Legal Duties and Responsibilities of Corporate Directors and Controlling Persons of U.S. Publicly-Owned Companies

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INTRODUCTION

This article outlines the legal duties and responsibilities of corporate directors and controlling persons1 of U.S. publicly-owned companies. Its purpose is to provide a general understanding of the legal duties involved in serving as a director or in being a controlling person and to provide practical guidance in performing such duties.

To that end, this article is divided into three main sections. The first section outlines general duties and responsibilities imposed by basic principles of law in the United States on corporate directors. The second section outlines more specific duties and responsibilities imposed by the federal securities laws. Finally, the third section attempts to provide some guidelines for performance of the duties outlined in the first two sections.

It should be noted, however, that in the United States the laws prescribing the duties and liabilities of corporate directors and controlling persons include a combination of state and federal statutes and court decisions. The business laws of a given state where a corporation is formed will, in most cases, govern the conduct of its directors and controlling persons. The federal securities laws also impose specific requirements upon public company directors and controlling persons. In addition, each state has its own laws governing sales of corporate securities within that state which must be observed.

Due to the existence of these various sources of legal principles which may differ among jurisdictions, this article undertakes to deal with broad areas of concern and attempts to provide legal standards and principles common to the majority of jurisdictions. It does not purport to state exact solutions to particular problems. Corporate directors and controlling persons are urged to seek advice on both general and particular matters from their corporation's legal advisors and their own legal counsel.

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1. A "controlling person" for the purposes of this article is a person or corporate entity which has the ability to control or influence the voting or disposition of 10% or more of the securities of a U.S. publicly-owned company, whether through direct or indirect ownership of such securities, by corporate agreements or otherwise.
I. GENERAL DUTIES AND RESPONSIBILITIES

A. Standard of Care

The legal obligations of directors fall into two broad categories: a duty of loyalty and a duty of care (including a duty to be attentive to the corporation's business). In exercising such obligations the directors may rely on information provided by management or advisors, and decisions duly made by such directors may be protected under the "business judgment rule." The directors may also be indemnified in certain circumstances when they are made a party to litigation by reason of their role as directors.2

1. Duty of Loyalty

By assuming office, the corporate director commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any personal, individualized interest. The basic principle to be observed is that the director should not use his corporate position to make a personal profit or gain other personal advantage. As a practical method of complying with the duty of loyalty, many directors have adopted the practice of absenting themselves from that portion of a board meeting during which matters which concern them personally are considered. The duty of loyalty is manifested by certain particularized legal concepts, discussed below.

a. Conflict of Interest

When the corporate director has a material personal interest in a contract or transaction to which the corporation is to be a party (either directly or indirectly, because of an employment or investment relationship with an entity with which the corporation is dealing or otherwise) the director should disclose the existence of such interest, and describe the nature thereof (e.g., financial, family relationship, professional or business affiliation, etc.) to the other directors prior to the time action is taken by the board with respect to the matter and, further, he should abstain from acting thereon.4 In addition, the interested director should be aware that appropriate voting and quorum requirements must be met.5 Under prevailing practice, but with significant exceptions in some states,6 the
interested director may be counted in determining the presence of a quorum but his vote of consent may not be counted for purposes of the requisite action.\(^7\)

**b. Duty of Fairness**

When conflicting interests are present, the corporate director must be concerned that fairness obligations are recognized and satisfied. If a transaction by a director with the corporation involves a possible conflict of interest, fairness to the corporation should be a primary concern for both the interested director and those disinterested directors entertaining a request for favorable action.\(^8\) The standard commonly used involves ascertainment that the proposed transaction is on at least as favorable terms to the corporation as might be available (assuming appropriate comparability) from any other person or entity.\(^9\) If minority shareholders may be adversely affected, all directors should be concerned with the fairness of their treatment. This concern is heightened in instances where a dominant shareholder or shareholder group has a divergent conflicting interest known to the corporate director.

c. **Corporate Opportunity**

When an opportunity (commonly referred to as a "corporate opportunity") to acquire another business enterprise, to acquire property, to license patents or inventions, to market new products, or to seize any other business advantage comes to the attention of the corporate director as a result of his relation to the corporation in a way that would permit its personal realization, and is relevant to the enterprise’s present or prospective business activities, the director must first present it to his corporation.\(^10\) Only after informed evaluation and a determination (by disinterested peers) that the corporation should not pursue such corporate opportunity, should the corporate director pursue the matter for his own account or for the benefit of others.\(^11\) If an individual encounters a corporate opportunity which may be of interest to more than one corporation which he serves as a director, complicated and difficult conflict questions may be presented.

d. **Confidentiality**

The director should deal in confidence with all matters involving the corporation until such time as there has been a general public disclosure

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7. Model Act, supra note 2, § 8.31(c), (d).

8. See, e.g., Del. Code Ann. tit. 8, § 144(a) (Repl. Vol. 1983) (finding no transaction voidable solely for reason of conflict of interest if the transaction is fair to the corporation).

9. Courts have also looked at whether the transaction was fair and reasonable. See In re Franklin Nat’l Bank Sec. Litig. v. Franklin Nat’l Bank, 2 B.R. 687, 707 (E.D.N.Y. 1979), aff’d, 633 F.2d 203 (2d Cir. 1980).

10. See Miller v. Miller, 222 N.W.2d 71, 78 (Minn. 1974) (acknowledging that directors cannot exploit their positions as insiders by appropriating business opportunities properly belonging to the corporation).

11. See generally Model Act, supra note 2, §§ 8.60-8.63, cmt. at 8-391.
or unless he knows that particular information is a matter of public record or is a matter of common knowledge. This presumption of a need for confidential treatment should apply regarding all current information concerning board or corporate activities. The importance of confidentiality cannot be overemphasized, not only because of financial exposure for both the corporation and the individual under the federal securities laws in the event of improper use of so-called "inside information," but also because of the potential for jeopardy to the enterprise in terms of competitive disadvantage.

2. Duty of Care

In addition to owing a duty of loyalty to the corporation, the corporate director also assumes a duty to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management. The Model Business Corporation Act sets forth the legal standard as follows:

[a] director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.14

The corporate director also has a responsibility to participate actively in the oversight of the enterprise's activities. Regular attendance at meetings of the board of directors and board committees is an obvious requirement for acceptable director performance. In preparation for such meetings, the corporate director should be furnished with appropriate information regarding every important matter requiring board actions; in every case, there should be available to the corporate director sufficient information furnished in time so as to permit an informed judgment. If for any reason sufficient information is not made appropriately available, the corporate director should request that action be delayed until the information is made available. If action is nonetheless taken, the corporate director should at a minimum request that his abstention, and reason therefor, be recorded in the minutes of the meeting. Under these circumstances, he should consider the need for his resignation.

Once documents are provided, the corporate director is expected to read the material distributed to members of the board. Depending upon the individual's role (e.g., committee membership or chairmanship), more detailed analysis may be required.


13. The corporation may become competitively disadvantaged; for example, if one of its directors disclosed new product developments and that information facilitated a competitor's introduction of a similar product.

14. MODEL ACT, supra note 2, § 8.30(a).
It is both permissible and expected that the corporate director will delegate to others (including a board committee) some functions traditionally associated with board activity; however, the delegator has a responsibility to keep informed as to the activities of the delegatee. The extent of this monitoring function (which is distinct from the ongoing monitoring of management’s performance) will vary depending upon the nature and importance of the delegation, and will be satisfied in the usual case by receipt of periodic reports concerning the activities of the delegatee.

3. Reliance

The Model Business Corporation Act expressly endorses the concept of reliance, and this codification of a somewhat diffused common law standard has been adopted or is under active consideration by a number of states:

In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person’s professional or expert competence; or
(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.15

The corporate director can make a valuable contribution through relevant inquiry and discussion of management’s proposals, and does not jeopardize the protection intended to be afforded to him if he complements the “input” on which he proposes to rely with questions and focused discussion. Moreover, recurring mechanical reliance without critical analysis could place in question the corporate director’s exercise of informed judgment.

4. The Business Judgment Rule

Recognizing that, consistent with the business corporation’s profit orientation, business judgment inevitably involves risk evaluation and assumption, and recognizing that the office of corporate director, as such, does not require full time commitment to the affairs of the enterprise, the corporate director frequently makes important decisions which may eventually prove to be erroneous. A director exercising his good faith judgment may be protected from liability to his corporation under the so-called “business judgment rule.”16 While not part of the statutory

15. Id. § 8.30(b).
16. See supra note 2.
framework, this legal concept is well established in the case law of most jurisdictions.\textsuperscript{17} When viewing the decisions of directors acting in the exercise of free and independent judgment, courts have been extremely reluctant to find that the directors acted negligently.\textsuperscript{18} Recognizing that business decisions may seem unrealistically simple when viewed with hindsight, and expressing reluctance to substitute their judgment for that of directors, courts have generally refrained from questioning the wisdom of board decisions.\textsuperscript{19} For the business judgment rule to apply, however, a director must have acted in good faith and with a reasonable basis for believing that the action authorized was in the lawful and legitimate furtherance of the corporation's purposes, and must have exercised his honest business judgment after due consideration of what he reasonably believed to be the relevant factors.\textsuperscript{20} The business judgment rule will not apply in situations where conflict of interest or other breaches of the duty of loyalty are present.\textsuperscript{21}

5. Indemnification

The Model Business Corporation Act sets out in detail the circumstances in which there can be indemnification of a corporate director made a party to litigation.\textsuperscript{22} Such a suit might be brought by the corporation or by a shareholder in the right of the corporation challenging the director's performance of duties as a director (commonly called a "derivative action"),\textsuperscript{23} or by a governmental agency or private party for a breach of contract, tortious conduct or violation of law (commonly called a "third party action").\textsuperscript{24} The Model Act provisions, which have been adopted by numerous states (including Delaware), give the corporation power to indemnify directors in third party actions against expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement of the action, and in derivative actions against expenses, including attorneys' fees.\textsuperscript{25}

The common standard for such indemnification is that the director must have acted in good faith and in a manner he reasonably believed to be in (or not opposed to) the best interests of the corporation\textsuperscript{26} and, if a criminal action or proceeding is involved, the director must also

\begin{itemize}
\item \textsuperscript{17} As of December 1, 1993, thirty-eight jurisdictions require that a director discharge his duties in good faith and with a stated standard of care. \textit{Model Act}, \textit{supra} note 2, § 8.30, cmt. at 8-175 to 8-176.
\item \textsuperscript{18} Instead, "director liability is predicated upon concepts of gross negligence." \textit{Smith v. Van Gorkom}, 488 A.2d 858, 873 (Del. 1985) (quoting \textit{Aronson v. Lewis}, 473 A.2d 805, 812 (Del. 1984)).
\item \textsuperscript{19} \textit{Paramount Communications, Inc. v. QVC Network, Inc.}, 637 A.2d 34 (Del. 1994) (finding court will not substitute its views for those of directors).
\item \textsuperscript{20} \textit{See Aronson}, 473 A.2d at 812.
\item \textsuperscript{21} \textit{See id.}
\item \textsuperscript{22} \textit{Model Act}, \textit{supra} note 2, § 8.51.
\item \textsuperscript{23} \textit{See, e.g.}, Blasband v. Rales, 971 F.2d 1034 (3d Cir. 1992).
\item \textsuperscript{24} \textit{See, e.g.}, Pestolite, Inc. v. Cordura Corp., 449 A.2d 263 (Del. Super. Ct. 1982).
\item \textsuperscript{25} \textit{Model Act}, \textit{supra} note 2, §§ 8.50(4)-(5), 8.51(d).
\item \textsuperscript{26} \textit{Id.} § 8.51(a)(1)(i), (ii)(A)(B).
\end{itemize}
have "had no reasonable cause to believe his conduct was unlawful." The indemnification for expenses is automatic if the director has been successful in the defense of any action, on the merits or otherwise. Indemnification is not mandatory under the customary bylaw provision where the director is not successful. If the director meets his duties of loyalty and care, however, it is likely that the standard of conduct required for indemnification will also be met. In the case of settlements or certain adverse court determinations in third party actions, indemnification is permitted upon a determination by an appropriate independent majority of directors or shareholders, or by independent legal counsel, that the director met the applicable standard of conduct.

It should be noted that the Securities Exchange Commission (SEC) has long held the position that indemnification of directors for liability under the 1933 Securities Act is contrary to public policy, and indemnification in these circumstances would in all likelihood be subject to prior judicial resolution of public policy considerations.

B. Management and Protection of Corporate Assets

Directors are charged with responsibility for the management and protection of corporate assets. This area of responsibility is governed principally by the laws of the state under which a corporation is formed. The statutes of most states specifically provide that the business of the corporation shall be managed by the board of directors and that directors are ultimately responsible to the stockholders who elect them for actions or omissions in connection with such management. The Foreign Corrupt Practices Act also charges directors with accountability for corporate assets. The assets of employee benefit plans are very significant assets for which directors also have responsibilities.

1. Foreign Corrupt Practices Act

Accountability for corporate assets is covered by the Securities Exchange Act of 1934 as amended by the Foreign Corrupt Practices Act of 1977 (FCPA). The FCPA not only prohibits bribing foreign officials and

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27. Id. § 8.51(a)(1)(iii).
28. Id. § 8.52.
29. Id. § 8.55.
31. See, e.g., Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970) (finding that the policies underlying the 1933 Securities Act render void an indemnification agreement to the extent that as applied it would cover fraudulent misconduct).
32. Model Act, supra note 2, § 8.01(b).
35. See infra text accompanying notes 46-47.
38. See supra note 34.
other persons in order to obtain business, but also imposes on United States companies the obligation to keep books, records and accounts which “in reasonable detail, accurately and fairly reflect the transactions and dispositions of” the company’s assets. The FCPA also requires that a United States company devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed consistent with management authorization; (ii) transactions are recorded as necessary both to permit the preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria and to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management’s general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

It seems reasonable to expect that the Commission, vested with responsibility for enforcement (along with the Department of Justice, to which it may recommend criminal prosecutions) of this authority under the 1934 Act, will proceed vigorously where it believes the FCPA has been violated as part of a scheme to conceal an improper payment or otherwise prevent the detection of misconduct within the corporation. It is important to note the SEC’s position (which has support in the legislative history of the FCPA) that it is not necessary to prove corrupt or criminal intent in order to bring an action to enjoin conduct which violated the FCPA.

Subsequent to enactment of the FCPA, the SEC adopted Regulation 13b-2 under the 1934 Act. Rule 13b2-1 prohibits any person from directly or indirectly falsifying or causing to be falsified “any book, record or account subject to Section 13(b)(2)(A)” of the 1934 Act. The SEC determined that although this Rule was not directed solely to the problem of questionable or illegal payments and practices, its adoption “should serve to discourage a repetition of the serious abuses the Commission has uncovered.” Rule 13b2-2 applies to officers and directors of the corporation and prohibits the making or causing to be made of “a materially false or misleading statement” or failing to state material facts to an accountant in connection with the audit of the corporation’s financial statements or the preparation or filing of any document or report required to be filed with the Commission. The Commission emphasized its belief that this Rule would “encourage careful and accurate

44. 17 C.F.R. § 240.13b2-1 (1994).
46. 17 C.F.R. § 13b2-2(a) (1994).
47. Id. § 13b2-2(b).
communications between auditors and the corporations from whom they request information” and that it was “intended to help restore the efficacy of the system of corporate accountability and to encourage boards of directors to exercise their authority to deal with the problem.”

2. Employee Benefit Plans

An important aspect of a director’s duties with respect to corporate assets is his fiduciary duty to beneficiaries under employee benefit plans sponsored by the corporation. Directors’ responsibilities in this area are governed by federal law, namely the Employee Retirement Income Securities Act of 1974 (ERISA). Section 404(a)(1)(B) of ERISA requires a fiduciary to discharge his or her duties “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

Overlapping the “prudent man” standard are two others: “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries” of the plan, and he must do this “for the exclusive purpose” of providing benefits to them.

Fiduciaries may not knowingly cause plans which they administer to enter into any of a number of prohibited transactions, including, with certain exceptions, the sale, exchange or leasing of property between the plan and a “party in interest” as defined (which term includes fiduciaries); the lending of money or other exchange of credit between the plan and a party in interest; and acquisition of securities or real property from the corporate employer in excess of certain specifically permitted limits.

Fiduciaries are also prohibited from dealing in plan assets for their own interest, acting in any transaction involving the plan on behalf of a party whose interests are adverse to those of the plan or its participants, or receiving any personal consideration from any party dealing with the plan in connection with a transaction involving the assets of the plan.

ERISA provides that any person breaching his or her fiduciary duties thereunder will be personally liable to make good any losses a plan incurs as a result of the breach. A fiduciary will also be liable for a breach of fiduciary duty by another fiduciary with respect to the same plan under circumstances including knowing participation in or knowing concealment of acts or omissions by other fiduciaries which are known to be a breach of duty. If a fiduciary has knowledge of a breach of duty

50. Id. § 1104(a)(1)(B).
51. Id. §§ 1104(a)(1), (a)(1)(A)(i). A fiduciary shall also discharge his duties for the purpose of “defraying reasonable expenses of administering the plan.” Id. § 1104(a)(1)(A(ii).
52. Id. § 1106(a)(1)(B).
53. Id. § 1107(a).
54. Id. § 1106(b).
55. Id. § 1109(a).
56. Id. § 1105(a)(1).
by another fiduciary, he must make reasonable efforts to remedy the breach. While ERISA does not permit exculpatory agreements to relieve a fiduciary of the personal liability decreed by the statute, an employer may purchase insurance to cover the potential liability of persons who act in a fiduciary capacity.

II. FEDERAL SECURITIES LAWS

The Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act") impose specific disclosure obligations on corporate directors and "controlling persons." Compliance with these two federal regulatory statutes, as well as with other statutes administered by the SEC, is essential in order to avoid penalties provided thereunder. Violation of federal securities laws may result in imposition of criminal penalties or civil injunctions against the corporation, with similar penalties, possibly including jail sentences, for its directors, officers and employees. Substantial damages may also be imposed. Under both the 1933 Act and the 1934 Act, persons who control a corporation will be liable jointly and severally to the same extent as the corporation. The controlling person may avoid liability under the 1933 Act by proving lack of awareness of the facts giving rise to the corporation's liability, and under the 1934 Act by proving good faith and lack of inducement of the conduct in question.

A. 1933 Act Registration Requirements

Under the 1933 Act, disclosure is accomplished by requiring registration every time a corporation sells its securities. Unless an exemption from the Act exists, the registration process must be followed. Significantly, the person asserting an exemption has the burden of proving his/her rights to rely on it. The 1933 Act imposes liability for participation in an illegal distribution of securities. If a corporation distributes securities through a registration statement which contains untrue statements or fails to make necessary statements, the directors of the corporation will be subject to suit by

57. Id. § 1105(a)(3).
58. Id. § 1131.
59. Id. § 1110.
61. Id. §§ 78a-7811.
62. See, e.g., id. § 78ff (criminal penalties under 1934 Act).
63. Id.
64. See, e.g., id. § 78t (discussing liability of controlling persons under 1934 Act).
65. Id. § 77o.
66. Id. § 78t.
67. Id. § 77e(c).
68. Id. § 77d.
69. See, e.g., SEC v. Murphy, 626 F.2d 633, 641 (9th Cir. 1980).
those persons who purchased the securities.\textsuperscript{71} Section 11 of the 1933 Act imposes liability upon directors who fail to demonstrate that they made a reasonable investigation (consistent with the individual's role and training) of the facts set forth in the registration statement.\textsuperscript{72} To this end, directors should have an opportunity to question management, the outside auditors and legal counsel as to the procedures followed to achieve adequate and accurate disclosure.

Section 12(2) of the 1933 Act imposes liability upon any person who negligently sells a security by means of a written offer to sell or an oral communication which includes an untrue statement or a half-truth.\textsuperscript{73} Under expanded definitions of the phrase "person who sells," a director could be included in the category of seller.\textsuperscript{74} As a result, a director who participates in the sale of his corporation's securities may be subject to liability for negligence in failing to assure that statements in selling documents are accurate.

Likewise, if a director participates with an issuer in an unregistered distribution of securities, he may, under the expanded definitions of the phrase "person who sells," be subject to liability for violation of section 12(1) of the 1933 Act, which grants remedies against a person who unlawfully offers or sells a security without registration.\textsuperscript{75}

All of the federal securities law restrictions which apply to the corporation's dealings with others and to its compliance with the federal securities laws generally also apply indirectly to those persons within the corporation who assist the corporation in its activities. These persons may violate the federal securities laws as participants, as controlling persons, or as aiders and abettors.\textsuperscript{76}

Although regulation of the initial distribution of securities is the primary thrust of the 1933 Act, it is important to recognize that disclosures are also required when a corporation or a controlling person undertakes to resell securities previously acquired.\textsuperscript{77} In such circumstances, the registration requirements apply to all shares sold by a corporation or by its controlling persons, and the shares must either be registered or an exemption from registration must be found. Significantly, a corporate director may, in certain circumstances, be regarded as a controlling person for this purpose.

\textsuperscript{71} Id. § 77k(a).
\textsuperscript{72} Id.
\textsuperscript{73} Id. § 77l.
\textsuperscript{76} See, e.g., id. (liability under section 11 of the 1933 Act attaches to directors); id. § 78t (controlling persons jointly and severally liable for violations of either section 11 or section 12 of the 1934 Act); THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 7.2, at 281 (2d ed. 1990) (finding that aiding and abetting liability generally applies to the securities acts).
\textsuperscript{77} These disclosures may be required because the controlling person fits within section 2(11)'s broad definition of underwriting, which includes persons who acquire securities with a view toward distribution. 15 U.S.C. § 77b(11) (1988).
B. Continuing Disclosure Requirements

The 1934 Act requires most publicly-owned corporations to file periodic reports with the SEC and to comply with the federal proxy rules. These include the filing of annual and quarterly reports (Forms 10-K and 10-Q, respectively) and reports upon the occurrence of specified events (Form 8-K); disclosure in connection with proxy statements and annual reports to shareholders; and the filing of reports in connection with tender offers and takeover bids. In addition to the formal disclosure requirements, the corporation has an ongoing duty to disclose to shareholders and investors, normally through press releases, all material events in a timely manner. In this connection, the SEC has expressed the view that a corporation violates the 1934 Act if it makes a positive press release but fails concurrently to reveal material adverse information (whether or not related to the disclosures made) about itself. The corporation may also be required to make certain disclosures when it purchases, or offers to purchase, significant amounts of its own securities or the securities of another corporation. Further, federal securities laws, as well as a number of state corporations laws, may impose various other constraints.

If a false or misleading statement in a periodic report or other document filed with the SEC affects the market price of a security, Section 18 of the 1934 Act makes any person who made or caused the statement to be made liable for damages to anyone who purchases or sells the security in reliance on the statement, unless the person sued proves that he "acted in good faith and had no knowledge that such statement was false or misleading." Section 18 applies only to periodic SEC reports and to proxy statements. In part because of the necessity for an investor to prove reliance upon a document filed with the Commission, instances of liability under Section 18 are rare.

More frequently, claims based on false and misleading statements in reports and other communications have been brought under the broader antifraud provisions of the 1934 Act. Rule 10b-5 states that it is unlawful for any person in connection with the purchase or sale of a security:

to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the

78. Id. §§ 78q, 78n.
79. See 17 C.F.R. §§ 240.13a-1 (annual reports); 240.13a-13 (quarterly reports); 240.13a-11 (special events); 240.14a-3 to -12 (proxy solicitations); 240.14d-1 to -103 (tender offers and takeover bids).
81. Id.
82. For example, section 13(d) of the 1934 Act requires any person who acquires more than five percent beneficial ownership interest in any class of equity securities subject to the Act's reporting requirements to file a statement of ownership with the SEC. 15 U.S.C. § 78m(d) (1988).
83. Id. § 78r(a).
84. See id.
light of the circumstances under which they are made, not misleading...\textsuperscript{86}

The antifraud provisions are not limited in their application to documents filed with the Commission. For example, the provisions cover statements in shareholder reports and press releases.\textsuperscript{87}

Although proxy statements are subject to the provisions of the 1934 Act that apply to false and misleading statements in filed documents\textsuperscript{88} and to the antifraud provisions that may apply to any communication,\textsuperscript{89} proxy statements are governed by separate provisions of the 1934 Act which have been interpreted to impose a higher standard of care than is applicable in some other contexts.\textsuperscript{90}

Rule 14a-9 under the 1934 Act provides that no solicitation shall be made by means of any proxy statement or other communication which shall contain a statement that,

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...\textsuperscript{91}

Guidance as to what constitutes a material fact in a proxy statement has been given by the Supreme Court in \textit{TSC Industries, Inc. v. Northway, Inc.}\textsuperscript{92} The general standard of materiality as set forth in that case is that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."\textsuperscript{93}

As a result of these provisions, it is extremely important for directors to ascertain that all reasonable efforts are made to assure that corporate publicity and reports are accurate and complete. Further, it is important that public disclosure of material developments be made on a timely basis when the information is reliable and appropriately verified, subject in certain limited cases to legitimate deferral in furtherance of a valid corporate purpose. To this end, directors should examine the procedures established for corporate publicity and reports, including the role of legal counsel and, in the case of financial information, the corporation's auditors, and should also consider the role and involvement of the directors and senior management in the process. Circumstances vary widely, and there can be no broadly prescribed procedures. While they should not be held responsible for personally verifying the accuracy of underlying

\textsuperscript{87} Timely Disclosure, \textit{supra} note 80.
\textsuperscript{88} Section 18(a) of the 1934 Act imposes liability on any person responsible for false or misleading statements in connection with documents required to be filed with the SEC. 15 U.S.C. § 78r(a) (1988).
\textsuperscript{89} 17 C.F.R. § 240.10b-5 (1992).
\textsuperscript{91} 17 C.F.R. § 240.14a-9(a) (1992).
\textsuperscript{92} 426 U.S. 438 (1976).
\textsuperscript{93} Id. at 449.
facts contained in corporate publicity and reports, the directors should be satisfied that the procedures in place are reasonably designed to assure that accuracy and completeness will be achieved.

C. The Williams Act

The so-called Williams Act provides of the 1934 Act require persons making tender offers or owning beneficially more than 5% of the outstanding stock of a corporation to file certain disclosure documents (on Form 13D) and to comply with other substantive requirements.

The determination of the beneficial ownership of securities in cases of complex corporate structures may sometimes be difficult. Section 13(d)(1) imposes disclosure requirements on a person who "directly or indirectly" acquires the "beneficial ownership" of more than 5% of a class of publicly traded equity securities. Securities Exchange Act Rule 13d-3 states:

a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:
(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,
(2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

Failure to file under Section 13(d) and (e) exposes the company and its directors to the possibility of an enforcement action by the SEC and to legal actions by the company's shareholders.

D. Insider Trading

The federal securities law also prohibits corporate insiders from purchasing or selling securities, either in the open market or in private transactions, without revealing all material information known to them about their corporation. The federal courts have stated clearly that insiders, including directors, who do not make adequate disclosures must refrain from entering into securities transactions.

Not only do the federal securities laws prohibit insiders from taking advantage of material nonpublic corporate information, but they prohibit them from giving tips—either by revealing nonpublic information to others

96. Id.
98. The SEC has been given wide investigatory and enforcement powers in the courts. See generally Thomas L. Hazen, Administrative Enforcement: An Evaluation of the Securities and Exchange Commissions' Use of Enforcement Techniques, 31 HASTINGS L.J. 427 (1979).
100. See Affiliated Ute Citizens v. United States, 406 U.S. 128, reh'g denied, 407 U.S. 916 (1972) (finding that rule 10b-5 bars insiders from engaging in purchases or sales of securities while in possession of material nonpublic information without making adequate disclosure).
for the purpose of assisting their trading activities or by making recommendations to buy or sell based upon such information.\textsuperscript{101} The federal securities laws also prohibit the receiver of tips, the "tippee," from acting on corporate inside information.\textsuperscript{102}

The prohibitions against trading based upon inside information raise concerns regarding directors' possible possession of material inside information. The corporation's management can be helpful in providing directors with guidance as to whether at any given time there is any material information concerning the corporation which is not public. Many corporations have developed procedures for directors to contact regular corporate counsel before trading, permitting each proposed transaction to be reviewed by counsel in the light of the current state of public information.

Section 16(a) of the Exchange Act requires beneficial owners of more than 10\% of a class of publicly traded equity securities, as well as officers and directors of corporations that issue such securities, to file reports with the SEC disclosing the amount of all classes of the issuer's securities that are so beneficially owned.\textsuperscript{103} Initial reports of beneficial ownership must be made on Form 3 within ten days after any person becomes the beneficial owner of 10\% or more of any class of equity security or becomes an officer or director.\textsuperscript{104} Statements of changes in ownership must be filed on Form 4 within ten days after the end of each month in which any change in beneficial ownership has occurred.\textsuperscript{105}

Section 16(b) of the Exchange Act allows the issuer, or any security holder suing on its behalf, to recover certain securities trading profits made by a stockholder owning more than 10\% of any class of its equity securities, or by any of its officers or directors.\textsuperscript{106} The profits recoverable from the above-described persons are those arising from any purchase and sale, or any sale and purchase, of any equity security of the company within a period of less than six months.\textsuperscript{107} To be liable, a beneficial owner must own at least 10\% of the stock at the time of both the purchase and the sale of the security involved.\textsuperscript{108}

Liability may unexpectedly result from the application of section 16(b), since the profit realized is determined by considering all of the individual's transactions within a six month period and matching them by taking the highest sale price and the lowest purchase price until all purchases and sales have been accounted for.\textsuperscript{109} Under this system, the highest sales price during a six month period is matched with the lowest purchase price during that period and each purchase and sale or sale and purchase

\begin{itemize}
  \item \textsuperscript{101} 15 U.S.C. § 78t-1 (1988).
  \item \textsuperscript{102} Id. § 78t(b).
  \item \textsuperscript{103} Id. § 78p(a).
  \item \textsuperscript{104} Id.
  \item \textsuperscript{105} See id.
  \item \textsuperscript{106} Id. § 78p(a).
  \item \textsuperscript{107} Id. § 78p(b).
  \item \textsuperscript{108} Id. § 78p(a).
  \item \textsuperscript{109} See Arrow Distrib. Corp. v. Baumgartner, 783 F.2d 1274 (5th Cir. 1986).
\end{itemize}
is then compared in order to compute "profit" in a manner so as to produce the greatest possible profit. As a result, it is possible for a beneficial owner or director to be liable to make payment to his corporation under section 16(b) even though he has not in fact made a profit.

1. Definition of Purchase or Sale

Section 16(b) has been broadly interpreted so that the terms "purchase" and "sale" may in certain circumstances include gifts, reclassifications, intercorporate transactions and pledges. Thus, a merger of the corporation with another corporation could be a sale or purchase transaction and could be matched with purchases and sales made six months before or after the merger.

2. Timing of Purchase

An individual may be subject to liability as a director for purchases or sales which occurred before becoming a director or after his status as a director terminates. Thus, if a director purchases (sells) shares of his corporation, resigns, and sells (purchases) those shares within six months after the purchase (sale), liability will be imposed for short swing profits.

Although Section 16(a) and Section 16(b) are based on beneficial ownership of securities, as is Section 13(d), the concepts of beneficial ownership under Section 13(d)(1) and Section 16 may be different. In an interpretive release, the SEC has stated:

The Commission has never specifically defined the term "beneficial ownership" for purposes of Section 16(a) of the Exchange Act. Rule 13d-3 [17 CFR 240.13d-3] under the Exchange Act sets out a very detailed definition of beneficial ownership for purposes of the reporting requirements under Section 13(d) and the Commission's tender offer rules. While the concepts of beneficial ownership under Section 16(a) and under Rule 13d-3 have much in common, the former stresses the economic benefit to be derived from the securities and the latter emphasizes the ability to control or influence the voting or disposition of the securities. As a result, different determinations of beneficial ownership under the section and rule are possible.

110. Id.

111. For example, although a gift generally is not subject to section 16(b), if a donee is the alter ego of the corporate insider and sells a security soon after receiving it as a gift, then the sale of such security may be attributed to the insider and thus trigger section 16(b) liability. See Truncale v. Blumberg, 80 F. Supp. 387, 391 (S.D.N.Y. 1948).

112. See Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970) (finding section 16(b) liability attached to director who resigned prior to a sale at a profit within six months of his purchase); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) (attaching section 16(b) liability to officer who became officer after his purchase but prior to sale within six months of purchase).

Whether an individual or corporate entity has the ability to "control or influence the voting or disposition of the securities" of a publicly-held U.S. company is a factual question which can only be answered after full discussion of all the pertinent facts with legal counsel.

III. GUIDELINES FOR PERFORMANCE OF DUTIES

The responsibilities of the individual corporate director have been outlined above. This section translates those responsibilities into more specific actions which directors might take in order to meet their legal responsibilities.

A. Corporate Management

As discussed above, the fundamental responsibility of the individual corporate director is to represent the interests of the shareholders as a group, as the owners of the enterprise, in directing the business and affairs of the corporation within the law. To this end directors should:

- review and confirm basic corporate objectives
- select competent senior executives and monitor personnel policies and procedures with a view to assuring that the enterprise is provided with other competent managers in the future
- review the performance of the senior managers thus selected and monitor the performance of the enterprise.

Under the Model Business Corporation Act, the individual corporate director, together with his fellow directors, is also required or authorized to:

- adopt or change bylaws
- approve amendments to the articles of incorporation (subject to shareholder approval)
- cancel reacquired shares
- allocate to capital surplus consideration received for shares without par value
- change the registered office or registered agent
- approve any plan of merger or consolidation (subject to shareholder approval)
- recommend dissolution
- declare dividends
- elect corporate officers
- call special meetings of the shareholders114

In addition, each corporate director should be concerned that appropriate board attention is given to material transactions affecting the assets of the enterprise, such as those involving the issuance or reacquisition of

114. See Model Act, supra note 2, §§ 2.06 (adopt bylaws); 10.03 (approve amendments); 6.31 (acquire shares); 6.40(2a-c) (shareholder distribution rules); 5.02 (change of office or agent); 11.01 (approve merger plan); 14.02 (recommend dissolution); 6.40(1a) (declare dividends); 8.40 (elect officers); 7.02 (call special meetings).
its securities or indebtedness, capital investment, business acquisitions or dispositions or other new business activities.

The corporate director should be concerned that the enterprise's principal disclosure documents, such as prospectuses, proxy statements and annual reports to shareholders, are complete and accurate. While the individual should read such documents carefully for possible errors or omissions of which he may have personal knowledge, his primary responsibility is to be satisfied that procedures being followed are likely to result in completeness and accuracy in the preparation of these disclosure documents, including the opportunity for their review by the corporation's auditors and legal counsel. Questions that the individual director may have regarding the adequacy of disclosure should be pursued by him until satisfactorily resolved, and he should familiarize (and satisfy) himself concerning the procedures established for authorization, review and clearance of both disclosure documents and important press releases.

In exercising his duties, it is important that the corporate director avoid taking an adversarial attitude in his relationship with management. However, in those special cases where actual or potential conflicts of interest involving management or those advising management are presented, it has been appropriately suggested that "[a] healthy skepticism and a bias toward seeking outside advice are useful attitudes for the outside director . . . ."\(^{115}\)

If a corporate director has reservations concerning a proposed course of action, he has a duty to express them to both management and his fellow directors. If he disagrees with any action taken by the board having significant implications or consequences, he should vote against the proposal and request that his dissent, and reasons therefor, be recorded in the minutes of the meeting.\(^{116}\) Genuine disagreement regarding a particular proposal normally should not cause him to consider resigning.

B. Information Flow

The corporate director should be concerned with the establishment and maintenance of an effective reporting system. The information flow from management to members of the board should encompass:

- internal financial statements, structured in a way that presents a meaningful breakdown of the enterprise's activities and summarized in a way that permits ready comprehension and reasonable analysis
- periodic briefing by senior executives concerning developments affecting the business and affairs of the enterprise; in some cases, this dimension of reporting will be effectively accomplished by a memorandum from the chief executive officer distributed to the board members in advance of each meeting


\(^{116}\) *See Model Act*, supra note 2, § 8.24(d).
forward planning, including crucial issues facing the enterprise and new directions appropriate for board consideration in the context of corporate policy.

Aside from direct communications from the chief executive officer and the chief financial officer, the corporate secretary frequently serves as the regular channel of communication to directors on corporate matters. The adequacy of the information provided to directors should be reviewed from time to time.

The corporate director should also obtain, to the extent available, information materials available from outside sources, such as research analyses by investment firms and business publication materials, dealing with not only the enterprise but also with its competitors and trade association advisory reports.

The corporate director should feel that he is sufficiently informed about a proposal so that he can explain a vote for or against it. If he believes that adequate information is not being provided for such purposes and is unsuccessful in his efforts to remedy the situation, he should consider resigning.

C. Legal Compliance and Assistance

The corporate director should be concerned that the corporation has programs looking toward compliance with applicable laws and regulations, both foreign and domestic; that it circulates (as appropriate) policy statements to this effect to its employees; and that it maintains procedures for monitoring such compliance. In order to facilitate the corporation's compliance with the law, it is desirable that regular corporate counsel have appropriate access to the board of directors; that the corporation be supplied with legal services adequate to assure that its policies will be implemented; and that all lawyers rendering legal services for the corporation have a direct channel of communication to regular corporate counsel so as to assure that failures of compliance will be promptly brought to his attention and, in appropriate cases, by regular corporate counsel to the chief executive officer, in order to permit corrective steps to be taken. Not only will adequate legal services contribute to the implementation of a corporation's legal compliance policies, but it is more likely that a corporation's public disclosure obligations in regard to legal problems will be appropriately discharged.

Directors should ask to be advised concerning any special legal compliance problems, such as court orders imposing continuing restrictions on operations or higher standards of conduct in particular areas. Examples would include an antitrust consent decree restricting the corporation's marketing practices for certain products or prohibiting acquisitions in certain markets, or a consent decree directed toward future compliance with disclosure responsibilities under the federal securities laws. The director's inquiry should be as to the existence of mechanisms that will cause the corporation to observe such special legal requirements.

There may be occasions when there is need for the corporate director to have outside advice. The director should be assured that, in appropriate
circumstances, he (alone or together with fellow directors) has a direct channel of communication with the enterprise's principal advisors, including its auditors, its regular corporate counsel and, when such a relationship exists, its investment banking advisors and its executive compensation counselors. Further, there may be occasions when an outside advisor should be specially retained to assist the board or a committee in connection with a particular matter. The need for outside advice should be infrequent, arising most often in the unusual or corporate crisis situation.

D. Disclosure and Confidentiality

The discussion of federal securities laws above deals principally with SEC requirements for filing disclosure documents. Additionally, if a material event occurs, it should be reported promptly to investors generally, although courts have recognized that a variety of proper business purposes will justify a delay in disclosure. Typically, such public disclosure is accomplished through a press release. Occasionally the releases are mailed directly to shareholders, in addition to distribution through other financial information channels. Certain developments are appropriate for public disclosure, but may not be so critical as to make an immediate press release appropriate. These items can be communicated as part of the quarterly earnings reports.

Press releases must avoid misstatements or material omissions. A high degree of accuracy, completeness and balance between positive and negative factors is required. There is no room for the degree of puffing in financial disclosures which would be acceptable in general commercial advertising or other areas of commercial communication.

In this connection directors should make sure that the corporation adopts internal procedures regarding disclosures to the financial community. The corporation should be certain that material information is disclosed on a timely basis when appropriate, and also that there are no leaks or inadvertent disclosures when release of information is inappropriate. There should be clear lines of authority and responsibility within the corporation, with a limited number of persons authorized to deal with the financial community. All employees should be alerted to these basic principles, including particularly the obligations to maintain the confidentiality of undisclosed material information and to refrain from trading while privy to such information.

As a corollary of the foregoing, it is essential that the confidentiality of material information be strictly maintained by all persons who may have access to that information, regardless of title or position. A public company normally has some degree of discretion in determining when

117. Preliminary acquisition negotiations, for example, need not be disclosed until an agreement has been reached as to the transaction's structure and price. See Flamm v. Eberstadt, 814 F.2d 1169, 1177 (7th Cir.). cert. denied, 484 U.S. 853 (1987) (finding preliminary acquisition negotiations nonmaterial).
an event is ripe for public disclosure, assuming no leaks. A reasonable standard, consistently applied for affirmative as well as negative information, usually will avoid difficulties. However, there are certain circumstances where a company's hand may be forced and good practices will require a disclosure—for example, where there has been a leak of information or where rumors are circulating in the financial community. Care should be taken to prevent these circumstances.

E. Director's Role in Selected Circumstances

1. Financial Audits

The proper conduct of the financial audit bears directly upon directors' personal exposure to liability as well as upon the financial welfare of the corporation and its shareholders. Audited financial statements lie at the heart of the annual report to shareholders required of all publicly-held business corporations, as well as of annual reports and registration statements filed with the SEC. As discussed above, a person will be exposed to legal liability under the federal securities laws if he or she shall "make or cause to be made" any statement that is "false or misleading with respect to a material fact" in a report filed under the 1934 Act. As for audited financial statements in 1933 Act registration statements, directors probably would be among those called upon to defend themselves in the event of a claim that the financial statements were false or misleading. The directors would then bear the burden of proving that they "had no reasonable ground to believe and did not believe" that the financial statements were false or misleading.

The independence of the auditor is central to the function of the financial audit. The auditor's independence in fact, in the sense of freedom from management influence, is in turn a matter about which the board of directors needs to be assured. To perform this task, the board of directors often forms an audit committee.

A principal function of the independent audit committee is to protect the auditors from undue management influence by serving as a communications link between the independent auditors (as well as the corporation's internal audit staff) and the board of directors. In the SEC's view the review of an audit by the audit committee should cover the following in addition to the auditor's report or opinion:

- the auditor's perception of the corporation's financial and accounting personnel;

118. See, e.g., 1934 Act, supra note 37, § 78n(c); 17 C.F.R. § 240.14c-3(1) (1981); 1933 Act, supra note 30, Schedule A, Items 25, 26.
120. Id. § 77k(b)(3).
121. See MODEL ACT, supra note 2, § 8.25(a) (authorizing board of directors to create committees and appoint members).
122. See generally id. § 8.25, cmt. at 8-146 (finding audit committees perform vital review and control functions).
- the cooperation they received during the audit;
- the extent to which the corporation's resources were and should be used to minimize the time spent;
- any significant transactions not a normal part of the corporation's business;
- any changes in accounting principles and practices;
- any significant proposed adjustments; and
- any recommendations the auditors may have for improving internal accounting controls, choice of accounting principles, or management systems.123

In practice the audit committee's review should include review, before publication, of the financial statements themselves.

2. Acquisitions and Mergers

Three fundamental questions arise in merger transactions: (1) should management have the exclusive role in framing the merger; (2) to what extent can the director rely upon the management's presentation of the facts of the merger proposal; and (3) can a director conscientiously vote for the transaction if he or she thinks the proposal is merely within reason, as opposed to one that coincides precisely with the director's personal view of the transaction. Professors Leech and Mundheim, who pose these questions in assessing the outside directors' role in mergers, suggest that the answer to each depends upon the degree to which the directors have reason to believe that management's interests may diverge from those of the shareholders.124

Directors seeking to satisfy themselves as to the desirability of a merger will want to direct their attention to the following matters:

- Does the merger make substantive, long-term good sense for the company?
- Are there special factors (such as those referred to in the preceding paragraph) that may cause management's judgment to be skewed in the particular case?
- How successful have been management's prior experiences in evaluating and acquiring companies and in securing the expected benefits of such acquisitions?
- Is there a determination, based on articulated standards, of the cash worth of the company being acquired (including a justification for any premium over market value)?125

The director's fiduciary duties to the corporation include the duty to act honestly and fairly when acquisition proposals are made to the

corporation or its shareholders. Directors presented with acquisition proposals have the duty to exercise independent judgment in evaluating the proposal and in making a recommendation to shareholders. The question of performing or breaching these fiduciary duties is presented, along with other legal issues, whenever the board of directors authorizes the use of corporate funds to conduct a proxy contest or to defend against a tender offer. The issue involved is easily stated: whether the expenditures were made and other actions were taken in the interest of furthering some legitimate corporate purpose, or were intended solely or primarily to enable management to perpetuate itself in office.

3. Management Compensation

The legal issue involved in management compensation is basically the fairness of the compensation. Generally, the directors have the exclusive right to determine the value of services rendered by the executive officers, and the directors' decision as to the amount is final if made as result of a good faith exercise of honest business judgment. Under familiar principles, a decision based upon the directors' self-interest or involving some breach of trust would not be protected. The protection of the business judgment rule may also be dissolved when the amount of compensation (in the form of salaries or bonuses or both) is so large as to amount to a waste of corporate assets.

Novel arrangements such as severance payments linked to changes in control of the employer corporation in some cases involve very large amounts; legal challenges which are just beginning to move through the courts may result in developments in the law governing management compensation.

Guidelines to assure that directors' decisions relating to management compensation are soundly based, and demonstrably so, are as follows:

- create compensation plans that work on the basis of relevant business factors and are consistent with the long-term interests of the corporation - e.g., compensation practices that do not encourage maximization of short-term profit at the expense of longer-term growth;
- review any variable compensation plan continually to see that it operates fairly and objectively;
- periodically scrutinize any bonus plan as to philosophy and application - e.g., make an effort to confine it to management personnel whose effect on the corporation is measurable and upon whose performance the incentive is measurable;

126. These duties are derived from the director's general duty of care found in Model Act, supra note 2, § 8.30.
128. See Pogistin v. Rice, 480 A.2d 619, 626 (Del. 1984) (stating that challenges to compensation plans must allege that compensation was "so devoid of a legitimate corporate purpose as to be a waste of assets").
- take steps to reform any compensation plan that begins to yield amounts not reasonably related to executive performance;
- have financial calculations under incentive compensation plans reviewed by independent accountants;
- obtain advice from independent counsel when questions arise concerning compensation arrangements as to which inside counsel has a personal interest.\textsuperscript{129}

CONCLUSION

This article is a general summary and outline of some very complex legal principles and requirements. It necessarily omits details, refinements and exceptions which would be pertinent in the legal analysis of a particular issue and therefore should not be used in the place of legal advice in taking specific actions.

\textsuperscript{129} See generally Leech & Mundheim, \textit{supra} note 115, at 1823.