Vanderbilt Law Review

Volume 56 | Issue 3 Article 3

4-2003

Securities Fraud as Corporate Governance: Reflections upon Federalism

Robert B. Thompson

Hillary A. Sale

Securities Fraud as Corporate Governance: Reflections upon Federalism

*Robert B. Thompson**

*Hillary A. Sale***

* New York Alumni Chancellor's Chair in Law, Vanderbilt University Law School.

** Professor of Law and F. Arnold Daum Corporate Law Scholar, University of Iowa. The authors would like to thank Marcel Kahan, Michael Klausner, Adam Pritchard, and participants in the Third Annual Vanderbilt Law and Business Program Conference for helpful comments and Kate Besch, Jenness Parker, Michael Russell, and Brian Van derPol for their gracious and able research assistance.

State law gives corporate managers extremely broad power to direct increasingly large pools of collective business assets. Not surprisingly, economic incentives, norms, markets, and law all work to constrain the breadth of the power and the potential for abuse of what is other people's money.[1] State corporate law has occupied the center stage in the legal portion of this landscape, with federal securities law playing a supporting role—at least in the academic presentation of the debate. The New Deal's securities legislation eschewed a general federal corporations statute in favor of a more focused federal role emphasizing disclosure and antifraud protections for those who purchase and sell securities.[2] The Supreme Court has made clear that "fraud" as proscribed in federal law was not to be defined in a way that annexed corporate governance.[3] And, in 1995, Congress expressed a clear desire to limit the use of federal securities fraud lawsuits, at least insofar as those lawsuits were perceived to be frivolous.[4]

Yet, as this Article demonstrates, federal securities law and enforcement via securities fraud class actions today have become the most visible means of regulating corporate governance. Securities fraud law is ostensibly directed at buyers and sellers of securities,[5] but

---

1. *See, e.g.*, William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 667, 671 (1974) ("Such confidence [by private investors entrusting funds to public companies] can be sustained only by a combination of high standards coupled with disclosure and management accountahility coupled with vulnerability to derivative or direct shareholder action.").

2. *See* JAMES COX ET AL., SECURITIES REGULATION, CASES AND MATERIALS 7 (3d ed. 2001), ("The Securities Act's exclusive orientation was disclosure, a clear victory for those who emhraced a less intrusive role in capital markets.") (citing James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34 (1959)).

3. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478-79 (1977) (overturning lower court opinion that defined Rule 10b-5 to include constructive fraud, the unfair misuse of authority by a fiduciary: "Ahsent a clear indication of congressional intent we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.").

4. Private Securities Litigation Reform Act § 101(b), Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. § 74u-4(b) (2000)).

5. Rule 10b-5, the primary federal antifraud vehicle, applies to fraud "in connection with the purchase or sale of any security," *see* 17 C.F.R. § 240.10b-5 (2001), and the Supreme Court

in the context of class actions, this purchaser-seller connection acts more like the minimalist jurisdictional hook of the interstate commerce requirement than a real constraint on the use of securities law to regulate corporate governance.[6] Federal securities law is, of course, not the only legal constraint on managerial behavior, and a shareholder lawsuit based on disclosure is not the only litigation remedy. State law continues to provide the legal skeleton for the corporate form, and state fiduciary duty litigation continues as a mechanism frequently utilized to monitor managers. Yet, in today's world, state law does so almost entirely in two contexts—acquisitions and self-dealing transactions. The empirical evidence in this Article illustrates that corporate governance outside of these areas has passed to federal law and in particular to shareholder litigation under Rule 10b-5.

The Sarbanes-Oxley Act of 2002, passed by Congress in the wake of numerous corporate accountability scandals, provides new evidence of the expanded role of federal law.[7] The move to federal corporate governance, however, is broader than that law and has a longer history than the current scandals. The ascendancy of federal law in corporate governance reflects at least three factors. First, disclosure has become the most important method to regulate corporate managers, and disclosure has been predominantly a federal, rather than a state, methodology. Second, state law has focused largely on the duties and liabilities of directors, and not those of officers. Yet, officers have become the fulcrum of governance in today's corporations, and federal law has increasingly occupied the space defining the duties and liabilities of officers. Third, federal shareholder litigation based on securities fraud has several practical advantages over state shareholder litigation based on fiduciary duty that have contributed to the greater use of the federal forum. As a result of these trends, federal law now occupies the largest part of the

---

has ruled that a private cause of action under that rule accrues only to one who is a purchaser or seller of securities. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-45 (1975).

6. Corporate law is not one of the enumerated powers given the federal government in the Constitution, and its presence as a subject of federal law turns on the interstate commerce power of Article I, Section 8 of the Constitution. The securities laws passed in President Franklin Roosevelt's first term went to some length to bring the acts witbin interstate commerce, reflecting concern that the Supreme Court of that era would strike down federal legislation not connected to interstate commerce. Although the current Supreme Court bas indicated some willingness to find federal acts insufficiently connected to interstate commerce, *see* United States v. Lopez, 514 U.S. 549, 567 (1995), the activities of our largest corporations seem well within the federal range of interests, and a very tangential connection to interstate commerce will satisfy the constitutional requirement.

7. Sarbanes-Oxley Act of 2002 §§ 101-109, 15 U.S.C.A. §§ 7211-7219 (West, WESTLAW through Pub. L. No. 107-377) [hereinafter Sarbanes-Oxley Act].

legal corporate governance infrastructure in the twenty-first century. The outpouring of suggested reforms that have followed in the wake of the Enron and WorldCom scandals have focused on federal law and on the conduct of officers and directors, rather than on state law, which in practice focuses mainly on directors. Indeed, the discussions about reforms have excluded state law almost entirely.[8]

In this Article, we develop the idea of federal law as corporate governance in three parts organized around history, empirical data, and analysis. In Part 1, we begin with the traditional legal template. State corporate law is the focus, and federal securities law plays a supporting role. We discuss the history of the two sources of law and some of the dramatic changes that have occurred through the impact of federal disclosure law on corporate governance.

8. There has been some focus on the failure of the board's oversight, as in the Senate Permanent Subcommittee on Investigations report, *The Role of the Board of Directors in Enron's Collapse*, but that report makes recommendations only to directors, the Securities and Exchange Commission, and self-regulatory agencies, like the national stock exchanges, without any discussion of possible changes in state law. *See* S. REP. NO. 107-70, at 4 (2002). Moreover, these discussions are federal discussions about state law, not state-level discussions about state law.

In contrast, compare the corporate governance changes made in 2002 outside of state law:

- Federal law has created a new accounting regulatory system that federalizes most of the regulation of those who monitor financial information presented to shareholders. *See* Sarbanes-Oxley Act §§ 101-109, 15 U.S.C.A. §§ 7211-19.
- Federal law requires CEOs and CFOs to certify that disclosure reports fairly present the financial condition and results of operations of the company. *See* Sarbanes-Oxley Act § 401(b), 15 U.S.C.A. § 7261(b). This followed SEC action pursuant to its investigatory powers that required the top officers of almost one thousand companies to certify their financial results.
- The New York Stock Exchange has proposed changes to its listing requirements to require greater director independence. *See NYSE Approves Measures to Strengthen Corporate Accountability*, *at* http://www.nyse.com/content.articles/NTO0056F8D4.html (last visited Jan. 30, 2003).
- NASDAQ has put forth changes to its listing requirements, requiring boards to have a majority of independent directors and directors to meet without company management. *Nasdaq to Toughen Company Standards*, N.Y. TIMES, July 26, 2002, at C6.
- Federal legislation requires officers to report stock transactions with their companies immediately. Previously they did not need to be reported until the end of the company's fiscal year. *See* Sarbanes-Oxley Act § 403, 15 U.S.C.A § 78(p).
- The SEC has proposed a dramatically increased number of events that must be immediately reported via Form 8-K. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 67 Fed. Reg. 42914 (June 25, 2002) (to be codified at 17 C.F.R. pts. 228, 229, 240 & 249) and Sarbanes-Oxley Act § 409, 15 U.S.C.A. § 78(m)(1) (containing a congressional mandate for additional real-time disclosure).
- The SEC has approved accelerating the date by which annual and quarterly reports are due. Acceleration of Periodic Filing Dates and Disclosure Concerning Website Access to Reports, SEC Release No. 33-8128 (Sept. 5, 2002) (final rule), *at* http://www.sec.gov/rules/final/33-8128.htm; *see* Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, 67 Fed. Reg. 19895 (proposed Apr. 23, 2002) (to be codified at 17 C.F.R. pts 229, 240 & 249).

In Part II, we present empirical data on the use of both federal and state litigation to regulate corporate governance. We begin with a data set we have developed of securities fraud class action complaints filed in 1999.[9] Our analysis of those complaints shows that securities fraud class action litigation is being used mostly in areas that relate to the managers' operation of the business. Not surprisingly, for example, many of the complaints raise concerns about the ways in which managers have recognized revenues or engaged in some form of accounting manipulation. From that base, we expand the story using data developed by others on securities fraud class actions more generally. We then compare transactions that give rise to securities fraud claims to another data set that covers all corporate cases filed in the Delaware Chancery Court for that same year.[10] The result is a surprisingly narrow focus for state litigation and a much broader one for federal suits, revealing a gap in the standard learning about corporate governance. In Part III, we address how the federal securities fraud picture we provide might fit with state shareholder litigation in a current theory of corporate governance.

Although previously unexplored in any detail in the academic literature, federal securities fraud litigation operates much like state fiduciary duty litigation in policing corporate governance.[11] To be sure, the federal claims continue to reflect the requirement that the plaintiff be a purchaser or seller of a security.[12] But the protracted length of

9. Our database contains complaints in securities fraud class action suits that were filed in the Courts of Appeals for the Second, Third, and Ninth Circuits during that year. The suits filed in those circuits reflect about half of all securities fraud class action suits filed in that year, and we believe that they are representative of all securities class action suits filed during that year and since tbe 1995 Private Securities Litigation Reform Act. The 2001 class action data, for example, reflect a large jump in the number of securities fraud class actions, reflecting a surge in suits related to investment bankers placing new offerings with favored customers.

10. Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, VAND. L. REV. (forthcoming) (2003) (reporting on all fiduciary cases filed in Delaware in 1999 and 2000—more than one thousand cases).

11. Few academic commentators have focused on the important role that securities law plays in regulating the day-to-day governance of our corporations. The most detailed argument for this view has been made by Joel Seligman, whose corporations casebook reflects such a theme and who, in other writings, has recognized the paucity of corporate law, particularly in the duty of care context. *See* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993). He also advocated that Congress create a federal law of care, specifically eliminating the use of special litigation committees. *See* Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 973 (1990). Others have advocated the use of federal corporate law as a mechanism to address the atrophy of state corporate law, though they have largely focused on the duty of care. *See, e.g.*, Cary, *supra* note 1, at 701-02. Still others have documented the increasing presence of securities law and its influence on the corporate structure, but without focusing on the gap that we posit it is filling. *See, e.g.*, Arthur Fleischer, Jr., *"Federal Corporations Law": An Assessment*, 78 HARV. L. REV. 1146, 1146-48 (1965).

12. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-45 (1975).

most class periods means that the class includes a substantial percentage of the shareholder body. And, the small amount per share of each recovery makes the incentives look similar to traditional corporate derivative and class litigation, including the importance of lawyers as repeat players. We conclude that in this common universe, state fiduciary duty litigation, with its amorphous focus on directors' failure to monitor officers and other parts of the enterprise, is at a systematic disadvantage relative to federal law which, in a more focused way, seeks to explore what officers need to do to meet their corporate disclosure obligations.

I. THE TRADITIONAL TEMPLATE

A. State Law—Combating Agency Costs When Managers Control Other People's Money

As created by state law, corporations are a business form based on specialization of function and centralized control. At the core of corporations law is what we discuss here as corporate governance, the relative allocation of power in the collective entity among three groups of participants named by the statute: shareholders, directors, and officers.[13] This allocation of power defines the nature of the relationship between these participants and their role in determining the direction, strategy, and policy of the corporate entity and, ultimately, its performance. The term "corporate governance," then, incorporates all of these relationships and issues.

The starting point for American corporations statutes is clear: Corporate power is exercised by or under the direction of the board of directors.[14] In reality, officers exercise the most important corporate powers,[15] but in legal theory they are clearly subordinate to the board and are barely mentioned in most corporations statutes.[16] Indeed,

---

13. There are of course other stakeholders of the corporation not named in the statute. Employees, for example, are key stakeholders and are part of corporate statutes in other countries such as Germany, where there is a supervisory hoard on which labor populates half of the seats.

14. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (providing that all corporate power "shall be managed by or under the direction of a board of directors").

15. *See* Alan Greenspan, *Excerpts from Report by Greenspan at Senate*, N.Y. TIMES, July 17, 2002, at C8 ("Our vast and highly liquid financial markets enable large institutional shareholders to sell their shares when they perceive inadequacies of corporate governance, rather than fix them. This has placed de facto control in the hands of the chief executive officer.")

16. Section 142 refers to officers, but the statute defers almost completely to a corporation's bylaws or board resolutions as to what officers might do, how they are chosen, and how vacancies are filled, except for minimal default provisions, such as the provision that officers may resign at any time. Section 143 addresses loans to employees and officers, and section 145 includes

more sections of corporation law codes are directed to the role of shareholders, the default owners of the corporation, than to officers. Shareholders vote, sell, and sue, although each action occurs only in carefully measured doses that, even collectively, do not change the ultimate control of the corporation.[17] As far as the law is concerned, directors are the key players. Accordingly, most of corporate governance as it has developed at the state level focuses on defining the duties and responsibilities of directors and the relative rights of shareholders to constrain director action.

The law, then, both centralizes corporate decisionmaking power in the board and provides constraints against possible misuses of that power. The most important state law constraint is fiduciary duty, which comes in three flavors—care, loyalty, and good faith. These fiduciary duties provide individual shareholders with a means to seek ex post judicial review of managerial and directorial actions, one of the many checks on the exercise of power in the corporate governance relationship. The practical constraints on shareholder voting and selling in modern public corporations, commonly discussed as collective action problems, left fiduciary duty litigation as the principal legal check on centralized corporate authority during the twentieth century.

The fiduciary duty of care requires that managers perform their duties with sufficient attention and care. As developed at common law, the duty grew out of law borrowed from the law of trust and then from tort law.[18] For many years, the courts described this duty in a manner that appeared to hold directors and other managers to a negligence standard. This duty is, however, accompanied by the business judgment rule. That rule is a judicially applied presumption of correctness that effectively shields directors from liability for all but the most egregious decisions.[19]

---

officers, along with directors and others, as persons whom the corporation may indemnify. The Model Business Corporation Act goes further, including a section setting standards of conduct for officers. *See* MODEL BUS. CORP. ACT § 8.42 (2002). This section is less extensive than that provided for directors. The official comment observes that "deficient performance of duties by an officer . . . will normally be dealt with through intracorporate disciplinary procedures . . . [and] in some cases, failure to observe relevant standards of conduct can give rise to an officer's liability to the corporation or its shareholders." § 8.42, cmt.

17. Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 216 (1999).

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

19. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

The well-known 1985 Delaware decision of *Smith v. Van Gorkom*[20] created a firestorm of discussion.[21] Most commentators argued that the Delaware Supreme Court had expanded the realm of director liability in the care setting by allowing a case to survive business judgment rule review when the officers and directors had not explicitly engaged in a loyalty violation. According to the court, bad acts amounting to gross negligence brought judicial oversight of the transaction.[22] The reaction to that case resulted in legislation in all but a handful of states allowing shareholders to adopt, but not, ironically, to recommend or to rescind, provisions to insulate directors for violations of their fiduciary duty of care.[23] Absent violations of loyalty, good faith, or some intent to harm the corporation or its shareholders, directors are now exculpated from private monetary liability for failures to adhere to their duty of care.[24] As a result, this aspect of the shareholders' corporate governance role was significantly diminished.

Loyalty and good faith, then, remain the only significant bases for a claim asserting a breach of fiduciary duty. Loyalty claims fall mostly into the category of cases involving self-dealing transactions between the corporation and one of its managers. Other claims include taking a corporate opportunity and various self-dealing allegations. Insider trading, a long-standing example of insider breach of fiduciary duty under state law, has effectively been ceded to federal law through Securities and Exchange Commission ("Commission" or "SEC") enforcement actions and, occasionally, through individual and class action claims brought under sections 10(b)[25] and 20A[26] of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5.[27] The duty

---

20. 488 A.2d 858 (Del. 1985).

21. For a discussion of the impact of *Van Gorkom*, see the recent symposium in the *Northwestern Law Review*. Symposium, Van Gorkom *and the Corporate Board: Problem, Solution, or Placebo?*, 96 NW. U. L. REV. 449 (2002).

22. 488 A.2d at 864, 867-69 (directors approved the sale of the company at a two-hour meeting, without advance notice and without seeing the final written agreement).

23. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

24. The Delaware statute and similar provisions in the Model Business Corporation Act permit liahility for intentional wrongdoing by directors. *See* MODEL BUS. CORP. ACT § 2.02(b)4-5 (2002).

25. 15 U.S.C. § 78j (2000).

26. § 78t-1.

27. 17 C.F.R. § 240.10b-5 (2002); *see* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 823 (1983) (stating that Rule 10b-5 has transformed the traditional state law "minority rule" into "the law of the land").

of good faith has undergone recent common law development, but its role remains unclear.[28]

The expanded role of disclosure in the growth of federal law as a monitor of corporate governance is discussed more fully below, but a brief word is in order here as to the role of disclosure in state corporate law. Most state corporation statutes impose few mandatory disclosure obligations. Delaware, for example, permits shareholders to inspect stock ledgers, minute books, and books of account, when a proper purpose is alleged.[29] Although shareholders have the right to see what management has said in those documents, Delaware law does not require that the information be delivered to shareholders. Nor does it opine as to the content of the information to be maintained.[30]

Indeed, the Delaware Supreme Court has often discussed content largely in the context of the federal law, referring, for example, to potential violations of good faith for managements' failure to disclose information properly in a federally required proxy statement.[31] Delaware's common law, as developed by its chancery court and supreme court, has sometimes required disclosure as a condition for directors to satisfy their fiduciary duty, for example in seeking to cleanse a self-dealing situation.[32]

Misleading disclosure can give rise to a state cause of action for one of the sporadic actions for which Delaware law permits shareholder participation. Direct state-law liability for misleading statements in nonvoting cases, however, is presently limited. To date, the only significant Delaware decision on point is *Malone v. Brincat.*[33] Presumably, this case was filed under state law because federal securities causes of action are restricted to purchasers and sellers,

---

28. *See, e.g.*, Brehm v. Eisner, 746 A.2d 244 (2000) (noting existence of duty of good faith in Delaware jurisprudence and applying duty in context of executive compensation decision).

29. DEL. CODE ANN. tit. 8, §§ 219(c)-220 (2001). Access to hooks and records is a heavily litigated issue. *See, e.g.*, Conservative Caucus v. Chevron Corp., 525 A.2d 569, 570 (1987) (describing a situation in which the plaintiff was forced to litigate its right to the shareholder list). *See generally* Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 334 (1996) (describing the use of inspection statutes).

30. Lewis v. Vogelstein, 699 A.2d 327, 332-33 (Del. Ch. 1997) (Allen, C.) (commenting that disclosure is left to federal law where there is more expertise: "An administrative agency—the Securities and Exchange Commission—has a technical staff, is able to hold public hearings, and can, thus, receive wide and expert input, and can specify forms of disclosure, if appropriate.").

31. Smith v. Van Gorkom, 488 A.2d 858, 890-93 (Del. 1985).

32. *See, e.g.*, Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 158 n.10 (Del. 1996) (noting that the prophylactic effect of disclosure through formal board approval could have prevented litigation of corporate opportunity case).

33. 722 A.2d 5 (Del. 1998).

which the plaintiffs were not, leaving the shareholders to search for a state law remedy in a case involving allegations of significant corporate fraud. In *Malone*, the Delaware Supreme Court made clear that misleading disclosures to shareholders could be a basis for a fiduciary duty cause of action.[34] But Delaware case law[35] and the preemptive effects of the Securities Litigation Uniform Standards Act[36] effectively limit the remedy to those few situations in which the law expressly provides for collective action by shareholders.

In corporate governance terms, Delaware has chosen to focus on directors as the fulcrum of corporate governance. Delaware law is distinctive for its emphasis on directors and its preference for allowing the markets and private ordering, as opposed to law, to regulate (or not regulate) how directors use that power. It does not require independent directors, except as a basis for cleansing conflict of interest transactions; it does not require disclosure, except in the sporadic circumstances in which shareholders are asked to vote;[37] it does not require monitoring by independent accountants, even though the New York Stock Exchange does. Instead, under Delaware corporate law, corporations are free to adopt any or all of these requirements if their directors believe those devices might benefit the corporation. The power of shareholders to respond to such director decisions is relatively limited. More particularly, Delaware has abandoned most legal controls on the manager's duty of care, again leaving that to private ordering.[38] As a result, as Alan Greenspan said recently, when "[a]n infectious greed seemed to grip much of our business community... [o]ur historical guardians of financial information were overwhelmed."[39] And, shareholders had federal

34. *Id.* at 9.

35. Delaware does not recognize "fraud on the market" as a way to meet the reliance requirement for fraud and more generally limits the effectiveness of class actions for disclosure claims outside of voting. *See Malone*, 722 A.2d at 13-14.

36. Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. § 77p(f)(2) (2000)) (preempting most class actions involving nationally traded securities but providing a Delaware carve-out preserving corporate claims traditionally heard in state courts such as derivative suits, class actions relating to purchase or sale by the issuer from its equityholders, or transactions requiring shareholder approval).

37. The Delaware Supreme Court has suggested a broader disclosure duty: "Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders." *Malone*, 722 A.2d at 10. However, there is little indication, including in all of the contexts described in Part II of this Article, that Delaware is moving to provide a remedy outside of requests for shareholder action. *See generally* Lawrence A. Hamermesh, *Calling off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996).

38. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

39. Greenspan, *supra* note 15, at C8.

disclosure mechanisms, but not effective state law, to pursue claims of wrongdoing.

B. Federal Law

Calls for bringing corporate law into the realm of federal regulation were vocalized almost from the beginning of general incorporation statutes and the first widespread use of the corporate form for large publicly held businesses. Shortly after taking office, President Theodore Roosevelt asserted a need for government control over corporations as part of his trust-busting effort.[40] His proposed legislation for making this regulation federal in nature was repeated by two subsequent Presidents, although it was not enacted by the Congress in any of those administrations.[41]

The government response to the excesses of the 1920s and to the pain of the Great Depression again led to calls for federal corporations law, but the New Deal Congress that passed securities legislation in 1933 and 1934 chose less intrusive means. The Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act," together, the "Acts") focus on protecting the integrity of the markets both by demanding that specific documents exist and by requiring that, when made, all disclosures be complete and accurate. The litigation remedies based on fraud connected to the sale of securities might suggest a departure from the core of corporate governance. This Article presents evidence suggesting otherwise.

1. The Original Focus: Disclosure in the Purchase or Sale of Securities and Sporadic Shareholder Governance Actions

The 1933 Act focuses on the issuance of securities and, particularly, the initial pubic offering. Initial public offerings present the most significant form of informational asymmetry that the New Deal legislation attempts to address. Issuers are selling securities to noninsiders who may know little or nothing about the company. It is a form of insider trading, but unlike the traditional form, this version is publicly disclosed. To address this informational imbalance and to prevent the sale of bad securities, or even securities in companies that

---

40. Theodore Roosevelt, First Annual Message (Dec. 3, 1901), *in* 15 THE WORKS OF THEODORE ROOSEVELT 81, 92 (Herman Hagedorn ed., 1926) ("The nation should, without interfering with the power of the States in the matter itself, also assume power of supervision and regulation over all corporations doing an interstate business.").

41. LOUIS LOSS & JOEL SELIGMAN, 1 SECURITIES REGULATION 154-56 (1989).

do not exist, the 1933 Act requires that all offering documents conform to specific requirements and that all disclosures be true and accurate. Obviously, the informational asymmetry diminishes over time as publicly held companies release regular reports,[42] but depending on the nature and timing of an offering—for example, a shelf offering—the asymmetry problem can still be quite significant.[43]

The regulatory baseline is to require extensive disclosure (absent an exemption) before companies or others seek money from investors. In addition, the 1933 Act charges other parties—for example, underwriters, investment bankers, and accountants—with specific due diligence responsibilities.[44] These market gatekeepers enable companies to make offerings and, therefore, are charged with the responsibility of preventing fraudulent offerings. If they do their jobs correctly, the gatekeepers monitor the accuracy of issuer representations, ensuring accurate pricing of the securities to be offered and accurate issuer information at the time of the offering.

In contrast, the 1934 Act focuses on disclosures that take place after the company's stock is publicly traded. Here, the approach is not one focused on regulating the gatekeepers who are supposed to monitor the companies, but on ensuring that when a public company speaks, it does so truthfully. Disclosure, again, is the primary focus. Statutorily, the most significant and direct extension into the corporate governance realm occurs when managers or others solicit proxies to gain shareholder votes as may be required by state law. State and federal law interact in the proxy context, jointly regulating the means and ends of management-to-shareholder communications.[45]

Ostensibly, the federal proxy statutes and rules are deferential to state corporate law. The federal realm does not determine the rights of shareholders within the corporate governance structure. Instead, federal law regulates the process of disclosure—deferring to state law to designate when shareholder participation is required or appropriate. Largely, then, federal law's role is to require that whenever such disclosures occur, they are full and complete.

Despite its ostensible deference to state law, the role of federal law in this area has grown substantially. As originally enacted, the

42. *See id.* at n.345.

43. *See* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1200 (1st Cir. 1996) (discussing informational asymmetry that occurred when company did offering three weeks before quarter ended and later filed quarterly report revealing the company's financial concerns).

44. 15 U.S.C. § 77k(a) (2000).

45. *See* Hillary A. Sale, *Of Corporate Suffrage, Social Responsibility, and Layered Law: Teaching Basic Business Law Through Federal Securities Law*, 34 GA. L. REV. 809, 815-17 (2000) (discussing interaction of state and federal law in proxy context).

1934 Act required disclosure triggered by proxy solicitation in only the largest set of companies.[46] The 1964 amendments expanded the proxy disclosure requirements to all publicly held companies.[47] Then, in 1968, the Williams Act analogized shareholder tender offer decisions to shareholder proxy solicitation decisions and required similar disclosures in a tender offer setting.[48] Subsequent judicial interpretations of the proxy laws have extended federal protection to shareholder decisions as to whether to seek an appraisal remedy under state law.[49]

These federal rules perform two significant and reciprocal functions. First, they enhance the opportunities for shareholders to exercise their corporate governance role. Second, they impose substantial limits on those who control the corporations. Their impact, however, is limited in two significant ways. First, the federal rules explicitly defer to state law. For example, Rule 14a-8 permits shareholders to initiate agenda items for a shareholders' meeting[50] and arguably expands the shareholder role beyond that provided by state corporate law, but it is limited to matters that the Commission finds appropriate for shareholder determination under state law.[51] Second, the proxy provisions usually take effect only when state law requires shareholder decisionmaking. The sporadic nature of that decisionmaking, then, is the trigger for federal involvement and, thereby, its role.

---

46. Section 14 applies to companies required to register under section 12 of the 1934 Act, which originally applied to companies traded on a national securities exchange.

47. *See* 15 U.S.C. § 77*l*(g) (2000) (added hy the 1964 Amendments and phasing in the disclosure requirements to apply first to companies with 750 shareholders or more and at least $1 million in assets and then to companies of the same size with 500 or more shareholders). By SEC rule, the dollar minimum has been increased to $10 million, to reflect some of the changes caused by inflation. *See* 17 C.F.R. § 240.12g-1 (2002).

48. *See* 113 CONG. REC. 854 (1967) ("[T]he need for such legislation has been caused by the increased use of cash tender offers rather than the regular proxy fight to gain control of publicly-owned corporations .... This legislation will close a significant gap in investor protection under the federal securities laws ....") (remarks of Senator Williams); *see also* S. REP. NO. 90-550, at 2, 4 (1967), *reprinted in* 1968 U.S.C.C.A.N. 2811, 2814.

49. Wilson v. Great Am. Indus., Inc. 979 F.2d 924 (2d Cir. 1992) (providing an example of a cause of action where disclosure was said to have affected a shareholder decision to give up appraisal rights).

50. *See* 17 C.F.R. § 240.14a-8 (2002).

51. *See, e.g.*, N.Y. City Employees' Ret. Sys. v. SEC, 45 F.3d 7 (2d Cir. 1995) (discussing the changing nature of the Commission's stand concerning when shareholders can require companies to place matters on proxy for shareholder consideration).

2. The Expanded Federal Focus: Continuous Disclosure and Corporate Governance

Other sections of the 1934 Act provide the foundation for a more expansive federal role in corporate governance. The two most prominent mechanisms are the periodic disclosure requirements under section 13 and the antifraud provisions and concomitant liability under section 10(b) and Rule 10b-5. We use the term disclosure here as broadly as the regulations and the case law have provided, referring to all types: mandatory, voluntary, and, in some cases, silence.

These disclosure mechanisms have also expanded since 1934, and, thereby, again expanded the role of federal law in corporate governance. Unlike the proxy requirements, however, these provisions are not linked to sporadic shareholder action, such as voting. Instead, the trigger for standing to sue in these cases requires only that shareholders purchase or sell shares in a company.[52] Purchase and sale decisions, of course, occur continuously in larger enterprises where there is a developed market for shares. These provisions, then, create a much broader mechanism for asserting the shareholders' role in corporate governance and for requiring a more active role for officers and others in corporate governance—even if directors have not chosen or do not wish to allocate such power to shareholders or officers.

a. *The Dramatic Increase in Mandatory Disclosure*

In the years since 1934, mandatory disclosure regulation has expanded. For example, pursuant to the authority Congress delegated in the 1934 Act, the Securities and Exchange Commission promulgated regulations requiring large public companies to make disclosures in annual and quarterly reports with increasing amounts of information required to be disclosed between these periods on a real-time basis.[53] In 1964, Congress extended this provision, like the

52. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754 (1975).

53. *See* 15 U.S.C. § 78m (2000) (providing that the Commission may prescribe such information and documents as necessary and appropriate for the proper protection of investors and to ensure fair dealing in the security). Annual reports are filed on Form 10-K and Quarterly reports are filed on Form 10-Q. The real-time disclosure occurs by means of Form 8-K. The items to be disclosed have traditionally been limited but by Commission proposal and congressional action in 2002 seem poised to grow dramatically. *See supra* note 8.

proxy provision, to all public companies as defined by the 1934 Act.[54] These reports are commonly referred to as 10-Qs, 10-Ks, and 8-Ks.

In 1982, the Commission promulgated an integrated disclosure package using Regulation S-K.[55] In doing so, the Commission systematized the disclosure package that public companies must provide. As a result, in addition to the timing of the disclosures, the Commission regulates the actual content of disclosures. The regulations are extensive and provide for disclosures arguably designed to enforce what are basic state law fiduciary duties. The required disclosures aid directors in performing their governance functions. The disclosure also aids other monitors, including accountants, whose work is required by the stock exchanges and the Commission. As recent corporate announcements about restated financial statements reveal, these mandated disclosures are detailed and are therefore potential sources of manipulation and fraud. These mandated disclosures are also considerably more substantive in nature than the proxy provisions. They now include more than sixty items and occupy more than one hundred pages of the federal rulebook.[56]

For example, under Regulation S-K, Item 303 (Management's Discussion and Analysis), the Commission requires registrants' annual reports to include descriptions of the company financial conditions, changes in those conditions, and results of operations.[57] The specific categories of required financial information include explanations of liquidity,[58] capital resources,[59] and operational results.[60]

Without going into mind-numbing detail, it is worth considering one passage of Item 303 to see specifically how the Commission is using a description of liquidity to enforce, at least indirectly, management care. To comply with Item 303, the registrant must identify "known trends or any known demands, commitments, events, or uncertainties that will result" in material increases or

---

54. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified as amended in scattered sections of 15 U.S.C. § 77a-78*lll*) (2000).

55. Proposed Revision of Regulation S-K and Proposed Rescission of Guides for the Preparation and Filing of Registration Statements and Reports, Securities Act Release No. 33-6332 (Aug. 18, 1981). For some of the earlier history including the promulgation of Regulation S-K in 1977 and the Advisory Committee Report of that same year, see LOSS & SELIGMAN, *supra* note 41, at 621.

56. *See* 17 C.F.R. § 229.10-.1016 (2002).

57. § 229.303(a).

58. § 229.303(a)(1).

59. § 229.303(a)(2).

60. § 229.303(a)(3).

decreases in liquidity.[61] Managers who are fulfilling their duty of care should be concerned about liquidity and the events related to those changes. Through a requirement that such changes be disclosed, the Commission is enforcing the substantive duty.

Further, once management identifies the trend, it must "indicate the course of action that [it] has taken or proposes to take to remedy the deficiency."[62] Again, managers acting to fulfill their duty of care would presumably resolve to remedy any such deficiency. But, by forcing managers to disclose the trend and describe how they plan to remedy it, the Commission is regulating the conduct, not just what management says about the conduct. Through disclosure can come substance—here, the duty of care.

Forty years ago, the SEC said that "[t]he [Securities] Act does not purport . . . to define federal standards of directors' responsibility in the ordinary operations of business enterprises."[63] That view of the securities laws, despite its dominance for most of the seventy years of federal securities regulation, does not describe the post-Sarbanes-Oxley world.

In another part of Regulation S-K, Item 10, the Commission provides its support for companies that want to include projections and predictive material in their filings, within certain prescribed limitations.[64] This requirement is an example of how the Commission fosters disclosure, and, by doing so, regulates in a duty of care fashion. While providing companies the option to make predictive disclosures (an option long denied them under SEC rules[65]), the Commission makes clear that management must have "a reasonable basis for such an assessment."[66] Although one might assume that management would have such a basis before making any predictive statements, when the Commission spells out the requirement, it prescribes the requisite and appropriate level of care.

The Commission also requires companies to make mandatory disclosures in other contexts. Form 8-K's purpose is to provide a disclosure mechanism for significant events occurring between the company's quarterly updates. Historically, the list of required 8-K

61. § 229.303(a)(1).

62. *Id.*

63. *In re* Franchard Corp., 42 S.E.C. 163, 176 (1964).

64. § 229.10(b)(1).

65. For the Commission Releases, see Disclosure of Projections of Future Economic Performance, 38 Fed. Reg. 7220 (Feb. 2, 1973); Guides for Disclosure of Projections of Future Economic Performance, 43 Fed. Reg. 53246 (Nov. 7, 1978). For a short discussion of the Commission's reluctance to adopt this position, see COX ET AL., *supra* note 2, at 63.

66. § 229.10(b)(1).

updates has been very short (six items) and restricted to significant occurrences, like a change of control or bankruptcy filings.[67] In the wake of the Enron scandal, the Commission proposed a major increase (up to thirteen additional items covering far more of the company's day-to-day business) in the items requiring interim, immediate disclosure. The Sarbanes-Oxely Act required the Commission to promulgate regulations for real-time disclosure, resulting in more frequent 8-K filings.[68]

Finally, the Commission has also adopted various mandatory disclosure items that arguably regulate the duty of loyalty. For example, managers must tell shareholders what they are paying themselves.[69] And the Commission dedicates fifteen pages of the rulebook to telling management how to do so, providing specific categories of compensation and exact formulations for the charts in which management must present the information.[70] Here, again, disclosure is presumably forcing substance in contexts in which conflicted loyalty might be at issue.

The statutory provisions on short-swing profits reveal a much more pronounced and direct approach to federal regulation of corporate fiduciaries. Pursuant to section 16 of the 1934 Act,[71] the Commission promulgated requirements that managers and directors file reports to disclose both ownership of company securities[72] and, on a timely basis, the execution of trades in company securities.[73] Disclosure here is the mechanism for the enforcement of an actual statutory provision that prohibits insiders from engaging in short-swing trading transactions.[74] This provision has been interpreted broadly to force any profits earned by the insider to be returned to the issuer.[75] According to one court, the purpose of this provision is "to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the

---

67. *See*, ALPHONSE A. SOMMER ET AL., SECURITIES PRIMARY LAW SOURCEBOOK, pt. H, Form 8-K, Items 1-9 (Matthew Bender & Co.).

68. *See supra* note 8. In 2000, the Commission adopted Regulation FD, or Fair Disclosure, to prevent selective disclosure of material company information to certain favored individuals, like analysts. § 243.101(e). Now, when companies disclose material company information to, for example, analysts, they must also disclose the information to the general public, which may be accomplished via a Form 8-K filing.

69. *See* § 229.404.

70. *See id.*

71. 15 U.S.C. § 78p (2000).

72. SOMMER ET AL., *supra* note 67, Form 3.

73. *Id.* at Form 4.

74. § 78p.

75. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).

selfish interest of a fiduciary officer, director or stockholder and the faithful performance of his duty."[76] Here, then, the duty of loyalty connection is explicit. In the Sarbanes-Oxley Act, Congress mandated accelerated reporting under section 16(a) and added a new disgorgement provision tied to accounting restatements.[77]

The responses to the recent corporate crises show that almost no one is talking about state regulation or law to combat the corporate governance problems. Instead, Congress has passed legislation to remedy the situation.[78] The President addressed the issue, including traveling to New York for a speech before a corporate governance backdrop. The SEC regulations mandated by Sarbanes-Oxley are the most dramatic regulatory changes affecting corporate governance since 1934.[79]

These proposals reveal both a serious federal emphasis on governance issues and the continued expansion of the Commission's role in corporate governance. For example, in addition to proposing a decrease in the lag time between the end of the quarter and fiscal year and the date on which the appropriate reports must be filed,[80] the Commission demanded that corporate executive officers vouch for the financial statements contained in the periodic reports.[81] Officers already had to sign the 10-K, for which personal liability was a possibility.[82] The Commission's new requirement, reinforced by subsequent legislation, goes beyond simply requiring the CEOs and CFOs "to swear that the numbers they've reported in their financial

76. *Id.* at 239.

77. *See* Sarbanes-Oxley Act §§ 403, 404, 15 U.S.C.A. §§ 7261-7262 (West, WESTLAW through Pub. L. No. 107-204).

78. *See* Sarbanes-Oxley Act §§ 1-1107, 15 U.S.C.A. §§ 7201-7266.

79. Former SEC Chairman Harvey Pitt, Remarks at the National Press Club (July 19, 2002), *available at* www.sec.gov/news/speech/spch577.htm (last visited Mar. 22, 2003); *see also* Harvey Pitt, Remarks at the Meeting of the Economic Club of New York (June 26, 2002), *available at* http://www.sec.gov/news/speech/spch573.htm (last visited Mar. 22, 2003).

80. Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, 67 Fed. Reg. 19895 (proposed Apr. 23, 2002) (to be codified at 17 C.F.R. pts 229, 240 & 249).

81. This demand originally occurred as a one-time obligation, required in an unusual procedural setting by an SEC order pursuant to its powers under section 21(a) of the Act to apply only to the largest 947 companies. *See* Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, *available at* http://www.sec.gov/rules/other/4-460.htm (last visited Mar. 22, 2003). The requirement was extended by the Sarbanes-Oxley Act to be a permanent obligation of all publicly held companies. *See* Sarbanes-Oxley Act § 302, 15 U.S.C.A. § (West, WESTLAW, through Pub. L. No. 107-204).

82. *See* SOMMER ET AL., *supra* note 67, General Instruction D to Form 10-K.

reports are correct and that they've left nothing important out."[83] Managers must sign a statement declaring that they have reviewed the requisite reports and, where appropriate, discussed them with the audit committee or board, before determining that the reports are in fact correct.[84] The congressional legislation codified much of the earlier proposal and added criminal penalties.[85]

This provision directly imposes a duty of care on company managers. It not only makes them agree to a particular disclosure, but it also tells them what they must do before signing the disclosure statement. State law has long addressed this issue, as illustrated in the well-known recent case, *In re Caremark International, Inc. Derivative Litigation*.[86] The executive officer declaration is, however, a direct intrusion of federal legislation into what has traditionally been the province of state law corporate governance.

Note the emphasis here—on officers, not directors. As Alan Greenspan recently observed, "the state of corporate governance to a very large extent reflects the character of the CEO."[87] And, in recognition of where the locus of today's governance is, federal law imposes obligations directly on officers, bypassing the intermediaries of the board.[88] A telling example of the federalization of corporate governance is the section of the Sarbanes-Oxley Act that regulates the fiduciary duty of loyalty by banning corporate loans to executive officers and directors.[89] Such a ban was historically part of state corporate law.[90] In many states the earlier prohibition has been watered down to a requirement for director approval, and the Model Business Corporation Act deleted the provision entirely in its 1988

83. *See* Investor Confidence Measure Applies to 945 Largest SEC-Registered Publicly Traded Companies, Exchange Act Release No. 2002-96 (quoting Commission Chair Harvey L. Pitt), *available at* http://www.sec.gov/news/press/2002-96.htm (last visited Mar. 22, 2003).

84. *Id.* For a copy of the declaration statement, see *id.* at app.

85. Sarbanes-Oxley Act §§ 302, 906, 15 U.S.C.A. §§ 7241 (West, WESTLAW through Pub. L. No. 107-204).

86. 698 A.2d 959 (Del. Ch. 1996).

87. T.K. Moby, *Greenspan Blasts Infectious Greed*, WASH. TIMES, July 17, 2002, at C8.

88. A notable exception is the Sarbanes-Oxley Act requirement that audit committees of the board of directors be responsible for the outside audit of the company, not the company's management, and that the members of that committee be independent, even if such independence is not required by state law. § 301, 15 U.S.C.A. §§ 78j-*l*. There are also several provisions of Sarbanes-Oxley that include directors along with officers or executive officers in their prohibitions (for example for insider trading and prohibiting loans), but the focus on the new law is more on officers than directors, and even those new obligations on directors are coming from federal law, not state law that has been seen as having the traditional authority to define director obligations.

89. *See* Sarbanes-Oxley Act § 402, 15 U.S.C.A. § 78(m)k.

90. *See* MODEL BUS. CORP. ACT ANN. 2D § 47 (1971) (describing the 1969 Model Act and earlier state law).

revision.[91] The federal government has now mandated a contrary view.

The Sarbanes-Oxley Act also requires an annual report to be accompanied by a statement that management is responsible for creating and maintaining adequate internal controls and that officers making the required certification have evaluated the effectiveness of those controls within ninety days.[92] Even more directly, it requires the companies' chief executive and financial officers to disgorge any incentive- or equity-based compensation within twelve months of reports that lead to an accounting restatement.[93] The new federal act also intervenes in corporate governance by requiring the SEC to promulgate rules requiring attorneys to report to the chief legal officer and then the chief executive officer any evidence of a material violation of the federal securities laws or breaches of a fiduciary duty.[94] Here, then, the federal government has gone over the directors' heads, rejecting the deference to their prerogative that characterizes Delaware law. Instead, it has specified officer-level governance at a level exceeding the state law mechanisms and applied it not just to securities fraud but to fiduciary duty as well. In doing so, Congress has explicitly recognized the now-connected nature of federal securities law and fiduciary duty that we describe in this Article.

b. The Increase in Disclosure Obligations Beyond Mandatory Disclosure

Apart from the increase in mandatory disclosure accomplished through direct regulatory intervention defining the reach of line-item disclosures, and, we argue, the concomitant expansion of federal law into the corporate governance realm, disclosure obligations have grown significantly through the antifraud provisions of the 1934 and, to a lesser extent, the 1933 Act. Generally speaking, misleading statements and omissions in corporate disclosure statements, whether voluntary or mandatory, give rise to federal securities fraud liability claims. The location, so to speak, of the alleged misstatements or omissions can be the required quarterly and annual reports, but it can

91. *See* MODEL BUS. CORP. ACT ANN. 3D § 8.60 (1984) (describing thirty-five states that continue to prohibit loans to directors and/or officers or allow them in limited circumstances).

92. *See* Sarbanes-Oxley Act § 302, 15 U.S.C.A. § 7241.

93. *See* Sarbanes-Oxley Act § 304, 15 U.S.C.A. § 7243. SEC rules promulgated in 2003 require attorneys to report to an independent board committee if the officer's response is inadequate.

94. *See* Sarbanes-Oxley Act § 307, 15 U.S.C.A. § 7245.

also be a press release, conference call, or any other oral or written statement made by the company.[95]

Companies, of course, make statements because they think it will benefit their business. Sometimes they make misleading disclosures to protect their business—for example, by attempting to prevent premature discussion of a merger that is being negotiated.[96] If the statement is misleading and material, it will give rise to fraud liability.[97] In some situations, the company managers feel wedged because adverse business consequences may ensue following the early release of information. But, in a developed market for information, they know that if they say nothing once an issue has been publicly raised, their silence will be taken as confirmation that something is happening. Of course, in some situations company managers are anxious to release information (or are driven by a perceived need to meet the earnings expectations of the market),[98] but doing so prematurely without sufficient qualifying information—for example, in the context of an upcoming product release—can also result in fraud liability.[99]

Generally speaking, under the securities laws, companies are liable whenever they misspeak. Absent a duty to disclose, companies need not speak.[100] On occasion, however, silence can be fraudulent. This area of the securities realm has also expanded greatly. For example, silence can be fraudulent in the context of insider trading in at least five circumstances. First, if insiders, who have fiduciary duties to their shareholders under state law, have information about the company and are trading in the company's stock without disclosing that information, they are liable.[101] Second, when insiders tell, or tip information to someone else, in breach of a fiduciary duty, and the tippee trades in the company stock and knows or should have known that the tip was a breach, the duty passes to the tippee, and both are

---

95. Antifraud liability also attaches to any person who makes a misleading statement, but our focus here is on the entity, the source of most statements.

96. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 226-30 (1988).

97. *Id.* at 249-50.

98. *See* Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, 14 J. APPLIED CORP. FIN. 41, 41 (2002) (discussing earnings-management cycle); *see also* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. (forthcoming 2003) (discussing earnings-management cycle and corporate misstatements in context of analysts' symbiotic relationship with management).

99. *See* Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 541-49 (1998).

100. *Basic, Inc.*, 485 U.S. at 236 n.14.

101. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

liable.[102] Third, if a person (such as an accountant or a lawyer) received information from the company for a lawful purpose but with an expectation of confidentiality, that person also inherits a fiduciary duty, and if she fails to disclose information before trading, she is liable.[103] Fourth, if the trader has information acquired by breach of a fiduciary duty to someone else (not the shareholder or company whose shares are being traded) and fails to disclose that information before trading (i.e., "misappropriates"), the trader is liable.[104] And, fifth, if the trader has information about a tender offer and fails to disclose that information before trading, the trader is liable even if she breaches no state law fiduciary duty.[105]

Selective disclosure to outsiders can be the basis for a duty to make further disclosure. This duty occurs as a result of Regulation FD, though it arguably existed prior to it.[106] Here, even if the disclosure occurs for a company purpose and not in violation of a fiduciary duty, if the information is material, it must be disclosed to all or none.[107]

Finally, silence may be the basis for a duty to disclose when there is a duty to update or a duty to correct. The duty to update applies to forward-looking information—for example, a projection, which was accurate when made, and is still alive in the market but no longer accurate.[108] The duty to correct applies to past historical facts, for example, last year's financial reports in a 10-K report, which it turns out, were not accurate at the time released,[109] or when the company is entangled with false statements made by another.[110] Both theories are based on common law. Like most securities fraud law, the Supreme Court has addressed neither. As a result, the exact application of these duties varies from circuit to circuit, but they

102. Dirks v. SEC, 463 U.S. 646, 659-61 (1983).

103. *Id.* at 658 n.17.

104. United States v. O'Hagan, 521 U.S. 642, 653-59 (1997).

105. *Id.* at 666-67.

106. Fisch & Sale, *supra* note 98 (discussing Regulation FD and the history of the Commission's regulation of analysts).

107. 17 C.F.R. §§ 243.100-103 (2000).

108. *See* Weiner v. Quaker Oats Co., 129 F.2d 310, 315-18 (3d Cir. 1997). The PSLRA enacted safe harbors for forward-looking statements in certain circumstances and specified that the offered protection for those statements did not create a duty to update. As a result, some courts have refused to impose a duty to update post-PSLRA. *See, e.g.*, Phillips v. LCI Int'l, Inc. 190 F.3d 609, 621 (4th Cir. 1999).

109. *See, e.g.*, *In re* Healthcare Compare Corp. Sec. Litig., 75 F.3d 276, 282-83 (7th Cir. 1996) (holding that company has duty to correct if information about declining patient enrollments were true at the time a statement to the opposite effect was made).

110. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980).

cannot be excluded from a description of the universe of disclosure obligations.

c. The Dramatic Expansion in the Scope of Federal Liability Relating to Disclosure

Even more dramatic than the expansion of mandatory disclosure and the ancillary liability for half-truths and silence is the broadened scope of liability once a misstatement is established. A simple comparison to common law fraud makes the point. At common law, the basic liability for misstatements extended only to those in privity with the fraud feasor who could prove actual reliance on the fraud. Under the 1933 Act, liability extends specifically to various parties named in the Act—not just to the registrant and its directors, but also to accountants and underwriters involved in the offering. These people are experts and, as described above, gatekeepers. These parties, who have acted wrongfully as defined by the 1933 Act, are directly enriched by the securities that were sold. Thus, there is a link between the plaintiffs' harm and the defendants' benefit. Liability is premised on their actual role in the offering document in question or sale of a security without a required document.

There are eight express causes of action under the Acts[111] and four implied causes of action under the 1934 Act.[112] The express actions under the 1933 Act relax the common law requirements as to reliance and scienter,[113] for example, but the size of their plaintiff group is limited either by a requirement that purchasers be in privity with the issuer or other seller in the transaction or by a limitation that the shares held be connected to the questioned offering.[114] Under

---

111. The 1933 Act provisions are as follows: § 11 (liability for registration statement misstatements and omissions); § 12 (liability for misstatements and omissions in public prospectuses and sales of unregistered securities); § 15 (liability for controlling persons). The 1934 Act provisions are as follows: § 9 (liability for manipulations of securities on stock exchanges); § 16 (liability for short-swing profits); § 18 (liability for misleading statements in certain SEC-filed reports); § 20 (liability for controlling persons); § 20A (liability for insider-trading with contemporaneous traders).

112. 15 U.S.C. § 78j, § 10b, Rule 10b-5 (2000), 17 C.F.R. § 240.10b-5 (2000) (liability for misleading statements and omissions); 15 U.S.C. § 78n(a), § 14(a) (1994) (liability for fraud in proxy solicitations); 15 U.S.C. § 78n(e), § 14(e) (1994) (liability for fraud in tender offers); 15 U.S.C. § 78m(e)(1), § 13(e)(1) (1994) (liability for fraud in connection with issuer repurchases).

113. The section 12 causes of action are strict liability claims. The section 11 cause of action is negligence-like because it provides all defendants, except the issuer, with a due diligence defense.

114. Exposure for liability under section 11 is specifically limited to the offering price, or, more or less, to the consideration that the defendants as a group received in the transactions giving rise to the claim. Section 12(a)(2) requires privity, altbough the courts are divided as to how to interpret that requirement.

the 1934 Act, the key express causes of action operate in similar fashion with two significant and practical limitations. First, liability attaches only to individuals who actually speak or are directly responsible for the misstatement or omission. Second, the express private cause of action has a double reliance requirement that has blocked effective use in private actions.[115]

In this void, the cause of action responsible for most of the litigation under the securities laws is court-created, an implied right of action pursuant to Rule 10b-5.[116] Liability under this implied right of action is more expansive than common law liability in at least three ways that are relevant to its use in the corporate governance context. First, any person who purchases or sells securities in connection with a material misstatement or omission may sue if they are damaged thereby.[117] The case law makes clear that courts interpret this cause of action broadly such that fraud feasors can be liable for the losses not just of the person with whom they trade, but also for the losses of anyone who traded in reliance on the misleading statement.[118] In a 10b-5 context, the plaintiffs might, for example, claim that they lost money in a trade. Someone else presumably made money, but that offsetting trader is probably not the defendant. In fact, unless she is also part of the class, she may actually be a stranger to the 10b-5 litigation, and, of course, she will not be required to contribute to any settlement. The defendants are exposed to all of the plaintiffs' trading losses even though the defendants did not necessarily have an offsetting trading benefit. Of course, the defendants may have indirectly benefited—for example, through a compensation package tied to short-run market performance. Either way, the connection between the fraud and the harm is indirect and through the market, with a potentially severe impact on the defendants.

Second, the Supreme Court's acceptance of the fraud on the market doctrine to establish reliance has facilitated plaintiffs' litigation in a governance context.[119] Under this doctrine, plaintiffs

---

In recent years, the courts have begun to narrow the realm of liability under these causes of action by deploying a doctrine known as tracing. *See* Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act,* 75 WASH. L. REV. 429, 430-33 (2000). Although arguably contrary to the terms of the statute, the tracing doctrine functions in a privity-like fashion.

115. 15 U.S.C. § 78r(a) (2000).

116. *See* Herman & McLean v. Huddleston, 459 U.S. 375, 380 (1983) (noting that the implied nature of a 10b-5 action was beyond "peradventure").

117. *See* SEC v. Texas Gulf Sulphur, Co., 401 F.2d 833, 858-62 (2d Cir. 1968) (describing the "in connection with" requirement).

118. *See id.*

119. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241-47 (1988).

who did not, for example, read a public document containing a misstatement or omission, can utilize a rebuttable presumption allowing them to plead and prove that they traded in an active and efficient market like the New York Stock Exchange.[120] If they succeed in doing so, their reliance on the market incorporating the alleged misstatement or omission is presumed.[121] This doctrine makes class actions by plaintiffs more attractive and, thus, expands the potential for lawsuits focused on governance issues.

Third, damages for 10b-5 claims brought in a developed market can be large and the means for determining them seem, at least at first glance, to be accessible to judges and litigants. In a typical securities fraud suit, the damages depend on the size of the class period and the magnitude of the change in the stock price.[122] The longer the class period and the more dramatic the price change in the stock after the "truth" is revealed, the larger the size of the total potential recovery.[123] Individual recovery, however, is relatively small because it is spread over a large class of shareholders.[124]

The class-action mechanism was created to address this type of collective action problem, although, as originally conceived, it was to be used largely in the civil rights arena.[125] The theory is that small individual recoveries lead to a lack of lawsuits in contexts where enforcement of the law is warranted, but due to resource constraints are likely to happen only through private attorneys general.[126] By definition, then, the litigation is lawyer driven and aimed more at deterrence than compensation.[127] When translated into complaints, the focus becomes governance, with fraud as a hook.

---

120. *Id.* If the market is "thin," the presumption does not apply. *See, e.g.*, Cammer v. Bloom, 711 F. Supp. 1264, 1285-87 (D.N.J. 1989) (utilizing a five-factor test to reject the presumption of reliance in non–stock exchange transaction).

121. *Basic, Inc.*, 485 U.S. at 241-47.

122. *See generally* Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 883 (1990) (arguing that finance theory is useful for measuring damages in fraud-on-the-market class actions); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 611 (1985) (explaining the law of damages in securities cases).

123. The most common measure of damages in a Rule 10b-5 action is the difference between the price paid and the true value at the time of the initial transaction, but since that value is not readily available, the drop in price around the time the truth was revealed is used as a proxy for the difference between price paid and true value.

124. Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1487-90 (1996).

125. *See* 3B JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 23.02-6 (2d ed. 1995) (noting that Rule 23 was enacted for the "specific purpose" of ensuring that class actions would be available to enforce civil rights statutes).

126. *See id.* ¶ 23.02-1.

127. *See id.*

Securities litigation shares these characteristics with much of today's litigation under state corporate law. This litigation also shares with its state counterpart the downside risk that comes from representative suits, when the incentives of the party acting for the entire group, often the lawyer, might diverge from the interests of the group.[128] Federal courts encountering securities fraud claims face the same problem that the Delaware courts do—in hindsight, anything might look bad.[129] The problem is separating what looks like fraud today from what was actually fraud at the time of the misstatement or omission. The courts developed the scienter element to draw this line, however unsuccessfully.[130]

Several years of growth in the market and in the number of public companies, combined with growth in the number of lawsuits and in recoveries against accounting firms, led to attempts to restrict the class-action mechanism for securities lawsuits. The major initial proponents of the legislation were members of the accounting industry.[131] The debate in Congress, too lengthy to recount here, was

---

128. For discussions of the role of class actions in business litigation generally, see John C. Coffee, *The Unfaithful Champion: Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROB. 5, 5 (1985) (noting tbe perception that shareholder litigation was no longer respected as a monitor of corporate management); Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337, 390-92. This discussion of the conflicts of lawyers extends to a general debate about the role of the legal system in achieving broader societal goals as well. *See, e.g.*, Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509, 564-66 (1994); Robert C. Clark, *Why So Many Lawyers? Are They Good or Bad?*, 61 FORDHAM. L. REV. 275, 301-02 (1992); Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 916 (1990). *But see* Lucian Arye Bebcbuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404, 414 (1984); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. OF L. & ECON. 3, 25-27 (1990).

The reality, at least witb securities litigation, is much more complicated. *See* Denise M. Martin et al., *Recent Trends IV: What Explains Filings and Settlements in Shareholder Class Actions*, 5 STAN. J.L. BUS. & FIN. 122, 156-57 (1999); Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority"*, 108 HARV. L. REV. 438, 442-44, 448-49 (1994) (noting that little proof existed for claims that securities litigation was frivolous or increasing and that the number of lawsuits filed had not increased significantly); Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 593-96 (2000) (rejecting as insufficient general arguments that securities litigation is frivolous and that cases are only of strike-suit nature).

129. *See, e.g.*, Serabian v. Amoskeag BankShares, Inc., 24 F.3d 357, 367 (1st Cir. 1997) (noting that courts must guard against the "assumption that the defendants must have known of the severity of their problems earlier because conditions became so bad later on").

130. *See, e.g.*, *In re* Time Warner Sec. Litig., 9 F.3d 259, 268-69 (2d Cir. 1993) (noting reasons for the use of scienter element).

131. *See* Ianthe Jeanne Dugan, *Did You Hear the One About the Accountant? It's Not Very Funny*, WALL ST. J., Mar. 14, 2002, at A1 (noting that the savings-and-loan "debacle" prompted hundreds of lawsuits against accountants who paid $1 billion in penalties to the government and

largely anecdotal in nature and focused on stereotypical lawsuits against a high-tech company sued after a drop in its stock prices.[132] According to the reform proponents, these lawsuits were abusive strike suits.[133] Although little empirical evidence existed then or now to support those claims, the arguments prevailed.[134] The result was the Private Securities Litigation Reform Act of 1995,[135] with its limits on pleading, discovery, scienter, damages, and other aspects of securities litigation.

When securities litigation is used to regulate the relative rights of shareholders, directors, and officers in corporate governance, the federalism doctrine also acts to restrain the litigation. This tension between the fraud-based mechanism and corporate governance is revealed, in part, in the refrain in securities fraud opinions that the cause of action is not properly used to target mismanagement.[136] The Supreme Court addressed the role of federal litigation and regulation in the traditional state law context in *Santa Fe Industries, Inc. v. Green.*[137] In *Santa Fe,* the Court focused on whether federal judges were allowing securities fraud claims to determine when directors' actions were unfair to minority shareholders.[138] This corporate governance issue, concerning the relative rights of directors and shareholders, had been established at state law. The Court was unwilling to federalize it absent explicit congressional action. Indeed, in *Santa Fe* the Court clearly attempted to cabin the role of federal law in corporate governance and management contexts.

Ironically, the actual concern might well have been the tension caused by the use of a fraud-based mechanism as a corporate governance mechanism, which, in turn, grew to fill the growing hole in state governance law. The Court's concerns in *Santa Fe* were not dissimilar to those expressed about securities litigation and, more

---

responded by forming a coalition to channel money to Washington, donating $39 million through various mechanisms from 1989 to 2001); *id.* (asserting that, with the help of Harvey Pitt, accountants fought for the PSLRA, which makes it more difficult for them and other non-company officials to be sued).

132. *See, e.g.,* Sale, *supra* note 99, at 543 n.22 (collecting and citing comments from legislative history).

133. *See id.* at 553 n.74 (collecting from legislative history testimony about inappropriate plaintiffs' counsel practices).

134. *See* Hillary A. Sale, *Judging Heuristics,* 35 U.C. DAVIS L. REV. 903, 915 n.57 (2002) (collecting and citing literature about the merits of the reform debate).

135. Pub. L. No. 104-67, 109 Stat. 737 (1995).

136. *See, e.g.,* Colby v. Hologic, Inc., 817 F. Supp. 204, 206 (D. Mass. 1993).

137. 430 U.S. 462 (1977).

138. *Id.* at 472-79.

generally, corporate litigation.[139] As described above, this litigation is lawyer driven. By definition, in a class action, few of the plaintiffs know the details of the claims or the nature of the litigation. Many have expressed the concern that lawyers, not clients, decide whether and when to file claims, and that lawyers, not clients, decide when to settle the claims. As a result, the concern is that lawyers' needs and interests dominate, rather than those of the client. Commentators have posited that the result is frivolous litigation and inappropriate settlements.[140] To some extent, the accuracy of this argument depends on whether one focuses on the corporate governance element of the claims and the correlative deterrence effect of the claims and settlements.

Despite the principles articulated in *Santa Fe,* this Article describes a dramatic growth in the role of federal law in regulating officers and directors. The growth arguably runs afoul of the principles expressed in *Santa Fe,* because, after all, state law gives directors free rein to determine how much or how little officers can do. When federal law increases the role of officers it also diminishes the corporate authority of directors to determine the governance structure of the business. Simultaneously, this action increases the role of shareholders by permitting them (rather than the directors) to hold officers accountable.

There is, however, room to fit this expanding federal role within the parameters set forth in *Santa Fe.* In that case, the Court expressed its federalism concern that absent a clear indication of congressional intent, it would not override "established state policies of corporate regulation."[141] State law actually says very little affirmatively about what officers are supposed to do (in contrast to the relatively well-developed roles of directors and shareholders). Congress expressed its clear intent, through the Sarbanes-Oxley Act, to regulate the conduct of officers, in the context of the duties of care, loyalty, and good faith.[142] The data on securities fraud litigation described below reveal the ways in which the federal complaints are attempting to plug those holes.

139. *See id.* at 478-79 ("In addition to posing a 'danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5,' *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S., at 740, this extension of the federal securities laws would overlap and quite possibly interfere with state corporate law.").

140. *See supra* note 128.

141. *Sante Fe Indus.,* 430 U.S. at 479.

142. *See supra* text accompanying notes 77-94.

II. DATA ON CORPORATE GOVERNANCE LITIGATION

A. The Different Faces of Shareholder Litigation

The extent to which securities fraud litigation functions effectively as a tool of corporate governance can be seen by comparing it to other shareholder litigation that performs a corporate governance role, particularly the other types of representative litigation—derivative suits and class actions based on fiduciary duty and brought under state law. Sbareholder litigation in the corporate governance context consists of at least five categories of suits pursuant to state and federal law: state fiduciary duty derivative suits; state statutory claims, such as those based on inspection of records or election disputes; state fiduciary duty class action acquisition suits; federal securities fraud suits; and federal insider trading actions.

State-Law Fiduciary Duty Derivative Cases Raising, Principally, Loyalty Allegations. The classic shareholder litigation case is one based on breach of fiduciary duty brought by a shareholder against an insider who has engaged in a transaction with the corporation that benefits the insider more than the corporation. These cases are usually derivative actions in which any recovery goes to the corporation, rather than to the individual plaintiffs. Given the lack of incentive to an individual plaintiff that necessarily exists in such a situation, lawyers have long been the dominant players in this litigation and there have been long-running debates about the possibility of strike suits.[143] In a recent study of Delaware complaints (the "Thompson and Thomas Study"), there were about fifty derivative cases a year brought against public corporations in Delaware courts. Almost two-thirds of those alleged conflict of interest or other loyalty claims. About 20% of the complaints alleged improper financial reporting or a failure to supervise.[144]

Direct Shareholder Claims for Violations of State Corporations Statutes. The fiduciary duty claims just described usually derive from the common law. That law developed on a case-by-case basis to protect shareholders from possible abuse by those who have control of the corporation's assets. Fiduciary duty suits make up the great majority of shareholder litigation, but a variety of specific claims are possible under provisions of the corporations code. The Thompson and Thomas Study found that about 20% of complaints filed in the Delaware

143. *See generally* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) (examining the effectiveness of shareholder litigation and arguing that it is an ineffective instrument of corporate governance).

144. Thompson & Thomas, *supra* note 10, at tbl.4.

Chancery Court asserted such claims.[145] The most common claims, accounting for about thirty-five cases per year, were those in which shareholders sought to inspect corporate books. Claims relating to dissolution and receivers came next with about twenty-five cases a year, and cases raising director determination questions produced about twenty complaints per year on average. Claims seeking to force a shareholder meeting or seeking appraisal averaged about ten complaints per year. These cases are usually direct claims by aggrieved shareholders and have a different impact than the representative claims that are the focus of this Article.

State-Law Fiduciary Duty Class Actions in Acquisitions. By far the largest number of state shareholder litigation claims against publicly held companies are fiduciary duty claims brought as class actions arising out of acquisitions. The Thompson and Thomas Study shows that such class actions dwarf derivative suits in terms of the number of suits filed, with about four hundred cases a year, or about eight times the number of derivative suits filed against public corporations.[146] These suits have some similarities to traditional derivative suits and some notable differences. In the typical state-law acquisition case, either managers announce a merger or another fundamental change in control, or a second company makes a hostile bid.[147] The shareholders respond by suing to limit the directors' freedom to act or not to act.[148] The most common count in the complaints states that the directors have breached their duty to maximize share value.[149] The desired result, then, is a higher price for the transaction. Although a federal Williams Act claim is possible in such cases, tbe claims are usually brought under state law as a class action against the company and its directors.[150] Additional

145. *Id.* at tbl.3.

146. *Id.* at tbl.2.

147. Under state law, shareholders must vote on a merger, but only if submitted to tbem by the board. *See* DEL. CODE ANN. tit. 8, § 251(a)-(c) (2001). Shareholders are able to accept or reject a tender offer made to them by a hostile bidder who has not gained the assent of the board, but defensive tactics such as poison pills tbat the board can implement, when coupled with a staggered board structure, effectively limit the use of tender offers without the board's consent.

148. This type of suit is usually based on fiduciary duty, the subject of the Delaware data set described earlier. *See* note 144 *supra*.

149. The court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986), held that directors are required to maximize shareholder value, but only if the company is up for sale. In subsequent cases, the Delaware courts have said that stock-for-stock mergers with public companies without a controlling shareholder do not trigger this fiduciary obligation. A *Revlon*-type claim was made in about one-third of all acquisition cases, but did not produce much in the way of affirmative relief. *See* Thompson & Thomas, *supra* note 10.

150. In contrast to the data reported in our federal case database in Part II, the state suits are against directors, not officers. *See infra* Part II.B 2.

consideration for the transaction occurs in approximately 12% of these cases.[151] Another 12% of the cases result in other substantive relief, including additional disclosures and/or attorneys fees.[152] Most cases, however, are dismissed within a year of filing, without damages or other relief.[153]

Securities Fraud Class Actions. The securities fraud class actions brought in recent years follow a typical pattern. These cases are brought under the federal securities laws, generally following a company's correction of a prior earnings misstatement.[154] Of course, the company's stock price falls when the new earnings numbers are released. The stock price fall represents the alleged damages.[155] These cases are almost entirely federal, filed against the company and its officers, and last somewhat longer than the state acquisition cases. Moreover, when these cases result in settlements, rather than dismissals, they produce smaller recoveries than the state acquisition cases.[156]

Further, these earnings management cases combine elements of both loyalty and care claims and might have been made in state court. As discussed above, the theory of these cases is that the managers have caused the corporation to do something that has made the corporation's shares less valuable and, thereby, harmed the shareholders. Unlike the traditional state court conflict of interest case, the insider is not on the other side of the transaction from the corporation and its shareholders. However, the insider may receive some indirect benefit from the action, perhaps related to additional consideration.

Insider Trading Cases. The insider trading cases resemble the conflict transaction cases in that both involve alleged conflicts between shareholders and management. Here, however, the allegation is one of the management engaging in insider trading with a shareholder, rather than the transaction conflicts described above.[157]

---

151. Most of the cases that produce additional relief occur in the context of a controlling shareholder who has cashed out the publicly held minority interest on terms set by the majority shareholder.

152. Thompson & Thomas, *supra* note 10, at tbl.6.

153. More than half of the acquisition fiduciary duty cases (113 of 213) were dismissed without prejudice with an additional 5% dismissed with prejudice. *Id.* Slightly more than 10% were still open. *See id.* at tbl.6.

154. *See supra* text accompanying notes 125-130.

155. *See supra* text and table accompanying note 171.

156. The median recovery in the acquisition cases is about $5 million, with about 12% to 14% in additional consideration.

157. The company can engage in insider trading, but it is usually individual participants who do so.

These claims are almost always brought under federal law, although more often by the government (the Commission for civil claims, or the U.S. Attorney for criminal claims) than by private litigants. Since these are not representative claims, but direct claims, they have less in common with the more common securities fraud or derivative claims. In our data set of complaints there are allegations pertaining to the trades of insiders, but these allegations appear to be raised to meet the pleading standard for the scienter element of the misrepresentation claim and not for the direct recovery on insider trading.[158] Actual insider trading claims are hard to prove because the courts have attached a privity-type requirement to the claims that, as applied, requires the class action to have proposed plaintiffs who traded company securities contemporaneously with the defendants.

B. Characteristics of the Securities Fraud Class Actions

We have undertaken a detailed examination of securities fraud class action complaints filed in 1999 for the purpose of examining to what extent these cases seek to redress claims that relate to corporate governance. We created our data set from the list of securities class action filings for 1999 as found on the Stanford class action clearinghouse website.[159] We limited our examination of complaints to those filed in district courts within the Second, Third, and Ninth Circuits. We defined our sample to include the courts within the Second and Ninth Circuits, because these circuits are widely recognized to be the most prominent courts today in securities litigation. The Third Circuit includes Delaware, the site for the state law database to which we make comparisons in this discussion.[160] The total cases filed in those three circuits make up approximately half of all cases filed in that year.[161]

158. *See infra* notes 186-88 and accompanying text.

159. STANFORD LAW SCHOOL SECURITIES CLASS ACTION CLEARINGHOUSE, *available at* http://securities.stanford.edu (last visited Mar. 22, 2003).

160. For a complete description of the state law database, see Thompson & Thomas, *supra* note 10.

161. Our data set of 86 complaints is smaller than the total number of cases on the website. We have excluded non–class actions and cases transferred out of the three jurisdictions we chose. We have also eliminated from the data set cases that were listed on the website as securities fraud cases, but which, upon examination, turned out to be based on other causes of action. Finally, we were unable to locate complaints in a few of the cases.

1. The Companies Sued

Most of the companies named in these suits were incorporated in Delaware. About three-fourths of the companies for which we identified an American state of incorporation had their legal home in Delaware; for the non-Delaware companies there were almost as many from abroad as there were from other American states.[162] Although the sample is not large enough to support findings of a significant statistical difference between the Delaware and non-Delaware corporations, it suggests that the comparison of federal and Delaware complaints discussed in this part should cover most cases in which state and federal corporate governance suits could overlap.

California was the headquarters for half of the companies in the sample; companies sued were more likely to be listed on NASDAQ than the NYSE; and more companies were in high-tech industries than traditional manufacturing. These results are consistent with the story told about the securities fraud class action, for example, in the debate surrounding the 1995 Act[163]—and they suggest that the federal class action suits have a somewhat different flavor than the state fiduciary duty cases—even if both relate to corporate governance.

For example, nationally, approximately 15% of all corporations are headquartered in California, and 11% are headquartered in New York.[164] The complaints in the Thompson and Thomas Study break down in a similar manner for California companies, with a somewhat larger number for New York.[165] In our database, however, more than three times as many companies headquartered in California are sued as compared to New York–headquartered companies.[166] Although we

---

162. The totals were as follows: Delaware—thirty-seven; unspecified—thirty-two; Nevada and New Jersey—two each; California, Maryland, Minnesota, Nebraska, Oklahoma, and Virginia—one each; Israel—three; Canada—two; and British Virgin Islands and Bermuda—one each.

163. *See, e.g.*, John W. Avery, *Securities Litigation Reform: The Genesis of the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996).

164. *See* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1814 (2002) (reporting 15% of American corporations headquartered in California from Compustat database and 11% in New York).

165. Thompson & Tbomas, *supra* note 10, at n.147. California-headquartered companies made up 15.9% of the seventy-six companies for which a principal office could be identified, the same percentage as reported in Subramanian, *supra* note 164, at 1814.

166. The numbers (for eighty-six cases) were as follows: California—forty-three; New York—twelve; Arizona—seven; New Jersey—six; Pennsylvania—three; Washington—two; Colorado, Delaware, Massachusetts, Nevada, Texas, and the Virgin Islands—one each; Israel—two; and Antigua, Canada, and Hong Kong—one each; two were unspecified. These numbers reflect the circuit court jurisdictions from which the complaints were taken. Only nine companies were headquartered outside the three circuits in the study.

cannot draw firm conclusions given the limited nature of our database and jurisdictional requirements, California-headquartered companies do seem to represent a disproportionate number of companies sued in federal cases—at least relative to their national incorporation rate.

The data, then, raise an interesting question for further study. If, as we posit, securities litigation is playing largely a care-based corporate governance role, it is possible that these young companies lack some of the internal governance structures of their more established counterparts. If securities fraud claims are working to address some of those issues, then the lawsuits against those companies may be playing an ex post deterrence role. Or it may be, as many have claimed, that start-up, high-tech companies are disproportionately and inappropriately sued.

Our data on exchange listing and line of business also show other differences between companies sued under federal and state law. Companies listed on NASDAQ outnumbered those with stock traded on the New York Stock Exchange by an almost two-to-one margin in our database of federal class action complaints.[167] In contrast, fiduciary duty suits in Delaware were more often brought against New York Stock Exchange companies.[168] The federal data set has a greater representation of high-tech companies than the state fiduciary duty data set. Computers, software, and information technology made up about one quarter of the sample with telecommunications representing an additional 15%.[169] These data are consistent with the industry base in earlier discussions of federal securities fraud class action suits but differ from the industry identification of the state law database, which is more spread out across the economy.[170] These data probably reflect the segmentation of the lawsuit world with state litigation focusing on acquisitions and loyalty claims and federal suits focused more on earnings changes and care-based concerns in high-tech companies, although both are corporate governance claims.

167. The totals were as follows: NASDAQ—fifty-two; NYSE—twenty-seven; other public companies—five; and unspecified—two.

168. Thompson & Thomas, *supra* note 10, at tbl.4 (reporting that NYSE companies outnumbered NASDAQ companies by more than two-to-one for all cases filed and five-to-four for lead cases after multiple suits per transactions were consolidated).

169. The numbers are as follows: computers, software, and information technology—twenty-one; telecommunications—thirteen; manufacturing and business service—each with nine; retail—eight; finance—seven; pharmaceuticals—four; healthcare, real estate, and biotechnology—each with three; recreation and apparel—two each; and personal services and airlines—each with one.

170. Thompson & Thomas, *supra* note 10, at n.148 (reporting that internet computing made up about 15% of the companies sued and telecommunications represented an additional 6%).

2. Securities Fraud Class Actions and the Perils of Representative Litigation

Securities fraud class actions are representative claims in which a class member seeks to bring the litigation on behalf of a large group of affected class members. These suits share a number of characteristics with other types of representative litigation, such as derivative suits, that have led to various rules to limit their abuse and the possibility of strike suits. The debate over the 1995 Act centered on this element. We do not seek to repeat or even summarize that debate here, but our study does offer some additional information relevant to that debate on two items: the extent to which federal suits follow precipitous drops in the company's stock price and the extent to which repeat law firms bring these suits. Our analysis of the federal complaints reveals that complaints are often premised on allegations of fraud related either to a significant drop in earnings or other accounting allegations. The majority of complaints in our sample identify a precipitous drop that precedes the suit. Where a percentage drop was reported, the median percentage decline was 54%.[171] These types of claims are consistent with today's major corporate scandals, like Enron and WorldCom. They are also consistent with the climate of earnings management, about which much has been written recently.[172]

Table 1. Drop in Share Value Prior to Suit

Percentage Drop Reported Prior to Suit	No. of Complaints (of 48)
80-99%	8
60-79%	15
40-59%	11
20-39%	13
1-19%	1

State and federal representative shareholder litigation share some characteristics. For example, both federal securities fraud class

171. As reflected by these drops, the sample was decidedly skewed toward allegations of misrepresentation that led plaintiffs to pay too much (eighty-one complaints) as opposed to allegations that led them to sell for too little (four complaints); one was unspecified.

172. *See, e.g.*, Fuller & Jensen, *supra* note 98, at 41-43 (positing that earnings management and officer interaction with analysts is partly responsible for the current accounting manipulation crisis).

actions and state fiduciary duty claims in acquisitions are filed very quickly, both often involve multiple lawsuits for the same transactions, and both are brought by an identifiable, small group of lawyers.[173] Our data on law firms are consistent with those of other studies. Milberg, Weiss, Bershad, Hynes, and Lerach is the dominant law firm for plaintiffs, representing plaintiffs in thirty of the eighty-five complaints for which this information was available.[174] Four of the next five firms are also in the top dozen firms bringing shareholder fiduciary duty claims in Delaware.[175] The Thompson and Thomas Study showed that sixteen firms filed more than 75% of Delaware fiduciary duty class actions, although Milberg, Weiss had a less dominant role in that set of complaints. Our data set, being complaint focused, does not reveal how the lead plaintiff provisions of the 1995 Act have evolved or even whether they have been effective in reaching the targets at which they were aimed. The other studies now available reveal that the provisions have had little, if any, impact to date.[176]

173. These points are among those discussed in Thompson & Thomas, *supra* note 10, at tbl.9. In tbe state law data set, for example, there were about 800 lawsuits brought in 214 acquisitions. Almost 70% of the class action lawsuits in the state law complaint database were filed within three days of the questioned transaction, for example, three days after the date of an acquisition announcement.

174. One complaint was incomplete on this question. In other studies, Milberg, Weiss has been reported to have been involved in about half of all post–Reform Act cases that were settled through 2002. *See* Laura E. Simmons, Post–Reform Act Securities Lawsuits: Settlements Reported Through December 2001, at 10 (2002), *available at* http://www.cornerstone.com/fram_rec.html. Bajaj et al. report a smaller involvement for Milberg, Weiss at about one third of post-reform cases. *See* Mukesh Bajaj et al., Securities Class Action Settlements: An Empirical Analysis 13 (Nov. 16, 2000) (unpublished manuscript, on file with authors).

175. Milberg, Weiss (ninth), Weiss & Yourman (seventh), Stull & Stull (sixth) and Abbey, Gardy & Squitieri (fourth) are in the top ten among firms bringing fiduciary duty lawsuits in Delaware. *See* Thompson & Thomas, *supra* note 10, at tbl.12. Wolf & Haldenstein is twelfth. The law offices of Bruce G. Murphy is further down the state list but is still within the top twenty. *Id.*

176. *See* SEC, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (1997), *available at* http://www.sec.gov/ncws/studies/1reform.txt (last visited Jan. 20, 2003); Elliott J. Weiss, Comment, *The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act*, 39 ARIZ. L. REV. 561, 563-72 (1997).

Table 2. Plaintiffs' Law Firms

Plaintiff Firm	No. of Complaints Filed
Milberg, Weiss	30
Weiss & Yourman	13
Stull & Stull	11
Wolf & Haldenstein	9
Bruce G. Murphy	9
Abby, Gardy & Squitieri	8

3. Claims Made in Securities Fraud Class Actions

Our data set reveals some dramatic differences between securities fraud class actions and other shareholder litigation. Specifically, we find that securities litigation suits are most often brought against officers, not directors. In addition, securities litigation is based on specific substantive allegations, unlike the acquisition-based claims of fiduciary duty suits. Finally, the location of the alleged misleading statement in documents discussing the ongoing nature of the business and the length of the class period provide evidence of the corporate governance focus of securities fraud litigation.

Securities fraud claims are directed against individuals in their capacity as officers, not directors. State law fiduciary duty complaints are brought against directors, but federal claims are made against officers. Often, of course, the same individuals serve in both positions, but the position in which they are sued is telling with respect to the function that each law seeks to serve. All the complaints in our data set specify the entity as a defendant, and four sue only the entity. Of the eighty-two complaints that identify individual defendants, eighty-one name the chief executive officer ("CEO") as a defendant, and sixty name the chief financial officer ("CFO"). Nine name the chief operating officer ("COO"), and thirty-one name vice-presidents who do not have one of the "chief" positions.

Table 3. Corporate Positions of Individuals Named as Defendants

Defendant's Status	Subtotal	No.
Total Cases That Name Defendant		86
Entity Only		4
Total Cases Naming Individuals		82
Chief Executive Officer		81
CEO but Not Chair	11	
CEO & Chair	26	
CEO, Chair & President	24	
CEO & President	20	
Nonexecutive Chair		21
President		7
Chief Financial Officer		60
CFO & Other	46	
CFO & Director	10	
CFO & President	3	
CFO & Chair	1	
Chief Operating Officer		9
Chief Technology Officer		3
Vice-President (& Not Named Above)		31
Outside Directors		21
& Prospectus/Registration Statement	9	
& Proxy	2	
Other Settings	10	
No Outside Directors Beyond Officers		61

In contrast to the state-law cases, only twenty-one securities fraud complaints name any outside directors as defendants.[177] Nine of these twenty complaints are suits brought pursuant to 1933 Act registration statements, under which there is specific statutory liability for directors.[178] To summarize, few of the cases include any directors beyond those who are also officers, and even in the few cases in which outside directors are named, not all outside directors are

177. In the state law database, all of the suits name directors, but none names officers who are not directors.

178. Section 11(a) of the 1933 Act names directors among the five named categories of individuals who can be liable under the Act. Securities Act of 1933, ch. 38, § 11(a)(2), 48 Stat. 74, 82 (codified as amended at 15 U.S.C. § 77k(a)(2) (2000)).

sued.[179] Instead, only those outside directors who actually acted in a manner consistent with responsibility for the misstatement or omission are named as defendants.[180]

This difference in defendants between the state and federal claims is consistent with the difference in the governance focus of the claims. The federal cases focus on the failure of managers, principally officers, to fulfill their management obligations. Put in fraud terms, the complaints allege that the managers committed fraud by saying one thing while knowing another or recklessly failing to know another. That claim is akin to one asserting a failure to manage properly.

Securities fraud claims address officer behavior in managing the company and in their duty of care. Notably, the subject matter of the alleged misrepresentations encompasses the duty of care/duty to monitor governance aspects of traditional corporate law and reflects the care-based concerns expressed in the debates about recent corporate scandals. The majority of the alleged misrepresentations focus on accounting misrepresentations. These misrepresentations arguably represent the earnings-management phenomenon that others have documented in today's public companies.[181] The theory is that corporations focus on earnings announcements and short-term stock prices in response to analyst demands. The market, whether appropriately or not, focuses on the earnings announcements because, at least in theory, analysts review and cleanse them. The process becomes cyclical. Companies make earnings estimates, and analysts promote the numbers. Companies then have to meet those numbers. As the end of the quarter approaches, and the companies are not close to the numbers, the companies must choose between coming clean and continuing to assert the numbers. The more unrealistic the estimate, the greater the pressure to meet it. Some estimates, in fact, become unattainable, and an unsustainable cycle of ever-increasing earnings announcements and share prices begins.[182] Eventually, of course, the companies have to come clean, and that act is the one documented in the complaints. Fuller and Jensen posit that analysts' focus on predictions, short-term numbers, and earnings data, thus, influences managerial decisions, resulting in changes in management focus that

179. Two of the remaining ten complaints named only one outside director, and two named only two.

180. For example, these outside directors are often said to have engaged in insider trading during the class period.

181. Fuller & Jensen, *supra* note 98, at 41-43.

182. *See id.* at 42-43.

may impact operational decisions and harm long-term corporate profitability.[183]

As Table 4 reveals, the plaintiffs have alleged various accounting misrepresentations that, according to our review of the complaints, fit into this earnings-management category. Approximately 88% of the complaints (seventy-six of eighty-six) include allegations that involve company misrepresentations about earnings or sales or production problems tied to a failure to meet earnings predictions. Many complaints include more than one type of misrepresentation and each is depicted here.

The second prominent category of misrepresentation alleged involves acquisitions. About 43% of the complaints (thirty-seven of eighty-six) include cases involving this type of allegation. Interestingly, these allegations can also be categorized as earnings-management allegations. For example, companies without revenue growth have an incentive to acquire other companies with positive revenues. Companies wishing to be acquired have an incentive to try to keep their stock prices high, at least until the acquisition occurs. These are the types of stories the complaints tell.

Table 4. Subject Matter of Misrepresentations

Type of Misrepresentation	No. of Complaints
Accounting and Earnings	
Accounting—General	54
Sales/Product Cycle	43
Accounting—Revenue Recognition	31
Production Problems	18
Accounting—Understating Expenses	6
Accounting—Restatement	1
Acquisition	
Company Made Acquisition	24
Company Was Acquired	8
Failed Acquisition by Company	3
Failed Acquisition of Company	2

Securities fraud claims arise out of statements made in periodic reports and other statements reflecting management's stewardship of the business. In the majority of the cases, the specific claims are

183. *See id.*; *see also* Jill Fisch & Hillary A. Sale, *Analyzing the Analysts*, 88 IOWA L. REV. (forthcoming 2003) (discussing analyst conflicts of interest and earnings-management complications).

framed in terms of allegations of misleading statements or omissions occurring in the ongoing operation of business, like regularly filed reports, press releases, and conference calls.[184] In a majority of the complaints the alleged misstatements and omissions (forty-six of eighty-six) occur in a 10-K or 10-Q filing. The alleged misrepresentations in periodic reports often overlap with allegations as to registration or proxy filings; only ten arise solely from a registration statement, one solely from a proxy filing, and three from a tender offer. And the allegations are not limited to situations involving mandatory disclosures: More than three-fourths of the complaints refer to misstatements appearing in press releases and to other voluntary disclosures.[185] These claims arise in the regular course of business, conversations with the media and required reports, or situations implicating day-to-day decisionmaking and, largely, the duty of care. Thus, most of the cases involve corporate governance–type allegations.

Table 5. Place of Misstatement as Alleged in Complaint

Location	Subtotal	No.
Mandatory Disclosures		
Section 13 Disclosures		
10K		32
Alone	4	
& 10Q	16	
& Registration Statement	3	
& 10Q & Registration Statement	5	
& 10Q & Tender	1	
& 10Q & 8K	1	
& 10Q & Proxy & Registration St	1	
& 8K & Proxy	1	
10Q		38
Alone	10	
& 10K	16	
& Proxy	1	

184. *See infra* tbl.5 accompanying note 185.

185. Sixty-eight of the eighty-six complaints listed statements appearing in press releases. The categories are not mutually exclusive and the same complaint can record more than one. For example, a complaint alleging a misstatement in a 10-K and 10-Q would appear twice in the count in this table. Most complaints listed a variety of places among the choices described in Table 5.

Location	Subtotal	No.
& 8K & Proxy	1	
& 10K & Registration Statement	5	
& Regis Statement	2	
& 10K & 8K	1	
& 10K & Tender	1	
& 10K & Proxy & Registration St	1	
8K		4
& 10Q & Proxy	1	
& 10Q & 10K	1	
& Proxy	1	
& 10K & Proxy	1	
Registration Statements/ Prospectus		24
Alone	10	
&10K	3	
&10Q	2	
& 10K & 10Q	5	
& Proxy	3	
& Proxy & 10K & 10Q	1	
Proxy Statement		9
Alone	1	
& Registration Statement	3	
& 10K & 8K	1	
& 10Q	1	
& 8K	1	
& 10Q & 8K	1	
& Registration St & 10K & 10Q	1	
Tender Offer Disclosure		3
Voluntary Disclosure		
Press Release		68
Analyst Report		30
Conference Call		26
Media Interview		20
Conversation with Analysts		18
Analyst Conference		17
Media Article		10
Letter to Shareholders		8
Road Show		4
Trade Conference		4
Other		4

Securities fraud complaints often allege that a misreprcsentation occurred for insider benefit. As a result, they often appear to contain loyalty-type claims.[186] For example, some complaints rely on the trades of insiders in company stock to support these allegations. Others focus on executive compensation. Consistent with our care/governance findings, these allegations are merely hooks, not substantive claims. Insider trades, for example, serve as proxies for scienter—an alleged motive for managers to commit fraud—rather than evidence of the fraud itself.[187] The use of insider trades as a hook for fraud was increasing before the 1995 Act, but its use has grown since that time, in part to meet the increasingly restrictive pleading standard imposed by Congress and welcomed by the courts.[188]

Securities fraud class actions usually cover a class period that includes significant numbers of company shareholders. Federal claims may be limited in their ability to serve a governance function if those who have standing as purchasers and sellers during the class period have interests that diverge from the interests of the complete set of shareholders. The length of the class periods, in combination with the average turnover in company stock, offers one method to evaluate the severity of this problem. In the complaints covered in our sample, the median length of the class was ten months. Twenty-eight of eighty-six complaints alleged class periods extending for one year or more.

Table 6. Length of Class Period

Length of Class Period (in Months)	No. (of 86 Cases)
< 1	9
1-6	21
7-12	24
13-18	8
19-24	10
25-30	1
31-36	6
37-42	2
Indefinite	1
Unknown	4

186. About 37% of the complaints in our study do not include either insider trading or executive compensation allegations, relying mostly on the mismanagement allegations tied to mandatory and voluntary disclosure. Twenty-five (29%) list executive compensation in the complaint, and thirty-nine (45%) list insider trading counts. (Ten of the cases include both and therefore are included in each count.)

187. *See* Hillary A. Sale, *Judging Heuristics,* 35 U.C. DAVIS L. REV. 903, 925 (2002).

188. *Id.* at 924-25.

The turnover rate of share ownership has increased substantially during the last fifty years, and recent data put it at 100% on an annualized basis.[189] Of course, some shareholders hold for a longer period, and some shares trade more than once, resulting, for example, in a divergence between current shareholders and those with standing to sue. But in a universe of corporate stock ownership dominated by institutional investors owning diversified portfolios, there may, however, be an alignment of interest between the two groups.

Further, even if the overlap between current holders and those with standing were smaller, the small per share award in most securities fraud class actions suggests a deterrence function that is more consistent with corporate governance than with compensating a class of purchasers or sellers.[190] A significant percentage of the relief in securities class actions, 20 to 30%, goes to attorneys, and the remaining relief is increasingly small relative to the alleged loss in corporate value.[191]

4. Transactions Generating Both State and Federal Lawsuits

Only a small fraction of the companies sued in the Delaware data set were also sued in our federal study.[192] There were about a

189. *See* NEW YORK STOCK EXCHANGE, DATA LIBRARY, NYSE STATISTICS ARCHIVE (reporting year-to-date annualized monthly turnover rate of 100% for April 2002, 98% for May 2002, 101% for June 2002, and 106% for July 2002), *at* http://www.nyse.com/marketinfo/marketinfo.html (last visited Aug. 14, 2002). For a discussion of turnover rates over a longer period, see Seymour Smidt, *Long-Run Trends in Equity Turnover*, J. PORTFOLIO MGMT., Fall 1990, at 66 (reporting turnover rates on the New York Stock Exchange as higher in the early 1900s (200-300% per year), lower from 1940 to 1965 (12-24%), and increasing to 73% in 1987); *see also The Impact of Institutional Investors on Corporate Governance, Takeovers, and Capital Markets: Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous. & Urban Affairs*, 101st Cong. 68 (1989) (reporting increase in turnover of New York Stock Exchange listed stocks from 19% in 1955 to 55% in 1988).

190. See A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 945-47 (1999).

191. *See* Laura E. Simmons, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2001*, CORNERSTONE RES., at 6 fig.3 (2002) (showing that the median settlement as a percentage of estimated damages for post-1995 suits is 5%, the percentage declines as the absolute amount of damages increases, and the percentage has declined since 1995), *at* http://www.cornerstone.com/pdfs/settlements.pdf (last visited Mar. 22, 2003).

192. Twenty-four companies were sued in both Delaware and in federal court during the same time period. We estimate this number to be 7 to 10% of the companies in the two data sets. It is approximately 7% of the 290 public companies sued in Delaware for breaches of fiduciary duty in those two years. The total number of companies sued for securities fraud is a bit larger and includes non-Delaware incorporated entities. Estimating from the overall sample of Delaware companies in our economy, of the 400 companies that were sued for securities fraud in those two years, approximately 60% (about 240) would be incorporated in Delaware, so 10% of them would be included in the overlap set.

dozen settings in which there were federal and state suits relating to the same transactions. Most of the overlapping cases remain open in Delaware, an unusual characteristic, because more than 90% of the Delaware class actions have been resolved.[193] These overlapping cases are also unusual in that only two have produced any kind of relief and two others were resolved with no relief.[194] These data contrast with the overall recovery rate in the Thompson and Thomas Study where about 25% of cases result in additional consideration or other relief.[195] Thus, the overlap cases look different than the state law cases generally, and where there is an overlap they tend to fall more into the federal pattern.

The dominance of federal litigation in the overlap cases can also be seen in another data point. There are twenty-one cases in the state data set that allege improper financial records or misleading statements that could possibly support federal claims. Of the four cases in this group that have provided affirmative relief, three are linked to federal securities suits. In two of those, the dollar amount paid in settlement for the state suit went directly from the corporation to the settlement of the federal suit.

III. SHAREHOLDER LITIGATION'S ROLE IN CORPORATE GOVERNANCE

All of the shareholder suits discussed in Part II reflect a shared purpose of countering the agency costs inherent in managers running a corporation in which they have only a small interest. The basic concern is that management has misused its position with respect to corporate assets. As discussed above, the state law default norm centralizes corporate power in the hands of management—more

---

193. Thompson & Thomas, *supra* note 10, at tbl.14 (reporting tbe median time to resolution for an acquisition case raising a fiduciary duty claim to be 287 days). It is not surprising that the state cases generally settle more quickly than the federal suits. First, the Delaware courts pride themselves on dealing with cases efficiently and quickly. Second, the 1995 Act incorporated significant procedural burdles for the litigation of federal claims. So, for example, plaintiffs wishing to survive dismissal in federal court must meet restrictive pleading standards. Those standards evolved from pre-1995 case law in which the plaintiffs were allowed discovery to do so. Now, however, the plaintiffs are barred from discovery. The process of meeting the standard and surviving dismissal can take quite a long time, and settlement discussions are off the table until that point. That the state court cases with related federal cases do not fall into this pattern, however, suggests the greater resemblance of these overlap cases to federal as opposed to state cases.

194. *See* Thompson & Thomas, *supra* note 10.

195. After consolidating the multiple suits into their underlying controversies, the 1,000 complaints resulted in 349 controversies, of which only 84 resulted in relief of any sort. Of those, 41 resulted in relief with additional consideration. The other 43 resulted primarily in rescinding some corporate acts or other substantive relief, additional disclosure, or attorneys' fees.

specifically, directors—and these forms of litigation check the abuse of that position.

As the federal disclosure obligations have increased, they have begun to provide the basis to enforce duty of care obligations that in the past might have been enforced under state law. In either jurisdiction the allegation would be that the managers' actions have harmed shareholders by decreasing the corporation's value. Federal law, of course, allows only those shareholders who bought and sold to recover for this loss, but that limit seems to reflect concern for vexatious litigation more than a substantive belief about the culpability of managers. In theory, state law duty of care litigation continues to afford relief to these shareholders, but as disclosure and securities fraud litigation have expanded, and as Delaware has raised the bar for care claims, the balance has shifted to a larger federal role.[196]

Fiduciary duty and securities fraud litigation have much in common. Both occur after the fact and through a lawsuit brought by a self-appointed individual, ostensibly a shareholder but in reality an attorney acting as a private attorney general, motivated by the fees to be earned in successful suits. Further, litigation in the two settings works with roughly the same set of incentives. No one shareholder has sufficient interest to make litigation worthwhile. Collectively, however, the damage is sufficient to warrant recovery. The attorney's job is both to create and file the complaint and to help the class plaintiffs understand and follow the litigation.

It is not surprising that the lawyers may have mixed incentives in both settings. Those delegated to act as class plaintiffs must represent both the class and themselves, at least in the context of fees. And, both sets of claims suffer from parallel litigation agency cost problems to the extent that the economic incentives of the attorney for the plaintiffs are not closely aligned with the economic incentives of the class as a whole.

The overlap between the governance motives in both sets of litigation is striking. Today's federal securities fraud claims are largely efforts to recover from what could be care claims at state law. To be sure, elements of the duty of loyalty appear in the context of, for example, insider trading by a defendant or efforts to increase executive compensation. But the main story line of these complaints is focused not on recovery of a wrongful benefit received by the insider, as in the Delaware cases, but on recovery of the entire loss that can

196. *See, e.g.*, DEL CODE ANN. tit. 8, § 102(b)(7) (2002).

arguably be said to flow from the managerial mistake, overvaluation, or misrepresentation.

Arguably, then, these federal cases are working to fill the hole in Delaware law brought about by the lack of liability for, and concomitant inability to sustain, suits for breaches of the fiduciary duty of care. Unlike their loyalty-focused, state law counterparts, the federal cases detail shareholders' complaints that the officers' stewardship of the business has not been what the owners would like it to be. The question raised is the one currently in the news every day—what did the CEOs at WorldCom, Enron, Qwest, Xerox, and others actually know about their respective company's financial situation and when did they know it? And, if as some claim, they did not know, then why not? The latter question raises the same issues as the duty of care/duty to monitor, with the duty of loyalty in the background.

To the extent that federal securities fraud and state fiduciary litigation are both constraints on possible abuses of managers' positions, it is worth comparing the relative manner in which the two types of litigation function. The increased growth in the role of federal law in corporate governance can be explained by several advantages that federal litigation has relative to state litigation. First, the disclosure basis for federal securities law provides other ancillary benefits beyond shareholder litigation that contribute to its use as the preferred response when problems like those in 2002 occur in corporate governance. Disclosure can aid several parties in the corporate monitoring context. In addition to assisting shareholders, disclosure aids directors in their monitoring function and can be an important support for accountants as they undertake the monitoring role that is a key component of corporate governance. Given these multiple uses, it is not surprising that disclosure law has grown dramatically. Delaware conceded much more of corporate governance than it may have anticipated when it forwent the affirmative use of disclosure obligations or, through the exculpation clause, the affirmative regulation of managerial care. Moreover, even if Delaware were now to decide to reenter that arena, the Securities Litigation Uniform Standards Act of 1998 would likely prevent it from doing so.[197]

Second, the federal focus on the behavior of officers is much more in line with the reality of modern corporate America. As our business enterprises have become larger and more complex, increased

---

197. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified at 15 U.S.C. §§ 77p, 77v(a), 78bb, and 78u-4(b)(3) (2000)).

power has passed to chief executive officers and the line hierarchy that flows from that person. Directors, acting collectively, continue to have a role in crises and sometimes in picking a successor to the CEO,[198] but a governance system based on directors is less efficacious now than early in the last century. Thus, the federal layer of law is more important than before.

For Delaware to expand its focus on officer conduct it would have to amend its jurisdictional statute to include officers rather than just directors. In 1977, the U.S. Supreme Court rejected Delaware's use of quasi in rem jurisdiction to reach corporate directors and officers, holding that the shares in a Delaware-based corporation did not meet the constitutional minimum contacts standard.[199] The opinion distinguished Delaware's quasi in rem jurisdiction from jurisdiction based on fiduciary status.[200] The Delaware legislature responded by passing a statute stating that the corporation's registered agent serves as the directors' agent, thereby creating a form of implied jurisdiction.[201] The statute, however, does not apply to officers. This statutory gap may explain the lack of lawsuits naming officers, but it does not explain the legislature's choice not to include officers as corporate fiduciaries who ought to be subject to litigation in the Delaware court system to enforce their corporate governance functions. Delaware could, of course, remedy this situation by including officers in the jurisdictional statute and removing the jurisdictional barrier to lawsuits against officers who otherwise lack the requisite contacts with Delaware to establish traditional personal jurisdiction.[202] Or, as in other areas, Delaware could continue to concede this area of the law to the federal government.[203]

Third, disclosure questions, the focus of federal law, can be more easily handled under the current legal regime than questions alleging a duty to supervise and monitor, which are the basis of care review under state law. Delaware's implementation of section

198. For a traditional discussion of the role of directors emphasizing their role in crises, see MILES MACE, DIRECTORS: MYTH AND REALITY 101-12 (1971)

199. Shaffer v. Heitner, 433 U.S. 186, 195, 216-17 (1977).

200. *Id.* at 214.

201. DEL. CODE ANN. tit. 10, § 3114(a) (2002); *see also* Armstrong v. Pomerance, 423 A.2d 174, 179 (Del. 1980) (holding that statute met constitutional requirements).

202. This solution has been proposed by two Delaware judges. *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, U. PA. L. REV. (forthcoming 2003). Our inclusion of this point derived from a suggestion from Vice-Chancellor Strine.

203. *See* Mark J. Roe, *Delaware's Competition* (Nov. 2002) (unpublished manuscript, on file with authors) (arguing tbat pressure from the federal government is the only relevant form of pressure on Delaware's corporate law choices).

102(b)(7) and judicial focus on the failure to supervise has made it very difficult for it to be a presence in determining the care portion of corporate governance. When infectious greed overwhelmed our historical guardians, Delaware was at a relative disadvantage in acting. Federal law has been stepping into that vacuum for years, and recent legislation expands the federal corporate governance role—most strikingly in the care context. State law continues to have the core role for duty of loyalty issues, but it now explicitly shares corporate governance with the federal government.

Fourth, the damages question is much more accessible to litigants and judges under federal securities fraud law than under state fiduciary duty law. In a federal claim, the plaintiffs must link the alleged misstatements or omissions to their damages. They do so by complaining about the difference in the price at which they bought (typically high because of inflation from misleading statements) and the lower, actual value of the stock with which they are stuck after the truth, or breach of the duty of care, is revealed. In the state claims shareholders complain of the decreased value of the corporation because of the manager's action. Often the damages would be measured by the difference between the same two figures—the inflated value of the company before the disclosure of the wrongful act and the lower value after the wrongful act was revealed. Here, however, there is not a purchase or sale to mark the prices as distinctly.

The policy question does not necessarily differ from that which arises in the federal cases. If managers, through a wrongful act, cause the corporation to appear to be worth more than it is, then some shareholders who bought at the "inflated" price have been harmed by the decline in price from the inflated figure. For each buyer, there was a seller who presumably was not one of the defendants. Those sellers then made a profit on their sales, but are not part of any litigation about the inflation of the price or forced to return the profits to the buyers. The debate then becomes whether managers should be liable to those who have lost because of the improper acts, without netting out the benefit that has accrued to other members of the public, a common result in tort suits but one which can lead to an arguably incorrect measure of damages in cases involving securities. This debate is common in the securities fraud damages context and is connected to whether one perceives the purpose of the damages to be compensation or deterrence. If deterrence is the purpose, and what is to be deterred is bad governance behavior, then the debate has arguably been focused on the wrong issues.

This debate has been the subject of many other articles[204] and was, in part, resolved by Congress in the PSLRA. In that legislation, Congress arguably affirmed the deterrence aspect of damages paid by individuals to the covered class, but created certain statutory mechanisms to limit the total damages paid.[205] The appropriate measure of damages is by no means clear, but the easier measure of damages is certainly a prime attraction of the federal forum for plaintiffs and their lawyers.

Fifth, given that both state fiduciary duty litigation and federal securities fraud litigation raise possible litigation agency cost issues, it is worth examining the relative checks that are in place to respond to those possibilities. At this point the federal checks are more developed than the checks in the state system. Federal law, for example, has been in the vanguard in developing lead plaintiff provisions. If such provisions were effective, they would respond to some of the litigation agency cost concerns.

Much of the debate over the reform of the securities laws focused on the scienter element.[206] This element functions to screen cases in a manner consistent with the way in which state law regulates the fiduciary duty of care. As a result of the exculpation statutes mentioned earlier, managers are liable under state law only where their acts are intentional or attributed to a lack of good faith or loyalty. In the federal law claims, particularly since 1995, plaintiffs have deployed individual breaches of the duty of loyalty (insider trading or executive compensation) as a hook for the scienter element, or as a means to allege the requisite intent to hold the individual defendants and the corporation liable for claims suffered by all who traded on the market at the wrong price.[207] This Article reveals, however, that the underlying claim is generally one of mismanagement or a breach of the duty of care.

---

204. *See, e.g.*, Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984) (discussing courts' use of both the tort concept of legal causation and the fraud concept of unjust enrichment in Rule 10b-5 cases, and noting that the remedy of unjust enrichment is well suited to federal securities laws that have both compensatory and deterrent purposes); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985) (applying to federal securities cases a rule of damages based on optimal deterrence levels).

205. The key change on damages is a provision requiring that plaintiffs plead and prove that their losses were in fact caused by the alleged fraud. For articles discussing the PSLRA's provisions on damages, see Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639 (1996), and Robert B. Thompson, *Simplicity and Certainty in the Measure of Recovery Under Rule 10b-5*, 51 BUS. L. REV. 1177 (1996).

206. *See* Sale, *supra* note 187, at 905-14.

207. *See id.* (collecting all opinions recounting insider trades since 1995).

The under examined aspect of this litigation is the expanding role of disclosure. Over time, mandatory and voluntary disclosure pursuant to the federal securities laws has increased dramatically. As the quantity of disclosure has increased, so has the litigation over its quality. The original premise for requiring disclosure was to decrease informational asymmetries and thereby to improve market efficiency through accurate information, while stopping short of creating a body of federal corporate law. State law was to remain the monitor of the shareholders' relationship with corporate management and only marginally be the focus of disclosure discussions.[208] In reality, federal law now occupies the space originally reserved for the states—monitoring corporate managers through disclosure.

Although, in general terms, disclosure is a good thing, it is not necessarily entirely good or a good regulatory mechanism for corporate governance claims. First, disclosure is an indirect way to regulate managerial behavior. As discussed above, disclosure is, at best, a monitor of what managers say, not what they do. The two may be linked only at the margin. Second, disclosure can, as the recent cycle reveals, create pressure for more disclosure—truthful or not. Disclosure then is a double-edged sword. Truthful disclosures work to decrease informational asymmetries. Fraud increases them. More disclosure can lead to pressure for more disclosure. In a world where analysts and others depend on releases of company information, the expectation and appetite for more disclosure grows with each new disclosure. In addition, the pressure to meet the predictions and make the disclosures accurate increases. Yet, the current corporate climate reveals that, short of a major market turnaround, it is not clear that the pressure will produce accurate disclosures. In that world, then, the disclosures are of little value except as ex post litigation links. And, third, if managers are truthful about their shortcomings, the securities laws presumably offer no protection for breaches of the duty of care, no matter how egregious. The remaining question for further discussion, then, is whether the disclosure approach is sufficiently efficacious, and if not, whether we should recognize the strong role of federal law in monitoring corporate governance and reformulate it to do so in a more direct fashion.

IV. CONCLUSION

Corporate governance, once almost the exclusive domain of state law, is now very much a function shared by the federal and state

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

governments. State law continues to define the skeleton of the corporate governance system, but when it comes to filling out the body of that system, we now have a functional division of monitoring between the state and federal governments. State litigation remedies focus on claims against directors for failing to adhere to their duty of loyalty. Federal law remedies need a disclosure hook but are usually claims against officers for breaches of the duty of care or monitoring during the day-to-day running of the corporation. As corporations have evolved, increasing in size and specialization, Delaware has turned away from the duty of care and focused instead on the duty of loyalty. Today's SEC is using its disclosure-based power to regulate that duty of care—for example, by making officers certify the financial statements of each quarter. The result of this two-tiered system is to augment the presence of the federal system in the corporate governance realm and to decrease the importance of state corporate law to the more limited and sporadic set of acquisition and conflict transactions. Now the question is whether the choice we have made indirectly is a good one and whether we should proceed to regulate corporate governance more directly at the federal level.