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The Monitoring Committee and Outside Directors' Evolving Duty of Care

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INTRODUCTION

In recent years there has been an expanding view of the role the outside director should play in corporate governance. Securities and Exchange Commission Chairman Harold Williams has gone so far as to call for boards of directors composed of outside directors, save for a single management representative.¹ The corporate board room has not changed to this extent, but there is a strong movement to utilize outside directors as monitors of management conduct. This movement has manifested itself, at many corporations, in the establishment of committees of the board, controlled by outside directors, whose assigned task is to oversee specific management functions. This article will explore the evolution of these monitoring committees and their impact on the exposure to liability of both the directors who serve on the committees and those who rely on the committee reports.

THE EVOLUTION OF THE MONITORING COMMITTEE

The Role of the Traditional Board of Directors

The traditional statutory and common law duty of a corporate board of directors was to manage the affairs of the corporation.² This duty was to be dispatched with care and loyalty.³ The board of directors itself was generally composed of senior officers of the corporation and an occasional outsider placed on the board as an honor or because he had a close working relationship with the management of the corporation. Directors in this latter category included the corporation's lawyers, accountants and bankers.

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1. SEC. REG. & L. REP. (BNA) No. 437 at A-22 (Jan. 25, 1978)(speech at Securities Regulation Institute).

2. See, e.g., DEL. CODE tit. 8, § 141(a) (1974); ILL. REV. STAT. ch. 32, § 157.33 (1975); N.Y. BUS. CORP. LAW § 701 (McKinney 1977 Pocket Part).

3. See, e.g., N.Y. BUS. CORP. LAW § 717 (McKinney 1977 Pocket Part); Bowerman v. Hamner, 250 U.S. 504, 511-13 (1917); Briggs v. Spaulding, 141 U.S. 132, 152 (1891); Guth v. Loft, Inc., 23 Del. 255, 270, 5 A.2d 503, 510 (1939).

As the modern corporation became more complex, the board of directors in many instances did not actually manage the corporation. Rather, it delegated that responsibility to officers and the professionals who assisted those officers. The entire board of directors continued to perform statutorily required formal functions such as issuance of securities,⁴ declaration of dividends,⁵ election of officers,⁶ and significant disposition of assets.⁷ Often, the board did not, however, perform the analysis of the data necessary to make significant business decisions, and thus did not really make the decisions themselves. Instead, key officers, often acting as the board's executive committee, analyzed the data and made the important decisions. Normally, major policy questions were presented to the entire board, but these issues were generally accompanied by a minimal amount of background information and a management recommendation. The recommendation generally would be accepted virtually pro forma by the entire board. If questions arose, they were referred either to the officer with the most expertise in the area or to outside professionals: lawyers, accountants, and bankers, who were chosen by and were basically responsive to management.

Under this system, the non-management members of the board of directors often did not have the necessary information with which to intelligently oversee management. To the extent that they possessed the information, the data was filtered through management. In this context, the non-management director, who was minimally compensated, infrequently called upon, and often the personal friend of the management group, could not and did not hold the officers accountable for their actions. The role of the outside director within this arrangement was aptly described by Lord Boothby as follows:

No effort of any kind is called for . . . You go to a meeting once a month in a car supplied by the company. You look both grave and sage, and on two occasions say 'I agree,' say 'I don't think so' once, and if all goes well, you get \$1,440 a year. If you have five of them, it is total heaven, like having a permanent hot bath.⁸

4. See, e.g., DEL. CODE tit. 8, § 141(c) (1974).

5. *Id.*

6. *Id.* at § 142(b).

7. *Id.* at § 141(c).

8. Lord Boothby, *quoted in* H. HENN, CORPORATIONS 454 n.3 (2d ed. 1970), in the context of a statement that directors may be liable for corporate losses resulting from passive, as well as active, negligence.

Traditional Shareholders' Actions at Common Law

When a shareholder sought to hold a director liable for his failure to meet his statutory and common law duty to manage the corporation, including the oversight of management, he invariably lost.⁹ The courts never formally relieved directors of their traditional duty to manage the corporation with care. Nevertheless, they recognized the reality of the director's role and sanctioned his conduct as long as it could be justified by the reasonable exercise of business judgment,¹⁰ or by reliance on management,¹¹ reports of outside experts,¹² or committees of the board of directors.¹³ Directors were said to have no obligation to establish a system of corporate espionage.¹⁴ Even in cases of apparent gross failure to monitor management, they were relieved of liability because of the realization that success or failure of the enterprise really rested on management, to whom the responsibility was delegated.¹⁵

In a typical case of this era, *Martin v. Hardy*,¹⁶ a trustee in bankruptcy brought an action for negligence against the directors of a company which had suffered substantial losses due to the mismanagement by the major shareholder who ran the business. The court relieved all the directors of liability, including one who had paid no attention to the business whatsoever. The court found this director to have been negligent, but it declined to hold him accountable because even if he had tried to exercise some supervision, it would not have had any impact, due to the delegation of responsibility to management.

The Mounting Pressure to have Directors Monitor Management

In the 1960's and 70's the Securities and Exchange Commission (SEC) began to pressure companies to have their boards of directors exercise a meaningful check on management conduct.¹⁷ For exam-

9. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L. J. 1078, 1099 (1968) [hereinafter cited as Bishop].

10. See 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (rev. ed. 1975); *Cheff v. Mathes*, 41 Del. 494, 199 A.2d 548 (1964).

11. *Warner v. Penoyer*, 91 F. 587 (2d Cir 1898); *Lowell Hoit & Co. v. Detig*, 320 Ill. App. 179, 50 N.E.2d 602 (1943); *Ohlendorf v. Rathje*, 230 Ill. App. 427 (1923). See MODEL BUSINESS CORPORATION ACT § 35 (1977).

12. See *Cory Mann George Corp. v. Old*, 23 F.2d 803 (4th Cir. 1928). See also MODEL BUSINESS CORPORATION ACT § 35 (1977).

13. See *Allen v. Roydhouse*, 232 F. 1010, 1015 (E.D. Pa. 1916); *Ohlendorf v. Rathje*, 230 Ill. App. 427 (1923); MODEL BUSINESS CORPORATION ACT § 35 (1977).

14. *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. 78, 85, 188 A.2d 125, 130 (1963).

15. *Martin v. Hardy*, 251 Mich. 413, 232 N.W. 197 (1930).

16. *Id.*

17. See, e.g., Speech by former SEC Commissioner, A.A. Sommer, Jr. to the Colorado

ple, the SEC report on the Stirling Homex Corporation Investigation¹⁸ found that two prominent non-management directors of a public corporation were systematically deceived by management as to the true state of the company's affairs. After the company became bankrupt, with substantial loss to the investing public, the SEC analyzed the conduct of the non-management directors and publicly declared that their monitoring function had been inadequately performed. Specifically, the SEC found that: (1) during the years in question the board had as many as seven directors, but only two of them were dissociated from management; (2) during the two and a half years in question there were only seven board of directors' meetings and several of these were conducted over the telephone; (3) the board of directors' meetings consisted of announcements made by management with little discussion or interrogation; (4) the real decision-making body was the executive committee to which no outside directors belonged; (5) no other directors' committees besides the executive committee were established; (6) there were no written agendas for the directors' meetings; (7) no information was given to the outside directors on such subjects as backlog, aging receivables, cash flow and competition; (8) no financial projections, corporate development plans, or reports on the status of contracts or agreements were provided; (9) the company's auditors were changed without prior approval and with inadequate explanation; and (10) the outside directors signed the registration statement for the second public offering without independently checking with auditors or counsel, and without being aware of the SEC's questions

Association of Corporate Counsel (February 1974) entitled "Directors And The Federal Securities Laws," in which he stated:

It is axiomatic to say these days that society is demanding constantly more from those who occupy positions of trust . . . [I]n corporate life, expectations are constantly rising . . . Increasingly the focus is upon those who, at least theoretically, have the ultimate control over the vast corporate wealth of this country—the directors of publicly-held corporations . . . In general I think it fair to say that historically directors have not been held to an excessively high, or even very high, standard of conduct . . . State corporate laws do not appear to erect an unreasonably, or again, even very high, standard for directors . . . The tough questions concerning the responsibilities and liabilities of directors have not in recent times arisen under state statutes, but rather have their origins in federal securities law. The impact of these federal cases has led to a renewed interest in the statutory delineation of directors' duties and responsibilities.

[1974] SEC. REG. & L. REP. (BNA) 1; see also SEC v. Penn Central, [1974] FED. SEC. L. REP. (CCH) ¶ 94,527 at 95,828 (E.D. Pa. 1974)(directors were sued because they "had reason to know" of the wrongdoing of management).

18. Report of Investigation In The Matter of Stirling Homex Corporation Relating To Activities Of The Board Of Stirling Homex Corporation, SEC Release No. 34-11516, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,219 (July 2, 1975).

concerning the registration.¹⁹ By stressing the board of directors' failure to perform the monitoring function, the SEC clearly gave notice to the corporate community that personal liability could result from similar breaches of duty in the future.

In addition to the threat of SEC action, there was substantial concern with the possibility of private plaintiffs holding directors responsible under the securities laws for failure to monitor management. There was a spate of private actions against directors and officers who allegedly engaged in fraudulent sales of securities within the meaning of rule 10b-5.²⁰ In these actions several courts of appeals, prior to the Supreme Court decision in *Ernst & Ernst v. Hochfelder*,²¹ concluded that something short of a knowing misstatement or omission would be sufficient to establish liability.²² The concern thereby engendered in the corporate community was very real, that the traditional director who failed to oversee management and who consequently failed to discover material misstatements or omissions in the sale of the corporation's securities, would be found liable under rule 10b-5 for his negligence.

Writers labeled this surge of private and SEC actions against directors "the age of corporate litigation,"²³ and they described at length the personal and financial costs and risks to the director who failed to monitor management.²⁴ With the commencement of this new era in securities litigation, the position of the outside director, who continued to function in the traditional, inactive manner, became untenable. The \$1,440 which Lord Boothby described as so attractive,²⁵ became inadequate compensation for the risk of an SEC investigation or a shareholder's suit. The time seemed to have arrived when, as Judge Learned Hand said, "No men of sense would take the office if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence."²⁶

19. *Id.*

20. See, e.g., *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962); *Stevens v. Vowell*, 343 F.2d 374, 379-80 (10th Cir. 1965); *Myzel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *City Nat'l Bank v. Vanderboom*, 422 F.2d 221, 229-30 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). See also *SEC v. Van Horn*, 371 F.2d 181, 185 (7th Cir. 1966).

21. 425 U.S. 185 (1976).

22. See note 20 *supra*, for a sampling of typical cases from this era.

23. See, e.g., Caplin, *Outside Directors and Their Responsibilities: A Program For The Exercise Of Due Care*, 1 J. CORP. L. 57 (1975).

24. *Id.*

25. See text accompanying note 8 *supra*, quoting Lord Boothby.

26. *Barnes v. Andrews*, 298 F. 614, 617 (S.D.N.Y. 1924).

*The Committee System as a Response to the Need to Monitor
Management*

By the 1970's, the corporate community began making significant changes in the form of corporate governance. This was precipitated both by a desire to respond to valid criticism about lack of management accountability and also by a need to provide directors with a practical way of fulfilling their monitoring duties in this age of corporate litigation. The traditional notion of corporate governance through division of labor and delegation of responsibility was retained as the only reasonable way to manage the modern corporation. In fact, the new Model Business Corporation Act specifically contemplates that directors will place reasonable reliance on committees of the board of directors.²⁷ With the functional emphasis of a director's duty focused on the monitoring of management, however, the inherent conflict in delegating to management the job of overseeing their own affairs became apparent. Accordingly, while the principle of delegation generally, and delegation to committees of the board of directors specifically, was retained, the identity of those doing the monitoring changed from primarily management to committees of non-management or outside directors.²⁸

The exact definition of an outside director varies among corporations. The most prevalent view is that those who are labeled outside directors for purposes of determining their eligibility to perform the monitoring function should be unaffiliated with and generally independent of the corporation.²⁹ This would exclude those who have material dealings with the corporation, such as the corporation's lawyers and bankers.

In enforcement actions, the SEC has insisted that independent directors control these "monitoring" committees.³⁰ The New York Stock Exchange rule on Audit Committees provides that such committees shall be "comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member."³¹ Additionally, writers in this

27. MODEL BUSINESS CORPORATION ACT § 35 (1977).

28. See *Corporate Director's Guidebook*, 32 BUS. LAW. 5, 35-36 (1976) [hereinafter cited as *Director's Guidebook*].

29. *Id.* at 31-36.

30. See, e.g., SEC v. Mattel, Inc., [1974] FED. SEC. L. REP. (CCH) ¶ 94,807 (D.D.C. 1974); SEC v. Lum's, Inc., [1974] FED. SEC. L. REP. (CCH) ¶ 94,504 (S.D.N.Y. 1974); SEC v. Killearn Properties, Inc., [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,256 (N.D. Fla. 1977); Zale Corp., Wall St. J., Aug. 22, 1977, at 9, col. 1.

31. 2 NYSE GUIDE (CCH) ¶ 2,495H at 4229.

area have almost uniformly concluded that only committees controlled by independent directors can effectively perform the monitoring function.³²

The conclusion that only independent directors can perform the oversight function carries with it the acknowledgement that sufficient basic information must be made available to these monitoring committees to allow them to hold management accountable in a meaningful sense.³³ This corollary, in turn, leads to the recognition of three facts: (1) monitoring directors must be of the caliber necessary to perform their new function; (2) they must devote considerable time to the job; and (3) they must be adequately compensated for their new efforts.³⁴ Finally, many commentators, including former Supreme Court Justice Arthur Goldberg, feel that these committees should be provided with their own staffs and access to independent legal and accounting assistance.³⁵

Thus, what has emerged in response to SEC and shareholders' pressure to have meaningful management accountability is a functional framework whereby the modern corporation can be managed under the direction of the board of directors.³⁶ The key to this framework is a system of committees made up of independent monitoring directors.³⁷

Form of the New Committees

The exact form of the committee system varies among corporations. It will be useful for the purposes of this article, however, to describe briefly some of the more common variations and their general functions.

The most common committee of the new mold is the audit committee. The New York Stock Exchange will be requiring audit committees for all corporations listed on the Exchange by June 30, 1978.³⁸ Its function as described in the *Corporate Director's Guidebook*³⁹ is:

1. To recommend the particular persons or firm to be employed by the corporation as its independent auditors;

32. See, e.g., *Director's Guidebook*, *supra* note 28, at 31-36.

33. *Id.* at 22.

34. *Id.* at 32.

35. See Goldberg, *Debate on Outside Directors*, N.Y. Times, Oct. 29, 1972, § 3 (Business and Finance) at 3, col. 2.

36. See MODEL BUSINESS CORPORATION ACT § 35 (1977): "All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors . . ."

37. See *Director's Guidebook*, *supra* note 28, at 35-36.

38. 2 NYSE GUIDE (CCH) ¶ 2,495H at 4229.

39. *Director's Guidebook*, *supra* note 28.

2. To consult with the persons so chosen to be the independent auditors with regard to the plan of audit;
3. To review, in consultation with the independent auditors, their report of audit, or proposed report of audit, and the accompanying management letter, if any; and
4. To consult with the independent auditors (periodically, as appropriate, out of the presence of management) with regard to the adequacy of internal controls and, if need be, to consult also with the internal auditors (since their product has a strong influence on the quality and integrity of the resulting independent audit).⁴⁰

The SEC has also called for audit committees to review and report to the full board on such matters as non-arms length dealings between the corporation, and its subsidiaries and those affiliated with the corporation.⁴¹ In general, the SEC has sought to have the audit committee serve as the quasi-public watchdog for corporate disclosure.⁴²

Two other committees recommended by the *Corporate Director's Guidebook* are nominating and compensation committees.⁴³ One of the traditional elements of the inside director's power was the control of the corporate nominating mechanism. Under the *Guidebook's* recommendation, however, the nominating committee, which would be controlled by outside directors, would have responsibility for nomination of new directors and the manner in which management succession is effected. The nominating committee would also have the responsibility for bringing recommendations to the full board concerning membership of board committees and the successor to the chief executive officer when a vacancy occurs. The compensation committee would be charged with approving or recommending to the full board the salaries of senior management as well as any stock option or other benefit program granted to officers or directors.

Monitoring Directors' Evolving Duty of Care Under the Federal Securities Laws and the Common Law

The remainder of this article will explore the evolving duty of care under both the securities laws and the common law as it applies to monitoring directors in the modern committee system of corporate governance. In particular, the article will address the three sections

40. *Id.* at 36.

41. SEC v. Petrofunds, [1977] FED. SEC. L. REP. (CCH) ¶ 96,098 at 91,947.

42. For cases which reflect this goal, see note 30 *supra*.

43. *Director's Guidebook*, *supra* note 28, at 35-36.

of the federal securities laws⁴⁴ under which directors have traditionally experienced the greatest danger of liability, and will focus on the potentially heightened liability for monitoring directors under the common law.

DIRECTORS' STANDARDS OF CARE FOR REGISTRATION STATEMENTS

Scope of Liability Under Section 11

It is axiomatic that the federal securities laws and the 1933 Act in particular were designed to protect the investing public from the chicanery of securities sellers by placing "the buyer on the same plane so far as available information is concerned, with the seller."⁴⁵ This preeminent philosophy of disclosure finds its heart in section 5 of the 1933 Act,⁴⁶ which provides that a registration statement must be in effect before the security is sold.⁴⁷ In addition to creating the duty to disclose pertinent information, the 1933 Act establishes in section 11⁴⁸ an express private right of action for persons who have purchased securities for which a materially false prospectus in a registration statement has been distributed.⁴⁹

A basic understanding of the statutory provisions of section 11 is particularly relevant when considering the potential impact the monitoring committee may have on the liability of both directors serving on the committee and directors relying on the committee. Section 11's provisions are important because they create an elaborate framework wherein liability attaches on the basis of an individual's functional role in the distribution of securities. Unlike other provisions of the federal securities acts which speak in terms of general liability, section 11 deliberately enumerates those persons who will be liable if the information disclosed in a registration statement is materially inaccurate or inadequate. Whether or not an

44. These sections are § 11 of the Securities Act of 1933, §§ 10(b) and 14(a) of the Securities Exchange Act of 1934.

45. 77 CONG. REC. 2918 (1933)(statement by Congressman Rayburn, House manager, discussing drafting of Securities Act of 1933).

46. 15 U.S.C. § 77e (1976).

47. The central regulatory provision of the 1933 Act is generally considered to be § 12, 15 U.S.C. § 77(l)(1976), which makes sellers liable to immediate purchasers for offering or selling a security either in violation of § 5 or on the basis of untrue oral or written statements of material facts.

48. 15 U.S.C. § 77k (1976).

49. As Professor Folk has noted, § 11's private right of action provides the purchaser with an extremely broad remedy inasmuch as privity between the purchaser and seller is not required, the purchaser need not show that he relied on the misleading statement or omission and liability will be imposed regardless of the defendant's intention. Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1, 10-11 (1969) [hereinafter cited as Folk].

individual is so named appears to be a function of that person's potential ability to influence the content of the registration statement as well as the extent to which a purchaser might rely on that person's authority.⁵⁰

It is not surprising that the drafters of section 11 specifically designated directors who are incumbent at the time of filing the registration statement, prospective directors named in the statement, and all those who have signed the statement,⁵¹ to bear the burden of liability if those statements are false or misleading.⁵² However, the use of the monitoring committee injects yet another entity into the distribution process. Therefore, a discussion of the manner in which one must analyze a director's liability under section 11 is necessary to determine what effect the monitoring committee may have on a functional analysis of that liability. Such a discussion will also provide a useful analytical framework in which to consider the liability that directors face under other sections of the federal securities laws.

In spite of the precision with which section 11 singles out directors for liability, a review of the section's legislative history indicates that the drafters did not intend to hold directors strictly liable as guarantors of the "absolute accuracy of every statement that they

50. See *id.* at 12. See also H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933); H.R. REP. NO. 152, 73d Cong., 1st Sess. 26 (1933).

51. 15 U.S.C. § 77k (1976) states in pertinent part:

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

. . . .
(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; . . .

See, e.g., *Kramer v. Scientific Control Corp.*, 365 F. Supp. 780, 791 (E.D. Pa. 1973). The creation of an express private right of action in purchasers, as well as the specific designation of directors for liability underscores the drafters' primary concern to create an atmosphere of corporate accountability and to "do away with the . . . dangerous and unreliable system of depending upon dummy directors who have no responsibility." Folk, *supra* note 49, at 17, quoting S. REP. NO. 47, 73d Cong., 1st Sess. 6 (1933).

52. A director may also find himself liable as a seller under § 12, 15 U.S.C. § 77l (1976), whether or not a prospectus is delivered or required to be delivered. See, e.g., *In re Caesars Palace*, 360 F. Supp. 366 (S.D.N.Y. 1973). For a comprehensive discussion regarding the potential liability a director faces under § 12(2) of the 1933 Act, as compared with that under § 11, see Folk, *supra* note 49, at 199-271.

are called upon to make.”⁵³ Rather, as the Supreme Court noted in *Hochfelder*, by providing those persons who have prepared registration statements with a “due diligence” defense, liability under section 11 is essentially predicated on a standard of negligence.⁵⁴ However, prior to determining whether or not a director has exercised the degree of care necessary to satisfy the due diligence defense, one must first examine the type of information which is involved.

The Due Diligence Defense and the Type of Information Involved

Section 11's defense of due diligence incorporates the common sense realization that, in order to meet the demands of their position, directors find it necessary to delegate many of their investigatory duties.⁵⁵ Accordingly, section 11 provides that certain portions of a registration statement may be prepared by “experts.” These experts may be held liable if they have consented to being named as having prepared or certified any part of the registration statement, or if they have prepared or certified any report which is used in connection with the registration statement.⁵⁶ It is not surprising, therefore, that in recognition of the expert's role, section 11 makes a distinction between the “expertized” and the “non-expertized” portions of a registration statement, and specifically creates two different standards of care to be applied when a director raises the defense of due diligence.

To avoid liability for the non-expertized parts of a registration statement, a director must show that

he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading⁵⁷

53. H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933). Although it is apparent that directors were never intended to be held strictly liable, the same is not true of issuers who are absolutely liable under § 11(b), 15 U.S.C. § 77k(b) (1976).

54. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200, 207-08 (1976). See also *Burger v. CPC Int'l, Inc.*, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,157 (S.D.N.Y. 1977).

55. See H.R. REP. No. 152, 73d Cong., 1st Sess. 26 (1933), stressing the reasonableness of delegating responsibility where “the character of the acts involves professional skill or facilities not possessed by the fiduciary himself.”

56. 15 U.S.C. § 77k(a)(4)(1976). See, e.g., *Grimm v. Whitney-Fidalgo Seafoods*, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,029 (S.D.N.Y. 1973)(independent accountant's liability under § 11 limited to those figures which he certifies).

57. 15 U.S.C. § 77k(b)(3)(A) (1976).

This standard serves to prevent a director from relying on the representations of others and places upon him a burden of undertaking his own investigation to determine whether the registration statement complies with the law.

A lesser degree of due diligence is required for expertized portions where a director must show that

he had . . . reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading⁵⁸

Thus, a director need not independently investigate the statements of experts unless he has reason to believe they are inaccurate.

By defining "reasonable" in the context of both the expertized and the non-expertized portions of a registration statement to be "the standard of reasonableness . . . required of a prudent man in the management of his own property,"⁵⁹ section 11 implies that the negligence standard derived from the due diligence defense is a flexible one which will be affected not only by the type of information involved but by the relationship of the director to that information.⁶⁰ Indeed, the functional role of the director within the corporate structure is crucial to any discussion of liability under section 11.

The BarChris Case—A Functional Analysis of Liability

The fact that a director's liability under section 11 is affected by the functional role which he plays within the corporate structure is borne out by a review of *Escott v. BarChris Construction Corp.*⁶¹ Although by no means recent, *BarChris* remains the leading case on directors' liability under section 11. A brief discussion of the court's holdings is therefore necessary to understand what effect, if any, the use of committees may have on the standard of care demanded of both inside and outside directors.

58. 15 U.S.C. § 77k(b)(3)(B) (1976).

59. 15 U.S.C. § 77k(c) (1976).

60. This fundamental concept was confirmed by James M. Landis who participated in the drafting of § 11 and stressed that it was the intent of the legislature to vary the duty of care according to the involvement of the individual in the registration process. See Landis, *Liability of Securities Act Authoritatively Discussed*, 18 AM. ACCOUNTANT 330, 332 (1933).

61. 283 F. Supp. 643 (S.D.N.Y. 1968). *BarChris* involved a class action by buyers of debentures issued by the defendant corporation. Defendants were the issuer, signers of the registration statement, underwriters, and the corporation's auditor. The court found that the prospectus did contain material misstatements and omissions. None of the defendants succeeded in establishing their due diligence defenses.

In assessing the liability of numerous directors, the *BarChris* court basically focused on two elements—the functional role of the individual director and the type of information involved. As a result of the court's analysis, those "inside" directors who were found to be active members of the executive committee could not meet the burden of due diligence with respect to either the expertized or the non-expertized portions of the registration statement. This failure was occasioned primarily because the court presumed that these directors were naturally familiar with the workings of the corporation and therefore could not possibly have "reasonable ground to believe" the truth of a registration statement containing a false statement or omission.⁶²

Thus, active inside directors may find that only the most vigorous investigations into the content of a registration statement will enable them to sustain their burden of due diligence.⁶³ The inherent difficulty that such a director has in avoiding liability places him in a position akin to that of the issuer of securities who serves virtually as a guarantor of the accuracy of the registration statement.⁶⁴ Nor is this presumption and concurrent liability at odds with the belief of the drafters that the diligence required of a person under section 11 should "var[y] in its demands upon participants in [a] security . . . distribution and with the degree of protection that the public has a right to expect."⁶⁵ It is clear that the investing public is entitled to expect an extremely high degree of care from active inside directors whose status and access to information create in them a "moral responsibility to the public."⁶⁶

In marked contrast to the burden placed on active inside directors, *BarChris* established that outside directors not intimately associated with the preparation of a registration statement will not be subjected to the same presumption of knowledge which an inside director must bear.⁶⁷ Consequently, outside directors may establish their due diligence defense by conducting reasonable investigations into non-expertized portions of a registration statement while at the same time relying on the competence of experts for other portions.⁶⁸

62. *Id.* at 684-85. This same presumption was made earlier in *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967).

63. *See, e.g., Goldstein v. Alodex Corp.*, 409 F. Supp. 1201, 1203 n.1 (E.D. Pa. 1976); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971).

64. *See Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 578 (E.D.N.Y. 1971). *See also* note 53 *supra*.

65. H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).

66. *Id.*

67. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 687-89 (S.D.N.Y. 1968).

68. *See Folk, supra* note 49, at 26-32. *See also Blakeley v. Lisac*, 357 F. Supp. 255, 264-65 (D. Ore. 1972).

Whether or not an investigation will be deemed reasonable, and the extent to which reliance on experts will be permitted, also varies from director to director.⁶⁹ *BarChris* does, however, make it clear that in virtually all cases, outside directors must do more than accept the oral assurances of inside directors.⁷⁰

Impact of the Committee System on Directors' Section 11 Liability

It is reasonable to assume that at least one monitoring committee of the board of a modern corporation will be charged with overseeing a portion of management's work on registration statements. The effect such a monitoring committee will have on the traditional liability of outside directors under section 11 is as yet unclear. Nevertheless, several theories appear worthy of discussion.

One might argue initially that the placement of an outside director on a committee which has some responsibility for the oversight of significant portions of a registration statement will enable the director to gain access to corporate records. This access could in turn permit him to better conduct "reasonable investigations" to establish a due diligence defense.

However, the danger exists that by sitting on such a committee, the outside director may suddenly find that, like the inside directors in *BarChris*, because of his access to and involvement with corporate information, he is presumed to have detailed knowledge of the company. This presumption may make it extremely difficult for him to meet the burden of due diligence.⁷¹

Even more interesting is the notion that because monitoring committees are composed of persons who are independent of management and are supposedly more responsive to the needs of the investing public, a director who sits on such a committee could be held to a standard of care analogous to that imposed on underwriters. Like directors, underwriters are specifically designated for liability under section 11⁷² and are provided with the defense of due diligence.⁷³ However, *BarChris* established that, unlike inside directors

69. The decisions since *BarChris* have focused on the functional role of the director when determining what is a reasonable investigation. Because of the paucity of cases and the multitude of variables, it is impossible to perceive universal guidelines. Rather, as the court noted in *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 577-78 (E.D.N.Y. 1971): "What constitutes reasonable investigation and a reasonable ground to believe will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions."

70. 283 F. Supp. at 687-89.

71. See note 20 *supra* and accompanying text for cases illustrative of this presumption.

72. 15 U.S.C. § 77k(d)(1976).

73. *Id.*

who may be faced with an automatic presumption of knowledge and therefore may find it virtually impossible to meet the burden of due diligence, an underwriter may meet the burden by undertaking an independent verification of the contents of a registration statement.⁷⁴ The reason for the imposition of this particular duty of care lies once again in a functional analysis of the underwriter's role.⁷⁵

The *BarChris* court recognized that in the scheme of securities distribution, the underwriter stands in an "adverse" position to company officers.⁷⁶ Because the underwriter's community standing and economic livelihood depend upon the integrity of its recommendations, the underwriter must necessarily investigate thoroughly the claims of prospective issuers.⁷⁷ These factors combine to create a feeling of public trust and reliance in the underwriter which in turn demands that if underwriters are to satisfy the requirement of due diligence they must always verify the statements of management.

Similar reasoning may result in the same public trust and reliance being placed upon the outside director sitting on a monitoring committee. Although directors traditionally have not been viewed as standing in an "adverse" role to one another, the use of the committee system may foster this perception.⁷⁸ The outside director who does not owe his livelihood to the company but who now monitors the preparation of the registration statement may well develop a sense of "public" integrity akin to that demanded of the underwriter. Although he does not labor under the same presumption of knowledge as inside directors, he may find that, like the underwriter, he must independently investigate each representation made by management if he is to satisfy the requirements of due diligence and avoid liability under section 11.

74. 283 F. Supp. at 693-97. See also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 578 (E.D.N.Y. 1971) wherein the underwriters, but not the inside directors, met the burden of due diligence.

75. The *BarChris* court made it quite clear that the underwriter was responsible for "the truth of the prospectus." *Id.* at 697. Therefore it was necessary to independently verify the data submitted by the company's officers and counsel although no such investigation was necessary regarding "expertized" portions of a statement inasmuch as the underwriters had no reason to believe there was a material misstatement or omission. *Id.* at 697-98.

76. *Id.* at 696.

77. *Id.* See also *Folk*, *supra* note 49, at 54-55.

78. A related theory has been advanced by SEC Chairman Williams who sees corporations as being, in essence, quasi-public institutions and has stated that boards of directors should be composed of disinterested outside directors whose "tension-producing forces" will create the atmosphere of adversity necessary to achieve effective corporate governance. SEC. REC. & L. REP. (BNA) No. 437 at A-23 (January 25, 1978). But see *Leech & Mundheim, The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1811 (1976), cautioning against the concept of the monitoring director as an adversary.

Whereas the outside director who has assumed an active role in the registration statement process may be held to a higher standard of care, it is unlikely that inside directors no longer actively participating in the preparation of the statements will be held to the lesser standard of care formerly reserved for unknowledgeable outside directors. It is impractical to suggest that mere removal from the registration process will relieve inside directors of the presumption that they have a working knowledge of the company.

Applying section 11's sliding scale of liability and functional role approach, it is not illogical to assume that the use of monitoring committees may have the effect of altering the standard of care demanded of inside directors who are not on the committees. Because the new monitoring committees do not face the inherent conflicts of interest found in the traditional committee system, their recommendations should receive particular credence. Accordingly, inside directors who receive these recommendations should be permitted to rely heavily on both the expertized and non-expertized portions. This element of reliance may in turn make it possible for inside directors to rebut their presumption of knowledge and to establish a due diligence defense by reasonably investigating the non-expert portions of the committee's report.⁷⁹ Of course, whether an investigation is reasonable in any given situation will depend upon the director's own knowledge and the type of information involved. Likewise, outside directors who are not on the committee and who are disinterested members of the board, should find themselves even farther removed from liability. These directors should only be required to undertake their ordinary due diligence investigation, and a careful review of the monitoring committee report or comments should be of assistance in fulfilling that obligation.

DIRECTORS' STANDARDS OF CARE FOR PROXY STATEMENTS

Scope of Liability Under Section 14

The Securities Exchange Act of 1934⁸⁰ expands upon the theme of "protection through full disclosure" which dominates the Securities Act of 1933. Whereas the 1933 Act deals primarily with the dissemination of material information in connection with public offerings of securities, the 1934 Act focuses on preventing manipulation of stock prices through regulation of securities exchange trans-

79. See Caplin, *Outside Directors and Their Responsibilities: A Program for the Exercise of Due Care*, 1 J. CORP. L. 57, 80 (1975).

80. 15 U.S.C. §§ 78a-hh (1976).

actions.⁸¹ To accomplish this goal, the 1934 Act imposes a series of regular reporting requirements on companies whose stock is listed on national securities exchanges.⁸² Those who violate these regulations may be held liable under either express or implied private rights of action.⁸³

In the past, directors have been particularly vulnerable under two sections of the 1934 Act—section 14(a)⁸⁴ regarding proxy solicitation, and section 10(b),⁸⁵ the “catch-all” antifraud provision. Both sections have enabling rules⁸⁶ which speak in broad terms of liability

81. The 1934 Act also covers transactions on unregistered exchanges as well as over-the-counter markets. 15 U.S.C. § 78b, e (1976).

82. See S. REP. No. 792, 73d Cong. 2d Sess. 1-5 (1934); H.R. REP. No. 1383, 73d Cong., 2d Sess. 14 (1934).

83. Compare 15 U.S.C. §§ 78(i), (r), (t) (1976) with 15 U.S.C. § 78(j), (n) (1976).

84. Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1976), provides in pertinent part:

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title. (emphasis added)

85. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), provides in pertinent part:

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—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

86. SEC rule 14a-9, 17 C.F.R. § 240.14a-9 (1975) provides:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1975) 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,

(a) To employ any device, scheme, or artifice to defraud,

(b) 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

(c) To engage in any act, practice, or course of business which operates as a

but, unlike section 11 of the 1933 Act, directors are not held liable merely because of their status. Although neither section expressly creates a private right of action, the Supreme Court has recognized that potential litigants have an implied right under each of the provisions.⁸⁷

In discussing the scope of the judicially created private right of action under section 14(a), the Supreme Court has emphasized that the language of section 14(a) indicates that the drafters were concerned primarily with protection of the individual shareholder whose proxy is solicited.⁸⁸ For this reason, the function and importance of the proxy statement is recognized as analogous to that of the registration statement, and the tone of section 14(a) is considered to resemble section 11 of the 1933 Act more closely than it does section 10(b) of the 1934 Act.⁸⁹

Moreover, the Court has tacitly recognized that because directors stand in a fiduciary relationship to existing shareholders, it is the duty of those directors to insure that full and fair disclosure will be made to stockholders so that they can make an informed and meaningful choice among alternative courses of action.⁹⁰ In spite of the imposition of this responsibility, lower courts have rejected the notion that directors are guarantors of the accuracy of proxy materials disseminated by a corporation.⁹¹

fraud or deceit upon any person, in connection with the purchase or sale of any security.

87. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (§ 10(b)).

Earlier, in *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964), the Supreme Court held that the broad remedial purposes of § 14(a) made it necessary to imply a private cause of action for violations of that provision and the rule promulgated thereunder. In so holding, the Court recognized that "[t]he purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."

88. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964).

89. See, e.g., *Gould v. American Hawaiian Steamship Co.*, 351 F. Supp. 853, 862, 863 n.12 (D. Del. 1972), *aff'd*, 535 F.2d 761 (3d Cir. 1976). Although it has been suggested that the language of rule 14a-9(a) closely parallels that of rule 10b-5, a crucial distinction exists. Whereas rule 10b-5 speaks in specific terms of fraudulent or manipulative activity connoting an illicit motive on the part of the solicitor, no such language is present in either § 14(a) or rule 14a-9(a). See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298 (2d Cir. 1973); *Globus v. Law Research Serv. Inc.*, 287 F. Supp. 188, 197-99 (S.D.N.Y. 1968).

90. See *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

91. See, e.g., *Gould v. American Hawaiian Steamship Co.*, 351 F. Supp. 853, 859 (D. Del. 1972).

Because "any person" may violate § 14(a) by either "soliciting" or "permitting the use of his name" to solicit a proxy, all directors should be especially leery of their potential liability. Moreover, the fact that an outside director is not a part of "management" and therefore did not actually participate in the proxy solicitation or affirmatively consent to having his name

The courts have recognized, however, that because of the peculiar position of trust which directors occupy vis-à-vis the corporation and its shareholders, directors must be held to a higher standard of care than proof of scienter would impose. With these considerations in mind, the courts have generally agreed that both inside and outside directors should be held to a standard of negligence⁹² and have permitted directors faced with an alleged violation of section 14(a) to raise a defense frequently labeled "due diligence."⁹³ Liability has been determined on a sliding scale akin to that employed in section 11 cases⁹⁴ and, inherent in this scale, has been an analysis of the functional role of the director.

Functional Approach to Liability

The functional approach to section 14(a) liability, particularly as it applies to outside directors, was initially expressed by a federal district court in *Gould v. American Hawaiian Steamship Co.*⁹⁵ and was recently affirmed by the Third Circuit Court of Appeals.⁹⁶ In *Gould*, McLean Industries proposed to merge with R. J. Reynolds Tobacco Company. The merger agreement proposed that several of McLean's largest shareholders would receive fifty dollars per share for their stock while other shareholders would be given one share of Reynolds preferred for each share of McLean's common stock.⁹⁷ Following the merger, numerous shareholders brought suit against both the inside and outside directors alleging that they had participated in a proxy solicitation containing a number of materially misleading statements and omissions.⁹⁸

used in connection with the solicitation will not protect him from liability where the board of directors is authorized to act on behalf of management. See *Gould v. American Hawaiian Steamship Co.*, 351 F. Supp. 853, 858 (D. Del. 1972). But see *Yamamoto v. Amiya*, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,263 (9th Cir. 1977) (presence of buyer's name in allegedly misleading proxy statement insufficient to attach liability to buyer).

Nevertheless, the SEC has provided a mechanism whereby a dissenting director may disassociate himself from the board of directors' recommendations and thereby avoid liability under § 14(a). 17 C.F.R. § 240.14a-101(3)(a)(1) (1977). See also 15 U.S.C. § 77(b)(1), (2) (1976), providing for a similar disassociation mechanism under § 11 of the 1933 Act.

92. See, e.g., *In re Clinton Oil Co. Securities Litigation*, 368 F. Supp. 813 (D. Kan. 1977); *Gould v. American Hawaiian Steamship Co.*, 535 F.2d 761, 777 (3d Cir. 1976), and cases cited therein.

93. See, e.g., *Gould v. American Hawaiian Steamship Co.*, 535 F.2d 761, 776-81 (3d Cir. 1976).

94. See text accompanying notes 61-70 *supra*, for a discussion of § 11 liability.

95. 351 F. Supp. 853 (D. Del. 1972).

96. 535 F.2d 761 (3d Cir. 1976).

97. *Id.* at 766.

98. *Id.* at 767-68. A discussion of what statements or omissions may be considered material under § 14(a) is beyond the scope of this article. However, the Supreme Court has recently attempted to define the test for determining that crucial element in *TSC Indus. Inc.*

In determining the extent of the outside directors' liability, the lower court in *Gould* adopted a negligence standard, the test of which was whether a director "knew or should have known" that a statement was "erroneous or misleading."⁹⁹ Realizing, however, that the knowledge any particular director may have is a function of his position within the corporation, the court articulated a "principle of individualization":

[T]he liability of any individual defendant is dependent upon his due diligence or exercise of reasonable care, and therefore, the negligence standard embodies a criterion which would permit consideration of the individual's particular position with the corporation and his relationship to the pertinent information held to be erroneously or incompletely stated in the proxy materials.¹⁰⁰

Applying this criterion, the *Gould* court held that a director must read a proxy statement which the corporation is distributing if he is to avoid being found negligent.¹⁰¹ Moreover, it is clear that if a director discovers information in a proxy statement which he knows to be false or misleading, he is under an affirmative duty to take steps to correct it.¹⁰²

In spite of the guidance which *Gould* provides, the parameters of negligent conduct under section 14(a) have remained largely undefined. Because of the close analogy drawn between section 14(a) of the 1934 Act, and section 11 of the 1933 Act, the question arises whether courts will look to the "due diligence" obligation imposed on a director under section 11 in order to arrive at a precise definition of negligent conduct under section 14(a). Under section 11, in order to avoid liability, a director must undertake a "reasonable investigation" of the non-expertized portions of a registration statement while only undertaking such an investigation of expertized portions in unusual circumstances.¹⁰³ No such duty is statutorily mandated under section 14(a), and it therefore remains unclear whether or not directors have an affirmative duty to investigate the content of a proxy statement.¹⁰⁴ Although *Gould* suggests that no

v. Northway, Inc., 426 U.S. 438 (1976), and the interested reader is advised to see Hewitt, *Developing Concepts of Materiality and Disclosure*, 32 BUS. LAW. 887 (1977).

99. 351 F. Supp. at 866.

100. *Id.* at 865.

101. *Id.*

102. See rule 14a-9, 17 C.F.R. § 240.14a-9 (1975), which specifically states that false or misleading solicitation materials must be corrected.

103. See notes 57 & 58 *supra* and accompanying text, concerning § 11's duty to investigate.

104. The fact that the defense of "reasonable investigation" is a 1933 Act concept and therefore inapplicable to the duties imposed under various sections of the 1934 Act, has been

duty is required¹⁰⁵ at least one court has held that an outside director must, at a minimum, make a "reasonable investigation" into the content of a proxy statement if he is to meet the "should have known" test and avoid liability for negligence under section 14(a).¹⁰⁶

Impact of the Committee System on Directors' Liability Under Section 14(a)

Just as placement on a monitoring committee may increase an outside director's potential liability under section 11 by making him an "active" director, placement on a committee which monitors the preparation or distribution of a proxy statement may increase the potential liability of an outside director under section 14(a), both by increasing his involvement in the process and by providing him with access to information he might otherwise not have. While this change in status facilitates the making of a "reasonable investigation" which may be necessary to avoid liability under section 14(a), it may also raise a presumption similar to that of section 11 that the outside director "should have known" of any false or misleading statement appearing in the proxy materials.¹⁰⁷ Thus, the outside director on the monitoring committee may find himself faced with a heightened duty of care.

Another question is raised by the fact that while the Supreme Court has not addressed directly the issue of which culpability standard is applicable to actions brought under section 14(a), its analysis of the federal securities laws in the *Hochfelder* section 10(b) case suggests that proof of scienter is unnecessary and that a negligence

raised by numerous commentators. Compare A Program by the Committee on Federal Regulation of Securities, *Current Issues and Developments in the Duties and Liabilities of Underwriters and Securities Dealers*, 33 BUS. LAW. 335, 372-73 (1977), with GOLDSCHMID, *The Role of the Outside Director in Assuring Adequate Disclosure*, Fifth Annual Institute on Securities Regulation, 121, 127-28 (1974).

105. Although the *Gould* court stated that the "burden of scrutiny" rested primarily on directors, absent some "evident misstatement or irregularity," directors could rely on the work of experts and were not required to "recalculate or reassemble financial or other reports." 351 F. Supp. at 865.

106. *Berman v. Thomson*, 403 F. Supp. 695 (N.D. Ill. 1970). Even more alarming than the fact that an outside director may have to undertake his own independent investigation into the contents of a proxy statement is the recent decision of *Del Noce v. Delyar Corp.*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,670 (S.D.N.Y. 1976), wherein the court held that a director's subjective interpretation of whether or not a statement made in a proxy solicitation was material would expose him to liability for negligence if a court found that "the reasonably prudent shareholder would be misled by the words." *Id.* at 90, 303.

107. But see *Mundheim & Leech, The Outside Director of the Public Corporation*, reprinted in *PLI'S DUTIES & RESPONSIBILITIES OF OUTSIDE DIRECTORS* at 187 (1977), wherein the authors suggest that knowledge alone will not lead to an increase in liability for outside directors unless it is coupled with a failure to take corrective measures akin to those already specified in rule 14a-9. See note 102 *supra* and accompanying text.

standard will suffice.¹⁰⁸ However, in making its observations, the Court cited the Second Circuit decision of *Gerstle v. Gamble-Skogmo, Inc.*,¹⁰⁹ which specifically left undecided the issue of whether scienter, rather than negligence, would be the appropriate standard by which to judge “*directors and other individuals* having some responsibility for such a [proxy] statement, as distinguished from a controlling corporation which has been the beneficiary of the action that was induced.”¹¹⁰

The failure of the Supreme Court to adopt a specific standard of liability under section 14(a), combined with the *Gerstle* court's suggestion that individuals who do not benefit directly from a false or misleading statement should not be liable under section 14(a) for mere negligence in the preparation of a proxy statement, creates several interesting problems for the monitoring director. Indeed, the *Gerstle* dichotomy between the individuals preparing the statement and the corporation which solicits it becomes especially important when viewed in the context of the committee system. Bearing these factors in mind, it may be argued that outside directors on a committee which monitors proxy materials are so far removed from management and have so little stake in the outcome of the solicitation that they should only be liable for actions amounting to intentional misconduct. Alternatively, inside directors with pecuniary and proprietary interests should be held to a higher standard of care.

On the other hand, if the standard of care which is demanded of a director is based on an analysis of his functional role within the corporate structure, it is reasonable to suggest that a very high standard might be required of the monitoring directors. Precisely because such a director is divorced from traditional management conflicts of interest, shareholders may place special confidence in him as the watchdog of shareholder welfare and may rely heavily on the monitoring committee to assure the accuracy of proxy information. This added reliance together with access to internal information may well create a most stringent duty of care.

108. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n. 27 (1976). *See also* *TSC Indus. Inc. v. Northway Inc.*, 426 U.S. 438, 444 n.7. (1976), in which the Court specifically declined to decide what standard of liability applies to § 14(a); *see also* note 89 *supra*.

109. 478 F.2d 1281 (2d Cir. 1973).

110. *Id.* at 1298 n.16 (emphasis added).

DIRECTORS' STANDARDS OF CARE IN CONNECTION WITH THE SALE OF
SECURITIES*Scope of Liability Under Rule 10b-5*

In marked contrast to the negligence standards which are applied in proxy and registration cases, it has been clear since the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*¹¹¹ that proof of scienter will be necessary for an action to lie under section 10(b) and rule 10b-5,¹¹² the general antifraud provisions of the 1934 Act. In arriving at this decision, the Court focused on the wording of section 10(b), which it considered to be unlike either section 11 or section 14(a).¹¹³ Rather, the Court found that because section 10(b) is directed toward "insiders," and specifically prohibits the use of "any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security,"¹¹⁴ it was clear that the drafters intended liability to be determined under a stricter standard than mere negligence would impose.¹¹⁵

Although scienter was defined by the Court as a "mental state embracing intent to deceive, manipulate or defraud,"¹¹⁶ a concept which may be labeled "strict" scienter, the question of whether recklessness may be considered a form of intentional conduct was left open.¹¹⁷ This has created confusion among lower courts which have been left to define proof of scienter on their own.¹¹⁸ In the

111. 425 U.S. 185 (1976). An in-depth decision of *Hochfelder* is beyond the scope of this article. For a general discussion of the background of *Hochfelder*, see *Recent Decision, Rule 10b-5—Civil Liability Will Not Be Imposed In A Private Cause Of Action Under §10(b) of the Act and Rule 10b-5 Absent An Allegation Of Scienter*, 10 GA. L. REV. 856 (1976).

112. See notes 85 & 86 *supra* for the text of § 10(b) and rule 10b-5. Although *Hochfelder* dealt specifically with the liability of accountants under § 10(b) and rule 10b-5, it is clear that directors will be held to the same standard.

113. 425 U.S. at 207-09. See note 89 *supra* and accompanying text discussing the similarity between §§ 14(a) and 11. In the wake of *Hochfelder*, a defendant could escape liability under the § 10(b) scienter standard but, under the same facts, may still be found liable under § 14(a)'s negligence standard. See, e.g., *Clinton Oil Co. Securities Litigation*, 368 F. Supp. 813 (D. Kan. 1977). Whether actions under §§ 11 and 10(b) are mutually exclusive remains unclear. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 n.15 (1975), suggesting there may be no implied right of action under rule 10b-5 for conduct which is also actionable under the express civil liability provisions of §§ 11 and 12 of the 1933 Act. While it is beyond the scope of this article to discuss the impact which *Hochfelder* may have on the interrelationship of the various sections of the federal securities law, the interested reader should see Cox, *Ernst & Ernst v. Hochfelder: A Critique and an Evaluation of its Impact upon the Scheme of the Federal Securities Laws*, 28 HAST. L.J. 569 (1977).

114. 15 U.S.C. § 78j (1976) (emphasis added).

115. 425 U.S. at 197-206.

116. *Id.* at 193 n.12.

117. *Id.*

118. For an excellent discussion of the confusion which the Supreme Court's vague definition has caused among the courts see Bucklo, *The Supreme Court Attempts to Define Scien-*

absence of any significant guidelines, the courts have been determining liability much as they always have—on a case-by-case basis. While some hold that a defendant must have an “intent to defraud,”¹¹⁹ others require nothing more than the defendant’s knowledge of the material misstatement or omission to satisfy the scienter requirement.¹²⁰ Still others have found common law reckless behavior to be sufficient to support an action under section 10(b).¹²¹ However, regardless of how one defines scienter, it is apparent that, just as liability for negligent conduct under sections 11 of the 1933 Act and 14(a) of the 1934 Act is determined by resorting to an analysis of the functional role of the individual in the exchange of securities, proof of scienter must be established in a similar manner.

This type of functional analysis was made by the Second Circuit which rejected the negligence standard in *Lanza v. Drexel & Co.*,¹²² and which, since *Hochfelder*, remains the leading case of outside directors’ liability under section 10(b). Applying a scienter standard defined as “proof of a willful or reckless disregard for the truth,”¹²³ the *Lanza* court found that the defendant, an outside director of BarChris, was not liable under section 10(b) for the material misrepresentations and omissions made by the BarChris management to the Victor Billiards Company during merger negotiations. To arrive at this conclusion, the court focused on the fact that, although the defendant had voted to approve the merger, he had not participated in the negotiations and had no knowledge of the representations

ter under Rule 10b-5: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213 (1977).

Prior to *Hochfelder*, the futility of defining a single standard of conduct to be applied to all persons dealing with the issuance of a security was advanced and discussed in depth in 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).

119. See, e.g., *Kaback v. Schweickart & Co.*, 415 F. Supp. 646 (S.D.N.Y. 1976); *United States v. Charny*, 537 F.2d 341 (9th Cir. 1976).

120. See, e.g., *Herzfeld v. Laventhal Krekstein Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719 (D. Okla. 1977); *Equity Funding Corp.* [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,714 (C.D. Cal. 1976).

121. In *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033 (7th Cir. 1977), the court explained the rationale for including recklessness within the scope of rule 10b-5:

At common law reckless behavior was sufficient to support causes of action sounding in fraud or deceit. Since there is no hint in *Hochfelder* that the Court intended a radical departure from accepted Rule 10b-5 principles, it would be highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than in common law analogs.

Id. at 1044.

122. 479 F.2d 1277 (2d Cir. 1973).

123. *Id.* at 1305-06, citing *Chris Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363-64, 396-99 (2d Cir. 1973).

which were being made to the purchasing company.¹²⁴ The court acknowledged that, had the defendant participated in the "dissemination of false information reasonably calculated to influence the investing public,"¹²⁵ he might well have been liable under rule 10b-5.

It appears from *Lanza* that the less an outside director is involved in the internal affairs of a corporation, the better able he will be to withstand liability under a scienter standard.¹²⁶ This will certainly be the case under a standard which demands actual knowledge or participation before liability will be imposed.

Nevertheless, it is also clear after *Lanza* that use of the "willful or reckless disregard" standard implies that a director has some duty to maintain an awareness of significant corporate developments. Indeed, the majority in *Lanza* held that an outside director has "an obligation to maintain an awareness of significant corporate developments which may come to his attention."¹²⁷ However, the court specifically denied that this duty of awareness was synonymous with the imposition of a duty on non-participating directors *to inquire* as to what representations have been made to potential purchasers of a company's stock and to ensure that all significant adverse information has been *conveyed* to them.¹²⁸

The Committee System and Liability Under Rule 10b-5

If a strict scienter standard is applied to rule 10b-5 cases, the

124. *Id.* at 1281, 1289. The court concluded that in such circumstances "[a] director's liability to prospective purchasers under Rule 10b-5 can thus only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others." *Id.* at 1289.

It is beyond the scope of this article to deal with the concept of secondary liability advanced in *Lanza*. However, for an informative analysis of this problem in the wake of *Hochfelder*, see *Rule 10b-5: Liability for Aiding and Abetting After Ernst & Ernst v. Hochfelder*, 38 FLA. L. REV. 999 (1978).

125. 479 F.2d at 1302.

126. See, e.g., *Robinson v. Heilman*, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,233 at 92,600 (9th Cir. 1977), wherein the Ninth Circuit indicated that proof of scienter rather than negligence is the applicable standard for determining the liability for all participants in a securities transaction. However, the court noted that an individual's relationship to the corporation and involvement in the transaction will alter the burden of proof.

127. 479 F.2d at 1306.

128. *Id.* at 1293-99. In this regard the court undertook a lengthy analysis of the language and legislative histories of the securities acts. The court contrasted what it considered to be the statutory duty imposed on directors under § 11 of the 1933 Act, i.e., to "reasonably investigate" the contents of a registration statement, with the broad prohibitions of § 10(b) of the 1934 Act. It concluded that requiring directors under § 10(b) to investigate statements by management and to convey adverse information to potential purchasers would create a duty stricter than that imposed by § 11. Imposition of such a duty would frustrate the purpose of the 1934 Securities Act, which was to provide protection for the public "with the least possible interference with honest business." *Id.* at 1309.

existence of a monitoring committee should have little impact on directors' liability. Only those with demonstrable intent to defraud would be subject to liability. However, the committee system may have a significant impact on potential liability for directors if the applicable scienter standard includes willful or reckless disregard of the truth. Although the court in *Lanza* specifically denied that a non-participating director had any duty of inquiry, a director's heightened involvement in the corporation by means of his presence on a monitoring committee may increase his chances of being found reckless and liable under rule 10b-5 if he fails to inquire into the basis for management's statements. The extent to which this duty of inquiry includes making an independent investigation remains unclear, but it is reasonable to assume that even when applying the willful and reckless scienter standard, a monitoring director should only have to undertake an investigation when he has been put on notice that the management statement contains a materially false statement or omission.¹²⁹

Additionally, the committee system may increase the exposure of certain directors in the area of reckless failure to disclose material information. This is particularly true in light of the SEC's recent *Report of Investigation in the Matter of National Telephone Co., Inc. Relating to Activities of the Outside Directors of National Telephone Co., Inc.*¹³⁰ wherein the Commission criticized certain outside directors for allowing management to continue to make optimistic public statements when the company was in financial difficulty. Part of the remedy suggested by the SEC was the delegation of the responsibility for monitoring disclosure matters to an audit committee.

Traditionally, the decisions as to what and when information should be disclosed to the investing public were made by management. However, the SEC is now suggesting in the *National Telephone* report that monitoring committee directors should also assume some responsibility in the area of public disclosure.¹³¹ Cer-

129. Compare Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799, 1814-23 (1976), with *Lanza v. Drexel*, 479 F.2d 1277, 1307-09 (2d Cir. 1973). Cf. *Steinberg v. Carey*, 439 F. Supp. 1233 (S.D.N.Y. 1977) (outside trustees did not act recklessly by relying upon management and counsel for the accuracy of the prospectus).

130. See Exchange Act Release No. 14380, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,410 (January 16, 1978).

131. Although the National Telephone Report made it clear that outside directors have some duty to correct publicly-disseminated materially misleading statements or omissions, the manner in which this is to be done was not discussed. In this regard, it has been suggested that in order to avoid liability under § 10(b) a director must, at the very least, resign his position and may have an obligation to inform the SEC. See Wall St. J., Jan. 18, 1978, at 9.

tainly concomitant with the assumption of this duty would be heightened exposure under rule 10b-5 in SEC injunctive actions¹³² and possibly exposure to private actions under a standard of reckless disregard of the truth.

THE COMMON LAW DUTY OF CARE AND THE COMMITTEE SYSTEM

The Supreme Court has responded to the rash of private actions under the securities laws by limiting plaintiffs' standing to sue and by refusing to grant relief except in situations clearly contemplated by Congress.¹³³ At the same time, however, the Court has suggested in *Santa Fe Industries, Inc. v. Green*¹³⁴ that aggrieved shareholders can seek relief elsewhere:

Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in *Cort v. Ash, supra*, "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."¹³⁵

Thus, the Supreme Court suggested that the continuation of the battle to have directors hold management accountable for its ac-

132. Although the Supreme Court did not address the issue in *Hochfelder*, at least two courts have held that scienter rather than negligence will be the appropriate standard for SEC injunctive actions under § 10(b) and rule 10b-5. See, e.g., *SEC v. Bausch & Lomb*, 420 F. Supp. 1226 (S.D.N.Y. 1976); *SEC v. Cenco, Inc.*, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,133 (N.D. Ill. 1977). See also Lowenfels, *Scienter or Negligence Required for SEC Injunctions Under Section 10b and Rule 10b-5: A Fascinating Paradox*, 33 BUS. LAW. 789 (1978).

133. *Piper v. Chris-Craft Indus., Inc.*, 97 S. Ct. 926 (1977) (no implied private right of action under anti-fraud provisions of the Williams Act); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (rule 14a-9 action; material fact defined as one involving substantial likelihood that a reasonable shareholder, knowing fact, would vote differently); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (proof of scienter required for rule 10b-5 violation); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976) (no § 16(b) liability when defendant not 10% owner before the purchase and sale alleged to constitute violation); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) (no violation of § 13(d)(1) when failure to disclose made in good faith and without injury to plaintiff); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (stock of cooperative housing project not security within meaning of securities law); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (non-purchasers or sellers of security in question have no cause of action under rule 10b-5); *Securities Investors Protection Corp. v. Barbour*, 421 U.S. 412 (1975) (no implied private right of action under Securities Investor Protection Act); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973) (no § 16(b) liability when defendant had no access to inside information and no potential for speculative abuse).

134. 97 S. Ct. 1292 (1977).

135. *Id.* at 1303-04.

tions must be shifted from the federal to the state courts.

The New York court in *Diamond v. Oreamuno*¹³⁶ accepted that burden over a decade ago. In that case the court allowed corporate recovery in an insider trading case, the traditional province of the federal courts under rule 10b-5. The *Diamond* court perceived nothing in the federal law to indicate that it was intended to limit the state's power "to fashion additional remedies to effectuate similar purposes The primary source of the law in this area ever remains that of the state which created the corporation."¹³⁷

More recently, the Delaware Supreme Court in *Singer v. Magnavox Co.*¹³⁸ found that a cause of action had been stated against directors and officers of a company which merged in formal accordance with the Delaware statute but were nevertheless alleged to have breached their fiduciary duties because the merger was designed solely to eliminate the minority interest. This result certainly follows the course suggested by the Supreme Court in *Green*¹³⁹ in that it decides basic corporate fairness issues under the common law, rather than under rule 10b-5.

For the most part, however, private litigants seeking to hold directors liable for failure to monitor management will find almost no helpful common law precedent. As one commentator observed: "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."¹⁴⁰

Statutory foundation for breach of the duty of care is certainly present in state law. State statutes typically hold directors accountable for exercising "that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."¹⁴¹

These statutes have rarely been successfully invoked because state courts have been reluctant to hold that the traditional outside director, having delegated his responsibilities to management and possessing limited factual information about corporate affairs, is breaching his duty of care when he does not oversee management. Although courts have excused such directors' failure to supervise under the business judgment rule or in reliance on some form of the

136. 24 N.Y.2d 494, 248 N.E.2d 910 (1969).

137. *Id.* at 503-04, 248 N.E.2d at 915.

138. 380 A.2d 969 (Del. Sup. Ct. 1977).

139. *Santa Fe Indus., Inc. v. Green*, 97 S. Ct. 1292, 1303-04 (1977).

140. See Bishop *supra* note 9, at 1099-1100. Professor Bishop found only four such cases and concluded that "none of these cases carries real conviction." *Id.*

141. See, e.g., N.Y. BUS. CORP. LAW § 717 (McKinney 1977 Pocket Part).

delegation doctrine,¹⁴² the usual factual basis for such decisions has been evidence that the directors were not expected to actually monitor management and did not have the resources to perform this function.

The question remains as to the possible result of a shareholder's state court action against directors who had been participants in the modern committee system. The reasonable expectation is that the state courts will continue to apply the basic tenets of corporate law, including the like-position standard of the duty of care, the reasonable delegation principle, and the business judgment rule. When these principles are applied to directors operating under the modern committee system, the results may differ somewhat from the traditional conclusion of no liability for directors who fail to oversee management.

For example, the modern outside director who serves on an audit committee and has reasonable access to extensive information and sophisticated independent professional assistance and who nevertheless fails to monitor management, may well be found to have breached his common law duty of care. Courts could find that ordinarily prudent persons in that position, by today's corporate standards, would perform a meaningful oversight function. The business judgment rule in this context may provide only limited protection for the director who fails to become sufficiently knowledgeable about company affairs to make the necessary business decisions. Such directors will no longer be able to argue that a gross failure to exercise judgment should be attributed to the management to whom the job had been delegated.

Those directors who do not serve on the particular committees to which the oversight function was assigned will probably be able to escape liability under the reasonable reliance doctrine. The doctrine of "reasonable reliance," however, is probably more strictly construed today than it was traditionally. The non-committee member will probably have to show that the committee itself was chosen with care and that its reports were carefully read and reviewed. If this review discloses mistakes, the non-committee director's duty of care will require him, at a minimum, to bring those points to the attention of the full board.

CONCLUSION

Directors will be carrying out their jobs against an unsettled legal background in their new role as members of monitoring committees.

142. See notes 10-15 *supra*.

Much of the case law, certainly in the common law decisions, was developed with an implicit assumption that outside directors were not expected to and did not have a significant role in corporate governance. Given the emergence of the monitoring director, this assumption will have to change as the courts respond to the more responsible role of the outside director. Future cases may not announce radical new standards of care for directors, but as the use of the committee system grows, monitoring directors may find themselves facing new applications of existing corporate and securities law principles based on a functional analysis of the director's developing role in an era of corporate accountability.