

## Working Paper

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# The Use of Efficient Market Hypothesis: Beyond SOX

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# The Use of Efficient Market Hypothesis: Beyond SOX

by

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&  
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## I. Introduction

As scholars in employee benefits and corporate governance respectively our interest in the Sarbanes-Oxley Act (SOX)<sup>1</sup> here is in asking what insights its motivating principles, enactment, and substantive provisions provide for these fields. In some ways the intersections are obvious. In past work we have considered how securities law, state corporate law, and federal employee benefits law differ in setting standards for directors' conduct<sup>2</sup> and have examined directors' loyalty obligations in the context of company stock transactions.<sup>3</sup> Other commentators have expressed a variety of views on the intersection between federal regulation under SOX and the traditional realm of state corporate governance law.<sup>4</sup>

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<sup>1</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and other chapters (2002)).

<sup>2</sup> Dana M. Muir & Cindy A Schipani, *New Standards of Director Loyalty and Care in the Post-Enron Era: Are Some Shareholders More Equal Than Others?*, 8 N.Y.U. J. LEGIS. & PUB. POL'Y 279 (2004-2005).

<sup>3</sup> Dana M. Muir & Cindy A Schipani, *The Challenge of Company Stock Transactions for Directors' Duties of Loyalty*, 43 HARV. J. ON LEGIS. 437 (2006).

<sup>4</sup> Compare William B. Chandler III & Leo E. Strine, Jr., *News From the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003) (reflecting on the marked increase in federal involvement); Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under*

One criticism directed at SOX is that its substantive corporate governance mandates conflict with the empirical finance literature's findings on what constitutes effective regulation.<sup>5</sup> In this paper we focus on the regulatory use of finance theory, particularly the efficient market hypothesis (EMH), in two related areas where securities pricing is at issue: shareholder appraisal cases and the use of employer stock in company-sponsored employee investment plans.<sup>6</sup> For a substantial period it seemed that the general trend in legal and finance literature was to accept some form of EMH.<sup>7</sup> EMH's acceptance in jurisprudence accelerated after the Supreme Court effectively adopted it for purposes of securities fraud claims in *Basic v. Levinson*<sup>8</sup> in 1988. More recently, though, EMH has met increasing skepticism in financial theory due to research in areas such as noise trading,<sup>9</sup> the existence of market bubbles,<sup>10</sup> and behavioral finance.<sup>11</sup> Although the legal scholarship has remained current with this debate,<sup>12</sup> arguably much jurisprudence and policymaking in state corporate law and in federal employee benefits law has remained loyal to the basic principles EMH.<sup>13</sup>

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*the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 3 (2002) (raising the possibility that SOX's personal certification requirement may be largely symbolic); with Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law*, 53 BUFFALO L. REV. 721 (2005) (proposing a system of mixed state and national governance); Margo Eberlein, *Recovering Retirement Security: An Analysis of the Lockdown Claims Under ERISA, as Illustrated by the Enron Litigation*, 79 CHI.-KENT L. REV. 699, 710 (2004) (implying SOX will be effective in protecting employees in lockdown situations).

<sup>5</sup> Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1527-1529 (2005). See also Larry E. Ribstein, *Sarbanes-Oxley After Three Years*, 3 N.Z. L. REV. 365 (2005).

<sup>6</sup> By this term we generally intend to encompass both 401(k) plans and ESOPs. For the reasons we have adopted this term see Muir & Schipani, *supra* note 2, 324-26.

<sup>7</sup> See e.g., Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

<sup>8</sup> 485 U.S. 224 (1988).

<sup>9</sup> Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U.L. REV. 135, 143 (2002).

<sup>10</sup> ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2000).

<sup>11</sup> See Langevoort, *supra* note 9, at 143-47.

<sup>12</sup> See e.g., *id.* (analyzing securities law issues from the perspective of behavioral finance).

<sup>13</sup> See *infra* Parts II & III.

In this Article we begin, in Part II, by examining the use of EMH in shareholder appraisal cases. In this Part, we find that the Delaware courts seem to implicitly respect the principles of EMH when ascertaining the fair value of stock, but recognize that markets cannot operate efficiently if information is withheld. In addition, the concurrent fiduciary duty claims often brought in these cases involve high levels of scrutiny where conflicts of interest are raised. In Part III we analyze EMH as it relates to the use of employer stock in company-sponsored employee investment plans. The focus is on the explicit adoption of EMH by the Department of Labor (DOL) to exempt directed trustees from historic duties of inquiry regarding the prudence of investment directions. This offers the opportunity to consider the opposite side of Professor Romano's critique of substantive provisions in SOX – how well or poorly policy makers do when they purport to rely on principles developed in finance research.

Although securities law scholars take a variety of positions on the robustness of market efficiency theory and the extent to which federal legislation should intervene in favor of capital market efficiency, all seem to agree that markets benefit from sufficient and accurate information. Similarly, regardless of whether scholars view SOX as a positive step on the road to increased reliability of information transmission to the markets, it appears that was Congress' intent.<sup>14</sup> Our inquiry finds that the Delaware courts and legislators believe that informational problems can necessitate fact-specific analyses of whether market price reflects fair value. In contrast, the DOL appears to believe, almost without exception, in the efficiency of markets for all publicly traded securities. As a result, its policies protect from liability fiduciaries who otherwise would

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<sup>14</sup> See Presidential Signing Statement of H.R. 3763, The Sarbanes-Oxley Act of 2002 (July 30, 2002) (“The only risks, the only fair risks are based on honest information.”).

have incentives to engage in reviews that could be expected to bring additional information to the markets.

## **II. Corporate Governance Implications**

The Delaware courts deciding cases involving stock price valuations seem more concerned than the DOL<sup>15</sup> with the possibility that the markets may be unable to price shares fairly, and thus seem somewhat more skeptical of reliance on the market price, and the EMH, for the fair valuation of stock. At least one of the concerns of the courts seems to be that material information may be withheld from the market. The courts recognize that without full information, the market, in a particular instance, may be unable to price shares fairly.

### **A. Statutory Appraisal Actions**

One area where the EMH is implicated in this way, at least implicitly, is in the Delaware jurisprudence regarding shareholder statutory appraisal actions. In these actions, minority shareholders claim that they have not received fair value for their shares given up in the merger or consolidation. Under these circumstances, the minority shareholders may seek judicial determination of the fair price for their shares.<sup>16</sup>

The EMH appears to underlie the claim of the defense in these actions. That is, the defendants often argue that the buyout price is fair to the extent it reflects the market price of the stock. Plaintiffs, however, not surprisingly, dispute this contention and question the market price as the appropriate benchmark for assessing the fair value of the

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<sup>15</sup> See *infra* Part III.

<sup>16</sup> DEL. CODE. ANN. tit. 8, § 262 (2006).

shares. We recognize that valuation is rather complex topic<sup>17</sup> and do not attempt to provide an exhaustive review of the valuation approaches used by the Delaware courts in appraisal actions nor the surrounding controversies. Rather, in this Part, we review selected Delaware cases which are indicative of the subtle role the EMH plays in the valuation analysis.<sup>18</sup>

According to Delaware General Corporate Law, stockholders of Delaware corporations are entitled to statutory appraisal of their shares when the shares of stock are held through the effective date of a merger or consolidation, provided that certain procedures have been followed.<sup>19</sup> The statute excludes appraisal rights for shares traded on a national exchange, thus implicitly, it seems, respecting the EMH. This exclusion, however, does not apply if these shareholders are required to accept cash rather than stock or depository receipts for their shares in the merger or consolidation.<sup>20</sup> Thus, shareholders who are frozen out of the corporation and forced to accept cash for their

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<sup>17</sup> See generally John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359 (1996) (criticizing the current state of the law in Delaware regarding transfers of control); Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines and Markets: Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003) (discussing doctrinal anomalies in the freeze-out jurisprudence); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 618 (1998) (arguing that courts "should not place undue reliance on market prices, and should not permit minority or 'lack of marketability' discounts"); Richard A. Booth, *Minority Discounts and Control Premiums in Appraisal Proceedings*, 57 BUS. LAW. 127 (2001) (arguing against inclusion of a control premium in the valuation analysis); Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121 (1998) (explaining the theoretical underpinnings of the appraisal remedy and proposing changes).

<sup>18</sup> Statutory appraisal statutes, and the corresponding judicial interpretation of those statutes, vary across jurisdictions. We focus on the Delaware statute and case law due to the preeminence of Delaware as the state of incorporation for the majority of publicly-traded companies. See Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J. CORP. L. 965, 1011 (1995) ("Delaware remains the preeminent state of incorporation."). See also Harriet Windsor Smith, Delaware Department of State - Division of Corporations, Greetings from the Secretary of State, <http://www.state.de.us/corp/corposbio.shtml> (last visited Aug. 15, 2006) ("More than half a million business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 60% of the Fortune 500.").

<sup>19</sup> DEL. CODE ANN. tit. 8, § 262(a) (2006).

<sup>20</sup> *Id.* at § 262(b)(2).

shares are entitled to appraisal rights, even if the shares of the company were traded on a national exchange.<sup>21</sup>

In the appraisal action, the court must determine the “fair value” of the corporation that issued the stock.<sup>22</sup> Thus, the court’s “task in an appraisal proceeding is to value what has been taken from the shareholder.”<sup>23</sup> A crucial question in this analysis is how much weight, if any, should be given to the market value of the corporation’s stock in the valuation.<sup>24</sup>

When the market for a publicly traded security is active and efficient, the market price of the corporation’s common stock is important corroborative evidence of value.<sup>25</sup> According to the efficient market hypothesis (in semi-strong form),<sup>26</sup> financial markets are efficient, and thus all public information is calculated into a stock's current share price such that securities prices reflect all known information.<sup>27</sup> If courts are confident that the markets are operating efficiently, it would be reasonable to expect courts to give strong preference to the market price of a corporation’s stock in a stock appraisal action. However, although respecting the capital markets and considering market price as a factor to be weighed in the analysis, the Delaware courts acknowledge that market prices

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<sup>21</sup> *Id.* This, of course, assumes that the statutory process for perfecting approval rights was followed.

<sup>22</sup> *See, e.g.,* Cede & Co. v. Technicolor, Inc. (*Technicolor IV*), 684 A.2d 289, 296 (Del. 1996); *In re* Emerging Commc’ns, Inc. S’holders Litig., No. 16415, 2004 WL 1305745, at \*9 (Del. Ch. May 3, 2004, revised June 4, 2004). *See also* DEL. CODE. ANN. tit. 8, § 262(h) (2006).

<sup>23</sup> *Technicolor IV*, 684 A.2d at 298.

<sup>24</sup> *See In re Emerging Commc’ns*, 2004 WL 1305745, at \*9..

<sup>25</sup> *Id.*

<sup>26</sup> The semi-strong form of the efficient market hypothesis is only one of three forms of the theory. In weak form efficiency, the hypothesis asserts that all past market prices and data are fully reflected in the price of securities. In strong form efficiency, the hypothesis asserts that *all* information is fully reflected in the price of securities, including insider information. *See generally* Fama, *supra* note 7.

<sup>27</sup> *See generally* Burton G. Malkiel, *The Efficient Market Hypothesis and its Critics*, 17 J. OF ECON. PERSPECTIVES 59 (2003).

do not necessarily reflect the fair value of the stock,<sup>28</sup> even when the stock is traded on a national market.

One of the earlier cases in Delaware evidencing skepticism with respect to market price as a proxy for valuation in appraisal proceedings is *Chicago Corp. v. Munds*.<sup>29</sup> The *Munds* court decided the issues pursuant to an earlier version of the appraisal statute. In *Munds*, the court observed that “[t]he experience of recent years is enough to convince the most casual observer that the market in its appraisal of values must have been woefully wrong in its estimates at one time or another . . . . Markets are known to gyrate in a single day.”<sup>30</sup> The *Munds* court further noted that market value “undoubtedly is a pertinent consideration,” but not exclusive.<sup>31</sup> *Munds* was decided in 1934, on the heels of the Great Depression, and at the onset of federal regulation of securities.<sup>32</sup> Thus, especially given the time frame of the decision, it is not difficult to understand the concerns the court expressed about market value.

The parameters of modern valuation analysis were set by the Delaware Supreme Court in *Weinberger v. UOP, Inc.*<sup>33</sup> The *Weinberger* court stated that stock valuation proceedings “must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court . . . .”<sup>34</sup> This case is thus currently cited for the proposition that the Chancery Court has wide discretion to determine the most appropriate financial model to use to determine

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<sup>28</sup> See, e.g., *Munds*, 172 A. 452; *In re Emerging Commc’ns*, 2004 WL 1305745, at \*9; *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983); *Technicolor IV*, 684 A.2d at 298.

<sup>29</sup> *Chicago Corp. v. Munds*, 172 A. 452 (Del. Ch. 1934).

<sup>30</sup> *Id.* at 455.

<sup>31</sup> *Id.* at 457.

<sup>32</sup> Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2006)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (2006)).

<sup>33</sup> *Weinberger*, 457 A.2d 701.

<sup>34</sup> *Id.* at 713.



the fair value of shares in any given case.<sup>35</sup> Although market value is one factor that may be considered in the analysis, it is not dispositive.<sup>36</sup>

The court in *In re Emerging Communications, Inc. Shareholders Litigation*,<sup>37</sup> had occasion to apply the *Weinberger* analysis.<sup>38</sup> In *Emerging Communications*, plaintiffs filed a statutory appraisal action, combined with a class action for breach of fiduciary duty, after the majority stockholder in Emerging Communications, Inc. (“ECM”) acquired its publicly owned shares to take the company private.<sup>39</sup> The former public stockholders of ECM claimed that the privatization “was the product of unfair dealing that, in turn, resulted in an unfair transaction price.”<sup>40</sup> Defendants’ expert countered that ECM was traded in an efficient market and that the market price of ECM common stock prior to the buyout was a reasonable reflection of its value.<sup>41</sup> On this issue, the court sided with plaintiffs.<sup>42</sup> ECM had been trading on the American Stock Exchange.<sup>43</sup>

Although not discussing the EMH, the *Emerging Communications* court noted that under Delaware law, market price is not always indicative of true value, although it is evidence to be considered.<sup>44</sup> According to the court, the record undermined any assertion that ECM was traded in an efficient market.<sup>45</sup> It appears that the court was concerned that the market for these shares could not function efficiently and therefore

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<sup>35</sup> See, e.g., *Cede & Co. v. Technicolor, Inc. (Technicolor IV)*, 684 A.2d 289, 297 (Del. 1996); *In re United States Cellular Operating Co.*, No. 18696, 2005 Del. Ch. LEXIS 1, at \*37-38 (Del. Ch. Jan. 6, 2005); *Prescott Group Small Cap, L.P. v. Coleman Co.*, No. 17802, 2004 Del. Ch. LEXIS 131, at \*41-42 (Del. Ch. September 8, 2004).

<sup>36</sup> *Weinberger*, 457 A.2d at 713 (quoting *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950)). See also *In re Emerging Commc’ns*, 2004 WL 1305745, at \*23; *Technicolor IV*, 684 A.2d at 290.

<sup>37</sup> *In re Emerging Commc’ns*, 2004 WL 1305745.

<sup>38</sup> *Id.* at \*9-10.

<sup>39</sup> See *id.* at \*1.

<sup>40</sup> *Id.* at \*9.

<sup>41</sup> *Id.* at \*23.

<sup>42</sup> See *In re Emerging Commc’ns*, 2004 WL 1305745, at \*23.

<sup>43</sup> *Emerging Commc’ns, Inc.*, Definitive Proxy Statement (Form DEF 14A), at 5 (Sept. 28, 1998).

<sup>44</sup> *In re Emerging Commc’ns*, 2004 WL 1305745, at \*23.

<sup>45</sup> *Id.*

could not price the shares accurately because information was withheld from it.<sup>46</sup> First, the court found ECM's shares to be artificially depressed because the market was not educated about salient features of the business. The market appeared to view the company as a developing third-world telephone company when in fact it had the attributes of a U.S. telephone company.<sup>47</sup> Rather than attempt to educate the market, ECM's chairman and chief executive officer instead exploited this misinformation and set the privatization at an unfair price.<sup>48</sup> It was precisely because the stock market price did not reflect ECM's underlying value that an earlier proposal for a merger transaction was abandoned, which would have yielded value to the minority shareholders, and instead the chairman and CEO effectively acquired the minority interest in the privatization.<sup>49</sup>

In addition, the court noted that while the stock was trading freely, before the announcement of the privatization proposal, the market did not have the benefit of disclosed earnings nor the most recent projections of future results.<sup>50</sup> These projections were deliberately withheld from the market.<sup>51</sup> Based in large part on the lack of information afforded the market, the court found that the market did not price the stock fairly. The court thus held that the market price for the stock merited "little or no weight" in its valuation analysis.<sup>52</sup> Furthermore, because the majority interest was not for sale, the market price of ECM stock necessarily reflected a "minority discount."<sup>53</sup>

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<sup>46</sup> *See id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* The issue of whether courts should consider the "minority discount" is a topic of much debate. *See, e.g.,* sources cited *supra*, note 17.

The *Emerging Communications* court considered the analysis of the Delaware Supreme Court in *Cede & Co. v. Technicolor, Inc.* (“*Technicolor IV*”)<sup>54</sup> in rendering its decision. In *Technicolor IV*, a minority shareholder similarly dissented from a cash-out merger and brought a statutory appraisal proceeding.<sup>55</sup> One issue raised was whether the market price of the company’s stock could be relied upon as evidence of fair value.<sup>56</sup> The court briefly stated that “market price of shares may not be representative of true value”<sup>57</sup> and that “information and insight not communicated to the market may not be reflected in stock prices.”<sup>58</sup> Without forming an opinion, the court allowed the party to argue that the stock market price at the time was of little significance to the issue of fair value.<sup>59</sup> The court then remanded the case to the Court of Chancery to determine the fair value of the stock.<sup>60</sup> In a later remand,<sup>61</sup> the Chancery Court underwent a rather complex valuation analysis and used market prices as a way to validate its analysis.<sup>62</sup>

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<sup>54</sup> *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996). This case is the fourth of six appeals to the Delaware Supreme Court in this line of cases so far. See *Cede & Co. v. Technicolor, Inc. (Technicolor I)*, 542 A.2d 1182 (Del. 1988); *Cede & Co. v. Technicolor, Inc. (Technicolor II)*, 634 A.2d 345 (Del. 1993), modified, 636 A.2d 956 (Del. 1994); *Cinerama, Inc. v. Technicolor, Inc. (Technicolor III)*, 663 A.2d 1156 (Del. 1995); *Cede & Co. v. Technicolor, Inc. (Technicolor IV)*, 684 A.2d 289 (Del. 1996); *Cede & Co. v. Technicolor, Inc. (Technicolor V)*, 758 A.2d 485 (Del. 2000); *Cede & Co. v. Technicolor, Inc. (Technicolor VI)*, 884 A.2d 26 (Del. 2005).

<sup>55</sup> See *Technicolor IV*, 684 A.2d at 290.

<sup>56</sup> *Id.* at 301.

<sup>57</sup> *Id.* (quoting *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 n.12 (Del. 1989)). The Delaware Chancery court recently reiterated a concern about relying on the fairness of market value, particularly when the stock is traded in an illiquid market. See *Gesoff v. IIC Industries, Inc.*, Nos. 19473, 19600, 2006 Del.Ch. LEXIS 91 (May 18, 2006).

<sup>58</sup> *Technicolor IV*, 684 A.2d at 290 (quoting *Technicolor I*, 542 A.2d at 1187 n.8).

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 302.

<sup>61</sup> *Cede & Co. v. Technicolor, Inc.*, No. 7129, 2003 WL 23700218 (Del. Ch. Dec. 31, 2003, revised July 9, 2004), affirmed in part, reversed in part, *Technicolor VI*, 884 A.2d 26, 30 (Del.2005). The Delaware Supreme Court reversed on the issues concerning the discount rate and pre-judgment interest.

<sup>62</sup> See *Cede*, 2003 WL 23700218 at \*44.

It follows then that the *Technicolor* courts were at least implicitly recognizing that markets will react to available information.<sup>63</sup> Although these courts considered market value in the analysis, they did not simply rely on it. Instead, they recognized that further analysis was needed, particularly where information may not be communicated to the market.

The case of *Paramount Communications, Inc. v. Time Inc.*<sup>64</sup> adds an interesting dimension to this issue and is cited by the Delaware Supreme Court in *Technicolor IV*,<sup>65</sup> although it was not a case concerning a statutory appraisal action. *Paramount* involved an attempt to preliminarily enjoin a corporation from concluding a merger.<sup>66</sup> In *Paramount*, the Delaware Supreme Court stated that market value is not always representative of true value.<sup>67</sup> According to *Paramount*, “a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover.”<sup>68</sup> In a footnote the court also states that “it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock.”<sup>69</sup>

The context for the discussion of market value in *Paramount* was the claim by plaintiffs that the board of directors of Time breached their fiduciary duties by failing to permit the shareholders to accept Paramount's hostile takeover offer, at a price

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<sup>63</sup> See also *Cede & Co. v. Technicolor*, No. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990), wherein the court noted that the traded security “must always be evaluated to ascertain the degree of weight it deserves in an appraisal.” *Id.* at \*31. The court then considered “market price data not as an independent source of valuation but as corroboration . . .” *Id.*

<sup>64</sup> *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

<sup>65</sup> 684 A.2d at 301.

<sup>66</sup> See *Paramount*, 571 A.2d at 1141-42.

<sup>67</sup> *Id.* at 1150.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 1150 n.12.

substantially higher than the price the market was valuing the shares of the company.<sup>70</sup> The plaintiffs argued that the directors had a fiduciary obligation to secure the best price for the shareholders.<sup>71</sup> But the court was not convinced that the market price of the shares represented the true value of the company and left it to the directors' business judgment to determine the most appropriate course of action.<sup>72</sup> Again, this case evidences recognition by the courts that the markets may not have all the information necessary to assess the long-term prospects of the company. It seems that the courts' deference to the business judgment of the officers and directors regarding whether to proceed with the transaction is implicit judicial recognition that officers and directors may be better informed than the market.<sup>73</sup>

The *Emerging Communications*<sup>74</sup> court also cited two earlier Delaware Chancery Court decisions in support of its conclusion that market price is not always indicative of fair value - *Rapid American Corp. v. Harris*,<sup>75</sup> and *In re Shell Oil Co.*<sup>76</sup> *Rapid-American* involved a merger between two companies and a statutory appraisal action to challenge the merger price of the shares.<sup>77</sup> The primary issue debated in *Rapid-American*

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<sup>70</sup> *Id.* at 1149.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 1150.

<sup>73</sup> This decision has been criticized, however. See, e.g., Marc I. Steinberg, *The Nightmare on Main Street: The Paramount Picture Horror Show*, 16 DEL. J. CORP. L. 1, 31 (1991) (arguing that *Paramount* is a "poorly reasoned opinion" that "neglects legitimate shareholder interests"); Alan E Garfield, *Paramount: The Merits of Mixed Mush*, 17 DEL. J. CORP. L. 33, 33 (1991) (arguing that *Paramount* rejected precedent and lacked clarity); E. Ashton Johnston, *Defenders of the Corporate Bastion in the Revlon Zone: Paramount Communications, Inc. v. Time Inc.*, 40 CATH. U.L. REV. 155, 158 (1990) (arguing that the "new expansive reading of director discretion harms shareholders' interests"); Lyman Johnson & David Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105, 2105 (1990) (claiming that *Paramount* threatens to "destabilize seemingly settled doctrine governing the conduct of target company management"); Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1932 (1991) (stating that *Paramount* "will remain a significant constraint on merger and acquisition activity").

<sup>74</sup> *In re Emerging Commc'ns*, 2004 WL 130574.

<sup>75</sup> *Rapid-American Corp. v. Harris*, 603 A.2d 796 (Del. Ch. 1992).

<sup>76</sup> *In re Shell Oil Co.*, No. 8080, 1990 WL 201390 (Del. Ch. Dec. 11, 1990), *aff'd*, 607 A.2d 1213 (Del. 1992).

<sup>77</sup> *Rapid-American*, 603 A.2d at 798.

concerned whether the Chancery Court’s exclusion of a control premium in its valuation analysis constituted error.<sup>78</sup> The Delaware Supreme Court found it was error not to consider the control premium and remanded the case to the Chancery Court.<sup>79</sup> In so holding, the *Rapid-American* court, citing *Weinberger*<sup>80</sup> and *Munds*,<sup>81</sup> stated that the trial “court’s rejection of the ‘control premium’ implicitly placed a disproportionate emphasis on pure market value.”<sup>82</sup> Further noting the continuing relevance of the analysis of the *Munds* court, *Rapid-American* also found that “[r]ecent price changes in the stock market dramatically illustrate the defects of an overstated reliance on market price to determine a corporation’s intrinsic value in an appraisal proceeding.”<sup>83</sup>

In *Shell*, minority shareholders also sought an appraisal of the fair value of their shares of stock when the company went private.<sup>84</sup> Prior to the merger, Shell was a publicly traded company.<sup>85</sup> Although the market price at the relevant time period was trading in the \$43-\$45 range, and after examining many issues, the lower court found a fair value of \$71.20.<sup>86</sup> Shell appealed, arguing that the valuation analysis conducted by the Chancery Court was improper on a number of fronts. Of interest to us is Shell’s argument that the trial court erred by not giving any weight in its analysis to the trading value of Shell’s stock.<sup>87</sup> The Delaware Supreme Court noted that the Chancery Court found the result of the trading analysis conducted by Shell’s expert, Morgan Stanley, to

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<sup>78</sup> *Id.* at 798-99.

<sup>79</sup> *Id.* at 807.

<sup>80</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-13 (Del. 1983).

<sup>81</sup> *Chicago Corp. v. Munds*, 172 A. 452, 456 (Del. Ch. 1934).

<sup>82</sup> *Rapid-American*, 603 A.2d at 807-08.

<sup>83</sup> *Id.* at 806.

<sup>84</sup> *In re Shell Oil Co.*, No. 8080, 1990 WL 201390 (Del. Ch. Dec. 11, 1990), *aff’d*, 607 A.2d 1213 (Del. 1992).

<sup>85</sup> *In re Shell Oil Co.*, 607 A.2d 1213, 1215 (Del. 1992).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 1220.

be “highly illogical” and less valid than other analyses presented.<sup>88</sup> The Delaware Supreme Court deferred to the judgment of the Chancery Court regarding which validation experts presented more objective evidence, expressing dismay with the lack of objectivity of all the experts.<sup>89</sup>

On the other hand, there have been situations when the Delaware court relied primarily on the market price in a valuation context. The case of *The Union Illinois 1995 Investment Limited Partnership v. Union Financial Group, Ltd.*<sup>90</sup> is illustrative. In this case, the court stated that “our case law recognizes that when there is an open opportunity to buy a company, the resulting market price is reliable evidence of fair value.”<sup>91</sup> *Union Illinois* involved the appraisal rights of dissenting shareholders resulting from the sale of the company by auction.<sup>92</sup> The company was not a publicly held company.<sup>93</sup> In its analysis, it was important to the *Union Illinois* court that the transaction being evaluated was not a squeeze-out merger where the only buyer was the parent company.<sup>94</sup> Instead, this company was sold in an auction “conducted fairly and openly.”<sup>95</sup> In its valuation analysis, the court gave 100% weight to the auction preceding the execution of the merger agreement, as “the most reliable evidence of fair value.”<sup>96</sup> The court was able to do so because there was no evidence that the board or its investment banker did anything

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<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 1218. The Supreme Court held that the Chancery Court did not abuse its discretion when it assigned no weight to the minority shareholders' expert argument that “the stock of integrated oil companies typically trade in the stock market at substantial discounts from their intrinsic value, and when an integrated oil and gas company, like Shell, is sold in the deal market, it typically has commanded a large premium over its stock market price.”

<sup>90</sup> *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340 (Del. Ch. 2004).

<sup>91</sup> *Id.* at 357.

<sup>92</sup> *Id.* at 342.

<sup>93</sup> *Id.* at 343.

<sup>94</sup> *Id.* at 350.

<sup>95</sup> *Id.* at 358.

<sup>96</sup> *Id.* at 357.

other than seek the highest possible value for the company.<sup>97</sup> The court further noted that “the sales process was an effective one that involved the provision of confidential information to numerous potential buyers . . . .”<sup>98</sup> Thus, this case was unlike the minority freeze-out cases discussed above where the courts were concerned about information being withheld from the market. Here, the information was readily provided to the bidders in an efficient auction, therefore the market price reflected fair value.<sup>99</sup>

These cases demonstrate that implicit in the rulings of the Delaware courts deciding the fair value of stock in statutory appraisal cases is respect for the semi-strong form of the efficient market hypothesis,<sup>100</sup> but recognition that markets can only operate efficiently with full information. Furthermore, the courts recognize that in the context of some statutory appraisal actions, particularly in those actions where the majority shareholder squeezes out the minority, the markets are often not afforded all necessary information. Market price is thus one factor to be weighed in determining fair value, and the weight market value should be given depends on the facts and circumstances of each

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<sup>97</sup> *Id.* at 343.

<sup>98</sup> *Id.* at 343. The court pegged its award to the price resulting from the auction, adjusted to subtract synergies. *Id.*

<sup>99</sup> See also, e.g., *Applebaum v. Avaya, Inc.*, 812 A.2d 880 (Del. 2002); *Prescott Group Small Cap, L.P. v. Coleman*, No. 17802, 2004 Del. Ch. LEXIS 131 (2004). In *Applebaum*, the court considered valuation issues in the context of a reverse-forward stock split, where the corporation planned to buy back fractions of shares from minority shareholders. *Applebaum*, 812 A.2d at 882-83. Pursuant to section 155(2) of the Delaware Code, these shareholders are entitled to “fair value” of their fractional shares. *Id.* at 889. Similarly, in *Prescott*, the court found that “the most reliable and persuasive evidence of . . . fair value at the time of the . . . front-end merger, [was] the value of the consideration that was negotiated at arm’s length . . . .” *Prescott*, 2004 Del. Ch. LEXIS 131, at \*117. The transaction in *Prescott* involved a two-part going private merger of The Coleman Company, Inc. into its parent company, Sunbeam. The issue was complicated by a nearly two year delay before completion of the second step of the transaction, due to fraud discovered in Sunbeam’s earnings statements. *Id.* at \*2.

<sup>100</sup> See, e.g., Lawrence Hamermesh & Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 IOWA J. CORP. L. 119, 133 (2005) (noting that “[t]he law’s rejection of public market prices should not be viewed as a wholesale rejection of efficient market theory.”) (citations omitted). But see David J. Ratway, *Delaware’s Stock Market Exception to Appraisal Rights: Dissenting Minority Stockholders of Warner Communications, Inc. are “Market-Out” of Luck*, 28 U. TOL. L. REV. 179, 216 (1996) (“Delaware’s ‘market-out’ exception to appraisal rights is in direct conflict with the courts’ general skepticism of using market price as the only measure of value.”) (citations omitted).



case. Of particular concern is the extent to which information may be withheld from the market.

This point is also demonstrated by the provision of the appraisal statute that prevents minority shareholders from seeking the appraisal remedy when they receive shares that are traded on a national securities exchange in the merger or consolidation.<sup>101</sup> This is logical because these shareholders are permitted to invest in the ongoing enterprise, thus they are not “squeezed out.” They are given the choice of either accepting the investment in the new enterprise together with the majority, or selling their shares in the open market.<sup>102</sup> Thus, there is no inherent concern about market valuation and hence, no appraisal remedy. Any remedy afforded to the minority will depend on whether there was evidence of breach of fiduciary duties. A brief analysis of potential fiduciary duty claims follows.

## **B. Fiduciary Duties**

The information asymmetries the courts have highlighted in minority freeze-out cases stem from the conflicts of interest inherent in these transactions. Due to the nature of the transaction, the majority shareholders are in a position to use information not publicly available to take advantage of the minority interest. This scenario presents the potential for breach of fiduciary duty.

When examining claims of fiduciary duty breaches, corporate law has attempted to strike a balance between respecting the business decisions of corporate fiduciaries and

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<sup>101</sup> DEL. CODE ANN. tit. 8, § 262(a) (2006). *See also Applebaum*, 812 A.2d at 890 n.29 (noting the “market exception” to the Delaware appraisal statute when supporting its decision to rely on market price in the valuation issue presented with the reverse-forward stock split); Hamermesh & Wachter, *supra* note 100 at 14 (noting that the market-out exception is a significant limitation to the appraisal remedy.).

<sup>102</sup> *See, e.g., Klotz v. Warner Commc’ns*, 674 A.2d 878, 882 (Del. 1995).

recognizing that there are situations where decisions should be closely scrutinized. Through the doctrine commonly known as the business judgment rule, when there is no evidence of breach of the duty of loyalty, and where it appears all reasonably available information was considered in the decision-making process,<sup>103</sup> the courts presume that the decision was made in good faith and in the best interest of the corporation.<sup>104</sup> Where the business judgment rule applies, courts will thus evaluate the decision-making process, but not the substance of the decision, to determine whether there is a breach of the duty of care.<sup>105</sup> If the allegations, however, include claims of conflicts of interest – thus implicating the duty of loyalty – or lack of good faith, the courts will not hesitate to employ a higher level of scrutiny and evaluate the decision.<sup>106</sup>

The Delaware courts' application of the business judgment rule thus seems consistent with general acceptance of the EMH. Absent a reason to doubt the presumption, the courts do not second-guess the good faith business decisions made by the board and shareholders have no right to complain. Instead, if shareholders are unhappy with the decision, they can employ the market and sell their shares.<sup>107</sup>

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<sup>103</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995); *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049 (Del. Ch. 1996). See also Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989) for a discussion of *Van Gorkom*, the duty of care and the business judgment rule.

<sup>104</sup> See sources cited *supra* note 103.

<sup>105</sup> See, e.g., Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971 (1994) (tracing the development of the duty of care in Delaware); Hal Arkes & Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587 (1995) (reviewing justifications for the business judgment rule). See also E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1405 (2006)

<sup>106</sup> See, e.g., *Continuing Creditors' Comm. of Star Telecomms. Inc. v. Edgecomb*, 385 F. Supp. 2d 449, 460 (D. Del. 2004) (quoting *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002)); *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 476 (Del. Ch. 2000); *McMillan v. Intercargo Corp.*, 768 A.2d 492 (Del. Ch. 2000).

<sup>107</sup> See, e.g., Arkes & Schipani, *supra* note 105, at 629. Of course, it is more difficult for shareholders to sell their shares if there is no market for the shares, or if they are restricted from sale. In such cases, where there are egregious concerns, shareholders may attempt to pursue claims under minority oppression statutes

Similarly, the provision in Delaware law that permits corporations to include a provision in the articles of incorporation limiting or eliminating monetary liability of directors for fiduciary duty breaches is also consistent with an inherent belief that the EMH works when markets are provided information and interests are not conflicted. Although Section 102(b)(7) of the Delaware Code allows for exculpation of directors, exculpation is not available where breach of the duty of loyalty, lack of good faith or intentional misconduct are implicated.<sup>108</sup>

This provision was enacted by the Delaware legislature in the aftermath of the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*.<sup>109</sup> In *Van Gorkom*, the directors were found to be grossly negligent in approving a merger decision without ascertaining the true intrinsic value of the firm before recommending the merger to the shareholders.<sup>110</sup> The directors were held to be personally liable for damages. The case was remanded to the Delaware Chancery Court for a determination of damages,<sup>111</sup> but settled in the interim. Approximately eighteen months later, the Delaware legislature enacted Section 102(b)(7) of the Delaware Code to permit corporations to provide exculpation for directors for breach of the duty of care.<sup>112</sup> But, as noted above, directors

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and case law. See Adam Chernichaw, *Oppressed Shareholders in Close Corporations: A Market-Oriented Statutory Remedy*, 16 CARDOZO L. REV. 501, 508-09 (1994). But see Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 251 n.255 (1997) (stating that Delaware “[fails] to provide the remedy of involuntary judicial dissolution for oppression of minority shareholders of any type of corporation”).

<sup>108</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).

<sup>109</sup> *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). See Bradley & Schipani, *supra* note 103, at 36-43 for detailed discussion of this case. See also Lawrence A. Hamermesh, *Twenty Years After Smith v. Van Gorkom: An Essay on the Limits of Civil Liability of Corporate Directors and the Role of Shareholder Inspection Rights*, 45 Washburn L.J. 283, 286 (2006).

<sup>110</sup> *Van Gorkom*, 488 A.2d at 874, 893.

<sup>111</sup> *Id.* at 893.

<sup>112</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2006). This statute was adopted in June, 1986. *Van Gorkom* was decided in January, 1985.

are excluded from exculpation for acts not in good faith or in breach of the duty of loyalty.

Thus it seems that the Delaware legislature recognized that to the extent shareholders wished to exonerate their directors for breach of the duty of care, they should be permitted to do so. Inherently, market forces would be at play, and regulation which imposed personal liability on directors for negligence, or even gross negligence, would not be needed. However, the legislature also implicitly recognized that market forces cannot be relied upon if the directors are conflicted, breach their duties intentionally, or fail to act in good faith. No exculpation is available for these behaviors. This again seems consistent with our premise that conflicted situations, i.e, those that raise duty of loyalty concerns, pose a more serious threat that information may be withheld from the market and markets cannot operate efficiently in this context.

Briefly, the fiduciary duty of loyalty requires corporate officers and directors to put corporate interests ahead of personal interests and thus refrain from using their position in the corporation for their own benefit.<sup>113</sup> According to the early Delaware case of *Guth v. Loft*,<sup>114</sup> a director is obligated to “affirmatively . . . protect the interests of the corporation committed to his charge.”<sup>115</sup> This duty was restated recently by the Delaware Chancery Court in *In Re The Walt Disney Co. Derivative Litigation*.<sup>116</sup> In *Disney*, the court held that “[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . The rule that

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<sup>113</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)). See also *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987). See generally Muir & Schipani, *supra* note 3 for further discussion of the duty of loyalty.

<sup>114</sup> *Guth v. Loft*, 5 A.2d 503 (Del. 1939).

<sup>115</sup> *Id.*

<sup>116</sup> *In re Walt Disney Co. Derivative Litigation*, No. 15452, 2005 Del. Ch. LEXIS 113 (August 9, 2005).

requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest.”<sup>117</sup>

But even in the context of a conflicted transaction, the courts are still willing to defer to the business judgment of the board provided that the conflict has been disclosed and the transaction has been approved by disinterested directors.<sup>118</sup> If a claim is made that a transaction presented a conflict of interest, and if the transaction was not approved by a disinterested board, the court will heighten the scrutiny of the transaction and undertake a substantive evaluation to determine whether it was entirely fair to the corporation and the shareholders.<sup>119</sup> The entire fairness standard is one of the highest levels of scrutiny applied by the Delaware courts.

The statutory appraisal cases involving minority freeze-outs are often intertwined with allegations of breach of fiduciary duty. That is, shareholders who allege receipt of an unfair price for their shares often also allege that the directors breached their fiduciary duties by accepting the unfair price. In Delaware, the courts examine these fiduciary claims substantively against the heightened entire fairness standard.<sup>120</sup>

In cases where the majority shareholders have frozen out the minority shareholders in a merger or consolidation, the defendants will have the burden of proving that the transaction was fair, unless the transaction was approved by independent members of the board, or by a majority vote of the minority shareholders.<sup>121</sup> But even when there is purported approval by an independent committee of the board or by the

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<sup>117</sup> *Id.* at \*163-64 (quoting *Guth*, 5 A.2d at 510).

<sup>118</sup> *Stegemeier v. Magness*, 728 A.2d 557, 562 (Del. 1999); *Schock v. Nash*, 732 A.2d 217, 225 n.21 (Del. 1999); *see also Oberly v. Kirby*, 592 A.2d 445, 466-67 (Del. 1991).

<sup>119</sup> *Stegemeier*, 728 A.2d at 562; *see also Oberly*, 592 A.2d at 466; *President & Fellows of Harv. Coll. v. Glancy*, No. 18790, 2003 Del. Ch. LEXIS 25, at \*69 (Del. Ch. Mar. 21, 2003).

<sup>120</sup> *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001).

<sup>121</sup> *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1137 (Del. Ch. 1994); *Kahn v. Lynch Commc'n Sys.*, 638 A.2d 1110, 1117 (Del. 1994).

minority shareholder vote, the burden of proving fairness will still remain on the majority if the independent members of the board or the minority shareholders were not given full information prior to their vote.<sup>122</sup> In assessing the entire fairness of a transaction, “the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide.”<sup>123</sup>

In addition to their statutory appraisal claim, the plaintiffs in *Emerging Communications*<sup>124</sup> discussed in the previous section, alleged breach of fiduciary duty. This allegation triggered a fair dealing analysis. The court first determined that the burden of proof remained on the defendants to prove that the transaction was entirely fair because the votes of the purportedly independent special committee and the minority shareholders were not fully informed.<sup>125</sup> The court reviewed all relevant aspects of the transaction, including the timing and structure of the transaction, how it was negotiated and how director and shareholder approvals were obtained.<sup>126</sup> The court’s review of these factors led it to conclude that the privatization transaction was not entirely fair.<sup>127</sup> The court found the transaction unfair in how it was initiated and structured and how it

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<sup>122</sup> See, e.g., *In re Emerging Commc’ns, Inc. S’holders Litig.*, No. 16415, 2004 WL 1305745, at \*111-15 (Del. Ch. May 3, 2004, revised June 4, 2004); *In re Tele-Commc’ns., Inc. S’holders Litig.*, No. 16470, 2005 Del. Ch. LEXIS 206, at \*33 (Del. Ch. Dec. 21, 2005).

<sup>123</sup> *Cinerama*, 663 A.2d at 1140.

<sup>124</sup> See *In re Emerging Commc’ns*, 2004 WL 1305745. See *supra* notes 37-53 and accompanying text for a discussion of the statutory appraisal claim. Appraisal, however, is the only remedy when a freeze-out is accomplished via a short-form merger or a tender offer followed by a short form merger. See Peter V. Letsou, *The Dilemma that Should Never Have Been: Minority Freeze Outs in Delaware 5* (May 18, 2005), <http://ssrn.com/abstract=726511>.

<sup>125</sup> *Emerging Commc’ns*, 2004 WL 1305745 at \*112-116.

<sup>126</sup> *Id.* at \*32 (quoting *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985)).

<sup>127</sup> *Id.* at \*32-35.

was timed.<sup>128</sup> The transaction was timed to take place at a time when the stock price was artificially low.<sup>129</sup>

Recently, the Delaware Chancery Court addressed both a claim for statutory appraisal and breach of fiduciary duty in *Delaware Open MRI Radiology Associates, P.A. v. Kessler*.<sup>130</sup> The company involved in *MRI Radiology* was a small, non-public company.<sup>131</sup> In discussing the claims for breach of fiduciary duty, the court reaffirmed application of the entire fairness standard when it is alleged that conflicted fiduciaries breached their duties.<sup>132</sup> The court noted that the burden was on the majority group – the defendant – to prove that the merger was entirely fair.<sup>133</sup> The burden would have shifted back to the minority group – the plaintiffs – to prove the transaction was unfair if the merger had been approved by a committee of disinterested, independent directors, or by a majority vote of the minority stockholders.<sup>134</sup> In this case, there was neither approval of the transaction by an independent board committee, nor a vote of the majority of the minority shareholders, and thus the burden did not shift. The court then evaluated all aspects of the transaction to determine whether the conflicted merger was “both procedurally and substantively fair.”<sup>135</sup>

In the end, the court held that the merger was unfair and that the minority shareholders prevailed on the breach of fiduciary duty claim.<sup>136</sup> The court found both the

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<sup>128</sup> *Id.* at \*32-33.

<sup>129</sup> *Id.*

<sup>130</sup> Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290 (Del. Ch. 2006).

<sup>131</sup> *See id.* at 299.

<sup>132</sup> *Id.* at 311.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 313, 344.

appraisal process and price unfair.<sup>137</sup> The court conducted its own valuation analysis to determine the amount the minority group “would have received in a merger negotiated at arm’s-length between parties with equal bargaining strength.”<sup>138</sup> The remedy for breach of fiduciary duty was identical to the appraisal award.<sup>139</sup>

As discussed above, in statutory appraisal cases, the Delaware courts are required to determine whether the minority shareholders received fair value.<sup>140</sup> The courts consider the market value of the stock in these cases, but do not rely completely on the market value.<sup>141</sup> The market, in such circumstances, may be unable to act efficiently, particularly if information was withheld from it, and thus may not value the shares fairly. When statutory appraisal actions are brought with claims of fiduciary duty breach, the claim is similar. That is, the litigants are asking the court to determine whether the majority has dealt with the minority fairly. Both analyses, therefore, turn on the issue of fairness, and implicitly reflect the belief that when the parties are not acting fairly, the market may not operate efficiently.

A related body of fiduciary duty case law concerns the integrity of disclosures made by corporate fiduciaries. In Delaware, the duty to communicate fully and accurately to shareholders is part of the duty of loyalty and good faith.<sup>142</sup> This duty has been clearly articulated by the Delaware courts as requiring directors to disclose to

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<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 313.

<sup>139</sup> *Id.* at 344.

<sup>140</sup> See notes 22-24 *supra*, and accompanying text.

<sup>141</sup> See notes 25-36 *supra*, and accompanying text.

<sup>142</sup> See, e.g., *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Malpiede v. Townson*, 780 A.2d 1075, 1086-88 (Del. Ch. 2001). See also E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1476 (2006) (“In my view, it is axiomatic that directors who deliberately lie to their stockholders about material company finances have violated one or more of their fiduciary duties.”).



shareholders all material facts bearing on a transaction requiring shareholder action.<sup>143</sup>

More recently, the Delaware courts have been expanding the duty to require honesty and fairness when directors of a corporation voluntarily communicate with shareholders.<sup>144</sup>

This obligation is consistent with the notion that the Delaware courts are concerned with assuring that markets operate efficiently. They can only do so if provided full and honest information.

### C. Link to SOX

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<sup>143</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (finding that there is an obligation to disclose material facts pertaining to a merger); *Zirn v. VLI Corp.*, 621 A.2d 773 (1993) (focusing on the materiality of disclosures); *Stroud v. Grace*, 606 A.2d 75 (Del. 1992) (finding no breach because shareholders were fully informed and there was no threat to the board's control); *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 281 (Del. 1977) (holding that there is a requirement of complete candor in cases involving disclosure).

<sup>144</sup> See, e.g., *Malone*, 722 A.2d at 14. ("Delaware law also protects shareholders who receive false communications from directors even in the absence of a request for shareholder action."); *Shamrock Holdings of Cal. v. Iger*, No. 1330-N, 2005 Del. Ch. LEXIS 83, at \*16 (Del. Ch. 2005) (finding complaint well-pled regarding allegations of breach of fiduciary duty due to misleading statements in CEO selection process); *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377 (Del. Ch. 1999) (refusing to dismiss the complaint where it was alleged that the former company president provided misleading information to a preferred stockholder). In *Jackson National Life*, the court further ruled:

When directors communicate with stockholders, they must recognize their duty of loyalty to do so with honesty and fairness, regardless of the stockholders' status as preferred or common, and regardless of the absence of a request for action required pursuant to a statute, the corporation's certificate of incorporation or any bylaw provision.

*Id.* at 390. This issue has prompted significant commentary. See, e.g., Jennifer O'Hare, *Director Communications and the Uneasy Relationship Between the Fiduciary Duty of Disclosure and the Anti-Fraud Provisions of the Federal Securities Laws*, 70 U. CIN. L. REV. 475 (2002) (compares disclosure law in Delaware to federal securities laws); Holly M. Barbera, *Fiduciary Duties and Disclosure Obligations: Resolving Questions After Malone v. Brincat*, 26 DEL. J. CORP. L. 563 (2001) (arguing that a director's mental state should be a critical component to a disclosure analysis); Faith Stevelman Kahn, *Transparency and Accountability: Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure*, 34 GA. L. REV. 505 (2000) (examining the connection between fiduciary law and corporate disclosure to shareholders); Nicole M. Kim, *Malone v. Brincat: The Fiduciary Disclosure Duty of Corporate directors Under Delaware Law*, 74 WASH. L. REV. 1151 (1999) (arguing that *Malone* created uncertainty in disclosure law); Mark Klock, *Lighthouse or Hidden Reef? Navigating the Fiduciary Duty of Delaware Corporations' Directors in the Wake of Malone*, 6 STAN. J. L. BUS. & FIN. 1 (2000) (examining *Malone* in the context of fiduciary duty and against federal securities laws).

The objectives of the statutory appraisal statutes and courts adjudicating whether shareholders have been dealt with fairly are consistent with the goals of SOX.<sup>145</sup> As noted by the Committee Report on Banking, Housing, and Urban Affairs, the purpose of SOX “is to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility . . . .”<sup>146</sup> Moreover, Thomas A. Bowman, President and CEO of the Association for Investment Management and Research testified in a prepared statement that “[o]nly if the investing public believes that the information available to them is fair, accurate, and transparent can they have confidence in the integrity of the financial markets and the investment professionals who serve them.”<sup>147</sup>

Fairness in value is the lynchpin of Delaware’s statutory appraisal statute and its fiduciary duty concerns. To the extent one of the goals of SOX is to promote disclosure of fair and accurate information to the markets, it is consistent with the fairness concerns of Delaware corporate law. However, SOX does not eliminate the need for careful review of fairness by the state courts. To the extent conflicts of interest still exists, fairness can only be attained by careful scrutiny of conflicted transactions. In the words of Chancellor Strine: “We need the federal government to vigorously enforce national laws mandating accurate and sound accounting of corporate health, and the routine disclosure of material information to stockholders. When the federal government plays

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<sup>145</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in various sections of 11, 15, 18, 28 and 29 U.S.C.).

<sup>146</sup> S. REP. NO. 107-205, at 2 (2002).

<sup>147</sup> *Id.* at 32-33. See also *infra* notes 257-58 for further comments regarding the purpose of SOX.

that role well, and when Delaware enforces fiduciary duties expertly, investors are well-served.”<sup>148</sup>

### III. Retirement Plan Policy and EMH

U.S. retirement plan policy has long reflected the tension between balancing tax and other incentives for sponsorship of benefit plans with provisions that protect employees from malfeasance in employer-sponsored benefit plans. As such, regulatory authority for defined contribution plans is divided between the Department of Labor (DOL) and the Internal Revenue Service.<sup>149</sup> The primary bifurcation in pension plan typology is between defined benefit (DB) plans, in which the investment risk incides on employers, and defined contribution (DC) plans, in which the investment risk incides on employees.<sup>150</sup> In this article we address only DC plans.

DC plans, which include 401(k) plans and ESOPs, have become the dominant type of employer-sponsored retirement planning vehicle in the U.S.<sup>151</sup> The 401(k) plans of most large public companies provide an employer stock fund as one investment option for plan members.<sup>152</sup> By definition ESOPs are formed to invest primarily in the stock of the employer.<sup>153</sup> The company that sponsors a 401(k) plan or ESOP, its directors, those of its employees who have discretionary authority over plan administration or its assets,

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<sup>148</sup> Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 686 (2005).

<sup>149</sup> Dana M. Muir, Note, *Changing the Rules of the Game: Pension Plan Terminations and Early Retirement Benefits*, 87 MICH. L. REV. 1034, 1038 (1989). The PBGC shares responsibility with the DOL and IRS for regulation of DB plans. *Id.*

<sup>150</sup> Dana M. Muir, *Plant Closings and ERISA's Noninterference Provision*, 36 B.C. L. REV. 201, 205-06 (1995).

<sup>151</sup> Pension & Welfare Benefits Admin., U.S. Dept. of Labor, Private Pension Plan Bulletin: Abstract of 2001 Form 5500 Annual Reports, p. 1 (Feb. 2006) (contrasting DC plan assets of approximately \$2.1 trillion with DB plan assets of \$1.8 trillion).

<sup>152</sup> Jack L. VanDerhei, *Company Stock in 401(k) Plans: Results of a Survey of ISCEBS Members*, EBRI Special Rep. 4 (Jan. 31, 2002).

<sup>153</sup> See IRC § 4975(e)(7) (2000).

and the plan's directed trustee all have fiduciary responsibilities to the employees who participate in the plan. In the wake of stock price drops due to factors such as corporate fraud, the reevaluation of high tech stock, and weakness in industry groups, employees have alleged that fiduciaries for their company-sponsored employee investment plans breached their obligations associated with the use of employer stock in the plans.<sup>154</sup> This part analyzes the role of EMH in these controversies. It begins with some history on the use of EMH in pension policy. It then considers the fallacies and misunderstandings reflected in the courts' and DOL's EMH analysis regarding directed trustee liability.<sup>155</sup>

#### **A. History of EMH in Pension Policy**

Regulatory interest in using efficient markets financial theory to set pension plan policy dates back to at least 1975. The then-current head of welfare and pension programs at the DOL stated: "Advocates of modern portfolio theory reject the view that focuses solely on the risky assets held by a plan and instead realize that each investment should be evaluated in the context of the entire portfolio."<sup>156</sup> By 1979 the DOL had

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<sup>154</sup> See Muir & Schipani, *supra* note 2, at 462-70.

<sup>155</sup> In some employer stock cases, fiduciaries that are not directed trustees have attempted to rely on EMH as a defense. The arguments typically are made in response to allegations that fiduciaries breached their obligations either by failing to communicate sufficient information regarding the company stock's prospects or by conveying inaccurate information about those prospects. Fiduciaries respond that, according to EMH, if they would have made the more extensive or corrective disclosures, those disclosures would have caused the stock price to fall. The price decrease would have caused the employee investors to lose money. Thus, the argument goes, the principles of EMH mean that fiduciaries did the right thing by not making the more extensive or corrective disclosures. To date courts have either rejected the argument or determined it constituted a factual matter for trial and not the basis for summary disposition. See *In re: The Goodyear Tire & Rubber Co. ERISA Litig.*, No. 5:03CV2182, 2006 U.S. Dist. LEXIS 48734, at \*31-32 (N.D. Ohio July 6, 2006) (holding not suitable for summary judgment); *In Re Honeywell Int'l ERISA Litig.*, No. 03-1214, 2004 U.S. Dist. LEXIS 21585, at 42 (D.N.M. Sept. 14, 2004) ("First, because they raise issues of causation and damages, they are essentially fact-based arguments inappropriate on a motion to dismiss. Second, and perhaps more significantly, they are flawed on the merits.").

<sup>156</sup> Richard H. Koppes and Maureen L. Reilly, *An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor an Index Fund Through Relationship Investing*, 20 IOWA J. CORP. L. 414, 437 (1995) (quoting a statement on file with authors).

issued a final regulation on fiduciary obligation in the diversification of pension plan assets.<sup>157</sup> The regulation requires a pension plan fiduciary to take into account such factors as “[t]he composition of the portfolio with regard to diversification...”<sup>158</sup> The preamble makes clear that the prudence of a particular investment must be judged within the context of the entire plan portfolio.<sup>159</sup> Most commentators have cited these regulatory statements as evidence of the DOL’s acceptance of modern portfolio theory (MPT).<sup>160</sup> Others have observed though that the DOL “acknowledge[s] portfolio theory, but almost wholly fail[s] to incorporate the insights of modern portfolio theory.”<sup>161</sup>

Diversification of plan investments is one of the four statutory duties of a plan fiduciary.<sup>162</sup> DC plans may relieve the fiduciaries’ of responsibility for asset allocation and diversification by delegating those decisions to employees. In order to insulate fiduciaries a plan must offer at least three investment vehicles with different risk and return qualities.<sup>163</sup> Nothing, though, requires employees to diversify their assets among the available investment vehicles. Thus, although fiduciaries have a statutory and

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<sup>157</sup> Investment Duties, 29 C.F.R. § 2550.404a-1 (1979).

<sup>158</sup> *Id.* at § 2550.404a-1(b)(2)(ii)(A).

<sup>159</sup> Rules and Regulations for Fiduciary Responsibility: Investment of Plan Assets Under the “Prudence” Rule, 44 Fed. Reg. 37221, 37222 (June 26, 1979).

<sup>160</sup> Thomas M. Griffin, *Investing Labor Union Pension Funds in Workers: How ERISA and the Common Law Trust May Benefit Labor by Economically Targeting Investment*, 32 SUFFOLK U. L. REV. 11, 46 (1998); Koppes & Reilly, *supra* note 156, at 437; Jerry W. Markham, *Privatizing Social Security*, 38 SAN DIEGO L. REV. 747, 798 (2001); Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 NOTRE DAME L. REV. 199, 226 (1992); Stephen P. Johnson, Note, *Trustee Investment: The Prudent Person Rule or Modern Portfolio Theory, You Make the Choice*, 44 SYRACUSE L. REV. 1175, 1185 (1993).

<sup>161</sup> Deborah M. Weiss & Marc A. Sgarglino, *Prudent Risks for Anxious Workers*, 1996 WIS L. REV. 1175, 1177 (1996).

<sup>162</sup> ERISA § 404(a)(1); 29 U.S.C. § 1140(a)(1) (2000). ERISA’s legislative history implicitly adopts the concept that diversification decreases risk. H.R.REP. NO. 1 280, 93d Cong., 2d Sess. 304, reprinted in 1974 U.S. Code Cong. & Ad. News 5038, 5085 (“Ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses.”).

<sup>163</sup> ERISA § 404(c) plans; 29 C.F.R. § 2550.404c-1(b)(3) (1992).

regulatory obligation in DB plans to diversify assets, that obligation does not apply in 401(k) plans if plans delegate investment allocation decisions to plan participants.

The result of the diversification exception is that DB plans, where employers bear investment risk, have diversification obligations whereas DC plans, where employees bear the investment risk, have no such requirement. The rationale for allowing employees to invest their plan assets without regard to MPT principles may be a willingness to allow individual employees to invest in accordance with their own risk tolerances and an unwillingness to be paternalistic in this setting. Or, perhaps it is a response to the preference of employers who have sought to avoid limitations on plan use of company stock.<sup>164</sup> In any case, the policy is entrenched. Congress has considered capping employee account holdings of employer stock but to date has refused to do so.<sup>165</sup>

Commentators such as Professor Jeffrey Gordon have questioned the wisdom of permitting employees to remain undiversified in their company-sponsored employee investment plan accounts.<sup>166</sup> The concentrated investment of plan assets in employer stock, after all, has led to substantial losses in employee accounts at companies such as Enron and may not be the wisest use of tax incentives intended to enable the

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<sup>164</sup> See, e.g., The ERISA Industry Committee, *ERIC Position Statement: Defined Contribution Provisions in the National Employee Savings and Trust Equity Guarantee Act (July 2005)*, at [http://www.eric.org/forms/uploadFiles/571200000013.filename.DC\\_Position\\_Statement.pdf](http://www.eric.org/forms/uploadFiles/571200000013.filename.DC_Position_Statement.pdf) (objecting to proposed diversification requirements regarding company stock); *House Comm. On Educ. And the Workforce*, 109th Cong. (2002) (statement of Angela Reynolds, Director, International Pension & Benefits for NCR Corp.), at <http://edworkforce.house.gov/hearings/107th/ee/enronfour22702/reynolds.htm> (arguing against proposals to cap company stock investments in 401(k) plans).

<sup>165</sup> Dana M. Muir, *The U.S. Culture of Employee Ownership and 401(k) Plans*, 14 ELDER L.J. 1, 8 (2006).

<sup>166</sup> Jeffrey Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1248- 49 (2002); Susan J. Stabile, *Pension Plan Investments in Employer Securities: More is not Always Better*, 15 YALE J. ON REG. 61, 88 (1988) (advocating a 10 percent cap on employer stock); see also *Summers v. State Street Bank & Trust Co.*, No 05-4005, 2006 U.S. App. LEXIS 16186, at \*20 (7th Cir. June 28, 2006) (“The time may have come to rethink the concept of an ESOP, a seemingly inefficient method of wealth accumulation by employees because of the under diversification to which it conduces...”).

accumulation of wealth for retirement.<sup>167</sup> Professor Gordon implicitly recognizes the much broader problem missed by commentators who would cap the amount of employer stock any individual could hold in a plan account. Rather than accepting too much risk by concentrating investments in employer stock, significant numbers of employees under diversify by selecting low risk investments such as fixed-income alternatives and bonds.<sup>168</sup> Given that most large plans offer a number of investment alternatives<sup>169</sup> and some offer employees the ability to invest in any publicly-traded security,<sup>170</sup> the possibilities for under diversification are not limited just to employer stock.<sup>171</sup> If future policy makers rely on MPT to require diversification of DC plan accounts they must recognize the full extent of the under diversification issues.

In its most recent use of finance theory, in December 2004 the DOL issued a field assistance bulletin largely relieving directed trustees for plans sponsored by publicly traded companies from fiduciary obligation for investment directions.<sup>172</sup> In that bulletin, which is discussed below in more detail,<sup>173</sup> the DOL states that a directed trustee “will rarely have an obligation under ERISA to question the prudence of a direction to purchase publicly traded securities at the market price solely on the basis of publicly available information.”<sup>174</sup> The bulletin explicitly refers to the efficiency of markets in

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<sup>167</sup> Gordon, *supra* note 166, at 1249.

<sup>168</sup> *Id.*

<sup>169</sup> See Profit Sharing/401(k) Council of America, *48<sup>th</sup> Annual Survey of Profit Sharing and 401(k) Plans*, at <http://www.pasca.org/DATA/48th.html> (finding plans offer an average of 18 fund investment options).

<sup>170</sup> Ian D. Lanoff & Roberta J. Ufford, *ERISA Protections Provide Guidance for Social Security Privatization*, 58 WASH. & LEE L. REV. 1353, 1360 (2001) (discussing open brokerage accounts).

<sup>171</sup> Professor Muir has suggested that rather than capping particular types of investments or mandating diversification, plans should be encouraged to offer investment advice to plan participants. Dana M. Muir, *The Dichotomy Between Investment Advice and Investment Education: Is No Advice Really the Best Advice?* 23 BERKELEY J. EMP. & LAB. L. 1, 50-54 (2002).

<sup>172</sup> Field Assistance Bulletin 2004-03 (2004) (hereinafter FAB 2004-03).

<sup>173</sup> See *infra* text accompanying notes 182-220.

<sup>174</sup> FAB 2004-03 at 5.

ensuring “that stock prices reflect publicly available information and known risks,”<sup>175</sup> apparently reflecting the DOL’s acceptance of the semi-strong version of EMH.

In sum, ERISA’s legislative history and statutory language reflect some acceptance of modern finance theory, at least to the extent of the benefits of asset diversification. Over time the DOL has moved from general statements about and acceptance of MPT to its recent explicit reliance on EMH to largely relieve directed trustees from fiduciary obligation for transactions involving the stock of publicly traded companies. The next section examines the DOL’s reliance on EMH.

## **B. The Directed Trustee and EMH**

Conflicts of interest are inherent in the use of employer stock in company-sponsored employee investment plans. The typical conflicts arise because company executives and directors decide whether a 401(k) plan will offer employees the option of investing in company stock, whether the company will use company stock to match employee contributions, whether the company will sponsor an ESOP, and whether changes should be made to any of these arrangements. The situation of company executives partially parallels the situation of the defendants in the appraisal actions discussed above because both cohorts often enjoy comparative informational advantages.

An entity that typically has fewer conflicts than the company employees who act as fiduciaries is the directed trustee.<sup>176</sup> The assets of each plan must be held in a trust.<sup>177</sup>

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<sup>175</sup> *Id.*

<sup>176</sup> The directed trustee’s interest in maintaining its work on behalf of the plan creates the possibility it will be inclined to favor the wishes of the plan sponsor. To date courts have rejected arguments that this constitutes a sufficient conflict of interest to taint the directed trustee’s decision making. *In re RCN Litig.*, No. 04-5068(SRC), 2006 U.S. Dist. LEXIS 12929, at \*28-29 (D.N.J. Mar. 21, 2006).

<sup>177</sup> See ERISA § 403(a), 29 U.S.C. § 1103. Note minor exception.



Sponsoring employers typically appoint a directed trustee to accept contributions and execute investment directions. The DOL's adoption of EMH has changed the landscape of directed trustee fiduciary responsibility.<sup>178</sup>

Prior to December 2004, courts were split over the extent of a directed trustee's obligation to review the prudence of investment directions. In the high profile Enron case the court denied the directed trustee's motion to dismiss, stating that plaintiffs had alleged "with factual support that the directed trustee knew or should have known from a number of significant waving red flags and/or regular reviews of the company's financial statements that the employer company was in financial danger and its stock greatly diminished in value..."<sup>179</sup> Other courts disagreed, determining that directed trustees rarely have an obligation to review the prudence of the investment directions they receive.<sup>180</sup> Regardless, though, of the courts' positions on the scope of liability of directed trustees nowhere in the opinions issued prior to December 2004 do any of the courts explicitly refer to EMH as the rationale for their decisions.

That changed radically in December 2004 with the DOL's release of Field Assistance Bulletin 2004-03 ("FAB 2004-03"). The DOL appears to have adopted the semi-strong form of EMH because it distinguishes directed trustee obligations based on whether the directed trustee possesses nonpublic or only public information about the employer.<sup>181</sup> This section first addresses situations where directed trustees allegedly

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<sup>178</sup> See *infra* Part III.B.1.

<sup>179</sup> *In re Enron Corp. Secs, Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 601 (S.D. Tex. 2003); see also *Firstier Bank v. Zeller*, 16 F.3d 907, 911(8th Cir. 1994) (finding that trustee had complied with a "knows or ought to know" standard) (quoting IIA SCOTT ON TRUSTS § 185 (4th ed. 1987)). Northern Trust, the directed trustee for Enron's plan, settled the ERISA litigation for \$37.5 million. *At Deadline*, PENSIONS & INVESTMENTS, April 3, 2006, at 1.

<sup>180</sup> See, e.g., *Maniace v. Commerce Bank*, 40 F.3d 264, 268 (8th Cir. 1994).

<sup>181</sup> FAB 2004-03, at 4-6.

have access only to public information. The next section turns to considerations of nonpublic information.

### 1. Directed Trustees with Public Information and EMH

FAB 2004-03 states that a directed trustee's obligation to review the prudence of individual investments is "significantly limited"<sup>182</sup> and an ERISA directed trustee's fiduciary responsibilities are "significantly narrower than the duties generally ascribed to a discretionary trustee under common trust principles."<sup>183</sup> According to the FAB, a directed trustee may have an obligation of further inquiry regarding employer stock directions at the point public information such as 8-Ks or a bankruptcy filing "call into serious question a company's viability as a going concern."<sup>184</sup> The only other factual situation that may give rise to a duty regarding public information is where the "company, its officers or directors [have been] formally charged by state or Federal regulators with financial irregularities."<sup>185</sup>

The first directed trustee decision issued after December 2004, *In re: WorldCom, Inc. ERISA Litig.*, largely adopted the DOL's application of EMH and established the trend of using efficient market considerations in these cases.<sup>186</sup> After WorldCom's financial implosion in the wake of accounting scandals, employees who had held

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<sup>182</sup> *Id.* at 4.

<sup>183</sup> *Id.* at 2.

<sup>184</sup> *Id.* at 6.

<sup>185</sup> *Id.*

<sup>186</sup> *In re WorldCom, Inc. ERISA Litig.*, 354 F. Supp. 2d 423, 446-47 (S.D.N.Y. 2005), *later opin.* 2005 U.S. Dist. LEXIS 28686, at \*5-6 (S.D.N.Y. Nov. 22, 2005) (approving settlement); *see also In re Cardinal Health, Inc. ERISA Litig.*, No. C2-04-643, 424 F. Supp. 2d 1002, 1038-41 (S.D. Ohio 2006) (applying the DOL standard to dismiss the claims against Putnam Fiduciary Trust Co. as directed trustee since there was no significant publicly available information questioning the company's financial viability and Putnam did not have any material nonpublic information); *In re RCN Litig.*, No. 04-5068(SRC), 2006 U.S. Dist. LEXIS 12929, at \*20-21 (D.N.J. Mar. 21, 2006) (applying the DOL standard to dismiss the claims against Merrill Lynch Trust Co. FSB as directed trustee since there was insufficient publicly available information questioning the company's financial viability).

WorldCom stock in its 401(k) plan sued numerous defendants including Merrill Lynch as directed trustee.<sup>187</sup> Plaintiffs argued, among other things, that Merrill Lynch breached its fiduciary duties when it continued to execute buy orders for the WorldCom stock fund after WorldCom became an imprudent retirement plan investment for employees.<sup>188</sup> All of the plaintiffs' allegations involved Merrill Lynch's possession of public information.<sup>189</sup>

First among the "well settled principles" cited by the *WorldCom* court as supporting FAB 2004-03's narrow view of fiduciary obligation is the court's belief that "financial markets are assumed to be efficient, such that the prices of securities reflect all publicly available information and known risks."<sup>190</sup> In turn the court relied on *Basic, Inc. v. Levinson* as its authority for the endorsement of EMH.<sup>191</sup>

Ultimately the *WorldCom* court articulated the standard for a directed trustee to be: "When a directed trustee receives a direction to invest plan assets in the securities of a company, or when plan assets are already invested in such securities, a directed trustee has a fiduciary duty of inquiry under ERISA when it knows or should know of reliable public information that calls into serious question the company's short-term viability as a going concern."<sup>192</sup> This standard modifies the DOL's suggested standard by requiring the public information to be "reliable" as opposed to "clear and compelling" and by limiting the time frame to "short-term."<sup>193</sup> In spite of analyst recommendations to sell WorldCom securities and a six month period during the class period when WorldCom's

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<sup>187</sup> *In re WorldCom, Inc. ERISA Litig.*, 2005 U.S. Dist. LEXIS 28686, at \*1-3.

<sup>188</sup> 354 F. Supp. 2d 423, 426-27 (S.D.N.Y. 2005).

<sup>189</sup> *Id.* at 449 n.24.

<sup>190</sup> 354 F. Supp.2d at 447; *see also* DeFelice v. US Airways, Inc., 397 F. Supp. 2d 735, 752 (E.D. Va 2005).

<sup>191</sup> 354 F. Supp. 2d at 447, n.23.

<sup>192</sup> *Id.* at 449 (citations omitted).

<sup>193</sup> *Id.* at 449 n.25.

stock price decreased, the court decided there was no evidence of “reliable public information . . . that called into serious question the short-term viability of WorldCom as a going concern.”<sup>194</sup> The court dismissed all claims against Merrill Lynch.<sup>195</sup>

To date, the only significant court criticism of the DOL’s FAB comes from the Seventh Circuit in an opinion authored by Judge Posner. The court affirmed summary judgment in favor of State Street Bank & Trust Co. (State Street), the directed trustee for United Airline’s ESOP.<sup>196</sup> The plaintiffs asserted that State Street’s fiduciary violation occurred when it failed until “the eve of United’s bankruptcy”<sup>197</sup> to sell the ESOP’s United stock. Plaintiffs argued State Street should have begun selling United stock immediately after United’s CEO authored a letter to all employees containing serious warnings about United’s financial prospects.<sup>198</sup> Judge Posner and his colleagues determined that the letter did not give rise to a sell obligation for State Street, saying that it is not imprudent for a directed trustee “to assume that a major stock market . . . provides the best estimate of the value of the stocks traded on it that is available to him.”<sup>199</sup> Although Judge Posner’s opinion indicates complete acceptance of EMH,<sup>200</sup> it criticizes the FAB’s standard as not being administrable because the FAB only states that a directed trustee “may” have duties and any selling mandated by the FAB would occur after the stock had lost much of its value.<sup>201</sup>

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<sup>194</sup> 354 F. Supp. 2d at 449-50.

<sup>195</sup> *Id.* at 451.

<sup>196</sup> *Summers v. State Street Bank & Trust Co.*, Nos. 05-4005, 05-4317, 2006 U.S. App. LEXIS 16186, at \*19, 26 (7th Cir. June 28, 2006).

<sup>197</sup> *Id.* at \*7.

<sup>198</sup> *Id.* at \*9.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at \*10 ([A]t every point in the long slide of United’s stock price, that price was the best estimate available either to State Street or to the Committee of the company’s value. . .”).

<sup>201</sup> *Id.* at \*20-21.

The Seventh Circuit did, however, suggest an alternative approach, also based in finance theory, for evaluating the prudence of directed trustees. As United's stock price fell, the ratio of fixed-interest debt to equity increased so the risk borne by stockholders also increased.<sup>202</sup> The court explained its theory of liability: "The source of the duty to diversify would not be the trustee's disagreement with the market valuation (their failure to predict the company's impending collapse), but the excessive risk imposed on employee-shareholders by the rise in the debt-equity ratio of the employer's stock. . . . How excessive would depend in the first instance on the amount and character of the employees' other assets, for, as we have already indicated, it is the riskiness of one's portfolio, not of a particular asset in the portfolio, that is important to the risk-averse investor."<sup>203</sup>

The "excessive risk" theory of liability suggested by Judge Posner and his colleagues seems to recognize that the various risks of owning a particular stock as part of a portfolio, which include market risk, industry risk, and firm risk,<sup>204</sup> are different from the problem of under diversification, which, according to MPT, is always uncompensated risk.<sup>205</sup> As Professor Langbein has recognized when writing about the Uniform Prudent Investor Act:<sup>206</sup> "The idea that some securities are intrinsically too risky . . . collides with the central findings of Modern Portfolio Theory. MPT teaches that risk intrinsic to any marketable security is presumptively already discounted into the current price of the security. Hence, on an expected return basis, the risk is compensated

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<sup>202</sup> *Id.* at \*11-12.

<sup>203</sup> *Id.* at \*17-18.

<sup>204</sup> John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 647 (1996).

<sup>205</sup> *Id.* at 648.

<sup>206</sup> Unif. Prudent Investor Act (1994).

risk.”<sup>207</sup> Under efficient markets concepts and MPT undiversified risk is uncompensated so it always is unduly risky. The point the Seventh Circuit misses though is that for those who believe in efficient markets, finance theory provides only one answer to the question of when an undiversified portfolio becomes too risky – and that answer is: “always.”<sup>208</sup>

The Seventh Circuit’s “excessive risk” theory raises a number of other concerns including the scope of a directed trustee’s obligation to track firm-specific risk and investor portfolios.<sup>209</sup> If directed trustees must evaluate the potential for excessive risk in the context of individual employee portfolios that requirement will increase agency and informational costs. Firm-specific risks include far more than debt-equity ratios so monitoring of firm-specific risk by directed trustees may require substantial familiarity with the company’s operations. Perhaps it would be sufficient protection for directed trustees to obtain statements from employees indicating a very high tolerance of firm-specific and portfolio risk but that raises another set of agency and monitoring obligations. Finally, in a scenario that is the opposite of *Summers*, where the employer stock price increases and the risk thereby drops (or firm-specific risk decreases for any reason), would the converse of the “excessive risk” theory apply to create an obligation for the directed trustee to consider diversification of plan accounts into riskier assets? The ultimate outcome of the “excessive risk” theory may be that it becomes a back door way to achieve diversification of plan assets because, according to MPT, a diversified portfolio is the only approach that would effectively decrease the volatility of risk.

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<sup>207</sup> Langbein, *supra* note 204, at 649.

<sup>208</sup> *See id.* at 664-65 (“We now know that the advantages of diversifying a portfolio of securities are so great that it is folly not to do it.”).

<sup>209</sup> The opinion recognizes that this theory may be challenging to litigate. *Summers*, 2006 U.S. App. LEXIS 16186, at \*18 (“[E]ven if the methods of litigation could feasibly determine the point at which the ESOP trustee should sell in order to protect the employee-shareholders against excessive risk...”).

## 2. Directed Trustees with Nonpublic Information and EMH

In some instances directed trustees may possess nonpublic information that could cause the directed trustee to question the prudence of investing in employer stock. That information may directly or indirectly relate to the employer and the source of the information may or may not be the employer. Under the semi-strong form of EMH the capital markets impound all publicly available information but not nonpublic information into the stock price.<sup>210</sup>

Nonpublic information is not usually assumed to be reflected in stock prices. The DOL still takes a narrow view, though, of a directed trustee's duty to evaluate prudence based on nonpublic information of which that directed trustee may be aware. Only where "individuals responsible for the directed trustee services have actual knowledge of material non public information"<sup>211</sup> does the obligation to consider prudence inure on the directed trustee.

In one recent case Merrill Lynch Trust Co. FSB (MLTC) served as directed trustee for RCN Corporation's plan.<sup>212</sup> According to plaintiffs, affiliates of MLTC, which allegedly advised RCN, possessed nonpublic information about RCN's financial health.<sup>213</sup> Consistent with FAB 2004-03 the court refused to impute the knowledge of nonpublic information to MLTC.<sup>214</sup> Nor did MLTC have any obligation to advise RCN employees that an MLTC affiliate was counseling institutional investors to steer away

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<sup>210</sup> Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U.L. REV. 761, 771 n.19 (1985).

<sup>211</sup> FAB 2004-03.

<sup>212</sup> In re RCN Litig., No. 04-5068(SRC), 2006 U.S. Dist LEXIS 12929, at \*3 (D.N.J. Mar. 21, 2006).

<sup>213</sup> *Id.* at \*19 n.6.

<sup>214</sup> *Id.*

from what it believed to be overly speculative RCN stock.<sup>215</sup> In contrast, in a number of related cases plaintiffs have survived motions to dismiss by alleging that directed trustees had nonpublic information that late trading was occurring in mutual funds.<sup>216</sup> For example, in *Zarate v. Bank One Corp.*, employees of Bank One allege that Bank One Trust, the directed trustee of their plan, possessed nonpublic information that late trading was occurring in One Group funds.<sup>217</sup> The *Zarate* court quoted the distinction drawn by FAB 2004-03 between public and nonpublic information to support its decision to deny dismissal.<sup>218</sup>

Selling employer stock or advising others to sell the stock on the basis of material nonpublic information could, of course, violate the federal securities laws. One would expect that even to the limited extent the DOL imposes a duty on directed trustees to evaluate prudence when the relevant individuals have nonpublic information, directed trustees would argue that the duty is nullified by the securities law's ban on insider trading and tipping. A parallel argument, however, has been made and frequently rejected by the courts in actions against company fiduciaries alleging violation of their duties of prudence and honest communication.

In one case the CEO and the outside directors argued that even if they had any fiduciary duties under ERISA to disclose information about the company's prospects, "they could not as a matter of law [have] breached them because to have disclosed non-public information about [the company to employees] would have violated securities

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<sup>215</sup> *Id.* at \*21-22.

<sup>216</sup> *Corbett v. Marsh & McLennan Cos.*, No. JFM-04-0883; MDL-15863, 2006 U.S. Dist. LEXIS 12022, at \*6-7 (D. Md. Feb. 27, 2006); *Calderon v. Amvescap PLC*, No. JFM-04-0824; MDL-15864, 2006 U.S. Dist. LEXIS 12023, at \*6-7 (D. Md. Feb. 27, 2006); *Zarate v. BankOne Corp.*, No. JFM-04-0830; MDL-15863, 2006 U.S. Dist. LEXIS 12026, at \*5-6 (D. Md. Feb. 27, 2006).

<sup>217</sup> *Zarate*, 2006 U.S. Dist. LEXIS 12026, at \*5-6.

<sup>218</sup> *Id.*



laws."<sup>219</sup> In response to similar arguments, the WorldCom and Enron district courts decided that ERISA fiduciaries can and should satisfy extensive disclosure duties under ERISA and the securities laws even though that may require the fiduciaries to make public disclosures beyond those needed to meet the minimum standards of the federal securities laws.<sup>220</sup>

If directed trustees argue that they cannot make further inquiries based on nonpublic information because doing so could result in transactions that violate the securities laws, one would expect the courts to reach the same result they come to when other fiduciaries make the argument. Directed trustees must fulfill their fiduciary obligations even if that also requires additional disclosures in order to avoid securities law liability. Note that if a directed trustee's inquiry stopped the plan from purchasing employer stock, that action would not constitute insider trading because either a purchase or a sale of securities is required to establish a violation.

### **3. EMH as a Ruse for Directed Trustee Protection?**

In contrast to SOX, where Professor Romano and others have criticized policy development for ignoring academic finance research,<sup>221</sup> in the ERISA context policy makers and courts are relying on EMH in setting substantive standards. Instead of evaluating whether "policy entrepreneurs" created inefficiencies in legislating while

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<sup>219</sup> Rankin v. Rots, 278 F. Supp. 2d 853, 873 (E.D. Mich. 2003), *later opin.*, 2006 U.S. Dist. LEXIS 45706, at \*10 (E.D. Mich. June 28, 2006) (approving settlement).

<sup>220</sup> *In re WorldCom Litig.*, 263 F. Supp. 2d 745, 766-67 (S.D.N.Y. 2003), *later opinion*, 2005 U.S. Dist. LEXIS 28686, at \*5-6 (S.D.N.Y. Nov. 22, 2005) (approving settlement); *In re Enron Corp. Secs., Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 563-67 (S.D. Tex. 2003). *But see In re McKesson HBOC Inc. ERISA Litigation*, No. C00-20030 RMW, 2002 U.S. Dist. LEXIS 19473, at \*21 (N.D. Cal. Sept. 30, 2002) ("fiduciaries are not obligated to violate the securities laws in order to satisfy their fiduciary duties").

<sup>221</sup> See Romano, *supra* note 5, at 1527-29.

ignoring empirical literature, the question here becomes how well policy makers do when they decide to rely on academic theory. Not only did the DOL explicitly rely on EMH to narrow the scope of directed trustee' fiduciary obligations, it also extended the Supreme Court's use of EMH in *Basic* far beyond *Basic*'s context of proving plaintiff reliance in actions for alleged securities law violations. What began in *Basic* as a concept acting as a plaintiff's sword has been hammered by the DOL and directed trustees into a shield for defendants.<sup>222</sup> Whether this use of EMH establishes a trend that will be picked up in other areas of law remains to be seen.

The bottom line question for consideration is whether sufficient rationales support the position that directed trustees have no duty of inquiry regarding investment directions unless one of the narrow exceptions exist. The next section considers that question.

**a. The SOX and EMH Rationales**

The DOL recites three reasons to support its view that directed trustees rarely have any duty of inquiry unless they possess material nonpublic information. One explanation is that the securities laws require accurate disclosures.<sup>223</sup> The numerous corporate scandals that preceded SOX make it silly to argue that federal securities law was fully effective in ensuring against fraud in the securities markets. Perhaps the DOL believes that SOX solved all potential problems of noncompliance in the future but the wealth of academic analysis, including this symposium, considering the efficacy of SOX shows the fallacy of relying on SOX to stand in the place of fiduciary obligation. As we

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<sup>222</sup> Securities law also permits the use of EMH as a defense such as in the situation of a defendant arguing that the market saw through misstatements – the 'truth on the market' defense. Langevoort, *supra* note 9, at 176-77.

<sup>223</sup> *Id.* at 5.

have shown above,<sup>224</sup> the Delaware courts do not operate under the illusion that federal securities laws always result in full and accurate disclosure.

In the explanation that has gained the most momentum in the courts since the FAB, the DOL states that “markets generally are assumed to be efficient so that stock prices reflect publicly available information and known risks.”<sup>225</sup> The DOL’s use of EMH is laudable in the sense that the DOL did not fall into the trap Congress did in passing SOX and ignore an entire field of research that might contribute to the development of efficient regulation. The DOL’s use of EMH, however, goes too far in the other direction. It fails to recognize the general challenges to EMH, the fact that many would agree that, in the real world, not all publicly-traded securities<sup>226</sup> always trade in an efficient market, and the heightened standard of fiduciary obligation to which directed trustees are subject.

Any use of EMH in establishing legal standards must take into account the current academic dispute on the robustness of EMH. A full evaluation of that dispute is beyond the scope of this article. However, there is no indication that the DOL assessed the significant criticisms of EMH. Such an assessment should be part of any policy maker’s decision to rely on empirical research in setting broad policy. Even in the situation of EMH, where the Supreme Court indicated some agreement with its principles, it is important to remember that “the Court was not conducting a finance class when it

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<sup>224</sup> See *supra* Part II.

<sup>225</sup> FAB 2004-03 at 5.

<sup>226</sup> The FAB is somewhat inconsistent in whether it leaves room for consideration that publicly traded securities may or may not trade in an efficient market. In its discussions of directed trustee obligations, it refers to all “publicly traded stock” and “publicly traded securities.” *Id.* at 4, 5. In its conclusion it refers to “publicly traded securities on a generally recognized market.” *Id.* at 7.

wrote the *Basic* decision.”<sup>227</sup> Indeed, since then Professor Robert Shiller has argued that the existence of market exuberance and bubbles leads to entire markets being overpriced for periods of time.<sup>228</sup> Research on noise trading,<sup>229</sup> behavioral finance,<sup>230</sup> insufficient availability and use of short selling opportunities,<sup>231</sup> and other contrary phenomena<sup>232</sup> also have led researchers to question the premises of EMH.

In other contexts courts and policy makers are far more skeptical of the real world robustness of EMH than is the DOL. The Delaware statutory appraisal cases often use market price as one factor but only one factor in establishing the appropriate valuation of a security.<sup>233</sup> The Delaware courts also examine, on a case-by-case basis, whether the market for a particular stock appears efficient.<sup>234</sup> In fact, the very recognition of a right of action for security sellers to challenge the fairness of a market price is inconsistent with the belief that the market always accurately prices securities. The law review literature abounds with discussions of the need for legal intervention in order to enhance the efficiency of markets.<sup>235</sup> Similarly, courts typically evaluate a number of factors in securities fraud cases to determine whether the security traded in an efficient market.<sup>236</sup>

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<sup>227</sup> William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 856 (2005).

<sup>228</sup> See SCHILLER, *supra* note 10, at 190 (“The invocation of efficient markets theory to imply that the recent upspike in the stock market is a routine and accurate response to genuine news is just not correct. To justify the notion that the stock market is at the appropriate level now, we would have to argue that it was not before. Such an argument would stand in sharp contradiction to efficient markets theory...”)

<sup>229</sup> Langevoort, *supra* note 9, at 143.

<sup>230</sup> *Id.* at 143-47.

<sup>231</sup> Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 IOWA J. CORP. L. 715, 725-30 (2003).

<sup>232</sup> See Gordon, *supra* note 166, at 1235 (“Although the efficient market hypothesis is a useful null hypothesis about the workings of a well-developed capital market, sophisticated application in policy settings requires awareness of its limits as well as its power.”)

<sup>233</sup> See *supra* text preceding note 101.

<sup>234</sup> See *supra* text accompanying note 31.

<sup>235</sup> See Langevoort, *supra* note 9, at 138 (“The securities markets (and securities regulation) are a natural crucible for the research agenda of behavioral law and economics generally”).

<sup>236</sup> Fisher, *supra* note 227, at 858-62 (discussing the Cammer factors and others).

Arguably, increasing the efficient functioning of the capital markets was a primary purpose of some of SOX's disclosure provisions.<sup>237</sup>

Even accepting the general premise of EMH for purposes of this discussion, the employer stock context is one that raises at least the normal range of issues for questioning the reliability of EMH in specific instances. After all, when a company executive makes a decision regarding the use of company stock that executive may be operating under a range of conflicts of interest including valuation of personal stock and options investments, pressures from shareholders regarding stock price, and the liquidity incentives associated with the use of company stock for plan contributions. EMH's hypothesis that the executive would place a buy order only due to a belief that the stock is undervalued should be subject to particular scrutiny in this context. Similarly, behavioral economists have observed that employees frequently appear to engage in irrational behavior when making decisions regarding employer stock investments.<sup>238</sup> The DOL's recognition of the limits of EMH may be reflected in the FAB's exceptions though, if so, the DOL never admits its concerns and the exceptions are grossly under inclusive.<sup>239</sup>

Since the DOL relies on the efficiency of markets as its rationale to relieve directed trustees that possess only public information from any obligation of diligent inquiry except in the two exceptional circumstances, perhaps it believes that market inefficiencies may occur in these two, and only in these two, situations. Uncertainty

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<sup>237</sup> See S. REP. NO. 107-205, at 1 (2002) ("The purpose of the bill is to address the systemic and structural weaknesses affecting our capital markets...").

<sup>238</sup> Muir, *supra* note 171, at 11-15

<sup>239</sup> Another explanation for the exceptions in the FAB is that the DOL may be using the filing of bankruptcy and formal charges against a company or its officers as proxies for situations where directed trustees should for some reason be especially cautious about the prudence of directions from company fiduciaries. Again, though, this explanation is unlikely to justify the exceptions. But, why choose only these two situations and why delay implementation of a directed trustee duty until the stock likely would have lost most of its value? Indeed, if those were the DOL's actual concerns one would expect to see a general standard identifying the concern, not two specific and narrow fact situations.

about market inefficiency would be consistent with the ambiguous nature of the directed trustee's duty in these contexts. In both instances, the FAB states that the directed trustee "may" have to further assess the transaction at issue.<sup>240</sup> Perhaps the goal is for the directed trustee to evaluate potential market failures in the hopes of identifying an opportunity to liquidate at least a portion of the plan's investment in employer stock prior to a price collapse.

The 'exception to efficient markets' explanation, however, makes little sense from either a practical or a theoretical standpoint. From a theoretical perspective, there is no indication that these two situations are particularly likely to lead to efficient market failures. Even if there were market failures in these situations it is fair to question why other situations giving rise to market inefficiencies would not equally give rise to obligations for directed trustees to evaluate those failures. An exception for all occurrences of market failures might make theoretical sense but an exception limited to two specific situations does not.<sup>241</sup>

Practically speaking, using a "may" standard to define the obligation of inquiry, with so little explication of when "may" might mean "must," provides little useful direction to directed trustees.<sup>242</sup> Finally, as Judge Posner has implied,<sup>243</sup> questioning the market integrity of a stock's price once the company is in bankruptcy or formal charges

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<sup>240</sup> FAB 2004-03 at 6.

<sup>241</sup> According to the language of the FAB the directed trustee's obligation is limited to questioning directions it receives from the named fiduciary – typically the company or a member of management. This would appear to extend only to directions to purchase employer stock for matching or other employer contributions. It is likely that the DOL intends the FAB to be construed in this broader sense either because it believes that individual employees act as named fiduciaries when giving directions to directed trustees or because directions from the named fiduciary includes all general directions such as the direction to follow participant directions and to maintain the status quo of plan investments.

<sup>242</sup> See *Summers v. State Street Bank & Trust Co.*, Nos. 05-4005, 05-4317, 2006 U.S. App. LEXIS 16186, \*19-20 (7th Cir. 2006).

<sup>243</sup> See *supra* text accompanying note 201.

have been brought against it or its officers is much too late to avoid significant loss for the employee shareholders whom the DOL is charged with protecting.

The DOL's position that directed trustees only may have obligations of inquiry based on information of which they have actual knowledge creates yet another concern. The actual knowledge standard provides an incentive for directed trustees to avoid investigations even in the face of strong signals that something is amiss at the employer. This is inconsistent with the usual view that additional information is good for the functioning of an efficient market as well as the traditional belief that fiduciaries should not be permitted to avoid liability by willfully remaining ignorant.

**b. The Fiduciary Rationale**

The other rationale that the DOL supplies for its narrow view of directed trustee obligation is fiduciary-related. Specifically, the DOL relies on stringent ERISA fiduciary standards, which apply to the fiduciaries giving investment directions, to support its view that directed trustees have virtually no duty of inquiry regarding the correctness of those investment directions.<sup>244</sup> Elsewhere in the FAB the DOL recognizes that the statute prohibits directed trustees from following any direction that the directed trustee “knows or should know is contrary to ERISA [including a direction that] violate[s] the prudence requirement of [ERISA.]”<sup>245</sup> In effect though the DOL assumes that the statute's fiduciary provisions effectively prevent a fiduciary giving an investment direction from violating ERISA's prudence standards. Apparently, since the underlying directions will not violate the prudence requirements, the directed trustee will never be faced with a

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<sup>244</sup> FAB 2004-03 at 5.

<sup>245</sup> *Id.* at 3.

situation where the direction it receives violates its prudence obligation so it has no duty to make an independent inquiry about the direction. This reflects a view of statutory compliance by conflicted fiduciaries that is as naïve as the DOL's apparent position that the federal securities laws fully eliminate fraud and ensure market efficiency.

Comparing the ERISA approach on EMH with the approach used in Delaware for appraisal actions is particularly apt in the sense that the most significant concerns tend to arise in circumstances where conflicted insiders have substantial involvement in company stock transactions. Under both ERISA and state corporate law those conflicted insiders with asymmetrical informational advantages are fiduciaries. In comparison, the normal corporate actors being regulated by SOX do not owe fiduciary obligations to the company's shareholders.

Along with fiduciary status comes obligation that cannot be wiped out by mumbling the magic letters EMH. Traditionally fiduciary law has reflected the principle that a trustee acting under a conflict of interest will too often be tempted to place personal interest ahead of the beneficiary's best interest.<sup>246</sup> This concern is implicit in the appraisal cases as the courts' evaluations of numerous factors in establishing a fair price frequently arise when conflicted fiduciaries with informational advantages are heavily involved in the transactions.<sup>247</sup> Similarly, corporate law policymakers permit exculpation of fiduciaries for breaches of duty of care but not of loyalty.<sup>248</sup> There appears to be inherent distrust in market forces in the face of meaningful conflicts of interest.

Significant differences exist among directed trustees, the corporate insiders who take part in the decision to use company stock in benefit plans, and those insiders who

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<sup>246</sup> Muir & Schipani, *supra* note 2, at 440.

<sup>247</sup> See *supra* text accompanying notes 29-89.

<sup>248</sup> See *supra* text accompanying notes 108-112.



participate in a going private transaction or other similar corporate reorganization. The directed trustee's conflicts of interest typically would be more attenuated than the conflicts of the insiders. Although the insiders may have a direct interest in manipulating the company's stock price, the conflict experienced by the directed trustee typically would be its interest in maintaining the plan's business by not alienating company management and in minimizing its expenditures on plan oversight. Directed trustees also typically have substantially less access than internal corporate actors to informational advantages.

Recognition that directed trustees tend to operate under fewer conflicts than do company insiders, though, is not at all the same as wholly negating the importance of the directed trustee's fiduciary role or the threat of a loyalty violation. The common law equivalent of ERISA's directed trustee is a trustee where "a person other than the trustee [has] the power to control the trustee's actions."<sup>249</sup> If the party giving directions is a fiduciary then the common law trustee has an obligation to follow the directions unless, and here the standard varies depending on the authority referenced, the trustee "'knows,' 'ought to know,' [had] 'reason to suspect,' [or had] 'no notice'"<sup>250</sup> that the direction is in violation of the fiduciary's duty.<sup>251</sup>

Regardless of whether one chooses the term "ought to know," or had "reason to suspect," or something similar, the common law standard establishes a sensible basis for directed trustee liability. Over hundreds of years of trust law directed fiduciaries have

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<sup>249</sup> Patricia Wick Hatamyar, *See No Evil? The Role of the Directed Trustee Under ERISA*, 64 TENN. L. REV. 1, 38 (1996).

<sup>250</sup> *Id.* at 40.

<sup>251</sup> In contrast, if the direction is given by a trust beneficiary then the trustee must follow the direction so long as the direction complies with the terms of the trust *Id.* at 38.

always had an obligation of care and prudence in situations where “waving red flags”<sup>252</sup> warned the trustee of danger to trust beneficiaries. There is no indication in ERISA that Congress intended to abrogate this centuries-long clearly developed protection for trust beneficiaries. ERISA’s requirement that most plan assets be held in trust,<sup>253</sup> broad definition of fiduciary status,<sup>254</sup> and articulated fiduciary standards<sup>255</sup> signify the exact opposite.

**c. A Litigation Efficiency Rationale?**

So, we return to the bottom line question. Do sufficient rationales support the argument that directed trustees have no duty of inquiry regarding the prudence of investment directions unless one of three narrow situations exist? None of the DOL’s rationales – EMH, federal securities regulation, and ERISA fiduciary regulation – fully sustain such a broad exemption from a duty of prudence nor do they do so when looked at cumulatively.

Let us assume then a world where the broad insulation from obligation outlined in the DOL’s FAB is nullified. Directed trustees would face litigation in significant numbers of 401(k) employer stock and ESOP cases. Using a traditional “ought to know,” or had “reason to suspect,” or similar standard, one would expect plaintiffs to have an uphill battle in these cases. Proponents of EMH can be expected to argue that any ‘waving red flags’ that should have alerted directed trustees were equally observable by all investors. As a result, EMH adherents will believe that the market price of the

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<sup>252</sup> *In re Enron Corp. Secs, Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 601 (S.D. Tex. 2003).

<sup>253</sup> ERISA § 403, 29 U.S.C. § 1103 (2000).

<sup>254</sup> ERISA § 3(21), 29 U.S.C. § 1002(21) (2000).

<sup>255</sup> ERISA § 404(a), 29 U.S.C. § 1104 (2000).

employer stock always reflects those publicly observable flags and that the employer securities were, thus, efficiently priced for the observable conditions.

This EMH argument is fair so far as it goes but it does not justify an irrebutable presumption that the directed trustee has met its fiduciary obligation simply because a security is publicly traded. Even accepting the basic premise of EMH, there are too many reasons to believe that there are times when stocks are not efficiently priced because of manipulative behavior, thin markets, exuberance, and all the other reasons being raised in the finance literature. But, other than the very narrow exceptions, that is exactly what the DOL has established in favor of directed trustees – an irrebutable presumption that they have met their fiduciary obligations simply because the stock is publicly traded. If, after serious review of the finance literature, policy makers remain convinced of the general principles of EMH, it would make sense to articulate standards permitting directed trustees to use EMH as a defense. In the meantime, the courts should evaluate EMH arguments on a case-by-case basis. Plaintiffs, however, should be allowed to overcome any EMH defense by proving either that the stock in question did not trade in an efficient market or that even though the market was efficient in incorporating information that there was insufficient or inaccurate information in the market and that the directed trustee knew or ought to have known or had reason to suspect that the stock was not a prudent investment. This approach would permit the robustness of EMH to be considered on a case-by-case basis and would enable the law to incorporate the insights of the finance literature as that literature continues to mature.

Directed trustees may argue that the size and complexity of today's benefit plans would require them to accept too much risk under the "ought to know" or "reason to

suspect” standards but reasonable alternatives exist. No entity is forced to act as an ERISA trustee. An entity may remain active in the plan business but act only as a custodian without any discretionary authority, and thus without fiduciary status. By accepting directed trustee status but seeking to avoid historic fiduciary obligations directed trustees seek the best of both worlds – the higher fees and trust of plan participants that presumably come with directed trustee status along with limited fiduciary liability. As an alternative to limiting its actions to that of a custodian, an entity acting as a directed trustee may engage an independent fiduciary to review directions regarding plan assets. So long as the directed trustee meets the usual ERISA standards for delegation of fiduciary duties, which requires due care in the selection and oversight of the independent fiduciary,<sup>256</sup> the directed trustee should be permitted to rely on the decisions of the independent fiduciary.

From a larger systemic perspective one might argue that the DOL did the right thing to protect directed trustees from any duty of inquiry regarding the prudence of investment directions except in the rarest of circumstances. After all, depending on one’s view of the general prudence of employer stock, one might expect that those directions rarely would order the directed trustee to make imprudent investments. The litigation costs that result from claims against directed trustees can be expected to be substantial as those cases are likely to require extensive analyses of market efficiency and whether the directed trustee was in a position to make a valid call of imprudence. Alternatively, directed trustees will settle those suits, as they have in cases such as Enron and WorldCom. Either way, the costs directed trustees can be expected to face, and ultimately pass along to employees who participate in 401(k) plans and ESOPs, likely

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<sup>256</sup> Muir & Schipani, *supra* note 3, at 467.

will be substantial. Those who accept the low likelihood of problematic investment directions, the difficulties directed trustees would have in identifying imprudent directions, and the costs of establishing and enforcing reasonable behavior through litigation, may decide it is sensible from a public policy standpoint to insulate directed trustees from the duty to ensure investment directions are prudent. But, eliminating a statutory fiduciary obligation is a decision that Congress should make explicitly, not one to be made by an administrative agency in a release never subject to public notice and commentary.

#### **D. Link to SOX**

Whether one looks at SOX, state corporate law, or company-sponsored employee investment plans, the availability of sufficient and accurate information is critical to securities pricing. The same corporate scandals that resulted in the enactment of SOX - Enron, WorldCom, and so many others - also were among the situations that led to employees losing vast amounts of assets in their retirement accounts. It should be no surprise that those employees have sought to hold liable the fiduciaries, who according to federal law are responsible for ensuring the prudence of both the plans' investment alternatives and the companies' use of employer stock in making their plan contributions. These claims have counterparts in most instances to fraud claims made by general investors under the federal securities laws.

Here we not only consider those general issues, we also look at the use of finance theory, focusing primarily on EMH, in establishing regulatory policies intended to address the sufficiency and reliability of information flows to the market. Commentators

have alleged that in seeking through SOX to enhance the reliability of corporate disclosure congress failed to consider the empirical finance literature. The argument made is that as a result SOX establishes a costly and ineffective regulatory regime. In comparison, the DOL relied heavily on EMH in establishing broad protections for directed trustees. Although that protection may be institutionally efficient, it does not conform with the fiduciary obligations established by statute. The DOL's rationale fails to recognize the scholarly debate on the robustness of EMH and the situations where, even assuming significant robustness of EMH, the market for publicly traded securities may not be efficient. Finally, by protecting directed trustees from the duty to ensure the prudence of investment directions they receive, the DOL negates the incentives those fiduciaries would have to engage in reviews that could be expected to bring additional information, albeit perhaps in rare instances, to the markets.

#### **IV. Conclusion**

SOX was enacted in 2002 in response to the corporate scandals wreaking havoc on the capital markets.<sup>257</sup> The legislation was intended to help restore the faith of the

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<sup>257</sup> According to Senator Sarbanes:

Our markets, which have the reputation of being the fairest, the most efficient, the most transparent in the world, have suffered greatly in recent times, so much so that they seem to have lost the confidence of our investors. It is our purpose, with this legislation and through other actions that will have to be taken by the regulatory agencies and by the private sector, to see that once again our capital markets deserve the enviable reputation for fairness, efficiency, and transparency that they have enjoyed through the years.

148 CONG. REC. S7350, S7352 (2002) (Remarks of Sen. Sarbanes). The President of the United States, George W. Bush, has also remarked:

America's system of free enterprise, with all its risk and all its rewards, is a strength of our country and a model for the world. Yet, free markets are not a jungle in which only the unscrupulous survive or a financial free-for-all guided only by greed. The fundamentals of a free market—buying and selling, saving and investing—require clear rules and confidence in basic fairness.

Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 WEEKLY COMP. PRES. DOC. 1283, 1284 (August 5, 2002). See also S. REP. NO. 107-205, at 2 (2002) ("The purpose of the bill is to address the systemic and

investing public through enhanced disclosure requirements.<sup>258</sup> Implicitly, the legislators seem to have recognized that the markets cannot operate efficiently if corporate officials withhold information and perpetrate fraud.

Like the legislators adopting SOX, there seems to be implicit recognition by the Delaware legislators and courts that markets can only work when accurate information is forthcoming. Where transactions present conflicts of interest, which in turn may cause information to be withheld from the markets or relevant parties, Delaware corporate law is quick to closely scrutinize the transactions for fairness.<sup>259</sup>

The statutory appraisal cases in Delaware illustrate this point. Where the minority shareholders are frozen out for cash, they are not given the opportunity to reap the benefits of the new enterprise with the majority shareholders. In these circumstances, the minority shareholders are provided the right, by statute, to a judicial determination of the fair value of their shares.<sup>260</sup> This is true even when the shares the minority shareholders are forced to surrender were traded, prior to the transaction, on a national exchange.<sup>261</sup>

This situation presents serious concerns that the majority shareholders, due to the inherent conflict of interest, may be withholding information from the markets, and the

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structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years.”); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1153 (2003); Roberta S. Karmel, *Appropriateness of Regulation at the Federal or State Level: Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOKLYN J. INT’L L. 495, 545 (2003); Kourtney T. Cowart, *The Sarbanes-Oxley Act: How a Current Model in the Law of Unintended Consequences May Affect Securities Litigation*, 42 DUQ. L. REV. 293, 293 (2004).

<sup>258</sup> See, e.g., S. REP. NO. 107-205, *supra* note 257, at 32-33 (“Only if the investing public believes that the information available to them is fair, accurate, and transparent can they have confidence in the integrity of the financial markets and the investment professionals who serve them”); *ABI Roundtable Discussion: Remember When – Recollections of a Time When Aggressive Accounting, Special Purpose Vehicles, Asset Light Companies and Executive Stock Options were Positive Attributes*, 11 AM. BANKR. INST. L. REV. 1, 39 (2003).

<sup>259</sup> See *supra* note 119 and accompanying text.

<sup>260</sup> See *supra* notes 19-23 and accompanying text.

<sup>261</sup> See *supra* note 21 and accompanying text.

market price may thus not reflect fair value. The courts then utilize financial models acceptable in the financial community to determine fair price,<sup>262</sup> providing a check on the market.

The DOL and company stock cases take a different approach. The DOL has stated that directed trustees have no duty of inquiry regarding transactions in publicly-traded securities except in three specified and very limited situations. It appears the DOL reasons that federal fiduciary and securities regulation ensure the sufficiency and accuracy of information flows to the capital markets. According to EMH those markets efficiently incorporate that information. This logic indicates that directed trustees should rarely have any reason to inquire regarding the prudence of investment directions. The DOL's position relies on EMH and other federal regulation then to deregulate directed trustees.

This deregulation, however, depends on the robustness of other federal regulation and EMH to exempt directed trustees from their fiduciary obligation of prudence. In doing so, the deregulation ignores the scholarly controversy over the robustness of EMH. It ignores the possibility that specific stocks may trade in inefficient markets. It ignores the possibility that conflicted fiduciaries may issue investment orders that violate their duties of prudence and that a directed trustee would know or have reason to suspect a violation.

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<sup>262</sup> See *supra* notes 34-36 and accompanying text.