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THE FIFTH ABRAHAM L. POMERANTZ LECTURE

THE NEW CORPORATE LAW

*Joel Seligman**

INTRODUCTION

My thesis is a simple one. In the twentieth century state corporate law norms for the large publicly held corporation have been progressively supplanted by federal standards, particularly those originating in federal securities law. This has occurred both because of the promulgation of new federal standards and because of the atrophy of state corporate law.

Certain applications of this thesis are little questioned today. For instance, it is now a conventional idea that the state law applicable to insider trading has largely been ignored and has been generally displaced by such federal securities law staples as Rule 10b-5,¹ section 16 of the Securities Exchange

* Professor of Law, The University of Michigan Law School. I would like to express gratitude to Professors Al Conard, Merritt Fox, Harvey Goldschmid, and Louis Loss, as well as Harold Marsh, Jr., for critically reading drafts of this essay.

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¹ 17 C.F.R. § 240.10b-5 (1993).

Act of 1934 ("1934 Act"),² and Rule 14e-3.³ Similarly, it is commonly understood that certain of the most fundamental principles of corporate suffrage emanate from the federal proxy rules, and not from state corporate law.⁴ I want to urge, however, that the process of augmenting state corporate law fiduciary duty concepts with federal securities law disclosure standards and fraud cases is also quite advanced and, of late, has been accelerating.

Let me illustrate the extent to which federal securities has become "the new corporate law" by focusing on the two most fundamental fiduciary duties, the duty of loyalty and the duty of care. In doing so, I want to emphasize three implications of this new corporate law. First, a transition from state fiduciary duty concepts to this new corporate law portends a change in the primary remedial theory of corporate law. Where state law fiduciary duties essentially are grounded in a compensatory purpose, the primary purpose of most Securities and Exchange Commission ("SEC") enforcement actions is deterrence. This means, among other things, that the federal standards have exploited the relatively greater flexibility of the administrative process to employ a host of different types of interventions into dysfunctional corporations such as cease and desist orders or administrative proceedings against corporate attorneys or accountants—interventions that are essentially unavailable in state corporate law.

Second, as the transition is made from a focus on traditional corporate law duty of care concepts to a new corporate law based on federal securities law, the significance of accounting and auditing to corporate governance becomes more evident. In the real world, the language of corporate governance is accounting. Boards of directors are concerned with whether they were adequately informed before making a decision. But they express this concern in such terms as, "Do we have adequate internal controls?" or "Was that process sufficiently audited?" Similarly, most corporations are managed by comparing

² 15 U.S.C. § 78p (1988).

³ 17 C.F.R. § 240.14e-3 (1993). Compare 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3466-85 (1991) (state common law) with 7 *id.* at 3485-3545 and 8 *id.* 3547-70 (federal insider trading law).

⁴ See 4 *id.* at 1916-2119.

actual performance to annual or more frequent internal operational budgets or business plans. These plans or budgets are projections of future earnings and expenses. When a corporation's performance is significantly short of the "plan," this usually is a signal or "red flag" for senior officers or the board to investigate. The occasional state law duty of care proceeding has largely been succeeded today by a host of federal securities proceedings against corporate issuers or their accountants for deficient use of accounting standards in auditing procedures.

Third, and more broadly, the new corporate law has significant implications for the process of corporate governance. While state corporate law interventions long have been largely *ex post* fiduciary duty litigations against corporate officers and directors, the emphasis of federal securities law reporting requirements is to prevent corporate dysfunction from occurring by requiring compliance with detailed disclosure standards *ex ante*.

While federal securities law has been the more dynamic partner in the recent development of corporate law norms, state corporate law today also retains a significant role. This role is not confined to the residual function of developing the nuts and bolts standards of corporate law, but on occasion has also been dynamic and creative. What I urge is that the general tendency of corporate law development is progressively tilted toward federal norms, but this is a process not without considerable backing and filling. There is no reason at this time to assume that federal standards soon will totally preempt the corporate law field, even for the largest public corporations. In the concluding part of this Article I briefly discuss the extent to which there may be today a case for the enactment of concurrent federal fiduciary duty standards.

I. THE DUTY OF LOYALTY

The duty of loyalty is the most important fiduciary duty of corporate officers and directors. This duty requires that officers and directors not profit at the expense of their corporation, whether through self-dealing contracts, usurpation of corporate opportunities, or other means. The duty applies also to parent corporations in their treatment of subsidiaries in such transac-

tions as mergers. The duty is applicable typically when a director, officer, or parent corporation has a conflict of interest; for example, when influencing or potentially influencing both sides in a contract negotiation.

In an often-cited article, Harold Marsh traced the loosening of legal restrictions on transactions involving conflicts of interest.⁵ In 1880 he wrote: "[I]t could have been stated with confidence that in the United States the general rule was that any contract between a director and his corporation was voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction."⁶ Typical of decisions of this period was *Munson v. Syracuse, Geneva & Corning Railway*,⁷ which termed this type of limitation as "the great rule of law."⁸ This prohibition was grounded in concepts that today might be called "structural bias."⁹ As the Maryland Supreme Court wrote in 1875 of the

⁵ Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

⁶ *Id.* at 36.

⁷ 103 N.Y. 59 (1886).

⁸ *Id.* at 73.

⁹ For a description of possible structural bias when a board of directors' litigation committee recommends dismissal of a lawsuit brought against other members of the board, see James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 962-63:

Commentators have explained in detail why the special litigation committee's independence may be more apparent than real. Their concern is founded on the observation that the defendants and the members of the special litigation committee share a common cultural bond: directorship of a public corporation. The natural empathy and collegiality that this bond engenders makes an adverse judgment of a colleague's behavior distasteful at best. Also, when the committee is formed after the instigation of the derivative suit, the situation is rife with opportunities for the defendants to select for committee membership those directors most sympathetic to their position. The committee's independence may be further undermined by its members' desire to curry favor with their fellow directors or with the business community in general. Finally, special litigation committees operate under the constant threat of dissolution should they displease the board by pursuing the plaintiff's cause with excessive zeal.

The likelihood that these factors will corrupt the committee's independent judgment will be referred to as "structural bias."

Professor Cox amplified his argument in two subsequent articles, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (Summer

inflexibility of this rule, when a contract was entered into with even one director, "the remaining directors are placed in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and accounts of one of their own body, with whom they are associated on terms of equality in the general management of all the affairs of the corporation."¹⁰

Great or otherwise, this rule proved short lived. By 1910, Marsh concluded

the general rule was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged; but that a contract in which a majority of the board was interested was voidable at the instance of the corporation or its shareholders without regard to any question of fairness.¹¹

Marsh expressed some puzzlement for this abrupt shift in legal philosophy: "[d]id the courts discover in the last quarter of the Nineteenth Century that greed was no longer a factor in human conduct?"¹² The only explanation Marsh found in judicial opinions for this change in position "was the technical one that a trustee, while forbidden to deal with himself in connection with the trust property, could deal directly with the *cestui qui trust* if he made full disclosure and took no unfair advantage"¹³

I think one can go further and acknowledge that the absolute prohibition of the 1880 period was an unworkable rule, at least for the publicly traded corporation. The notion, for example, that a competitor could acquire stock in a particular corporation and block its acquisition of a desirable patent from a director-inventor—even at a fair price—would have required the perpetuation of an excessively rigid standard. Nonetheless there were some teeth in the 1910 approach. For the courts

1985); James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984); see also Hasan v. Clevetrust Realty Investors, 729 F.2d 372, 376-77 (6th Cir. 1984); Miller v. Register and Tribune Syndicate, Inc., 336 N.W.2d 709, 716-18 (Iowa 1983).

¹⁰ *Cumberland Coal & Iron Co. v. Parish*, 42 Md. 598, 606 (1875).

¹¹ Marsh, *supra* note 5, at 39-40.

¹² *Id.* at 40.

¹³ *Id.*

were willing in some instances to invalidate contracts when less than a majority of the board voted for an interested transaction when it found that "[a] dominating influence may be exerted in other ways than by a vote."¹⁴

Even this limited willingness of the courts to invalidate contracts when a majority of the board was interested in a transaction dissipated over time. By 1960, in Marsh's view,

it could be said with some assurance that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation.¹⁵

In retrospect, it seems clear that the most significant basis for abandoning the principle of automatic invalidation of conflict of interest transactions (at least those involving a majority of the board) has been the adoption of so-called safe harbor statutes¹⁶ by approximately forty-five states through 1992. These statutes provide, in essence, that no contract or transaction between a director or officer and the corporation shall be void or voidable solely because of this conflict of interest if there has been disclosure of the relevant material facts to the board of directors, a board committee, or the shareholders who approve the transaction by the vote of a disinterested majority or the contract or transaction is fair to the corporation.¹⁷ Under this type of statute in Delaware, approval of an interested transaction by a majority of disinterested directors or stockholders is subject to review under the business judgment rule.¹⁸

¹⁴ *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 489, 121 N.E. 378, 379-80 (1918).

¹⁵ Marsh, *supra* note 5, at 43.

¹⁶ AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §5.02, at 312-25 (Proposed Final Draft Mar. 31, 1992).

¹⁷ Compare DEL. CODE ANN. tit. 8, § 144(a) (1992) with AMERICAN LAW INSTITUTE, *supra* note 10, at § 5.02.

¹⁸ *Marciano v. Nakash*, 535 A.2d 400, 405 n.3 (Del. 1987); *Citron v. E. I. Du Pont de Nemours & Co.*, 584 A.2d 490, 500-01 (Del. Ch. 1990); cf. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983) (same rule for approval by disinterested shareholder approval); *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976) (disinterested director or shareholder approval shifts the burden of persuasion to the person challenging the transaction).

The practical significance of the decline of the duty of loyalty between 1880 and 1960 was great. As Dennis Block, Nancy Barton and Stephen Radin stated in *The Business Judgment Rule*,¹⁹ there were five traditional aspects of the duty of loyalty: "interested director transactions, usurpation of corporate opportunities, executive compensation, transactions between a dominating shareholder and the corporation and the sale of control at a premium."²⁰ These authors concluded: "The courts have utilized business judgment rule analysis to one degree or another in connection with the first four of these issues; the rule has no applicability with regard to the fifth."²¹

The difference between a duty of loyalty review of a transaction where the defendants have the burden of persuading a court that the transaction was fair—that is, it would have been approved by a disinterested board negotiating at arm's length with a stranger²²—and a business judgment rule analysis, where the plaintiff must persuade the court that a director or officer did not rationally believe that his or her business judgment was in the best interests of the corporation²³ (a burden

¹⁹ DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS* 49 (1988).

²⁰ *Id.* at 72.

²¹ *Id.* In 1990, after these words were written, one Delaware Chancery Court opinion suggested that recent decisions may have backed away from applying the business judgment rule in parent-subsidiary transactions. See *Citron*, 584 A.2d at 500 n.13.

²² See, e.g., *Weinberger*, 457 A.2d at 710-11:

When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], including all relevant factors However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as whole since the question is one of entire fairness.

²³ An often-cited Delaware articulation of the business judgment rule appears in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985):

Under Delaware law, the business judgment rule is the offspring of

requiring proof in Delaware of the equivalent to gross negligence),²⁴ is a fundamental one in corporate law. Directors and officers very rarely lose lawsuits when they are subject to a business judgment rule review. The odds are considerably less favorable when directors or officers themselves must prove the fairness of contracts or transactions they enter with their corporations.²⁵

I want now to add two claims to this history: first, the period after 1960 has seen a further decline in the state law duty of loyalty because of both the frequent characterization of tender offer defenses and other transactions as requiring a business judgment, rather than a duty of loyalty, analysis and

the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors. In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." . . . Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves "prior to making a business decision, of all material information reasonably available to them."

Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty

The standard of care applicable to a director's duty of care has also been recently restated by this Court. In *Aronson* [*Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)]; we stated:

While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.

We again confirm that view. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

Id. at 872-73 (citations and footnote omitted).

²⁴ *Id.* at 873.

²⁵ Cf. David S. Ruder, *Duty of Loyalty—A Law Professor's Status Report*, 40 BUS. LAW. 1383 (1985), which besides discussing Marsh, *id.* at 1387-89, found "remarkable uniformity," in the leading law school casebooks of the day in their treatment of the duty of loyalty. *Id.* at 1384.

the use of the litigation committee and kindred procedural devices to resolve duty of loyalty and other cases without a trial on the merits. Second, paradoxically, as the significance of the state law duty of loyalty has declined, the deterrent force of the duty of loyalty at the federal level has somewhat increased, largely because of the "new corporate law," which effectively has transformed traditional state law doctrines such as the duty of loyalty into federal securities law disclosure and fraud concepts.²⁶

A. *The Further Decline of the State Law Duty of Loyalty*

One significance of the duty of loyalty safe harbor statutes and related court decisions is that they provide a procedure by which transactions which might otherwise be subject to state law fairness review are instead less rigorously scrutinized under the business judgment rule. For example, if a corporate chief executive officer ("CEO") was a board member and the full board were to approve his or her compensation, the CEO might be involved in negotiating with himself or herself (as an individual executive on the one hand and a board member on the other), and be subject to a duty of loyalty requiring the CEO to carry a burden of persuasion and prove that the compensation contract was fair to the corporation. If, however, all of the directors delegate negotiation and approval of compensation contracts to a board committee on which the CEO does not sit, and that committee is fully informed of all material facts, the transaction is subject to the waste doctrine (an analogue of

²⁶ In making these claims I want to highlight two limitations to my analysis. I have focused exclusively on publicly traded corporations, ignoring what I concede are quite different recent developments concerning close corporations, see, e.g., *Donahue v. Rodd Electrotype Co. of New Eng., Inc.*, 328 N.E.2d 505 (Mass. 1975), and other nonpublicly traded firms. I have also largely focused my analysis of case law on Delaware decisions, both because a substantial plurality of the nation's largest corporations are incorporated there, see N.Y.S.E. Guide (CCH) (as of May 31, 1992, 843 of 1,816 domestic NYSE corporations (46 percent) were incorporated in Delaware), and because Delaware has a more highly developed corporate law case law than any other state. For example, in Michigan where I live, the courts look to Delaware law when there is no Michigan corporate law opinion on point. See, e.g., *Estate of Detwiler v. Offenbecher*, 728 F. Supp. 103, 150 (S.D.N.Y. 1989); *Gray v. Zondervan Corp.*, 712 F. Supp. 1275, 1280-81 (W.D. Mich. 1988); *Priddy v. Edelman*, 679 F. Supp. 1425, 1430 (E.D. Mich. 1988), *aff'd*, 883 F.2d 438 (6th Cir. 1989).

the business judgment rule), which will only proscribe a contract in Delaware if the objecting shareholders convince the court that "no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given."²⁷

This type of procedure gives a director or officer a choice. If negotiation and approval of a contract or transaction is made by an independent or disinterested committee that is fully apprised of the material facts, then the courts generally will defer to these procedural safeguards. One could debate whether or not a board committee could be sufficiently independent in this context to justify business judgment rule review,²⁸ but that is not my purpose here. Rather I want to highlight the frequency since 1960 with which the courts in Delaware and elsewhere have been willing to apply a business judgment rule review to transactions when a board has not, at least initially, adopted these types of procedural safeguards.

1. Characterization of Tender Offer Defenses

When a board of directors is confronted with an unsolicited tender offer, does the board have a conflict of interest if it adopts a defense? In the abstract, this question may be viewed as turning on whether or not a director's or officer's continued employment, powers or perquisites within a corporation is properly characterized as involving a sufficient personal benefit to justify the more rigorous fairness review of the duty of loyalty. The law is unsettled here. Cases in New York,²⁹ Cali-

²⁷ *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962). The Chancery Court added:

Where waste of corporate assets is alleged, the court, notwithstanding independent stockholder ratification, must examine the facts of the situation. Its examination, however, is limited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid. If it can be said that ordinary businessmen might differ on the sufficiency of the terms, then the court must validate the transaction.

Id.; see also *Beard v. Elster*, 160 A.2d 731 (Del. 1960).

²⁸ *Cf. supra* note 9 (discussion of structural bias).

²⁹ See, e.g., *Norlin Corp. v. Rooney Pace, Inc.*, 744 F.2d 255, 264-67 (2d Cir. 1984) (New York law).

foria,³⁰ Michigan³¹ and a distinct minority in Delaware³² have applied the duty of loyalty to tender offer defenses, but usually under extreme circumstances. A few decisions from various other jurisdictions review tender offer defenses by applying the same business judgment rule that would be applicable to a decision to build a new plant unfettered by director or manager self-interest.³³

The dominant strain in recent cases, however, appears to be a modified business judgment rule that developed in Delaware during the past thirty years. This is, in effect, a tripartite standard. First, the burden of proof is placed on the board to show reasonable ground to believe that a danger to corporate policy or effectiveness is posed by a tender offer. "[D]irectors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made."³⁴ Second, in 1985 the Delaware Supreme Court, in *Unocal Corp. v. Mesa Petroleum Co.*,³⁵ added a further aspect to the board's duty when exercising its power to forestall a takeover bid—"the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to

³⁰ Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 128, (Cal. Ct. App. 1985) ("Once it is shown a director received a personal benefit from the transaction . . . the burden shifts to the director to demonstrate not only the transaction was entered in good faith, but also to show its inherent fairness from the viewpoint of the corporation . . .").

³¹ Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986).

³² In Delaware, when a board's primary purpose is to perpetuate its own control, a tender offer defense will be analyzed under the duty of loyalty. See, e.g., Mills Acquis. Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) ("[J]udicial reluctance to assess the merits of a business decision ends in the face of illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries."); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 408 (Del. 1985).

³³ See, e.g., Radol v. Thomas, 772 F.2d 244, 256-58 (6th Cir. 1985), cert. denied, 477 U.S. 903 (1986) (Ohio law); Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 719-24 (5th Cir. 1984) (Texas law); Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374 (7th Cir. 1984) (Illinois law); Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir.) (Delaware law), cert. denied, 454 U.S. 1092 (1981); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 701-03 (2d Cir. 1980) (New York law); Treadway Co. v. Care Corp., 638 F.2d 357, 382-83 (2d Cir. 1980) (New Jersey law).

³⁴ Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964).

³⁵ 493 A.2d 946 (Del. 1985).

the threat posed."³⁶ Third, the Delaware Supreme Court further held in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*³⁷ that when the target is put up for sale, "[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."³⁸ Any defense against a hostile bid is "no longer a proper objective."³⁹ A subsequent Delaware Supreme Court decision has characterized violations of *Revlon* as involving violations of both the duty of care and of the duty of loyalty.⁴⁰

Let me return to my initial question: Why isn't the retention of corporate positions, power, or perquisites deemed a sufficient interest to justify a duty of loyalty analysis?⁴¹ There is little question that an executive who causes the board to offer him or her a desirable compensation arrangement would be subject to a duty of loyalty analysis. Yet, in Delaware, if the same executive causes a board to adopt a tender offer defense that frustrates the offer, he or she will generally not be viewed as subject to the same duty of loyalty analysis even though the practical consequence of the defense may be to perpetuate desirable compensation arrangements for the foreseeable future. Why not? A triad of Delaware cases, *Kors v. Carey*,⁴² *Bennett v. Propp*,⁴³ and *Cheff v. Mathes*⁴⁴ addressed this issue in the early 1960s.

In *Kors*, a 1960 opinion, the Chancery Court found the personal interest of directors in voting for retention of their offices insufficient "in overcoming the presumption that directors form their judgment in good faith."⁴⁵ Since this business

³⁶ *Id.* at 955; see *AC Acquis. Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986); Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standards for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).

³⁷ 506 A.2d 173 (Del. 1986).

³⁸ *Id.* at 182.

³⁹ *Id.*

⁴⁰ *Mills Acquis. Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1284 (Del. 1988).

⁴¹ See *supra* notes 29-33 and accompanying text.

⁴² 158 A.2d 136 (Del. Ch. 1960).

⁴³ 187 A.2d 405 (Del. 1962).

⁴⁴ 199 A.2d 548 (Del. 1964). The Delaware Supreme Court has continued to rely on *Kors*, *Bennett*, and *Cheff* in share repurchase cases. See, e.g., *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988); *Polk v. Good*, 507 A.2d 531, 537 (Del. 1986).

⁴⁵ The relevant passage of the decision reads *in toto*:

judgment rule presumption normally is not applicable when there is a conflict of interest, this type of analysis appears to have put "the cart before the horse."

It did not stand. Two years later the Delaware Supreme Court in *Bennett* more aptly recognized:

We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest They sustained that burden in the *Kors* case; they have not done so here.⁴⁶

This language is considerably less generous than it may appear. It is true that the burden of persuasion is placed on the board, as it would be in a typical duty of loyalty case. It is further true that the court acknowledged that when directors adopt a tender offer defense, they are "of necessity confronted with a conflict of interest." But having said this, the court then stopped short of imposing on directors the burden of persuasion to prove that the transaction is fair under the duty of loyalty analysis. Instead, the directors are charged with the considerably lesser burden of showing that the "purchase is

As to plaintiffs contentions that the Lehn & Fink directors were selfishly voting for the retention of their offices and the emoluments thereof, I conclude, having heard the testimony of the principals involved and considered their personal evaluation of the dilemma posed by the existence of a substantial block of their stock in the hands of United Whelan, that plaintiff has not succeeded in overcoming the presumption that directors form their judgment in good faith, *Allaun v. Consolidated Oil Co.*, 16 Del.Ch. 318, 147 A. 257. While it appears that the five active members of Lehn & Fink's management currently receive salaries ranging from sums in excess of \$35,000 per annum to Mr. Edward Plaut's of slightly more than \$100,000 per year, that consultant directors receive compensation ranging from \$3,200 to \$12,100 and that substantial legal fees have been paid to lawyer-directors, I find no evidence that a selfish desire to retain jobs on the part of the non-managerial Lehn & Fink directors was a factor in their decision. Furthermore, assuming that Edward Plaut, who had most at stake in preserving the status quo at Lehn & Fink, was strongly influenced by family considerations in reaching his decision, nonetheless I am not persuaded that he so dominated the board that its non-managerial members were unable to make their own decisions about the purchase under attack.

158 A.2d at 141-42.

⁴⁶ 187 A.2d at 409.

one primarily in the corporate interest."⁴⁷ This usually is not difficult to demonstrate. The Delaware Supreme Court subsequently explained about the facts in *Kors*: "The evidence . . . showed clearly that United wished to control Lehn & Fink in order to force upon it a business policy that Lehn & Fink's directors believed, on manifestly reasonable grounds, would be quite injurious to their corporation."⁴⁸ This essentially reduces the substantive test in *Bennett* to a business judgment rule, albeit with the burden of persuasion on the board. Directors can fail to carry that burden if they do not make an informed judgment.⁴⁹

In *Cheff*, Delaware's supreme court returned once more to this question. After reaffirming the allocation of the burden of persuasion to defendants, the court added:

To say that the burden of proof is upon the defendants is not to indicate, however, that the directors have the same "self-dealing interest" as is present, for example, when a director sells property to the corporation. The only clear pecuniary interest shown on the record was held by Mr. Cheff, as an executive of the corporation, and Trenkamp, as its attorney. The mere fact that some of the other directors were substantial shareholders does not create a personal pecuniary interest in the decisions made by the board of directors, since all shareholders would presumably share the benefit flowing to the substantial shareholder. Accordingly, these directors other than Trenkamp and Cheff, while called upon to justify their actions, will not be held to the same standard of proof required of those directors having personal and pecuniary interest in the transaction.⁵⁰

This is both a sweeping and decisive rationalization of why in Delaware the duty of loyalty normally does not apply to a tender offer defense. The court, perhaps unreflectively, immediately subverts its own analysis by concluding: "[A] substan-

⁴⁷ *Id.*

⁴⁸ *Id.* at 408-09.

⁴⁹ The directors in *Bennett* "made no finding of immediate threat. They were not even consulted." *Id.* at 409. For a later case with a similar holding, see, e.g., *Condec Corp. v. Lunkenheimer Co.*, 230 A.2d 769 (Del. Ch. 1967). *But see* *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971).

⁵⁰ *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964) (citation omitted); *see also* *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) ("Nor does this become an interested director transaction merely because certain board members are large stockholders. As this Court has previously noted, that fact alone does not create a disqualifying personal pecuniary interest to defeat the operation of the business judgment rule. *Cheff v. Mathes*, 199 A.2d at 554.").

tial block of stock will normally sell at a higher price than that prevailing on the open market, the increment being attributable to a 'control premium.'⁵¹ Why would an investor pay more for a controlling block of stock than for a smaller lot if control itself did not have value to the board members or others in control?⁵² The court simply ignored this question. But if one plausible explanation is that control blocks sell for more than smaller lots because of the value of the powers and perquisites associated with control to directors and officers, then the court's assertion that "[t]he only pecuniary interest shown on the record was held by Mr. Cheff, as an executive of the corporation, and Trenkamp, as its attorney"⁵³ collapses. I submit that this *non*-analysis of the pivotal issue of whether or not the duty of loyalty should apply to tender offer defenses is equivalent to original sin. Once this omission occurs, much of what follows is preordained.

In *Cheff*, for example, the Court soon reaffirmed that the directors' burden is equivalent to the one imposed by business judgment rule:

⁵¹ *Id.* at 555.

⁵² For elaborations on the current literature concerning the possible gains from control, see, e.g., Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 606-13 (1989); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 893-901 (1988) (analyzing alternative theories of why acquirers routinely pay large premia over share prices for the assets of target firms); cf. LEWIS D. SOLOMON ET AL., *CORPORATIONS: LAW AND POLICY MATERIALS AND PROBLEMS* 996 (2d ed. 1988):

The controlling person is able to profit from a corporation in several ways, some of which are unique to his controlling position. As an investor in the corporation the controlling stockholder is in the same boat as all other investors, and will profit (or lose) proportionately the same as all others do from the affairs of the company. Most important, he can impose his will on the corporation to make the business decisions he believes are best. But the controlling person can profit in other ways as well. He can decide to hire himself and to pay himself a salary. The controlling person can cause the corporation to buy and sell property to himself. He can cause other transactions, in which he or favored friends can profit. The controlling stockholder, in effect, has the keys to the corporate treasury, and this is immense power which can be used properly or improperly. Of course, power and right are not always the same, and the law can impose barriers to improper use and impose costs on those who abuse their power, but these are not guarantees against abuse. Some exercises of power will always occur in the seams of the zone between proper and improper conduct.

⁵³ *Cheff*, 199 A.2d at 554-55.

The question then presented is whether or not defendants satisfied the burden of proof of showing reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the Maremont stock ownership. It is important to remember that the directors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made.⁵⁴

The directors satisfied the court "based upon direct investigation, receipt of professional advice, and personal observations [of the bidder] . . . that there was a reasonable threat to the continued existence of [their corporation], or at least existence in its present form"⁵⁵ To put this another way, *Cheff*, in effect, held that when directors make a reasonable investigation they can withdraw from shareholders the right to sell their stock to an unsolicited bidder at a premium if they can show a "threat" to corporate existence such as a bidder's insistence that the corporation eliminate its retail sales force.⁵⁶ The directors in essence are not charged with the burden of proving that their sales policy is superior or fair, but merely with demonstrating that after reasonable investigation the unsolicited bidder's policy is different.

A practical consequence of this "threat" analysis is to drive a wedge between the best interests of shareholders and of their corporation. While it is typically difficult to see how a tender offer with a premium on average approximately 50 percent above the preexisting stock market price⁵⁷ could "threaten"

⁵⁴ *Id.* at 555; see also *Johnson v. Trueblood*, 629 F.2d 287, 293 (3d Cir. 1980) (burden on plaintiff to show that sole or primary motive of directors was to retain control), *cert. denied*, 450 U.S. 999 (1981).

⁵⁵ *Cheff*, 199 A.2d at 556.

⁵⁶ *Id.*; cf. *Kaplan v. Goldsamt*, 390 A.2d 556, 569 (Del. Ch. 1977). As Gilson and Kraakman, *supra* note 36, at 249, put it: "Because competent counsel could always document a policy conflict between a would-be acquirer and defending management, the *Cheff* test inevitably [was] reduced to a routine application of the business judgment standard."

⁵⁷ Both Kraakman, *supra* note 52, at 892, and Black, *supra* note 52, at 598, 601, cite 50 percent (or greater) as the average premium. This figure represents successful tender offers and includes any prebid price run-up. See also Michael Bradley et al., *Synergistic Gains from Corporate Acquisitions and Their Division between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3, 11 (1988); Debra K. Dennis & John J. McConnell, *Corporate Mergers and Security Returns*, 16 J. FIN. ECON. 143, 153-54 (1986); Michael C. Jensen & Richard S.

shareholders, directors are given the alternative of arguing that the tender offer "threatens" the corporation in some other way. This challenges what long was an underlying premise of corporate law. As the Michigan Supreme Court wrote in 1919 in *Dodge v. Ford Motor Co.*,⁵⁸ "A business corporation is organized and carried on primarily for the profit of the stockholders."⁵⁹ The *Dodge* approach does not distinguish between the best interests of the corporation and those of its shareholders. They are insoluble. They are one.

The implicit derogation of shareholder interests in *Cheff*, in contrast, was made explicit in *Unocal*, the case that propounded the second aspect of Delaware's current business judgment rule analysis of tender offer defenses. *Unocal* approved a selective self-tender offer by the target corporation to all outstanding shareholders but the hostile bidder.⁶⁰ After affirming the applicability of *Cheff* to this type of selective stock repurchase,⁶¹ the Delaware Supreme Court added:

A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange. While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.⁶²

Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 9-16 (1983); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990).

⁵⁸ 170 N.W. 668 (Mich. 1919).

⁵⁹ *Id.* at 684.

⁶⁰ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985).

⁶¹ *Id.* at 955.

⁶² *Id.* at 955-56. Subsequent Delaware cases have relied on *Unocal* or both *Unocal* and *Cheff* in a variety of contexts. See, e.g., *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1143-48 (Del. 1990) (tender offer settlement agreement); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1151-54 (Del. 1990) (merger agreement); *Mills Acquis. Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1287-88 (Del. 1988) (asset lockup option); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d

This language requires careful parsing. When one examines the element of balance, one analyzes "the nature of the take-over bid and its effect on the corporate enterprise." No longer is the inquiry the narrow one: will an offer primarily be for the profit of stockholders. Now one can examine "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)." ⁶³ Moreover, "the basic stockholder interests at stake" can be derogated by characterizing them in whole or in part as the interests of "short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long-term investor." ⁶⁴ If this language were to be construed broadly, it would be revolutionary in its significance. No longer would corporations be run primarily for the profit of their shareholders. Now shareholders would be just another constituency, perhaps one subject to a special stigma as "short term speculators," whose interests could be vitiated by taking into account the impact of a tender offer on other constituencies, such as the creditors, customers or employees mentioned in *Unocal*.

There is good reason to doubt that the Delaware Supreme Court intended so broad a reading. In *Revlon*, the same court wrote:

The Revlon board argued that it acted in good faith in protecting the note holders because *Unocal* permits consideration of other corporate constituencies. Although such considerations may be permissible, there are fundamental limitations upon that prerogative. A board may have regard for various constituencies in discharging its

1334, 1341-43, 1351-58 (Del. 1987) (declaration of special dividend and amendment to standstill agreement); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986) (exchange offer for company stock); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350-51, 1354, 1356 (Del. 1985) (adoption of poison pill or preferred share purchase rights plan); *Stahl v. Apple Bancorp., Inc.*, 579 A.2d 1115, 1123-25 (Del. Ch. 1990) (delay of annual meeting); *In re Holly Farms Corp.*, 564 A.2d 342, 351-52 (Del. Ch. 1989) (redemption of poison pill); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 269-71 (Del. Ch. 1989) (validity of employee stock ownership plan); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (expansion of board); *Grand Metro. Pub. Ltd., Co. v. Pillsbury Co.*, 558 A.2d 1049, 1054-56 (Del. Ch. 1988) (retention of poison pill); *AC Acquis. Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111-12 (Del. Ch. 1986) (stock repurchase).

⁶³ *Unocal*, 493 A.2d at 955.

⁶⁴ *Id.* at 956-57.

responsibilities, provided there are rationally related benefits accruing to the stockholders. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.⁶⁵

On the other hand, still later the court in *Paramount Communications, Inc. v. Time, Inc.*⁶⁶ again quoted the constituencies passage from *Unocal* without adding the *Revlon* gloss.⁶⁷ Thus, the significance of the constituencies passage in *Unocal* remains somewhat uncertain.

Perhaps most significantly, however, through 1990 at least twenty-five states had enacted "other constituency" statutes.⁶⁸ This development, which in part can be traced to *Unocal*, led the American Bar Association Committee on Corporate Laws to decline to adopt a similar revision to the Revised Model Business Corporation Act, because of what it termed a "potential for confusion:"

While legislatures may not have intended it, adding other constituencies provisions to state corporation laws may have ramifications that go far beyond a simple enumeration of the other interests directors *may* recognize in discharging their duties. Directors might have a duty to oppose a transaction with whatever means are available because it would have a demonstrably adverse impact upon one or more of the constituencies (e.g., the acquirer plans to move the headquarters from the small town in which the company had been rooted for decades resulting in community disruption and loss of jobs). Or directors might be called upon to decide how much of the premium over market price being paid in an acceptable transaction should be allocated among the various constituencies (e.g., how much should accrue to communities in which plants might be closed; how much should be allocated to the terminated hourly employees; and how much should be allocated to a supplier who might lose his market).

....

As was recently pointed out in the *Columbia Business Law Review*, the reallocation of wealth is a function for which directors are not especially suited and one beyond the general pale of their

⁶⁵ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

⁶⁶ 571 A.2d 1140 (Del. 1990).

⁶⁷ *Id.* at 1153; see also *Mills Acquis. Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989).

⁶⁸ ABA Comm. on Corp. Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

perceived mandate from society. Such allocations of wealth (which essentially a balancing of the interests of various constituencies would be) are *political* decisions. Absent the vesting of enforceable rights in those whose interests would have to be acknowledged, directors would not be accountable for their conduct in preferring the interests of one constituency over others.⁶⁹

Make no mistake about it, boards of directors did not seek to take into account other constituencies out of a new-found enthusiasm to do something nice for their employees or surrounding communities. Their motivation, pure and simple, was to adopt a new takeover defense that is applicable even when a tender offer would be in the best interests of their shareholders. This, it seems to me, is the real problem with the constituency approach. It ultimately can unhinge directors from a duty of loyalty to shareholders in one important context.

The Delaware Supreme Court has adopted one significant limitation on this broadening of a board's discretion. In *Revlon*, the court concluded when "the break-up of the company was inevitable,"⁷⁰ the duty of the board changes

from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.⁷¹

This is an unvarnished application of the duty of loyalty. However the court subsequently construed this language stingily. In *Ivanhoe Partners v. Newmont Mining Corp.*,⁷² the Delaware Supreme Court held that the board's auctioneer duty under *Revlon* applies only if it was inevitable that the target would be sold.⁷³ An increase in the holdings of the target's largest stockholder, even to 49.7 percent of the outstanding

⁶⁹ *Id.* at 2269-70; see also James J. Hanks, *Non-Stockholder Constituency Statutes; An Idea Whose Time Should Never Have Come*, 3:3 *INSIGHTS* at 20 (1989).

⁷⁰ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

⁷¹ *Id.*

⁷² 535 A.2d 1334 (Del. 1987).

⁷³ *Id.* at 1345.

shares, did not alone invoke the *Revlon* rule.⁷⁴ Similarly in *Paramount Communications, Inc. v. Time, Inc.*,⁷⁵ the court rejected the argument that Time was for sale when Warner shareholders were to receive sixty-two percent of the combined company after a merger.⁷⁶ This decision, in effect, reduces *Revlon* to a matter of form. Had Warner bought Time through a tender offer, *Revlon* would apply. In contrast, when Warner's former shareholders received a controlling interest in Time after a merger, *Revlon* did not.

I contend that Delaware's corporate law would have been far more defensible had tender offer defenses been analyzed in terms of their fairness to shareholders under the duty of loyalty, rather than through consideration of such factors as different corporate policies or impacts on other constituencies. This would not have foreclosed all defenses. For example, the same court that in *Unocal* disparaged a tender offer as involving a grossly inadequate price and a coercive two-tier bid⁷⁷ presumably would have found it fair for a board to interpose itself in a selective self-tender offer. On the other hand, under a duty of loyalty analysis it is very difficult to understand how a reasonable court could have supported Warner's offer in the *Paramount* case when Paramount's \$200 all-cash offer represented an increment of seventy-four dollars per share over where Time's stock had traded before Paramount entered the scene, unless the court had concluded that the Paramount offer was not feasible or not serious.⁷⁸

The power of the board to adopt tender offer defenses could have been limited to those instances in which the board

⁷⁴ *Id.* at 1344-45.

⁷⁵ 571 A.2d 1140 (Del. 1989).

⁷⁶ *Id.* at 1149-51; see also *In re J. P. Stevens & Co., Inc. Shareholders Litig.*, 542 A.2d 770, 781 (Del. Ch. 1988) (further limiting *Revlon* by requiring a finding that the board appeared not to be acting in good faith for the shareholders' benefit).

⁷⁷ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 945, 956 (Del. 1985).

⁷⁸ *Cf. Paramount*, 571 A.2d at 1147, 1149. In *Paramount*, the court notes that Warner was to receive 7,080,016 shares (11.1%) of Time's outstanding common stock. *Id.* at 1146. Extrapolating from this figure, Time had approximately 63,783,927 shares, which when multiplied by the \$74 increment per share offered by Paramount, deprived Time's shareholders of an aggregate premium of approximately \$4.7 billion. *Cf. also Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 407-08 (Del. 1985) (holding that it was inequitable to fund ESOP shares after control had already passed to another group).

could carry the burden of showing that a tender offer was "unfair." This could have been shown either in terms of "unfair dealing," meaning the offer could be challenged because it was not feasible or serious or unfair in some other sense, for example, that it involved a two-tier bid,⁷⁹ or that the offer was "unfair" or inadequate in price.⁸⁰ This type of formulation would have narrowed the permissibility of tender offer defenses in two ways. First, a defense would have had to be adopted because of its fairness to shareholders rather than because of broader corporate policies or corporate constituencies. Second, presumably tender offer defenses would have had to have been narrowed in a temporal sense as well. Given the specific shareholder interest involved, "pre-planned defensive mechanisms" such as the poison pill could be more difficult to justify when the terms of a potential tender offer were unknown.⁸¹

At the same time, it is important to note that, had Delaware and other state judiciaries so employed the duty of loyalty, they would have developed a mode of judicial review well short of that advocated by certain commentators which would have barred all or virtually all tender offer defenses, at least when a tender offer had been initiated.⁸² Be that as it may, the key point here is that Delaware and the considerable number of states that follow its corporate law court decisions decided instead to permit tender offer defenses broadly, applying a modified business judgment standard. Whatever else one may say about this line of analysis, there is no reasonable question that it narrowed the applicability of the duty of loyalty in what was the most significant category of corporate law decisions during the last two decades.

⁷⁹ See *Unocal*, 493 A.2d at 956; *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 & n.14 (Del. 1985).

⁸⁰ This elaboration of unfairness was meant to parallel the one cited earlier in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

⁸¹ See *Moran*, 500 A.2d at 1350.

⁸² See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1190-92 (1981).

2. Derivative Action Litigation Committees

There is a second fundamental explanation for the decline of the state corporate law duty of loyalty during the last thirty years. In the last two decades or so there have evolved new procedures for the termination of shareholder derivative actions against board members based on the recommendations of other board members. To be sure, state courts long had been willing to terminate derivative actions against outside parties on the recommendation of a board, but rarely had they considered the legality of terminating derivative actions against some board members on the basis of the recommendations of other board members.⁸³ Only after the questionable payment cases of the 1970s⁸⁴ inspired a number of suits against board members did the judiciary focus on the propriety of terminating actions against board members based on the recommendations of what is usually called a litigation committee, comprised of disinterested members of the board.

Judicial review of a litigation committee's recommendations has led to an unsettled body of law that is somewhat reminiscent of that applicable to tender offer defenses.⁸⁵ At one extreme the New York Court of Appeals held in 1979 held that if the members of a litigation committee are disinterested and if the committee followed appropriate procedures, a court should defer to the committee's business judgment and not examine the substantive merits of its decision.⁸⁶ At the other extreme the Iowa Supreme Court refused to permit directors who were parties to a derivative action to appoint a litigation committee for the purpose of recommending the dismissal of a derivative lawsuit⁸⁷ because of the committee's structural bi-

⁸³ See, e.g., John C. Coffee, Jr. & David E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Cox, *supra* note 9, at 963; George W. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U. L. REV. 96, 96-100, 105 (1980).

⁸⁴ See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 534-51 (1982). See generally 1 LOSS & SELIGMAN, *supra* note 3, at 24 n.62. .

⁸⁵ See *supra* notes 29-33 and accompanying text.

⁸⁶ *Auerbach v. Bennett*, 47 N.Y.2d 619, 629-35, 393 N.E.2d 994, 999-1003, 419 N.Y.S.2d 920, 926-29 (1979).

⁸⁷ *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 715-16 (Iowa

as.⁸⁸

Again, Delaware has an influential and quite reticulate middle ground.⁸⁹ In *Zapata Corp. v. Maldonado*,⁹⁰ then Justice Quillen, mindful that "there but for the grace of God' go I empathy"⁹¹ might influence directors on a litigation committee, established a two-step test for Delaware courts. First, the trial court was required to "inquire into the independence and good faith of the committee and the bases supporting its conclusions"⁹² when reviewing a litigation committee's recommendation to dismiss a derivative action. There are a number of possible outcomes of this first step:

If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied . . . that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.⁹³

If the court does proceed to the second step, the court must apply its own independent business judgment—and not defer to the business judgment of the board committee—to determine whether the action should be dismissed.⁹⁴

This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet

1983); see also *Alford v. Shaw*, 324 S.E.2d 878, 886-87 (N.C. Ct. App. 1985), modified, 358 S.E.2d 323 (N.C. 1987).

⁸⁸ *Miller*, 336 N.W.2d at 716.

⁸⁹ For example, §§ 7.03-.04, .07-.10, of the American Law Institute's *Principles of Corporate Governance*, supra note 16, particularly emphasizes Delaware precedents. See also *Houle v. Low*, 556 N.E.2d 51, 57 (Mass. 1990) (the "emerging ALI approach draws upon *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981) for its two-step inquiry . . .").

⁹⁰ *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

⁹¹ *Id.* at 787.

⁹² *Id.* at 788. The Court further elaborated: "Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness." *Id.*

⁹³ *Id.* at 789. See also *Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del. 1985).

⁹⁴ *Zapata*, 430 A.2d at 789.

the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest.⁹⁵

When Justice Quillen wrote these words, he added in a footnote: "Our approach here is analogous to and consistent with the Delaware approach to 'interested director' transactions, where the directors, once the transaction is attacked, have the burden of establishing its 'intrinsic fairness' to a court's careful scrutiny."⁹⁶

Delaware subsequently proceeded with a somewhat less generous spirit. In *Aronson v. Lewis*⁹⁷ Delaware's supreme court no longer concerned itself with the dilemma of the director asked to sue other directors and "there but for the grace of God' go I empathy."⁹⁸ Instead the court emphasized, "[b]y its very nature the derivative action impinges on the managerial freedom of directors."⁹⁹ No longer were there footnotes comparing judicial review in demand excused cases to "the Delaware approach to 'interested director' transactions."¹⁰⁰ Now the text thundered: "In our view the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability."¹⁰¹ And, while *Aronson* took some pains to emphasize that "the business judgment rule has no application in determining demand futility,"¹⁰² the court strikingly declared that when the business judgment rule was applicable, it would from now on be based on "concepts of gross [not simple] negligence."¹⁰³

When, then, should a court conclude that demand was

⁹⁵ *Id.*

⁹⁶ *Id.* at 788 n.17. Former Justice Quillen now characterizes the *Zapata* special litigation procedure as a "discarded procedure," implicitly acknowledging the significance of the increased use of the demand requirement to dismiss claims. See William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 121-24 (1993).

⁹⁷ 473 A.2d 805, 805 (Del. 1984).

⁹⁸ See *Zapata*, 430 A.2d at 787.

⁹⁹ *Aronson*, 473 A.2d at 811.

¹⁰⁰ *Zapata*, 430 A.2d at 788, n.17.

¹⁰¹ *Aronson*, 473 A.2d at 812.

¹⁰² *Id.*

¹⁰³ *Id.*

futile and that a board was required to follow *Zapata* procedures to cause a derivative suit's dismissal? The *Aronson* court explained:

Our view is that in determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.¹⁰⁴

The *Aronson* court provided further interpretative guidance to this standard. The reasonable "doubt" in its standard was meant to be more difficult for a plaintiff to satisfy than the reasonable "inferences" test earlier applied in the case by the chancery court. As the supreme court stated:

The problem with this formulation is the concept of reasonable inferences to be drawn against a board of directors based on allegations in a complaint. As is clear from this case, and the conclusory allegations upon which the Vice Chancellor relied, demand futility becomes virtually automatic under such a test. Bearing in mind the presumptions with which director action is cloaked, we believe that the matter must be approached in a more balanced way.¹⁰⁵

It was insufficient for the plaintiff to ask the court to *infer* that Fink, the recipient of a challenged employment agreement dominated and controlled the Meyers Parking System's ("Meyers") board based on "(1) Fink's 47% ownership of Meyers' outstanding stock, and (2) [the fact] that he 'personally selected' each Meyers director. Plaintiff also alleges that mere approval of the employment agreement illustrates Fink's domination and control of the board."¹⁰⁶

The burden on plaintiffs was not merely to provide facts from which a court could make a reasonable inference, but rather the higher threshold, a reasonable *doubt*. Here, the court explained, plaintiffs "contentions do not support any claim under Delaware law that these directors lack independence."¹⁰⁷ Why? Because, the court added:

¹⁰⁴ *Id.* at 814.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 815; cf. *Davidowitz v. Edelman*, 153 Misc. 2d 853, 857, 583 N.Y.S.2d 340, 343-44 (Sup. Ct. Kings County 1992) (special litigation committee lacked required disinterestedness).

¹⁰⁷ *Aronson*, 473 A.2d at 815.

[I]n the demand context even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation. There must be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person.

....

We conclude that in the demand-futile context a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting "a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling". The shorthand shibboleth of "dominated and controlled directors" is insufficient.

....

Here, plaintiff has not alleged any facts sufficient to support a claim of control. The personal-selection-of-directors allegation stands alone, unsupported. At best it is a conclusion devoid of factual support. The causal link between Fink's control and approval of the employment agreement is alluded to, but nowhere specified. The director's approval, alone, does not establish control, even in the face of Fink's 47% stock ownership.¹⁰⁸

Appreciate that this burden is imposed on the plaintiff *before* discovery.¹⁰⁹ Delaware places the plaintiff in a quandary. Unless the plaintiff, without the aid of deposition or interrogatory, can allege sufficiently specific facts to persuade a trial court that demand is futile, the board can treat dismissal of the lawsuit as just another business decision. If, however, the plaintiff does succeed in alleging sufficiently specific facts to persuade the court that demand is futile, *then* the board can appoint a disinterested litigation committee and seek dismissal under the *Zapata* procedure. Aronson threw plaintiffs one small bone. The court stressed: "[T]he plaintiff need only allege

¹⁰⁸ *Id.* at 815-16 (citations omitted). For subsequent applications of the Aronson approach, see *Spiegel v. Buntrock*, 571 A.2d 767, 773-74 (Del. 1990); *Grobow v. Perot*, 539 A.2d 180, 183, 186-89 (Del. 1988) ("Unless the presumption of the business judgment rule is overcome by the pleadings, questions of fairness play no part in the analysis."); *Pogostin v. Rice*, 480 A.2d 619, 624-25 (Del. 1984); *cf.* *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 731-32 (Del. 1988) (corporation's failure to object to shareholder derivative suit is viewed as approval of the suit).

¹⁰⁹ See *Levine v. Smith*, 591 A.2d 194, 209 (Del. 1991) ("The rationale for allowing discovery in a demand excused-*Zapata* context has no application in the case of either demand refused or demand excused, absent the *Zapata* context.").

specific facts; he need not plead evidence."¹¹⁰ The same court subsequently narrowed even this point when, in *Levine v. Smith*,¹¹¹ it held that the plaintiff's pleading under Delaware Chancery Court's Rule 23.1 burden is "more onerous" than that required to withstand a motion to dismiss.¹¹² The text of the decision then quoted with approval *Allison ex rel. General Motors Corp. v. General Motors Corp.*:¹¹³ "Rule 23.1 is a marked departure from the 'notice' pleading philosophy governing the Federal Rules of Civil Procedure."¹¹⁴

Where does this leave a plaintiff with a meritorious claim? He or she faces an imposing gauntlet of procedural hurdles before being allowed to litigate on the merits: First, the plaintiff initially must plead, absent any discovery, that a majority of the board "either has a financial interest in the challenged transaction or lacks independence or otherwise failed to exercise due care."¹¹⁵ Alternatively, if the plaintiff cannot prove that a majority of the board is interested or otherwise incapable of exercising independent business judgment, the plaintiff must plead particularized facts creating a reasonable doubt concerning the "soundness" of the challenged transaction sufficient to rebut the presumption that the business judgment rule

¹¹⁰ *Aronson*, 473 A.2d at 816. Even at the time this may have been less charming to plaintiffs than the quoted sentence suggests, for the next sentence reads: "Otherwise he would be forced to make allegations which may not comport with his duties under Chancery Rule 11." *Id.*

¹¹¹ 591 A.2d at 194.

¹¹² *Id.* at 207.

¹¹³ 604 F. Supp. 1106 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985).

¹¹⁴ 591 A.2d at 207 (quoting *General Motors*, 604 F. Supp. at 1112). The Court also noted: "*Allison* cannot be fairly read as intending any departure from *Aronson's* and *Grobow I's* requirement of well-pleaded allegations of fact which create a reasonable doubt that a board of directors' decision is protected by the business judgment rule." *Id.* at 211.

But this creates a peculiar difficulty for the plaintiff. As Judge Easterbrook explained:

The amount of information in the public domain is unrelated to the ability of the board to make a business judgment concerning litigation, is unrelated indeed to any function of the demand requirement. Why should the board acquire the power to dismiss under *Zapata* just because the plaintiff needs discovery and so cannot make the required showing "with particularity" in the complaint? *Aronson* and its successors do not discuss the point.

Starrels v. First Nat'l Bank of Chicago, 870 F.2d 1168, 1176 (7th Cir. 1989) (Easterbrook, J., concurring).

¹¹⁵ *Levine*, 591 A.2d at 205.

attaches to the transaction.¹¹⁶ Under either test, the plaintiff's pleading burden is "more onerous" than that required to withstand a motion to dismiss or notice pleading under the Federal Rules of Civil Procedure.¹¹⁷ The plaintiff ultimately has to plead sufficiently specific evidence to persuade the trial court not merely that it is reasonable to *infer* that the directors are not disinterested and independent or that the transaction is not the product of a valid business judgment, but rather that the higher threshold of a reasonable *doubt* regarding one of these two standards can be alleged.¹¹⁸

Second, the defendant can challenge plaintiff's assertion that demand is futile. If the court agrees with the defendant that demand is required, the board of directors or all disinterested members usually will reject demand. The plaintiff then may challenge that decision as not protected by the business judgment rule. Given the fact that the plaintiffs have historically succeeded in challenging decisions as not protected by the business judgment rule in such a small number of cases, it seems reasonable to assume that the plaintiff will normally lose this type of lawsuit.

Third, if, on the other hand, the court concludes that demand is excused, the corporation's board of directors then may appoint an independent litigation committee to investigate the plaintiff's allegations, prepare a thorough written report, and almost invariably seek dismissal of the derivative action.¹¹⁹ Under *Zapata*,¹²⁰ "[e]ach side (and as to the motion this means the plaintiff on the one hand and the corporation through its representative, the Special Litigation Commit-

¹¹⁶ *Id.* at 205-06.

¹¹⁷ *Id.* at 204; see *Allison ex rel. General Motors v. General Motors*, 604 F. Supp. 1106, 1112 (D. Del.), *aff'd*, 782 F.2d 1026 (3d Cir. 1985).

¹¹⁸ *Aronson v. Lewis*, 473 A.2d 805, 814-16 (Del. 1984).

¹¹⁹ See Cox, *supra* note 9, at 963: "Whatever one's view about the impact of the factors that feed a committee's structural bias, the committee's record is itself disquieting; although there have been more than a score of special litigation committee cases to date, in all but one the committee concluded that the suit in question was not in the corporation's best interest." Professor DeMott similarly cites only one case in which a litigation committee recommended that the corporation sue a former officer, *Kaplan v. Peat Marwick, Mitchell & Co.*, 529 A.2d 254, 256 (Del. Ch. 1987). See DEBORAH A. DEMOTT, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 5:19 (1987 & Supp. 1991).

¹²⁰ *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981).

tee—and not the other defendants—on the other) shall have an opportunity to make a record on the motion.”¹²¹ At this point there may be discovery, at the discretion of the court, limited to issues related to the good faith and independence of the litigation committee and the bases supporting its conclusions.¹²²

Fourth, as Chancellor Brown explained in *Kaplan v. Wyatt*:¹²³

If, after the motion has been argued or submitted for decision, the Court

(1) is satisfied on the record presented by the motion that there is a genuine issue as to one or more material facts, *or*

(2) determines on the undisputed material facts that the Committee is not independent, *or*

(3) determines on the undisputed material facts that the Committee has not shown reasonable bases for its conclusions, *or*

(4) is not satisfied on the undisputed material facts that the Committee has acted in good faith, *or*

(5) is satisfied for other reasons relating to the investigative process engaged in by the Committee that it has failed to carry its burden of proving its independence, good faith and a reasonable basis for its recommendation, then the Court shall deny the motion for such reason and need go no farther, the result being that the shareholder plaintiff may resume immediate control of the litigation with a view toward prosecuting it to a conclusion regardless of the position taken by the special investigating committee appointed by the corporation's board of directors.¹²⁴

Chancellor Brown did not analyze whether the court could remand the matter to the litigation committee to allow it to supplement its report. On the other hand, he continued:

If, however, after the motion has been argued or submitted for decision, the Court

(1) is satisfied that there is no genuine issue as to any material fact presented by the record made on the motion, *and*

(2) is further satisfied on the undisputed facts of record pertaining to the motion that the Committee is independent of the corporation's board of directors, that it has made a reasonable

¹²¹ *Kaplan v. Wyatt*, 484 A.2d 501, 507 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

¹²² *Id.*

¹²³ *Id.* at 508.

¹²⁴ *Id.*

investigation and has shown reasonable bases for its findings and recommendations, and that they were made in good faith, then the Court may do either of two things, namely, (1) grant the motion, order a dismissal of the suit and end the litigation, or (2) *in its discretion*, proceed to the second-step analysis [of whether in the Court's own business judgment the action is in the corporation's best interest] before rendering a decision on the motion.¹²⁵

All this in Chancellor Brown's pungent phrase was a "legal mouthful . . . fraught with practical complications at the trial court level."¹²⁶ A plaintiff in a demand excused case may have had to proceed through four separate hearings concerning: (1) whether demand was, in fact, excused—the result of this hearing can be appealed; (2) a hearing to determine whether a stay should be granted to stop the plaintiff's discovery until the litigation committee has reported;¹²⁷ (3) a hearing to determine the extent, if any, of plaintiff's limited discovery after the litigation committee has filed its report;¹²⁸ and (4) a hearing on the litigation committee's motion to dismiss the suit.¹²⁹ In *Kaplan*, where only the last three of these hearings occurred, Chancellor Brown explained: "[W]e are some three years after the amended complaint was filed"¹³⁰

Chancellor Brown, however, was an optimist. Some fifteen months transpired between the time the litigation committee submitted its motion to the Delaware Chancery Court and the Delaware Supreme Court issued its opinion on the appeal of Chancellor Brown's order granting that motion.¹³¹ Had the plaintiff prevailed before the supreme court, only then—more than four years after the initial complaint was filed—would the plaintiff have been allowed to proceed to discovery, motion

¹²⁵ *Id.*

¹²⁶ *Id.* at 509.

¹²⁷ Chancellor Brown believed: "It is a foregone conclusion that such a stay must be granted. Otherwise, the entire rationale of *Zapata*, i.e., the inherent right of the board of directors to control and look to the well-being of the corporation in the first instance, collapses." *Id.* at 510.

¹²⁸ *Id.* at 510-11.

¹²⁹ *Id.* at 511.

¹³⁰ *Id.*

¹³¹ Compare *id.* at 501 (action submitted July 6, 1984) with 499 A.2d 1184 (Supreme Court action decided October 9, 1985).

practice, and potentially a trial on the merits.

It seems to me there are two aspects of this protracted procedure that particularly deserve comment. First, my underlying assumption that the plaintiff might have a meritorious case could be rejected as being always or nearly always wrong. The expensive and time consuming litigation committee process could be rationalized as a type of legal realist response to systematically bad cases. To suggest one basis for this type of argument, my gifted colleague, Jack Coffee, is hardly alone in suggesting that at times the plaintiff (or, more accurately, the plaintiff's attorney) may be an "unfaithful champion" in shareholder litigation, more interested in attorneys fees than corporate recoveries.¹³² I am skeptical that focus on the motivation of plaintiffs' attorneys takes us very far. Since the time of Adam Smith, after all, a glory of capitalism has been that "private vice makes public virtue."¹³³ If the self-interest of plaintiffs' attorneys leads to deterrence of officer and director misconduct, this should be seen as a benefit, not a bane.

Whether or not the cases themselves are meritorious, however, is a question that can be analyzed. But here the data are enigmatic. In one eight-year study of 531 derivative and class action lawsuits brought against officers and directors between 1971 and 1978, plaintiffs obtained some form of relief 75.3 percent of the time. However plaintiffs won a litigated judgment less than one percent of the time; and, since the study did not collect data concerning the size or adequacy of the settlement funds, it is uncertain how often, if at all, plaintiffs' recoveries were because of the merits of the lawsuits, or simply to avoid more expensive litigation.¹³⁴

A second study conducted by Professor Roberta Romano examined a random sample of 535 public corporations between the late 1960s and 1987. Here too there was a strikingly high rate of settlement. Some sixty-five percent (eighty-three of the 128 claims resolved during this period) were settled. In approximately fifty-five percent of the settled claims (forty-six out of

¹³² John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (Summer 1985).

¹³³ See generally ADAM SMITH, *THE WEALTH OF NATIONS* (1776).

¹³⁴ Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542, 544-47 (1980).

eighty-three), there was a monetary recovery with an average recovery of nine million dollars in the thirty-nine cases where the settlement fund could be valued.¹³⁵ From these data, it is again difficult to infer how often meritorious claims were settled and how often settlements were simply to relieve the corporation of the "nuisance" of unwarranted potential trial costs.

However, one aspect of Romano's data is intriguing:

Settlement funds vary substantially by type of action. The average recovery in derivative suits (\$6 million) is about half that in class actions (\$11 million). As a percentage of firm assets it is also much less (0.5 percent compared to 1.6 percent). The proportion of derivative suits with a cash payout to shareholders (21 percent) is significantly lower than that of class actions (67 percent).¹³⁶

These data, although based on relatively small samples (twelve derivative suits and twenty-nine class actions),¹³⁷ suggest that one possible consequence of the increased time and expense of the derivative claim is to reduce the frequency with which this type of litigation deters managerial misconduct. But one cannot be particularly confident about that inference. A substantial proportion of the derivative claims, but a lesser proportion of securities class actions, resulted in structural modifications to the board, executive compensation, tender offer defenses, self-interested transactions and the like, but no monetary relief.¹³⁸ Hence the lower frequency of monetary relief in derivative claims may merely reflect the greater likeli-

¹³⁵ Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55, 58-61 (1991); cf. Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 500 (1991) (finding, based on a very small sample, that securities class actions tend to settle at 25% of the asserted potential damages). Professor Romano added:

This aspect of shareholder litigation is unremarkable; most civil suits settle. In fact, with powerful incentives to settle from the structure of indemnification rights and insurance coverage, it is, perhaps, surprising that one-third of the suits did not settle. Shareholder-plaintiffs, however, have abysmal success in court. Only one suit had a judgment for the plaintiff (upholding some of the plaintiff's claims in a ruling on stipulated facts), and in one other suit a state supreme court reinstated a complaint that had been dismissed by the trial court. This is a success rate of 6 percent of adjudicated cases, but plaintiffs actually won no judgments for damages or equitable relief.

Romano, *supra*, at 60.

¹³⁶ *Id.* at 61.

¹³⁷ *Id.* at 61 n.12.

¹³⁸ *Id.* at 63-65.

hood of *nonmonetary* relief.

A better question can be posed. If one assumes, *arguendo*, that a substantial proportion of plaintiffs' derivative claims are nonmeritorious, how does the new litigation committee procedure facilitate earlier and less expensive resolution of these claims than the alternatives of pretrial motions to dismiss and sanctions for nonmeritorious claims through state law equivalents to Federal Rule of Civil Procedure 11? True, the litigation committee procedure does long tend to prevent plaintiffs from discovery, which makes it difficult to analyze the merits of their claims; but one is hard pressed to see any other advantage of the litigation committee procedure over the conventional judicial tools for disposing of nonmeritorious lawsuits. And, even if advantages can be theorized, they merely press us toward the ultimate question: at what cost? For the available data suggest that the increased expense in time and money to plaintiffs of the litigation committee may tend indiscriminately to discourage both meritorious and nonmeritorious claims.

There is a second aspect of the Delaware variant of the litigation committee procedure that also deserves comment. Both the theory¹³⁹ and the litigated cases¹⁴⁰ make it clear that it is more difficult to dismiss a duty of loyalty claim on the ground that demand is required. By definition, a duty of loyalty claim concerns a decision that is not "the product of a valid exercise of business judgment."¹⁴¹ But this highlights a more fundamental issue. If a plaintiff, absent any discovery, is

¹³⁹ See *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

¹⁴⁰ See, e.g., *Heineman v. Datapoint Corp.*, 611 A.2d 950 (Del. 1992) (waste and self-dealing); *Kells-Murphy v. McNiff*, 1991 Del. Ch. LEXIS 127 (Del. Ch. July 12, 1991) (self-dealing); *Strougo v. Carroll*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,815 (Del. Ch. Jan. 29, 1991) (insider trading); *Thorpe v. Cerbco, Inc.*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,416 (Del. Ch. Nov. 15, 1991) (diversion of a corporate opportunity to sell a subsidiary); *Manchester v. Narragansett Capital, Inc.*, 1989 Del. Ch. LEXIS 141 (Del. Ch. Oct. 18, 1989) (waste and duty of loyalty); *L.A. Partners, L.P. v. Allegis Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,505 (Del. Ch. Oct. 22, 1987) (entrenchment motive underlay tender offer defensive measures); see also *Merritt v. Colonial Foods, Inc.*, 505 A.2d 757 (Del. Ch. 1986) (challenged cash-out merger constituted a breach of the duty of loyalty because it was effectuated to preclude plaintiffs litigating self-dealing claims); *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985) (rejecting litigation committee recommendation to dismiss corporate opportunity claim).

¹⁴¹ *Aronson*, 473 A.2d at 815.

capable of raising a reasonable doubt that demand is futile either because of a persuasive pleading of an underlying duty of loyalty violation or a disabling conflict of interest on the board, why should that plaintiff then be subject to a subsequent protracted delay while a litigation committee investigates the complaint, files and then defends a report? Duty of loyalty claims, after all, are the most serious allegation of state corporate law misconduct. They involve taking advantage of shareholders through such means as self-dealing or usurpation of corporate opportunities. Yet it is almost inevitable that the litigation committee will recommend dismissal of the these claims.¹⁴²

An underlying problem with the litigation committee procedure has been the judiciary's indifference to the psychological realities of a litigation committee investigation. I assume no bad faith on the part of either the committee or the attorneys who typically conduct the investigation. But even absent any bad faith, there are none of the devices in a litigation committee investigation that are found in more conventional litigation to fortify the investigator's skepticism or, to use perhaps a better phrase, appropriate agnosticism. Unlike a trial or deposition setting, no opposing counsel is present to conduct a hostile cross-examination or to interpose a timely objection. The investigator, when witnesses are not under oath, has no real ability effectively to remind a witness of the penalties for perjury. Furthermore, while an investigator can reach conclusions about the likelihood that a witness will appear persuasive to a jury or other fact finder, this type of conclusion arguably has little place in a final report. In sum, the very nature of the proceeding is biased in favor of not finding fault or of minimizing fault.¹⁴³

Whatever the merits of the *Zapata* procedure in corporate governance theory may be, it simply has not provided a fair or balanced procedure in fact. Besides Chancellor Brown's critique of the added time and expense of this procedure,¹⁴⁴ it is

¹⁴² See Cox, *supra* note 9, at 63.

¹⁴³ For a more detailed elaboration of this theme, see Joel Seligman, *The Disinterested Person: An Alternative Approach to Shareholder Derivative Litigation*, 55 LAW & CONTEMP. PROBS. 357 (Autumn 1992).

¹⁴⁴ See Kaplan v. Wyatt, 484 A.2d 501, 508-11 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

worth observing that as much as seventy-one percent of a recent random sample of settlements of shareholder claims have apparently been litigated under the federal securities laws, not state corporate law. This result, in part, appears to reflect the reality that state corporate law has become a less effective means of protecting shareholder interests.¹⁴⁵ This would appear to be a particularly regrettable development with respect to duty of loyalty cases.

C. *Federal Securities Law*

Now let me suggest that matters are not quite so bleak as the analysis to this point might suggest. At approximately the same time that state corporate law has receded in the duty of loyalty area, federal securities law—the new corporate law—has emerged. Again let me take as a baseline Harold Marsh's article.¹⁴⁶ While his analysis of the evolution at the state level of the law of conflicts of interest has been often cited, his article also included a brief discussion of three federal securities law approaches to conflicts of interest: (1) the SEC's executive compensation requirements;¹⁴⁷ (2) its administrative approval of certain investment company conflicts of interest under section 17(a) of the Investment Company Act;¹⁴⁸ and (3) discussion of one administrative action

¹⁴⁵ The sample size, however, is small: 41 lawsuits (of which 29 were class actions) and 12 derivative suits. Romano, *supra* note 135, at 61 n.12.

In a letter dated December 29, 1992, Professor Romano provided additional data indicating that, of the total of 128 claims studied in her study,

	Settled	Dismissed
Class Action	30	8
Derivative Action	33	17
Both Class and Derivative	18	13
Individual Shareholder	2	7

Letter from Roberta Romano, Professor of Law, Yale Law School, to Joel Seligman, Professor of Law, University of Michigan Law School (Dec. 29, 1992) (on file with author).

¹⁴⁶ See generally Marsh, *supra* note 5, at 35.

¹⁴⁷ *Id.* at 50-51; see also *id.* at 65-67, 70-71. These requirements are now reflected in Regulation S-K Item 402, 17 C.F.R. § 229.402 (1993). See 2 LOSS & SELIGMAN, *supra* note 3, at 675-78.

¹⁴⁸ 15 U.S.C. § 80a-17(a) (1988). Marsh, *supra* note 5, at 51-53; see also *id.* at 65, 67, 71 (discussion of affiliated person under the Investment Company Act). Regarding § 17 of the Investment Company Act, see generally 2 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS; THE INVESTMENT COMPANY ACT AND THE

brought by the Commission that proscribed a controlling shareholder's self-dealing transactions with a publicly held corporation.¹⁴⁹ Marsh concluded his article with a tone of frustration and a legislative proposal:

It should be apparent that the current rules do little or nothing to inhibit conflicts of interests with respect to corporations generally, and that they correct any overreaching which may occur only in a haphazard fashion in a small minority of cases. However, we deferred above consideration of the effect of requiring prior administrative approval of such transactions, as exemplified in the Investment Company Act of 1940.

A consideration of the history of the investment company industry before and after 1940 should convince anyone that this requirement has been an outstanding success. Prior to that date investment companies furnished the most flagrant examples of fraud and overreaching as detailed in the monumental study of the Securities and Exchange Commission which led to the enactment of the 1940 Act. Since that date, with respect to transactions covered by Section 17 these practices have virtually disappeared. The current controversy in the investment company field is concerned entirely with the relationship of investment companies with their investment advisers and underwriters, a relationship not subjected to the treatment accorded other conflict of interest situations in Section 17.

On the other hand, legitimate and beneficial transactions have been granted approval. Therefore, the argument against absolute prohibition, that in many cases it is to the advantage of a corporation to have a transaction with an officer, director or other related person, does not apply to this type of regulation.¹⁵⁰

Marsh then proposed the enactment of a general conflict of interest provision as a new section of the 1934 Act.¹⁵¹ As with section 17 of the Investment Company Act,¹⁵² Marsh's proposed new section would allow the Commission, on application, to exempt a proposed conflict of interest transaction if the agency found that: "(i) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of

INVESTMENT ADVISERS ACT 408-606 (1978 & Supp. 1991).

¹⁴⁹ The action was the well-known case of *In re Franchard Corp.*, SEC No-Action Letter, [1964-1966 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶ 77,113 (July 31, 1964). See Marsh, *supra* note 5, at 53-54.

¹⁵⁰ See Marsh, *supra* note 5, at 73-74.

¹⁵¹ *Id.* at 74-76.

¹⁵² 15 U.S.C. § 80a-17 (1988).

any person concerned; and (ii) the proposed transaction is consistent with the purposes of this Section and the protection of investors."¹⁵³ While the late Commission Chairman William Cary,¹⁵⁴ among others,¹⁵⁵ later made proposals for federal conflict of interest or fairness standards, no general provision along these lines has been adopted at the federal level. Nonetheless, the Commission and the courts have taken substantial, albeit partial, steps to address duty of loyalty problems through mandatory disclosure standards and in litigated cases. Let me offer several examples, ignoring such special cases as section 17 of the Investment Company Act or issues concerning accountants' independence.¹⁵⁶

1. Disclosure Requirements

There was more that Marsh could have addressed. Building on the Brandeisian premise, "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman,"¹⁵⁷ considerable anecdotal evidence was developed during the course of the 1931-32 Senate Foreign Bond¹⁵⁸ and 1932-34 Pecora Hearings¹⁵⁹ that preceded enactment of the

¹⁵³ See Marsh, *supra* note 5, at 75 (Proposed § (c)).

¹⁵⁴ William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

¹⁵⁵ See, e.g., SEC, STAFF REPORT ON CORPORATE ACCOUNTABILITY: A REEXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY, SENATE COMM. ON BANKING, HOUS. & URBAN AFFAIRS, 96TH CONG., 2D SESS. 98-127 (Comm. Print 1980) (history of federal corporate law proposals); see also Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 971-74 (1990).

¹⁵⁶ See, e.g., 2 LOSS & SELIGMAN, *supra* note 3, at 726-42.

¹⁵⁷ LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY, AND HOW THE BANKER'S USE 62 (1914).

¹⁵⁸ The Senate Finance Committee developed evidence that gross spreads on foreign bond sales ranged up to 14 percent. See *Sale of Foreign Bonds or Securities in the United States: Hearings Pursuant to S. Rep. No. 19, Before the Senate Comm. on Finance*, 72d Cong., 1st Sess. 1356 (1932).

¹⁵⁹ See, e.g., discussion of Kuhn, Loeb fee and stock options for floating two Pennroad Corporation stock issues and offering advice, S. Rep. No. 1455, 72d Cong., 2d Sess. 114-15 (1934); the partially disclosed United Corporation options received by the Morgan and Bonbright firms discussed in *id.* at 103, 115, 117, S. Rep. No. 19, 72d Cong., 1st Sess. 1356 (1932). The profits earned by Albert Wiggin as a result of insiders' information, *supra* at 204-05; and the profits earned

1933 and 1934 Federal Securities acts concerning undisclosed insider or underwriter compensation. In both the 1933¹⁶⁰ and 1934¹⁶¹ acts, disclosure provisions publicizing insider conflicts of interest, self-dealing, waste, or unfair transactions were emphasized. In the post-1934 period, anecdotal evidence has been published concerning the prophylactic effect of disclosure on insider self-dealing or conflicts of interest.¹⁶² More rigorous findings have been made concerning the effects of disclosure on underwriters' compensation.¹⁶³

Under the current mandatory disclosure system, deterrence of corporate director and officer conflicts of interest is

by favored individuals on J. P. Morgan, Kuhn, Loeb, and National City Company "preferred lists." S. Rep. No. 1455, 72d Cong., 2d Sess. 101-10 (1934).

¹⁶⁰ Of the 32 items required to be disclosed by Schedule A of the 1933 Act, 20 explicitly or implicitly concerned insiders' or underwriters' compensation or conflicts of interest. See Items 4-7, 10, 13-22, 24-25, 27-28, and 30. Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74, 88-91 (1933). A similar emphasis on disclosure of insider compensation appears in the Congressional reports. See, e.g., S. Rep. No. 47, 73d Cong., 1st Sess. 3 (1933).

¹⁶¹ See §§ 12(b), Items (D)-(H) and 13(a)(1) of the 1934 Act, 15 U.S.C. §§ 78l(b), 78m(a)(2) (1988).

¹⁶² See, e.g., SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 51 (1969) (The "Wheat Report"):

The registration process has sometimes been referred to as a housecleaning: One of its most valuable consequences is the elimination of conflicts of interest and questionable business practices which exposed to public view, have what Justice Frankfurter once termed "a shrinking quality." Many illustrations could be given; one representative example is provided by a paragraph from a recent '33 Act registration statement:

"From time to time during the past three years, certain officers, directors, and stockholders received loan accommodation from [name of company], without interest, all of which loans were repaid by September 30, 1968. This practice has been discontinued and such loans will not be made in the future."

Id. (citation omitted).

¹⁶³ As far as can be gleaned from available data, the average size of underwriters' compensation decreased in the two decades before enactment of the Securities Act of 1933 and afterwards continued to decline for approximately two decades. Much of this 40-year decline in underwriters' compensation can be attributed to causes other than SEC mandatory disclosures, including the growth in the size of issues, increased sales to institutions, increased competition among underwriters, and SEC and other competitive bidding requirements.

Nonetheless, several studies of underwriter spreads in the period just before and just after the Securities Act became operative suggest that the Act's mandatory disclosure of underwriters' compensation was also a factor in the decline in the size of underwriters' compensation. For a discussion of available data, see 1 LOSS & SELIGMAN, *supra* note 3, at 215-17.

most fully addressed in Regulation S-K, Items 401-404.¹⁶⁴ These Items identify directors, executive officers, and certain significant employees, with disclosure of any family relationships or involvement by those persons or promoters and control persons in specified legal proceedings;¹⁶⁵ require disclosure of executive compensation;¹⁶⁶ indicate security ownership of management, as well as any person or "group" known to the registrant to be the beneficial owner of more than five percent of any class of voting securities and any arrangements that may result in a change of control of the registrant;¹⁶⁷ and require disclosure of material relationships and transactions involving management, directors, director nominees, holders of five percent or more of a class of voting stock, and any member of the immediate family of any of the persons that may involve a conflict of interest.¹⁶⁸

Historically, as Marsh implicitly observed, the most controversial of these provisions was Item 402, concerning executive compensation. Originally adopted in 1942 as a revision to the proxy rules,¹⁶⁹ Item 402 today requires disclosure of the salary, bonus, and other annual compensation provided to the chief executive officer and the four most highly compensated executives whose compensation exceeds \$100,000; explanations of stock option, pension, and other specified compensation plans provided to the same individuals; disclosure of personal benefits or perquisites distributed outside a plan in excess of the lesser of \$50,000 or ten percent of the reported total salary and bonus; directors' compensation; and compensation arrangements in the event of termination of employment or change of control arrangements ("golden parachutes").¹⁷⁰

¹⁶⁴ 17 C.F.R. §§ 229.401-404 (1993).

¹⁶⁵ 17 C.F.R. § 229.401 (Item 401) (1993).

¹⁶⁶ 17 C.F.R. § 229.402 (Item 402) (1993).

¹⁶⁷ 17 C.F.R. § 229.403 (Item 403) (1993).

¹⁶⁸ 17 C.F.R. § 229.404 (Item 404) (1993).

¹⁶⁹ In part, because they were adopted after the United States entered World War II, the rules were controversial. On their origin, see JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 238 (1982).

¹⁷⁰ The most recent amendments to Item 402 provide detailed discussion of these and other items. See Executive Compensation Disclosure, Securities Act Release No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 (Oct. 16, 1992).

Item 402 has been amended frequently. During the 1970s, as an off-shoot of the Commission's investigation into questionable payments,¹⁷¹ the Commission filed several complaints concerning the failure to disclose material management perquisites¹⁷² and, in 1978, ultimately adopted amendments requiring disclosure of specified personal benefits.¹⁷³ More recently, after commentators such as Graef S. Crystal criticized the lack of any meaningful relationship between certain senior executives' compensation and their corporations' performance,¹⁷⁴ the Commission in 1992 required registrants to provide "a line graph comparing the registrant's cumulative total shareholder return with a performance indicator of the overall stock market and either a published industry index or registrant-determined peer comparison."¹⁷⁵

The disclosure prophylaxis, however, has not been limited

¹⁷¹ See 2 LOSS & SELIGMAN, *supra* note 3, at 660-61.

¹⁷² See, e.g., SEC v. Sharon Steel Corp., Litigation Release No. 8119, 13 SEC Docket (CCH) 178 (D.D.C. 1977) (permanent injunction issued as a result of corporate payments over \$1.7 million for nonbusiness personal expenses to corporate chief executive officer and his family); SEC v. Ormand Indus., Litigation Release No. 7910, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,046, at 96,695 (D.D.C. May 25, 1977) (permanent injunction issued as a result of unaccounted for cash advances in excess of \$250,000 to corporate officer); SEC v. Charles Jacquin et Cie, Inc., Litigation Release No. 8164, 13 SEC Docket (CCH) 407 (D.D.C. 1977) (permanent injunction entered both because of payments to state alcoholic beverage control officials as inducements to purchase Jacquin products and because of the diversion of funds to relatives of senior officers of the company). Other cases are listed in Disclosure of Management Remuneration, Securities Act Release No. 5856, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 23,019, at 17,059-*3 n.1 (Aug. 18, 1977) ("In general, the cases instituted by the Commission have suggested misappropriation of the company's assets in addition to noncompliance with disclosure provisions.").

¹⁷³ See Disclosure of Management Background: Uniform Reporting Requirements, Securities Act Release No. 5758, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,783 (Nov. 2, 1976) (comments solicited); Disclosure of Management Remuneration, Securities Act Release No. 5856, 12 SEC Docket (CCH) 1520 (1977) (interpretation of earlier management remuneration disclosure requirements); Uniform and Integrated Reporting Requirements: Proposed Amendments to Disclosure Forms and Regulations, Securities Act Release No. 5950, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,650 (July 28, 1978); Uniform and Integrated Reporting Requirements: Management Remuneration, Securities Act Release No. 6003, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,765 (Dec. 4, 1978) (adoption). See generally 2 LOSS & SELIGMAN, *supra* note 3, at 677-78.

¹⁷⁴ GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 96-109 (1991).

¹⁷⁵ Executive Compensation Disclosure, Securities Act Release No. 6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 at 83,433-34 (Oct. 16, 1992).

to director and officer duty of loyalty concerns. The SEC's Rule 13e-3,¹⁷⁶ promulgated under section 13(e) of the 1934 Act,¹⁷⁷ is directed at "going private" transactions.¹⁷⁸ To put Rule 13e-3 in context, in 1977 Delaware established that a going private merger would be permissible only when there was a business purpose to the transaction¹⁷⁹—a position Delaware abandoned in 1983 in favor of a bifurcated fairness standard involving examination of both fair dealing and fair price.¹⁸⁰ Also in 1977, the Supreme Court aborted a Rule 10b-5 challenge to a going private transaction that allegedly had no corporate purpose because that Rule did not reach "a breach of fiduciary duty by majority stockholders, without any deception, misrep-

¹⁷⁶ 17 C.F.R. § 240.13e-3 (1993).

¹⁷⁷ 15 U.S.C. § 78m(e) (1988).

¹⁷⁸ When shareholders of a publicly held corporation are bought out and the corporation is subsequently not listed on a stock exchange or traded over the counter, it has "gone private." Often because of the debt borrowed to finance a buyout, these transactions are called "leveraged buyouts." When the subsequent owners are corporate insiders, these transactions alternatively are called "management buyouts." When the public shareholders are compelled to accept cash or debt securities (and hence, among other things, incur a tax), these transactions have been called "freeze-outs," "squeeze-outs," or "take-outs." See also 5 LOSS & SELIGMAN, *supra* note 3, at 2137-39 n.36, 2144-45 & nn.45-46.

¹⁷⁹ *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Tanzer v. Int'l Gen. Indus.*, 379 A.2d 1121 (Del. 1977).

¹⁸⁰ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703-04 (Del. 1983); see also *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985). Some other state jurisdictions also hold that there need not be a business purpose when a going private transaction occurs. See, e.g., *Rosenstein v. CMC Real Estate Corp.*, 522 N.E.2d 221 (Ill. App. Ct. 1988) (Wis. law); *Yeager v. Paul Semonin Co.*, 691 S.W.2d 227 (Ky. Ct. App. 1985); *Sifferle v. Micom Corp.*, 384 N.W.2d 503 (Minn. Ct. App. 1986); *Armstrong v. Marathon Oil Co.*, 513 N.E.2d 776, 797-98 (Ohio 1987); *In re Jones & Laughlin Steel Corp.*, 398 A.2d 186 (Pa. Super. Ct. 1979), *aff'd*, 412 A.2d 1099 (Pa. 1980); see also *Schloss Assocs. v. Chesapeake & Ohio Ry.*, 536 A.2d 147, 157 (Md. Ct. Spec. App. 1988).

Other state jurisdictions adhere to the requirement of a business purpose when a going private transaction is challenged. See, e.g., *Coggins v. New Eng. Patriots Football Club, Inc.* 492 N.E.2d 1112 (Mass. 1986); see also *Bryan v. Brock & Blevins Co.*, 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974) (Georgia law); *Berkowitz v. Power/Mate Corp.*, 342 A.2d 566 (N.J. Super. Ct. Ch. Div. 1975); *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct. N.Y. County 1975), *aff'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1st Dep't 1976) (N.Y. blue sky law); but see *Perl v. IU Int'l Corp.*, 607 P.2d 1036 (Haw. 1981); *Gabhart v. Gabhart*, 370 N.E.2d 345 (Ind. 1977); *Alpert v. 28 William St. Corp.*, 63 N.Y.2d 557, 473 N.E.2d 19, 483 N.Y.S.2d 667 (1984); *Green v. Santa Fe Indus., Inc.*, 70 N.Y.2d 244, 514 N.E.2d 105, 519 N.Y.S.2d 793, (1987).

resentation, or nondisclosure.”¹⁸¹ The Commission then tried its hand by way of Rule 13e-3, which it adopted in 1979.¹⁸²

Presumably because of concerns about the SEC’s rulemaking authority, Rule 13e-3 does not *require* a valid business purpose. But the Rule has pushed disclosure of the fairness of a going private transaction about as far as it could go. The Rule requires that a Schedule 13E-3 statement be filed with the Commission¹⁸³ and that the content of most of the statements in response to the items in Schedule 13E-3 be distributed to security holders.¹⁸⁴ Item 8(a) of Schedule 13E-3 requires the issuer or affiliate to state whether it “reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders.”¹⁸⁵ An instruction adds, “A statement that the issuer or affiliate has no reasonable belief as to the fairness of the Rule 13e-3 transaction to unaffiliated security holders will not be considered sufficient disclosure in response to Item 8(a).”¹⁸⁶

Item 8(b) amplifies:

(b) Discuss in reasonable detail the material factors upon which the belief stated in Item 8(a) is based and, to the extent practicable, the weight assigned to each such factor

Instructions. (1) The factors which are important in determining the fairness of a transaction to unaffiliated security holders and the weight, if any, which should be given to them in a particular context will vary. Normally such factors will include, among others, those referred to in paragraphs (c), (d) and (e) of this Item and whether the consideration offered to unaffiliated security holders constitutes fair value in relation to:

- (i) Current market prices
- (ii) Historical market prices
- (iii) Net book value
- (iv) Going concern value
- (v) Liquidation value
- (vi) The purchase price paid in previous purchases disclosed in Item 1(f) of Schedule 13e-3

¹⁸¹ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475 (1977).

¹⁸² *Going Private Transactions by Public Companies*, Exchange Act Release No. 6100, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,166 (Aug. 2, 1979). Regarding this Rule, see generally 5 LOSS & SELIGMAN, *supra* note 3, at 2238-47.

¹⁸³ 17 C.F.R. § 240.13e-3(d)(1) (1993).

¹⁸⁴ 17 C.F.R. §§ 240.13e-3(e), (f) (1993).

¹⁸⁵ 17 C.F.R. § 240.13e-100 (1993).

¹⁸⁶ *Id.*

- (vii) Any report, opinion, or appraisal described in Item 9 and
- (viii) Firm offers of which the issuer or affiliate is aware made by any unaffiliated person, other than the person filing this statement, during the preceding eighteen months for:
 - (A) the merger or consolidation of the issuer into or with such person or of such person into or with the issuer,
 - (B) The sale or other transfer of all or any substantial part of the assets of the issuer or
 - (C) Securities of the issuer which would enable the holder thereof to exercise control of the issuer . . .¹⁸⁷

A mere itemization of the factors considered by the issuer or affiliate in approving a Rule 13e-3 transaction is not adequate in response to Item 8(b).¹⁸⁸ As the Division of Corporation Finance noted in an interpretative release, "The Division is concerned that in many instances the Item 8(b) disclosure being made to security holders is vague and non-specific and is therefore of limited utility to security holders."¹⁸⁹ The Commission staff takes the position further. When a Rule 13e-3 transaction has different impacts on different groups of unaffiliated security holders, the Item 8 disclosure should include consideration of the fairness of the transaction to all unaffiliated security holders. This might require, for example, separate analysis of the fairness of a tender offer or reverse stock split transaction for security holders who retain their interest in the company and those who do not.¹⁹⁰

In *Howing Co. v. Nationwide, Inc.*,¹⁹¹ the Sixth Circuit highlighted the extent to which an issuer or affiliate may rely on an investment banker's fairness opinion.¹⁹²

¹⁸⁷ *Id.*

¹⁸⁸ Going Private Transactions Under Rule 13e-3, Exchange Act Release No. 17,719, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 23,709, at 17,337 (Apr. 13, 1981) (Question 21).

¹⁸⁹ *Id.* See, e.g., *In re Myers Parking Sys., Inc.*, Exchange Act Release No. 26,069, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,333, at 89,498 (Sept. 12, 1988); *In re FSC Corp.*, Exchange Act Release No. 17,892, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,886 (June 25, 1981); *In re Tideland Capital Corp.*, Exchange Act Release No. 17,641, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,854, at 84,197 (Mar. 19, 1981).

¹⁹⁰ Going Private Transactions Under Rule 13e-3, *supra* note 188, at 17,337.

¹⁹¹ 826 F.2d 1470, 1479 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988).

¹⁹² Regarding fairness opinions, see Lucian Anye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done about It?*, 1989 DUKE L.J. 27; William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing about It*, 70 WASH. U. L.Q. 523 (1992); Ted J. Fiftis, *Re-*

While the Commission has stated that an issuer in a going private transaction can rely on an investment banker's opinion to meet its disclosure obligations, such opinion itself must fully analyze the factors enumerated in Item 8(b) as well as be "expressly adopted" by the issuer The issuer in this case did not conduct its own investigation but chose to rely on the expertise of First Boston. The problem with defendants adopting the First Boston opinion letter as their disclosure to shareholders is that this one-page letter is itself woefully inadequate when measured against the specific disclosure requirement of the rule. An issuer cannot insulate itself from 13e-3 liability by relying on an investment banker's opinion letter which itself does not comply with the specific disclosure requirements of the Rule. Therefore, defendants' conclusory statements are not cured by conclusory statements made by First Boston in its opinion letter.¹⁹³

Item 9 of Schedule 13E-3¹⁹⁴ then requires a summary of any report, opinion (other than an opinion of counsel), or appraisal from an outside party that is materially related to the Rule 13e-3 transaction, including any report, opinion, or appraisal relating to the fairness of the consideration to be offered to security holders or the fairness of the transaction to

sponsibility of Investment Bankers to Shareholders, 70 WASH. U. L.Q. 497 (1992); Edward D. Herlihy et al., *Disclosure of the Analyses Underlying Investment Banker Fairness Opinions*, 6:3 INSIGHTS at 11 (1992); Dale A. Oesterle, *Fairness Opinions as Magic Pieces of Paper*, 70 WASH. U. L.Q. 541 (1992); John F. Olson & Mitri J. Najjar, *Fairness for Whom? Fairness Opinions in LBOs and MBOs*, 3:8 INSIGHTS at 27 (1989); Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119 (1986).

¹⁹³ *Howing*, 826 F.2d at 1479.

In *Howing Co. v. Nationwide Corp.*, 927 F.2d 263 (6th Cir.), *vacated on other grounds*, 112 S. Ct. 39 (1991), the court held that the language of Rule 13e-3, Item 8, created a rebuttable presumption that a discussion of net book value, going concern value, and liquidation value in a proxy statement was material to minority shareholders who contemplated a going private offer. This reasoning, the court said, was "in accord with other courts that have recognized the appropriateness of a 'heightened' TSC materiality standard in coercive securities transactions." That is to say, "certain facts may be material in the context of a 'one-sided transaction' which otherwise would not be material in the context of an adversarial transaction." *Id.* at 266. On the *Howing* case generally, see Ndira Kofele-Kale, *The SEC's Going-Private Rules—Analysis and Developments*, 19 SEC. REG. L.J. 139 (1991).

"A conclusory statement containing a 'laundry list' of factors," does not satisfy the requirement of a board opinion that the offering price is fair. *Meyers Parking Sys., Inc.*, *supra* note 129 at 81,498; see also Ndira Kofele-Kale, *Some Unfinished Business, Some Unresolved Issues: Section 13(e) and the SEC's Going Private Rules after Howing Co. v. Nationwide Corp.*, 20 U. TOL. L. REV. 625 (1989).

¹⁹⁴ 17 C.F.R. § 240.13e-100 (1993).

the issuer to affiliate or to nonaffiliated security holders.¹⁹⁵

2. Fraud Litigation

To some extent the disclosure of these types of insider or merging corporation conflicts of interest may tend to deter duty of loyalty violations. What has been most striking in recent decades, however, has been the extent to which the Commission and private parties have been able to enforce fraud claims based on undisclosed conflicts of interest that were not expressly required to be disclosed by Regulation S-K.¹⁹⁶

To a large extent this development can be traced to the Supreme Court's 1976 decision in *TSC Industries, Inc. v. Northway, Inc.*,¹⁹⁷ a case best known for its definition of materiality. In *TSC*, the Court held that two omitted facts relating to another company's [National's] potential influence or control over the management of TSC were not material as a matter of law: (1) that the chairman of the TSC board, Stanley Yarmuth, was National's president and chief executive officer, and the chairman of the TSC executive committee was Charles Simonelli, National's executive vice president; and (2) that neither TSC nor National had indicated that National "may be deemed to be a 'parent' of TSC as that term is defined in [SEC

¹⁹⁵ For illustrative violations of this Item, see, e.g., *Tidelands Capital Corp.*, *supra* note 189, at 84,197; *Meyers Parking Sys., Inc.*, Exchange Act Release No. 26,069, *supra* note 189, at 89,497. *Cf. Radol v. Thomas*, 772 F.2d 244, 252-53 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986). See John S. Poole, *Management Forecasts. Do They Have A Future in Corporate Takeovers*, 42 SW. L.J. 765 (1988).

In May, 1989 SEC Chairman Ruder proposed extending Rule 13e-3 to third-party transactions. "Shareholders should be entitled to disclosures in both affiliated and nonaffiliated transactions that are sufficiently broad enough to allow them to judge the fairness of the transaction and the adequacy of the board's efforts to bring them the best available offer for the corporation." *Ruder Supports Extending LBO Disclosure Rule to Third Parties*, 21 Sec. Reg. & L. Rep. (BNA) 763 (1989). Rule 13e-3 currently applies only to transactions between an issuer and its affiliates. *Woodward & Lothrop, Inc. v. Schnabel*, 593 F. Supp. 1385, 1400 (D.D.C. 1984). A "going private" or "leveraged buyout" transaction that involves both management and a third party is subject to Rule 13e-3. *Plaza Sec. Co. v. Fruehauf Corp.*, 643 F. Supp. 1535 (E.D. Mich. 1986).

In 1987 there were 633 Schedule 13E-3 statements filed with the Commission. Arthur M. Borden, *A Fresh Look at Going-Private Disclosure*, 21 REV. SEC. & COMMODITIES REG. 73 n.1 (1988).

¹⁹⁶ 17 C.F.R. § 229 (1993).

¹⁹⁷ 426 U.S. 438 (1976).

Rules and Regulations under the Securities Act of 1933]."¹⁹⁸

In a footnote the Court nonetheless emphasized that the total omission of material information concerning a conflict of interest, *as a matter of law*, would have violated section 14(a) of the 1934 Act¹⁹⁹ and Rule 14a-9.²⁰⁰

We emphasize that we do not intend to imply that facts suggestive of control need be disclosed only if in fact there was control. If, for example, the proxy statement in this case had failed to reveal National's 34% stock interest in TSC and the presence of five National nominees on TSC's board, these omissions would have rendered the statement materially misleading as a matter of law, regardless of whether National can be said with certainty to have been in "control" of TSC. The reasons for this are twofold. First, to the extent that the existence of control was, at the time of the proxy statement's issuance, a matter of doubt to those responsible for preparing the statement, we would be unwilling to resolve that doubt against disclosure of facts so obviously suggestive of control. Second, and perhaps more to the point, even if National did not "control" TSC, its stock ownership and position on the TSC board make it quite clear that it enjoyed some influence over TSC, which would be of obvious importance to TSC shareholders.²⁰¹

The lower federal courts subsequently have often required disclosure of conflicts of interest.²⁰² In one case, the court ob-

¹⁹⁸ *Id.* at 451.

¹⁹⁹ 15 U.S.C. § 78n(a) (1985) ("It shall be unlawful for any person . . . in contravention of such rules and regulations as the Commission may prescribe . . . to solicit any proxy or consent or authorization in respect of any security . . . registered pursuant to section 12 of this title.").

²⁰⁰ 17 C.F.R. § 240.14a-9 (1993). Rule 14a-9 forbids the solicitation of any proxy by means of a proxy statement containing a statement that "is false and misleading with respect to any material fact, or which omits to state any material fact." *Id.*

²⁰¹ *Northway*, 426 U.S. at 453-54 n.15. See *Susman v. Lincoln Am. Corp.*, 578 F. Supp. 1041, 1057 (N.D. Ill. 1984) ("If the 1973 Proxy actually failed to reveal Consumers was being merged into its parent in a controlled transaction, that would undeniably be material."); *Edelman v. Salomon*, 559 F. Supp. 1178, 1184 (D. Del. 1983).

²⁰² See, e.g., *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987, 993-94 (2d Cir. 1988) (in merger between corporations A and B, failure to disclose that general counsel of corporation A personally represented senior executives of corporation B and that he and his firm served as counsel to several entities controlled by these executives constituted material omissions); *Kas v. Financial Gen. Bankshares, Inc.*, 796 F.2d 508, 513 (D.C. Cir. 1986) ("The violation arising from the failure to disclose such a potential conflict of interest does not turn on the failure to disclose a director's true motivations but rather stems from the failure to disclose a fact that puts the shareholder on notice of a potential impairment of the director's judge-

served "a self-dealing insider may have a 'heavier burden of disclosure' in the sense that he will find it more difficult to convince the court that he has met the requirements of section 14(a)."²⁰³ Once a proxy statement purports to disclose the factors considered by an insider in evaluating the fairness of a merger, there is an obligation to portray them accurately.²⁰⁴ Several conflict decisions have concerned stock option plans. In one such decision, a proxy statement was held to be fraudulent when it failed to advise stockholders that the board possessed information to the effect that an imminent tender offer would increase the value of its stock at the time it had amended its stock option plan to accelerate the exercise date.²⁰⁵

By 1981 the Ninth Circuit, speaking of the proxy rules under section 14 of the 1934 Act, drew

a sharp distinction . . . between allegations of director misconduct involving breach of trust or self-dealing—the nondisclosure of which

ment."); *Kennedy v. Tallant*, 710 F.2d 711, 719 (11th Cir. 1983); *TBK Partners v. Shaw*, 689 F. Supp. 693, 698-701 (W.D. Ky. 1988); *Hahn v. Breed*, 587 F. Supp. 1369, 1375 (S.D.N.Y. 1984); *Dofflemyer v. W. F. Hall Printing Co.*, 558 F. Supp. 372, 382-83 (D. Del. 1983) (rejecting defendants' motion to dismiss); *SEC v. World-Wide Coin Inv., Ltd.*, 567 F. Supp. 724, 757 (N.D. Ga. 1983); *SEC v. Falstaff Brewing Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,117, at 92,022 (D.D.C. Aug. 1, 1977).

For Rule 10b-5 purposes, a registered investment adviser is a fiduciary and, therefore has an affirmative duty to disclose "all possible conflicts of interest." *Laird v. Integrated Resources, Inc.*, 897 F.2d 826, 835 (5th Cir. 1990); *see also Kramer v. Time Warner, Inc.*, 937 F.2d 767, 777 (2d Cir. 1991) ("That inside directors stand to gain from a recommended transaction is material information that must be disclosed to shareholders considering a tender offer.").

²⁰³ *Pavlidis v. New Eng. Patriots Football Club, Inc.*, 737 F.2d 1227, 1231 (1st Cir. 1984); *see also Plaza Sec. Co. v. Fruehauf Corp.*, 643 F. Supp. 1535, 1544 (E.D. Mich. 1986).

²⁰⁴ *Berg v. First Am. Bankshares, Inc.*, 796 F.2d 489, 495-96 (D.C. Cir. 1986) ("The drafters of the proxy statement could not legitimately attribute to Casey factors which he did not actually consider, thereby making his decision appear well-informed, and then shield themselves by arguing that Casey's subjective motivations are not material."). This type of analysis is consistent with the Supreme Court's subsequent decision in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991).

²⁰⁵ *Maldonado v. Flynn*, 597 F.2d 789, 797 (2d Cir. 1979). The board also did not disclose an amendment to the plan permitting shares to be purchased on a loan basis in place of the prior cash-only requirement. *Id.*

The manner in which the total compensation package was disclosed in *Fradkin v. Ernst*, 571 F. Supp. 829, 849-52 (N.D. Ohio 1983), was held to be materially false and misleading. *Cf. Halpern v. Armstrong*, 491 F. Supp. 365, 378-79 (S.D.N.Y. 1980); *Mills v. Esmark, Inc.*, 544 F. Supp. 1275, 1292-96 (N.D. Ill. 1982).

is presumably material—and allegations of simple breach of fiduciary duty/waste of corporate assets—the nondisclosure of which is never material for § 14(a) purposes²⁰⁶

While subsequent commentators²⁰⁷ and cases²⁰⁸ have questioned whether the ambit of federal securities law fraud enforcement should be limited to nondisclosure of possible duty of loyalty violations or should also reach questionable payments made on behalf of the corporation, there is today no significant question that undisclosed insider or merging corporation conflicts of interest both can be fraudulent *and* material.

II. THE DUTY OF CARE

The process of augmenting or displacing traditional state corporate law is even more advanced in the area I now want to discuss, the duty of care. In corporate law, the duty of care is the basic negligence concept. Directors and officers, according to leading cases such as *Francis v. United Jersey Bank*,²⁰⁹ must “discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent [persons] would exercise under similar circumstances in like posi-

²⁰⁶ *Gaines v. Haughton*, 645 F.2d 761, 776-79 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982). *But cf. Roeder v. Alpha Indus., Inc.*, 814 F.2d 22 (1st Cir. 1987); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 115-19 (2d Cir. 1982).

²⁰⁷ See Bevis Longstreth, *SEC Disclosure Policy Regarding Management Integrity*, 38 BUS. LAW. 1413 (1983). The *Gaines* opinion, he says, “seems to rest on the rather cynical assumption that shareholders, in exercising their rights of corporate suffrage, care plenty about a management that is stealing *from* the company, but are concerned not a whit about a management that is stealing *for* the company.” *Id.* at 1418; see also George S. Branch & James A. Rubright, *Integrity of Management Disclosures under the Federal Securities Laws*, 37 BUS. LAW. 1447, 1478-79 (1982); Michael G. Michaelson, “Breach of Trust”: The Duty to Disclose Pending Litigation in a Contest for Corporate Control, 37 RUTGERS L. REV. 1 (1984); Dennis J. Block et al., *Judicial Limitations on Federal Disclosure Requirements Regarding Management Integrity*, 14 SEC. REG. L.J. 354 (1987).

²⁰⁸ In *Roeder*, the First circuit stated that “[m]anagement’s willingness to engage in practices that probably or obviously are illegal, and its decision to put the corporation at risk by so doing, may be critically important factors to investors.” 814 F.2d at 25; see also *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 655 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980); *Shields v. Erikson*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,723 at 93,904-05 (N.D. Ill. Aug. 23, 1989).

²⁰⁹ 432 A.2d 814 (N.J. 1981).

tions."²¹⁰ When, say, a director fails to acquire a rudimentary understanding of the business of a corporation, to keep informed of its activities, or to monitor adequately corporate affairs and policies *and* this failure is the proximate cause of (or, at least a substantial factor contributing to) a loss, the director can be held liable for a failure to supervise the corporation. Typically this lesson is embellished by observing that directors normally may rely on the reports of officers, committees, and outsiders such as the certified public accountant,²¹¹ and that, in many instances, a director can be held liable for a failure to supervise only when the circumstances provide notice that something may be amiss.²¹² As a famous Delaware case put it, "there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."²¹³

Enter now the voracious exceptions. When directors actually do make a decision, that decision normally will be insulated from judicial review by the business judgment rule, which in essence applies as long as the directors were both untainted by a conflict of interest and adequately informed.²¹⁴ In the leading corporate law jurisdiction for publicly traded corporations (Delaware), "the concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one."²¹⁵ Delaware goes further. A corporation can amend its certificate of incorporation to preclude the personal liability of any director to the corporation or its stockholders for monetary damages for the director's negligence or gross negligence.²¹⁶ And, even if a Delaware corporation does not go so far, most plaintiffs' complaints raising duty of care cases are dismissed under the same litigation committee and kindred procedures I earlier

²¹⁰ *Id.* (quoting N.J. STAT. ANN. § 14A:6-14 (West 1969 & Supp. 1993)).

²¹¹ *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(e) (1991).

²¹² *See, e.g.*, *Bates v. Dresser*, 251 U.S. 524 (1920).

²¹³ *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

²¹⁴ *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985); *supra* note 23 and accompanying text.

²¹⁵ *Id.* at 873. For circumstances that can lead to a holding that directors made an uninformed decision, see also *Grobow v. Perot*, 539 A.2d 180, 191 (Del. 1988).

²¹⁶ DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

discussed in the duty of loyalty context.²¹⁷

Let me compare more dynamic federal securities law developments in this area. The SEC has authority to regulate both accounting standard-setting and, probably, auditing as well.²¹⁸ The distinction between accounting and auditing was described by an *ad hoc* Commission on Auditors' Responsibilities in these terms:

In the broadest sense, the discipline of accounting includes auditing. However, accounting can be described as measuring and reporting the effects of economic activities of individual entities. Auditing, on the other hand, involves an independent examination to determine the propriety of accounting processes, measurements, and communication. Stated simply, the accountant prepares financial information; the auditor checks it.²¹⁹

The Commission first became seriously concerned with auditing after its 1940 investigation of McKesson & Robbins.²²⁰ In that case an annual audit by a reputable firm of accountants did not prevent the senior officers of the company from siphoning away several millions in cash, primarily by overstating its inventory and accounts receivable by approximately \$20 million and reporting large profits from a wholly fictitious crude drug business.²²¹ Beginning in the 1970s with

²¹⁷ See *supra* note 83-145 and accompanying text.

²¹⁸ This authority derives from § 19(a) of the Securities Act of 1933, 15 U.S.C. § 77s(a) (1988), which empowers the Commission to prescribe "the methods to be followed in the preparation of reports . . .". See also § 13(b) of the 1934 Act, 15 U.S.C. 78m(b) (1988) ("preparation of reports"); Sched. A (25),(26) of the Securities Act, 15 U.S.C. § 77aa(25),(26) (1988); § 12(b)(1)(J) of 1934 Act, 15 U.S.C. § 78l(b)(1)(K) (1988). From the fraud provisions of the Securities Act of 1933, see especially §§ 11, 17, 15 U.S.C. §§ 77k, 77q (1988); §§ 18(a), 10(b) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78r(a) (1988). For authority under the Investment Company Act of 1940, see § 30(e), 15 U.S.C. 80a-29(e) (1988); under the Public Utility Holding Co. Act of 1935, see § 14, 15 U.S.C. § 79n (1988).

²¹⁹ COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS AND RECOMMENDATIONS xii (1978).

²²⁰ SEC, UNITED STATES OF AMERICA BEFORE THE SECURITIES AND EXCHANGE COMMISSION IN THE MATTER OF MCKESSON & ROBBINS, INC.: REPORT ON INVESTIGATION (reprint 1982) (1940) [hereinafter MATTER OF MCKESSON]. For summaries of the report, and of action with respect to auditing procedures taken by professional societies after the disclosures of the investigation, see *id.* at 4-12, 361-70; *In re McKesson & Robbins, Inc.-Summary of Findings and Conclusions*, Acct. Ser. Rel. 19, 1940 WL 977 (1940); see also 5 SEC Ann. Rep. 110-11, 119-20 (1939); 6 MATTER OF MCKESSON, *supra*, 155, 164-69 (1940).

²²¹ For further discussion of the McKesson & Robbins and other leading audit failures, see generally 2 LOSS & SELIGMAN, *supra* note 3, at 715-25.

such cases as the criminal conviction of the auditors involved in the Equity Funding fraud²²² and with the Commission's questionable payment or overseas bribery enforcement actions,²²³ attention again was focused on the problem of "audit failures."

Besides continuing with enforcement actions against auditors, the Commission mounted a two-pronged response during the 1970s to the problem of audit failures. First, in 1977 the Commission approved a rule change in the listing requirements of the New York Stock Exchange, requiring each domestic company with common stock listed on that exchange,

as a condition of initial and continued listing of its securities . . . to establish not later than June 30, 1978, and maintain thereafter an audit committee composed solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member."²²⁴

This was a salutary, if modest, reform. On March 11, 1976, when SEC Chairman Roderick Hills requested that the NYSE make this amendment to its listing requirements, he estimated that almost 90 percent of the nation's largest corporations already had established audit committees.²²⁵ A 1980 SEC survey of 1,200 business corporations whose securities were publicly traded found that the typical audit committee met 2.7 times per year and limited its functions to approving the selection of the firm's outside auditor and reviewing its audit plans and results.²²⁶

²²² United States v. Weiner, 578 F.2d 757 (9th Cir. 1978); *In re Seidman & Seidman*, Accounting Series Release No. 196, [1927-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,128, at 62,527 (Sept. 1, 1976). ("By the time the massive fraud was disclosed, Equity had in excess of \$120 million (net of deferred taxes) in fictitious or fraudulently inflated assets on its books.").

²²³ See 2 LOSS & SELIGMAN, *supra* note 3, at 660-61.

²²⁴ *In re New York Stock Exchange, Inc.*, Exchange Act Release No. 13,346, 11 SEC Docket (CCH) 1945 (1977).

²²⁵ Roderick Hills, Addresses of June 21, 1976 and June 30, 1976, summarized in JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 547 (1982).

²²⁶ SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS, SEC, 96TH CONG., 2D SESS., STAFF REPORT ON CORPORATE ACCOUNTABILITY: A RE-EXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY

More significantly, at approximately the same time the Commission persuaded Congress to enact the Foreign Corrupt Practices Act. It added section 13(b)(2) to the 1934 Act, which requires each reporting corporation to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles"²²⁷ A primary purpose of section 13(b)(2) was to prevent corporate officers or directors from making materially false or misleading statements or omitting to state material facts "to an accountant in connection with (1) any audit or examination of the financial statements of the issuer . . . or (2) the preparation or filing of any document or report required to be filed with the Commission"²²⁸ As the first litigated section 13(b)(2) decision explained:

It is clear that section 13(b)(2) and the rules promulgated thereunder are rules of general application which were enacted to (1) assure that an issuer's books and records accurately and fairly reflect its transactions and the disposition of assets, (2) protect the integrity of the independent audit of issuer financial statements that are required under the Exchange Act, and (3) promote the reliability and completeness of financial information that issuers are required to file with the Commission or disseminate to investors pursuant to the Exchange Act.²²⁹

496-506, 608 (Comm. Print 1980).

²²⁷ 15 U.S.C. §§ 78m(b)(2)(B)(i)-(ii) (1988). For citations concerning this Act, see 2 LOSS & SELIGMAN, *supra* note 3, at 696 n.223.

In 1988 Congress adopted the *Foreign Corrupt Practices Act Amendments*, which added §§ 13(b)(4)-(7). See H.R. REP. NO. 576, 100th Cong., 2d Sess. 916-17 (1988), reprinted in 1988 U.S.C.C.A.N. 1415. These Sections, among other things, limit criminal liability to persons who knowingly violate § 13(b)(2); and define the terms *reasonable assurances* and *reasonable detail* to mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

²²⁸ Rule 13b2-2(b), 17 C.F.R. § 240.13b2-2(b) (1993).

²²⁹ SEC v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 747 (N.D. Ga. 1983). For illustrative SEC proceedings, see *In re Sweeney*, Exchange Act Release No. 24,888, 39 SEC Docket (CCH) 160 (1987). *In re De Laurentis Entertainment Group, Inc.*, Exchange Act Release No. 24,786, 38 SEC Docket (CCH) 1343 (1987); *In re Citizens Trust Co.*, Exchange Act Release No. 22,802, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,484 (Jan. 15, 1986); *In re Tonka Corp.*, Exchange Act Release No. 22,448, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,473 (Sept. 24, 1985); *In re Burroughs Corp.*, Exchange Act Release No. 21,872, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,450 (Mar. 20,

Violations of section 13(b) and the other SEC auditing provisions are essentially failures of the outside auditor or the corporate registrant to exercise due care. Let me offer an illustration. In 1992, the Commission brought a disciplinary action against two certified public accountants, John R. Schoemer and Michael P. Denkensohn for alleged misconduct in their audit of the December 31, 1983, consolidated financial statements of Marsh & McLennan Companies, Inc. (MMC).²³⁰ The Commission's summary of the proceeding reads like a paraphrase of the duty of care:

The Commission concludes that Respondents did not examine MMC's 1983 consolidated financial statements in accordance with GAAS [Generally Accepted Auditing Standards] in that they (1) failed to obtain sufficient competent evidential matter to afford a reasonable basis for the opinion on those financial statements; and

1985); *see also In re Komm*, Exchange Act Release No. 25,354, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,644 (Jan. 11, 1988) (chief financial officer violated Rule 13b-2 when he falsified books, records, and accounts concerning disposition of automated teller machines); *In re Maurry*, Exchange Act Release No. 23,067, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,413 (Mar. 26, 1986) (company controller who was highest ranking accounting employee, though not a decisionmaker, had a duty to the company and its stockholders not to assist, or even acquiesce in, false financial statements).

Even before enactment of § 13(b)(2), the Commission emphasized in enforcement actions the need for a registrant to maintain an adequate system of internal controls. *See, e.g., In re S. D. Leidesdorf & Co.*, Exchange Act Release No. 13,268, [1977-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,231, at 62,578 (Feb. 8, 1977) ("Independent auditors should carefully test and evaluate the internal control systems of an audit client before placing any reliance upon those controls."); *In re Drayer-Hanson, Inc.*, Exchange Act Release No. 3277, [1977-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,082, at 62,165 (Mar. 15, 1948) ("the auditors should have made a more thorough examination of the registrant's system of internal control and . . . should have determined they were being operated effectively"); *see also SEC v. Gemcraft*, Litigation Release No. 11,170, 36 SEC Docket (CCH) 264 (S.D. Tex. 1986); *In re Harrison*, Exchange Act Release No. 22,466 [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,474 (Sept. 26, 1985); *In re Frederick S. Todman & Co.*, Exchange Act Release No. 21,258, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,436 (Aug. 20, 1984); *In re Murphy, Hauser, O'Connor & Quinn*, Exchange Act Release No. 20,465, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,418 (Dec. 9, 1983); *In re Goldberg*, Exchange Act Release No. 20,209, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,413 (Sept. 22, 1983).

No private right of action is available under §13(b). *See, e.g., Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024 (6th Cir. 1990), *cert. denied*, 498 U.S. 1086 (1991); *McLean v. International Harvester Co.*, 817 F.2d 1214 (5th Cir. 1987).

²³⁰ *In re John R. Schoemer, C.P.A.*, Exchange Act Release No. 30,535, 51 SEC Docket (CCH) 158 (1992).

(2) failed to exercise due professional care in performing the audit.

Standard of Field Work No. 3 of GAAS states: "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." The Commission finds that the evidence obtained by Respondents during the course of the 1983 audit of MMC's consolidated financial statements was insufficient to afford a reasonable basis for their opinion that MMC's method of recording the existence, completeness and value of certain of its investments was proper. As discussed below, the Commission finds that Respondents did not obtain competent evidence concerning the nature and extent of the investment activities of MMC's investment unit, the Investment Management Group ("IMG"), when various other audit steps likely would have produced the necessary information.

General Standard No. 3 of GAAS states: "Due professional care is to be exercised in the performance of the audit and the preparation of the report." The Commission finds that Respondents did not conduct their audit with due professional care in that, having made the decision to perform substantive testing of the company's investment portfolio accounts within the IMG, they failed to follow established audit procedures to test that (a) securities recorded in the investment portfolio accounts existed at the balance sheet date; (b) all securities that should have been recorded were in fact recorded in the investment portfolio accounts; (c) securities were properly valued in accordance with GAAP; and (d) all liabilities related to the securities were recorded in the financial statements.²³¹

What distinguishes Commission audit failure proceedings from state corporate law duty of care activities, however, is not merely that they focus on financial auditing, but also the variety of remedies the SEC can employ and the frequency with which the agency brings actions. At the current time the Commission, in essence, can invoke five different types of remedies:

- (1) Judicial injunctions under, among other provisions, section 21(d)(1) of the Securities Exchange Act;²³²
- (2) Disciplinary actions against accountants under Rule 2(e) of the Commission's Rules of Practice;²³³
- (3) Disciplinary proceedings against the corporate registrant under section 15(c)(4) of the Securities Exchange

²³¹ *Id.* at 159-60.

²³² 15 U.S.C. § 78u(d) (1988). Regarding Commission injunctive proceedings, see generally, 10 LOSS & SELIGMAN, *supra* note 3, at 4661-83.

²³³ 17 C.F.R. § 201.2e (1993). Regarding Rule 2(e) proceedings, see generally 10 LOSS & SELIGMAN, *supra* note 3, at 4799-812.

Act;²³⁴

- (4) Administrative cease and desist proceedings against either the accountant or the registrant;²³⁵ or
- (5) References to the Justice Department for criminal prosecution.²³⁶

The frequency with which SEC accounting proceedings has been brought dwarfs state corporate law duty of care proceedings. Since 1970, for example, there have been over 120 Rule 2(e) proceedings brought against accountants;²³⁷ and, of the 60 section 15(c)(4) proceedings brought between 1975 and June 1985, 46 were said to have concerned accounting and financial disclosures.²³⁸ Similar totals have already begun to develop for accounting violations under the Commission's cease and desist powers, which were only adopted in 1990.²³⁹ In contrast Professor Joseph Bishop observed in 1968 about the state corporate law duty of care that

²³⁴ 15 U.S.C. § 78o(c)(4) (1988); see 4 LOSS & SELIGMAN, *supra* note 3, at 1898-1902.

²³⁵ See 10 LOSS & SELIGMAN, *supra* note 3, at 4911-914. There are also civil fines and bar orders that can be imposed. See *id.* at 4906-10, 4914-15.

²³⁶ See 10 LOSS & SELIGMAN, *supra* note 3, at 4684-716. Leading criminal accounting fraud cases include *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); *United States v. Benjamin*, 328 F.2d 854 (2d Cir. 1964), *cert. denied*, 377 U.S. 953 (1964); *United States v. White*, 124 F.2d 181 (2d Cir. 1941).

²³⁷ In *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979), the Second Circuit upheld Rule 2(e) as applied to accountants as "a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general." Regarding the greater than 120 Rule 2(e) proceedings, see citations in 10 LOSS & SELIGMAN, *supra* note 3, ch. 13.A(3) (forthcoming 1993).

²³⁸ William R. McLucas & Laurie Romanowich, *SEC Enforcement Proceedings Under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 BUS. LAW. 145, 152 (1985).

²³⁹ See, e.g., *In re Abington Bancorp, Inc.*, Exchange Act Release No. 30,614, [Current] Fed. Sec. L. Rep. (CCH) ¶ 73,837 (Apr. 22, 1992) (also internal accounting controls); *In re Caterpillar Inc.*, Exchange Act Release No. 30,532, [Current] Fed. Sec. L. Rep. (CCH) ¶ 73,330 (Mar. 31, 1992) (Item 303 of Reg. S-K); *In re Amre, Inc.*, Exchange Act Release No. 30,431, [Current] Fed. Sec. L. Rep. (CCH) ¶ 73,823 (Mar. 2, 1992) (also internal accounting controls); *In re Richard D. Lemmerman*, Exchange Act Release No. 29,737, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,789 (Sept. 26, 1991); *In re Excel Bancorp, Inc.*, Exchange Act Release No. 29,675, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,785 (Sept. 11, 1991) (same); *In re Fleet/Norstar Fin. Group, Inc.*, Exchange Act Release No. 29,557, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,146, at 90,814 (Aug. 14, 1991) (also internal accounting controls).

[t]he search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. Few are the cases in which the stockholders do not allege conflict of interest, still fewer those among them which achieve even such partial success as denial of the defendant's motion to dismiss the complaint.²⁴⁰

Twenty-five years later Bishop's words still ring true. Bishop identified only four cases in which directors of industrial corporations had been held potentially liable for negligence uncomplicated by self-dealing. The 1992 American Law Institute Principles of Corporate Governance Proposed Final Draft cited only three cases as examples of "negligent liability."²⁴¹

Recently in several individual months, private plaintiffs have filed at least that many duty of care cases, employing the federal securities laws. For a failure to disclose a duty of care violation can be fraud, a point, for example, implied by Delaware's supreme court in *Smith v. Van Gorkom*.²⁴²

Most of these private federal securities fraud cases are based on misrepresentations or omissions in a corporation's financial statements. For example, in recent years, a substantial number of lawsuits have alleged that corporations made projections or forward looking statements of such matters as future earnings "without a reasonable basis."²⁴³ Other cases have involved such cognate areas as bank loan loss reserves,²⁴⁴ pending legal proceedings²⁴⁵ or trends or uncer-

²⁴⁰ Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Officers and Directors*, 77 YALE L.J. 1078, 1099 (1968).

²⁴¹ Cf. AMERICAN LAW INSTITUTE, *supra* note 16, § 4.01, at 210.

²⁴² 488 A.2d 858, 890-92 (Del. 1985).

²⁴³ Rule 175(a) of the Securities Act, 17 C.F.R. § 230.175(a) (1993). For discussion of the SEC's policy on projections, including citations to the literature and leading cases, see 2 LOSS & SELIGMAN, *supra* note 3, at 622-36 (1989 & Supp. 1992).

²⁴⁴ See, e.g., *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272 (3d Cir.), *cert. denied*, 113 S. Ct. 365 (1992); *In re First Chicago Corp.*, Exchange Act Release No. 24,567, [1987-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,603 (June 10, 1987).

²⁴⁵ See, e.g., *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989) (unclean power plant approval proceeding); *Levine v. NL Indus., Inc.*, 926 F.2d 199, 203-04 (2d Cir. 1991) (Regulation S-K Item 101(c)(1)(xii) requires disclosure of both the cost of complying with environmental regulations and potential costs for failing to comply); cf. *In re United States Steel Corp.*, Exchange Act Release No. 16,223, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,319

tainties concerning liquidity, capital resources and income that the SEC requires corporate registrants to disclose in the Management Discussion and Analysis Item of Regulation S-K.²⁴⁶

A duty of care suit can also arise under the federal securities laws for such "plain vanilla" accounting misconduct as inventory deficiency fraud,²⁴⁷ improper income recognition²⁴⁸ or improper accounting for goodwill.²⁴⁹ Moreover the Commission can also bring fraud actions directly against the corporation for material misrepresentations or omissions in the nonfinancial parts of required filings. Currently Regulation S-K specifies narrative disclosure of such disparate topics as:

Item 101: Description of a corporation's business (including information about financial segments);²⁵⁰

Item 102: Description of its property;²⁵¹

Items 201-02: Securities of the corporation;²⁵² or

Item 503(c): Risk factors in a new securities issuance.²⁵³

Indeed the practical consequence of requiring large publicly held corporations to comply with the SEC's Regulations S-K and S-X both in their mandatory periodic disclosures to share-

(Sept. 27, 1979) (corporation was found to have failed to disclose between 1973 and 1977 the material effects that compliance with environmental laws would have on capital expenditures and earnings and failed to disclose a series of pending or contemplated environmental administrative proceedings when it stated in its filings, "U.S. Steel had pledged to confront and resolve its environmental problems as effectively and efficiently as technology, time and money permit"). See generally 2 LOSS & SELIGMAN, *supra* note 3, at 649-62 (1989 & Supp. 1992) (concerning general responsibilities for pending legal proceedings).

²⁴⁶ Regulation S-K Item 303, 17 C.F.R. § 229.303 (1993); see, e.g., *In re Caterpillar, Inc.*, Exchange Act Release No. 30,532, [1982-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,830 (Mar. 31, 1982). For discussion and citations to literature and leading cases, see generally 2 LOSS & SELIGMAN, *supra* note 3, at 669-72 (1989 & Supp. 1992).

²⁴⁷ See, e.g., *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 432-35 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980); cf. *In re Burroughs Corp.*, Exchange Act Release No. 21,872, 32 SEC Docket (CCH) 935 (1985).

²⁴⁸ See, e.g., *United States v. Stirling*, 571 F.2d 708 (2d Cir.) *cert. denied*, 439 U.S. 824 (1978).

²⁴⁹ See, e.g., *Republic Technology Fund, Inc. v. Lionel Corp.*, 483 F.2d 540 (2d Cir. 1973), *cert. denied*, 415 U.S. 918 (1974).

²⁵⁰ See 2 LOSS & SELIGMAN, *supra* note 3, at 639-46.

²⁵¹ *Id.* at 647-49.

²⁵² *Id.* at 662-64.

²⁵³ *Id.* at 678-82.

holders and the Commission *and* when they issue new securities to the public is largely to transform concern with the duty of care from a highly episodic involvement for a small number of corporations in state fiduciary litigation to an ongoing compliance responsibility of all corporations subject to SEC jurisdiction.

Supreme Court decisions such as *Santa Fe v. Green*,²⁵⁴ which in 1977 aborted a Rule 10b-5 challenge to a going private transaction, because that Rule did not reach "a breach of fiduciary duty by majority shareholders, without any deception, misrepresentation, or nondisclosure,"²⁵⁵ may suggest that fraud is something fundamentally different than fiduciary duty violations. This is an error corporate law practitioners don't tend to make. When a business corporation misstates either the text or numbers in its financial statements (in the absence of a conflict of interest), this is typically viewed as fraud based on a form of negligence. In some instances there will be a pleading requirement that the plaintiff assert that at least severe recklessness was involved.²⁵⁶ But as the SEC's safe harbor rule for projections²⁵⁷ with its reference to "reasonable basis" well illustrates, recklessness is not invariably a prerequisite for a securities fraud claim.²⁵⁸ A private action can be successfully litigated against an accountant involved in the preparation of a registration statement under section 11 of the Securities Act of 1933 when the accountant is unable to carry a "due diligence" (or, duty of care) defense.²⁵⁹ Similarly when the SEC brings fraud actions against accountants under sections 17(a)(2) or (3) of the same Act, the Commission only has to prove the equivalent of negligence, rather than scienter.²⁶⁰ To be sure, actions against accountants under Rule 14a-9²⁶¹ and aiding and abetting claims against accountants

²⁵⁴ 430 U.S. 462 (1977).

²⁵⁵ *Id.* at 476.

²⁵⁶ See 8 LOSS & SELIGMAN, *supra* note 3, at 3665-67 n.521.

²⁵⁷ Rule 175 of the 1933 Act, 17 C.F.R. § 230.175 (1993) and Rule 3(b)-6 of the 1934 Act, 17 C.F.R. § 240.3b-6 (1993).

²⁵⁸ See 8 LOSS & SELIGMAN, *supra* note 3, at 3653-77.

²⁵⁹ See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

²⁶⁰ See *Aaron v. SEC*, 446 U.S. 680 (1980).

²⁶¹ See 9 LOSS & SELIGMAN, *supra* note 3, at 4479-88, 4487-88 n.66; see also *supra* note 200.

under Rule 10b-5²⁶² require at least reckless misconduct. But the difference between negligence, gross negligence, and recklessness is one of degree. The key is that securities fraud claims, in fact, are often based on conduct that is the equivalent to a state law fiduciary duty violation regardless of the formal pleading requirements of a federal securities law cause of action.

III. A PROPOSAL

These federal securities law developments leave the duties of loyalty and care in an awkward state. While the federal securities laws, for example, have expanded the necessity for corporations to disclose material conflicts of interest, these same federal laws provide no remedy when there has been full disclosure of a conflict *and* an unfair transaction. At that point enforcement is solely a matter of state law. But the states in recent years have increasingly erected barriers to derivative claims challenging duty of loyalty violations in publicly traded corporations. Federal and state laws, therefore, appear to be moving in opposite directions.

Against this background, if Congress chose to act it would have a choice. Congress, for example, could adopt a regulatory conflict of interest provision along the lines suggested by Harold Marsh²⁶³ or a more limited litigation approach.

While I sympathize with the end sought by Marsh, I doubt that a general regulatory approach would be wise. Either it would be limited to officer and director conflicts of interest, in which case it would exclude important categories of duty of loyalty violations such as those involved in parent-subsidiary mergers, or more broadly it would have to address potential conflicts of interest generally. If the more general approach were pursued, Congress would be enacting exactly the type of "merit" regulation that it eschewed in adopting the Securities Act of 1933.²⁶⁴ Ironically while merit regulation is often de-

²⁶² *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

²⁶³ See Marsh, *supra* note 5, at 74-5.

²⁶⁴ Regarding merit regulation, see 1 LOSS & SELIGMAN, *supra* note 3, at 109-22.

riden as heavy-handed or bureaucratic, the difficulty with a preemptive review of potential conflict transactions is that it might tend to give an agency blessing to transactions that when completed may raise substantial questions of fairness. Perhaps the risk of premature regulatory approval of potential interested transactions can be fully obviated through skillful statutory or rule drafting or skillful administration. Nonetheless the potential delays and costs for those engaged in merger or similar types of transactions persuades me that a less intrusive, *ex post* approach is preferable.

In 1974, former SEC Chairman and then Columbia Law School Professor William Cary, troubled by Delaware's role in the deterioration of state corporate law standards, proposed a Federal Corporate Uniformity Act.²⁶⁵ More recently I have endorsed an amplification of this idea.²⁶⁶ The essence of Cary's proposal was that Congress should preempt state corporate law norms only when a compelling need for a limited intervention can be shown. This limited type²⁶⁷ of approach is particularly appropriate in a country with our long history of state corporate law standards. One area today where sufficient evidence has accumulated to justify possible congressional action would be the duties of loyalty and care. I would urge that this examination be limited to only the largest of the publicly traded corporations; for example, those otherwise subject to SEC jurisdiction under section 12 of the 1934 Act.²⁶⁸

The federal fiduciary duty cause of action Congress could enact would be litigated in federal court and would expressly prohibit federal courts from deferring to special litigation committees in suits properly alleging the misconduct of any mem-

²⁶⁵ See Cary, *supra* note 154, at 701.

²⁶⁶ See Seligman, *supra* note 143, at 947.

William Quillen, in an accompanying response, emphasizes the last few pages of my Article in which I recommend that Congress consider a limited preemption of state fiduciary duty law for corporations subject to § 12 of the 1934 Act. See Quillen, *supra* note 96, at 123 n.80. I have no interest in writing a detailed reply to his response, but I will observe that while I did co-write a proposal for federal chartering in 1976 with Ralph Nader and Mark Green, my current article relies solely on the more limited proposal contained in my 1990 article in the *Maryland Law Review*, *supra* note 155.

²⁶⁷ See Cary, *supra* note 154, at 701.

²⁶⁸ For discussion of § 12, see 4 LOSS & SELIGMAN, *supra* note 3, at 1733-73.

ber of the board of directors. The federal fiduciary standard should substitute for the special litigation committee the federal courts' standards for dismissal of nonmeritorious suits.²⁶⁹ The new standard will pose some difficult drafting problems. For instance, how should Congress respond to those states that currently permit a corporation to "opt out" of duty of care liability?²⁷⁰ And, what if these same states went further and permitted corporations to opt out of duty of loyalty liabilities or capped duty of loyalty damages? These types of issues might be resolved by the adoption of language such as that contained in section 29(a) of the 1934 Act, prohibiting the enforcement of state or private conditions, stipulations, or provisions binding any person to waive or limit compliance with the newly adopted federal fiduciary duties.

The substance of the standards will also require considerable thought. Should Congress adopt as its duty of care standard a gross negligence standard such as that in Delaware, language similar to the definition of reasonableness in section 11(c) of the Securities Act²⁷¹ or another formulation? Congress has already had some experience in making these types of judgments, for example, in section 36(b) of the Investment Company Act.²⁷² This is both a manageable and conventional drafting problem. At the same time it is likely that if Congress does address the need for new federal fiduciary duty standards, it will examine other topics as well. I do not believe that this should be a one-sided inquiry. There may also be a need, as I have suggested elsewhere,²⁷³ to examine applicable discovery and joinder rules to see if it is possible to design a new federal approach that more effectively deters duty of loyalty violations yet can do so at a lower transaction cost to the corporations that foot the bill for derivative litigation.

In sum, I believe we have reached a point where Congress should consider buttressing the state law duties of loyalty and care with concurrent federal legislation. The appropriate legis-

²⁶⁹ See, e.g., FED. R. CIV. P. 12, 56.

²⁷⁰ DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

²⁷¹ 15 U.S.C. § 77k(c) (1988).

²⁷² 15 U.S.C. § 80a-35(b) (1988).

²⁷³ Seligman, *supra* note 143, at 403.

lation, however, should not fully preempt state law and should be no broader than its demonstrated need.

