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Nicole M. Kim

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MALONE v. BRINCAT: THE FIDUCIARY DISCLOSURE DUTY OF CORPORATE DIRECTORS UNDER DELAWARE LAW

Nicole M. Kim

Abstract: In *Malone v. Brincat*, the Supreme Court of Delaware significantly broadened the fiduciary disclosure duty of corporate directors under Delaware law. *Malone* allows shareholders to bring either a direct or a derivative action against directors for the public release of misleading financial statements reported to the Securities Exchange Commission, regardless of whether the alleged misstatements were made in connection with a request for shareholder action. The court also held that a federal preemption statute, the Securities Litigation Uniform Standards Act of 1998, did not preempt the shareholders' action in Delaware state court. This Note argues that the Supreme Court of Delaware failed to provide precise limits to its new disclosure rule and thereby rendered unclear the elements of the cause of action by which directors may now be accountable for a breach of the disclosure duty. In addition, the court's erroneous grant of a direct cause of action creates problematic overlaps between state and federal causes of action regarding corporate disclosures, particularly in light of the new federal preemption statute. In conclusion, this Note argues that *Malone* ultimately contributes little to the understanding of the fiduciary disclosure duty and unnecessarily disrupts the balance between state and federal regulation of corporate disclosures.

For the past twenty years, Delaware state courts[1] have imposed disclosure duties upon corporate directors based on the directors' fiduciary relationship to the corporation and its shareholders.[2] This fiduciary duty has been characterized as an obligation that is a "derivative of the [directors'] duties of care and loyalty,"[3] and its application significantly affects the way directors disseminate corporate information to shareholders. In *Malone v. Brincat*,[4] the Supreme Court of Delaware held that corporate directors were liable to shareholders for reporting inaccurate financial statements to the Securities Exchange Commission even though no shareholder action required the release of

1. Many corporations incorporate in Delaware because of its numerous "pro-business" statutes and a judiciary that has been known to give favorable treatment to corporations. Therefore, changes in Delaware's corporate law may have a significant impact on a corporation incorporated in Delaware, even if it conducts business elsewhere. For a general discussion of the prominence of the Delaware Court of Chancery, see William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 Bus. Law. 351 (1992).

2. *See* Lawrence A. Hamermesh, *Calling off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 Vand. L. Rev. 1087, 1090 (1996).

3. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 (Del. 1995); *see also* Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993) (citing Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)).

4. 722 A.2d 5 (Del. 1998).

the reports.[5] This decision substantially expanded the fiduciary disclosure doctrine because the majority of Delaware cases had previously applied the duty only when directors solicited shareholder action.[6] The court further held that the plaintiffs could bring either a direct or derivative action against the directors for the misdisclosures and noted that the Securities Litigation Uniform Standards Act[7] preserved the plaintiffs' action in Delaware state court.[8]

This Note argues that the Supreme Court of Delaware insufficiently explained why a substantial extension of corporate directors' liability was appropriate, particularly in view of recent federal changes in securities fraud litigation. As a result, the court's opinion muddled the precise scope of the disclosure duty and failed to clarify the nature of the cause of action by which directors may now be liable for violating their fiduciary duty. The opinion also creates overlapping state and federal causes of action concerning corporate disclosure that can potentially undermine the congressional objective of limiting securities fraud litigation exclusively to federal courts.[9] The new rule announced in *Malone* is cryptic for several reasons. First, the court gave no principled basis for distinguishing *Malone* from existing Delaware authority that limited disclosure obligations to situations in which directors solicited shareholder action. Second, by allowing a direct action when the directors' misconduct did not implicate any shareholder rights, the court altered the traditional circumstances under which directors owe a disclosure duty directly to shareholders, and in the process the court created a state equivalent of a federal securities action. Finally, the opinion rendered unclear the operational effects of the Uniform Act on fiduciary disclosure suits brought in Delaware state courts.

Part I of this Note summarizes pre-*Malone* Delaware case law on director fiduciary disclosure duty. Part II discusses the purpose and scope of the federal Private Securities Litigation Reform Act of 1995[10] (Reform Act) and the Securities Litigation Uniform Standards Act (Uniform Act).

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5. *See id.* at 14.

6. *See infra* Part I.

7. Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections in 15 U.S.C.).

8. *See Malone*, 722 A.2d at 13.

9. *See infra* Part II.

10. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections in 15 U.S.C.).

Part III describes the facts, procedural history, and reasoning of the Supreme Court of Delaware's decision in *Malone*. Part IV argues that the *Malone* court (1) failed to clarify the scope of the newly expanded disclosure duty, (2) erroneously allowed the shareholders to replead their complaint as a direct action, (3) incorrectly interpreted the provision of the Uniform Act that preserved the availability of state courts for certain actions, and (4) created potential conflicts between the application of state and federal laws concerning corporate misrepresentations. Part V concludes that *Malone* convolutes, rather than clarifies, the fiduciary disclosure duty and creates needless tensions between state and federal law regarding corporate disclosures.

I. THE FIDUCIARY DISCLOSURE DUTY OWED BY DIRECTORS TO SHAREHOLDERS

Delaware statutes impose no specific responsibilities on corporate directors to provide shareholders with financial information other than the limited disclosures mandated by the provisions related to shareholder action.[11] However, since the 1980s, Delaware courts have imposed disclosure duties on corporate directors based on the directors' fiduciary relationship to the corporation and its shareholders.[12] A review of the case law reveals a complex and confusing evolution of this judicially created duty of disclosure. Nevertheless, the cases exhibit an overriding theme: liability for a breach of the disclosure duty ordinarily arises when directors, either in response to statutory mandate or the desire to procure shareholder approval of a contested transaction, seek shareholder action and fail in that process to provide all material information that reasonable shareholders would consider significant in exercising their rights in the corporation.[13] Initially, many uncertainties about the disclosure doctrine

11. *See* Del. Code Ann. tit. 8, §§ 222(a) (written notice of meeting), 242(b) (notice of charter amendments), 251(c) (notice of merger), 262(d)(1) (notice of appraisal rights), 271(a) (notice of meeting to approve sale of assets) (1998).

12. *See* Hamermesh, *supra* note 2, at 1090.

13. *See* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1280–81 (Del. 1994); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977); Loudon v. Archer-Daniels-Midland Co., 21 Del. J. Corp. L. 724, 731–33 (Del. Ch. Feb. 20, 1996); Herd v. Major Realty Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,772, at 98,717–18 (Del. Ch. Dec. 21, 1990); Raskin v. Birmingham Steel Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,668, at 98,131–32 (Del. Ch. Dec. 4, 1990).

14. *See infra* note 79.

existed, but one boundary seemed firm—Delaware decisions held consistently that fiduciary liability does not exist when a request for shareholder action is absent.[14]

A. *Justifications Behind Imposing Disclosure Duties When Directors Solicit Shareholder Action*

Delaware state courts have imposed fiduciary disclosure obligations on corporate directors in transactions where directors request or counsel shareholders to vote, sell, or otherwise take action with regard to their shares.[15] For example, courts have imposed the duty when directors solicit shareholder votes for the election of directors[16] or distribute proxy statements regarding stockholders' rights to undo charter amendments after implementation.[17] One of the justifications for requiring disclosure in these contexts is that a request for shareholder action necessarily affects fundamental shareholder rights in stock ownership, such as voting rights.[18] In a recent holding emphasizing this point, the Supreme Court of Delaware held that directors may not deny or interfere with any of the rights incident to ownership of shares, moving beyond voting rights to include such rights as the right to compel dividends or the right to challenge the issuance of stock for a wrongful purpose.[19]

A second justification for imposing disclosure obligations when shareholder rights are affected lies in the nature of the directors' relationship to shareholders.[20] Shareholders often rely on directors' knowledge and advice about the corporation's affairs when directors ask shareholders to take action in regard to shares.[21] Relying on directors for

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15. *See supra* note 14. However, courts have noted that there is no reason to apply the fiduciary duty where the transaction recommended by directors could have been effected without shareholder action. *See In re* USACafes, L.P. Litig., 600 A.2d 43, 54 (Del. Ch. 1991) (dismissing plaintiffs' claims because "[n]either plaintiffs nor any class member could have been injured by the alleged [disclosure] defect as they had neither a right to vote nor a right to dissent and seek appraisal"); *see also* Abajian v. Kennedy, 18 Del. J. Corp. L. 179, 191–92 (Del. Ch. Jan. 17, 1992).

16. *See* Columbia Pictures Indus., Inc. v. Kerkorian, No. 6394, letter op. at 1–2 (Del. Ch. Dec. 16, 1980).

17. *See* Cavalcade Oil Corp. v. Texas Am. Energy Corp., 9 Del. J. Corp. L. 417, 418–19 (Del. Ch. May 22, 1984).

18. *See* Hamermesh, *supra* note 2, at 1143–46.

19. *See* Stroud v. Grace, 606 A.2d 75, 91 (Del. 1992) (citing Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971)).

20. *See* Hamermesh, *supra* note 2, at 1143–44.

21. *See id.* at 1159.

accurate information is natural given the directors' responsibilities to monitor the conduct of the corporation's business for the benefit of shareholders who have invested in the corporation[22] and to make recommendations to shareholders regarding certain transactions.[23] A disclosure duty ensures that directors, as corporate fiduciaries, do not manipulate shareholder action to their own benefit by providing false or misleading information to shareholders.[24]

Apart from these two justifications, directors' disclosure obligations are particularly important because under Delaware law, a fully informed shareholder vote can ratify management misconduct absent fraud.[25] Thus, the fiduciary disclosure duty safeguards shareholders from making uninformed decisions regarding a transaction that can adversely affect shareholders' interests in the corporation.[26] The case law shows that the fiduciary disclosure duty, although now a prominent fixture in Delaware corporate law, evolved from arguably questionable beginnings in an erratic fashion.

B. Judicial Treatment of the Disclosure Duty in the Context of Shareholder Action

Most of the Delaware cases discussing a disclosure duty on the part of directors cite *Smith v. Van Gorkom*[27] as one of the foundations for such a duty.[28] *Van Gorkom* is best known for its finding that corporate directors

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22. *See* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations: Proposed Final Draft* § 3.01 (1992).

23. Transactions include tender offers to acquire corporation stock, mergers, or charter amendments. *See* 17 C.F.R. § 240.14e-2 (1999); *see also* Del. Code Ann. tit. 8, §§ 242(b) (charter amendments), 251(c) (mergers) (1998).

24. *See, e.g.*, *Stroud*, 606 A.2d at 91 (citing Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971)).

25. *See id.* at 82; Bershad v. Curtiss Wright Corp., 535 A.2d 840, 846 (Del. 1987); Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985).

26. *See* Hamermesh, *supra* note 2, at 1160.

27. 488 A.2d 858 (Del. 1985).

28. *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 (Del. 1995); *Stroud*, 606 A.2d at 86–87 (citing *Van Gorkom* for proposition that directors have fiduciary duty to disclose material facts that would have notable effect upon stockholder vote); Weinberger v. Rio Grande Indus., Inc., 519 A.2d 116, 121 (Del. Ch. 1986); Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 279 (Del. Ch. 1986). Many courts have considered *Lynch v. Vickers*, 383 A.2d 278 (Del. 1977), as the genesis of Delaware law concerning disclosure obligations. *See, e.g.*, Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1276 (Del. 1994). However, *Lynch* involved a stock purchase where a majority shareholder failed to disclose material information in a tender offer to the minority

breached their fiduciary duty of care in rapidly approving an arm's length merger.[29] In a less prominent part of its analysis negating shareholder ratification, the court separately identified a fiduciary disclosure duty.[30] It reasoned that because a fully informed shareholder vote would have ratified director action, the shareholders were entitled to receive accurate proxy materials regarding the transaction at issue.[31] The court held that because disclosure had been defective, the shareholders' action in approving the merger did not ratify the directors' misconduct.[32] Although the *Van Gorkom* court did not explicitly adopt a fiduciary disclosure duty, the Supreme Court of Delaware in *Cinerama v. Technicolor*[33] interpreted *Van Gorkom* as a duty-to-disclose case.[34] *Van Gorkom* remained the seminal case regarding directors' disclosure duty in the context of shareholder action until the Supreme Court of Delaware decided *Stroud v. Grace*[35] in 1992.

In *Stroud*, the Supreme Court of Delaware reaffirmed the notion that the fiduciary disclosure duty is necessarily incident to situations where directors seek shareholder action.[36] In that case, the shareholders brought individual and derivative actions against the board of directors challenging the accuracy of the disclosures the board made to shareholders in giving notice of a meeting at which the shareholders were to consider certain amendments to the corporation's charter and bylaws.[37] Although the court found that the

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shareholders. The directors were liable for being complicit in the majority's breach. *See Lynch*, 383 A.2d at 279. Properly understood, *Lynch* represented a rule that required corporate fiduciaries, when purchasing the corporation's stock, to disclose material information to the selling shareholders. The case did not create a fiduciary disclosure duty requiring directors in all contexts to disclose information that might affect the shareholders' decision. *See* Hamermesh, *supra* note 2, at 1117. Therefore, for the purposes of discussing the directors' disclosure duty in the context of shareholder action, *Lynch* is an inappropriate starting point.

29. *See* Hamermesh, *supra* note 2, at 1124 n.153.

30. *See Van Gorkom*, 488 A.2d at 890–91.

31. *See id.* at 890–93.

32. *See id.*

33. 663 A.2d 1156 (Del. 1995).

34. *See id.* at 1166. The *Van Gorkom* court also cited *Lynch* for authority to support its finding of fiduciary liability. *See Van Gorkom*, 488 A.2d at 890. *Lynch*, however, is not on point. *See supra* note 28.

35. 606 A.2d 75 (Del. 1992).

36. Several cases have cited *Stroud* as support for the proposition that directors have a fiduciary disclosure duty when they seek shareholder action. *See* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1277 (Del. 1994); Loudon v. Archer-Daniels-Midland Co., 21 Del. J. Corp. L. 724, 731 (Del. Ch. Feb. 20, 1996); Bragger v. Budacz, No. 13376, 1994 WL 698609, at *5 (Del. Ch. Dec. 7, 1994).

37. *See Stroud*, 606 A.2d at 78. The shareholders alleged that certain by-law and charter amendments served no other purpose than to entrench the majority shareholders in control.

board did not have a duty to disclose information beyond what was required by the statute,[38] it noted that "directors . . . are under a fiduciary duty to disclose . . . all material information within the board's control when it seeks shareholder action."[39] Stating that Delaware imposed a disclosure duty when determining the adequacy of proxy materials,[40] the court explained that otherwise, directors may use their "special knowledge to their own advantage and to the detriment of the stockholders."[41] *Stroud* reinforced the court's interest in using the disclosure duty to protect the integrity of shareholder rights and interests in a corporation.[42] After *Stroud*, the nature of shareholders' claims challenging the directors' breach of the disclosure duty was relatively clear.

C. *Elements of the Cause of Action by Which Directors Are Liable for Misdisclosures*

Delaware law provides shareholders with a direct cause of action for a breach of the fiduciary disclosure duty.[43] Many shareholders' claims alleging

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Furthermore, the shareholders advanced these claims despite the fact that the directors did not solicit any proxies. *See id.* at 80, 84.

38. The court emphasized that the directors' duty to disclose material information "does not exist in a vacuum" and must be considered in conjunction with the disclosure requirements of the Delaware General Corporation Law. *Id.* at 85–88.

39. *Id.* at 84.

40. *See id.* at 86 (citing Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985)).

41. *Id.* at 87 (internal quotation omitted).

42. *See id.* at 85–87; *see also* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1277 (Del. 1994) ("The [disclosure] obligation attaches to proxy statements and any other disclosures in contemplation of stockholder action."). Transactions that fundamentally affect shareholders' interests in a corporation include tender offers to acquire corporation stock, mergers, voting to approve or disapprove charter amendments, and voting in directors' elections. *See* Hamermesh, *supra* note 2, at 1144; *see also, e.g.*, Del. Code Ann. tit. 8, §§ 222(a) (written notice of meeting), 242(b) (notice of charter amendments), 251(c) (notice of merger), 262(d)(1) (notice of appraisal rights), 271(a) (notice of meeting to approve sale of assets) (1998).

43. *See In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 326–33 (Del. 1993); Thorpe v. Cerbco, Inc., 18 Del. J. Corp. L. 1196, 1199 (Del. Ch. Jan. 26, 1993).

44. *See Arnold*, 650 A.2d at 1273 (class action alleging directors breached their fiduciary disclosure duty by failing to disclose material facts of merger in proxy statement); Smith v. Van Gorkom, 488 A.2d 858, 858 (Del. 1985) (class action alleging board of directors' proxy statements in cash-out merger were incomplete in material respects); Williams v. Grier, 13 Del. J. Corp. L. 815, 815 (Del. Ch. May 20, 1987) (class action attacking recapitalization of corporation because of material misdisclosures in proxy statements); Weinberger v. Rio Grande Indus., Inc., 519 A.2d 116, 116–17 (Del. Ch. 1986) (class action alleging directors failed to disclose material information in Schedule 14d-9 recommendation in connection with proxy solicitation).

breach of the disclosure duty have been class actions challenging directors' misstatements in proxy solicitations.[44] Because the directors' request for shareholder action invoked the rights incident to share ownership, directors owe the disclosure duty directly to shareholders, not the corporation.[45] Therefore, shareholders have brought direct actions, instead of derivative actions, against directors who violated shareholder rights.[46]

To bring a direct action, shareholders must allege more than an injury resulting from a wrong done to the corporation; instead, they must allege a wrong involving their contractual rights that existed independently of any right of the corporation.[47] Consequently, most direct shareholder actions have involved suits where corporate actions deprived the shareholders of their individual rights to cast fully informed votes regarding various transactions.[48] By contrast, courts have held that claims alleging dilution of shareholders' stock constituted derivative actions because the claims consisted entirely of injuries to the corporation and its shareholders as a class.[49]

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45. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 662–63 (Del. Ch. 1988) (holding expansion of board of directors ultimately foreclosed effective shareholder voting and constituted violation of duty of loyalty directors owed to shareholders).

46. *See* Jay W. Eisenhofer & Megan D. McIntyre, *Causes of Action Available to Investors Under Delaware Law in the Wake of Federal Securities Reform: Part I*, Insights, Oct. 1996, at 8, 10; *see also Principles of Corporate Governance*, *supra* note 22, § 7.01 (describing actions courts have characterized as direct actions). A breach of the duty owed by the director to the corporation usually leads to corporate derivative actions, brought by the shareholders on behalf of the corporation, against the wrongdoers. *See* Kramer v. Western Pac. Indus., Inc., 546 A.2d 348, 353 (Del. 1988) (citing Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970)). Derivative actions are appropriate when the directors' misconduct affects the corporation as a whole, such as a wrongful act that depletes the corporation's assets. For example, in *Kramer*, the Supreme Court of Delaware held that a complaint alleging directorial mismanagement that resulted in the waste of corporate assets, including the depression of the value of shareholders' stock, constituted a basis for a derivative suit. *See id.* at 353; *see also infra* note 49.

47. *See* Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996).

48. *See Tri-Star*, 634 A.2d at 330 (finding claim of stock dilution and corresponding reduction in shareholders' voting power are grounds to assert direct shareholder action); Lipton v. News Int'l, PLC, 514 A.2d 1075, 1078 (Del. 1986) (stating that shareholders who alleged corporate stock exchange agreement violated their voting rights by securing for corporation management veto power over all shareholder actions set forth direct action rather than derivative action); Thorpe v. Cerbco, Inc., 18 Del. J. Corp. L. 1196, 1200 (Del. Ch. Jan. 26, 1993) (holding breach of fiduciary claims based on inadequate proxy disclosure are direct rather than derivative actions); Margolies v. Pope & Talbot, 12 Del. J. Corp. L. 1092, 1103 (Del. Ch. Dec. 23, 1986) (holding plaintiff-shareholders' claim relating to diminution of voting rights asserts direct action); Seibert v. Harper & Row, Publishers, Inc., 10 Del. J. Corp. L. 645, 656 (Del. Ch. Dec. 5, 1984) (holding plaintiff's claim alleging proxy violation due to inadequate disclosures is direct action).

49. *See* Elster v. American Airlines, Inc., 100 A.2d 219, 222 (Del. Ch. 1953); *see also Grimes*, 673 A.2d at 1213; Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970); *In re* Rexene Corp.

To remedy directors' violation of the disclosure duty, most shareholder suits have pursued injunctive relief, rescission of the transaction at issue, or rescissory damages instead of monetary damages. Examples of injunctions requested by shareholders include enjoining issuance of a class of stock[50] and overturning the re-election of directors.[51] Moreover, the Supreme Court of Delaware has noted that shareholders injured by a breach of the disclosure duty can enjoin a contested transaction where money damages cannot be adequately assessed against directors because provisions in the certificate of incorporation shield directors from liability.[52]

Unlike requests for injunctive relief, courts have been reluctant to grant monetary damages even though Delaware has a virtual per se rule of damages for violations of the disclosure duty.[53] Few Delaware cases have permitted monetary redress. *Van Gorkom* authorized a post-hoc monetary damages remedy for the shareholders, but the remedy arose out of the directors' breach of their duty of care, not their disclosure duty.[54] In *Zirn v.*

Shareholders Litig., 17 Del. J. Corp. L. 342, 348 (Del. Ch. May 8, 1991). Derivative suits have also included shareholder claims seeking to enjoin a corporation from honoring the exercise of option rights to purchase shares of common stock, *see Elster*, 100 A.2d at 222, and claims to cancel the issuance of stock in violation of the legal requirements as to its consideration. *See* Bennet v. Breuil Petroleum Corp., 99 A.2d 236, 241 (Del. Ch. 1953). In derivative suits, any damage recovery returns to the corporation on whose behalf the suit is filed; however, a shareholder in a derivative suit may recover attorneys' fees if the shareholder's efforts benefited the corporation as a whole or benefited shareholders as a class. *See, e.g.*, *In re* Beatrice Co., Litig., 12 Del. J. Corp. L. 199, 212 (Del. Ch. Apr. 16, 1986).

50. *See* Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 271 (Del. Ch. 1986).

51. *See* Loudon v. Archer-Daniels-Midland Co., 21 Del. J. Corp. L. 724, 727 (Del. Ch. Feb. 20, 1996). However, the court in *Loudon* dismissed the shareholder's complaint because the shareholder failed to identify specific material facts that were wrongfully omitted in the proxy statement.

52. *See* Arnold v. Society for Sav. Bancorp, Inc., 678 A.2d 533, 542 (Del. 1996).

53. Shareholders may obtain monetary awards without having to show actual loss from the misrepresentations. *See Tri-Star*, 634 A.2d at 333; *see also* Zirn v. VLI Corp., 681 A.2d 1050, 1060–61 (Del. 1996). However, monetary damages may be excluded in the corporation's certificate of incorporation if the misstatement or omission was a good faith error. *See* Del. Code Ann. tit. 8, § 102(b)(7) (1998); *see also Arnold*, 650 A.2d at 1286–88. Some commentators have suggested that the application of a per se damages rule should not extend to representations made by disinterested directors and should apply only to transactions involving a director's self-dealing transaction. *See, e.g.*, Hamermesh, *supra* note 2, at 1171–72 (arguing that because basis for fiduciary liability is analogous to basis for liability in tort of negligent misrepresentation, notion that proof of pecuniary loss is not required in claim of breach of fiduciary duty by disinterested directors is "out of step with fundamental fiduciary principles").

54. *See* Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985). The court found that the directors breached their fiduciary duty to the shareholders by being grossly negligent in approving

VLI Corp.,[55] the Supreme Court of Delaware determined that the shareholders had provided sufficient proof of their damages claim and remanded the damages issue for further proceedings.[56] On remand, however, the Delaware Court of Chancery found no breaches of fiduciary duty and thus no viability to the shareholders' claims.[57] Despite the judicial aversion toward awarding monetary relief, there have been instances where courts have granted such damages. For example, in *Weinberger v. UOP, Inc.*,[58] the court on remand awarded the shareholders one dollar per share.[59] Evidence existed that if the shareholders had received complete disclosure and subsequently rejected the proposed cash-out merger, the majority shareholder would have acquired the other shareholders' shares at twenty-two rather than twenty-one dollars per share.[60] However, the court noted that while a rescission of the merger may have been a more appropriate remedy, monetary relief was proper in this instance because the complicated nature of the merger made it "logically impractical" to rescind the transaction.[61]

D. *Testing the Bounds of the Fiduciary Disclosure Duty: The Court of Chancery Cases*

Although the nature of the fiduciary disclosure duty and the remedies available for violations of that duty seemed well settled in Delaware courts after *Stroud*,[62] the court of chancery slowly began to extend the

amendments to the merger proposal and failing to disclose all material information before securing the shareholders' approval of the merger. *See id.*

55. 621 A.2d 773 (Del. 1993).

56. *See id.* at 783.

57. *See* Zirn v. VLI Corp., 20 Del. J. Corp. L. 1155, 1174–75 (Del. Ch. June 12, 1995).

58. 10 Del. J. Corp. L. 945 (Del. Ch. Jan. 30, 1985), *aff'd*, 497 A.2d 792 (Del. 1985). Although *UOP* addressed the disclosure duty, it discussed the duty as it pertained to a majority shareholder, not a director.

59. *See id.* at 960.

60. *See id.* at 950.

61. *Id.*

62. Several court of chancery opinions affirmed that fiduciary liability for misrepresentations existed only when shareholder action was required or sought. *See* Raskin v. Birmingham Steel Corp., Fed. Sec. L. Rep. (CHH) ¶ 95,668, at 98,131–32 (Del. Ch. Dec. 4, 1990) (rejecting claim that directors breached fiduciary disclosure duty by failing to notify shareholders about deterioration of pending merger negotiation because company did not seek vote of shareholders); *see also* Herd v. Major Realty Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,772, at 98,718 n.2 (Del. Ch. Dec. 21, 1990) (dismissing claims alleging false press releases and Form 10K because "the duty of candor requires

application of the disclosure duty to situations where directors did not solicit shareholder action. In *Weinberger v. Rio Grande Industries, Inc.*,[63] the court of chancery found that the directors' omission of information in a Schedule 14d-9,[64] filed pursuant to Rule 14d-9 of the federal securities laws and submitted to shareholders in connection with a tender offer, may have violated the directors' fiduciary duty to disclose all material facts in a transaction involving shareholder action.[65] However, the court presented no authority or justification to support its finding that directors may be liable even though they did not request shareholder action but merely provided information to shareholders as required by federal law.[66] Furthermore, although the shareholders could have pursued a federal remedy under § 14 of the Securities Exchange Act of 1934 for false disclosures in proxy solicitations,[67] the court did not address this alternative recovery route.

In 1991, the court of chancery expressed concern over the idea that directors could be less than fully honest with stockholders about the condition of the company just because the directors did not request shareholder action.[68] One year later, in *Marhart, Inc. v. Calmat Co.*,[69] the court of chancery had the opportunity not only to speak directly to the issue, but also to forge a fiduciary disclosure duty beyond the traditional application in the context of shareholder action.

disclosure of all material facts only in connection with a transaction on which shareholders are asked to vote") (citing Lynch v. Vickers, 383 A.2d 278, 279 (Del. 1977)).

63. 519 A.2d 116 (Del. Ch. 1986).

64. A company must file a Schedule 14d-9 with the Securities Exchange Commission when an interested party such as an issuer, a beneficial owner of securities, or a representative of either, makes a solicitation or recommendation to the shareholders with respect to a tender offer that is subject to Regulation 14D. *See* 15 U.S.C. § 78n(d)(1) (1994).

65. *See Rio Grande*, 519 A.2d. at 121. The court mentioned *Van Gorkom* to support the proposition that under Delaware law, corporate directors have fiduciary disclosure obligations when they seek shareholder action. *See id.*

66. *See* Hamermesh, *supra* note 2, at 1128.

67. *See Rio Grande*, 519 A.2d at 120. Because the shareholders tendered their shares in response to the directors' Schedule 14d-9 recommendation, they were able to bring action under § 14.

68. *See In re* Rexene Corp., 17 Del. J. Corp. L. 342, 351 n.1 (Del. Ch. May 8, 1991). The *Rexene* court ultimately did not reach the issue of whether fiduciary liability lay with the directors in the absence of any request for shareholder action because it found that the alleged nondisclosures were not material. *See id.* at 351.

69. 18 Del. J. Corp. L. 330 (Del. Ch. Apr. 22, 1992).

1. The Expansion of the Fiduciary Disclosure Duty

Marhart significantly departed from Delaware precedent and set in motion a series of judicial decisions that struggled to determine the precise scope of directors' disclosure obligations. In *Marhart,* Vice Chancellor Berger held that directors could be liable for a breach of the fiduciary duty of disclosure even though the misrepresentation was not connected with any request for shareholder action.[70] *Marhart* involved a press release issued by the directors, in response to a possible takeover, that outlined a restructuring plan designed to provide shareholders with a better cash benefit than that offered by the hostile acquiror.[71] The corporation later publicly announced a modification of the plan that provided shareholders with half of what they would have received under the original plan.[72] An institutional shareholder brought a class action alleging that the directors breached their fiduciary duty by distributing the false press release to inflate artificially the value of the corporation's shares.[73] The court found that the announcement encouraged shareholders to retain the corporation's stock[74] and held that once the directors voluntarily disclosed information to shareholders, they had to do so fully and accurately or else they were liable for breach of the fiduciary duty of disclosure.[75] The court also noted that if the shareholders could prove they suffered damages because of the misdisclosures, they would be entitled to relief.[76] As support for its holding, the *Marhart* court referred to a repealed Delaware statute to infer that corporate directors have a common law disclosure duty when they voluntarily release information to shareholders but do not seek shareholder action.[77] However, the statute's history suggests that it was merely an antifraud statute that allowed corporate creditors and investors to sue corporate directors for

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70. *See id.* at 336.

71. *See id.* at 333.

72. *See id.* at 335. After the announcement, the price of the corporation's stock dropped from $40 to $30. *See id.*

73. *See id.* at 333. Plaintiffs claimed that the restructuring plan was actually designed to allow the tender offeror to dispose of the corporation's stock at a premium rather than to maximize the corporation's stockholder value as reported in the press release. *See id.* at 334.

74. *See id.* at 334.

75. *See id.* at 336.

76. *See id.*

77. *See id.* at 335–36 (citing 21 Del. Laws 273, § 21 (1899), codified at Del. Code Ann. tit. 8, § 144 (1953) (repealed 1967)).

fraudulent written statements regardless of whether a pre-existing fiduciary relationship existed with the directors.[78]

2. *The Retreat from* Marhart

Despite *Marhart*'s expansive interpretation of the disclosure duty, subsequent Delaware decisions declined to follow *Marhart* in imposing fiduciary liability when directors did not seek shareholder action.[79] In *Unimarts, Inc. v. Stein*,[80] the court explained the problematic issues involved in finding fiduciary liability for misrepresentations not connected with a call for shareholder action.[81] The court concluded that this principle would "open state courts under the fiduciary duty rubric to the regulation of all market transactions . . . whenever a shareholder traded after a public announcement" by a corporate fiduciary.[82] Such a "radical result," the court held, would signal judicial disrespect for the evolved roles of state corporate law and federal securities regulation.[83] By refusing to follow *Marhart*'s lead, the *Unimarts* court prevented overlap between state and federal causes of action regarding corporate misdisclosures. The limited application of the disclosure duty stemmed from the understanding of the different roles played by state law, which governs issues of internal corporate governance that typically arise when shareholder action is implicated, and federal securities laws, which focus on the effect of the disclosure on the national securities markets.[84] Two of these federal laws brought significant substantive and procedural changes to state regulation of securities.

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78. *See* Hamermesh, *supra* note 2, at 1104–06.

79. *See* Unimarts, Inc. v. Stein, CIV. A. Nos. 14713, 14893, 1996 WL 466961, at *6 (Del. Ch. Aug. 12, 1996) (holding fiduciary liability for misdisclosure requires material misstatement be made in connection with request for shareholder action); Bragger v. Budacz, No. 13376, 1994 WL 698609, at *5 (Del. Ch. Dec. 7, 1994) (dismissing claim that statement was misleading because, among other things, no shareholder action was sought).

80. Nos. 14713, 14893, 1996 WL 466961 (Del. Ch. Aug. 12, 1996).

81. *See id.* at *6–7.

82. *See id.* at *7. A sale by a shareholder following a corporate misrepresentation constitutes a Rule 10b-5 action under federal securities laws. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 228 (1988).

83. *Unimarts*, 1996 WL 466961, at *7.

84. *See id.*

II. CONGRESSIONAL FORAYS INTO SECURITIES LITIGATION REFORM

The federal Private Securities Litigation Reform Act[85] (Reform Act) and the federal Securities Litigation Uniform Standards Act[86] (Uniform Act) are noteworthy in the context of the fiduciary disclosure duty because both Acts are primarily designed to create a uniform national approach to securities litigation.[87] The Acts also seek to rectify commonly perceived problems considered endemic to an entire genre of litigation—securities fraud class actions, which often turn on allegations of misrepresentations of financial data.[88]

A. *The Reform Act*

The Reform Act was the culmination of an almost five-year effort by various accounting firms and small, high-tech corporations to curb private securities litigation.[89] Designed to redress the perceived increase in frivolous private securities actions,[90] the Reform Act crafted substantial procedural hurdles to make it more difficult to bring and maintain a class action in federal court under the Securities Act of 1933

85. Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections in 15 U.S.C.).

86. Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections in 15 U.S.C.).

87. *See* S. Rep. No. 105-182, at 3 (1998).

88. *See* Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 Ariz. L. Rev. 1003, 1023 (1998).

89. *See* Martha L. Cochran, *An Introduction to the Special Securities Litigation Reform Act Issue*, Insights, Jan. 1996, at 2, 2. According to the Reform Act's legislative history, Congress concluded that abusive practices in securities litigation existed in four areas: (1) the frequent filing of lawsuits against issuers of securities whenever there was a dramatic change in the issuer's stock price without consideration of the issuer's culpability, (2) the targeting of defendants with deep pockets without regard to their culpability, (3) the flagrant abuse of the discovery process designed to impose burdensome costs on defendants to coerce them to settle, and (4) the class action lawyers' manipulation of their clients. *See id.* at 3.

90. *See* H.R. Conf. Rep. No. 104-369, at 32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 ("This legislation implements needed procedural protections to discourage frivolous litigation."). Arguments that it was too easy to file securities litigation suggest that Congress also believed there was too much nonmeritorious litigation. *See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 103d Cong. 46, 47, 49, 285 (1993) (statements of Dr. Vincent O'Brien, Law and Economic Consulting Group, and Rep. Tauzin).

and the Securities Exchange Act of 1934.[91] The Reform Act also instituted heightened pleading standards, which require that a plaintiff's complaint must state with particularity all the facts on which a belief of securities fraud is based.[92] In addition, a plaintiff must state the facts that give rise to a strong inference that the defendant acted with the requisite state of mind.[93] These procedural provisions have made it more difficult for plaintiffs to bring suit under section 10(b) of the Exchange Act,[94] the primary vehicle by which investors can recover their losses due to directors' false or misleading disclosures.[95]

The passage of the Reform Act purportedly prompted a shift of much securities fraud litigation to state courts, mainly as strategic attempts to evade some of the procedural hurdles now required by federal courts.[96] Two phenomena seemed to explain this shift. First, plaintiffs filed complaints in state court when the underlying facts of their suits did not meet the stringent federal pleading requirements.[97] Second, plaintiffs resorted to state court litigation to avoid federal discovery stays or to create state forums for the settlement of other federal claims.[98] This migration to state forums arguably threatened to undermine one of

91. The Reform Act requires mandatory discovery stays while a motion to dismiss the action is pending. *See* 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B) (Supp. III 1997); *infra* note 96 and accompanying text. The Reform Act also includes an exception to the discovery limitations that allows "particularized discovery" if it is "necessary to preserve evidence or to prevent undue prejudice to [the moving] party." 15 U.S.C. §§ 77z-1(b), 78u-4(b)(3)(B). Moreover, the Reform Act provides a safe harbor for forward-looking statements. *See* 15 U.S.C. §§ 77z-2(c)(1)(A)(i), 78u-5(c)(1)(A)(i) (Supp. III 1997). Under the safe harbor provisions, forward-looking statements are protected if they are accompanied by cautionary statements that specify certain conditions that can cause results different from than those presented in the forward-looking statement. *See* 15 U.S.C. §§ 77z-2(c)(1)(B)(i), 78u-5(c)(1)(B)(i) (Supp. III 1997). However, the statement is not protected if it can be shown that the statement was made with actual knowledge that it was false or misleading. *See* 15 U.S.C. §§ 77z-2(c)(1)(B)(i), 78u-5(c)(1)(B)(i).

92. *See* 15 U.S.C. § 78u-4(b)(1) (Supp. III 1997).

93. *See* 15 U.S.C. § 78u-4(b)(1).

94. 15 U.S.C. § 78j(b) (1994).

95. *See* Arnold S. Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 Cornell L. Rev. 27, 28–29 (1973).

96. *See* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 Stan. L. Rev. 273, 307 (1998).

97. *See* S. Rep. No. 105-182, at 3 (1998).

98. *See id.*

Congress' major policy choices in adopting the Reform Act: the reduction of frivolous securities fraud claims.[99]

B. The Uniform Act

To ensure that securities fraud litigation would conform to federal standards established by the Reform Act, Congress passed the Uniform Standards Act in 1998.[100] The Uniform Act preempts state securities class actions by requiring most of them to be brought solely in federal court.[101] However, the statute preempts only class actions involving fifty or more plaintiffs[102] and these actions must involve purchases or sales of securities.[103] The statute does not preempt shareholder derivative actions,[104] and it preserves state securities class actions if the action involves any communication made with respect to the sale of securities that "concerns decisions of those equity holders with respect to voting their securities, acting in response to tender . . . offer[s], or exercising dissenters' or appraisal rights."[105] Proponents of the uniform standards legislation have acknowledged that the statute does not preempt actions arising under state corporate law.[106] Therefore, claims alleging violation of Delaware's fiduciary disclosure duty may remain viable state claims.[107]

The Uniform Act and the Reform Act established significant barriers for shareholders who wish to bring securities actions based on misdisclosures in state court. However, the Supreme Court of Delaware's opinion in *Malone v. Brincat*[108] left uncertain the precise nature and

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99. *See* Walker & Seymour, *supra* note 88, at 1022.

100. Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.).

101. *See* 15 U.S.C.A. § 77p(b) (West Supp. 1999).

102. *See* 15 U.S.C.A. § 77p(f)(2) (West Supp. 1999).

103. The Uniform Act preempts only class actions that allege (1) "an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security"; or (2) "that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C.A. § 77p(b).

104. *See* 15 U.S.C.A. § 77p(f)(2)(B).

105. 15 U.S.C.A. § 77p(d)(1)(B)(ii)(II) (West Supp. 1999).

106. *See Securities Litigation Act: Hearing on S. 1260 Before the Subcomm. on Fin. and Hazardous Materials of the House Comm. on Commerce, H.R.*, 105th Cong. 84–85 (1998) (testimony of John F. Olson, of Gibson, Dunn and Crutcher).

107. *See* Walker & Seymour, *supra* note 88, at 1037.

108. 722 A.2d 5 (Del. 1998).

applicability of the fiduciary disclosure duty in the face of these federal restrictions.

III. *MALONE V. BRINCAT*

A. *Facts*

Mercury Finance Company is a publicly traded Delaware corporation engaged in purchasing installment sales contracts from automobile dealers and providing short-term installment loans to automobile purchasers with credit problems.[109] In 1997, while auditing Mercury's 1996 year-end financial statements, the company's accountants discovered substantial overstatements of Mercury's earnings, its financial performance, and its shareholders' equity.[110] As a result, Mercury Finance announced to its shareholders a substantial reduction in its unaudited earnings for 1996 as well as its audited annual earnings for 1993–95.[111] Following the company's announcements of restated earnings for 1993–96,[112] the company's share price declined dramatically, with a two-billion-dollar drop in the total value of shares.[113] The directors' announcement triggered more than fifty lawsuits in four jurisdictions, most of which were federal securities fraud actions and derivative actions brought on Mercury's behalf.[114] In *Malone*, a group of Mercury shareholders brought a state corporate law action alleging that the directors breached their fiduciary disclosure duty by making false disclosures to Mercury shareholders since 1994.[115] In apparently the only

109. *See id.* at 8.

110. *See id.*

111. *See* Malone v. Brincat, No. 15510, 1997 WL 697940, at *1 (Del. Ch. Oct. 30, 1997), *rev'd in part*, *Malone*, 722 A.2d 5.

112. Pursuant to the investigation, Mercury directors announced to the shareholders that the unaudited earnings for 1996 were only $56.7 million as opposed to the publicly reported $120.7 million: 1995 earnings were only $76.9 million rather than the reported $98.9 million; earnings for 1994 were $83 million rather than the reported $86.5 million; and in 1993, Mercury's earnings were only $64.2 million in contrast to the reported $64.9 million. At the end of 1996, Mercury's directors had announced that the shareholders' equity was $353 million when it was actually only $263 million or less. *See Malone*, 722 A.2d at 8.

113. *See id.*

114. *See Malone*, 1997 WL 697940, at *1.

115. The plaintiffs also brought an aiding-and-abetting claim against Mercury's accountants, KPMG Peat Marwick, LLP, for knowingly participating in the directors' breaches of their fiduciary disclosure duties. *See id.* The court of chancery summarily dismissed the aiding-and-abetting claim because of the plaintiffs' failure to show the directors' breach of their fiduciary disclosure duties. *See*

action of its kind, the plaintiffs in *Malone* brought suit in Delaware state court individually and on behalf of all persons who owned Mercury common stock from 1993 through 1997, alleging that Mercury directors had breached the fiduciary duty of disclosure.[116] The plaintiffs did not assert any claims for remedy.[117]

B. *Procedural History*

The court of chancery held that the directors had no fiduciary disclosure duty in the absence of a request for shareholder action.[118] The chancellor characterized the corporation's restatement of its earnings as an attempt to comply with federal disclosure laws, independent from the "shareholder decisional process affecting corporate governance" of the type normally governed by state corporate law.[119] Timely and accurate disclosures of financial information into the marketplace, the court noted, are governed by federal law, and if shareholders are injured as a result of the release of false information "unconnected with any Delaware corporate governance issue, that shareholder must seek a remedy under federal law."[120] The court held that to recognize a fiduciary disclosure duty in this context would be to "duplicate[] or impliedly usurp[]" federal remedies under the securities laws.[121]

On appeal, the Supreme Court of Delaware affirmed in part and reversed in part. It held that corporate fiduciaries may be liable for making corporate misrepresentations even in the absence of a call for shareholder action.[122] Although the court upheld the court of chancery's dismissal of the case, it further held that the dismissal should have been

id. at *3. Furthermore, the Supreme Court of Delaware upheld the lower court's dismissal based on the plaintiffs' absence of a well-pleaded allegation stating a derivative, class, or individual cause of action and properly assertable remedy. *See Malone*, 722 A.2d at 14–15. Because the focus of this Note is on the corporate directors, a determination of the validity of the dismissal of plaintiffs' allegation against the accountants will not be discussed.

116. *See Malone*, 1997 WL 697940, at *1.

117. *See Malone*, 722 A.2d at 14.

118. *See Malone*, 1997 WL 697940, at *2–3.

119. *Id.* at *2.

120. *Id.*

121. *Id.*

122. *See Malone*, 722 A.2d at 10.

without prejudice.[123] The court permitted the shareholders to amend their complaint into either a direct or derivative action and allowed them to assert any damages or equitable remedies for their claim.[124]

C. Analysis by the Supreme Court of Delaware

In a surprisingly short en banc decision, the Supreme Court of Delaware held that false disclosures of financial information by corporate directors may constitute the basis for a direct or derivative cause of action under Delaware law, even if the alleged misrepresentations were not made in connection with a request for shareholder action.[125] The court concluded that when directors disseminate information to shareholders in this context, the fiduciary duties of care, loyalty, and good faith still apply; therefore, false or misleading disclosures can violate one or more of those duties.[126] Although it agreed that the complaint as drafted should have been dismissed, the court allowed plaintiffs the option to replead and assert either a direct or a derivative action against the directors.[127]

Recognizing that federal disclosure regulations are the principal mechanisms for policing the disclosure of information into the general interstate market, the court acknowledged that there is "no legitimate basis to create a new [state] cause of action which would replicate . . . the provisions of . . . the 1934 Act."[128] Nevertheless, the court observed that because the shareholders did not sell or purchase securities on the market, their claim did not implicate federal securities laws.[129] The court found that the Uniform Act did not preempt the shareholders' case because they brought their suit before Congress enacted the Act. The court noted, however, that even if the action had been brought after enactment and the statute was applicable, the statute could not preempt the shareholders' claim because the claim fell under one of the statute's exemptions from preemption.[130]

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123. *See id.* at 15.

124. *See id.* at 14–15.

125. *See id.* at 10.

126. *See id.* at 12.

127. *See id.* at 14.

128. *Id.* at 13 (quoting Arnold v. Society for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996)).

129. *See id.*

130. *See id.* ("[Delaware] law already provide[d] that corporate directors have fiduciary disclosure obligations to shareholders."); *see also* 15 U.S.C.A. § 77p(d)(1)(B)(ii)(II) (West Supp. 1999).

IV. *MALONE V. BRINCAT* RENDERS THE FIDUCIARY DISCLOSURE DUTY UNCLEAR

In *Malone v. Brincat*, the Supreme Court of Delaware significantly expanded the fiduciary disclosure duty of corporate directors under Delaware law without providing sufficient guidance as to the scope of the duty's application. In the progression of Delaware cases setting forth the duties of corporate directors under state law, *Malone* is confusing because it fails to define clearly the nature of the cause of action by which directors may now be liable for violating the fiduciary disclosure duty. Moreover, the court's grant of a direct action was inappropriate because the proper vehicle for litigation in this case should have been a derivative action. By allowing a direct action in the absence of shareholder action, the court also blurred the boundaries between state and federal actions concerning corporate disclosure. The potential application of Delaware's fiduciary laws in a securities fraud context where federal laws were designed to operate may undermine the congressional objective of limiting litigation of securities fraud class actions to federal courts. *Malone* may then lead to extensive forum abuse by defrauded shareholders who will want to bring their suits in Delaware state court to avoid the rigid procedural requirements of federal courts.[131] Given these results, *Malone* convolutes, rather than clarifies, corporate directors' fiduciary disclosure obligations under Delaware law.

A. The Court Failed to Define Adequately the New Disclosure Duty

In *Malone*, the Supreme Court of Delaware failed to articulate, beyond vague incantations of fiduciary duties, what principles supported the expansion of the disclosure duty. The court neither sufficiently explained the reasons behind its expansion nor provided the principal basis for distinguishing *Malone* from previous authorities regarding the application of the disclosure duty. The *Malone* court mentioned that the fiduciary duties of "care, loyalty and good faith" apply when directors disseminate information to shareholders;[132] however, it did not specify whether one or all of these fiduciary obligations apply in such a situation. Having asserted only general fiduciary rhetoric, the opinion created a disclosure duty without a clear articulation of principle.

131. *See infra* Part IV.E.

132. *Malone*, 722 A.2d at 12.

Under settled Delaware law, fiduciary principles operate when directors' misconduct accompanies a solicitation of shareholder action that impacts shareholder rights and responsibilities within a corporation. Therefore, fiduciary principles apply when corporate misstatements affect internal corporate governance issues.[133] For example, *Stroud* and *Lynch v. Vickers*[134] involved situations where the fiduciary disclosure duties arose out of directorial conduct that implicated shareholder action.[135] In *Malone*, the Supreme Court of Delaware cited to cases such as *Lynch* and *Stroud* to support its expansion of the disclosure duty, yet these cases are factually distinguishable from *Malone.* The directors in *Malone* did not release Mercury's financial statements in conjunction with a request for shareholder action.[136] In fact, the dissemination of those statements suggests only that Mercury attempted to comply with various federal securities regulations that mandate periodic reporting requirements from certain corporations. When directors release information to the public, independent of a call for shareholder action, past Delaware cases suggest that no fiduciary relation is involved; therefore, no fiduciary duties are implicated.[137] Despite the factual dissimilarities between *Malone* and the other disclosure duty cases, the court neither acknowledged nor attempted to resolve these incongruities.

In addition, the court's reference to *Marhart* as legal support and justification for the expansion of the fiduciary disclosure duty is suspect in light of *Marhart*'s reliance on a repealed statute that now plays no part in the fiduciary context.[138] A director's liability under the law relied on in *Marhart* did not depend specifically on the existence of a fiduciary relation between the injured creditor or investor and the director. Therefore, the Supreme Court of Delaware's reliance on *Marhart* to expand the disclosure duty was inappropriate.

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133. *See supra* Part I.

134. 383 A.2d 278 (Del. 1977).

135. In *Lynch*, the Supreme Court of Delaware held that the majority shareholders, when purchasing stock from minority shareholders, had a fiduciary duty to disclose all information regarding the stock purchase. *See id.* at 281. The court also found the directors liable for being complicit in the majority shareholders' breach of the disclosure duty. *See id.* at 279, 281. Similarly, *Stroud* involved the disclosure duty in the context of the shareholders' vote of certain by-law and charter amendments. *See* Stroud v. Grace, 606 A.2d 75, 75 (Del. 1992).

136. *See Malone*, 722 A.2d at 9.

137. *See supra* note 79.

138. *See supra* notes 77–78 and accompanying text.

The *Malone* court missed the opportunity to explain its finding of fiduciary liability when it declined without explanation to follow the lower court decisions that explicitly refused to find fiduciary liability for misrepresentations made in the absence of shareholder action.[139] When the court decided *Malone*, it had before it the chancery decision in *Unimarts*, which held that if the contested transaction did not require shareholder approval or action, Delaware law simply had no application to the alleged misstatements.[140] The court in *Unimarts* recognized that an expansion of state fiduciary laws could potentially intrude upon the effectiveness of federal protections available to investors in the purchase or sale of securities.[141] *Unimarts* raised a legitimate concern because an imposition of fiduciary liability in the absence of shareholder action burdens state courts with the responsibility of regulating all market transactions that involve shareholder trading based on corporate communications.[142] The application of fiduciary laws in the absence of shareholder action also disturbs the balance between state law, which governs internal corporate affairs, and federal law, which regulates transactions on the securities markets.[143] Despite this concern, the *Malone* court avoided discussing the issue altogether. The court's failure to explain why it rejected previous lower court decisions rendered unclear the scope of the new fiduciary disclosure duty.

B. *The Court Erroneously Permitted a Direct Action*

By allowing shareholders to bring a direct action, the court confused the proper cause of action required to challenge directors' breaches of the disclosure duty. Because the misdisclosures in *Malone* were not connected with an exercise of any shareholder rights, there was no breach of a duty owed directly to the shareholders and therefore no

139. *See supra* note 79.

140. *See* Unimarts v. Stein, Nos. 14713, 14893, 1996 WL 466961, at *6 (Del. Ch. Aug. 12, 1996).

141. *See supra* note 81.

142. *See Unimarts*, 1996 WL 466961, at *7.

143. Federal securities laws require accurate disclosure regarding a corporation's business so that investors have the information necessary to make informed decisions about their investments on the market. *See* Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 Harv. L. Rev. 1146, 1148 (1965).

justification for a direct action. In Delaware, most direct shareholder actions have involved suits where directorial misconduct affected some kind of shareholder right, such as the right to vote in a transaction.[144] Much of the discussion regarding the fiduciary duties that directors owe directly to shareholders has been based on the shareholders' franchise rationale[145] or even ordinary tort concepts.[146] The fiduciary duty raised in *Malone* did not arise out of either of these circumstances. On the contrary, the directors' misstatements in *Malone* were not associated with a transaction that implicated any shareholder rights. Instead, the release of the company's financial records was an attempt to comply with the annual reporting requirements of the federal securities laws.[147] In sum, a direct action in *Malone* was improper because the directors did not owe a disclosure duty directly to the shareholders when releasing information in accordance with federal regulations.

Furthermore, a direct action was inappropriate given that *Malone* involved a situation traditionally redressed by shareholder derivative actions. Mercury's false financial reports resulted in a decrease in the value of the corporation's stock, a corporate injury that Delaware courts have identified as a proper basis for a derivative action.[148] In *Malone*, a direct action could not have remedied the shareholders' claim because the shareholders were able to show only an overall corporate injury, making calculation of individual shareholder damages speculative at best. Although Delaware courts have previously granted monetary relief in suits alleging directors' breach of the disclosure duty,[149] shareholders in those cases provided sufficient proof of individual damages to support their damages claim.[150] Given the propriety of a derivative suit, the court should not have granted a direct action.

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144. *See supra* note 48 and accompanying text.

145. According to this rationale, shareholder action necessarily affects fundamental shareholder rights in stock ownership; therefore, corporate directors have fiduciary obligations when directorial conduct affects any rights incident to share ownership. *See supra* Part I.A.

146. Directors are directly liable to shareholders for their tortious misconduct. *See* Gaffin v. Teledyne, Inc., 611 A.2d 467, 472 (Del. 1992) (discussing equitable fraud as basis of liability for material omissions in corporation's offer to purchase its own outstanding shares).

147. *See* Malone v. Brincat, 722 A.2d 5, 8 (Del. 1998); 15 U.S.C. § 78m(a) (1994).

148. *See supra* note 49.

149. *See supra* Part I.C.

150. *See supra* notes 56, 60, and accompanying text.

C. Malone *Obscured the Elements of the Cause of Action by Which Directors May Be Liable for Violating the Disclosure Duty*

Assuming that a disclosure duty exists even in the absence of shareholder action, the Supreme Court of Delaware did not clearly indicate to whom the duty is owed, what standard of culpability applies, or what measure of relief is available to those injured by corporate directors' misrepresentations. Although the court initially noted that the directors owed the disclosure duty to the shareholders,[151] it later stated that the particular plaintiffs in *Malone* were not purchasers or sellers of securities, but merely holders of stock.[152] Therefore, it is unclear whether the cause of action is available only to those shareholders who did not trade, or whether buyers and sellers of securities who relied on the misrepresentations are also entitled to bring this cause of action. Furthermore, the opinion did not establish what standard of culpability is required in an action alleging a breach of the disclosure duty. The court did state that a violation of the fiduciary duty existed when directors "deliberately misinform[ed]" shareholders with false or misleading financial information.[153] However, it is unclear whether simple negligence meets the culpability requirement. Finally, the court failed to address what kinds of relief are available for plaintiffs who prevail in this type of action. The court merely allowed the shareholders to replead and assert any damages claim.[154] Without a clear articulation of the elements of the cause of action that shareholders can bring against directors for corporate misdisclosures, the nature and applicability of the new disclosure duty remains uncertain, particularly in the face of federal securities laws.

D. Malone *Inappropriately Creates a State Equivalent of a Federal Securities Claim*

Malone interferes with the purpose of a dual system of securities regulation by leaving open the possibility that Delaware's fiduciary laws may apply in situations already governed by federal securities laws. Comprehensive federal regulation of securities works to ensure full and

151. *See Malone*, 722 A.2d at 10 ("The directors' fiduciary duties include the duty to deal with their stockholders honestly.").

152. *See id.* at 13.

153. *Id.* at 14.

154. *See id.*

accurate disclosures regarding a corporation's business so that investors may have the information necessary to make informed investment decisions.[155] By contrast, Delaware fiduciary laws govern the relationship and rights of directors and shareholders within a corporation.[156] If certain disclosures are made independent of a request for shareholders to exercise their rights, no fiduciary issues arise and Delaware's fiduciary laws should not apply. Although the Supreme Court of Delaware noted that Mercury's shareholders could not invoke the federal securities laws because they neither bought nor sold securities in reliance on the false reports,[157] nothing in the court's statement of the new disclosure duty explicitly limited its application to circumstances where shareholders have no federal recourse. Therefore, the new disclosure duty applies even when directors make misstatements in the course of complying with federal securities regulations. The court's failure to limit the application of the new disclosure duty blurs the boundaries between state and federal actions concerning corporate misrepresentations.

Even if *Malone* is designed to provide a remedy for misdisclosures only when the federal securities laws do not, the mere fact that the court found the directors liable for breach of the fiduciary duty for purposes of Delaware corporate law does not mean that *Malone* is not, at heart, a federal securities case. The misstatements in *Malone* occurred in the annual reports compiled by Mercury pursuant to section 13 of the Exchange Act.[158] Shareholders injured by misleading statements in such reports can pursue federal remedies under section 18 of the Exchange Act. By allowing an action under Delaware fiduciary laws in this situation, the Supreme Court of Delaware created a state cause of action for what was essentially a federal securities claim. Creation of such a cause of action undermines recent congressional attempts to restrict securities fraud litigation exclusively to federal courts.

E. Malone *Undermines the Objectives of the Federal Reform Act*

The blurring of boundaries between state and federal disclosure laws may induce plaintiffs, who might otherwise pursue adequate federal

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155. *See supra* note 143.

156. *See supra* note 11 and accompanying text.

157. Under *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731 (1975), only purchasers or buyers of securities have standing to bring a 10b-5 action in federal court to challenge inadequate or false disclosures in connections with share transactions.

158. *See Malone*, 722 A.2d at 8.

remedies, to bring their cases under state law to avoid the stringent federal procedural requirements. Congress has declared such conduct to be an impermissibly abusive device.[159] Despite the potential for forum shopping, the *Malone* court failed to address how it would prevent such abuse.

The fundamental changes in the securities class action landscape brought by the Reform Act conflict with the desire of defrauded shareholders to bring their breach-of-fiduciary-duty claims to Delaware state court and to take advantage of Delaware corporate law's attractive avenues of recovery. The lack of clearly defined boundaries to Delaware's fiduciary laws brought about by *Malone* implies that these laws can apply concurrently with federal laws regarding corporate disclosure. It is not difficult to imagine a group of shareholders, who might otherwise file federal actions alleging that they relied on a corporation's Form 10-K in deciding to buy or sell their shares,[160] instead bringing their actions under Delaware law to avoid the complex procedural requirements of the federal Reform Act. Seen in this light, the *Malone* court may have inappropriately provided plaintiffs with incentives to pursue a state law forum for securities fraud claims that should otherwise be brought in federal court under federal law.

Plaintiffs will have several other reasons to bring an action under Delaware law. First, they may take advantage of Delaware's attractive avenues of recovery for defrauded shareholders. For example, Delaware corporate law provides greater potential for recovery than Rule 10b-5.[161] Under Delaware law, plaintiffs have a number of available remedies including injunctive relief, rescission of the transaction, or rescissory damages.[162] By contrast, under federal law, plaintiffs can recover monetary damages only if the misrepresentations inflated or deflated the stock price at the time of plaintiffs' purchase or sale of the securities.[163]

159. *See* S. Rep. No. 105-182, at 3 (1998); *see also* H.R. Conf. Rep. No. 105-803, at 1 (1998).

160. Form 10-K is an annual report that provides a comprehensive overview of a company's business and must be filed within 90 days of the end of a company's fiscal year. *See* 15 U.S.C. § 78m(a)(2) (1994).

161. *See* Jay W. Eisenhofer & Megan D. McIntyre, *Causes of Action Available to Investors Under Delaware Law in the Wake of Federal Securities Reform: Part II*, Insights, Nov. 1996, at 2, 4. Rule 10b-5, promulgated under § 10(b) of the Securities Exchange Act of 1934, is the most well-known antifraud provision of the federal securities laws. Section 10(b) is the primary vehicle by which investors attempt to recover their losses due to a director's false or misleading disclosures.

162. *See id.*

163. Rule 10b-5, promulgated under § 10(b) of the Securities Exchange Act of 1934, protects only buyers and sellers of securities and creates an implied private right of action, which

In Delaware, plaintiffs do not have to show actual reliance on the misstatement[164] and may obtain monetary damages without proving actual loss.[165] Second, Delaware law interprets the fiduciary disclosure duty strictly and directors can incur liability without regard to their negligence or other culpability.[166] By contrast, liability under Rule 10b-5 will not lie without a showing of scienter.[167] Now that plaintiffs may be able to file securities fraud claims under state law in state court, the Supreme Court of Delaware should have outlined, if not implemented, procedural requirements analogous to those mandated by the Reform Act to prevent such forum abuse.

F. Malone *Renders Unclear the Operational Effects of the Federal Uniform Act*

The Supreme Court of Delaware's finding of fiduciary liability in the absence of a request for shareholder action makes it difficult to determine how the preemptive effect of the Uniform Act applies to state fiduciary duty suits. First, if state fiduciary laws apply and state courts are available even when plaintiffs buy or sell securities and therefore have federal claims,[168] there is a conflict with the Uniform Act's explicit

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shareholders can use to challenge inadequate or fraudulent disclosures in connection with share transactions. *See* 17 C.F.R. § 240.10b-5 (1998).

164. *See In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 327 n.10 (Del. 1993) (citing Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)).

165. *See Tri-Star*, 634 A.2d at 333. However, monetary damages may be excluded in the corporation's certificate of incorporation, but only if the misstatement or omission was a good faith error. *See* Del. Code Ann. tit. 8, § 102(b)(7) (1998); *see also* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1286–88 (Del. 1994).

166. None of the following cases indicate that only a culpable failure to disclose will constitute a breach of the disclosure duty:

In re Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59, 66 (Del. 1995); *Arnold*, 650 A.2d at 1277; Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992); Shell Petroleum, Inc. v. Smith, 606 A.2d 112, 114–15 (Del. 1992); Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1288 (Del. 1989); Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985); Lewis v. Leaseway Transp. Corp., 1990 Fed. Sec. L. Rep. (CCH) ¶ 95,275, at 96,268 (Del. Ch. May 16, 1990); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 n.2 (Del. Ch. 1988).

167. The term "scienter" as applied to the conduct necessary to give rise to an action for civil damages under the Securities Exchange Act of 1934 and Rule 10b-5 refers to the mental state embracing an intent to deceive, manipulate, or defraud. *See Black's Law Dictionary* 1345 (6th ed. 1990). In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), the Court held that scienter was a necessary element of a Rule 10b-5 damage action. The Court also held that scienter was required in an injunctive action.

168. *See supra* Part IV.C.

preemption of those actions where shareholders buy or sell securities as a result of corporate misrepresentations.[169] Second, even assuming that the *Malone* court did not intend to contradict the terms of the Uniform Act, the court provided an inaccurate explanation of why the statute did not apply to the plaintiffs' case.[170] Read literally, the Uniform Act does not apply to actions where plaintiffs did not purchase or sell securities but merely retained them in reliance on the corporate misrepresentations.[171] Because the plaintiffs in *Malone* did not buy or sell securities, their claim could likely be heard in state court.

Instead of relying on this fact to explain its decision to provide plaintiffs with a state forum, the court turned to and incorrectly interpreted a provision of the Uniform Act that preserved the availability of certain state actions.[172] In this provision, the interplay between the Uniform Act and Delaware's state fiduciary laws is clear.[173] The Uniform Act does not preempt an action brought under state law if the challenged misrepresentations, made in connection with the sale of securities, solicited shareholder action or called for the exercise of shareholder rights such as voting, acting in response to a tender offer, or exercising appraisal rights.[174] If there was no shareholder action, the claims must be brought under federal law.[175] Despite this clearly written provision, the *Malone* court determined that the existence of state fiduciary disclosure laws, not the existence of shareholder action, provides plaintiffs with a state law forum.[176] This conclusion is inconsistent with the unambiguous language of the Uniform Act. The Act's distinction between communications that do and do not solicit shareholder action indicates that viable state claims involve internal corporate governance issues. By contrast, the absence of shareholder action in *Malone* indicates that there were no

169. *See supra* note 103.

170. The Uniform Act did not apply to the shareholders in *Malone* because they brought their suit before Congress enacted the statute and the statute does not affect or apply to any action commenced before and pending on the date of its enactment. *See* Pub. L. No. 105-353, § 101(c), 112 Stat. 3227, 3233 (1998). However, the statute's preemption of certain state fiduciary suits and the preemption's effect on the scope of Delaware state fiduciary laws are important issues that merit a discussion in this Note and deserved discussion in the court's opinion.

171. *See supra* note 103.

172. *See* Malone v. Brincat, 722 A.2d 5, 13 (Del. 1998).

173. *See supra* note 105.

174. *See supra* note 105.

175. *See* 15 U.S.C.A. § 77p(b) (West Supp. 1999).

176. *See Malone*, 722 A.2d at 13.

internal governance matters at issue. Therefore, the court should not have relied on this provision to hold that a state forum was available for the plaintiffs' claim. The court's flawed interpretation of the Uniform Act will undoubtedly create problems in future cases dealing with the applicability of the federal preemption statute in fiduciary duty suits.

V. CONCLUSION

Malone v. Brincat presented an excellent opportunity for the Supreme Court of Delaware to clarify the fiduciary disclosure doctrine and the relationship between state and federal securities laws. Had the court supplied an explanation for its departure from precedent and correctly stated the cause of action required to challenge the directors' breach of the disclosure duty, *Malone* would have transformed the disclosure duty under Delaware law into a formidable state fiduciary doctrine. Instead, the court expanded the corporate directors' disclosure duty without providing sufficient guidance as to the scope of its application. Furthermore, *Malone* produces substantial uncertainty as to the application of Delaware fiduciary laws in the face of recent federal restrictions on securities fraud litigation.