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Breach of Fiduciary Duty as Securities Fraud: SEC v. Chancellor Corp.

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NOTE

BREACH OF FIDUCIARY DUTY AS SECURITIES FRAUD: *SEC V. CHANCELLOR CORP.*

by Carl W. Mills[*]

INTRODUCTION

The federal government has assumed an increasingly prominent role in the regulation of substantive corporate governance, an area traditionally regulated by the states. Striking evidence of this shift can be seen in recent action by the Securities and Exchange Commission (the "SEC" or the "Commission"). Recent, widely publicized corporate scandals, such as Enron and WorldCom, explain the timing of the shift. The factors that led to those scandals, however, have been festering for years, and may be inextricably tied to the corporate form itself. The shift in regulatory power, therefore, is more properly viewed as the culmination of a slow awakening to the fundamental failure of market forces and state regulatory regimes to adequately protect shareholders and the public. Delaware, the preeminent state with regard to the development of corporate law, played a key role in, and is likely to suffer the consequences of, this failure.

Despite the inevitability of federal regulation of substantive corporate governance, the propriety of such regulation is far from settled. It is questionable whether the federal government has the power to effect such a change. The wide latitude the Supreme Court has given Congress in exercising its powers under the Commerce Clause, however, makes the success of legal challenges to any perceived

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overreaching unlikely. Federalization of corporate governance nevertheless invites a discussion of the proper limits of federal power, and whether such federalization will benefit corporations, their shareholders, and the public, or whether entrenched directors and officers will continue to exercise influence beyond their nominal power.

In addition to these broad concerns, the details of federalization remain unclear. Corporate governance has been federalized on an ad hoc basis, with Congress, the SEC and federal courts addressing specific problems, seemingly without an overall plan. This has left corporations and the public to guess at what form the new regulatory regime will take. There are, however, clues to the contours of the newly federalized regime, including expansion of Rule 10b-5 to include liability for breaches of the duty of care, and the development of a federal common law of director liability. This note focuses on this particular aspect of federal involvement in corporate governance regulation.

Federal regulation of director conduct raises several questions, including whether or the extent to which federal law will incorporate state fiduciary duty standards that are already well developed, particularly in Delaware. Closely related to this substantive issue is whether state regulatory systems will continue to operate parallel to the federal apparatus, or whether the states will abdicate responsibility, as they have in the past when the federal government has asserted jurisdiction in various legal contexts.

All of these issues are brought to the fore in the SEC's action against Rudolf Peselman, an outside director of a small, but public, Massachusetts transportation company. A close examination of the facts of that case provides insight into the substance of the emerging federal corporate governance duties.

Part I of this note discusses the corporate form generally. An understanding of the tensions that are inherent in corporate governance reveals the need for government regulation. Part II discusses the traditional roles of the federal government and the states in regulating corporations. Part III examines the history of state regulation of corporations, and the development of state regulation of director conduct, particularly the duty of care under Delaware law. Part III also analyzes the failure of state corporate law to adequately protect shareholders and the public from marauding managers.

Part IV begins by discussing recent corporate scandals, and their implications for corporate governance reform. Part IV continues with an in-depth look at the how these implications are already very real, as exemplified by the SEC's allegations against Peselman. Part V discusses the development of federal regulation of corporate governance, focusing on causes of action under Rule 10b-5, and discussing the SEC's past forays into regulating director conduct. Part V then analyzes the increase in federal regulation of corporate governance under the Sarbanes-Oxley Act. Part V presents some of the arguments in favor of an increased federal role in regulating corporate governance. Part V discusses the possible scope of the new federal fiduciary standard, in particular how the standard is linked to disclosure requirements. Part V also presents some arguments against an increased federal role in regulating corporate governance, especially where that role would preempt state regulation. Part VI concludes.

I. THE CORPORATE FORM

The prime source of tension in corporate law is the divergence between the interests of managers and shareholders: a separation of ownership and control.[1] Shareholders are the owners of a corporation, but because they are too numerous to run it efficiently, they employ managers—the officers—to do the job.[2] Shareholders elect representatives—the directors—to monitor the management.[3] Although directors are nominally charged with overseeing the activities of the company, officers perform the actual day to day management of most corporations.[4] The directors have broad discretion to delegate their authority to officers, agents, and committees of directors.[5] The rationale

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1. *See* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119–20 (1932).

2. *See* Usha Rodriquez, *Let the Money do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J. L. BUS. & FIN. 254, 254 (2004).

3. *Id.*; *see, e.g.*, Aronson v. Lewis, 473 A.2d 805, 811 (1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.") (citing DEL. CODE tit. 8, § 141(a)).

4. *E.g.*, Harman v. Willbern, 374 F. Supp. 1149, 1161 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); Kelly v. Bell, 254 A.2d 62, 72 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. 1970); Burlington Indus., Inc. v. Foil, 202 S.E.2d 591, 603 (N.C. 1974).

5. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(c) (authorizing delegation of board's authority, except in certain specified situations, to committee of directors). MASS. GEN.

for this delegation is that outside directors, who do not also hold management positions, are subject to constraints of time and lack of detailed information and cannot be expected to focus on non-critical matters or to be involved in hands-on management of corporate affairs.[6] Such delegation does not, however, relieve directors of their general duty to act with care and attention.[7] The directors' task is supposed to be to ensure that the managers are serving the interests of the shareholders.[8] Several factors, however, have resulted in officers exercising most of the important corporate powers.[9] Although it is argued that motivated shareholders have the power to effect change in managerial policy,[10] most shareholders lack such an interest, due in part

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LAWS ch. 156B, § 65 (West 2004) states, in relevant part:

> In performing his duties, a director . . . shall be entitled to rely on information, opinions, reports or records, including financial statements, books of account and other financial records, in each case presented by or prepared by or under the supervision of (1) one or more officers or employees of the corporation whom the director, officer or incorporator reasonably believes to be reliable and competent in the matters presented.

See also Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) ("An informed decision to delegate a task is as much an exercise of business judgment as any other.").

6. *See* Harvey Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMP. L. REV. 13, 14 (1988) (directors are not expected to engage in the day-to-day management of the corporation); R. Link Newcomb, Note, *The Limitation of Directors' Liability: A Proposal for Legislative Reform*, 66 TEX. L. REV. 411, 432 (1987).

7. *E.g.*, Lowell Hoit & Co. v. Detig, 50 N.E.2d 602, 603 (Ill. App. Ct. 1943); McEwen v. Kelly, 79 S.E. 777, 779 (Ga. 1913).

8. *See, e.g.*, DEL CODE ANN. tit. 8, § 141 (2003) ("business and affairs of every corporation organized under this chapter shall be managed by *or under the direction of* a board of directors") (emphasis added); Stephen M. Bainbridge, *The Board of Directors as a Nexus of Contracts*, 88 IOWA L. REV. 1, 4 n.9 (2002).

9. Robert B. Thompson, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 860 (2003) (citing Alan Greenspan, *Excerpts from Report by Greenspan at Senate*, N.Y. TIMES, July 17, 2002, at C8 ("Our vast and highly liquid financial markets enable large institutional shareholders to sell their shares when they perceive inadequacies of corporate governance, rather than fix them. This has placed de facto control in the hands of the chief executive officer.")).

10. *See* Aronson v. Lewis, 473 A.2d 805, 811 (1984) ("The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management."). Some scholars view the situation differently. *See, e.g.*, Rodriquez, *supra* note 2, at 261 (stating that "shareholders have little real power to effect change in the governance of the corporations they own"). Even if shareholders could garner such power, some have noted that it may not be viewed as positive,

to the highly liquid nature of the stock market.[11] Other factors leading to officer domination stem from the internal realities of the corporate form.

In the ideal corporate model, directors are diligent in fulfilling their duties and maintain an attitude of "constructive skepticism" to the information and recommendations presented by management, even asking "incisive, probing questions" and requiring "honest answers."[12] Directors are "supposed to bring integrity and intelligent oversight" to the corporations they oversee.[13] Directors' duties are especially important in ensuring that information disclosed to shareholders is accurate, and their duties have particular significance when they have reason to doubt the motives of management.[14]

In a perfectly functioning corporate model, regulation of corporate governance is unnecessary because various market mechanisms will lead to optimally efficient restrictions on corporate officers.[15] These

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especially by the federal government. Larry Cata Backer, *In the Wake of Corporate Reform: One Year in the Life of Sarbanes-Oxley – a Critical Review Symposium Issue: Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327, 349 (2004) (citing Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association, *Report on Proposed Changes in Proxy Rules and regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109, 118–20 (2003)) ("Shareholder democracy may lead to instability that may result in anarchy.").

11. *Id.* at 901 ("The turnover rate of share ownership has increased substantially during the last fifty years, and recent data put it at 100% on an annualized basis.") (citing New York Stock Exchange, Data Library, NYSE Statistics Archive, *at* http://www.nyse.com/marketinfo/marketinfo.html).

12. Rodriquez, *supra* note 2, at 258 (quoting The Business Roundtable, PRINCIPLES OF CORPORATE GOVERNANCE iii, 3 (2002), *at* http://www.brtable.org/document.cfm/704).

13. Speech by SEC Staff: Remarks at the University of Michigan Law School by Stephen M. Cutler (Nov. 1, 2002), *available at* http://www.sec.gov/news/speech/spch604.htm.

14. Report of Investigation In the Matter of the Cooper Companies, Inc. as it Relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 35,082, 34-35082, at 1 (Dec. 12, 1994) (stating that "corporate directors have a significant responsibility and play a critical role in safeguarding the integrity of [a] company's public statements and the interests of investors when evidence of fraudulent conduct by corporate management comes to their attention").

15. Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 947 (1990).

mechanisms fit into three categories: market forces, such as product, capital and control; monitoring devices, such as the directors and outside auditors; and "bonding techniques," which are implicit contracts between managers and shareholders restricting various aspects of corporate policy, for example, executive compensation.[16] If these forces fail, however, legal restrictions are needed to prevent harm to shareholders and the public from, for example, corporate managers engaging in self-interested conduct.[17] It has long been viewed as the government's role to correct these failures, but the question remains, which government?

II. FEDERALISM

The framers of the Constitution envisioned a government with power divided between dual sovereigns: the federal government and the states.[18] The states were to retain plenary powers in the interest of "permitting diversity, encouraging competition, and facilitating experimentation."[19] As Justice Brandeis wrote, "[i]t is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country."[20] The federal government's powers were to be limited to national and international matters.[21]

16. *Id.* at 947.

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

18. Alden v. Maine, 527 U.S. 706, 748 (1999) (citing Lopez v. United States, 514 U.S. 549, 583 (1995) (Kennedy, J., concurring); Printz v. United States, 521 U.S. 898, 935 (1997); New York v. United States, 505 U.S. 144, 188 (1992)) ("Although the Constitution grants broad power to Congress, our federalism requires that Congress treat the States in a manner consistent with their status as residuary sovereigns and joint participants in the governance of the Nation.").

19. Richard W. Barnett, *The New Federalism, The Spending Power, and Federal Criminal Law*, 89 CORNELL L. REV. 1, 17 (2003).

20. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

21. *See* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 585–586 (1985) (O'Connor, J., dissenting) (citing Fry v. United States, 421 U.S. 542, 547 n.7 (1975); State of New York v. United States, 326 U.S. 572, 586–587 (1946) (Stone, C.J., concurring); NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1, 37 (1937) (holding

Pursuant to this scheme, states have traditionally set the rules for incorporation. In 1811, New York enacted the first general corporation law.[22] Flowing from the ability to create corporations,[23] states also assumed primary responsibility for regulating internal corporate affairs.[24] The states' power to regulate corporations, and internal corporate governance in particular,[25] has been repeatedly and firmly upheld by the Supreme Court.[26]

Despite such strong enunciations, the states' monopoly on corporate regulation has always been subject to reevaluation. The original federalists envisioned that the state and federal governments would compete to persuade the public as to which was better suited to regulate in any particular field.[27] If states failed to regulate adequately or

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that "means by which national power is exercised must take into account concerns for state autonomy"). *But see* Peter J. Henning, *Federalism and the Federal Prosecution of State and Local Corruption*, 92 KY. L.J. 75, 144 (2003–2004) ("Federalism limits the scope of Congress' authority to regulate commerce, but it does not impose an impenetrable barrier between what may be considered truly national and truly local with regard to every regulation under that grant of power.").

22. *See* N.Y. LAWS ch. 67, § 111 (1811) (currently N.Y. BUS. CORP. §§ 101–102 (McKinney 2004)); *see also* Katharina Pistor, et. al., *The Evolution of Corporate Law, A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 798 (2002).

23. *See* CTS Corp. v. Dynamics Corp., 481 U.S. 69, 89 (1987) (stating that "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law").

24. *See* Cort v. Ash, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."); *see also* Edgar v. MITE Corp., 457 U.S. 624, 645–46 (1982); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987).

25. *See* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Apr. 1, 2003, at 26, 27–28 ("The Supreme Court has . . . consistently recognized that state law governs the rights and duties of corporate directors.") (citing Burks v. Lasker, 441 U.S. 471, 478 (1979) (stating that the "first place one must look to determine the powers of corporate directors is in the relevant state's corporation law")).

26. CTS Corp. v. Dynamics Corp., 481 U.S. 69, 88 (1987) ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations.").

27. Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 635 (2004) (citing Todd E. Pettys, *Competing for the People's Affection: Federalism's Forgotten Marketplace*, 56 VAND. L. REV. 329, 333

persisted in permitting a regulatory void, the federal government could step in and win public confidence by filling the void with its own regulation.[28]

For over a century federal law was totally silent on the internal governance of corporations. This changed with the Securities Act of 1933 (the "33 Act")[29] and the Securities Exchange Act of 1934 (the "34 Act").[30] The legislative history of the 34 Act explains the intrusion of federal law into an area traditionally regulated by the states, pointing out that for some time management had exploited gaps in state regulation, to the disadvantage of shareholders and the public.[31] As a direct result these managerial abuses, and the failure of the states to adequately regulate the voting and disclosure process, Congress included in the 34 Act comprehensive provisions transferring regulatory authority to the newly created SEC.[32] Congress was careful to also point out, however, that the legislation was not intended to supplant state regulation of internal corporate governance.[33] Congress made no effort to directly interfere with or regulate the duties and obligations of directors, and expressly disavowed any desire to interfere in managerial responsibility.[34]

For years after the enactment of the 33 and 34 Acts, federal involvement in securities regulation was viewed as strictly limited to

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(2003)).

28. *Id.* at 627.

29. Codified 15 U.S.C. §§ 77a–77aa.

30. Pub. L. No 73-291, 48 Stat. 881 (1934) (codified 15 U.S.C. §§ 78a–78nn); *see* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1442 (1992) (discussing the foray of the new acts into internal corporate governance).

31. H.R. REP. NO. 73-1383, pt. 2, at 12 (1934) (noting that disclosure requirements are necessitated in part by "a growing tendency toward extreme broadness and flexibility in the corporation laws of many states").

32. Pub. L. No. 73-404, 48 Stat. 885 (codified, as amended, at 15 U.S.C. § 78(d) (2000)).

33. *Id.*

34. *See* S. REP. NO. 73-792, pt. 2, at 10 (1934) ("The principal objection directed against the provisions for corporate reporting is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations. The committee has no such intention, and feels that the bill furnishes no justification for such an interpretation. To make this point abundantly clear, Section 13(d) specifically provides that nothing in the act shall be construed to authorize interference with the management of corporate affairs.").

rules regarding disclosure, and procedural and anti-fraud rules to ensure the accuracy of disclosures.[35] Both Congress and the Supreme Court have occasionally reiterated the limited role of federal involvement in securities regulation.[36] Nevertheless, federal securities law now plays a significant role in regulating corporate affairs.[37] Although the states may still retain primary responsibility for corporate regulation, and state law continues to govern the major aspects of corporate law,[38] federal involvement is a constant specter.[39] As with the 33 and 34 Acts, the increasing federal role in corporate governance today can be attributed to the failures of state regulation.

III. STATE REGULATION OF CORPORATIONS

In keeping with federalism's notion of states as laboratories for experimentation with various regulatory regimes, corporations can shop around for attractive corporate domiciles by comparing the legal regimes offered by different states.[40] States have several reasons to be interested in having companies incorporate within their boundaries, including franchise taxes and fee revenues yielded by incorporations[41] and patronage provided by corporations for local law firms, corporation

35. Bainbridge, *supra* note 25, at 31 (stating that "federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and anti-fraud rules designed to make disclosure more effective").

36. Thompson, *supra* note 9, at 860 ("In 1995, Congress expressed 'a clear desire to limit the use of federal securities fraud lawsuits, at least insofar as those lawsuits were perceived to be frivolous.'") (citing Private Securities Litigation Reform Act § 101(b), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. § 74u–4(b) (2000))).

37. Thompson, *supra* note 9, at 860 (stating that "federal securities law and enforcement via securities fraud class actions . . . have become the most visible means of regulating corporate governance").

38. *See* Bebchuk, *supra* note 30, at 1442 (citing Cary, *supra* note 17, at 633); Romano, *supra* note 24, at 709.

39. Jones, *supra* note 27, at 635 (citing Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596–98 (2003) (noting that "whenever the federal government disapproves of state policy, it may, and often does, preempt state law").

40. Bebchuk, *supra* note 30, at 1442–43.

41. *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 888 (1990).

service companies, and other businesses.[42] Many scholars argue that these factors lead to state competition for corporate charters.[43]

Scholars have been engaged in a longstanding, heated debate about the effects of this competition. Some argue that state competition produces a "race to the bottom," whereby state corporate law develops as dictated by competitive pressure to produce legal rules attractive to managers, who make incorporation decisions.[44] It is widely acknowledged that a company's state of incorporation is determined by the company's management.[45] Managers both initiate the selection of the state of incorporation and retain control over any reincorporation decision.[46] Race to the bottom theorists posit that, absent countervailing factors, management will select a jurisdiction that favors their own self-interest.[47] Some commentators have noted that competition among states will only effect those areas of corporate law that are vital enough to cause management to reincorporate.[48] The areas of "paramount importance" to management are the maximization of decision-making flexibility, the minimization of personal liability and the preservation of their positions.[49] The problem of management interest in seeking a favorable corporate domicile is exacerbated by the fact that shareholders are usually not residents of the state making the management-friendly corporate law, and therefore are not constituents of the legislators who write it.[50] The rules developed by states in areas of importance to

42. Cary, *supra* note 17, at 668–69; John C. Coffee, *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759, 762 (1987).

43. *See* Cary, *supra* note 17; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); *see also* Lucian Bebchuk, et. al., *Does The Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1776 (2002). *But see* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

44. *See* Bebchuk, *supra* note 30, at 1457.

45. *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002); J. Robert Brown, *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 322 (2004) (citing Winter, *supra* note 43, at 252).

46. Jones, *supra* note 27, at 636.

47. *See* Cary, *supra* note 17, at 663.

48. Brown, *supra* note 45, at 331.

49. *Id.*

50. Bebchuk, *supra* note 30, at 1452 (noting that Delaware citizens are likely hold

corporate managers can be expected to be at best ambivalent toward the interests of shareholders, if not directly adverse.[51]

The race to the bottom that results from state competition is intertwined with the problems inherent in the separation of ownership and control.[52] By one estimate, competition for charters began in the 1880s, when states removed limitations on the size of corporations, possibly due to pressure from management eager to aggregate capital.[53] Following the repeal of size restrictions, managers of public corporations also sought maximum discretion in conducting business, arguing, correctly, that control by a large number of shareholders was impracticable. This led to the amendment of corporate codes, shifting authority from shareholders to directors.[54]

Another set of scholars, however, argue that state competition produces a "race to the top," whereby competition leads to greater innovation and experimentation in the development of corporate law rules.[55] Advocates of the race to the top theory argue that companies incorporated in states with efficient legal rules will perform better in the long run.[56] In turn, their share prices will rise, and eventually more companies will want to incorporate in states with similarly efficient rules.[57] Race to the top theorists use a market rationale to counter the argument that states will pander exclusively to management: investors, they argue, will not purchase, or at least will not pay as much for, securities of companies that incorporate in states that "cater too excessively" to management.[58] In addition, lenders might not lend to

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an "insignificant fraction" of shares of Delaware corporations for the purposes of giving Delaware a significant direct interest in the consequences of its corporate law for shareholder value; whereas it has a major interest in how their law affects incorporation decisions).

51. *See* Cary, *supra* note 17.

52. *See* Bebchuk, *supra* note 30, at 1458.

53. Brown, *supra* note 45, at 335.

54. *Id.*

55. *See* Winter, *supra* note 43.

56. *Id.*

57. *See* RALPH WINTER, GOVERNMENT AND THE CORPORATION (1978); Daniel Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982).

58. Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 626 (1991).

such companies without compensation for the risks posed by the lack of managerial accountability that is inherent in management-friendly rules.[59] This risk aversion on the part of lenders will increase the cost of capital, and cut into the earnings of companies incorporated in excessively pro-management states.[60]

More recently, some scholars have argued that state competition produces a race to the top with respect to some corporate issues, but a race to the bottom with respect to others.[61] Their argument, however, does not hinge on the infallibility of state competition in producing good corporate law. Rather, they ask "whether some competition is better than none."[62] A number of recent articles have taken the position that there is, in fact, no state competition.[63] Regardless of whether state competition is a driving force behind the development of corporate law, the essence of the debate is about the proper substance of corporate law rules.[64] It is to that substance that this note now turns.

a. Corporate Governance Under State Law

The modern history of corporate law is inextricably linked to Delaware. Delaware is the dominant state domicile for Fortune 500 and New York Stock Exchange-listed companies,[65] and the leading destination of companies that reincorporate.[66] The Delaware court system and bar are widely recognized as expert in corporate law, and their decisions have a profound influence on the corporate law of most

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59. Bainbridge, *supra* note 25, at 30.

60. *Id.*

61. *See* Bebchuk, *supra* note 30, at 1440.

62. *See* Bainbridge, *supra* note 25, at 30 (suggesting that the answer be in the affirmative).

63. *See* Jones, *supra* note 27, at 627 (noting that "the implied absence of state-to-state competition suggests the need to reconsider the appropriate role of the federal government as a corporate regulator"); *See also* Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L. J. 553 (2002); Kahan & Kamar, *supra* note 43.

64. Jones, *supra* note 27, at 630.

65. JEFFREY BAUMAN, ET. AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 61 (5th ed. 2003); JAMES D. COX & THOMAS L. HAZEN, CORPORATIONS 36–38 (2d ed. 2003); Bebchuk & Hamdani, *supra* note 63, at 568.

66. BAUMAN, *supra* note 65, at 61; Bebchuk & Hamdani, *supra* note 63, at 593–96.

other states.[67] This note focuses on the development of the directors' duty of care under Delaware law. The weakness of state corporate governance in this particular area provides an opportunity, if not the impetus, for the federal government to assert itself.

b. The Duty of Care

Upon accepting the office of director of a corporation, a person assumes a duty of loyalty to the company and its shareholders, and a duty to act with care in fulfilling his responsibilities.[68] Some judges and scholars have recognized a third duty, that of good faith, although this is often seen as a bridge between the duties of loyalty and care.[69] These fiduciary duties flow from the agency relationship that exists between the directors and shareholders.[70] Under Delaware law, the duty of loyalty is primarily applied in situations where directors have a more or

67. *See, e.g.*, McMurray v. De Vink, 27 Fed. Appx. 88 (3d Cir. 2002) ("We share the appellees' high regard for the courts and jurists of Delaware, and we are well aware of the unique stature of corporate law in Delaware."); Teamsters Local Nos. 175 & 505 Pension Trust Fund v. IBP, Inc., 123 F. Supp.2d 514, 519 (D. S.D. 2000) ("Not only does Delaware law apply to this case, but the Delaware chancery court, through its daily interpretation of that law, has earned a reputation for its expertise concerning corporate governance.").

68. *See* BAUMAN, *supra* note 65, at 591.

69. *See* Larry D. Soderquist, *The Proper Standard for Directors' Negligence Liability*, 66 NOTRE DAME L. REV. 37, 52–55 (1990) ("In addition to the requirement of due care, a director must perform his duties in good faith. The good faith requirement demands that a director act honestly in performing his duties and precludes actions designed to benefit the director personally to the detriment of the corporation."). *See also* Corporate Director's Guidebook, 33 BUS. LAW 1591, 1601 (1978). Revised Model Bus. Corp. Act § 8.30 also requires that the director perform his duties in a manner he "reasonably believes to be in the best interest of the corporation." The requirement that the director's belief be "reasonable" has generated controversy as to whether this language goes beyond the common law in permitting courts to second guess directors' good-faith decisions. *See* Norman Veasey & William E. Manning, *Codified Standard-Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 953–962 (1980). In certain states, the requirement of "reasonable" belief has been omitted from the due care statutes. *See, e.g.*, CAL. CORP. CODE § 309(a) (West 2004); N.Y. BUS. CORP. LAW § 717 (West 2004).

70. *See* BAUMAN, *supra* note 65, at 39–44 (excepts from Bayer v. Beran, 49 N.Y.S.2d 2 (N.Y. 1944)).

less direct financial interest in a company transaction, whereas the duty of care applies to director decisions that do not involve conflicts of interest.[71]

Many states specify the degree of care required of a corporate director.[72] Although Delaware has no statutory formulation of directors' fiduciary duties, its courts have (to a certain extent) developed a standard of conduct against which to measure director action.[73] The statutory formulations of the duty of care, which generally require the care of an ordinary prudent person in a like position, do not give much guidance as to what precisely is demanded of directors or what constitutes a breach of the duty.[74]

Delaware cases have used various formulations to describe the duty of care generally and have haphazardly given it some more specific substance as the facts of individual cases have presented themselves. In general, directors must discharge their duties and act in good faith, that is, the honest belief that the actions they take are in the best interest of

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71. State of Wisconsin Inv. Bd. v. Peerless Systems Corp., No. Civ. A. 17637, 2000 WL 1805376, at *16, 27 Del. J. Corp. L. 726 (Del. Ch. Dec. 4, 2000) (citing Guth v. Loft, 5 A.2d 503, 510 (1939)) ("Under longstanding Delaware precedent, director action that is self-interested or for selfish reasons is a breach of the fiduciary duty of loyalty."); *see also* BAUMAN, *supra* note 65, at 592 & 685.

72. *See* ALA. CODE § 10-2B-8.30; ALASKA STAT. § 10.06.450(b); ARK. CODE ANN. § 4-27-830(A); CAL. CORP. CODE § 309; COLO. REV. STAT. § 7-108-401; CONN. GEN. STAT. § 35-756; FLA. STAT. ANN. § 607.0830; GA. BUS. CORP. CODE § 14-2-830; HAW. BUS. CORP. ACT § 415-35(b); IND. CODE § 23-1-35-1; ME. REV. STAT. ANN. tit. 13-A, § 716; MD. CODE ANN. CORPS & ASS'NS § 2:405.1; MASS. GEN. LAWS ch. 156D, § 8.3; MISS. BUS. CORP. ACT § 79-4-8.30; MONT. CODE ANN. § 35-1-418; N.H. REV. STAT. ANN. § 293-A:830; N.J. REV. STAT. § 14A:6-14; N.M. STAT. ANN. § 53-11-35(B); N.Y. BUS. CORP. LAW § 717; OHIO REV CODE ANN. § 1701.59(B), (C); OKLA. STAT. tit. 18, § 1.34(B); R.I. GEN. LAWS § 7-1.1-33; S.C. BUS. CORP. ACT § 33-8-300; TENN. CODE ANN. § 48-18- 301; UTAH CODE ANN. § 16-10a-840; VA. CODE ANN. § 13.1-690(A); VT. STAT. ANN. tit. 11A, § 8.30; WASH. REV CODE § 23B.08.300; WYO. STAT. § 17-16-830.

73. Jones, *supra* note 27, at 646–47 (citing ROBERT C. CLARK, CORPORATE LAW 123 (1986)).

74. *E.g.*, ALA. CODE § 10-2B-8.30(a)(2) (setting the standard as "the care an ordinarily prudent person in a like position would exercise under similar circumstances"); CAL. CORP. CODE § 309; MASS. GEN LAWS ch. 156D, § 8.3(a)(2) (setting the standard as "the care that a person in a like position would reasonably believe appropriate under similar circumstances").

the company.[75] Directors are required to make decisions based on informed business judgment, meaning that they should inform themselves of all "material information reasonably available to them."[76] Directors should use "reasonable diligence" in gathering and considering information that is material, or merely relevant, prior to making a decision, and should exercise "reasonable care" in the attention they give to the performance of their general responsibilities.[77]

More recently, Delaware courts have clarified that the duty of care has two distinct forms: the procedural duty of care and the substantive duty of care.[78] To the extent the distinction is meaningful, the substantive duty of care prohibits directors from wasting corporate assets,[79] whereas the procedural duty of care requires that directors consider certain information and take certain actions during their decision-making process.[80] The procedural duty of care is most closely related to federal securities disclosures, and is therefore the focus of this section.

Delaware courts have held that under the duty of care directors are responsible for: overseeing the activities of the corporation by attending directors' meetings; requiring that the company provide adequate information for decision-making; carefully reviewing any documents provided by the company; and monitoring the activities that they have delegated to officers.[81] Other courts have held that, at a minimum,

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75. Aronson v. Lewis, 472 A.2d 805, 812 (Del. 1984).

76. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting *Aronson*, 473 A.2d at 812).

77. *Aronson*, 473 A.2d at 812 (Del. 1984); Solash v. Telex Corp., Fed. Sec. L. Rep. (CCH) ¶93,608, 97,727, 1998 WL 3587 (Del. Ch. 1988) ("good faith decision by a disinterested board cannot be the source of director liability even if the process by which the decision was made was arguably negligent"); *see also* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274 (2d Cir. 1986).

78. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244 (2000).

79. *See* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) ("[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.").

80. *See Aronson*, 473 A.2d at 812 (Del. 1984) (stating that, prior to making business decisions, directors must inform themselves of "all material information reasonably available to them").

81. *See* Ivanhoe Partners v. Newmont Min. Corp., 535 A.2d 1334 (Del. 1987); *see also* Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003) (interpreting Delaware law);

directors should insist that they receive adequate information concerning all important matters requiring their attention in time to permit a review of the information before any vote is taken.[82] Evidence that directors took sufficient time to consider relevant information, within the limits of any time constraints, will help establish that they acted with care.[83] Other courts have gone further, suggesting that directors should carefully read disseminated material and discuss, ask questions, and give full consideration to relevant factors before making a decision, and that the board minutes should reflect such discussion.[84]

Under the standard duty of care analysis, directors have no special obligations with regard to information supplied by management.[85] Reliance on management or expert representations or reports is justified absent "red flags."[86] Courts have recognized, however, that it is unlikely that directors are exercising informed judgment where there is evidence of "recurring mechanical reliance" on information supplied by management "without critical analysis."[87] Some scholars have cautioned that any absolute requirement that directors verify information

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EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS & DIRECTORS, RIGHTS, DUTIES & LIABILITIES, § 2:01 (rev. ch. 2001).

82. Growbow v. Perot, 539 A.2d 180, 191 (Del. 1988) (Delaware Supreme Court, holding that the plaintiffs had not adequately alleged a breach of duty of acre, noted that the plaintiffs had not claimed that the board failed to inform themselves of available critical information before approving the transaction, consider expert opinion, provide all Board members with adequate and timely notice of the transaction, or inquire adequately into the reasons for the transaction).

83. *See, e.g.*, Treadway Companies, Inc. v. Care Corp., 638 F.2d 357 (2d Cir. 1980) (directors adjourned deliberations for one week to consider requested information). *Cf.* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275 (2d Cir. 1986) (directors acted hastily, without emergency need for such haste). *See also* Priddy v. Edelman, 883 F.2d 438, 442–44 (6th Cir. 1989) (rejecting claim that quick approval showed lack of due care, where delay could have prejudiced shareholders and where directors were advised by outside financial experts).

84. *See, e.g.*, Muschel v. Western Union Corp., 310 A.2d 904, 907 (Del. Ch. 1973).

85. *See* BRODSKY & ADAMSKI, *supra* note 81, at § 2:15.

86. *See* Solash v. Telex Corp., Fed. Sec. L. Rep. (CCH) ¶93,608, 97,727, 1998 WL 3587 (Del. Ch. 1988) (directors fulfill their duty of care by reviewing management supplied information in the standard manner, as long as they are "unaware, and in the exercise of due care would not have been aware, of facts or discrepancies signaling the need for additional information").

87. Corporate Director's Guidebook, 33 BUS. L. 1591, 1603 (1978); *see also* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

supplied by management would be inefficient and might create an adversarial relationship between directors and officers.[88]

i. Scienter for Breach of Fiduciary Duty & The Business Judgment Rule

The substantive obligations that constitute directors' duty of care have evolved without explicit focus on the scienter required for a breach. Certainly a willful violation of, or conscious disregard for, the duty of care would suffice to show a breach.[89] The duty has been so amorphously defined, however, that a finding of willful breach is almost precluded.[90] Director liability has more often been predicated on a theory of gross negligence in the exercise of the duties that fall under the rubric of care.[91] Although some cases refer merely to the use of reasonable care, and therefore could imply a negligence standard,[92] very few cases have imposed liability for negligence in the absence of self-

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88. *See* Brodsky & Adamski, *supra* note 81, at § 2:15 ("any absolute requirement of verification could interfere with corporate efficiency, increase costs and tend to create an adversarial relationship between management and outside directors that may be counterproductive"). *Cf.* John C. Coffee, *Beyond the Shut-Eyed Sentry, Toward a Theoretical View of Corporate Misconduct and Effective Legal Response*, 63 VA. L. REV. 1099, 1108 (1977).

89. *See, e.g.*, Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) (requiring "reckless indifference . . . or a deliberate disregard").

90. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 n.6 (noting that "Delaware cases have not been precise in articulating the standard by which the exercise of business judgment is governed").

91. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (en banc); Solash v. Telex Corp., Fed. Sec. L. Rep. (CCH) ¶93,608, 97,727, 1998 WL 3587 (Del. Ch. 1988) (applying gross negligence standard and stating that although reasonable minds may differ as to whether it was prudent to rely on an investment banker which had a predominating financial interest in the transaction, "it is at the very time when reasonable persons might differ that the policy of the law supporting gross negligence standard becomes so important").

92. *See, e.g.*, Keyser v. Commonwealth Nat'l Fin. Corp., 675 F. Supp. 238, 257–58 (M.D. Pa. 1987) (holding that negligence was sufficient to impose liability under Pennsylvania law prior to the enactment of 42 PA. CONS. STAT. ANN. § 8364, permitting the elimination of negligence as a ground for the imposition of liability); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973); Heit v. Bixby, 276 F. Supp. 217 (E.D. Mo. 1967).

dealing or some other abuse, i.e. not for breaches of the duty of care.[93]

The choice of a gross negligence standard complements the business judgment rule, which is designed to give directors leeway to act and take risks without fear of judicial second guessing.[94] The rule presumes that directors act in good faith, and absent evidence to the contrary gives directors wide discretion within which to act without fear of liability.[95] In most instances, the invocation of the business judgment rule suffices to insulate directors from liability to the corporation or its shareholders for losses that result from poor decision-making.[96]

Delaware courts have held that the business judgment rule does not

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93. *See* Harvey Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMP. L. REV. 13, 16 (1988) (few reported cases in which directors have been held liable for mere negligence); *see also* Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968); J. Gordon Christy, *Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duty of Care and Loyalty*, 21 HOUS. L. REV. 105, 109–10 (1984); Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1150 (5th Cir. 1989) ("The cases which use negligence and gross negligence as concepts to aid in interpreting the duty owed [to the corporation] simply have not gone so far as to find liability where a director or officer has been merely negligent.").

94. *See* Solash Corp. v. Telex Corp., Fed. Sec. L. Rep. (CCH) ¶93,608, 97,727 (Del. Ch. 1988):

> In order to prevent second guessing on what might be close questions concerning the appropriateness of the process by which a business decision was made, the law has set a high standard. Only if the process is grossly negligent may liability for damage resulting from a good faith decision be found.

See also Daniel Fishel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1442 (1985) (increased judicial scrutiny would reinforce the tendency to avoid risk); Donald E. King, *Director Protection Under Virginia Law*, 20 REV. SEC. & COMMODITIES REG. 129, 131 (1987) (some states reduce the risk of second guessing by requiring that a breach of the duty of care go beyond mere negligence before personal liability will be imposed).

95. *See* Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 273 (2d Cir. 1986) (noting that "a presumption of propriety inures to the benefit of directors"). *See also* Daniel Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 283–84 (1986) (business judgment rule precludes judicial review of the merits of managerial decisions in a wide variety of contexts, and thus reflects the limits of liability rules in assuring contractual performance of managers in public corporations).

96. Jones, *supra* note 27, at 627 (citing Williams v. Geier, 671 A.2d 1368 (1996)).

apply if the directors have breached their duty of care.[97] Scholars have noted, however, that Delaware courts usually limit their analysis of the business judgment rule presumption to the process used in making a decision.[98] The so-called "procedural duty of care" has been described as the "most amorphous and unpredictable exception to the business judgment rule."[99] The process analysis is seen by some as a "rubber stamp" of director behavior.[100]

The business judgment rule and the scienter requirement in the demand context were brought before the Delaware Supreme Court in *Aronson v. Lewis*.[101] The specific issue before the court was when a stockholder's demand on the board of directors would be excused as futile prior to the filing of a derivative suit.[102] The court stated that the test for futility of demand is "whether the Board, at the time of the filing of the suit, could have impartially considered and acted upon the demand."[103] The court noted that "under the business judgment rule director liability is predicated upon concepts of gross negligence."[104]

In *Brehm v. Eisner*, the Delaware Supreme Court once again interpreted the issue of whether there was a reasonable doubt that the directors' conduct was protected by the business judgment rule, thereby

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97. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); *see also* Cuker v. Mikalauskas, 692 A.2d 1042 (1997) (citing ALI, Principles of Corporate Governance, § 4.01(c)); *Grobow*, 539 A.2d at 187 (stating that "good faith and the absence of self-dealing are threshold requirements for invoking the rule").

98. Wells M. Engledow, *Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties*, 63 ALB. L. REV. 505, 508 (1999) (stating that the "business judgment rule reflects little more than process inquiry").

99. Jones, *supra* note 27, at 627 (citing COX & HAZEN, *supra* note 65, at 191–95).

100. Brown, *supra* note 45, 340 (citing Engledow, *supra* note 98, at 507).

101. 473 A.2d 805 (Del. 1984).

102. *Id.* at 805 ("The demand requirement of Rule 23.1 is a rule of substantive right designed to give a corporation the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise.") (citing Aronson v. Lewis, 466 A.2d 375, 380 (Del. Ch. 1983)). A similar roadblock is presented by the demand rules which require that shareholders make a demand on the board to sue on behalf of the corporation. If the board refuses, a shareholder derivative action will be dismissed. Without demand, the shareholders must prove that demand would be futile, which is a hard burden to fulfill. *Aronson*, 473 A.2d at 805.

103. *Id.* at 809 (citing *Aronson,* 466 A.2d at 381).

104. *Id.* at 812.

obviating the need for a demand on the board.[105] The court reiterated that the directors' decision-making process is only actionable if it is grossly negligent.[106] The court held that directors are only responsible for considering material facts that are reasonably available,[107] and are entitled to rely on qualified experts.[108] The court held that plaintiffs' complaint failed to allege that the directors would not be protected by the business judgment rule.[109] Thus, the business judgment rule remains a significant hurdle to stockholder suits.

The tantalizing but ephemeral nature of the duty of care is also illustrated by *Smith v. Van Gorkom* and its aftermath.[110] In *Van Gorkom*, the Delaware Supreme Court held directors liable for making an uninformed decision in a case not involving personal gain, fraud or bad faith.[111] Some scholars viewed the *Van Gorkom* decision as a signal that the duty of care had taken on significance as an actual source of liability.[112] Others scholars argued, however, that *Van Gorkom* did "little more than require boards to paper the file and create the appearance of deliberation."[113] Nevertheless, the Delaware legislature responded to *Van Gorkom* by adding Section 102(b)(7)[114] to the

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105. 746 A.2d 244, 258–59 (2000).

106. *Id.* at 259 (citing *Aronson*, 473 A.2d at 812).

107. *Id.* (defining material as "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking" and differentiating between materiality in this sense and materiality in the disclosure context, which means "substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote") (citing O'Malley v. Boris, 742 A.2d 845, 850 (1999)).

108. *Id.* at 260–61.

109. *Id.* at 262.

110. 488 A.2d 858 (Del. 1985).

111. *Id.*

112. *See id.*; 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, 117–18 (1993) (noting that the "*Van Gorkom* decision and its aftermath led to heightened awareness and enforcement of the duty of care, and undoubtedly has raised the level of performance of corporate directors").

113. Brown, *supra* note 45, at 340–41 (citing R. Franklin Balotti, et. al., *Equity ownership and the Duty of Care: Convergence, Revolution, or Evolution?*, 55 BUS. LAW. 661, 663 (2000) (describing *Van Gorkom* as emphasizing the "procedural rituals that a board should follow in making a decision")).

114. DEL. CODE tit. 8, § 102(b)(7) (1988).

Delaware Code.[115] Section 102(b)(7) allows corporations to insert into their articles of incorporation a provision that waives monetary damages for breaches of the duty of care.[116] After Delaware enacted Section 102(b)(7), similar provisions were enacted by most states.[117]

Shareholders responded by filing cases that alleged that directors had not acted in good faith.[118] This was met with hostility from the Delaware courts. In *In re Dataproducts Corp. Shareholders Litigation*, the shareholders sued Dataproducts' directors in connection with the directors' approval of Hitachi's acquisition of the company.[119] The shareholders' claim asserted that the directors had not met their oversight responsibilities, and alleged that the directors abdicated their oversight obligations by acquiescing to manipulation by individual managers.[120] The plaintiffs' assertion centered on the fact that the merger announcement was timed to predate, and therefore prevent, positive information about Dataproducts' business from causing Dataproducts' stock to rise, to the benefit of shareholders.[121] To avoid the effects of Section 102(b)(7), the plaintiffs claimed that the directors' abdication was not in good faith.[122] The vice chancellor disagreed, reasoning that abdication was equally indicative of gross negligence as it was of intentional or bad faith behavior, and that the action was therefore barred by the liability limiting provision in Dataproducts' certificate of incorporation.[123] *Dataproducts* indicates that Delaware courts will interpret Section 102(b)(7) exclusions narrowly.[124] Chancellor Strine has argued that a director who is "conscious that he is

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115. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 n.18 (Del. 1985) (stating that the Section was "a legislative response to the Supreme Court of Delaware's liability holding in *Van Gorkom*").

116. DEL. CODE tit. 8, § 102(b)(7).

117. Within twenty years, all fifty states had some type of provision that limits director liability. *See* Brown, *supra* note 45, at 341 n.152.

118. *See, e.g.*, In re Best Lock Corp. S'holder Litig., 845 A.2d 1057 (Del.Ch. 2001).

119. 1991 WL 165301, at *4–5, Fed. Sec. L. Rep. ¶ 96,227 (Del. Ch. Aug. 22, 1991).

120. *Id.* at *5.

121. *Id.* at *6.

122. *Id.* at *6.

123. *Id.*

124. MARK A. SARGENT & DENNIS R. HONABACH, D&O LIABILITY HANDBOOK § DE:1; Charter option.

not devoting sufficient attention to his duties" would not be acting in good faith, and therefore would not be entitled to exculpation from damages liability under 102(b)(7).[125] Thus, the existence of a 102(b)(7) provision supplements the protection of the business judgment rule by requiring a showing of intentional wrongdoing instead of gross negligence.

Corporations may also use special litigation committees to further impede shareholder actions.[126] Special litigation committees are formed to decide if a corporation should sue its directors or officers for, among other things, breaches of fiduciary duties.[127] In most cases, if a special litigation committee decides that a suit is not warranted, a shareholder derivative action will be dismissed.[128]

The development of the business judgment rule and passage of Section 102(b)(7) have been viewed by some as weakening the duty of care to a nullity.[129] It has also led some scholars to believe that Delaware's deference to management has neutered corporate governance and resulted in shareholder protections that are "more theoretical than real."[130] Despite the lack of a clear formulation of the

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125. Leo Strine, *Derivative Impact? Some Early Reflections on Corporate Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1393 (2002).

126. *See* Stein v. Bailey, 531 F. Supp. 684 (S.D.N.Y. 1982) (Where decision of a committee on litigation not to sue on corporation's behalf was reached in good faith by independent and disinterested committee members after a reasonable and thorough investigation, the corporation's refusal to pursue securities litigation was not wrongful under Delaware law; because the application of Delaware's business judgment rule to shareholder's securities claims was consistent with the policy underlying the securities law, the business judgment rule applied to the decision not to sue on the securities claim.).

127. *See* In re Oracle Corp. Derivative Litig., 824 A.2d 917, 928 (Del. Ch. 2003) (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 788–89 (Del. 1981)); Katell v. Morgan Stanley Group, Civ. A. No. 12343, 1995 WL 376952, at *6 (Del. Ch. June 15, 1995).

128. *See, e.g.*, Kaplan v. Wyatt, 499 A.2d 1184 (Del. 1985); *see also* BAUMAN, *supra* note 65, at 840 (noting that special litigation committees have the "potential to curtail almost totally the availability of a shareholder's right to use the courts for redress of alleged breaches of fiduciary duty"). *But see* Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003) (finding that the board was not independent for purposes of dismissal of derivative action).

129. Thompson, *supra* note 9, at 866 ("Loyalty and good faith . . . remain the only significant bases for a claim asserting a breach of fiduciary duty.").

130. Jones, *supra* note 27, at 646.

duty of care, Delaware court determinations nevertheless provide some certainty for directors because the duty of care has been "reduced . . . to a series of formalities."[131] The formalities themselves, however, are subject to change, and more recent Delaware cases may indicate a "trend toward stricter judicial decision-making."[132]

In *In re Walt Disney Co. Derivative Litigation*,[133] the Delaware Chancery Court "undermined the reliability of the two stalwart defenses to due care claims: the business judgment rule and exculpation."[134] The plaintiff shareholders alleged that Disney's directors failed to exercise any business judgment in approving president Michael Ovtiz's employment agreement and subsequent non-fault termination.[135] The court evaluated the plaintiffs' allegations under *Aronson's* second prong (whether sufficient facts were alleged to raise a reasonable doubt that the challenged transactions were entitled to business judgment rule protection) and concluded that the allegations did create such a doubt.[136] The court concluded that the board's alleged conduct may have constituted such gross negligence as to violate Delaware's "good faith" requirement, and thereby precluded the defendants' use of exculpatory protections.[137] The court "lambasted" the board's decision-making process,[138] noting that the board had taken only ten minutes to consider the termination agreement, had only one and a half pages of minutes, and had little information at the time of approval.[139] The court viewed the allegations as suggesting that the "directors consciously and intentionally disregarded their responsibilities."[140] This does not clarify, however, whether the required level of scienter is gross negligence or the intentional disregard that the court implied was operating in the background.

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131. Brown, *supra* note 45, at 334.
132. Jones, *supra* note 27, at 662.
133. 825 A.2d 275 (Del. Ch. 2003).
134. Jones, *supra* note 27, at 655.
135. In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 277–78 (Del. Ch. 2003).
136. *Id.* at 288–89.
137. *Id.* at 286.
138. *See* Jones, *supra* note 27, at 656 (discussing *In re Walt Disney*).
139. *In re Walt Disney*, 825 A.2d at 287–88.
140. *Id.* at 289.

ii. Duty to Monitor

Out of the amorphous duty of care requirements, a slightly more specific duty on the part of outside directors to monitor the business affairs of the corporation has recently emerged from the Delaware case law and scholarly articles.[141] Under the general duty of care, directors were not held accountable for corporate misdeeds when they had no knowledge of the matter that caused the harm.[142] This provided an incentive for directors to remain uninformed.[143]

In *In re Caremark*, the Delaware Chancery Court suggested that directors have a fiduciary obligation to monitor, and to put in place procedures designed to keep them informed about, the activities of the company.[144] Scholars have noted, however, that *Caremark* did not establish a meaningful standard for director conduct, rather it merely "required the paper trail procedures that were already common practice," and furthermore was never ratified by the Delaware Supreme Court.[145]

Although Delaware courts have still not imposed "meaningful obligations" on directors to monitor the activities of the company,[146] it is generally accepted that they do have to investigate if they are put on notice by "red flags."[147] On the other hand, *Disney*, and other recent cases such as *Abbott Laboratories*,[148] "adopt a tone completely consistent with the current wave of popular opinion calling for outside, independent directors to take a more proactive role in corporate governance or risk substantial personal liability."[149] The standard for

141. *See* Grobow v. Perot, 539 A.2d 180, 191 (Del. 1988) ("We view a board of directors with a majority of outside directors . . . as being in the nature of overseers of management."); Mobridge Cmty. Indus., Inc. v. Toure, Ltd., 273 N.W.2d 128, 133 (S.D. 1978) (by accepting a position on the board "each director is charged with monitoring the heartbeat of the business and knowing where the corporation stands in regard to finances, obligations, goals, policies"); Francis v. United Jersey Bank, 432 A.2d 814, 822 (1981) (directorial management requires "general monitoring of corporate affairs and policies"); *see also* Brown, *supra* note 45, 343–44.

142. *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 131 (Del. 1963).

143. Brown, *supra* note 45, at 344.

144. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

145. Brown, *supra* note 45, at 345.

146. *Brown, supra* note 45, at 334.

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

148. In re Abbott Labs. Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2003).

149. *See* SARGENT & HONABACH, *supra* note 124.

director conduct under Delaware law remains unclear.

c. Weakness in the System

The three principal restraints on corporate managers—market forces, monitoring devices and bonding techniques—were weakened throughout the 1980s.[150] Part of this weakening can be attributed to Delaware court decisions.[151] Delaware decisions interpreting management's fiduciary obligations are widely followed by other states,[152] leading, over time, to a national impact on corporate governance.[153] Arguably none of the states responded adequately to the failures of the market. The Delaware court system, which is perceived to have a deep body of case law and a high level of expertise,[154] probably had the best opportunity to develop good corporate governance standards, but it failed, leaving little hope that other states would succeed.

Instead, Delaware was the state where managers turned for "assurances of minimal exposure to personal liability for mistakes, misjudgments, wrongdoing, or self-dealing."[155] Meanwhile directors, whose high-paying jobs are tethered to an election process controlled by

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150. Seligman, *supra* note 15, at 971.

151. Kahan & Kamar, *supra* note 43 (concluding that all states have a pro-management bias in the development of corporate law).

152. *See* NCR Corp. v. AT&T Co., 761 F. Supp. 475, 499 (S.D. Ohio 1991) (recognizing that "the decisions of Delaware courts are often persuasive in the field of corporate law").

153. Bayless Manning, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 783 (1987).

154. *See, e.g.*, McMurray v. De Vink, 27 Fed. Appx. 88 (3d Cir. 2002) ("We share the appellees' high regard for the courts and jurists of Delaware, and we are well aware of the unique stature of corporate law in Delaware."); Teamsters Local Nos. 175 & 505 Pension Trust Fund v. IBP, Inc., 123 F. Supp.2d 514, 519 (D. S.D. 2000) ("Not only does Delaware law apply to this case, but the Delaware chancery court, through its daily interpretation of that law, has earned a reputation for its expertise concerning corporate governance.").

155. Jones, *supra* note 27, at 646; *see also* Brown, *supra* note 45, at 334 ("Delaware . . . took the lead in minimizing liability for directors and maximizing job retention.") (discussing Delaware courts' acquiescence in corporations' adoption of poison pills).

management, had every incentive to engage in behavior that would keep them on the board.[156] Board membership became "viewed by outsiders as an honor or a perk instead of a substantive job,"[157] and may well have been viewed as such by directors themselves. As a result, Delaware became "the poster child for bad corporate governance."[158] Managers grew fat and complacent on Delaware law, while the Delaware courts reveled in their own perceived success.[159]

Meanwhile, another actor quietly began to share the spotlight. The federal government, primarily through Rule 10b-5,[160] has begun to regulate director conduct. Although federal involvement in several areas of corporate governance has effectively ended state regulation,[161] Delaware remains in a position to play a significant role in the regulation of director conduct. Despite the adoption of management-friendly doctrines and devices described above, Delaware law remains as broad and flexible as anything in the federal arsenal,[162] including Rule 10b-

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156. Brown, *supra* note 45, at 373–74.

157. Speech by SEC Staff: Remarks at the University of Michigan Law School by Stephen M. Cutler (Nov. 1, 2002) *available at* http://www.sec.gov/news/speech/spch604.htm.

158. Bainbridge, *supra* note 25, at 30. It should be noted, however, that the companies involved in the two largest scandals, WorldCom and Enron, were not Delaware corporations, they were Georgia and Oregon (as of 2000) corporations, respectively. *See* WorldCom, Inc., PROSPECTUS (1995), *available at* http://www.sec.gov/Archives/edgar/data/723527; Enron Corp., 2000 ANNUAL REPORT ON FORM 10-K (2001), *available at* http://www.sec.gov/Archives/edgar/data/1024401/0001024401-00- 000002.txt.

159. *See* Cary, *supra* note 17, at 672; *see also* Mark J. Lowenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 376 (2004) ("[D]irectors have failed the system . . . because, in many instances, they lack the will, the time, and/or the incentives to do so.").

160. 17 C.F.R. § 240.10b-5 (West 2004).

161. For example, federal regulation has shown the ability to replace state regulation, however briefly, of voting and takeovers. *See* Roe, *supra* note 39, at 630–33 (citing Edgar v. MITE Corp., 457 U.S. 624, 640–43 (1982) and CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987)); *see also* Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127, 146 (2004) (noting that "federal authorities have displaced states' corporate law on a set of important issues"); Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 113-116 (2004-2005); Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 267 (1990).

162. Jones, *supra* note 27, at 644 (arguing that the "open-ended nature of Delaware

5.[163] Scholars have noted, however, that Delaware has been unable or unwilling to provide a realistic threat of liability for breaches of fiduciary duty.[164]

Partly in response to the passage of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act"),[165] Delaware courts may have been attempting to preempt the threat of federalization by moving toward more a restrictive application of the business judgment rule and more vigorous enforcement of officers' and directors' fiduciary duties.[166] Some scholars have noted that the Delaware courts appear ready to impose liability on defendant directors in situations "devoid of any hint of self-dealing."[167] Other scholars counter that other recent Delaware cases show that the Chancery Court is not increasing the availability of director liability.[168] If Delaware courts find their corporate governance law preempted by federal regulation,[169] they will have only themselves to blame.[170]

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jurisprudence has allowed its courts to respond swiftly and deftly to forestall federal action") (citing Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1925–28 (1998)).

163. Thompson, *supra* note 9, at 904 (stating that "state law duty of care litigation continues to afford relief to . . . shareholders, but as disclosure and securities fraud litigation have expanded, and as Delaware has raised the bar for care claims, the balance has shifted to a larger federal role") (citing DEL. CODE ANN. tit. 8, § 102(b)(7) (2002)).

164. Thompson, *supra* note 9, at 905 (arguing that "federal cases are working to fill the hole in Delaware law brought about by the lack of liability for, and concomitant inability to sustain, suits for breaches of the fiduciary duty of care").

165. Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (codified in scattered sections of 11, 15, 18, 28 and 29 of the United States Code).

166. Jones, *supra* note 27, at 625 & 662 (there may be a "trend toward stricter judicial decision-making in Delaware", a trend that "correlates in time with significant corporate reforms at the federal level").

167. SARGENT & HONABACH, *supra* note 124.

168. John F.X. Peloso & Ben A. Indek, *Outside Directors and Red Flags*, at 4, *available at* http://morganlewis.com/pubs/outsidedirectors.pdf (taking note of Beam v. Stewart, 833 A.2d 961 (Del. Ch. 2003) (dismissing breach of fiduciary duty claims) and In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003)).

169. *See, e.g.*, Thompson, *supra* note 9, at 904 ("Today's federal securities fraud claims are largely efforts to recover from what could be care claims at state law.").

170. *Id.* at 905 ("Delaware conceded much more of corporate governance than it may have anticipated when it forewent the affirmative use of disclosure obligations, or,

IV. SCANDAL!

a. The Big Ones

Beginning in 2001, a wave of corporate scandals came to light involving some of the nation's largest corporations. The resulting stock collapses and collateral fallout were severely detrimental to shareholders and the public.[171] The scandals were caused by a combination of factors: an age-old menace, "infectious greed," and the failure of the regulatory system to adapt to modern realities.[172] "In each case, controls that were supposed to prevent the defrauding of investors—boards of directors, independent auditors, attorneys, financial analysts—failed."[173]

In most cases the scandals did not result from director

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through the exculpation clause, the affirmative regulation of managerial care.").

171. *See, e.g.*, Joseph Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801, 805–06 (2003) ("Enron, WorldCom, Tyco, and a host of other large-scale corporate scandals . . . have cost investors . . . billions of dollars in the aggregate.") (internal citations omitted); R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 829 (2003) ("The damage to shareholders, innocent employees, vendors, and communities . . . was devastating.") (citing Bob Dart, *Company Collapse Leaves Toll*, ATL. J. & CONST., Oct. 3, 2002), at Q2.).

172. Thompson, *supra* note 9, at 860 (citing Alan Greenspan, *Excerpts from Report by Greenspan at Senate*, N.Y. TIMES, July 17, 2002, at C8 ("historical guardians of financial information were overwhelmed")); *see* Brown, *supra* note 45, at 317–18 (scandals represented a "systematic failure of the regulatory system"). Greenspan notes that "infectious greed gripped much of the business community" throughout the 1990s. The implication, however, that such greed was something new to American corporations or limited to that period is not credible. Greed may well be an underpinning of capitalism.

173. Rodriquez, *supra* note 2, at 255 (citing Am. Bar Ass'n, REPORT ON GOVERNANCE POLICY RESOLUTION 7 (2003), *at* http://www.abanet.org/leadersip/2003/journal/119c.pdf:

> Inordinate self-interest on the part of corporate executives in short term corporate stock price levels, and instances in which that self-interest has led to aggressive accounting or assumption of extreme business risks, were not tempered by the checks and balances which the general corporate governance scheme expected from the directors or the professional firms engaged by the corporation to provide review and advice.

malfeasance.[174] Nevertheless, the scandals sharpened focus on the role of outside directors.[175] In particular, it was perceived that directors failed to oversee managers, and thereby failed to protect the interests of the corporations and their shareholders.[176] "Too often boards of directors . . . proved to be passive spectators, either unwilling or unable to monitor the actions of management."[177] Some laid blame for the lack of oversight on the directors themselves.[178] Others took the states to task for not imposing "meaningful obligations on directors in supervising the activities of the company,"[179] which made the legal risks of abdicating oversight functions "appear tolerable" to directors.[180] Before the big scandals made national headlines, a little-known Massachusetts transportation equipment company was embroiled in a scandal of its own. The allegations in the case, if true, are a clear example of how directors can fail to monitor the companies they are supposed to represent.

b. SEC v. Chancellor Corp.

In April 2003, the SEC filed a complaint in Massachusetts District Court alleging securities fraud and other violations against several officers of Chancellor Corporation ("Chancellor"), as well as the company's independent auditor, and an outside director, Rudolf Peselman.[181] Although Peselman's conduct would almost certainly be

174. Brown, *supra* note 45, at 358 (citing Ellen E. Schultz & Theo Francis, *Well-Hidden Perk Means Big Money for Top Executives*, WALL ST. J., Oct. 11, 2002, at A9).

175. Peloso & Indek, *supra* note 168, at 2.

176. Brown, *supra* note 45, at 317 & 358 (stating that "directors did not act as a meaningful check on managerial self-interest") (citing Schultz & Francis, *supra* note 174, at A9; Stephanie Strom, *Where Does a C.E.O. End and a Company Start?*, N.Y. TIMES, Sept. 22, 2002, § 3, at 13).

177. Rodriquez, *supra* note 2, at 255.

178. *Id.* at 259 (directors have "failed to devote enough time and attention to monitoring, instead tending to defer to management decisions") (citing Am. Bar Ass'n, *supra* note 173).

179. Brown, *supra* note 45, at 317–18.

180. Speech by SEC Staff, *supra* note 13 (Stephen Cutler).

181. SEC v. Chancellor Corp., 03 Civ. 10762, at ¶ 12 (D. Mass. 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm.

considered a breach of the duty of care under Massachusetts[182] and Delaware law, whether it rises to the level of securities fraud is considered by many to be a case of first impression.[183] Peselman has denied the allegations.[184] On April 24, 2003, the SEC agreed to a settled cease and desist order with Michael Marchese, another of Chancellor's

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182. If the SEC takes note of state law regarding directors' fiduciary duties, Massachusetts law would apply. The Massachusetts Business Corporation Law ("MBCL") was repealed in its entirety and replaced last November. MASS. GEN. LAWS ANN. ch. 156D (West 2004). Although the new law was in the works for years, predating both corporate scandals and passage of Sarbanes-Oxley, it is interesting that the changes responded directly to concerns raised by those events and that Act. The new version separated the duties and standards of care for officers and directors. *See* MASS. GEN. LAWS ANN. ch. 156D, §§ 8.02, 8.30, 8.41, 8.42. and added some provisions that mirror changes made at the federal level by the Sarbanes-Oxley Act of 2002. *Compare* MASS. GEN. LAWS ANN. ch. 156D, § 8.32 (barring loans to directors) *with* Sarbanes-Oxley § 402(a), 15 U.S.C. §78m(k) (director loan bar). The new MBCL's section 8.30 sets forth the new standards for directors. MASS. GEN. LAWS ANN. ch. 156D, § 8.30. The standard dictates that directors discharge their duties in good faith, with "the care that a person in a like position would reasonably believe appropriate under similar circumstances," and "in a manner the director reasonably believes to be in the best interests of the corporation." MASS. GEN. LAWS ANN. ch. 156D, § 8.30(a). Directors are entitled to rely on information in making decisions, provided the information had certain indicia of reliability. MASS. GEN. LAWS ANN. ch. 156D, § 8.30(b) (a director may rely on "information, reports, or statements, including financial statements and other financial data, if prepared or presented by: (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent with respect to the information, opinions, reports or statements presented; (2) legal counsel, public accountants, or other persons retained by the corporation, as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence; or (3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence) and that the directors had no knowledge that would cause such reliance to be "unwarranted," MASS. GEN. LAWS ANN. ch. 156D, § 8.30(b) (setting forth that "a director who does not have knowledge that makes reliance unwarranted"); MASS. GEN. LAWS ANN. ch. 156B, § 65 provides in applicable part that a director "shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted," a provision similar to the "red flag" doctrine that has been developing in Delaware.

183. *See, e.g.*, Morrissey, *supra* note 171, at 368–369.

184. Otis Bilodeau, *Directors Who Turn a Blind Eye to Fraud Face SEC Sanctions*, PITTS. POST-GAZETTE, Aug. 21, 2003, at C19.

outside directors, whose conduct was nearly identical to Peselman's.[185]

Chancellor was a Massachusetts corporation headquartered in Boston, principally engaged in buying, selling and leasing transportation equipment.[186] On August 10, 1998, Chancellor entered into a letter of intent to acquire MRB, Inc. ("MRB"), a Georgia corporation also engaged in the transportation equipment industry.[187] The acquisition closed on January 29, 1999.[188] According to the SEC, Chancellor's CEO, Brian M. Adley, requested that Chancellor account for the MRB acquisition as of August 1998, thereby overstating its 1998 revenue by nearly 200%.[189]

In February 1999, Chancellor's outside auditors, Reznick Fedder & Silverman ("Reznick Fedder"), informed Adley and other managers that they did not believe the consolidation was appropriate under generally accepted accounting principles ("GAAP"), which dictate that such a consolidation would only be proper if there was a written agreement between the parties giving Chancellor effective control over MRB as of a date in 1998.[190] Reznick Fedder sent a memorandum to Adley and Marchese, setting forth their position that GAAP required a 1999 consolidation date.[191]

It is alleged that Adley had a written agreement fabricated that supported a 1998 consolidation.[192] Despite this fabrication, Reznick Fedder maintained that the consolidation was improper,[193] and reaffirmed their position in a memorandum sent to Chancellor's audit committee, which consisted of Adley and Marchese.[194] Reznick Fedder once again made their position known at a meeting of Chancellor's board of directors, which was attended by Adley, Peselman, and

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185. In the Matter of Michael Marchese, Exchange Act Release No. 34-47732, 2003 WL 1940244 (Apr. 23, 2003).

186. SEC v. Chancellor Corp., 03 Civ. 10762, ¶ 12 (D. Mass. 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm.

187. *Id.* at ¶¶ 20 & 22.

188. *Id.* at ¶ 22.

189. *Id.*

190. *Id.* at ¶ 23.

191. *In re Marchese*, 2003 WL 1940244, at *3.

192. *Chancellor*, 03 Civ. 10762, at ¶ 24.

193. *Id.* at ¶ 24.

194. *Id.* at ¶ 25; *In re Marchese*, 2003 WL 1940244, at *3.

Franklyn E. Churchill, Chancellor's president and chief operating officer.[195]

Despite additional forgeries, Reznick Fedder refused to approve the 1998 consolidation, and Chancellor's management fired them.[196] In the cease and desist order, the SEC notes that Marchese approved the dismissal.[197] The SEC also alleges that Peselman was aware of the continuing disagreement over the consolidation date, but that he nevertheless approved the dismissal without taking any steps to determine whether Chancellor's position was incorrect.[198]

After firing Reznick Fedder, Chancellor engaged BKR Metcalf Davis ("Metcalf Davis") to conduct the independent audit of its 1998 financial statements.[199] Based on the forged documents that had been rejected by Reznick Fedder, and some newly created documents, Metcalf Davis agreed to sign-off on the financial statements.[200]

In April 1999, after conducting its audit, Metcalf Davis personnel met with Marchese, Peselman, and Chancellor's top management. At the meeting, Metcalf Davis indicated that it would provide an unqualified audit report for Chancellor's 1998 year-end financial statements. For accounting purposes, Metcalf Davis approved an August 1998 acquisition date for MRB.[201] The SEC notes in the cease and desist order that Marchese knew that Chancellor's prior auditors had disagreed with Chancellor's management and had stated that a 1998 acquisition date did not comport with GAAP. The SEC further notes that Marchese neither made an inquiry into the reasons for Metcalf Davis's contrary view, nor determined whether there was any factual support for the 1998 acquisition date.[202]

Also in connection with the acquisition of MRB, the SEC alleges that Adley caused Chancellor to improperly record $3.3 million in consulting fees payable to Vestex Capital Corporation ("Vestex"), a venture capital firm owned by Adley.[203] Once again, the SEC alleges

195. *Chancellor,* 03 Civ. 10762, at ¶ 25.
196. *Id.* at ¶ 27 & 28.
197. *In re Marchese*, 2003 WL 1940244, at *3.
198. *Chancellor*, 03 Civ. 10762, at ¶ 29.
199. *Id.* at ¶ 30.
200. *Id.* at ¶¶ 31 & 32.
201. *In re Marchese*, 2003 WL 1940244, at *3.
202. *Id.*
203. *Chancellor,* at ¶ 33.

that several documents were forged to legitimize this transaction, including board resolutions and minutes.[204]

On April 16, 1999, Chancellor filed a Form 10-KSB for the year ended December 31, 1998, which was signed by Peselman and Marchese, among others.[205] The Form 10-KSB and the financial statements accompanying it contained information regarding the payments to Vestex and the MRB consolidation.[206] The SEC alleges that Peselman signed the Form 10-KSB without taking any steps to ensure that it did not contain materially misleading statements.[207] The SEC suggests that Peselman might have made inquiry into the reasons underlying Metcalf Davis's approval of the 1998 MRB consolidation, in light of the fact that their approval was completely contrary to Reznick Fedder's position.[208] The SEC also suggests that he might have checked whether there was adequate support for the amounts owed to Vestex, and whether this "related party" arrangement was adequately disclosed.[209]

Marchese did not seek re-election as a director in 1999, and ceased being a director on June 25, 1999.[210] In August 1999, Marchese wrote a letter to the SEC staff expressing concern about Chancellor's financial reporting.[211]

An SEC review of the 1998 Form 10-KSB and accompanying financial statements resulted in the Commission informing Chancellor that it would have to restate its financial statements to reflect the MRB acquisition as of January 1999 and to expense, rather than capitalize, the \$3.3 million in consulting fees paid to Vestex.[212] In January 2000, Chancellor filed an amended Form 10-KSB (the "10-KSBA"), which was signed by Adley, Peselman, and several other managers, and which correctly reflected the January 1999 acquisition of MRB.[213] The Form

204. *Id.* at ¶¶ 34, 36–38.
205. *Id.* at ¶ 44; *In re Marchese*, 2003 WL 1940244, at *3.
206. *Chancellor*, 03 Civ. 10762, at ¶¶ 44–47.
207. *Id.* at ¶ 48.
208. *Id.*
209. *Id.*
210. *In re Marchese,* 2003 WL 1940244, at *4.
211. *Id.*
212. *Chancellor*, 03 Civ. 10762, at ¶¶ 51, 52.
213. *Id.* at ¶ 53.

10-KSBA, however, expensed only $1.1 million of the $3.3 million in consulting fees paid to Vestex.[214] Chancellor also failed to disclose the discrepancy between the descriptions of the fee in the 10-KSB and the 10-KSBA, continued to falsely state services provided by Vestex, failed to make a public announcement of the restatement, and failed to identify the financial statements accompanying the 10-KSBA as restated, or to explain the reason for the restatement.[215]

After further review, the SEC required Chancellor to file a second amended Form 10-KSB.[216] This was filed in June 2000, and again signed by Peselman.[217] The SEC alleges, however, that the second 10-KSBA continued to contain several materially misleading statements.[218] The SEC further alleges that Peselman signed both the amended Forms despite the misstatements, and their conflict with the original 10-KSB, and that despite these "red flags," he never questioned the basis for the changes or whether they were appropriate.[219] These actions, the SEC argues, constituted a complete neglect on the part of Peselman of his duties as a director, and as an audit committee member,[220] which he became in June 1999.[221] They point out that he failed to oversee Chancellor's financial reporting, and exercised no care to ensure that the company had appropriate accounting procedures and internal controls, or that its financial records were accurate.[222]

In the cease and desist order, the SEC states that Marchese violated and caused Chancellor's violation of Section 10(b) and Rule 10b-5 when he signed Chancellor's 1998 Form 10-KSB. The Commission also states that he was reckless in not knowing that the Form contained materially misleading statements, noting that he knew that the Form 10-KSB reflected a 1998 MRB acquisition date, that Reznick Fedder had been fired, with his approval, due in part to its disagreement with the 1998 date, and that he nevertheless recklessly failed to make any inquiry into the circumstances leading to Metcalf Davis's approval of a 1998

214. *Id.* at ¶ 54.
215. *Id.*
216. *Id.* at ¶¶ 55, 56.
217. *Id.* at ¶ 57.
218. *Id.* at ¶ 58.
219. *Id.* at ¶ 59.
220. *Id.* at ¶ 60.
221. *Id.* at ¶ 17.
222. *Id.* at ¶ 60.

MRB acquisition date.[223] In addition, the SEC states that Marchese knew that in the previous year Chancellor had written-off $1.14 million in related-party fees to an entity owned by Adley. Despite this, the SEC stated that Marchese recklessly failed to make any inquiry into the basis for the reported $3.3 million in fees payable to an entity owned by Chancellor's CEO, which were included in Chancellor's 1998 Form 10-KSB, and failed to make any inquiry into the existence of documents substantiating the services for which the fees were purportedly due.[224]

The SEC complaint against Chancellor alleges that Adley, Peselman, and several other managers, engaged in fraudulent activities resulting in material overstatements of revenue, income, and assets in Chancellor's public announcements and in its filings with the SEC.[225] By reason of this, the SEC claims that they violated Section 10(b) and Rule 10b-5.[226]

The SEC's complaint seeks to permanently enjoin Peselman from violating Section 10(b) and Rule 10b-5, and several other sections of the 34 Act.[227] The complaint also seeks to prohibit Peselman from acting as an officer or director of any public company[228] and to force him to pay penalties.[229] In order to place the charges against Marchese and Peselman in context, a review of federal involvement in corporate

223. *In re Marchese*, 2003 WL 1940244, at *4.

224. *Id.*

225. *Chancellor*, 03 Civ. 10762, at ¶ 84.

226. *Id.* at ¶ 85. The SEC further claims that their conduct involved fraud, deceit, or deliberate or reckless disregard of regulatory requirements, and resulted in substantial loss, or significant risk of substantial loss, to other persons, within the meaning of Section 21(d)(3) of the Exchange Act. *Id.* at ¶ 86 (citing 15 U.S.C. § 78u(d)(3)). Peselman was also charged with aiding and abetting Chancellor's reporting of false and misleading information in its annual statement, in violation of Section 139(a) of the Exchange Act and Rules 12b-20 and 13a-1, and aiding and abetting Chancellor's maintenance of false and misleading books and records in violation of Section 13(b)(2)(A) of the Exchange Act. *Id.* At ¶ 94 (citing 15 U.S.C. § 78m(a); 17 C.F.R. § 240.12b-20; and 17 C.F.R. § 240.13a-1) & ¶ 109 (citing 15 U.S.C. § 78m(b)(2)(A)). Adley, several other managers, and Metcalf Davis are also claimed to have violated a host of other provisions. *See id.* at ¶¶ 87–125.

227. *Id.* at Prayer for Relief ¶ IV.

228. *Id.* at Prayer for Relief ¶ VI (citing 15 U.S.C. § 781 and 15 U.S.C. § 78o(d)).

229. *Chancellor*, 03 Civ. 10762, at Prayer for Relief ¶ VIII (citing 15 U.S.C. § 78u(d)(3)).

governance is necessary.

V. FEDERAL REGULATION

After its significant initial foray into regulating corporations, embodied in the 33 and 34 Acts, the federal government continued to increase its role in regulating corporations, albeit at a slower pace. Nominally, federal and state regulations still cover different spheres of corporate activity, with the federal government ensuring the integrity of markets, primarily through disclosure requirements and prohibitions on fraud, while the states regulate the corporate form and corporate governance. The distinction, although considered fundamental, has been eroding for years. Securities fraud actions under Rule 10b-5 have moved steadily closer to regulating substantive corporate conduct and, of particular importance here, have been applied to conduct covered by the duty of care. Some scholars have argued that neither the language of the Rule nor the legislative intent behind the 33 and 34 Acts reach such director conduct.[230] Even if this application is not inconsistent with the language of the Rule, as it has been construed, or with the ambitious legislative intent of the statutes, it may be a cause for concern. For example, the potential for conflict is apparent in comparing the scienter requirements for a breach of the duty of care with that required for securities fraud.

a. Securities Fraud: Rule 10b-5's Applicability to Claims for Breach of Fiduciary Duty

Rule 10b-5 makes it unlawful for any person to

> "employ any device, scheme, or artifice to defraud, . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[231]

230. *See* note 391, *infra*.
231. 17 C.F.R. § 240.10b-5 (West 2004).

An implied private right of action under Rule 10b-5 is firmly established,[232] and has been "responsible for most of the litigation under the securities laws."[233] The Rule is also the most widely litigated criminal provision of the securities laws.[234]

The 33 and 34 Acts were "remedial legislation."[235] Consistent with this congressional intent, Section 10(b) and Rule 10b-5 have been liberally construed.[236] The purposes of Section 10(b) and Rule 10b-5 have been articulated in various ways, but are consistently broad. Courts have described Section 10(b) as a "catchall clause to prevent fraudulent practices,"[237] and other courts have stated that the overriding purpose of the Section is to protect the "purity of the securities market,"[238] and to "achieve [a] high standard of business ethics,"[239] substituting "a philosophy of full disclosure for the philosophy of caveat emptor."[240] As early as 1963 some courts described the purpose of

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232. *See* Herman & McLean v. Huddleston, 459 U.S. 375, 380 (1983).

233. Thompson, *supra* note 9, at 882.

234. MARVIN PICKHOLZ, 21 SEC. CRIMES § 6:19 (Section 10 and Rule 10b-5) (2003).

235. S. REP. NO. 73-792, at 3 (Apr. 17, 1934) ("[A]n exhaustive investigation into stock exchange practices was conducted by the committee. Commencing on April 11, 1932, and at frequent intervals since that date, evidence gathered by its investigating staff has been presented to the committee at public hearings, which has laid the foundation for remedial legislation in a field heretofore unregulated.").

236. Tcherepnin v. Knight, 389 U.S. 332 (1967); Int'l Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir. 1974) (Section must be read "flexibly, not technically and restrictively"), *cert. denied*, 417 U.S. 932 (1974); Commerce Reporting Co. v. Puretec, Inc., 290 F. Supp. 715 (S.D.N.Y. 1968) (Section must be liberally construed).

237. Chiarella v. United States, 445 U.S. 222 (1980).

238. *See* Rochelle v. Marine Midland Grace Trust Co. of New York, 535 F.2d 523 (9th Cir. 1976); *see also* O'Brien v. Cont'l Illinois Nat. Bank and Trust Co. of Chicago, 593 F.2d 54 (7th Cir. 1979) (purpose is to assure that full information is available to decision makers in security transactions); In re Penn Cent. Secs. Litig., 357 F. Supp. 869 (E.D. Pa. 1973) (Section 10(b) and Rule 10b-5 were designed to "protect purity of the process of buying and selling securities and to insure that investors would receive full disclosure of information they need if they are intelligently to make significant investment decisions"), *aff'd*, 494 F.2d 528 (3d Cir. 1974).

239. Tomera v. Galt, 511 F.2d 504 (7th Cir. 1975); *see* Reeder v. Mastercraft Electronics Corp., 363 F. Supp. 574 (S.D.N.Y. 1973). *But see* Woodward v. Metro Bank of Dallas, 533 F.2d 84 (5th Cir. 1975) (cautioning that 10(b) is "not the ethical Ten Commandments for all securities transactions").

240. Cant v. A. G. Becker & Co., Inc., 374 F. Supp. 36, *supplemented* 379 F. Supp. 972 (N.D. Ill. 1974). *But see* Freeman v. Laventhol & Horwath, 915 F.2d 193 (6th Cir.

Section 10(b) in a way that seemed to stray into state law territory: "Section [10(b)] was intended to create a form of fiduciary relationship between so-called corporate insiders and outsiders with whom they deal in company securities placing upon insiders duties more exacting than mere abstention from what generally is thought to be fraudulent practices."[241] Under state law, a fiduciary relationship exists between such "insiders" and all shareholders, regardless of whether the insiders are dealing in company securities.

There are four elements to any Rule 10b-5 violation. The Rule proscribes certain misrepresentations and omissions, or the use of fraudulent devices, when those misrepresentations or omissions are accompanied by a certain level of scienter.[242] Instrumentalities of interstate commerce, such as post mail, e-mail or the telephone, must be used in furtherance of the scheme to defraud or the fraudulent conduct, thus providing the basis for federal jurisdictional.[243] The fraud must also be "in connection with" the purchase or sale of a security.[244] To satisfy the "in connection with" requirement, courts have held that a device must be employed that is "of a sort that would cause reasonable

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1990) (Section 10(b) and Rule 10(b)-5 were not meant to "establish a scheme of investors' insurance").

241. Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

242. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *see also* Lawrence v. Cohn, 325 F.3d 141 (2d Cir. 2003) ("To state a claim for securities fraud under §10(b) of the Securities Exchange Act and Rule 10b-5, plaintiff must establish that defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused injury to plaintiff.").

243. United States v. Teyibo, 877 F. Supp. 846 (S.D.N.Y. 1995), *aff'd*, 101 F.3d 681 (2d Cir. 1996) ("To establish securities fraud, government must prove that defendant employed device, scheme or artifice to defraud, or made untrue statement of material fact which made what was said, under the circumstances, misleading, or engaged in an act, practice or course of business that operated, or would operate, as fraud or deceit upon the purchaser or seller; participated in scheme to defraud knowingly, willfully, and with intent to defraud; and knowingly used, or caused to be used, instrumentalities of interstate commerce in furtherance of scheme to defraud or fraudulent conduct.")

244. 17 C.F.R. § 240.10b-5 (West 2004); *see* SEC v. First Jersey Securities, Inc., 101 F.3d 1450 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997) ("In order to establish primary liability under § 10(b) and Rule 10b-5, plaintiff is required to prove that, in connection with the purchase or sale of security, defendant, acting with scienter, made material misrepresentation, or material omission if defendant had duty to speak, or used fraudulent device.").

investors to rely thereon and, in connection therewith so relying, cause them to purchase or sell a corporation's securities."[245] "Would" is the operative word in this formulation, as courts have held that neither a private plaintiff nor the government need provide any positive proof of reliance or traditional causation for a loss.[246] Where management and directors are parties to a securities fraud, the test, with respect to "causation," is whether the facts that were not disclosed or were misleadingly disclosed to shareholders "would have assumed actual significance in the deliberations" of reasonable and disinterested directors or created "a substantial likelihood" that such directors would have considered the "total mix" of information available to have been "significantly altered."[247]

In *Santa Fe Industries, Inc. v. Green*, the Supreme Court considered the "reach and coverage" of Section 10(b) and Rule 10b-5 in the context of a Delaware short-form merger.[248] The plaintiffs, minority shareholders, alleged two bases for fraud. First, they alleged that the majority shareholder breached his fiduciary duty to deal fairly with the minority shareholders by not having a valid business purpose for the merger.[249] Second, they alleged that the company had made material misrepresentations and had failed to make required disclosures.[250]

The Court admonished the Second Circuit Court of Appeals for its liberal statutory interpretation, emphasizing that "[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law."[251] The Court noted that the scope of Rule 10b-5 could not exceed the power granted to the SEC by Congress under Section 10(b).[252] In examining that power, the Court looked to the language of Section 10(b), and concluded that it gave "no indication that Congress meant to prohibit

245. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

246. *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

247. IIT, an Int'l Inv. Trust v. Cornfeld, 619 F.2d 909 (2d Cir. 1980).

248. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 464–65 (1977).

249. *Id.* at 470 n.8.

250. *Id.* at 474.

251. *Id.* at 472 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212–14 (1976) (internal marks omitted)).

252. *Id.* (quoting *Ernst*, 425 U.S. at 212–14).

any conduct not involving manipulation or deception."[253] Thus, the claims of fraud and fiduciary breach could only state a cause of action under Rule 10b-5 if the conduct alleged could fairly be viewed as "manipulative or deceptive" within the meaning of the statute.[254] The Court stressed the fact that "the complaint failed to allege a material misrepresentation or material failure to disclose . . . there was no 'omission' or 'misstatement' in the information statement accompanying the notice of merger."[255] The Court also found no material nondisclosure, and therefore found that the plaintiffs' references to cases in which breaches of fiduciary duty were held to violate Rule 10b-5 were inapposite.[256] The Court further found that the "conduct alleged in the complaint was not 'manipulative.'"[257]

With these specific facts in mind, the Court went on to discuss the reach of the 33 Act in general. The Court noted that the "fundamental purpose" of the 33 Act is to implement a "philosophy of full disclosure," but that once full and fair disclosure has occurred, the fairness of the terms of a transaction are of "tangential concern, at most," to the statute.[258] The Court also noted that in interpreting congressional intent with respect to the 33 Act, in circumstances where the conduct did not fall within the language of the statute, courts would have to ask whether the cause of action is one "traditionally relegated to state law."[259] The Court cautioned that allowing fraud actions without a showing of manipulation would result in bringing within Rule 10b-5 a "wide variety of corporate conduct traditionally left to state regulation."[260] The Court warned that such an "extension of federal securities laws would overlap and quite possibly interfere with state corporate law. Federal courts applying a federal fiduciary principle under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system."[261] The Court was reluctant to take such a step "[a]bsent a clear indication of

253. *Id.* at 472.
254. *Id.* at 473–74.
255. *Id.* at 474.
256. *Id.* at 475.
257. *Id.* at 476.
258. *Id.* at 477–78.
259. *Id.* at 478 (quoting Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 40 (1977)).
260. *Id.* at 478.
261. *Id.* at 479 (internal quotations omitted).

congressional intent[] . . . to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[262] The Court went on to note that "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[263]

The Court held that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[264] It is worth reiterating, however, that the Court was writing after having found that the alleged fraud had no connection to any misrepresentation or omission.[265] Thus, *Santa Fe* can be read as indicating that Rule 10b-5 does not reach breaches of the duty of care in the waste context. However, *Santa Fe* may bolster the argument that Rule 10b-5 can be violated by a breach of the procedural duty of care, where the result of the breach is the issuance of a false or misleading statement in a required disclosure.

In *United States v. O'Hagan*, the Court considered whether criminal liability under Section 10(b) can be predicated on the misappropriation theory.[266] O'Hagan was an attorney who made a substantial profit trading call options on the stock of a company that was the target of a takeover bid by a client of O'Hagan's firm.[267] Although O'Hagan owed a fiduciary duty to his firm and the client, he breached that duty by trading with unspecified third parties, to whom he owed no duty.[268] The Court found that the elements of a Rule 10b-5 claim were satisfied.[269] O'Hagan's conduct, the Court found, involved deception when he failed

262. *Id.* (internal quotations omitted).
263. *Id.* (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).
264. *Id.* (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971)).
265. *See id.* at 473–74.
266. United States v. O'Hagan, 521 U.S. 642, 649–50 (1997).
267. *Id.* at 648–49.
268. *Id.* at 654–57. *Cf.* Chiarella v. United States, 445 U.S. 222 (1980) (refusing to find 10b-5 liability where the defendant owed no duty either to those with whom he traded, or to those from whom he discerned the information).
269. *O'Hagan*, 521 U.S. at 655.

to disclose his intent to trade to his employer and the client.[270] The conduct was "in connection with the purchase or sale of securities" because the fraud was consummated when O'Hagan traded on the information.[271]

The argument that a director's breach of the duty of care is actionable under Rule 10b-5 is not disturbed by *O'Hagan*. A breach of the duty of care may be premised on a director allowing a disclosure containing false information to be issued, thus providing deception. The fraud might be consummated when third parties trade in reliance on the new, tainted, total mix of information. For the actions to be interchangeable, however, the scienter required for securities fraud must match that required for a breach of the duty of care.

b. Scienter Requirement

Although scienter is not explicitly required by statutory text, it has nevertheless been found to be an essential element of a Rule 10b-5 claim.[272] Some scienter should be required because not every misstatement or omission in a corporation's disclosures necessarily constitutes fraud.[273] The level of scienter required, however, is far from clear. Some courts have defined scienter, in the securities fraud context, as intent to deceive, manipulate, or defraud, or at least knowing misconduct.[274] Other courts have found that "severe recklessness involving highly unreasonable omissions or misrepresentations amounting to extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it," will satisfy the scienter requirement.[275] Other courts

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270. *Id.* at 655.

271. *Id.* at 656.

272. Alpern v. UtiliCorp. United, Inc., 84 F.3d 1525 (8th Cir. 1996). *Cf.* Clark v. Watchie, 513 F.2d 994 (9th Cir. 1975) (scienter is not a necessary and separate element of an action under Rule 10b-5), *cert. denied*, 423 U.S. 841 (1975); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

273. Tuchman v. TSC Communications Corp., 14 F.3d 1061 (5th Cir. 1994).

274. SEC v. First Jersey Securities, Inc., 101 F.3d 1450 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1996); *see* SEC v. Sayegh, 906 F. Supp. 939 (S.D.N.Y. 1995), *aff'd*, 101 F.3d 685 (2d Cir. 1995).

275. Kushner v. Beverly Enters., Inc., 317 F.3d 820 (8th Cir. 2003); *Alpern*, 84 F.3d

have held that either "gross disregard" for the truth of statements or actual fraudulent intent is necessary.[276] It is unclear whether "gross disregard" is equivalent to recklessness, or whether it indicates that gross negligence might suffice for a securities fraud action. It is well settled that mere negligence is not sufficient.[277]

The scienter requirement for a fraud violation, therefore, seems higher than that required for a breach of the duty of care.[278] It could be argued, however, that gross negligence suffices for both. In *Kushner v. Beverly Enterprises*, the court held that scienter for a securities violation may be shown if the defendants, short of having intent to deceive, "knew facts or had access to information suggesting that their public statements were not accurate, or . . . failed to check information they had a duty to monitor."[279] Other courts have stated that the presence of red flags will bolster an allegation of recklessness.[280] These constructions of the scienter requirement are striking in the way that they parallel the scienter required for a breach of the duty of care. If the scienter requirements match, then all of the elements of a duty of care violation and a securities fraud action would be consistent. Even if the causes of action are technically compatible, however, there may be other reasons to hesitate before federalizing regulation of director conduct.

1525 (recklessness also satisfies the scienter requirement). It should be noted, however, that the Supreme Court has not held that anything short of intent to defraud will satisfy the scienter requirement.

276. Panos v. Island Gem Enters., Ltd., 880 F. Supp. 169 (S.D.N.Y. 1995).

277. *Alpern*, 84 F.3d 1525 (stating that "scienter may be established by proof of knowing or intentional practices to deceive, manipulate, or defraud; negligence is not sufficient"); *Sayegh*, 906 F. Supp. 939 (mere negligence not enough).

278. *See supra* Section III(b)(i).

279. *Kushner*, 317 F.3d at 827 (citing Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012, (2000)) (plaintiffs failed to allege facts sufficient to support scienter requirement); *see also* Panos v. Island Gem Enters., Ltd., 880 F. Supp. 169 (S.D.N.Y. 1995) (gross disregard for the truth will suffice).

280. *See* Nappier v. Pricewaterhouse Coopers LLP, 227 F. Supp.2d 845 (D. N.J. 2002) (plaintiffs failed to allege facts sufficient to satisfy scienter requirement). Although there is no civil cause of action for aiding and abetting under Section 10(b), the requirements for aiding and abetting as applied to directors and others with fiduciary duties is informative. *See* Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997). In the aiding and abetting context, recklessness will satisfy the scienter requirement where the director owes a fiduciary duty. *See* Frankel v. Wyllie & Thonhill, Inc., 537 F. Supp. 730 (W.D. Va. 1982).

c. Federal Involvement in Corporate Governance

Writing in 1990, Professor Joel Seligman predicted that "at some point Congress might be forced to address the need for substantive federal corporate law."[281] He did not think that 1990 was that time,[282] but in the aftermath of the recent corporate scandals many believed that the time had come. For others, passage of Sarbanes-Oxley represented a welcome federal foray into substantive corporate governance.[283] It is more accurate, however, to appreciate that federal actors were becoming increasingly involved in regulating corporate governance for years prior to the scandals and passage of Sarbanes-Oxley.[284]

Nevertheless, Sarbanes-Oxley represented a major push forward for the federal corporate governance agenda. Ironically, however, the major impetus for the surge in federal power was not the triumph of a particular corporate law theory (alluring as that idea may be for corporate law scholars), rather, its origin is political: "there is nothing a politician wants more than to persuade investors that he or she is 'doing something' and being 'aggressive' in rooting out corporate fraud."[285] In the wake of the high-profile scandals, Congress felt that they had to do something.[286] It is only coincidental that they operate at the federal level. Some worry, however, that Congress' response was imprudent.[287]

For years after the enactment of the 33 and 34 Acts, federal

281. Seligman, *supra* note 15, at 974.

282. *Id.* at 974; *see also* Cary, *supra* note 17, at 701 ("I do not advocate, or even conceive of, federal incorporation as an imminent possibility except in the event of a catastrophic depression or a corporate debacle.").

283. *See, e.g.*, Morrissey, *supra* note 171, at 807–810 (asking Is Sarbanes-Oxley enough?).

284. *See* Backer, *supra* note 10, at 353 (directors now face "potential federal liability for breaches of fiduciary duty").

285. Bainbridge, *supra* note 25, at 28.

286. *See, e.g.*, Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1153 (2004) ("In a 'do-something!' atmosphere, Congress did something."); Jones, *supra* note 27, at 638, 640; Morrissey, *supra* note 171, at 807 ("Congress rightly felt the need to reassure investors that fraudulent actions would not go unpunished"); Ide, *supra* note 171, at 831 (describing Sarbanes-Oxley as a "classic example of policy giving way to politics").

287. Bainbridge, *supra* note 25, at 31 (noting that "the prudent legislator is hesitant to promulgate purported reforms that may give rise to new and unforeseen abuses worse than the evil to be cured"); *see infra* Section V(h).

involvement in securities regulation was viewed as strictly limited to disclosure, and procedural and anti-fraud rules to facilitate that disclosure.[288] State regulation and market forces, however, failed to generate meaningful limits on director behavior,[289] and many scholars felt that federal intervention into this aspect of corporate governance was "inevitable."[290]

Prior to Sarbanes-Oxley, there were scholars who argued that corporate governance should be fully federalized.[291] Others, however, have maintained that the drawbacks of federal involvement outweigh any possible benefits. Examining the contours of these arguments, and the more moderate views in between, helps to explain how the SEC came to take the position it did with respect to Peselman in *Chancellor*.[292] This examination, in addition to comparing the arguments for federal involvement with past federal corporate governance efforts and the provisions of Sarbanes-Oxley, provides a glimpse of what the new federal regulatory regime might look like.

d. The Case for Federalization

The case for federalization is premised on the conclusion that state and market forces have failed to adequately protect shareholders and the public.[293] This has led some scholars to advocate a general increase in

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288. Bainbridge, *supra* note 25, at 31 (noting that "federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and anti-fraud rules designed to make disclosure more effective").

289. Brown, *supra* note 45, at 358 (citing Schultz & Francis, *supra* note 174, at A9); *see also* Section III(c), *supra*.

290. Brown, *supra* note 45, at 358.

291. *See* Cary, *supra* note 17, at 705 (stating that "as long as we operate in a capitalist society and as long as confidence in management is a prerequisite to its continuance, there should be a federal interest in the proper conduct of the corporation itself as much as in the market for its securities"); Seligman, *supra* note 15, at 949.

292. *Directors Will Face Closer SEC Scrutiny*, SAN DIEGO UNION TRIB., Aug. 21, 2003, at C4 (citing Stephen Cutler, Director of the SEC's Enforcement Division) (SEC is "stepping up its efforts to punish corporate fraud by pursuing charges against board members who ignore misconduct").

293. *See generally* Cary, *supra* note 17; Seligman, *supra* note 15; *see also* A.A. Sommer, Jr., *Further Thoughts on "Going Private,"* SEC. REG. & L. REP. (BNA) No. 294, at D-1 (Mar. 19, 1975) ("Delaware [is] notorious for the favor its laws show to

federal involvement in corporate governance, without suggesting any specific form or goals.[294] In the aftermath of the scandals, state regulation has not been seriously considered as a possible solution to corporate governance problems.[295]

Some scholars nevertheless see a continued role for state regulation, even in a regulatory regime where the federal government is dominant.[296] Some argue that states, such as Delaware, will respond to the "threat" of federal involvement by strengthening their corporate governance rules to protect shareholders and investors.[297] There is reason to believe, however, that if the federal threat receded, Delaware would revert to its more lax jurisprudence,[298] and that therefore a "sustained federal engagement . . . to prevent such retrenchment" is necessary.[299]

Some scholars have advocated a fully-federalized law of corporate governance.[300] One of the main arguments of these scholars is that

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management, often at the expense of shareholders.").

294. Brown, *supra* note 45, at 321 ("There is a need for increased, meaningful regulation of corporate governance standards for public companies at the federal level.").

295. Thompson, *supra* note 9, at 876 (noting that "responses to the recent corporate crises show that almost no one is talking about state regulation or law to combat the corporate governance problems"). As support for this proposition, it is notable that the European Union has imposed more substantial constraints on state competition than those existing in the United States. Bebchuk, *supra* note 30, at 1439 (citing TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, art. 54, § 3, cl. g.; Alfred F. Conrad, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150, 2151 (1991)).

296. *See, e.g.*, Jones, *supra* note 27, at 639 (noting that state regulation could "back-stop" federal regulation).

297. *Id.* at 625 (noting that a "realistic threat of federalization is necessary to ensure the robust development of corporate law at the state level," and would "push Delaware to shape its corporate law to increase protections for shareholders and other constituent groups").

298. *Id.* at 663 (citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) and Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) as "examples of Delaware decisions that imposed strict standards of liability that were later reversed or disregarded by courts").

299. Jones, *supra* note 27, at 663.

300. *See* Cary, *supra* note 17, at 705; *see also* Joan MacLeod Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 FORDHAM CORP. & FIN. L.J. 225, 233 (assuming that "well defined rules of corporate governance at the federal level are or will be necessary or desirable").

federal regulation is the only way to adequately protect shareholders from exploitation by managers.[301] Others have stated that federal law should provide the minimum standards for directors' fiduciary duties.[302] Some scholars have argued for more limited federal intervention, aimed at addressing particular weaknesses in existing state corporate law. For example, Professor Seligman has argued for a federal cause of action based on state fiduciary duty standards.[303] He has posited that the cause of action could be litigated in federal courts and would "expressly prohibit [those] courts from deferring to special litigation committees in suits properly alleging the misconduct of any member of the board of directors."[304] The fiduciary standards applied by the federal courts would remain state corporate law.[305] Seligman argues that this arrangement would preserve the opportunity for corporations to choose a state of incorporation, based in part on an evaluation of fiduciary standards.[306] Other scholars have called for federal intervention focused on other specific problems, such as a heightened requirement for director approval of self-interested transactions.[307] Some of these arguments are reflected in the changes made by the Sarbanes-Oxley Act.

e. Sarbanes-Oxley

The complaints against Marchese, Peselman, and Chancellor came in the wake of the passage of the Sarbanes-Oxley Act.[308] The corporate scandals discussed above sparked "public outrage" and evoked broad public dissatisfaction with the existing corporate regulatory regime.[309]

301. *Id.* at 701.
302. Bebchuk, *supra* note 30, at 1484.
303. Seligman, *supra* note 15, at 973.
304. *Id.*
305. *Id.*
306. *Id.*
307. Brown, *supra* note 45, at 378.
308. *Compare* Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002) (July 2002) *with* In the Matter of Michael Marchese, Exchange Act Release No. 34-47732, 2003 WL 1940244 (Apr. 23, 2003) (April 2003); SEC v. Chancellor Corp., 03 Civ. 10762, ¶ 12 (D. Mass. 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm (April 2003).
309. Jones, *supra* note 27, at 640 (citing John Harwood, *Americans Distrust Institutions in Poll*, WALL ST. J., June 13, 2002, at A4).

This "forced" the federal government into a "mode of direct regulation," which took the form of Sarbanes-Oxley.[310] Broadly conceived, Sarbanes-Oxley prompted the SEC to be more aggressive in pursuing wrongdoing "among those who advise and supervise chief executive officers," including directors.[311] Although the changes made by Sarbanes-Oxley with respect to directors nominally only effect disclosure requirements, the SEC is using those requirements to "effect changes in [directors'] substantive behavior."[312] Sarbanes-Oxley arguably fills the statutory gap left by the 33 and 34 Acts, which may not have provided enough of a statutory basis for the SEC to pursue directors who breached their fiduciary duties.[313] For many of the scholars discussed above, Sarbanes-Oxley is at least a step in the right direction, toward federal regulation of corporate governance.[314]

An understanding of some of the specific changes made by Sarbanes-Oxley is necessary to recognize how substantive behavior has been pulled within the federal regulatory scheme. Prior to Sarbanes-Oxley, federal courts were authorized to prohibit violators of Section 10(b) from serving as officers and directors of public companies if a court found "substantial unfitness to serve as an officer or director."[315] The remedy was available in court actions only, not in administrative proceedings, and the "substantial unfitness" standard operated as some restraint on the SEC's intrusion into areas traditionally left to state law.[316] Sarbanes-Oxley granted the SEC the authority to seek officer and director bars in administrative proceedings and lowered the "substantial unfitness" standard to mere "unfitness."[317] The inclusion of

310. Jones, *supra* note 27, at 638.

311. Bilodeau, *supra* note 184, at C19.

312. Bainbridge, *supra* note 25, at 29.

313. Peloso & Indek, *supra* note 168, at 3.

314. *But see* Brown, *supra* note 45, at 320 (Sarbanes-Oxley does not alter the competition for charters, and therefore "meaningful standards are not likely to emerge." By extension, "neither the states nor the federal government adequately regulates the behavior of officers and directors.").

315. 15 U.S.C. § 78u(d)(2).

316. William R. McLucas et. al., *An Overview of SEC Enforcement, Remedial and Settlement Powers Before and After The Sarbanes-Oxley Act*, 1396 P.L.I. CORP. 1111, 1116 (2003).

317. Sarbanes-Oxley amended Section 21C of the 34 Act, adding subsection (f) which grants the SEC authority to bar a person from serving as an officer or director if that person violates Section 10(b), among other provisions. *See* Sarbanes Oxley Act §

the lower standard was a response to the perception that courts refrained from imposing officer and director bars even in cases of egregious misconduct.[318]

Many of the Sarbanes-Oxley changes focus on the composition and role of audit committees. Sarbanes-Oxley mandates that audit committees be composed entirely of independent directors, and heightens the standards for director independence.[319] Sarbanes-Oxley may have improved the independence standard, but many scholars believe the standard still does not ensure that directors are truly "independent."[320] Each audit committee is now required to have at least one member who is a financial expert, as defined by the Act.[321]

Sarbanes-Oxley also altered the responsibilities of the audit committee in connection with the review of financial information.[322] Some scholars have argued that the audit committee is now "directly responsible for the financial disclosure process."[323] The substantive responsibilities of the audit committee are, therefore, determined by disclosure requirements,[324] which have been firmly within the federal government's regulatory control for some time.[325] The regulation of audit committees is seen by some as a departure from the securities laws' traditional mode of disclosure regulation, and as an example of the federalization of an aspect of corporate governance that had previously had been exclusively regulated by the states.[326]

1105(a) (codified 15 U.S.C. 78u-3(f) and adding § 21C(c)(3) to the 1934 Act); *see also* McLucas, *supra* note 316, at 1116.

318. McLucas, *supra* note 316, at 1118 (citing S. REP. NO. 107-205, at 27 (2002)).

319. 15 U.S.C. § 78j-1(m)(3)(A).

320. *See* Brown, *supra* note 45, at 377 (arguing that the "definition of independence should explicitly recognize that non-financial interests can impair independence"); Rodriquez, *supra* note 2, at 260 (pointing out that "supposedly independent directors share social connections with management").

321. 15 U.S.C. § 7265(a).

322. 15 U.S.C. § 78j-1(m)(2).

323. Brown, *supra* note 45, at 370.

324. *See, e.g.*, Backer, *supra* note 10, at 365 (Sarbanes-Oxley "institutionaliz[es] . . . a set of minimum obligations on outside directors to monitor officers and inside directors.").

325. *See* BAUMAN, *supra* note 65, at 480.

326. Jones, *supra* note 27, at 629; Brown, *supra* note 45, at 319 ("Sarbanes-Oxley supplants state law in the regulation of the behavior of management, removing the last

The link between policing disclosure and policing the audit committee itself may seem minor, but it represents a convergence of two areas of law that were thought to be discrete. The significance of this convergence cannot be overstated. "[Seventy] years ago, the SEC said that 'the Securities Act does not purport . . . to define federal standards of directors' responsibility in the ordinary operations of business enterprises.' That view of the securities laws does not describe the post Sarbanes-Oxley world."[327] Some scholars have stated that Sarbanes-Oxley constitutes "the most dramatic expansion of federal regulatory power over corporate governance since the New Deal."[328] Despite this seemingly profound change in corporate regulatory responsibility, the quietness of the change has also been noteworthy, with one scholar describing Sarbanes-Oxley as the "creeping federalization of corporate law."[329]

In response to the argument that the federal government lacks the power to regulate substantive corporate conduct, scholars point to Sarbanes-Oxley as giving the SEC inherent power to regulate director behavior insofar as it relates to disclosure requirements.[330] Congress has given tacit approval to the SEC's new role by continuing to increase the

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significant area of state regulation of the governance of public companies."); Backer, *supra* note 10, at 350 (citing Larry Cata Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897, 941–42 (2002) (citing U.S. Dep't of Justice Memorandum, Office of the Deputy Attorney General, Bringing Criminal Charges Against Corporations (June 16, 1999), *at* http://www.usdoj.gov./criminal/fraud/policy/Chargingcorps.html; amended as U.S. Dep't of Justice Memorandum, Office of the Deputy Attorney General, Federal Prosecution of Business Organizations (Jan. 20, 2003), *at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) and In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996)) (Sarbanes-Oxley "represents a continued federalization of critical trends in state corporate law, especially respecting the role of independent directors and the importance of monitoring under the evolving fiduciary law of Delaware."). This change has not been limited to strictly federal actors, Self-Regulatory Organizations have also gotten in on the act. Bainbridge, *supra* note 25, at 28 (pointing to the "troubling expansion of stock exchange listing standards that displace state corporate law").

327. Thompson, *supra* note 9, at 873 (quoting In re Franchard Corp., 42 S.E.C. 163, 176 (1964)) (internal edits omitted).

328. Bainbridge, *supra* note 25, at 26.

329. *Id.*; *see* Lowenstein, *supra* note 159 (describing the federalization of corporate law as a "quiet transformation").

330. *See, e.g.*, Lowenstein, *supra* note 159, at 365.

Commission's funding,[331] which is an effective way for Congress to set its priorities and signify approval of an agency's work.[332] Prior to Sarbanes-Oxley, however, the SEC was already concerned with the efficacy of the disclosure regime and the general integrity of capital markets.[333] The Commission viewed corporate governance and director conduct as having a significant impact on both of these concerns, and therefore well within their purview.[334] This concern was manifested in SEC releases long before the corporate scandals, Sarbanes-Oxley and *Chancellor*.

In *In the Matter of W.R. Grace & Co.*, the Commission and the company agreed to a cease and desist order, with the company neither admitting nor denying the matters asserted by the SEC.[335] Nevertheless, the Commission issued both the entry of the cease and desist order and a Section 21(a) report (the "21(a) Report").[336] The order and the report provide significant insight into the Commission's concerns regarding director conduct. The SEC found that certain W.R. Grace directors had incorrectly answered questions on directors' and officers' questionnaires used by the company to prepare its Form 10-K and proxy statements.[337]

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331. McLucas, *supra* note 316, at 1113 (citing William H. Donaldson, Testimony Concerning Appropriations, United States Senate (Apr. 8, 2003), *available at* http:www.sec.gov/news/testimony/040803tswhd.htm) ("In its efforts to protect investors and restore confidence, and armed with new regulatory and remedial powers granted by the Sarbanes-Oxley Act of 2002 and record-high budgetary appropriations, the SEC's Enforcement Division is busier than ever.").

332. *See, e.g.*, Daniel C. Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 793–96 (1999).

333. *See, e.g.*, Exchange Act Release Nos. 39,156 and 39,157, 85,963, at 89,897 (Sept. 30, 1997).

334. Report of Investigation In re The Cooper Cos., Inc. as it relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 35082, 34-35082, at 6 (Dec. 12, 1994) (citing Report of Investigation in the Matter of National Telephone Co., Inc., Exchange Act Release No. 12380 (Jan. 16, 1978); Report of Investigation in the Matter of Stirling Homex, Exchange Act Release No. 11516 (July 2, 1975) ("[The SEC] has long viewed the issue of corporate governance and the fiduciary obligations of members of management and the board of directors of public companies to their investors as an issue of paramount importance to the integrity and soundness of our capital markets.").

335. In the Matter of W.R. Grace & Co., Exchange Act Release Nos. 39-156 & 39-157, 85,963 (Sept. 30, 1997).

336. *Id.*

337. *Id.* at 5.

The SEC also found that the company had failed to disclose certain perks it was giving to its former CEO.[338] The directors, for their part, were aware of the benefits, but did not question the absence of that information in the company's disclosures.[339] The SEC further found that a proposed transaction with J. Peter Grace III, the son of Grace's CEO, and chairman of a subsidiary, was not properly disclosed as an interested transaction.[340] This lack of disclosure was similarly ignored by the directors.[341] In the 21(a) Report, the Commission asserted that the directors should have taken steps "to ensure full and proper disclosure."[342] The Commission stated that they issued the 21(a) Report to "emphasize the affirmative responsibilities of corporate . . . directors to ensure that the shareholders whom they serve receive accurate and complete disclosure" of required information.[343] The Commission further stated that directors "must be vigilant in exercising their authority throughout the disclosure process."[344]

The Commission may have been emboldened because it found that the directors had actual knowledge of the omitted facts, yet still did nothing to ensure that the disclosures were accurate.[345] The Commission stated that even though the record did not indicate that the directors had acted in bad faith, the directors had nevertheless failed to "fulfill their obligations under the federal securities laws."[346] The Commission stated that directors with actual knowledge have a duty to "go beyond . . . established procedures to inquire into the reasons for non-disclosure of information."[347] Specifically, the Commission stated that the directors should have "inquired as to whether the securities laws required disclosure" of the information of which they had knowledge, and that they should have sought legal counsel, and, if not satisfied, they should have insisted that the documents be corrected.[348]

338. *Id.*
339. *Id.*
340. *Id.* at 6.
341. *Id.*
342. *Id.* at 9.
343. *Id.* at 10.
344. *Id.*
345. *Id.*
346. *Id.*
347. *Id.*
348. *Id.* at 16.

Commissioner Steven Wallman dissented from the 21(a) Report.[349] He asserted that there was no evidence that there were any red flags that would have indicated to the directors that the process the company used to produce its disclosure documents was not working, and that the directors should have been able to rely on a system that they reasonably believed was working.[350] Commissioner Wallman's dissent seems to recognize that the majority was using Section 10(b) to reach conduct governed by state law.[351] Scholars noted that "*Grace* had little basis in the securities laws and instead rested squarely on traditional notions of fiduciary obligations."[352]

Whereas in *Grace* the SEC implicitly indicated that they had a role in regulating director conduct, Sarbanes-Oxley gives more explicit recognition to that role. The new federal standard discussed below can therefore be seen as the culmination of years of development, with the most overt changes provided by Sarbanes-Oxley in response to the corporate scandals.

f. The New Federal Standard

Although directors' duties have often been described as "affirmative,"[353] federal enforcement of these affirmative obligations is relatively new,[354] and the precise nature of directors' federal duties is far from clear. Both corporations and the government value certainty. The current uncertainty about possible federal liability leaves corporations and their directors in a precarious position, and may force directors to

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349. *Id.* (Wallman, dissenting).

350. *Id.* at 17 (Wallman, dissenting).

351. *Id.* (Wallman, dissenting) (taking issue with the standard applied by the majority "to the extent it suggests that officers and directors must ensure the accuracy and completeness of company disclosures").

352. Brown, *supra* note 45, at 355 (citing In the Matter of W.R. Grace & Co., Exchange Act Release Nos. 39-156 & 39-157, 85,963, 89,894 n.4 (Sept. 30, 1997)).

353. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("director's duty is [to] affirmatively to protect the interests of the corporation committed to his charge").

354. Backer, *supra* note 10, at 411 ("[Directors'] duties are now understood by the government as active and positive obligations . . . . Failure to take aggressive action may lead to liability – even where the independent director did not profit from the transaction."); *Id.* at 341 ("Someone is always supposed to be watching.").

err on the side of extreme caution.[355] On the other hand, hastily formulated rules for federal fiduciary duties may harm rather than help shareholders and the public.

Recognizing these concerns, some scholars have argued that if the balance between federal fraud violations and state violations for breaches of fiduciary duty is to be altered, "the proper approach would be through new legislation with appropriate opportunity for comment, including consideration of the correct interplay between state corporate law and the federal securities laws."[356] Such an organized system, however, may not be advantageous for federal regulators. At present they are able to develop a federal fiduciary duty standard on an ad hoc basis, selecting egregious cases that tend to result in a standard that is both flexible and harsh. This reflects, in part, the federal government's concern with being seen as acting, rather than acting in the best interests of all its constituents: corporations, the shareholders and the public.[357] Nevertheless, even in the absence of an explicit announcement from Congress, it is fairly clear that federal regulation of director behavior will be tied to the SEC's disclosure requirements, as indicated by the charges against Marchese and Peselman, and recent statements from the SEC.[358]

g. Federal Disclosure Requirements; Driving Securities Fraud's Ascendancy

Securities fraud actions are often prompted by false or misleading statements made in disclosure reports mandated by the SEC.[359]

355. It could be argued that Delaware left directors in a similar position, however, directors had the comfort of knowing that Delaware's obfuscation leaned heavily toward protecting their interests. This is not the case with federal regulation.

356. Peloso & Indek, *supra* note 168, at 7.

357. *See, e.g.*, Strine, *supra* note 125, at 1372 (cautioning that there is a risk that "policies that are too rigid and punitive, and that cannot respond flexibly to future developments" will be created).

358. Backer, *supra* note 10, at 422 (the charges against Marchese and Peselman point to a "consolidation by the SEC of a (new) law of federal fiduciary duty, tied not to satisfaction of the needs of shareholders, but instead, tied to compliance with the reporting requirements demanded by federal law"); Jones, *supra* note 27, at 663 ("The SEC, through its enforcement and rule-making functions, should remain at the forefront of [corporate regulatory] vigilance.").

359. *See, e.g.*, In the Matter of Michael Marchese, Exchange Act Release No. 34-

Mandatory disclosure reports are required for most large public companies.[360] The reports are commonly referred to as 10-Qs, 10-Ks, and 8-Ks,[361] and were systematized in 1982 by Regulation S-K.[362] The SEC has begun to give substance to director duties, particularly their role in overseeing a company's financial disclosures, through, for example, audit committee reports under Regulation S-K.[363] The audit committee, composed of outside directors, must monitor the inside directors.[364] Another example would be compliance with Item 303, which requires that a registrant identify "known trends or any known demands, commitments, events, or uncertainties that will result" in material increases or decreases in liquidity.[365] This is a signal to directors that in order to fulfill their duty of care they should be concerned about liquidity and events related to changes in liquidity, and should adjust their conduct accordingly.[366]

The federal standard of due care has been given substance by, and has increased in proportion to, disclosure requirements, such that it now overlaps with areas traditionally regulated by the states.[367] Disclosure requirements are now "extensive" and "provide for disclosures . . .

47732, 2003 WL 1940244 (Apr. 23, 2003); SEC v. Chancellor Corp., 03 Civ. 10762, ¶ 12 (D. Mass. 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm.

360. Companies with more than $10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. *See* www.sec.gov.

361. *See* 15 U.S.C. § 78m (2000).

362. Proposed Revision of Regulation S-K and Proposed Rescission of Guides for the Preparation and Filing of Registration Statements and Reports, Securities Act Release No. 33-6332 (Aug. 18, 1981).

363. *See* Audit Committee Disclosure, Exchange Act Release No. 34-42,266, 64 Fed. Reg. 73,389 (Dec. 30,1999) (codified 17 C.F.R. §§ 210, 227, 229, 240); *see also* Thompson, *supra* note 9, at 909 (positing that "disclosure is an indirect way to regulate managerial behavior").

364. Backer, *supra* note 10, at 365 ("Increasingly, the federal government has imposed obligations to monitor and discipline inside directors, officers and employees on outside directors – or face discipline in turn.").

365. 17 C.F.R. § 229.303(a)(1) (West 2004).

366. Thompson, *supra* note 9, at 874 ("Through a requirement that such changes be disclosed, the Commission is enforcing the substantive duty.").

367. *Id.* at 904 ("As the federal disclosure obligations have increased, they have begun to provide the basis to enforce duty of care obligations that in the past might have been enforced under state law.").

designed to enforce what are basic state law fiduciary duties,"[368] as is arguably the case with Peselman and Marchese.[369] The SEC's actions indicate that, in the federal view, the interest in ensuring effective disclosure trumps federalism concerns.[370]

There are several benefits that flow from linking directors' duties to disclosure requirements.[371] The existence of extensive disclosure procedures makes it easier to show scienter in a fraud action,[372] the requirements for which had been toughened by the Private Securities Litigation Reform Act of 1995.[373] In addition, the new federal duty, if enforceable by a private right of action, will allow shareholders to get around the state hurdles that often bar such actions from court.[374] This is a result of both procedural and substantive differences between a securities fraud action and a state fiduciary duty action.

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368. *Id.* at 873 & 897 ("Securities fraud claims address officer behavior in managing the company and in their duty of care. Notably, the subject matter of the alleged misrepresentations encompasses the duty of care/duty to monitor governance aspects of traditional corporate law and reflects the care-based concerns expressed in the debates about recent corporate scandals.").

369. Backer, *supra* note 10, at 421 (citing Francis v. United Jersey Bank, 432 A.2d 814, 823 (N.J. 1981)) (noting that the allegations against Marchese and Peselman are "striking for the way [they] mimic traditional state court discourse of a director's state law fiduciary duties – especially the duty to monitor").

370. Thompson, *supra* note 9, at 909 (arguing that "federal law now occupies the space originally reserved for the states – monitoring corporate managers through disclosure") (internal changes omitted).

371. *See, e.g.*, Thompson, *supra* note 9, at 905 ("Disclosure basis for federal securities law provides other ancillary benefits beyond shareholder litigation . . . can aid several parties in the corporate monitoring context . . . aids directors in their monitoring function."); *Id.* at 906 ("Disclosure questions, the focus of federal law, can be more easily handled under the current legal regime than questions alleging a duty to supervise and monitor, which are the basis of care review under state law.").

372. Brown, *supra* note 45, at 368.

373. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of titles 15 and 18 of the United States Code); *see* Florida State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 660 (8th Cir. 2001) ("[U]nder the Reform Act, a securities fraud case cannot survive unless its allegations collectively add up to a strong inference of the required state of mind.").

374. Seligman, *supra* note 15, at 970–71 (citing 17 C.F.R. § 240.10b-5 (1989) and Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977)) ("None of the approaches to dismissal of shareholder litigation – not even that in New York – can prevent a shareholder from litigating a fraud action based on federal securities law claims such as rule 10b-5.").

The substance of directors' federal duty of care can be partially gleaned from *Chancellor* and *Marchese*. *Chancellor* provided a near-perfect set of facts for the SEC to establish federal liability for due care breaches because it involved flagrant misdeeds, management self-interest and repeated red flags.[375] The SEC has indicated that actions against directors, based on facts similar to *Chancellor*, will be part of a new mode of federal enforcement. Stephen Cutler, Director of Enforcement at the SEC, called *Chancellor* the "first salvo in this area."[376] According to Cutler, the SEC will be willing to "pursue cases against outside directors who [are] reckless in their oversight of management and asleep at the switch."[377]

The new standard is based on a requirement of "aggressive positive inquiry,"[378] a requirement to which the SEC gave some substance by noting that "Marchese should have engaged in substantially more due diligence before signing any report filed with [the Commission]."[379] The SEC also noted that both Marchese and Peselman completely failed to review Chancellor's accounting procedures and internal controls.[380] It is unclear whether the new federal duty will require directors to "ferret out wrongdoing," something Delaware law has been careful not to require.[381] Nevertheless, the federal standard does seem more rigorous

375. For evidence of the egregiousness of the case, one need look no further than the fact that almost everyone involved is facing charges or has already reached settlements with the SEC. The individual accountants who worked at Metcalf Davis, such as David Decker and Theodore Fricke who consented to a cease and desist order, by which both are barred from appearing before the Commission for at least two years. In re Decker, Exchange Act Release No. 34-47731 (Apr. 24, 2003).

376. Bilodeau, *supra* note 184, at C19 (quoting Stephen Cutler) (*Chancellor* will "serve as a model" for enforcement actions against directors, especially where they ignore red flags).

377. Bilodeau, *supra* note 184, at C19 (quoting Stephen Cutler); *see also* Backer, *supra* note 10, at 429 (describing *Chancellor* as, perhaps, "the tip of the federal securities fiduciary duty iceberg").

378. Backer, *supra* note 10, at 420.

379. *Id.* at 421.

380. *Id.* at 422.

381. *Id.* at 426 ("Always suspicious, directors must oversee a system of monitoring reasonably calculated to ferret out wrongdoing."). *Compare* In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969 (Del. Ch. 1996) (quoting Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (1963)) (noting that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage

than that of any state, in effect deputizing directors with surveillance duties and subjecting them to discipline if they fail to carry out their orders.[382]

Furthermore, it seems that there is now a bright line rule that "[i]ndependent directors may not rely on [information supplied by] officers without independent verification."[383] Even more striking is that, as Marchese learned, even a director who "resigns and reports" may fail to perform his duties under the federal standard.[384] This result, however, is not new to federal securities law, although it would seem a departure from the far more protective Delaware jurisprudence.[385]

It has long been noted that directors' duties are especially important where management self-dealing is at issue or where management fraud comes to the attention of directors,[386] and the existence of red flags probably played a decisive role in the liability of Peselman and Marchese.[387] In this respect, the federal standard hews somewhat closely to Delaware law as exemplified by *Caremark*.[388] In addition, the problem of reconciling the scienter requirements for a breach of fiduciary duty and securities fraud may be eliminated because imputed knowledge or recklessness can be predicated on the existence of red flags.

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to ferret out wrongdoing which they have no reason to expect exists").

382. Backer, *supra* note 10, at 345 (noting that "outside directors . . . now increasingly serve as the eyes and ears of the state").

383. *Id.* at 426.

384. *Id.* at 420.

385. Francis v. United Jersey Bank, 432 A.2d 814, 823 (N.J. 1981) ("In certain circumstances, the fulfillment of the duty of a director may call for more than mere objection and resignation. Sometimes a director may be required to seek the advice of counsel . . . concerning the propriety of his or her conduct, the conduct of other officers and directors or the conduct of the corporation.").

386. Report of Investigation In re The Cooper Cos., Inc. as it relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 35082, 34-35082, at 6 (Dec. 12, 1994) ("These obligations are particularly acute where potential violations of the federal securities laws involving self-dealing and fraud by management are called to the attention of the board of directors.").

387. *See* In the Matter of Michael Marchese, Exchange Act Release No. 34-47732, 2003 WL 1940244 (Apr. 23, 2003); SEC v. Chancellor Corp., 03 Civ. 10762, ¶ 12 (D. Mass. 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm.

388. *See* In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) ("sustained or systematic failure . . . to exercise oversight").

h. Federalize at Your Own Risk

There are several criticisms of and arguments against federalization of corporate governance. Some criticism stems from the fact that any increase in regulation will increase the actual or perceived risk associated with being a director.[389] Other criticisms focus on the lack of a clear basis for federal intervention. There is also a related argument that states are better equipped to regulate corporate governance, as they traditionally have. Finally, a major criticism is that the federal government is moving into the area without sufficient discussion and consideration,[390] and that its ad hoc rulemaking will wreak havoc on corporate decision-making while a federal common law is hashed out.

i. Federal Government Lacks the Power

One of the principal arguments against federalization of corporate governance is that the federal government does not have the power to regulate such conduct.[391] As discussed above, Sarbanes-Oxley may have changed that.[392] On a more practical level, many worry that the SEC is expanding its enforcement authority without sufficient consideration or planning, into the area of directors' duties that was traditionally left to the states.[393] It may be up to the Supreme Court to determine when the

389. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, ch.1 (1991); Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 252–54 (1993); *see also* Brian Pastuszenski, et. al., *Outside Directors in the Government's Spotlight*, (Apr. 23, 2004), *available at* http://www.altaassets.com/knowledgebank/learningcurve (noting that Sarbanes-Oxley and recent SEC actions have "dramatically increased the risk of serving as an outside director of a public company").

390. *See* Heminway, *supra* note 300, at 228 (encouraging an "analytical, comparative approach"); Peloso & Indek, *supra* note 168, at 6–7.

391. Peloso & Indek, *supra* note 168:

> Congress authorized a variety of actions for securities fraud, both civil and criminal, against persons who can be shown to have acted with fraudulent intent and purpose; and the sanctions and penalties for such fraudulent activities are severe. However, it did not authorize such proceedings and penalties for non-manipulative or deceptive breach of fiduciary duty of negligent behavior, which traditionally have been the province of state law and which may not merit the same sanctions and penalties.

392. *See supra* note 327, and accompanying text.

393. Bilodeau, *supra* note 184, at C19 (quoting David Becker, former SEC general

connection between a required disclosure and an alleged fraud will be too attenuated to justify application of the securities laws. If Commerce Clause jurisprudence is any guide, the connection will not have to be strong.[394]

There are also those who believe that the states play a valuable role in shaping corporate governance, a role that cannot be adequately replaced by a uniform federal standard.[395] They reason that "ousting the states from their traditional role as the primary regulators of corporate governance will eliminate a valuable opportunity for experimentation with alternative solutions to the many difficult regulatory problems that arise in corporate law."[396] National regulation would disrupt competition between states because the federal government would enjoy monopoly power, nullifying the competitive forces that advance market-optimal legal rules.[397] In light of this monopoly, several scholars worry that federal lawmakers will be overly punitive. Corporations would be unable to check excessive regulation by opting-out of federal regulation and selecting a different jurisdiction for incorporation.[398] Federal actors, therefore, are not under the same competitive pressure to consider the interests of corporate managers.[399]

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counsel and partner at Cleary, Gottleib, Steen & Hamilton).

394. *See* Wickard v. Filburn, 317 U.S. 111 (1942); *cf.* United States v. Morrison, 529 U.S. 598 (2000); United States v. Lopez, 514 U.S. 549 (1995).

395. Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 281 (1985); Bainbridge, *supra* note 25, at 31 (warning that "the uniformity imposed by Sarbanes-Oxley will preclude experimentation with different modes of regulation").

396. Bainbridge, *supra* note 25, at 31.

397. Romano, *supra* note 395, at 281; Bainbridge, *supra* note 25.

398. Bainbridge, *supra* note 25, at 31 (stating that "exit is no longer an option and an essential check on excessive regulation is lost"); Bebchuk, *supra* note 30, at 1457 ("federal officials are not subject to the discipline of such competitive pressure [as between states for charters]"). On the other hand, scholars have noted that "sophisticated and organized aggregations of shareholders can and do lobby Congress and the SEC to ensure that shareholder interests are considered." Jones, *supra* note 27, at 637 (noting that labor unions, public pension funds, and trade groups like the Council for Institutional Investors are able to command attention from Congress).

399. Corporate managers, however, have ways of influencing federal legislators that do not involve the threat of reincorporation.

ii. Increased Director Liability Will Discourage Service

A basic tenet of corporate law is that shareholders benefit from reasonable risk-taking by directors, because risk-aversion among a large group of shareholders will vary.[400] Scholars argue that increased regulation will make directors too cautious.[401] As federal regulation of director conduct becomes more prevalent, the perceived risk of accepting a directorship will increase.[402] This will be true even if federal regulation is limited to simultaneously enforcing directors' duties that are identical in substance (and even procedure) to current state law. The risk is already very real: "[directors] who cross the line now face an array of authorities, each of which may want their own headline and their own pound of flesh."[403] Some scholars worry that repeatedly increasing the severity of punishment or multiplying the sources of enforcement for any particular wrongdoing may lead to a point where "[p]enalties . . . add no deterrence."[404] Others worry that the directors' punishment may be disproportionate to the alleged offenses.[405]

For years some scholars have argued that the states should impose stricter requirements on directors.[406] In response, proponents of protective measures such as the business judgment rule developed arguments urging caution about putting too much pressure on directors.[407] They have argued that it will be harder or more expensive

400. *See* BAUMAN, *supra* note 65, at 330–332; *see also* Ide, *supra* note 171, at 833 ("In our free market system of capitalism, it is essential that corporations have the flexibility to take risks and to fail if they are wrong.").

401. *See* Strine, *supra* note 125, at 1376.

402. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 389, at 99–100; *see also* Bilodeau, *supra* note 184, at C19 (quoting Stanley Sporkin, former Director the Division of Enforcement at the SEC, retired United States District Judge for the District of Columbia, and General Counsel to the Central Intelligence Agency) ("[The new standard] means that people who take these jobs as outside directors have got to be careful and make sure they're really prepared to do the job.").

403. McLucas, *supra* note 316, at 1126 (discussing "balkanization of enforcement mechanisms in the securities markets" in the form of overlapping state and federal authority).

404. McLucas, *supra* note 316, at 1126.

405. *Id.* at 1126.

406. *See, e.g.*, Cary, *supra* note 17.

407. *See* Strine, *supra* note 125, at 1376 ("[C]orporate boards will not function

to get qualified and talented directors to serve.[408] Beefed-up fiduciary duties are not the only new consideration for would-be directors. The SEC's recent proposals for reform, especially in director nomination,[409] commendably attempt to give shareholders a greater voice in the election process.[410] However, the prospect of contested elections, coupled with the recent decline in the coverage of director and officer insurance, are further deterrents for individuals considering serving as directors.[411]

Directors have been shown to be a sensitive group when it comes to perceived personal liability. In the wake of a handful of chancery court decisions that seemed to lower the bar for due care breaches, evidence showed that directors became anxious and hesitant to continue to serve.[412] The Delaware legislature responded by allowing corporations to permit or require the elimination or limitation of directors' liability under certain circumstances.[413] Such charter provisions probably could not shield directors from liability for securities fraud, and no similar amelioration is likely at the federal level.[414] Increased federal disclosure

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well . . . if their every decision is subject to relatively unconstrained judicial review. Such easy second-guessing is likely to have a paralyzing effect, and diminish risk-taking, to the larger detriment of stockholders.").

408. *See* EASTERBROOK & FISCHEL, *supra* note 389, at 15–20.

409. Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 34-48626 (Oct. 14, 2003), *at* http://www.sec.gov/rules/proposed/34-48626.htm.

410. Rodriquez, *supra* note 2, at 257.

411. Div. of Corporate Fin., Sec. & Exch. Comm'n, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors 12 (2003), *at* http://www.sec.gov/news/studies/proxyreport.pdf).

412. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

413. DEL. CODE ANN. tit. 8, § 102(b)(7); *see, e.g.*, MASS. GEN. LAWS ANN. ch. 156B, § 13(b):

> The articles of organization, in addition, may state . . . a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director notwithstanding any provision of law imposing such liability; provided, however, that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section sixty-one or sixty-two, or (iv) for any transaction from which the director derived an improper personal benefit.

See also N.Y. BUS. CORP. L. § 402(b).

414. *See* Zirn v. VLI Corp., 621 A.2d 773, 783 (Del. 1993) (liability for equitable fraud cannot be waived). *But see* Arnold v. Society for Sav. Bancorp., Inc., 650 A.2d

requirements and other regulations have already had an impact on some companies: the "cost and difficulty of compliance has increased the number of (especially small) public companies going private."[415]

A uniform federalized standard, however, may not be aimed at serving the interests of shareholders and potential investors. As opposed to the market, which represents potential investors, the federal government is a representative of varied constituencies, which may "force a dynamic on corporate conduct potentially very different from that which might have been tolerable by markets and stakeholders."[416] Sarbanes-Oxley and other federal corporate governance initiatives are responsive to the concerns of a group far larger than those directly affected by the reforms.

CONCLUSION

The potential importance of *SEC v. Chancellor* is indicated by the attention garnered by the filing of the complaint,[417] as well as the SEC's statements about the case, and its inclusion among the "elite" corporate scandals, such Enron and WorldCom, in the Corporate Fraud Taskforce's First Report to the President.[418] One scholar notes that *Chancellor* "may well be a landmark case, where the [director] didn't profit, didn't buy and sell, but just fiddled while Rome burned," and was liable for securities fraud.[419] Unfortunately, *Chancellor* does not bode well as a bell-weather for future corporate governance. To the extent that it is emblematic of the federal government's general approach to dealing with management misdeeds, it continues the regulatory trend of

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1270, 1288 (Del. 1994) (liability can be waived by 102(b)(7) charter provision for unintentional failure to disclose).

415. Backer, *supra* note 10, at 340 (citing Carol Elliot, *CPA's Told of Laws Probable Effects*, S. BEND. TRIB., Aug. 25, 2003, at B8).

416. *Id.* at 352.

417. *See, e.g.*, Marc J. Lane, *There's No Compromising With Weak-Kneed Directors*, CRAIN'S CHI. BUS., Oct. 6, 2003, at 11 (discussing *Chancellor*).

418. *See* Corporate Fraud Task Force, First Year Report to the President, ch. 3, p. 29 (July 22, 2003), *available at* http://www.usdoj.gov/dag/cftf/first_year_report.pdf.

419. Bilodeau, *supra* note 184, at C19 (quoting Stanley Sporkin, former Director the Division of Enforcement at the SEC, retired United States District Judge for the District of Columbia, and General Counsel to the Central Intelligence Agency).

failing to recognize that management self-interest is promoted by the corporate form itself.[420] Without fundamental change in the corporate structure, no amount of regulation will stop *Chancellor*-type fact patterns from emerging.

Chancellor marks a new beginning for federal regulation of corporate governance, but it may also mark the beginning of the end of state regulation of corporate conduct.[421] Although Delaware is unlikely to give up without a fight, there may simply be no reason for the federal government to defer to it or any other state.[422] This is dismaying because federal involvement has proven to be haphazard, and has proceeded without taking into consideration many of the lessons that Delaware and other states have learned through their years of regulating corporations.

Chancellor also represents a departure from past securities regulation. This departure, however, is neither extreme nor unexpected in the context of the continuous evolution of the securities laws since the passage of the 33 and 34 Acts. Although the Acts did not seek to regulate director conduct, such regulation is not beyond the scope of modern federal power, especially after the passage of the Sarbanes-Oxley Act. Nevertheless, *Chancellor* is representative of the SEC's broad interpretation of the securities laws. Although Rule 10b-5 may be technically compatible with breach of fiduciary duty claims, the transition will certainly be detrimental to corporations, and by extension their shareholders and the public.

Congress, the SEC, and federal courts should make every effort to formulate a coherent plan for federal regulation of corporate governance, one that takes into consideration all of the valid criticisms and concerns that have been leveled at both federal and state regulation in the past. In

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420. *See, e.g.*, John Clemency, *Corporate Fraud: Where Should the Buck Really Stop?*, 21 AMER. BANKR. INST. J. 20, 20 (2002) ("If corporations being used as tools of fraud were a disease, we would have an epidemic").

421. Thompson, *supra* note 9, at 909 (state corporate law will now only be of importance in the "limited and sporadic set of acquisition and conflict transactions").

422. *See* William W. Bratton & Joseph A. McCahery, *The Content of Corporate Federalism*, UCLA LAW & ECON. WORKSHOP, at 2 & 4 (discussion draft Aug. 30, 2004) (noting that federal lawmakers have often disregarded the internal affairs norms as the "national system grows episodically" and that "federal intervention into internal affairs is inevitable because Delaware follows an evolutionarily stable strategy that constrains its ability to respond to shocks that create national political demands").

the end, the federal actors should remember that their constituents include shareholders as well as the general public, and that neither of those groups' interests will be served by reactionary legislation. In the meantime, corporate insiders will be cautious, and Chancellor Strine has this advice for investors: "Caveat Emptor! Caveat Emptor! Caveat Emptor!"[423]

423. Strine, *supra* note 125, at 1402.

Notes & Observations