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DIRECTORS' DUTIES AND LIABILITIES UNDER THE SECURITIES ACTS AND CORPORATION LAW

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Now, *here,* you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!***

Introduction

The concern of directors for their possible personal liability for corporate actions has diminished in intensity since the early 1970s.[1] A diligence wrought by a growing respect for potential liability,[2] coupled with preventive measures[3] and directors' wide use of indemnification rights and liability insurance[4] are among factors serving to reduce apprehensions. However, directorial responsibilities under state corporation statutes, common law rules,[5] the Securities Act of 1933 (the '33 Act) and the Securities Exchange Act of 1934 (the '34 Act)[6] continue to be augmented, notably through director-oriented settlements in well-publicized SEC consent decrees entered against numerous corporations and their boards.[7] To para-

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*** Carroll, THROUGH THE LOOKING GLASS, Chap. 2 (1871).

[1] Two oft-cited cases which triggered reappraisal of directorship liabilities are Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) and Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971). *See* text accompanying notes 31-35 *infra.*

[2] There are at least 133 grounds for suing a director for actions he might take or fail to take. *See* KNEPPER, LIABILITY OF OFFICERS AND DIRECTORS § 1802, at 558 (1978). *See also* Farrell & Murphy, *Comments on the Theme: "Why Should Anyone Want to be a Director?"* 27 BUS. LAW. 7 (1972). Insurance statistics indicate that claims against corporate directors have increased 300% in 1974-1979. *See* Article, *End of the Directors' Rubber Stamp,* BUS. WEEK 72, 73 (Sept. 10, 1979) [hereinafter cited as *End of Rubber Stamp*].

[3] *See, e.g.,* PRACTICING LAW INSTITUTE, PROTECTING THE CORPORATE OFFICER AND DIRECTOR FROM LIABILITY (1978); Note, *Framework for the Allocation of Prevention Resources with a Specific Application to Insider Trading,* 74 MICH. L. REV. 875 (1976).

[4] *See* Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers,* 33 BUS. LAW. 1993 (1978). *See also* A.B.A. Committee on Corporate Laws, *Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel,* 34 BUS. LAW. 1595 (1979). Some 95% of the top 1,000 United States corporations now carry director and officer liability insurance, compared with only about 60% in 1974, and annual premiums approximate $125 million. *End of Rubber Stamp, supra* note 2, at 73.

[5] *See* text accompanying notes 106-79 *infra.*

[6] When referred to collectively, the '33 Act and the '34 Act will be termed the Securities Acts. *See* text accompanying notes 26-105 *infra.*

[7] *See, e.g.,* SEC v. Mattel, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH)

phrase the Red Queen's admonition to Alice, their evolving responsibilities demand directors' redoubled efforts if they are to remain sufficiently aware of liabilities their actions may entail.

Directors' duties and liabilities are now complicated by new concerns about how boards, increasingly staffed by outside directors,[8] should act as instruments of corporate governance in a time of rising societal expectations of private industry.[9] While the SEC and private plaintiffs increasingly have influenced directors' behavior through federal securities actions,[10] corporate governance matters in large part remain a function of state law. Indeed, the Supreme Court continues to signal plaintiffs that the corporation statutes and common law, rather than the Securities Acts, are the proper grounds for many corporate governance disputes.[11]

Since the limits of legal controls on directors have been abundantly stressed,[12] a review of the current status of directorial duties and liabilities is timely. To this end, this article addresses *seriatim* the general functions of directors in practice, and how the Securities Acts, corporation statutes, and common law impose specific duties and responsibilities on corporate

¶ 94,807 (D.D.C. 1974) (consent decree by which Mattel, Inc. was to name majority of independent —SEC approved directors to its board to help prevent future violations of Securities Acts). *See generally* Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits,* 89 HARV. L. REV. 1779 (1976); Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief,* 32 WASH. & LEE L. REV. 637 (1975) [hereinafter cited as Treadway]. *Cf.* Note, *The Appropriate Remedy for Breach of an SEC Settlement Agreement,* 51 TEMP. L. Q. 127 (1978).

[8] "More than two thirds of all company boards and seven out of ten billion dollar industrial boards are now dominated by outsiders." Heidrick & Sruggles, *The Changing Board: Profile of the Board of Directors,* 3 DIR. & BOARDS 49, 52 (1979). *See* Cohen, *The Outside Director - Selection, Responsibilities and Contribution to the Public Corporation,* 34 WASH. & LEE L. REV. 837 (1977); Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors,* 52 N.Y.U.L. REV. 1341 (1977) [hereinafter cited as Soderquist].

[9] Ewing, *Civil Liberties in the Corporation,* 50 N.Y.S.B.J. 188 (1978); Manning, *Thinking Straight About Corporate Law Reform,* 41 LAW & CONTEMP. PROB. 3 (1977); Moss, *The Crisis of Corporate Accountability: A Legislator's View,* 3 J. CORP. L. 251 (1978); Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered,* 77 COLUM. L. REV. 388 (1977).

[10] *See, e.g.,* Gubman, *SEC Roundup:Developments Affecting the Director in 1978,* 3 DIR. & BOARDS 33 (1979); Sommer, *The Impact of the SEC on Corporate Governance,* 41 LAW & CONTEMP. PROB. 115 (1977) [hereinafter cited as Sommer]; Treadway, *supra* note 7.

[11] *See, e.g.,* Burks v. Lasker, 99 S. Ct. 1831 (1979). In *Lasker,* the Supreme Court held that state law governs independent directors' authority where not inconsistent with the Investment Company and Investment Advisors Acts, and is applicable to determine whether statutorily disinterested mutual fund directors can terminate a non-frivolous derivative suit against the majority directors and investment advisor. The *Lasker* decision is further reflection of the Court's recent restrictive reading of the Securities Acts. *See* Whitaker & Rotch, *The Supreme Court and the Counter-Revolution in Securities Regulation,* 30 ALA. L. REV. 335 (1979); note 107 *infra.*

[12] *See, e.g.,* Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct,* 31 BUS. LAW. 1031 (1976) [hereinafter cited as Folk]; Schwartz, *A Case for Federal Chartering of Corporations,* 31 BUS. LAW. 1125 (1976).

boards. The subject matter is broad in scope.[13] Hence, the discussion focuses on statutes and decisions[14] which appear of salient concern to directors of widely-held business corporations.[15] This means of organization and analysis will provide a useful degree of synthesis and suggest why directors may be forced into renewed familiarity with their common law duties and liabilities, long de-emphasized due to concentration on securities-related matters.

The Functions of Directors

In examining the duties and liabilities of directors, a preliminary review

[13] Critical articles about the duties and liabilities of directors are extensively noted in the margin since the authors have for the most part necessarily eschewed detailed commentary on the soundness of the statutes and cases discussed.

[14] Outside the scope of this Article are directorial liabilities which may arise under several other important federal statutes. Considerable guidance is already available for directors of multinational firms regarding the Foreign Corrupt Practices Act of 1977 under which the Justice Department and the SEC share enforcement responsibilities. *See, e.g.*, Atkeson, *Foreign Corrupt Practices Act of 1977: An International Application of SEC's Corporate Governance Reforms*, 12 INT'L. LAW. 703 (1978); Mathews, *Functioning of Directors in "Sensitive Payments Inquiries"*, 9 INST. SEC. REG. 83 (1978); *Foreign Corrupt Practices Act of 1977 and the Regulation of Questionable Payments: A Program*, 34 BUS. LAW 623 (1979).

In the important area of antitrust liability, see United States v. Crocker National Corp. 422 F. Supp. 686 (N.D. Cal. 1976); O'Leary, *Criminal Antitrust and the Corporate Executive: The Man in the Middle*, 63 A.B.A.J. 1389 (1977). *See generally* GARRETT, ANTITRUST COMPLIANCE: A LEGAL AND BUSINESS GUIDE (Practicing Law Institute, 1978). In the federal tax area, see Cromartie, *Civil and Criminal Sanctions Applicable to the Corporate Taxpayer, Its Officers, Directors and Employees*, 55 TAXES 786 (1977).

Directors also may incur liability under the environmental protection laws. *See generally* Olds, Unkovic & Lewin, *Thoughts on the Role of Penalties in the Enforcement of the Clean Air and Clean Water Acts*, 17 DUQUESNE L. REV. 1 (1978). As to civil rights violations, see Note, *Intracorporate Conspiracies Under 42 U.S.C. § 1985(c)*, 92 HARV. L. REV. 470 (1978). Regarding liability for criminal behavior generally, see Note, *Criminal Sanctions for Corporate Illegality*, 69 J. CRIM. L. 40 (1978).

[15] Certain precedents cited herein concern directors of financial, insurance and investment institutions. Their directors, however, have special duties and liabilities due to governing legislation which are not specifically addressed in this Article. *See, e.g.*, Coombe, *Directors' Duties and Responsibilities: New Dimensions, New Opportunities*, 95 BANKING L. J. 634 (1978) (bank directors); Castruccio & Hentrich, *Developments in Federal Securities Regulation - 1978*, 34 BUS. LAW. 1159, 1192-97 (1979) (directors of investment companies) [hereinafter cited as Castruccio & Hentrich]; Ulbricht, *Federal Savings and Loan Insurance Corporation Conflicts of Interest Regulations — One Year Later*, 33 BUS. LAW. 693 (1977) (insurance company directors). Similarly, directors of non-profit corporations face special problems not examined here. *See* Note, *Fiduciary Duties of Loyalty and Care Associated With the Directors and Trustees of Charitable Organizations*, 64 VA. L. REV. 449 (1978); Article, *Not-For-Profit Corporation Director: Legal Liabilities and Protection*, 28 FEDERATION INS. COUN. Q. 57 (1977). Further, while many cases in the sections of this article addressing state corporation law and common law involve directors of close corporations, these directors may have certain responsibilities different from their counterparts in widely-held corporations. *See, e.g.*, Jackson, *Federal and State Securities Laws and the Closely Held Corporation*, 4 BLACK L.J. 85 (1975); Leech and Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976).

of the functions currently performed by boards of most publicly held corporations will be useful. While state corporation statutes characteristically provide that directors "manage,"[16] most directors perform considerably different functions,[17] with "management" left to corporate officers.[18]

Boards of directors generally advise chief executive officers, discipline or constrain the actual corporate managers, and actually "manage" corporate resources only in those situations where officers have lost control of operations.[19] Although some boards "establish objectives, strategies, and policies" and "ask discerning questions of the management," the majority do not.[20] This limitation of most boards to very general decision-making and high-level supervision reflects the constraints of chief executives' preferences for advisory boards,[21] the scarce time resources of outside direc-

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[16] *See, e.g.*, DEL. CODE ANN., tit. 8, § 141 (1974); N.J. STAT. ANN. § 14A:6-1 (1969) (West); N.Y. BUS. CORP., art. 7, § 701 (1963) (McKinney).

[17] MACE, DIRECTORS: MYTH AND REALITY (1971) [hereinafter cited as MACE]. Professor Mace based his findings on several hundred interviews with executives of corporations in which the president and directors owned insignificant percentages of the corporation's stock. Also, he mainly examined the functions of outside directors. *Id.* at 3-4.

[18] *See* Conard, Mace, Blough & Gibson, *Functions of Directors Under the Existing System*, 27 BUS. LAW. 23 (1972) [hereinafter cited as *Functions*]. Managers decide on the products to be made by the corporation, give orders to implement these decisions, supervise compliance with their orders, report the results to the appropriate people, and hire, fire, demote and promote personnel. *Id.*

In line with the direction of case law, the drafters of the Model Business Corporation Act (MBCA) in 1974 amended the first paragraph of MBCA § 35 to align it with the unquestioned delegation requirements of today's corporations, particularly large and diversified enterprises. The section in material part now states that "[a]ll corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors . . ." ABA-ALI MODEL BUS. CORP. ACT § 35 (1976).

The draftsmen observe that "[b]efore the advent of the so-called 'outside' director, it was not unreasonable to expect the board to be actively involved in the corporation's business . . . [b]ut such involvement is clearly neither practical nor feasible insofar as today's complex corporation, other than perhaps the closely-held corporation, is concerned." § 35 Comment at 43. The draftsmen further state that:

> It is generally recognized that the board of directors may delegate to appropriate officers of the corporation the authority to exercise those powers not required by law to be exercised by the board itself. While such a delegation will not serve to relieve the board from its responsibilities of oversight, it is believed appropriate that the directors not be held personally responsible for actions or omissions of officers, employees or agents of the corporation so long as the directors, complying with the enunciated standard of care, have relied reasonably upon such officers, employees or agents.

Id.

[19] *See* Mace, *supra* note 17, at 14, 23, 27. Subsequent research has largely confirmed Mace's findings. *See* Bacon & Brown, *Corporate Directorship Practices: Role, Selection and Status of the Board* (The Conference Board, Rep. No. 646, 1975). *But see End of Rubber Stamp, supra* note 2, at 75.

[20] *Functions, supra* note 18, at 36-37.

[21] *See Functions, supra* note 18, at 24-25. Indeed, one prominent manager has plausibly warned that if a board of directors should stray into day-to-day management functions, *see* note 18 *supra*, there is "the danger of ending up with committee management on a part-time

tors,[22] and recognition of the fact that boards increasingly dominated by outsiders[23] do not and cannot actually manage day-to-day operations.[24]

Directors' Responsibilities Under the Securities Acts

A major responsibility of the board, paramount in these inflationary times, is to see that the corporation raises and maintains adequate capital. The issuance and sale of equity securities is of course an important means of raising capital. When their corporations engage in such transactions, directors may be exposed to liability on a number of grounds under the '33 Act[25] and the '34 Act.[26] Although directorial liability is expressly provided in only two provisions of these statutes,[27] a variety of other directorial

basis and nothing could be more disastrous." *Functions, supra* note 18, at 41 (quoting Charles B. Thornton, Chairman of the Board of Litton Industries, Inc.).

[22] An extensive review of directorial time constraints concluded that "[t]he one indispensible requirement for board membership is success at one's principal endeavor and successful people . . . tend to be extremely busy. Outside directors of major corporations spend between 150 and 250 hours per year on board and board committee business, including related travel." Soderquist, *supra* note 8, at 1352-54. One commentator noted emerging demands on directors and raised the issue of time expenditure as follows:

> suppose you regard the role of the board of directors to be . . . in addition: (1) to select and de-select the president — which, in most cases they do not; (2) to monitor and evaluate and measure the president's performance — which, in most cases, they do not; (3) to study and appraise company objectives, strategies and broad policies, such as product line changes, capital appropriation, diversification moves, labor agreements, and so on; (4) to ask discerning questions — which, in most cases, they do not; and (5) to be responsible and accountable to all shareholders — should not directors spend a great deal more time as directors?

Functions, supra note 18, at 37.

[23] *See* note 8 *supra.*

[24] The courts do not expect outside directors to become involved in the day-to-day operations which are rather the function of corporate officers and middle and lower management levels. *See, e.g.,* Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc) (quoting Brief for SEC as Amicus Curiae, at 5). Indeed, one court has indicated that directors should not become so involved. *See, e.g.,* Barnes v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924) (Hand, J.); Burlington Indus. Inc. v. Foil, 284 N.C. 740, 758, 202 S.E.2d 591, 603 (1974). Nevertheless some boards have recently become quite assertive vis-a-vis top management. *See End of Rubber Stamp, supra* note 2.

[25] 15 U.S.C. § 77a (1976). The '33 Act is "designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

[26] 15 U.S.C. § 78a (1976). "The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

[27] Under § 11 of the '33 Act, a director as such may be liable for "material" misstatements and omissions in registration statements filed in respect to securities distributions unless he can establish the so-called "due diligence" defense. 15 U.S.C. §§ 77k(a)(2) (1976) and 77k(b)(3)(A) (1976). *See* text accompanying notes 32-40 *infra.* A director's only other

responsibilities and liabilities derive from those provisions which apply equally to all persons, from the director's position as a "controlling person,"[28] as conspirator,[29] and as "aider and abettor" of others' offenses.[30] Liability based on these grounds may be just as severe as that founded on direct liability.

Federal regulation of securities transactions was initially undertaken in the '33 Act. The '33 Act requires the filing of registration statements and the use of prospectuses in the public sale of securities by an issuer or controlling person. The '33 Act is the first statute to impose liability on directors for "material"[31] false statements or omissions in securities-marketing communications, and imposes directorial liability under several provisions.

If a registration statement is alleged to contain material misstatements or omissions, directors, whether or not they signed the registration statement,[32] will usually be among those sued for damages[33] by disappointed purchasers under section 11 of the '33 Act. The principal defense to an

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express liability is under § 16(b) of the '34 Act which mandates repayment of a director's profits realized in improper short-term trading. 15 U.S.C. § 78p(b) (1976); *see* text accompanying notes 94-105 *infra.*

[28] The '33 Act provision for "controlling persons" is § 15. 15 U.S.C. § 77o (1976). *See* notes 48-50 *infra.* A similar provision is § 20 of the '34 Act. 15 U.S.C. § 78t (1976). *See* notes 72-74 *infra.*

[29] *See* 18 U.S.C. § 371 (1976). Section 371 generally makes unlawful any conspiracy to commit an offense against or to defraud the United States or any agency thereof. *See generally* Ruder, *Multiple Defendants in Securities Law Fraud Causes: Aiding and Abetting, Conspiracy, In Pari Delicto, Idemnification, and Contribution,* 120 U. PA. L. REV. 597 (1972) [hereinafter cited as Ruder].

[30] *See* SEC v. Coven, 581 F.2d 1020, 1028 (2d Cir. 1978), *cert. denied,* 99 S. Ct. 1432 (1979). *See also* Ruder, *supra* note 29, at 620. *See generally* Note, 1978-1979 *Securities Law Developments: Rule 10b-5,* 36 WASH. & LEE L. REV. (1979) [hereinafter cited as 1978-1979 *Developments*].

[31] Materiality is a fundamental yet slippery concept whose definition has been left to the courts. Oft-cited cases have variously defined a "material" fact as (i) a fact which a reasonable investor might have considered important in making an investment decision, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); (ii) information an investor might have considered important, Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970); (iii) a fact which might reasonably affect value, S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); (iv) information to which a reasonable person would attach importance in determining his choice of action, List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965); (v) a fact which a significant number of traders would have wanted to know before making an investment decision, Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971); and (vi) an omitted fact for which, under all the circumstances, there was substantial likelihood of its assuming actual significance in the deliberations of a reasonable shareholder. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[32] *See* 15 U.S.C. § 77k(a)(2), (3) (1976).

[33] Section 11(e) provides that damages shall be the difference between the amount paid for the security and (1) the value of the security at the time suit was brought, or (2) the price at which the security was sold before suit was commenced, or (3) the price received after commencing suit but before judgment [if such damages are less than those recoverable under clause (1)].

action under section 11 is that the director exercised due diligence in meeting registration requirements. The diligence standard is higher for violations occurring in portions of the registration statement considered "non-expertised" (statements not made on expert authority) than for "expertised" portions. As to non-expertised portions, the director generally must prove that he made a "reasonable investigation" after which he had "reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact."[34] As to expertised portions, the non-expert director must prove only that "he had no reasonable ground to believe and did not believe" that there were material misstatements or omissions.[35]

The majority opinion in *Escott v. BarChris Constr. Corp.*[36] was the initial effort to delineate the scope of directors' liability under section 11.[37] Those found liable included the corporation's general counsel, an inside director, who had prepared a faulty registration statement which the court deemed as mostly a "scissors and paste job" from prior prospectuses.[38] Subsequently in *Feit v. Leasco Data Processing Equip. Corp.*,[39] an attorney, who was an outside director, was also found liable under section 11. The *Feit* court suggested that a director's high level of personal expertise may elevate his own due diligence standard. The director in *Feit*, though

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[34] Section 11(b)(3)(A)'s requirement of a "reasonable investigation" by directors creates the due diligence duty. *See generally* Annot., *Due Diligence Defenses Under 15 U.S.C. § 77k(b) Dealing With False Statements Made in Registration Statements*, 2 A.L.R. FED. 180 (1969).

[35] 15 U.S.C. § 77k(b)(3)(C), (D) (1976). Directors have been reminded that expertising can cover only limited portions of the registration statement.

> It has been suggested that first proofs of company registration statements be submitted in advance to the directors so that they may have ample time to comment while changes can be made. (cit.) The most hopeful relief in this area for directors is the indication that directors may rely on actuaries as "experts" as to matters within their particular realm of mystery . . . and to that extent escape liability for statements made in registration statements on their authority. It has long been clear, however, that lawyers are not "experts" within the meaning of the securities acts and reliance on their advice would not absolve the directors from liability.

Hershman, *Liabilities and Responsibilities of Corporate Officers and Directors*, 33 BUS. LAW. 263, 276 (1977).

[36] 283 F. Supp. 643 (S.D.N.Y. 1968).

[37] *See generally* Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1 (1969). The usefulness of *BarChris* "lies in its analysis and application of section 11's elaborate scheme of defenses, particularly its delineation of the standard of care required from persons attempting to take advantage of those defenses." *Id.* at 4. *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200, 208 n.26 (1976).

[38] Escott v. BarChris Const. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968). In discussing the general counsel-director's liability, the court stated that "[a]s the director most directly concerned with writing the registration statement and assuring its accuracy, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work." *Id.* at 690.

[39] 332 F. Supp. 544 (E.D.N.Y. 1971).

not an officer, was intimately involved in the corporation's management.[40]

Material misstatements are not the only way a director may incur liability with respect to a registration statement. If no registration statement was filed but should have been, a director may be liable under section 12(1),[41] under which the purchaser may be granted recision[42] or damages against "any person who offers or sells a security in violation of § 5."[43] Although one's status as a "seller" may frequently be in dispute,[44] liability is practically absolute under section 12(1).[45] A director will not, however, be held liable unless he has taken an active role in facilitating an offering which was not properly registered.[46]

Whereas section 12(1) does not apply to transactions or securities exempted from registration,[47] section 12(2)[48] applies to virtually all transactions, exempt or non-exempt. Under section 12(2), the remedies of recision or damages may lie for material misstatements or omissions in verbal communications or prospectuses[49] "aided and abetted" by a director.[50]

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[40] *Id.* The *Feit* director "was so intimately involved in this registration process that to treat him as anything but an insider would involve a gross distortion of the realities of Leasco's management." *Id.* at 576. It appears that a director with particular legal or corporate experience is especially exposed to § 11 liability because of his expertise. *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1321 (2d Cir. 1973). For earlier reasoning, *compare* McDowell, *Director's Liabilities in Securities Transactions,* 22 BUS. LAW. 76, 78 (1966). "[A]n outside director . . . has a hard time meeting the burden of proof", for "[i]n most cases, the outside director makes no independent investigation of the corporation's affairs in connection with the . . . registration statement"; *"[y]et [his] standard of care . . . is the same as that for an inside director-officer who has spent all this time and effort." Id.* [emphasis added].

[41] 15 U.S.C. § 77e, (1976).

[42] *See generally* Bromberg, *Curing Securities Violations: Rescission Offers and Other Techniques,* 1 J. CORP. L. 1 (1975).

[43] Section 5 of the '33 Act, 15 U.S.C. § 77e, makes various acts unlawful unless certain registration and prospectus requirements are satisfied. Such requirements are not necessary for securities transactions exempted under sections 3 or 4 of the '33 Act. *See generally* Pierce, *Current and Recurrent Section 5 Gun-Jumping Problems,* 26 CASE W. RES. L. REV. 370 (1976).

[44] *See generally* Rapp, *Expanded Liability Under Section 12 of the Securities Act: When is a Seller Not a Seller?,* 27 CASE W. RES. L. REV. 445 (1977).

[45] *See* Lewis v. Walston & Co., 487 F.2d 617, 621 (5th Cir. 1973); Gridley v. Sayre & Fisher Co., 409 F. Supp. 1266, 1272 (D.S.D. 1976). Actions under § 12(1) quite frequently turn on the statute of limitations. Section 13, 15 U.S.C. § 77m, provides that a § 12(1) action must be "brought within one year after the violation upon which it was based" and within "three years after the security was bona fide offered to the public."

See Katz v. Amos Treat & Co., 411 F.2d 1045, 1046-47 (2d Cir. 1969). In *Katz,* two outside directors were held not liable under § 12(1) because one was not a board member at the time of the violations and the other merely signed stock certificates in reliance on officers' representations of proper compliance. The court concluded that § 12(1) is not intended "to embrace a corporate officer or director merely because he has knowledge of a sale of unregistered stock and [had] a minor role in facilitating it".

[47] *See* note 43 *supra.*

[48] 15 U.S.C. § 77l(2) (1976).

[49] *See generally* Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5,* 13 HOUSTON L. REV. 231, 260-61 (1976) (suggestion that § 12(2) places higher disclosure requirements on seller than does Rule 10b-5 of the '34 Act).

[50] *See* Gould v. Tricon, Inc., 272 F. Supp. 385 (S.D.N.Y. 1967). *See generally* Note, *The*

Defenses available to directors include that the misrepresentation was unintentional[51] or that he was not negligent in the matter.[52]

Any director who controls a person liable under sections 11 or 12 of the '33 Act may himself be "liable jointly and severally" under section 15[53] to "any person to whom such controlled person is liable." Since control may derive from "stock ownership, agency, or otherwise," section 15 imposes so-called "secondary liability"[54] for a director who does not directly participate in the distribution of unregistered securities (section 12(1)) or material misrepresentations (sections 11, 12(b)). Clearly, section 15 is of particular concern to inside directors, who must prove that they "had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[55] Outside directors, who often are not knowledgable about disputed aspects of day-to-day operations of the corporation, more easily qualify for such no knowledge defenses than do insiders.

Posing proscriptions much broader than sections 11 or 12, section 17(a) of the '33 Act[56] regulates the offer or sale of any securities, exempt from registration or not. Directors are covered by its anti-fraud provisions,[57] although the courts are split as to whether defendants are subject to implied civil liability[58] or only to SEC injunctions and criminal penalties.[59]

Private Action Against a Securities Fraud Aider and Abettor: Silent and Inactive Conduct, 29 VAND. L. REV. 1233 (1976); authorities cited in note 30, *supra.*

[51] Innocent misrepresentations do not give rise to a cause of action because of § 12(2)'s language "he did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission." *See* Jackson v. Oppenheim, 533 F.2d 826, 829 n.7 (2d Cir. 1976).

[52] *See* Wilko v. Swan, 346 U.S. 427, 431 (1953) (defendant has burden of proving his lack of negligence and knowledge); Hill York Corp. v. American Int'l. Franchises, Inc., 448 F.2d 680, 695 (5th Cir. 1971); Gridley v. Sayre & Fisher Co., 409 F. Supp. 1266, 1273 (D.S.D. 1976). *See also* Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964) (proximate cause analysis of defendant's alleged negligence).

[53] 15 U.S.C. § 77o (1976).

[54] Some courts have held that § 15 is the exclusive source of secondary liability for violations of §§ 11 and 12. *See* Russell v. Travel Concepts Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,230 (M.D. Tenn. 1975). *Accord, In re* Caesar's Palace Sec. Litigation, 360 F. Supp. 366, 378-83 (S.D.N.Y. 1973).

[55] 15 U.S.C. § 77o (1976). *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 210 (1976).

[56] 15 U.S.C. § 77q(a) (1976).

[57] Section 17(a) makes it unlawful for "any person in the offer or sale of any securities . . . (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property" through material misstatement or omission, "or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[58] *Compare* Newman v. Prior, 518 F.2d 97, 99 (4th Cir. 1975) (private right of action under § 17(a) exists); *with* Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 155, 159 (8th Cir. 1977), *cert. denied,* 434 U.S. 1086 (1978). *See generally* Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933,* 64 VA. L. REV. 641 (1978) [hereinafter cited as Hazen].

[59] *See, e.g.,* SEC v. American Realty Trust, 586 F.2d 1001 (4th Cir. 1978); Russell v. Travel Concepts Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,230 (M.D. Tenn. 1975). A '33 Act draftsman has stated that § 17(a) was intended only to provide basis

The negligence of a director may trigger SEC injunctions and related ancillary relief[60] under section 17(a). However, recovery of damages by a private plaintiff, where allowed, requires proof of at least a "wilful or reckless disregard for the truth" by the director.[61]

Any person "willfully" violating the '33 Act or SEC rules and regulations thereunder, or willfully making a material misstatement or omission in a registration statement, commits a felony under section 24.[62] While the prosecution must prove its case beyond a reasonable doubt, proof of a "reckless disregard for the truth" may support a conviction.[63] Directors who become closely involved in securities transactions may take warning from *United States v. Natelli*[64] of their need to make reasonable investigations and not to ignore any irregularities discovered. In *Natelli* accountants of a prominent accounting firm were convicted under section 24 for willful misrepresentations in their work on the financial portion of a proxy statement. On appeal the Second Circuit affirmed the conviction of a partner in the firm, holding that he could not "shut his eyes in reckless disregard of his knowledge that highly suspicious figures, known to him to be suspicious, were being included in the unaudited earnings figures with which he was 'associated' in the proxy statement."[65]

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for injunctive relief or criminal prosecution. Landis, *Liability Sections of the Securities Acts,* *18* AM. ACCOUNTANT 330, 331 (1933).

[60] *See* SEC v. American Realty Trust, 586 F.2d 1001 (4th Cir. 1978); *accord,* SEC v. Coven, 581 F.2d 1020, 1027 (2d Cir. 1978). *See generally* Note, *Scienter and SEC Injunctions Actions Under Securities Act Section 17(a),* 63 IOWA L. REV. 1248 (1978).

[61] Several courts have observed that if a private action for damages is allowed under § 17(a) and scienter not required, the effect might negate the limitations on private recoveries for negligence contained in §§ 12(2) and 15 of the '33 Act. *See* Sanders v. John Nuveen & Co., Inc., 554 F.2d 790, 795-96 (7th Cir. 1977); SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975). A § 17(a) standard higher than negligence accords with policy arguments forwarded by Mr. Justice Powell when the Supreme Court rejected negligence as a sufficient basis for damage suits under Rule 10b-5. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *But see* SEC v. Aaron, [Current] FED. SEC. L. REP. (CCH) ¶ 96,800 (2d Cir. 1979) (legislative history of § 17 rebuts use of scienter standard in SEC action); SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978). *See generally* Hazen, *supra* note 58.

[62] 15 U.S.C. § 77x (1976). The sanctions are a fine of up to $10,000 and imprisonment for up to five years, or both.

[63] *See* Wall v. United States, 384 F.2d 758 (10th Cir. 1967); United States v. Dardi, 330 F.2d 316 (2d Cir.), *cert. denied,* 379 U.S. 845 (1964).

[64] 527 F.2d 311 (2d Cir. 1975), *cert. denied,* 425 U.S. 934 (1976).

[65] *Id.* at 320. In United States v. Bruce, 488 F.2d 1224 (5th Cir. 1973), *cert. denied,* 419 U.S. 825 (1974), the court affirmed convictions causing imprisonment of two inside directors and a public accountant for violations of § 17(a) and a mail fraud statute, 18 U.S.C. § 1341, for willful misrepresentations in two prospectuses.

Section 20b of the '33 Act, 15 U.S.C. § 77(t), authorizes the SEC to submit evidence to the Justice Department for criminal prosecution where willfulness appears present. However, United States v. Fields, [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,074 (S.D.N.Y. 1977) holds that the SEC cannot itself negotiate a settlement of a civil case while secretly triggering Justice Department prosecution. The *Fields* court dismissed certain indictment counts against corporate directors and officers that the Justice Department had based upon evidence the defendants had disclosed to the SEC in an earlier civil investigation and settle-

The basis of liability under the '34 Act differs markedly from that under the '33 Act and thus expands the legal risks confronting a director. Plaintiffs frequently ground their actions on both statutes, seeking to establish misrepresentations or omissions under the '34 Act, or defective registration under the '33 Act.[66] Claims against directors under the '34 Act are principally grounded on sections 10(b), 14(a), and 16(b), which pose broadly applicable anti-fraud rules.[67]

Probably the leading source of director liability in securities matters is Rule 10b-5,[68] an anti-fraud rule similar to section 17 of the '33 Act.[69] However, Rule 10b- 5's strictures protect not only buyers and offerees, but sellers as well.[70] While the SEC is given express enforcement responsibility, implied private actions have long been permitted for Rule 10b-5 violations[71] involving securities transactions negotiated on exchanges,[72] over the counter[73] or privately.[74]

Except where a director is directly involved in disclosures or nondisclosures influencing securities transactions, his potential liability under

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ment, arising from alleged violations of § 17(a) of the '33 Act and § 14 of the '34 Act (proxy regulations). The SEC's evidence had been referred for criminal prosecution on the same day an agreement was reached on a consent decree.

[66] McDowell, *Director's Liabilities in Securities Transactions,* 22 Bus. Law 76, 82 (1966).

[67] At least three other '34 Act provisions provide express or implied causes of action for which a director qua director may be liable. Section 9, 15 U.S.C. § 78i, is an express remedy permitting suit for harm caused by manipulation on national exchanges. *See, e.g.,* SEC v. D'Onofrio, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,201 (S.D.N.Y. 1975). Directors of brokerage firms must be concerned with § 15 of the '34 Act, 15 U.S.C. § 78o, which proscribes fraudulent practices by brokers in the over-the-counter market and certain fraudulent and financial practices of all brokers and dealers. *See, e.g.,* Davis v. AVCO Corp., 371 F. Supp. 782 (N.D. Ohio 1974). Further, directors as such may be liable under § 18, 15 U.S.C. § 78r, which permits recovery by persons who detrimentally rely on false reports filed with the SEC, but poses difficult standards for the plaintiff to meet.

[68] Rule 10b-5, 17 C.F.R. § 240.10b-5 (1978), is promulgated under § 10(b) of the '34 Act, 15 U.S.C. § 78j(b) (1976).

[69] *See* text accompanying notes 56-61 *supra.*

[70] Rule 10b-5 uses almost the identical language of § 17 of the '33 Act, *see* note 57 *supra,* but substitutes the language "in connection with the purchase or sale of any security" for § 17's language "offer or sale of any securities." *See* 1978-1979 *Developments, supra* note 30, at 940-44. It is now established that Rule 10b-5 indeed requires that damages be derived from an actual purchase or sale rather than ancillary matters regarding securities. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[71] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

[72] *See, e.g.,* Crane v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (2d Cir. 1969) (held, defendant corporation, major shareholder in Westinghouse Air Brake Co., violated Rule 10b-5 by failure to disclose trading scheme whereby it purchased a huge block of shares and then secretly sold them, thereby manipulating the market to freeze out a competitor and another corporate shareholder). *See also* Cady, Roberts & Co., 40 SEC 907 (1961).

[73] *See, e.g.,* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

[74] *See, e.g.,* Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Schine v. Schine, 250 F. Supp. 822 (S.D.N.Y. 1966).

the '34 Act is secondary,[75] and principally derives from the '34 Act's provision for "controlling persons" in section 20(a).[76] While any active director is subject to controlling person classification,[77] *Ernst & Ernst v. Hochfelder*[78] holds that directors and other defendants in Rule 10b-5 damages actions are not liable absent scienter, which is an "intent to deceive, manipulate, or defraud."[79] Extreme recklessness by the director, however, may meet this standard,[80] while mere negligence may remain a basis for SEC injunctive actions against directors and other defendants.[81]

Under these standards, Rule 10b-5 imposes on directors responsibilities to convey material inside information[82] as well as to inquire whether all

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[75] *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[76] Section 20(a), 15 U.S.C. § 78t, of the '34 Act states:

> Every person who, directly or indirectly, controls any person liable under any provision of [the 1934 Act], or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

[77] 15 U.S.C. § 78t (1976). The circuits are split on what triggers § 20(a) liability. The Third Circuit has held that § 20(a) liability may be imposed on those who possess the power or potential power to influence or control another's activities, as contrasted with the actual exercise of such power. Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 890-91 (3rd Cir. 1975). The Second Circuit, however, has held that § 20(a) imposes "liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud by controlled persons." Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973).

[78] 425 U.S. 185 (1976).

[79] *Id.* at 193.

[80] In *Hochfelder*, the Court declined to address whether reckless behavior may be sufficient to impose Rule 10b-5 damages liability, 425 U.S. at 193, but categorically stated the Court's unwillingness "to extend the scope of the statute to negligent conduct." *Id.* at 214. A subsequent Seventh Circuit decision stated that reckless disregard for the truth would satisfy Hochfelder's scienter standard. *See* Wright v. Heizer Corp., 560 F.2d 236, 251 (7th Cir. 1977), *cert. denied,* 434 U.S. 1066 (1978). The *Wright* court defined recklessness in the context of a failure to disclose material information as a "highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 251-52 (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976).

[81] *Compare* SEC v. Blatt, 583 F.2d 1325, 1332-33 (5th Cir. 1978) (SEC must prove scienter) *with* SEC v. Aaron, [Current] FED. SEC. L. REP. (CCH) ¶ 96,800 (2d Cir. March 12, 1979) (SEC does not have to prove scienter). *See generally* 1978-1979 *Developments, supra* note 30, at 935-37.

[82] Directors and other insiders may be liable under Rule 10b-5 for making misrepresentations to persons trading in the market, even where the director or his corporation are not purchasing or selling securities. *See* Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969). However, a director's liability for misrepresentations may arise not only when the corporation issues public statements, but also when he discovers nonpublic information, the disclosure of which is necessary to correct past incorrect corporate

material corporate information required to be conveyed has, in fact, been conveyed.[83] Directors find little solace in judicial acknowledgment that "Congress was quite aware of the 'agonizingly subtle' choices continually facing directors when it passed the securities acts."[84]

Another '34 Act provision which may impose liability on directors is section 14,[85] which regulates the solicitation of proxies. Section 14(a) makes it unlawful for "any person . . . in contravention of such rules and regulations as the Commission may prescribe . . . to solicit . . . any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 12 of [the '33 Act]."[86] The SEC's proxy rules can only be enforced by holders of such registered securities.[87]

More specifically, a director may incur liability in this area of corporate

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statements, such as misstated financial reports of past years, *see* Fischer v. Kletz, 266 F. Supp. 470 (S.D.N.Y. 1967); or which is necessary to make past correct statements (correct when issued) not misleading. *See* SEC v. Shattuck Denn Mining Corp., 297 F. Supp. 470 (S.D.N.Y. 1968). Further, a director may be liable under Rule 10b-5 for a complete failure to convey material non-public information, as in mergers and negotiations for treasury stock, even though no representations of any sort have been made by the corporation. *See, e.g.,* Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), *supplemented,* 135 F. Supp. 176 (D. Del. 1955), *aff'd* 235 F.2d 369 (3d Cir. 1956). However, no court has found directors or insiders to have an absolute duty to convey all business secrets absent insider trading. In SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), the court stated that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed."

[83] In respect to the director's responsibility to investigate, the courts draw a distinction between the liability of directors who actually participate in a securities transaction and those who do not. As to participants, the Second Circuit in *Texas Gulf Sulphur* imposed a duty of inquiry on participating directors in an action for injunctive relief holding that those helping prepare a press release must exercise due diligence in ascertaining that the release was the whole truth. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859-60 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). A similar due diligence inquiry standard for participating directors must be met in the negotiation of corporate transactions in securities, at least in actions for injunctive relief. *See, e.g.,* SEC v. Pearson, 426 F.2d 1339, 1343 (10th Cir. 1970); SEC v. Van Horn, 371 F.2d 181, 186 (7th Cir. 1966). However, such inquiry duty does not yet appear applicable to directors not substantively participating in securities transactions. In Lanza v. Drexel & Co., 479 F.2d 1277, 1289 (2d Cir. 1973), the court held that nonparticipating directors may be liable only if they aided or abetted in the violations of others. Liability as an aider or abettor requires a showing that another has in fact violated Rule 10b-5, that the nonparticipating director knew or should have known of the other's violation, and that the director indeed gave substantial assistance or encouragement to the principal wrongdoer. *See* Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973). *See generally* 1978-1979 *Developments, supra* note 30, at 911-23.

[84] Lanza v. Drexel & Co., 479 F.2d 1277, 1308 (2d Cir. 1973) (footnote omitted).

[85] 15 U.S.C. § 78n (1976).

[86] Section 12 requires registration of any equity security (other than an exempted security) of an issuer having total assets exceeding $1 million, which are held of record by at least 500 persons. There are numerous exceptions, however, to § 12's registration requirements.

[87] *See* Gruss v. Curtis Publishing Co., 534 F.2d 1396 (2d Cir.), *cert. denied,* 429 U.S. 887 (1976).

governance under Rule 14a. This anti-fraud rule proscribes proxy communications containing material misstatements or omissions.[88] The Supreme Court in *J.I. Case v. Borak*[89] held that both derivative and direct shareholder suits are implied under section 14(a) and Rule 14a-9.[90] A private plaintiff probably must prove that the director's involvement was more than merely negligent,[91] and also establish his reliance on a materially misleading proxy statement. The plaintiff must, of course, establish a causal relationship between such statement and the action taken.[92] Directors are invariably named in Rule 14a-9 lawsuits since, in addition to injunctive and other equitable relief, a court may order damages "to the extent that they can be shown."[93]

Unlike Rule 10b-5's apparently different standards respecting inside and outside directors as to inquiry responsibility,[94] section 16(b)[95] imposes

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[88] Rule 14a-9 states:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. § 240.14a-9 (1978).

[89] 377 U.S. 426 (1964).

[90] 377 U.S. at 431. The plaintiff in *Borak* alleged damages resulting from a materially misleading proxy statement and the defendant argued there was no implied private right of action. The Court held that "a right of action exists as to both derivative and direct causes." *See also* General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 161 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969); Vernon J. Rockler & Co. v. Minneapolis Shareholders Co., 69 F.R.D. 1, 3 (D. Minn. 1975); Chris-Craft Indus., Inc. v. Independent Stockholders Comm., 354 F. Supp. 895, 903 (D. Del. 1973).

[91] In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Supreme Court rejected negligence as a basis for liability for damages under Rule 10b-5. This decision arguably suggests that future damages liability under § 14(a) may also require a higher level of culpability. Negligence, however, was the standard in most earlier § 14(a) cases. *See, e.g.,* Gruss v. Curtis Publishing Co., 534 F.2d 1396, 1403 (2d Cir. 1976).

[92] *See In re* Equity Funding Corp. of Am. Secs. Litigation, 416 F. Supp. 161, 191 (C.D. Cal. 1976). In *Equity Funding,* the court held that a stockholder need not have bought or sold securities on the basis of a false proxy statement as the gravamen of the claim was that he was misled when he voted.

[93] Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389 (1970). Further, the Supreme Court in *Mills* also held that once a cause of action has been proved, regardless of whether any monetary recovery has been or will be forthcoming, the plaintiff is entitled to attorney's fees. *Id.* at 389-97. *See also* Gerstle v. Gamble-Skogmo, Inc., 348 F. Supp. 979 (E.D.N.Y. 1972), *aff'd* 478 F.2d 1281 (2d Cir. 1973) (recovery can be had for damages to the corporation); Howard v. Furst, 140 F. Supp. 507, 513 (S.D.N.Y.), *aff'd on other grounds,* 238 F.2d 790 (2d Cir. 1956), *cert. denied,* 353 U.S. 937 (1957) (damages incurred in compelling rectification of deceptive proxy material); Miller v. Steinbach, 43 F.R.D. 275, 278 (S.D.N.Y. 1967) (permitting amendment to complaint requesting punitive damages in suit alleging breach of fiduciary duties and violations of §§ 10(b) and 14(a) of the '34 Act).

[94] *See* note 83 *supra.*

[95] 15 U.S.C. § 78p(b) (1976).

the same standards on all directors of reporting companies.[96] Section 16(b) informs all directors — as persons with "inside information" — that "if you trade, pay over the profit."[97] The subject of scores of cases[98] and extensive legal commentary,[99] section 16(b) is thus designed to recover insiders' short-swing stock trading profits.[100] Actions can be brought by the corporation or an individual security holder.[101] Plaintiffs do not have to show that a director actually made a profit since his liability does not depend on actual profits,[102] and shareholder suits are encouraged by the right to attorney's fees[103] and the absence of a security requirement.[104] The principal defenses available to a director facing liability under section 16(b) lie within the SEC's narrow exemptions.[105]

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[96] Section 16(b) applies to transactions in "any equity security (other than an exempted security)" registered under § 12 of the '34 Act, and an issuer must register under § 12 if any of its securities is listed on a national exchange or if any class of its equity securities are held of record by 500 or more persons and its total assets exceed $1 million. *See* note 86 *supra.*

[97] Woodside, *Resume of the Report of the Special Study of Securities Markets and the Commission's Legislative Proposals,* 19 Bus. Law. 463, 477 (1964).

[98] For a review of recent § 16(b) decisions, see Castruccio & Hentrich, *supra* note 15, at 1202-06.

[99] *See, e.g.,* Hecker, *Section 16(b) of the Securities Exchange Act: An Analysis of the Time When Insider Status is Required,* 24 Kan. L. Rev. 255 (1976); Weinstock, *Section 16(b) and the Doctrine of Speculative Abuse: How to Succeed in Being Subjective Without Really Trying,* 29 Bus. Law. 1153 (1974).

[100] § 16(b) provides in material part:

> For the purpose of preventing the unfair use of information which may have been obtained by such . . . director [referred to in § 16(a)] by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or sale and purchase, of any equity security . . . (other than an exempted security) [of the issuing corporation being directed by the director and having a class of equity securities registered under § 12] within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such . . . director . . . in entering into such transaction . . . .

15 U.S.C. § 78p(b) (1976).

[101] Any security holder may sue on behalf of the issuer if the issuer fails to sue the director or other insider within 60 days after being requested to do so, *see, e.g.,* Dottenheim v. Murchison, 227 F.2d 737, 740 n.4 (5th Cir. 1955), *cert. denied,* 351 U.S. 919 (1956); or if the issuer fails to sue diligently. *See* Molybdenum Corp. of America v. International Mining Corp., 32 F.R.D. 415 (S.D.N.Y. 1963). The *Molybdenum* court allowed a minority shareholder to intervene in an action by the corporation to recover short-swing profits where the shareholder contended the corporation was dominated by the defendants. *See generally* Note, *Insider Trading: The Issuer's Disposition of An Alleged 16(b) Violation,* 1968 Duke L.J. 94.

[102] Disgorgement of actual profits realized would not be oppressive. However, "profit" under § 16(b) may be computed by matching the lowest-priced purchases against the highest-priced sales within the preceding or following six months. *See, e.g.,* Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951) (judgment against defendant for $300,000 on basis of such method of computation, despite $300,000 actual loss).

[103] *See, e.g.,* Snolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943). In *Snolowe,* the court said that "in many cases . . . the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of § 16(b)." *Id.* at 241. *See also* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 390-91 (1970).

[104] *See* Truncale v. Blumberg, [1948-1952 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,470, at 91,498 (S.D.N.Y. 1948) (no security for expenses since based on federal statute).

[105] Pursuant to authority explicitly granted the SEC to exempt transactions, the SEC

Directors' Responsibilities Under State Law

While directors are most attuned to their liabilities under federal statutes, the legal foundation of corporate governance resides in state statutes and the common law. In *Burks v. Lasker,*[106] the Supreme Court recently reemphasized the demarcation between the Securities Acts and state corporation law.[107] The *Lasker* court stated:

> it is state law which is the font of corporate directors' powers. By contrast, federal law in this area is largely regulatory and prohibitory in nature—it often limits the exercise of directorial power, but only rarely creates it . . . . Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute.[108]

The corpus of a director's duties and liabilities generally is not reflected in state corporation statutes, although some statutes provide lists of prohibited transactions. Rather, most complaints asserting liability of directors under state law are grounded upon breaches of common law duties.[109]

has promulgated various rules to exempt certain persons from § 16(b)'s liabilities, e.g., Exchange Act Rule 16a-4 (executors, receivers, issuers). Defenses unavailable to a director include that the director did not use inside information, *see, e.g.,* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 595 (1973); or that the defendant acted in good faith. *See id.* Nor is waiver a successful defense. *See* Allied Artists Picture Corp. v. Giroux, 312 F. Supp. 450, 451 (S.D.N.Y. 1970). *See also* American Standard, Inc. v. Crane Co., 346 F. Supp. 1153, 1164 (S.D.N.Y. 1971), *supplemented,* 346 F. Supp. 1165 (S.D.N.Y. 1972), *cert. denied,* 421 U.S. 1000 (1975).

[106] 99 S. Ct. 1832 (1979). In *Lasker,* the Court held that state law governs independent directors' authority where not inconsistent with Investment Company and Investment Advisers Acts. The Court also concluded that state law is applicable to determine whether statutorily disinterested mutual fund directors can terminate a nonfrivolous derivative suit against the majority directors and an investment adviser. *Id.* at 1835.

[107] Even prior to its decision in *Lasker,* the Supreme Court in a series of recent cases has made clear its disapproval of expansionist interpretations of the Securities Acts into corporate governance areas. Thus, the Supreme Court has ruled that Rule 10b-5 actions can only be brought by purchasers or sellers of securities. Blue Chip Stamps v. Manor Drug Stroes, 421 U.S. 723 (1975). It has limited the definition of the term "securities." United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). Proof of scienter rather than negligence is now required in Rule 10b-5 damage actions. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); *see* notes 78-81 *supra.* The Supreme Court has declined to expand the scope of § 14(e) of the '34 Act to include protection of unsuccessful tender offerors. Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977). As well, it has held that "a breach of fiduciary duty by majority shareholders, without any deception, misrepresentation, or nondisclosure" does not violate Rule 10b-5. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

[108] Burks v. Lasker, 99 S. Ct. 1831, 1837 (1979). The holding in *Lasker* should be compared with Great Western United Corp. v. Kidwell, 577 F.2d 1256, 1279, 1286 (5th Cir. 1978) where the court held Idaho's takeover law invalid because it was preempted by the Williams Act and was unduly burdensome to interstate commerce.

[109] *See* Adkins & Janis, *Some Observations on Liabilities of Corporate Directors,* 20 BUS. LAW. 817, 817-18 (1965) [hereinafter cited as Adkins & Janis]. The authors observe that because few jurisdictions have statutory standards for imposing liability, guidelines for direc-

Certain duties are indeed listed in current statutes.[110] However, express liabilities are limited to violation of statutes similar to Model Business Corporation Act (MBCA) section 48, which governs legal capital matters.[111] This model statute imposes joint and several liability on directors for (a) a declaration of dividends contrary to statute or charter restrictions; (b) corporate share repurchases contrary to statute;[112] and (c) asset distributions to shareholders during liquidation without provision for repaying corporate creditors.[113]

Obviously, these particular liabilities are of predominant concern to directors of closely held corporations. However, directors of firms large and small perform under the vague but universally stated general rule that "the business and affairs of [the] corporation . . . shall be managed by or under the direction of a board of directors."[114] While courts have settled that a director is neither guarantor[115] nor insurer[116] of the firm's success, the cases generally have not identified specific management functions that directors should undertake. However, the common law rubric does reveal three forms of directorial duty: obedience, loyalty, and care or diligence.

The first of these duties has been largely of historical significance. The duty of obedience derives from the familiar rule of *ultra vires,* that any action taken by directors beyond the powers granted by the corporation's charter is not binding on the corporation.[117] Whereas *ultra vires* liability in recent years arose only from unauthorized acts coupled with corporate injury,[118] state legislatures have weakened this duty by allowing exceed-

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tors' liabilities have largely been developed through case law.

110 The director's familiar statutory tasks typically include by-laws adoption, ABA-ALI MODEL BUS. CORP. ACT § 27 (rev. ed. 1974); election of officers, MBCA § 50; approval of mergers, MBCA § 71; sales of substantially all corporate assets, MBCA §§ 78-79; and voluntary dissolutions, MBCA § 84. These MBCA provisions have been substantially adopted in a number of states.

111 The MBCA provisions for legal capital matters is a reflection of state law in this regard. *See, e.g.,* NEV. REV. STAT. § 78.625 (1973) (unlawful withdrawal of corporate assets); MD. CORP. & ASSOC. CODE ANN. §§ 2-315(c), 2-417 (1975) (illegal payment or return of assets to shareholders); MICH. COMP. LAWS ANN. § 450.1551(a) (1973) (unlawful distributions of capital stock); and N.Y. BUS. CORP. L. § 719 (1963) (unlawful reduction of capital).

112 *See In re* Gribbin Supply Co., 371 F. Supp. 664 (N.D. Tex. 1974). In *Gribbin Supply* the court held the rule expressed in MBCA § 48(b) also applied to a former director who resigned his directorship and sold his shares to the corporation in a scheme to avoid liability.

113 If a corporation is rendered insolvent after corporate officers have divided the assets among the stockholders, the officers may be held personally liable for the corporation's debts. *See* Nevada Land & Mortgage Co. v. Lamb, 90 Nev. 247, 248, 524 P.2d 326, 327 (1974).

114 DEL. CODE ANN. tit. 8, § 141(a) (CUM. SUPP. 1977).

115 It is settled law that directors do not personally guarantee corporate success or the fidelity of officers and agents to whom the board has with due care delegated managerial tasks. *See, e.g.,* Briggs v. Spaulding, 141 U.S. 132, 147 (1891); Cutler v. Hicks, 268 Ill. App. 161 (1932).

116 *See, e.g.,* Briggs v. Spaulding, 141 U.S. 132, 147 (1891); McEwen v. Kelly, 140 Ga. 720, 79 S.E. 777 (1913).

117 One of the first cases in this area was Pennington v. Seals, 49 Miss. 518 (1873) which held that diretors were absolutely liable for corporate injury sustained in *ultra vires* actions.

118 In A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, *cert. denied,* 346 U.S.

ingly broad purpose clauses in corporate charters. Nevertheless, allegations of *ultra vires* activity are frequently included in derivative and shareholder suits against directors.[119] Further, the recent legislative propensity to regulate private industry is revitalizing this traditional duty. This is because actions claiming injury from corporate activities not authorized by law, such as bribes of public officials, obviously turn on the rule of *ultra vires*,[120] and a negligence standard may apply.[121]

A director's second duty under the common law is that of loyalty. Most state law decisions holding directors liable to their corporations involve breach of the duty of loyalty. Basically, this duty prohibits a director from pursuing personal interests in a manner injurious to the corporation.[122] The courts frequently analyze obedience in terms of a "conflict of interest" with the interested director bearing the burden of proof as to the fairness of the challenged transaction.[123] Such cases for the most part reflect liabilities of principal concern to owner-directors of close corporations. The cases deal with conflicts of interest in salary matters, dividend policy, recapitalizations, business dealings with a director or an organization in which he is interested, loans to and from the corporation, business dealings with a relative of a director, common directors, and interests in competing or similar businesses.[124] However, breach of the duty of obedience may also impose liability on directors of widely-held firms where contests for corporate control spawn litigation.

Directors opposing an insurgent group are unavoidably faced with a conflict of interest,[125] and board actions to defend their control[126] are often

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861 (1953) the court used a "direct benefit" test, and held that a corporation may exercise any power not expressly prohibited if the power benefits the corporation. *Accord*, Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1947).

[119] Creditors, however, cannot be heard to argue breach of obedience. *See* Sutton v. Reagan & Gee, 405 S.W.2d 828, 836 (Tex. Ct. App. 1966). In *Sutton* the court held that even though the director permitted *ultra vires* action on behalf of the corporation, an injured creditor had no standing to argue breach of the obedience duty.

[120] In the past the courts allowed few defenses in holding directors personally liable for *ultra vires* expenditures. *See* Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909). In *Roth* an amusement company manager was held liable to the corporate owner for "hush money" paid from corporate funds to officials to prevent shutdown for Sunday closing law violations. Some recent decisions, however, have allowed introduction of the "business judgment rule" as a defense to director liability. *See* Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878, 879 (Del. 1970). For discussion of the business judgment rule, *see* text accompanying notes 168-79, *infra*.

[121] *See* Litwin v. Allen, 25 N.Y.S. 2d 667, 678 (Sup. Ct. 1940).

[122] As with the duty of obedience, the directorial duties of loyalty and due care or diligence are owed to the corporation, and not to the corporation's creditors. *See* Fagan v. La Gloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Ct. App. 1973).

[123] *See* Pepper v. Litton, 308 U.S. 295, 306-07 (1939); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 296, 93 A.2d 107, 110 (1952).

[124] Marsh, *Are Directors Trustees?*, 22 Bus. Law. 35 (1966) [hereinafter cited as Marsh]. *See* O'Neal, Oppression of Minority Shareholders (1975).

[125] One close observer has described the conflicting pressures on a corporate director facing a tender or proxy contest as follows:

suspect and vulnerable to judicial correction.[127] A variety of defensive techniques are available including proxy contests,[128] open-market stock repurchases[129] or redemptions,[130] freeze-out mergers,[131] and the selective issuance of additional shares.[132] Many lawsuits arising from control contests involve close corporations, with plaintiffs claiming violations of the controlling shareholders' so-called "fiduciary duty" to the minority.

However, there are several instances of personal liability to which a director acting *qua* director may be exposed in control contests. Liability arises on grounds that directors have breached their duty of loyalty by using corporate funds to defend their control. For example, while neither freeze-out mergers nor issuances of additional shares appear to involve director liability (assuming no securities laws violations),[133] directors may be liable for proxy fight expenditures funded by the corporation unless they establish that the dispute is one of policy.[134]

Similarly, when faced with an outsider's buying of a large block of

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> The desire to retain . . . control, when challenged by an insurgent group, may involve the board's self interest in the compensation and perquisites attached thereto, or may be entirely motivated by a belief in the unwisdom of the policies advocated by the insurgents. It is impossible to command the directors in this situation to avoid any conflict of interest, since it has been unavoidably thrust upon them. And to suggest that they abdicate before every challenge would be ridiculous.

Marsh, *supra* note 124, at 60.

[126] Corporate "control" is a frequently addressed concept, considered generally to represent the power entrusted within the board's management responsibilities. *See* Hill, *The Sale of Controlling Shares,* 70 HARV. L. REV. 986 (1957). "The ordinary connotation of corporate control, as something which is bought or sold, or used or abused, is a power of entrenched management over an enterprise which is owned, at least in substantial part, by others." *Id.* at 992. However, "[t]he holder of control is not so much the owner of a proprietary right as the occupier of a power-position." Berle, *"Control" in Corporate Law,* 58 COLUM. L. REV. 1212, 1215 (1958).

[127] *See* Kaplan, *Fiduciary Responsibility in the Management of the Corporation,* 31 BUS. LAW. 883, 911 (1976).

[128] *See, e.g.,* Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955).

[129] *See* Cheff v. Mathes, 41 Del. 494, 199 A.2d 548 (1964) (purchase of shares in market, followed by buy-out of dissident shareholder).

[130] *See id. See also* Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960) (buy-out of dissident shareholder); Martin v. American Potash & Chemical Corp., 33 Del. 234, 92 A.2d 295 (1952) (buy-out of dissident shareholder).

[131] In Singer v. Magnavox, 380 A.2d 969, 980 (Del. 1977), the court held that a business purpose must be shown before a long-form merger may proceed with the result of eliminating minority shareholders. *Accord,* Bryan v. Brock & Blevins Co., 490 F.2d 563, 571 (5th Cir.), *cert. denied,* 419 U.S. 844 (1974) (applying Georgia law).

[132] *See, e.g.,* O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Cummings v. United Artists Theatre Circuit, Inc., 237 Md. 1, 204 A.2d 795 (1964).

[133] *See generally* McIntyre, *Shareholders' Recourse Under Federal Securities Law Against Management for Opposing Advantageous Tender Offers,* 34 BUS. LAW. 1283 (1979); *Proceedings of ABA National Institute, Corporate Takeovers — The Unfriendly Tender Offer and the Minority Shareholder Freezeout,* 32 BUS. LAW. 1297 (1977).

[134] *See, e.g.,* Selama-Dindings Plantations, Ltd. v. Cincinnati Union Stock Yard Co., 337 F.2d 949 (6th Cir. 1964); Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 169,

shares or a proxy fight, directors risk liability when they spend corporate funds either to redeem the outsider's shares or to purchase open-market shares in competition with the outsider. In *Bennett v. Propp,*[135] a president and board chairman without board approval spent some $2.3 million in corporate funds to purchase shares after receiving a letter from an outsider stating his intention to purchase a large block. The director was held personally liable to his corporation for resulting damages. However, courts have not held directors liable in control contests for such open-market purchases, or redemptions, given proper authorization and persuasive proof that the outsider's proposed policies would have harmed the corporation.[136]

Among the three common law duties, the director's duty of diligence may increasingly become grounds for damage claims. All jurisdictions require in various words that directors owe a duty of reasonable care and diligence to their corporations[137] in performing their functions.[138] This duty's corresponding liability is now based upon ordinary negligence, a standard violated more easily than the gross negligence standard employed in several older cases.[139] A director's action or inaction is measured against how a "reasonable director" would have performed.[140] Sufficient care and diligence was defined by the Supreme Court in *Briggs v. Spaulding*[141] as that "which ordinarily prudent and diligent men would exercise under similar circumstances, and in determining that the restrictions of the statute and the usages of business should be taken into account."[142]

Most corporation statutes similarly define the director's duty of care and diligence.[143] Several states track MBCA section 35, which states in material part that:

> [a] director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he

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128 N.E.2d 291, 292 (1955).

[135] 41 Del. 14, 187 A.2d 405 (1962).

[136] *See* notes 129-30 *supra.*

[137] It has been held that the directorial duty of due care and diligence is owed to the corporation and not to the corporation's creditors. Hence, creditors have no standing to sue directors of an ongoing corporation on grounds they were damaged because the director did not exercise care. *See, e.g.,* Fagan v. LaGloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Civ. 1973).

[138] *See, e.g.,* Wolf v. Fried, 473 Pa. 26, 273 A.2d 734 (1977); McDonnell v. American Leduc Petroleums, Ltd., 491 F.2d 380 (2d Cir. 1974) (applying California law); Home Tel. Co. v. Darley, 355 F. Supp. 992 (N.D. Miss. 1973), *aff'd* 489 F.2d 1403 (5th Cir. 1974).

[139] *See* Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 411, 8 N.E.2d 895, 904 (1937) (directors acting in good faith liable only for "clear and gross negligence" in their conduct). *See generally* Note, *Liability of Directors to Shareholders for Negligence Under American Law and Their Indemnification,* 16 McGill L.J. 323, 333-34 (1970).

[140] Morrison, *Factors That Limit the Negligence Liability of a Corporate Executive or Director,* 1968-69 Corp. Prac. Commentator 201, 209-10.

[141] 141 U.S. 132 (1891).

[142] *Id.* at 152.

[143] *See generally* Folk, *supra* note 12.

> may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

Because of the importance of MBCA section 35 to corporate governance the section has drawn careful drafting attention, and its last amendment and the accompanying comments are instructive. In the 1974 amendment the terms "diligence" and "skill," found in some state statutes,[144] were omitted. This change was engendered by the scarce common law authority defining these terms, as distinguished from the present term "care."[145] Within MBCA section 35's definition of "care," the draftsmen have used the term "ordinarily prudent person" to reflect the common law[146] and "to focus on the basic director attributes of common sense, practical wisdom and informed judgment."[147]

MBCA section 35's phrase "in a like position" indicates that the courts should expect a director to use the care of an ordinarily prudent person who was a director of the particular company.[148] The use of the words "under similar circumstances" recognizes, however, that the special background, qualifications, knowledge, and expertise of a particular director may place upon him a measure of care different from that placed on his dissimilarly situated peers.[149] This "similar circumstances" concept has been modified in some cases to mean the director's "personal business affairs."[150] This personalized standard has been criticized for injecting subjective considerations into assessments of director liability.[151]

Three other issues determine imposition of liability on a director if he is found negligent. These are standing to sue, causation, and the business judgment rule. Cases in which these issues have been resolved in favor of plaintiffs can be roughly categorized as involving either acts or omissions, namely, active mismanagement directly attributable to the director,[152] or

[144] *See, e.g.*, MINN. STAT. ANN. § 301.31 (1969).

[145] *See Corporate Directors Guidebook*, 32 BUS. LAW. 42, 44 (1976) [hereinafter cited as *Corporate Directors Guidebook*].

[146] *See, e.g.*, Briggs v. Spaulding, 141 U.S. 132 (1891).

[147] *Corporate Directors Guidebook*, *supra* note 145, at 44.

[148] *Id.*

[149] *Id.* at 44-45. *Compare* text accompanying note 40 *supra*.

[150] *See, e.g.*, McDonnell v. American Leduc Petroleums, Ltd., 491 F.2d 380, 383 (2d Cir. 1974) (applying California law); Bellis v. Thal, 373 F. Supp. 120, 123 (E.D. Pa. 1974), *aff'd* 510 F.2d 969 (3d Cir. 1975); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 244 (D. Neb. 1972), *aff'd* 473 F.2d 537 (8th Cir. 1973); Dept. of Banking v. Colburn, 188 Neb. 500, 505, 198 N.W.2d 69, 73 (1972). Professor Henn cites earlier cases measuring director negligence in subjective terms such as "[w]hether the director is part-time or full-time, whether or not he is being compensated, whether distant residence causes his absence, whether or not he has special background, his health and state of mind . . . [and] the nature of the business." HENN, LAW OF CORPORATIONS 455 (1970).

[151] Adkins & Janis, *supra* note 109, at 820.

[152] When the director has engaged in active mismanagement, the defendant-director is primarily responsible for the injury. The question is whether the law will force him personally

director liability for failure to supervise corporate officers.[153]

As regards standing, the corporation itself may sue a director, shareholders may sue derivatively or as shareholders, and even creditors may bring actions in certain circumstances. Corporate suits against directors for negligence are unusual[154] since the alleged wrongdoers remain in office. Creditors may have class standing in bankruptcy[155] and individual standing where the director is responsible for negligent misrepresentations made directly to the individual creditor.[156] Most complaints of directorial negligence are brought by shareholders, who may gain standing either deriva-

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to pay for his misdeed by labeling him actionably negligent for his carelessness. *See, e.g.*, Levitan v. Stout, 97 F. Supp. 105 (W.D. Ky. 1951); Uccello v. Golden Foods, Inc., 325 Mass. 319, 90 N.E.2d 530 (1950).

[153] In a suit against directors for corporate losses due to conversion by a corporate officer, a New Mexico decision expressed as follows a director's liability for inattentive supervision:

> Corporate directors are not personally liable for conversion committed by the corporation or one of its officers merely by virtue of the office they hold. To be so liable directors must participate or have knowledge amounting to acquiesence or be guilty of negligence in the management and supervision of the corporate affairs causing or contributing to the injury.

Taylor v. Alston, 79 N.M. 643, 447 P.2d 523, 524 (1968). In this type of case the underlying wrong is clearly actionable, the issue being whether the director who has done no intentional wrong can be found vicariously liable. In Harman v. Willbern, 374 F. Supp. 1149, 1161 (D. Kan. 1974), *aff'd* 520 F.2d 1333 (10th Cir. 1975), the court held that a director was not vicariously liable for reasonable reliance on officers' representations since "[t]o mechanically hold directors constructively responsible for the acts of their officers would . . . do harm to the concept of corporate responsibility by deterring men of good character from becoming directors." Also within this group of cases are decisions finding directors liable for injurious actions taken in their unexcused absence from board meetings. *See, e.g.*, Bentz v. Vardaman Mfg. Co., 210 So.2d 35, 40 (Miss. 1968).

[154] There are several cases applying the familiar rule that a corporation, as the legal entity that most directly may be injured by negligent management, may sue its directors. *See* Holland v. American Founders Life Ins. Co., 151 Colo. 69, 376 P.2d 162 (1962); Bosworth v. Allen, 168 N.Y. 157, 61 N.E. 163 (1901).

[155] The jurisdictions divide about evenly on whether to permit creditor suits against individual directors for negligence. *Compare* Michelson v. Penney, 135 F.2d 409 (2d Cir. 1943) (creditor class has no standing) *with* Skinner v. Hulsey, 103 Fla. 713, 138 So. 769 (1931) (creditor class has standing). However, it appears accepted that, absent a statute, creditors may not sue for directorial negligence occurring before the corporation became obligated to them. *See, e.g.*, Whitfield v. Kern, 122 N.J. Eq. 332, 341, 192 A. 48, 55 (1937). Likewise it is clear that creditors *qua* class have no standing until bankruptcy occurs, since to that point only the shareholders and the corporation itself have standing. *Id.* at 345, 192 A. at 53. Creditors exercising class rights must bring their suit through the bankruptcy trustee. *See, e.g.*, Roach v. Reldan Trading Corp., 321 F.2d 42, 43 (2d Cir. 1963).

[156] The individual creditor has standing where a director in privity has made misrepresentations to him. *See* Hi-Pro Fish Prod., Inc. v. McClure, 346 F.2d 497, 498 (8th Cir. 1965); Minnis v. Sharpe, 198 N.C. 364, ___, 151 S.E. 735, 737 (1930). The director may also be liable for negligently permitting another to make a direct misrepresentation. *See* Cameron v. First Nat'l Bank of Galveston, 194 S.W. 469, 476-77 (Tex. Ct. App. 1917). The courts are divided on class versus individual standing where the director is found negligent where misleading information is communicated by publication. *Compare* Grandprey v. Bennett, 41 S.D. 619, 172 N.W. 514 (1919) (individual creditor granted standing) *with* Cairns v. DuPont, 135 Misc. 278, 238 N.Y.S. 74 (Sup. Ct. 1929) (no individual standing).

tively[157] or individually.[158]

While affirmative and deviant director actions such as misappropriation[159] cause clear and immediate injury, normally damages from directorial negligence are financial and indirect. For instance, whether money has been unduly spent or not received may become evident only after some time has elapsed.[160] Particularly where damages materialize slowly, the plaintiff's task is difficult. The specific directorial act or omission leading to injury must be identified, and the plaintiff must prove that the director thereby violated his duty of care and, in turn, establish proximate cause.[161]

Causation is not easily established in the negligent supervision cases. To reiterate, the courts recognize that a board's fundamental responsibility is to supervise the officers who in turn manage the corporation on a daily basis.[162] A parsing of judicial reasoning in supervision cases is not very helpful because express causation analysis usually is present only where courts find a lack of causation dispositive. Most often, knowledgeable and closely-involved officers or employees, rather than the defendant directors, are found to be the proximate cause of injury.[163] On the other hand, in

[157] Shareholder derivative actions against allegedly negligent directors may be brought if the board has not actively protected the corporation's interests. *See, e.g.,* Ashwander v. Tennessee Valley Authority, 297 U.S. 288, 319 (1936).

[158] Direct shareholder suits against directors are allowed in three classes of cases. The first includes actions brought after the corporation is defunct. *See, e.g.,* Word v. Union Bank & Trust Co., 111 Mont. 279, 283, 107 P.2d 1083, 1086-87 (1940). The second includes actions in which the defendant directors are themselves substantial shareholders and the plaintiff seeks to prevent their joining in any recovery. *See* Perlman v. Feldman, 219 F.2d 173, 178 (2d Cir.), *cert. denied,* 349 U.S. 952 (1955). The third includes actions brought by shareholders individually injured by a misrepresentation for which a director is responsible. *See, e.g.,* Coronado Dev. Corp. v. Millikin, 175 Misc. 1, 5, 22 N.Y.S.2d 670, 675 (Sup. Ct. 1940); Stinnett v. Paramount Famous Lasky Corp., 37 S.W.2d 145, 150 (Tex. Com. App. 1931).

[159] *See, e.g.,* Anderson v. Bundy, 161 Va. 1, 171 S.E. 501 (1933); Mercer v. Dunscomb, 110 Cal. App. 28, 293 P. 836 (1930). Misappropriation cases of course are within the group of "active mismanagement" cases. *See* note 152 *supra.*

[160] *See, e.g.,* Hi-Pro Fish Prod., Inc. v. McClure, 346 F.2d 497 (8th Cir. 1965). *See also* cases cited in note 151 *supra.*

[161] The burden of showing the causal relationship between the director's failure to exercise care and the corporate injury or loss is on the plaintiff. *See, e.g.,* Polon v. Huffines, 446 F.2d 384, 386 (7th Cir. 1971). A frequently cited analysis of the causation required for director negligence liability is Allied Freightways v. Cholfin, 325 Mass. 630, 91 N.E.2d 765 (1950). In *Cholfin,* the passive director of a company managed by her husband was held personally liable for misspent corporate funds which benefitted her personally. However, she was not liable for other misspending since she was ignorant of her husband's business defalcations. *Id.* at 767. In Barnes v. Andrews, 298 F. 614, 616-18 (S.D.N.Y. 1924), Judge Hand held that proximate cause was not established when it could not be shown that intervention by the defendant-director could have prevented harm caused by general mismanagement. *See also* Bellis v. Thal, 373 F. Supp. 120 (E.D. Pa. 1974), *aff'd* 510 F.2d 969 (3rd Cir. 1975); Chasin v. Gluck, 282 A.2d 188 (Del. Ch. 1971).

[162] *See* text accompanying notes 16-24 *supra.*

[163] The cases discussing causation present an almost uniform array of victories for defendant directors. *See, e.g.,* Hoehn v. Crews, 144 F.2d 665 (10th Cir. 1944), *aff'd* 324 U.S. 200 (1945); Holand v. American Founders Life Ins. Co., 151 Colo. 69. 376 P.2d 162 (1962); Hathaway v. Huntley, 284 Mass. 587, 188 N.E. 616 (1933).

numerous cases involving facts similar to those present in such non-liability cases, plaintiffs have prevailed against directors. Causation, however, is infrequently addressed in these cases, even though the courts describe the director's carelessness in terms implying an underlying causation analysis.[164] Perhaps the clearest guidance from these negligent supervision cases is that a director who exercises care and diligence will not be held liable because he is unskilled,[165] but his lack of skill or competence is no defense to a claim based upon alleged negligence.[166]

The third issue special to the duty of care cases is whether the business judgment rule may serve the director as a defense. The courts are split as to the nature and effect of this rule,[167] which may absolve the director from liability for exercises of judgment made in good faith.[168] By its very definition, however, the rule provides no defense to a director charged with omission, a failure to exercise his judgment.[169] Some courts have used the business judgment rule as a rationale for imposing liability only upon a showing of gross negligence, omitting a reasonableness standard and requiring only good faith.[170] Other cases cite the rule as a verbalization of a

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[164] *See, e.g.*, Van Schaick v. Aron, 170 Misc. 520, 10 N.Y.S.2d 550 (Sup. Ct. 1938); Crews v. Garber, 188 Okla. 570, 111 P.2d 1080 (1941). In Whitfield v. Kern, 122 N.J. Eq. 332, 192 A. 48 (1937), a New Jersey court did not discuss causation as such but found directorial liability for negligent "acquiesence" in actions by other members of management that clearly caused injury to the corporation. *Id.* at ___, 192 A. at 56. Formal causation analysis was also missing in Vujacich v. Southern Commercial Co., 21 Cal. App. 439, 132 P. 80 (1913), where a director was held liable for damages for negligence in failing to show "that she could not have obtained [fore-knowledge of a misappropriation] by the exercise of ordinary diligence as a director." *Id.* at ___, 132 P. at 81.

[165] Some statutes and cases, however, include "skill" in their statement of qualities that directors should have. *See, e.g.*, Keck Enterprises, Inc., v. Braunschweiger, 108 F. Supp. 925, 927 (S.D. Cal. 1952) ("care, skill and diligence in transacting the corporate business"). In practice, however, the courts may make allowance for varying "skills" but not for lack of diligence and care. *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 86, 188 A.2d 125, 130 (Sup. Ct. 1963).

[166] In Allied Freightways v. Cholfin, 325 Mass. 630, 91 N.E.2d 765 (1950), the court acknowledged that the skills of the defendant director ran to being a housewife, rather than a corporate director. The court was concerned that Mrs. Cholfin did not diligently learn about the corporation nor exercise care in at least attempting to review and understand its books. *Id.* at ___, 91 N.E.2d at 768. The import of this and many other director negligence cases is that if Mrs. Cholfin had done so she would not have been negligent.

[167] *See generally* Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 367-71 (1965).

[168] The principle that directors should not be personally liable in tort for "mere errors of judgment" is long-standing. *See* Smith v. Prattville Mfg. Co., 29 Ala. 603 (1857); Security Trust Co. v. Dabney, ___ Ky. ___, 372 S.W.2d 401, 406 (1963). The law recognizes that the director is not an insurer of his corporation's success, that business necessarily involves risk-taking, and that some errors of judgment are inevitable. *See* Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 204, 38 N.Y.S.2d 270, 273 (Sup. Ct. 1942), *aff'd* 267 App. Div. 890, 47 N.Y.S.2d 589 (1944).

[169] *See, e.g.*, Otis & Co. v. Pennsylvania Ry., 61 F. Supp. 905 (D. Pa. 1945), *aff'd* 155 F.2d 522 (3d Cir. 1946); Loyer, *Negligent Management of Corporations*, 9 CLEV.-MAR. L. REV. 554, 558 (1960).

[170] A significant number of cases have applied the business judgment principle to con-

finding that the director had not breached the ordinary negligence standard.[171] The best reasoned cases, however, expressly hold that the business judgment rule protects only reasonable judgments, and ordinary negligence is the standard. In *Casey v. Woodruff*,[172] a derivative action involving a bond issue by the Erie Railroad, the court stated:

> [a] director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.[173]

Several cases clearly indicate that a director has not closed his eyes if he has sought and received information which contributes to the reasonable exercise of his judgment. Accordingly, a director's care in the performance of his responsibilities can be shown by his proven reliance on reports from officers,[174] accountants,[175] the advice of counsel,[176] and from a properly authorized committee of the board upon which he does not serve.[177] The director must establish, however, that his reliance was itself reasonable.[178]

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done absurdly gross errors of judgment made in good faith. An early case in this regard is Spering's Appeal, 71 Pa. 11, 24 (1872), which held that directors are "not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest." More recently, in Security Trust Co. v. Dabney, ___ Ky. ___, 372 S.W.2d 401, 406 (1963), the court stated that "[a]ll of the allegations . . . address themselves to the matter of business judgement [and] [a]bsent fraud . . . the courts will not interfere with the management of a private corporation." *See also* Fielding v. Allen, 99 F. Supp. 137 (S.D.N.Y.), *aff'd* 181 F.2d 163 (2d Cir. 1950); Holland v. American Founders Life Ins. Co., 151 Colo. 69, 376 P.2d 162 (1962); Devereux v. Berger, 264 Md. 20, 284 A.2d 605 (1971).

[171] *See, e.g.*, Sellers v. Head, 261 Ala. 212, 73 So.2d 747 (1954); Spaulding v. Hotchkiss, 62 N.Y.S.2d 151 (Sup. Ct. 1946); Williams v. Fidelity Loan & Sav. Co., 142 Va. 43, 128 S.E. 615 (1925).

[172] 49 N.Y.S.2d 625 (Sup. Ct. 1944).

[173] *Id.*, 49 N.Y.S.2d at 643.

[174] In Harman v. Willbern, 374 F. Supp. 1149 (D. Kan. 1974), the court held a director was not liable for officers' acts since "[a]bsent notice of suspicious circumstances . . . [the] defendant was entitled to rely on those officers, and he cannot be held liable for failing to assume their responsibilities or engage in an exhaustive independent examination of the corporation's business transactions." *Id.* at 1164. *See also* Bates v. Dresser, 251 U.S. 524 (1920).

[175] *See* Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 240, 244 (D. Neb. 1972), *aff'd* 473 F.2d 537 (8th Cir. 1973); Pool v. Pool, 22 So. 2d 131, 133 (La. App. 1945); Epstein v. Schenck, 35 N.Y.S.2d 969, 980-81 (Sup. Ct. 1939).

[176] *See* Spirit v. Bechtel, 232 F.2d 241 (2d Cir. 1956).

[177] MBCA § 35, *supra* note 110.

[178] If the director learns of irregularities or of adverse information relating to corporate affairs, he must take appropriate action or risk liability for any consequent inaction. *See* McDonnell v. American Leduc Petroleums, Ltd., 491 F.2d 380 (2d Cir. 1974) (applying California law); Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938) (applying Kentucky law). A

Conclusion

Recent Supreme Court decisions have limited the efforts of private plaintiffs and the SEC to extend the Securities Acts into many corporate governance matters marginally associated with securities.[179] As the Supreme Court pointed out in the recent *Lasker* decision, state law remains "the font of corporate directors' powers."[180] Furthermore, directors' fears of personal liability in securities matters have been lessened by the ruling in *Hochfelder*[181] that more than mere negligence must be proven in damage suits brought under Rule 10b-5.

Although directors' responsibilities in securities matters are and will remain formidable and somewhat evolutionary,[182] the demarcation of directors' liabilities is at least being refined by the ongoing stream of decisions applying the Securities Acts. Directors may expect an increasing number of complaints alleging breaches of their common law duties of obedience,[183] loyalty,[184] care and diligence.[185] As indicated above, these duties pose significant liabilities and afford effective remedies under state law to those complaining of director misconduct.

An expectation of increased litigation against directors under state law follows from the combined pressures of the Supreme Court's decisions relegating to the state courts many corporate governance controversies, and SEC enforcement actions which focus on the role of directors. A notable indication of the first impetus is found in the opinion of the Delaware Supreme Court in *Singer v. Magnavox.*[186] Holding that a business purpose must be shown for a long-form merger that eliminated minority shareholders,[187] the state court expressly acknowledged a Supreme Court suggestion in *Santa Fe Indus., Inc. v. Green*[188] that state courts should resolve issues in majority-minority stockholder relationships.[189]

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well-known corporate law principle states that a director generally can avoid personal liability for improper activities by informing other directors of the impropriety and proposing and voting for a proper course of action. *See, e.g.*, Vujacich v. Southern Commercial Co., 21 Cal. App. 439, ___, 132 P. 80, 81 (1913).

[179] *See* text accompanying notes 106-08 *supra.*

[180] Burks v. Lasker, 99 S. Ct. 1831, 1837 (1979).

[181] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See* text accompanying notes 68-84 *supra.*

[182] *See* text accompanying notes 25-105 *supra.*

[183] *See* text accompanying notes 117-21 *supra.*

[184] *See* text accompanying notes 122-36 *supra.*

[185] *See* text accompanying notes 137-78 *supra.*

[186] 380 A.2d 969 (Del. 1977).

[187] *Id.* at 979. *See generally* Goldman & Wolfe, *In Reponse to* A Restatement of Corporate Freezeouts, 36 WASH. & LEE L. REV. 683 (1979).

[188] 430 U.S. 462 (1977). The *Green* Court held that a breach of fiduciary duty by majority shareholders, absent misrepresentation or omission of a material fact, does not violate Rule 10b-5. *Id.* at 476.

[189] Singer v. Magnavox, 380 A.2d 969, 976 n.6 (Del. 1977). The *Singer* court's business purpose test was innovative since, as the Supreme Court noted in *Green*, the Delaware law had not required such a test for short-form mergers. 430 U.S. 462, 479 n.16 (1977). Other

A second impetus to increased state law litigation against directors is a strategic shift by the SEC in response to the Supreme Court's narrowing of the reach of the Securities Acts. Followed closely by numerous private plaintiffs, the SEC has recently moved vigorously into corporate governance matters. However, such decisions as *Hochfelder* and *Green* have set unexpected limits on the success of private plaintiffs, whose efforts are essential to the SEC's thinly-staffed enforcement activities. Accordingly, through extra-judicial consent decrees the SEC has proceeded to lay a better groundwork for litigation against directors under state law.

Private plaintiffs may be expected, in particular, to file more negligence actions against directors for alleged breaches of their duty of care and diligence.[190] A plaintiff's evidentiary problems in such actions[191] will have been eased by SEC consent decrees, which serve in varying degrees as guidance for directors in all well-counseled corporations.[192] Notably, an increased specificity of director responsibilities[193] and increased information flow to directors[194] go directly to the reasonableness required by many courts of directors who interpose the business judgment rule[195] as a defense. Business capital needs in an inflationary economy will keep boards of directors acutely aware of the requirements of the Securities Acts. However, directors may also expect state law to become an increasingly important point of reference in the coming decade, which means no relaxation of the pressures on corporations and those who direct them.

Supreme Court decisions signalling plaintiffs of state laws' importance included Cort v. Ash, 422 U.S. 66, 84 (1975). The *Ash* Court held that "[i]f . . . state law permits corporations to use corporate funds as contributions in state elections, . . . shareholders are on notice that their funds may be so used and have no recourse under any federal statute." *Id.* at 84. *See also* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977). The Court held in *Piper* that a defeated tender offeror did not have standing to sue for violations of § 14(e) by the target or the successful offeror, as the claim in substance was for interference with prospective economic advantage and should be pursued in state court. *Id.* at 37-41.

[190] *See* text accompanying notes 137-78 *supra.*

[191] *See* text accompanying notes 162-66 *supra.*

[192] Former SEC Commissioner Sommer has concluded that "[i]t is through the medium of [consent] settlements . . . that the Commission has made its most notable inroads into corporate governance and accountability." Sommer, *supra* note 10, at 130. Furthermore, "[i]t is the implication of these settlements that will endure and influence corporations long after the issues of political and sensitive payments have ceased to claim newspaper space." *Id.*

[193] A number of consent decrees between the SEC and corporate defendants have resulted in "settlements in which specific responsibilities, sometimes of an ad hoc nature, sometimes of a continuing nature, are imposed on an existing board." Sommer, *supra* note 10, at 130.

[194] A long list of consent decrees have resulted in settlements "which require the appointment of an audit and/or other committee given special responsibilities," Sommer, *supra* note 10, at 130; "which require the appointment of a special counsel to conduct an investigation into certain practices, *id,* at 130-31; and settlements which require "appointment of a special auditor to assist in the work of special counsel." *Id.* at 131.

[195] *See* text accompanying notes 167-78 *supra.*