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THOUGHTS FOR THE INSURANCE COMPANY DIRECTOR

An Address By

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Discussing the impact of federal securities laws on the responsibilities and the duties of insurance company directors is in a sense something of a melding of uncertainties.

Because of the McCarran-Ferguson Insurance Regulation Act which was intended to preserve the regulation of insurance to the states the general feeling has existed that the federal securities laws have minimal importance to insurance companies. Surely it has always been clear that insurance companies were subject to the registration provisions of the Securities Act of 1933. However, the amendments to the Securities Exchange Act of 1964 reinforced in the minds of many the minimal relevance of the federal securities law scheme to insurance companies when insurance companies were exempted from the proxy, insider trading and reporting provisions of the 1934 Act provided they satisfied comparable provisions in the laws of their states of incorporation.

I would suggest that the true scope of applicability of the federal securities laws to the insurance industry began to appear in the case of SEC v. National Securities, Inc. in 1969 when the Supreme Court gave a fairly narrow reading to the McCarran-Ferguson Act and determined that indeed Rule 10b-5 did have applicability to the

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conduct of insurance companies and those who managed and controlled them. This conclusion was rather decisively reinforced in the case of Superintendent of Insurance v. Bankers Life & Casualty Co., decided by the Supreme Court in 1971, in which, while the Court made law of significance to many more than those involved in insurance companies, it made clear that the requirement of Rule 10b-5 that prohibited conduct be "in connection with the purchase and sale of securities" was satisfied by dealings of an insurance company in its portfolio securities and not only be dealings in securities issued by itself. This, of course, meant that even mutual insurance companies which have technically no shareholders nonetheless might, along with their officers, directors and controlling persons, find themselves in violation of Rule 10b-5 if in some fashion they committed fraudulent, manipulative, deceptive or other kinds of improper conduct which resulted in harm to their corporations in connection with their dealings in portfolio securities.

I mentioned at the beginning that the relationship of Rule 10b-5 and the insurance industry involved a melding of uncertainties. The second uncertainty melded together is, of course, Rule 10b-5 itself. Despite extended litigation over a period exceeding three decades, despite case books bulging with procedural and substantive decisions involving Rule 10b-5, despite the admirable effort of Professor Alan R. Bromberg in his three volume work on Rule 10b-5 to bring together and rationalize all of the disparate elements, vast areas of uncertainty exist. These uncertainties are, to use the phrase increasingly found in decisions involving Rule 10b-5, "aided and abetted" by the peculiar structure of American jurisprudence which divides up appellate jurisdiction not only into a Supreme Court but among 11 circuits, each of which, in keeping with

traditional common law theory, by its decisions binds only the district courts within its circuit. Rule 10b-5 is undoubtedly one of the most prolific sources of litigation presently found in the United States Code or the Code of Federal Regulations. It is not surprising then that it has fomented innumerable conflicts among the circuits. While I do feel that many of the conflicts have gradually been reduced in significance, nonetheless many remain.

It is both fortunate and unfortunate that Rule 10b-5 has grown in significance to the extent that it has. It is fortunate because it filled a rather gaping void - - or more accurately a number of gaping voids which if some means had not been found to fill them might have had extremely adverse social consequences. Any of us who have read Professor William Cary's recent masterful article entitled, Federalism and Corporate Law: Reflections Upon Delaware, knows the sad deficiencies in our state corporation laws. We also know how ineffective have been proposals for a federal corporation law. We all know the manner in which involvement of the public in securities matters has grown over the last 30 years. We all know of the increasing public demand for higher standards of performance on the part of corporate executives, directors, accountants, lawyers. And we all know the profound distaste which has grown among the members of the public for overreaching and inside dealing among corporate officials, ethical reactions which have now spread to other countries, notably the United Kingdom. I would suggest that in many respects Rule 10b-5 has been the safety valve which has prevented the buildup of these pressures to intolerable proportions and which has permitted the Securities and Exchange Commission in a remarkable fulfillment of its role as an administrative agency, and the courts in fulfillment of their common law

tradition, to relieve these pressures by constructive and imaginative law-making. Without Rule 10b-5 and its flexible ability to respond to the ethical conceptions which the public demanded be translated into legal mandates, and given the counter pressures which in my estimation would have prevented sufficiently timely and effective state action to deal with these demands, I think we would have had an even greater erosion of confidence in corporate responsibility and corporate decency than we have had with many misfortunes following from that.

I spoke of Rule 10b-5 being both fortunate and unfortunate. I think it is unfortunate that we have, because of the circumstances that I mentioned, been impelled to load so much on this Rule, which after all was admittedly adopted in haste, expressed with bewildering and sometimes even angering breadth and generality, and which is only 115 words long. Responsible commentators have suggested that it is wholly inappropriate for the Commission and the courts to try to draw through some alchemy out of those few words a whole code of conduct for the legal profession, the accounting profession, directors, corporate officers, insiders of all types, financial analysts and a host of other people. It would perhaps indeed be better if through the debative process by which legislation is developed greater particularity had become a part of this endeavor and perhaps it would have been better if there had been at some point in time a more comprehensive realization of what was being done, rather than a piecemeal, case-by-case manner of achievement that has characterized the growth of the Rule 10b-It would perhaps indeed be better if through the debative process by which legislation is developed greater particularity had become a part of this endeavor and perhaps it would have been better if there had been at some point in time a more comprehensive

realization of what was being done, rather than a piecemeal, case-by-case manner of achievement that has characterized the growth of the Rule 10b-5 concept. While such an ordered structural development has much to commend it, I think there would also be within that a severe disadvantage: inflexibility. Social commentators have repeatedly warned that the pace of change in our life is steadily accelerating and that our institutions, our psyches and even our bodies must develop a capacity to change more quickly. The corporate world is not immune to this rapidly accelerating pace of change and it is extremely important that the means of social control of this terribly important part of our national economic life be flexible and relatively swift in reaction. Through Rule 10b-5 I think we have accomplished a great deal of that flexibility and the ability to adapt that is so necessary.

The price that is paid for such flexibility and adaptability, of course, is the inability to have a photographic rendition of the state of law at any given moment which is fixed, clear, delineated, sharply focused and reliable.

This reminds me somewhat of the physical principle which stated, as I recall it, that it was impossible to calculate the position of a particle and at the same time chart its motion. Consequently, it is extremely difficult to determine from the relatively meager precedents that we have available today the exact extent of a director's responsibility; this in part has been the reason why the Commission has been so dilatory in preparing and publishing guidelines for the conduct of directors, as it promised it would do for some time. Similarly, the task of trying to predict what future lines may be drawn is difficult; there must be in such a venture a liberal mixing of prophecy with legal analysis.

Obviously a starting point in this analysis should be the Securities Exchange Act of 1934. Section 10(b) of that Act gives the Securities and Exchange Commission extremely broad power to adopt rules to thwart manipulative and deceptive activities. Thomas Corcoran during his testimony before the Congressional Committee considering Section 10(b) very aptly characterized it as saying in effect "thou shalt not devise any other cunning devices." Section 10(b) has been for the Commission a rich source of power to deal with a variety of problems as they arose, and being one of the partisans of the administrative process and flexibility in its exercise, I must say that the power has been most beneficial to the effective administration of the securities laws.

The most all-embracing of the rules adopted under this statute is Rule 10b-5, with which I think most of you are probably quite familiar. Rule 10b-5 is addressed to "any person" and it makes it unlawful to engage in various types of conduct " in connection with the purchase or sale of any security." The types of forbidden conduct are set forth in three clauses:

(1) to employ any device, scheme, or artifice to defraud.

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

There are several ways that the director of a corporation can be brought within the embrace of this rule. Obviously the first way is if he does himself, directly, personally, not through any corporate entity to which he has a relationship, any of the

forbidden acts in connection with the purchase or sale of a security, or if he participates directly in the doing of any such conduct.

A second way in which he may be implicated would be if he were considered to be in control of a corporate entity that committed an offense, or was a member of the controlling group of such an entity. This source of liability is set forth in Section 20 of the 1934 Act which provides:

> "Every person who, directly or indirectly, controls any person liable under any provision of this title 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 . . ."

A third way in which he may be involved is through the invocation of the ancient doctrine of aiding and abetting. This is nowhere defined in the Securities Exchange Act of 1934, but rather is contained in the more general legal provisions. One who "aids and abets" a violation of the securities law may be subject to administrative proceedings, injunctive actions or conceivably financial and criminal liability.

This much is fairly clear and I would think that it is now beyond cavil that directors may have responsibility under Rule 10b-5 for actions they take in their role as directors of corporations. Unfortunately, in the few cases in which these determinations have been made the courts have not been fastidious in delineating the conduct of directors in accordance with the categories I have mentioned above, although in some cases there has been explicit discussion of the responsibility of directors as controlling persons.

The standard of care applicable to directors in their role as controlling persons is fairly clearly set forth in Section 20 of the 1934 Act. This section says that a controlling person has the same liability as the person he controls "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."

Of course, the problem of determining whether a director is indeed a controlling person is not free of difficulty. The classical understanding of the term "control" is the power to control, or the actual control of, the affairs of another entity, usually a corporation. This control can derive from a number of sources, including share ownership, office, contractual arrangement and a variety of other relationships with the corporate entity. A person may be deemed to be a controlling person because he is a member of a group that, although not formally bound together, nonetheless functions in a manner that effectively controls the affairs of the corporation.

In Myzel v. Fields, the Court of Appeals for the Eighth Circuit held that all directors per se were controlling persons for the purposes of the 1934 Act. I think this is much too sweeping a statement. Rather, I would suggest that for purposes of advising clients the appropriate test is this: a director is presumed to be a controlling person or a member of a controlling group -- subject to a rebuttal. What would that rebuttal consist of? It seems to me that if a person is a director of a corporation in which, say, the chief executive officer owned 55% of the stock, that person might well be able to sustain the burden of showing that he was not a member of the controlling group because of the clear-cut control vested in the chief executive officer. However, I would caution that, given the trend toward the expansion of directoral responsibility in

favor of shareholders and investors in general, it may well be that despite the presence of such overwhelming voting power a director might still, if he customarily supported the wishes of the dominant shareholder, be deemed to be a member of the controlling group.

Thus, if a corporation commits a violation of the 1934 Act, and particularly Rule 10b-5, then a director who is a controlling person or a member of a controlling group, failing to make the statutory defense, would have the same liability as the corporation.

The last way in which a director might be deemed liable would be as an aider and abettor of the offense of the corporation. The classical definition of aider and abettor provides that whoever aids, abets, counsels, commands, induces or procures the commission of an offense is punishable as a principal.

This concept of aiding and abetting which is not spelled out expressly in the federal securities laws is nonetheless a real hazard to directors, even though the courts have not dwelled upon this notion extensively in dealing with the liability of directors. As we all know, aiding and abetting can take a multitude of forms. At one time a fairly active course of conduct was thought to be essential for a finding of aiding and abetting; however, since the Brennan v. Midwestern United Life Insurance Co. case, decided by the Seventh Circuit in 1969, something less than affirmative action may be sufficient, and as a matter of fact it would now appear that passivity or inaction in the face of a duty may be sufficient to invoke the doctrine.

The most pervading argument, not only with respect to directors' liability, but with respect to that of accountants, lawyers and others as well, is: what standard of

care is applicable with respect to either liability because of direct participation or because of aiding and abetting? Not surprisingly, there has been a great deal of dispute among the circuits and commentators concerning this. Professor David Ruder of Northwestern University Law School in a most able article entitled, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution, has argued very persuasively that with respect to aiding and abetting the proper standard should not simply be negligence but something more than that. His argument was mentioned and rather sharply rejected by the court in S.E.C. v. Spectrum, Ltd., decided in 1973 by the Second Circuit. There the court, in discussing the liability of an attorney in giving an opinion with respect to the availability of an exemption for a sale without registration under the Securities Act of 1933, said:

> "We do not believe, moreover, that imposition of a negligence standard with respect to the conduct of a secondary participant is overly strict, at least in the context of this case. The legal profession plays a unique and pivotal role in the effective implementation of the securities laws.
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> "We do not find persuasive the argument by one recent commentator that since 'the alleged aider and abettor will merely be engaging in customary business activities, such as loaning money, managing a corporation, preparing financial statements, distributing press releases, completing brokerage transactions, or giving legal advice, [a requirement that he] investigate the ultimate activities of the party whom he is assisting [may impose] a burden . . . upon business activities that is too great.' . . . In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of

> convenience. The public trust demands more of its legal advisers than 'customary' activities which prove to be careless."

The Spectrum case, which I think has applicability in considering the liability of directors, involved an injunctive proceeding by the Commission. I would suggest that with respect to such actions there is beginning to jell a consistent pattern, namely, that with respect to responsibility, whether the question be one of participation in wrongdoing or aiding and abetting it, the proper test is negligence. I would further suggest that the returns are still not in with regard to the standard of liability to be applied with respect to a suit for damages. It seems to me that the misgivings expressed by Judge Henry J. Friendly in the Texas Gulf case continue to be of concern:

> "The consequences of holding that negligence in the drafting of a press release such as that of April 12, 1964, may impose civil liability on the corporation are frightening . . . If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts -- all judged in the bright gleam of hindsight -- will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former."

It is very easy for a trier of fact to find negligence on the part of directors. With regard to even corporations of moderate size the liability consequences of negligence for directors can be absolutely ruinous; the holding of the court in the Second Circuit in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith that a defendant accused of selling stock on an exchange on the basis of an illegally communicated "tip" may be liable to everyone who purchased or sold a security in the market during the period of the offense opens the threat of even greater liability than had previously been considered.

If the standard in money damage cases is to be negligence, then I would suggest that perhaps we must reconsider the exposure of directors to monetary liability. Professor Alfred Conard has discussed this in a thoughtful article entitled, A Behavioral Analysis of Directors' Liabilities for Negligence. He there suggests, among other things, that perhaps a director should have a liability limited to the after tax amount he received from the corporation during the year in which his offense occurred. I would suggest that this is much too light an exposure. Such a penalty would in most cases be small deterrent to neglect of duty on the part of directors. It may well be that a more realistic test would be that proposed in the Federal Securities Code now under consideration by the American Law Institute which, for all practical purposes, would limit directors' liability to $100,000. If there were such a limitation, obviously it would be much easier for smaller corporations to secure liability insurance for their directors, although I suppose any re-examination of the exposure of directors' liability should also include a consideration of the public policy implications of officer and director liability insurance.

As I mentioned, the limits of responsibility are obscure. Perhaps the most significant recent case with respect to directors' liability is that of Lanza v. Drexel & Co. In this case, one Coleman, an outside director of the ill-fated BarChris Construction Corporation and a partner of the company's principal financial advisor, was charged with liability for the failure of the management of BarChris to inform a company to be acquired concerning the problems of BarChris. The Second Circuit split five to four on the question of Mr. Coleman's responsibility, with the majority holding he did not have liability.

In my estimation the majority's opinion has been interpreted in a fashion that preserves a low standard of directional responsibility. It held that Mr. Coleman, because he had not attended critical meetings at which the acquisition was discussed, had no responsibility to inform the company to be acquired about BarChris and its troubles. The court appeared to indicate that he had no responsibility to ascertain the nature of the representations being made by BarChris management or their accuracy.

The minority opinion, on the other hand, insisted that Mr. Coleman, in view of his knowledge of the gathering clouds over BarChris, had the obligation to at least inquire concerning the information management was furnishing to the company to be acquired. The minority placed great emphasis upon Mr. Coleman's financial expertise, his presence on the board as a representative of the underwriter, his awareness of the problems of the company.

The court did not confine its discussion to the standard of conduct -- negligence, scienter, recklessness, etc. The court placed considerable emphasis on the duty of an outside director in an acquisition situation involving the issuance of stock.

I am rather strongly in sympathy with the minority opinion. Mr. Coleman, prior to the completion of the acquisition, had become aware of the increasingly difficult financial plight of BarChris, the existence of bitter dissension within the executive ranks, the declining fortunes of the company. In this situation does he not have at least the responsibility to inquire whether the management of his company has been leveling with the company to be acquired? After all, the board had authorized the issuance of the securities to the shareholders of the company being acquired. Were these shares to be issued in a vacuum, were they simply pieces of paper without relationship to the

totality of the issuing corporate enterprise? I shrink from admitting that the role of the director is so limited and his responsibility in such a situation so little. Rather it seems to me that, given the expertise of Mr. Coleman, the fact that shares, deriving their value only from the state of the mother enterprise, are to be issued for economic interests, there should be at least the obligation to inquire whether the whole story is being told the lambs. To the shareholders of the acquired company the transaction was perhaps the most important of their lives. Should not they expect the interested, involved, careful concern of the directors of the acquiring company in assuring that they are given the benefits of information concerning the true state of the company whose shares they are about to receive? It is to my mind little short of shocking that Mr. Coleman apparently had not even the obligation to inquire whether, knowing the deteriorating situation in BarChris, the whole unpleasant truth had been told the trusting shareholders of the company to be acquired.

The minority opinion in the Lanza case has an interest beyond the conclusion reached by the judges. Judge Hays, writing for the minority, suggested that conventional analysis of fault was inappropriate in Rule 10b-5 cases. He said:

> "It is not profitable in considering a case such as this merely to characterize the allegedly unlawful conduct as either negligent or willful and to impose liability only if the conduct was willful. Neither the Act nor the Rule creates such a simple dichotomy. The purpose of the Act and the Rule are not furthered by a mechanical application of labels. The relationship of the parties and the transaction involved must be analyzed in order to determine whether the Act and the Rule impose a duty on one party with respect to the other and the nature of that duty."

This notion in White v. Abrams, decided in 1974 by the Ninth Circuit, became law, at least in that circuit. There, in a case involving an advisor, the court said:

> "The proper analysis, as we see it, is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify . . ."

I would suggest that close scrutiny of the technicalities of the degrees of fault in the context of Rule 10b-5 cases will steadily become obsolete. I doubt seriously whether juries confronting the complexities of conduct within the framework of the modern corporation pay much attention to the niceties of the degrees of scienter; rather I think they do pretty much as the court in the White case suggests; they look at the relationship of the parties, try to understand the duties attending the situation of the defendant, assess the measure of reliance of those to whom the duty is owed, define the depth of involvement of the defendant in the affairs of the corporation, understand the skills and ability the director brings to the chore at hand. Analysis involving these elements in my estimation is more meaningful than the conventional analysis of fault.

This is in some measure the process the Commission went through in determining which among the outside directors of Penn Central should be named in that action. You will recall that only three were named. It would, I think, be inappropriate for me to presume to search out the thinking of my colleagues in reaching that decision, or even to express my own. However, I think an examination of the total situation, including the history of the named directors in relation to the company, their expertise, and similar considerations, divulges many clues to our thinking.

Obviously, as greater attention than ever before is focused upon the conduct of directors, and in view of the still expanding scope of Rule 10b-5, those who serve in the capacity of director and those who advise them are driven to find means of assuring avoidance of liability, not only in connection with SEC-instituted actions, but civil litigation as well.

It is perhaps idle to simply repeat the old rules with respect to "duty of loyalty" and "duty of care." People need more specific advice than that. I have on occasions suggested various means of avoiding the perils. Without repeating unduly, I would suggest these as among the safeguards which directors should consider, though they are far from being exhaustive.

First, if I were a director, I would be most interested in whether the corporation I serve has a functioning, effective audit committee. I would be concerned with whether those serving on it understood their responsibilities and performed them diligently and regularly. Beyond that, I would want an opportunity to discuss myself with the auditors the problems they identified, the practices of management, the extent to which management appeared to be "prettying up" the financial statements. I would try to observe whether the auditors truly appeared independent, whether their personal relationships or other circumstances might impede their independence. I emphasize the role of the auditors as guardians of the directors for increasingly I feel they are critical to the integrity of the corporate process.

Secondly, I think directors should be particularly sensitive to developments and occurrences within the corporation which may give clues to problem areas or which are peculiarly suited to give trouble to directors. For instance, whenever the corporation

proposes to issue securities, whether for cash or in an acquisition, directors should exercise great caution to assure that disclosures are proper and complete; certainly, if the securities are being offered through written means, they should review the disclosure documents being used. If there is any reason to fear that the full story is not being told to those who are to receive the stock, they should at least make inquiry concerning the measure of truth telling.

Further, I think directors should be peculiarly sensitive to litigation involving the corporation, especially litigation involving charges of wrongdoing against officers of the company. Often the first hints of trouble lie buried in a complaint in a complaint in some courthouse file. Charges should be carefully investigated. This means inside or outside counsel should report regularly concerning new litigation and the nature of the charges, as well as developments in previously pending litigation.

Certainly an occasion demanding full analysis is a change of auditors. We all know that for practical purposes management chooses the auditors and management fires them. When they are fired or quit, the directors should investigate with great care the circumstances surrounding the change. Conversation with the retiring auditors would seem to be a minimum.

More generally, I think directors should have well developed antennae; they should be alert for any indications that all is not going well, that trouble is lurking down the road. When there are material developments within the company, they should inquire concerning the measures taken to assure that the information is disclosed in the marketplace. They should scrutinize the materials furnished them -- and if they are not furnished sufficient information they should demand it -- with a questioning eye -- and

if they do not understand some part of it, they should cast pride aside and find out what it means.

Having said all this, I must also add that as the reexamination of the role of directors continues there is the temptation to impose upon them excessive demands, demands that are inconsistent with the historical role of directors in American corporations. It is easy to say that directors have responsibility whenever an enterprise goes "bust," whenever the shareholders suffer harm, whenever tribulations assault the enterprise they serve.

I would strongly disavow any such notion. Outside directors are necessarily limited in the time and energy they can devote to the enterprise on whose board they serve, and to judge them as if they were full-time employees is in my estimation a mistake. Similarly, they have not the time nor the opportunity to review every particular of the enterprise to ascertain whether management is honest, forthright, candid, straight. They must, as has been recognized in many states' corporation laws, rely upon the reports of management and auditors in carrying out their responsibilities.

But in achieving the necessary balance, it is wrong to impose upon directors so low a standard that the shareholders and potential investors really derive from the presence of outside directors no strength at all. Where perhaps once directors were conceived of as desirable to bring outside expertise to the running of the business, there has unquestionably been a shift in the direction of more emphasis upon the protection their presence affords shareholders and investors in general. And it is in this role that their danger lies.

Undoubtedly many of the corporate disasters of the recent past could not have been avoided if the boards of the involved companies had been the most astute to be found. But in many cases the perils would sooner have been known and many losses suffered by investors could have been avoided had the directors acted in the manner they should have. If confidence in American corporations is to be sustained and strengthened, there is much for directors to do. I repeat they are not insurers of success or even honesty, but there is open for them opportunity for much greater contributions to the success of our corporate economy.