating the composition of AIG’s Board of Directors from 2002–07).

216. Dan R. Dalton et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 278 (1998).

217. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 267 (2002).

218. Lauren Cohen et al., *Hiring Cheerleaders: Board Appointment of “Independent” Directors* 13 (Nat’l Bureau of Econ. Research Working Paper No. 14232, 2008), available at <http://ssrn.com/abstract=1230856>.

219. On these issues, see generally Langevoort, *supra* note 200 (explaining existing literature on the matter).

220. The independence requirement is set forth in section 301 of the Sarbanes–Oxley Act of 2002. Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (2002).

221. This is a fairly big “if,” considering the limited role that has been assigned to the directors in recent American corporate theory. Directors as the guardians of corporate interests would conflict with the prominent notion that they are essentially watchdogs whose job is to keep the managers in check and protect shareholder wealth.

Directors' standard of care as a governance principle and the legal rules on duty of care are, at present, two different animals. One must not be confused with the other. The current legal rule on directors' duty of care is mostly concerned with holding the directors accountable, ex post, for specific failures.²²² It is apparent that the rule had its origin in the tort concept of negligence and the measure for directors' degree of care is what "a person in a like position would reasonably believe appropriate under similar circumstances."²²³ The law on directors' duty of care is a product of adversarial litigation in cases centered around specific facts.²²⁴

Another difficulty with the duty of care cases is the fact that they have mostly been about the monitoring function of the directors. Two examples of this are CEO pay²²⁵ and share price in takeovers.²²⁶ The principles of these cases would be quite inappropriate in developing an affirmative standard of duty for guiding the directors in their service function.

Delaware has not codified the duty of care applicable to corporate directors.²²⁷ On the contrary, its statute permits corporations to exclude monetary liability for directors for breach of the duty of care, except in cases of bad faith of the directors.²²⁸ The bad faith standard that has been applied for directors' duty with respect to legal compliance has met with veiled criticism.²²⁹ Tracing the law on duty of care, Stephen Lubben and Alana Darnell have recently concluded that "the classic duty of care no longer exists in Delaware."²³⁰

The business judgment rule casts another shadow on directors' duty of care. The business judgment defense had its origin in the idea that corporations must have commercial freedom and courts must not sit in appeal over, or "second-guess," business decisions.²³¹ Strictly speaking, the business judgment rule operates in a different field and must have little relevance in determining whether the directors exercised due care.²³²

222. For a commentary on directors' duty of care, see DOUGLAS M. BRANSON, *CORPORATE GOVERNANCE* 247-323 (1993).

223. AMERICAN BAR ASSOCIATION, *MODEL BUSINESS CORPORATIONS ACT* § 8.3(b) (2005).

224. This is evident from most discussions of the subject. See, e.g., Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor* (Nov. 19, 2008), NYU Law and Economics Research Paper No. 08-57, available at <http://ssrn.com/abstract=1304272> (last visited May 9, 2010).

225. E.g., *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 760 (Del. Ch. 2005).

226. E.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

227. The recent decades have witnessed a trend in the common law jurisdictions for codification of the standards for directors' duties. Canada provided the lead in 1975 Canada Business Corporations Act, R.S.C., ch. C-44, §§ 122-24 (1985). The latest jurisdiction to codify directors' duties is the United Kingdom. Companies Act 2006, ch. 46, §§ 171-77 (Eng.).

228. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010). This provision was inserted after the court held the directors in breach of the duty of care in *Smith v. Van Gorkom*, *supra* note 226.

229. See generally Jennifer Arlen, *supra* note 224, at 25. (highlighting the changing duty of directors).

230. Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 591 (2006). However, the authors also point out that judicial intervention is not completely absent and the courts sometimes interfere with corporate decisions by resort to other rules such as loyalty.

231. William Allen, former Chancellor of the Delaware court, has recently bemoaned the erosion of the business judgment rule and referred to "some tendency of courts to be willing to review . . . director decisions at least in some settings." William T. Allen, *Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law*, Davies Fund Lecture in Business Law (Jan. 22, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105591.

232. This is pointed out by Fried W. Triem, *Judicial Schizophrenia in Corporate Law: Confusing the*

Nonetheless, courts have quite often applied the business judgment rule while examining directors' duty of care.

Yet another issue is indemnification of directors and providing them insurance coverage. These practices have statutory sanction.²³³ The Delaware statute restricts indemnity to acts done in good faith, but places no limitations on the scope of the insurance coverage that a corporation can purchase for its directors and officers.²³⁴ While the safeguards of indemnity and insurance are essential in a world of part-time external directors, they dilute the principle that boards are responsible for overseeing corporations.²³⁵ In any event, the whole picture on directorial accountability is clouded by the statutory option provided to the corporations to exempt their directors from liability for breach of the duty of care, subject to limited exceptions.²³⁶

The slippery legal slope described above is hardly the appropriate ground for erecting a stable structure for directors' duty of care as a principle of governance. The legal rules, with their origin in the tort of negligence, cannot be the starting point for developing an affirmative duty of care for the directors of public corporations. The directors, both internal and external, are usually experts in their respective fields and this must be factored into the duty of care applicable to them.

Despite its limitations, the law offers some valuable clues in formulating a standard of care as an affirmative principle of governance. The line of inquiry adopted in some legal cases can provide guidance in streamlining directors' responsibilities and their duty of care. To illustrate, courts have recognized the duty of directors to "become familiar with the fundamentals of the business in which the corporation is engaged"²³⁷ and the duty to stay informed.²³⁸

The legal duty of directors to make inquiries is, however, somewhat unclear. In *Deal v. Johnson*,²³⁹ the directors were held not liable although they simply accepted bland assurances from the president of the corporation who bankrupted the company by speculating. The directors failed to make any inquiries. In California, the law places the directors under a duty to make inquiries in limited circumstances.²⁴⁰ The directors must make "reasonable inquiry when the need therefor is indicated by the circumstances."²⁴¹

In AIG's case, as noted earlier, the primary difficulty is in determining how far the

Standard of Care with the Business Judgment Rule, 24 ALASKA L. REV. 23, 29–31 (2007).

233. DEL. CODE ANN. tit. 8, § 145 (2010).

234. *Id.* § 145(g).

235. A recent study shows that cases brought against directors are almost routinely settled, if they survive the motions stage. Insurance has been identified as an important factor in this trend. Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 762 (2009).

236. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2010). A recent survey of the top 100 Fortune corporations found that all but one of them had opted to exempt their directors from liability. J. Robert Brown, Jr., & Sandeep Gopalan, *Opting Only in: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285, 288 (2009).

237. *Francis v. United Jersey Bank*, 432 A.2d 814, 821–22 (N.J. 1981).

238. *Harman v. Willbern*, 374 F. Supp. 1149, 1164 (D. Kan. 1974).

239. *Deal v. Johnson*, 362 So. 2d 214 (Ala. 1979).

240. CAL. CORP. CODE, § 309(b) (2006).

241. *Id.*

directors were involved with the default swaps business.²⁴² The ambiguity in the current structure of governance, which I have pointed out here, was recently demonstrated in *In Re Citigroup Inc. Shareholder Derivative Litigation*.²⁴³ The shareholders of Citigroup, another major corporation that suffered in the credit crisis, brought the action questioning the performance of the directors specifically in the context of the credit derivatives business. The charge made against the directors concerned the company's investments in the Special Investment Vehicles (SIV) that were unable to pay off maturing debt.²⁴⁴ The Delaware Court of Chancery pointed out that "[p]laintiffs do not adequately plead that the asset purchases or the investments in SIVs were the result of board action rather than inaction."²⁴⁵

Setting out the major functional responsibilities of the directors can be a good starting point both for streamlining corporate governance and for developing an affirmative standard of care for the directors of public corporations. In this endeavor, legal inputs can be valuable. The need to gain familiarity with the business model of the companies, to keep themselves informed and to inquire have all been issues in litigation and they can enrich the debate on developing an appropriate standard-of-care framework for the directors.

VI. CONCLUSION

With the AIG episode as a case-in-example, this Article argues for regulatory intervention in corporate governance through a blend of corporate theory and management principles. Intervention is advocated in the areas of board composition, role and responsibilities, and defining the standard of care applicable to directors. These measures can close many of the gaps in the governance framework that were at least partly responsible for the AIG episode and other failures in the recent credit crisis.

For two reasons, federal intervention would be the workable means for achieving these goals. Delaware, with its focus on the revenue from incorporation,²⁴⁶ is unlikely to take meaningful action. Indeed, the recent decision *In re Citigroup Shareholders Derivative Action* suggests that nothing is wrong with the status quo.²⁴⁷ With the Sarbanes-Oxley Act, federal law has made a beginning in shaping corporate governance,²⁴⁸ and the proposals made in this article would be in keeping with the trend.

242. See *supra* Part III.A (examining AIG's disclosures and statements on credit derivatives from 2002–07).

243. *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

244. *Id.*

245. *Id.* at 135 n. 96. The decision appears to be based on "policy" considerations. In the case of Citigroup, there is some prima facie evidence of director involvement. A news report implicated Robert Rubin, a director, and Charles Prince, CEO and director, in the credit derivatives business. Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1. Apparently, the court was not willing to launch a factual inquiry.

246. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (citing 54 Del. Laws 724 (1963) and noting the importance of incorporation revenues to the state). For a plea in favor of status quo, see generally Bernard S. Sharfman, *The Enduring Legacy of Smith v. Van Gorkom*, 33 DEL. J. CORP. L. 287 (2008).

247. *In re Citigroup Inc.*, 964 A.2d 106.

248. See generally Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39 (2005) (focusing on potential changes in corporate law as federal regulation increases); see also

Significantly, the Securities and Exchange Commission has already initiated action on the recent failures in the financial sector—more specifically into the role of the directors.²⁴⁹ Considering the greater readiness of the federal government, it would be more realistic to look for meaningful action on the securities law front.

Intervention in corporate governance must necessarily encounter arguments about costs and the consequences for economic efficiency. It is difficult to see how rules that require the directors of public corporations to treat their responsibilities with greater seriousness can undermine efficiency, in any sense of the word. In any event, these arguments would likely have less validity and appeal in the current climate given the massive failures in the financial corporations and its impact on the general economy.

The regulatory goal must be to develop a stable and efficient set of standards to govern public corporations.²⁵⁰ This calls for greater convergence between corporate theory and management theory. Such efforts would wean corporate law away from what Joseph Raz called the “lawyer’s perspective,” which is preoccupied with disputes and adjudication in adversarial litigation.²⁵¹ For corporations, it would be more appropriate for the law to adopt the “institutional approach,” which Raz offered as a contrast to the lawyer’s perspective.²⁵² In the institutional model, the law would be informed by the consideration of building healthy and efficient institutions, rather than being overly concerned with the outcome in legal cases.²⁵³

The proposals for regulatory standards made in this article involve neither bureaucratic oversight of the traditional style, nor do they rely on the “command-and-control” principle. It is also unlikely that codification of directors’ responsibilities or their standard of care would impose significant additional costs on the corporations—costs that are not commensurate with the goals to be accomplished. The standards are intended to carve out a more meaningful role for the directors of public corporations that is aligned to corporate theory. After all, the statutes vest very substantial powers in the directors, and it is not unreasonable to expect that they exercise these powers in a diligent manner and act with greater seriousness in discharging their responsibilities. These measures would, hopefully, lead to better functioning boards for public corporations and better governance.

Mark Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003).

249. Zachary A. Goldfarb, *SEC to Examine Boards’ Role in Financial Crisis*, WASH. POST, Feb. 20, 2009, at D01.

250. Chris Riley has predicted increasing “juridification”—a process by which codified regulations will progressively guide the governance of public corporations. Chris Riley, *The Juridification of Corporate Governance*, in THE REFORM OF UNITED KINGDOM COMPANY LAW 179, 200 (Cavendish Publ’g 2002).

251. J. Raz, *The Problem About the Nature of Law*, in 3 CONTEMPORARY PHILOSOPHY: A NEW SURVEY 115–16 (Martinus Nijhoff 1982).

252. *Id.*

253. *Id.*