

Puzzling over the Directors' and Officers' Duty of Loyalty: Some Implications and Developments

af

James D. Cox¹

Mapping the scope of the directors' or officers' fiduciary obligations in the United States is not easy. The nature of the challenge is concisely stated in the now classic observation by Supreme Court Justice Felix Frankfurter in *Securities and Exchange Commission v. Chenery Corp.*: »[T]o say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?«² In the early formative years of corporate law, it was assumed that the rules governing directors and officers should conform to the strict rules governing trustees and agents. Hence, courts frequently referred to directors as both trustees and agents with the effect of holding directors to the same strict rules of disqualification to contract with their principal the corporation.³ However, the functions performed, and hence the obligations implicit to fulfill the fiduciary's undertakings, are not the same for trustees, guardians, executors, administrators, agents, partners, promoters, directors and officers.⁴ The differences in the expressed tasks, and the undertakings implicit for their accomplishment, necessarily weaken the analogy between, on the one hand, trustees and, on the other hand, corporate

¹ Brainerd Currie Professor of Law, Duke University. This article is adapted from James D. Cox & Thomas Lee Hazen, 1 Cox and Hazen on Corporations ch. 10 (Aspen Law and Bus. 2003).

² 318 U.S. 80, 85-86 (1942).

³ See e.g., *North Confidence Mining & Dev. Co. v. Fitch*, 208 P. 328 (Cal. Ct. App. 1922); *Stack v. Welder*, 31 P.2d 436 (Cal. Ct. App. 1934); *Gates v. Plainfield Trust Co.*, 191 A.304, 318 (N.J. Ch. 1937), *aff'd*, 194 A. 65 (N.J. 1937). As to agents, see Restatement (Second) Agency §§ 389-393 (1958). One can even find in the Supreme Court's rhetoric the analogy to the law of trusts when setting forth the obligations of corporate directors. See e.g., *Pepper v. Litton*, 308 U.S. 295, 311 (1939) (»He who is in such a fiduciary position cannot serve himself first and his cestuis second. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and how meticulous he is to satisfy technical requirements.«).

⁴ See *Austin Wakeman Scott*, *The Trustee's Duty of Loyalty*, 49 Harv. L. Rev. 521 (1936). But see, *Bovay v. H.M. Byllesby & Co.*, 38 2d 808 (Del. 1944).

directors or officers.⁵ Nevertheless, an aspect of the relationship of directors and officers to the corporation is a fiduciary relationship, and the corporation's owners are the beneficiaries of the duties owed by the officers and directors.⁶ The rhetoric of the director or officers as a trustee, therefore, continues to appear in today's decisions, although the guidance that courts invoke to determine the content of the officer's or director's fiduciary obligation is gleaned not by reference to the law of trusts but the extensive body of corporate fiduciary case law.⁷

Directors and officers must also comply with their duty of loyalty⁸ and their duty of care if they are to enjoy the protective benefits of the business judgment rule. The divide between the duty of care and loyalty is not a sharp one, and the courts frequently blur the distinction between these twin obligations.⁹ There are many dimensions to the duty of care. In broad overview, the duty of care is about process by which officers and directors are to reach decisions and, more generally, fulfill

⁵ For early recognition of the problems of extrapolating from the law of trusts obligations for directors and officers, see *York v. Guaranty Trust Co.*, 143 F.2d 503, 514 (2d Cir. 1944), *rev'd on other grounds*, 326 U.S. 99 (1945); *Wyman v. Bowman*, 127 F. 257, 273 (8th Cir. 1904); *Seinbjorn Johnson*, *Corporate Directors as Trustees in Illinois*, 23 Ill. L. Rev. 654 (1929); *Rudolf E. Uhlman*, *The Legal Status of Corporate Directors*, 19 B.U.L. Rev. 12 (1939); Note, 39 Colum. L. Rev. 219, 237 (1939).

⁶ Thus, when the shareholder's relationship with the company ends, so does the fiduciary obligation attendant that relationship. In *Stephenson v. Drever*, 57 Cal. Rptr. 2d 662, 665 (Cal. Ct. App. 1996), the court held that the directors' fiduciary obligation to an employee-minority shareholder ended upon the occurrence of the event triggering the mandatory purchase of that stockholder's shares by the corporation. In many disputes involving allegations of mistreatment of an employee-minority shareholder, courts sometimes circumvent the more troubling fiduciary duty question by instead characterizing the dispute as involving what is appropriate treatment of the complainant as an employee rather than as a shareholder. See *Riblet Products Corp. v. Nagy*, 683 A.2d 37 (Del. 1996).

⁷ On the general topic of determining the roots for corporate fiduciary obligations, see e.g., *Victor Brudey*, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. Rev. 595 (1997); *Park McGinty*, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 Emory L. J. 163 (1997). For an early consideration of the same topic, see *E. Merrick Dodd, Jr.*, *Is Effective Enforcement of Fiduciary Duties of Corporate Managers Practicable?*, 2 U. Chi. L. Rev. 194 (1935).

⁸ The duty of loyalty is equated to the »good faith« requirement that appears in statutes and in court opinions dealing with the obligations of directors and officers. See e.g., *Gaylord Container Shareholders Litigation*, 753 A.2d 462, 475-76 n. 41 (Del. Ch. 2000)

⁹ See *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1284 n.32 (Del. 1988) (disinterested directors who abandon their oversight responsibilities in context of takeover breach their duties of care and loyalty); *Lawrence A. Cunningham & Charles M. Yablon*, *Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)*, 49 Bus. Law. 1594, 1625 (1994).

their monitoring obligations. Hence their duty includes obligations to be attentive,¹⁰ make reasonable inquiry,¹¹ and have a rational basis for decision making.¹² In contrast, loyalty is not about the decision making process or, for that matter, monitoring. The duty of loyalty is about the director's or officer's motives, purposes, and the goals that are necessary if his action is to enjoy the protective benefits of the business judgment rule.

The duty of loyalty most certainly includes officer or director self-dealing contracts and transactions which more generally are referred to as conflict of interest transactions. But an officer or director can be disloyal to her corporation in many more ways than merely transacting business with the corporation. There are many situations that raise concern for the director's or officer's loyalty. A prime example of such a situation is the directors' defense of control where the courts uniformly remove the actions of the board of directors from the protective presumption of the business judgment rule for fear that the directors may be acting to protect their personal self interest and not serving the interests of the corporation or its stockholders.¹³ An even more blatant form of loyalty breach arises when the officer or director has usurped a corporate opportunity.¹⁴ Interestingly, in special instances, loyalty violations can even arise when the directors or officers are acting in their good faith belief they are advancing the corporation's interest.¹⁵ Thus, most certainly the duty of loyalty includes more than either self-dealing or usurping corporate opportunities.

An important question regarding the scope of the duty of loyalty is whether it requires more than the absence self interest, personal gain, and the like on the part of a director or officer. Or, does the duty of loyalty move beyond such minimalist considerations to require the fiduciary to act positively to advance the corporation's

¹⁰ See e.g., *Hoye v. Meek*, 795 F.2d 893 (10th Cir. 1986); *Barnes v. Andrews*, 298 F.2d 614 (2d Cir. 1924); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981). See generally *James D. Cox & Nis Jul Clausen*, *The Monitoring Duties of Directors Under the EC Directives: A View from the United States Experience*, 2 *Duke J. Comp. & Int'l L.* 29 (1992).

¹¹ See e.g., *Hanson Trust PLC v. SCM Corp.*, 781 F.2d 275 (2d Cir. 1986); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

¹² See e.g., *Meyers v. Moody* 693 F.2d 1196 (5th Cir. 1982); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Kamin v. American Express Co.*, 383 N.Y.S.2d 807 (Sup.Ct.), *aff'd*, 387 N.Y.S.2d 211 (App.Div. 1976).

¹³ See e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

¹⁴ See e.g., *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996); *Rapistan Corp. v. Michaels*, 511 N.W.2d 918 (Mich. Ct. App. 1994).

¹⁵ See *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988)(even though acting in the good faith belief they are serving the corporation's interest, management must demonstrate a compelling justification for action taken for purpose of thwarting the on-going efforts of a stockholder to exercise its rights of corporate suffrage).

interests? That is, does the duty of loyalty have both negative and positive descriptions for how officers and directors are to behave?¹⁶ For example, the American Law Institute's Corporate Governance Project sweeps the duty of loyalty into its obligation for »fair dealing« which prescribes a course of behavior when an officer, director or controlling stockholder is financially interested in a matter.¹⁷ Pronouncements of the Delaware Supreme Court can be seen as embodying a more expansive view of the duty of loyalty. For example, in a leading case on the disclosure obligations of officers and directors, the court analogized the duty to a »compass« that is to serve as constant guide for the fiduciary when acting for the corporation.¹⁸ And, in a leading corporate opportunity case, *Guth v. Loft, Inc.*,¹⁹ the court observed that the directors have a duty to »affirmatively to protect the interests of the corporation committed to his charge.«²⁰ To so view the duty of loyalty places the obligations of directors and officers on a footing equal to that of contemporary standards for fiduciaries generally where the obligation is not simply to subordinate self interested behavior, but also to »act exclusively for the benefit of the other party.«²¹ So viewed, the duty of loyalty is not merely regulatory, but has a strong moral element.

Those who prefer to view the corporation as a web of contract have little regard for the duty of loyalty being morally based. Instead, adherents of such a contractual view of the corporation argue that the source of officer and director obligations is what the parties would have agreed to ex ante.²² Even with such a simplified view

¹⁶ See *Lyman Johnson*, *Enron: Loyalty Discourse in Corporate Law*, 28 J. Corp. L. (forthcoming 2002).

¹⁷ A.L.I., 1 *Principles of Corporate Governance: Analysis and Recommendations* ch. V (1992); See generally *Melvin A. Eisenberg*, *Corporate Law and Social Norms*, 99 *Colum. L. Rev.* 1253, 1265 & 1273 (1999).

¹⁸ See *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

¹⁹ 5 A.2d 503 (Del. 1939).

²⁰ *Id.* at 510. The court, in recognizing this broad responsibility then proceeded to find that this carried with it the additional obligations »to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it.« *Id.* See also *Model Bus. Corp. Act. Ann.* § 8.60 commentary (in determining whether a transaction is fair to the corporation, the court should be persuaded the transaction *further*s the corporation's interest) and A.L.I. *Principles of Corporate Governance: Analysis and Recommendations* 219 (1992) (for director of conflict of interest transactions the decision maker must be satisfied the transaction is »affirmatively will be in the corporation's best interests«).

²¹ See *Gregory S. Alexander*, *A Cognitive Theory of Fiduciary Relationships*, 85 *Cornell L. Rev.* 767, 776 (2000).

²² See e.g., *Frank H. Easterbrook & Daniel R. Fischel*, *Contract and Fiduciary Duty*, 36 *J. L. & Econ.* 425 (1993).

of the corporate enterprise, it is not clear that owners and their officers and directors would not have embodied in their contract a broad duty of loyalty. Indeed, the information asymmetries that abound when passive owners commit funds to the stewardship of others should minimally give rise to a strong presumption that the stewards were to always act exclusively to benefit the firm and its owners. The difference in the result is that the meaning of the duty of loyalty pursuant to the contractual view is driven exclusively by self interest of the economic actors, whereas for non-contractarians the content is moral in nature having its roots social values of our culture.²³ What may be at risk in making a choice between these two views is that a view anchored so firmly in the methodology of economics, as is the case with the contractual view, may well blind or divert the inquiry from a richer perspective that gives regard to a wider range of social inputs.

An example of a breach of the director's duty of loyalty when the director, even though financially disinterested, arises when he knowingly fails to warn his fellow directors of material facts relevant to a transaction before the board.²⁴ Similarly,

²³ Consider here the insight of former Chancellor William Allen: »[C]orporation law exists, not as an isolated body of rules and principles, but rather in a historical setting and as part of a larger body of law premised upon shared values.« *City Capital Associates Limited Partnership v. Interco, Inc.*, 551 A.2d 787, 800 (Del. Ch. 1988).

²⁴ See e.g., *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787 (S.D.N.Y. 1978) (Some of the directors failed to disclose to their fellow directors their knowledge that the investment banker whose fairness opinion the board would rely upon had a material financial interest in the outcome of the transaction). In an early decision, *Globe Woolen Company v. Utica Gas & Electric Company*, 121 N.E. 378 (N.Y. 1918), Judge Cardozo examined the director's duty of loyalty in terms of failing to bring to the board's attention the one-side nature of a contract with a company in which the director was deeply involved. Rather than emphasizing the pure conflict of interest nature of the transaction, Judge Cardozo focused on the broader obligation to protect the interest of the corporation from a potentially harmful contract. In *Globe Woolen Company* the plaintiff corporation sued to compel specific performance of contracts to supply electric current to its mills. The defendant corporation answered that the contracts were made under the dominating influence of a common director and were unfair and oppressive. Maynard, the plaintiff's chief stockholder, resident, and member of its board of directors, was also a director of the defendant and chairman of its executive committee, holding a single share to qualify him for office. Maynard presided at the defendant's executive committee at which the contract was ratified, but he did not vote. It was held that the contract was voidable at the defendant's election. Judge Cardozo said: The trustee is free to stand aloof, while others act, if all is equitable and fair. He cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent on the surface or lurking beneath the surface, but visible to his practiced eye.. There slumbered within these contracts a potency of profit which the plaintiff neither ignored in their making nor forgot in their enforcement... [T]he refusal to vote does not nullify as of course an influence and predominance exerted without a vote. *Id.* at 380. It thus becomes a question of fact whether a fiduciary's (director's or officer's) dominance has been exerted and, further, whether the contract is fair to the complaining corporation. See e.g., *Borden v. Siskey*, 530 F.2d 478, 495 (3d Cir. 1976); *Puma v. Marriott*, 283 A. 2d 693 (Del. Ch. 1971); *Alliegro v. Pan Am. Bank*, 136 So. 2d 656 (Fla. Dist. Ct. App. 1962); *Case v. New York Cent. R.R.*, 204 N.E.2d 643 (N.Y. 1965). See generally Note, *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations*, 74 *Yale L. J.* 338 (1965).

when two of the company's four directors receive significant salaries as employees of the majority shareholder, the court held the two directors breached their fiduciary duty by being indifferent to their duty of loyalty by supporting the repurchase of the majority shareholder's stock with the effect of boosting the president's ownership interest from 6.9 percent to 55 percent.²⁵ And, a director who permits the company's CEO to purchase 30 percent of the company's shares at a substantial discount from their market price breaches his fiduciary duty by not causing the corporation to pursue the opportunity for itself.²⁶ The more common cases in which courts find that an officer or director has acted in »bad faith,« however, involve instances of the officer or director garnering a »secret profit« in connection with performing his corporate responsibilities. The notion of a secret profit does not imply that the fiduciary's gain is not disclosed to anyone. Thus, the senior vice president breached his fiduciary duty by negotiating a »finder's fee« to be received from the firm acquiring his employer.²⁷ Though he had disclosed the arrangement with several other company officers, he failed to obtain formal approval of the arrangement as called for by the company's ethics code.

Outside directors, especially those who serve on multiple boards, can face conflicting tugs on their loyalties. Indeed, conflicts can arise without multiple board service. Thus, the inventor's attorney served on the board of a start-up company that held a license to the inventor's novel system for processing sugar cane. When the start-up company became insolvent, the attorney advised the inventor to exercise its rights under the licensing arrangement to terminate the license to the start-up company. The court held the attorney had met his fiduciary responsibilities by disclosing his relationship to the inventor when he agreed to become a director of the start-up company.²⁸ The court's emphasis on disclosure and consent is consistent with the specific statutory treatment of transactions between the corporation and the officer or director where the statutory demand that directors and officers act in »good faith« are interpreted within the context of the state's conflict of interest statute.²⁹

A panoply of remedies are available for a breach of the officer's or director's duty of loyalty. First, it must be observed that the contract or transaction giving rise to the breach is itself voidable; hence, even a third party (i.e., someone with no ownership interest in the officer's or director's corporation) can raise the officer's or director's breach as a defense in a suit by the fiduciary to enforce the contract that is an

²⁵ See *Strassburger v. Earley*, 752 A.2d 557, 581 (Del.Ch. 2000).

²⁶ *Kohls v. Duthie*, 2000 WL 1041219 (Del. Ch. 2000), *rev. ref'd*, 765 A.2d 950 (Del. 2000).

²⁷ *Geller v. Allied-Lyons PLC*, 674 N.E.2d 1334 (Mass. App. Ct. 1997).

²⁸ See *Astarte, Inc. v. Pacific Indus. Sys., Inc.*, 865 F. Supp. 693 (D. Colo. 1994).

²⁹ See e.g., *Camden v. Kaufman*, 613 N.W.2d 335 (Mich. Ct. App. 2000).

integral part of the director's or officer's breaching conduct.³⁰ Moreover, the breaching officer forfeits all right to compensation during the period of his misbehavior.³¹ The breach can be the basis as well for accounting by the fiduciary with a constructive trust being imposed on any funds or other assets wrongfully acquired.³²

A rapidly developing area of fiduciary responsibility is the disclosure duty owed shareholders by directors, officers, and controlling shareholders.³³ Though there has long been a developed body of state law pertaining to directors' and officers' disclosure obligations when trading in their company's shares on the basis of material non-public confidential corporate information,³⁴ only recently has there been the recognition of broader disclosure obligations for company fiduciaries. In the seminal case, *Lynch v. Vickers Energy Corp.*,³⁵ the Delaware Supreme Court held that directors owe shareholders a duty of »complete candor,« so that the objective was »completeness and not adequacy.«³⁶ From this broad language, Delaware courts have imposed a duty of full disclosure on directors³⁷ and controlling shareholders.³⁸ The duty is most readily applied when shareholder approval has been sought through

³⁰ See e.g., *General Dynamics v. Torres*, 915 S.W. 2d 45 (Tex. App. 1995); *Geller v. Allied-Lyons PLC*, 674 N.E.2d 335 (Mass. App. Ct. 1997); *Cascades West Assoc. Ltd. P'ship v. PRC, Inc.*, No. 128818, 1995 WL 1055858 (Va. Cir. Ct. May 11, 1995).

³¹ See *Zakibe v. Ahrens & McCarron, Inc.*, 28 S.W. 3d 373 (Mo. Ct. App. 2000).

³² See *Levin v. Levin*, 405 A.2d 770 (Md. Ct. App. 1979) *Talbot v. James*, 190 S.E.2d 759 (S.C. 1972).

³³ See generally Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 Vand. L. Rev. 1087 (1996); Nicole M. Kim, *Malone v. Brinkat: The Fiduciary Disclosure Duty of Corporate Directors Under Delaware Law*, 74 Wash. L. Rev. 1151 (1999). A claim for breach of the fiduciary duty of disclosure implicates only the duty of care when the violation occurs as a result of a good faith, but nevertheless erroneous, judgment about the proper scope or content of the required disclosure. However, if a disclosure violation is made in bad faith or is knowing or intentional, it implicates the duty of loyalty. *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914-915 (Del. Ch. 1999).

³⁴ See e.g., *Brophy c. Cities Service Co.*, 70 A.2d 5 (Del. 1949); *Diamond v. Oreamuno*, 248 N.E.2d 919 (N.Y. 1969). See generally *Douglas M. Branson*, *Choosing the Appropriate Default Rule – Insider Trading Under State Law*, 45 Ala. L. Rev. 753 (1994).

³⁵ 383 A.2d 278 (Del. 1977).

³⁶ *Id.* at 281.

³⁷ See, e.g., *Arnold v. Society for Savings Bancorp.*, 650 A.2d 1270 (Del. 1994).

³⁸ See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711-12 (Del. 1983).

proxy materials that omit or misstate material facts.³⁹ However, the emerging disclosure doctrine has now been recognized for misleading information in SEC filings in connection with a firm's takeover,⁴⁰ in the notice of a stockholders' meeting for a close corporation where no proxy was solicited,⁴¹ and for misrepresentations that were not in connection with any transaction that would call for shareholder action.⁴² Directors who breach the duty are liable for damages that the shareholders suffer as a consequence of their breach, even though they did not benefit personally because of their omission or misstatement.⁴³ By far the most significant expansion of *Lynch* was made in *Malone v. Brincat*,⁴⁴ which held that directors and officers breached their duty of candor by knowingly releasing false financial information regarding the company's performance and financial position. The significance of *Malone* is that the court expressly held that *Lynch's* duty of candor applied even when shareholders were not being asked to vote or otherwise approve a matter.

³⁹ *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271 (Del. Ch. 1986). Cf. *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000) (omitted facts are not material simply because they might be helpful; court rejected claims of minority stockholders who were cashed out in merger that information statement did not contain enough financial information for them to decide whether to accept merger consideration or seek appraisal); *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 388 (Del. Ch. 1999) (since neither corporation statute nor certificate of incorporation provided preferred stockholder with right to vote on corporation's sale of assets, president had no fiduciary obligation to disclose transaction to preferred stockholder).

⁴⁰ *Weinberger v. Rio Grande Ind., Inc.*, 519 A.2d 116 (Del. Ch. 1986).

⁴¹ *Stroud v. Grace*, 606 A.2d 75 (Del. 1992).

⁴² *Malone v. Brincat*, 722 A.2d 5 (Del. 1999). Claims based on disclosure violations arising out of communications that do not contemplate stockholder action must be supported by a well-pleaded complaint with allegations sufficient to warrant the remedy sought, regardless of whether the requested remedies are for nominal damages, compensatory damages or some other type of relief. *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 919-920 (Del. Ch. 1999).

⁴³ *Zirn v. VLI Corp.*, 621 A.2d 773 (Del. 1993). The *Zirn* court concluded that the directors were not protected by the exculpatory provision in the company's charter, reasoning that any breach of the directors' disclosure duty was a breach of their duty of loyalty, which is beyond the type of conduct Delaware law permits to be included in such an exculpatory provision. *Id.* at 783. In *Arnold v. Society for Savings Bancorp*, 650 A.2d 1270, 1277 (Del. 1994), the court, providing a close reading of the Delaware statute that authorizes such exculpatory provisions, held that disclosure breaches were covered by the exculpatory provision in the company's articles of incorporation. *See also O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914 (Del. Ch. 1999) (when certificate of incorporation contains exculpatory provision, claims against directors can be dismissed only if complaint fails to plead sufficiently that directors' conduct falls into at least one statutory exception under which directors are not protected).

⁴⁴ 722 A.2d 5 (Del. 1999).

A further expansion of the disclosure obligations under state law occurred in *Rossdeutscher v. Viacom, Inc.*⁴⁵ The plaintiff's successfully plead a breach of the Viacom directors' disclosure obligations by charging they had released false financial data for the purpose of inflating the Viacom's price to the disadvantage of its merger partner, Paramount. Of significance in *Rossdeutscher* was that the plaintiff's were not stockholders in Viacom, but of the merger partner so that disclosure violation could not be based upon a pre-existing fiduciary relationship. The court instead the duty imposed upon the Viacom directors was premised on an implied contract of good faith and fair dealing.

Lynch and its progeny are not without limits. One possible restriction may arise where the unlawful conduct is a matter that historically was regulated by federal securities laws, and not state fiduciary law. Thus, complaints alleging manipulation of securities prices via short selling were dismissed on the ground market manipulation is beyond the purview of state fiduciary law.⁴⁶ And, recently the Delaware Chancery Court narrowly construed *Malone* to apply only to shareholders whose injury was not accompanied by a purchase or sale. Thus, the court dismissed an action where the class members exchanged their old shares for new shares in a transaction allegedly tainted by fraudulent representations.⁴⁷ And, absent an allegation the officers or directors *knowingly* engaged in a material misrepresentation, *Malone* does not control.⁴⁸

One further limiting factor is whether reliance will, in facts similar to *Malone*, be presumed. The vitality of a disclosure claim in an open market situation, such as occurred in *Malone*, depends on the ability to pursue the suit as a class action. In the federal securities law context, class action suits are facilitated by relieving the class members from having to establish their reliance upon the misrepresentation. Under the fraud on the market doctrine as embraced in *Basic Inc. v. Levinson*,⁴⁹ reliance is satisfied by an allegation that the plaintiff relied upon the integrity of the market and the false information was released into an efficient market. Thus, common questions of law and fact are permitted to predominate so that the class action can be certified. This could not be the case if each investor were required to establish his or her reliance upon the allegedly false misrepresentation. *Basic Inc.* involved the federal securities laws and has not been followed by the states as several state courts have

⁴⁵ 768 A.2d 8 (Del. 2001).

⁴⁶ See *RGC International Investors, LDC v. Greka Energy Corp.*, 2000 WL 984689 (Del. Ch. 2001).

⁴⁷ See *Derdiger v. Tallman*, 773 A.2d 1005 (Del. Ch. 2000) (the case also involved an on-going class action in the federal courts by another set of plaintiffs).

⁴⁸ See *In re Triarc Companies, Inc.*, 791 A.2d 872 (Del. Ch. 2001).

⁴⁹ 485 U.S. 224 (1988).

rejected the fraud on the market approach.⁵⁰ Thus, for example, a divided the New Jersey Supreme Court rejected incorporating *Basic Inc.* into the state's jurisprudence as being a substantial departure from the common law requirements for an action in deceit.⁵¹

Though these fiduciary-based disclosure obligations are growing rapidly in Delaware, there is little litigation on this subject in other states. In 1998, Congress enacted the Securities Litigation Uniform Standards Act to preempt the state court's jurisdiction over securities class actions.⁵² However, among the exceptions it provided was the so-called Delaware carve-out that preserves state court jurisdiction to hear claims of disclosure violations premised upon state law fiduciary obligations.⁵³ Thus, the rapidly expanding disclosure obligations founded on state law fiduciary principles will not likely be slowed by the recent federal legislation.

⁵⁰ See e.g., *Mirkin v. Wasswereman*, 858 P.2d 568 (Cal. 1993); *Kahler v. E.F. Hutton Co.*, 908 P.2d 1095 (Colo. 1995); *Constantine v. Miller Ind., Inc.*, 2000 WL 336663 (Tenn. Ct. App. 2000); *Gohler v. Wood*, 919 P.2d 561 (Utah 1996). *Contra* *Allyn v. Wortman*, 725 So.2d 94 (Miss. 1998)(dicta).

⁵¹ See *Kaufman v. I-stat Corp.*, 754 A.2d 1188 (N.J. 2000).

⁵² The provisions are in Securities Exchange Act Section 28(f), 15 U.S.C. § 78bb(f) (2000). SLUSA applies to suits seeking damages on behalf of more than 50 persons and applies only to »covered securities,« meaning securities traded on the New York Stock Exchange, American Stock Exchange and Nasdaq, as well as certain other exchanges designated by the SEC, issued by a company subject to the periodic reporting requirements of the Exchange Act, as well as securities offered pursuant to certain exemptions from the registration requirements of the Securities Act. See section 18(b) of the Securities Act, 15 U.S.C. § 77r(b) (2000)(defining covered securities). States may also choose to dismiss the action on the traditional considerations of forum non conveniens. See *Friedman v. Alcatel Alsthom*, 752 A.2d 544 (Del. Ch. 1999).

⁵³ See e.g., *Gibson v. P.S. Group Holdings, Inc.*, 2000 WL 777818 (S.D. Cal. 2000)(holding removal to federal court under SLUSA conflicted with the Delaware carve out provision)*Gordon v. Buntrock*, 2000 WL 556763 (N.D. Ill. 2000)(same); *Pauline Lalodriz v. USA Networks, Inc.*, 68 F. Supp.2d 285 (S.D.N.Y. 1999)(approving *Malone* and holding SLUSA did not bar the action).