

## St. John's Law Review

---

Volume 76  
Number 4 *Volume 76, Fall 2002, Number 4*

Article 12

---

February 2012

### The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations

Lisa M. Fairfax

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

---

#### Recommended Citation

Fairfax, Lisa M. (2002) "The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations," *St. John's Law Review*. Vol. 76 : No. 4 , Article 12.

Available at: <https://scholarship.law.stjohns.edu/lawreview/vol76/iss4/12>

This Symposium is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact [selbyc@stjohns.edu](mailto:selbyc@stjohns.edu).

# THE SARBANES-OXLEY ACT AS CONFIRMATION OF RECENT TRENDS IN DIRECTOR AND OFFICER FIDUCIARY OBLIGATIONS

LISA M. FAIRFAX<sup>†</sup>

## INTRODUCTION

It is axiomatic that corporate directors and officers owe a fiduciary duty of care to the corporations that they manage.<sup>1</sup> While courts and other bodies have reshaped the parameters of that duty throughout the years, at its core, the duty is designed to ensure that top managers govern in good faith and in the best interests of the corporation.<sup>2</sup> Many have responded to the recently enacted Sarbanes-Oxley Act of 2002 (the “Sarbanes Act” or the “Act”)<sup>3</sup> as if it dramatically alters the responsibilities of corporate managers. This Article argues, however, that the Sarbanes Act confirms at least some case law—even in Delaware—and other recent articulations of management’s fiduciary duty.

At a minimum, recent allegations regarding corporate misconduct may suggest some degree of confusion on the part of corporate officers and directors about the manner in which corporate managers comply with their fiduciary duty. Indeed,

---

<sup>†</sup> Assistant Professor of Law, University of Maryland School of Law; A.B., Harvard College, 1992; J.D., Harvard Law School, 1995. This Article benefited from conversations with participants in the Symposium: *Enron and Its Aftermath*, St. John’s University School of Law, Jamaica, New York (Sept. 20, 2002). Specifically, I would like to thank Leonard M. Baynes and Cheryl L. Wade for their comments regarding fiduciary duty and the importance of *In re Caremark International Inc.*, 698 A.2d 959 (Del. Ch. 1996), to discussions regarding the evolution of that duty.

<sup>1</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

<sup>2</sup> By statute, the standard of conduct for directors and officers requires that they act in good faith and in a manner they reasonably believe to be in the best interests of the corporation. See MODEL BUS. CORP. ACT §§ 8.30(a), 8.42(a) (1999).

<sup>3</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

congressional inquiries related to director and officer behavior reflect a relatively low standard of conduct on the part of such managers and suggest that some corporate officers believe this conduct to be consistent with their corporate duties.<sup>4</sup> While this belief may be consistent with some case law on the subject, other, often more recent, trends reflect an alternative view.<sup>5</sup> Recent pronouncements by courts, the Securities and Exchange Commission (SEC), and even the United States Sentencing Commission (the "Sentencing Commission") appear to require more exacting standards of conduct from directors and officers.<sup>6</sup> Thus, far from charting a new course, the Sarbanes Act represents a natural extension of these pronouncements—affirmatively embracing the enhanced standard called for by these bodies. In this way, the Sarbanes Act may be viewed as a welcome confirmation of more stringent requirements for corporate managers.

By way of background, this Article begins by identifying the principle components of corporate fiduciary law and then uses congressional testimony to demonstrate the manner in which some directors and officers appeared to comply with those components. Part I of this Article ends by explaining case law that appears to support the relatively lax standard of conduct revealed by congressional testimony. Part II reveals how the Sarbanes Act imposes various fiduciary-type obligations on directors and officers that demand standards at odds with those highlighted in Part I. Drawing on the United States Sentencing Guidelines (the "Guidelines"), as well as on case law and SEC releases, Part II underscores the parallels between the obligations in the Sarbanes Act and those imposed by recent articulations of corporate fiduciary law. Part II also reveals that much of the behavior of some corporate officers and directors highlighted in congressional testimony would fail to pass muster under such articulations. The Article concludes with an assessment of the Sarbanes Act's ability to ensure that directors and officers will comply with the more stringent fiduciary obligations it imposes.

---

<sup>4</sup> See *infra* Part I.B.

<sup>5</sup> See *infra* Part II.B.

<sup>6</sup> See *infra* Part II.B.

## I. FIDUCIARY DUTY AND CORPORATE MISCONDUCT

A. *Some ABCs of Corporate Fiduciary Duty Identified*

Corporate law, buttressed by securities law, imposes upon directors and officers a fiduciary duty of care, which often manifests itself in the form of a monitoring function. For directors, a duty to monitor corporate affairs stems from the principle that all corporate affairs must be managed under the direction of the board of directors.<sup>7</sup> Courts and commentators interpret this monitoring duty to mean that directors have an oversight function.<sup>8</sup> Executive officers have a similar oversight role. Such officers often delegate responsibilities to lower level employees.<sup>9</sup> Like directors, officers also must monitor the actions of employees to whom they delegate responsibility.<sup>10</sup>

This monitoring function involves several different, and often overlapping, duties.<sup>11</sup> One principle duty requires corporate officers and directors to remain informed about the affairs of the corporation.<sup>12</sup> As one court noted, the duty to manage corporate affairs means that directors and officers are under a “continuing obligation to keep informed about the activities of the corporation.”<sup>13</sup> Another duty, which is a natural by-product of the duty to remain informed, is the duty to ask questions of the corporate agents to whom top-level managers have delegated various corporate functions.<sup>14</sup> Indeed, while

---

<sup>7</sup> See MODEL BUS. CORP. ACT § 8.01(b) (“All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . .”).

<sup>8</sup> See *id.* § 8.30(b) (stating that directors must devote attention to their oversight function); *Briggs v. Spaulding*, 141 U.S. 132, 147 (1891) (finding that directors have a duty to supervise and manage corporate affairs); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (discussing the duty of directors to actively supervise and manage corporate affairs).

<sup>9</sup> See MODEL BUS. CORP. ACT § 8.42(b)(1) (noting that officer is entitled to rely on employees of the corporation).

<sup>10</sup> See *id.* § 8.42 cmt. at 8-79-8-80.

<sup>11</sup> See *id.* § 8.30(a) cmt. at 8-40 (noting that directors’ conduct entails several duties including the duty to become informed, the duty of inquiry, the duty of informed judgment, and the duty of attention).

<sup>12</sup> See *infra* Part II.B.1 (explaining duty to remain informed).

<sup>13</sup> *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981); see also *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (“[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.”).

<sup>14</sup> See *infra* Part II.B.2 (describing duty of inquiry).

these managers may rely on other agents to keep them informed, under certain circumstances, they have a duty to second-guess those agents and make independent inquiries into corporate affairs.<sup>15</sup> Directors and officers who discharge their responsibilities in compliance with these obligations avoid liability to shareholders and the corporation.<sup>16</sup>

### *B. Fiduciary Obligations As Reflected in Corporate Misconduct*

The recent allegations regarding corporate misconduct provide important insights about the manner in which directors and officers believe they must demonstrate compliance with their fiduciary obligations.<sup>17</sup> Although this behavior may not represent a universal pattern, congressional testimony and investigations surrounding this misconduct indicate how some managers performed their duties. Indeed, the directors and

---

<sup>15</sup> See *infra* Part II.B.2 (describing duty of inquiry).

<sup>16</sup> See MODEL BUS. CORP. ACT § 8.42(c) (stating that an officer is not held liable if she performs duties in compliance with Sections 8.42(a) and 8.42(b)); see also *id.* § 8.42 cmt. at 8-80 (noting that statute makes clear that performance meeting the section's requirement will eliminate officer's exposure to liability).

<sup>17</sup> This Article's purpose is not to restate the lengthy accounts of such allegations. For an in-depth review of the conduct related to Enron Corporation, see Peter Behr & April Witt, *Visionary's Dream Led to Risky Business; Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured its Demise*, WASH. POST, July 28, 2002, at A1 (first of five part series detailing the various financial transactions leading to Enron's rise and ultimate collapse); April Witt & Peter Behr, *Dream Job Turns Into a Nightmare*, WASH. POST, July 29, 2002, at A1 (second in five part series detailing events in August 2001 related to the fall of Enron's stock price and its growing debt burden); Peter Behr & April Witt, *Concerns Grow Amid Conflicts; Officials Seek to Limit Probe, Fallout of Deals*, WASH. POST, July 30, 2002, at A1 (third of five part series detailing Enron's activities in September 2001 related to preliminary internal investigation into Enron accounting problems); April Witt & Peter Behr, *Losses, Conflicts Threaten Survival*, WASH. POST, July 31, 2002, at A1 (fourth of five part series detailing events in October related to Enron's declaration of \$1 billion in losses); Peter Behr & April Witt, *Hidden Debts, Deals Scuttle Last Chance*, WASH. POST, Aug. 1, 2002, at A1 (last of five part series detailing Enron's disclosure of additional losses and final declaration of bankruptcy). For information related to other corporate misconduct, see generally, Frank Ahrens, *AOL Discloses Revenue Errors: \$49 Million From Ad Deals Misbooked, Firm Tells SEC*, WASH. POST, Aug. 15, 2002, at A1; Kathleen Day, *XEROX Restates 5 Years of Revenue; '97-'01 Figures Were Off By \$6.4 Billion*, WASH. POST, June 29, 2002, at A1; David S. Hilzenrath, *Former Rite Aid Officials Indicted; U.S. Says Executives Inflated Profits, Diverted Funds*, WASH. POST, June 22, 2002, at A1; Carrie Johnson & Christopher Stern, *Adelphia Founder, Sons Charged; Family Looted Sixth-Largest Cable TV Company, U.S. Says*, WASH. POST, July 25, 2002, at A1; Kevin Maney, *Latest Charges Leave WorldCom in Limbo: Company, Former CEO Ebberts Could be Next on Fed's List*, USA TODAY, Aug. 2, 2002 (Magazine), at 1B.

officers who appeared before Congress seemed to recognize that they were under an obligation to monitor the affairs of the corporation and that this function included some duty to be informed and to ask relevant questions.<sup>18</sup> Their testimony and other reports suggest, however, that they felt comfortable with meeting this obligation in a less than vigilant fashion.

These directors appeared to satisfy their duty to remain informed primarily through reliance on other officers and agents, coupled with a relatively cursory review of specific transactions. In fact, several directors testified regarding the difficulty of overseeing the companies on whose boards they served because of the part-time nature of their jobs and the magnitude of the enterprises they were charged with governing.<sup>19</sup> A majority of the directors had other demanding jobs or obligations to occupy their time.<sup>20</sup> As a consequence, a report of the congressionally appointed special investigation committee, chaired by William C. Powers, Jr. (the "Powers Report"),<sup>21</sup> reveals that these directors may have made decisions without sufficient information regarding company transactions or their companies' financial situation.<sup>22</sup> Other testimony confirms the Powers Report.<sup>23</sup> Admittedly, congressional probes revealed that certain officers withheld vital information from the board and top corporate

---

<sup>18</sup> See, e.g., *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs*, 107th Cong. (2002) (statement of Robert K. Jaedicke, former Chairman, Audit and Compliance Committee, Board of Directors, Enron Corporation) (discussing duties and responsibilities of board and its committees); *id.* (statement of Herbert S. Winokur, Jr., Member, Finance Committee, Board of Directors, Enron Corporation) (discussing Board's responsibilities).

<sup>19</sup> See *id.* (statement of Winokur) (noting directors' limited role within large corporations and the part-time nature of their job).

<sup>20</sup> See *id.* Twelve of the fourteen board members were outside directors. The Chairman of the Audit Committee also served at Stanford Business School during his tenure. See *id.* (statement of Jaedicke).

<sup>21</sup> See *Report of Investigation by the Special Investigative Comm. of the Bd. of Dirs. of Enron Corp.* (Feb. 1, 2002) [hereinafter *Powers Report*], available at <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>.

<sup>22</sup> See *id.* at 151 (noting Board's failure to consider issues necessary to ensure the viability of conflict of interest transaction involving LJM1 and Andrew Fastow, Enron's chief financial officer).

<sup>23</sup> See Jackie Spinner & David S. Hilzenrath, *Enron CEO Felt "Betrayed," Panel Told; Head of Internal Probe Testifies on the Hill*, WASH. POST, Feb. 6, 2002, at A1 (noting that Former Enron Chairman Kenneth Lay claimed that he should have paid more attention to company documents, and that he did not appreciate the nature of the financial information within company documents).

executives.<sup>24</sup> Further probing also revealed that even when such officials had access to information, often they only briefly considered complex, and potentially risky, transactions.<sup>25</sup> Instead of an in-depth review, these corporate officials regularly relied on other managers and agents to monitor and ensure the accuracy of company information, or the validity of specific transactions.<sup>26</sup> This was true even when officials had access to information that should have raised suspicions about the reliability or integrity of various information or transactions.<sup>27</sup> In this respect, directors suggested that their duty to remain informed depended almost completely on reliance on other agents and limited review of complex transactions.

Congressional testimony and related investigations also suggested a less than rigorous standard for the duty of inquiry. Directors' admissions that they had a limited awareness of the financial information contained in documents that they signed reveals their failure to make any significant inquiries regarding those documents.<sup>28</sup> In this respect, some appeared to ignore the duty of inquiry altogether.<sup>29</sup> Other corporate officials appeared to believe that the existence of internal control procedures obviated the need for extensive inquiry. Hence, when asked about their failure to question information contained within a document or officers who prepared them, such officials expressed their belief that control procedures served as a guarantee of such information.<sup>30</sup> Again, managers held this belief even though they recognized that the control procedures may not have mitigated the risk of improper activity.<sup>31</sup> Still other corporate

---

<sup>24</sup> The Powers Report notes several instances where corporate officers withheld information about critical transactions. See *Powers Report*, *supra* note 21, at 151 n.68, 156 n.72, 159-61.

<sup>25</sup> See *id.* at 162-65 (pointing out limited board scrutiny of transactions between Enron and LJM partnerships, which were controlled by its CFO, and limited review of Andrew Fastow's compensation from such partnerships); *id.* at 168 (noting limited review by managers of various risky transactions).

<sup>26</sup> See *id.* at 153.

<sup>27</sup> See *id.* at 157-58.

<sup>28</sup> See *id.* at 148-49.

<sup>29</sup> See *id.* at 149 (noting that many board members did not make the inquiries necessary under the Enron Code of Conduct to permit approval of conflict of interest transactions between Enron and its CFO); *id.* at 157 (citing lack of detailed questions related to the hedging activity of Raptor I).

<sup>30</sup> See *id.* at 154-56 (explaining reliance on controls).

<sup>31</sup> See *id.* at 156 (explaining board members awareness of the severe risk associated with conflict of interest transactions at issue).

officers and directors appeared to perform their inquiry duty, but only in a very perfunctory manner. Such managers insisted that they questioned others about misleading or contradictory information of which they were aware.<sup>32</sup> Reports reveal, however, that their questions were general in nature, eliciting general responses. Consistent with this assessment, the Powers Report concluded that corporate managers failed to closely and critically question transactions, even when they were aware of red flags.<sup>33</sup> In this way, most officers and directors appeared to recognize their obligation to make relevant inquiry, but their conduct suggests a belief that compliance with this obligation could be met with less than vigilant attention.

Congressional reports and testimony suggest a lack of sufficient oversight by executives and directors alike, highlighted by cursory reviews of, and lack of detailed inquiries into, important corporate transactions. After his investigation, William Powers emphasized that the fraudulent transactions he uncovered “could and should have been avoided” if executives and board members had taken their fiduciary obligations more seriously.<sup>34</sup> Instead, his report revealed a “fundamental default of leadership and management.”<sup>35</sup> This default appeared to stem from the relatively casual manner with which some such officials approached performance of their fiduciary responsibility.

### C. *Seeds of Support for Lax Standards*

This manner of compliance may stem from the relatively lax standard under which courts examine violations of the duty of care. While acknowledging the duties to remain informed and ask questions, courts point out that a corporate manager’s liability for breach of those duties is “predicated upon concepts of

---

<sup>32</sup> See *The Role of the Board of Directors in Enron’s Collapse: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs*, 107th Cong. (2002) (statement of Robert K. Jaedicke, former Chairman, Audit and Compliance Committee, Board of Directors, Enron Corporation) (noting that board and audit committee raised questions about various conflict of interests transactions).

<sup>33</sup> See *Powers Report*, *supra* note 21, at 157–58.

<sup>34</sup> See *Hearing on Causes, The Role of the Bd. of Dirs. of Enron Impact of Enron Collapse: Hearing Before the Senate Comm. on Fin. Servs.*, 107th Cong. (2002) (statement of William C. Powers, Chairman, Special Investigative Committee, Board of Directors, Enron Corporation).

<sup>35</sup> See *id.*



gross negligence."<sup>36</sup> Courts review director and officer conduct under the business judgment rule, which operates as a presumption that their actions are a product of good faith, and hence should be protected.<sup>37</sup> Only when a manager's conduct can be viewed as a severe departure from reasonable conduct will courts hold him liable for violating his fiduciary duty of care. Supporting this concept, there have been at least two major studies revealing the lack of cases holding corporate directors and officers liable for a breach of their duty of care.<sup>38</sup> One commentator explained:

The foundation stone of the American law of corporate governance is currently enunciated in the holdings (not the dicta) of the leading corporate law states: there must be a minimum of interference by the courts in internal corporate affairs. Except in the egregious case of bad judgment or when there is evidence of bad faith, courts have made no attempt to second-guess directors on the substantive soundness of decisions reached.<sup>39</sup>

This comment reflects an unwillingness to hold directors and officers liable for a breach of their duty of care except in the most extreme circumstances. This unwillingness, in turn, suggests that the threshold for compliance with fiduciary duties was relatively low.

## II. PARALLELS BETWEEN THE SARBANES ACT AND ALTERNATIVE ARTICULATIONS OF FIDUCIARY DUTY

### A. *Strands of Fiduciary Duty in the Sarbanes Act*

The Sarbanes Act appears to impose on corporate directors and officers many fiduciary-like obligations that alter the low

---

<sup>36</sup> Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984) (citing Delaware cases).

<sup>37</sup> See *id.*; Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

<sup>38</sup> See Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968) ("The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."); see also Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 981 (1994) (noting that review of Delaware cases involving breaches of the duty of care "were as disappointing as that earlier encountered by Bishop").

<sup>39</sup> Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule*, 41 BUS. LAW. 1237, 1239 (1986).

threshold indicated in Part I. Indeed, the Act can be viewed as adding content to, and buttressing, the overall monitoring role of corporate directors and officers. In addition, the Act appears to ensure that compliance with that role involves more active and vigilant participation on the part of directors and officers.

### 1. Duty to Remain Informed

With respect to directors, the Sarbanes Act adds content to directors' duty to remain informed. In particular, section 301 of the Act requires the board of directors, through its audit committee, to appoint and oversee the work of the accounting firm employed by the corporation.<sup>40</sup> In connection with its oversight, the audit committee is responsible for resolving disagreements between management and the auditor regarding financial reporting.<sup>41</sup> Members of the audit committee must also establish a procedure for complaints related to accounting and auditing matters.<sup>42</sup> They also can engage independent counsel or advisers to assist them in carrying out their duties.<sup>43</sup>

In this way, the Sarbanes Act imposes a seemingly heightened standard for compliance with the duty to remain informed. The responsibility for resolving auditing disputes ensures that directors who serve on the audit committee take an active role in the auditing process. Their review of complaints also ensures that board members who serve on that committee remain informed about the company's financial practices and the manner in which any audit is conducted. Moreover, these requirements make it difficult for directors to comply with their duty without gaining knowledge about the process. Hence, mere reliance on other agents appears insufficient to comply with the Act's requirements. This certainly suggests a heightened standard for the duty to remain informed.

The Sarbanes Act also addresses executives' duty to keep themselves informed regarding company information. The Act requires executive officers to establish and maintain internal controls that will ensure that material information is made

---

<sup>40</sup> See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776 (to be codified as amended at 15 U.S.C. § 78j-1).

<sup>41</sup> See *id.*

<sup>42</sup> See *id.*

<sup>43</sup> See *id.*

known to such officers.<sup>44</sup> In addition, both the chief executive officer and the chief financial officer must certify the effectiveness of those control procedures.<sup>45</sup> Moreover, the Sarbanes Act requires that a company's annual report contain an internal control report that includes management's assessment of internal control structures.<sup>46</sup> In this way, the Sarbanes Act requires executives to bear responsibility for the flow of information within their company. These fiduciary-like requirements for executives mean that the Sarbanes Act can be viewed as providing content to the more general duty of information outlined by corporate statutes and case law.

Then too, these requirements appear to enhance the fiduciary obligations of such officers. Indeed, because they must not only ensure that critical information is made known to them, but also must make a certification to that effect, officers' duty to remain informed cannot be a passive one. Because they must provide an assessment of control structures, the Act requires these officers to be continuously aware of their company's affairs and any changes to those affairs. While the Act provides for reliance on low-level employees, it also appears to require executives to second-guess those employees when they evaluate the overall effectiveness of the company's control process. Thus, the Sarbanes Act significantly contrasts with the standards of care adhered to by the executives of Enron and other corporations.

## 2. Duty of Inquiry

While the Act does not specifically impose upon officers or directors a duty of inquiry, this duty represents an implicit component of the obligations imposed by the Sarbanes Act. Indeed, because the audit committee is responsible for ensuring that complaints about the auditing process are made known to them, they presumably also must make inquiries about those complaints to make sure that any report they provide related to the internal audit remains accurate. Similarly, in order for

---

<sup>44</sup> See *id.* § 302(a)(4) (to be codified as amended at 15 U.S.C. § 7241).

<sup>45</sup> See *id.* § 302(a)(4)(D) (to be codified as amended at 15 U.S.C. § 7241).

<sup>46</sup> See *id.* § 404 (to be codified as amended at 15 U.S.C. § 7262) (directing the SEC to prescribe rules requiring that each annual report contain an internal control report, and that the accounting firm responsible for preparing the report attest to management's assessment).

executives to evaluate the effectiveness of any internal controls, they must ask officers or other agents about questionable practices that come to their attention. In this way, they cannot merely rely on the reports of such persons. This suggests a more probative inquiry than currently exists.

### B. *Comparison with Recent Formulations of Fiduciary Duties*

The reaction to the Sarbanes Act suggests that it imposes new obligations on directors and officers. Indeed, it appears to provide a stark contrast to the actions of directors and officers as revealed by congressional testimony. However, while there is a wealth of case law reflecting a less than exacting standard for the duty of care, the Sarbanes Act is closely aligned with more recent case law and formulations from other entities that make more stringent demands on corporate officials.

#### 1. Duty to Remain Informed

Some recent case law reveals that at a minimum, the duty to remain informed encompasses the duty to take an active role in the company's affairs. In *Francis v. United Jersey Bank*,<sup>47</sup> the New Jersey Supreme Court addressed whether a director could be held liable for her failure to prevent the misappropriation of funds by two corporate officials who were both officers and directors of the corporation. In that case, Mrs. Pritchard served as a director of the corporation, along with her two sons.<sup>48</sup> The trial court found that her two sons had siphoned funds from the corporation under the guise of loans.<sup>49</sup> Both officers had designated the loans as such on the company's balance sheet, but the loans far exceeded the officers' salaries as well as the company's revenue.<sup>50</sup> Moreover, the loans were never repaid and increased annually, leaving the company with insufficient funds to operate and eventually forcing the company to declare

---

<sup>47</sup> 432 A.2d 814 (N.J. 1981).

<sup>48</sup> *Id.* at 816.

<sup>49</sup> *Id.* at 818. The trial court rejected the characterization of the payments as loans, and instead found them to be fraudulent conveyances. *Id.* at 816. The appellate division agreed that the officers had siphoned assets, but characterized the misconduct as conversion. *Id.* at 817. The New Jersey Supreme Court accepted the conversion characterization, but found that the critical issue was Mrs. Pritchard's liability. *Id.*

<sup>50</sup> *Id.* at 819.

bankruptcy.<sup>51</sup> Mrs. Prichard was unaware of the actions of the corporate officers. In fact, she was not active in the business, did not read its financial statements, and knew virtually nothing about its corporate affairs.<sup>52</sup> The trial court found that she did not make "the slightest effort to discharge any of her responsibilities."<sup>53</sup> The New Jersey Supreme Court agreed, explaining that while directorial management does not require a detailed inspection of daily activities, directors do have a monitoring role that requires them to remain informed.<sup>54</sup> Thus, directors have to attend meetings regularly and make an effort to become informed about the company's status.<sup>55</sup> Although Mrs. Pritchard attempted to show that her physical condition had deteriorated in order to exonerate her conduct, the court maintained that she had a responsibility to play a role in the corporation.<sup>56</sup> In fact, the court suggested that the director's inattention contributed to the corporate misconduct because the officers knew that she would not serve as a check on their behavior.<sup>57</sup> The court held that Mrs. Pritchard's failure to participate in any of the corporation's affairs violated her fiduciary duty.

This duty to remain informed also includes the responsibility to understand business and financial matters relevant to the company. Indeed, the *Francis* court pointed out that a director has a responsibility to maintain familiarity with the company's financial status. This responsibility includes reading and understanding the company's financial statements.<sup>58</sup> In fact, the court noted that a director's lack of knowledge or expertise with respect to financial matters does not shield her from liability; instead, a director has an obligation to gain experience or sufficient assistance to qualify her to perform her duties.<sup>59</sup> If she cannot gain this experience or assistance,

---

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 820 (quoting *Francis v. United Jersey Bank*, 392 A.2d 1233 (N.J. Super. Ct. Law Div. 1978)).

<sup>54</sup> *See id.* at 822.

<sup>55</sup> *See id.*

<sup>56</sup> *See id.* at 819-20.

<sup>57</sup> *See id.* at 829.

<sup>58</sup> *See id.* at 825.

<sup>59</sup> *See id.* at 822 (quoting *Campbell v. Watson*, 50 A. 120 (N.J. 1901)).

then the director should refuse to act.<sup>60</sup> *Francis* indicates that acting without adequate financial and business information related to a given transaction is a violation of the corporate duty to remain informed.

Similarly, in *Smith v. Van Gorkom*,<sup>61</sup> the Delaware Supreme Court pronounced that proper exercise of the duty of care turns on whether directors have informed themselves "of all material information reasonably available to them prior to making a decision."<sup>62</sup> The court pointed out that fulfillment of that duty requires more than the absence of fraud or bad faith.<sup>63</sup> In *Van Gorkom*, the directors were generally familiar with the company's financial condition.<sup>64</sup> Hence, the directors' level of awareness related to business and financial matters far exceeded Mrs. Pritchard's. Despite this awareness, the directors approved a cash-out merger without the benefit of specific financial and other material information regarding the merger.<sup>65</sup> The court concluded that without such information, their decision could not be viewed as informed.<sup>66</sup> Moreover, because they made an uninformed decision, they violated their fiduciary duty.<sup>67</sup> *Van Gorkom* reveals that generalized knowledge is insufficient to satisfy the duty to remain informed. Rather, managers must have information, particularly financial information, specific to the transaction at issue in order to satisfy their duty to make informed decisions. SEC releases confirm this articulation of corporate managers' duty to make informed decisions.<sup>68</sup>

---

<sup>60</sup> *See id.*

<sup>61</sup> 488 A.2d 858 (Del. 1985).

<sup>62</sup> *Id.* at 872 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

<sup>63</sup> *See id.* (noting that directors had an affirmative duty to protect shareholder interests by critically analyzing all relevant information).

<sup>64</sup> *See id.* at 868 (explaining that the board received regular detailed reports about the company's financial condition as well as its future projections).

<sup>65</sup> *See id.* at 874 (noting that directors did not inform themselves regarding the manner in which the sale price was established or as to the intrinsic value of the company).

<sup>66</sup> *See id.* at 878 (noting that the board lacked the valuation information necessary to reach an informed decision about the fairness of the sale price).

<sup>67</sup> *See id.* at 893 (concluding that the directors breached their fiduciary duty by their "failure to inform themselves of all information reasonably available to them and relevant to their decision").

<sup>68</sup> *See, e.g.*, Report of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Outside Directors of National Telephone Co., Inc., Exchange Act Release No. 34-14380 (Jan. 16, 1978), available at 1978 WL 171339 (noting that even outside directors must maintain a general familiarity with company documents).

Moreover, this case law suggests that officers and directors may not be able to rely on others to keep them informed. In fact, the directors in *Van Gorkom* sought to shield themselves from liability through claims that they relied on both the chief executive officer and their lawyer's advice.<sup>69</sup> Although the court pointed out that directors are fully protected when they rely in good faith on reports or other officers,<sup>70</sup> the court noted that good faith does not allow blind reliance.<sup>71</sup> Instead, under certain circumstances, good faith requires managers to seek out additional information that would support the information provided by their CEO and other officers.<sup>72</sup> Similarly, the directors in *Van Gorkom* could not blindly rely on their lawyer, but had to prove that they had a reasonable basis for their reliance.<sup>73</sup> The court found that since they lacked adequate information to make a decision, their mere reliance on the advice of counsel was meaningless.<sup>74</sup> *Van Gorkom* indicates that corporate officials are not at liberty to completely supplant reliance for their own knowledge. Hence, reliance, without some information to support it, does not suffice to comply with the duty to remain informed.

While they may stand out as the exceptions, both *Francis* and *Van Gorkom* undermine the notion that directors' and officers' behavior, as illustrated by congressional testimony, was consistent with their fiduciary duties. Indeed, these cases suggest that directors cannot use the fact of their limited role or other outside obligations to excuse their relative lack of knowledge regarding corporate transactions. Certainly, if under *Francis*, a director's illness does not excuse such behavior, then concurrent obligations should not. *Francis* suggests that if directors do not have sufficient knowledge to make an informed

---

<sup>69</sup> *Van Gorkom*, 488 A.2d at 874–81.

<sup>70</sup> *See id.* at 874–75 (citing DEL. CODE ANN. tit. 8, § 141(e) (2001), enabling the board to rely upon accounts or reports prepared by corporate agents). The Model Business Corporation Act contains a similar provision, as well as one that allows reliance on corporate officers. *See* MODEL BUS. CORP. ACT §§ 8.30(c) (officers), 8.30(d) (reports) (1984). A similar provision allows officers to rely on employees or corporate reports. *See id.* §§ 8.42(b)(1) (employees), 8.42(b)(2) (reports).

<sup>71</sup> *See Van Gorkom*, 488 A.2d at 875.

<sup>72</sup> *See id.*

<sup>73</sup> *See id.* at 880–81. The defendants claimed that their lawyer advised them that they did not need additional information in order to make a decision. *See id.* at 881.

<sup>74</sup> *See id.*

decision, then they should refuse to act or resign from their position.

Further, both *Francis* and *Van Gorkom* suggest that when making any decisions, directors have an affirmative responsibility to familiarize themselves with the company's financial health, as well as the specific financial information underlying a given transaction. This appears to be true regardless of the complexities involved with such transaction. Hence, the directors' seeming inability to understand the intricacies of the financial transaction they approved reflects a violation of their duty to remain informed. Indeed, these cases suggest that if directors are uncertain they should refuse to act and probe more deeply in order to gather the requisite information.

Finally, the cases suggest that blind reliance on lower level employees is insufficient to satisfy a manager's duty. Indeed, congressional testimony reveals that many directors and executives maintained that they relied on others who claimed to have knowledge about business matters, without having any actual knowledge of their own regarding such matters, or the reliability of the information provided to them. While reliance may be sufficient in some contexts, the availability of additional information may have undermined the ability of these managers to rely completely on others. Indeed, cases reveal that these managers' duties included gathering such information. Thus, their efforts at finger pointing may not be sufficient to shield these managers from their own duty to remain adequately informed. In this regard, *Francis* and *Van Gorkom* cast doubt on claims that blind reliance by managers satisfied their duty of care.

The Sarbanes Act appears to reiterate this more exacting standard of the duty to remain informed. Indeed, the board's responsibility to oversee public accounting firms under the Sarbanes Act suggests an affirmative obligation on its part to keep abreast of financial information. Given that the board must sign the company's annual report,<sup>75</sup> the Sarbanes Act's

---

<sup>75</sup> See Amendments to Annual Report Form, Securities Act Release No. 6231, Exchange Act Release No. 17,114, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,301, at 62,812 (Sept. 2, 1980) (amending signature requirement for annual report to require signature by a majority of the board, the chief executive officer, the chief financial officer, and the controller).



requirement to remain informed regarding accounting information seems consistent with cases that require directors to obtain appropriate information prior to making decisions. Similarly, case law suggests that the CEO and CFO's responsibility to sign company disclosure documents<sup>76</sup> requires that they should be informed prior to approving such documents. Hence, by imposing an affirmative duty on them to gather material information related to financial and other data within public reports, the Sarbanes Act seems consistent with the more general fiduciary duty to remain informed.

The Sarbanes Act apparently goes further than the aforementioned cases by requiring managers to take affirmative responsibility for implementing and maintaining internal information systems. Old case law negated any affirmative responsibility for such systems. As early as 1963, the Delaware Supreme Court determined whether corporate directors had such a responsibility in *Graham v. Allis-Chalmers Manufacturing Co.*<sup>77</sup> In that case, four employees of the corporation pled guilty to anti-trust violations.<sup>78</sup> Evidence revealed that the directors had no actual knowledge of the antitrust activity of their employees.<sup>79</sup> Despite this lack of actual knowledge, shareholders brought a derivative suit against the directors on the theory that they failed to take actions to learn about and prevent the illegal activity.<sup>80</sup> In support of this theory, the shareholders pointed to consent decrees entered against the company in 1937 prohibiting similar forms of antitrust activity.<sup>81</sup> According to the shareholders, these decrees put the company on notice of possible antitrust activity, and consequently triggered an affirmative duty to actively monitor the company to protect against such violations.<sup>82</sup> The court pointed out, however, that none of the current defendants were directors at the time of the decrees, and that those who were aware of such decrees had satisfied themselves that the company had not been guilty of

---

<sup>76</sup> See *id.* at 62, 812-13.

<sup>77</sup> 188 A.2d 125 (Del. 1963).

<sup>78</sup> *Id.* at 128 (noting that the employees pled guilty to a price fixing scheme in violation of the federal anti-trust laws).

<sup>79</sup> *Id.* at 127.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* at 129 (identifying decrees that had enjoined various price fixing agreements).

<sup>82</sup> *Id.*

engaging in violations.<sup>83</sup> Hence, mere knowledge of the decrees did not put them on notice of possible current violations.<sup>84</sup> Without evidence that the directors knew of facts that should have put them on notice of possible wrongdoing, the court found that they did not have an obligation to implement a system of watchfulness.<sup>85</sup> Moreover, the court rejected the proposition that corporate directors have a duty to implement such a system in the absence of suspicious behavior. The court explained that it knew of “no rule of law”<sup>86</sup> requiring directors to put a monitoring system in place designed to ferret out information regarding illegal activity.

Under the Sarbanes Act, there now exists an identifiable rule of law with such a requirement. As noted, the Act not only requires executives to implement and maintain internal controls, but also requires that the annual report give an account of the status and viability of that system.<sup>87</sup> Arguably, the current climate of corporate managers’ seemingly widespread noncompliance with various corporate and securities laws may put corporations on notice of possible violations. *Allis-Chalmers* makes clear, however, that general allegations against other corporate officials should not be sufficient to put corporations on notice of possible violations within their own company. Absent such notice, *Allis-Chalmers* does not appear to require the implementation of monitoring procedures. Hence, the Sarbanes Act may be viewed as an abrupt departure from existing law on this subject.

The Guidelines suggest that managers’ duty to remain informed can be satisfied through the maintenance of monitoring devices. The Guidelines allow sentencing courts to decrease the amount of criminal fines they impose on corporations if such entities have in place a program to prevent and detect violations of the law.<sup>88</sup> While the Guidelines do not serve as a source of corporate fiduciary obligations, they can impact how corporate

---

<sup>83</sup> Apparently, the company consented to the decrees in order to avoid the expense of a proceeding and never admitted to price fixing. *See id.*

<sup>84</sup> *See id.* at 129–30.

<sup>85</sup> *See id.* at 130.

<sup>86</sup> *Id.*

<sup>87</sup> *See supra* notes 40–46 and accompanying text.

<sup>88</sup> *See* Sentencing Reform Act of 1984, 18 U.S.C. §§ 3551–3556; U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2001).

managers comply with those obligations.<sup>89</sup> Indeed, the Guidelines create incentive for managers to meet their duty to remain informed through implementation of adequate control procedures.<sup>90</sup>

Also, the SEC has indicated that compliance procedures may represent a necessary component of board members' duty to remain informed. Indeed, after reporting on several directors' lack of knowledge about important company events, the SEC concluded that this lack of knowledge "demonstrate[d] the need for adequate, regularized procedures under the overall supervision of the Board to ensure that proper disclosures are being made."<sup>91</sup> Such procedures should be designed to ensure that the board takes part in the disclosure process in a more meaningful way by remaining informed about company activities.<sup>92</sup> The SEC pointed out that even corporate directors with considerable business experience cannot adequately perform their duties when the corporation does not have an internal monitoring system.<sup>93</sup> In the SEC's view, such a system allows corporate managers to appreciate the company's business so that they may make informed judgments.<sup>94</sup> The SEC has a strong preference for establishing monitoring procedures in order to ensure corporate managers comply with their fiduciary duty.

Moreover, the Delaware chancery court has affirmatively maintained that directors satisfy their duty of information only when effective control systems are in place. *In re Caremark International Inc.*<sup>95</sup> involved a motion for settlement of a derivative action against corporate directors alleging breaches of

---

<sup>89</sup> See *In re Caremark Int'l Inc.*, 698 A.2d 959, 969 (Del. Ch. 1996) (noting the importance of the Guidelines in the conduct of business corporations).

<sup>90</sup> See *id.*

<sup>91</sup> Report of Investigation in the Matter of National Telephone Co., *supra* note 68, at \*4.

<sup>92</sup> See *id.*

<sup>93</sup> See Report of Investigation in the Matter of Stirling Homex Corp. Relating to Activities of the Board of Directors of Stirling Homex Corp., Exchange Act Release No. 34-11516, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80, 219, at 85,462-63 (July 16, 1975).

<sup>94</sup> See *id.* at 85,462.

<sup>95</sup> 698 A.2d 959 (Del. Ch. 1996). For a discussion of *Caremark's* application in the context of racial discrimination suits, see Cheryl L. Wade, *Racial Discrimination and the Relationship Between the Directorial Duty of Care and Corporate Disclosure*, 63 U. PITT. L. REV. 389, 403-10 (2002).

the duty of care. In *Caremark*, Chancellor Allen, speaking for the court, addressed in detail the manner in which directors comply with their duty to remain informed. Chancellor Allen pointed out that “relevant and timely *information* is an essential predicate” for satisfaction of a board members’ duty of care.<sup>96</sup> Interpreting *Allis-Chalmers*, Chancellor Allen argued that its holding could not be generalized to stand for the notion that corporate directors have no duty to maintain an information gathering system absent suspicion of wrongdoing.<sup>97</sup> Chancellor Allen insisted that, in light of the more exacting standards required by the Delaware Supreme Court under *Van Gorkom* and other more recent cases, the current court would not accept such a formulation of *Allis-Chalmers*.<sup>98</sup> Chancellor Allen found that:

corporate boards [can not] satisfy their obligation to be reasonably informed . . . without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.<sup>99</sup>

Chancellor Allen suggested that only when corporations have these information systems in place can they establish good faith and avoid liability for a breach of their fiduciary duty.<sup>100</sup>

The Sarbanes Act’s requirement of an internal monitoring system appears to codify the dictates of *Caremark*, as well as the preferences of the SEC and the Guidelines. In that sense, it appears to be a natural extension of corporate directors’ and officers’ duty under *Caremark* to affirmatively acquire material information relevant to the performance of their fiduciary responsibility.

---

<sup>96</sup> *In re Caremark*, 689 A.2d at 970.

<sup>97</sup> *See id.* at 969. Instead, the court maintained that *Allis-Chalmers* can be interpreted to mean that corporate directors cannot be held liable for assuming the integrity of their employees without grounds to suspect deception. *See id.*

<sup>98</sup> *See id.* at 969–70.

<sup>99</sup> *Id.* at 970.

<sup>100</sup> Chancellor Allen concluded that the existence of a corporate compliance committee demonstrated the directors’ “good faith attempt to be informed of relevant facts.” *Id.* at 971.

## 2. Duty of Inquiry

The duty of inquiry is intricately related to corporate managers' ability to rely on other officers or corporate reports. The previous section suggested that while directors and officers have the ability to rely in good faith on others, under some circumstances, their duty of care may require more. In this way, the duty to remain informed suggests some duty of inquiry, but does not suggest when that duty may be triggered. This section reveals that there are at least three circumstances under which the duty of inquiry arises: (1) when corporate officials know of possible wrongdoing; (2) when they have responsibility for approving specific documents; and (3) during major corporate transactions.

As early as 1920, the Supreme Court recognized that corporate managers have a duty of inquiry at least when they are put on notice about illegal or suspicious activity within their company.<sup>101</sup> Other more recent cases confirm this duty of inquiry.<sup>102</sup> The formulation of the duty of inquiry rests on a "red flag" conception, which maintains that directors cannot be held liable for inaction unless they failed to act in the face of significant and clear indications of corporate wrongdoing. Thus, in *Allis-Chalmers*, the Delaware Supreme Court rejected the argument that directors' knowledge of illegal activities twenty years earlier should have put them on notice of a duty to "ferret out such activity and to take active steps to insure that it would not be repeated."<sup>103</sup> The court concluded that the directors had no actual knowledge of current facts that should have put them on guard and therefore did not have a responsibility to make further inquiries of their agents.<sup>104</sup>

Also, the SEC has noted that the duty to investigate upon knowledge of red flags arises even when a company has an internal monitoring system in place. In its investigation of W.R. Grace & Co., the SEC found that certain of the company's officers and directors had violated federal securities laws.<sup>105</sup> The

---

<sup>101</sup> See *Bates v. Dresser*, 251 U.S. 524, 530-31 (1920).

<sup>102</sup> See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) ("[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.").

<sup>103</sup> *Id.* at 129.

<sup>104</sup> See *id.*

<sup>105</sup> See Report of Investigation Pursuant to Section 21(a) of the Securities

SEC issued a report emphasizing the affirmative responsibilities of the corporate officers who had not been involved in securities violations.<sup>106</sup> While those officers were aware of information appearing to contradict company disclosure documents,<sup>107</sup> the company had in place procedures designed to ensure that material information would be properly disclosed.<sup>108</sup> Thus, the officers did not make inquiries regarding the reasons for contradictory information because they assumed that company procedures and the agents responsible for those procedures had considered such information in making their disclosure.<sup>109</sup> The SEC maintained that the officers were not at liberty to make such an assumption. Instead, they had a responsibility to “go beyond the established procedures” and question the absence of disclosure because they were on notice that the internal procedures may be defective.<sup>110</sup> Thus, they had no reasonable basis for reliance on the procedures.<sup>111</sup> In this way, the SEC has suggested that corporate officers have a duty of inquiry even when corporations implement monitoring systems.

The duty of inquiry also appears to be triggered when executive officers and directors approve particular documents. Certainly the SEC’s pronouncements in W.R. Grace reflect its understanding that corporate officers and directors’ responsibility for approving company periodic reports requires them to make inquiries about the content of those reports.<sup>112</sup> More specifically, the Securities Act of 1933, as amended (the “Securities Act”), makes directors and officers responsible for reasonably investigating the information within a company’s registration statement.<sup>113</sup> Directors and officers who sign a

---

Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Exchange Act Release No. 34-39157, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,963, at 89,893 (Sept. 30, 1997).

<sup>106</sup> See *id.* at 89,893–94.

<sup>107</sup> See *id.* at 89,894.

<sup>108</sup> See *id.* at 89,893.

<sup>109</sup> See *id.* at 89,897.

<sup>110</sup> *Id.* at 89,894.

<sup>111</sup> See *id.* at 89,897.

<sup>112</sup> See *id.* at 89,894 (noting the duty to be vigilant in the disclosure process).

<sup>113</sup> Section 11 of the Securities Exchange Act, 15 U.S.C. § 77k, imposes civil liability on the chief executive officer, chief financial officer and every board member for any material misstatement or omission contained with an effective registration statement. These officers and directors can avoid liability with respect to non-expertised portions (which excludes financial statements of the registration statement) if, after reasonable investigation, they had reasonable ground to believe

defective registration may avoid liability only if they have satisfied their due diligence defense.<sup>114</sup> This means that officers and directors must investigate the adequacy of the information in the registration statement.<sup>115</sup> In fact, officers cannot avoid liability by relying on accountants or other experts to perform investigations for them.<sup>116</sup> This is true even when an officer has a limited role in a company or does not have the financial background necessary to understand financial matters.<sup>117</sup> Then too, officers must ask questions aimed at eliciting information specific to the disclosures being made; general inquiries will not suffice.<sup>118</sup> In this way, the Securities Act imposes a duty of investigation on directors and officers in connection with their approval of the registration statement.

A duty of inquiry also appears to arise in the context of a director or officer's responsibility to make major decisions. Like the duty accompanying the signer's responsibility under the Securities Act, the duty of inquiry with respect to transactions also may be triggered even when directors and officers do not

---

and did believe that the statements were true and not misleading. *See* § 77(k)(b)(3). With regard to expertised portions such as the financial statements, such managers must prove that they had a reasonable ground to believe and did not believe that the statements were untrue or misleading. *See id.*

<sup>114</sup> *See* *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682-92 (S.D.N.Y. 1968) (holding that several directors and executives failed to establish a due diligence defense).

<sup>115</sup> *See id.*

<sup>116</sup> *See id.* at 685-86. With respect to the treasurer and CEO, the court found that he could not rely on information provided by the independent accountants. *See id.* at 685 (noting that officer, who had some knowledge of relevant facts "could not shut his eyes to the facts and rely on Peat, Marwick"). The court held that the controller did not establish his due diligence defense because he assumed that others would check financial data. *See id.* at 686 (noting that as a signer, the controller "could not avoid responsibility by leaving it up to others to make it accurate"). The court also found that a person who served as a secretary and director could not rely on others to get it right even when he had no personal knowledge of the company's accounts. Instead, he had to make an investigation regarding those facts. *See id.* at 687.

<sup>117</sup> *See id.* at 653, 684 (noting the limited educational background of certain officers who did not have a high school education and hence may have difficulty reviewing the registration statement); *id.* at 684 (noting that certain officers only supervised limited activities within the company); *id.* at 688 (noting that an individual who served as secretary and director did not have experience, but nevertheless could be held liable).

<sup>118</sup> *See id.* at 688 (noting that while the outside director had made general inquiries about the company, he did not ask questions regarding the information within the prospectus and therefore did not satisfy his duty of investigation).

have actual knowledge of improprieties. In *Van Gorkom*, the Delaware court suggested that directors were “duty bound to make reasonable inquiry” of corporate executives given the magnitude of the decision before them and the absence of information related to that decision.<sup>119</sup> In that case, there were no “red flags,” but the court focused on the fact that directors had a duty to inform themselves regarding the specifics of the transaction, and that no one raised questions or sought information regarding the financial aspect of the transaction.<sup>120</sup> Under those circumstances, the directors’ responsibility to properly approve the conditions of a merger triggered a duty to ask relevant questions about those conditions, particularly when they were not presented with sufficient information to assess all aspects of the merger. Similarly, directors are responsible for approving conflict of interest transactions. The fact that this function rests solely on their shoulders appears to trigger a duty of inquiry. The SEC has explained that under such circumstances, “the board should not rely solely on information from interested management but should also seek information from independent non-interested sources when available.”<sup>121</sup> Thus, when directors and officers are entrusted with the responsibility of approving specific kinds of transactions, their duty of care includes the duty to ask appropriate questions.

These cases again suggest that the conduct of the directors and officers reflected in the congressional testimony violated their duty of inquiry. Indeed, such managers appeared to rely completely on internal procedures, even though they had concerns about the sufficiency of those procedures. The SEC’s release suggests that these managers had a responsibility to probe more deeply. More importantly, because these managers bore responsibility for approving conflict of interest transactions, they had a duty to ask detailed and critical questions of the officers involved with such transactions. Their failure to do so violated the duty of inquiry articulated by the SEC and the Delaware Supreme Court in *Van Gorkom*.

This exacting duty of inquiry is reflected in the Sarbanes

---

<sup>119</sup> See *Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985).

<sup>120</sup> See *id.* at 877.

<sup>121</sup> Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the Investigation of Gould Inc., Exchange Act Release No. 34-13612 (June 9, 1977), available at 1977 WL 175761.



Act. To the extent corporate managers have knowledge that suggests problems with the quality of the information they have received, there appears to be an implicit obligation to make further inquiries. This may be explicit in the case of board members who have the responsibility for ensuring that complaints about accounting information is made known to them. In this same view, because officers must analyze the sufficiency of their internal monitoring procedures, they appear to have a duty much like those in *W.R. Grace* to go beyond those structures and obtain some independent verification of the structures validity. Hence, the implied duty of inquiry within the Sarbanes Act seems to be in line with SEC releases and other case law in this area.

#### CONCLUSIONS AND PROBABLE IMPACT OF SARBANES ACT

The fact that the Sarbanes Act appears to confirm recent articulations of corporate managers' fiduciary responsibility has both positive and negative repercussions. On the one hand, these parallels should serve to reassure corporate managers because they suggest the pre-existence of roadmaps for meeting the obligations under the Sarbanes Act. Indeed, courts and the SEC indicate that if such directors maintain an adequate monitoring system and remain informed about the adequacy of that system, their behavior will be protected under the business judgment rule and the securities laws. The Sarbanes Act, by outlining the manner in which control mechanisms should be developed, serves to highlight how corporate managers can satisfy their obligations. Aside from such monitoring systems, corporate officers and directors, guided by case law, have established a process designed to satisfy their due diligence defense in connection with registration statements. This process, which involves both remaining informed about material information and asking appropriate questions, can be implemented more broadly for filings of all public documents, and should serve to shield directors and officers from liability. Hence, because the obligations under the Sarbanes Act bear similarity to those required under the securities law and other corporate doctrine, corporate directors and officers already have guidance regarding the manner in which they can meet those obligations.

The Sarbanes Act also represents a positive development

because it validates trends that impose more stringent obligations on corporate managers. The fact that widespread conduct in violation of these trends occurred suggests that many corporate directors and officers felt free to ignore the more exacting obligations. Certainly there is a healthy body of corporate law appearing to condone less exacting standards of conduct. The Sarbanes Act may be just the impetus corporate law needs to undermine those presumptions.

On the other hand, if one views the Sarbanes Act as merely mimicking existing law, there may be cause for skepticism about its ability to alter corporate officials' conduct. Indeed, if pronouncements by courts, the SEC, and even the Sentencing Commission, failed to force directors and officers to pay greater attention to their responsibilities, there may be no reason to believe that the Sarbanes Act will generate greater compliance.

Despite its similarity with some existing strands of fiduciary law, the Sarbanes Act includes provisions that may serve to deter more effectively violations of those duties. Indeed, the Act contains criminal and other provisions that may serve to deter violations of fiduciary duty by increasing the potential that directors and officers will face liability for such violations.<sup>122</sup> Also, the public attention to the inadequacies of corporate behavior may compel many officers and directors to pay greater attention to their own responsibilities. As a consequence, the Sarbanes Act may be a welcome response to the current systems' inability to enforce adequately the fiduciary duties of corporate officers and directors. In this way, the Sarbanes Act should be viewed as a positive development because it may ensure that managers will take more seriously the duty they owe to the corporate enterprise.

---

<sup>122</sup> See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 906, 116 Stat. 745, 806 (to be codified as amended at 18 U.S.C. § 1350) (imposing \$1 million fine, 10 years in jail, or both for persons who knowingly violate the certification requirement and a \$5 million fine, 20 years in jail, or both for willful violations of that provision).

