CORPORATE LAW IN THE TWENTY-FIRST CENTURY: THE PRACTITIONERS' PROGNOSIS

Presenters

ARTHUR FLEISCHER, Esquire
Fried, Frank, Harris, Shriver & Jacobson

PETER A. ATKINS, Esquire
Skadden, Arps, Slate, Meagher & Flom

Commentators

THE HONORABLE STEPHEN P. LAMB
Vice-Chancellor, Court of Chancery

PROFESSOR PAUL L. REGAN
Widener University School of Law

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PROFESSOR REGAN: Well, good morning and welcome back from your break. My name is Paul Regan and I'm a professor at Widener Law School. Originally, I was to have been on the earlier interesting panel on corporate litigation into the next century, but I'm substituting for Professor Stilson on this panel who was unable to be with us this morning. It falls to us to bring to you the last segment of this very interesting conference and it's been very pleasurable to be here the last couple of days with such distinguished speakers, and this panel is no exception.

It's my privilege to be on this panel with such esteemed colleagues. The first member I'd like you to meet, on my immediate left, is Peter Atkins who is an M&A partner at Skadden, Arps in New York. Further to my left is Art Fleischer, from the firm of Fried, Frank, Harris, Shriver & Jacobson. Peter and Art are both very experienced practitioners in this field and appropriate presenters for us on this topic today of the practitioner's prognosis. And we, on this panel, will also hazard some predictions about the near and long-term future.

Sharing responsibilities with me as a commentator is Vice-Chancellor Stephen Lamb of the Delaware Court of Chancery. We are all most grateful for the time and insight which our Delaware judges have contributed to the conference, and I know all of us are looking forward to Vice-Chancellor Lamb's remarks as well.

So without further ado, Peter, you can kick us off. Thanks.

MR. ATKINS: It is a real pleasure to be here — although I almost declined the invitation. Somehow I had a hard time imagining myself publicly prognosticating about what would happen over the next 100 years — even in a very targeted area of human endeavor.

However, I decided to say yes. Mostly because it seemed like an interesting exercise — to peek above the trenches and look into the future of corporate law. Also, I recognized that it is quite unlikely that I'll be around at the next centennial symposium to see how off-base I was.

Having said yes, naturally, as a good corporate lawyer, the first thing I did was to make a list. I've kept it short in the interests of time — there are many other subjects that could be added. My thought was to pick out a few topics which seemed to have a potential for influencing the direction and nature of the practice of corporate law well into next century. For better or worse, I now have such a list. Your lists may be quite different. However, I would like to say a few words about each of the items on mine. These items are:

- The impact of globalization
- The impact of information technology developments
- Corporate governance and director responsibility
- And finally, change in control in the unsolicited bid context

Let me start with some thoughts on the impact of globalization. The next century is likely to see an acceleration of the globalization of business enterprises that already has marked the closing decades of the twentieth century.

One inevitable result will be that the corporate law model as we know it will increasingly interact — and perhaps even conflict — with the corporate law regimes of other jurisdictions. Corporate lawyers will need to be cognizant of the potential for significant differences in the treatment of basic corporate transactions — and will need to develop the creativity to engineer around unexpected obstacles to achieve desired business objectives.

A classic example was the recent combination of Daimler Benz and Chrysler Corporation. The German corporate law differs in important respects from Delaware's, where Chrysler was incorporated. Had German law been like Delaware's, the stock for stock business combination transaction could have been accomplished in a straightforward way, the choice of which company was to be the surviving public company would have been left to be decided as a business issue, and a desired objective — that the transaction be accounted for as a pooling of interest — would have been easily handled. But this was not the case. In the first instance, there was no corporate merger mechanic permitting German shareholders to receive stock of a non-German corporation which also would assure

elimination of continuing minority shareholders in the German company. So the option of having Chrysler be the surviving legal entity was simply not available. Moreover, there is no straightforward merger mechanic even for a combination of two German companies which does not provide for potentially broad appraisal rights. Thus a voluntary exchange offer with a new German holding company was required and 90% of the shares had to be obtained in it in order to avoid disqualifying pooling treatment. Fortunately, this all worked — but it involved a level of corporate acrobatics that, while quite exciting, would not exactly have been the program of choice in trying to accomplish a multibillion dollar cross-border business combination.

The variation among international corporate law regimes leads, of course, to the possibility of corporate lawyers and academicians from around the globe initiating a brand new project for the twenty-first century — creating the International Model Business Corporation Law. From a U.S. corporate lawyer's perspective, it would be quite comforting to extend the modern business corporation law mechanisms and flexibility — as we have grown to appreciate them — to foreign shores. As tasks go, however, this may be one of the more daunting to accomplish. Corporate law can reflect a carefully guarded parochialism. Even in the U.S., where common legal traditions and the economic interaction across state borders should moderate corporate law variances, each state carefully — and in some cases, perhaps jealously — oversees the critical legal framework governing companies incorporated in its jurisdiction. The differences in approaches taken to non-shareholder constituencies, and the acceptance or rejection of the *Revlon*[1] and *Unocal*[2] enhanced scrutiny jurisprudence, are two important examples. The prospect of harmonizing widely disparate corporate law systems on an international scale does seem to call for great courage — and an effort that might well take the entire next century.

However, if a European Union can be formed, and a eurocurrency can be adopted, other transnational reforms which support a regional and perhaps the global economy certainly should not be discarded lightly. In attacking the international corporate law reform problem in the twenty-first century, I would make just a few comments. First, don't assume this is simply an exercise in "exporting America." We are comfortable with, and convinced of the efficacy of, our model. But so are many of the other countries about theirs. Second, attack the problem piecemeal. Some elements of reform, aiming at commonality of corporate regulation, will be much easier to address than others. For example, it would seem easier to

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[1]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
[2]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

get consensus on the mechanics and procedures for such matters as share transfers, voting rights, inclusion of provisions in charters and bylaws, etcetera, than on the regulation of changes in corporate control. *Finally*, be prepared for a few problems to hang around until the twenty-second century! The governance construct at the board level might be one such area. For example, how do we choose — or compromise — between, a single body, shareholder-elected board with no other constituency representation (the basic U.S. model) and a German-style dual board structure — with management on the inside board, outside advisory directors on the advisory board, responsibilities allocated between them, and labor representation on the advisory board?

At the present time the Organization of Economic Cooperation and Development has underway an initiative to develop a set of Principles of Corporate Governance which it hopes will become globally accepted standards for defining the relationships among corporations, shareholders, regulators and other stakeholders. A report setting forth these Principles has been issued and is scheduled for a vote of the 29 member countries of the OECD at its annual meeting later this month.[3] These Principles, even if adopted, would not be binding. Broadly speaking, the OECD Principles reflect many corporate governance practices in the U.S. However, as you might expect, there are some important variations — and, of course, the devil will be in the details.

While we are waiting for this basic reform, corporate law practitioners might be well-served by taking a comparative corporate law course here at Widener Law School.

PROFESSOR REGAN: One question, Peter, involves the OECD Principles of Corporate Governance which you mentioned. There does appear to be in these principles at least a reference to protecting the rights of stakeholders beyond just the conventional conception of protecting stockholders as owners of the corporation. What's your reaction to that as part of this harmonization effort by the OECD?

MR. ATKINS: I think that's probably one of the most difficult issues to try to get a consensus on. I wasn't part of the OECD effort, but I do understand that that might have been the one that took the longest, was the hardest to come to grips with, and I think it's probably the least satisfying from the standpoint of the various members. And the idea of having a principle that acknowledges constituencies unrelated to shareholders and with a stature that's independent of shareholders, obviously, that debate is going on in the United States, but it's a debate that there are — it's not even

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[3]OECD Ad Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance* (April 1999).

clear where that's going here, and to have that sort of rise to the level of an accepted principle on an international scale, I think that to me is one of those issues that if the effort of a truly international model act were ever pursued, I think that one may be the one that waits until the twenty-second century.

VICE-CHANCELLOR LAMB: Peter, let me ask you, do you know, as part of the integration in Europe of the Euro and so forth, is there any effort afoot in Europe to create a European corporate structure so that corporations wouldn't be German corporations but, rather, European corporations if they chose to do so?

MR. ATKINS: I'm not aware of that at this time, sir.

VICE-CHANCELLOR LAMB: One other question on that subject then. Do you see the globalization of business activities by U.S. companies leading to or creating any interest in a national incorporation law in this country?

MR. ATKINS: Interest from whom? I think there is a genuine interest in this country in maintaining a system which has been around a long time and I think jealously guarded. I mean, that's my view as to the sources of corporate law. And it would be easy for somebody to stand up and say, look, if we're going to deal in the international community in a broad way, you ought to have a set of rules that's common among the states and that the outside world, the non-U.S. business community can look to and rely on and feel that there's a consistency. I can say it. I don't really think it's going to happen.

MR. FLEISCHER: A national corporation law is not necessary; Delaware in every real sense is the national corporation law. There is no indication that status will change or Delaware's status be diminished. In a recent survey that the firm did, the last hundred or so public offerings, sixty of the hundred companies were incorporated in Delaware. There was no other state that had a dominant proportion.

As a practicing lawyer, what you look for in corporation law is structural flexibility, on the one hand, and some sense of morality or righteousness on the other hand — a fiduciary responsibility on the directors and managers.

Essentially business corporations should be able to structure transactions and effect transactions in as flexible a way as possible without the circumscription of rigid legal principles. Again, that is the theme in Delaware. I believe that other states, although their laws are not as fully developed as Delaware, typically embody a similar theme. The type of concerns that Peter has raised in the global area, which demonstrate a rigidity and an inflexibility do not seem to be, at least in my experience, a general product of our laws.

Therefore, in our situation, what is the basis for moving toward a national corporation law? What are the policy concerns that would lead you

to that conclusion? I certainly do not see critical flaws in terms of the functioning of our corporation laws that would lead you in that direction.

MR. ATKINS: Moving ahead, another force likely to have a real affect on how we practice corporate law in the twenty-first century, and on the advice we give our clients, is the burgeoning field of information technology. Corporate law and practice will not be immune from the impact of this pervasive force.

It is perhaps easiest to illustrate this point by focusing on an area familiar to us all — the fiduciary responsibility of directors. One of the basic directorial duties is to make informed decisions. The predicate for such decisions is consideration of all material information reasonably available. In the new age of information technology — and information availability — new awareness will have to be continually applied to guide directors about how to meet this standard.

Will boards and board committees need a "Board Search Engine Officer," to participate with them in their decision making and provide assurance that relevant sources of information have been accessed? Exactly what will those sources be? Can directors simply rely on management and experts to identify those sources, or to confirm that they have been reviewed and that the information derived has been factored into the presentations made to the board? Will the defense of reliance on management and experts be undermined by virtue of the fact that databases and other information are as easily accessible to board members as to management and board advisors. Should directors, or counsel on their behalf, query management or key advisors regarding what information sources were accessed, and how?

Take a case where a buyer is acquiring a business that has certain known areas of potential contingent liabilities, such as environmental or product liability claims. Has the acquisition team done a broad database search to determine if relevant and perhaps important information about these potential claims areas is available and, if so, have they included it as part of their acquisition assessment? What if the information existed, was not accessed, proved to be negative, the deal closed, the information was subsequently discovered, the value of the acquired business declined and money was lost. If the board had not asked whether the EPA's Superfund site docket had been checked, or whether the acquired company's name had been run through some product liability class action reporter database, will their approval of the transaction satisfy their duty of care?

Perhaps the answer, in many cases, will be that, indeed, directors will continue to be able to rely on management and experts much as they may today — at least if they ask the basic questions which reasonable directors should ask and receive acceptable answers. But therein lies the rub — just what are those questions and answers? The sources, content and accessability of then existing relevant information — and the computer

literacy and internet information access awareness of individual directors — may well shape or influence this judgment.

The information technology revolution has created another widespread and important phenomenon — the drive for real time, often virtually instantaneous response and decisions. Certainly, as corporate law practitioners, we all have experienced this ever increasing demand for speed, for instant answers, for immediate turnaround. The relatively recent phenomenon of a faxed mark-up of a lengthy agreement, accompanied by a cover note requesting a prompt response — which already has dramatically increased the demand for real time response — is being replaced as we meet here by the further wonders of modern information technology — in particular, internet e-mail with hundreds of document pages attached. If you think prompt turnaround was being demanded before, just wait.

The fact is, getting more stuff faster does not necessarily improve the quality of performance. There is a danger in speed — things can get out of control, and can crash and burn as a result. This is as true in the boardroom as on the highway. Which is why the requirement that directors make informed decisions includes the requirement that they be made in a deliberative manner. A process which combines good information and thoughtful consideration of it is what is needed to satisfy the directors' bedrock fiduciary duty of care. Yet, supported by the new world of instant electronic communications and information transfer, and the fast action environment which it encourages, the push for quick decisions by boards of directors on even matters of a very serious nature can already be seen. It appears that we are on the edge of a new century that will put more pressure than ever before on the requirement of thoughtful board deliberation.

Speaking of thoughts, the ease and broadly expanding habit of electronic communication — and storage — of thoughts is likely to have a growing and significant impact on how corporations assess their responsibilities and risks in such areas as corporate record keeping, document retention programs, corporate compliance programs and the conduct of corporate litigation.

For now, one thing seems certain. The information, and information technology, explosion is forcing change everywhere — and there is no reason to believe that the boardroom or other areas of corporate responsibility and risk are or should be impregnable to the shock waves reverberating everywhere else. How this sorts out will be a key question left to be answered in the coming century. And in their role as counselors to directors, corporate practitioners will need to be aware of the new age of information, especially how it intersects with the proper functioning of a board of directors. And they will need to be prepared, from time to time and probably more often than in the past, to say to a roomful — or teleconference full — of action oriented directors: "slow down," " get information," "ask

questions," "deliberate." This can be a truly necessary and valuable service, although admittedly not always appreciated at the time.

MR. FLEISCHER: I agree with Peter. Fulfillment of a director's obligations is not a formulaic kind of activity. Thus, to be properly informed, there is no rule that a board must have two or more meetings on a particular subject. Obviously, the complexity of the issues, the magnitude of the transaction, the board's general and continuing familiarity with the subject matter, and the demands of the situation are all factors to be evaluated.

One of the important roles for counsel is managing the process that is involved in critical board decisions. I believe that the theme of Delaware's jurisprudence respecting directors' responsibilities is primarily process. How do you place the board in a position so that it is informed, so that it can evaluate the advantages and disadvantages of a course of action? Certainly, if a board has more meetings, the directors appear to be more involved. What is key, as we have noted, is the content of the meetings.

The context for the decision process is typically different from one company to another. For example, some boards on a continuing and, indeed, intensive basis periodically review strategic directions — whether these be acquisitions, dispositions, or spinoffs, or otherwise. A group of directors that is engaged in the planning process may need less time regarding a particular strategic alternative than another group of directors that does not have this kind of continuing exposure and analysis.

It is always a question of perspective, an issue of the facts and circumstances. This past year a few acquisitions have occurred in which one of the companies subsequently turned out to have employed questionable accounting practices and the acquiror was required to take significant write-offs. What due diligence does an acquiror do in public transactions? Can you ferret out financial fraud? How do you balance the need for secrecy about a possible deal with the need to know?

VICE-CHANCELLOR LAMB: Art just brought up these instances, and they did all relate to acquisitions. But looked at it from a different point of view, they each relate to the failure of the audit system, really, the internal financial reporting systems of one of the component companies.

One of the people here yesterday was commenting, he thinks that the external independent audit function has been given less money to function within many public companies in the past couple years. There's real pressure to reduce audit fees. And, with Sunbeam, there have been real failures in auditing. Do either of you have thoughts what, if anything, needs to be looked at with respect to the function of the external auditors and how they relate to the audit committee and the board of this company?

MR. ATKINS: Yes, I have some thoughts on it. I guess I have the misfortune of having been involved in sort of the aftermath of one right now and as a firm we've been involved in the aftermath of several.

I look at the auditors and try to get an insight into how they perform, and there is a reality which I think nobody should ignore. The audit function is also the victim often of what people decide to keep from the auditors. I mean, that is a real problem. Auditors can go through the normal mechanisms, and I think there the general procedures that auditors have are well-structured, well thought out, and getting more rigorous over time. But if you ask a question and you don't get the right answer because somebody has kept it from you, lied to you, or what have you, there's no audit function that's going to really get to that. That's an education process. That's a company culture issue.

There are a lot of other issues, and the audit function is an investigative arm of the company. Not to say that auditors perform perfectly all the time, because I think they don't. And there can be a tendency to maybe get a little too familiar sometimes with the company that you're auditing.

The concept of changing auditors every five years, pick a period of time, might have some salutary effect on not creating too much intimacy between the audit function outside and the audit function inside, the accounting function.

But I think I've seen enough to think that a larger part of some of these problems really has to do with what the personnel inside companies were doing. Starting, unfortunately, from the top. And the auditors can't track that if somebody doesn't tell them that that's what they're supposed to be looking for.

MR. FLEISCHER: With the SEC active in the area of financial reporting, with the Department of Justice bringing criminal proceedings, and with the debate about The Blue Ribbon Committee report, strong warning signals are being sent to corporate America and its advisors that financial statements must meet the standards of fair disclosure. I would suggest that the great majority of businesses are aware of this. The deviants will pay the price.

VICE-CHANCELLOR LAMB: One of yesterday's participants expressed a view that over the last number of years, there's been a continuing drum beat to reduce audit fees. Perhaps from the accountant's point of view, the response to lower audit fees to increase the amount of consulting business, where they perhaps are earning better returns. But that the audit function itself has been beaten down both in terms of what's being paid and perhaps the scope of the work being done.

Do you see that? And if so, is there something that boards and audit committees should be focusing on there.

MR. ATKINS: Honestly, I mean, I guess I have no evidence that that is the case. I mean, maybe that's a survey we're conducting. I'm not aware of that at all. I think that actually the audit committee in the company, in many companies, has gotten more active and that active mode translates into more direct contact frequently with the auditors. And the one thing the auditors are just like — they're human beings just like anybody else. When they feel there's somebody looking at them and asking questions, their tendency is going to be to do a better job and to be more thorough. Now, whether they get paid enough for it or not, that's a different question. But I don't think — I would be surprised if maybe fees are coming down, maybe not much, but I would be surprised if there was a direct correlation or any real correlation between that and the performance of the auditors of any given company.

I'd be surprised if there is any better correlation between how active the questioning process is of the auditors. I think those that aren't being asked to explain themselves or to be particularly informed, informative, that they can get sloppy. And maybe they will. But those that are called in and asked to account for what they are doing and explain what's going on and show the management exception letters to the audit committee, those people, I think, will do the job because they can be held accountable for the job.

PROFESSOR REGAN: Is there a question from the floor?

PROFESSOR ALLEN: I have relevant information with respect to audit fees because of work I do on the independent standards board. And the profession, the accounting profession, the auditing profession was under pressure on fees five years or ten years ago. But what I understand from asking people in that business that they don't feel pressure any longer. And, indeed, with the SEC putting all this emphasis on audit committees, it's very unlikely for audit committees to, or for CFOs to be pressing too hard on the audit fees at this point in history.

MR. ATKINS: Let me turn more generally to a central area of corporate law — and practice: the role and responsibility of directors. As we look into the next century, the prospect of and need for further clarification — and possibly significant change — in this area seems real. For the corporate practitioner, guiding directors in these still not fully charted waters will present some of the more interesting challenges in the twenty-first century.

I would like to comment first on the duty of disclosure. Historically, the regulation of corporate disclosure conduct by public companies in the United States has been primarily under the federal securities laws. State oversight in this area has been limited, although not nonexistent. Delaware certainly has recognized that, in some instances, majority stockholders and directors have a fiduciary duty of disclosure to stockholders. In *Lynch v.*

Vickers Energy Corp.,[4] the Delaware Supreme Court applied the duty of disclosure to a self-dealing transaction, involving a tender offer by a majority stockholder for the minority shares. In *Smith v. Van Gorkom*,[5] which was essentially a duty of care case, the Delaware Supreme Court identified, as one basis of disinterested director liability, the failure of the board to provide stockholders with "all material information such as a reasonable stockholder would consider important" for purposes of assessing the merger submitted for a stockholder vote.

More recently, the Delaware Supreme Court extended the reach of the duty of disclosure beyond self-dealing and stockholder vote situations. In *Malone v. Brincat*,[6] the Delaware Supreme Court addressed the board's obligation to make proper disclosure not in the context of seeking stockholder action, but, rather, in connection with periodic disclosure of corporate information. The Court made a number of noteworthy observations. It said:

- Corporate directors have a "tripartite fiduciary duty"[7] that encompasses the duties of good faith, due care and loyalty.

- These duties do "not operate intermittently but [are] the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided."[8]

- As to communications by directors, "the sine qua non of directors' fiduciary duty to shareholders is honesty."[9]

- "Shareholders are entitled to rely upon the truthfulness of all information disseminated to them by the directors they elect to manage the corporate enterprise."[10]

- "Directors who knowingly disseminate false information that results in corporate injury or damage to an individual

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[4]383 A.2d 278, 281 (Del. 1977).
[5]488 A.2d 858, 893 (Del. 1985).
[6]722 A.2d 5, 10 (Del. 1998).
[7]*Id.*
[8]*Id.*
[9]*Id.*
[10]*Malone*, 722 A.2d at 10-11.

> stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances."[11]

Arguably, while expanding the reach of director fiduciary responsibility to a general "duty of honesty" in communicating with stockholders, the Delaware Supreme Court in *Brincat* did so only narrowly. On the face of it, the decision seems to impose a requirement that the inaccurate communication be intentionally so. If this is the limit of the expanded concept of disclosure — that is, when directors speak to stockholders, they should not intentionally lie — and if a plaintiff will have the burden of proof to show facts demonstrating this scienter, as appears to be the case, then the boundaries of director responsibility will not have changed much as we enter the new century.

However, one needs to ask whether a requirement of intentional inaccuracy is a necessary or even logical stopping point. In other contexts, reckless disregard, gross negligence and perhaps even negligence can impose liability on directors. Is the duty to be truthful, once generally acknowledged, any less compelling than the duty to be careful? There certainly seems to be room for testing the definitional boundaries of director misconduct when inaccurate communications are disseminated to stockholders. My guess is that we will see this testing occur early in the next century.

Until this area is clarified — and probably in any event[12] — it would seem prudent for practitioners to sensitize their public company clients to the pre-disclosure review process at the board level of disclosure documents, press releases, etcetera.

MR. FLEISCHER: I could not understand any other conclusion if you accept the facts. That is, you are certainly not going to condone a director who intentionally lies to shareholders. In my view, the Court did not have any other choice as long as it formulated the issues in the fashion that it did.

The decision has no counseling significance. Would a director ask whether he can mislead shareholders?

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[11] *Id.* at 9.

[12] In September, 1997, the Securities and Exchange Commission issued an order which instituted proceedings against W.R. Grace & Co. and issued a report of its results. The SEC "emphasize[d] the affirmative responsibilities of corporate officers and directors to ensure" that their company fully complies with all disclosure requirements. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,963, at 89,894 (Sept. 30, 1997).

PROFESSOR REGAN: I wanted to take one little stab in reaction to Peter's comments on *Malone v. Brincat*.[13] It's fair to ask whether the claim of an intentionally misleading disclosure is a logical stopping point for the rule announced in *Malone*. Maybe the fiduciary duty of disclosure, which imposes liability without regard to the innocence or guilt of the disclosing directors, will be read more broadly to include directors' market communications in addition to cases involving disclosures that seek some kind of shareholder action.

I don't read it that way. I don't see *Malone* as being a disclosure case so much as a loyalty problem. The court in *Malone* emphasized scienter as a violation of the duties, loyalty, and good faith.[14] I think the duty of disclosure as such, without this scienter component, will continue to be limited in the future to cases involving disclosures seeking shareholder action.

The way that I conceptualize *Malone* is that it's disloyal and in bad faith to purposely mislead the marketplace because part of that audience is your shareholder group. Consequently, I believe the broad fiduciary claim announced in *Malone*, where no shareholder action was sought, will continue to require proof of intentionally, or at least recklessly, misleading disclosures.

VICE-CHANCELLOR LAMB: Let me just add one observation. In terms of the fit between the claim as recognized in *Malone*[15] and the federal securities laws regime, under 10(b)(5), the federal courts have been very careful in holding that you have to be either a purchaser or a seller in order to bring a claim. Well, what *Malone* seems to recognize is the ability to sue of someone who is neither a purchaser nor a seller, but only a holder of stock.[16] And, indeed, it's the holding of the stock that gives rise to the duty that underlies the claim in *Malone*.[17]

But at the same time, part of the reason I think federal courts insist on the "purchasers or sellers" requirement is the threat of fraud in the litigation itself, arising from the need to prove the element of reliance. How does a defendant disprove reliance by someone who neither purchased nor sold?

The court in a footnote carefully pointed out that because of the reliance issue, you can't have a class action based on the claim recognized

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[13] 722 A.2d 5 (Del 1998).

[14] *Id.* at 14.

[15] *Id.*

[16] 722 A.2d 5 (Del 1998).

[17] *Id.* at 10.

in *Malone*.[18] So, the opinion suggests that there will be very difficult reliance issues and there won't be any class action.

MR. ATKINS: Another area of director responsibility that seems likely to come into sharper focus in the next century is the oversight or compliance aspect of the basic duty of directors to manage the corporation's business and affairs. There are at least two aspects to consider.

First, beyond understanding the existence of their oversight responsibility — which was well-articulated by then Chancellor Allen in the 1996 *Caremark* decision[19] — it is important for directors to appreciate that there is likely to be a greater need to exercise this responsibility as we move through the twenty-first century. We are moving further and further into a world of increased regulation and risk for the business community. The complexity of oversight is compounded by the global nature of many business enterprises. And the risks that companies can encounter can be serious to life-threatening. If the derivative securities scare of several years ago is not enough to prove the point, consider the Y2K issue which virtually every company has had to address — and hopefully has done so carefully.

What we should expect — and prepare for — is the prospect of increased scrutiny of — and challenges to — director oversight performance. It follows that compliance, and risk identification and oversight, should be given a high priority by boards in the next century. Companies need to develop approaches that will permit effective review of the key areas of their legal/regulatory compliance and business risk. Periodic outside review of the processes that are in place for assessing where compliance and risk assessment oversight is necessary, as well as of the compliance programs themselves, would seem rather important for directors interested in conducting reasonable oversight — and demonstrating that they have done so.

Second, directors should know that turning a blind eye not only won't do, it may be downright dangerous. Delaware corporation directors who make judgments regarding corporate business decisions (putting change in control circumstances aside) are protected by the traditional business judgment rule. This rule establishes a presumption that the directors have made a business decision on a basis consistent with their fiduciary duty unless a plaintiff challenging their action can carry the burden of proof by showing facts that demonstrate at least gross negligence.

When addressing the board's oversight function, some question may exist whether directors are exercising business judgment of the type

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[18] *Id.* at 14 n.47.

[19] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

protected by the business judgment rule.[20] The risk that such protection will be found to not be available seems greatest in a case where directors simply abdicate their oversight responsibility — as contrasted with a situation where directors at least attempted to perform their oversight role. In such event, the gross negligence standard for finding a breach of duty would not necessarily apply, and negligence might be sufficient. While directors might still be able to avoid monetary liability under the terms of a Section 102(b)(7) exculpatory provision contained in the corporation's charter, this should hardly be complete solace to a director found to have violated his or her fiduciary duty.

MR. FLEISCHER: My experience is similar to Peter's; I think the system — and it is not just because of the law — is working to the end that companies are paying extraordinary attention to these very visible issues like Y2K. Companies rely on their audit committees, through their staffs, and through consultation and continuous interaction with outside advisors. Companies are obviously motivated by clear business concerns; it makes sense to be engaged.

The directors themselves become involved because of a sense that this review is a part of their continuing oversight responsibility. Whenever a board identifies a problem of significance, the directors seek to assure that the company is taking steps to respond.

MR. ATKINS: Looking into the twenty-first century, another area that may well get attention is the role of special expertise in the boardroom. Until now, corporate law in this country has treated all directors equally — by not distinguishing between or among them in terms of responsibility or standards of conduct based on special knowledge, training or expertise. Clearly, boards seek out directors with special talents and experience to enhance the performance of various board functions. And this often is quite salutary. However, no higher duty or standard of performance applies to such persons.

Recently, a Blue Ribbon Committee appointed under the auspices of the Securities and Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers issued a report that recommended, among other things, that audit committees of publicly traded companies have at least three members, and that its members meet financial literacy standards (including one member having accounting or

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[20]E. Norman Veasey, *The Director and the Dynamic Corporation Law with Special Emphasis on Oversight and Disclosure*, THE CORPORATE GOVERNANCE ADVISOR, July/Aug. 1997, at 22-23, Keynote address to 17th Annual Ray Garrett Jr. Corporate Securities Law Institute, Apr. 24, 1997 ("The business judgment rule does not strictly apply in oversight context, but there are judgment aspects to mechanisms directors decide to set up to monitor management.").

related financial management expertise). This initiative is largely an outgrowth of SEC Chairman Levitt's concerns about a perceived increase in the number of cases of false financial statement reporting and so-called managed earnings.

Various objections have been raised to this and other recommendations of the Blue Ribbon Committee. In particular, concern has been expressed that by adopting a "financial literacy" requirement for audit committee members — and an accounting or financial management expertise for one member — these directors may be held to a higher standard of conduct in terms of their oversight of and responsibility for reported financial information. The resulting disincentive to service has been raised as a particular negative.

The Blue Ribbon Committee's recommendations may not survive the opposition. But it has highlighted a concept that has intriguing possibilities — "specialist directors." The value of special expertise in the boardroom is easy to see, particularly given the increasingly complicated world in which many companies operate. The quality of board decisions and oversight might be measurably improved. A business corporation law system which encourages — or even requires — the involvement of directors with special expertise may well be one of the more important innovations in corporate governance that we might see in the coming century.

For this concept to have any serious viability, however, it undoubtedly will need to address head on the major obstacle posed by the risk of higher standards of conduct and increased potential liability for "specialist directors." A clear legislative pronouncement up front might do the trick — one that acknowledged that providing special expertise as a director will neither raise the standard of conduct for assessing a breach of duty nor reduce in any way the business judgment rule protection currently afforded directors.

Of course, nothing is simple — especially changing the ground rules for something as important as the composition of boards of directors and the roles of their members. However, from a practitioner's perspective, I can envision this change leading to a different and improved process for board consideration of many of the difficult issues which boards regularly face. Perhaps this will be an area where Delaware once again chooses to take the lead in reshaping and improving the modern business corporation model.

MR. FLEISCHER: There may be an existing question in that the audit committee is in periodic contact with the auditors and the financial management. The audit committee, of course, reports to the remainder of the board; under Delaware law, the board can rely on the reports of the audit

committee, just as members of the audit committee can rely on the accountants.

If members of the audit committee were found to either have known or had reason to know (and were grossly negligent) that the financial statements were materially deficient — but, for whatever reason, did not report that to the board — there could be a distinction in liability between the audit committee and the remaining members of the board.

MR. ATKINS: We're going to leave that in the future.

MR. FLEISCHER: We're going to leave that in the future. Okay.

MR. ATKINS: There is one other subject about which I would like to make a few comments — change in corporate control in the unsolicited bid context. This is a subject that could take up volumes. I will be much briefer. As a practitioner, I have spent more than a little time over the years in the trenches of hostile takeovers, representing targets and bidders. Much has changed during that period – especially in the articulation and refinement, through cases decided by the Delaware courts, of basic principles of conduct applicable to target companies. *Revlon*,[21] *Unocal*,[22] *Unitrin*,[23] *Time*,[24] *QVC*,[25] *Household*,[26] *Toll Brothers*,[27] and *Quickturn*,[28] just to name a few of these cases, have provided definition and guidance in the conduct of corporate takeover battles.

As we approach the end of this decade, and peer into a new century, one question that comes to mind is: What's missing; what more is needed? There is, of course, no single answer. In fact, to even begin to address the question you must know the answer to a predicate question: What are you trying to achieve? There could be many answers to this simple question, depending on your perspective. Certainly you have noticed, from time to time, more than slight differences in perspective among bidders, target boards and management, founding family shareholders, institutional shareholders, small individual shareholders, arbitrageurs, target company employees, affected communities and other constituencies.

You can relax. I don't propose to hold you here while I expand on and define all of these perspectives and then try to discern what more is

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

[22]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[23]Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995).

[24]Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

[25]QVC Network, Inc. v. Paramount Communications, Inc., 637 A.2d 34 (Del. 1994).

[26]Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

[27]Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998).

[28]Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).

needed from each perspective. But I would like to focus on a particular area which is central to the dynamic of many takeovers and presents a basic issue of balance and fairness — the timing of unsolicited bids. In the real world of takeovers, two critical factors often are price and timing. They are closely linked — from the point of view of the target's board and stockholders, the ability to get the best value often is a function of having enough time to identify, explore and implement value-enhancing alternatives to a steamroller bid.

Let me be more specific. The basic strategy of many unsolicited bidders is to hold out to the target's stockholders the economic carrot of a premium-to-market price for their stock and, concurrently, to use the big stick of threatening to replace the target's board, or get representation on it, if the Board resists the bid. In a market where institutional and other professional investors dominate public company ownership, the pressure on the target's board to sell mounts quickly and vocally. As a result, this strategy can be quite effective in forcing a board to put the target up for sale at the time selected by the bidder and in limiting the time to run a value-maximizing sale process.

Critical to this strategy is finding a target board vulnerable to complete or partial removal and replacement on a relatively quick timetable. This vulnerability, in turn, is a function of the structural profile of the company in certain key respects: Is the board classified? Can stockholders call a special meeting and, if so, what time frame (if any) is provided for calling and holding the meeting? Does the company have advance notice bylaws and, if so, what is the notice period? Can stockholders act by less than unanimous written consent?

The companies with the highest vulnerability profile are those without a classified board — which normally means that directors can be removed without cause — and in which stockholders can act by less than unanimous written consent, including to remove and elect directors. Also quite vulnerable are companies without classified boards where stockholders can call a special meeting for the removal and election of directors. At the other end of the spectrum are those companies with a classified board — which normally means directors can only be removed for cause — and which permit the election of directors only at an annual meeting.

There is a crazy-quilt vulnerability pattern out there — with companies at both ends of the spectrum and various places in between. There is no particular logic to which companies are relatively more or less vulnerable to the pressure tactics of an unsolicited bid. There is only the serendipity of focus and timing — those companies which focused on strengthening their profiles before they went public or when stockholders

would vote for necessary charter amendments are better protected; those which waited are extremely unlikely to get stockholder support for so-called "antitakeover protection" today.

Which leads to the question: Should serendipity determine the outcome of such a momentous event as a takeover? Let me say, quickly, that I understand many of you would take issue with the characterization of a company's structural profile as "serendipitous." Fine. The point is, stockholders can easily be treated unfairly when there is an imbalance between the pressure tactics of a bidder and the target board's need for time to develop value-enhancing alternatives and adequately communicate them to stockholders. I say this from personal experience. I have represented two companies in the recent past the stockholders of each of which benefitted by more than $1 billion because enough time was scratched out to develop a much superior transaction.

What am I proposing? Essentially, that this issue be looked at with a fresh eye in the new century. Any number of "solutions" are possible. A limited partial step might be to amend the corporation law to eliminate the use of the consent process as a tool for action supporting unsolicited takeovers. A more comprehensive approach might be found in some of the European takeover regulation models. I offer no preconceived answer — only the distinct feeling that a better balance can and should be found to better serve the interests of stockholders of many public companies.

MR. FLEISCHER: Until the Supreme Court ruled in *Mentor Graphics*,[29] the "dead-hand" or "re-hand" provisions of pills were viewed as a vehicle for buying time for a company without a staggered board. If the Supreme Court had adopted a fact-intensive approach, as did the Chancery Court, room for maneuvering would have been available. Instead, the Court suggested simply: these provisions are absolutely inconsistent with Delaware law.[30] There are some safeguards available. Thus, with an advance bylaws provision, you can obtain ninety or fifty days delay.

MR. ATKINS: Not if it's by consent.

MR. FLEISCHER: That is correct. If you are subject to a consent solicitation, the target may be able to delay action for a few weeks. A company, in Delaware, is clearly at its most vulnerable, if it does not have a staggered board and is subject to a consent solicitation. From a policy point of view, should directors be able to be elected in a consent solicitation without the type of notice and process that accompanies a meeting?

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[29]Mentor Graphics Corp. v. Quickturn Design Sys., Inc., 728 A.2d 25, 28 (Del. Ch. 1998), *aff'd*, Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).

[30]*Id.*

PROFESSOR REGAN: I wonder if I might throw out some thoughts for reaction from everybody up here. Peter, in some way this relates to your point about the widepsread availability of information through the explosion of information technology. I speak to the concept of substantive coercion and the use of poison pills.

The poison pill was a remarkable solution to the T. Boone Pickens bust-up two-tier coercively structured tender offer, but the pill seems to be as necessary for the all cash, all shares fully financed tender offer. In *Time Warner*,[31] the Court embraced this notion of substantive coercion from that seminal article by Professors Gilson and Kraakman. In particular, Delaware courts have accepted substantive coercion as a *Unocal*-qualifying threat. The idea is that shareholders might be incapable of resisting an up-front cash premium because it's such a significant and immediate gain, and unadvisedly discount the value of management's long-term strategy. And I think this touches on what Dick Agnich said yesterday from Texas Instruments: the idea that long-term plans deliver value over time and they don't have to necessarily deliver it month-by-month or quarter-by-quarter. But if substantive coercion means investors might not understand or grasp what management sees as the future financially, does the increasing availability of information and, moreover, the increasing presence of institutional investors as fairly sophisticated players undermine that rationale? Or is there something else going on here?

MR. ATKINS: Well, I guess that's a multipart question. I'm not sure I can tell you what's going on there. I guess I have — I can sort of fall back to the practitioner's point of view, since that's what I was asked to do here. From a practitioner's point of view, sitting in a board room of a target company, I can honestly say that there are boards of directors who do look at the value inherent in their business strategy, their business plan, the timing of the bid in relation to market price and nominal premiums, where the interest rate cycle is, and they look at all those things and they have formed conclusions which they honestly believe that this is just a lousy time to sell a company. And you can get a premium. But it's just not a fair value premium for the company. There may be a lot of shareholders who would like to sell the company at that point in time.

The institutions have things that motivate institutions and I have nothing bad to say about them but their motivations sometimes have to do with making quarterly results and producing returns that are relatively short-term oriented. So there's a lot of different agendas, perfectly

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[31]US West, Inc. v. Time Warner, Inc., No. CIV.A. 14,555, 1996 WL 307445, at *21 (Del. Ch. June 6, 1996).

legitimate, but they're not the same because people do have different points of view and different interests to serve.

But you have that board sitting there. And when that board sort of turns around and says, hey, look, we're not out to cause shareholders harm. We actually want to do something good for shareholders. But in our heart of hearts, we think this is just a really bad time to sell this company. And the fact that somebody's offering a premium just doesn't change that equation.

So we're sitting here as a board of directors. We can be thrown out and maybe annually, maybe tomorrow, or maybe over a couple of years. But while we're sitting here, our judgment, best judgment, is that we ought to do what we can to stop this so that that value can be realized. And I guess the system at the moment it's truly serendipitous as to whether that can even be done, but, if the theory of — I'm not sure I exactly know where you were heading with your multipart question, but there's smart enough people out there, there's sophisticated investors, there's a lot of information, they can find it all out, don't get in their way, you know, I guess I don't particularly subscribe to that as the ultimate test of what a board's judgment about value of a company.

PROFESSOR REGAN: One point may be that, to the extent you have a majority of the stock of public corporations owned by various institutions, maybe there is a different investment time horizon between boards and the institutional stockholders. When a board insists on seeing its long-term business plan play itself out, there is always a safety valve of a proxy contest for the shareholders. Yet, depending on the company's defenses, a hostile but premium takeover opportunity might be lost.

It's a short-term focus, perhaps, of some of the institutions.

MR. FLEISCHER: If the overall governance structure is reviewed, the fact is that the directors can completely transform the nature of a company by buying another company for cash without a shareholder vote. Furthermore, again without a shareholder vote, the directors can sell key assets so long as not substantially all and can spin-off major divisions.

Moreover, a merger or asset transaction cannot occur without board intervention. On the other hand, the board has no explicit responsibilities if control is transferred through the transfer of shares, although Section 203[32] of the DGCL provides the board with certain residual authority. The fundamental policy issue is the allocation of power between the board and the shareholders — what can the board do without sharheolder intervention?

MR. ATKINS: With that thought, let me thank you for your patience.

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[32]DEL. CODE ANN. tit. 8, § 203 (1991).

PROFESSOR REGAN: I'm going to ask my fellow panelists to stay up here with me, and thank you all very much for such a good discussion on a nice range of issues.

At this point, it's my privilege to bring up to the podium Delaware Supreme Court Justice Randy Holland who has a few concluding remarks for us for our conference.