

CORPORATE DIRECTORS AND THE FEDERAL SECURITIES LAWS

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Securities and Exchange Commission

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It has been a joy to watch this Institute grow and prosper over the years. In a loose sense, it is the successor to conferences that used to be held at the University of Wisconsin Law School, in Madison, during the summer, under the joint sponsorship of the corporation lawyer groups of both the Illinois and Wisconsin state bar associations. I participated in the last of those Madison sessions by organizing a panel to discuss the sources of capital for small and intermediate businesses. In those days that was a lively and pleasant topic, and, of course, the location was delightful.

While troublesome at the time, the move to Chicago, however, and the sponsorship of Northwestern University Law School, has obviously been good. The Institutes have attracted a broad and loyal group of persons who attend regularly, so that today the Institutes constitute a significant event in continuing legal education, not only for corporate counsel but also for all persons interested in the myriad legal problems presently confronting

corporations and their counsel. Consequently, I am very happy to be invited to speak at lunch this year.

The Institutes have been blessed with a most able and industrious planning committee, whose sensitivity to the full range of corporate legal problems has produced especially imaginative selections of topics and speakers. They keep in tune with the times. For example, I was not asked to talk about registration for new cash offerings of securities. While there are and will be some interesting changes in this area, the subject, alas, is not one of burning interest at present. Nothing would please me more than to have the registration of new issues at the center of our attention. Hopefully, they will return to center stage before long, if only because American industry has such enormous deferred and prospective needs for additional capital, but the time is not quite yet.

On the other hand, the possible legal exposure of corporate officers and directors remains a topic of unabated and widespread concern. I might include the possible legal exposure of accountants and lawyers, but that might be bad for the digestion of this group, right after lunch, so I will limit my attention to directors and to activities other than '33 Act registrations and the specific provisions of Section 11.

Shortly after we filed our civil complaint in the Penn Central case, which included several outside directors among the defendants, I had dinner with a group of corporate executives, one of whom, obviously straining to be

reasonably polite, clearly thought our action outrageous. In his view, it looked as though every time a corporation goes under we intend to sue all the directors, and that we were second guessing, at leisure, the decisions that men made under fire, or as he put it, policemen who had to decide in an instant whether or not to fire at a menacing figure approaching in a dark alley. While we all understood that it was not appropriate for me to discuss then, or now, the merits of that action while it is still under adjudication, I did urge him to read the complaint and ponder it a bit. Whatever the merits of our action, we obviously were not suing all of the directors and we equally obviously were not complaining of conduct in any way resembling the problem of the policeman in the dark alley. I mention this, only because it obscures understanding and generates unnecessary hostility when actions that are carefully thought but by us, after a great deal of study and discussion, are characterized in such an off-hand, black or white, fashion. We have, no doubt, surprised some corporate executives and their counsel, by actions we have brought or threaten to bring, and it may very well be that there is less than universal agreement as to the wisdom of our decisions, but I do not think we can be fairly criticized for being rash and hasty in these matters.

I also believe that if you study our few complaints in this area with care, you will at least agree that the conduct complained of was not up to any reasonable standard of behavior for corporate directors. If this is true, the question then really boils down to what the consequences should be of inadequate behavior. Should it be reachable by the injunctive process available to us under the Securities Exchange Act of 1934, and, of even more

moment to the individuals involved, should it be a basis for civil liability under the provisions of our Acts, including Rule 10b-5? Are we engaged in developing a federal corporation law under the authority given us with respect to corporate disclosures, and, if so, is that bad? It is true that, in order to find authority in ourselves to proceed, and jurisdiction under Rule 10b-5 or cognate provisions of the laws that we administer, there must be a fraudulent or deceptive element or failure of disclosure of material information. It is also true that in some cases the gravamen of the complaint lies in the substantive evil of the conduct involved and not in the failure to disclose this to investors. In this sense, we may be going beyond enforcement of disclosure and engaged in efforts to encourage right conduct among corporate directors. If this is the case, I make no apology for it. Except for specific, limited types of misbehavior, there is no other agency, state or federal, with responsibility or authority over the activities of our publicly-owned corporations, and while plaintiffs and their attorneys in class actions on the whole do more than we do in this area, we think there is need for official federal action.

In this process, we encounter criticism from all sides, purists, which I confess used to include myself in this regard, complain about the extent to which the Commission has strained or, as they might put it, perverted, the purposes of the federal securities laws, from the simple mission of prodding adequate disclosure to investors to one of seeking to protect shareholders by attacking substantive misconduct in which the disclosure element merely serves as the jurisdictional peg. Business executives and their counsel, on the

other hand, complain that the standards that we seek to impose are unreasonably strict and, what is even more painful, provide a legal basis for personal liability which is fully exploited by plaintiffs' attorneys, once we have called attention to the existence of a possible violation of our acts, and that this personal exposure is making the directorship of a publicly-held corporation so hazardous an occupation as to be of decreasing interest to men of affairs who are not judgment proof. On the other hand, many public commentators and legislators criticize us for not being aggressive enough and letting obvious malefactors off with a slap on the wrist. The consent decree, which so frequently concludes our civil actions, is widely deplored by business critics and, I think, misunderstood. While we would much prefer to have the intellectual and moral support of thoughtful persons in our enforcement activities, there is, of course, also some consolation in having satisfied neither extreme in such matters as these.

The legal principles that we employ are, I think, simple enough. Corporations can act only through individuals and certain more important aspects of corporate behavior should be under the control of the board of directors, either affirmatively or negatively. That is to say, certain corporate actions require affirmative action by the board of directors and the board of directors should be alert to see that certain other types of corporate actions do not occur. When something wrong has happened, to the detriment of investors, the wrong was, of course, in legal contemplation done by the corporation. But enjoining the corporation itself from further misconduct is frequently frustrating because it does not reach the individuals who have in

fact permitted this to occur, or caused it to occur. To reach the individual directors, we can and do, where appropriate, argue either that the directors did the act themselves, which is sometimes the case, or were in the position of controlling persons causing an act to occur, or aiding and abetting the causing of the act. Any, or all, of these theories for asserting individual responsibility run into certain difficult problems.

It is not a problem, in terms of asserting legal responsibility, when the board of directors knowingly adopts a resolution causing a false filing to be made, or some other deceptive practice to occur. These cases are relatively easy, and if the offense is serious enough, might even result in criminal responsibility. If it remains any surprise to individual directors that they are responsible for this kind of behavior, however, I hope the message can be spread.

The difficult questions, naturally, are those where there is a difference of opinion or judgment with respect to the materiality, or the adequacy of certain disclosures, or where there is a lack of knowledge on the part of individual directors as to the facts involved in the offending transaction. I am sure it is this area that makes many directors nervous. They reasonably believe that they can protect themselves against knowingly committing or permitting wrong conduct, but they are afraid of being charged for having made bad guesses or for not knowing something that it later appears that they could and should have known.

As to the judgment question, where the directors know all of the relevant facts and make a judgment with respect to the adequacy of disclosure which later is challenged by us or a plaintiff security-holder, there is understandably fear of unfair second-guessing. It is a problem that is not unique to this particular area of the law. It pervades the law of negligence and somewhat the same human problems are presented. When someone crashes into another car and causes injury, it is perfectly obvious that something bad occurred and that one or the other parties probably did something wrong which caused it to occur. Our common law has strived to protect against automatic negligence, so to speak, inferred from the fact of the action itself, by employing the concept of the reasonable man and urging the trier of fact to imagine the reasonable man in such a circumstance and how he would have behaved. While we have not spoken in quite these terms, I think we are working toward a reasonable director concept. We, in making our enforcement decisions, and obviously the triers of fact in the litigation, must weigh the conduct that caused the harm in terms of a reasonable director in the circumstances and not infer that simply because harm occurred, the judgment of the directors was necessarily faulty, in the legal sense.

If this is a good analysis, it raises the question of the qualities of the reasonable director. The same question is presented where the director's information is inadequate. Here the challenge, when we do challenge, is that the director "should have known," or at least had a duty to inquire, which he did not perform, and the phrase "should have known," in this context, has a characteristic ambiguity. In the one sense, it means that the director was told

the information or read the document in which the information was contained, and, as the old judges liked to say, will not be heard to deny that he knew what he was told. This is the most limited sense, and the most narrow sense, of the term. It also frequently encompasses the concept of duty to know, meaning an obligation to take steps to find out what the facts are. In the first sense, I think everyone would agree that a director is responsible for what he should have known. In the second sense, we have a much more difficult question. How much duty of investigation or inquiry is the law to impose upon the individual, particularly the individual outside director?

In the judgment case, where the director has the facts, how do we describe the applicable legal standard, that kind of judgment possessed by the reasonable director. If the question regards the materiality of the undisclosed fact, our courts have been active in constructing a standard. If the fact is one with market significance, it seems clear that the law is moving toward reasonably probable market effect, or reasonably probable influence upon trading decisions of speculators as well as investors, and away from the prudent investor standard, if that means the prudent long-term, cautious investor. In the area of merger proxy material and similar documents, the Supreme Court has held that materiality depends upon the omitted fact being something that a reasonable stockholder would want to know. These standards are not precise, because they cannot possibly be precise, but I think they are becoming workable to directors who are conscientiously endeavoring to apply them.

The ignorance case is more troublesome. What does the individual director, particularly the individual outside director, have a duty to know with respect to activities of the corporation and all of the facts relevant to a transaction upon which he is voting? I think it is fair to say that the law here is not at all well settled. It is safe to say that the director who either fails to attend meetings, or attends but does not do his homework, asks no questions, merely listens to proposals submitted by officers of the corporation, and votes regularly with the majority, is not going to be found to have behaved like a reasonable director, if it turns out that there was a material failure of disclosure and he should have known about it, or could have known about it if he had taken some little effort. But how much effort? We certainly cannot impose, the standard that Judge McLean held applied to the directors of the BarChris Corporation under Section 11. In the first place, Section 11 does not apply, but furthermore, the thought that every director of a large publicly-held corporation should read the full text of every material contract to which the corporation is a party, seems to go beyond what one could expect of human beings.

In this area in particular, my predecessor offered the prospect of the SEC publishing guidelines for outside directors as to when they would and would not be found to be aiders and abettors or otherwise responsible for violations of the Securities Exchange Act. At least, the principles that would guide the SEC's decisions with respect to enforcement actions. We have found this an exceedingly difficult thing to do. It is easy to draft rules that should be followed by the ideal director and equally easy in the process to

come up with a code of conduct that no person could possibly follow. On the other hand, we are quite reluctant to propound easy-going standards that would encourage neglect. We are equally reluctant to come up with rules so precise that they invite easy evasion. For example, I would be most hesitant for us to state as an official guideline, so to speak, that a director, in approving a particular transaction, was necessarily protected from responsibility if he had read the full text of all the documents involved. There are too many ways of literally reading. Surely the law expects him to employ some intelligence. It may be that he can employ that intelligence better by reading a summary of critical points prepared by a person whose judgment he trusted, rather than wallowing through hundreds of pages of printed boilerplate. We so far have not discovered how to state in a few simple words exactly what the individual director should do in every circumstance.

This observation has led, and will lead, critics of our actions and attitudes to observe that, if we can't even state what a director ought to do in simple English, how can we expect a director to be held legally liable for having done something wrong? However satisfying this observation might be emotionally to a hard-pressed corporate executive, I don't think any lawyer would give it much weight. We haven't even prescribed such rules with respect to driving automobiles. While observing the speed limit is helpful in establishing freedom from negligence, it is not conclusive in all circumstances, and everybody knows that, and everybody knows that we cannot set forth in specific text exactly what is necessary to avoid negligence. The same thing is true many times over with respect to the behavior of

corporate directors. I think the most we can say at the moment, is that directors should behave as reasonably conscientious persons, aware of their responsibilities to investors, and the fact that investors are rightly relying upon them, and that they must be very careful in placing their reliance upon others.

You are all aware of certain devices that have been adopted by some corporations to enable outside directors, in particular, more nearly to perform all that the law might require of them. These include outside counsel, the appointment of a fulltime salaried outside or independent director, and various review committees of outside directors, such as the audit committee. We have welcomed experimentation in these areas. We have particularly endorsed the use of an audit committee made up of outside directors. Beyond that, our posture has been one of interested watching.

Let me return to the more fundamental question of why we are, more than in the past, employing legal theories not previously asserted against individual directors in order to increase the instances in which they will be found legally responsible under the federal securities laws. It is customary in talks such as this for officials to observe that the great rank and file of American businessmen and corporate directors are honest and conscientious persons and that we are concerned only with the occasional crook who makes life more difficult for all of us and should be routed out of our economic society.

I have no statistical proof of the proposition that most businessmen are honest, although I believe it to be true. If it were not true, I think our economy and society would have collapsed long since. As to how conscientious our corporate directors have been, I think the answer is less obvious.

There have developed habits familiar to all of us which discourage rather than encourage conscientious performance by outside directors. The typical, well-orchestrated board meeting, with the quick agenda, followed by some report of general interest on the operation of the business, followed by lunch, all on a tight schedule, induce an atmosphere of compliance and non-inquiry that may be dangerous, if it should turn out that management itself was making some bad judgments or, even worse, was engaged in illegal activity. How much legal actions against directors have broken into the free flow of this type of behavior we do not know, but I think they should.

We are well aware of the practical problems, the low incentive to serve as directors in most cases, the fact that directors are busy men with other affairs -- at least the outside directors typically are -- and the fact that the efficiency of management of a complex organization is not enhanced if every proposal put by management leads to a major debate with independent investigation by all of the members of the board. Important as it is that our corporations be managed fairly and honestly in the interests of investors, it is also important that they do be managed, and no business can be effectively managed by a debating society.

Nevertheless, the performance of the outside directors of corporations should be improved in terms of the affirmative exercise of responsibility. However defensive corporate executives and directors may feel about their own behavior, there is widespread discontent with many aspects of the management of American business. If one needed a reminder, he would certainly receive it by reading the proceedings at President Ford's Summit Conference of last Friday and Saturday. One could not help but be impressed with the degree of hostility shown toward American business, and big business especially, by many of the speakers at that Conference.

It is true that much of the discontent with management was not based upon the treatment of investors, but rather on the treatment of the environment and consumers. This is a matter that should give American business much concern. But there is also increasing unfriendly questioning of the legitimacy of corporate management at large. How does it justify the authority which it exercises over our economy and indeed our society under the present methods of selection and accountability?

I don't wish to prolong this talk by philosophic speculation on these questions, but one observation can certainly be made. A strong practical basis for legitimacy of power is its fair and reasonable exercise. While we are primarily concerned with the quality of management as it affects investors, directors must of course be conscious of the total picture.

It is not part of the program of the SEC to seek to change the basic structure of American corporate organization and management. We are deeply conservative in this regard and have long been, and continue to be, committed to the virtues of economic activity conducted through business corporations that are publicly-owned by-our investors. It is no secret, however, that there are others who are not so wedded to this method of organization, and corporate directors should be conscious of the fact that their total activity, including their fairness with respect to investors, is under close scrutiny today by many persons, including those who appear to be eager to find excuses for claiming that the system does not work.

I do not expect any director to enjoy being sued by the SEC, but I do strongly assert that our actions are intended to make our present system of economic organization stronger and more responsive to the needs of our society. We would like nothing better than a state of affairs in which private enterprise is encouraged to flourish and in which the conduct of corporate management is such as to make our enforcement efforts unnecessary and obsolete.