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DIRECTORS AND PRESENT SHOCK

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In listening to the discussion today, and in listening to similar discussions in the past, I think it is important to differentiate the concern which the Commission has with respect to the problem of director responsibility and director activity and that of others. In many instances people are concerned with the manner in which directors carry out their responsibilities principally as they relate to the social responsibilities of corporations. It is felt that directors have a distinct responsibility to assure that corporations act in a socially responsible manner and that changes in the manner of selecting directors, attention to their standards of conduct and various structural changes in the makeup and activity of the board should be for the purpose of enhancing the willingness of directors to move their corporations in the direction of greater concern for the public welfare. Without suggesting in the slightest that the Commission is unconcerned with these aspects of directoral responsibility, nonetheless I think it is fair to say that the Commission's principal focus is somewhat different and perhaps narrower. The Commission is principally concerned with the protection of investors and the integrity of securities markets; hence, when it considers the responsibilities of directors,

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it thinks of those in terms related to investors and markets and it is concerned with whether directors have violated the laws administered by the Commission which are designed to those ends.

I have heard today much discussion, and I have read extensively in the past, about various purposals for structural change in either the composition of the board or the manner of its election or its relationship to the corporation it serves and I am aware of the experiments that has taken place in other countries, as well as by corporations on a voluntary basis in this country. I apologize if I seem unduly pessimistic and cynical, and perhaps in the eyes of many unduly conservative (that is a trait of which I am rarely accused), but I frankly doubt whether we may expect dramatic changes in the manner in which boards of directors function as a consequence of any of the structural changes that have been proposed. Furthermore, I am not at all sure that if some of the proposals were fully implemented the net result would be a discernible public benefit, or that corporations would be more responsible, or that investors would be better protected, or that the criticisms with regard to boards of directors would be stilled. Furthermore I think evidence is lacking that some of the new approaches, such as the two-tier system in Germany and now emerging in other European countries, have really resulted in net benefits. Similarly, in cases in which there have been "public representatives" on the board of directors, I think evidence is lacking that this has resulted in a better performance by those boards than boards without such public

representation. It seems to me that in many instances the suggestions for change draw their life from ideology or from frustrations, but none of these are sufficient to assure a happy result.

Beyond the pessimism I express about whether these changes might really accomplish as much as their advocates believe they would, I think there is the further question whether it is reasonably expectable that significant structural changes will be accomplished. Certainly anyone who is familiar with the history of state legislation in the corporate area knows that is futile to expect states to significantly raise the standards of performance expected of directors and it is idle to believe that states will adopt changes concerning the composition, mode of election or other aspects of boards of directors if such proposals encounter strong opposition from management. Through the entire course of this century there has been competition among states to lure corporations to incorporate in them on the promise of minimum interference with managerial discretion. As the Report of the Corporation Law Revision Commission of New Jersey said in 1968, "Any attempt to provide such regulations of the public interest through state incorporation acts and similar legislation would only drive corporations out of the state to a more hospitable jurisdiction." Thus I doubt if we can expect much in a way of change emanating from state legislatures, and similarly, restrained as they are by the words of the statutes, it seems unlikely that state courts will provide much energy toward reform.

As far as the possibility of federal incorporation goes, I think most commentators today are fairly pessimistic as to the likelihood of such an enactment. This is not a new idea. For decades scholars and others have considered the desirability of federal incorporation of major corporations and perhaps all publicly held corporations; nonetheless, no less experienced public servant and teacher than Professor William Cary does not foresee the likelihood of near term progress in accomplishing federal incorporation. Personally, I think there is much to be said for a federal corporation statute under which publicly held corporations would be incorporated. It seems to me that at this time in the history of our nation, when public corporations stretch from coast to coast and beyond, when their shareholders are spread throughout the 50 states, when they have impact upon the economies of states far removed from the states in which they are incorporated, it is a little bit ridiculous to perserve the notion that their basic charters should depend upon the whim of a single state's legislature. The manner in which corporations are governed, the powers that are given them, the rights accorded shareholders, the duties imposed upon the directors and officers, and a host of other matters are much better handled on a uniform national basis. However, having said that, I must say it is by no means certain that federal incorporation will be the panacea foreseen by many; after all, while it would be extremely unlikely given the present political atmosphere, it is not impossible that Congress would

enact an incorporation law bearing striking similarities to Deleware. What I am saying is simply that the extent to which federal incorporation would constitute reform would depend upon the contents of the federal incorporation law and on that we certainly at this time have no assurance.

While I admire the voluntary innovations that have been developed by such corporations as General Electric Corporation and Texas Instruments, nonetheless, I think it requires a degree of optisimism far beyond that possessed by me to foresee that these or similar changes are going to become epidemic voluntarily. These experiments undoubtedly provide very valuable lessons for other corporations and it may well be that they will have a certain number of imitators. However, I would think that the overwelming bulk of businesses will, absent legal pressures, continue to do business the same way, with the same methods of organization, the same composition of boards and the same structure. It may be that the performance of directors will be improved, but I would suggest that this will come about more as a result of factors I will discuss shortly than the impact of voluntary changes accomplished by a few corporations.

At the cost of sounding parochial, I would suggest that perhaps the best hope of significant change in the manner in which directors carry out their responsibilities to shareholders, the investment community and the market place lies in the continuation and perhaps acceleration of the work that is being done by the federal

courts and the Securities and Exchange Commission. If one looks to federal law for sustenance in the effort to improve directors' conduct, about the only place this can be found, at least in so far as it applies to the bulk of publicly held corporations, is in the federal securities laws, and even their, explicit sustenance is meager. With a single exception there is nothing in the Securities Act of 1933 or the Securities Exchange Act of 1934 - the statutes that most directly impact publicly held corporations - which is designed to define or raise the expected conduct of directors. The only portion of which that might be said is Section 11 of the Securities Act of 1933 which provides the standard of care that a director must establish if he would escape liability for misstatements and omissions in registration statements filed in connection with the distribution of securities. This has application only to a registered offering of securities and has no application to the run-of-the-mine, day-to-day conduct of a corporation.

This is somewhat strange, since the literature of the early 30's out of which was born the '33 Act and the hearings which led to its adoption and that of the Securities Exchange Act of 1934 are heavy with searing comments about the passivity of directors and abundant testimony of their shortcomings. Despite this Congress dealt with considerable leniency with the problem. In some measure this may stem from federalism concepts then prevalent, which resulted in Congress being reluctant to step into areas that were then, as they had traditionally been, regarded as the problems of the states.

The source of most of the Commission's and Court's accomplishments in the area of director responsibility has been that all-embracing and enigmatic administrative expedient, Rule 10b-5 adopted under Section 10(b) of the 1934 Act. This Rule makes no reference whatsoever to directors except insofar as they are included in the term "persons" who are the ones addressed by the rule. This rule makes it illegal for "any person" to engage in manipulative, deceptive, fraudulent and certain other kinds of activity "in connection with the purchase or sale of a security". It has been the breadth of this rule, with it virtually limitless opportunities for application to a variety of factual situations, and its imaginative interpretation that, combined with expansion of the concept of "aiding and abetting" a violation of the law, has been the principal basis upon which federal courts and the Commission have, quite frankly, begun erecting a fairly formidable set of standards for not only directors, but accountants and lawyers as well.

As a consequence of Rule 10b-5 and the proxy rules, it has been said that the Commission and the courts have been developing "federal corporation law". Certainly there is some truth in this. Increasingly the relationships between shareholders and directors, shareholder participation in corporate electoral processes, the responsibilities of controlling persons, officers and directors have become matters of federal concern where previously they were governed, to the extent they were at all, by state law. This has

come about, in my estimation, and in this I parrot to some extent reflections of Professor William Cary, because the expectations of the people with regard to the conduct of those bearing responsibility for corporate affairs were not met by state law. In a democracy the expectations of large numbers of people either get satisfied in one way or another or there is serious rupture. These expectations, unsatisfied by state law, sought satisfaction in the federal arena through Rule 10b-5 and the proxy rules, and the courts and the Commission provided the means of at least satisfying in part these expectations. While neither the courts nor the Commission are elected, nonetheless, I think it can fairly be said that they are responsive to the expectations of the public and will often within the limits of their power seek to satisfy those expectations. Examples in which this has happened leap to mind: when state legislatures and Congress failed to satisfy the expectations of significant numbers of people in regard to the elimination of segregation and the inequities deriving from apportionment, the courts found within the framework of the Constitution the means to satisfy those demands.

The courts have construed the words "in connection with the purchase or sale of a security" as meaning that the defendant in an action need not have actually participated in the purchase or sale of a security and the courts have, urged by the Commission, concluded that whenever a corporation's securities are publicly traded, conduct prohibited by Rule 10(b)(5) is in connection with the purchase or sale of a security. Thus, the simple existence of a trading market is enough to result in liability under federal law for manipulative, fraudulent or deceptive conduct, or the aiding and abetting of it.

While very little litigation involving outside directors has reached final adjudication, nonetheless there have been significant settlements and there have been many rulings by courts which have pricked out the boundaries of Rule 10b-5. These events have shaped opinion, as have determinations by the Commission with regard to commencement of litigation. As probably everyone here knows, recently the Commission authorized action against three outside directors in the Penn Central Corporation as well as its auditors and various other people. Without discussing the merits of this litigation, I think it should be noted that the Commission did not sue all directors but rather determined that in this situation only the conduct of some of them fell sufficiently short of appropriate standards to justify the initiation of an injuctive proceeding.

As a consequence of this entire course of events - preliminary rulings by courts, the commencement of actions by the Commission, discussion in public fori - there has in my estimation been laid the ground work for profound change in the manner in which directors conduct their business, the standards to which they adhere and their involvement in the corporate process. Unquestionably the federal courts and the Commission reflect a higher expectation from directors than do state courts and state legislatures. As this becomes evident through decisions and proceedings the attorneys of publicly held companies have surely taken note; in fact if anything their concern sometimes rises to the level of near panic. This concern and this discernment of trends is communicated to the directors of the corporations they represent and in this manner I think it can be said that there is a distinct "rub-off" effect which probably is nearly as meaningful and

effective as specific legislation would be. In addition to that there is another "rub-off" effect and that is on state courts. Diamond v. Oreamuno decided by a New York State Court is clear evidence of the impact which concepts developed in the federal context can have on state courts and I would expect that in the future there will be even more evidence of this impact.

I recognize that this process is so subtle and seemingly so slow that it is discouraging to those who would like to see a faster pace. And yet, given the pessimisms that I expressed earlier, I think this is the surest course available to us today to accomplish the objectives we have discussed. As a consequence of these developments of Rule 10b-5 I believe there is spreading, and perhaps spreading more rapidly than we realize, through corporate halls a realization that directors may not be as passive as they have been, may not delute their efforts as has often been done by serving on an excessive number of boards, may not rely upon the low standards established by the states as immunization against liability.

As these higher standards are realized, the concern is expressed that it may result in the unwillingness of anyone of competence to serve on the board of a public company. Personally I doubt this seriously. Repeatedly we hear suggestions that the flood of cases against accountants may result in unwillingness on the part of anyone to serve in this role. And yet each year thousands upon thousands of aspiring accountants complete thier education and seek out employment by the accounting firms which have been so frequently assaulted in the courts. Similarly it has been suggested that the heightened interest of the plaintiffs' counsel in the conduct of lawyers may similarly dry up the desire of young men and women to become attorneys - and yet enrollment in law school has never been higher

and the number of young men and women seeking employment in corporate law firms shows no sign of diminution. Similarly after the electrical conspiracy case resulted in the jailing of several corporate executives, it was suggested that no one would serve as a corporate executive since it posed the peril of incarceration, and yet there is no evidence whatsoever that competent men are not seeking advancement into high corporate ranks. Likewise after the Bar Chris [1] case was decided and the directors of that unhappy corporation were found liable for the misstatements and omissions in a registration statement, it was thought it would be impossible to secure anyone to serve on the board of a public company. And yet there are still on the boards of public companies innumerable competent, highly qualified people. Again after the Texas Gulf Sulphur case [2] it was suggested that corporate information would dry up out of fear that the corporation would wander into a misstatement or omit some pertinent fact. Notwithstanding these fears corporate public relations firms have flourished and the Wall Street Journal fills its pages five days a week with outpourings of corporate information.

It is not completely beyond reason to think that perhaps there may be increasing numbers of potential director candidates whose misgivings will cause them to forego serving on boards of directors. If this happens I would suggest it will be temporary and will last until businessmen once again feel comfortable with the heightened standards. There is always a period of acclimation to such changes in society. If one looks back to the enactment of the Securities Act of 1933, you will find in the Fortune magazine issue of August 1933 the direst of forebodings by a prominent New York

[1] Escott v Bar Chris Corp., 283 F.Supp.643 (S.D.N.Y.,1968)

[2] SEC v Texas Gulf Sulphur Co., 401 F.2nd. 833 (2nd. Cir.,1968)

attorney (still living) who foresaw that no underwriter would ever again be willing to undertake any underwritings because of the dangers of Securities Act of 1933. Since that time, of course, numerous underwriters have become extremely rich and the underwriting process has been more affected by poor markets than it has by the Securities Act of 1933. Similarly at that time George O. May, the then dean of the accounting profession, predicted that no accountant could live with the danger of liability imposed by that act, and yet since that time literaly tens of thousands registration statements have became effective, all of them containing the opinions of accountants.

In summary, then, higher standards are being demanded by the public and I think they are being achieved. The federal courts and the Commission are responsive to these demands and are acting. I believe that already there are manifestations of the impact of court decisions and Commission actions. Directors in many cases are being provided with more information than they ever had before; perceptive attorneys are advising their clients that the old rules are no longer sacrosanct. Directors are being compensated in reasonable fashion commensurate with the time they are giving to their tasks, and as they are paid more, they are obviously more willing to devote the time to the task that is required for its competent performance. And increasingly corporations are adopting their own guidelines with regard to conduct of their directors.

This seems like a slow, tedious, frustrating course, and yet, all things considered, I think it provides the most promise of movement toward the goals that I think most people here desire: increased responsibility on the part of directors.

The Commission made known some time ago that it was planning to prepare specific guidelines with regard to the conduct of directors in matters relating to the purchase and sale of securities. We are frequently asked when these guidelines will appear. At the risk of disappointing many I feel compeled to express my absence of faith in the value of the guidelines that have been discussed. In the first place, any guidelines would be limited to conduct related to the purchase and sale of securities, although as I have indicated, in the case of publicly held corporations that concept is extremely broad, and furthermore of course, there would likely be a "rub-off" effect from whatever the Commission did, limited though the sphere of its influence be. Secondly, of necessity it seems to me the Commission would have to stud any guidelines with the same old watchwords of uncertainty, "reasonably", "should have known", and the like, with the result that the guidelines would provide far less consoltation and assurance to directors than they desire. It seems to me that in many areas of the law we have never been able to achieve the sort of certainty that is desired by many and I am doubtful whether directors' responsibilities is an area in which that kind of certainty can be accomplished.

Finally, it seems to me that there is a distinct disadvantage in freezing a rapidly developing area of the law in verbal formulae that may, and perhaps should, be obsolete in the near future. Society's conception of the manner in which corporations should be governed is changing rapidly and it could well be that the adoption of guidelines would impede, rather than hasten, the development of sounder notions in regard to the responsibilities of directors. In a book with which I think

most of you are familiar, Future Shock, the author indicates that the pace of change is constantly accelerating and that our ability to survive both emotionally and physically depends upon our ability to adapt to this change. Certainly conceptions with regard to director responsibility and the functions of corporations are among the most rapidly changing areas in which we are involved. To freeze our concepts today in guidelines could very well hinder the development of much sounder notions tomorrow concerning these matters.