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DISTRIBUTION OF RISK IMPOSED UPON CORPORATE OFFICIALS BY FEDERAL SECURITIES LEGISLATION

A CHANGED public attitude has led to the demand that corporate officials be held to the high standards of trusteeship.[1] But imposition of strict personal

1. The United States has followed the lead of England in this regard. See H. R. REP. No. 85, 73d Cong., 1st Sess. (1933) 3; DEPARTMENTAL COMMITTEE ON THE COMPANIES ACTS, 1908 to 1917, MINUTES OF EVIDENCE (1925) 21, 45, 66, 68, 143, 197, 246. For Senator O'Mahoney's suggestion that officers and directors be made personally liable for damages sustained whenever their corporation violates the Anti-Trust Laws, see N. Y. Times, June 29, 1939, p. 6, col. 2; July 4, 1939, p. 21, col. 4; July 5, 1939, p. 16, col. 3; July 17, 1939, p. 1, col. 6; July 19, 1939, p. 18, col. 3. This attitude has been supplemented by a recurring agitation for professional directors more actively interested in their duties and more responsive to the interests of stockholders. N. Y. Times, March 23, 1940, p. 21, col. 1; March 31, 1940, § 3, p. 7, col. 1; SAMUEL, SHAREHOLDERS' MONEY (1933) 140. See Quintal v. Greenstein, 142 Misc. 854, 861, 256 N. Y. Supp. 462, 470 (Sup. Ct. 1932); Douglas, *Directors Who Do Not Direct* (1934) 47 HARV. L. REV. 1305, 1307; N. Y. Times, Jan. 10, 1939, p. 27, col. 5; Jan. 17, 1939, p. 38, col. 1; Jan. 26, 1939, p. 37, col. 1; Jan. 31, 1939, p. 35, col. 1; March 10, 1939, p. 35, col. 1; March 11, 1939, p. 16, col. 3.

liability upon corporate officials[2] is an abrupt departure from tradition.[3] This new concept of responsibility has brought with it a personnel problem, reflected in demands that corporations compensate their officials for legal risks and that there be distribution of risk or loss between the corporations and individuals liable.[4] Federal legislation regulating the sale and issuance of securities[5] contains the most positive expression of the legal responsibilities now imposed upon directors and officers of corporations. It is therefore proposed to consider briefly the nature of liability under these laws, and to discuss the availability of possible methods of risk distribution.

Section 11 of the Securities Act of 1933 makes the corporation, its directors and all who sign a registration statement liable to an investor for any untrue statement or omission of a material fact in the registration statement. Individuals may avoid liability by proving that they believed after reasonable investigation and upon reasonable grounds that the statements were properly made, or that they had no reasonable ground to believe statements made on the authority of experts were improperly reported. They may also show that any damages suffered by the purchaser were a result of causes other than the misrepresentations contained in the registration statement.[6] Under the Securities Exchange Act[7] and the Public Utility Holding Company Act,[8] any person making or causing to be made a false or misleading statement in the annual reports or periodic information and documents required by the Securities and Exchange Commission is liable to anyone who in reliance purchases a security at a price affected by such statement. These provisions,

2. In most cases it is immaterial whether a person sought to be held is an officer or director, except that the duties of officers actively participating in company management may be deemed more extensive. See 3 FLETCHER, CORPORATIONS (1931) § 991.

3. The word "director" has traditionally been a complete misnomer. See Rex v. Barnard, 57 Ont. L. R. 397, 424 (1925); Shulman, *Civil Liabilities and the Securities Act* (1933) 43 YALE L. J. 227, 242; Comment, *A Defense of Non-Managing Directors* (1938) 5 U. OF CHI. L. REV. 668, 671.

4. See Washington, *Litigation Expenses of Corporate Directors in Stockholders' Suits* (1940) 40 COL. L. REV. 431, 432, 451; Comment (1934) 82 U. OF PA. L. REV. 364, 368.

5. Securities Act, 48 STAT. 74 (1933), *amended*, 48 STAT. 905, 15 U. S. C. §§ 77a *et seq.* (1934); Securities Exchange Act, 48 STAT. 881, 15 U. S. C. §§ 78a *et seq.* (1934); Public Utility Holding Company Act, 49 STAT. 803 (1935), 15 U. S. C. §§ 79 *et seq.* (1938 Supp.). Section 12 of the Securities Act also imposes a civil liability but as it relates only to those who sell securities the section is not pertinent for this article.

6. A corporation is a "person" according to § 2(2) of the Securities Act; under § 6 the issuer is to sign a registration statement; and § 11a(1) makes every person signing a registration statement subject to liability. Directors are made liable by § 11a(3). The indicated defenses are provided for in §§ 11b(3)(A), 11b(3)(C), and 11e(3).

7. SECURITIES EXCHANGE ACT § 18. This section refers to § 15d wherein it is required that an issuer of securities give an undertaking to file with the Commission such supplementary and periodic information as may be required.

8. PUBLIC UTILITY HOLDING COMPANY ACT § 16.

unlike those of the Securities Act, impose liability only on those who themselves participated in the misleading statement, and give relief only to investors who acted in reliance. Moreover, individual defendants appear not to be held to a comparable high standard of conduct; they may successfully defend on the ground of their good faith or lack of knowledge of the statement's false or misleading character.

So few cases have arisen under the civil liabilities sections of these acts that no determinative construction of their practical import is possible. But a consideration of the isolated American decisions against a background of the numerous cases under the similar English statute[9] warrants at least a tentative conclusion as to the probable development of the American law. One American court[10] has indicated that under the Securities Act, directors and officers will be held to a requirement of "competence" and "innocence."[11] This differs perceptibly[12] from holdings under the English counterpart[13] to the Securities Act,[14] which have established that corporate officials need bring no special qualification to their office,[15] nor so competently perform their duties as to insure in advance preparedness and knowledge of the truth of statements made concerning the corporation's business.[16] Extreme caution is not required; motives are irrelevant; and it is a sufficient defense that there were reasonable, though not necessarily sufficient, grounds for believing

9. Companies Act, 1929, 19 & 20 Geo. V, c. 23, derived from Companies Act, 1908, 8 Edw. VII, c. 69 and Directors' Liability Act, 1890, 53 & 54 Vict. c. 64.

10. Martin v. Hull, 92 F. (2d) 208 (App. D. C. 1937).

11. 92 F. (2d) at 210. The phrase was quoted from H. R. REP. No. 85, 73d Cong., 1st Sess. (1933) 9.

12. A similar division of opinion at common law concerned whether a director or officer is negligent for failure to exercise care according to the circumstances, or for failure to exercise the degree of care an ordinary man would exercise in his own affairs. See 3 FLETCHER, CORPORATIONS (1931) §§ 1035, 1037.

13. COMPANIES ACT, 1929, § 37. See Douglas & Bates, *The Federal Securities Act of 1933* (1933) 43 YALE L. J. 171 *passim*. It may be noted that the Securities Act imposes liability on directors and signatories for misrepresentations in the registration statement. Section 10 requires that the same statements made in a registration statement be included in the prospectus; thus as to those statements repeated in prospectuses directors and signatories would be subject to liability under § 11. The Act does not, however, appear to cover any additional statements contained in the prospectus and not in the registration statement. The English Act, on the other hand, has concentrated specifically on the information contained in prospectuses.

14. At common law there was a division of opinion as to the competence corporate officials must bring to the performance of their duties. See Comment (1938) 5 U. OF CHI. L. REV. 668, 671. Some courts have held that officials are accountable for the knowledge they actually possessed or with diligence might have obtained. See People v. Equitable Life Assurance Soc., 124 App. Div. 714, 731, 109 N. Y. Supp. 453, 467 (1st Dep't 1908); Van Schaick v. Aron, 170 Misc. 520, 534, 10 N. Y. S. (2d) 550, 563 (Sup. Ct. 1938).

15. *In re* Brazilian Rubber Plant. & Est., Ltd., [1911] 1 Ch. 425; see Robertson, *The Liability of Directors* (1926) 4 CAN. B. REV. 358, 361; *cf.* Dunn's Adm'r v. Kyle's Ex'r, 77 Ky. 134 (1878); Jones v. Johnson, 86 Ky. 530, 6 S. W. 582 (1888).

16. Rex v. Barnard, [1925] 57 Ont. L. R. 397.

the prospectus was properly prepared.[17] When, however, officials of British companies have sought to rely on the fact that statements in the prospectus were phrased or omitted[18] under legal advice, the courts have occasionally been most severe in denying the defense.[19] It seems probable that in cases arising under the Securities Act, and possibly also under the other federal acts, courts will at least be as stringent as the English courts in holding corporate executives to reasonable investigation of those corporate affairs reflected in the reports and documents required under the acts.

The English cases have not placed many obstacles in the path of an investor seeking to prove a cause of action. The requirement that plaintiff show reliance on the prospectus has been no serious deterrent to his cause in England, for he need not prove that any particular statement in the prospectus induced him to subscribe.[20] Insofar as the Securities Act omits any condition of reliance, plaintiff's cause will, of course, be even more easily pursued.[21] However, another restriction has been placed upon the plaintiff's case by one American court, which, having refused to consider evidence concerning events subsequent to the date of determining damages,[22] dismissed a suit[23] for failure to show the "actual" damage suffered.[24] This court also demanded proof

17. Alman v. Oppert, [1901] 2 K. B. 576; Stevens v. Hoare, 20 T. L. R. 407 (Ch. 1904); Adams v. Thrift, [1915] 2 Ch. 21; see De La Cour v. Clinton, Trechmann v. Calthorpe, 20 T. L. R. 420, 422 (Ch. 1904).

18. The omission of sufficient facts from a prospectus to provide a fair appraisal induces liability. Greenwood v. Leather Shod Wheel Co., [1900] 1 Ch. 421. The Companies Act, 1867, 30 & 31 Vict., c. 131, § 38, Securities Exchange Act § 18, and Holding Company Act § 16, allow defendants to prove they had no knowledge of the omission. *Cf.* Macleay v. Tait, [1906] A. C. 24. The Companies Act, 1929, and Securities Act § 11, do not allow this defense.

19. Broome v. Speak, [1903] 1 Ch. 586. But see Adams v. Thrift, [1915] 2 Ch. 21, 24. For an opinion of the SEC taking an equally severe view to that in the *Broome* case, see In the Matter of Interstate Hosiery Mills, Inc., SEC Release No. 2048 (1939).

20. Macleay v. Tait, [1906] A. C. 24, 26; see Shulman, *Civil Liability and the Securities Act* (1933) 43 YALE L. J. 227, 249. Moreover, the notice plaintiff has which would bar his cause must be more than some vague information, which if followed up, would lead to notice. Greenwood v. Leather Shod Wheel Co., [1900] 1 Ch. 421.

21. Under § 11 reliance need not be shown where the issuer has not made public an earnings statement prior to plaintiff's purchase. Under other circumstances his recovery is barred by proof he knew of the untruth or omission at the time of purchase. Martin v. Hull, 92 F. (2d) 208 (App. D. C. 1937). The Securities Exchange Act § 18, and Holding Company Act § 16, make reliance a condition of suit.

22. A substantial authority had already established that subsequent events may be considered in determining value at a previous date. Hotaling v. Leach, 247 N. Y. 84, 159 N. E. 870 (1928); Whiting v. Price, 172 Mass. 240, 51 N. E. 1084 (1898).

23. Shonts v. Hirliman, 28 F. Supp. 478 (S. D. Cal. 1939).

24. *Cf.* Thorn v. Austin Silver Mining Co., 171 Misc. 400, 12 N. Y. S. (2d) 675 (Sup. Ct. 1939); Clark v. Urquhart, [1930] A. C. 28; Thomson v. Lord Clanmorris, [1900] 1 Ch. 718; Shulman, *supra* note 20, 248 n. 60; (1933) 33 COL. L. REV. 1220, 1233. The damage provisions of § 11 do appear to be clearly compensatory. *Cf.* Dean v. Shingle, 198 Cal. 652, 246 Pac. 1049 (1926); Preston v. Howell, 219 Iowa 230, 257 N. W.

that the plaintiff had begun suit within one year after he should reasonably have ascertained the necessary facts. Yet the statutes do not so clearly place on the plaintiff the burden imposed by this court, and it may be expected that other courts will deem the result an unnecessary limitation[25] upon the causes of action created by the federal statutes. It seems doubtful that liability will be mitigated by difficult obstructions to an investor's cause of action.

Remaining uncertainties as to the precise limits of directors' and officers' liability do not affect the question of whether the risk which that liability imposes may be successfully distributed. Because the civil liabilities sections of the acts are scarcely explored, the criminal provisions[26] generally unprovoked, and the extent of directors' accountability by no means definitely determined, resort to collateral analogy likewise becomes necessary in investigating the possibilities of compensating or distributing risk.

The new liability imposes one practical risk even upon innocent and competent corporate executives — officials successfully defending the conduct of their office must still meet the expense of defense and court costs. Officers and directors who have been successful in defending actions brought against them for some cause associated with their corporate function have sometimes sought or taken[27] reimbursement from the corporation. The various theories advanced to justify such payments have depended upon definitions of directors as mandatories, managing partners, bailees, trustees, fiduciaries or agents.[28] For present discussion these categories may be broadly divided into the two groups of agents and trustees.

Relying on agency doctrine, an attempt has been made to utilize the principle that an agent is entitled to indemnification for the direct consequences of an act which he was instructed to do, and which his principal knew but which he did not know would subject him to liability.[29] The courts, however,

415 (1934); Continental Corp. v. Gowdy, 283 Mass. 204, 186 N. E. 244 (1933). *But cf.* Park Bank v. Remsen, 158 U. S. 337 (1895).

25. Incongruous results may be obtained by a failure to take subsequent events into account in determining damages at the designated period. For an example see McConnell v. Wright, [1903] 1 Ch. 546; *cf.* De La Cour v. Clinton, Trechmann v. Calthorpe, 20 T. L. R. 420 (Ch. 1904); Stevens v. Hoare, 20 T. L. R. 407 (Ch. 1904).

26. SECURITIES ACT § 24; SECURITIES EXCHANGE ACT §§ 20(c), 32; PUBLIC UTILITY HOLDING COMPANY ACT § 26-3.

27. One commentator has suggested that since the individual defendants are usually in control of the corporate treasury, they do not hesitate to call on it for initial disbursements, at least. He deems recovery from them later, by the corporation problematical. See Berlack, *Stockholders' Suits: A Possible Substitute* (1937) 35 MICH. L. REV. 597, 601.

28. See Comment (1934) 82 U. OF PA. L. REV. 364, 365; *cf.* Briggs v. Spaulding, 141 U. S. 132, 147 (1891).

29. Brown v. Mechanics & Traders' Bank, 16 App. Div. 207, 44 N. Y. Supp. 645 (1st Dep't 1897); D'Arcy v. Lyle, 5 Bin. 441 (Pa. 1813); Corporation of Sheffield v. Barclay, [1903] 2 K. B. 580, *rev'd*, [1905] A. C. 392; Adams v. Morgan & Co., Ltd., [1923] 2 K. B. 234, *aff'd*, [1924] 1 K. B. 751; Thacker v. Hardy, [1878] 4 Q. B. 685

have been reluctant to allow indemnification of litigation expenses under this doctrine. In order to obtain reimbursement, the corporate official has been required to show that the loss sustained was caused directly by the agency, and without the intervention of any unsuccessful suit brought by a third person against him.[30] The officer has also had to prove affirmatively that his act was properly performed.[31] In a British case squarely in point, the director of a corporation, having successfully defended both criminal and civil suits on an alleged fraudulent prospectus, attempted to secure reimbursement from the corporation. He relied in part on agency principles. The House of Lords denied recovery[32] upon the peculiar reasoning that, inasmuch as the expenses were incurred because of an allegation of an act he had not done, and which would have been a breach of duty to have done, the expenses were not the result of an act done in discharge of his duties as a director. These decisions appear to make it fairly certain that agency doctrines will not avail officers or directors in suits for reimbursement.[33]

Corporate executives have likewise sought to utilize equitable principles to obtain reimbursement for the costs incurred in a successful defense. Where beneficiaries of trusts or decedents' estates have failed in an effort to remove for misconduct a trustee or executor-administrator, the defendant has been allowed reimbursement from the trust estate. The doctrinal basis for this result is that the defendant, having been appointed by the testator, assumed office for him and undertook to defend his position against unjust attack and to prevent the estate from falling into strange hands.[34] Although the analogy of this relationship to that between a corporation and its directors is hardly precise, considerable case law has developed in reliance upon it. Among the cases decided upon trust principles, it is important to distinguish those in which the officer or director has successfully defended against a stockholder's derivative suit brought for an alleged wrong to the corporation from those

(liability incurred under a gaming contract null and void by statute but not illegal). 1 MECHEM, AGENCY (2d ed. 1914) § 1603; STORY, AGENCY (9th ed. 1882) §§ 339, 340.

30. Hoch v. Duluth Brewing & Malting Co., 173 Minn. 374, 217 N. W. 503 (1928).

31. Or perhaps the result of an honest mistake. See Du Puy v. Crucible Steel Co., 288 Fed. 583, 588 (W. D. Pa. 1923).

32. Tomlinson v. Liquidators of Scottish Amalg. Silks, Ltd., [1935] Sess. Cas. (H. L.) 1.

33. There has been some disposition to allow directors or managers deductions for attorney's fees paid even in the unsuccessful defense of criminal prosecutions for violation of law as corporate officials, when it was found that exposure to suit was reasonably within the scope of the business engaged in. Foss v. Commissioner of Int. Rev., 75 F. (2d) 326 (C. C. A. 1st, 1935); *cf.* Kornhauser v. United States, 276 U. S. 145 (1928). But when the New York legislature granted city and county officers reimbursement from tax funds for costs incurred in defending any suit connected with their duties, the statute was declared unconstitutional. Matter of Chapman v. City of New York, 168 N. Y. 80, 61 N. E. 108 (1901).

34. Armstrong v. Boyd, 140 Ga. 710, 79 S. E. 780 (1913); Jessup v. Smith, 223 N. Y. 203, 119 N. E. 403 (1918); Ogden v. Shropshire & Adkins, 37 S. W. (2d) 249 (Tex. Civ. App. 1931).

in which the defendant, as a result of some act arising from his official duties, has been sued for an alleged wrong personal to the plaintiff.

The situation in which officers or directors have successfully defended a stockholder's derivative suit has produced no agreement as to the possibility of reimbursement for litigation expenses.[35] But in the most recent case[36] denying reimbursement, there was an indication that if the corporation had had a substantial interest to serve in defending the stockholder's suit, the corporation might have assumed the costs of defense. This has been a generally accepted rule,[37] the opinions differing as to the quantum of a substantial interest.[38] Whenever the plaintiff minority stockholder has sought a receiver for the corporation in addition to his allegations of misconduct against the defendant directors or officers, the corporation's interest in defending has usually been deemed sufficient to justify its paying the costs of suit.[39] In some instances a corporation has gone so far as to undertake the actual defense for the individual defendants as well as for itself. It has been held, however, that a corporation as a nominal defendant cannot thus be permitted to defeat what is practically its own cause of action, nor can the directors call upon the corporation to do so.[40] But a contrary view has also been taken on the ground that, even if the plaintiff should win to the benefit of the corporation, the latter would probably be liable for costs and so has a sufficient interest to participate in or undertake the defense.[41]

Precedents arising out of stockholders' derivative suits are valuable to this discussion only insofar as they indicate judicial sanction of reimbursement where the corporation has a sufficient interest in the defense of its officers and directors. Otherwise such cases do not appear relevant, since

35. Recovery allowed: Figge v. Bergenthal, 130 Wis. 594, 109 N. W. 581 (1906); Coeur D'Alenes Lead Co. v. Kingsbury, 59 Idaho 627, 85 P. (2d) 691 (1938) *semble*. Recovery denied: New York Dock Co., Inc. v. McCollum, 16 N. Y. S. (2d) 844 (Sup. Ct. 1939); Griesse v. Lang, 37 Ohio App. 553, 175 N. E. 222 (1931). See Washington, *supra* note 4, at 444; Comment (1938) 27 KY. L. J. 102.

36. New York Dock Co., Inc. v. McCollum, 16 N. Y. S. (2d) 844, 849 (Sup. Ct. 1939).

37. Davis v. Memphis City Ry., 22 Fed. 883 (C. C. W. D. Tenn. 1885); Singh v. U. S. American Malwa Sudharak Soc., 5 Cal. (2d) 405, 54 P. (2d) 1099 (1936); Esposito v. Riverside Sand & Gravel Co., 287 Mass. 185, 191 N. E. 363 (1934); Godley v. Crandall & Godley Co., 181 App. Div. 75, 168 N. Y. Supp. 251 (1st Dep't 1917), *aff'd without opinion*, 227 N. Y. 656, 126 N. E. 908 (1920); Atwater v. Elkhorn Valley Coal-Land Co., 184 App. Div. 253, 171 N. Y. Supp. 552 (1st Dep't 1918), *aff'd without opinion*, 227 N. Y. 611, 125 N. E. 912 (1919).

38. Compare cases cited *supra* note 37 with Brock v. Automobile Livery & Sales Co., 137 La. 9, 68 So. 195 (1915); New York Dock Co., Inc., v. McCollum, 16 N. Y. S. (2d) 844 (Sup. Ct. 1939); Beyer v. North Am. Coal & Mining Co., 42 N. D. 483, 173 N. W. 782, 43 N. D. 401, 175 N. W. 216 (1919). See (1931) 16 MINN. L. REV. 102; (1934) 43 YALE L. J. 661.

39. See cases cited *supra* note 37.

40. Myers v. Smith, 190 Minn. 157, 251 N. W. 20 (1933).

41. McHarg v. Commonwealth Finance Corp., 44 S. D. 144, 182 N. W. 705 (1921); see (1934) 43 YALE L. J. 661, 663.

in such stockholders' suits officers and directors have allegedly been guilty of misconduct toward the corporation. Civil suits under the federal acts are not based, at least primarily, upon any wrong to the corporation, but upon an alleged wrong personal to the plaintiff for which both the corporation and the individual defendants are liable.

The situations in which officers and directors have sought reimbursement for litigation expenses incurred in defending actions personal to the plaintiff are, therefore, of more present significance. Where directors and officers in control of the corporation have gone ahead and used corporate funds to pay for litigation expenses arising from an inter-company controversy, the corporation has been allowed to recover from them.[42] A similar recovery has been allowed[43] in a case where directors, sued for fraudulent misrepresentation in the sale of stock, had been voted an appropriation by the directors to defend themselves. In the latter case the litigation was still pending at the time proceedings were begun to determine their right to use the funds; the corporation, moreover, had not been made a party to the suit against the directors and consequently had no interest in the outcome. Denial of reimbursement under these circumstances follows a collateral line of authority which holds that an agent, trustee, corporate director or officer may not pay his own debt out of the funds of his principal, cestuis or corporation.[44] Such payments are validated not by the consent of the directors, but only by stockholder approval or ratification of the action.[45] Nor may appropriations for satisfaction of private debts be sanctioned as salaries or bonuses to the directors or officers. In the absence of statute, by-laws or charter provisions, extraordinary salaries and bonuses may not be paid without the consent of stockholders, and to be properly paid there must have been a contractual understanding in advance of performance by the director or officer.[46] It is only where the services are clearly beyond the scope of duty and are performed to the benefit of the corporation by officers and directors, that they are entitled to compensation for the value of their services,[47] and then only if they do not participate in the corporate act of appropriating the money.[48]

42. Mason v. Pewabic Min. Co., 66 Fed. 391 (C. C. A. 6th, 1894); Wickersham v. Crittenden, 106 Cal. 329, 39 Pac. 603 (1895); Hooker, Corser & Mitchell Co. v. Hooker, Corser and Whitaker, 88 Vt. 335, 92 Atl. 443 (1914).

43. Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 189 N. W. 276 (1922).

44. Kenyon Realty Co. v. Nat'l Deposit Bank, 140 Ky. 133, 130 S. W. 965 (1910); Clow-Schaaf Lumber Co. v. Kass, 30 S. D. 497, 138 N. W. 1120 (1912); Mooney v. Mooney Co., 71 Wash. 258, 128 Pac. 225 (1912).

45. Kenyon Realty Co. v. Nat'l Deposit Bank, 140 Ky. 133, 130 S. W. 965 (1910); *In re* George Newman & Co., [1895] 1 Ch. 674; *In re* Lee Behrens & Co., Ltd., 48 T. L. R. 248 (Ch. 1932).

46. Godley v. Crandall & Godley Co., 153 App. Div. 697, 139 N. Y. Supp. 236 (1st Dep't 1912), *modified and aff'd*, 212 N. Y. 121, 105 N. E. 818 (1914); Felsenheld v. Bloch Bros. Tob. Co., 119 W. Va. 167, 192 S. E. 545 (1937).

47. Huffaker v. Krieger's Assignee, 107 Ky. 200, 53 S. W. 288 (1899); Rider v. The Union India Rubber Co., 18 N. Y. Super. Ct. 85 (1859).

48. Cahall v. Lofland, 12 Del. Ch. 299, 114 Atl. 224 (1921).

When directors or officers seek reimbursement for litigation expenses, therefore, a wholly different result may be expected in those cases in which the successful defense of an action against the corporation's officials is found to have been to the benefit or interest of the corporation. This situation was presented by a recent New York case,[49] in which a corporation, its officers and directors were sued by a stockholder to compel the cancellation of an allegedly illegal resolution adopted at a shareholders' meeting. The plaintiff prevailed; nevertheless, the court decreed that the expense of the whole litigation, including that of the directors, be borne by the corporation. The decision was based on the fact that the latter was a necessary party to the litigation and on the finding that the directors had acted in good faith and on the mandate of the stockholders. This result would appear to fall within the limits of a proposition recently laid down by an English court to the effect that corporate money can be spent only on purposes reasonably incidental to the company's business, where the transaction is bona fide, and when done for the benefit or prosperity of the company.[50]

Insofar as an inferential conclusion can be drawn from these cases, it seems likely that officers or directors successful in the defense of suits brought under the federal securities legislation may obtain reimbursement of litigation expenses from the corporation.[51] The acts make the corporation jointly and severally liable with the directors and other participants for misleading statements in the registration statement or supplementary instruments, and grant a right of contribution between the parties liable.[52] The successful defense of a suit under any of these sections is, therefore, of substantial interest to the corporation, and the costs incurred by innocent officers and directors might reasonably be considered the debt of the corporation.[53] Whether a fund for the defense of the individual defendants could be appropriated in advance upon the threat of litigation seems doubtful. To allow a corporation to shield its directors from an exposure to liability is a proposition quite

49. Albrecht, Maguire & Co., Inc. v. General Plastics, Inc., 256 App. Div. 134, 9 N. Y. S. (2d) 415 (4th Dep't), *aff'd without opinion*, 280 N. Y. 840, 21 N. E. (2d) 837 (1939).

50. See *In re* Lee Behrens & Co., Ltd., 48 T. L. R. 248, 249 (Ch. 1932).

51. Where corporations, having paid the expenses of unsuccessfully defending itself and corporate directors against prosecutions for violation of law, have attempted to deduct the payments as business expenses, the deductions have not been allowed. Burroughs Bldg. Material Co. v. Commissioner of Int. Rev., 47 F. (2d) 178 (C. C. A. 2d, 1931); Gould Paper Co. v. Commissioner of Int. Rev., 72 F. (2d) 698 (C. C. A. 2d, 1934). But the deduction as a business expense of the corporation has been allowed as to that part which the corporation successfully defended for itself and the directors. Nat'l Outdoor Adv. Bureau, Inc. v. Helvering, 89 F. (2d) 878 (C. C. A. 2d, 1937).

52. SECURITIES ACT § 11; SECURITIES EXCHANGE ACT § 18; PUBLIC UTILITY HOLDING COMPANY ACT § 16.

53. See (1931) 16 MINN. L. REV. 102, 103.

different from holding that it may indemnify its officers and directors who have vindicated the conduct of their corporate function.[54]

The corporate officer who, on the other hand, has been held liable to a plaintiff investor faces greater obstacles in his attempt to secure reimbursement from the corporation.

It may readily be concluded that an individual held liable for fraudulent or wilful misrepresentation in a registration statement would not be entitled to recover litigation expenses from the corporation, much less the judgment against him. An agent subjected to liability for his fraudulent or wilful acts may not obtain reimbursement from his principal.[55] An officer or director, furthermore, who has been found guilty of misconduct to the corporation has obviously been unfaithful to his trust and thus may not use corporate funds to pay his losses.[56]

Under the Securities Act, however, a director may also be held liable for mere negligence; he need not have signed the registration statement or even have known of its preparation.[57] In this situation the policy of a law which subjects directors to liability for inattention to corporate affairs may perhaps conflict with judicial sympathy for a hapless defendant. In an analogous situation the House of Lords allowed the defendant to recover from the third party for whose benefit he had acted. A contract to indemnify was implied in order to relieve from liability one who, in performing a ministerial duty at the direction of another, had committed acts which, though of apparent legality, were actually a breach of duty.[58] In that case a bank took stock as security on a loan and sent it to the issuing corporation to have the stock transferred on its books. The new certificate was then negotiated by the bank. The real owner of the original certificate subsequently discovered that his stock had been fraudulently indorsed by the person making the loan at the bank, sought and obtained a reissue of the shares from the corporation. The latter brought suit against the bank for the loss it had sustained, and the court, finding the corporation to have been an agent of the bank, granted the recovery. It was emphasized in the opinion that the corporation owed

54. *Cf.* Jesse v. Four Wheel Drive Auto Co., 177 Wis. 627, 189 N. W. 276 (1922); Percy v. Millaudon, 3 La. 568 (1832).

55. 1 MECHEM, AGENCY (2d ed. 1914) § 1611.

56. McCourt v. Singers-Bigger, 145 Fed. 103 (C. C. A. 8th, 1906); Witherspoon v. Hornbein, 70 Colo. 1, 196 Pac. 865 (1921); Chabot & Richard Co. v. Chabot, 109 Me. 403, 84 Atl. 892 (1912); General Mtge. & Loan Corp. v. Guaranty Mtge. & Sec. Corp., 264 Mass. 253, 162 N. E. 319 (1928); McConnell v. Combination Min. & Mill. Co., 31 Mont. 563, 79 Pac. 248 (1905); Monahan v. Kenny, 248 App. Div. 159, 288 N. Y. Supp. 323 (1st Dep't 1936).

57. SECURITIES ACT § 11.

58. Corporation of Sheffield v. Barclay, [1905] A. C. 392, 399, *rev'g* [1903] 2 K. B. 580; *cf.* Betts v. Gibbins, 2 Ad. & El. 57 (K. B. 1834); Westropp v. Solomon, [1849] 8 C. B. 344; Thacker v. Hardy, [1878] 4 Q. B. 685; Adams v. Morgan & Co., Ltd., [1923] 2 K. B. 234, *aff'd*, [1924] 1 K. B. 751.

no duty to the defendant bank, but only a duty to its stockholders to keep the stock register correct.[59] This case offers an adequate analogy for allowing the director of a corporation held liable under the Securities Act for mere negligence or nonfeasance to secure indemnity from the corporation. In both situations the agent, in performing an act for the benefit of his principal, incurs liability to a third person for violation of a duty and requests indemnification from his principal, who did not realize that the agent's act would violate the rights of another. But the cases litigated and decided on trust principles have reached a different result. Where a trustee failed to object to an inheritance tax assessment within the prescribed statutory period, and had to incur the expenses of an attorney in reopening the assessment, he was not allowed reimbursement from the trust estate.[60] The court felt that the expenses had been incurred in part to relieve the trustee from responsibility for his negligence, and therefore not for the exclusive benefit of the estate. While directors are preferably considered as *sui generis*[61] rather than classified as agents or trustees, these two cases may represent the poles within which the issue will be determined.

A middle ground is suggested by the suretyship terminology used in some cases arising under state statutes which impose liability on directors. These statutes have made directors liable for dividends paid out of capital, for fraudulent misappropriations by other officers of the corporation, and for debts incurred by the corporation in a greater amount than total capital. As under the Securities Act, judgment may be entered against the defendants for mere nonfeasance, without proof of fraud or active negligence. A substantial number of cases have discussed this liability as one of suretyship for the corporation.[62] There is some reason in a contention that the full impact of liability should not be imposed upon directors guilty merely of nonfeasance, but that it is sufficient to hold them liable only as sureties for the corporation to afford plaintiffs greater assurance of having their judgments satisfied than if the corporation alone were liable. In answer to the criticism that corporate officials ought not to be relieved of their statutory responsibility, it may be suggested that the risks attendant upon suits for reimbursement are possibly sufficient to induce directors to give that degree of active and competent attention to corporate affairs plainly contemplated by the statute. But it is not certain that the courts' description of directors

59. [1905] A. C. at 403.

60. *In re* Flaacke's Estate, 64 Atl. 1020 (N. J. Prerog. Ct. 1906), *aff'd without opinion*, 72 N. J. Eq. 944, 73 Atl. 1117 (1907).

61. See New York Dock Co., Inc. v. McCollum, 16 N. Y. S. (2d) 844 (Sup. Ct. 1939).

62. Brown v. Major, 164 Fed. 673 (C. C. A. 9th, 1908), Crane-Johnson Co. v. Commissioner of Int. Rev., 105 F. (2d) 740 (C. C. A. 8th, 1939); Dean v. Shingle, 198 Cal. 652, 246 Pac. 1049 (1926); Slater v. Taylor, 241 Ill. 102, 89 N. E. 271 (1909); (1927) 25 MICH. L. REV. 458; *cf.* Lukach v. Blair, 108 Misc. 20, 178 N. Y. Supp. 8 (Sup. Ct. 1919).

as sureties under state liability statutes is to be taken so literally as to give directors the rights and remedies of sureties in suits against a corporate principal. At least no case so holding has been found.[63] Furthermore, the fact that Section 11(f) of the Securities Act imposes a joint and several liability on directors, signatories to the statement and the corporation, and allows contribution between them, may indicate that all parties are principals in this liability and that a principal-surety relationship is not contemplated.

Since it appears that implied rights of indemnity are, at least, doubtful, a more certain method of shifting risks must be sought. One method which immediately suggests itself is the making of specific contracts in advance to avoid liability or to distribute loss.

In England the practice has grown up of including in indentures or prospectuses a non-recourse provision to immunize directors from the statutory liability imposed by the Companies Act.[64] One prospectus considered by the House of Lords provided that purchasers "agree to waive any fuller compliance with Section 38 of the Companies Act, 1867, than is contained in the said prospectus."[65] It was held that this clause was sufficient to relieve directors from liabilities arising from an honest mistake, but the court indicated that if the clause had been a part of the machinery for fraud it would not have protected those who contrived it.[66] American courts have likewise had little difficulty in upholding waiver clauses inserted in various contracts between corporations and their creditors to enable directors and stockholders to escape liability imposed by state statutes. These statutes are designed to protect creditors from false financial statements and debts incurred in excess of permitted amounts, and to make directors and stockholders responsible for the debts of the corporation.[67] This generally agreed upon result has been reached by treating the state liability statutes as remedial rather than penal,[68] and thus waivable by creditors for whose protection they were enacted.

63. Where the president of a corporation was sued for fraudulent management, he was credited with two-thirds the amount of the judgment, since plaintiff had released two of his co-defendant directors, and contribution between tortfeasors is allowed in New York. Union Discount Co., Inc. v. MacRobert, 134 Misc. 107, 234 N. Y. Supp. 529 (Sup. Ct. 1929); *cf.* Duell v. Brewer, 92 F. (2d) 59 (C. C. A. 2d, 1937).

64. COMPANIES ACT, 1867, § 38; COMPANIES ACT, 1908, § 84; COMPANIES ACT, 1929, § 37.

65. Macleay v. Tait, [1906] A. C. 24.

66. *Cf.* Stevens v. Hoare, 20 T. L. R. 407 (Ch. 1904).

67. Babbitt v. Read, 236 Fed. 42 (C. C. A. 2d, 1916), *cert. denied*, 243 U. S. 648; Preston v. Howell, 219 Iowa 230, 257 N. W. 415 (1934); Continental Corp. v. Gowdy, 283 Mass. 204, 186 N. E. 244 (1933), Comments (1934) 34 COL. L. REV. 107; (1933) 19 CORN. L. Q. REV. 98; (1933) 28 ILL. L. REV. 564; (1933) 82 U. OF PA. L. REV. 59; Katz v. Dunn, 285 Mass. 340, 189 N. E. 54 (1934); Marfield v. Cincinnati, D. & T. Traction Co., 111 Ohio 139, 144 N. E. 689 (1924); see Bonbright, *Shareholders' Defenses Against Liability to Creditors on Watered Stock* (1925) 25 COL. L. REV. 408, 423.

68. But some courts have held the statutes penal and not waivable. Park Bank v. Remsen, 158 U. S. 337 (1895); Swancoat v. Remsen, 78 Fed. 592 (C. C. S. D. N. Y. 1897); Patterson v. Thompson, 86 Fed. 85 (C. C. Ore. 1898).

There is also general concurrence with the English view that liability for fraudulent conduct may not be thus waived.[69] Provisions of the three securities statutes, however, seem fully and clearly to repel any attempt to avoid loss by this method. The acts declare that any condition, stipulation or provision binding any person to waive compliance with the statutes is void.[70]

Though liability cannot be avoided, the loss which it may impose may perhaps still be shifted by explicit agreements between the corporation and its officers. Contracts to indemnify corporate officials and hold them harmless from liability have been adopted as a presumably workable method of risk distribution.[71] Yet an immediate question arises in view of the contribution provisions of the federal securities legislation,[72] dealing with the validity of those contracts insofar as they contemplate indemnification of persons against whom judgments may be entered. Parties subject to Section 11 of the Securities Act are jointly and severally liable; parties liable under any of the three acts have a right to contribution between them. If indemnification contracts with the corporation are permitted, then the arrangement will not be one in which each party liable under the acts will have to bear some portion of the ultimate liability, for the ultimate burden will rest with the corporation which has contracted to bear it. If, then, judgment were first recovered against the corporation for misrepresentation in a registration statement, it would have no right to contribution from the directors or officers whose liability to purchasers of shares the corporation had agreed to assume.[73] Furthermore, if the directors or officers were first sued by the security holder, they would have a right of recovery in full against the corporation. The Securities Act probably does not specifically[74] or even impliedly[75] preclude such an arrangement. Section 11 of the Securities Act in fact would seem to sustain its validity, for the issuing corporation alone of all possible de-

69. Slater Trust Co. v. Randolph-Macon Coal Co., 166 Fed. 171 (C. C. S. D. N. Y. 1908); Walker v. Howell, 209 Iowa 823, 226 N. W. 85 (1929); Small v. Sullivan, 245 N. Y. 343, 157 N. E. 261 (1927); State v. Comer, 176 Wash. 257, 28 P. (2d) 1027 (1934).

70. SECURITIES ACT § 14; SECURITIES EXCHANGE ACT § 29; PUBLIC UTILITY HOLDING COMPANY ACT § 26.

71. N. Y. Times, Dec. 10, 1939, § 3, p. 1, col. 8; March 23, 1940, p. 21, col. 1; March 31, 1940, § 3, p. 7, col. 1.

72. SECURITIES ACT § 11f; SECURITIES EXCHANGE ACT § 18(b); PUBLIC UTILITY HOLDING COMPANY ACT § 16.

73. Hayden v. Thrasher, 18 Fla. 795 (1882); Blake v. Cole, 39 Mass. 97 (1839); Hoyt v. Griggs, 164 Iowa 672, 146 N. W. 745 (1914); see Batard v. Hawes, 2 El. & Bl. 287, 297 (Q. B. 1853).

74. Section 14 of the Securities Act, for example, provides only that contracts or conditions by which the purchaser of securities waives compliance with the Act shall be void.

75. See Douglas & Bates, *The Federal Securities Act of 1933* (1933) 43 YALE L. J. 171, 178.

fendants is deprived of certain important defenses.[76] It thus appears that the Act does not intend to mitigate the corporation's responsibility, but rather holds the corporation, more than any other party, to an absolute liability for a misleading registration statement.

Since the federal securities legislation does not, at least in terms, militate against the execution of such contracts, the problem becomes one of the procedure that directors and officers must follow in contracting with the corporation for indemnification, and of the corporations' power to pay out funds pursuant to such contracts. Contracts between corporations and their directors and officials are hedged about with limitations which seek to secure the interests of creditors and stockholders,[77] and at the same time to preserve to directors and officers the capacity to deal independently with the corporation.[78] When a corporate official takes part in making or authorizing a contract between the corporation and himself, and his vote is necessary to bind the corporation, the transaction is at least voidable by the latter. Where, however, the resolution of stockholders fixing an extra compensation for the managing directors was passed by the votes of the directors, who were also stockholders, it has been held that the contracts would not be set aside unless found to be disadvantageous to the minority stockholders.[79] Moreover the great weight of authority upholds the validity of such transactions, when the corporation is represented by disinterested directors or officers who have acted in good faith in its behalf.[80] Directors or officers may be sued by the corporation for using corporate credit to their private ends, for profits realized through individual dealings in transactions closely related to the corporate business, and for profits obtained by engaging in a competing business; yet all of these transactions have been sanctioned when accomplished by contract.[81] Certainly an officer or director can put such price on

76. According to § 11 the corporation may not plead in defense that it believed upon reasonable ground that the matters asserted were true and that all necessary facts were included, or that there was no reasonable ground to believe and no belief that the assertions made by experts were untrue or that there had been any improper omissions.

77. Twin-Lick Oil Co. v. Marbury, 91 U. S. 587 (1875); see 1 FLETCHER, CORPORATIONS (1931) §§ 193 *et seq.*

78. Fort Payne Rolling Mill v. Hill, 174 Mass. 224, 54 N. E. 532 (1899).

79. Booth v. Beattie, 95 N. J. Eq. 776, 118 Atl. 257 (1922), *aff'd without opinion*, 95 N. J. Eq. 776, 123 Atl. 925 (1924).

80. 3 FLETCHER, CORPORATIONS (1931) § 931. For a usual provision to cover this situation inserted in many certificates of incorporation see DOUGLAS & SHANKS, CASES AND MATERIALS ON THE LAW OF MANAGEMENT OF BUSINESS UNITS (1931) 807. Ratification or acquiescence by the stockholders will bind the company and the minority stockholders. Putnam v. Juvenile Shoe Corp., 307 Mo. 74, 269 S. W. 593 (1925); Tefft v. Schaefer, 136 Wash. 302, 239 Pac. 837 (1925).

81. *In re* Country Club Bldg. Corp., 91 F. (2d) 713 (C. C. A. 7th, 1937); Lowe v. Copland, 125 Cal. App. 315, 13 P. (2d) 522 (1932); Rabbitt v. Union Indemnity Co., 140 Cal. App. 575, 35 P. (2d) 1066 (1934); Anderson v. Dunnegan, 217 Iowa 672, 250 N. W. 115 (1933); Thilco Timber Co. v. Sawyer, 236 Mich. 401, 210 N. W. 204 (1926);

his services as he sees fit, so long as the corporation has the option through its other officials to decide whether or not the offer is to be accepted.[82]

Even though it be assumed that a director or officer may contract with the corporation in regard to his services, the corporation may still not be empowered to pay out its funds pursuant to contracts of indemnity. Whenever individual defendants under the federal statutes are found to have acted fraudulently, it seems most probable no court would tolerate recovery from the corporation of the amount of the judgment rendered against them.[83] This leaves the situations in which the defendants seek to exercise contract rights to indemnity for judgments rendered against them for negligence, and for litigation expenses incurred when their defenses were successful. It has been held, as previously indicated,[84] that corporate money can be spent only on purposes reasonably incidental to the company's business, when the transaction is bona fide, and when done for the benefit or prosperity of the company. Releases given directors or officers discharging them from some financial obligation to the corporation are, in effect, likewise a grant of corporate property to corporate officials. Yet releases have given rise to a large number of cases whose effect is not to restrict the power of corporations over their assets. The accepted principle is that such arrangements are internal affairs of the corporation; and courts, in the absence of fraud, will not interfere with internal management and policy even though claims for gross negligence and mismanagement are waived. When creditor's rights do not intervene,[85] it is said that the corporate assets belong to stockholders who may do with them as they will,[86] subject only to the objections of the domiciliary state. Where only a majority of stockholders or a quorum of directors assented to releases, some courts have refused to sustain them without an examination to see that the releases were not improvident for

Steinway v. Steinway, 2 App. Div. 301, 37 N. Y. Supp. 742 (1st Dep't 1896); Lange Soap Co. v. Ward, 269 S. W. 851 (Tex. Civ. App., 1925); Comment (1939) 39 COL. L. REV. 219, 226.

82. Anderson v. Dunnegan, 217 Iowa 672, 250 N. W. 115 (1933).

83. *Cf.* Macleay v. Tait, [1906] A. C. 24; Walker v. Howell, 209 Iowa 823, 226 N. W. 85 (1929).

84. See page 1431 *supra.*

85. *In re* John B. Rose Co., 275 Fed. 416 (C. C. A. 2d, 1921).

86. Releases have been generally held valid where stockholders consented or apparently acquiesced in their execution. Karasik v. Pacific Eastern Corp., 180 Atl. 604 (Del. Ch., 1935); Princeton Coal and Mining Co. v. Gilchrist, 51 Ind. App. 216, 99 N. E. 426 (1912); Whitfield v. Kern, 122 N. J. Eq. 332, 192 Atl. 48 (1937), *rev'g* 120 N. J. Eq. 115, 184 Atl. 333 (1936); Mendelson Bros. Factors, Inc. v. Sachs, 253 App. Div. 270, 1 N. Y. S. (2d) 838 (1st Dep't 1938). *But cf.* Siegman v. Electric Vehicle Co., 140 Fed. 117 (C. C. N. J. 1905); Erie R. R. v. Vanderbilt, 5 Hun. 123 (N. Y. 1st Dep't 1875); Harris v. Chambers, 121 Okla. 75, 247 Pac. 695 (1926). For a case where a covenant not to sue between minority stockholder and corporation was sustained, see Butler v. Butler Bros., 186 Minn. 144, 242 N. W. 701 (1932).

the corporation;[87] but other courts have permitted the proper officers and directors alone to make the settlement or release without any judicial supervision.[88] Corporations, then, may have the legal power to contract with their officers and directors and to appropriate assets to their benefit when good faith and fair dealing are present. Contracts of indemnification for losses incurred under the federal securities legislation, through an adverse judgment for negligence or for the costs of a successful defense, would appear to present a strong case for the exercise of these powers. Exposure to suit in the first instance and risks attendant on reimbursement may insure that the contracts will not induce disregard of duties.[89] Corporations, moreover, would be in a position to secure the services of a desired personnel and an able defense of suits in which they were vitally interested. The tools of the law are adequate for this result. The question remains whether the policy of the law permits their use.

Similar exculpatory provisions were formerly used in England with some success.[90] One such clause, given effect in In re *Equitable Fire Insurance Co., Ltd.*,[91] was particularly complete. It provided, *inter alia,* that the directors "shall be indemnified and secured harmless out of the assets and profits of the company from and against all actions, costs . . . and expenses which they . . . shall or may incur by or by reason of any acts done, concurred in or omitted in or about the execution of their duty or supposed duty . . ." except wilful neglect or default and "none of them . . . shall be answerable for . . . any other loss, misfortune or damage which may happen in the execution of their respective offices or trust or in relation thereto, unless the same shall happen by or through their own wilful neglect or default." It was held that the latter part of the clause provided a successful defense to directors sued by the official receiver of the corporation for mismanagement and neglect of duty, although those defendants were found guilty of a breach of duty as directors.[92] Possibilities predicated for

87. United States Lines v. United States Lines Co., 96 F. (2d) 148 (C. C. A. 2d, 1938); Williams & Miller Gin Co. v. Knutson, 63 S. W. (2d) 576 (Tex. Civ. App., 1933); *cf.* Stanton v. Occidental Life Ins. Co., 81 Mont. 44, 261 Pac. 620 (1927).

88. Browne-Brun Wholesale Groc. Co. v. Hinton, 179 Ark. 831, 18 S. W. (2d) 369 (1929); Holland v. Presley, 255 App. Div. 667, 8 N. Y. S. (2d) 804 (2d Dep't 1939); Troy Mining Co. v. White, 10 S. D. 475, 74 N. W. 236 (1898); *cf.* Craig v. James, 89 App. Div. 541, 85 N. Y. Supp. 583 (1st Dep't 1904), *aff'd without opinion,* 181 N. Y. 538, 73 N. E. 1121 (corporation had derived and retained some benefits from settlement); see Independent Order of Foresters v. Scott, 223 Iowa 105, 115, 272 N. W. 68, 74 (1937).

89. Contracts which do induce a disregard of duties are often deemed illegal. 3 FLETCHER, CORPORATIONS (1931) § 1000.

90. SAMUEL, SHAREHOLDERS' MONEY (1933) 125; Robertson, *The Liability of Directors* (1926) 4 CAN. B. REV. 358.

91. [1925] 1 Ch. 407.

92. [1925] 1 Ch. 407 at 468; *cf. In re* Brazilian Rubber Plantations and Estates, Ltd., [1911] 1 Ch. 425; Leeds City Brewing, Ltd., v. Platts, [1925] 1 Ch. 532; *In re* London Insurance Co., Ltd., 41 T. L. R. 521 (Ch., 1925).

this type of clause, however, were short-lived, for after considerable discussion in England,[93] Parliament in 1929[94] voided all clauses exempting any director or officer from, or indemnifying him against, any liability which by any rule of law would attach to him for negligence, default or breach of trust in relation to the company. But a company may still indemnify any director or officer against liability incurred in defending any proceedings in which judgment is given in his favor. Moreover, these statutory provisions apparently do not apply to individual defendants sued for misrepresentations in prospectuses, in which case the duty is owed to purchasers of stock rather than "to the company." The House of Lords, however, has effectively limited the force of such clauses, even in the cases where official conduct in the preparation of prospectuses has been vindicated. In the articles of one company it was provided that every director should be indemnified by the corporation against all costs, losses or expenses incurred by reason of any contract entered into, or act or deed done by him as such director, in any way, in the discharge of his duties. The plaintiff-director was sued civilly and criminally for having issued an alleged false prospectus, and judgment was entered in his favor in both cases. He thereupon sought to recover his attorney's fees from the corporation under the article paraphrased above. The English Courts had already established that the articles of incorporation had to be taken to express the terms upon which directors accepted their position.[95] Yet the court held that the fees, having been incurred by reason of allegations of matters which would have been a breach of duty had they been proved, were not expenses incurred by reason of an act done by him as a director in the discharge of his duties.[96] While the decision rested on a construction of the article and not upon its validity, it is difficult to see how the article could have been validly worded to effect a contrary result. Apparently, the article would have had to provide that the director should be indemnified for expenses incurred both within and beyond the scope of his duties. It is evident, then, that Parliament has not permitted a relaxation of the duties owed by officers and directors to their corporation, and that the English courts, expressing the same attitude, are not willing to relieve corporate officials of their responsibility in controlling other peoples' investments. Insofar as the English interpretation of the Companies Act becomes persuasive in decisions under the Securities Act, such expressions of policy will be of material significance.[97]

93. GREAT BRITAIN, BOARD OF TRADE, COMPANY LAW AMENDMENTS COMMITTEE, MINUTES OF EVIDENCE (1925) XV, XVIII, XLVIII, LXIII, LXXIV; see also *supra* note 1.

94. COMPANIES ACT, 1929, § 152.

95. Isaacs' Case, [1892] 2 Ch. 158; see *In re* City Equitable Fire Ins. Co., [1925] 1 Ch. 407, 521.

96. Tomlinson v. Liquidators of Scottish Amalgamated Silks, Ltd., [1935] Sess. Cas. (H. L.) 1. See p. 1428 *supra*.

97. As an alternative to contracts for indemnification, the proposal has been made that corporations insure their officers and directors to protect them against increasing

It may be conceded that the practical effect of the Securities and Exchange Commission's supervision over registration statements is to decrease the possible liability of directors and signatories, since under Section 11 liability may not be incurred until the statement has become effective. But after a statement becomes effective, the Commission has authority to enter a stop order if it finds that there is any untrue statement or omission of a material fact.[98] An entry of a stop order may tend to increase the number of shareholders' suits, even though it is not yet decided that the stop order will be accepted as evidence in a court of law to facilitate further an investor's cause of action.[99] The English Companies Act gives the courts power to relieve a director or officer of liability when it appears that he is or may be liable for negligence, default, breach of duty or trust, even though he has acted reasonably and honestly and ought fairly to be excused.[100] American jurisdictions achieved a similar result at common law by varying the legal responsibilities of directors and officers according to the function they were intended to perform and the compensation they received.[101] But the federal securities legislation has made no such allowances, although it is generally conceded that boards of directors should be composed of widely diverse groups including the corporation's executives, representatives of its stockholders, persons with business and banking connections, and experts in other fields.[102]

The federal acts, however, do present one answer to the problem of risk distribution, quite distinct from the doctrines associated with the ordinary contracts for reimbursement. Under the Securities Act,[103] the Securities

liability in an effort to prevent additional resignations and to encourage a policy of "professional directors." Yet it has been indicated that insurance companies could not permit directors to retain their own counsel and receive an allowance for fees from the insurance; nor could they insure as to a particular registration statement without being allowed to participate in the preparation of the statement, and to approve the counsel and auditor. See statement by J. R. Rooney of the Insurance Co. of North America, N. Y. Times, April 23, 1939, § 6, p. 8, col. 5; see also N. Y. Times, April 9, 1939, § 6, p. 1, col. 2. It seems fairly clear that no corporation could insure under these conditions. Moreover, to provide insurance for directors and officers is similar to payment of additional compensation or contracts to indemnify against loss. It is true that parties would still be exposed to suit, and the corporation would not be committed to defending the individual defendants in court, but such policies might still be struck down on a theory that they induce an evasion of statutory duty. See 3 FLETCHER, CORPORATIONS (1931) § 1000.

98. SECURITIES ACT § 8(d).

99. See Comment (1940) 49 YALE L. J. 1250, 1267.

100. COMPANIES ACT, 1929, § 372. It has been held that this section would not relieve a director from paying damages owed to the corporation, unless he showed approval of the stockholders or directors for such relief. *In re* Barry & Staines Linoleum, Lt'd, [1934] 1 ch. 227.

101. See Comment (1938) 5 U. OF CHI. L. REV. 668.

102. See Douglas, *Directors Who Do Not Direct* (1934) 47 HARV. L. REV. 1305, 1313.

103. SECURITIES ACT § 11f.

Exchange Act[104] and the Public Utility Holding Company Act,[105] anyone liable to suit may recover contribution, as in cases of contract, from any person who would have been liable if sued separately, provided that the person originally paying the judgment was not guilty of fraudulent misrepresentation.[106] Thus the statutes alter the common law rule prohibiting contribution between joint tortfeasors.[107] Since the corporation is liable along with the individual defendants under the federal acts, it seems possible that by-laws, corporate charter or contracts between the corporation and its officers may provide that the various parties should be liable in amounts varying according to their function and their remuneration. Thus, while anyone would be liable for the whole damage at the suit of a purchaser or seller[108] of securities, he would have a right to contribution from the others according to the extent of their undertaking.[109] Attorney's fees may be collectible, also, according to the undertakings, for it has been held that a co-surety who has defended a suit on a bond in good faith is entitled to contribution for court costs.[110]

A difficulty with this plan arises, however, with the possibility that a corporation occasioned loss by the acts of its directors or officers in preparing a registration statement would have a cause of action against them for breach of their fiduciary duties to the corporation. This cause of action would be quite apart from, and in effective opposition to, the contribution provisions. Corporate officials are, of course, liable for their fraudulent acts. Officers and directors are generally said to be liable to the corporation for damages caused by their want of care according to the circumstances, or as otherwise stated, for want of the care an ordinary man would exercise in his own affairs.[111] Honest or excusable mistake or an error of judgment, will, however, afford a sufficient defense.[112] If directors or officers were held liable under the federal acts for such negligence or fraud for which the corporation would ordinarily have a cause against them, and the cause of the cor-

104. SECURITIES EXCHANGE ACT § 18b.

105. PUBLIC UTILITY HOLDING COMPANY ACT § 16 (which refers to § 18 of the Securities Exchange Act).

106. The latter clause appears only in the Securities Act § 11(f).

107. Gerson v. Simpson, [1903] 2 K. B. 197; 2 WILLISTON, CONTRACTS (Rev. ed. 1936) § 345, 1023, n. 19.

108. The provision for sellers of securities appears in § 18 of the Securities Exchange Act.

109. United States Fidelity & Guaranty Co. v. Naylor, 237 Fed. 314 (C. C. A. 8th, 1916); Loring v. Bacon, 57 Mass. 465 (1849); Jones v. Blanton, 41 N. C. 115 (1849).

110. United States Fidelity and Guaranty Co. v. Naylor, 237 Fed. 314 (C. C. A. 8th, 1916). None of the parties had paid without suit, and the court found that the defense, though unsuccessful, had been prudent and hopeful. *But cf.* Shepheard v. Bray, [1905] 2 ch. 235.

111. 3 FLETCHER, CORPORATIONS (1931) §§ 1035, 1037.

112. 3 FLETCHER, CORPORATIONS (1931) § 1039.

poration were entertained, the contribution sections of the acts would clearly be of little effect. The situation may be envisaged in which individual defendants held liable under these statutes seek contribution from the corporation, while the latter brings a counter suit for the entire damage resulting from its payments to the defendants to indemnify them against a loss caused by their negligence. Or a corporation held liable under the acts might sue the individuals subject to liability for the whole loss incurred by it rather than for the lesser amount due by way of contribution. There are several combinations of circumstances under the acts in which this may occur.[113] Assuming the contribution provisions are intended to have force, a constitutional question arises as to the power of Congress to take from corporations this right of action against directors or officers. But it is not a matter of constitutionality when the corporation has contracted for contribution between itself and its officials. It is not to be supposed, moreover, that a corporation would have a right of action over against an officer or director as to matters against which it had undertaken partially to indemnify him by way of contribution.[114]

Ten or twenty-five directors and officers cannot, each one, be the general manager of a corporation, attending to details of organization on a principle of distrust.[115] Utilization of contracts for contribution will serve the practical purpose of making each official's responsibility commensurate with the function he is intended to perform. Liability to suit in the first instance, the risks that a right to contribution may not in fact be satisfied, and the burden of a proportionate part of the ultimate liability appear to be adequate sanctions to enforce the purposes of the federal statutes. While contribution does not deter the imposition of standards of trusteeship, it may assist resolution of the problem of obtaining competent and responsible persons to serve as directors and officers.

113. This might occur when both the corporation and the individual defendant were negligent, or when both were fraudulent, or when the individual defendant was negligent and the corporation was not but liable nevertheless, being deprived of certain defenses under § 11 of the Securities Act.

114. See *In re* Brazilian Rubber Plantations and Estates, Ltd., [1911] 1 Ch. 425, 440; Leeds City Brewery, Ltd. v. Platts, [1925] 1 Ch. 532, 537.

115. See Rex v. Barnard, 57 ONT. L. R. 397, 424 (1925).