SECURITIES LITIGATION IN STATE COURTS—SOMETHING OLD, SOMETHING NEW, SOMETHING BORROWED ....

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Using an old marital saying to title this Article may mislead. In particular, owing to federal legislative attempts to preempt state securities law actions, all may not be, or remain, bliss in the state courts.

Yet, in an article I recently published about the plight of securities action plaintiffs in the federal courts, I used a martial metaphor, the gauntlet.[1] Federal judges, legislators and the Private Securities Litigation Reform Act of 1995 ("Reform Act" or "PSLRA")[2] have created a number of cudgels with which defendants can rain blows down on any plaintiff seeking to proceed to the federal courthouse door. I concluded in that article, "Because of the many instruments that now exist with which blows can be administered, only the toughest plaintiff who can be swift at times and crafty at others and who has an extraordinarily meritorious suit, generous funding, the most able of counsel, and extreme staying power will survive."[3] The gauntlet has lengthened, and many a plaintiff will receive a crippling blow along the way.

Potential plaintiffs face the following possible blows: the "bespeaks caution" doctrine; requirements that fraud be pleaded with particularity; special and strict state of mind pleading standards; effective elimination of professional and semiprofessional plaintiffs; a mandatory quest for the "most appropriate plaintiff"; mandatory Rule 11 review of plaintiffs' pleadings; the specter of shifting enormous defense legal fees onto plaintiffs; mandatory stays on discovery by plaintiffs; and on and on. These are "reforms" intended to intimidate. A gauntlet exists. Every federal plaintiff must run it: "each anti-plaintiff development or device [represents] a cudgel that defense lawyers will use, and they will use them in every case, not just in marginal and frivolous ones."[4]

In some states, plaintiffs' lawyers turned to state courts long before the era of federal reform.[5] Unlike the federal statutory scheme, state securities

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1. *See* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3 (1996) [hereinafter Branson, *Gauntlet*].

2. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

3. Branson, *Gauntlet*, *supra* note 1, at 4.

4. *Id.* at 5.

5. One experienced plaintiff's attorney told me that for the past several years he has gone

laws commonly provide the prevailing plaintiff with an award of attorneys' fees.[6] State substantive "blue sky" law also may be more favorable, allowing damages in cases of mere negligence,[7] or requiring express liability for key secondary defendants.[8] Post-PSLRA attorneys turn to state courts to avoid heightened pleading standards or discovery stays that the PSLRA imposes on federal court claims.[9] In another post-Reform Act article, I describe some of the obvious means by which securities claims plaintiffs may pursue their cases in state court.[10]

The reformers, however, are at it again. They now propose legislation that would preempt state court class actions involving nationally traded securities,[11] or, under an extreme measure, require all securities fraud suits, not just class actions, to be litigated exclusively in federal court.[12] Even though they involve "overkill heaped upon overkill," these federal

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exclusively to state court because he and his partners have regarded their home state's securities laws as much "friendlier." In addition, they avoid class actions because they feel they have much more control over the case when they represent a number of named plaintiffs. Interview with Kim T. Buckley, partner of Esler, Stephens & Buckley, in Portland, Or. (Dec. 8, 1997); *see also* Marc I. Steinberg, *The Texas Securities Act: A Plaintiff's Preferred Route?*, 58 TEX. B.J. 1096 (1995).

6. *See* ALASKA STAT. § 45.55.930(a) (Michie 1994) (awarding "reasonable attorneys' fees"); ARIZ. REV. STAT. ANN. § 44-2001A (1994 & Supp. 1997) ("taxable courts costs and reasonable attorneys' fees"); TEX. REV. CIV. STAT. ANN. art. 581-33, § D(7) (West 1964 & Supp. 1998). *See generally* Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027, 1028 (1992) [hereinafter Branson, *Collateral Participant Liability (State)*].

7. *See* State v. Gunnison, 618 P.2d 604, 607 (Ariz. 1980); Pottern v. Bache Halsey Stuart, Inc., 589 P.2d 1378, 1379 (Colo. Ct. App. 1978): State *ex rel.* Mays v. Ridenhour, 811 P.2d 1220, 1232-33 (Kan. 1991): Fakhrdai v. Mason, 696 P.2d 1164, 1166-67 (Or. Ct. App. 1985): Kittilson v. Ford, 608 P.2d 264, 265 (Wash. 1980); State v. Temby, 322 N.W.2d 522, 526 (Wis. Ct. App. 1982). *See generally* Branson, *Collateral Participant Liability (State)*, *supra* note 6, at 1046-47.

8. Express secondary liability under the Uniform Securities Act includes: "[e]very person who directly or indirectly controls a seller liable [under the Act], every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such seller who materially aids in the sale...." UNIFORM SECURITIES ACT § 410(b), 7B U.L.A. 643 (1985). *See generally* Douglas M. Branson, *Chasing the Rogue Professional After the Private Securities Litigation Reform Act of 1995*, 50 SMU L. REV. 91, 120-21 (1996) [hereinafter Branson, *Chasing the Rogue Professional*].

9. One study found state court class action filings up 26%. *See* Joseph Grundfest & Michael Perino, *Securities Litigation Reform: The First Year's Experience*, *in* 29TH ANNUAL INSTITUTE ON SECURITIES REGULATION 243 (1997). In contrast, a study by National Economic Research Associates Inc. ("NERA") found 1997 state court filings consistent with the five years preceding the PSLRA, leading to the conclusion that "any migration of class suits to state courts was transitory." *Congress Targets 'Loophole' in 1995 Act Barring Vexatious Suits*, 29 SEC. REG. & L. REP. (BNA) 1211, 1212 (Aug. 29, 1997). State courts have also refused to stay litigation on grounds that it is a naked attempt to evade the PSLRA pleading and discovery stay provisions. *See, e.g.*, *In re* Oak Tech. Secs. Litig., 1997 WL 448168, at *4-*9 (N.D. Cal. July 1, 1997).

10. *See* Branson, *Chasing the Rogue Professional*, *supra* note 8, at 115-25.

11. *See* H.R. 1689, 105th CONG. (1997).

12. *See* H.R. 1653, 105th CONG. (1997); *see also* Rachel Witmer, *White, Eshoo Introduce Securities Bill That Would Federalize Private Class Suits*, 29 SEC. REG. & L. REP. (BNA) 694 (May 23, 1997) (proposing legislation by Representative Tom Campbell of California).

preemption efforts are seeing the full light of legislative day.[13] Nonetheless, these preemption efforts cause a largely proplaintiff advocate such as I to continue to examine state law. What additional legal theories might a plaintiff pursue in state court? Preemption efforts might not close all avenues.

Also, the existing judicial and Reform Act measures make federal court an inhospitable place for any securities claim, whether it involves a public company or smaller deals to which the PSLRA does not apply.[14] I would advise any lawyer less schooled in securities litigation, and even more experienced lawyers who nonetheless lack the resources and credibility of a Milberg Weiss,[15] to pursue claims in state rather than federal court. Knowledge of additional state law theories they might pursue cannot help but be a benefit.

If preemption efforts succeed, one of the theories I explore will remain useful in the publicly held arena. Both the SEC General Counsel and members of the Delaware Bar are working, unopposed, to carve an exemption to preemption legislation that will preserve state law causes of action premised on state law duties of disclosure, formerly known in Delaware as the duty of "candor"[16] and still called by that name in the few other jurisdictions with authority on the subject.

Other theories, common-law fraud and, in particular, constructive fraud, have evolved, and possess greater utility than commonly believed. These theories, however, probably remain useful only in smaller cases such as those involving private placement and intrastate offerings or nonrepresentative (nonclass) actions, whether preemption efforts succeed or not.

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13. One SEC Commissioner, Steven Wallman, has publicly supported preemption as a "good idea." *SEC Commissioner Wallman Sees Need for Uniform Standards Law*, 29 SEC. REG. & L. REP. (BNA) 1259, 1259 (Sept. 12, 1997); *cf. Justices Hear Arguments on Viability of Misappropriation Theory of Insider Trading*, 29 SEC. REG. & L. REP. (BNA) 522, 523 (Apr. 18, 1997) (quoting SEC chair Arthur Levitt as stating "it is premature to propose legislative changes"); *SEC, Private Bar Working to Address Flaw in Litigation Reform Bills*, 30 SEC. REG. & L. REP. (BNA) 170 (Jan. 30, 1998) (stating Commissioner Norman Johnson opposes any form of preemption).

14. *Accord* William S. Lerach, Private Securities Litigation Reform Act 1995—22 Months Later, Address to USX Fall Law Conference, Oct. 18-19, 1997, at 20 (stating that "in the Northern District of California . . . *every motion to dismiss a New Act complaint has been granted*") (on file with author).

15. Milberg Weiss, a 130 lawyer firm with offices in New York and San Diego, was lead counsel in 65 of 210 (31%) and 57 of 147 (39%) federal securities class actions settling in 1995 and 1996, respectively. The firm recovered an estimated $3 billion in the past 10 years. With its experience and access to potential plaintiffs with large shareholdings, predictions are that Milberg Weiss will dominate the field even more in the post-Reform Act era. *See* Dean Starkman, *Milberg Weiss Still Reigns in Holder Suits*, WALL ST. J., Dec. 30, 1997, at B6.

16. *See, e.g., SEC, Private Bar Working to Address Flaw in Litigation Reform Bills*, *supra* note 13, at 169-71 ("It is therefore highly unlikely that the pending securities litigation reform legislation—backed by Wall Street, the accounting profession, and the high tech and venture capital industries—would be enacted without the changes necessary to preserve this body of [Delaware] precedent.").

State law common law also includes theories of secondary liability, in particular, aiding and abetting violations of fiduciary duties. Given the abolition of aiding and abetting and other implied add-on theories of secondary liability in the federal area by the United States Supreme Court in *Central Bank v. First Interstate Bank*,[17] and the potential expansion of the duty of candor, which is after all a duty denominated as fiduciary, state common-law aiding and abetting theories may become another state law growth area.

These three theories—common-law and constructive fraud, the duty of disclosure (candor) and aiding and abetting—are the "something old, something new, something borrowed . . . ." They may provide comfort, if not outright success, to plaintiffs in some forms of state court securities litigation.

I. SOMETHING OLD: COMMON-LAW FRAUD—HOW HAS IT EVOLVED?

A. Introduction and Overview

Many securities lawyers viewed common-law causes of action, including fraud and misrepresentation, as if those lawyers were caught in a Victorian time warp. Some continued to examine the House of Lords 1889 decision on directors' liability for a false prospectus, *Derry v. Peek*,[18] or the 1873 decision in *Peek v. Gurney*.[19] *Peek* refused to hold directors liable for fraud because the plaintiff purchased his shares on an anonymous stock exchange. The privity the common law required was therefore lacking. Common-law fraud was thought to be a complex cause of action requiring a plaintiff to allege and prove eight or nine distinct elements.[20] Most knowledgeable lawyers thought it better to bypass common-law fraud, relying instead on the SEC's catchall antifraud provision, Rule 10b-5.

In securities law, lawyers thought the common-law action had several sticking points. First, the plaintiff had to prove that the defendant uttered the

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17. 511 U.S. 164 (1994).
18. 14 App. Cas. 337 (1889).
19. 6 L.R.-E. & I. App. 377 (1873).
20. See, for example, *McAnally v. Gildersleeve*, 16 F.3d 1493, 1497 (8th Cir. 1994), stating:

> To recover under common-law fraud, the plaintiff must prove a "false representation of a material fact with knowledge or belief on the part of the defendant that the representation is false. The false representation must be made with the intent to induce the other party to rely upon that representation." Specifically, this circuit requires a finding of scienter, i.e., the plaintiff must demonstrate that the defendant knew that the misrepresentation was false when made. The plaintiff also must demonstrate that any damage "resulted from his justifiable reliance on the defendant's misrepresentation." Justifiable reliance requires that the plaintiffs actually relied on the misrepresentations, and that this reliance was reasonable.

Id. (citations and footnote omitted).

misrepresentation or half-truth knowing of its falsity and with intent that the misrepresentation be acted upon by the person to whom it has been made (high degree of scienter).[21] Second, the privity requirement limited the usefulness of common-law fraud: the plaintiff could recover only from those with whom she had had dealings (transactional privity). Third, a plaintiff had to prove that she relied upon the misrepresentation or half-truth and that such reliance was reasonable (strict reliance requirement).

But are these historical barriers still in place? As the Securities Act of 1933 and the Securities Exchange Act of 1934, along with state blue sky laws, relegated common-law fraud securities to obscurity, have common-law courts relaxed or modified these elements? Has common-law fraud made a comeback on those three key issues (scienter, privity and reliance)? The answer to the question on each issue respectively is yes, yes and perhaps.

B. State of Mind Requirements

In the federal area, Mr. Justice Powell began his *Ernst & Ernst v. Hochfelder*[22] opinion with the question of whether a Rule 10b-5 action for damages "may lie ... in the absence of an allegation of intent to deceive, manipulate, or defraud."[23] However, his discussion of the issue involved whether negligent conduct is sufficient and not whether a Rule 10b-5 plaintiff must allege and prove intent, as in older cases of common-law fraud. By footnote, the Justice left for another day the question of whether allegations of recklessness would suffice.[24]

After *Hochfelder*, all the federal circuits that addressed the issue held that recklessness,[25] or at least recklessness evincing a conscious disregard or an extreme departure from ordinary care, or what Mr. Justice Holmes termed

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21. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 107, at 741 (5th ed. 1984). Prosser and Keeton stated:

> The intent which underlies an intentional misrepresentation is a more complex matter than the relatively simple intention in the case of assault and battery. It involves the intent that a representation shall be made, that it shall be directed to a particular person or class of persons, that it shall convey a certain meaning, that it shall be believed, and that is shall be acted upon in a certain way.... In addition, there is the intent to accomplish an ultimate purpose, as to benefit the speaker, or to cause harm to the one addressed.

Id. (footnotes omitted).

22. 425 U.S. 185 (1976).

23. *Id.* at 187-88.

24. *See id.* at 193 n.12 (stating "we need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability").

25. *See, e.g.*, Don J. McDermett, Jr., Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087, 1100-03 (1984) (presenting a circuit by circuit analysis).

"recklessness dishonesty,"[26] would suffice.[27]

Now enters the PSLRA of 1995, with its heightened pleading standard. Plaintiffs must state "with particularity" facts giving rise to a "strong inference" that the defendant acted with the requisite state of mind.[28] Federal judges are misreading the Reform Act, holding that the pleading standard eliminates recklessness of any sort as a ground for liability. Several cases have held that plaintiffs must plead and prove intentional or knowing misconduct.[29] Only a minority of federal judges seems to get it right: they have been careful to distinguish between a change in the pleading standard, which has occurred, and a change in the substantive law, which has not.[30] And, of course, defendant's fault, or state of mind, and the pleading of it, are the heart of any securities or other fraud case.[31]

All of this sets the stage for a discussion of state of mind in common-law fraud cases.[32] In state courts, no heightened pleading standard exists. In states adopting the *Federal Rules of Civil Procedure*, "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally,"[33] that is, the pleading standard which prevailed in federal court before the PSLRA.

That is the procedure. In terms of substance, beginning with *Hochfelder*,

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26. O.W. HOLMES, THE COMMON LAW 130-38 (1881).

27. *See* Douglas M. Branson, *Statutory Securities Fraud in the Post-Hochfelder Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50, 87 (1977) (stating that "many refinements of gross negligence into various gradations are possible").

28. 15 U.S.C. § 78j(b) (1982).

29. The leading case is *In re Silicon Graphics, Inc. Securities Litigation*, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325 (N.D. Cal. Sept. 25, 1996), in which Judge Smith dismissed a complaint alleging that insiders "devised a scheme to boost stock prices to protect [their own] interests." *Id.* at ¶ 99,959; *see also* Hockey v. Medhekar, 1997 WL 203704 (N.D. Cal. Apr. 15, 1997) (holding that recklessness does not suffice); Powers v. Eichen, 977 F. Supp. 1031 (S.D. Cal. 1997) (holding that higher actual knowledge standard was adequately alleged); Friedberg v. Discreet Logic, Inc., 959 F. Supp. 42 (D. Mass. 1997) (holding that "plaintiff must set forth specific facts that constitute strong circumstantial evidence of conscious behavior by defendants").

30. *See, e.g.*, Fugman v. Aprogenex, Inc., 961 F. Supp. 1190 (N.D. Ill. 1997); Zeid v. Kimberley, 930 F. Supp. 431, 438 (N.D. Cal. 1996) (stating that "a plaintiff can allege 'facts constituting circumstantial evidence of either reckless or conscious behavior'" (citation omitted)); Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1309 & n.9 (C.D. Cal. 1996) (holding that there exists "no basis to conclude that Congress altered the mental state requirement" and "recklessness can constitute scienter").

31. *See, e.g., Panelists Dispute Reform Law's Impact on Private Class Securities Fraud Litigation*, 29 SEC. REG. & L. REP. (BNA) 1134, 1135 (May 15, 1997) (quoting William Lerach, "The pleading standard was intended to be a 'gatekeeper'" by providing a hostile judge assisted by clever lawyers with a complete weapon to block any case, no matter how meritorious).

32. Of course, under state blue sky laws, a fair number of courts have held that, because the antifraud language is statutory rather than an agency rule such as Rule 10b-5, allegation and proof of negligence will ground a damage recovery. *See supra* note 7.

33. FED. R. CIV. P. 9(b). Overall, however, allegations of fraud must be "stated with particularity."

in a pronounced jurisprudential shift, the Supreme Court severely pruned back the reach of federal securities law.[34] By contrast, state courts have taken common-law fraud in the opposite direction. Overall, then, in contrast to post-PSLRA federal courts, which require proof of knowing or intentional conduct, state courts firmly pinion liability on a finding of recklessness.[35]

More importantly, while focusing on the relationship of the parties and frequently the greedy motive of the defendant,[36] something that post-*Hochfelder* federal courts largely abandoned in favor of across-the-board binary rules,[37] many state courts lowered the required state of mind to lack of reasonable care. The negligent misrepresentation cases are difficult to categorize but often seem to involve superior access to information on the defendant's part, or other ability of the defendant to control the destiny of the plaintiff, the trust the plaintiff had in the defendant, the length or intended permanence of the relationship and the potential benefit for the defendant that could be garnered through an untruth or omission.

State courts have held employers liable to employees for mere negligent misrepresentation.[38] The relationship of insurer to insured may give rise to such liability.[39] A title company may be liable to a home buyer for negligent misrepresentation.[40] Several state courts have held liable broker-dealers who

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34. In the Burger and Rehnquist eras, the Supreme Court decided 32 of 40 securities law cases for defendants and, "in almost every one, significantly narrowed the reach of federal securities laws. In one stretch, the Burger Court decided 15 of 16 consecutive securities cases for defendants and defense interests." Branson, *Gauntlet*, *supra* note 1, at 6 & nn.9-11. The Court's 41st opinion, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), which upholds the misappropriation theory of insider trading, would generally be regarded as a proplaintiff decision.

35. In an exhaustive study, Professor Kevin Johnson found that in 47 states and the District of Columbia clear authority exists for fraud liability based upon recklessness. *See* Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 700 (1991). In only one state, North Carolina, is there clear authority to the contrary. In *Meyers & Chapman, Inc. v. Thomas G. Evans, Inc.*, 374 S.E.2d 385, 391 (N.C. 1988), the Supreme Court of North Carolina required a plaintiff to prove "both knowledge *and* an intent to deceive" in fraud actions. *Id.*; *see* Johnson, *supra*, at 702 & n.144.

36. These were key factors in at least two federal circuits' pre-*Hochfelder* common-law based analyses of the state of mind issue. *See* White v. Abrams, 495 F.2d 724, 735 (9th Cir. 1974); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973) (en banc). *See generally* Douglas M. Branson, *Statutory Securities Fraud in the Post-*Hochfelder *Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50 (1977).

37. *See, e.g.*, Johnson, *supra* note 35, at 706-07 ("Before *Hochfelder*, some courts, encouraged by academic commentators, emphasized the importance of the relationship between the parties in determining whether a defendant had acted with the state of mind necessary for Section 10(b) liability. After *Hochfelder*, the [federal] courts abandoned that endeavor.").

38. *See, e.g.*, Bubbel v. Wien Air Alaska, Inc., 682 P.2d 374, 380 (Alaska 1984); D'Ulisse-Cupo v. Board of Dirs. of Notre Dame High Sch., 520 A.2d 217, 223 (Conn. 1987).

39. *See, e.g.*, Rempel v. Nationwide Life Ins. Co., 370 A.2d 366, 367-68 (Pa. 1977); Moore v. Kluthe & Lane Ins. Agency, 234 N.W.2d 260, 264-65 (S.D. 1975).

40. *See* Chun v. Park, 462 P.2d 905, 908-09 (Haw. 1969).

made merely negligent statements,[41] in contrast to post-*Hochfelder* federal cases, which have required plaintiffs to prove that broker-dealers acted recklessly or with intent.[42]

Two well-recognized and overlapping categories of state law cases crystallize this development. In negligent misrepresentation and constructive fraud cases, state courts, focusing primarily upon relationship, permit damages based merely upon a lack of reasonable care. State courts still regard the relationship between the parties as important, particularly as to the allegation and proof they require of plaintiffs on the state of mind issue.[43]

C. *Cautionary Words Versus Due Diligence: The PSLRA Versus Common-Law Fraud*

In addition, when recklessness (rather than mere negligence) is the state of mind required, state courts make clear that a speaker is reckless not only when she was consciously indifferent as to the truth of her statement, but also when she had no sufficient basis or was indifferent as to the existence or not of a basis to justify statements made.[44] A leading authority finds that these "no basis" or indifference to the extent of information cases satisfy the common-law state of mind requirement[45]

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41. *See, e.g.*, Brown v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 640 P.2d 453, 458-59 (Mont. 1982); *see also, e.g.*, Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1048-51 (11th Cir. 1987) (broker-dealer not liable under federal securities law but could still be held liable for violation of Florida state law duty of care); Emmons v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 532 F. Supp. 480, 485 (S.D. Ohio 1982) (broker not liable under federal law but could be held for both compensatory and punitive damages on pendant state law claims).

42. Before broker-dealer cases submerged into arbitration, federal courts consistently required proof of a high degree of recklessness. *See, e.g.*, McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989) (broker-dealer case required proof of "'severe recklessness,'" that is, "'highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care'" (citations omitted)); Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 739 F.2d 1434, 1435 (9th Cir. 1984) (broker-dealer case required proof of recklessness, defined as a "'lesser form of intent'" rather than "'merely a greater degree of ordinary negligence'" (citations omitted)).

43. This is an approach that leading, conservative commentators commended to the federal courts, to no avail. *See, e.g.*, David S. Ruder, *Factors Determining the Degree of Culpability Necessary for Violation of the Federal Securities Laws in Information Transmission Cases*, 32 WASH. & LEE L. REV. 571, 577 (1975) (arguing that courts should focus on the relationship between the parties to ascertain the requisite state of mind); Bruce Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. REV. 1206 (1970) (similar).

44. *See, e.g.*, Sovereign Pocohontas Co. v. Bond, 120 F.2d 39 (D.C. Cir. 1941); Fausett & Co. v. Bullard, 229 S.W.2d 490 (Ark. 1950).

45. See KEETON ET AL., *supra* note 21, § 107, at 742, concluding that under state law:

> A defendant who asserts a fact as of his own knowledge, or so positively as to imply that he has knowledge, under circumstances where he is aware that he will be so understood when he knows

These no basis and indifference cases also arise frequently in the securities area, in which offering circulars or press releases project future economic performance without the benefit of any measure of due diligence.[46] Due diligence, of course, is a time-honored exercise in which attorneys and issuers ensure that every substantive statement and projection in an offering document has a demonstrable basis in reality. Often, a due diligence file will backstop every statement and projection on multiple bases. If litigation commences at a later time, defense counsel will use the due diligence file to defeat claims of "pie in the sky projections" by the issuer, its officers and others, and resolve the case by means of summary judgment or other dispositive motion. The due diligence materials frequently will accompany that motion to demonstrate multiple bases for every statement.

The PSLRA, however, contains a safe harbor for forward looking statements. The PSLRA provision provides that if a statement is "accompanied by meaningful cautionary statements,"[47] plaintiffs are denied discovery and the court must dismiss allegations as to the false or misleading nature of the statement when presented with a dispositive motion.[48] There are some exceptions,[49] and the safe harbor is limited to statements by or about issuers that are reporting companies or, by virtue of IPOs, will become reporting companies under the Exchange Act.[50]

The effect of the PSLRA provision, as with stronger forms of the judge-made bespeaks caution doctrine, is to substitute:

> mere cautionary words for the due diligence traditionally associated with preparation of statements in disclosure documents. Rather than building a due diligence file that, through research, establishes more than plausible, and often alternative, bases for making the statements made in the documents, securities lawyers will plaster forward-looking statements with cautionary warnings .... No incentive now exists for hiring the traditional, classical securities lawyer who quarterbacked the research and other effort necessary to do the due

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that he does not in fact know whether what he says is true, is found to have the intent to deceive, not so much as to the fact itself, but rather as to the extent of his information.

Id.

46. *See, e.g.*, Douglas M. Branson & Karl S. Okamoto, *The Supreme Court's Literalism and the Definition of "Security" in the State Courts*, 50 WASH. & LEE L. REV. 1043, 1082-83 (1993) (containing examples of such cases).

47. 15 U.S.C. § 77z-2(c)(1)(A)(i) (Supp. II 1996).

48. *See id.* § 77z-2(e)-(f).

49. Exceptions include blank check offerings, penny stock issuances, rollup offerings and going private transactions. *See id.* § 77z-2(b)(1)(B)-(E).

50. *See id.* § 77z-2(a)(1)-(4).

diligence exercise. Instead, Congress has placed a premium on buying and using ink by the barrel.[51]

A close examination of the state recklessness standard might, however, provide a continuing incentive for due diligence exercises. Under evolving notions of what constitutes the requisite state of mind, a speaker and those who assist her may be held liable if they are proven to have been consciously indifferent (reckless) as to the extent of information upon which they have based forward looking or other substantive statements in offering documents, press releases and so on, cautionary boilerplate to the contrary.

D. An Approximation of Privity

That is the good news for plaintiffs. The drawback is that the state court focus on relationship in fraud cases, while not causing a regression to common-law sorts of privity, does require either privity, a semblance of privity or a duty to a foreseen rather than merely foreseeable plaintiff group. That may render common-law fraud an inappropriate vehicle for some claims. In the case of statements by officers of a publicly held corporation, however, shareholders may well be able to claim that they are not only a foreseeable group but the foreseen group that today's common-law fraud requires as opposed to old-fashioned types of privity. Shareholders may well allege the requisite relationship with the corporate officers, directors or spokespersons responsible for the misleading prospectus, earnings forecast or press release.

Old-fashioned common-law privity has, as its paradigm, passage of title or similar direct dealing, a level of privity some commentators urged under certain liability provisions of the federal securities laws.[52] Common-law privity, however, encompassed more. If "representations were made to the complaintant, or with any expectation that they would come to his knowledge, or with any belief or reason to believe that they would induce him to act in the matter in question," the common-law privity requirement was satisfied.[53]

Today many state courts embrace *Restatement (Second) of Torts* section 552 which provides:

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51. Branson, *Gauntlet*, *supra* note 1, at 35-36.

52. *See* Patricia O'Hara, *Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller*, 31 UCLA L. REV. 921, 933 (1984); *cf.* Douglas M. Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 OR. L. REV. 327, 344-46 (1986) [hereinafter Branson, *Collateral Participant Liability (Federal)*].

53. 9 STUART M. SPEISER ET AL., THE AMERICAN LAW OF TORTS § 32:42, at 293 (1992).

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.[54]

The jurisdictions adopting this section are capable of holding defendants liable under state law in the types of cases targeted by the PSLRA, namely cases involving, misrepresentations, misleading statements and material omissions by corporate officers, spokespersons and the corporation they represent.[55]

E. Constructive Fraud

Another state law route to not only low (recklessness) but the lowest (negligence) state of mind allegation and proof requirements is constructive fraud.[56] Experienced securities lawyers tell me that constructive fraud allegations are extremely difficult to defend. Well-pled constructive fraud allegations are difficult to knock out on summary judgment. Accordingly, they enhance the value of a plaintiff's case considerably.[57]

Constructive fraud has been defined as "the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests."[58] As such, constructive fraud is nebulous and may be the

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54. RESTATEMENT (SECOND) OF TORTS § 552(1) (1977). The section goes on to provide:

> [T]he liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Id. § 552(2)(a)-(b).

55. *See* Lawrence A. Hamermesh, *Calling off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1163 (1996) ("a director, when he recommends stockholder action, is acting 'in the course of his business' to supply information 'for the guidance of others,' namely the 'limited group' consisting of the stockholders" (quoting RESTATEMENT (SECOND) OF TORTS § 552(1) (1977))).

56. Indeed, the Delaware Supreme Court has stated that "the only difference between common-law fraud and equitable [constructive] fraud is 'Chancery's willingness to provide a remedy for negligent or innocent misrepresentations.'" Gaffin v. Teledyne, Inc., 611 A.2d 467, 472 n.4 (Del. 1992) (quoting Stephenson v. Capano Development, Inc., 462 A.2d 1069, 1074 (Del. 1983)).

57. Telephone Interview with William O'Connor, member of Kightlinger & Gray (Nov. 18, 1997) (notes on file with the author).

58. Archer v. Griffith, 390 S.W.2d 735, 740 (Tex. 1964) (conveyance to divorce attorney who

carte blanc for a judge to do justice as she sees fit.

Traditionally, the "legal or equitable duty" had to arise from a fiduciary or confidential relationship between the defendant and the group of which the plaintiff was a member.[59] In the case of misrepresentations or omissions by corporate officers and directors, then, a plaintiff might run afoul of the traditional defense that the corporate official owes her duties solely to the corporation and not any particular person within it.[60]

Although the cases are not plentiful, recent state court decisions focus on the "tendency to deceive others, to violate confidence, or to injure public interests."[61] Thus, the Supreme Court of Vermont allowed a creditor to recover from a second corporation, with whom the creditor had not dealt, when the controlling shareholder had shifted funds, quite legitimately, from the debtor corporation under the guise of administrative fees payable to the second, parent corporation.[62] The court upheld constructive fraud claims in which "a party in position of superior knowledge or influence intentionally gains an unfair advantage at the expense of another person."[63] Constructive fraud lies "where a wrongful act injures another but is done without bad faith or a malevolent purpose on the part of the perpetrator."[64] The second corporation, of course, had no fiduciary or confidential relationship to the creditor.

Modern constructive fraud law emphasizes capacity to mislead as much or more than the relationship between parties,[65] as "[w]here a party, by his words or conduct creates a false impression concerning serious impairments or other important matters and subsequently fails to disclose relevant

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also received cash fee from husband set aside as constructive fraud); *see also* 9 SPEISER ET AL., *supra* note 53, § 32.10, at 227 ("Actual fraud must ... involve wilful deception, while constructive or legal fraud may arise from the circumstances of the transaction or the relationship of the parties, without the existence of fraudulent intent....").

59. *See, e.g.*, Quinn v. Phipps, 113 So. 419, 421 (Fla. 1927) ("The rule embraces both technical fiduciary relations and those informal relations which exist wherever one man trusts in and relies upon another.... The relation and the duties involved in it need not be legal. It may be moral, social, domestic or merely personal." (citation omitted)); Wells v. Wells, 150 N.E. 361, 365 (Ind. 1926) (constructive fraud performed by son and son's attorney on aged father).

60. *See, e.g.*, Percival v. Wright, 2 Ch. 421, 425-26 (1902) (insider trading could not be vindicated by selling shareholder because corporate insider's duty owed only to the corporation).

61. Archer v. Griffith, 390 S.W. 2d 735, 740 (Tex. 1965) (citing 37 C.J.S. *Fraud* § 2 (1943)).

62. *See* Hardwick-Morrison Co. v. Albertsson, 605 A.2d 529 (Vt. 1992).

63. *Id.* at 531.

64. *Id.*

65. *But see* Darlington's Appeal, 86 Pa. 512 (1878).

> An act or contract, though not originating in any evil design or contrivance to injure another, *yet tending to deceive and mislead*, or violate private confidence, is a constructive fraud, equally reprehensible with actual fraud, and prohibited by law.

Id. at 518 (emphasis added).

factors."[66] Thus, the controlling shareholder of a corporation was held liable on grounds of constructive fraud when he failed to volunteer to plaintiff contractor that 1) a personal guarantee sought by the contractor had little worth because of the guarantor's financial instability and 2) an escrow arrangement remained unfunded.[67] The court expressly held that in certain circumstances no fiduciary or similar relationship would be required.[68]

Because of their capacity to mislead, promissory misrepresentations are sometimes held to amount to constructive fraud. Thus, one Indiana court held that a representation as to future action gives rise to constructive fraud if the representation turned out to be false, the plaintiff relied upon the representation to his detriment and the representation created an advantage for the defendant in the transaction.[69]

Understanding constructive fraud is difficult. The theory is a nebulous, result-oriented catchall creature of equity. But because of its emphasis on the capacity to mislead rather than on relationships deemed fiduciary, constructive fraud seems to hold promise as a plaintiff-oriented tool in state court securities actions.

F. Relaxed Reliance Requirements?

A common-law fraud supplicant has to plead and prove reliance.[70] Reliance may be direct.[71] The supplicant may be able to show that she had heard the misleading statement or has seen and read the misleading statements.[72] Reliance may also be indirect.[73] For example, the supplicant could prove that she had relied upon a recommendation from her broker who, in turn, had relied upon a research report prepared by a securities analyst who, in turn, saw an offending press release or disclosure document such as an annual report.[74]

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66. Drilcon, Inc. v. Roil Energy Corp., 749 P.2d 1058, 1061-62 (Mont. 1988).

67. *See id.* at 1060.

68. *See id.* at 1065.

69. *See* Dominion Invs. v. Yasechko, 767 F. Supp. 1460, 1470 (N.D. Ind. 1991) ("constructive fraud is fraud that arises by operation of law from conduct which, if sanctioned by law, would secure an unconscionable advantage"). Furthermore, a promise made with no intention to perform at the time the promise is given rises from breach of contract to actual, and not merely constructive, fraud. *See* KEETON ET AL., *supra* note 21, § 109, at 763 ("[A] promise made without the intent to perform it is held to be a sufficient basis for an action of deceit." (footnotes omitted)).

70. *See generally* KEETON ET AL., *supra* note 21, § 108, at 749-50.

71. *See* SPEISER ET AL., *supra* note 53, §§ 32.50-.52, at 301-09.

72. *See id.*

73. *See id.*

74. *See, e.g.*, Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981) (holding that plaintiff who made a stock purchasing decision based on a newspaper item containing information from a misleading annual

The fraud on the market theory is a reliance substitute, especially valuable in cases in which the plaintiff is unable to show either direct or indirect reliance. The theory accepts two premises. First, while investors may not have relied upon a misleading statement, they do rely on the integrity of market prices. Second, because the market is efficient, the misleading statement will have caused share prices to lose congruence with the reality of what has actually occurred in a corporation or other issuer. The fraud on the market theory then sets up a presumption of reliance that a defendant may rebut, for example, by demonstrating that the market in which the shares traded was not open and well-developed. That is, the defendant can put plaintiff back to square one on the reliance issue by raising serious doubts as to the efficiency of the market.

In *Basic v. Levinson*,[75] the United States Supreme Court accepted the fraud on the market theory. In the area of common-law fraud, the issue is whether state courts will follow. To date, the picture is mixed.

In a leading case, *Mirkin v. Wasserman*,[76] the plaintiffs claimed that they purchased shares of Maxicare, Inc. "in reliance upon the integrity of the securities market and the securities offering process, and the fidelity, integrity and superior knowledge of the defendants."[77] The Supreme Court of California held that the fraud on the market theory is not available in common-law fraud actions.[78] The court emphasized that plaintiff investors have other remedies which do presume reliance, including federal remedies and state blue sky law causes of action.[79]

Because the PSLRA and other proposed legislation narrow plaintiff investors' remedies, the issue should perhaps be decided differently today. Nonetheless, a number of decisions have refused to accept the fraud on the market reliance substitute in common-law fraud cases.[80] The Delaware Supreme Court's opinion in *Gaffin v. Teledyne, Inc.*[81] is representative of those decisions. It is an exercise in mechanical jurisprudence: common-law

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report stated a sufficient claim of reliance), *vacated as moot*, 457 U.S. 1027 (1982).

75. 485 U.S. 224 (1988).

76. 858 P.2d 568 (Cal. 1993).

77. *Id.* at 570.

78. *See id.* at 584.

79. *See id.*

80. *See, e.g., In re* One Bancorp Sec. Litig., 136 F.R.D. 526, 533 (D. Me. 1991); *In re* Consol. Capital Sec. Litig., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,238 (N.D. Cal. Feb. 26, 1990); Cammer v. Bloom, 711 F. Supp. 1264, 1298 (D.N.J. 1989); Gruber v. Price Waterhouse, 117 F.R.D. 75, 81 (E.D. Pa. 1987); Katz v. Comdisco, Inc., 117 F.R.D. 403, 412 (N.D. Ill. 1987); Gavron v. Blinder Robinson & Co., 115 F.R.D. 318, 325 (E.D. Pa. 1987); Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1151-52 (D. Or. 1984); Glosser v. Cellcor, Inc., 1995 Fed. Sec. L. Rep. (CCH) ¶ 98,708 (Del. Ch. Mar. 10, 1995).

81. 611 A.2d 467 (Del. 1992).

fraud plaintiffs must prove reliance and that is simply the way the law is. The opinion lacked any policy or other analysis.[82]

A minority of courts have allowed plaintiffs to utilize fraud on the market in common-law fraud cases, noting, "An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price . . . [and the theory] is no less persuasive in a negligent misrepresentation case involving a securities market."[83] These courts recognize the theory regardless of whether the stock is traded OTC or on a recognized exchange, as long as the market is efficient.[84]

Acceptance of the fraud on the market theory is crucial in cases involving all but the smallest publicly held corporations. At an early stage of the litigation, defendants' demand for individual proofs on the reliance issue may defeat class certification.[85] Defendant issuer will argue that "questions of fact and law common to the members of the class [do not] predominate over any questions affecting only individual members."[86] In a smaller class action, minitrials on the reliance issue may make the class action manageable. Alternatively, in a group action each of the named plaintiffs may take the stand to offer individual proofs on the reliance issue.

Common-law fraud has evolved in the decades since Congress enacted the securities laws, but it still has an Achilles heal. The weakness is that, under the prevailing view, plaintiffs must plead and prove reliance without the aid of the fraud on the market theory reliance substitute. Only when state courts make a breakthrough on the reliance issue will common-law fraud become useful in the type of lawsuit which the PSLRA aims to govern.

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82. *See id.* at 474-75.

83. *In re* Healthcare Serv. Group, Inc. Sec. Litig., [1992-93 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,374 (E.D. Pa. Mar. 1, 1993).

84. *See, e.g.*, Hurley v. FDIC, 719 F. Supp. 27, 33-34 (D. Mass. 1989); *see also, e.g.*, Minpeco, S.A. v. Hunt, 718 F. Supp. 168, 175-76 (S.D.N.Y. 1989); *In re* Boardwalk Marketplace Sec. Litig., 122 F.R.D. 4, 8 (D. Conn. 1988); *In re* United Energy Corp. Sec. Litig., 122 F.R.D. 251, 254-55 (C.D. Cal. 1988).

85. *See, e.g., In re* One Bancorp Sec. Litig., 136 F.R.D. 526, 533 (D. Me. 1991) ("proof of individualized reliance from each member of the proposed plaintiff class effectively . . . prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones" (quoting Basic, Inc. v. Levinson, 485 U.S. 224, 242 (1988))); Garvron v. Blinder Robinson & Co., 115 F.R.D. 318, 325 (E.D. Pa. 1987) ("'common-law fraud count raises numerous issues which are personal to each plaintiff and are, therefore, uncommon to the class as a whole'[; s]ince individual issues, not common issues, predominate, certification is denied" (quoting Ungar v. Dunkin Donuts, 68 F.R.D. 65 (E.D. Pa. 1975)); *see also, e.g.*, Gaffin v. Teledyne, Inc., 611 A.2d 467, 474-75 (Del. 1992) (finding reversible error for chancery court not to have decertified class in case of equitable fraud).

86. FED. R. CIV. P. 23(b)(3).

II. SOMETHING NEW: THE FIDUCIARY DUTY TO DISCLOSE, FORMERLY KNOWN AS THE DUTY OF CANDOR

The duty formerly known as candor has evolved but not without twists, turns and a few setbacks. In its present form, the duty probably dates from the Delaware Supreme Court's decision in *Lynch v. Vickers Energy Corp.*[87] One commentator notes,[88] somewhat erroneously, "The evolution of judicial treatment of the director's disclosure duty has received little systematic attention."[89] Since *Lynch*, the Supreme Court of Delaware has rendered twenty or so decisions in which this duty figured prominently.

The Delaware Supreme Court has, however, a habit of occasionally letting the genie out of the bottle before first ascertaining the ramifications. The court did so with its well-known decision, *Schnell v. Chris-Craft, Inc.*,[90] holding that "inequitable action does not become permissible simply because it is legally possible."[91] Subsequently, the court has spent over twenty-five years fleshing out the *Schnell* doctrine's contours, pruning it back here and there when overly zealous plaintiffs' counsel attempted to use it as a universal solvent.[92]

Similarly, the court has seemingly backpedaled with so-called *Revlon* analysis in which the court held that if a corporation's sale is inevitable, the "directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for stockholders."[93] In subsequent decisions, for example, the court has narrowed dramatically the occasions when a corporation actually is "for sale" and *Revlon* duties are implicated.[94]

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87. 383 A.2d 278, 281 (Del. 1977) (corporations and their directors had a fiduciary duty of "complete candor [under which] completeness, not adequacy, is both the norm and the mandate").

88. *See* Hamermesh, *supra* note 55, at 1096.

89. For systematic discussion of directors' disclosure duty, see DOUGLAS M. BRANSON, CORPORATE GOVERNANCE § 10.07, at 562-64 (1993) ("Emergence of a New Duty—The Duty of Candor-Disclosure").

90. 285 A.2d 437 (Del. 1977).

91. *Id.* at 439.

92. For a description of the evolution of the *Schnell* doctrine, see BRANSON, *supra* note 89, § 2.04, at 80-83; Douglas M. Branson, *The Chancellor's Foot in Delaware:* Schnell *and its Progeny*, 14 J. Corp. L. 515 (1989).

93. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

94. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (finding no duty under *Revlon* when corporation enters into initial merger agreement); Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989) (finding that *Revlon* does not require that every corporate change of control be preceded by bidding contest); Invanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) (holding that *Revlon* does not apply unless sale of company in inevitable). *But see* Paramount Communications, Inc. v. QVC Network, 637 A.2d 34, 46 (Del. 1993) (stating that *Revlon* does not hold that "inevitable dissolution or 'break-up' is necessary" before directors can be subjected

The Delaware Supreme Court seemed to sense that the duty of candor was getting out of control when it rechristened the duty with the more prosaic "duty of disclosure." In *Stroud v. Grace*,[95] the court refused to apply the doctrine to directors' failure to disclose the effect of a number of proposed bylaw changes.[96] The court emphasized that the duty of candor, or complete candor, does not establish more extensive disclosure duties under state law than are required by the federal securities laws.[97] The court also retrenched in spirit:

> Plaintiffs allege a breach of the "duty of candor." Preliminarily we note that the term "duty of candor" does not import a unique or special rule of disclosure. It represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action. . . . Thus, it is more appropriate for our courts to speak of a duty of disclosure based on a materiality standard rather than the unhelpful terminology that has crept into Delaware court decisions as a "duty of candor."[98]

Despite the Delaware court's dissatisfaction, the few other courts that have dealt with the doctrine seem to find the "candor" terminology helpful.[99]

Whatever the label, from plaintiffs' point of view the doctrine offers several inducements for pursuing a state law cause of action. Nothing in this world ever is simple, however, and this exposition also must describe the refinements and cutbacks the Supreme Court of Delaware has decreed as the doctrine has evolved. Here, then, are four benefits, three potential drawbacks and one final small benefit to a state law duty of disclosure/candor litigation theory.

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to heightened judicial scrutiny). *See generally* Lawrence Cunningham & Charles Yablon, *Delaware Fiduciary Duty After QVC and Technicolor: A Unified Standard (And the End of Revlon Duties?)*, 49 BUS. LAW. 1593 (1995).

95. 606 A.2d 75 (Del. 1992).

96. *See id.* at 84.

97. Musings on this subject were made in, among other things, Donald E. Pease, *Delaware's Disclosure Rule: The "Complete Candor" Standard, Its Application, and Why Sue in Delaware*, 14 DEL. J. CORP. L. 445, 447, 452 (1989).

98. *Stroud*, 606 A.2d at 84; *cf.* Hamermesh, *supra* note 55, at 1097 n.36 ("Whether the substitution of the phrase 'duty of disclosure' for 'duty of complete candor' has done more for doctrinal clarity than new clothes did for the emperor is unclear.").

99. *See, e.g.*, Persinger v. Carmazzi, 441 S.E.2d 646, 652 (W. Va. 1994) ("Part of fair dealing is the obvious duty of candor.").

1. Benefit: Virtual Per Se Rule of Damages

The doctrine received a boost in the case of *In re Tri-Star Pictures, Inc.*[100] There, the court held that violation of the duty gives rise to an independent right to damages.[101] Justice Andrew Moore wrote, "In Delaware existing law and policy have evolved into a virtual *per se* rule of damages for breach of the fiduciary duty of disclosure."[102] Any disclosure claim is at a minimum worth one to two dollars per share.[103] In a mid-cap publicly held corporation, with fifteen to twenty million shares outstanding, one to two dollars per share in damages provides the potential of a common fund creating adequate incentive to litigate.

2. Benefit: Low State of Mind—Strict Liability or Liability for Mere Negligence

Early commentators noted that then-existent Delaware candor cases said nothing about state of mind.[104] Those commentators thought that the liability might be strict.[105] Later, the Delaware Supreme Court noted that that the duty is "an obligation that has been characterized as a derivative of the duties of care and loyalty."[106] The duty of care would require at least negligence for liability.

One commentator suggests that the court may impose strict liability if the

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100. 634 A.2d 319 (Del. 1993).

101. *See id.* at 334.

102. *Id.* at 333. Seemingly, the Delaware court did great violence to that principle in its recent decision, *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135 (Del. 1997), but in reality it seems to have left the principle undisturbed. The *Loudon* court would not permit damages for disclosure violations in election of directors but did note that "[t]here may ... be a potential damage remedy where the misstatement or omission implicates the stockholders' economic or voting rights." *Id.* at 138. Continuing, the court held, "But there is no *per se* doctrine imposing damage liability on directors in a disclosure case absent these elements." *Id.* That apparently is the meaning of the court's later statement, "The dictum in *Tri-Star* is confined to the facts of that case." *Id.* at 147.

103. *See* Hamermesh, *supra* note 55, at 1158 & n.322.

104. *See, e.g.*, J. ROBERT BROWN, JR., THE REGULATION OF CORPORATE DISCLOSURE § 9.03, at 9-20 (2d ed. Supp. 1995) ("Delaware cases have not explicitly imposed a state of mind requirement for violations of the duty of candor")

105. *See, e.g.*, Pease, *supra* note 97, at 486 ("Under the Delaware cases ... the plaintiff need not prove that the flawed disclosure was caused by either scienter of negligence."). The author concluded that "Delaware has a strict liability standard." *Id.* at 487; *see also* Hamermesh, *supra* note 55, at 1093 n.18 (noting 12 Delaware candor cases in which no mention is made of culpability).

106. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 (Del. 1995). In *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994) ("*Arnold I*"), the court asked for briefing on whether the duty was derivative or was an independent "free-standing fiduciary duty." Hamermesh, *supra* note 55, at 1139. However, in its second opinion, *Arnold*, 678 A.2d 533 (Del. 1996) ("*Arnold II*"), the court failed to clarify the issue. *See* Hamermesh, *supra* note 55, at 1140.

relief sought is an injunction against, or recision of, a transaction that was approved based upon misleading or incomplete disclosure.[107] Also, if directors are self-dealing, then strict liability also should apply.[108]

If, however, the directors made a recommendation concerning a takeover bid, urged shareholder approval of a merger or urged a shareholder vote in favor of a change in corporate governance rules, liability for damages should exist only if the directors failed to take due care in presenting the material information to the shareholders.[109] An essential element of duty of care violations is proof of actual damages.[110] The Delaware duty of disclosure/candor has a virtual per se rule of damages. Equivalence of the duty of disclosure with the duty of care, then, is not consistent with the Delaware Supreme Court's holding in *Tri-Star Pictures* and subsequent cases.

3. Benefit: Other Types of Relief and Ensuing Leverage

A possible remedy for a violation of the duty of disclosure is an injunction against the transaction.[111] Because of the directors' incomplete disclosure, shareholders have approved the transaction. A federal court, applying Delaware law, has rescinded a transaction, due to violations of the duty of disclosure.[112] A leading commentator argues that injunctive relief, including recision of an election of directors, may be warranted if the court finds duty of disclosure violations.[113] Such an injunction often represents a large bargaining chip for shareholders' class counsel, who may utilize that injunction to increase the settlement offered to the shareholders.

4. Benefit: No Preemption

All parties in the proposed "Uniform Standards" legislative debate, plaintiffs' bar, SEC, accounting profession and Silicon Valley, seem willing

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107. *See* Hamermesh, *supra* note 55, at 1162 ("On what theory of liability, then, would such a preliminary injunction rest? The only intellectually satisfying answer is some strict duty of disclosure, akin to that posited for trustees . . . ." (footnotes omitted)).

108. *See id.* at 1100; *see also id.* at 1102 ("Where director self-interest is absent, there is no need for strict liability or disgorgement-type remedies to discourage fiduciary opportunism . . . .").

109. *See id.* at 1101.

110. *See* BRANSON, *supra* note 89, § 6.14, at 291-95.

111. *See, e.g.*, Lacos Land Co. v. Arden Group, Inc., 517 A.2d 271, 278 (Del. Ch. 1986) (awarding an injunction against the implementation of a dual class capitalization plan).

112. *See* Edelman v. Salomon, 559 F. Supp. 1179, 1184 (D. Del. 1983) (nullifying amendment of articles of incorporation eliminating cumulative voting).

113. *See* Hamermesh, *supra* note 55, at 1170-71.

to create an exception for the Delaware common-law duty of disclosure.[114] Although state securities law class actions would be preempted by the legislation, as a corporate law fiduciary principle, the duty of disclosure/candor will remain available for state court class action litigation.

5. Possible Disadvantage: No Direct Corporate Liability

In corporate and securities litigation, the most readily accessible deep pocket is likely to be the corporation. The Delaware Supreme Court has held, however, that the individual directors, not the corporation, are liable for duty of disclosure violations.[115]

There is a division of authority as to whether the corporation itself owes fiduciary duties to its shareholders.[116] In jurisdictions holding that corporations may owe fiduciary duties, a court may find corporate liability for violations of the duty of disclosure.[117] Arguably, some of the duties a corporation owes to its shareholders are, and should be, fiduciary in character; the duty of disclosure should be among them.[118]

Although relegated to director liability in Delaware and jurisdictions following its jurisprudence, class counsel may find an indirect means to the corporate pocket. The corporation may be required to indemnify directors. If the corporation has directors' and officers' liability insurance, the coverage amounts will often fall short of the amount of the liability. At least on an indirect basis, indemnification provisions will "kick in" to render the corporation liable.

Additionally, if class counsel is able to obtain an injunction against a transaction, the leverage gained may aid in negotiation and creation of a common fund benefiting the shareholders.[119]

6. Possible Disadvantage: Directors May Be Free of Liability Due to Exculpation Provision in Articles of Incorporation

Since 1986, Delaware law has provided that a corporation may include in

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114. *See supra* note 16 and accompanying text; *see also Bill to Federalize Securities Class Suits Could Erase Important State Corporate Law*, 29 SEC. REG. & L. REP. (BNA) 1512 (Oct. 31, 1997).

115. *See* Arnold v. Society for Sav. Bancorp., Inc., 678 A.2d 533, 539-40 (Del. 1996).

116. *See, e.g.*, BRANSON, *supra* note 80, § 10.06, at 559-61.

117. *See, e.g.*, Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987) (Easterbrook, J.) (holding the corporation to a fiduciary duty when repurchasing shares from employee-shareholder); Michaels v. Michaels, 767 F.2d 1185, 1194-97 (7th Cir. 1985) (holding that corporation itself has state law fiduciary duty of disclosure).

118. *See* BRANSON, *supra* note 89, § 10.06, at 561.

119. *See supra* notes 111-12 and accompanying text.

its articles:

> A provision eliminating or limiting the personal liability of a director ... for monetary damages for breach of fiduciary duty as a director, provided that such a provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders.[120]

Because the duty of disclosure/candor was thought to be based upon the duties of care and loyalty,[121] it was thought that exculpatory provisions might not relieve directors of money damage liability. In *Zirn v. VLI Corp.*,[122] the court began with the proposition that the directors had a duty to "disclose to shareholders all material facts bearing upon a merger vote aris[ing]under the duties of care and loyalty."[123] The court concluded that under the authorizing statute, the corporation could not exculpate its directors from liability.[124]

The holding of *Zirn* was short-lived. A year later, the court in *Arnold v. Society for Savings Bancorp, Inc.*[125] read the Delaware statute as unambiguously allowing exculpation for duty of disclosure/candor violations, at least if no self dealing or "intentional misconduct or a knowing violation of the law" was involved.[126]

In the Delaware court's latest pronouncement, Delaware Chief Justice Veasey, attempting to reconcile *Zirn* and *Arnold*, noted that a corporation's "certificate of incorporation may eliminate the availability of money damages."[127] If disclosure violations result from good faith errors by the directors, Delaware law relieves them of money damage liability.[128]

In other jurisdictions, such as the thirty-five states that follow the Model Business Corporation Act,[129] the authorizing statute is broader. The statute permits exculpation for directors from all liabilities to the corporation or its shareholders with two exceptions: the court can require the director to pay "the amount of a financial benefit received," or the court can hold the

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120. DEL. CODE ANN. tit. 8, § 102(b)(7) (1996).
121. *See supra* notes 104-08 and accompanying text.
122. 621 A.2d 773 (Del. 1993).
123. *Id.* at 778.
124. *See id.* at 783.
125. 650 A.2d 1270 (Del. 1994).
126. *See id.* at 1286-88; *see also* Hamermesh, *supra* note 55, at 1140.
127. Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 141 n.20 (Del. 1997) (citing *Zirn* and *Arnold* as having identical holdings).
128. *See id.* at 142 n.27.
129. *See, e.g.*, Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258, 259-60 (1993) (noting that the Revised Model Business Corporation Act is basis for corporate law of 35 states).

director liable for "an intentional infliction of harm on the corporation or its shareholders."[130] Corporations that fully utilize the breadth of the statute may virtually eliminate duty of disclosure/candor liability for their directors. Therefore, in litigation, class counsel would be relegated to the remedies of injunction and recision and whatever leverage those remedies may give her.

7. *Possible Disadvantage: Limited Circumstances in Which the Duty of Disclosure Applies*

Many cases involve a misleading or incomplete press release, containing, for example, an earnings forecast or progress report on a new product line. Other nondisclosures or misleading statements can occur in the context of the directors' annual election. At its broadest, the duty of disclosure seemed to be a route to a state law remedy for these shareholder injuries.

In *Marhart, Inc. v. Calmat Co.*,[131] a corporate press release allegedly exaggerated the benefits of a defensive restructuring management proposed in response to a takeover bid. Vice Chancellor Berger held that corporate directors, as fiduciaries, had an obligation "to honestly disclose all material facts when they undertake to give out statements about the business to stockholders."[132] Therefore, the class complaint for damages survived a motion to dismiss.[133]

Chief Justice Veasey cut back on the doctrine's reach in *Loudon v. Archer-Daniels-Midland Co.*,[134] where the defendant company failed to disclose, in its annual solicitation for the election of directors, the well-publicized "troubles" ADM and its chairman Dwayne Andreas had encountered.[135] The court clearly held that the duty of disclosure, applied in conjunction with the court's concomitant "virtual per se rule of damages for breach of the duty of disclosure, does not apply to nondisclosures in the election of directors."[136]

Standing alone, the duty of disclosure does not require a slate of directors seeking election to engage in "self-flagellation" and "draw legal conclusions implicating [themselves] in a breach of fiduciary duty . . . prior to a formal

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130. Revised Model Business Corporation Act § 2.20(b)(4).

131. 18 DEL. J. CORP. L. 330 (Del. Ch. 1992).

132. *Id.* at 336 (citing Kelly v. Bell, 254 A.2d 62, 71 (1969)).

133. *See id.* at 338.

134. 700 A.2d 135 (Del. 1997).

135. *See id.* at 138-39. These troubles included an FBI investigation of price fixing allegations, resignation of a director, the commencement of various class actions against the corporation and its directors, appointment of a special litigation committee and various corporate actions taken against a former corporate officer. *See id.*

136. *Id.* at 141 (citing *In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319, 333 (Del. 1993)).

adjudication of the matter."[137] Indeed, Chief Justice Veasey states the proposition as a rule of law: "the self-flagellation rule."[138]

Loudon may eliminate the state law disclosure duty cause of action in the press release as well as in the election of directors context.[139] The case seems to limit the damage remedy to a "*transaction* that has in turn caused impairment to the economic or voting rights of stockholders,"[140] echoing a leading commentator who urges that the duty does not apply at all to "public statements not intended on their face to elicit or counsel stockholder action."[141] That commentator elaborates:

> At most, directors and officers who issue press releases or other public corporate statements have the market generally, and not the stockholders, as ordinarily intended objects or beneficiaries of the information.... Nothing in the law sets up directors as objects of stockholder reliance or sources of recommendations to stockholders, from which an all-encompassing fiduciary duty of continuous disclosure might be inferred.[142]

Nonetheless, a fairly wide, although not unlimited, field of play exists upon which the duty of disclosure may operate. The field of play includes disclosures regarding proposed changes in corporate governance rules.[143] The field includes disclosures made in a Schedule 14D-9 advising shareholders on a third-party tender offer.[144] The field includes omissions in a going private transaction initiated by a parent corporation.[145] It includes misleading disclosures made in an information statement distributed by a parent corporation in a short form merger.[146] And, it includes nondisclosures or misrepresentations when directors themselves are purchasing stock.[147]

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137. *Id.* at 143 (citing Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992)).

138. *Id.* at 145.

139. There still is a state law cause of action for fraud in the election of directors that requires pleading and proof of knowing or intentional conduct. *See* BRANSON, *supra* note 89, § 2.02, at 74-75 (prevailing state law fraud standard contrasted with negligence standard under the federal proxy rules).

140. Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 142 (Del. 1997) (emphasis added).

141. Hamermesh, *supra* note 55, at 1173.

142. *Id.* at 1173-74 (footnotes omitted).

143. *See* Stroud v. Milliken Enterprises, Inc., 552 A.2d 476, 480 (Del. 1989).

144. *See* Weinberger v. Rio Grande Indus., 519 A.2d 116, 121 (Del. Ch. 1986).

145. *See* Shell Petroleum, Inc. v. Smith, 606 A.2d 112 (Del. 1992).

146. *See* Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980).

147. *Compare* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) ("one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy"), *and* Brophy v. Cities Serv. Co., 70 A.2d 5 (Del. Ch. 1949) (director or officer must account to the corporation for all profit derived from use of inside information derived through his position), *with* Kors v. Carey, 158 A.2d 136, 143 (Del. Ch. 1960) ("directors generally do not occupy a fiduciary positioin vis á vis individual stockholders in direct personal dealings [except] in special cases where

8. Benefit: A Return to Mere Notice Pleading

In contrast to claims under the PSLRA, state law duty of disclosure claims may be plead as in any other civil case, at least according to one eminent source:

> In asserting direct claims, as distinct from stockholder derivative claims, the complaint need give only general notice of the claim asserted. To state a claim upon which relief may be granted, plaintiff need only provide a well-pleaded "short and plain statement of the claim showing that the pleader is entitled to relief." A requirement that the pleader state facts "with particularity" is reserved for derivative stockholder claims under Chancery Rule 23.1 and for fraud or mistake claims under Rule 9(b). We see no reason to depart from the general pleading rules when alleging duty of disclosure violations.[148]

The real benefit of state law is the liberal pleading requirements. Compared with pleading requirements under the PSLRA, as interpreted by a majority of federal judges,[149] the pleading requirements for a violation of the directors' duty of disclosure are minimal.

III. SOMETHING BORROWED—SECONDARY LIABILITY (AIDING AND ABETTING) FOR BREACHES OF STATE LAW FIDUCIARY DUTY

In federal securities law actions, secondary liability is visited upon secondary defendants, if at all, because someone else, the primary violator, has violated the securities laws. Plaintiffs often name as codefendants those collateral participants who knowingly, or recklessly, rendered substantial assistance to the primary violator in perpetration of the fraud or registration violations alleged. Collateral participants include corporate officers and directors, general partners of a limited partnership, accountants and accounting firms, banks and business consultants, attorneys, celebrity spokespersons and so on. Collateral participants may be, and frequently are, primarily liable if, for example, they themselves uttered misrepresentations, participated actively in statements made by others or had a direct hand in "selling the deal."[150] More frequently, however, plaintiffs are able only to

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advantage is taken of inside information").

148. Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 140 (Del. 1997) (footnotes omitted).

149. *See supra* notes 29-31 and accompanying text.

150. *See generally* Branson, *Collateral Participant Liability (Federal)*, *supra* note 52, at 329-35. The significance of the collateral participant's involvement in the sales process is due to the Supreme Court's rejection of the "substantial factor" test for determining seller status in section 12 liability

allege that collateral participants are liable, if at all, secondarily. Federal law in the last several years has, however, drastically curtailed both plaintiffs' ability and motivation to do so.[151]

Under SEC Rule 10b-5, aiding and abetting was the principal theory of secondary liability plaintiffs utilized. In *Central Bank v. First Interstate Bank*,[152] however, the Supreme Court held that aiding and abetting liability cannot exist under the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Plaintiffs often join a number of collateral participants. Plaintiffs do so because, at least in smaller offerings, the issuer itself has become judgment proof. Regardless of whether the issuer is judgment proof or not, plaintiffs also name collateral participants and then attempt to reach relatively quick settlements with those collateral participants who have less culpability. With those settlements, plaintiffs are better able to finance their continuing efforts to hold liable those defendants plaintiffs perceive to be more culpable.[153]

Just as *Central Bank* drastically curtailed plaintiffs' ability to pursue collateral participants, the PSLRA drastically curtails the motivation for doing so. Before the PSLRA, plaintiffs were able to achieve early settlements with some defendants by using the threat of joint and several liability as a "hammer." A less culpable individual, say, five percent responsible, could be held liable for all ten, twenty or thirty million dollars in damages to a plaintiff class or to a group of named plaintiffs. That defendant had a powerful incentive to take an early exit by way of settlement if plaintiffs offered one.[154]

In a section sensationally titled "Reduction of Coercive Settlements,"[155] the PSLRA eliminates joint and several liability except in cases in which the plaintiff is able to prove knowing conduct. A scheme of comparative fault

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cases. *See* Pinter v. Dahl, 486 U.S. 622 (1988); *see also* Branson, *Gauntlet*, *supra* note 1, at 7-9.

151. *See* Central Bank v. First Interstate Bank, 511 U.S. 164 (1994); Pinter v. Dahl, 486 U.S. 622 (1988); *see also* Branson, *Gauntlet*, *supra* note 1, at 5-13.

152. 511 U.S. 164 (1994).

153. *See, e.g.*, Stephenson v. Calpine Conifers II, Ltd., 652 F.2d 808, 811 & n. 1 (9th Cir. 1981) (eight individual, four corporate and I-XX Doe defendants); McFarland v. Memorex, 493 F. Supp. 631 (N.D. Cal. 1980) (42 defendants including accountants and their firms, issuer's officers and directors, three banks and 11 other individuals). The grandparent of them all must be *In re Washington Public Power Supply Systems Litigation*, 19 F.3rd 1291 (9th Cir. 1994) (200 defendants including 88 participating utilities, individual directors of utilities, law firms, New York bond counsel, engineers and engineering firms and others). *See generally* Branson, *Collateral Participant Liability (Federal)*, *supra* note 52, at 327-28.

154. The process is described in, among other things, Branson, *Gauntlet*, *supra* note 1, at 37-38, and in Branson, *Collateral Participant Liability (State)*, *supra* note 6, at 1035-37.

155. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, §§ 201-03, 109 Stat. 737, 758-62.

has been introduced in place of the joint and several liability traditional in the securities area. The result is that plaintiffs may never file some suits because of the reduced possibility of settlement. A second effect is that "[o]nce suit is brought, the dry spell will be longer—from the filing of the complaint to the courthouse steps, the possibility of settling cases along the way is vastly reduced."[156]

State law, however, preserves some, perhaps even much of plaintiffs' ability and motivation to prosecute culpable collateral participants. This preservation is partially achieved through state securities law.[157] But the state common law of corporations and other business associations also helps significantly.

Aiding and abetting allegations under state corporate law, then, are the "something borrowed" of this Article, although at least the early state law decisions did not seem, consciously anyway, to be looking to federal securities law for their inspiration.[158] In an early decision, without reference to federal securities law, the Delaware Vice Chancellor held:

> The legal theory [of aiding and abetting breaches of fiduciary duty] is sound. The directors of a corporation stand in a fiduciary relationship ... [a]nd one who knowingly joins with any fiduciary, including corporate officials, in a breach of his obligation is liable to the beneficiaries of the trust relationship.[159]

Four years later, the Delaware Supreme Court placed its imprimatur on aiding and abetting, approving the statement that "if outside experts, on whom many must depend for the integrity of corporate affairs, knowingly conspire with self-dealing fiduciaries to defraud those very persons who in practicality must rely on their advice, it is difficult to see why... trust principles ... should not apply ...."[160] Recently, the theory that an attorney could be held liable for aiding and abetting violations of fiduciary duty was accepted by the Court of Appeals of Maryland.[161] Recent cases in Virginia[162]

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156. Branson, *Gauntlet*, *supra* note 1, at 38.

157. *See* Branson, *Chasing the Rogue Professional*, *supra* note 8, at 115-22 ("Turn to State Securities Law"); *see also* Branson, *Collateral Participant Liability (State)*, *supra* note 6, at 1037-67.

158. Later state law cases that do examine and borrow from federal aiding and abetting cases include *Blow v. Shaughnessy*, 364 S.E.2d 444, 447 (N.C. Ct. App. 1988); *Greenfield v. National Medical Care, Inc.*, 12 DEL. J. CORP. L. 737 (Del. Ch. 1986).

159. Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972).

160. Laventhol, Krestein, Horwath & Horwath v. Tuckman, 372 A.2d 168, 170 (Del. 1976) (holding that the time bar to an action against the aider and abetter would be laches rather than the shorter statute of limitations under the principle of *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 820-21 (Del. Ch. 1944)).

161. *See* Alleco, Inc. v. Harry & Jeanette Weinberg Found., Inc., 665 A.2d 1038, 1049 (Md. 1995)

and Oregon[163] accept or apply the concept of collateral participants' aiding and abetting breaches of fiduciary duty.[164]

Many securities cases involve self dealing, or even outright theft, by partners, general partners, corporate officers or promoters, all of whom are fiduciaries under state law. Often, the defalcations or acts of self dealing are assisted by collateral participants who know of the wrongdoing and turn a blind eye, or even aid in creating a false appearance or impression. Aiding and abetting under state corporate or partnership law thus may be a valuable tool for class or group counsel in securities cases.

The drawback to state law aiding and abetting jurisprudence, as it has developed, is that state courts universally require that the secondary defendant knew that the primary violator was violating the law and rendered substantial assistance.[165] Federal securities aiding and abetting, when it did exist, generally held that reckless conduct, at least of the conscious disregard sort, satisfied the state of mind requirement.[166] Nonetheless, aiding and abetting—with knowing conduct as the state of mind element—is better than no aiding and abetting at all, which is the current situation under federal law.

Thus, in some cases in which the issuer is judgment proof and collateral participants are culpable, or in any case in which culpability is relatively clear, state law may provide a substitute for what the Supreme Court and the PSLRA took away. In some of the disclosure cases, in which corporate spokespersons sought shareholder action or inaction through misleading statements or documents, the fiduciary duty of disclosure and candor, cobbled together with aiding and abetting allegations against secondary defendants, may be an alternative.[167]

(finding, however, that plaintiffs failed to adequately allege primary violation).

162. *See* Tysons Toyota, Inc. v. Globe Life Ins. Co., 45 F.3d 428 (4th Cir. 1994), *available in* 1994 WL 717598 (unpublished table decision) (deciding case under Virginia law).

163. *See* Granewich v. Harding, 945 P.2d 1067, 1075 (Or. Ct. App. 1997) (accepting the concept of "aiding and assisting" but not holding liable attorney who prepared documents and rendered advice only after majority shareholders formed intention to squeeze plaintiff out of corporation).

164. A different secondary liability theory was accepted by a court in *Rome Industries, Inc. v. Johnson*, 415 S.E.2d 651 (Ga. Ct. App. 1992). The court approved a liability theory that, by assisting a wrongdoing corporate officer, collateral participant could be found liable for tortiously interfering with the implied contract, that is, fiduciary duty, between the corporate officer and the corporation.

165. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 & n.33 (Del. 1988); Weinberger v. Rio Grande Indus., Inc., 519 A.2d 116, 131 (Del. Ch. 1986); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972); Blow v. Shaughnessy, 364 S.E.2d 444, 447 (N.C. Ct. App. 1988).

166. *See, e.g.*, Ruder, *supra* note 43, at 575-77.

167. Of course, even the marginal utility of such a combination may be chiseled away unless proposed "Uniform Standards" legislation contains a "carve out" or exception for the Delaware duty of disclosure jurisprudence but at present that seems unlikely. *See supra* note 16 and accompanying text.

IV. CONCLUSION

As much as I am a cheerleader for state law and state courts, the research and writing of this Article have convinced me that, at best, state law is an imperfect substitute for what the reformers have taken away. What they have taken away is a large portion of the ability to vindicate wrongdoing by publicly held corporations, their officers, directors and spokespersons, and those who assist them.

On the state level, common-law fraud has evolved, but surprisingly not much, and the reliance element remains a sticking point in filling the gap. The Delaware duty of disclosure and candor once demonstrated fairly broad promise but, as with the *Schnell* doctrine or so-called *Revlon* analysis, the Delaware Supreme Court is chipping away, not reshaping but retrenching, stuffing the "genie" back into the bottle. State law aiding and abetting violations cover some lost ground but proof that collateral participants actually knew of wrongdoing, whether by direct or circumstantial proof, is difficult.

The last part of the marital metaphor in the title of this Article is the "something blue." The "blue" infects those practitioners and academics, including myself, who believe that securities law and litigation have an important role to play in making injured parties whole and, ultimately, in the process of encouraging capital formation. The reformers have gone too far—the pendulum has been pushed too far into the extreme.

State law has a role to play but, for the most part, that role will be confined to exempt transactions, small public offerings and similar small to mid-sized deals. The reformers have compromised our "capable and ... majestic federal courts,"[168] which are now relegated to administering a complex, detailed "add-on" code of civil procedure (the PSLRA) designed to neutralize the great securities legislation of the New Deal and to foil federal judges from doing substantial justice in big or important cases. There's no R & B—no rhythm—it's not "something blue"—it's pretty much "all blues."

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168. Branson, *Chasing the Rogue Professional*, *supra* note 8, at 125.