WHAT THE SEC EXPECTS OF CORPORATE DIRECTORS

An Address By
Ray Garrett, Jr., Chairman
Securities and Exchange Commission

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In a major address during his term in office, my immediate predecessor spoke of the Commission's concern for the uncertainties which had descended upon the directors of business corporations, in part, because of actions and utterances of the Commission. He thought it only fair that directors, present and prospective, have available a reasonably clear idea of what conduct is required to avoid personal liability under the Federal securities laws and to avoid suffering civil actions for injunction on our part, and the sometimes painful collateral consequences of such actions.

To this end, it was stated that the Commission would prepare and publish a set of guidelines on the duties of directors. I think this is an appropriate time to announce that we have abandoned the project — an announcement that probably does not come as a surprise to those who have had a particular interest in the idea and have been waiting in vain for something to appear.

We have not made this decision because of any lack of concern for the desirability of directors, like all citizens, knowing, or at least having the means of knowing, what the law expects of them. We have simply concluded that we cannot effectively advance the cause through guidelines. To the extent that there is genuine uncertainty in the minds of thoughtful persons, we may use other means — including speeches such as this — to enable businessmen and their counsel to know the state of our thinking.

I have already been subjected to the unfriendly observation that the law must be so confused that we cannot set it down clearly, and yet we stand ready to attack any director, when, after the fact, we think he has offended against some unknown rule or standard that we conjure up for the purpose. This leaves the director at helpless hazard while we remain free to pounce whenever we feel like it. My announcement today will surely intensify such criticism, except to the extent that I can refute it in the remainder of my remarks, which I shall try to do.

Before getting into the substance of our laws, let me say a few things about process in the law, because the now aborted guidelines project brings a basic and persistent problem of method into sharp focus. In the limited area of our jurisdiction, we are faced frequently with a fundamental choice facing government in general. In a broad sense it is the choice between the Common law and the Civil Code. When should the law be developed through legislation and when should it be through litigation — that is, case by case through judicial or administrative decisions? If there is legislation, should it

set forth only general standards, leaving specific applications up to the courts, or should it be detailed and precise?

Congress has taken both approaches in our statutes. Contrast the broad language relating to material false statements and omissions with the specificity in Section 16 (b) of the Exchange Act, relating to profits from short-swing trades.

Suppose we suspect a director, or other insider, of having sold shares while possessed of material, adverse, undisclosed information about the company. In deciding whether to act on such a case, we must decide whether we think we can establish that the information was material, that he knew or should have known the information, that the information was not available to the public, and that no reasonable effort had been made to make it available to the public.

The most contentious of these usually is the question of materiality. Now in lawyer’s parlance, there is a lot of law on the question of materiality, just as there is on the question of negligence. It is well settled that some types of information — such as the passed dividend where there has been a history of regularity — are indisputably material.

But there are always new types of information that do not fit into categories already established by precedent. There is no exhaustive list that, in a close case, the insider could check in a mechanical way and be certain of the answer. After reviewing the many efforts of judges to define "material," the draftsman of the American Law Institute's proposed Federal Securities

Code have so far settled on the following: "A fact is 'material' if a reasonable person would attach importance to it under the circumstances in determining his course of action."

The insider making the sale must rely on his own judgment or that of his counsel. If the case is at all close on materiality, he is taking a chance. If he does not want to take a chance, he must forego the sale until the news is out.

In contrast, suppose the question is not whether the sale was based on material non-public information, but whether it was made within six months of a purchase and at a profit. Here, at least when the transactions are simple market purchases and sales and the person was a director throughout the period, we have clarity and certainty in the law to about the greatest degree it can be found. On my assumptions, the only questions would be whether the sale was within 180 days of the purchase and, perhaps, how much was the profit. Whether there was any material non-public information, and, if there was, whether the director knew it or even whether the person on the other side of the trade knew it, are wholly irrelevant. If the sale followed the purchase by 180 days, the director is liable for his profit. If it was 181 days, he is not. I have seen men lose tidy fortunes in tragic circumstances because of miscalculations under the clear, simple and highly predictable provisions of Section 16(b).

It is a commonly expressed desire of businessmen to have clarity and predictability in the law. Reflection will reveal that you can have too much

and the cost from the irrationality and arbitrariness necessarily involved in specificity and precision of rules may be too high.

The cost of clarity in specific instances may also be too high from the point of view of the law enforcer. No one doubts the wisdom of Justice Frankfurter's oft-quoted observation that sometimes it is not so important whether the law be settled right as it is that it be settled. This attitude properly dominates much of commercial law where there isn't any clearly right rule but it is important that there be a rule all can know and abide by. Or, to take a simple analogy, there is no element of morality or justice involved in deciding whether we should drive on the left or right side of the road, but it must be clearly settled which one it is.

Compare that to negligence. It is important that people do not drive negligently. If you do drive negligently, and hurt someone or his property, you are liable for the damage. A sufficient degree of negligence becomes a crime, whether or not you violated any specific rule of the road. How does someone know whether or not he is driving negligently? He cannot know with mechanical exactitude.

The law requires that a driver abide by the rules of the road — drive on the right, obey speed limits, obey various traffic signs. But the driver's duty is not exhausted by obeying the rules of the road. He must also drive with reasonable care — that is to say, not negligently. What is reasonable care? Ultimately it is what the trier of fact — jury or judge — decides conforms to the behavior of a reasonable man in the circumstances. Is this hopelessly vague? There have been thousands of reported cases on this particular

problem, and the reasonable man standard has proved workable, though less than precise.

The reasonable man as driver should be awake and sober and driving in a reasonable way for the conditions in which he finds himself. In fairness, does he need, and should he have, a mechanistic checklist that tells him that on a stormy night, with wet leaves on the road, he may drive at 35 miles per hour but not at 36? Or that at any specific moment he should have on his high lights rather than his driving lights?

Such precision would obviously be ridiculous. While we want drivers to stay within prescribed speed limits, drive on the right, and obey other traffic signs, we are certainly not ready to agree that, having obeyed all these rules, they are free to drive unreasonably for local conditions and harm someone else with impunity.

So it is with corporate directors. Indeed, the business corporation acts of our several states are singularly devoid of helpful guidance as to directors' affirmative duties. Most merely provide that the business and affairs of the corporation shall be managed by a board of directors. Some go further and set forth a standard of care, such as that in the performance of their duties directors shall act like a prudent man in the conduct of his own affairs, or like a prudent man who is a corporate director. The largest number of cases under state law relate to conflicts of interest and self-dealing. On the affirmative side there is not much.

There are certain specific things that the law seems to require, but the ultimate standard has much in common with the legal concept of negligence. Obviously, directors should comply with the state and federal laws- directed toward their activities, to the extent that there are any.

Beyond that, they should attend meetings with reasonable regularity and pay attention to what is going on. But thinking of our travails over the possible guidelines, even on those simple matters what could we do?

I certainly would not favor a guideline that said all directors must attend all board meetings. This might be highly impractical. On the other hand, I would not favor a guideline that says a director must attend at least two-thirds of the meetings if the effect was to exonerate him from attending a particular meeting at which an obviously important matter was considered. This suggests a standard that says the reasonable director should attend meetings whenever feasible and that, if it is not feasible for him to attend most meetings, then he should not be a director. Furthermore, when a matter of special importance to a company and its shareholders is to be considered, he should make a special effort to attend and participate.

But what guidance can be given beyond this? Let me consider some of the substantive problems that arise and concern us under the federal securities laws.

The most obvious, and the easiest to discuss, is the burden placed upon directors individually by Section 11 of the Securities Act of 1933. That Act — chronologically the first of our federal securities laws — deals primarily

with the public offering of securities by companies. One of its purposes was to clarify, indeed overcome, the then common law attitudes as to who should be responsible for providing full and fair disclosure to prospective investors and bear the consequences of deficient disclosure.

In furtherance of this policy objective, the Securities Act, in Section 11, expressly provides for personal liability on the part of individual directors, with respect to the contents of registration statements (including prospectuses) relating to public offerings.

Omitting some details, the section provides that a director of a corporation is liable to a purchaser of the registered securities, in money damages, for a materially false or misleading registration statement, unless he can establish that, after reasonable investigation, he had reasonable ground to believe, and did believe, that the allegedly deficient statements made in the registration statement were true and were not misleading — the so-called "due diligence" defense. Section 11 further provides that a director's maximum liability in such a case shall be no greater than the price at which the registered securities were offered to the public.

Thus, the section appears to give corporate directors a fairly clear and specific warning as to the possibility, and scope, of the civil liability they may face in connection with a registered offering of securities to the public by the corporation on whose board they serve, at least under this one section of the Securities Act.

But, while Section 11 puts directors on notice of the possibility of liability, and defines the extent of the damages they may be required to pay, it contains no precise guidelines defining exactly what directors must do to be duly diligent and then to avoid such liability. Instead of guidelines, the section lays down a standard, namely, that in determining "what constitutes reasonable investigation and reasonable ground for belief, [that is, "due diligence"] the standard of reasonableness shall be that required of a prudent man in the management of his own property."

That is all the help a director gets from the statute. Beyond this, he must look to his own judgment and that of his counsel, who must look to the few decided cases on the subject plus his own judgment and experience. It takes judgment to apply the lessons to be gained from decided cases.

The decision that most thoroughly explored the world of due diligence was that of the late Judge McLean in *Escott v. BarChris Construction Co.*, decided nearly seven years ago. After finding the registration statement for the BarChris debentures materially false and misleading within the meaning of Section 11, the judge proceeded to examine in great detail the behavior of the BarChris directors, as well as that of the other defendants, to decide whether they had met the statutory standard of due diligence. One of the deficiencies in the prospectus was the statement of the company's backlog of orders. The backlog was materially overstated, in Judge McLean's opinion, because, among other things, the construction contracts involved had cancellation provisions which made them less than firm, and these provisions were not disclosed. The directors did not know this. They had relied on the

officers and professionals who prepared the statement. That was not enough for Judge McLean. They should have personally read the contracts.

Does one derive from this a rule that in all cases, in order to meet the standards of Section 11, all directors must read all contracts reflected in a reported backlog of orders? Or all contracts reflected in the financial statements? In BarChris, only a few contracts were involved, the company was obviously in deep trouble, and the backlog was of critical importance. While the court did not qualify its comments on this particular aspect by reference to the peculiar circumstances of BarChris, could the same rule possibly apply to a director of a large, multi-national corporation? Requiring something impossible of a director in the way of due diligence deprives him of his defense and Makes him a guarantor. So I would conclude that where it is manifestly impossible for a director to read all of the contracts, due diligence does not require that he do so.

Would it help to have a guideline to that effect? I doubt it, because it really wouldn't advance the cause of clarity very far. To say that a director need not read all of the contracts when it is impossible is not necessarily to say he need not read any, especially if one is of salient significance. Or suppose, as must often be the case, it is not literally impossible to read all of the contracts, but even to a most conscientious man it seems quite unreasonable and a gross waste of time. Or suppose the defense is that I read the contract, but I did not catch the point which has caused the trouble because it was written in legal prose too turgid for me to penetrate. How

much meaning does an otherwise able businessman get from reading a typical 150-page trust indenture?

The answers to these questions must be found in reasonableness under the circumstances. They cannot be found in guidelines, because we would end up saying the same thing over and over, and so hedged that it all comes back to reasonableness. The greatest contribution of BarChris, after all, has not been to lay out exact rules of director behavior but to remind directors that the Congress in Section 11 intended to cause directors of issuers to do all they reasonably could to assure accurate and complete prospectuses, and they can and must do more than simply sign the registration statement — how much more, and what they can do, must vary with the circumstances.

Directors' liability for registered public offerings, however, is not the focus of concern of those who are concerned about what the SEC expects of corporate directors. Their concern is doubtless directed toward our challenging the directors' involvement in other corporate activities and based upon other statutory provisions and rules. Here, the situation is more complicated.

First of all, the Commission has no direct, comprehensive jurisdiction over the duties of directors in managing a corporation. Except under Section 36 of the Investment Company Act of 1940, which permits us to sue to remove directors of investment companies for "breach of fiduciary duty involving personal misconduct," we must proceed generally on a disclosure theory. That is to say, the director's misconduct may not, in itself, have constituted a violation of the federal securities laws, but it resulted in false or misleading

filings with the Commission or false or misleading information being disseminated to investors. While misconduct frequently leads to misinformation, where it does not, there might not be a cause of action under our laws.

Parenthetically, I hope you will not be misled by my over-simplification. The reach of what we collectively refer to as the "fraud provisions" is not limited to false or misleading statements.

Rule 10b-5, the rule on which the type of actions which I am now discussing is most likely to be based, in addition to untrue statements and omissions, also makes unlawful "any device, scheme, or artifice to defraud" and "any act, practice, or course of business which operates . . . as a fraud or deceit".

The Exchange Act also outlaws manipulative devices or contrivances, which are not founded on disclosures, and I am talking about all these violations. But I lack a handy word for them all. Internally, as I say, it is customary to lump all these together as "fraud".

More and more, however, I encounter people who tell me how nervous and depressed it makes them to hear Commission personnel always talking about fraud. In the spirit of the season, I am trying to avoid that dread word.

So, our point of entry, so to speak, with regard to the conduct of directors of publicly-held companies, in their capacity as directors and not as principals for their own accounts, is normally the commission by the company of a violation of Rule 10b-5 or one of the statutory provisions

relating to market manipulation or false filings. If this is true, how do we get to the directors individually? If the company has included misleading financial statements in its annual report, for example, when and how do we proceed against the directors?

First, the how. Except where a public offering is involved and a stop order proceeding is available, and except for removal actions involving investment companies, the procedure normally available to us is a civil action to enjoin further violations of our laws, plus, where appropriate, what lawyers call ancillary relief — disgorgement of unjust gains, the appointment of a receiver, or other measures. Our injunctive actions frequently end in consent decrees arrived at in settlement negotiations, and these may involve changes in the board subject to court and Commission approval, the retaining of special counsel for the company to seek out and enforce any claims the company have had for past misconduct, or any other device that seems to fit the situation. Where we think there has been a willful violation of the laws that warrants more severe measures, we refer the case to the Department of Justice for possible criminal prosecution.

That, in brief, is how we proceed. When do we seek injunctions and other relief from directors individually rather than just against the company, and possibly its officers and maybe its professional advisers? The truth is that we have not done it very often, but we have done it, and we have talked about it, and we may well do it again, so the question has current meaning and interest, remembering always that I am now concerned only with the director whose sole involvement is in that capacity. Many directors have other

involvements that are the cause of difficulty. We have for years moved against promoters, officers, major shareholders who also happen to be directors, but that is another matter.

In exploring the question let me begin with the easy case. The directors at a meeting approve the filing of an annual report on Form 10-K clearly knowing that in some material respect it is incomplete, or false and misleading. We have no trouble asserting that in such a case the directors are individually responsible. They made, or caused to be made, a materially false statement, which is a violation of Section 18 of the Exchange Act. We might assert that they are controlling persons and thus liable for violations of the controlled person — the company — under Section 20 of the Exchange Act. Or we may assert that they aided and abetted the commission of a violation.

I doubt that anyone would have much trouble with such a case. The defendants would no doubt argue about what they actually knew and about the materiality of the deficiency, but if in fact they knew and it was material, the case is easy. The difficult cases are those where the most that we can show is that the defendants should have known, or in the exercise of reasonable care in the performance of their duties would have known. These are the tough cases, not only from the standpoint of proof, but also because they bring me back to where I began. What duty to know can reasonably be imposed on corporate directors?

We tend to think that the duty of care of directors is what most courts have imposed where the question has been put, whether phrased in terms of the prudent man in the conduct of his affairs or a reasonable man as director.

The difficulty is that few cases have been brought which did not involve either conflict of interest, or self-dealing, or the business judgment rule, so that practices have become careless and the idea has been lost that directors of publicly-held companies have a prudent or reasonable man duty to investors to provide full and accurate information and otherwise to cause the company to comply with the federal securities laws.

What is new is that we propose to encourage the performance of that duty by appropriate actions. It means adequate attention to the affairs of the company. It means adequate examination into the materials the directors are asked to approve and authorize, and the relevant corporate procedures. Most of all, it means remembering that a director's duty is to investors and not to the individuals who make up management from time, to time. It is our experience that the last of these most needs to be kept in mind.

As I have explained, we have no authority or responsibility to enforce directors' obligations directly. We cannot sue a director simply for non-performance of his duty. But in the effort to enforce our laws, we do intend to hold directors responsible for corporate violations, not absolutely responsible as guarantors, but responsible within the standard of performance of their duties imposed upon them by corporate law. Directors are, therefore, obviously responsible for knowingly authorizing or permitting violations to occur. And they may be responsible for permitting them to occur unknowingly unless it appears that they exercised reasonable diligence in the performance of their duties and were nevertheless unaware of the misconduct or omission.

I would be remiss, however, in creating the impression that reducing the analysis to the simple proposition that directors must use reasonable diligence in causing the company to comply with the federal securities laws, as well as other laws, provides easy answers for concrete cases. It obviously does not. We are well aware of the trend to demand more of the reasonable director and of the growing quandaries arising from the different statuses of directors. Is more expected of the inside than of the outside director? I assume yes, but how much more, or, the more cogent question, how much less, is hard even to phrase, much less measure.

Is more expected of the outside director with relevant professional expertise than of one without it? Again, I think the law is coming to say yes to some immeasurable degree. At least it is saying that the reasonable director must use such knowledge, experience and expertness as he possesses in considering company matters. But is a director held to a lesser standard if he has special ignorance rather than special expertise? This will become a bigger question to the degree that companies have special interest directors who are not generally experienced in relevant business and financial matters. I am not sure I wish to predict how such persons will be judged.

A recent case, curiously also arising out of the problems of BarChris Construction Co., presents clearly the sharply differing views on the duties of an outside director to take affirmative steps to find out what company officers are up to and to take measures to prevent illegal activity.

In *Lanza v. Drexel*, BarChris offered to exchange its stock with shareholders of the Victor Billiard Company. The Lanza family exchanged

20,000 shares, believing BarChris to be a viable, solidly-run company, an impression of BarChris's status they received by virtue of untrue statements of various inside directors and officers of BarChris.

No one questioned the liability of these inside directors and officers. The real issue in the case concerned the liability, if any, of Bertram D. Coleman, an "outside" director of BarChris, and the partner of an investment banking firm.

Mr. Coleman apparently knew that BarChris's financial condition was faltering, but he did not take part in negotiating the exchange offer, did not see or actually know of any misstatements that may have been made to the Lanzas or others, and did not interject himself into the details of the exchange offer.

The plaintiffs alleged that Coleman's knowledge of the likely adverse nature of BarChris's financial condition imposed a duty upon Coleman to advise the plaintiffs, or to see to it that they were advised, of the adverse information Coleman knew or suspected.

The court of appeals concluded that a director like Coleman, in his capacity as a director (a non-participant in the transaction) owed no duty to insure that all material adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits.

The dissent took strong issue with the majority and concluded, as this Commission had urged in an <u>amicus curiae</u> brief, that Mr. Coleman's special financial sophistication, coupled with his awareness of the increasing

misfortunes of BarChris, should have made him vigilant enough at least to inquire whether the shareholders obtaining BarChris stock were fully informed.

While the special capacities of an outside director thus have not been held to be determinative of such a director's liability, corporate directors should not take too much comfort from this decision. For one thing, the Commission's position, and that of almost half the Court of Appeals for the Second Circuit, is clearly to rely on any special expertise an outside director may bring to the Board, in determining whether a director has a duty of inquiry, and has breached that duty. More importantly, the majority did not purport to answer the same question as the minority and the Commission. The majority opinion simply held that an outside director has no duty to insure that all material adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he serves. Thus, the majority reached a question that neither the plaintiffs nor the Commission had raised.

In summary, the SEC expects every corporate director to do his duty, but we are not willing to try to tell him exactly what his duty is in every situation in which he finds himself. We are, however, willing to say, indeed are eager to say, that we expect directors to take seriously what the law has in fact long required of them. Realizing that their duty and loyalty run to investors and not to CEO's, they must overcome the traditional and very human tendency to be compliant good guys and make the job of management more pleasant, and must take reasonable measures to protect the interests of

investors. We believe that a sincere and diligent effort to perform this duty is sorely needed to preserve confidence in business corporate enterprise and, if accomplished, will keep directors free from personal hazard.