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DIRECTOR RESPONSIBILITY -- A GOVERNMENT VIEW

REMARKS OF

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I am very glad to be here and to have a chance to participate in this discussion of an important topic. I was rather intrigued by the title assigned to my remarks which is "Director Responsibility -- A Government View." This appears to assume that there is such a thing as a government view, or at least an SEC view, of this subject. This assumption is a little surprising in view of the fact that the functions and responsibilities of corporate directors have their origin in state law. The typical state corporation statute says, with majestic generality, that "the business of the corporation shall be managed by a board of directors" who are elected by the shareholders. There has been surprisingly little change in the basic concepts of a corporation embodied in state corporation law over approximately a century during which time corporations themselves have changed to an extent which makes them almost unrecognizable. This is not to say that state corporation laws have not been improved in various respects, nor that accommodations have not been made, particularly to the needs of corporate financing.

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As the publicly-owned corporation evolved and grew in the latter part of the 19th Century and the early part of the 20th Century into the primary economic institution in our increasingly complex and interdependent society, the general concepts provided by state law as a basis for its governance came under increasing strain. In the first place, the idea that large publicly-owned corporations are "managed" by boards of directors began to look increasingly fictional. A part-time board of directors could hardly do the job of managing such a corporation, even if they wanted to, and frequently they did not want to. Thousands of scattered public stockholders could not control the corporation either, even if they wanted to, and increasingly, they also did not want to. Rather, they invested, as investors have always done, in the hope of a reasonable return and possible appreciation. Publicly-owned corporations came, in fact, to be managed by a management team headed by a chief executive officer, although in legal theory these executive officers were merely employees of the corporation selected by and responsible to the board of directors.

The corporate scandals of the 1920's and the depression of the 1930's produced widespread dissatisfaction with the way corporations were being run and with the treatment accorded to investors. Some consideration was given to the idea of a federal corporate law, although this proposal did not get far.

But it is against this background that the federal securities laws were enacted. It is quite clear from the legislative history of the Securities Act of 1933, as well as from certain specific provisions of that Act, that the Congress intended to place considerable reliance upon the board of directors and that it was highly critical of "directors who do not direct." As the House Report on that Act explained,

> "Directors should assume the responsibility of directing and if their manifold activities [of serving on numerous boards] make real directing impossible they should be held responsible to the unsuspecting public for their neglect." 1/

To accomplish this objective, Congress required that a registration statement for a new issue of securities, which was the primary disclosure document contemplated by the statute, should be signed by a majority of the board of directors, and, in Section 11 of the Act, imposed personal liability on any such signatory if the registration statement contained any "false statement of a material

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1/ H.R. 85, 73rd Cong., 1st Sess. (1933) at 5.

fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." A director can avoid such liability, however, if he proves that "he had, after reasonable investigation, reasonable ground to believe and did believe" that the registration statement contained no such deficiency.[2/] Particularly illuminating as to the mood of Congress is the evolution of what became Section 15 of the Securities Act. The bill as reported to the Senate, proceeded to define the term "dummy", and to provide that if any director or other person who signed the registration statement was a "dummy", he should identify himself as such and state for whom he was a "dummy". This was replaced in conference between the House and the Senate by existing Section 15 of the Act, which, in substance, imposes liability on any person who controls a person who is liable under the Act unless the controlling person establishes that he acted in good faith and did not induce the conduct creating the liability. This provision may be applicable to directors, on the theory that the board controls the corporation and its

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2/ Where a portion of the registration statement, such as a financial statement, is included upon the authority of an expert such as a public accounting firm, then the director's duty of investigation may be dispensed with but he still must have reasonable cause to believe that the information was not defective.

officers. Curiously enough, although Section 11 of the Securities Act has been on the books ever since 1933, the first authoritative judicial exposition of its meaning and scope, including the liability of directors under that Section, did not come until 35 years later in 1968, when the decision in Escott v. Barchris Construction Corporation came down in the Federal District Court in New York. Judge Edward McLean, who decided that case, was no newcomer to the financial scene. Before his elevation to the Bench, he was a senior partner in a distinguished Wall Street law firm. This decision, which held all the defendant directors liable, basically upon the ground that their independent investigation with respect to the registration statement did not amount to much, hit the financial community like something resembling a bombshell. I remember being invited to a session in New York to discuss the implications of the case shortly after it was decided. That session was a little like this one, except that we had over 2,000 people in attendance. Although Judge McLean's opinion covers some 50 pages of the federal reports,[3/] I commend it to all of you as a very lucid description of what can go wrong in the operation of a corporation by

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3/ 283 F. Supp. 643.

no means conceived in fraud or inequity but only in over-optimism and carelessness, and of the unfortunate consequences for all concerned.

The Securities Exchange Act of 1934 unlike the Securities Act contains no provision specifically imposing liabilities on directors as such. It does, however, contain a controlling person provision like the one in the Securities Act which I have mentioned. It also contains antifraud provisions, particularly Section 10 and Rule 10b-5 thereunder, of which all of you have probably heard. State law and Federal law interact in this area. The state courts at an early date held that the directors of a corporation have a fiduciary responsibility to that corporation and in many instances to the stockholders as well. In turn, it has been held under the federal securities laws that in a variety of instances a breach of fiduciary duty in a securities transaction may violate these antifraud provisions. In the context of director's responsibilities, this concept of fiduciary duty establishes a relationship, but it does not answer particular questions. As Justice Frankfurter said in an SEC case some thirty years ago,[4/]

"but to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What

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4/ SEC v. Chenery Corporation, et al., 318 U.S. 80, 84-85 (1943).

> obligation does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

I think it fair to say that with respect to director's responsibility under the federal securities laws the "further inquiry" has been proceeding, but all of the questions have not yet been answered. I will not attempt to explore the development of case law and Commission precedent in this area, since it would take an inordinate length of time and those of you who are not lawyers would probably be both confused and bored before I got through. It is clear, however, that there is at least a federal interest in this subject, if not a fully developed government view.

In recent years, we have commenced some lawsuits in which directors were named as defendants. In response to this it was suggested that instead of suing people based on our conclusion that they had not lived up to responsibilities which were not clearly defined, we should lay out a set of guidelines for corporate directors specifying what they should, and what they should not, do. This seemed an eminently reasonable proposition and we, accordingly, asked our staff to develop such guidelines. In a speech in April, 1973, former Chairman Cook optimistically suggested that these guidelines should be forthcoming in a matter of

weeks. As you may have noticed, they have not yet appeared. Our present Chairman, Ray Garrett, announced in a speech on December 17, 1974, that this project had been shelved. I think this announcement was greeted with a sigh of relief not only on the part of our staff, who found the assignment to be an almost impossible one, but also upon the part of the corporate community, who looked with considerable apprehension upon what we might come up with. That experience demonstrates that this is not an area which lends itself to the formulation of what law professors refer to as black letter law. On the contrary, the circumstances which confront directors are so infinitely variable that in this, as in many other areas, good judgment is the primary requisite.

It is, of course, clear that a director cannot intentionally participate in a fraudulent scheme. There is no disagreement about this. The problem rather is what are the responsibilities of the honest and well-meaning director. I refer here primarily to the outside director, since a director who is also an officer has responsibilities, and may get into trouble, in the latter capacity. Such a situation is not really a problem of director's responsibilities. Even with respect to the honest outside director, some propositions are fairly well settled.

A director who knows that the officers of his company are engaged in deceiving the investing public, and does nothing about it, will probably be held responsible, even though he does not participate in such a scheme. At the other extreme, an outside director cannot be expected to know everything that goes on in a large corporation or supervise the activities of all its personnel; nor can he be an insurer that violations will not occur.

Perhaps the most perplexing problem for directors is to identify those situations which are of such a nature as to call for an unusual response upon the part of a director. As a practical matter, so long as everything is going well, an outside director is fairly safe. But when things start to go wrong then he has a potential problem as well as a challenge. The crucial question for the director is his ability to recognize such a situation before it has gotten out of hand. This is complicated by the distinct possibility that management, may not fully recognize the seriousness of a situation, or may try to gloss things over in the hope that everything will turn out well. A regular and reliable information system for directors together with an understanding of the business on their part is their best protection.

There is another type of analysis with respect to directors which, while not addressed specifically to legal issues and legal duties, may hold more promise for resolution of some of the underlying problems than a purely legal approach can do. This involves the examination by thoughtful businessmen, scholars and economists of such basic questions as what the functions of the board of directors should be, how should it be organized, what should the contribution of an individual outside director be and how does the board, and particularly the outside director, interact with management? When you look at these questions you find a variety of suggested answers, as well as some dilemmas in terms of responsibility. Some have suggested that the primary function of the board is to concern itself with matters of overall policy or to exercise general supervision. Others suggest that a principal value of the board is to bring to the management of the corporation a fresh viewpoint, such as may be provided by a minority representative, a univerity professor or a woman. Others conclude that a major value of the board is to provide management with advice, drawn from their own experience in business, as to possible approaches

to business problems. And there are some who propose that the board, or at least the outside directors, should serve as watchdogs on behalf of the shareholders. It has also been suggested that the most important function of the board is to select the chief executive officer, to make sure that succession to that position is provided for, and to replace the chief executive officer if it, unhappily, comes to that. All of these functions may well be important, but it is a little hard to see how a board can satisfactorily perform all of them at once. It would be helpful if a consensus could be developed as to which of these functions are primary and how best can they be performed. It also may be that the relative importance of these board functions may vary both from company to company and from time to time, depending upon circumstances. Given the variety of important functions which a board can perform, it necessarily follows, however, that the idea sometimes encountered that membership on the board of directors of a large publicly-owned corporation is a species of civic honor, the duties of which do not extend much beyond showing up for meetings, enjoying a good lunch and receiving an honorarium, has become obsolete. If that idea receives decent burial at the hands of the business community, a good deal will have been gained.

Another approach which I have observed is to examine the workings of the boards of directors of corporations which are generally regarded as very well managed. I have been surprised at the amount of thought which some such corporations devote to such matters as keeping the members of the board well informed, providing them with staff assistance, informing them at the outset as to what will be expected of them and assuring them that the chief executive officer takes the board seriously and expects its members to do the same. Of course, the elaborate and rather expensive procedures in this regard which are utilized by some of the largest corporations can hardly be applied to smaller companies and in this area I suspect that more work needs to be done. Our enforcement problems with respect to directors seem to arise more often in smaller corporations where the directors have no very clear idea as to what they are supposed to do, where the information flow to directors is somewhat haphazard and where things are sprung on them at the last minute. In view of the fact that smaller corporations may be particularly vulnerable to adverse developments, it would seem that their directors may need more help than the directors of General Motors but they are unlikely to get it.

The whole idea of having true outside directors is of rather recent origin. Of course companies have frequently had their banker and their lawyer and a large stockholder or two on the board, and the chief executive officer may bring in a couple of executives of other companies whom he respects in order to have the benefit of their advice on business problems. But the modern outside director seems to be something rather different. He is certainly different from the leading citizen who was sometimes selected for the sake of his name, or to lend respectability to a compny which was in need of it. If the recent emphasis on director's responsibilities and liabilities eliminates that type of director it will have served a useful purpose.

The modern outside director may be a professional director, which is also a novel idea and may take some getting used to. It seems to me very promising, however. One of its virtues is the fact that such a person may be expected to take the job of being a director seriously, it is not a side line for him, and he will probably have studied the question of what a director and a board of directors should do. This could well revitalize a board which has never been anybody's primary job. Furthermore, the very fact that such a professional director has been selected evidences the fact that the chief executive

officer believes that the job of the board is important. This, I have been told is a key factor in the effectiveness of a board and I can well believe it.

You may well ask at this point what all this discussion of the functioning and the composition of the board has to do with the question of director's responsibilities under the federal securities laws. I think it has a good deal to do with it. The Congress quite clearly was dissatisfied with the way boards of directors operated in the 20's and imposed responsibilities and liabilities upon directors as one means of protecting investors and advancing the public interest. Any developments which improve the effectiveness and stature of directors should serve that end. While the idea that directors should serve as watchdogs for the stockholders can be, and often is, overdone, nevertheless vigilant and independent directors, functioning effectively, can be an important safeguard.

Finally, we do not really enjoy suing directors since it often happens that they are the victims of circumstances and bad luck, or did not realize what they were getting into. If it was never necessary to do this we should be very pleased. Where directors understand what they are supposed to do, take their responsibilities seriously and are kept adequately informed, they will not only do a

better job but should be able to show a record of performance which will commend itself to a court if the occasion arises. This is probably the best insurance against unwarranted liability.