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Indemnifying Corporate Officials for Williams Act Violations

> Labor can do nothing without capital, capital nothing without labor, and neither labor nor capital can do anything without the guiding genius of management; and management, however wise its genius may be, can do nothing without the privileges which the community affords.[1]

In recent years, the depressed state of the economy, the securities market in particular, has produced fertile ground for corporate takeovers and acquisitions. A particularly attractive and increasingly popular route to such takeovers has been the the cash or exchange tender offer.[2] In a takeover situation, with job, money, prestige, and power at stake, vulnerable corporate managers may take precipitous action. Such action, which must necessarily be quick, may not be in the best interest of the investors. The action may possibly run afoul of various fiduciary and statutory responsibilities, including those set forth in the Williams Act.[3] In such situations, managers, whether pursuing or defending control, may be held liable for burdensome expenses and damages.

In general, two broad purposes are served by imposing liability on directors and managers. One is to provide compensation to the injured investors. The other is to create an *in terrorem* effect to promote com-

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[1] Address by W. L. Mackenzie King (1874–1950), Canadian Club, Montreal, Canada, Mar. 17, 1919, *quoted in* J. BARTLETT, FAMILIAR QUOTATIONS 931 (14th ed. 1968).

[2] In describing the tender offer or takeover bid, this note will refer to the various players as the target (that firm which is the object of the bid), the raider (offeror or bidder), target shareholders (offerees), and the respective incumbent corporate managements (officers and directors of the respective firms, differentiated when necessary). The term "manager," when used, is meant to include directors and officers (to the level of treasurer and secretary).

The Williams Act does not specifically define the term "tender offer." One suggested definition is found in Aranow & Einhorn, *Essential Ingredients of the Cash Tender Invitation,* 27 BUS. LAW. 415 (1972):

> A tender offer may be defined as a public offer or solicitation by a company, an individual or a group of persons to purchase during a fixed period of time all or a portion of a class or classes of securities of a publicly held corporation at a specified price or upon specified terms for cash and/or securities.

It should be noted that this definition is not complete. Indeed, the intent of Congress appears to have been to leave the term "tender offer" susceptible to judicial interpretation. The courts have taken up the gauntlet. *See* Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934,* 86 HARV. L. REV. 1250 (1973).

[3] Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, *amending* 15 U.S.C. §§ 78m-n (1964) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1970)) [hereinafter referred to as the Williams Act].

pliance with the law. Clashing with these policies is the economic demand that the most competent individuals be managers—a demand that will not be met if the risks of managing are prohibitive. This conflict of objectives—legal versus economic—reaches an apex during a heated contest for corporate control wherein the target company's managers, the target's shareholders, the raiding company's managers, the raider's shareholders, and investors all have a stake in the outcome. Clearly, the overriding objective should be to encourage the best individuals to serve as corporate managers. Yet such encouragement must operate within the framework of the responsibilities imposed by the legal system. One resolution is to be found in the grant or denial of indemnification to officers and directors.

Indemnification and insurance are matters of contract arising among the state, the corporation, and its officers and directors. State law provides the rules for decision of such matters. Yet federal statutes have in part pre-empted state prerogatives. In some situations federal requirements actively operate to regulate manager indemnification and insurance.[4] State courts, if asked to pass upon indemnification agreements, should be responsive to federal policies which underlie an imposition of manager liability while paying heed to state policies that recognize the need for indemnification.

This note will begin with an examination of the history and theories of the concept of indemnification, then look at the policies and provisions of the federal securities laws, particularly the Williams Act, and finally, this note will suggest some guidelines for indemnification designed to afford maximum protection to both corporate managers and the investing public.

HISTORY AND THEORIES OF THE CONCEPT OF INDEMNIFICATION

Free market competition dictates that the most competent among the citizenry should manage. In accordance with this requirement, corporations must make every effort to encourage the best individuals to serve as their officers and directors. The manager must not be discouraged from defending legitimate corporate policies, or from taking necessary risks on a project which might benefit the corporation. Managers must be encouraged to answer strike or nuisance suits in order to avoid damage to the corporation. As the chosen representatives of the "owners," managers should be encouraged to defend their

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[4] G. WASHINGTON & I. BISHOP, INDEMNIFYING THE CORPORATE EXECUTIVE (1963) [hereinafter referred to as WASHINGTON & BISHOP] is the classic study in this area.

decisions, policies, and office.[5] No doubt, remuneration,[6] prestige, and power provide an incentive to serve. However, if the risks of such service become prohibitive, only the incompetent, the gambler, and the crook will be found to fill these employment roles.[7]

It appears that it is in the best interest of both the corporation and society to prevent the risk of economic hardship from becoming too great. This is one function which indemnification and insurance perform. Indemnification and insurance of officers and directors may also create a "deep pocket" to facilitate compensation of injured investors.[8] Yet the corporation, and the stockholders, should not have to bear the risks if corporate officials are encouraged to act recklessly or contrary to legal norms.[9]

Much of the law on the subject of idemnification has developed in derivative suits.[10] The focus in this note, however, is on third party

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[5] *See* Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888 (3d Cir. 1953); WASHINGTON & BISHOP at 5.

[6] Often, outside directors are paid token sums to assume positions of responsibility which may nonetheless leave them open to considerable personal liability. *See generally* G. WASHINGTON & V. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE (3d ed. 1962).

[7] This was the fear expressed by the corporate community following Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970). The court in *Globus* denied indemnification to an underwriter for liabilities incurred due to a violation of Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1970). *See also* Escott v. Bar Chris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of Bar Chris and Globus,* 24 BUS. LAW. 681 (1969).

[8] *See* WASHINGTON & BISHOP.

[9] It is a premise of this note that indemnification or insurance should be available to corporate management for liability only under color of official action. The question of insurance or indemnification for "outside" or personal activities in the form of compensation or remuneration is thus beyond the scope of this note. For a discussion of these issues see WASHINGTON & BISHOP at 6–19. However, any activity which is ostensibly undertaken in the capacity as corporate manager, even though against the corporation's best interests, will be treated herein.

[10] In stockholder derivative actions, an unsuccessful officer or director had little hope of gaining reimbursement from the corporation. *See, e.g.,* Wickersham v. Crittenden, 106 Cal. 329, 39 P. 603 (1895); General Mtg. & Loan Corp. v. Guaranty Mtg. & Sec. Corp., 264 Mass. 253, 162 N.E. 319 (1928). Yet if the manager acted in good faith, he might be reimbursed for expenses. *See, e.g.,* Albrecht, McGuire & Co. v. General Plastics, Inc., 256 App. Div. 134, 9 N.Y.S.2d 415 (1930). The director's liability must have arisen from actions performed in his corporate managerial capacity if any reimbursement were to be justified. *See* Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 189 N.W. 276 (1922).

The truly confusing development in the area, to both corporate management and the corporate bar, was the coming of the "benefit theory." *See* WASHINGTON & BISHOP at 85. In Griesse v. Lang, 37 Ohio App. 553, 175 N.E. 222 (1931), an Ohio court spawned the benefit theory by apparently misinterpreting an earlier New York case, Godley v. Crandell & Godley Co., 153 App. Div. 697, 139 N.Y.S. 236 (1912). The Ohio court required the successful directors to show that there was a benefit flowing to the corporation *from their successful defense* of a stockholder suit. In *Godley* the directors were found to be guilty, yet because some benefit of their actions inured to the corporation, actions brought under the federal securities law; nevertheless, an examination of the history of the concept and the development of the various theories of indemnification should provide some guidance for its applicability to third party actions.[11]

Common Law Development

Prior to 1939, case law dealing with corporate manager indemnification was unsettled. In that year *New York Dock Co. v. McCollom*[12] was decided, epitomizing the confusion in the common law concept of indemnification. In *McCollom*, a New York court found that directors, successful on the merits in a stockholders' suit, were required to show some benefit flowing to the corporation before the corporation would be justified in reimbursing their expenses. This benefit had to be something more than merely winning the suit, since, in the opinion of the court, the attorneys retained by the corporation had performed the services resulting in the exoneration of the corporation. Rather, the director needed to show substantial benefit flowing to the corporation from *his* successful defense[13] in order to be reimbursed. *McCollom*, together with the later case of *Baily v. Bush Terminal Co.*,[14] express the rule that

> no common law right to recover reimbursement exists, and . . . in the absence of contract or statute, a director who successfully defends an action brought against him by his corporation or in its behalf cannot require the corporation to reimburse him. . . .[15]

Statutory Development

McCollom set off a wave of both statutes and corporate bylaw

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they could then require the corporation to use its funds to defend the stockholders' suit.

By way of comparison, the English Companies Act, 19 & 20 Geo. 5, ch. 23, § 152(c) (1929), allows the court to relieve an officer of liability for negligence, default, breach of duty, or breach of trust if he acted honestly and reasonably, and ought fairly to be excused.

[11] For a general discussion of indemnification as a whole, the classic study is WASHINGTON & BISHOP. Reference should also be made to 3 L. LOSS, SECURITIES REGULATION 1829-36 (2d ed. 1961); 6 *id.* 3977-82 (2d ed. Supp. 1969); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968); Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153; Symposium, *Officers' and Directors' Responsibilities and Liabilities*, 27 BUS. LAW. 1 (Feb. 1972 Special Issue); Note, *Public Policy in Directors' Liability Insurance*, 67 COLUM. L. REV. 717 (1967).

[12] 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

[13] *Id.* at 111.

[14] 46 N.Y.S.2d 877 (Sup. Ct. 1943), *aff'd mem.*, 267 App. Div. 899, 48 N.Y.S.2d 324 (1943), *aff'd mem.*, 293 N.Y. 735, 56 N.E.2d 739 (1944).

[15] 46 N.Y.S.2d at 880.

provisions to facilitate indemnification. New York was the first state to act,[16] followed by many of the rest of the states of the Union.[17]

These statutes, when first enacted, were generally of two types. One type (enabling statutes) allowed the corporation to provide for indemnification through bylaws, but was limited to those situations in which a director or officer was adjudged not culpable for willful misfeasance or gross negligence.[18] The other type of statute conferred a qualified right on insiders to be indemnified when successful on the merits at litigation.[19] A few states passed statutes combining these two types.[20] These statutes have been amended in the intervening years. Yet until the 1960's, the statutes generally followed the aforementioned classifications. However, two important issues were left unresolved.

One issue involved a director who was made a party to an action merely because of his status as a director.[21] However, the newest Delaware statute[22] makes indemnification available so long as the manager was acting "in a manner . . . not opposed to the best interests of the corporation. . . ."[23] This phrasing would seem to cover situations where the manager is not necessarily acting in his corporate capacity, but is being sued because of his status as an insider.

The second issue not generally covered by the original statutes was the third party action. The statutes had been thought to be applicable only to the derivative suit.[24] However, some of the statutes have been amended or reenacted so as to cover, to some extent, the third

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16 [1941] N.Y. Sess. L. 1941, ch. 209, § 27a, ch. 350, § 61-a.

17 ALASKA STAT. § 10.05.009(15) (1962); CAL. CORP. CODE § 830 (West 1955); COLO. REV. STAT. § 7-3-101(o) (1973); D.C. CODE ANN. § 29-904(p) (1973); IND. ANN. STAT. § 23-1-2-2(b)(10) (Code ed. 1972); IOWA CODE § 496A.4(15) (1971); KY. REV. STAT. ANN. § 271.375 (1972); ME. REV. STAT. ANN. tit. 13A, § 719 (1964); MD. ANN. CODE art. 23, § 64 (1957); MICH. COMP. LAWS § 450.10-*l* (1948); MINN. STAT. § 301.095 (1971); MO. REV. STAT. § 351.355 (1959); NEB. REV. STAT. § 21-2004(15) (Supp. 1974); NEV. REV. STAT. § 78.751 (1973); N.C. GEN. STAT. § 55-20 (1975); N.D. CENT. CODE § 10-19-04(15) (1960); OHIO REV. CODE ANN. § 1701.13(E) (Page 1964); ORE. REV. STAT. § 57.255 (1973); PA. STAT. ANN. tit. 15, §§ 410, 1410 (1967); TEX. BUS. CORP. ACT art. 2.02(16) (1956); UTAH CODE ANN. § 16-10-4(o) (1953); VA. CODE ANN. § 13.1-3.1 (1950); WIS. STAT. § 180.04(14) (1971); WYO. STAT. ANN. § 17-36.4(o) (1957).

18 *E.g.*, COLO. REV. STAT. 7-3-101(o) (1973); OHIO REV. CODE ANN. § 1701.13(E) (Page 1964).

19 *E.g.*, PA. STAT. ANN. tit. 15, §§ 410, 1410 (1967).

20 Most notably the original New York Act, [1941] N.Y. Sess. L. 1941, ch. 209, § 27a, ch. 350, § 61-a.

21 This is precisely the problem encountered in suits brought under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1970), and in some instances those suits brought under section 10(b) of that act, 15 U.S.C. § 78j(b) (1970).

22 The Delaware statute has often served as a model for other states. *Compare* DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1974), *with, e.g.*, statutes cited note 17 *supra*.

23 DEL. CODE ANN. tit. 8, §§ 145(a)-(b) (1974).

24 Note, *Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation*, 76 HARV. L. REV. 1403, 1406 (1963).

party suit. For example, the Delaware statute was reenacted in 1968 to cover situations in which an insider is judged liable in third party actions.[25] The insider may be indemnified if

> he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.[26]

Other statutes have dealt with the third party suit by adding the words "civil or criminal" in describing the type of actions covered.[27] The Indiana statute is representative of these legislative provisions:

> (b) Subject to any limitations or restrictions imposed by law or the articles of incorporation, each corporation shall have the following general rights, privileges and powers:
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> . . . .
>
> (9) to indemnify any person who is or was a director, officer . . . of the corporation . . . against expenses reasonably incurred by him in connection with the defense of any action, suit or proceeding, *civil or criminal*, in which he is made or threatened to be made, a party by reason of being or having been in any such capacity, or arising out of his status as such, except in relation to matters as to which he is adjudged in such action suit or proceeding, *civil or criminal*, to be liable for negligence or misconduct in the performance of duty to the corporation . . . .[28]

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[25] 8 Del. C. 1953 § 145; 56 Del. Laws, C. 50; 56 Del. Laws, C. 186, § 6; 57 Del. Laws, C. 421 § 2.

[26] DEL. CODE ANN. tit. 8, § 145(a) (1974).

[27] *E.g.*, NEB. REV. STAT. § 21-2004(15)(a) (Supp. 1973); MODEL BUSINESS CORPORATION ACT § 5, in ABA-ALI MODEL BUS. CORP. ACT. ANN. (2d ed. 1971).

[28] IND. ANN. STAT. § 23-1-2-2(b)(9) (Code ed. Supp. 1974) (emphasis added). In addition, the Indiana statute, in section 23-1-2-2(b)(10), grants the corporation the power to insure the manager

> against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section.

Insurance, on the whole, is more widely available under the indemnification statutes, than is indemnification proper. It seems to be a compromise between the full indemnification by the corporation, and no support whatsoever for the manager. The premiums for this insurance are generally paid by the corporation, and may be viewed as a form of compensation. While such provision reduces the load on the corporation by spreading the risk outside the circle of corporate players, and may thereby circumvent any lingering common law "benefit" requirements, such a program is still open to many of the same objections raised against indemnification. While the standard policy excludes situations in which the manager is held liable for wanton or intentional violations, the *in terrorem* effect of the laws is significantly diluted. The director or officer may thus be encouraged to act recklessly, without regard to possible legal consequences. For a more detailed and complete discussion of these concepts and the coverage of these insurance policies see WASHINGTON & BISHOP, *supra* note 6, at 75; 3 L. LOSS, SECURITIES REGULATION 1834 n.498 (2d ed. 1961); Wheat & Blackstone, *Guideposts for a First Public Offer-*

New York and California have attempted to deal comprehensively with third party situations.[29] For example, the New York Business Corporation Law provides that the corporation may provide indemnification for any person

> made, or threatened to be made, a party to an action or proceeding . . . whether civil or criminal; [brought to impose a liability or penalty on such person as a director or officer of the corporation] against judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys' fees . . . if [he] acted, in good faith, for a purpose which he reasonably believed to be in the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful.[30]

No statute limits the indemnification of the manager who is successful on the merits in third party actions.[31] The situations in between, that is, settlement before adjudication on the merits,[32] pleas of nolo contendere,[33] suits won on technical or procedural grounds,[34] or proceedings, hearings or investigations in which liability is not normally assessed,[35] however, have led to some inconclusive results. Some courts have even allowed indemnification of the loser.[36] These statutory de-

ing, 15 Bus. Law. 539, 552 (1960); Applebaum & McDowell, *Indemnification Against Securities Acts Liabilities,* 27 Bus. Law. 131 (Feb. 1972 Special Issue); Hensey, Delancey, Stahl & Kramer, *What Existing D & O Policies Cover,* 27 Bus. Law. 147 (Feb. 1972 Special Issue); Note, *Liability Insurance for Corporate Executives,* 80 Harv. L. Rev. 648 (1967); Note, *Public Policy in Directors' Liability Insurance,* 67 Colum. L. Rev. 716 (1967).

[29] N.Y. Bus. Corp. Law §§ 721–26 (McKinney 1963); Cal. Corp. Code § 830(f) (West Supp. 1975).

[30] N.Y. Bus. Corp. Law § 723(a) (McKinney 1963). Just who is to make the determination on the factual issues presented by such a statute shall be treated at text accompanying note 125 *infra.* The choice seems limited to the courts, the corporation's board of directors (or at least a disinterested majority thereof), some third party (of a quasi-official nature), or the corporation's stockholders.

[31] *See,* however, the earlier common law cases discussed at note 12 *supra* & text accompanying.

[32] *See, e.g.,* Kansas City Operating Corp. v. Durwood, 278 F.2d 354 (8th Cir. 1960); Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888 (3d Cir. 1953).

[33] *See, e.g.,* Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942) (based on the benefit inuring to the corporation from the plea of nolo contendere).

[34] *See, e.g.,* Tomash v. Midwest Technical Dev. Corp., 281 Minn. 21, 160 N.W.2d 273 (1968).

[35] See the categorization used by Bates & Zuckert, *Directors' Indemnity: Corporate Policy or Public Policy?,* 20 Harv. Bus. Rev. 244 (1942). This article, which is based on a study of some 169 indemnification agreements, also points to the immediate reaction by the corporate community to *New York Dry Dock Co. v. McCollom* and related decisions. The authors note that without the indemnification agreements, outside directors were becoming increasingly reluctant to serve. *Id.* at 246.

[36] DePinto v. Landoe, 411 F.2d 297 (9th Cir. 1969) (indemnification by another

velopments and judicial interpretations illustrate an increasing concern on the part of state governments to insulate the corporate manager from an expanding possibility of personal financial disaster. In 1940, when much of this development began, holding corporate managers to a high level of accountability was a fairly recent occurrence.[37] Thus the two concepts, indemnification and responsibility, have had a chronologically parallel development. However, manager indemnification and responsibility in third party situations are recent and still unfolding concepts. Application of state indemnification policies to allow compensation of damaged individuals and to remedy harm caused by a director's breach of duty in areas largely governed by state law is laudable. However, broad statutory provisions authorizing indemnification and insurance, even in cases where directors have been adjudged liable[38] "cannot be decisive . . . to the extent that it may be inconsistent with the provisions or policies of the federal acts."[39] The possibility that such indemnification can be applied under the Williams Act depends on whether, and in what situations, such indemnification is in accord with the policy and purpose of that legislation. An examination of the application of indemnification under the general range of federal corporate laws can lend some guidance for indemnifying corporate managers during contests for corporate control.

FEDERAL LAW TREATMENT OF INDEMNIFICATION

By Statute

From the manager's viewpoint, director liability under the federal securities acts has been expanding at an alarming rate.[40] The securities acts themselves do not face the problem of indemnification directly.

The basic purpose of the acts was to correct the causes and faults in the securities market which led to the economic conditions of the 1930's. Disclosure and information were to be the keys.[41] Disclosure would turn the "white light of publicity"[42] on activity and would, it was hoped, discourage any questionable transactions. Information would

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wrongdoer based on a contract is permissible); Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942).

[37] *See* Bates & Zuckert, *supra* note 35, at 245.

[38] DEL. CODE ANN. tit. 8, § 145 (Rev. 1974).

[39] 3 L. LOSS, SECURITIES REGULATION 1830 (2d ed. 1961).

[40] Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968).

[41] *See, e.g.*, Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959); Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171 (1933).

[42] 78 CONG. REC. 7925 (1934).

allow the investor to make intelligent decisions. Liability for violation of the acts would have a two-fold purpose: first, to compensate victims of deviate transactions and, second, to provide an *in terrorem* effect to discourage violation and, therefore, prevent compensable loss.[43] Indemnification is viewed as contrary to the *in terrorem* purpose.

Other federal legislation enacted during the period of economic reconstruction in the 1930's and 1940's may shed some light on the problem of indemnification. Sections 12(f) and (g) of the Public Utility Holding Company Act of 1935[44] grant to the Securities and Exchange Commission (SEC) power to pass upon indemnification agreements. The Commission has approved those provisions which allow indemnification of successful officers and directors, and indemnification for actions which were taken in good faith.[45] Washington and Bishop relate that the SEC has set out a model bylaw provision, but due to its dearth of clarity, the provision fails to shed any light on the Commission's position.[46]

The Trust Indenture Act[47] contains a provision allowing the trustee to assess the trust for costs of defending his actions (with some exceptions) unless the trustee's actions are adjudged negligent.[48]

Section 11(f) of the Securities Act of 1933[49] provides for contribution from any person who would have been liable if sued separately. Thus, if the corporation is sued for misstatements in the registration statement, it could demand contribution from the directors and vice-versa. The Act does not forbid indemnification in the form of an agreement which would bar the corporation from seeking contribution from the directors.[50] (This section does not apply to a person guilty of fraud.)

The Securities and Exchange Commission has taken a restrictive

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[43] *See* 3 L. Loss, Securities Regulation 1830–31 (2d ed. 1961).

[44] 49 Stat. 803 (1935), 15 U.S.C. § 79 (1970).

[45] *See* Washington & Bishop at 244–45; Purcell, Foster & Hill, *Enforcing the Accountability of Corporate Management and Related Activities of the S.E.C.*, 32 Va. L. Rev. 497, 517 & n.57 (1945).

[46] Washington & Bishop at 245.

[47] 53 Stat. 1149 (1939), 15 U.S.C. §§ 77aaa–77bbbb (1970).

[48] 53 Stat. 1149 (1939), 15 U.S.C. § 77*ooo* (1970).

[49] 48 Stat. 83 (1933), 15 U.S.C. § 77k(f) (1970).

> All or any one or more of the persons specified in subsection (a) of this section shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

Id.

[50] Douglas & Bates, *supra* note 41, at 178–79.

view of indemnification. Under the Securities Act of 1933, the Commission requires that to obtain acceleration of the statutory 20-day waiting period following the filing of a corporation's pricing amendment to a registration statement,[51] the registrant must comply with note (a) under rule 460.[52] The registrant, whenever it appears that there is any possibility of the corporation indemnifying its officers or directors, must obtain waiver of the indemnification agreement. If waiver is not obtained, the registration statement must disclose the substance of the agreement and include a statement that, in the view of the Commission, the agreement "is against public policy as expressed in the act and is, therefore, unenforceable."[53] Further, except for indemnification of expenses to successful officers or directors, enforcement of the agreement must be submitted to a court unless, in the opinion of the registrant's counsel, the matter is settled by controlling precedent.[54] This procedure (known as the "Johnson & Johnson" formula[55]) represents the Commission's most lucid statement on indemnification under the securities acts.

The Commission believes that only the expenses of a successful manager may be reimbursed commensurate with the policy and objectives of the Securities Act. Thus, expenses from a settlement, regardless of the manager's innocence, would not be indemnified. Yet, expenses from a suit dismissed on technical grounds, no matter how culpable the manager, may be indemnified without violating the policy of the Act.

The aforementioned federal acts were passed prior to the *McCollom* case, and prior to the passage of the various state indemnification provisions. Indeed, these federal acts were passed prior to the beginning of the era in which directors and officers were held to high standards of accountability.[56]

Amidst these developments on the state level, the Investment Com-

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[51] This acceleration power, which is the SEC's main enforcement weapon, is based on section 8(a) of the Securities Act, 48 Stat. 79 (1933). The Commission uses the acceleration power to promote the standards set forth in section 8(a). As a practical matter, acceleration is necessary for a successful offering. During the waiting period, market conditions are likely to change, often causing the underwriters to refuse to proceed. Thus, compliance with rule 460 is, in effect, required before an offering.

[52] 17 C.F.R. § 230.460 n.(a) (1974). Although this rule has been in effect formally since 1957, there has yet been no judicial holding squarely considering its validity.

[53] *Id.*

[54] *Id.*

[55] The formula is so named after the corporation that was first subjected to its application.

[56] *See* Comment, *Distribution of Risk Imposed upon Corporate Officials by Federal Securities Legislation,* 49 YALE L.J. 1423 (1940); Bates & Zuckert, *supra* note 35.

pany Act was passed in 1940.[57] That act, in section 17(h),[58] contains the only federal legislation dealing directly with indemnification of corporate insiders. Section 17(h) is phrased in the negative, providing that no indemnification can be had by the director if liability is based on his "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."[59] Despite an early interpretation by the SEC which would have significantly narrowed section 17(h),[60] the Commission has not yet rejected any broad bylaws making full use of its provisions.[61]

Neither the securities acts nor the Commission provide meaningful guidance for the application of indemnification provisions. The courts have interpreted the policy of the securities regulations and applied indemnification statutes and bylaws on a number of occasions, in some cases perhaps a little more liberally than the Commission would like.[62]

Judicial Construction

Globus v. Law Research Service Inc.[63] was a suit brought by 13 purchasers of an issue of common stock of Law Research Service, charging violations of sections 12(2)[64] and 17(a)[65] of the Securities Act and sections 10(b)[66] and 15(c)[67] of the Exchange Act. The de-

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[57] Act of Aug. 22, 1940, ch. 686, 54 Stat. 789, 15 U.S.C. §§ 80a-1 to -52 (1970).

[58] *Id.* § 80a-17(h).

[59] *Id.* *See* WASHINGTON & BISHOP at 163-64.

[60] SEC ANN. REP. 16 (1941).

[61] *See* WASHINGTON & BISHOP at 165-66. In a recent pronouncement, the Commission staff recommended that a no-action letter issue with regard to an investment company bylaw which was limited to indemnification of expenses, and did not specifically cover liability. Dodge and Cox Balanced Fund, [1972-1973] CCH FED. SEC. L. REP. ¶ 79,160.

[62] Other than the "Johnson & Johnson" formula, SEC position statements have been few and far between. Since this area is of increasing importance, it is hoped that the Commission will take a more vocal role in future developments. But WASHINGTON & BISHOP, at 248, voiced the same concern in 1942, and again in 1963, apparently to no avail. Perhaps the method of amicus curiae adopted in *Feit v. Leasco,* discussed *infra* note 78 & text accompanying, marks a new offensive in the area by the Commission.

It is very significant that while the SEC has seemingly condemned indemnification in this situation, the Commission has not so condemned the use of officers' and directors' insurance. It certainly seems that the same objections that the SEC raises against indemnification would be applied to insurance. Yet, apparently, the Commission does not feel this way, allowing insurance for managers violating the securities acts, even if the insurance premiums are paid by the corporation. *See* Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws,* 1972 DUKE L.J. 1153, 1159.

[63] 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part, rev'd in part,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

[64] 48 Stat. 84 (1933), 15 U.S.C. § 77*l*(2) (1970).

[65] 48 Stat. 84 (1933), 15 U.S.C. § 77q(a) (1970).

[66] 48 Stat. 891 (1933), 15 U.S.C. § 78j(b) (1970).

[67] 49 Stat. 1377 (1935), 15 U.S.C. § 78*o*(c) (1970).

fendant underwriter filed a counterclaim based on an indemnity agreement with the corporation. It was held that an underwriter found guilty of actions graver than ordinary negligence could not enforce an indemnification agreement as this would be against the public policy embodied in the federal securities legislation.[68] The underwriter replied that the plaintiff investor would be made whole anyway by reimbursement from the issuer. To this the district court replied:

> If an underwriter were to be permitted to escape liability for its own misconduct by obtaining indemnity from the insurers, it would have less an incentive to conduct a thorough investigation . . . than it would be [*sic*] if the indemnity was unenforceable under such circumstances.[69]

The district court limited this finding to "circumstances where [the underwriter] has been found guilty of misconduct evincing actual knowledge or reckless disregard . . . ."[70]

The Court of Appeals for the Second Circuit, in affirming the district court, added that cases which uphold indemnification focus on compensation of the investor.[71] However, the Securities Act is more concerned with prevention than cure.[72]

The policy announced in *Globus*, while not drawn from the activities of a director, is applicable to the director's position. The emphasis is on the *in terrorem* effect which the possibility of liability has on the director.

A section 10(b)[73] case, *Baumel v. Rosen*, [74] decided by the Court of Appeals for the Fourth Circuit, held that the plaintiff-sellers were entitled only to damages from the defendant-corporation, and not to recission, even for an apparently deliberate violation of the statute. The court found that the purpose of section 10(b) was compensatory and not punitive. Although not involving indemnification, one can assert that, if section 10(b) is compensatory, the *in terrorem* effect of denying indemnification is outweighed by a policy to provide compensation, and

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[68] 287 F. Supp. at 199, 418 F.2d at 1278.

[69] 287 F. Supp. at 199.

[70] *Id.*

[71] *See* text accompanying note 8 *supra.*

[72] 418 F.2d 1276, 1285–86. It should be observed that the lower court in this case had imposed punitive damages, which certainly add to the deterrent effect. The appellate court denied the award. The appellate court sought uniformity with the Exchange Act which, in section 28(a), 48 Stat. 903 (1933), 15 U.S.C. § 78bb(a) (1970), prohibits punitive damages in actions under that act.

[73] 48 Stat. 891, 15 U.S.C. § 78j(b) (1970).

[74] 412 F.2d 571 (4th Cir. 1969). *See also* Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968).

that such a policy provides sufficient bases for indemnification.

Feit v. Leasco Data Processing Equipment Corp.[75] involved an exchange tender offer to which the Williams Act was inapposite at the time.[76] The suit was brought against the offeror corporation, several of its officers, the underwriter and the dealer-managers by target shareholders who tendered their shares in exchange for the offeror's stock. The action was based on an allegation of omissions from a registration statement. The registrant failed to disclose that it had available $100,000,000.00 of "surplus surplus." The court held this to be a material omission.[77] After the district court's opinion, defendant Leasco announced that it would pay the judgment against the managers, including attorney's fees, without asking for contribution from the managers. The SEC viewed this as a declaration of intent to indemnify the directors. The Commission filed an amicus brief, claiming in part:

> The intent of Congress in passing § 11 was to stimulate diligence on the part of persons actually responsible for the preparation of registration statements. . . . Thus to allow directors to avoid the consequences of their lack of diligence by indemnification from the issuer would frustrate the Congressional purpose.[78]

The directors ultimately paid token sums to the corporation and the court found that this arrangement did not violate public policy.[79]

When first passed, the federal regulatory framework was in reality a substitute for a more comprehensive system of controls over securities.[80] As such the preventative function of the system had to be stressed, making the compensatory function of secondary importance. Yet, until the courts could interpret the federal acts and clarify potential liability

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[75] 332 F. Supp. 544 (E.D.N.Y. 1971).

[76] The 1970 amendments to the Williams Act, 84 Stat. 1497 (1970), *amending* 15 U.S.C. §§ 77c, 78c, m, n (1970), extended the Act's coverage to exchange as well as cash tender offers.

[77] 332 F. Supp. at 572. The court defined "surplus surplus" as being the excess of the target insurance company's (Reliance) total surplus over that surplus required by the regulations of the Insurance Commissioner of Pennsylvania. "Required surplus" is "one that will be adequate to cover for a reasonable period of time any losses and expenses larger than those predicted and any declines in asset values, including all chance variations in the crucial factors of the operation." *Id.* at 550–51 *quoting from* STATE OF NEW YORK INSURANCE DEP'T, REPORT OF THE SPECIAL COMMITTEE ON INSURANCE HOLDING COMPANIES 43 (1968).

[78] Summary of Brief for SEC as Amicus Curiae, Feit v. Leasco Data Processing Equip. Corp., Civ. No. 69–1329 (E.D.N.Y. 1972), in [1971–1972] CCH FED. SEC. L. REP. ¶ 93,415, at 92,046.

[79] Feit v. Leasco Data Processing Equip. Corp., Civ. No. 69–1329 (E.D.N.Y. 1972).

[80] *See* Berle, *High Finance: Master or Servant,* 23 YALE REV. 20, 42 (1933). Indeed, some individuals, for instance New York attorney (later Secretary of State) John Foster Dulles, believed that the Securities Act would undermine the financial system!

under them, there could be no real *in terrorem* effect. The policy of the securities acts was to prevent and cure the cause of investor injury.[81] This purpose has been borne out in subsequent litigation in which the consequences of violation were defined, and teeth given the *in terrorem* effect of the securities acts.[82]

The federal securities regulation system seemed extensive, yet left one important transaction, the cash tender offer, without significant regulation.[83] This omission was corrected in 1968 with the passage of the Williams Act.[84] What, then, are the policies of the Williams Act with which indemnification would be consistent?

THE WILLIAMS ACT

The Williams Act is designed not as a method to compensate injured investors, but as an informational, preventative measure by which investor injury may be avoided.[85] When Senator Williams introduced

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[81] Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933). Comment, *Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act*, 44 YALE L.J. 456 (1934).

[82] *E.g.*, J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Tcherepnin v. Knight, 389 U.S. 332 (1967).

[83] In fact, Congress expected that the Exchange Act would provide protection from "irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials." S. REP. No. 1455, 73d Cong., 2d Sess. 77 (1934). Such an expectation was not to be fulfilled, however, and the realization of this led to the move for the tender offer legislation.

One especially glaring shortfall of the existing provision was the inability of a nontendering shareholder to utilize section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1970), to attack fraudulent activity in connection with a tender offer. He simply did not have standing under the buyer-seller requirement of the "*Birnbaum* doctrine," Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974).

It should be noted that when considering tender offer legislation, the Congress felt that the exchange tender offer was adequately regulated by the existing securities provisions. 113 CONG. REC. 854, 855 (1967). This view was later changed and, in 1970, Congress further amended the Exchange Act to include exchange tender offers within the Williams Act provision. Act of Dec. 22, 1970, Pub. L. No. 91-567, 84 Stat. 1497, *amending* 15 U.S.C. §§ 77c, 78c, m, n (1970).

[84] Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454.

[85] The cash tender offer, as a method of acquisition, while not unknown in earlier years, has been of increasing importance in the last decade. The use of the tender offer vehicle by unscrupulous raiders who would, after a successful offer, loot the target company, seems to have precipitated the move toward the legislation. When first introducing the bill, Sen. Harrison Williams, in an address entitled "Protection Against Corporate Raiders," 111 CONG. REC. 28, 257 (1965), called for a tighter disclosure rule that would penalize a raider rather than a legitimate businessman. His main concern was with the untaxed earnings of "illegal" companies being used to buy up stock without stockholders knowledge. The legislation was considerably weaker than the comparable British rule, and was viewed as placing "no obstacles in the way of honest and fairly conducted transactions."

Congress failed to pass the legislation in 1965, and considerable debate arose in the journals as to the need for such legislation. *See, e.g.*, Cohen, *A Note on Takeover Bids* the legislation in 1967[86] the emphasis and policy of the bill was in tune with existing securities acts, *i.e.*, investor protection was said to be paramount.[87] Disclosure akin to that required under the existing securities acts was to be required in order to afford the stockholder the opportunity to make a full and fair evaluation of the offer, and an informed decision on whether or not to tender his shares.[88]

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and Corporate Purchases of Stock, 22 BUS. LAW. 149 (1966); Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen,* 1967 DUKE L.J. 231; Brudney, *A Note on Chilling Tender Solicitations,* 21 RUTGERS L. REV. 609 (1967).

[86] S. 510, 90th Cong., 1st Sess. (1967).

[87] 113 CONG. REC. 854 (1967). Perhaps one of the reasons for Sen. Williams' shift of emphasis was the ongoing discussion of the legislation in legal journals. Manuel Cohen, chairman of the Securities Exchange Commission, favored legislation requiring disclosure as the panacea for this troubled area. Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock,* 22 BUS. LAW. 149 (1966). Professor Henry G. Manne opposed this view, saying that in the first place disclosure surely did not provide such a cure-all and, in the second place, the raider served a very useful purpose of ridding the corporate community of inefficient managers. He felt the investing public was sufficiently protected by existing securities law. Manne, *Cash Tender Offers For Shares—A Reply to Chairman Cohen,* 1967 DUKE L.J. 231. Manne's most telling argument was that no supporter of the legislation had demonstrated any case in which an investor had been harmed because of the lack of legislation such as the Williams Act.

[88] Senator Williams believed that a disclosure system, like that required under the existing securities laws, would suffice to accomplish this purpose. He believed that the decision whether to tender or not was substantially the same as the decision whether to invest in the issue originally. It seems clear that such disclosure is not sufficient. The most material piece of information the investor needs to make an intelligent decision is the likelihood of the success of the offer. Such a degree of disclosure is not required under the Williams Act. This may prove to vitiate the Act. *See* Brudney, *A Note on Chilling Tender Solicitations,* 21 RUTGERS L. REV. 609, 615 n.16, 617–18 (1967); Kennedy, *Tender Moment,* 23 BUS. LAW. 1091 (1968).

Under section 11 of the Securities Act, 15 U.S.C. § 77k (1970), one court, in passing on the sufficiency of a raider's disclosure in an exchange tender offer, required that the offeror disclose some evidence of the intensity of its desire to succeed in the exchange. Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971). It should be noted that such speculative disclosures, as of uncertain future plans, are not required to be disclosed by an offeror. Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969).

Becase of this lack of full disclosure of pertinent information and, as demonstrated by Professor Manne, *supra* note 87, the lack of a clearly demonstrable need for the legislation by the investing public, a plausible argument can be made that the 1967 bill had an identical purpose with the purpose expressed for the 1965 bill, *i.e.,* to protect incumbent management from unscrupulous corporate raiders. The protection allegedly afforded the investor seems sugar-coating to make the Act palatable and superficially reconcilable with the existing securities acts. Indeed, one commentator notes that the courts, in interpreting and applying the Williams Act provisions, have tended to be overprotective of incumbent management. Note, *Judicial Control of Cash Tender Offers—A Few Practical Recommendations,* 50 IND. L.J. 114 (1974). This judicial phenomenon may be accounted for by two theories. First, courts have tended to interpret state indemnification statutes to lend maximum protection to the manager. This seeming bastardization of the Williams Act may be an extention of that development. The other theory may be that the Act was drafted in such a way so as to allow incumbent management maximum protection. Then the avowed purpose of the Act, demonstrated by the legislative history and early judicial dicta, would simply be rhetoric or sugar-coating to facilitate the Act's passage and acceptance by the corporate community.

In addition to the disclosure requirements, the Williams Act also contains a broad antifraud provision,[89] which seeks to promote full disclosure of all material information by any person who would influence the investor's tender decision, or who would influence the results of the contest for control.

From the provisions of the Act it can be seen that the intent and policy of the legislation is forward looking. That is, the Act is prophylactic. It is designed not as a method to compensate injured investors, but as an informational, preventative measure by which investor injury can be avoided.

The courts have generally paid heed and at least lip service to this avowed federal purpose and policy. In *Electronic Specialty Co. v. International Controls Corp.*,[90] the first appellate court case to judicially interpret the Williams Act, the court said "the focus of legislative interest was on the public shareholders; Congress wanted to ensure that he had the benefit of a full statement from the offeror, with a chance for 'incumbent management' to 'explain its position publicly' if so disposed."[91] In *Cattlemen's Investment Co. v. Fears*,[92] the court says the object of the Act is to

> provide investors who hold equity interests in public corporations, material information which respect to the potential impact of any effort to acquire control of a company, sufficient time within which to make an unhurried investment decision as to whether to dispose of or retain their securities, and to assure fair treatment of the investors.[93]

In *H. K. Porter Co. v. Nicholson File Co.*,[94] the court described the purpose of the Williams Act as being to "regulate the emerging 'tender offer' takeover device in the interest of the investor."[95] The court further stated, in refusing to dismiss a claim brought under section 14(e) of the Exchange Act,[96] that the "overriding purpose of

[89] 15 U.S.C. § 78n(e) (1970). Under this section, the purchaser-seller standing requirement (the *Birnbaum* doctrine) is done away with, and even nontendering shareholders can invoke this provision. *See* Note, *Remedies for Defrauded Tender Offerors Under Section 14(e) of the Securities Exchange Act of 1934*, 62 GEO. L.J. 1693 (1974). Thus, this fraud provision is expected to be as fruitful a source of litigation in this area as section 10(b) of the Exchange Act is in the area of purchase and sale of securities.

[90] 409 F.2d 937 (2d Cir. 1969).

[91] *Id.* at 945. The court is quoting from H.R. REP. No. 1711, 90th Cong., 2d Sess. 2 (1968).

[92] 343 F. Supp. 1248 (W.D. Okla. 1972).

[93] *Id.* at 1251.

[94] 482 F.2d 421 (1st Cir. 1973).

[95] *Id.* at 423.

[96] 15 U.S.C. § 78n(e) (1970).

§ 14(e) is the protection of the investor."[97]

Also, the court in *Bath Industries, Inc. v. Blot*[98] noted that "the protected class of investors includes both investors in general as well as stockholders of the particular corporation involved."[99]

The manager may be held liable for violations of any section of the Williams Act, whether he is a raider or target manager. The civil liabilities for false or misleadng statements and omissions under section 18 of the Exchange Act[100] especially apply to the disclosure and reporting requirements of sections 13(d),[101] and 14(d) and (f).[102] The criminal penalties imposed by sections 20(c)[103] and 26[104] of the Exchange Act are equally applicable. In addition, section 9[105] imposes civil and criminal liability on any person who manipulates security prices. Such activity could easily result from either raider's takeover strategy or target's defensive maneuvers.[106] Also section 14(e),[107] the antifraud provision of the Williams Act, promises to produce fertile ground for manager liability akin to that developed under section 10(b) and Rule 10b-5 of the Exchange Act.[108]

This liability has both an *in terrorem* and compensatory function. Yet the purpose of the Williams Act is to prevent manager violation, and to protect the investor, not merely to compensate him. Indemnification is consonant with the compensation function, and, generally not consonant with the preventative function.

INDEMNIFICATION AND THE WILLIAMS ACT

Application of the previously discussed statutory, judicial, and

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[97] 482 F.2d at 424.

[98] 427 F.2d 97 (7th Cir. 1970).

[99] *Id.* at 109. *See also* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974); Susquehanna Corp. v. Pan Am. Sulphur Co., 423 F.2d 1075 (5th Cir. 1970); Ronson Corp. v. Liquifin AG, 370 F. Supp. 597 (D.N.J. 1974).

[100] 15 U.S.C. § 78r (1970).

[101] 15 U.S.C. § 78m(d) (1970).

[102] 15 U.S.C. §§ 78n(d), (f) (1970).

[103] 15 U.S.C. § 78t(c) (1970).

[104] 15 U.S.C. § 78z (1970).

[105] 15 U.S.C. § 78i (1970).

[106] *See* Schmults & Kelly, *Cash Take-Over Bids—Defensive Tactics,* 23 BUS. LAW. 115 (1967); Note, *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers,* 21 STAN. L. REV. 1104 (1969).

[107] 15 U.S.C. § 78n(e) (1970).

[108] *See* note 92 *supra* & text accompanying. For a further discussion of possible manager liability under the Williams Act see Schwartz, *Personal Liability of Directors of an Acquiring Company,* 4 MERGERS & ACQUISITIONS 4 (Mar.-Apr. 1969). Liability under the securities acts generally is discussed in WASHINGTON & BISHOP at 26; Ruder, Wheat & Loss, *Standards of Conduct Under the Federal Securities Acts,* 27 BUS. LAW. 75 (1972).

SEC positions to the Williams Act is theoretical at best. The public policy expressed in the legislation would seem to be of the same cut as that found in other securities regulations.[109] The Williams Act contains no express declaration on indemnification, nor has the judiciary yet ruled directly on the question, although the *Feit v. Leasco* case may contain the key.[110] The SEC's position on the Williams Act should align with its position on the rest of the federal securties legislation. However, that position can only be surmised from the Commission's position on indemnification in other securities areas. Applying the "Johnson & Johnson" formula[111] and considering the Commission's amicus brief in *Feit v. Leasco*,[112] it may be argued that indemnification should be allowed only when in accord with the policy of the securities acts, and that policy dictates that only the successful manager be indemnified. However, the Commission does not condemn insurance which would have the same effect as indemnification.[113] This point is significant. If insurance is permitted as consonant with the Act, the *in terrorem* effect sought to be achieved by denying direct indemnification is lost.[114] While the Commission may not be able to prevent the issuance of such insurance,[115] the treatment of insurance akin to the "Johnson & Johnson" formula might have a similar effect. However, the Commission has not acted in this area. As a result the Commission's position toward insurance is both inconsistent and, to a degree, confusing.

A system, objective where possible, should be developed to give guidance to parties involved in tender offers, as well as give greater

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[109] *See* note 88 *supra.*

[110] *See* note 75 *supra* & text accompanying.

[111] *See* text accompanying note 55 *supra.*

[112] *See* text accompanying note 78 *supra.*

[113] *See* Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of Bar Chris and Globus,* 24 Bus. Law. 681 (1969).

[114] That is insurance which will reimburse the corporation for payments it must make when the manager's actions result in liability on the part of the corporation, and reimburse the manager himself for liability because of his "wrongful acts." "Wrongful acts" are defined in the basic Lloyds, Ltd. form as: "Any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by (the individual Assureds) or any of the foregoing so alleged by any claimant or any matter claimed against them solely by reason of their being such (Directors or Officers or Assureds)." Hinsey, Delancey, Stahl & Kramer, *What Existing D & O Policies Cover,* 27 Bus. Law. 147 (Feb. 1972 Special Issue).

It should be noted that these policies do not cover fines or penalties imposed by law, nor any matter which would be deemed "legally uninsurable." This term is based on the law of the state whose indemnification statute is being applied.

[115] The Commission would seem to have no direct power to forbid the *issuance* of these policies. Pressure on the states to control in-state insurers would only serve to require the "Assureds" to go to London to obtain coverage.

than illusory effect to the purported policy of investor protection. This system must attempt to balance the two competing policies, *i.e.*, to compensate the investor-victim, while preserving the *in terrorem* effect of the Act.

RECOMMENDATIONS

Successful Defendants

Indemnification of managers who are successful on the merits would have no real debilitating effect on the statute or its prophylactic policy. Such a provision would serve to benefit the corporation and the corporate community. It encourages the manager to defend the corporation, its policies, the stockholders, himself and his office. The Commission would not disagree with this.

Willful Violation or Gross Neglect

The situation in which the manager is adjudged guilty of willful violation of the law, or gross neglect of his corporate duties, would seem clearly non-indemnifiable. While there may be a strong need to compensate[116] in such situations, the balance must shift in favor of enforcing the prophylactic policy of the Act. The inability of the manager to be reimbursed for his expenses in defending his actions may have a serious *in terrorem* effect. The same can be said for fines and penalties which may be assessed against him.[117] In such cases, any civil liability should not be indemnifiable either. Though this may leave the injured investor without proper compensation, such a provision would lessen the incentive to the manager not to comply with the Act.[118]

Criminal Proceedings

In criminal proceedings under the Act, another policy must be acknowledged. That is the public policy that a defendant in a criminal cases have counsel to represent him. This policy should be ignored only

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[116] *I.e.*, create a "deep pocket."

[117] These fines and penalties are uninsurable under the standard policy, and, generally, unindemnifiable under state statutes. *See* Hinsey, Delancey, Stahl & Kramer, *supra* note 114.

[118] Actions brought under section 14(e) (the fraud provision) may be thought to elevate the compensation function to pre-eminence under the theory of Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969). *See* note 70 *supra* & text accompanying. Section 14(e) is very much like section 10(b) and might be thought of as a compensatory provision. However, the courts, particularly the Court of Appeals for the First Circuit in H.K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1973), found section 14(e) designed to promote the *in terrorem* chilling effect which will encourage enforcement of the securities acts. *Id.* at 424.

when it "might not frustrate a sharply defined national or state policy proscribing particular types of conduct."[119] After a director was found guilty of securities act violations in *Commissioner v. Tellier*,[120] he was allowed a tax deduction for legal fees as an ordinary and necessary expense.

Therefore, while there is no compensatory function involved, the strongly articulated public policy of providing counsel seems to outweigh the *in terrorem* effect. Penalties and fines should provide sufficient incentive to comply. Legal expenses in criminal cases should, therefore, be indemnifiable when the manager is sued in his corporate capacity.[121]

Terminated Litigation

The situations in between the extremes of culpability and innocence, those consisting of litigation and threatened litigation that cease prior to adjudication on the merits, represent a more perplexing area.[122] When an action is terminated on technical grounds resulting only in the incurrence of defense expenses, there seems little reason to deny indemnification. The manager should be encouraged to defend his office and himself (as stockholder's chosen representative) in groundless, nuisance or strike suits.

However, when a settlement results in liability or a plea of nolo contendere[123] results in a fine, a more complicated situation is presented. In some settlements the manager may be guilty of some deviate behavior, but can capitalize on a weakness in his opponent's case. In other settlements he may be innocent, yet to minimize expenses, or avoid adverse publicity, may find it wiser to settle. To allow indemnification across the board in settlement situations would surely damage the *in terrorem* effect of the Act. The Delaware statute allows such indemni-

119 Commissioner v. Heininger, 320 U.S. 467, 473 (1943).

120 383 U.S. 687 (1966). *See also* Lilly v. Commissioner, 343 U.S. 90 (1952).

121 When the director or officer is sued for criminal actions undertaken outside his corporate capacity, there seems to be no justification for permitting the corporation to pay the expenses.

122 *See* Bates & Zuckert, *Director's Indemnity: Corporate Policy or Public Policy?*, 20 HARV. BUS. REV. 244 (1942).

123 The two cases which have allowed indemnification after nolo contendere pleas, Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942), *aff'd mem.*, 267 App. Div. 890, 47 N.Y.S.2d 589 (1944), and Koster v. Warren, 297 F.2d 418 (9th Cir. 1961), both depend too heavily on a benefit theory and a contract theory, ignoring the prophylactic purpose of the antitrust legislation involved in the cases.

The plea of nolo contendere, while not strictly an admission of guilt, does result in sentence being imposed as if guilt were admitted. Lott v. United States, 367 U.S. 421, 426 (1961). However, since such pleas often result after negotiations between the adversaries, these cases are classed, for the purposes of this note, with settlements.

fication.[124] Other statutes, such as those of New York[125] and California[126] call on the board of directors or the court to determine whether the managers should be indemnified, based on the facts of each case. Such a system, while lacking objectivity, promises to be fariest to both managers and the investing public. The court should be asked to approve an indemnification scheme in these questionable areas, seeking guidance from a disinterested board of directors or from the stockholders themselves, where possible. Such a procedure would allow indemnification for the manager, while providing a viable watchdog system to protect investor interest.

Adjudication of Negligence

When the manager is negligent, the balance is tipped more in favor of compensation through indemnification.[127] The English Companies Act[128] allows the court to exonerate a director if he is found to have acted in good faith compliance with the law. However, to allow indemnification in all such circumstances would only serve to encourage reckless conduct, and discourage reasonable investigation. Thus, in this situation also, the court should be asked to rule on the advisability of indemnification.

The Insurance Alternative

Insurance, if allowed across the board, would do great harm to the *in terrorem* effect of the Williams Act. Insurance should be limited to the extent that it is available only in situations where indemnification was available. Statutes allowing insurance in cases in which the corporation may not indemnify the manager[129] are based on the desire to compensate the victim in derivative actions. These provisions should be seen as not applicable because of their debilitating effect on the *in terrorem* function of the Williams Act. State legislation should be structured in such a way so as to limit the use of insurance programs to situations where their application, in lieu of indemnification, would be consistent with the policies of the federal securities laws. Such a structuring would serve to encourage the manager to utilize his talents to maximum benefit while sparing the corporation a possibly

[124] DEL. CODE ANN. tit. 8, § 145 (1974).
[125] N.Y. BUS. CORP. LAW §§ 721-26 (1963).
[126] CAL. CORP. CODE § 830(f) (West 1957).
[127] *Compare* Companies Act, 11 & 12 Geo. 6, ch. 38, § 448(1) (1948), *with* CAL. CORP. CODE § 830(f) (West 1957) *and* DEL. CODE ANN. tit. 8, § 145 (1974).
[128] Companies Act, 11 & 12 Geo. 6, ch. 38, § 448(1) (1948).
[129] IND. ANN. STAT. § 23-1-2-2(b)(10) (Code ed. Supp. 1974). *See* note 28 *supra*.

debilitating expense.

CONCLUSIONS

The indemnification scheme set out above is as objective as possible. Objectivity is necessary in order to allay the manager's fears that he will meet with financial disaster if he, in good faith, acts by and for the corporation. Objectivity also makes it clear to the manager who would abuse the Williams Act that he does so at *his own risk*. The subjective, judicial application of indemnification and insurance in settlement and nolo contendere situations gives the innocent manager an opportunity to prevent unwarranted expense and adverse publicity without absorbing heavy financial burdens. Yet it also prevents the culpable manager from exploiting technicalities to the detriment of the corporation.

EDWARD J. HUSSEY