DIRECTORS' AND OFFICERS' LIABILITY FOR Y2K: A CORPORATE GOVERNANCE LITIGATION BEAR AND A SECURITIES LITIGATION BULL?

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I. INTRODUCTION

By now, most businesses, and certainly all business attorneys, have heard about the "Year 2000 Problem" or "Millennium Bug" (or "Y2K" by cognoscenti), a major dilemma caused by a glitch in computer language. Through their efforts to save memory space, programmers made a fatal decision to use only two digits to identify calendar years so that, for example, 1999 is identified as "99." The potential problem is that unless fixed, these programs will shorten the year 2000 to "00" and recognize it as 1900. Consequently, computers reading time-sensitive information may either shut down or process the data incorrectly. The problems that could be caused by Y2K are limitless.[1]

Y2K has been called one of the greatest problems of recent history.[2] It is certainly the greatest computer programming problem civilization has ever seen.[3] Countless experts, whom some would label as doomsayers, espoused the view that businesses, and society as a whole, would not be capable of completing the program corrections to prevent the Y2K problem before the turn of the century.[4] Therefore, Y2K may be one of the greatest exposures facing Corporate America and its officers and directors.[5] The two

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[1]Examples include: credit-card bills could be mistaken as 99 years past due; credit cards may be rejected as having expired; a company's computer records may show that its debt has been on the books for more than one hundred years.

[2]*See, e.g.*, CAPERS JONES, THE YEAR 2000 SOFTWARE PROBLEM: QUANTIFYING THE COSTS AND ASSESSING THE CONSEQUENCES 20 (1998) (noting that "the Year 2000 problem [may be] ... one of the most expensive single problems in human history").

[3]*Id.* at 5.

[4]*See generally* EDWARD YOURDON & JENNIFER YOURDON, TIME BOMB 2000: WHAT THE YEAR 2000 COMPUTER CRISIS MEANS TO YOU! (1998) (discussing the possibility of correcting the Y2K problem before year 2000).

[5]JONES, *supra* note 2, at 5.

most prominent types of claims that may be brought against corporate management are: (1) corporate governance claims for breach of fiduciary duty, and (2) federal securities claims for fraud and misrepresentation.

This article begins with an overview of the significance and pervasiveness of Y2K. Part III discusses potential corporate governance claims, including claims for breaches of the fiduciary duties of care, loyalty, and candor, and the application of the business judgment rule to Y2K. Part IV discusses federal securities claims, focusing on the Y2K disclosures mandated by the Securities and Exchange Commission (SEC), and the potential for claims under both the 1933 and 1934 Acts. This article ultimately concludes that, absent unlikely or extraordinary factual circumstances, unless a corporate board utterly failed to take any action to address Y2K, or the courts greatly expand liability under the fiduciary duty of disclosure, successful corporate governance claims will be rare. Because of the business judgment rule and defenses such as statutes that immunize directors from liability for breach of fiduciary duty, management is more likely to be the target of securities claims. Consequently, it is shareholder class-action securities complaints rather than shareholder corporate governance class and/or derivative actions that are likely to clog the court dockets in the new millennium.

II. THE Y2K PROBLEM AND THE POTENTIAL FOR LITIGATION

Before confronting the statistics, it is important to note that adding to the potential and limitless problems that may be caused by Y2K is that publicity surrounding Y2K may have had an unintended effect: some people viewed Y2K as a media ploy staged by consultants, programmers and lawyers rather than a legitimate problem. Although predictions of world-wide catastrophe may have not come to fruition, the real Y2K prognosis is gloomy for many businesses, and those that ignored the problem may have merely exacerbated it. Businesses need to assess their Y2K compliance — both from technological and legal perspectives — to minimize the problem's effect.

Even ignoring the hype, a consensus of government and industry observers expected the problem to be enormous. Compounding the problem is the pervasiveness of the Y2K design defect — it is a hardware as well as software problem, and it may impair up to 5% of the estimated 25 billion embedded computer chips (CPUs) controlling our cars, elevators, and medical devices, to name a few applications. Moreover, some of the embedded chips are difficult to get to because they are integrated into complicated machinery and structures, and some are in satellites (many of which are used for air and sea navigation). According to Global Business Technology, ninety percent of the personal computers sold in 1996 were not

Y2K compliant, and only a little more than half of the PCS sold in 1997 were Y2K compliant.[6] In essence, just about all of the 250 million PCS running in the world, if not fixed, may experience Y2K related errors. The following are just a few of the eye-opening Y2K statistics:

- 500,000 to 700,000 additional programmers will need to go to work in the United States . . . to handle [Y2K problems];[7]
- 80% of large companies were not Y2K compliant by the end of 1997;[8]
- [a]verage correction costs, not including litigation and lost productivity costs;[9]
  - $50 million (Fortune 500 company);[10]
  - $4 million (small company, less than 2000 employees);[11]
- $400 billion to $600 billion in correction costs world-wide;[12] and
- total world-wide costs *including* litigation and lost productivity:
  - $2 trillion[13]
  - $3 trillion[14]

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[6]Scheidel, *Millennium Bug Unleashed*, <http://www.alamo 2000.com/unleash.htm>.

[7]John L. Reed & Richard K. Herrmann, *An Alternative to the not-ready-for-the-Year-2000 Court System*, DISP. RESOL. J. 16, 17 (November 1998).

[8]*Id.*

[9]*Id.*

[10]Reed & Herrmann, *supra* note 7, at 17.

[11]*Id.*

[12]*Id.*

[13]*Id.*

[14]Reed & Herrmann, *supra* note 7, at 17.

Estimated Worldwide Y2K Costs[15]

Source	(in Billions of Dollars)
Giga Information Group	$1,000
Software Productivity Research, Inc.	$3,600
Lloyd's of London	$3,000
Cap Gemini (not incl. litigation)	$717
Gartner Group (not incl. litigation)	$600

Historical Perspective of Expected Y2K Costs[16]

Event	(in billions of Dollars)
World War II	$4,200
Y2K	$600
Vietnam Conflict	$500
Kobe Earthquake	$100
LA Earthquake	$60

Sources: Gartner Group and Congressional Research Service

Year 2000 Budgets of Major Organizations

Organization	Estimated Budget (in Millions)
Citibank	$600
Fidelity	$100
General Motors	$400-545
Merrill Lynch	$275
Securities Industry	$6,000
Federal Government	$4,700

Experts predict a bankruptcy rate of 1-5 percent directly related to these costs.[15] The estimated preventive costs aside, there is a potential for a tremendous amount of litigation. Even if a business has taken steps to address its Y2K compliance, that business may nevertheless become a litigation target. If a business' system interacts with one that has not been fixed, that business may become a Y2K victim and, necessarily, a plaintiff.

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[15]MERRIL LYNCH, *The Millenium Challenge* (visited Apr. 8, 1998) <http://www.ml.com/woml/forum/millen.htm>.

[16]*Id.*

[17]Reed & Herrmann, *supra* note 7, at 17.

Attorneys will undoubtedly conjure up a myriad of claims. Some examples may include:

- shareholder derivative suits for failure to investigate and adequately address Y2K;
- securities class-actions arising out of disclosure violations, including actions against accountants;
- claims against software developers or system sellers for negligence and breach of warranty (express or implied);
- claims under various insurance policies (general commercial liability, errors and emissions, business interruption, directors and officers) for the costs of fixing Y2K or damages caused by a system failure;
- claims directly under contracts or other documents (covering vendor agreements to merger and acquisition agreements) misrepresenting Y2K compliance;
- claims against computer software system consultants and outsourcing vendors for failure to repair Y2K pursuant to fixed price and term contracts;
- claims against vendors for failure to process data correctly (e.g., failure to make a delivery due to an order processing Y2K glitch);
- claims against businesses whose uncorrected system interacted with and caused a corrected system to fail; and
- claims for personal injury and property damage.[18]

Prior to the turn of the century, it was universally recognized that directors and officers, as well as business owners, had a duty to fix their Y2K problem. Most companies took steps to repair or replace systems which were susceptible to Y2K failure. New software license contracts now contain clauses ensuring millennium compliance and virtually all banks, insurance companies and other businesses took steps to avoid problems and ensuing litigation. Comprehensive Y2K programs, however, may not have been enough. Given the large number of embedded computer chips as well as the interdependence of software and other services among companies, their customers and their suppliers, companies must contemplate the business and legal ramifications of Y2K failure. Furthermore, companies' efforts, or lack of efforts, to achieve Y2K compliance may themselves have

[18]In addition to these types of claims, there are likely to be criminal prosecutions against hackers for e-mails that create the appearance that a company has a Y2K problem, or against so-called remediation experts who, while under the guise of fixing Y2K, inserted programs to steal sensitive information, or, in the case of financial institutions, to transfer funds to bogus accounts.

significant legal consequences. Businesses facing Y2K problems had two paths: (1) repair their existing software and hardware; or (2) acquire new, Y2K-compliant software and hardware. Either way, as the turn of the century approached, companies faced difficult technological, economic and legal choices in undertaking Y2K repairs.

III. CORPORATE GOVERNANCE CLAIMS

A. *Overview of Directors' Fiduciary Duties*

Y2K presented significant challenges for corporate management, which owe various fiduciary duties to the corporation.[19] Under Delaware law,[20] the responsibility for managing a corporation's business and affairs falls upon its board of directors.[21] In discharging this responsibility, the directors have fiduciary duties, which include the duty of care, the duty of loyalty, and the duty of full disclosure, or duty of candor, to the corporation and its shareholders.[22]

The fiduciary duty of care requires that a board of directors not delegate duties that are "at the heart" of managing the company and that the

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[19]*See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

[20]Because Delaware is the "preeminent state in corporation law," it has become a forum of choice for corporate governance litigation, and therefore it serves as an excellent model for discussion of Y2K claims. Leo Herzel & Laura D. Richman, *Foreword* to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS F-1 (3d ed. Supp. 1999) (noting that more than half of the Fortune 500 companies are incorporated in Delaware, and that, between 1981 and 1984 alone, more than 40 publicly owned corporations reincorporated in Delaware). In recent years, the United States District Court for the District of Delaware has become the primary forum for intellectual property litigation. *See* Victoria Slind-Flor, *Del. Judge on IP's Frontline*, NAT'L L.J., Sept. 15, 1997, at A1, A22 (noting that Delaware's United States District Court is "the premium patent court in the United States") (quoting Harold F. Wegner, professor, George Washington University School of Law). Delaware courts can, therefore, expect to be inundated with Y2K-related matters in the near future — if the Y2K litigation predictions materialize.

[21]DEL. CODE ANN. tit. 8, § 141(a) (1991). The Delaware Supreme Court has identified § 141(a) as a "cardinal precept" of Delaware General Corporation Law. *See Aronson*, 473 A.2d at 811. Specifically, § 141(a) states:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a) (1991).

[22]Similar duties apply to "officers" of Delaware corporations. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 502-03 (Del. 1981) ("[A] fiduciary relationship [arises] from the directors and *officers* to their corporation . . . .") (emphasis added).

board exercise due care in overseeing the actions of those to whom it does delegate duties.[23] The duty of care also requires that, prior to making business decisions, directors inform themselves of all material information, including alternatives to the proposed course of action. In addition, directors must make a reasonable inquiry into the merits of the proposed course of action.[24]

The fiduciary duty of loyalty forbids corporate fiduciaries, including directors, officers, and controlling shareholders, from considering or acting to protect interests other than those of the corporation when making business decisions.[25] For example, fiduciaries cannot use their positions in the corporation to promote transactions between the corporation and entities in which they have a substantial economic interest, unless such transactions are substantively fair to the corporation.[26] Issues regarding the duty of loyalty arise in many contexts, such as direct dealings (e.g., purchases or sales) between the corporation and the fiduciary, dealings between a parent corporation and a subsidiary, unfair conduct by a majority shareholder in corporate reorganizations or acquisitions, actions taken by fiduciaries for the purpose of entrenching themselves in office, insider trading, sales of control, usurpation of corporate opportunities,[27] and conduct by fiduciaries in competition with the corporation.

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[23]*See* Chapin v. Benwood Found., Inc., 402 A.2d 1205, 1210 (Del. Ch. 1979) (quoted in Canal Capital Corp. v. French, No. 11,764, 1992 Del. Ch. LEXIS 133, at *5-6 (Del. Ch. July 2, 1992), *reprinted in* 18 DEL. J. CORP. L. 611, 614 (1993)).

[24]Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985); *Aronson*, 473 A.2d at 812; *see also* UIS, Inc. v. Walbro Corp., No. 9323, 1987 Del. Ch. LEXIS 490, at *5 (Del. Ch. Oct. 6, 1987), *reprinted in* 13 DEL. J. CORP. L. 806, 810 (1988).

[25]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Guth v. Loft, 5 A.2d 503, 509 (Del. 1939).

[26]Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (stating that directors must demonstrate both good faith and fairness in a transaction in which they possess a financial interest).

[27]Under Delaware law, a corporate officer or director may not benefit personally from a business opportunity if:

> (1) the corporation is financially able to take advantage of the opportunity; (2) the opportunity is within the corporation's line of business, (3) the corporation has an interest or expectancy in the opportunity; and (4) . . . the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.

Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 154-55 (Del. 1996). A corporate fiduciary may, however, take such an opportunity for his own if:

> (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity.

Id. at 155.

The fiduciary duty of full disclosure, also referred to as the duty of candor, mandates that corporate fiduciaries fully and fairly disclose to shareholders all material information[28] within their control whenever they communicate with shareholders, particularly when — though not necessarily only when — they seek some type of shareholder action (e.g., board solicitation of proxies[29] or advice on the right to appraisal).[30]

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[28]The standard for "materiality" under Delaware law for purposes of the duty of disclosure regarding proxy materials is the same as that applied under the federal securities laws: information will be considered "material" if a reasonable shareholder would consider it important in deciding what course of conduct to choose. *See* Bershad v. Curtis-Wright Corp., 535 A.2d 840, 846 (Del. 1987); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944-45 (Del. 1985) (stating that a fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available") (quoting TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438, 449 (1976)); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977) (noting that "information which a reasonable shareholder would consider important in deciding whether to sell or retain stock" should be disclosed). There is no duty to disclose information that is common knowledge, *Fisher v. United Technologies Corp.*, No. 5847, 1981 Del. Ch. LEXIS 622, at *8 (Del. Ch. May 12, 1981), *reprinted in* 6 DEL. J. CORP. L. 380, 385 (1981), or that which constitutes mere speculation. *See* Tuckman v. Aerosonic Corp., No. 4094, 1982 Del. Ch. LEXIS 452, at *34 (Del. Ch. May 20, 1982). Nor are corporate officers or directors required to engage in self-flagellation by confessing wrongdoing before it is determined by a court of law. Loudon v. Archer-Daniels-Midland Co., No. 14,638, 1996 Del. Ch. LEXIS 12, at *12 (Del. Ch. Feb. 20, 1996), *reprinted in* 21 DEL. J. CORP. L. 724, 732 (1996).

[29]*See, e.g., Loudon*, 1996 Del. Ch. LEXIS 12, at *12-14, *reprinted in* 21 DEL. J. CORP. L. at 732.

[30]*See* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1280-81 (Del. 1994); *Lynch*, 383 A.2d at 281. For a time, at least two vice-chancellors on Delaware's Court of Chancery recognized that if the board voluntarily discloses information, i.e., without seeking shareholder action, that it must do so fully, fairly, and accurately. *See* Marhart, Inc. v. Calmat Co., No. 11,820, 1992 Del. Ch. LEXIS 85, at *7-8 (Del. Ch. Apr. 22, 1992), *reprinted in* 18 DEL. J. CORP. L. 330, 335 (1993); Levy v. Stern, No. 11,955, 1996 Del. Ch. LEXIS 25, at *3-5 (Del. Ch. Mar. 12, 1996), *reprinted in* 21 DEL. J. CORP. L. 1218, 1221-23 (1996) (refusing to reconsider denial of motion to dismiss where plaintiff shareholder claimed to have suffered monetary damages as a result of making decisions based on misstatements in an annual report even though it was not disseminated for purpose of soliciting shareholder action), *rev'd on other grounds*, No. 211, 1996 Del. LEXIS 468 (Del. Dec. 20, 1996). However, in *Kahn v. Roberts*, No. 12,324, 1995 Del. Ch. LEXIS 151, at *20-21 (Del. Ch. Dec. 6, 1995), *reprinted in* 21 DEL. J. CORP. L. 674, 689 (1996), *aff'd*, 679 A.2d 460 (Del. 1996), Chancellor Allen held that misleading disclosures by directors in a company's annual report should be redressed pursuant to the federal securities laws rather than Delaware corporate law because no shareholder action was being sought. *Id.* at *20-22, *reprinted in* 21 DEL. J. CORP. L. at 689. On appeal, the Delaware Supreme Court found that none of the disclosure violations were material and thus stated, "[W]e need not and do not reach today the question of whether a duty of disclosure exists absent shareholder action." *Kahn*, 679 A.2d at 467. The court then stated, "Notably, the Court has never stated that full disclosure is required only when seeking shareholder action." *Id.* Following *Kahn*, Chancellor Allen opined, "[T]he better view and that accepted by a majority of the judges who have expressed an opinion, is that fiduciary liability for misdisclosures requires that the material misstatement or omission by a fiduciary be in connection with the solicitation of shareholder action, such as a tender, a vote, a consent or a withholding of the same." Uni-Marts, Inc. v. Stein, Nos. 14,713 & 14,893, 1996 Del. Ch. LEXIS 95, at *21 (Del. Ch. Aug. 9, 1996). "A respect for the evolved roles of state regulation of internal corporate affairs and federal

B. *Role of the Business Judgment Rule in Corporate Governance Claims*

In Delaware, decisions of a corporation's board of directors are presumed to be the product of valid business judgment (i.e., the "business judgment rule").[31] The presumption can be rebutted by, among other ways, establishing that the directors breached their duty of care or that a decision was approved by directors who had an interest in the transaction.[32] If the

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regulation of securities markets counsels against... [the] radical result" of finding breaches of the fiduciary duty of disclosure where no shareholder action is sought. *Id.* at *22. Recently, the Delaware Supreme Court clarified the state of the law on this issue:

> Delaware law also protects shareholders who receive false communications from directors even in the absence of a request for shareholder action. When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty. That violation may result in a derivative claim on behalf of the corporation or a cause of action for damages. There may also be a basis for equitable relief to remedy the violation.

Malone v. Brincat, 722 A.2d 5, 14 (Del. 1998) (footnote omitted).

[31]*See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). In evaluating the merits of a cause of action for breach of fiduciary duty filed against a corporation's directors with respect to decisions made or actions taken by those directors, the Delaware courts will ordinarily apply the "business judgment rule," which creates a rebuttable presumption that, in making the business decision in question, "the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The court will not substitute its own business judgment for the board's and impose personal liability upon the directors unless evidence indicates that they acted in bad faith or in a grossly negligent fashion. Smith v. Van Gorkom, 488 A.2d 858, 872-873 (Del. 1985); *Aronson*, 473 A.2d at 812; *Sinclair Oil Corp.*, 280 A.2d at 720. As the Delaware Supreme Court stated in *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995), "[T]he business judgment rule shields directors from personal liability if, upon review, the court concludes the directors' decision can be attributed to any rational business purpose." Although the business judgment rule creates a rebuttable presumption in favor of the board with respect to business decisions, it may not apply to other claims, such as claims alleging breaches of the fiduciary duty of disclosure. *See* Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 150 n.18 (S.D.N.Y. 1989) (noting that the business judgment rule does not apply to misrepresentations or omissions); *In re* Anderson, Clayton Shareholders' Litig., 519 A.2d 669 (Del. Ch. 1986).

> [T]he question whether shareholders have, under the circumstances, been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made, is not a decision concerning the management of business and affairs of the enterprise of the kind the business judgment rule is intended to protect; it is rather a matter relating to the directors' duty to shareholders who are technically outside of the corporation.

Id. at 675. *See also* Platt v. Richardson, No. CIV.A.88-0144, 1989 U.S. Dist. LEXIS 7933, at *6 (M.D. Pa. June 6, 1989) (holding that the defendant, in his capacity as an officer of SECCO, was not entitled to the presumption of reasonableness with respect to his business decisions involving SECCO).

[32]*See Aronson*, 473 A.2d at 812.

business judgment rule is rebutted, the burden then shifts to the board of directors to establish that the transaction was entirely fair.[33]

Shareholders of Delaware corporations who believe that fiduciaries of those corporations have violated their duties of care, loyalty, or disclosure may bring causes of action alleging breach of fiduciary duty in Delaware's Court of Chancery, a court of equity.[34] Such actions may be brought either

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[33]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); *Mills Acquisition*, 559 A.2d at 1279 n.27 (citing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986)). This standard, which has proven difficult for directors to meet, requires the directors to show not only that the transaction was for a fair price, but also that it was the result of fair dealing. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989); Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). In situations where one or more directors have a personal interest in a proposed transaction, it is common for corporations to appoint special committees of disinterested directors to evaluate the transaction. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 426 (Del. 1997). If such a committee is a properly functioning committee and meets certain rigorous requirements, a transaction approved by a majority of the members of that committee will be afforded the protections of the business judgment rule. *See, e.g., Mills Acquisition*, 559 A.2d at 1279 (holding that when a court is confronted with a breach of duty challenge to board action, it will decline to evaluate the wisdom behind such a decision unless the record demonstrates that the decision was not the "product of an informed, disinterested, and independent board").

[34]Breach of fiduciary duty claims are particularly valuable tools for shareholders seeking to bring class action claims against a corporate defendant. The Delaware courts specifically permit certification of nationwide shareholder classes in breach of fiduciary duty cases. *See generally In re* Tri-Star Pictures, Inc. Litig., 634 A.2d 319 (Del. 1993) (involving class action claim for breach of the fiduciary duty of disclosure); *but see* Gaffin v. Teledyne, Inc., 611 A.2d 467, 474 (Del. 1992) ("A class action may not be maintained in a purely common law or equitable fraud case since individual questions of law or fact, particularly as to the element of justifiable reliance, will inevitably predominate over common questions of law or fact.") (footnote omitted). What may be most important, however, is that the Delaware courts have personal jurisdiction over the directors of all Delaware corporations in actions brought against them under Delaware law in their capacities as directors. *See* DEL. CODE ANN. tit. 10, § 3114 (Supp. 1998); *In re* USA Cafes, L.P. Litig., 600 A.2d 43, 52-53 (Del. Ch. 1991) (holding personal jurisdiction existed over directors who merely authorized the creation of a Delaware corporation and a Delaware limited partnership); Hana Ranch, Inc. v. Lent, 424 A.2d 28, 30 (Del. Ch. 1980) (holding that nonresident directors subject themselves to personal jurisdiction by accepting the position of director of a Delaware corporation). Notably, the personal jurisdiction conferred by § 3114 does not extend to individuals who are officers of Delaware Corporations. *See* DEL. CODE ANN. tit. 10, § 3114 (Supp. 1998); *see also* Sternberg v. O'Neil, 550 A.2d 1105, 1126-27 (Del. 1988) (affirming dismissal of complaint due to lack of personal jurisdiction over nonresidents who were officers but not directors of the Delaware corporation at issue). Thus, by filing suit in Delaware, a plaintiff-shareholder eliminates concern about whether the state in which it is filing suit has the requisite contacts with each of the intended defendants to render those defendants amenable to the jurisdiction of that state's courts. This is often not the case, however, when filing suit in other jurisdictions. *See, e.g.*, Alpert v. Bertsch, 601 N.E.2d 1031, 1037 (Ill. App. Ct. 1992) (dismissing claims against directors, including claims for breach of fiduciary duty, due to lack of personal jurisdiction over nonresident directors whose only contact with the State of Illinois was in their capacity as corporate fiduciaries).

as direct actions[35] or as derivative suits,[36] or perhaps both, depending not on the type of infraction, but on the type of harm alleged. If an action is brought derivatively, there are certain factual[37] and procedural prerequisites that will have to be met, including either making a demand upon the corporation to bring the suit in its own name, or alleging that such demand

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[35]Direct actions are appropriate where the individual shareholder-plaintiff has suffered some special injury not generally shared by the shareholders. For example, board actions that interfere with a shareholder's contractual or voting rights may properly be the subject of direct actions for breach of fiduciary duty. *See Tri-Star Pictures*, 634 A.2d at 330 (holding minority shareholders had a cause of action for breach of fiduciary duty); Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1188 n.10 (Del. 1988) (noting the fundamental distinction between derivative and individual claims); Lipton v. News Int'l, Plc, 514 A.2d 1075, 1078-79 (Del. 1986) (noting that nature of the injury is determinative); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1069-70 (Del. Ch. 1985) (holding that the court is not bound by the plaintiff's determination of the claim as derivative or individual), *aff'd*, 500 A.2d 1346 (Del. 1985).

[36]Derivative actions are appropriate when the injury in question is to the corporation as a whole, as is typically the case with allegations of mismanagement or corporate waste. *See* Shapiro v. Pabst Brewing Co., No. 7339, 1985 Del. Ch. LEXIS 496, at *11 (Del. Ch. July 30, 1985), *reprinted in* 11 DEL. J. CORP. L. 704, 709 (1986) ("to the extent that the complaint purports to state an entrenchment or a waste of corporate assets breach of fiduciary duty claim ... those wrongs are derivative claims which may not be pursued either individually or as a class action."). For example, in *Kramer v. Western Pac. Indus. Inc.*, 546 A.2d 348, 349 (Del. 1988), the plaintiff alleged that the board of directors had engaged in a series of wasteful transactions - such as payment of unnecessary options, bonuses, and fees - that resulted in an illegal diversion of funds from the shareholders. The Delaware Supreme Court held that the gravamen of the plaintiff's complaint was mismanagement resulting in waste of corporate assets, and that "Delaware courts have long recognized that actions charging 'mismanagement, which depress[] the value of [the] stock [allege] a wrong to the corporation; i.e., the stockholders collectively, to be enforced by a derivative action.'" *Id.* at 353 (quoting Bokat v. Getty Oil Co., 262 A.2d 246, 249 (Del. 1970)). The court explained the basis for this rule as follows:

> A claim of mismanagement resulting in corporate waste, if proven, represents a direct wrong to the corporation that is indirectly experienced by all shareholders. Any devaluation of stock is shared collectively by all the shareholders, rather than independently by the plaintiff or any other individual shareholder. Thus, the wrong alleged is entirely derivative in nature.

Id. Recovery in a successful derivative action goes to the corporation itself, and the shareholders benefit indirectly in accordance with their proportional interest in the corporation. Levien v. Sinclair Oil Corp., No. 1883, 1975 Del. Ch. LEXIS 227, at *6 (Del. Ch. Aug. 12, 1975).

[37]Derivative actions are governed by § 327 and Chancery Court Rule 23.1, which require that a shareholder meet several requirements in order to become a shareholder derivative plaintiff. First, the plaintiff must have been a shareholder at the time of the alleged wrongdoing, or the stock must thereafter have devolved upon him or her by operation of law. DEL. CODE ANN. tit. 8, § 327 (Supp. 1998); DEL. CH. CT. R. 23.1. Second, a derivative plaintiff must continue to be a shareholder throughout the entire course of the litigation. *See In re* Resorts Int'l Shareholders Litig., Nos. 9470 & 9605, 1988 Del. Ch. LEXIS 130, at *33 (Del. Ch. Sept. 7, 1988), *reprinted in* 14 DEL. J. CORP. L. 830, 847 (1989), *aff'd*, 570 A.2d 259 (Del. 1990). A derivative plaintiff must also be an adequate representative of the interests of other shareholders. *See* Youngman v. Tahmoush, 457 A.2d 376, 379 (Del. Ch. 1983).

would be futile.[38] If demand is made upon the corporation and refused, the corporation's refusal will be respected by the courts unless the refusal itself was "wrongful."[39] Shareholders who elect to bypass the demand requirement because they believe it to be futile[40] must allege particular facts in the complaint[41] that support the existence of a reasonable doubt that: (1) a majority of the company's directors are disinterested[42] and independent,[43] or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[44]

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[38]*See* DEL. CH. CT. R. 23.1 (imposing a competency requirement under Rule 23.1); Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) (stating that "[a] stockholder filing a derivative suit must allege either that the board rejected his pre-suit demand that the board assert the corporation's claim or allege with particularity why the stockholder was justified in not having made the effort to obtain board action"); Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988) (stating that "shareholders seeking to assert a claim on behalf of the corporation must first exhaust intracorporate remedies by making a demand on the directors to obtain the action desired").

[39]Ordinarily, the board's decision to refuse the demand will be entitled to the presumptions of the business judgment rule. *Grimes*, 673 A.2d at 1219. If the shareholder alleges particular facts, however, creating a reasonable doubt that the board acted independently or with due care in rejecting the demand, the shareholder may assert that the demand was wrongfully refused and continue to prosecute his or her derivative claim. *See* Levien v. Smith, 591 A.2d 194, 212 (Del. 1991).

[40]It should be noted that, once a plaintiff has made a demand upon the board of directors to take action, he or she has waived the right to later assert that demand should have been excused as being futile. *See Grimes*, 673 A.2d at 1215, 1218-19 (adding that "[t]he stockholder [however] does not, by making demand, waive the right to claim that demand has been wrongfully refused").

[41]Only the facts contained in the complaint, or incorporated therein by reference, will be considered on a motion to dismiss for failure to plead demand futility. *See* Rothenberg v. Santa Fe Pac. Corp., No. 11,749, 1995 Del. Ch. LEXIS 117, at *8-11 (Del. Ch. Sept. 5, 1995), *reprinted in* 21 DEL. J. CORP. L. 309, 315-16 (1996).

[42]Directors will be considered interested if they derive a material financial benefit from a transaction in a manner not shared by the shareholders generally, or if a corporate decision will have a materially detrimental effect on the director not shared by the corporation and its other shareholders. *See* Katz v. Halperin, No. 13,811, 1996 Del. Ch. LEXIS 13, at *25-26 (Del. Ch. Feb. 5, 1996), *reprinted in* 21 DEL. J. CORP. L. 690, 704 (1996)(citing Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)); *Rothenberg*, 1995 Del. Ch. LEXIS 117, at *13-14, *reprinted in* 21 DEL. J. CORP. L. at 317.

[43]Directors will be considered "independent" if their decisions are based "on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson*, 473 A.2d at 816.

[44]*See Grimes*, 673 A.2d at 1216; Rales v. Blasband, 634 A.2d 927, 933-34 (Del. 1993); *Levien*, 591 A.2d at 205; *Aronson*, 473 A.2d at 814. It is the independence of the directors upon whom the demand for suit would be made that is relevant, not the independence of the directors who engaged in the alleged misconduct that would be the subject of the suit. *See Rales*, 634 A.2d at 933. Even having alleged such facts, however, the shareholder-plaintiff will not necessarily be able to pursue the litigation. Once the suit is filed, the corporation's board of directors may appoint a special litigation committee to evaluate the merits of the suit and determine whether or not it is in the corporations's best interest. *See Grimes*, 673 A.2d at 1216 n.13 (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981)). After throughly investigating the allegations in the suit, the special litigation committee may cause the corporation to move to dismiss the suit. The court of chancery will grant such a motion it if is satisfied that: (1) the special litigation committee

C. *Y2K as a Basis for Breach of Fiduciary Duty Claims*

For years, legal scholars observed that Y2K caused directors and officers to confront numerous and difficult decisions, including: which systems require Y2K remediation; whether third parties (including parties to hardware and software maintenance agreements, sellers and insurance carriers) have an obligation to fix Y2K problems and how best to pursue such performance, including the possible initiation of litigation; the type of remediation necessary (which invariably includes a serious balancing of cost and time constraints); whether to use current employees for the remediation or to contract with outside experts; how to ensure that the company's business is not impaired by a lack of Y2K readiness on the part of third parties (such as suppliers or customers); and what and how to tell the shareholders about all of the above.[45]

If a corporation suffers Y2K-related losses, its directors and officers may face numerous claims for any type of Y2K losses, which could include: adverse judgments or settlements paid in lawsuits brought by third parties alleging harm caused by the company's Y2K problems; the acquisition of,

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was independent, acted in good faith, and reached its conclusions after a reasonable investigation; and (2) in the court's own judgment, dismissal of the suit is in the corporation's best interests. *See Zapata*, 430 A.2d at 788-89.

[45]Bruce N. Telles, *Corporate Directors' and Officers' Year 2000 Related Liability: A Primer*, THE DEFENSE PRACTITIONER'S GUIDE TO THE YEAR 2000 PROBLEM 135-136 (Defense Research Institute 1998). All of this raises practical issues with additional legal implications, such as:

> what incentives should be included in a compensation package to dissuade highly marketable programmers from leaving for greener pastures at a critical stage of remediation? What types of indemnification and/or hold harmless agreements should a company grant consultants? Is the company taking care to ensure that it owns the copyright in any Y2K related computer programs being written on its behalf (as by using only employees or having independent contractors sign "work for hire" agreements)? Do some or all of the Y2K remediation techniques employed by the company or its consultants or other Y2K related confidential information constitute protectible trade secrets under applicable law? If so, may the company or its consultants invoke the "inevitable disclosure" doctrine to preclude employees leaving to work for competitors?

Id. at 136 n.5. Directors' and officers' duties may actually require the initiation of litigation, such as bringing claims against a recalcitrant software vendor to supply a Y2K compliant version of noncompliant software. *See id.* 136 n.4 (citing Rubin v. Intuit, Inc., No. CV774287 (Cal. App. Dep't Super. Ct. filed May 27, 1998) (discussing breach of implied warranty, violation of Magnuson-Moss warranty Act, fraud, and unfair business practices based on sale of non-Y2K compliant software and failure to offer free upgrade); Produce Palace Int'l v. TEC-America Corp., No. 97-3330CK (Mich. Ct. App. filed June 12, 1997) (discussing similar claims in connection with allegations that computerized cash register system "crashes" when credit cards having post-1999 expiration date are "swiped"); Courtney v. Medical Manager Corp., No. ATL-L-2031-98 (N.J. Super. Ct. App. Div. filed June 10, 1998) (discussing suit alleging violation of unfair practices act by failure to disclose Y2K non-readiness and failure to provide free upgrade to Y2K compliance)).

or merger with, a company that was not Y2K-compliant; costs alleged to have been wasted on unsuccessful Y2K remediation; and a decline in stock value due to any of the aforementioned or any other reason likely to be conjured up by plaintiffs' attorneys.[46]

Beyond liability for allegedly wrongful decisions, directors and officers may also face liability for failure to act, which could arise in one of three ways: (1) when the board of directors failed to take *any* Y2K remediation or preventive actions, after consideration of the issues, or (2) failed to even consider the issues, or (3) when the board failed to take timely action.[47]

D. *Role of the Business Judgment Rule in Y2K Claims*

A Y2K claim arising out of a decision made by a board addressing or failing to address Y2K will have to overcome the protections of the business judgment rule.[48] Recall, the business judgment rule is the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company,"[49] and a decision protected by the rule "will not give rise to liability . . . if it is made in good faith and in the exercise of due care."[50] Moreover, in making decisions, directors generally are entitled to rely upon information and analyses provided by officers, employees, and consultants or other experts, if reasonable to do so.[51]

As with other types of decisions confronting corporate boards, the business judgment rule will insulate directors from liability for erroneous Y2K-related decisions if (1) they adequately informed themselves and (2) did not have a conflict of interest.[52] If these conditions are satisfied, liability can be imposed only upon a showing that the director's actions arose to the

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[46]*See* Telles, *supra* note 45, at 137. Liability arising out of an acquisition or merger may include both "an alleged failure to perform due diligence prior to acquisition and/or a failure to insist upon adequate indemnification, hold harmless, or other agreements calculated to protect the acquiring company from potential liability." *Id.* at 137 n. 6. The basis for challenging improper Y2K expenditures "may include that the remediation alternative selected (i.e., replacement, date expansion, windowing, encapsulation, or compression)" did not meet industry standards or was "inadequate in light of the applicable deadlines or for other reasons, or that the Y2K consultant selected was inappropriate (perhaps because the selection process was flawed)" or fixed as a result of a conflict of interest. *Id.* at 137, n. 7.

[47]*See infra* notes 91-104 and accompanying text.

[48]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[49]*Id.*

[50]*In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 780 (Del. Ch. 1988).

[51]DEL. CODE ANN. tit. 8, § 141(e) (1991). *See also* CAL. CORP. CODE § 309(b)(2) (West 1987).

[52]*See Aronson*, 473 A.2d at 812.

level of "gross negligence."[53] Gross negligence has been defined as a "reckless indifference to or a deliberate disregard of the whole body of stockholders," or actions which are "without the bounds of reason."[54] In this regard, the pervasiveness and interconnectedness of Y2K issues throughout the economy may in some cases benefit directors facing derivative claims, as they can plausibly assert that achieving complete Y2K compliance was an unrealistic, if not impossible, standard.[55] On the other hand, as more companies achieved so-called Y2K compliance, they created an environment in which it is difficult for those who failed to argue they could not have achieved compliance. As with all "gross negligence" actions, if such claims are made with regard to Y2K, they will require an intense factual inquiry.

Unless the gross negligence standard can be met, any of the previously mentioned decisions of a board related to Y2K would appear to fall squarely within the ambit of the business judgment rule.[56] At a minimum, however, application of the rule requires an interrelated analysis of the answers to each of the following four questions: (1) was the decision a disinterested one? (2) was the decision made with due care? (3) was the decision made in good faith? and (4) can the decision be attributed to a rational business purpose?[57]

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[53]*See* Tomczak v. Morton Thiolol, Inc., No. 7861, 1990 Del. Ch. LEXIS 47, at *35 (Del. Ch. Apr. 5, 1990), *reprinted in* 16 DEL. J. CORP. L. 924, 924 (1991). This standard has not always been clearly articulated, and the sometimes difficult task of applying the standard has been commented on by other courts. *See* Katz v. Chevron Corp., 22 Cal. App. 4th 1352, 1366 (Cal. Ct. App. 1994); *Aronson*, 473 A.2d at 812 n.6 (stating that "[w]hile the Delaware Courts have not been precise in articulating the standard by which the exercise of business judgment is governed, a long line of Delaware cases hold that director liability is predicated on a standard which is less exacting than simple negligence").

[54]Kahn v. Roberts, No. 12,324, 1995 Del. Ch. LEXIS 151, at *11 (Del. Ch. Aug. 17, 1995).

[55]For example, in its June 1997 report to Congress, the Securities and Exchange Commission enunciated the following "essential principle" concerning Y2K issues:

> It is not, and will not, be possible for any single entity or collective enterprise to represent that it has achieved complete Year 2000 compliance and thus to guarantee its remediation efforts. The problem is simply too complex for such a claim to have legitimacy. Efforts to solve the Year 2000 problems are best described as "risk mitigation." Success in the effort will have been achieved if the number and seriousness of any technical failures is minimized, and they are quickly identified and repaired if they do occur.

Securities and Exchange Commission Report to the Congress on the Readiness of the United States Securities Industry and Public Companies to Meet the Information Processing Challenges of the Year 2000, at 2 (June 1997).

[56]*See* Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).

[57]*See generally* Aronson v. Lewis, 473 A.2d 805, 811-17 (Del. 1984) (discussing the requirements for application of the business judgment rule).

Although the business judgment rule may not apply if management is not "disinterested" or "independent,"[58] such a scenario is unlikely to exist so as to provide a basis for Y2K related actions.[59] Situations may exist, however, in which a director's financial or other interest might bring his actions outside the scope of the rule. For example, a director could own stock in a critical vendor whose Y2K compliance is questionable. If the vendor defaults and shareholders later bring a derivative action alleging that management improperly failed to replace the vendor with one whose Y2K compliance was assured, that director's interest might bring the case outside the purview of the business judgment rule. Another example might arise if a director held a financial interest in a company unqualified but nevertheless retained to remedy Y2K problems as a result of that director's influence.

Directors satisfy the due care requirement if they inform themselves "prior to making a business decision, of all material information reasonably available to them,"[60] which means they must "acquire knowledge concerning the problem before acting"[61] and turn a "critical eye" to said information.[62] Courts also recognize that directors cannot be aware of every single aspect of the corporations' operations, and that is why a decision by a board will be upheld unless the board engages in gross negligence.[63] Importantly, as previously discussed, Delaware law specifically provides that in making decisions, directors can rely on information, opinions, reports or statements prepared by corporate officers, employees or experts, if those chosen, and the decision to delegate, were made with reasonable care.[64] A board may be deemed to have acted with due care if it received a detailed briefing on Y2K (which would have to cover the company's internal problems, potential problems related to third parties, avenues of remediation and contingency plans if necessary), and then discussed and deliberated on the issues for a reasonable length of time before making its decision.[65]

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[58]*Id.* at 812. *See also* Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1265-66 (Cal. Ct. App. 1989) (stating that "courts should defer to the business judgment of *disinterested* directors who presumably are acting in the best interests of the corporation").

[59]The majority of Y2K-related claims will likely focus on professional malpractice. *See infra* note 122.

[60]*See Aronson*, 473 A.2d at 812.

[61]Moran v. Household Int'l, Inc., 490 A.2d 1054, 1075 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

[62]*See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[63]*See Aronson*, 473 A.2d at 812.

[64]*See* DEL. CODE ANN. tit. 8, § 141(e) (Supp. 1991).

[65]*See* Kaplan v. Centex Corp., 284 A.2d 117, 127 (Del. Ch. 1971). "The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'" *Van Gorkom*, 488 A.2d at 872 (quoting *Kaplan*, 284 A.2d at 127).

The good faith prong of the business judgment rule analysis is inextricably linked to the duty of loyalty and disinterestedness.[66] An absence of good faith will be found only where directors face conflicting economic or other interests.[67] It will be a rare situation when a conflict in the Y2K context will exist.[68] If a board makes a Y2K-related decision in the honest belief that it is acting in the best interests of the corporation, the defendant directors will have satisfied the good faith requirement.[69]

Lastly, to satisfy the rational business purpose analysis, a board simply must show that its decision was not patently frivolous or capricious or one which "no person of ordinary sound business judgment would believe."[70] The purchase of computers and related systems, hiring experts or using current employees, or approving a Y2K remediation plan almost certainly can be explained as furthering a rational business purpose.[71] Significantly, however, with the abundance of attention given Y2K, a decision not to implement any Y2K business plan could be deemed to be a decision that "no person of ordinary sound business judgment" would make.

E. *The* Caremark *Decision*

A Y2K plaintiff is likely to seize upon a board's failure to act, which could be accomplished in at least two ways: (1) by attacking a board that has done nothing at all to address Y2K; or (2) even in a situation where a board has acted, if the board acted only recently, by focusing on the time period prior to the board's action, arguing that the board was on notice of Y2K at an earlier date and should have fixed the problem earlier.[72] The later may have great appeal when a company suffers a severe Y2K problem that could have been avoided if the board had just acted sooner.[73]

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[66]*See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995).

[67]*See* Solash v. Telex Corp., No. 9518, 1988 Del. Ch. LEXIS 7, at *20-21 (Del. Ch. Jan. 19, 1988), *reprinted in* 13 DEL. J. CORP. L. 1250, 1262 (1988) (noting that good faith analysis is required where directors have an "adverse financial or personal interest such as an alleged entrenchment motivation or effect").

[68]*See supra* notes 58-61 and accompanying text.

[69]Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the decision must be made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

[70]*Id.*

[71]Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (stating that management's decisions will not be disturbed if they are related to any rational business purpose).

[72]Compare "unconsidered inaction" and "untimely considered action" as described *infra* Part III.E.2.

[73]The board's conduct, however, must rise to "reckless indifference" for liability to attach. Solash v. Telex Corp., No. 9518, 1988 Del. Ch. LEXIS 7, at *24 (Del. Ch. Jan. 19, 1988), *reprinted in* 13 DEL. J. CORP. L. 1250, 1264 (1988).

These plaintiffs will focus on what has been referred to as the *Caremark* exception to the business judgment rule.[74] The case of *In re Caremark International, Inc. Derivative Litigation*[75] provides for the argument that the business judgment rule may not apply in situations where the board's alleged wrongdoing consists of "unconsidered inaction" — where the failure to make a decision (as contrasted by a decision not to act) respecting a particular problem is attributable to a lack of corporate oversight or the implementation of a protocol adequate to identify and advise management of problems.[76]

1. The Decision Itself

Caremark was authored by Chancellor William T. Allen, and the opinion was one of the last of his many significant contributions to this country's corporate jurisprudence.[77] Caremark was a health care provider that was the focus of an investigation by the United States Department of Health and Human Services' Office of Inspector General.[78] The company was later indicted for numerous felonies.[79] On the heals of the indictment came several derivative actions filed in the Delaware Court of Chancery by Caremark's shareholders. The derivative action sought recovery from Caremark's directors, alleging that the board breached their duty of care "by failing adequately to supervise the conduct of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability."[80]

The case was litigated for two years before a settlement was reached.[81] The settlement became the subject of the court's decision, which focused on the fairness and reasonableness of the settlement.[82] The court analyzed the relative strengths and weaknesses of the parties' positions, and described the action as follows:

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

[75]698 A.2d 959 (Del. Ch. 1996).

[76]The Delaware Supreme Court observed in *Aronson v. Lewis* that "a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the [business judgment] rule." Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

[77]*Caremark*, 698 A.2d at 959.

[78]*Id.* at 960.

[79]*Id.* at 964-65.

[80]*Id.* at 964.

[81]*Caremark*, 698 A.2d at 966.

[82]*Id.* at 967.

> The complaint charges the director defendants with breach of their duty of attention of the corporation's business. The claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance.[83]

While the court, due to the procedural posture of the case, did not actually rule on liability, the court did conclude that the directors could be liable for losses resulting from "unconsidered inaction":

> It would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[84]

The court also concluded that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the Board concludes is adequate, exists, and the failure to do so under some circumstances may . . . render a director liable."[85]

The *Caremark* decision itself, however, expressly limited its impact in at least three noteworthy respects.[86] The first focuses on the actual extent of the conduct at issue, as the court stated that "only a sustained or systematic failure of the Board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system, exist — will establish the lack of good faith that is the necessary condition to liability."[87] By negative implication, *Caremark* provides no argument that liability could be imposed for isolated instances of director inaction; although, the magnitude of even a single issue – such as Y2K – should weigh heavily in the analysis. It is important to note as well that Y2K is not a single issue or single decision problem, and repeatedly ignoring Y2K

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[83] *Id.*
[84] *Id.* at 970.
[85] *Caremark*, 698 A.2d at 970.
[86] *See id.* at 970-71.
[87] *Id.* at 971.

information, both within the company and in the public domain, could be deemed systematic if not gross negligence.

The second limiting aspect of *Caremark* can be found in the court's resurrection of the business judgment rule, as the court observed that "obviously the level of detail that is appropriate for such an information system is a question of business judgment."[88] This appears to be a clear indication that directors can steer away from liability by ensuring that the company has in place an information gathering and monitoring system, which would provide a proper basis to invoke the business judgment rule — even if the system is later proven to be inadequate.

The third set of reins on *Caremark* are fastened to causation, as the court clearly pointed out that "[a]ny action seeking recover[y] for losses would logically entail a judicial determination of proximate cause, since . . . it could never be assumed that an adequate information system would be a system that would prevent all losses."[89] Consequently, efforts to use *Caremark* to establish liability should require a showing of: (1) a systemic problem; (2) the absence of any first-hand oversight or the inadequacy of any oversight protocol or system; and (3) a causal connection between the problem, the alleged inadequacy and the loss claimed.[90]

2. Implications of the *Caremark* Decision

To reiterate, the business judgment rule may be invoked as a defense to Y2K related litigation under either one of the following two scenarios: (1) challenges to Y2K related decisions made by a board, or (2) challenges to a board's "unconsidered inaction" or delay with regard to addressing Y2K.[91]

A derivative claim challenging a board's actual Y2K-related decisions may, as previously discussed, be premised on a wide variety of claimed

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[88] *Id.* at 970.

[89] *Caremark*, 698 A.2d at 970 n.27.

[90] *Id.* Similar limitations on the scope of the business judgment rule are imposed under the law of other states. For example, in *Casey v. Woodruff*, it was noted that under New York law:

> [w]hen courts say that they will not interfere in matters of business judgment, it is presupposed that judgment - reasonable diligence - has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment.

49 N.Y.S.2d 625, 643 (N.Y. 1944). Similar rules have been expressed by the courts in California, see National Auto v. Payne, 261 Cal. App. 2d 403 (Cal. Ct. App. 1968); Burt v. Irvine Co., 237 Cal. App. 2d 828 (Cal. Ct. App. 1965); and elsewhere. *See* Harman v. Willbern, 374 F. Supp. 1149, 1157-59 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975), and 18B AM. JUR. 2D *Corporations* § 1728 (1985).

[91] *Caremark*, 698 A.2d at 967-70.

erroneous conduct.[92] For example, shareholders may allege that the board: failed to purchase Y2K-compliant hardware and/or software; failed to conduct due diligence when merging with or acquiring another company or its assets; failed to implement an effective Y2K remediation plan; contracted with an unqualified Y2K remediation consultant; or failed to ensure that critical third parties were Y2K ready or failed to switch to Y2K ready vendors.[93] Again, however, these claims are likely to be defeated by the business judgment rule.

The more likely Y2K derivative claims, however, will be the ones which allege that the board failed to timely — or perhaps in rare situations to ever — address the company's Y2K situation.[94] These types of claims, if capable of proof, could pose real difficulty for management seeking to assert the business judgment rule as a defense,[95] and *Caremark* has certainly contributed to this difficulty. Shareholders may, and likely will, argue that under *Caremark*, or its progeny, corporate management should be held to a simple negligence standard for "unconsidered inaction."[96] In defending against such claims, a board undoubtedly would be in a better situation if it at least established — even if it is done late — a reporting system for Y2K along the lines of that discussed in *Caremark*. While a reporting system without a Y2K remediation plan may be enough to invoke the business judgment rule, a monitoring protocol in conjunction with a Y2K remediation plan should in most cases insulate management from liability, even if, to reiterate, the plan proves ill-considered and wrong.[97] This, of course, would make the case an "untimely considered action" case rather than an "unconsidered inaction" case.[98] Neither scenario is defensible from a management point of view, but, as will be discussed later, both scenarios may be defensible from a purely legal point of view.[99]

With an "unconsidered inaction" or a "failure to act" claim, one issue — though it would appear to be a stretch — could be whether management was "on notice" of Y2K problems such that the failure to take action should

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[92]*See supra* Part III.C.

[93]Telles, *supra* note 45, at 145; *see generally Securities and Exchange Commission SEC Interpretive Release: Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers* (visited May 24, 1999)<http://www.sec.gov/rules/concept/33-7558.htm>(discussing the possible sources of liability regarding Y2K issues).

[94]*See* Telles, *supra* note 45, at 145.

[95]*See id.*

[96]*See id.*

[97]*See id.* at 146.

[98]*See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) (discussing the application of the business judgment rule where the board of directors has not taken action).

[99]*See infra* notes 120-34 and accompanying text.

give rise to liability.[100] This is so because in some cases alleging a failure to act, courts have dismissed shareholders' claims on the grounds that management could not reasonably have been on notice of the problems.[101] In the Y2K context, however, it may and should be very difficult for management to argue that it was not "on notice" of Y2K issues.[102] Not only has the problem been widely known in the computer programming industry for decades, it has also been prominently discussed in the media for the last few years.[103] In addition, over those past few years, governmental agencies such as the SEC and others have made public pronouncements regarding Y2K that should arguably have alerted corporate management to the issue.[104]

F. *Defenses Beyond the Business Judgment Rule*

Besides the business judgment rule, derivative plaintiffs face significant procedural as well as additional legal obstacles, from issues of standing and the demand requirement to director protection statutes.[105]

1. Standing

A derivative plaintiff must have been a shareholder at the time of the transaction of which he or she complains, or the stock must have devolved

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[100]*See* Telles, *supra* note 45 at 146; *see also In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 968-70 (Del. Ch. 1996) (discussing liability for unconsidered inaction).

[101]*See, e.g., In re* Baxter Int'l, Inc. Shareholders Litig., 654 A.2d 1268 (Del. Ch. 1995) (discussing a company that overcharged the government for medical supplies).

[102]*See* Securities and Exchange Commission, *SEC Year 2000 Disclosure Interpretive Release Information Sheet* (visited May 24, 1999) <http://www.sec.gov/news/extra/y2k9868.txt> (stating that "[t]he Commission believes that the vast majority of companies have material Year 2000 issues").

[103]YOURDON & YOURDON, *supra* note 4, at 1 (stating that Y2K has "been widely discussed in magazines and newspapers for the last couple of decades").

[104]For example, the SEC's June 1997 Report to Congress recommends the development and implementation of Y2K project plans, including the formulation of objectives, steps to be taken, and estimated time of completion. *See generally* June 1997 Securities and Exchange Commission, Report to the Congress on the Readiness of the United States Securities Industry and Public Companies to Meet the Information Processing Challenges of the Year 2000, Issuers (visited May 22, 1999) <http://www.sec.gov/news/studies/yr2000.htm> (discussing the Y2K readiness of the securities industry and public company's). More recently, the SEC's July 29, 1998 Release states that "[t]he Year 2000 issue is certainly 'known' to all companies." SEC Release Nos. 33-7558; 34-40277; IA-1738; IC-23366; International Series Rel. No. 1149, at 18 n.30 Issuers (visited May 24, 1999) <http://www.sec.gov/rules/concept/33-7558.htm>.

[105]*See, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).

upon him or her by operation of law.[106] A derivative plaintiff must also continue to be a shareholder throughout the entire course of the litigation.[107] These requirements are intended to prevent the buying of claims by shareholders, who would purchase shares after the so-called wrongful board transaction solely for the purpose of bringing suit on the transaction.[108]

Y2K will provide for some creative arguments by corporate defendants as to when the wrongful "transaction" actually occurred. Management is likely to argue that the plaintiff's claims merely attack the manifestation of the Y2K problem, but that the real erroneous board action was the purchase of the computer system or software that caused the problem, which could be a much earlier date; and, if the argument is successfully made, it could eliminate many plaintiffs.[109]

In order to overcome the uncertainty of when the so-called wrongful transaction occurred, a derivative plaintiff may argue that a company's Y2K problem is the result of a continuing wrong.[110] However, when a shareholder alleges a continuing wrong, such as the failure to address a problem over time, courts will not permit a shareholder to maintain a derivative action if the shareholder purchased shares with knowledge of the claimed wrong.[111] The publicity surrounding Y2K, some of which has been hysterical, makes it difficult for a shareholder to argue that the risks of Y2K were unknown, even if the shareholder was not aware of the specific problems associated with the defendant company.[112] Of course, the situation may be different if the shareholder's knowledge was acquired from company disclosures.[113]

Additionally, a derivative plaintiff must also be an "adequate representative" of the corporation, qualified to serve in a fiduciary capacity

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[106]*See, e.g.*, FED. R. CIV. PROC. 23.1; DEL. CH. CT. R. 23.1; CAL. CORP. CODE § 800(b)(1)(West 1990); Pacific Lumber Co. v. Superior Ct., 226 Cal. App. 3d 371, 376 (Cal. Ct. App. 1990) (holding that shareholders cannot bring derivative suits based on wrongs occurring prior to share ownership).

[107]*See In re* Resorts Int'l Shareholders Litig., Nos. 9470 & 9605, 1988 Del. Ch. LEXIS 130, at *33 (Del. Ch. Sept. 7, 1988), *reprinted in* 14 DEL. J. CORP. L. 830, 847 (1989), *aff'd*, 570 A.2d 259 (Del. 1990).

[108]*Pacific Lumber*, 226 Cal. App. 3d at 376.

[109]This time of the "transaction" argument combined with the attention given Y2K could also provide the basis of a laches defense against those plaintiffs who wait for Y2K harm before attempting to address the issue with the company.

[110]*See* Brambles USA, Inc. v. Blocker, 731 F. Supp. 643, 649 (D. Del. 1990).

[111]*See id.* at 648 (noting that Federal Rule of Civil Procedure 23.1 and section 327 of the Delaware General Corporation Law require a derivative plaintiff to be a shareholder of the corporation prior to the challenged transaction).

[112]YOURDON & YOURDON *supra* note 4, at 1 (stating that Y2K has "been widely discussed in magazines and newspapers for the last couple of decades").

[113]*See SEC Interpretive Release, supra* note 93 (discussing Y2K disclosures).

as a representative of the interest of the other shareholders,[114] which generally requires that "the derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the rights of the corporation."[115] This requirement, however, is not likely to be any more significant in Y2K litigation than in other derivative litigation.

2. The Demand Requirement

As previously discussed, a derivative plaintiff must allege with particularly "the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort."[116] A shareholder who chooses not to make a demand must demonstrate that demand is futile by alleging facts in the complaint that raise a reasonable doubt that: (1) "the directors are disinterested and independent," and (2) "the challenged transaction was otherwise the product of a valid exercise of business judgment."[117] Because the issue of disinterestedness turns on the duty of loyalty, a Y2K plaintiff will have difficulty satisfying the first prong.[118] With regard to the second prong, because board action addressing Y2K will likely be protected by the business judgment rule, a derivative plaintiff should have problems with the second part of the test as well.[119]

3. Statutory Director Immunity

Most states, including Delaware, have so-called "raincoat statutes," which provide directors with a form of qualified immunity.[120] These statutes allow shareholders to adopt provisions in a company's certificate of incorporation that protect directors from personal liability for breach of their fiduciary duties.[121] There are, however, important exceptions. For example, Delaware's law permits a company's certificate of incorporation to contain:

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[114]In Delaware, this rule is also embodied in Chancery Court Rule 23.1. *See* DEL. CH. CT. R. 23.1; Youngman v. Tahmoush, 457 A.2d 376, 379 (Del. Ch. 1983).

[115]FED. R. CIV. P. 23.1.

[116]DEL. CH. CT. R. 23.1.

[117]*See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

[118]*See* Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984).

[119]*See supra* Part III.D.

[120]*See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1998).

[121]*See id.*

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such 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; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.[122]

If a corporation's certificate of incorporation includes a provision granting its directors protection from liability, and the exceptions to the immunity have not been adequately pleaded on the face of the complaint, such complaints alleging breach of fiduciary duty are generally dismissed as a matter of law.[123] The court in *Caremark* recognized that Delaware's statute may have limited all of the director's liability in that case.[124] Thus, even the "unconsidered inaction" cases could be subject to summary dismissal unless it can be shown that the inaction amounted to a lack of good faith — an argument that may prove difficult.[125]

By their express language, however, direction prediction statutes invariably apply only to directors, and not officers. This is understandable because unlike officers, directors generally are not involved in the hands-on, day-to-day management of the company. Nonetheless, most officers have contracts providing for indemnification to the fullest extent permitted by law, or the corporation may have a bylaw providing the same protection, or both. Like most states, for example, the Delaware General Corporation Law permits indemnification for breaches of the fiduciary duty of care.[126] Applying the same reasoning that calls for the dismissal as a matter of law of suits against directors where director protection statutes are in place,

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[122]*Id.* The statutes are similar in other jurisdictions. For example, New York Business Corporations Law § 402 (b) allows corporations to adopt provisions in their certificates of incorporation that eliminate the "personal liability of directors to the corporation or its shareholders for damages for any breach of duty." N.Y. BUS. CORP. L. § 402(b) (McKinney Supp. 1999). The statutes set forth exceptions for acts or omissions (a) that are in bad faith; (b) that involve intentional misconduct or knowing violation of law; or (c) where a director "personally gained in fact a financial profit or other advantage to which he was not legally entitled." *Id.* § 402(b)(1). *See also* CAL. CORP. CODE § 204(a)(10) (West 1990).

[123]*See, e.g.*, Arnold v. Society for Sav. Bankcorp. Inc., 650 A.2d 1270, 1286-88 (Del. 1994).

[124]*In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 970-71. (Del. Ch. 1996).

[125]*Id.* at 968-70.

[126]*See* DEL. CODE ANN. tit. 8, § 145 (Supp. 1998).

actions against officers for breach of the duty of care where protective contract or bylaw provisions are in place should be dismissed as a matter of law as well.

G. *Realistic Potential for Claims*

1. In General

To state the obvious, only cases establishing "gross negligence" or a breach of the "duty of loyalty" are assured to succeed. Beyond these *unlikely* scenarios,[127] other corporate governance claims are questionable.

2. Disclosure Violations

Because of the myriad of available defenses, the last hope then for shareholders would be to seize upon the duty of disclosure, i.e., by arguing that the directors misrepresented the state of the company's Y2K readiness, and when the company suffered the consequences of the true, undisclosed situation, the shareholders suffered derivatively and/or more likely, directly, based on their reaction to the disclosure violation.[128] While the business judgment rule may not apply to disclosure violations,[129] there are, however, at least three obstacles shareholders will have to overcome if they choose to pursue a Y2K disclosure based claim.

First, a disclosure violation is not likely to be made in conjunction with a shareholder vote, and the law on whether the duty of disclosure applies to all communications with shareholders is not fully developed.[130]

Second, the claim will have to be much more than a single allegation that the directors failed to disclose that they breached their duty of care in failing to adequately address Y2K. Such claims are barred by the rule on self-flagellation, which holds that the duty of disclosure is not a duty to

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[127]It is possible that if a corporation clearly failed to allocate sufficient resources to Y2K, while at the same time the directors or dual director/officers increased their compensation, a claim based on personal profit could be sustained.

[128]To start, one could imagine a scenario where a corporation's certificate does not contain a protective provision for directors, and the directors recognize the severity of their Y2K problem, which now cannot be fixed in time, and the directors cause the company to amend its certificate without the shareholders being informed that the purpose of the amendment was to relieve the directors of Y2K liability. In any event, beyond a disclosure violation, such a plan by the directors may also not be all that clever if the harm is deemed to be the already existing Y2K problem rather than the manifestation of the problem.

[129]See discussion *supra* note 31.

[130]See discussion *supra* note 30.

confess, and directors are not required to inform shareholders that they have or intend to breach their fiduciary duties.[131]

Shareholders will be left with having to argue that the required disclosure was not a mere confession, but the material facts of the company's Y2K readiness, which was either not disclosed or was willfully misrepresented. Even with this approach, however, shareholders will run up against the third obstacle: the director protection statutes. A breach of the duty of candor is nothing but a subset of a breach of fiduciary duty, to which the director protection statutes apply, and the exceptions to those statutes will have to pleaded and proved. Recall, the exceptions include breaches of loyalty or situations where directors personally profit (e.g., interested director transactions). If those situations exist, a shareholder does not need, and indeed may not have,[132] a separate disclosure claim because a breach of loyalty claim is available.

At this point in the analysis, it would appear that the only window of opportunity for a successful disclosure claim would be to argue that the Y2K misrepresentation was an act taken "not in good faith," which is an additional exception found in at least Delaware's law.[133] At first blush, one would think that an intentional Y2K misrepresentation would be an act "not in good faith," but the law has generally required a showing of conflicting economic or entrenchment motivations.[134] This essentially puts a shareholder back in the position of proving a breach of the duty of loyalty, unless the courts are willing to expand the application of the "not in good

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[131]*See* Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 143 (Del. 1997) (holding directors are not required to engage in self-flagellation and draw legal conclusions implicating themselves in a breach of fiduciary duty); Brody v. Zaucha, 697 A.2d 749, 754 (Del. 1997) ("It is settled Delaware law that a director need not make self-accusatory statements nor engage in 'self-flagellation' by confessing to wrongdoing . . . ."); Stroud v. Grace, 606 A.2d 75, 84 n.1 (Del. 1992) ("We recognize the long-standing principle that to comport with its fiduciary duty to disclose all relevant material facts, a board is not required to engage in 'self-flagellation' . . . implicating itself in a breach of fiduciary duty . . . ."); *In re* Rexene Corp. Shareholders Litig., Nos. 10,897 & 11,300, 1991 Del. Ch. LEXIS 81, at *7 (Del. Ch. May 8, 1991), *reprinted in* 17 DEL. J. CORP. L. 342, 351 (1992) (stating that "[d]irectors are not required to engage in self-flagellation and the failure to make an admission of wrongdoing 'is not a material omission even if plaintiff is able to prove director malfeasance'") (quoting Margolies v. Pope & Talbot, Inc., No. 8244, 1986 Del. Ch. LEXIS 507, at *20 (Del. Ch. Dec. 23, 1986), *reprinted in* 12 DEL. J. CORP. L. 1092, 1105 (1987)); Weingarden v. Meenan Oil Co., Nos. 7291 & 7310, 1985 Del. Ch. LEXIS 374, at *5 (Del. Ch. Jan. 2, 1985), *reprinted in* 10 DEL. J. CORP. L. 666, 670 (1985) (holding "[c]orporate officials are not required to engage in self-flagellation or speculate as to alleged improper motives").

[132]*See* Brown v. Perrette, No. 13,531, 1999 Del. Ch. LEXIS 92, at *20 (Del. Ch. May 14, 1999) (holding that a disclosure claim should be dismissed if it is contingent upon, and subsumed by, other avenues of relief for the wrongdoing).

[133]*See supra* text accompanying notes 120-22.

[134]See discussion *supra* Part III.D.

faith" exception to situations where the directors do not gain some personal economic advantage.

Arguing that the improper disclosure was made for entrenchment purposes also may not suffice. The argument that the directors did not disclose their negligence as to what they did, or did not do, to protect the company from Y2K because they did not want to be voted out for incompetence is an argument that would run up against both the rule on self-flagellation as well as a lack of developed law to establish such a claim.

The bottom line is that the window to successful Y2K disclosure claims appears to be closed, but there could be a crack in it. Whether the courts will let any claims through is impossible to predict.

IV. FEDERAL SECURITIES CLAIMS

Corporate management may also face a variety of Y2K related securities claims under both state and federal law.[135] Such claims would presumably be precipitated by a loss in value of a security holder's investment allegedly caused by misrepresentations or concealments of material information in connection with the sale or purchase of securities.[136] A loss in value of a security holder's investment may be alleged to have resulted from lost revenues caused directly by Y2K (including the company's own Y2K problems or that of its vendors, suppliers, or customers, causing business losses, and/or the need to expend money to fix the problem that was represented as having been fixed) to litigation arising out of Y2K problems.[137] A shareholder-plaintiff may argue that the company either actively misrepresented or concealed information in the following areas: its own Y2K readiness; the status of critical suppliers, significant customers or other third parties; the severity of potential Y2K problems; the company's actual expenditures on Y2K remediation; or any other "material" fact related to Y2K.[138]

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[135]This section focuses exclusively on federal securities claims involving public operating companies. There are certainly other types of claims arising out of misrepresentations that should be considered (e.g., negligent misrepresentation, common law fraud, etc.).

[136]Such lawsuits could be brought by shareholders alleging they "purchased their shares in reliance on allegedly material Y2K misrepresentations or omissions," or by shareholders alleging that "insiders" traded "on information not known to the shareholders at large, as in cases where directors who are aware of non-public information indicating that the company will not timely achieve Y2K compliance sell their shares before the information becomes known, driving stock shares down." Telles, *supra* note 45, at 150 n.64 (citing United States v. O'Hagan, 521 U.S. 642, 650 (1997)).

[137]*See SEC Interpretive Release, supra* note 93 (discussing the requirements of a corporation to disclose not only its own Y2K issues, but also those of third parties that may impact the corporation financially).

[138]*See* Telles, *supra* note 45, at 150.

A. *Overview of Federal Securities Disclosures*

Federal law mandates that companies with publicly traded securities make certain disclosures in: (1) registration statements pursuant to the Securities Act of 1933 (the 1933 Act),[139] and (2) periodic reports made pursuant to the Securities Exchange Act of 1934 (the 1934 Act).[140]

In general, "a disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation."[141] The test for determining materiality consists of two steps. First, the company must objectively determine if the known trend, event or uncertainty is reasonably likely to occur, and if the answer is no, no disclosure is required.[142] Second, if the company is unable to determine that the known trend, event or uncertainty is *not* reasonably likely to occur, it must *assume* it will occur and determine whether it is reasonably likely that the trend or uncertainty will have a material effect on the financial condition or result of operations of the company.[143]

Required disclosures can be found in registration statements or prospectuses accompanying offerings of securities as well as in periodic reports required by the 1934 Act (e.g., annual report on Form 10-K).[144] Disclosures must also be made to avoid liability under Rule 10b-5 of the 1934 Act, which provides for a civil cause of action against any person, who, in connection with the purchase or sale of any security, makes an "untrue statement of a material fact or omit[s] . . . a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[145] To avoid Rule 10b-5 liability, a disclosure may be made by a press release, in a formal SEC filing, or other appropriate means.[146]

Just a general, overall briefing on liability for securities violations should give any director or corporate officer concern because the law casts a big net, and imposes substantial liability under various statutory provisions.

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[139]*See* 15 U.S.C. § 77 (1994).

[140]*Id.* § 78.

[141]1934 Act Release No. 6835, 43 SEC Docket No. 12, 1575, 1579 (May 30, 1989).

[142]*Id.* at 1580 n.27.

[143]*Id.*

[144]*See* 15 U.S.C. § 77e-77h (1994) (registration statements); *id.* §§ 77e, 77j (prospectuses).

[145]17 C.F.R. § 240.10b-5 (1998). Rule 10b-5 also prohibits persons from "employ[ing] any device, scheme or artifice to defraud" and from "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security." *Id.*

[146]*Id.*

For example, Section 11 of the 1933 Act imposes liability for (1) making an untrue statement of material fact in a registration statement or prospectus or (2) omitting to state a fact necessary to be disclosed in order to make the statements contained therein not misleading.[147] Section 11 liability applies to any persons who signed the registration statement, any director of the issuing company (regardless of whether the director has signed the registration statement), any expert such as an accountant, engineer or appraiser whose work is incorporated into the registration statement, and underwriters.[148] Outside directors are only liable in proportion to their fault unless they knowingly violated the securities laws.[149]

Similarly, Section 12(2) of the Securities Act imposes liability on offerors and sellers of securities for misstatements or omissions in a prospectus unless the defendant shows (1) he did not know and (2) in the exercise of reasonable care, could *not* have known of the alleged material misstatements.[150] Section 12(2) liability does not apply to directors and officers who are not involved in soliciting the sale of securities for financial gain. Section 15 of the Securities Act imposes liability on "controlling persons" of an issuer for violations of Section 11 and 12. To recover under Section 15, however, a defendant must be shown to have actual power to direct corporate affairs.[151] Finally, misstatements or non-disclosures may also give rise to liability under Rule 10b-5.

The United States Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*[152] held that a misstatement of fact, or a non-disclosure of fact, is "material" if there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding" how to act.[153] Importantly, it is not necessary for an investor to establish that a proper disclosure would have actually changed his or her decision, as the *TSC* court further explained that there must merely "be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investors as having significantly altered the 'total mix' of information made available."[154]

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[147]*See* 15 U.S.C. § 77k(a) (1997).

[148]*See id.*

[149]*See* 15 U.S.C. §§ 77k(f) (1997); 15 U.S.C. § 78u-4(g) (1998).

[150]*See* 15 U.S.C. § 77l(2) (1994).

[151]*See* Durham v. Kelly, 820 F.2d 1500, 1502-04 (9th Cir. 1987).

[152]426 U.S. 438 (1976).

[153]*Id.* at 449.

[154]*Id.*

B. *Federal Y2K Disclosures*

In its efforts to heighten the general awareness and elicit meaningful disclosure by public companies of their Y2K issues, the SEC has itself struggled with its own recommendations to public companies. The Commission's approach to Y2K disclosure progressed from reliance on the flexibility provided by the existing disclosure framework to the issuance of specific guidelines including topics that should be discussed and issues to be considered. On October 8, 1997, the SEC issued Staff Legal Bulletin No. 5 alerting public companies, investment advisers and investment companies that they should consider disclosure of anticipated costs, problems and uncertainties associated with Y2K and suggestions for Y2K disclosure.[155] On January 12, 1998, the Commission revised Staff Legal Bulletin No. 5 by adding more specific guidance on Y2K disclosures.[156] For example, the SEC suggested that the determination of whether a company's Y2K issues are material, and therefore should be disclosed, should not include any remediation programs or contingency plans.[157] SEC Commissioner Laura S. Unger labeled this deviation from the standard definition of materiality the "gross" basis test.[158]

The SEC quickly concluded that the Staff Legal Bulletins were not sufficient. Results of SEC surveys showed that "many companies [were] not providing the quality of detailed disclosure that the Commission believes investors expect."[159] Consequently, on July 29, 1998, the SEC issued a release titled "Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal

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[155]*See* SEC, Staff Legal Bulletin No. 5 (CF/IM) (Oct. 8, 1997) (visited May 24, 1999) <http://www.sec.gov/rules/othern/sl6cf5.htm>. The Staff Legal Bulletin contains the Division's staff's guidance on good disclosure practices; however, it is not a rule, regulation, or statement of the Commission. *See id.*

[156]*Id.*

[157]*Id.*

[158]Laura S. Unger, SEC Commissioner, Testimony Before the Senate Subcomm. on Financial Service and Technology, Concerning Disclosure of Year 2000 Readiness (June 10, 1998).

[159]*Year 2000 Disclosure Interpretive Release Information Sheet* (July 29, 1998) (visited May 24, 1999) <http://www.sec.gov/news/extra/y2k9868.txt>. The SEC's Division of Corporation Finance's Task Force found that

> only 10% of the annual reports filed by public companies during the first four months of 1997 contain the phrase "Year 2000." For the quarterly reports filed after the staff published the Staff Legal Bulletin [No. 5 in October 1997], this percentage increased to 25%. After the staff revised the Staff Legal Bulletin [No. 5] in January 1998, 70% of the annual reports contained the phrase "Year 2000."

See supra note 93, at 4.

Securities Issuers" (Interpretive Release).[160] The Interpretive Release supersedes Staff Legal Bulletin No. 5, and it provides comprehensive guidance to companies on Y2K disclosures.[161]

More recently, on November 9, 1998, the SEC gave even more guidance to public companies regarding Y2K disclosure in a release titled, "Frequently Asked Questions About the Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies" (FAQ Release).[162] In the FAQ Release, the SEC addresses some frequently asked questions raised by interested persons regarding the Interpretive Release.[163]

In the Interpretive Release, the SEC indicated that it intends to step up its efforts in eliciting meaningful disclosure from public companies relating to Y2K.[164] It indicated that failure to provide such meaningful disclosure could result in possible referrals to the SEC's Division of Enforcement.[165]

1. What Triggers Y2K Disclosures

The Interpretive Release addresses a number of disclosure requirements, but focuses on the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), which is included in all registration statements, annual reports on Form 10-K, and quarterly reports on Form 10-Q filed with the SEC.[166] In the MD&A, companies are required to disclose management's assessment of known trends, demands, commitments, events, or uncertainties that are likely to have a material impact on the companies' operations or financial condition.[167] The

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[160] *SEC Interpretive Release, supra* note 93. Unlike the Staff Legal Bulletin, the Release carries the force of a commission vote on specific interpretations on disclosure policies. The Interpretive Release comprises releases nos. 33-7558, 34-40277, IA-1738, IC-23366, and International Series Release no. 1149. The releases amend Title XVII, Chapter 2 of the Code of Federal Regulations by adding the releases to parts 231, 241, 271, and 276. *See SEC Interpretive Release, supra* note 93.

[161] *Year 2000 Disclosure, supra* note 102, at 1.

[162] Securities and Exchange Commission, SEC Interpretation: *FAQ About the Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies* (visited May 24, 1999) <http://www.sec.gov/rules/concept/33-7609.htm>. The FAQ Release comprises releases nos. 33-7609, 34-40649 and International Series Release No. 1168.

[163] *Id.*

[164] *SEC Interpretive Release, supra* note 93, at 4.

[165] *Id.*

[166] *Id.* at 1.

[167] 17 C.F.R. § 229.303(a)(3)(ii) (1998).

Interpretive Release requires that a company provide a Y2K disclosure in the MD&A if:

> (1) its assessment of its Year 2000 issues is not complete, or
>
> (2) management determines that the consequences of its Year 2000 issues would have a material effect on the company's business, results of operations, or financial condition, without taking into account the company's efforts to avoid those consequences.[168]

Interestingly, the SEC stated that "a large majority of the companies will meet one or both of these tests and therefore will be required to provide Year 2000 disclosure" and that "significantly more companies will be providing Year 2000 disclosure in future disclosure documents."[169]

Importantly, in addition to its internal assessment of its Y2K readiness, satisfaction of the first test above requires that a company take "reasonable steps" to determine whether "third parties with whom a company has material relationships" are Y2K compliant.[170] The Interpretive Release also provides guidelines on how to properly make the determination,[171] and notes the obvious: That a relationship with a vendor, supplier, or other third-party is material if a lack of Y2K readiness on the part of a vendor or supplier would have a material effect in any way on the company's bottom line.[172] This includes an immediate effect on earnings or a future impact on performance, because the guidelines refer to the company's business, results of operations, as well as financial condition.[173] The Interpretive Release also suggests that a company conduct the same analysis with respect to significant customers whose Y2K noncompliance could result in a material loss of business to the company.[174] Third-party assessment may be conducted by sending questionnaires to third-parties; however, the Interpretive Release stresses that a company is not relieved of its obligations

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[168] *SEC Interpretive Release*, *supra* note 93, at 2.

[169] *Id.* at 7.

[170] *Id.* Specifically, the SEC stated that "[i]n our view, a company's Year 2000 assessment is not complete until it considers these third party issues and takes reasonable steps to verify the Year 2000 readiness of any third party that could cause a material impact on the company." *Id.*

[171] *Id.*

[172] *SEC Interpretive Release*, *supra* note 93, at 2.

[173] *Id.*

[174] *Id.* at 7.

with respect to third-parties if there is no response to a questionnaire, "there may be other means to assess third-party readiness."[175]

Additionally, the company's assessment of its Y2K issues should include consideration of whether it has potential liability to third parties if its systems are not Y2K compliant, which may result in possible legal actions.[176]

When making a determination whether disclosure is required under the second test, the SEC informed companies that it will assume they will not be prepared for the Year 2000 unless there is "clear evidence" of Y2K readiness.[177] Similarly, a determination as to third-party readiness must also assume a lack of compliance unless the third-party provides a written assurance that it will be ready for Y2K.[178] The Interpretive Release does not provide a definition of "clear evidence of readiness," but does note that "[i]f a company has substantially completed its testing and assessment of third party issues, and thus has a reasonable basis to believe that it is Year 2000 ready, it need not" assume that it will not be Y2K compliant.[179] Under the second test, companies should then measure materiality based on the consequences if the company is not prepared for Y2K, rather than on the amount of money spent or planned to be spent to address its Y2K issues.[180]

The patent conclusion to be drawn from all this is that management must have made a real effort, and the company's Y2K disclosures must be reasonably specific and meaningful rather than boilerplate. The Interpretive Release makes this point as well.

2. The Types of Y2K Disclosures That Must be Made

After a company determines that it has an obligation to disclose its Y2K issues, it then must decide what to disclose.[181] The SEC has set forth the following four categories of information that companies should address in their MD&A in order for their Y2K disclosure to be meaningful:

(1) the company's state of readiness;
(2) the costs to address the company's Year 2000 issues;
(3) the risks of the company's Year 2000 issues; and

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[175] *Id.*
[176] *SEC Interpretive Release, supra* note 93, at 7.
[177] *Id.*
[178] *Id.*
[179] *Id.* at 18 n.33.
[180] *SEC Interpretive Release, supra* note 93, at 7.
[181] *Id.*

(4) the company's contingency plans.[182]

The SEC has retained flexibility in its disclosure requirements in that "[t]he level of detail that a company provides under each category depends on each company's facts and circumstances."[183]

Disclosures regarding the company's Y2K compliance must address, at the very least, three areas.[184] The first deals with the scope of the disclosure as to the company itself, and indicates that the discussion should address not only the company's purely information technology systems (i.e., administrative, accounting, and other computer software and hardware systems that contain and process all data), but also non-information technology systems (i.e., embedded technology, which could effect the actual physical operation of the business).[185] The Interpretive Release states:

> A good description of a company's Year 2000 issues would address whether all its hardware and software systems, and all of its embedded systems contained in the company's buildings, plant, equipment and other infrastructure, have been assessed. If this assessment is not complete, the company should disclose the kinds and percentage of hardware and software systems and embedded systems that remain to be assessed.[186]

The second area of disclosure should focus on the company's state of readiness. This portion of the disclosure should discuss, in terms of phases, the status of the assessment of Y2K problems and any Y2K remediation plans, including the estimated timetable for completion of each phase of the assessment or plan.[187] This information should be provided both as to information technology and all other systems.[188]

The third disclosure area should include a description of Y2K issues relating to third-parties with which the company has a material relationship.[189] The Interpretive Release notes that "the interdependence of

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[182] *Id.* at 7-8.

[183] *FAQ Release, supra* note 162, at 1.

[184] *SEC Interpretive Release, supra* note 93, at 8.

[185] *Id.* The Interpretive Release notes that very few Y2K disclosures to date address the subject of embedded technology and expresses the SEC's concern that "companies are overlooking non-IT systems when they provide Year 2000 disclosure." *Id.*

[186] *Id.* at 19 n.40.

[187] *Id.* at 8. The Interpretive Release describes this information as "vital" to investors. *Id.*

[188] *SEC Interpretive Release, supra* note 93, at 8.

[189] *Id.*

computer systems . . . presents a unique policy issue" in the Y2K context.[190] For example, if a major telecommunications or utility company discloses that it may suffer a business interruption, "this may require many other companies to disclose that they too may have a business interruption, if material."[191]

The Y2K disclosure must also include a discussion of the costs to address the company's Y2K problems.[192] This discussion must include all material historical and estimated costs associated with Y2K remediation.[193] Costs include both external costs (e.g., hiring of external consultants and purchases of hardware and software) and the direct costs (e.g., compensation and fringe benefits) of internal employees working on Y2K projects.[194] If the company does not track the time and resources spent on Y2K projects by internal employees, that fact should be disclosed.[195]

A company must also provide disclosure of the risks of the company's Y2K issues.[196] The discussion should include a description of the potential consequences that the company believes are reasonably likely to occur due to Y2K.[197] If reasonably likely, the company should disclose the impact on a company if its systems, both information technology and non-information technology, or the systems of material third-parties, do not function and it has to implement its contingency plan.[198] Moreover, the company should discuss any failure to obtain assurances as to whether a material and significant relationship with a third-party will be impacted by Y2K.[199] If such a situation exists, then the company must disclose the related contingency plan in the event that the third party is not Y2K compliant and the costs of such contingency plan.[200]

A company must also provide disclosure regarding its contingency plans.[201] This disclosure should include a description of any contingency plan the company implemented for dealing with Y2K problems or that the

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[190] *Id.*
[191] *Id.*
[192] *SEC Interpretive Release*, *supra* note 93, at 8.
[193] *Id.*
[194] *Id.*
[195] *FAQ Release*, *supra* note 162, at 2.
[196] *SEC Interpretive Release*, *supra* note 93, at 9.
[197] *FAQ Release*, *supra* note 162, at 2.
[198] *Id.*
[199] *Id.*
[200] *Id.*
[201] *FAQ Release*, *supra* note 162, at 2.

company does not have a contingency plan, and whether it intends to implement one, along with the timetable for doing so.[202]

The SEC takes the position that providing the minimum level of disclosure set forth in the four categories of information above may not be enough for some companies to fulfill their meaningful disclosure obligations.[203] The Interpretive Release contains a list of additional disclosure suggestions for all companies to consider, although some or all of the items on this list may be irrelevant for each company.[204]

Finally, because of the risk of creating boilerplate language and the differing circumstances each company and industry faces, the SEC has refused to provide an example of what it considers good Y2K disclosure.[205]

3. Y2K Disclosures Under Other Regulations

A public company is not finished with its Y2K disclosure obligations after it has completed the MD&A.[206] The company should also consider whether other federal securities rules or regulations require disclosure of its Y2K issues.[207]

A company is required to include in registration statements and annual reports on Form 10-K filed with the Commission a description of its business.[208] This description includes the general development of the business of the company, its subsidiaries, and any predecessors during the past five years.[209] Among other things, Y2K may force disclosure under this rule if it forces a company to make a material change in the mode of conducting its business, if it affects the products or services the company produces or provides, or if the competitive environment changes in connection with Y2K.[210]

Companies are also required to describe any material pending legal proceedings to which it is a party or its property is subject.[211] In the event the company becomes involved in a Y2K related lawsuit which is material, it must be disclosed.[212]

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[202] *SEC Interpretive Release*, *supra* note 93, at 9.
[203] *Id.*
[204] *Id.*
[205] *FAQ Release*, *supra* note 162, at 2.
[206] *SEC Interpretive Release*, *supra* note 93, at 3.
[207] *Id.* at 11.
[208] 17 C.F.R. § 229.101 (1998).
[209] *Id.*
[210] *Id.*
[211] 17 C.F.R. § 229.103 (1998).
[212] *Id.*

Companies also must file as exhibits to its SEC filings contracts that are material to its business.[213] Material contracts include those upon which the business is substantially dependent, such as contracts with principal customers and suppliers.[214] Contracts with external consultants or professional advisors may be material if the failure of the service provider to perform its obligations under the contract would have a material affect on a company's business, results of operations or financial condition.[215]

The "Risk Factors" section must be included in all registration statements.[216] This section contains a description of certain factors that may have a material adverse affect on the company or any securities being offered.[217]

At some point in time, Y2K issues may rise to a level of importance that a company will consider filing a Current Report on Form 8-K.[218] Form 8-K allows a company to disclose at any time material information which it wishes to disseminate to the public.[219] Importantly, if the company has an effective registration statement on file with the SEC and a Y2K issue becomes material, it may desire to use Form 8-K to fulfill its obligation to keep such registration statement complete and accurate.[220]

Additionally, the federal securities laws require that companies disclose any other material information necessary to make any required disclosure not misleading.[221]

4. Safe Harbors for Y2K Disclosures

The Interpretive Release also touches on how corporations should interpret and possibly avail themselves of the statutory safe harbors created by the Private Securities Litigation Reform Act of 1995 (PSLRA) when confronting Y2K.[222] These safe harbors provide immunity from liability to companies and management for material "forward-looking" statements, as

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[213] 17 C.F.R. § 229.601 (1998).

[214] *Id.*

[215] *See, e.g.*, 17 C.F.R. § 229.601(b)(10) (1998) (discussing material contracts).

[216] *SEC Interpretive Release, supra* note 93, at 12.

[217] *Id.*

[218] *Id.*

[219] *See* 17 C.F.R. § 249.308 (1998).

[220] *Id.*

[221] Securities Act Rule 408, 17 C.F.R. § 230.408 (1998); Exchange Act Rules 12b-20, 17 C.F.R. § 240.12b-20 (1998); Securities and Exchange Act Rule 14a-9, 17 C.F.R. 240.14a-9 (1998).

[222] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in various sections of Title 15 of the United States Code).

long as certain, carefully circumscribed requirements are satisfied.[223] The Interpretive Release suggests that "[a]lmost all" of the disclosures involving projections of financial items such as costs of remediation and testing, costs of business interruption and expected future economic performance related to Y2K "contain forward-looking statements."[224] On the other hand, it is abundantly clear that the disclosure of historical facts, such as costs of Y2K contingency plans, Y2K assessments, the company's inventory of hardware and software, and the current state of remediation are not forward-looking statements for purposes of safe harbor protection.[225]

C. *Federal Y2K Disclosure Claims*

Corporate management may face substantial liability under a variety of state[226] and federal[227] statutes for Y2K disclosures or nondisclosures. Liability under federal law can arise from private rights of action or SEC enforcement actions brought under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.[228]

Section 11 of the 1933 Act imposes liability for: (1) making an untrue statement of material fact in a registration statement or prospectus, or (2) omitting a fact necessary to make the statement not misleading.[229] Section 11 of the 1933 Act imposes liability on: (1) any person who signs the registration statement; (2) any director of the company (regardless of

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[223]*See* 15 U.S.C. § 77z-2(a)-(b) (1998). *See* 15 U.S.C. § 77z-2(I)(A)-(F) (1998), which defines "[f]orward-looking statement" to as:

> (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items; (B) a statement of the plans and objectives of management for future operations; (C) a statement of future economic performance . . .; and (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C) . . . . These statutory safe harbors apply to disclosures made by "(1) an issuer . . .; (2) a person acting on behalf of such issuer; (3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or (4) an underwriter, with respect to information provided by such issuer or information derived from information provided by the issuer.

Id. § 77z-2(a)(1)-(4). In addition, exclusions from the statutory safe harbors apply to certain statements, i.e., "those made in connection with an initial public offering" or those made by investment companies. 15 U.S.C. § 78u-5(b)(2)(B), (D) (1998).

[224]*SEC Interpretive Release*, *supra* note 93, at 5.

[225]*Id.*

[226]*See, e.g.*, CAL. CORP. CODE §§ 25400, 25401 (West 1999); DEL. CODE ANN. tit. 6, §§ 7303, 7323 (1998); N.Y. GEN. BUS. LAW § 352-c (McKinney 1996).

[227]*See, e.g.*, 15 U.S.C.A. §§ 77k, 77o, 77t (1997); 17 C.F.R. §§ 230.175, 240.3b-6 (1998).

[228]*See* 15 U.S.C. §§ 77-78 (1994).

[229]*See* 15 U.S.C. §§ 77k-77l (1994).

whether the director has signed the registration statement); (3) any accountant, engineer, appraiser or any person whose profession gives authority to a statement made by him, whose has prepared or certified any part of the registration statement or who has prepared or certified any report or valuation used in connection with the registration statement with his consent; and (4) underwriters.[230] Outside directors, however, are only liable in proportion to their fault unless they knowingly violated the law.[231] This is a private right of action which may be claimed only by persons who acquired securities covered by the allegedly defective registration statement or prospectus.[232]

Section 12(a)(2) of the 1933 Act imposes liability on offerors and sellers of securities for misstatements or omissions in a prospectus unless the defendant shows (1) he did not know that the statement was untrue, and (2) in the exercise of reasonable care, could not have known of the alleged material misstatements.[233] Section 12(a)(2) liability does not apply to directors and officers who are not involved in soliciting the sale of securities for financial gain.[234] The offeror or seller is liable only to "the person purchasing such security from him."[235] Agents of the person who actually transfers the title to the security, however, will also be considered to be among those from whom the buyer purchased the security if they solicited the purchase and they or the seller financially benefitted from the transaction.[236]

Section 15 of the 1933 Act imposes liability on "controlling persons" of an issuer for violations of Sections 11 and 12 unless such person "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[237] Section 20(a) of the 1934 Act contains similar potential liability for a controlling person for Rule 10b-5 violations (discussed below) by the person it controls "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[238]

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[230] *See* 15 U.S.C. § 77k (1994).

[231] 15 U.S.C. §§ 77k(f) (1997); 15 U.S.C. § 78u-4(f) (1998).

[232] 15 U.S.C. § 77k(a) (1997).

[233] 15 U.S.C. § 77l(2) (1994).

[234] 15 U.S.C. § 77k(b) (1994).

[235] 15 U.S.C. § 77l (1994).

[236] Pinter v. Dahl, 486 U.S. 622, 643 (1988).

[237] 15 U.S.C. § 77o (1998). *See also* 15 U.S.C. § 78t(a) (1998) (discussing liability of controlling persons).

[238] 15 U.S.C. § 78t(a) (1994).

Misstatements or nondisclosures may also give rise to liability under Rule 10b-5.[239] Rule 10b-5 provides a civil cause of action against any person who, in connection with the purchase or sale of any security, makes an "untrue statement of a material fact or omit[s] to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading."[240] Rule 10b-5 applies to purchases or sales of securities[241] involving an instrumentality of interstate commerce regardless of whether they are registered under federal law.[242] Liability under Rule 10b-5 extends to "any person."[243] The Supreme Court held in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[244] that Rule 10b-5 does not impose "aider and abettor" liability on persons such as accountants, lawyers, or others who assist or advise companies in securities transactions or disclosures. Such persons, however, may be directly liable under Rule 10b-5 if their own actions violate the Rule.[245] Additionally, "controlling persons" of those who violate Rule 10b-5 are liable unless they can show that they acted in good faith and did not induce the wrongful acts.[246]

Section 17(a) of the 1933 Act mirrors the language of Rule 10b-5 with the exception that it applies both to "offers and sales" of securities, while Rule 10b-5 applies to "purchases and sales" of securities.[247] Thus, unlike Rule 10b-5, section 17(a) applies to the offer to sell.[248] This section currently is not available as a basis for a private right of action, however, the SEC may use this section as a basis for its enforcement actions.[249]

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[239]17 C.F.R. § 240.10b-5 (1998).

[240]17 C.F.R. § 240.10b-5 (1998). Rule 10b-5 also prohibits the use of "any devise, scheme or artifice to defraud" as well as "engag[ing] in any act, practice, or course of business which operates . . . as a fraud or deceit upon any person." *Id.*

[241]*See also* Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960) (stating that Rule 10b-5 is also meant to protect sellers).

[242]17 C.F.R. § 240.10b-5 (1998).

[243]*Id.*

[244]511 U.S. 164, 191 (1994).

[245]*Id. See also* McGann v. Ernst & Young, 102 F.3d 390, 393-96 (9th Cir. 1996), *cert. denied*, 520 U.S. 1181 (1997) (analyzing potential primary liability of accountant under 10b-5 in wake of *Central Bank*).

[246]15 U.S.C. § 78(t)(a) (1998). *See also* Paracor Finance, Inc. v. General Elec. Capital Corp., 96 F.3d 1151, 1161 (9th Cir. 1996).

[247]*See* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 836-839 (7th ed. 1992).

[248]*Id.*

[249]*Id.* at 837.

Certain "safe harbors" may apply to forward-looking statements made in connection with Y2K disclosures.[250] These safe harbors may be provided by statute through the PSLRA or by common law through the "bespeaks caution" doctrine.[251] Section 102 of the PSLRA safe harbors applies if: (1) the forward looking statement is accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement";[252] (2) the statement is immaterial; or (3) the plaintiff fails to prove that the forward-looking statement was made with actual knowledge of its falsity.[253]

Lastly, the PSLRA also contains several measures designed to limit the use of "professional plaintiffs," and it requires as well that a complaint "state with particularity facts giving rise to a 'strong inference' that the defendant acted with the required state of mind."[254]

Utilization of the safe harbor of the PSLRA is, however, limited.[255] For example, the safe harbor is not permitted where the forward-looking statement was made in connection with a tender offer or initial public offering or where the forward-looking statement was included in a financial statement prepared in accordance with generally accepted accounting principals.[256] Moreover, the safe harbor is only available for private rights of action (not SEC enforcement proceedings) in federal court.[257]

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[250]*See generally* 15 U.S.C.A. § 77z-2 (1998) (outlining the applicability of "safe harbors" to forward-looking statements).

[251]Polin v. Conduction Corp., 552 F.2d 797, 806 n.28 (8th Cir. 1977) (creating the "bespeaks caution" doctrine based on the terminology such as "expected" and "a possibility of a break-even soon" in an annual report falling short of qualifying as false and fraudulent).

[252]Specifically, such "meaningful cautionary statements" must identify "important factors that could cause actual results to differ materially from those in the forward-looking statement." *See* 15 U.S.C. §§ 78u-5(c)(1)(A)(I), 77z-2(c)(1)(A)(I) (1998).

[253]15 U.S.C. §§ 78u-5(c)(1)(B), 77z-2(c)(1)(B) (1998). This safe harbor applies to failures to prove that a forward-looking statement "made by a natural person, was made with actual knowledge . . . that the statement was false or misleading" or that a forward-looking statement "made by a business entity, was . . . made by or with the approval of an executive officer . . . with actual knowledge . . . that the statement was false or misleading." *Id.*

[254]15 U.S.C. § 78u-4(b)(2) (1998). Specifically, plaintiffs must verify, *inter alia*, that they authorized the filing of the complaint, and that they did not purchase the securities at the direction of counsel for the purpose of filing securities litigation. 15 U.S.C. §§ 78u-4(a)(2)(A)(ii), 77z-1(a)(2)(A)(ii) (1998). Plaintiffs also are precluded from serving as lead plaintiff in more than five class action suits within three years. *Id.* § 78u-4(a)(3)(B)(vi). Finally, the PSLRA provides that courts must appoint the "most adequate plaintiff" as the lead plaintiff in any class action, with the presumption that the most adequate plaintiff is the one with the greatest financial interest. *Id.* §§ 77z-1(a)(3)(B)(I), 78u-4(a)(3)(B)(I).

[255]*See generally* 15 U.S.C. § 77z-2(a)-(b) (1998) (describing the applicability of the safe harbor provision).

[256]*Id.* § 77z-2(b)(2).

[257]*Id.* § 77z-2(c)(2).

In addition to the statutory safe harbor provided by the PSLRA, the courts have created the "bespeaks caution" doctrine to protect forward-looking statements.[258] The "bespeaks caution doctrine" has been applied in cases brought under sections 11 and 12(a)(2) of the 1933 Act and Rule 10b-5 of the 1934 Act to conclude that forward-looking statements are not actionable if accompanied by "adequate" cautionary language.[259] Cautionary statements designed to afford the protection of the "bespeaks caution" doctrine must be "substantive and tailored to" the specific projection, estimate or opinion such that the forward looking statement "[does] not affect the 'total mix' of information the document provided investors."[260] Boilerplate cautionary language is not sufficient to invoke the doctrine.[261]

The SEC Safe Harbor provides protection for forward-looking statements made in or reaffirmed in certain documents or statements made subsequent to and reaffirming such forward-looking statements.[262] These documents include those that are filed with the SEC, those that are in Part I of a quarterly report on Forms 10Q and 10QSB or are in a publicly available annual report.[263] In order for a plaintiff to overcome the SEC Safe Harbor, the plaintiff must show that the statements lacked a reasonable basis or were made other than in good faith.[264]

As touched on earlier, corporate management is not alone under the securities laws, and as with other suits brought by plaintiffs' attorneys, with Y2K claims, accountants will likely be an inextricable part of the target. Y2K disclosure issues clearly affect accountants' obligations in conducting audits. Preparation of a company's financial statements are guided by "generally accepted accounting principles," promulgated by the Financial Accounting Standards Board and the American Institute of Certified Public Accountants (AICPA). Financial statements must include a note identifying all contingencies which are reasonably possible, whether or not the amount can be calculated or estimated. Moreover, certain estimated losses (specifically, losses that are "probable") may have to be charged against earnings, provided that an asset has been impaired or a liability incurred as

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[258]*See* Polin v. Conductron Corp., 552 F.2d 797, 806 n.28 (8th Cir. 1977) (creating the "bespeaks caution" doctrine).

[259]*In re* Donald J. Trump Casino Sec. Litig., 793 F. Supp. 543, 549 (D.N.J. 1992), *aff'd*, 7 F.3d 357 (3d Cir. 1993).

[260]Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 489 (3d Cir. 1994) (quoting *In re* Donald J. Trump Casino Sec. Litig., 7 F.3d 357, 371 (3d Cir. 1993)).

[261]*Id.*

[262]17 C.F.R. §§ 230.175, 240.3b-6 (1994).

[263]*Id.*

[264]*Id.*

of the date of the financial statements and that the amount of loss can be reasonably estimated.[265]

In view of the above, a company's auditors may consider it advisable, even necessary, to evaluate the business' Y2K status in the course of conducting an audit of its financial statements. Such a course may be advisable both in order to ensure compliance with the guidelines set forth in the AICPA's Generally Accepted Auditing Standards, as well as to avoid potential liability under the heightened due diligence standards applicable to "experts" under Section 11(b) of the Securities Act. Thus, auditors may decide to include in their opinions specific explanatory reference to any notes in financial statements respecting Y2K liabilities.

In short, both corporations and their accountants face numerous thorny issues affecting their ethical and legal obligations (and potential liabilities) in connection with disclosures relating to Y2K. Evaluating the required scope and content of Y2K disclosures will require considerable factual inquiry and the exercise of carefully considered professional judgment. The only certainty is that inaction is no longer an acceptable option.

V. CONCLUSION

The dawn of the new millennium is likely to be a stable environment in the Delaware courts. Corporate America has known for some time that Y2K is a significant problem.[266] As previously emphasized, it will be a rare situation when a Y2K derivative claim is predicated on a breach of the duty of loyalty, and with the abundance of notice given to boards of directors about Y2K, it should likewise be a rare situation when a board can be accused of doing nothing at all. Consequently, unless gross negligence can be proved, the business judgment rule will stand as an absolute bar to Y2K corporate governance claims, the only other possible exception being where some injunctive (preliminary or permanent, mandatory) relief is sought, is deemed to be necessary, and is then obtained. Even if a shareholder can identify a board that sat on its hands, thereby advancing the *Caremark* "unconsidered inaction" analysis, statutory immunity for breaches of fiduciary duty will still bar such claims absent a showing of a lack of good faith. This, combined with multiple other defenses, is likely to result in little Y2K corporate governance class and/or derivative litigation. Only a greatly

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[265] *Id.*

[266] YOURDON & YOURDON, *supra* note 4, at 1 (stating that Y2K has "been sidely discussed in magazines and newspapers for the last couple of decades").

expanded application of the fiduciary duty of disclosure could change the result.

On the other hand, Y2K disclosures appear to be fertile ground for plaintiffs lawyers. Even a cursory review of random SEC filings reveals that many companies are not following the proper guidelines, and this does not even begin to address whether the disclosures made are accurate.[267] It is safe to assume that every dip in stock price attributed to Y2K will be the subject of a disclosure claim by plaintiffs' lawyers. There is no immunity for the securities claims, and without a "safe harbor," the claims will not be decided on a motion to dismiss.[268] For no apparent or plausible reason, however, such claims are rarely litigated in Delaware's District Court — an issue for another day — so the predictions of docket overload are not likely to be felt in Delaware; though, that may not be the case in the Southern District of New York and other popular securities litigation fora. All of this is, of course, dependent on actual Y2K failures, which may or may not materialize.

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[267] *SEC Interpretive Release*, *supra* note 93, at 4.

[268] *See supra* Parts IV.B.4, IV.C.