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## Outside Directors and Red Flags

**I**N THE WAKE of recent corporate scandals, there has been a sharpened focus on the role of outside directors. As an example, SEC Enforcement Chief Stephen Cutler recently announced an intention to target outside directors for falling "asleep at the switch."<sup>1</sup> That statement and others by SEC officials, together with a related civil action against an outside director, indicate that the SEC has trained its sights on outside directors who may have failed to react to red flags warning of corporate impropriety and failed to fulfill their fiduciary duties.

This article will consider the SEC's stated initiative in this area in the context of traditional standards of liability for outside directors as recently analyzed in state and federal courts.

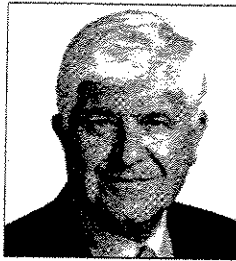
### The 'Chancellor' Case

In April, 2003, the SEC filed a complaint against the Chancellor Corp. and certain individuals associated with Chancellor, including outside director Rudolph Peselman, detailing a "multi-faceted financial fraud" involving "the creation of false corporate documents and fictitious accounting entries" leading to alleged material overstatements of revenue, income and assets.<sup>2</sup>

By naming the outside director as a defendant, *Chancellor* raised more than a few eyebrows. Although the complaint alleges that Mr. Peselman violated, inter alia, §10(b) of the Exchange Act and Rule 10b-5, thereunder, he is not charged with direct participation in the accounting fraud. Rather, in its release announcing the complaint, the SEC asserts that Mr. Peselman violated the antifraud provisions of the federal securities laws "by signing a number of false financial statements and, as an outside director with fiduciary responsibilities, by ignoring clear warning signs that financial improprieties were ongoing at the company and by failing to ensure that the company's public filings were accurate."<sup>3</sup>

Specifically, the complaint alleges that Mr. Peselman signed restatements of financial results that contained misstatements and contradicted earlier statements he had signed. In doing so, Mr. Peselman "ignored ... red flags." "Indeed," the complaint continues, "Peselman had completely neglected to fulfill his duties as a director and as an audit committee member. He failed to oversee Chancellor's financial reporting, exercising no care to ensure that the company had appropriate accounting procedures and internal controls and that its financial records were adequate. ..."<sup>4</sup>

Calling the case against Mr. Peselman "the first salvo in this area" and a model for such enforcement actions, Enforcement Director Cutler stated that he was unaware of any other SEC action against an outside director not directly involved in fraud. According to Mr. Cutler: "This case signifies the Commission's willingness to pursue cases against outside directors who were reckless in



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their oversight of management and asleep at the switch."<sup>5</sup>

Mr. Cutler's comments were recently echoed in a speech by SEC Chairman William H. Donaldson.<sup>6</sup> Commenting on the commission's current investigation of mutual funds, the chairman stated that the SEC is "carefully looking at the role that independent directors played, if any, in the problems at these firms. We are asking whether the directors were aware of these abuses, and whether there were red flags that were ignored." Mr. Donaldson added that the SEC would pursue aggressively those who harmed investors, "even if they turn out to be fund directors." Mirroring the reference to fiduciary duties in the *Peselman* action, the chairman concluded his remarks by stating: "Investors must be able to see for themselves that fund companies, and fund directors, are living up to their fiduciary obligations and the spirit underpinning all of our securities laws."

### Fiduciary Duties: State Laws Key?

The *Chancellor* action and the public comments of Messrs. Donaldson and Cutler together reflect the SEC's intent to target outside directors for negligent activity (or inactivity) and breaches of fiduciary duty, presumably invoking the antifraud provisions of the federal securities laws. The obvious question is whether the federal securities laws provide the statutory basis for the commission to pursue that campaign.

Almost 30 years ago, in *Sante Fe Industries, Inc. v. Green*, 430 US 462 (1977), the U.S. Supreme Court considered and expressly rejected the application of the antifraud provisions of §10(b) and Rule 10b-5 to all breaches of fiduciary duty. Rather, the Court recognized that a "claim of fraud and fiduciary breach ... states a cause of action under any part of Rule 10b-5 only if the conduct alleged can fairly be viewed as 'manipulative or deceptive' within the meaning of the statute." Twenty years later, this principle was reiterated by the Court in *United States v. O'Hagan*, 521 US 642 (1997). In ruling on the government's misappropriation theory of insider trading, the Court recognized as a predicate for liability under §10(b) in that context that there needed to be an underlying breach of fiduciary duty. Although finding such a duty in that case, the Court nevertheless again stated that "§10(b) is not an all-purpose breach of fiduciary ban; rather it trains on conduct involving manipulation or deception." (In *O'Hagan*, the Court found this requirement satisfied by the defendant's trading activity using the information obtained by the breach of duty.) Thus, we conclude that the fraud provisions of the federal securities laws may not be used as a weapon against every breach of fiduciary duty, absent evidence of manipulation and deception.

In contrast, director liability under state law is tied directly to breaches of fiduciary duty. Delaware, the benchmark for state corporate law, traditionally recognizes a triad of fiduciary duties: the duty of loyalty, the duty of care and the duty of good faith. Director liability is predicated on concepts of gross negligence in the exercise of, or conscious disregard of, these fiduciary

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of interest are similar, more disclosures are required under the California Standards. Failure to make the disclosures results in disqualification of the arbitrator, and an arbitration award can be vacated. If the arbitrator thus challenged fails to disqualify himself or herself, a California superior court judge is assigned responsibility for deciding whether the arbitrator should be disqualified.

When California adopted Standard 7, the SEC requested an exemption for NASD and NYSE arbitrations. In addition, the SEC commissioned a law professor to assess whether the NASD should modify its rules to incorporate the disclosure provisions of Standard 7. He concluded that the NASD should not, but made some other recommendations for reform which the SEC asked the SROs to implement.<sup>12</sup> There are two basic conflicts between the California Standards and NASD and NYSE rules with regard to arbitrators. First, the arbitrator disclosure requirements as to potential conflicts of interest are much more detailed in Standard 7 than in SRO rules. Second, the NASD director of arbitration has the final say in any challenge to an arbitrator as to disqualification, while under the California rules, the judiciary makes such a determination. After California refused to grant the SROs an exemption from the California Standards, they amended their arbitration rules to preclude application of the California Standards, and this rule change was approved by the SEC.<sup>13</sup> Further, the NYSE and NASD refused to empanel California arbitrators, and determined that parties to pending California arbitrations could require that the arbitrations be moved to neighboring states.

### Preemption of Standards?

As a result of these conflicts, litigation ensued on the issue of whether the California Standards are preempted by the Exchange Act or the Federal Arbitration Act.<sup>14</sup> Preemption may be express, implied, or by reason of conflict. Preemption is express when there is an explicit statutory command that state law be displaced.<sup>15</sup> Preemption is implied and state law is therefore displaced "if federal law so thoroughly occupies a legislative field as to make reasonable the inference that Congress left no room for the states to supplement it."<sup>16</sup> This type of implied preemption is often referred to as field preemption. State law may be displaced under a conflict analysis if either it is impossible to comply with both a state and a federal law, or if the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."<sup>17</sup>

In *Mayo v. Dean Witter Reynolds, Inc.*<sup>18</sup> a federal district court held that

the California Standards were preempted by both the Exchange Act and the Federal Arbitration Act. The court found conflicts between the SROs and California Standards with regard to arbitrator disclosures, control of the case by the SRO director of arbitration as opposed to the parties under court supervision, and with respect to the applicability of the California Standards in SRO dispute resolution cases. Further, the court found that SROs are an integral part of the federal regulatory scheme administered by the SEC and that an important function of the SROs was the conduct of arbitrations. If SROs were forced to comply with the California Standards they would become subject to a patchwork of state regulation at odds with their national function. The court also held that the California Standards were preempted by the Federal Arbitration Act because they interfered with the contractual provisions between a broker-dealer and

The *Mayo* and *Jevne* cases are not only interesting for their detailed analysis of preemption issues with respect to SRO arbitration procedures, but also because they set forth a framework for a preemption analysis in other areas. Two current examples could be considered. If the settlement struck by the New York attorney general against large securities firms with regard to their security analysts had been litigated instead of settled, could any of these cases have been preempted because of conflicts with SRO rules on security analysts? If SRO listing rules with regard to nominating committees or other corporate governance matters conflict with state laws can they preempt such state laws? While it is not clear that such interesting issues will be litigated, given the present competition between federal and state regulators in securities matters, the cases concerning the California Standards deserve careful attention.

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its customer to arbitrate according to SRO procedural rules.

In *Jevne v. The Superior Court of Los Angeles County*,<sup>19</sup> a California appellate court also held that the California Standards were preempted by the Exchange Act, but on narrower grounds. The court thought that there was no actual conflict between the arbitrator disclosure provisions of the California Standards and SRO procedural rules, but that the added disclosure provisions were nevertheless an obstacle to the SRO procedures because the California standards would increase the costs and complexity of and inject uncertainty into the arbitration process and therefore frustrate the Exchange Act's purpose of protecting investors and the public. In view of the SEC's intense oversight in the area of SRO arbitrations, the court was reluctant to second guess the federal agency on this matter. With respect to the procedures for arbitrator disqualification, the court did find a direct conflict between the California Standards and SRO procedural rules and, therefore, preemption on this ground as well. But insofar as the Federal Arbitration Act was concerned, the court held that there was no preemption because the Federal Arbitration Act did not express any federal policy in favor of a particular set of procedural requirements in arbitrations.

(1) *Mayo v. Dean Witter Reynolds, Inc.*, 258 FSupp2d 1097, amended by 260 FSupp2d 979 (N.D. Cal. 2003); *Jevne v. The Superior Court of Los Angeles County*, 113 Cal. App. 4th 486, 6 Cal. Rptr. 3d 542 (2d App. Dist. 2003). The California Judicial Council is composed of 27 members including the Chief Justice, 14 judges, 4 attorneys and two legislators. The California Constitution directs the Judicial Council to provide policy guidelines to the courts, make annual recommendations to the governor and Legislature and adopt and revise California Rules of Court with regard to administration, practice and procedure.

(2) Under §19(b) of the Exchange Act, the SEC is instructed to approve SRO rules which are consistent with the requirements of the Exchange Act. 15 USC §78s(b). Under §19(c) the SEC may abrogate, add to, and delete from SRO rules as the agency deems necessary or appropriate to insure the fair administration of the SRO, to conform its rules to requirements of the Exchange Act or otherwise in furtherance of the purposes of the Exchange Act. 15 USC §78s(c).

(3) See, e.g., *Silver v. New York Stock Exch.*, 373 US 341, 366 (1963) (describing the relationship between the New York Stock Exchange and the SEC as "a type of partnership between government and private enterprise") (emphasis added); *Bruan Gordon & Co. v. Hellmers*, 502 FSupp 897, 903 (SDNY 1980) (describing the NASD as "an arm or agent" of the SEC); Stephen J. Ware, Employment Arbitration and Voluntary Consent, 25 HOFSTRA L. REV. 83, 154 (1996); Richard L. Stone & Michael A. Perino, "Not Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law," 1995 COLUM. BUS. L. REV. 453, 483-84 (1995) (arguing that, because Congress has delegated substantial powers to SROs in securities matters, SROs should be deemed state actors when enforcing federal law under the Exchange Act).

(4) The NASD was created under the authority of §15A of the Exchange Act, 15 USC §78o-1, which was enacted in 1938.

(5) 905 F2d 406 (D.C. Cir. 1990).

(6) *Merrill, Lynch, Pierce, Fanner & Smith, Inc. v. Ware*, 414 US 117 (1973).

(7) *Id.* at 127.

(8) *Id.* at 135.

(9) See *Shearson/American Express v. McMahon*, 482 US 220 (1987).

(10) Securities Exchange Act Release No. 26,805 (May 10, 1989).

(11) *Mayo* at 1100.

(12) *Jevne* at n. 16.

(13) See Exchange Act Release No. 46,816, 67 Fed. Reg. 69,793 (2002).

(14) 9 USC §2.

(15) See *Morales v. Trans World Airlines*, 504 US 374, 382 (1992).

(16) *Cipollone v. Liggett Group, Inc.*, 505 US 504, 516 (1992).

(17) *Jones v. Rath Packing Co.*, 430 US 519, 525 (1977).

(18) Note 1, supra. Accord, *Wilmot v. McAbb*, 269 FSupp2d 1203 (N.D. Cal. 2003). But see *Credit Suisse First Boston Corp. v. Grunwald* (N.D. Cal. Mar. 31, 2003).

(19) Note 1, supra.