Vanderbilt Law Review

Volume 33
Issue 5 *Issue 5 - October 1980*

Article 4

10-1980

Liability of Directors Under the Federal Securities Code

Thomas D. Washburne, Jr.

NOTE

Liability of Directors Under the Federal Securities Code

I. INTRODUCTION

In 1978, Reporter Louis Loss presented the Proposed Official Draft of the Federal Securities Code [Code][1] to the fifty-fifth annual meeting of the American Law Institute for approval by the membership.[2] The Code—the product of nine years of work by the Reporter and the Consultants[3]—is a comprehensive regulatory package proposed as a replacement for the confusing array of statutes and rules that currently regulate securities.[4] Although intended as a codification of existing law and strongly influenced by it, the Code differs substantially in several substantive areas from the current scheme.[5] Perhaps the most significant change effected by the Code is the shift in emphasis away from the current registration requirements of the Securities Act of 1933 [1933 Act]. Instead of the registration of each offering of a security via a separate registration statement, the Code substitutes a single initial registration of companies followed by the registrant's periodic disclosures in order to provide investors with continuous current information.[6] To support this change, the Reporter proposed that civil

---

1. ALI FED. SEC. CODE (Proposed Official Draft, 1978) [hereinafter cited as 1978 Draft].

2. The Code is expected to be introduced in Congress in the fall of 1980. 558 SEC. REG. & L. REP. (BNA) A-1 (1980).

3. 55 ALI PROCEEDINGS 333 (1978) (remarks of Professor Louis Loss).

4. Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code*, 30 VAND. L. REV. 327, 329-30 (1977); Loss, *Introduction: The Federal Securities Code—Its Purpose, Plan, and Progress*, 30 VAND. L. REV. 315, 315-19 (1977).

5. *See generally* W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE (1979); ABA Committee on Federal Regulation of Securities, *ALI Proposed Federal Securities Code*, 34 BUS. LAW. 345 (1978); Lowenfels, *The Case Against the Proposed Federal Securities Code*, 65 VA. L. REV. 615 (1979); *Symposium: The American Law Institute's Proposed Federal Securities Code* (pt. 1), 30 VAND. L. REV. 311 (1977); *Symposium: The American Law Institute's Proposed Federal Securities Code* (pt. 2), 32 VAND. L. REV. 455 (1979).

6. Loss, *supra* note 4, at 321. The Code requires registered companies to file and send to all registered shareholders annual and quarterly reports as required by the Securities and Exchange Commission [hereinafter referred to as the SEC]. 1978 Draft, *supra* note 1, § 602.

liability provisions similar to those in effect under section 11 of the 1933 Act accompany the reporting requirements of the Code. Under section 1704 of the proposed Code, the registrant, its officers, its directors, and participating experts are jointly and severally liable for misrepresentations or mistakes of material fact in the periodic reports.[7] Any person who purchased a security of the registrant after the statement was filed or became effective has standing to sue under section 1704.[8] The section also adopts the so-called due diligence requirement of section 11 by allowing a defendant to avoid liability only by proving that, after a reasonable investigation, he reasonably believed the veracity of the registration statements.[9] In denying the defendant the defense of good faith and imposing upon him the additional burden of proving the plaintiff's knowledge of the defect or failure to rely on the statement, the Code imposes a negligence standard of liability that approaches strict liability.[10] Although section 11 of the 1933 Act provides the basis for section 1704,[11] the new section extends liability well beyond the scope of the present section. As the Note to section 1704 acknowledges, "[t]here is an inevitable tension between [section] 11's affirmative duty of registration as applied on an occasional 'one-shot' basis to a registration statement and the idea of continuous disclosure."[12] Unquestionably, the greatly expanded scope of the disclosure requirements proposed in section 1704 would be a significant step in the evolution of securities regulation.

When the membership of the American Law Institute [ALI] turned to consider section 1704, the debate on the merits of the provision proved to be particularly divisive.[13] The vote on the issue, ninety-five to ninety-four in favor of retaining the section as drafted,[14] was the closest that Professor Wechsler could recall in his sixteen years as director of the ALI.[15] In view of the closeness of the vote, Reporter Loss offered a compromise position excluding outside directors from the scope of section 1704 and its burdensome due diligence standard. He proposed placing them instead

---

7. 1978 Draft, *supra* note 1, § 1704(b). *See* note 144 *infra* and accompanying text.
8. 1978 Draft, *supra* note 1, § 1704(c).
9. *Id.* § 1704(f) and (g). *See* notes 151, 153-55 *infra* and accompanying text.
10. 55 ALI PROCEEDINGS 347 (remarks of Reporter Louis Loss).
11. *Id.* at 347-48.
12. 1978 Draft, *supra* note 1, § 1704 Note (1) at 571.
13. *See, e.g.*, 55 ALI PROCEEDINGS 347 (remarks of Dean David Ruder and of Professor Homer Kripke).
14. *Id.* at 376.
15. *Id.* at 464 (remarks of Director Wechsler).

within section 1705,[16] which imposes liability only for misrepresentations made with scienter.[17] Although the membership at the 1978 meeting agreed to present the Code to Congress as drafted with the compromise in brackets, the continued debate over the form of the presentation[18] persuaded the Reporter to withdraw the liability issue from the Code entirely. At the 1979 meeting, Reporter Loss stated that "[c]ivil liability has been the only issue in the Code that has split consultants, advisers, the ABA Committee [on Federal Regulation of Securities], and this House."[19] He therefore requested that the ALI present the Code to Congress without advocating any standard of liability for misleading statements or omissions in periodic reports. The membership agreed, and the Code will present several suggested alternatives without intimating that any one is preferable.[20]

In striking contrast to the attention that the liability formula in sections 1704 and 1705 received, section 1724, the provision on contribution and indemnification,[21] passed unnoticed.[22] Of necessity, however, the treatment of contribution and indemnification relates directly to the practical impact of any liability provision. Although the lack of attention is probably attributable to the fact that the Code, which is intended primarily as a codification, does

---

16. *Id.* at 402-03 (remarks of Reporter Louis Loss).

17. 1978 Draft, *supra* note 1, § 1705(a). *See* notes 159-61 *infra* and accompanying text.

18. 504 Sec. Reg. & L. Rep. (BNA) A-9 (1979). *See, e.g.,* Remarks of Professor Loss and Dean Ruder, Meeting of the ABA Committee on Federal Regulation of Securities, Chicago, Ill. (Oct. 13, 1978), *summarized in* Minutes of the Meeting 28-29 (1978).

19. 504 Sec. Reg. & L. Rep. (BNA) A-9 (1979).

20. *Id.* During the summer and into the fall of 1980, however, there were ongoing discussions between Reporter Loss, other members of the ALI, and the staff of the SEC with a view toward reaching compromise positions on certain aspects of the proposed Code. On September 18, 1980 the SEC, in SEC Release No. 33-6242, announced its support for the proposed Code as revised to incorporate certain compromises. *See* 571 Sec. Reg. & L. Rep. (BNA) A-1 (1980). Some of these compromises affect the civil liability provisions of the Code. It is not clear at this time, however, whether any compromises reached will be presented to the ALI for a formal vote or will simply he sent to Congress in the fall for consideration along with the current reading of the Code.

As understood, one compromise affects §§ 1704(a), 1705(a)(I), and 1705(f) concerning civil liability for the filing of annual "10-K" reports. These proposals reflect a compromise of the question whether civil liability with respect to the "10-K" report should be governed by § 1704 or § 1705. Under the compromise, the "10-K" is subjected, in effect, to § 1704-type liability so far as persons liable and defendant's burden of proof are concerned, but to § 1705-type liability to the extent that the defendant's burden of proof is satisfied if he establishes only lack of scienter rather than lack of due care as in § 1704.

21. 1978 Draft, *supra* note 1, § 1724(d)-(f). *See* notes 181-86 *infra* and accompanying text.

22. 55 ALI Proceedings 759 (1978) (Index to discussion of 1978 Draft sections).

little to disturb the status quo in the area of contribution and indemnification, the oversight is unfortunate. It is the thesis of this Note that, had the membership focused on indemnification and contribution, it could have arrived at a satisfactory compromise on director liability under section 1704 while improving the Code's treatment of indemnification and contribution. Furthermore, if the objective of section 1704 liability is to achieve an in terrorem effect, it is internally inconsistent not to harmonize that section with the liability shifting effect of contribution and indemnification.[23]

II. Background

A. *Securities Act of 1933*

Section 11 of the 1933 Act, modeled on the British Companies Act of 1924, was also the focus of considerable disagreement about the wisdom of imposing burdensome obligations and sanctions on officers and directors.[24] The Companies Act is, in effect, the father of section 11 and the grandfather of section 1704 of the proposed Federal Securities Code. Originally enacted as the English Director's Liability Act of 1890, the Companies Act required disclosure as a mechanism to protect investors.[25] Although similar to section 11 in many respects, the British Act did not impose liability on experts and did not permit the plaintiff to recover without affirmatively proving reliance.[26] Notwithstanding the fact that the Companies Act standards had satisfied the British investment community for over forty years, American businessmen considered its offspring, the 1933 Act, "terrifying."[27] Perhaps this fear was attrib-

---

23. Commentators have long recognized that the liability provisions of the federal securities laws are imposed primarily for their in terrorem effect. *See* Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 Va. L. Rev. 776, 809 (1972); Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 173 (1933); Shulman, *Civil Liabilities and the Securities Act*, 43 Yale L.J. 227, 227 (1933); Note, *The Role of Contribution in Determining Underwriters' Liability Under Section 11 of the Securities Act of 1933*, 63 Va. L. Rev. 79, 81 (1977).

24. 3 L. Loss, Securities Regulation 1684 (2d ed. 1961 & Supp. 1969) (citing Douglas & Bates, *supra* note 19, at 171); Ballantine, *Amending the Federal Securities Act*, 20 A.B.A. J. 85 (1934); Dean, *The Federal Securities Act: I*, Fortune, Aug. 1933, at 50; Seligman, *Amend The Federal Securities Act*, Atlantic Monthly, Mar. 1934, at 370.

25. Folk, *Civil Liabilities Under the Federal Securities Acts: The* BarChris *Case* (pt. 1), 55 Va. L. Rev. 1, 14 (1969). The English Directors' Liability Act of 1890, 53 & 54 VICT., c. 64, § 3 (1890), was passed in response to the inequitable result in a securities fraud case, Derry v. Peek, 14 App. Cas. 337 (1889), decided the preceeding year. Folk, *supra* this note, at 14.

26. *Id.*

27. 78 Cong. Rec. 8669 (1934), *cited in* Folk, *supra* note 25, at 19 n.117.

utable to the absence of a reliance requirement for recovery under the Act, but it probably stemmed from the tremendous change that the Act effected in the prevalent laissez-faire attitude of the 1920's.

Section 5 of the 1933 Act requires an issuer of securities to provide a prospectus detailing information regarding the security and the issuer.[28] Congress felt that the prospectus would provide a prospective purchaser of securities with a source of information that would enable him to make an intelligent decision whether to purchase.[29] To provide an enforcement mechanism for insuring accurate disclosure, the Act grants a private right of action in section 11 to persons who purchased securities based on a false and misleading statement in the prospectus. Section 11(a) imposes liability on the following: first, every person who signed the registration statement, including the issuer, its principal officer or officers, its principal financial officer, its comptroller or principal accounting officer, and the majority of its board of directors;[30] second, every person who was a director when the defective material was filed with the Securities and Exchange Commission [Commission]; third, every person who consented to nomination for directorship; fourth, every expert, such as an accountant or engineer, whose expert opinion was contained in the statement with his consent; and last, every underwriter of the security.[31] The Act, as originally passed, imposed liability on these persons, regardless of reliance by the plaintiff or causation, unless the defendant proved that the plaintiff knew of the defect when he purchased the security.[32] Furthermore, the statute of limitations permitted actions to be instituted for two years from the date the plaintiff discovered or should have discovered the defective prospectus, up to ten years from the date of sale.[33] Thus, for a period of ten years, a director risked liability to any purchaser regardless of whether the mistake or omission actually influenced the purchaser's decision to buy.[34] A director could successfully defend only by showing that he had made a reasonable investigation that led him to reasonably believe in the accuracy and completeness of the statements or that, either

28. 15 U.S.C. § 77e (1976).
29. 1 L. Loss, *supra* note 24, at 121-28.
30. Securities Act of 1933 § 6(a), 15 U.S.C. § 77f(a) (1976).
31. Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1976).
32. 3 L. Loss, *supra* note 24, at 1724-25.
33. *Id.* at 1743.
34. Dooley, *supra* note 23, at 802.

prior to or upon discovering the defect in the statement, he had disassociated himself from the issuer and advised the Commission.[35] The standard of care necessary to satisfy the reasonable investigation defense under the original 1933 Act was that required of a fiduciary.[36]

The liability provisions of the 1933 Act met with heavy criticism in the business community. Amidst allegations that it was inhibiting new offerings and that it was partly responsible for the failure of the stock market to recover from the 1929 crash, Congress, as part of the Securities Exchange Act of 1934 [1934 Act], amended section 11.[37] The amendments reduced the statute of limitations for a section 11 cause of action under the 1933 Act from two and ten years to one and three years.[38] The 1934 Act also added a provision requiring section 11 plaintiffs who purchased more than a year after the initial offering to prove reliance if the issuer made an earnings statement covering a period of at least a year following the effective date generally available.[39] Finally, the amendments decreased the standard of care necessary to satisfy the reasonable investigation defense for directors by substituting a "prudent man in the management of his own property" standard in place of the original fiduciary care language.[40] Although the amendments were undoubtedly a meaningful concession to the business interests opposing the liability provisions of the 1933 Act, the retreat was quite restricted. Even after the amendments, directors remained exposed to broad liability for failure to diligently review a prospectus.[41]

Despite this expansive exposure to liability, the number of cases brought under section 11 has been surprisingly limited. In his 1961 treatise, Professor Loss noted that, despite charges that the section would "stifle legitimate financing,"[42] it had produced only two reported recoveries in nearly twenty-eight years.[43] Although

---

35. 3 L. Loss, *supra* note 24, at 1724.

36. Hanna, *The Securities Act of 1934,* 23 Calif. L. Rev. 1, 7 (1934).

37. Dooley, *supra* note 23, at 805.

38. 3 L. Loss, *supra* note 24, at 1742.

39. *Id.* at 1725; Hanna, *supra* note 36, at 7.

40. Hanna, *supra* note 36, at 7.

41. *See* text accompanying notes 46-71 *infra.*

42. 3 L. Loss, *supra* note 24, at 1721.

43. The reasons for this are probably threefold. First, the statute of limitations is quite short. Second, many cases are settled out of court. Last, rule 10b-5 has provided many plaintiffs with an alternative cause of action.

section 11 actions have become more frequent in recent years,[44] apparently only two reported decisions have imposed liability on directors under section 11—*Escott v. BarChris Construction Corp.*[45] and *Feit v. Leasco Data Processing Equipment Co.*[46]

BarChris arose from the sale of debentures pursuant to a misleading registration statement by a bowling alley construction corporation that defaulted on the debentures and went bankrupt a year later.[47] The purchasers of the debentures, asserting that the registration statement contained material omissions and false statements, sued the issuer, its officers and directors, the underwriters, and the auditors.[48] Of the nine directors sued, five were BarChris officers, one was its outside counsel, another was a partner in the lead underwriting firm, and two were otherwise unconnected with BarChris.[49] Each director asserted that he had fulfilled his obligation to conduct a reasonable investigation and therefore was absolved from liability under section 11.[50] The court, in con-

44. *See* 7 L. Loss, Securities Regulation 3823-24 (Supp. 1969) (citing 17 section 11 actions between 1961 and 1969). *See also* Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of* BarChris *and* Globus, 24 Bus. Law. 681 (1969).

45. 283 F. Supp. 643 (S.D.N.Y. 1968).

46. 332 F. Supp. 544 (E.D.N.Y. 1971).

47. In the late 1950s bowling experienced a dramatic increase in popularity, affording BarChris a spectacular increase in its bowling alley construction business. BarChris had traditionally played a central role in financing the construction of each facility. The debenture issue arose because this assumption of the construction finance burden by BarChris created a great need for additional capital. The issue became effective in May 1961 and, shortly thereafter, the bottom fell out of the bowling market. Faced with declining sales and customer defaults, BarChris defaulted on the debentures and filed for bankruptcy a year later. 283 F. Supp. at 653-54.

48. Plaintiffs sued exclusively under section 11(a) of the Securities Act of 1933, 15 U.S.C. § 77k(a) (1976).

49. The five officers were Vitolo, the president; Russo, the executive vice president; Pugliese, the vice president; Kircher, the treasurer; and Birnbaum, the secretary. Birnbaum also served as BarChris' in-house counsel. The outside counsel to BarChris was Grant, a member of the firm of Perkins, Daniels, McCormack & Collins. Defendant Coleman was a partner in Drexel & Co., the lead underwriter and also a defendant. The two outside directors were defendants Auslander and Rose. Auslander, chairman of a local bank, had been led to believe that the directorship would result in substantial deposits by BarChris in his bank. Rose was a civil engineer who had worked on BarChris' books as an employee of its auditor. Other defendants in the suit were the auditor, Peat, Marwick, Mitchell & Co., and the seven other members of the underwriting group. *Id.* at 652, 687, 689.

50. Section 11(b)(3) provides a defense with respect to any part of the registration statement not made by or based on an expert's evaluation if the defendant can prove 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 misleading. . . ." This affirmative

sidering the due diligence defense of each director, appeared to hold the directors to different levels of diligence depending upon their position and responsibilities.[51]

In discussing the officer-directors, the court held the chief executive officer, the two founder-directors, and the chief financial officer to a standard of care approximating strict liability. The court stated that, because of their positions of great responsibility, these directors could not assert an inability to discover the deficiencies even if they had conducted a reasonable investigation.[52] With respect to the comptroller, a nondirector signer of the registration statement, the court implied that he had a lighter overall burden in proving due diligence because of his limited management role.[53] Despite this lower standard, the court found that the comptroller failed to prove a reasonable belief in the validity of the audit, a function of the corporation with which he was thoroughly familiar.[54] The court also apparently held BarChris' in-house counsel, a young, inexperienced attorney, to a lesser degree of care than those with more responsibility despite his position as a director.[55] The court imposed liability, however, observing that he had attended all of the directors' meetings and thus should have been on notice that the registration statement was not entirely complete and accurate.[56] The court imposed a similar, if not higher, standard of care on BarChris' outside counsel, the director who prepared the registration statement. Even though it expected the in-house counsel to be more aware of BarChris affairs than his outside counterpart, the court suggested that, because of his central role in preparing the registration statement, the outside attorney as a director should have undertaken a more affirmative investigation.[57] In light of the circumstances, the court concluded that the director failed to satisfy the standard of reasonable investigation and was therefore liable. Similarly, the court held the under-

---

defense is known as the "due diligence" defense.

51. The court rejected the suggestion that the limited education or intelligence of certain defendants should mitigate their liability. The court observed, "Vitolo and Pugliese are each men of limited education. It is not hard to believe that for them the prospectus was difficult reading, if indeed they read it at all. But whether it was or was not is irrelevant. The liability of a director who signs a registration statement does not depend upon whether or not he read it, or if he did, whether he understood what he was reading." *Id.* at 684.

52. *Id.* at 684-85.

53. *Id.* at 685-86.

54. *Id.*

55. *Id.* at 686-87.

56. *Id.*

57. *Id.* at 690-92.

writer-director liable for failing to perform an adequate investigation under the circumstances. He had delegated the investigatory task almost entirely to his attorneys and had performed no personal investigation after becoming director.[58] Furthermore, he faced liability both as a director and as an underwriter.[59]

Finally, the court considered the duties of the two recently elected directors who had no separate association with BarChris.[60] While the opinion acknowledged their position as true outsiders, it emphasized the fact that these directors conducted virtually no independent investigation.[61] Thus, the court imposed liability, but in so doing it implied that these defendants could have satisfied the due diligence requirement of reasonable investigation more easily than any of the other directors.[62]

The importance of the *BarChris* decision for the purpose of this analysis lies in its application of the "reasonable investigation" requirement to different types of directors. The court clearly implied that it expected a different type of investigation from an active officer-director or professional director, such as the outside counsel, than it did from the true outside directors. Reasonable investigation was a subjective standard tailored to each director's professional duties and position with the issuer.[63]

In *Feit v. Leasco Data Processing Equipment Corp.*,[64] which also considered the question of directors' liability under section 11, the court relied heavily on the *BarChris* analysis to impose liability on the three directors concerned. *Feit* arose out of a tender offer by Leasco for the Reliance Insurance Company in which Leasco issued a prospectus allegedly containing material misstatements and omissions.[65] Plaintiff, a former Reliance shareholder who accepted the Leasco bid, brought a class action against Leasco, its

58. *Id.* at 692-97.

59. *See* Folk, *supra* note 25, at 39.

60. *See* note 49 *supra*. Auslander and Rose signed the signature page of the registration statement less than a month after being elected directors. 283 F. Supp. at 687-89.

61. *Id.*

62. *Id.*

63. The standard did not, however, take into account limited education or knowledge. *See* note 51 *supra*.

64. 332 F. Supp. 544 (E.D.N.Y. 1971).

65. Leasco's primary interest in purchasing Reliance was to obtain control of the surplus funds that Reliance had collected from insurance premiums above the statutorily required surplus amount—the so-called "surplus surplus." Leasco, however, failed to indicate the true purpose of the proposed acquisition and its estimate of the amount of the "surplus surplus" funds available. *Id.* at 550-54.

directors, and two underwriting firms.[66] The three Leasco directors named as defendants were the chief executive officer, the president, and a partner in the law firm representing Leasco.[67]

In his discussion of the directors' due diligence defense, Judge Weinstein questioned whether it was appropriate to consider the directors together or separately.[68] He noted with approval that *BarChris* distinguished between inside and outside directors. Furthermore, he observed that *BarChris* held the outside attorney-director to "a very high standard of independent investigation of the registration statement precisely because he was the registrant's outside counsel."[69] Judge Weinstein then quoted a commentator's opinion that "in some cases the attorney-director may be so deeply involved that he is really an insider."[70] Based upon these observations, the *Feit* court held that Leasco's attorney was in fact an insider and therefore obligated to make an appropriately thorough investigation. Even though the court considered all the directors insiders, it stated that "[w]hat 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. . . ."[71] Therefore, even though *Feit* held all three directors liable as inside directors, it followed *BarChris'* flexible approach. The court assessed the adequacy of each director's investigation and belief in light of the director's duties.

B. *Securities Exchange Act of 1934*

As *BarChris* and *Feit* demonstrate, section 11 of the 1933 Act requires directors to exercise a fairly high degree of care in order to escape liability for false or misleading registration statements. The duty of care, however, is appreciably lower for the same directors in the preparation of annual reports and other filings made with the Commission[72] pursuant to the 1934 Act. Sections 12 and 15(d)

66. The plaintiff, alleging material misrepresentations and omissions, sued under sections 11, 12(2), and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77l(2) and 77q(a) (1976), and sections 10(b) and 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78n(e) (1976).

67. 332 F. Supp. at 575.

68. *Id.*

69. *Id.* at 575-76.

70. *Id.* (citing Folk, *supra* note 25, at 1).

71. *Id.* at 577-78.

72. L. Loss, *supra* note 44, at 3862.

of the 1934 Act[73] require issuers of registered securities to file periodic reports with the Commission, such as Form 10-K annual reports.[74] Professor Loss describes liability under section 18[75] for false or misleading statements made in connection with any document filed under the 1934 Act as "a very much attenuated [section] 11."[76] Although superficially similar to section 11, section 18 requires the plaintiff to prove that the misleading or false statement caused both the change in the price of the security and resulting damages and that the plaintiff relied on the statement.[77] Furthermore, section 18 omits the section 11 proviso that a plaintiff need not prove that he actually read the statement in order to establish reliance.[78] Finally, if the defendant merely proves that he "acted in good faith and had no knowledge that such statement was false or misleading,"[79] he cannot be held liable. Thus, section 18 poses formidable barriers to recovery, and apparently in no reported decision has a plaintiff prevailed on a section 18 claim.[80]

Due to the difficulties posed by section 18, plaintiffs began to base their actions on the rather broad antifraud provisions of section 10(b)[81] and rule 10b-5[82] promulgated by the Commission thereunder.[83] Section 10(b) states that it shall be "unlawful" to engage in any deceptive or manipulative activity in connection with the purchase or sale of a registered security and provides the Commission with rulemaking power to carry out that policy.[84] Rule

---

73. 15 U.S.C. § 78m (1976).
74. PLI, INTRODUCTION TO SECURITIES REGULATION 29 (1979).
75. 15 U.S.C. § 78r (1976).
76. L. Loss, *supra* note 24, at 1752.
77. 15 U.S.C. § 78m (1976).
78. *See* text accompanying note 39 *supra*.
79. 15 U.S.C. § 78r (1976).
80. L. Loss, *supra* note 24, at 1753 n.228; L. Loss, *supra* note 44, at 3863; [1979] 4 FED. SEC. L. REP. (CCH) ¶ 26, at 226.
81. 15 U.S.C. § 78j (1976).
82. Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5 (1979).
83. The Second Circuit held recently in Ross v. A.H. Robbins, 607 F.2d 545 (2d Cir. 1979), that section 18 is not an exclusive remedy and that plaintiffs may avail themselves of rule 10b-5 despite the concurrent applicability of section 18.
84. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976), 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—
>
> . . .
>
> (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 regula-

10b-5 outlaws false statements, omissions, deceit, and fraud.[85] Neither the statute nor the rule states an intent requirement. Consequently, a severe split arose in the circuits concerning whether negligence[86] or scienter[87] was the appropriate standard for a section 10(b) violation.[88] The Supreme Court finally resolved the majority of the intent questions in *Ernst & Ernst v. Hochfelder.*[89] In *Hochfelder* plaintiff alleged that defendant accounting firm's negligence in conducting an audit permitted a fraud upon plaintiff to go undetected.[90] The Court held that scienter, not negligence, was the level of intent necessary for actions under section 10(b) and dismissed the case.[91]

The leading case on director liability under rule 10b-5 is *Lanza v. Drexel & Co.*[92] Although decided before the Supreme Court resolved the intent question, the Second Circuit's conclusion in *Lanza* on that point paralleled the Supreme Court's decision, and *Hochfelder* cited *Lanza* with approval.[93] Like *BarChris, Lanza* arose out of the bankruptcy of the BarChris Construction Company, which left defrauded investors in its wake. BarChris induced plaintiffs in *Lanza* to sell their interest in a billiard manufacturing concern for BarChris stock on the basis of false and misleading

---

tions as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

85. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

86. *See, e.g.,* White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963).

87. *See, e.g.,* Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied,* 422 U.S. 1007 (1975); Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973).

88. Courts have interpreted section 10(b) and Rule 10b-5 to contain an implied private cause of action. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972).

89. 425 U.S. 185 (1976).

90. *Id.* at 188-90.

91. *Id.* at 214-15.

92. 479 F.2d 1277 (2d Cir. 1973).

93. 425 U.S. at 214.

financial data, including the BarChris annual report.[94] The district court, finding that the president, vice president, and treasurer directors acted with extreme recklessness or actual knowledge in giving plaintiffs false and misleading financial data, imposed liability under section 10(b) and rule 10b-5.[95] The district court, however, exonerated Coleman, a partner in the underwriting firm, and Ballard, the firm's attorney, both of whom were outside directors.[96] Plaintiffs appealed from the court's holding that Coleman's actions did not constitute a violation of rule 10b-5.[97]

The court of appeals focused on the standard of care historically required of an outside director and the level of care mandated by section 10(b) of the 1934 Act. The court concluded that the common-law rule did not require that a director personally satisfy himself of the accuracy of the corporation's financial statements. To support its conclusion, the court observed that Congress expressly imposed such an obligation under section 11 with respect to disclosures pursuant to the 1933 Act but elected not to use the same language to police 1934 Act disclosures. Therefore, the court held that section 10(b) required a showing of scienter, which plaintiffs had failed to establish.[98] Thus, in view of the scienter standard that arises under 10b-5 and the apparently insurmountable problems that section 18 presents, it is clear that disclosure requires considerably less of directors under the 1934 Act than it does under the 1933 Act.

C. *Indemnification, Insurance, and Contribution*

Issues that naturally arise following the imposition of liability under either the 1933 Act or the 1934 Act include whether the defendant director may be indemnified by the issuer and whether the director may seek contribution from the other tortfeasors. A related question is whether a defendant may obtain insurance against any securities acts liabilities.

The right of an officer or director to indemnification for litiga-

94. 479 F.2d at 1280-84.

95. Lanza v. Drexel & Co., [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,826 at 90,089, 90,101-03 (S.D.N.Y. 1970). The court also imposed liability on the president as a controlling person under § 20(a) of the Securities Exchange Act, 15 U.S.C. § 784(a) (1976). *Id.*

96. Lanza v. Drexel & Co., [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,826 at 90,101, 90,104-06 (S.D.N.Y. 1970).

97. Drexel & Co., the underwriter, and defendant Kircher also appealed because of the court's denial of a jury trial. 479 F.2d at 1280-81.

98. *Id.* at 1306-09.

tion expenses or for liability is generally a matter of state law.[99] Although there are a variety of state regulatory statutes on the subject, the majority of statutes are based on section 5 of the revised Model Business Corporation Act.[100] That section permits indemnification by the issuer provided the indemnitee acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation.[101] With the exception of Delaware, all of the statutes based upon the Model Act omit the clause permitting indemnification for actions that were "not opposed to" the best interests of the corporation. This omission requires the indemnitee to establish affirmatively that he was acting in the best interests of the corporation.[102]

Despite the state statutes, the legality of indemnification of defendants sued under the federal securities laws is uncertain. The Commission has long contended that under many circumstances indemnification violates public policy and should be prohibited.[103] In order to enforce its policy, the Commission requires that the registrant waive all indemnification claims. Alternatively, as a prerequisite to acceleration of the registration statement, the registrant must state that, in the Commission's opinion, indemnification is against public policy and therefore unenforceable. The registrant must also agree to submit any indemnification claim by an unsuccessful defendant to an appropriate court for a determination of the public policy question and must agree to be bound by the result.[104] In a somewhat contradictory fashion, however, the Commission accepts the use of liability insurance. The potential defendant may protect himself with liability insurance instead of an indemnification provision without subjecting himself to the preacceleration agreement regardless of whether the corporation buys

---

99. R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 129 (4th ed. 1976).

100. W. Knepper, Liability of Corporate Officers and Directors ¶ 19.04 at 591-92 (3d ed. 1978).

101. Section 5(a) of the Model Act states: "The corporation shall have the power to indemnify any person . . . by reason of the fact that he was a director, officer . . . if he acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation . . . ." Model Bus. Corp. Act Ann. § 5(a) (2d ed. 1971).

102. W. Knepper, *supra* note 100, at 597.

103. Comment, *Indemnification of Directors for Section 11 Liability*, 48 Tex. L. Rev. 661, 669-70 (1970).

104. Securities and Exchange Commission Rule 460 Note (a); 17 CFR § 230.460 Note (a) (1979). This requirement, known as the "Johnson & Johnson formula" was first introduced on an informal basis in 1944. Kroll, *supra* note 44, at 689.

the policy.[105] Accordingly, in response to *BarChris* and other similar cases, corporations in the late 1960's increasingly began to purchase liability insurance.[106]

Although liability insurance is acceptable to the Commission as an alternative to indemnification, the price of insurance in recent years has placed it beyond the means of many corporations. Even for those companies that can afford it, the insurance, if available at all, may have a high deductible and low total coverage.[107] Furthermore, Lloyd's of London recently introduced a new standard insurance policy that clarified a number of ambiguous provisions in favor of the insurer, diminishing further the limited and expensive protection available.[108] Therefore, because economic realities may render liability insurance inadequate, it becomes quite important to determine the extent to which courts, notwithstanding Commission policy, will permit indemnification.

Unfortunately, the status of indemnification is unclear. The cases prohibiting indemnification define the outer limits, but the issue of whether directors in a *BarChris* or *Feit* setting may be fully indemnified remains unresolved. The first case to confront the indemnification issue was *Globus v. Law Research Services, Inc. [Globus I]*.[109] In *Globus I* the jury found that defendants—the corporation, its president, and the underwriter—had actual knowledge of material misstatements and omissions in connection with the sale of stock.[110] The jury, however, also determined that the underwriter could recover on its cross-claim against the other defendants for indemnification pursuant to the underwriting agreement.[111] The trial court, rejecting the jury decision, rendered a judgment n.o.v., holding that contracts for indemnification are invalid if the indemnitee had actual knowledge of the false and mis-

---

105. W. KNEPPER, *supra* note 100, at 596 n.46a.

106. Kroll, *supra* note 44, at 685-87.

107. Bishop, *Understanding D & O Insurance Policies,* HARV. BUS. REV., Mar.-Apr. 1978, at 20; Kroll, *supra* note 44, at 686-87; 55 ALI PROCEEDINGS 357-58 (1978) (remarks of Mr. Eldon Olson).

108. Bishop, *supra* note 107, at 30. For a section by section analysis of the new Lloyd's form, see Hinsey, *The New Lloyd's Policy Form for Directors and Officers Liability Insurance—An Analysis,* 33 BUS. LAW. 1961 (1978).

109. 287 F. Supp. 188 (S.D.N.Y. 1968), *modified,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

110. Plaintiffs sued under sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77(R)(2), 77q(a) (1976) and sections 10(b) and 15(c) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78o(c) (1976). 287 F. Supp. at 191.

111. *Id.*

leading statements.[112] Emphasizing that the underwriter's actions constituted "a sin graver than ordinary negligence," and relying heavily on the deterrence policy of the securities laws, the court of appeals affirmed the denial of indemnification.[113] The Second Circuit's analysis of the in terrorem policy of securities regulation, which the court feared indemnification would circumvent, was based largely on section 11 of the 1933 Act, notwithstanding the fact that *Globus* was not a section 11 suit.[114]

Since *Globus,* a number of courts have prohibited indemnification if the defendant had intent or actual knowledge.[115] When the defendant's conduct is merely negligent, however, the decisions are less clear. In *Feit,* for example, defendant corporation in effect sought to indemnify its three directors by paying the entire $330,000 judgment.[116] The Commission opposed the corporation's motion, arguing that indemnification was contrary to the policy of section 11 of the Securities Act.[117] The court ultimately permitted the directors to pay five thousand dollars each to the corporation in settlement of any contribution claims that the corporation had against them.[118] This comparatively small sum amounted to substantial indemnification by the corporation.

Four years later, in *Odette v. Shearson, Hammill & Co.,*[119] a court in the same district, without mentioning *Feit,* extended the *Globus I* prohibition of indemnification for knowing or intentional securities law violations to cover negligent violations as well. In *Odette* plaintiff sued Shearson, Hammill & Co. under the 1933 and the 1934 Acts for the sale of securities of a subsidiary while in the possession of material adverse information concerning the subsidiary.[120] Shearson, Hammill alleged that it had also been deceived

112. *Id.* at 199.

113. The court explicitly acknowledged that the instant action was not based on section 11 of the Securities Act of 1933, but relied on its rationale nonetheless. 418 F.2d 1276, 1288-89 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

114. *Id.*

115. *See* Alexander & Baldwin, Inc. v. Peat, Marwick, Mitchell & Co., 385 F. Supp. 230, 239 (S.D.N.Y. 1974); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 135 (S.D.N.Y. 1974); Tucker v. Arthur Anderson & Co. [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,544 at 95,868 (S.D.N.Y. 1974).

116. Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws,* 1972 DUKE L.J. 1153, 1162.

117. *Id.* (citing Brief for S.E.C. as Intervenor, Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971)).

118. *Id.* at 1164.

119. 394 F. Supp. 946 (S.D.N.Y. 1975).

120. *Id.* at 949.

and sought indemnification from the bank that allegedly falsified records in order to misrepresent the subsidiary's financial position.[121] The court acknowledged that the *Globus* court had emphasized that it was basing culpability on more than ordinary negligence,[122] but the *Odette* court held that Shearson's mere negligence in failing to discover the bank's fraud was sufficient to bar indemnification.[123] As in *Globus*, the *Odette* court relied heavily on the policy of deterrence underlying the liability provisions of the federal securities laws and concluded that indemnification would thwart that policy.[124]

Odette is the most recent case to consider the indemnification issue. Thus, the trend, although not yet confirmed by a higher court, seems to be toward denying indemnification for liability flowing from negligent violations of the securities laws.[125] It is clear after *Globus* that courts prohibit indemnification for willful or knowing wrongdoing.[126] Consequently, directors may not be indemnified for liability under the 1934 Act standard of scienter for false or misleading statements in annual reports. Whether the same directors may be indemnified for negligent conduct in connection with a misleading or incomplete registration statement under the 1933 Act is less clear. The Code explicitly adopts the prohibition of indemnification of defendants acting with scienter, but does not consider indemnification in the context of a negligent violation; thus, the latter question would remain open. As an alternative, however, the Code does permit the use of liability insurance for any type of conduct.[127]

Issues closely associated with indemnification are whether the law should permit contribution and, if so, whether nonsettling defendants can assert claims for contribution against those who set-

---

121. *Id.* at 953.

122. *See* note 113 *supra* and accompanying text.

123. 394 F. Supp. at 956-57.

124. *Id.* at 954-57.

125. *See* Gould v. American-Hawaiian Steamship Co., 387 F. Supp. 163 (D. Del. 1974), *vacated,* 535 F.2d 761 (3d Cir. 1976); Sherlee Land v. Commonwealth United Corp., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,749 (S.D.N.Y. 1973). For cases that in dicta suggest a contrary view, see Wassel v. Eglowsky, 399 F. Supp. 1330 (D. Md. 1975); Muth v. Dechert, Price & Rhoads, 391 F. Supp. 935 (E.D. Pa. 1975); Gatter v. R.G. Dickinson & Co., 366 F. Supp. 559 (S.D. Iowa 1973). *See also* Note, *The Role of Contribution in Determining Underwriters' Liability Under Section 11 of the Securities Act of 1933,* 63 VA. L. REV. 79, 87-89 (1977).

126. *See, e.g.,* McLean v. Alexander, 449 F. Supp. 1251, 1266 (D. Del. 1978).

127. *See* note 188 *infra* and accompanying text.

tle. Section 11(f) of the 1933 Act[128] clearly permits contribution among joint tortfeasors; therefore, with respect to director liability under section 11 the contribution question is settled. In extending section 11's allowance of contribution to actions based on other sections, the *Odette* court reasoned that the deterrence objectives of the 1933 Act would be thwarted if joint tortfeasors did not face liability through contribution.[129] The *Odette* court on this point drew support from *Globus II*,[130] the sequel to *Globus I*. In *Globus II* the court, using a deterrence rationale, held that the underwriter, having paid the judgment in full, could seek contribution from its fellow defendants, the president and the corporation.[131]

Although it is plain that contribution under section 11 is both permitted and desirable,[132] it is unclear whether a nonsettling defendant can require contribution from parties to a good faith settlement.[133] Only two courts have squarely faced this issue.[134] In *Altman v. Liberty Equities Corp.*[135] three of the twelve defendants in a class action suit under section 10(b) of the 1934 Act proposed a $285,000 settlement of claims that approached $1,000,000. Although the remaining defendants agreed that the amount was reasonable, they asserted that the settlement should in no way impair their right to seek a subsequent contribution from the settling defendants in the event of an adverse judgment.[136] The court held that a settlement embodying a bar to claims for contribution would deny nonsettling defendants the right to assert such claims—a right that the *Globus II* decision guaranteed.[137] Three

---

128. Section 11(f) provides as follows:

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

15 U.S.C. § 77k(f) (1976).

129. 394 F. Supp. at 959.

130. Globus, Inc. v. Law Research Service, Inc., 318 F. Supp. 955 (S.D.N.Y. 1970).

131. *Id.*

132. *See* Heizer Corp. v. Ross, 601 F.2d 330 (7th Cir. 1979).

133. Fischer, *Contribution in 10b-5 Actions*, 33 Bus. Law. 1821, 1831 (1978).

134. Although the parties pleaded the issue in Wainwright v. Kraftco Corp., 53 F.R.D. 78 (N.D. Ga. 1971), the court did not squarely face the issue and refused to approve the settlement on the basis of Federal Rule of Civil Procedure 23(e). 53 F.R.D. at 84.

135. 54 F.R.D. 620 (S.D.N.Y. 1972).

136. *Id.* at 622.

137. *Id.* at 625.

years later, in *Muth v. Dechert, Price & Rhoads,*[138] another district court considered the issue in the context of a section 10(b) class action. *Muth* held that nonsettling defendants, who had no notice of a settlement specifically entered without prejudice to them, could sue for contribution. Although the conclusion seemed inevitable given the circumstances and terms of the settlement agreement, the court cited *Altman* in support of its decision.[139]

Commentators have criticized the *Altman-Muth* approach as directly contrary to the Uniform Contribution Among Joint Tortfeasors Act and conducive to uncertainty that will discourage the efficient resolution of suits through settlement.[140] Section (4)(b) of the Uniform Act provides: "When a release or a covenant not to sue or not to enforce judgment is given in good faith to one of two or more persons liable in tort . . . [i]t discharges the tortfeasor to whom it is given from all liability for contribution to any other tortfeasor."[141] This statute plainly contemplates a right to contribution in the absence of a settlement and protects the rights of nonsettling defendants by requiring that any settlement be given in good faith—a standard that is subject to judicial supervision. Therefore, the *Altman-Muth* rule is neither desirable nor mandated by *Globus II*'s approval of a right to contribution.[142] Unfortunately, however, the Code ignores the problem of settling and nonsettling defendants and thus appears to ratify by inaction the *Altman-Muth* approach.

III. The Code

A. *Director's Liability for Annual Reports*

In the civil liability chapter, sections 1704 and 1705 of the Code set forth the standard of care for directors in connection with the various reporting requirements.[143] Section 1704 places liability

138. 391 F. Supp. 935 (E.D. Pa. 1975).

139. *Id.* at 939.

140. Fischer, *supra* note 133, at 1832-33.

141. Uniform Contribution Among Joint Tortfeasors Act § 4(b) (U.L.A.).

142. *See* notes 131-32 *supra* and accompanying text.

143. As discussed in note 20, *supra,* certain compromises, whether adopted by the ALI or sent to Congress for consideration as separate proposals, may affect the current Code provisions concerning civil liability for the filing of annual "10-K" reports. The main thrust of these compromises is to adopt the § 1705-type liability provisions to the extent that the defendant's burden of proof is satisfied if he establishes only lack of scienter rather than lack of due care as in § 1704. This compromise appears designed to appease criticism that applying the due diligence standard of § 1704 imposes an unduly harsh burden on directors. Therefore, the compromise approximates the position espoused by Dean Ruder during the

for false registration statements, offering statements, and annual reports upon the following persons: first, the registrant; second, the principal executive officer or officers, the principal financial officer, and the principal accounting officer; third, every director; fourth, every person named with his consent as about to become a director; fifth, every expert named with his consent with respect to statements attributed to him; and last, every underwriter in the case of an offering statement.[144] Specifically, section 1704 applies "on proof that an effective registration statement, an effective offering . . . or an annual report filed with the Commission under section 602(a)(1), or any other report so filed and incorporated by reference in any such filing (1) contained a misrepresentation or (2) omitted a material fact or document required."[145] Section 1704 limits the defenses available to a nonexpert officer or director[146] to the following: first, that the defect was corrected subsequently in a well-publicized manner;[147] second, that the plaintiff knew the actual facts or that the falsity was obvious;[148] third, that the defendant resigned prior to the effective date of a registration or offering statement and advised the Commission;[149] fourth, that the registration or offering statement, or post-effective amendment, was filed without his knowledge and that the Commission was advised;[150] fifth, that "with respect to any part of the filing not purporting to be made on the authority of an expert . . . the defendant, after reasonable investigation, reasonably believed" that the statement was not defective;[151] or last, that "with respect to any part of the filing purporting to he made on the authority of an expert . . . that the defendant did not reasonably believe" either

---

ALI debate. *See* text accompanying notes 171-73 *infra*. This Note, however, maintains that this proposed compromise does not adequately resolve the questions raised by a consideration of civil liability for directors. Instead, as Part IV of this Note contends, the search for an adequate solution should focus on distinguishing between inside and outside directors and developing a relationship between the Code's liability provisions and its contrihution and indemnification provisions.

144. 1978 Draft, *supra* note 1, § 1704(b).

145. *Id.* § 1704(a). Section 602(a)(1) requires a registrant to file "whatever annual reports (with financial statements), quarterly reports, and other reports the Commission requires by rule." It is unclear from the language in § 1704 whether that section applies to all § 602(a)(1) reports, or only annual reports and reports incorporated in the annual report.

146. Expert defendants are treated separately with respect to imposition of liability and defenses. 1978 Draft, *supra* note 1, §§ 1704(b)(5), (f)(3)(B).

147. *Id.* § 1704(d).

148. *Id.* § 1704(e).

149. *Id.* § 1704(f)(1).

150. *Id.* § 1704(f)(2).

151. *Id.* § 1704(f)(3)(A).

that the expert's statement was defective or that the filing did not accurately reflect the expert's statement.[152] Quite obviously, section 1704 defenses closely parallel those in section 11 of the 1933 Act, particularly the "after reasonable investigation, reasonably believed" language. The Code, however, goes beyond section 11 and lists the factors that a court should consider in the reasonableness evaluation:

> In determining what constitutes reasonable investigation or care and reasonable ground for belief . . . the standard of reasonableness is that required of a prudent man under the circumstances in the conduct of his own affairs. Relevant circumstances include, with respect to a defendant other than the registrant, (1) the type of registrant, (2) the type of defendant, (3) the office held when the defendant is an officer, (4) the presence or absence of another relationship to the registrant when the defendant is a director or proposed director, (5) reasonable reliance on the officers, employees and others whose duties should have given them knowledge of the particular facts (in light of the functions and responsibilities of the particular defendant with respect to the registrant and the filing) . . . and (7) whether, with respect to a fact or document incorporated by reference, the particular defendant had any responsibility for the fact or document at the time of the filing from which it was incorporated.[153]

In recommending this subjective approach to the reasonableness standard the Code adopts the *BarChris* and *Feit* approach[154] and eliminates the danger under section 11[155] that an objective application of the standard might apply to all defendants.[156] Section 1704 limits damages to the greater of $100,000, one percent of gross annual revenues up to $1,000,000, or the profit on a related securities transaction, unless the misrepresentation was made with knowledge, in which case liability is unlimited.[157]

As mentioned previously, the most radical and controversial aspect of section 1704 is its breadth. The section includes within its scope annual reports, perhaps other section 602(a) reports,[158] and reports filed with the Commission that are incorporated by reference into the 602(a) report. The opponents of this section proposed the application of section 1705 standards of liability for false

---

152. *Id.* § 1704(f)(3)(C).

153. *Id.* § 1704(g).

154. *See* text accompanying notes 47-71 *supra*.

155. Section 11(c) of the 1933 Act provides: "In determining what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property." 15 U.S.C. § 77k(c) (1976).

156. *See* text accompanying notes 51 and 68-71 *supra*.

157. 1978 Draft, *supra* note 1, § 1708(c).

158. *See* note 146 *supra*.

and misleading annual reports instead.[159] As presently drafted, section 1705 is a residual section that provides plaintiffs with a cause of action against the registrant for misrepresentations made with "scienter" in any filing not covered by section 1704.[160] By definition, "scienter" is satisfied if "[the defendant] knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so."[161] Section 287(a) defines "knowledge" in the following manner: " 'Know' and its derivatives are not defined. Their meaning is left to construction in context. But see the definition of 'scienter' in section 299.50."[162] Section 1705 incorporates the same damage formula applied by section 1704.[163] Thus, the liability limitations would apply if the section 1705 defendant acted with "reckless disregard," but not if the defendant acted with "knowledge."[164]

In introducing section 1704 at the 1978 American Law Institute meeting, Professor Loss succinctly stated the issue that has since plagued discussions of the Code: "With the center of the universe being shifted from the occasional Securities Act [of 1933] registration statement to the basic company registration statements followed by . . . the 10-K [annual report], what do we do with civil liability?"[165] Professor Loss reported that all agreed that the new company registration statement and offering statements should fall under section 1704; similarly, there was unanimous agreement that miscellaneous filings should be subject to section 1705.[166] The controversy focused on the appropriate standard of care required in the preparation of the annual report under section 602(a).[167]

The advocates of preserving section 1704 as drafted emphasized that a central function of the Code was replacement of the sporadic disclosure accomplished by the 1933 Act with a system of continuous annual reporting, which would inspire confidence in the secondary trading market. That confidence, asserted the advocates,

---

159. 55 ALI PROCEEDINGS 352 (1978) (remarks of Dean David Ruder).

160. 1978 Draft, *supra* note 1, § 1705(a).

161. *Id.* § 299.50.

162. *Id.* § 287(a).

163. *See id.* § 1708(d); text accompanying note 156 *supra*.

164. *See id.* §§ 299.50, 1705, 1708(c), 1708(d).

165. 55 ALI PROCEEDINGS 347 (1978) (remarks of Professor Louis Loss).

166. *Id.* at 348.

167. Section 602(a) requires every registrant to file with the Commission, to send to every shareholder, and to publish all annual, quarterly, and other reports required by the Commission in order to keep investors informed. 1978 Draft, *supra* note 1, § 602(a). Note that although the Institute did not discuss the issue at the meeting, all § 602(a)(1) reports arguably fall within the scope of § 1704. *See* note 145 *supra*.

is essential to persuade investors to make their initial investment in securities in the primary market.[168]

In order to assure that registrants would faithfully carry out their continuous reporting duty, the drafters chose the in terrorem effect of civil liability. The proponents of the original draft repeatedly argued[169] that, although section 1704 was based on section 11, it alleviated the potential harshness of section 11 by providing a flexible standard of reasonableness.[170] These members claimed that this standard would protect directors who were not active participants in the corporation from being unjustly saddled with liability.

Dean Ruder led the opposition to section 1704 by contrasting the liability of a director under the new section with liability under section 18 of the 1934 Act. He noted that under the new section the burden of proof invariably shifts from the plaintiff to the defendant. He also emphasized that the plaintiff need not prove that he relied on the statement or that the defendant-director was in any way personally responsible for the improper filing. Dean Ruder suggested that the reasonable investigation standard was more difficult for a director to satisfy than a simple negligence standard.[171] He proposed shifting all liability for the annual report to section 1705, which would require the plaintiff to prove knowledge or recklessness on the part of the defendant.[172] Dean Ruder's supporters reiterated his concern that applying the due diligence standard to defendants without an offsetting reliance requirement for plaintiffs imposed an unduly harsh burden on directors.[173]

After an extended discussion, Professor Painter proposed shifting the liability of outside directors for annual reports from section 1704 to section 1705 as a compromise.[174] Painter had discerned that the real concern of the dissenters was whether it was wise to impose the heavy burden of due diligence on *outside* directors. He considered it unquestionable that the registrant itself, and its principal executive, financial, and accounting officers, were appropriate subjects for section 1704 liability.[175] Professor Loss, however, countered that the drafters had already achieved the desired

---

168. 55 ALI PROCEEDINGS 359 (1978) (remarks of Mr. Milton Cohen).
169. *Id.* at 360, 372, 411, 412, 413, 422 (remarks of Professor Louis Loss, Mr. Milton Cohen, Mr. Donald Schwartz, and Professor William Painter).
170. 1978 Draft, *supra* note 1, § 1704(g).
171. 55 ALI PROCEEDINGS 349-52 (1978) (remarks of Dean David Ruder).
172. *Id.* at 352.
173. *See, e.g., id.* at 355 (remarks of Professor Homer Kripke).
174. *Id.* at 370 (remarks of Professor William Painter).
175. *Id.*

result by including in section 1704 a flexible definition of the reasonableness standard and by making a specific reference to the nature of the directorship in that definition.[176] The Ruder group, at the other extreme, continued to object to standards that imposed liability on either insiders or outsiders in the absence of causation and reliance.[177]

After rejecting the compromise, the membership of the American Law Institute proceeded to vote on the Ruder proposal, failing to approve the proposal by a vote of ninety-four to ninety-five.[178] In view of the clear lack of consensus, the membership agreed to present the Code to Congress as drafted, along with bracketed language expressing Professor Painter's compromise on the unresolved issue.[179] During the 1979 meeting, however, at Reporter Loss' request the American Law Institute elected to take no position whatsoever on whether or not to apply section 1704 to annual reports. Thus, Congress will decide to which defendants sections 1704 and 1705 will apply.[180]

B. *Indemnification, Liability Insurance, and Contribution*

Although the question of liability insurance arose during the discussion of section 1704, the only aspect that the American Law Institute considered was the effect of that section and the associated liability limitations on the cost and availability of insurance.[181] An integrated treatment of section 1704 liability and the extent to which those found liable would or should personally bear the burden of liability was never suggested. In fact, an examination of the Code sections dealing with indemnification, contribution, and liability insurance raises the question of whether the drafters even considered it.

The Code deals with indemnification, contribution, and liability insurance primarily in section 1724. Paragraph (d) of that section condones contribution, providing that "[a]ll liability under this Code . . . is joint and several . . . ."[182] Under paragraph (f), parties may agree to allocate liability among themselves, if done in

176. *Id.* at 372 (remarks of Professor Louis Loss).

177. *Id.* at 374 (remarks of Professor Homer Kripke).

178. *See* note 15 *supra* and accompanying text.

179. 55 ALI PROCEEDINGS 402-16 (1978) (discussion and vote on the Painter compromise).

180. *See* note 20 *supra* and accompanying text.

181. 55 ALI PROCEEDINGS 357 (1978) (remarks of Mr. Eldon Olson).

182. 1978 Draft, *supra* note 1, § 1724(d).

a manner consistent with the Code's indemnification provisions.[183] Absent such an agreement, the paragraph vests the court with broad discretion to allocate damages among joint tortfeasors in an action for contribution.[184] The Code does not, however, discuss specifics, and it fails to resolve the problem of contribution among settling and nonsettling defendants.

Indemnification receives more detailed attention, but the overall effect is less satisfactory than the treatment of contribution. Section 2003(b)(2)[185] prohibits the Commission's traditional practice of refusing to accelerate a registration statement until the registrant agrees to subject its indemnification agreements to court approval. Instead, the Code specifically authorizes the Commission to bring an action to prevent contribution or indemnification not required or authorized by section 1724(e) or (f).[186] Section 1724 authorizes indemnification only to the extent that it is not prohibited by a Commission rule or by a court applying federal common law.[187] Although the Code limits the apparent elasticity of this rule by proscribing indemnification if bad faith, intentional misfeasance, or recklessness are involved,[188] it does not state whether the registrant may directly indemnify a defendant for negligent liability. Therefore, the uncertain status of indemnification for negligence after *Globus I*, *Feit*, and *Odette* remains unresolved under the Code.

Section 1724(e) explicitly condones the use of liability insurance as an alternative to indemnification. Furthermore, the Code permits insurance irrespective of any state law to the contrary and regardless of who pays the premium.[189] Thus, the Code specifically preempts any state law prohibiting liability insurance.

With the exception of the rules governing insurance, the Code seems to codify rather than resolve the existing uncertainty in

---

183. *Id.* § 1724(f)(1).

184. *Id.* § 1724(f)(2).

185. Section 2003(b)(2) states that, "The Commission may not refuse to accelerate the effective date of a filing solely because of the terms of an indemnification or contribution provision, whether contained in a statute, a bylaw or similar instrument, or a contract." 1978 Draft, *supra* note 1, § 2003(b)(2). *See also* notes 103-05 *supra* and accompanying text.

186. Section 1819(k) provides that, "The Commission may bring an action or intervene in any action in order to prevent indemnification or contribution not required or authorized by section 1724(e) or (f)." 1978 Draft, *supra* note 1, § 1819(k).

187. *Id.* § 1724(e)(3).

188. *Id.* § 1724(e)(5). Although this section permits insurance coverage for liability arising from bad faith, willful acts and recklessness, such coverage, as a practical matter, cannot be purchased. *See* note 108 *supra*.

189. 1978 Draft, *supra* note 1, § 1724(e)(4).

what one commentator called "this sensitive but seldom adjudicated area of securities litigation."[190] In fact, the explanatory notes suggest that uncertainty was precisely the effect that the drafters hoped to achieve. Note 2 states in part: "Nothing in the Code, however, prevents a management from indemnifying either pursuant to some sort of provision or voluntarily, without the benefit of a rule [promulgated by the Commission][191] or a precedent [under federal common law],[192] if state law permits and management is willing to risk a stockholder's derivative action as well as an SEC action . . .[193] that will put its payment to the test . . . after all."[194] Under the Code, therefore, until controlling precedent or a Commission rule conclusively establishes the validity of indemnification and clearly distinguishes conduct that is and is not indemnifiable, every indemnification will be subject to challenge.

C. *Interface Between Section 1704 and Section 1724*

It is disappointing that neither the drafters nor the American Law Institute membership chose to confront the indemnification and contribution issues. Possibly the intensity of the debate over section 1704 liability led the Reporter to reconsider any thoughts he may have had about strong Code positions on other sensitive points. Nonetheless, it is surprising that the discussion of section 1704 did not include an analysis of the interaction of that section with section 1724's contribution and indemnification provisions. The relationship between the imposition of liability and the identity of the person who ultimately bears the burden of paying damages is particularly relevant when liability is imposed in order to achieve an in terrorem effect. Likewise, in evaluating the fairness and possible repercussions of holding a particular individual or class liable, it is quite important to consider whether the subject of the liability will be required to pay damages from personal resources or will, in fact, be only nominally liable because of indemnification. Thus, both sides of the section 1704 debate should have

190. Mathews, *A.L.I. Proposed Federal Securities Code: Part XV—Administration and Enforcement*, 30 VAND. L. REV. 465, 545 (1977).

191. The Commission's rulemaking authority under this section is provided in § 1724(e)(3)(A).

192. Section 1724(e)(3)(B) permits courts "in accordance with the principles of common law and equity, applied as a matter of federal jurisprudence without regard to the statutory or other law of any State" to determine the validity of indemnification provisions. 1978 Draft, *supra* note 1, § 1724 (e)(3)(B).

193. *See* note 185 *supra* and accompanying text.

194. 1978 Draft, *supra* note 1, § 1724(e), Note 2 at 617.

been especially concerned with the Code position on indemnification. The proponents of section 1704 argued that the Code must base liability upon failure to make a reasonable investigation in order to achieve an in terrorem effect that would assure accurate disclosure.[195] The opponents countered that this standard would unreasonably force directors to bear such a high liability risk that corporations would have difficulty recruiting outside directors.[196] Neither group, however, considered section 1704 in conjunction with section 1724. If they had considered the relationship between the two sections, both groups would have found the uncertain effect of section 1724 on directors' liability for disclosure disturbing.

The advocates of a strong in terrorem effect would recognize that, by expressly sanctioning the use of liability insurance for any conduct and by failing to explicitly prohibit direct indemnification except in cases of egregious conduct,[197] the membership threatened the deterrent value of section 1704 liability. Furthermore, although the notes point out that any corporation choosing to indemnify one of its directors runs the risk of Commission intervention or a shareholder's derivative suit, the risk is not as great as the notes suggest. Under the Code, the Commission may no longer require the registrant to submit its indemnification agreements to a court for a determination of legality.[198] Moreover, absent a provision in the charter or by-laws, there is no requirement that the corporation notify its shareholders that it has indemnified an individual.[199] Therefore, an indemnification could easily pass unnoticed and unchallenged.[200]

Section 1704's opponents will probably find section 1724 just as discomforting as the proponents. Although the Code expressly permits liability insurance even for acts of intentional misfeasance, as a practical matter this type of coverage will not be available. In fact, under the present system the coverage available for negligence liability is already expensive and difficult to obtain.[201] Sev-

---

195. *See, e.g.*, 55 ALI PROCEEDINGS 359 (1978) (remarks of Mr. Milton Cohen).

196. *See, e.g.*, *id.* at 366 (remarks of Mr. Fred Fishman).

197. 1978 Draft, *supra* note 1, § 1724(e). *See* notes 187-88 *supra* and accompanying text.

198. *See* note 185 *supra* and accompanying text.

199. One commentator stated that, to the best of his knowledge, General Motors was the only corporation that required stockholder notice of indemnification payments. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1079-80 (1968).

200. *See generally id.* at 1079-80.

201. *See* notes 107-08 *supra* and accompanying text.

eral American Law Institute members suggested that with the Code's stricter standards, and in spite of its liability limitations, insurance would become even more costly, difficult to obtain, and limited in scope.[202] Thus, many defendants will of necessity be forced to rely at least partially on direct indemnification by the registrant. New Commission rules, the evolution of federal common law, or changes in state law, however, may foreclose this possibility at any time.[203] Indeed, the *Odette* holding[204] suggests that federal common law may already be developing significant restrictions on the availability of indemnification for negligent conduct. Finally, the opponents of section 1704 are likely to object to its treatment of contribution. By ignoring the issues in *Altman* and *Muth*, the Code does not permit defendants who reach a bona fide settlement to foreclose an obligation to contribute to the damages assessed against a nonsettling defendant.[205] Therefore, settlements will be a less attractive alternative to trial, and in all probability, litigation costs will be higher for directors under the Code than they would be under the Uniform Contribution Among Joint Tortfeasors Act system.[206]

Clearly any revision of the indemnification, insurance, and contribution provisions will have a direct impact on the liability provisions of section 1704, which proved to be so divisive. This impact creates the possibility of causing more dissension and disunity in a Code that the Reporter feels must have the unified support of the bar if it is to succeed in Congress.[207] Despite these dangers, it is possible that by restructuring the indemnification and contribution paragraphs of section 1724 the American Law Institute could also achieve a compromise on section 1704 liability. Any revision should begin with the premise that indemnification conflicts directly with the policy of deterrence and should be permitted only if necessary to mitigate an unduly harsh result. From a deterrence or in terrorem standpoint the source of payment—whether through indemnification by the registrant or from liability insurance—is irrelevant. This deterrence policy rationale was the basis of the court's

202. 55 ALI PROCEEDINGS 357-58 (1978) (remarks of Mr. Eldon Olson).

203. *See* notes 191-92 *supra* and accompanying text.

204. *See* notes 119-24 *supra* and accompanying text.

205. *See* notes 182-84 *supra* and accompanying text.

206. *See* notes 140-41 *supra* and accompanying text.

207. Remarks of Professor Loss, Meeting of the ABA Committee on Federal Regulation of Securities, Chicago, Ill. (Oct. 13, 1978), *summarized in* MINUTES OF THE MEETING at 29 (1978).

decision in both *Globus* and *Odette*.[208] Whether mitigating factors should have weighed more heavily in those decisions, it seems unassailable that both indemnification and insurance undercut any deterrent effect. For similar policy reasons, the law should permit and encourage contribution so that no defendant escapes liability.

IV. Proposed Changes

In recognition of the effect that indemnification and insurance have on deterrence, the American Law Institute should amend section 1724 to prohibit techniques that ease the burden of liability for section 1704 defendants, with modification in only a few specific cases. This prohibition should apply to both indemnification and liability insurance. In conjunction with the elimination of indemnification and insurance, the drafters might consider a reduction in the $100,000 liability limit in view of the certainty that the burden of damages will fall on the defendants personally.

Naturally, if the drafters adopt this proposal, section 1704 will be even less acceptable to the ninety-four American Law Institute members who voted in favor of the Ruder position. In order to meet their criticism that section 1704 places an undue burden on outside directors,[209] the drafters should modify the ban on reimbursement to expressly permit *outside* directors to recoup their losses either through insurance or indemnification. The use of insurance would be preferable in order to properly balance the competing policies of compensation and deterrence. On the other hand, indemnification is less desirable because it shifts the director's damages directly to the shareholders, including perhaps the plaintiff. The Code should retain its section 1724 restrictions prohibiting indemnification for intentional acts, recklessness, or bad faith.

In light of high litigation costs, a defendant's actual expenses in a section 1704 action may well exceed the current liability limit of $100,000. That possibility is even greater if the drafters decrease the liability limit, as this Note proposes. Thus, it is necessary to further refine the ban on reimbursement to permit a defendant to shift his litigation expenses as opposed to his liability for damages. In this limited circumstance, therefore, the Code should expressly permit the use of insurance contracts to fully fund the litigation costs of any section 1704 defendant. In order to ease access to insurance for litigation expenses, the Code should adopt the Uniform

---

208. *See* notes 114 & 124 *supra* and accompanying text.

209. *See* note 196 *supra* and accompanying text.

Contribution Among Joint Tortfeasors Act rule on contribution between settling and nonsettling defendants. By making settlement a more attractive alternative, this change would reduce litigation costs, which would reduce the cost of insurance, and increase its availability. Furthermore, such an approach would promote judicial economy.

The final issue that this proposal must consider is the definition of inside and outside director. At the 1978 Annual Meeting, Professor Loss proposed defining an inside director as "an officer or employee of, or who controls, is controlled by, or is under common control with, the registrant."[210] He defined outside directors as all other directors. As a general rule this definition is appropriate, but if rigidly applied it overlooks the possibility that one who fits the outside director definition may be acting with as much or more influence and responsibility as an inside director. For example, in *Feit v. Leasco Data Processing Equipment Corp.*,[211] the court held that the registrant's outside counsel, though nominally an outside director, was "so deeply involved that he was really an insider."[212] In order to meet this problem, the Code could reasonably adopt Professor Loss' definition as an initial rebuttable presumption that could be overridden by proof that the individual in question bore such a high level of responsibility that he was in fact an insider. By establishing responsibility rather than knowledge or awareness as the overriding criterion, the Code does not place the outside director in the potentially contradictory position of having acquired such a familiarity with the registrant in the course of his statutorily required reasonable investigation that he becomes an inside director without a right to indemnification.

V. Conclusion

The proposed solution to the controversy surrounding civil liability under the Code and its relationship to indemnification, contribution, and insurance is not a panacea. It is not as neat as one would desire, and it leaves questions unanswered, such as whether the indemnification and contribution changes ought to apply beyond section 1704.[213] Nevertheless, the proposal is internally consistent—an improvement over the Code's liability and indemnifica-

---

210. 55 ALI Proceedings 402 (remarks of Professor Louis Loss).

211. *See* note 64 *supra* and accompanying text.

212. *See* note 70 *supra* and accompanying text.

213. Sections 1724(d), (e)(2)-(5), and (f) apply to all liability arising under the Code, not merely § 1704 liability.

tion provisions. Furthermore, it has a sound policy basis, and it attempts to meet the arguments of both sides of the American Law Institute debate. In summary, the proposal is as follows:

(1) Define inside directors as those who are officers or employees of, or those who are controlled by or who control the registrant, and those persons whom the plaintiff proves to have such a high level of responsibility in the registrant's operations that they must be considered inside directors. Outside directors are all other directors and those defendants who can prove that they bore such insignificant responsibilities in the operation of the registrant that they should be considered outside directors.

(2) Maintain sections 1704 and 1705 as drafted, but consider lowering the liability limitations for individuals under section 1704 below $100,000.

(3) Prohibit indemnification and liability insurance for damages assessed against inside directors in section 1704 actions, but permit insurance to fund litigation expenses unless the defendant acted with scienter.

(4) Expressly permit indemnification and insurance for both damages and litigation expenses of outside directors in section 1704 actions, unless the defendant acted with scienter.

(5) Adopt the Uniform Contribution Among Joint Tortfeasors Act rule on contribution between settling and nonsettling defendants.

THOMAS D. WASHBURNE, JR.