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THE NEW ANNUAL REPORT TO SHAREHOLDERS

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I. INTRODUCTION

THE ANNUAL REPORT to shareholders (annual report) is probably the most widely disseminated and used corporate disclosure document. Through the annual report, management communicates not only with shareholders but with the investment community at large, customers, potential customers, and acquisition candidates. Because of its varied uses, companies generally print many more copies of the annual report than are needed to supply shareholders.

In all of its uses, the annual report has traditionally served as the voice of management. This results in large part from the fact that, notwithstanding the annual report's importance in the corporate disclosure process, its form and content have been left largely to management, free from regulation by the Securities and Exchange Commission (Commission or SEC), and subject only to the anti-fraud provisions of the federal securities laws. This freedom has been in direct contrast with the continually escalating requirements governing the form and content of prospectuses filed under the Securities Act of 1933¹ (Securities Act) and periodic reports filed under the Securities Exchange Act of 1934² (Exchange Act).

The freedom from SEC intrusion into the realm of the annual report has resulted from several factors. First, the various federal securities acts do not specifically give the SEC the power to control the content of the annual report. Second, the SEC has had an uncharacteristic concern that management should be free to use the annual report to communicate with shareholders without the inhibitions which would be attendant upon the adoption of technical and legal require-

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1. 15 U.S.C. §§ 77a *et seq.* (1970).

2. 15 U.S.C. §§ 78a *et seq.* (1970).

ments. Finally, corporate managements have been somewhat successful in dissuading the SEC from intruding into the annual report process.³

The annual report, however, has not been completely free from SEC regulation. The SEC regulation of the annual report has not been direct, but rather has been accomplished indirectly through the proxy rules.⁴ Companies which are subject to the proxy rules generally may not solicit proxies unless each person solicited is furnished with a proxy statement containing specified information.⁵ If the solicitation is made on behalf of management and relates to an annual meeting of shareholders at which directors are to be elected, the proxy statements must be accompanied or preceded by an annual report which satisfies certain requirements.⁶

The SEC recently announced the adoption of certain amendments to the proxy rules in SEC Securities Exchange Act Release No. 11079 (Covering Release) which will result in important changes in the annual report process.⁷ The professed purposes of the amendments are:

3. The SEC proposed wide-ranging changes in the proxy rules in 1942. The proposed amendments would have treated the annual report as proxy soliciting material which would have to be filed with the SEC for review at least 10 days before mailing to shareholders. Those proposed amendments were not adopted largely as the result of protests by companies. *See generally* Sommer, *The Annual Report: A Prime Disclosure Document*, 1972 DUKE L.J. 1093, reprinted in 5 SEC. L. REV. 116 (1973).

4. Rules 14a-1 to -12, 17 C.F.R. §§ 240.14a-1 to -12 (1974), as amended, 39 Fed. Reg. 40768-70 (1974). The rules have been issued by the SEC under section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1970), which authorizes the SEC to prescribe proxy rules and regulations which are "necessary or appropriate in the public interest or for the protection of investors." Similar rules cover companies which do not solicit proxies. Rules 14c-1 to -7, 17 C.F.R. §§ 240.14c-1 to -7 (1974), as amended, 39 Fed. Reg. 40770-71 (1974).

5. Rule 14a-3(a), 17 C.F.R. § 240.14a-3(a) (1970).

6. Rule 14a-3(b), 17 C.F.R. § 240.14a-3(b) (1947), as amended, 39 Fed. Reg. 40768-69 (1974).

7. SEC Securities Exchange Act Release No. 11079 (Oct. 31, 1974). The Release also announced the adoption of similar rules with respect to the furnishing of informational statements and the discussion in this article concerning the proxy rules will generally be applicable to the informational statement rules. The amendments are generally inapplicable to registered investment companies. Rule 14a-3(6)(11), 39 Fed. Reg. 40769 (1974). Amendments to the proxy rules and informational statement rules were originally proposed for comment in SEC Securities Exchange Act Release No. 10591 (Jan. 10, 1974).

For information concerning other new requirements which may be applicable to the annual report process, see SEC Securities Exchange Act Release No. 11147 (Dec. 20, 1974) (which requires disclosure in proxy statements concerning the relationship between companies and their independent accountants and requires disclosure in a note to the financial statements of any material disagreements on certain matters of accounting principles or practices or financial statement disclosure); SEC Securities Exchange Act Release No. 11198 (Jan. 23, 1975) (which relates to discussions between the SEC's chief accountant and the Internal Revenue Service regarding financial disclosure problems arising from the adoption of LIFO accounting and the book-tax conformity requirements of the Internal Revenue Code); and Financial Accounting Standards Board Opinion No. 3 (Dec. 31, 1974) (relating to disclosure in annual reports of accounting changes made in the fourth quarter of a company's fiscal year if no fourth quarter report is issued).

1) to require additional information in annual reports in order to make the material contained therein more meaningful, while generally leaving management the discretion to choose the content and the format of the reports it deems most effective for communicating with the shareholders; and 2) to improve the dissemination of the annual report and of the annual report on Form 10-K⁸ (Form 10-K Report) filed with the SEC.⁹ The amendments became effective on December 20, 1974 for companies which have fiscal years ending on or after that date and which solicit proxies on or after that date.¹⁰

In brief, the amended proxy rules require that annual reports include at least the following information: 1) certified financial statements for the company's last 2 fiscal years;¹¹ 2) a summary of the company's operations for the last 5 fiscal years and management's analysis thereof;¹² 3) a brief description of the company's business;¹³ 4) a "lines of business" breakdown for the company's last 5 fiscal years;¹⁴ 5) the identification of the company's directors and executive officers and the disclosure of each such person's principal occupation or employment as well as the name and principal business of any organization by which each such person is employed;¹⁵ and 6) the identification of the principal market in which the company's voting securities are traded and a statement of the market price ranges of and dividends paid on such securities for each quarterly period during the company's 2 most recent fiscal years.¹⁶

The amendments also require a company to undertake to furnish without charge to its shareholders as of the record date of its annual meeting, upon the written request of any such shareholder, a copy of its Form 10-K Report including the financial statements and schedules thereto required to be filed with the SEC for its most recent fiscal year and to provide copies of the exhibits to such reports upon payment of a reasonable fee.¹⁷ Either the annual report or management's proxy statement must also indicate the name and address of the person to whom shareholder requests for the Form 10-K Report should be directed.¹⁸ Finally, the amendments impose certain requirements re-

8. SEC Form 10-K, 17 C.F.R. § 249.310 (1974).

9. SEC Securities Exchange Act Release No. 11079 (Oct. 31, 1974).

10. *Id.*

11. Rule 14a-3(b)(3), 39 Fed. Reg. 40769 (1974).

12. Rule 14a-3(b)(4), 39 Fed. Reg. 40769 (1974).

13. Rule 14a-3(b)(5), 39 Fed. Reg. 40769 (1974).

14. Rule 14a-3(b)(6), 39 Fed. Reg. 40469 (1974).

15. Rule 14a-3(b)(7), 39 Fed. Reg. 40769 (1974).

16. Rule 14a-3(b)(8), 39 Fed. Reg. 40769 (1974).

17. Rule 14a-3(b)(9), 39 Fed. Reg. 40769 (1974).

garding the dissemination of the annual report and management's proxy statement.¹⁹

This article will consider the present requirements with respect to annual reports, the changes effected by the amendments to the proxy rules, and the liability of a company and its management for a false or misleading annual report.

II. THE ANNUAL REPORT PRIOR TO THE AMENDMENTS

Prior to the recent amendments, rule 14a-3²⁰ required that each proxy statement, used on behalf of management to solicit proxies for an annual meeting at which directors were to be elected, be accompanied or preceded by an annual report. The requirements were as follows:

1) The annual report was required to include, in comparative columnar form, such financial statements for the company's last 2 fiscal years as would in the opinion of management adequately reflect the financial position of the company at the end of each year and the results of its operations for each such year. Consolidated financial statements of the company and its subsidiaries were required to be included in the report if necessary to reflect adequately the financial position and results of operations of the company and its subsidiaries, but in such case the individual statements of the issuer could be omitted even though they would be required to be included in Form 10-K Reports filed with the SEC. The SEC could, however, permit the omission of the financial statements for the earlier of the 2 years when good cause was shown.²¹

2) Any deviation, reflected in the financial statements included in the annual report, from the principles of consolidation or other accounting principles or practices, or methods of applying accounting principles or practices, applicable to the company's financial statements filed with the SEC on Form 10-K, which would have a material effect upon the financial position or results of operations of the company had to be noted and the effect thereof reconciled or explained. The financial statements included in the report, however, could omit details and employ condensation to the extent deemed suitable by management, with the caveat that such statements, considered as a whole in the light of other information contained in the report, could not omit any material infor-

19. Rule 14a-3(d), 39 Fed. Reg. 40769-70 (1974).

20. Rule 14a-3, 17 C.F.R. § 240.14a-3 (1974), as amended, 39 Fed. Reg. 40768 (1974).

21. Rule 14a-3(b)(1), 17 C.F.R. § 240.14a-3(b)(1) (1974), as amended, 39 Fed. Reg. 40768-69 (1974).

mation necessary to a fair presentation or to make the financial statements not misleading under the circumstances.²²

3) The financial statements for at least the most recent fiscal year had to be certified unless the corresponding statements in the Form 10-K Report were not required to be certified or the SEC found that certification would be impracticable or involve undue effort or expense.²³

4) Seven copies of the annual report were required to be sent to the SEC "solely for its information" not later than the date on which the report was first sent or given to shareholders or the date on which preliminary copies of solicitation material were filed with the SEC, whichever date was later.²⁴ The annual report was not deemed to be "soliciting material" or to be "filed" with the Commission and was not subject to the proxy rules otherwise than as provided in the rule, or to the liabilities of section 18²⁵ of the Exchange Act, except to the extent that the company specifically requested that it be treated as a part of the proxy soliciting material or incorporated it in the proxy statement by reference.²⁶

Except for the foregoing requirements, the annual report could be in any form deemed suitable by management. In fact, managements have shown great ingenuity and creativity in designing their annual reports although the results in many cases have probably been more akin to public relations than to public disclosure.

III. NEW REQUIREMENTS FOR ANNUAL REPORTS

As stated above, the amended proxy rules change the disclosure requirements for the annual report as well as the dissemination requirements for the annual report and the Form 10-K Report.

A. Disclosure in the Annual Report

1. *Financial Statements*

Annual reports will continue to be required to contain financial statements, consolidated where appropriate, for the company's last 2 fiscal years except in cases where good cause can be shown to the SEC for the omission of the earlier of the 2 years.²⁷ The financial statements

22. Rule 14a-3(b)(2), 17 C.F.R. § 240.14a-3(b)(2) (1974), as amended, 39 Fed. Reg. 40769 (1974).

23. Rule 14a-3(b)(3), 17 C.F.R. § 240.14a-3(b)(3) (1974), as amended, 39 Fed. Reg. 40769 (1974).

24. Rule 14a-3(c), 17 C.F.R. § 240.14a-3(c) (1974).

25. 15 U.S.C. § 78r (1970).

26. Rule 14a-3(c), 17 C.F.R. § 240.14a-3(c) (1974).

for both years, however, will have to be certified rather than just those for the last fiscal year.²⁸ This requirement is unlikely to cause any significant problems especially since many companies presently include at least 2 years of certified financial statements in their annual reports. In cases where problems would be presented, the proxy rules continue to provide that the financial statements will not be required to be certified if (a) the corresponding financial statements included in the company's Form 10-K Report are not required to be certified or (b) the SEC finds in a particular case that certification would be impracticable or would involve undue effort or expense.²⁹

The proxy rules have also been amended to clarify the requirement that any material differences between the financial statements included in the annual report and the financial statements filed or proposed to be filed with the SEC must be noted and the effect thereof reconciled or explained in the annual report's "financial statements or notes thereto" where the differences will have a material effect on the financial position or results of operation of the company.³⁰ As was the case prior to the amendments, however, the financial statements in the annual report may omit such details or employ such condensation as is deemed suitable by management subject to the caveat that such financial statements, considered as a whole in light of the other information contained in the report, may not by such procedure omit any material information necessary to a fair presentation or to make the financial statements not misleading under the circumstances.³¹

Finally, there is a technical change in type-setting requirements of annual reports. The financial statements contained in the annual report must be set forth in roman type at least as large and legible as 10-point modern type as opposed to the 8-point modern type formerly required except that, to the extent necessary for the convenient presentation of the financial statements, the type may be in 8-point type.³² As was formerly the case, however, the notes to the financial statements are required to be in 10-point type.³³

The amended proxy rules specifically encourage companies to utilize tables, schedules, charts, and graphic information to present financial information in an understandable manner.³⁴ Any such presentation, however, must be consistent with the data in the financial statements contained in the annual report and, if appropriate, should

28. Rule 14a-3(b) (3), 39 Fed. Reg. 40769 (1974).

29. *Id.*

30. Rule 14a-3(b) (2), 39 Fed. Reg. 40769 (1974).

31. *Id.*

32. Rule 14a-3(b) (1), 39 Fed. Reg. 40769 (1974).

33. *Id.*

34. Note to Rule 14a-3(b) (10), 39 Fed. Reg. 40769 (1974).

refer to relevant portions of the financial statements and notes thereto.³⁵ The meaning of "consistent" in this regard is unclear. As originally proposed, financial highlights could not be presented in a light either more or less favorable than the financial statements included in the report.³⁶ This standard would have been almost impossible to apply. Financial statements contain a detailed explanation of financial position and results with caveats, explanations, and contingencies which cannot be graphically presented. Graphs and other financial highlights serve to assist in the understanding of complicated information and, as a result, should be encouraged. Hopefully, the proper construction of "consistent" will be one that will permit graphic illustrations to be utilized to summarize the actual information contained in other portions of the report with specific reference made to the more detailed material. Care will also be required, however, in avoiding an unbalanced selection of the information graphically presented.

2. *Summary of Operations*

Annual reports will now have to include a summary of the company's operations (Summary) containing the information required by item 2 of Form 10-K³⁷ except for the reconciliations, exhibits, and supplemental information required by the instructions to that item.³⁸ This represents a significant change since it introduces for the first time a requirement to include financial information for the company's last 5 fiscal years or its existence if shorter.

As initially proposed, the summary of operations would have been required to be "in substantially the form required by Form 10-K."³⁹ The SEC, however, retreated from this requirement and the information may be set forth in any form deemed suitable by management.⁴⁰ Presumably, this will enable companies to provide disclosure tailored to the needs of the average shareholder rather than presenting the detailed information required by item 2. Such an approach seems warranted especially since shareholders desiring the more detailed information will be able to obtain the company's Form 10-K Report. Many companies, however, can be expected to include essentially equivalent information in their annual reports and Form 10-K Reports to avoid the

35. *Id.*

36. SEC Securities Exchange Act Release No. 10591 (Jan. 10, 1974).

37. For the details required, *see* item 2, SEC Form 10-K, 17 C.F.R. § 249.310 (1974).

38. Rule 14a-3(b)(4), 39 Fed. Reg. 40769 (1974).

39. SEC Securities Exchange Act Release No. 10591 (Jan. 10, 1974).

40. *Id.* See also, *id.*, 39 Fed. Reg. 40769 (1974).

obvious problems inherent in presenting different information in different documents, especially since this information can be included in an appendix to the annual report.⁴¹

Significantly, Guide 1 of the Guides for Preparation and Filing of Reports and Registration Statements Under the Exchange Act⁴² (Guide) (as well as any other guides subsequently published by the SEC relating to item 2 of Form 10-K) is applicable to annual reports. This Guide requires a section entitled "Management's Discussion and Analysis of the Summary of Operations" (Management Discussion) immediately following the Summary. The Management Discussion must contain narrative information clarifying and explaining the periodic changes in the financial information included in the Summary.⁴³ In the view of the Commission, this disclosure is necessary to enable investors to appraise the quality of earnings, to understand the extent to which accounting changes and changes in business activity have affected the comparability of year-to-year data, and to allow them to assess the source and probability of recurrence of net income or loss.⁴⁴

The Management Discussion should explain and clarify (a) material changes from period to period in the amounts of the items of revenues and expenses required to be set forth in the Summary or disclosed pursuant to rule 12-16 of regulation S-X⁴⁵ and (b) changes in accounting principles or practices or in the method of their application that have a material effect on net income as reported.⁴⁶ The purpose of

41. Rule 14a-3(b)(10), 39 Fed. Reg. 40769 (1974).

42. 39 Fed. Reg. 31894 (1974). See SEC Securities Exchange Act Release No. 10961 (Aug. 14, 1974). Guide 1 is also applicable to Form 10's and Form 10-K's filed under the Exchange Act. Guide 22, which is substantially the same as Guide 1, is applicable to the summary of earnings or statement of income included in registration statements on Forms S-1, S-7, S-8, S-11, S-14. *Id.* The guides are not official rules of the SEC, but an indication of the policies and practices followed by the SEC's Division of Corporation Finance and Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws. The fact that the guides are not official rules probably will have little effect in view of the SEC Staff's ability to exert pressures especially over Securities Act filings. 39 Fed. Reg. 31894-95 (1974).

43. 39 Fed. Reg. 31896 (1974).

44. *Id.*

45. *Id.* Rule 12-16 of Regulation S-X, 17 C.F.R. § 210.12-16 (1974), relates to supplementary income statement information. If the materiality tests set forth in rule 12-16 are met, disclosure of the following items is required: maintenance and repairs; depreciation, depletion, and amortization of property, plant, and equipment; depreciation and amortization of intangible assets; deferred research and development expenses, pre-operating costs and similar deferrals; taxes other than income taxes; rents; royalties; advertising costs; and research and development costs.

46. 39 Fed. Reg. 31896 (1974). The Guide gives certain examples of subjects which would require disclosure: (a) material changes in product mix or in the relative profitability of lines of business; (b) material changes in advertising, research, development, product introduction, or other discretionary costs; (c) the acquisition or disposition of a material asset other than in the ordinary course of business; (d) unusual charges or gains including credits or charges associated with

this section is to provide management's analysis of the financial data included in the Summary through a discussion of the causes of material changes in the items of the Summary and disclosure of the dollar amount of each such change on the reported results for the applicable period. Presumably, it is permissible to make reference to an appropriate footnote to the financial statements or Summary of Operations in lieu of repeating the same information in the Management Discussion as long as the item being discussed is sufficiently identified.

In the annual report, the Management Discussion generally would be limited to changes during the latest 3 fiscal years — that is, those occurring between the most recent fiscal year presented and the prior fiscal year and those occurring between the prior fiscal year and the year preceding that year. The SEC, however, has pointed out that under certain circumstances an explanation of revenue or expense item changes between two or more of the earlier periods of the 5-year summary may be material to an understanding thereof.⁴⁷

The Guide has adopted a low threshold of materiality. Discussion of a change in an item of revenue or expense will generally be required when an item required to be set forth in the Summary or disclosed pursuant to rule 12-16 has increased or decreased by more than 10 percent as compared to the prior period presented *and* increased or decreased by more than 2 percent of the average net income or loss for the most recent 3 years presented.⁴⁸ Loss years will be excluded in calculating average net income except that, in cases when losses were incurred in each of the most recent fiscal years, the average loss will be used for purposes of the calculation.⁴⁹ Even when a change in an item of revenue or expense does not meet the materiality standards, the Guide urges management to discuss the change if it believes an explanation of that change is necessary to an understanding of the Summary.⁵⁰ On the other hand, in cases where management believes that explanation of a change is not necessary to an understanding of the Summary even though the change meets the standards of materiality, the Guide permits management to furnish to the SEC supplementally a written statement for the reasons for the omission.⁵¹ While this may provide an alterna-

discontinuation of operations; (e) material changes in assumptions underlying deferred costs and the plan for amortization of such costs; (f) material changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds; and (g) the closing of a material facility, material interruption of business, or completion of a material contract. *Id.*

47. 39 Fed. Reg. 31896 (1974).

48. *Id.*

49. *Id.*

50. *Id.*

tive in the context of registration statements filed under the Securities Act and reports filed under the Exchange Act where an amendment may be possible if the statement by management is not acceptable to the SEC, the alternative may not be helpful in the annual report process unless management is able to reach an accommodation with the SEC prior to the preparation of the annual report. One result of the low threshold of materiality may be the increase in the use of summaries rather than full income statements.

Additional disclosure may be necessary in either of two situations. Guide 1 is also applicable to Form 10 registration statements and Form 10-K Reports filed under the Exchange Act and an analogous Guide 22 is applicable to registration statements filed under the Securities Act.⁵² Both of the guides require that the Management Discussion include a discussion of material facts, whether favorable or unfavorable, which are required to be disclosed or are disclosed in the registration statement or report which, in the opinion of management, may make historical operations or earnings as reported in the Summary of Operations not indicative of current or future operations or earnings.⁵³ In addition, if the text of a registration statement or report contains a discussion of factors indicating a material change in operating results, whether favorable or unfavorable, subsequent to the latest period included in the Summary of Operations, both guides require the Management Discussion to call attention to the change and refer to the place in the registration statement or report where it is discussed.⁵⁴

The applicability of these requirements to the Management Discussion contained in the annual report is unclear. Certainly, the requirements would be applicable if the president's letter or other material contained in the annual report either disclosed or would be required to disclose material facts which made historical operations not indicative of current or future operations or earnings or contained a discussion of factors indicating a material subsequent change in operating results. In many cases, however, such facts would be absent in annual reports. Presumably, these requirements would then not be applicable to the Management Discussion included in the annual report. As a result, the Management Discussion included in an annual report could contain different information than that found in an Exchange Act registration statement, a Form 10-K Report, or a Securities Act registration statement containing financial statements for a similar period.

52. See note 42 *supra*.

53. 39 Fed. Reg. 31896 (1974).

3. *Description of Business*

Annual reports must now contain a brief description of the nature and scope of the business done by the company and its subsidiaries during its most recent fiscal year.⁵⁵ In the event that there is a material change in the business between the end of the fiscal year and the preparation of the annual report, this change probably should be described although the rule does not so require expressly.

There is good reason to believe that this requirement can be read literally to require only a brief description of the business. The requirement for a business description was formerly applicable only to companies which had not previously sent annual reports to their shareholders as required by the proxy rules.⁵⁶ In response, such companies typically included several introductory sentences from their last prospectus, Form 10-K Report, or Exchange Act registration statement. Moreover, the wording of the requirement differs markedly from the requirements for business descriptions in registration statements filed under the Securities Act, Form 10-K Reports, and registration statements filed under the Exchange Act. Those filings require descriptions of not only the business done but that intended to be done and, in addition, require, where material for an understanding of the business, information regarding competition, customers, backlog, sources and availability of raw materials, patents, trademarks, licenses, franchises and concessions held, research activities, environmental matters, number of employees, and the seasonal nature of the business.⁵⁷ Finally, and most importantly, the Covering Release directly states that the detailed information called for by items 1(a) and 1(b) of Form 10-K are not required in the annual report.⁵⁸

4. *Lines of Business Information*

Annual reports must also contain information regarding the company's lines of business and classes of similar products or services for its last 5 fiscal years.⁵⁹ The information may be set forth in any form deemed suitable by management but must be as comprehensive as that required by items 1(c)(1) and 1(c)(2) of the Form 10-K Report.

Companies have been able to and have used great discretion in identifying their lines of business and classes of similar products. Widely

55. Rule 14a-3(b)(5), 39 Fed. Reg. 40769 (1974).

56. Rule 14a-3(b)(5), 17 C.F.R. § 240.14a-3(b)(5) (1974), *as amended*, 39 Fed. Reg. 40769 (1974).

57. *See, e.g.*, SEC Form 10-K, 17 C.F.R. § 249.310 (1974); SEC Form S-1, 17 C.F.R. § 239.11 (1974); SEC Form 10, 17 C.F.R. § 249.210 (1974).

58. SEC Securities Exchange Act Release No. 11079 (Oct. 31, 1974).

59. Rule 14a-3(b)(5), 39 Fed. Reg. 40769 (1974).

diversified companies with many millions of dollars of sales have often only identified a few or even one line of business. As a result, this disclosure has not been as informative as originally intended. The amended proxy rules will not change this discretion.

5. *Management Information*

The annual report now must also identify each of the company's directors and executive officers, disclose the principal occupation or employment of each of them, and indicate the name and principal business of any organization by which each of them is employed.⁶⁰ For this purpose, "executive officer" means the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administrative, or finance), and any other person who performs similar policy-making functions for the company.⁶¹ Although there is no indication as to the date with respect to which the information concerning directors and executive officers should be given, it may be assumed that the annual report should contain information concerning those persons who are directors and officers at the time of the preparation of the report whether or not they occupied such positions at the end of the company's last fiscal year.

The required disclosure concerning directors and executive officers is significantly less than that required by the Form 10-K Report. Specifically, the Form 10-K also requires, with respect to each director and executive officer and any person chosen for such positions, his age, his family relationship with other officers and directors, all positions and offices with the company held by him, his term of office and the period during which he has served in the position, any arrangement or other understanding between him and any other person pursuant to which he was selected, and his business experience during the last 5 years.⁶² The Covering Release, however, states that companies may include additional information concerning directors and executive officers in their annual reports.⁶³

The information required by the amended proxy rules has typically been included in annual reports, at least as to directors. Consequently, there should be little resistance to this disclosure requirement. The disclosure, however, may be lengthy for certain companies which have numerous directors and executive officers. In addition, there may be some morale problems in determining the number of officers to be

60. Rule 14a-3(b) (7), 39 Fed. Reg. 40769 (1974).

61. Note to rule 14a-3(b) (7), 39 Fed. Reg. 40769 (1974).

62. SEC Form 10-K 17 C.F.R. § 249.310 (1974).

63. SEC Securities Exchange Act Release No. 11079 (Oct. 31, 1974).

included and it may be anticipated that, in certain cases, information will be included concerning persons who do not come within the definition of executive officer.

6. *Market and Dividend Information*

The annual report must identify the principal market in which each class of the company's voting securities are traded and include the high and low sales prices for such securities (or the range of bid and ask quotations in the absence of trading information) and the dividends paid on such securities for each quarterly period during the company's 2 most recent fiscal years.⁶⁴ For purposes of the rule, voting securities are those which can be voted at the meeting of the company for which the annual report is used whether or not the securities may be voted for the election of directors.⁶⁵ Although the inclusion of this information is not likely to evoke any controversy, it is interesting that this information is not presently required to be included in proxy statements or in Form 10-K Reports.

7. *Format of Annual Report*

Notwithstanding the new requirements, management will retain significant discretion over the form and content of the annual report. In this regard, the SEC has stated in the Covering Release and the proxy rules provide that the annual report may be in any form deemed suitable by management as long as the information required by the proxy rules is contained therein.⁶⁶ The amended rules also specifically permit any of the information required in the annual report, with the exception of the financial statements (but not tables or similar presentations with respect thereto), to be set forth in an appendix or other separate section of the annual report, provided that the attention of shareholders is called to such presentation.⁶⁷

Among other methods of presentation, this will permit companies to furnish their 10-K Reports to shareholders as a separate section of or appendix to the annual report in lieu of making changes in the traditional content of their annual reports. Of course, certain of the newly required information such as the market and dividend information is not presently required to be contained in Form 10-K Reports. It would

64. Rule 14a-3(b)(8), 39 Fed. Reg. 40769 (1974). The requirement to disclose the range of bid and asked quotation, as opposed to high and low bid prices as is generally required, is confusing. See, e.g., SEC Securities Act Release No. 4936 (Dec. 9, 1968).

65. Rule 14a-3(b)(8), 39 Fed. Reg. 40769 (1974).

67. *Id.*

be an easy matter, however, to voluntarily include such information in the Form 10-K Report.⁶⁸ Although the result is difficult to explain, the rules do not permit the financial statements to be "omitted" from the annual report even when the Form 10-K Report containing financial statements is used as a separate section of or appendix to the annual report despite the fact that this would result in duplication in the absence of incorporating the financial statements into the Form 10-K Report by reference to the annual report. Some clarification of this may be expected from the SEC.

B. Dissemination of Annual Reports

In adopting the amendments to the proxy rules, the SEC expressed its concern that shareholders whose securities are held of record by other persons such as brokers, dealers or banks may not receive copies of the annual report or of proxy solicitation material. In connection with the solicitation of proxies for any meeting of shareholders, the proxy rules as amended require a company, which knows that its voting securities are held of record by a broker, dealer, bank, voting trustee or their nominees, to inquire of such record holders whether they are holding the securities for beneficial owners.⁶⁹ If so, the company must also inquire of the record holders as to the number of copies of the proxy and other soliciting material and, in the cases of an annual meeting at which the directors are to be elected, the number of copies of the annual report necessary to supply such material to the beneficial owners.⁷⁰ In addition, the company must supply each such record holder with additional copies of the materials in such quantities, assembled in such form and at such a place as the record holders may reasonably request in order to address and send one copy of such material to each beneficial owner of securities.⁷¹ Finally, the company is required to pay the reasonable expenses of such record holders for

68. Part II of the Form 10-K Report which, among other things, includes information on directors, does not have to be filed if the company will file a definitive proxy statement with the SEC within 120 days after the end of its fiscal year. SEC Form 10-K, 17 C.F.R. § 249.310 (1974). As a result, it may be necessary to include information on directors in the annual report even if Part I of the Form 10-K Report is included with the annual report.

69. Rule 14a-3(d), 39 Fed. Reg. 40769-70 (1974). The note to rule 14a-3(d) states that if the company's list of shareholders indicates that some of its securities are registered in the name of "Cede & Co.", a nominee for the Depository Trust Company, or in the name of a nominee for any central certificate depository system, a company must make appropriate inquiry of the central depository system and thereafter of the participants in such system who may hold on behalf of a beneficial owner and must comply with the requirement with respect to any such participant.

71. *Id.*

completing the mailing of such material to shareholders to whom the material is sent.⁷²

C. Dissemination of Form 10-K Reports

Although the amendments to the proxy rules were designed to provide shareholders with annual reports containing expanded business and financial information, the Covering Release indicates the SEC's recognition that some shareholders will nevertheless be interested in the more detailed and extensive information contained in a company's Form 10-K Report.⁷³ Few persons other than research analysts or business competitors have obtained these reports in the past although they have been available at the office of the SEC or from private research companies.

In order to make the Form 10-K Report available to interested shareholders as of the record date of the company's annual meeting of shareholders, the amended proxy rules require either the company's proxy statement or its annual report to contain an undertaking in bold face or otherwise reasonably prominent type to provide without charge to each person solicited, upon the written request of any such person, a copy of the company's Form 10-K Report including the financial statements and schedules thereto for the company's most recent fiscal year and to indicate the name and address of the person to whom such a written request is to be directed.⁷⁴ The requirement to furnish Form 10-K Reports is applicable not only to record holders but to any other person who makes a written request containing a good faith representation that, as of the record date for the annual meeting of the company's shareholders, he was a beneficial owner of securities entitled to vote at such meeting.⁷⁵

The Form 10-K Report itself must be furnished without charge to requesting shareholders.⁷⁶ In recognition of the substantial expenses which could be attendant in furnishing to shareholders lengthy exhibits to Form 10-K Reports, however, a company may impose a fee limited to its reasonable expenses in connection with providing copies of the exhibits if the Form 10-K Report furnished to shareholders is accompanied by a list briefly describing the exhibits not contained therein and indicating that the company will furnish any exhibit upon the payment of the specified fee.⁷⁷ Presumably, the list of exhibits contained in the

72. *Id.*

73. SEC Securities Exchange Act Release No. 11079 (Oct. 31, 1974).

74. Rule 14a-3(b) (9), 39 Fed. Reg. 40769 (1974).

75. Note to Rule 14a-3(b) (9), 39 Fed. Reg. 40769 (1974).

76. Rule 14a-3(b) (9), 39 Fed. Reg. 40769 (1974).

77. *Id.*

Form 10-K Report itself can be used in lieu of a separate list as long as shareholders are advised they may obtain any of the exhibits upon payment of the required fee. Since the permitted fee is phrased in terms of the company's reasonable expenses rather than actual out-of-pocket expenses, it may be possible for a company to make a "reasonable" charge for the time of its employees in furnishing the exhibits. Fees charged by private research organizations (including the SEC's own contractor) to provide copies of documents filed with the SEC may serve as a guide in determining reasonable charges.

As stated above, the undertaking to furnish copies of the Form 10-K Report may be contained either in a company's proxy statement or in its annual report. Since the requirement is imposed indirectly through the proxy rules, only shareholders as of the record date of a company's annual meeting have the right to receive a copy of the Form 10-K Report. Numerous persons other than shareholders as of the annual meeting record date, however, receive copies of the annual report. There are several reasons for this. Companies regularly distribute the annual report to persons other than shareholders; certain companies distribute the annual report prior to distributing proxy statements and, as a result, some of the persons receiving the report may not still be shareholders on the record date; and certain companies distribute the annual report to persons who become shareholders after the record date. Because of this, companies may consider including the undertaking in the proxy statement rather than in the annual report, thereby limiting the disclosure of the undertaking to those who have the right to receive the Form 10-K Report and perhaps limiting the resulting requests for the Form 10-K Report since annual reports tend to be read more carefully than proxy statements.

The Covering Release attempts to clarify a company's obligation to furnish copies of any amendments to its Form 10-K Report. The SEC has taken the position that a company is not required under the proxy rules to furnish subsequently filed amendments to its Form 10-K Report to shareholders previously furnished with the Form 10-K Report unless the shareholder's request to receive the Form 10-K Report specifically requested subsequently filed amendments.⁷⁸ On the other hand, a company must furnish to each shareholder, who makes an appropriate written request at any time prior to the next annual meeting record date, a copy of the Form 10-K Report and any amendments thereto filed prior to the receipt of the request.⁷⁹

78. SEC Securities Exchange Act Release No. 11079 (Oct. 31, 1974).
<https://digitalcommons.law.villanova.edu/vlr/vol20/iss2/1>

79. *Id.*

Despite the professed view of the SEC, prudence may dictate that a company furnish any material amendments to its Form 10-K Report to any shareholders who previously received a copy of the report. In this regard, the SEC merely indicated that the proxy rules do not require that shareholders be furnished with subsequently filed amendments. It was silent as to any other requirements such as the anti-fraud provisions of the securities laws. This problem involves a determination of the purpose of the requirement to furnish the Form 10-K Report, a question which is not answered by the amended rules or the Covering Release. Since the requirement to undertake to furnish and to furnish on request copies of the Form 10-K Report is limited to shareholders on the record date of the annual meeting, it is arguable that the rationale behind the requirement is merely to provide shareholders with further information upon which to vote for directors. This view, however, is not supported by the fact that shareholders as of the record date can request the Form 10-K Report at any time prior to the next annual meeting record date. Based upon this, the Form 10-K Report should be considered to have broader application than to the annual meeting, thereby suggesting that the proper practice is to furnish copies of any material amendments.

The determination to furnish material amendments to persons who have previously received Form 10-K Reports and the requirement to furnish subsequent amendments to shareholders asking for them in their original request may have several results. It is likely that the regretful practice followed by certain companies of filing Form 10-K Reports which admittedly do not meet all appropriate requirements with the intention of filing a corrective amendment later will be reduced. In addition, companies may resist requests by the Staff of the SEC to file an amendment to a Form 10-K Report in situations where they do not believe the amendment is necessary rather than filing the amendment merely because it is easier to do so than to argue with the Staff.

Another result of the amendments to the proxy rules may be a decrease in the practice of incorporation by reference in Form 10-K Reports. SEC rules permit a company to include information in a Form 10-K Report by way of incorporating therein by reference information contained in a definitive proxy statement or annual report.⁸⁰ When this approach is utilized, the applicable rules also require copies of the documents or the pertinent pages thereof from which the information is incorporated to be filed with the Form 10-K.⁸¹ Although the proxy

80. Rule 12b-23(b), 17 C.F.R. § 240.12b-23(b) (1974).

rules do not specifically require any portion of such incorporated documents to be furnished to shareholders who request the related Form 10-K Report, it would be difficult to take the position that it is not necessary. In view of the fact that it is unlikely that companies which incur considerable time, effort, and expense on their annual report will want to furnish these incorporated documents or portions thereof to their shareholders if only for aesthetic reasons, the incorporation by reference practice can be expected to decline.

To date, most companies which have voluntarily offered to provide copies of their Form 10-K Reports to shareholders have had relatively few requests.⁸² Nevertheless the new requirements relative to furnishing copies of Form 10-K Reports can be expected to result in increased requests. With virtually all major corporations being required to provide these reports without charge on request, it may be assumed that as shareholders become more accustomed to the availability of the reports, they will be more likely to take advantage of the opportunity to obtain more complete information regarding their companies. The desire to obtain additional information probably will not be limited to shareholders. Analysts, customers, suppliers and competitors will also find it easier to gain information.

The increased, or at least potentially increased, dissemination of the Form 10-K Report will almost certainly result in increased concern with its form and content. Form 10-K Reports presently vary greatly in form, scope, and content. This results from a number of factors. Unlike registration statements filed under the Securities Act, the Staff of the SEC spends relatively little time reviewing and makes few comments regarding Form 10-K Reports. As a result, the substantial re-drafting, at the request of the Staff, which often follows the filing of registration statements is generally absent in connection with Form 10-K Reports. This absence is particularly important in the case of companies which are not experienced in securities matters. Second, managements usually have specific objectives in filing a registration statement including debt or equity financing, the acquisition of another company, or the registration of stock under a stock option, bonus, or other benefit program. These objectives have generally resulted in the expenditure of significant time and effort in the preparation of such filings. Such specific goals have been lacking in the filing of Form 10-K Reports with the result that managements have often regarded

82. A 1973 New York Stock Exchange survey of companies listed thereon indicated that of the companies which offered to send Form 10-K Reports to their shareholders (26% of the companies responding to the survey) approximately 65% reported that they sent out 40 or less copies and only 14% sent out more than 150. *Wall Street J.*, Dec. 19, 1974, at 10, col. 3 (E. ed.).

them as an unwanted burden of public ownership. Finally, responsible managements and their counsel have widely differing views of the proper scope of the Form 10-K. Some believe that documents which approach the magnitude of a registration statement are appropriate while others adopt a much less ambitious approach.

IV. LIABILITY FOR FALSE AND MISLEADING ANNUAL REPORTS

Despite the amendments, the annual report will retain its status as a non-filed document and as non-proxy-soliciting material so that it will not be subject to the express civil liability provisions of section 18 of the Exchange Act or to rule 14a-9 thereunder.⁸³ As a non-filed document, the annual report also will not be subject to prior SEC review.

Although there is no liability under sections 14 or 18 for material misstatements in or omissions from an annual report, it is clear that rule 10b-5⁸⁴ under the Exchange Act would apply to any such misstatements or omissions. It has been held that a cause of action is stated by a person who purchases securities in the open market on the basis of false information contained in the company's annual report.⁸⁵ In the famous case of *SEC v. Texas Gulf Sulphur Co.*⁸⁶ which involved a misleading press release, the court held that "Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, *e.g.* by means of the financial media . . . if such assertions are false or misleading or are so incomplete as to mislead."⁸⁷ Certainly, the responsibility of a company for a false or misleading annual report must be at least equal to that for a false or misleading press release.⁸⁸

83. Rule 14a-9, 17 C.F.R. § 240.14a-9 (1974). See notes 24-26 and accompanying text *supra*.

84. 17 C.F.R. § 240.10b-5 (1974). The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(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, in connection with the purchase or sale of any security.

85. See, *e.g.*, *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

86. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

87. 401 F.2d at 862.

88. For examples of cases involving liability for misleading annual reports, see *Butler Aviation Int'l, Inc. v. Comprehensive Designers, Inc.*, 425 F.2d 842 (2d Cir. 1970); *Green v. Jonhon, Inc.*, 358 F. Supp. 413 (D. Ore. 1973); *Dillon v. Berg*, 326 F. Supp. 1214 (D. Del. 1971), *aff'd*, 433 F.2d 876 (3d Cir. 1971); *Drake v. Thor*

The amended proxy rules will probably increase the potential liability of companies arising out of the annual report. The Management Discussion section can be expected to be a significant danger area especially for smaller companies with unsophisticated financial personnel. When experienced accountants are retained by these companies, however, they can be expected to provide significant guidance in this regard. In fact, early experience indicates that accountants have recognized that the Management Discussion, although not covered by the audit, is nevertheless closely related to the financial statements. As a result, they, rather than counsel, have appropriately taken the role as the primary consultant with respect to the Management Discussion. One particular problem with the Management Discussion will occur when the reasons set forth therein for changes in financial condition or operating results differ in language, scope, emphasis, or in other respects from those set forth in the president's letter. Certainly, the president should not be required to parrot the Management Discussion and should be able to describe the factors that he believes are the most important underlying reasons for a change. Care will be required in this regard, however, and it may be a good practice for the president's letter to refer to the Management Discussion. Other danger areas in the annual report involve summary financial information which must be consistent with the financial statements and the summary of operations and line of business information which do not have to be equivalent to similar information contained in the Form 10-K Report.

The responsibility of companies for misstatements in or omissions from their annual reports, aside from those with respect to the financial statements included therein, is a developing area. To date, there have been relatively few court cases or SEC proceedings.⁸⁹ Prudent managements, however, should recognize the potential of liability and review their annual reports with counsel and auditors. Hopefully, the courts and the SEC will continue to recognize the importance of the ability of managements to communicate with shareholders by means of "free writing" devoid of legalistic and technical terminology. The only way to maintain this ability, however, is to recognize that the nonrequired information contained in the annual report should not be judged in the same way as information contained in a Securities Act registration statement or Exchange Act report. On the basis that the required and nonrequired information contained in an annual report may be judged differently, it may be a good idea to separate physically the required and nonrequired information in the annual report.

Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

In addition, the fact that Form 10-K Reports are furnished to shareholders may result in an increased potential of liability. Form 10-K Reports are, of course, filed with the SEC and section 18⁹⁰ of the Exchange Act imposes liability upon any person making or causing to be made any false or misleading statement in any document so filed pursuant to the Exchange Act or the rules thereunder. Section 18, however, is not a particularly potent weapon. Among other things, the plaintiff must prove that he suffered damages as the result of his actual reliance on the false or misleading statement.⁹¹ Since few shareholders to date have obtained copies of Form 10-K Reports, the reliance obstacle has been a formidable one. Thus, one result of the increased dissemination of the Form 10-K Report will be the expansion of the class of potential plaintiffs in section 18 actions.

Companies would be well advised not to take undue solace in the fact that reliance is required in section 18 actions. It is presently unresolved whether section 18 constitutes the exclusive remedy for false or misleading documents filed with the SEC. Since rule 10b-5 clearly applies to false or misleading press releases, however, it would be difficult to believe that defendants ultimately will be held to a lesser standard of accountability with respect to filed documents than with respect to nonfiled documents such as press releases. In the event that rule 10b-5 is determined to be applicable to Form 10-K Reports, it should be kept in mind that there is a trend away from requiring actual reliance in rule 10b-5 actions.⁹² Probably the most sweeping of the various theories for eliminating the requirement of actual reliance is based upon the view that the market price of a company's securities reflects any

90. 15 U.S.C. 78r (1970).

91. In order to recover under section 18, the following factors must be present: 1) there must be a false and misleading statement of a material fact; 2) a person must purchase or sell a security at a price which was affected by the statement; 3) the person purchasing or selling the security must not have known that the statement was false or misleading; 4) the person purchasing or selling the security must have relied upon the statement; and 5) the person against whom the suit is brought must have failed to prove that he acted in good faith and had no knowledge that the statement was false or misleading. In addition, the court may require an undertaking to pay the costs and expenses of the suit. Finally, there is a relatively short statute of limitations. *Id.*

92. *See, e.g.,* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972) (positive proof of reliance is not necessary in a case primarily involving a failure to disclose); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) (proof of actual reliance by thousands of individuals is not feasible). *See also* 2 A. BROMBERG, *SECURITIES LAW: FRAUD — SEC RULE 10b-5* § 8.6, at 209 (1973) [hereinafter cited as BROMBERG]; 5 A. JACOBS, *THE IMPACT OF RULE 10b-5* § 64.01 (1947) [hereinafter cited as JACOBS]; Note, *The Reliance Requirement in Private Actions Under SEC*

false or misleading statements and people can trade in reliance on market price.⁹³

Although the issue of personal liability of a company's directors, officers, and employees for a false or misleading annual report is even more unsettled than the admittedly unresolved questions relating to the liability of the company itself, the danger of such liability should be an area of concern. While the court may have been influenced to an extent by insider trading, various directors and officers were found to be liable for a misleading annual report in *Blakely v. Lisac*.⁹⁴ In considering the potential liability for persons other than the company arising out of a false or misleading annual report, it is necessary to consider at least five classes of persons: 1) those who take part in the actual preparation of the deficient annual report; 2) those who aid and abet or conspire in the violation; 3) persons who control the company that issues the deficient reports; 4) inside directors who do not take part in the preparation of the report, participate directly or indirectly in the violation, or control the company; and 5) outside directors who do not take part in the preparation of the report, participate directly or indirectly in the violation, or control the company.

Directors, officers, or employees who participate in the preparation of a false or misleading annual report face the greatest danger of personal liability under rule 10b-5. This is not to say that all such participants will be held liable. Liability may depend upon the corporate position of the participant, his specialized area of corporate activity, and the extent of the role he plays in the preparation.⁹⁵ Based upon these distinctions, certain participants may be able to establish that their actions did not violate the applicable standard of conduct, whatever that standard may be. While no participant is a guarantor of the accuracy of an annual report, certain persons (such as high executive officers who have complete knowledge of the business and affairs of the company) obviously will have great difficulty establishing that they should not be held responsible for false or misleading statements.⁹⁶

93. See JACOBS, *supra* note 92, § 64.01, at 3-163 & n.22; Note, *supra* note 92, at 592-97. See also *Reeder v. Mastercraft Elec. Corp.*, 363 F. Supp. 574 (S.D.N.Y. 1973).

94. 357 F. Supp. 255 (D. Ore. 1972).

95. Cf. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). See also Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case* (pts. 1 & 2), 55 VA. L. REV. 1 & 199 (1969), reprinted in 1 SEC. L. REV. 3, 22-47 (1969).

Other persons who are involved only in a secondary fashion may face liability as aiders and abettors or conspirators.⁹⁷ A person may be found to have aided or abetted a violation of rule 10b-5 if he knows or should have known of the existence of the violation and renders substantial assistance either by remaining silent or inactive when he has a duty to speak or act or by taking affirmative action. The concept of aiding and abetting has been used to hold officers, directors, lawyers, accountants, and others accountable for a violation of the rule.⁹⁸ Conspiracy goes a step beyond aiding and abetting. A conspiracy involves actual participation by two or more persons in a violation of the rule rather than lending support to a more active wrongdoer.

Section 20(a)⁹⁹ of the Exchange Act imposes liability on any person who directly or indirectly controls any person liable under that Act whether or not the controlling person participates in the conduct which causes the violation. Liability, however, is not absolute. A controlling person will not be liable if he acted in good faith and did not directly or indirectly induce the act or acts constituting the violation.

Despite the significant consequences of being a controlling person, there is sparse authority regarding the class of persons deemed to be in control.¹⁰⁰ The SEC takes the position that there must be a controlling person or group in every company and, in the absence of such a person or group, the board of directors as a whole is in control.¹⁰¹ Although there is some authority to the contrary, an individual should not be regarded as a controlling person of a company merely because he is a director, executive officer, or major shareholder.¹⁰² Rather, the

97. For an in-depth analysis of these theories, see Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972). See also Ruder, *Aiding and Abetting*, 7 REV. SEC. REG. 882 (1974).

98. See, e.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974) (accountants); *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973) (lawyers); *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967) (officers and directors).

99. 15 U.S.C. § 78t(a) (1970). The Securities Act contains a similar provision in section 15, 15 U.S.C. § 77o (1970). For an examination of the liabilities of controlling persons under the securities laws, see Comment, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U.L. REV. 1019 (1973), reprinted in 6 SEC. L. REV. 616 (1974); Comment, *The Controlling Persons Provisions: Conduits of Secondary Liability Under Federal Securities Law*, 19 VILL. L. REV. 621 (1974).

100. See Schneider & Kant, *Uncertainty Under the Securities Act*, 26 BUS. LAW. 1623, 1625-26 (1971). See also Sommer, *Problems of Controlling Persons*, in PLI FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 105 (R. Mundheim, A. Fleischer, Jr., & D. Glazer eds. 1970); Sommer, *Who's "In Control"?* — S.E.C., 21 BUS. LAW. 559 (1966), reprinted in ABA SELECTED ARTICLES ON FEDERAL SECURITIES LAW (H. Wander & W. Grienberger eds. 1968).

101. See, e.g., American-Standard [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,071 (SEC Staff Letter, Oct. 11, 1972).

102. See Schneider & Kant, *supra* note 100, at 1625. Comment, *supra* note 99, at 639-40. See also *Mader v. Armel*, 461 F.2d 1123 (6th Cir.), cert. denied, 409 U.S.

concept of control should be regarded as a factual question. In resolving the question, it should be recognized that the controlling persons include both those who actually control the company and those who have the power to control the company whether or not such power is exercised. Therefore, in determining those who actually control or who have the power to control, it is necessary to consider shareholdings, management positions, and family and other relationships.

It is not surprising that persons who participate in the preparation of a false or misleading annual report, who aid, abet, or conspire in the violation, or who control a company which issues such an annual report may face personal liability. It is more difficult to understand that directors who do not fit into any of these categories also face a risk of liability for misstatements in or omissions from an annual report. It is certainly arguable that such directors should be able to rely entirely on management and management's professional advisers to prepare the report. In fact, the general practice has been not to furnish copies of the annual report to directors not taking part in its preparation prior to the time it is disseminated. Nevertheless, all directors are exposed to a very real risk of liability. In the aforementioned *Blakely* case,¹⁰³ two of the persons held liable were outside directors who took no part in the preparation of the report and whose conduct probably could not be considered to involve aiding and abetting or conspiracy.

Assuming that such directors do not participate in the preparation of the annual report, have actual knowledge of or aid or abet in the violation, or control the company, any such liability would have to be predicated upon their failure to exercise the care or diligence required of directors. Despite the risks of liability, the standard of conduct to which directors must conform has not been resolved.¹⁰⁴

The SEC and some courts have taken the position that a director is liable for misstatements or omissions of the corporation if his conduct

1023 (1972). *But see* *Myzel v. Fields*, 386 F.2d 718 (8th Cir.), *cert. denied*, 390 U.S. 951 (1968); *Moerman v. Zipco*, 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd on other grounds*, 422 F.2d 871 (2d Cir. 1970).

103. 357 F. Supp. 255 (D. Ore. 1972). See note 94 and accompanying text *supra*.

104. Ray Garrett, Jr., Chairman of the SEC, recently announced that the SEC will not issue guidelines for directors' conduct. Address by SEC Chairman Garrett, Arthur D. Little Inc. Corporate Directors Conference, Dec. 17, 1974, *reported in* 283 BNA SEC. REG. & L. REP. A-16 (Jan. 1, 1975). Mr. Garrett acknowledged that directors are not guarantors of the accuracy of corporate disclosure documents and that, in its enforcement of the securities laws, the SEC will hold directors responsible within the standard imposed by corporate law. In this regard, Mr. Garrett reminded directors of publicly-held companies that they have a prudent or reasonable man duty to investors to provide full and accurate information and otherwise to cause the company to comply with federal securities laws. Directors are responsible for knowingly authorizing or permitting violations to occur and may be responsible for permitting the act to occur. *Id.* Villanova Law Review, Vol. 20, Iss. 2, 296 (1975).
 digital commons law.villanova.edu/vol20/iss2/1 exercised reasonable diligence in the performance of their duties and were nevertheless unaware of the misconduct or omission.

is found to be negligent — most typically but not uniformly described as a failure to know that the corporate disclosure was false or misleading when he should have known of the deficiency.¹⁰⁵ Other courts have taken the position that to be liable the director's conduct must involve scienter — an element which encompasses an intent to defraud, actual knowledge of a false or misleading statement, or a reckless or wilful disregard of the truth.¹⁰⁶ The attempt to specify a standard of conduct for directors through the use of labels such as “negligence” and “scienter”, however, has neither resulted in consistent application nor provided a guide to persons whose failure to satisfy the applicable standard would result in adverse consequences.

In recognition of this, there appears to be a trend away from an unprofitable search for a single defined standard of conduct to fit all situations based upon labels which are inherently incapable of objective meaning or uniform application. In its place is a “flexible duty standard” which would delineate the duty of the director in connection with the totality of the particular factual context involved.¹⁰⁷ As applied to the annual report, this approach suggests an evaluation of the director's involvement in its preparation, his sophistication, expertise, and access to information, his corporate position, the procedures adopted to prevent deficiencies, and the reasonableness of his reliance upon management and its advisers in preparing the document.¹⁰⁸

105. See Address by SEC Chairman Cook entitled *The Director's Dilemma*, Southern Methodist University School of Business Administration, April 6, 1973, reported in [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,302; Address by SEC Chairman Garrett entitled *Continuity and New Challenges*, Securities Regulation Institute, Jan. 16, 1974, reported in [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,623; and Address by SEC Commissioner Sommer entitled *Directors and The Federal Securities Laws*, Colorado Association of Corporate Counsel, Feb. 21, 1974, reported in [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,669. See also *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1311 (2d Cir. 1973) (minority opinion); *Colvin v. Dempsey-Tegler & Co.*, 477 F.2d 1283, 1286, 1291 (5th Cir. 1973); *Financial Indus. Fund, Inc. v. McDonnell-Douglas Corp.*, 474 F.2d 514, 517 (10th Cir.), cert. denied, 414 U.S. 874 (1973).

106. See *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 364 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (majority opinion); *Cohen v. Franchard Corp.*, 478 F.2d 115, 123-24 (2d Cir.), cert. denied, 414 U.S. 857 (1973); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1290-91 (2d Cir. 1969). It has been suggested that the first and third clauses of Rule 10b-5 require scienter since they are both phrased in terms of fraud while the second clause, which does not specifically mention fraud, is not. In fact, most courts do not specify the particular clause which provided the basis of their decisions. For an analysis of the proper standard of conduct, see BROMBERG, *supra* note 92, § 8.4; JACOBS, *supra* note 92, § 63; Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970), reprinted in 3 SEC. L. REV. 253 (1971).

107. This approach was suggested in Mann, *supra* note 106. It was taken into account by the Ninth Circuit in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

108. In *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), which involved unsuccessful investments made by the plaintiff at the recommendation of the defendant,

Section 11¹⁰⁹ of the Securities Act contains the only reference to directors in the securities laws. It imposes liability on a director for a materially false registration statement unless he can establish a "due diligence" defense. To establish this defense the director must prove:

(A) as regards any part of the registration statement not purporting to be made on the authority of an expert . . . he had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were [not false or misleading] . . . and (C) as regards any part of the registration statement purporting to be made on the authority of an expert . . . he had no reasonable ground to believe and did not believe . . . that the statements therein were [false or misleading]¹¹⁰

As defined in section 11, "reasonable" investigation and a "reasonable" belief are those that would be made and held by "a prudent man in the management of his own property."¹¹¹

Despite the importance of the annual report in the disclosure process, even the SEC would acknowledge that the duty of care of directors with respect to the annual report is less than with respect to registration statements.¹¹² Accordingly, directors clearly should not be held to a duty to make an independent investigation of certified financial statements contained in an annual report since this is not even required with respect to registration statements. There is support for the proposition that directors also should not be required to make an independent investigation of the accuracy of other portions of the annual report. In *Gould v. American Hawaiian S.S. Co.*,¹¹³ the court determined that directors could be held personally liable for a false and misleading proxy statement if they knew or should have known of the inaccuracies. The court recognized, however, that the directors need only read the proxy statement and "correct statements and facts which they knew or should have known were erroneous or misleading."¹¹⁴ They were not "required to recalculate or reassemble financial or other reports absent some evident misstatement."¹¹⁵ Moreover, it was permissible to rely on "legal or

the court suggested that, in ascertaining a defendant's duty under rule 10b-5, there should be a determination of the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to that of the plaintiff, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decision, and the defendant's activity in initiating the securities transaction in question. *Id.* at 735-36.

109. 15 U.S.C. § 77k (1970).

110. *Id.*

111. *Id.*

112. See Sommer, *supra* note 105.

113. 351 F. Supp. 853 (D. Del. 1972).

114. *Id.*

115. *Id.*

financial counsel in areas pertinent to their respective expertise."¹¹⁶ Based on this, a reasonable standard would be that directors who review an annual report should not be personally liable for any misstatements or omissions unless facts actually known to them give them reason to believe there are inaccuracies in the annual report.

Whatever the standard of due care may be, however, all directors should not be treated alike. The standard of care should certainly vary with a director's involvement, his sophistication and expertise, and his access to pertinent information and data.¹¹⁷ For example, a public interest director with little expertise cannot reasonably be held to standards which he is not equipped to satisfy.¹¹⁸ In addition, outside directors should not have the same obligations in meeting the standard as inside directors, that is, those who hold a management position with the company and devote significant time to the company's affairs. Notwithstanding the contrary view of the SEC, there are significant reasons for and considerate judicial support of the proposition that outside and inside directors should not be treated alike.¹¹⁹ Outside directors are not normally involved in the day-to-day conduct of a company's affairs; their knowledge of significant facts is normally less than that of inside directors; and they have not traditionally played an important role in the preparation of corporate documents. These factors lend support to the position that significant reliance by outside directors on management and its professional advisers in the preparation of the annual report will not in itself detract from their "due diligence" defense.

Nevertheless, public interest and outside directors are directors and as such do have responsibilities to the company which they serve. In view of the importance of the annual report and the expanding duties of directors under the securities laws including their obligations to maintain an awareness of corporate activities, companies should institute procedures to enable directors to satisfy their responsibilities. Undoubtedly, there are numerous methods by which this can be accomplished. Perhaps the best approach would be a "due diligence" meet-

116. *Id.*

117. See note 95 and accompanying text *supra*.

118. See Cook, *supra* note 105.

119. See *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Moses v. Burgin*, 445 F.2d 90 (1st Cir.), *cert. denied*, 404 U.S. 1004 (1971). In *Lanza*, the Second Circuit held that an outside director did not have an affirmative "duty to convey" material adverse information to prospective purchasers of the company's securities when he did not participate in or have knowledge of the concealment of such information. 479 F.2d at 1289. For an analysis of the *Lanza* case, see Sonde & Friedman, "Seagulls on the Water — Some Ships in a Storm": A Comment on *Lanza v. Drexel*, 49 N.Y.U.L. Rev. 270 (1974); Ukropina, *Lanza v. Drexel & Co.: Some Comfort for the Outside Director, But More Needed*, 48 L.A.B. BULL. 330 (1973); Note, 87 HARV. L. REV. 1066 (1973), reprinted in O. SEC. L. REV. 520 (1974).

ing¹²⁰ with all directors or a committee of directors including outside directors.¹²¹ Directors should be provided with drafts of the annual report (or at least the president's letter and the material specifically required to be included in the annual report by the proxy rules) and probably the Form 10-K Report as well in advance of a meeting at which these materials would be discussed.

After having an opportunity to review these materials, the directors should meet with management personnel responsible for their preparation as well as the company's counsel and auditors. To satisfy the due diligence requirements, the meeting should not be a meaningless ritual, but an open and frank discussion of the reports. Management should explain the procedures utilized to insure the accuracy of the reports and review at least the most important aspects of the reports with particular emphasis on any difficult disclosure problems which were involved in their preparation. Directors should have the opportunity to ask questions and make comments on the annual report. It would also be helpful to have the minutes of the meeting reflect this in-depth review of the records. In most cases, the review session will not result in any material changes in the form or content of the material. This is particularly true when management is experienced in preparing such reports and has engaged qualified counsel and accountants. In such cases, the directors should have the right to rely to a great extent on management in the preparation of the reports. Nevertheless, such a meeting will assist directors in satisfying their obligations. They will have both maintained an awareness of the contents of the reports and instituted procedures to assure their accuracy. No more should be required.¹²²

120. For an examination of committees of directors, see McMullen, *Committees of the Board of Directors*, 29 BUS. LAW. 755 (1974).

121. Cf. Folk, *supra* note 95, at 82-83.

122. The author does not suggest that the failure to adopt this or any other procedure for the review of annual reports and Form 10-K Reports indicates a failure of directors to exercise due diligence. As previously stated, the responsibility of directors for these corporate reports is in the developmental stage. In this framework, the appropriateness of any procedure necessarily requires an analysis of many factors involving the company. The outlined procedure is an admittedly conservative approach which recognizes that the direction of the law is to require greater attention by directors to these very important disclosure documents. Based upon this, the theory that directors have a reduced risk of liability for documents that they do not review may be outmoded for certain important documents such as the annual report. In this regard, it is interesting that the chairman and chief executive officer of Hardee's Food Systems, Inc., recently resigned over the handling of that company's annual report and Form 10-K Report. He indicated that the specific event leading to his resignation was the fact that the 1974 annual report was mailed to shareholders and the Form 10-K Report was filed with the SEC before the board of directors met as a group with the company's officers and independent accountants to review and approve the reports.

V. CONCLUSION

The amendments to the proxy rules represent another of the seemingly endless new requirements for more complete corporate disclosure. Accordingly, they will result in a significant increase in time and expense. These burdens will have the most serious impact on small companies which are least able to assume them. It is interesting that the amendments were adopted at a time when numerous companies are attempting to "go private" in part to escape from the burdens of public ownership including corporate disclosure requirements.

If, however, the SEC and the courts do not significantly change their prevailing view of the annual report as the primary medium by which management may freely communicate with shareholders and others, the amendments will have generally salutary effects. The amendments will improve both the disclosure contained in the annual report and the dissemination of the annual report, proxy materials, and Form 10-K Report. To date, much of this information has been buried in the bowels of the SEC, practically available only to professionals and not to the persons to whom it should be available — the shareholders.