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THE DIRECTOR'S LIABILITY FOR NEGLIGENCE

RICHARD B. DYSON†

It is widely, though not universally, accepted that the corporate director has the duty to be prudent and diligent in carrying out the functions assigned to him by law and by the corporation itself. This responsibility, the duty of care, probably developed from older concepts in the law of trusts¹ and agency.² It has been more elusive, less absolute, and more subject to exceptions than the other main duty of the director, that of honesty and fidelity to the corporation he serves.³ One reason for this might be that intrinsically it is not as necessary; it is possible to have a system where honesty and fidelity are the only requirements as far as the director's legal responsibility is concerned. Some states, a small minority, appear to have taken that position.⁴ Another reason is that directors' negligence liability produces the irritating necessity of dividing the indivisible, of determining the line between excusable and actionable negligence, by little more than the venerable concept of the reasonable man. It is, after all, the application of the law of torts to the corporate director; and as with other branches of that law, it consists of a simple basic doctrine with numerous qualifications, exceptions, and mitigating factors.

The courts have indeed had their problems with it. The jury's well-known sympathy for plaintiffs has caused the courts to keep a tight rein through rulings on the sufficiency of pleadings and proof that have been the procedural basis for most of the reported cases. These rulings have necessarily been based on internalized notions of proper policy; such notions vary widely from court to court, producing different results from apparently similar rules. The doctrines have been too simple to attract much help from the scholarly quarter. Furthermore, the very idea of negligence in a managerial context seems to have been a difficult one for some judges to accept.

After a brief look at the development of directors' negligence liability, this article will consider the issues that appear to be live ones

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1. See 2 SCOTT, TRUSTS §§ 174, 201, 264 (2d ed. 1956).

2. See MECHEM, OUTLINES OF THE LAW OF AGENCY §§ 524-32 (4th ed. 1952).

3. See, e.g., *Mobile Land Improvement Co. v. Gass*, 142 Ala. 520, 39 So. 229 (1905); *Chelrob, Inc. v. Barrett*, 293 N.Y. 442, 57 N.E.2d 825 (1944).

4. Kentucky, Tennessee, and Wisconsin have apparently denied the liability of directors for anything short of bad faith. See text accompanying notes 121-24 *infra*.

today: standing to sue, the causation problem, the business judgment concept, and the standard of care.

Some Background Observations

There is nothing surprising about the origin of directors' liability for negligence. The courts early likened them to trustees, who were liable for negligently injuring the trust estate,⁵ and to agents, who were liable for negligent harm to the principal's interests in carrying out their duties.⁶ In what is usually said to be the first case on the point, *Charitable Corp. v. Sutton*,⁷ the court started out by calling the directors ("committees") agents and then went on to say that the directors, "by accepting a trust of this sort," were "obliged to execute it with fidelity and reasonable diligence" and therefore were "within the case of common trustees." They were held liable.

Charitable Corp. differed little from more modern cases on the subject. It embodied what was to be the most common factual basis for suit: the persons who were placed in day-to-day charge of the business (here it was a sort of quasi-business of lending money on collateral, supposedly to allow the poor to escape the grasp of the pawnbrokers) turned out to be dishonest. After they were apprehended or disappeared or at any rate were unsatisfactory defendants, it was sought to hold liable the directors who had entrusted the business to charlatans and failed to supervise them adequately.

A distinction might well be made between the two main types of case that give rise to negligence actions against directors. The first is illustrated by *Charitable Corp.* In that type an officer, usually in a managing position, has been dishonest or wildly imprudent, causing loss to the corporation; the attempt is to hold the directors, who, though not directly involved in the defalcations, allegedly "caused" the harm by their failure to perform properly their duties of supervision. It is characteristic of this type of case that there is no question that the underlying wrong is actionable; the only question is whether someone other than the chief wrongdoer can be made to answer for it. Although not legally innocent, the negligent director has done no intentional wrong and his liability is, in a sense, vicarious.

5. See *Delano v. Case*, 121 Ill. 247, 12 N.E. 676 (1887); *Hun v. Cary*, 82 N.Y. 65, 70-74 (1880).

6. See *Percy v. Millaudon*, 8 Mart. N.S. 68-78 (La. 1829); *Horn Silver Mining Co. v. Ryan*, 42 Minn. 196, 44 N.W. 56 (1889); *Hart v. Evanson*, 14 N.D. 570, 105 N.W. 942 (1895).

7. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

The other type of case⁸ involves some act by a director that turns out to be harmful to the corporation. Here the defendant is primarily responsible for the harm; there is no vicarious element. The question is whether the misdeed involved is one that the legal system will force the director to pay for by labeling him actionably negligent. Although the courts have generally treated the two types of case with the same legal doctrines, there are several differences between them. In the vicarious case, the defendant has simply been inattentive—he has failed to perform the duties that he assumed. In the non-vicarious case, the defendant's fault is incompetence or recklessness. In the first case the policy that is being applied is that of forcing directors to perform their minimal functions; in the second, that of making them act more circumspectly or possibly even making them decline positions that they are not competent to fill.

Non-vicarious liability has another function: to fill in some gaps in the area of intentional director fault (that is, breaches of loyalty). Often when insiders have been dealing improperly with the corporation's assets, it is difficult for an outside shareholder or creditor to gather evidence with which to prosecute a case against them. This is particularly true with large corporations whose directors have their fingers in many financial pies and can easily conceal their real motivations. Negligence liability can be more easily proved in some cases; the damage is there, and imprudence is the least of the managerial sins that can be inferred from it.⁹

One preliminary question that is somewhat unclear is whether banks and non-banking corporations can be validly treated alike or whether different rules must be applied. One state, Massachusetts, has established different standards for banks (ordinary negligence)¹⁰ and non-banks (clear and gross negligence).¹¹ No other state has explicitly observed this distinction; the majority purport to use ordinary negligence as the standard in both cases. One obvious distinction is that banks have a unique class of possible plaintiffs, the depositors. The nature of banking and the type of assets that it deals with might tend to create a higher standard of performance for the directors. On the other hand, bank directors, outside of the great metropolitan banks, are often local citizens

8. *E.g.*, *Hi-Pro Fish Prod., Inc. v. McClure*, 224 F. Supp. 485 (E.D. Ark. 1963); *Levitan v. Stout*, 75 F. Supp. 105 (W.D. Ky. 1951); *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950).

9. See *Bown v. Ramsdel*, 227 App. Div. 224, 237 N.Y.S. 573 (1929); *General Rubber Co. v. Benedict*, 164 App. Div. 332, 149 N.Y.S. 880 (1914); *Litwin v. Allen*, 25 N.Y.S. 667 (Sup. Ct. 1940).

10. *Prudential Trust Co. v. Brown*, 271 Mass. 132, 171 N.E. 42 (1930); *Greenfield Sav. Bank v. Abercrombie*, 211 Mass. 252, 97 N.E. 897 (1912).

11. *Allied Freightways v. Cholfin*, 325 Mass. 630, 91 N.E.2d 765 (1950); *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950).

with no particular business skill, whom the community perhaps does not expect to meet the standards of performance of the normal corporate director.¹² The reason the question is raised is that until the federal banking legislation of the thirties was enacted, bank cases far outnumbered the others; and much of the law on the subject consequently was formed by them. Since most courts seem to treat them alike, citing and discussing them indiscriminately, I shall assume that the court in question views the law of director negligence as the same for both types of corporations unless it has stated otherwise.

The early cases, and even more the early commentators, spent much time discussing the precise form of the proper "ordinary" (or other) standard. The main conflict was between those who would set the standard as "the ordinarily prudent man in his own affairs"¹³ and those who referred to "the ordinarily prudent director."¹⁴ If one feels that this distinction is rather fine, the feeling is justified. No significant differences in outcome developed from the distinction. Some seemed to feel that the ordinary man lavished loving care on his own concerns, and it was unreasonable to expect such assiduous attention from a director. But it is doubtful that those who used the standard, as distinguished from those who criticised it, thought of it that way. It is more likely that they simply were trying to articulate the standard of care of a director in a way that would be understandable to a lay jury. In effect, they were saying, "Is this the sort of thing that *you* would do?" Then, in answer to the imagined question in the minds of the juror, "Do under what circumstances?", they tacked on the thought, "in your own affairs," perhaps with the idea of inducing the jury to use its common sense rather than its imagination concerning what it would be like to direct a bank. This phrasing seems to have been misunderstood by those courts that rejected it, some of whom treated it as though it meant an equivalent amount of time and energy. *Swentzel v. Penn Bank*¹⁵ went to some length to reject the idea that a bank director would be obliged to spend full time at that position, which it conceived the own-affairs test as demanding. This is, of course, absurd. A director's duties are rather sharply defined, formal, and thus limited. The standards of care demand

12. See *Warner v. Penoyer*, 91 Fed. 587 (2d Cir. 1898); *Wheeler v. Aiken County Loan & Sav. Bank*, 75 Fed. 781 (C.C.D.S.C. 1896); *Wallace v. Lincoln Sav. Bank*, 89 Tenn. 630, 15 S.W. 448 (1891).

13. *E.g.*, *Fisher v. Parr*, 92 Md. 245, 48 Atl. 621 (1901); *Hun v. Cary*, 82 N.Y. 65 (1880); *Besselieu v. Brown*, 177 N.C. 65, 97 S.E. 743 (1919).

14. *E.g.*, *Briggs v. Spaulding*, 141 U.S. 132 (1891); *Rankin v. Cooper*, 149 Fed. 1010 (C.C.W.D. Ark. 1907); *Boulicault v. Oriol Glass Co.*, 283 Mo. 237, 223 S.W. 423 (1920).

15. 147 Pa. 140, 23 Atl. 405 (1892).

essentially two things from the directors: that they be present at the meetings at which they perform their duties and that they exercise a reasonable judgment during these meetings.

Part of the confusion over the quantity of performance demanded undoubtedly arose because a common source of director-negligence litigation was the director who simply absented himself altogether while the operating managers robbed the business. But directors in general are not required to perform any function of general investigation or informal supervision, except where defalcations have already come to their attention. And there the most normal method of investigation is to employ a firm of auditors.

It seems clear now that the courts were always talking about the "ordinary director;" no attempt has ever been made by courts to raise the level of the entire business world by suggesting that the average, ordinary director is negligent, although some commentators in their more crusading moments have come close to suggesting that they are.¹⁶ Any attempt to judge the conduct of a director by reference to a different area of experience seems misguided. There is certainly little similarity between the formal, statutorily-regulated world of the director and the amorphous world of the ordinary man's own affairs. Throughout the period when most of these cases were decided, the ordinary man did not even have a bank account. Directors' liability must be decided ultimately according to society's expectations of directors; and these expectations, like those in other areas of torts, are formed primarily by the normal conduct of directors themselves. The simplest formulation of the legal standard, and one that is in common use today, is that "ordinary care" is required, and its correlative default, "ordinary negligence," will be penalized. Despite the word battles, there is little or no evidence in the cases that courts who chose some "ordinary" standard (that is, the middle ground between slight care and extreme care) ever intended anything substantially different.

Another doctrinal conflict that is part of the history of director negligence liability concerns the question whether the director is essentially an agent or a trustee. *Charitable Corp. v. Sutton*¹⁷ used both words in the course of the opinion. Chancellor Hardwicke said that they were agents and that they were "in the case of common trustees." If he meant only *like* trustees in their liabilities, he was observing the distinctions and the problems of the analogy better than many judges after him. For the problem with these analogies is that agency is too broad and trustee-

16. See Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934); Wormser, *Directors—Or Figures of Earth?*, 1 BROOKLYN L. REV. 28 (1932).

17. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

ship is too narrow to describe adequately the position of a corporate director. A director is in fact and law an agent for the corporation, or perhaps it would be more proper to say the board of directors is collectively an agent. But attorneys and officers are also agents; the concept is not helpful in defining specific liabilities. Besides, the question usually has come up in connection with problems of the standing of shareholders or creditors to sue the directors; and it seems fairly clear that a director is technically not an agent of either. Neither are the directors trustees, either individually or collectively; there is no trust instrument, no separation of legal and equitable estates. Unfortunately this line of analysis was the basis for most of the formative decisions on standing,¹⁸ although today it is accepted that a director is a *sui generis* fiduciary.¹⁹ If the courts found that the director was a trustee for the shareholders, the shareholders were allowed to sue. If he was merely an agent for the corporation, then they were not. Similar types of analysis were applied to creditors.²⁰ Of course, more sophisticated judges probably made the underlying decision as to standing on unstated grounds of policy and chose among the traditional doctrines to justify it. To this extent the controversy again became merely semantic. At any rate, it does not play a significant part in modern decisions.

Underlying these doctrinal skirmishes has been a question that is perhaps more important both to the law and to society: whether directors (and ultimately businesses themselves) should be supervised more or less carefully by public agencies such as the courts. On one side is the management community, its lawyers, and its other adherents who argue that such supervision is an undesirable constraint on economic freedom and economic development, that it is a constraint that makes men of talent less desirous of accepting positions of responsibility and power. On the other side is a more varied alliance of shareholder democrats, economic progressives, and others who generally are of the opinion that the public, in this case the investing public, needs more protection from the ravages of management in-groups. The conflicting biases that these positions represent are further complicated by the advent of the modern gadfly shareholder who makes his living by bringing derivative suits against directors and by the tendency of courts and legislatures to view them with no more than an irritable tolerance.²¹ Each of the sections following represents a way that a court that is so disposed might avoid

18. See, *e.g.*, cases cited notes 5 and 6 *supra*.

19. See Uhlman, *The Legal Status of Corporate Directors*, 19 B.U.L. REV. 12, 15-16 (1939); Note, 82 U. PA. L. REV. 364, 366 (1934).

20. See generally Note, 82 U. PA. L. REV. 364, 369-71 (1934) and cases cited there.

21. See Note, *Derivative Suits—Mechanics, Motives and Suggested Improvements*, 36 B.U.L. REV. 78 (1956).

holding directors liable for negligence. It is impossible to avoid the feeling after reading the cases that the outcome is predetermined to a great extent by whether the court is favorably disposed to the cause of action in general. If it feels that such liability is a healthy thing, no difficulties appear; the trial court's finding on the question of negligence, coupled with loss to the plaintiff, is enough.

Standing to Sue

One issue concerning director negligence on which courts differ is what categories of persons shall be allowed to sue the directors, and in what posture (for example, individually, as a class, or derivatively) they must present their case.²² This problem is characteristic of the corporate field; it arises from the fact that the directors' primary responsibility is said to be to the corporation itself and not to any groups of real persons who are related to it. The derivative suit conforms to this idea, of course, by utilizing the theory that the corporation is the complaining party even where it is a nominal defendant. The only rights being ascertained are those between the defendant director and the corporation itself. That is not to say that the derivative suit presents no problems; it is one of the perennial problem children of corporation law. There are the questions of the necessity for demand on the directors and on the shareholders,²³ of contemporaneous ownership,²⁴ and of other obstacles that have been erected for the gadfly shareholder-plaintiff.²⁵ Furthermore, as will be discussed,²⁶ it is not always easy to tell whether a suit is in fact derivative.

Any action that is not brought "by the corporation" in some form raises the preliminary question whether the plaintiff is improperly seeking to take the recovery for himself rather than channeling it into the corporation. The cases are hard to categorize because the standing question is often seen dimly, if at all, by the opinion writers. Furthermore, there are some differences that amount only to terminology. Where a corporation is insolvent and shareholders bring a suit to settle its affairs by seeking to have the director-shareholders pay a judgment to the innocent

22. The question of standing to sue the directors is not, of course, peculiar to a negligence action but occurs also in areas of intentional director fault such as fraud and misappropriation of assets and with technical derelictions such as *ultra vires* acts.

23. See Stickells, *The Requirement of Demand Upon the Stockholders*, 33 B.U.L. REV. 435 (1953).

24. See Sykes, *Right of Shareholder to Attack Transactions Occurring Prior to His Acquisition of Stock*, 4 MD. L. REV. 380 (1940).

25. See Kaufman v. Wolfson, 136 F. Supp. 939 (S.D.N.Y. 1955); CAL. CORP. CODE § 834; N.Y. GEN. CORP. LAW § 61-b; Note, *Statute of Limitations and Shareholders' Derivative Actions*, 56 COLUM. L. REV. 106 (1956).

26. See text accompanying notes 36-46 *infra*.

shareholders for the damage they caused the corporation,²⁷ there seems to be no effective difference from a derivative suit, although the opinion might not mention the right of the corporation itself. Since the corporation is defunct, there is no question of paying the recovery into the treasury. The key question is whether it is damage to the corporation rather than to the shareholders themselves. If it is the latter, then it would seem that the suit could have been brought while the corporation was still operating for the diminution in value of the shares. That, of course, raises the question whether such damage is sufficiently definite and ascertainable to be recoverable. If so, then it would seem that *any* measurable damage to the corporation can be translated into pro rata diminution of value of the shares and therefore, logically, is recoverable. Which brings us back to the original question whether shareholders have standing to sue other than derivatively.

First, however, it will be useful to enumerate the parties whose standing is no problem. The most common and perhaps the most obvious of these are receivers or trustees in bankruptcy. They represent the right of the corporation as such, for the interest of all the creditors and shareholders, and have no personal interest in the recovery so that they are "ideal" plaintiffs from a theoretical standpoint.²⁸

Another obvious case where standing is not an issue is one where the corporation itself brings the suit through its normally elected officers

27. *E.g.*, *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950); *Boyd v. Applewhite*, 121 Miss. 879, 84 So. 16 (1920).

28. BALLANTINE, CORPORATIONS § 72a (rev. ed. 1946).

In two cases the courts seemed to misunderstand this principle and analyze the rights of the trustee in bankruptcy in terms of the rights of creditors. In *Skinner v. Hulsey*, 103 Fla. 713, 138 So. 769 (1932), the court said,

But since a trustee in bankruptcy . . . does not represent the bankrupt but represents the creditors only, it would seem to follow as a necessary consequence that, while a trustee in bankruptcy may have a right to sue for damages resulting from a breach of duty on the part of corporation directors, which breach of duty has resulted in some legal injury to the rights of the creditors of the corporation, the right of such trustee in bankruptcy is limited to such suit only as might have been maintained by the creditors themselves had no bankruptcy proceedings been had.

138 So. at 772. It then proceeded to take a restricted view of creditor standing to sue and held for defendants. *Whitfield v. Kern*, 122 N.J. Eq. 332, 192 Atl. 48 (1936), took a similar view, although in that case it was less clear since all the shareholders were defendants, and the court seemed to feel that the acts in question may not have been actionable at all. Both cases seem clearly wrong. The Bankruptcy Act vests in the trustee title to all "rights of action arising upon . . . the unlawful taking or detention of or injury to [the bankrupt's] property." 30 Stat. 565 (1898), as amended, 11 U.S.C. § 110(a) (6) (1958). He is normally thought of as acting for the benefit of creditors, to be sure; but procedurally he assumes the rights of the corporation itself. Creditors are often denied standing, in fact, for the very reason that the action should be brought by the trustee, with the proceeds distributed equitably to all claimants. See, *e.g.*, *Hi-Pro Fish Prod., Inc. v. McClure*, 224 F. Supp. 485 (E.D. Ark. 1963); *Webb v. Cash*, 35 Wyo. 398, 250 Pac. 1 (1926).

and directors.²⁹ This is a relatively unusual case; in most of the cases the corporation is insolvent, and in many of the others the alleged wrongdoers are still in office.

Some smaller classes of plaintiffs unanimously have been held to have standing to sue directors for negligence. Beneficiaries of trust-type accounts apparently can hold directors for losses caused by negligence. For example, in one case³⁰ the successor trustee of an estate brought suit against the directors of the trust company that had been the trustee and recovered for the negligent mingling of the trust funds.³¹ Depositors in escrow accounts have been held to have standing to sue directors for negligent loss of the funds, probably in cases where depositors would have been barred from direct suit.³² One famous old case, *United Soc'y of Shakers v. Underwood*,³³ allowed the owner of bonds placed on special deposit to sue the directors directly. In another case a trust settlor was allowed to recover from the directors of the corporate trustee for imprudent investments.³⁴ In the few cases where they have appeared, bondholders have been accepted as plaintiffs.³⁵

About one-third of the cases, however, do not fit readily into the above categories but involve plaintiffs who seem to be suing "individually" in some sense—either shareholders in actions that are not clearly derivative or creditors not represented by a receiver or trustee in bankruptcy.

Shareholders. The uncertainties surrounding the standing of shareholders to sue directors for negligence reflect the ambiguities of the shareholder derivative suit in general.³⁶ At first thought, it would seem that a derivative suit must seek to redress a wrong to the corporation by a recovery accruing to the corporation. One difficulty with that formulation, as mentioned above, is that where the corporation is insolvent or defunct, the recovery will normally be paid directly to the creditors or shareholders. Furthermore, in derivative suits judgments are sometimes paid directly to the shareholders where the wrongdoers are themselves

29. *E.g.*, *Holland v. American Founders Life Ins. Co.*, 151 Colo. 69, 376 P.2d 162 (1962).

30. *Winn v. Harby*, 171 S.C. 301, 172 S.E. 135 (1933).

31. See also *Masonic Bldg. Corp. v. Carlsen*, 128 Neb. 108, 258 N.W. 44 (1934); *Duncan v. Williamson*, 18 Tenn. App. 154, 74 S.W.2d 215 (1933).

32. *Hoehn v. Crews*, 144 F.2d 665 (10th Cir. 1944); *Crews v. Garber*, 188 Okla. 570, 111 P.2d 1080 (1941).

33. 72 Ky. (9 Bush) 609 (1873).

34. *Finley v. Exchange Trust Co.*, 183 Okla. 167, 80 P.2d 296 (1938).

35. *Chambers v. Land Credit Trust Co.*, 92 Kan. 30, 139 Pac. 1178 (1914); *Dinsmore v. Jacobson*, 242 Mich. 192, 218 N.W. 700 (1928); *Wells v. Carlsen*, 130 Neb. 773, 266 N.W. 618 (1936).

36. See *Developments in the Law—Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 874, 943-67 (1958).

shareholders and/or still in control of the corporation, and it is desired to keep the proceeds out of their hands.³⁷ More uncertainty arises from the variation in terminology from one decision to another. Is it a derivative suit where the plaintiff is suing "on behalf of himself and all other stockholders"?³⁸ What about "on behalf of himself and all other stockholders . . . who should come in and contribute to the expenses"?³⁹ Or, "in behalf of themselves and all other stockholders, creditors, and others similarly situated"?⁴⁰ In many of these cases, a close reading of the opinion will reveal that the suit is really derivative, as where the plea or the decree calls for misappropriated funds to be restored to the corporation.⁴¹ The fact that the wrong is done to the corporation itself is probably the only really essential element of a derivative suit.

In some cases where shareholder standing was allowed, the opinion does not make it clear whether the court considered the suit derivative or not. In some of the old cases, the derivative suit was not firmly established; at times the courts seemed to feel that shareholders were, by their position, in *pari delicto* with the directors whom they elected.⁴² This line of reasoning has largely vanished from the cases in this century; shareholders as such are no longer considered obliged to be well-informed.

The complaints sometimes combined a prayer for direct recovery from the directors for losses on the stock, an essentially non-derivative aspect, with a prayer for an accounting, which would indicate derivative-ness if made to the corporation.⁴³ An example is *Burckhardt v. Northwestern Nat'l Bank*,⁴⁴ a consolidated appeal from two suits, each brought by a shareholder of a national bank "on behalf of himself and the other stockholders," against the bank and its directors. The relief sought was

37. See *Perlman v. Feldman*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

38. *Kavanaugh v. Gould*, 147 App. Div. 281, 131 N.Y.S. 1059, 1062 (1911).

39. *Scott v. Depeyster*, 1 Edw. Ch. 513, 514 (N.Y. 1832).

40. *Warren v. Robison*, 19 Utah 289, 57 Pac. 287 (1899). Professor Ballantine uses the "similarly situated" language to describe a class suit, which he distinguishes from a derivative suit, but the language would not appear to have any definitive significance. BALLANTINE, CORPORATIONS § 145, at 344 (rev. ed. 1946).

41. *Foster v. Bowen*, 311 Mass. 359, 41 N.E.2d 181 (1942); *Hanna v. Lyon*, 179 N.Y. 107, 71 N.E. 778 (1904); *Kavanaugh v. Gould*, 147 App. Div. 281, 131 N.Y.S. 1059 (1911); *Goff v. Emde*, 32 Ohio App. 216, 167 N.E. 699 (1928); *O'Connor v. First Nat'l Investors' Corp.*, 163 Va. 908, 177 S.E. 852 (1935).

42. See *Dunn's Adm'r v. Kyle's Ex'r*, 77 Ky. (14 Bush) 134 (1878); *Rich v. Shaw*, 23 Me. (10 Shep.) 343 (1843); *Scott v. Depeyster*, 1 Edw. Ch. 513, 535-36 (N.Y. 1832). This position should not be confused with the situation where a given shareholder in fact is found to have acquiesced in the actions of the directors. See *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950).

43. See *Neall v. Hill*, 16 Cal. 146 (1860); *Smith v. Prattville Mfg. Co.*, 29 Ala. 503 (1857); *Scott v. Depeyster*, *supra* note 42.

44. 38 F.2d 568 (9th Cir. 1930).

to enjoin respondents from proceeding with the collection of the indebtedness of the appellants to the bank, to require an accounting of all financial transactions of the bank, to have the court make a finding to what extent and who shall be held and adjudged liable for the losses and impairment sustained by the complainant and all other stockholders of the bank.⁴⁵

The acts complained of were basically mismanagement in that the directors failed to take timely steps open to them to save the bank after the farm depression of the early twenties. The bank's assets had been sold to two other banks, which agreed to assume its liabilities. The agreement also provided that the shareholders would pay a large assessment on their stock. These shareholders were trying to prevent paying the assessment. Certainly the injunction against collecting the assessment from the shareholders was in no sense asserting a right of the bank; it actually ran against the interest of the bank. But the amount recovered from the directors would in any event serve to reduce the assessment against the shareholders so that the net result would be the same whether the suit was derivative or not. This is inherent in the nature of a corporation; at the point of liquidation, when the creditors have been paid or when as here the shareholders are bound to pay them, the interests of the corporation coincide with those of the shareholders. Nevertheless, *Burckhardt* is a case where the shareholders were seeking to recover from the directors for *their* losses, rather than those of the corporation, so that at least as a matter of form, the suit seemed not to fit the derivative mold.⁴⁶

The *Burckhardt* case illustrates another characteristic of the few cases where shareholders have recovered other than derivatively for director negligence: the corporation was no longer a going concern. Apparently, in no case since 1860 has a shareholder been allowed standing to sue directors of a going concern for their negligence other than derivatively or where there was "privity" of some sort.⁴⁷ This factor—that the businesses were defunct—makes these cases less important than they otherwise would be. One of the two main reasons for limiting shareholders' actions against management is to maintain the directors' control over the running of the business, but when the business stops running

45. *Id.* at 569.

46. In a case concerning a close corporation with four shareholders, one of the shareholders brought suit for damages. Here direct recovery was apparently sought to keep the proceeds out of the wrongdoers' hands; the case could be classed as a shareholder derivative suit with only one person in the class of eligible plaintiffs. *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950).

47. The cases cited in note 43 *supra* have some non-derivative aspects which may result from the courts' unfamiliarity with derivative suits as we now know them.

this reason is eliminated. The other reason is the preservation of the recovery for creditors.⁴⁸ No cases were found where a recovery might have bypassed the creditors, although there were two where the creditors might not have been paid at the time the suit was brought, and they were to participate in the recovery.⁴⁹ So, where the corporation is being liquidated, some courts have apparently felt that it was not necessary to use the derivative idea since the main reasons for it no longer were applicable.

The case where some misrepresentation has been made to a shareholder is an exception to the general rule; there individual standing is allowed. This is so even though the cases that have arisen in the negligence area have involved published reports or statements that were available equally to all the shareholders.⁵⁰ It is enough that the shareholder-plaintiff read the report, was misled, and suffered damage as a consequence.

One clear test of whether a suit is derivative or not is the measure of recovery. If the measure is the damage caused the corporation by the negligence of the directors, then the right would seem clearly derivative; if the measure is the loss to the shareholders, then the right is that of the individual or perhaps of the shareholders as a class. In many cases the test is inconclusive, of course, because the court does not precisely state the theory by which the damages are measured, and often either theory would give the same result. Usually it is damage to the corporation that is measured since the courts talk about the actual transactions and the losses involved in them. Only two cases were found where the court used the amounts actually lost by the shareholders as the measure of damages. One was *Bank of Commerce v. Goolsby*,⁵¹ where shareholders of a failed bank sued negligent directors for the assessments that they had been forced to pay on their stock. The court appointed a receiver and brought all parties to the corporation into the suit. The plaintiff shareholders recovered the amounts that they had paid for their stock. The individual nature of the suit was emphasized by the fact that the court allowed interest from the time, when the bank was still open, that the evidence

48. Sometimes the reason given is simply that the wrong is "to the corporation," but this is not a complete answer. Where the value of the shareholders' stock is diminished by the negligence of the directors, there is no reason in *tort* law why the shareholders should not sue. The answer must lie within the structure of the corporation itself.

49. *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803 (1917); *Warren v. Robison*, 19 Utah 289, 57 Pac. 287 (1899).

50. *Trembert v. Mott*, 271 Mich. 683, 261 N.W. 109 (1935); *Smalley v. McGraw*, 148 Mich. 384, 111 N.W. 1093 (1907); *Childs v. White*, 158 App. Div. 1, 142 N.Y.S. 732 (1913); *Houston v. Thornton*, 122 N.C. 365, 29 S.E. 827 (1898).

51. 129 Ark. 416, 196 S.W. 803 (1917).

revealed that their stock was worthless.⁵²

Having examined the exceptions, it still seems sound to state as a general rule that the shareholder's right against a negligent director is basically a derivative one, except where a misrepresentation is involved, and that standing to sue in any other posture will probably be denied.⁵³ Out of over one hundred negligence cases that have been brought by shareholders, only ten were found that raised any questions at all on this point.⁵⁴ These seemed to reflect a relaxing of the normally tight corporate structure when the corporation was being liquidated. The present assumption of the passive position of shareholders, whose function is more that of investing than anything else, logically leads to the conclusion that the only relevant damage arising from mismanagement is to the corporation. The cases that have looked to the amount lost by the shareholders⁵⁵ involved banks without an organized or active market for the stock, and in these the conceptual difference between the amount actually paid for the stock and the shareholder's pro rata share of the corporation's assets was probably overlooked by the court.

Creditors. Unlike shareholders, creditors are allowed to bring suit individually against directors for negligence in some states; the various jurisdictions divide about evenly on this point. The cases dealt with here are suits by individual creditors other than trustees in bankruptcy and receivers, bondholders, and persons with whom privity has definitely been established. As with shareholders, it is not always clear from an opinion whether the court considered the suit as an individual or a class suit; sometimes the court ambiguously states that the suit is by "creditors."⁵⁶

52. 196 S.W. at 813. See also *Boyd v. Applewhite*, 121 Miss. 879, 84 So. 16 (1920), where the award was of the book value of the stock.

53. See the following cases denying shareholder standing to sue: *Kelly v. Dolan*, 233 Fed. 635 (3d Cir. 1916) (receiver had been denied permission to sue by court); *Kirchdorfer v. Liberty Nat'l Bank & Trust Co.*, 313 Ky. 446, 197 S.W.2d 608 (1946) (one of only two shareholders failed to join corporation as plaintiff); *Caldwell v. Eubanks*, 326 Mo. 185, 30 S.W.2d 976 (1930) (suit for "themselves and all other stockholders" held not derivative); *Stuart v. Robertson*, 118 Okla. 259, 248 Pac. 617 (1926) (shareholders who lost stock through assessment could not separate wrong to them from wrong to corporation); *Craig v. Gregg*, 83 Pa. 19 (1876) (suit was for amount lost on bank stock).

54. *Burckhardt v. Northwestern Nat'l Bank*, 38 F.2d 568 (9th Cir. 1930); *Wheeler v. Aiken County Loan & Sav. Bank*, 75 Fed. 781 (C.C.D.S.C. 1896); *Smith v. Prattville Mfg. Co.*, 29 Ala. 503 (1857); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803 (1917); *Neall v. Hill*, 16 Cal. 146 (1860); *Wallach v. Billings*, 277 Ill. 218, 115 N.E. 382 (1917); *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950); *Boyd v. Applewhite*, 121 Miss. 879, 84 So. 16 (1920); *Scott v. Depeyster*, 1 Edw. Ch. 513 (N.Y. 1832); *Warren v. Robison*, 19 Utah 289, 57 Pac. 287 (1899).

55. *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803 (1917); *Boyd v. Applewhite*, 121 Miss. 879, 84 So. 16 (1920).

56. *Sternberg v. Blaine*, 179 Ark. 448, 17 S.W.2d 286 (1929); *Vujacich v. Southern Commercial Co.*, 132 Pac. 80 (Cal. Dist. Ct. App. 1913).

It is clear that a suit by a creditor against a director for negligence can only be brought when the corporation is insolvent, since otherwise there is no provable loss to the creditor.

Both among the cases allowing suit by creditors⁵⁷ and among those denying it,⁵⁸ the most frequent type of case involves the depositors in a failed bank suing directors who either failed to pay sufficient attention to a reckless or fraudulent manager or engaged in imprudent dealings with the bank's money. Actually the term "most frequent" is only valid in describing the pre-World War II situation; while there were dozens of cases involving negligent directors of insolvent banks from the Civil War to the end of World War II, there has been only one case concerning a bank in the last twenty years; and that one, significantly, involved not an insolvency but a merger.⁵⁹

One specific issue on which the courts have divided is the effect of the failure of the directors of a bank to close its doors after they know or should know of its insolvency. The issue is usually raised by a person who deposited money in the bank after it allegedly was insolvent and claims that defendant directors' negligent or deliberate failure to close the doors induced a deposit doomed to be lost. Some courts deny creditors standing to sue on these facts, usually declaring simply that creditors may not sue directors in any case where there was no direct fraud involved; that is,

57. *Michelsen v. Penney*, 135 F.2d 409 (2d Cir. 1943); *Virginia-Carolina Chem. Co. v. Ehrich*, 230 Fed. 1005 (E.D.S.C. 1916); *Boyd v. Schneider*, 131 Fed. 223 (7th Cir. 1904); *Johnson v. Coleman*, 179 Ark. 1087, 20 S.W.2d 186 (1929); *Sternberg v. Blaine*, 179 Ark. 448, 17 S.W.2d 286 (1929); *Vujacich v. Southern Commercial Co.*, 132 Pac. 80 (Cal. Dist. Ct. App. 1913); *Nix v. Miller*, 26 Colo. 203, 57 Pac. 1084 (1899); *Frontier Milling & Elevator Co. v. Roy White Co-operative Mercantile Co.*, 25 Idaho 478, 138 Pac. 825 (1914); *Delano v. Case*, 121 Ill. 247, 12 N.E. 676 (1887); *Pirott v. Heinen*, 137 Kan. 186, 19 P.2d 723 (1933); *Sweet v. Montpelier Sav. Bank*, 73 Kan. 47, 84 Pac. 542 (1906); *Id.*, 69 Kan. 641, 77 Pac. 538 (1904); *Forbes v. Mohr*, 69 Kan. 342, 76 Pac. 827 (1904); *Bank of Mut. Redemption v. Hill*, 56 Me. 385 (1868); *Patterson v. Minnesota Mfg. Co.*, 41 Minn. 84, 42 N.W. 926 (1889); *Cole v. Brandle*, 127 N.J. Eq. 31, 11 A.2d 255 (1940); *Cassidy v. Uhlmann*, 170 N.Y. 505, 63 N.E. 554 (1902); *Minnis v. Sharpe*, 198 N.C. 364, 151 S.E. 735 (1930); *Solomon v. Bates*, 118 N.C. 311, 24 S.E. 478 (1896); *Swentzel v. Penn Bank*, 147 Pa. 140, 23 Atl. 405 (1892); *Grandprey v. Bennett*, 41 S.D. 619, 172 N.W. 514 (1919); *Seale v. Baker*, 70 Texas 283, 7 S.W. 742 (1888).

58. *Bailey v. Mosher*, 63 Fed. 488 (8th Cir. 1894); *Hi-Pro Fish Prod., Inc. v. McClure*, 224 F. Supp. 485 (E.D. Ark. 1963); *Wilson v. Stevens*, 129 Ala. 630, 29 So. 678 (1901); *Skinner v. Hulsey*, 103 Fla. 713, 138 So. 769 (1932); *Proksch v. Bettendorf*, 218 Iowa 1376, 259 N.W. 383 (1934); *Allen v. Cochran*, 160 La. 425, 107 So. 292 (1926); *Union Nat'l Bank v. Hill*, 148 Mo. 380, 49 S.W. 1012 (1899); *Fusz v. Spaunhorst*, 67 Mo. 256 (1878); *Douglass v. Dawson*, 190 N.C. 458, 130 S.E. 195 (1925); *Hart v. Evanson*, 14 N.D. 570, 105 N.W. 942 (1895); *Daniels v. Berry*, 148 S.C. 446, 146 S.E. 420 (1929); *Deadrick v. Bank of Commerce*, 100 Tenn. 457, 45 S.W. 786 (1898); *Conrnick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. Civ. App. 1936); *Inter-Ocean Cas. Co. v. Lecony Smokeless Fuel Co.*, 123 W. Va. 541, 17 S.E.2d 51 (1941); *Zinn v. Mendel*, 9 W. Va. 580 (1876); *Killen v. State Bank*, 106 Wis. 546, 82 N.W. 536 (1900); *Webb v. Cash*, 35 Wyo. 398, 250 Pac. 1 (1926).

59. *Security Trust Co. v. Dabney*, 372 S.W.2d 401 (Ky. 1963).

they deny altogether creditor standing to sue directors for negligence.⁶⁰ Other courts allow this as a basis for direct suits by creditors.⁶¹ North Carolina's court takes a more complex position between these two. It apparently draws the line between the case where the management of the bank allows persons to deposit money in the bank after they know (or, more particularly for our purposes, should have known) that the bank is insolvent and the more typical cases where the bank has been ruined by the neglect of the directors, allowing recovery only in the first instance.⁶² The rationale is that allowing deposit in an insolvent bank is a form of direct fraud, by which the depositor, and not the bank, has been injured; therefore, the depositor should be able to recover individually from the directors. Thus, the doctrine is consistent with that of jurisdictions that deny creditor recovery for negligence altogether; the practical difference lies in the fact that most jurisdictions seem to consider the allowing of deposits after insolvency to be just another case of director negligence.⁶³

The situation where some misrepresentation has been made to one or more creditors is a broader category of which allowing deposits after insolvency is a part. If the misrepresentation is made directly to the plaintiff creditor, then of course he has standing since there is no general class whose rights might be affected by his recovery. For the purposes

60. See *Fusz v. Spaunhorst*, 67 Mo. 256 (1878); *Hart v. Evanson*, 14 N.D. 570, 105 N.W. 942 (1895); *Daniels v. Berry*, 148 S.C. 446, 146 S.E. 420 (1929).

61. See *Delano v. Case*, 121 Ill. 247, 12 N.E. 676 (1887); *Cassidy v. Uhlmann*, 170 N.Y. 505, 63 N.E. 554 (1902); *Seale v. Baker*, 70 Tex. 283, 7 S.W. 742 (1888).

62. See *Minnis v. Sharpe*, 198 N.C. 364, 151 S.E. 735 (1930); *Bane v. Powell*, 192 N.C. 387, 135 S.E. 118 (1926); *Douglass v. Dawson*, 190 N.C. 458, 130 S.E. 195 (1925).

63. The North Carolina position is not free of ambiguity. In *Douglass v. Dawson*, *supra* note 62, a depositor after insolvency sued the directors, alleging negligence in managing the business and in allowing the deposit. Standing was denied because no representations had been made especially to plaintiff, and therefore any recovery from defendants should accrue to the bank through a suit by the receiver for the benefit of all the creditors. In *Bane v. Powell*, *supra* note 62, a depositor sued another set of bank directors for allowing deposit after insolvency; this time standing to sue was granted, and *Douglass v. Dawson* was distinguished on the basis that in *Bane* there was no allegation that the bank was harmed by the negligence of the directors, and therefore the bank had no claim on the assets recovered. If allowing deposit after insolvency is, as in *Bane*, considered a direct wrong such that the depositor can sue the management directly, it seems rather odd to make an exception where the insolvency is caused by the management's negligence on the grounds that the receiver should be the one to sue. Individual standing created by a direct wrong should not be lost because a larger class has a cause of action based on an indirect wrong. The more normal course would be to allow both suits and subtract where appropriate the amount recovered by the individual depositor from the judgment awarded the receiver. Furthermore, it seems wrong on its face to imply, as did *Douglass*, that the corporation can recover for allowing deposits after insolvency; it is the depositors, not the bank, who are hurt by such transactions. Later North Carolina cases have simplified the distinction, describing it as between a depositor who loses his money through subsequent negligence (no individual recovery), and one who deposits after insolvency. They ignore, perhaps happily, the troublesome fact that both *Douglass* and *Bane* involved deposits after insolvency. See *Minnis v. Sharpe*, *supra* note 62.

of this article, this includes the case where the defendant director has negligently allowed another to make such a misrepresentation.⁶⁴

The other cases in this group involve negligently publishing or allowing to be published a misleading financial report. It would logically seem that the individual creditor should have standing to sue in such a case. Shareholders who have been misled to their detriment by published reports have been allowed individual standing.⁶⁵ It is true that a financial report may be available to an entire class of parties, but usually not all of them are hurt. The loss to the individual is caused by the particular way in which he reacts to that report, and thus the facts are different in each person's case. Nevertheless the courts again have divided on the standing question in this type of case.⁶⁶

A few of the cases allowing creditor suit involve situations where, at least in the eyes of the court, something of a trust-type relation existed between the creditor and the directors. In *Minnis v. Sharpe*,⁶⁷ involving a financial corporation that was not a bank but collected money from the plaintiffs "to be applied on mortgages and deeds of trust," the court found that there was a "trust quality" to the relation, distinguishing it from the banking situation where the money passes to the bank, and held that creditors could sue the negligent directors. Similar holdings have been made in other cases where the relation was different from that of a depositor in a bank.⁶⁸

Among the cases that have disallowed suits by depositors against directors of a failed bank, the usual statement is that directors owe no duty to the creditors of their corporation and hence are not liable to creditors unless they actively defrauded them.⁶⁹ This is a throwback to

64. See *Cameron v. First Nat'l Bank*, 194 S.W. 469 (Tex. Civ. App. 1917).

65. See text accompanying note 50 *supra*.

66. Allowing standing: *Solomon v. Bates*, 118 N.C. 311, 24 S.E. 478 (1896); *Grandprey v. Bennett*, 41 S.D. 619, 172 N.W. 514 (1919). Denying standing: *Bailey v. Mosher*, 63 Fed. 488 (8th Cir. 1894); *Cairns v. Du Pont*, 135 Misc. 278, 238 N.Y.S. 74 (Sup. Ct. 1929).

67. 198 N.C. 364, 151 S.E. 735 (1930).

68. See *Virginia-Carolina Chem. Co. v. Ehrich*, 230 Fed. 1005 (E.D.S.C. 1916) (plaintiff supplier authorized corporate dealer to collect money owed to plaintiff; active director-officers misappropriated proceeds, and inactive directors were sued); *Frontier Milling & Elevator Co. v. Roy White Co-operative Mercantile Co.*, 25 Idaho 478, 138 Pac. 825 (1914) (plaintiff had given goods to warehouse corporation for storage; they were embezzled by president, and directors were sued); *Pirott v. Heinen*, 137 Kan. 186, 19 P.2d 723 (1933) (plaintiff had authorized defendant bank director to sell his farm and deposit proceeds in bank, from which they were embezzled by cashier); *Sweet v. Montpelier Sav. Bank*, 69 Kan. 641, 77 Pac. 538 (1904) (plaintiff bank sent note to defendants' trust company for collection; trust company went bankrupt before remitting proceeds).

69. See *Allen v. Cochran*, 160 La. 425, 107 So. 292 (1926); *Union Nat'l Bank v. Hill*, 148 Mo. 380, 49 S.W. 1012 (1899); *Deadrick v. Bank of Commerce*, 100 Tenn. 457, 45 S.W. 786 (1898); *Zinn v. Mendel*, 9 W. Va. 580 (1876).

the old controversy whether directors are actually (or are treated as) agents of the corporation only, in which case they are only liable to the corporation, or are trustees for the shareholders or creditors or both, in which case they might be liable to either directly.⁷⁰ Courts no longer struggle to fit corporate directors into either of these categories, but the almost even split in the cases on the question of creditors' standing to sue directors probably reflects the older doctrinal disagreement.

In Arkansas, the situation was changed by the alteration of a statute. The 1869 corporation law of the state⁷¹ provided that the officers and directors of a corporation would be liable "for all debts of such corporation contracted during the period of any such neglect or refusal [to comply with provisions of the act]." Later codes of 1927⁷² and 1931 (the present one)⁷³ contained no such provision. The omission was held to preclude suit by creditors in a recent federal diversity case.⁷⁴

An old case in Texas held that a bank depositor could sue directors for loss of his deposit when it was induced by negligent misrepresentations of solvency.⁷⁵ A later case,⁷⁶ involving suit by a creditor of a non-profit civic opera company, rendered uncertain Texas' position on creditor suits against negligent directors. In a confused, rambling opinion, the court of civil appeals seemed to say first that creditors could not sue unless the corporation was insolvent and had gone out of business (implying, though it was nowhere stated, that such was not the case here), and then implied that the matter depended on whether there had been misfeasance or non-feasance by the directors. The court went on to say that directors were not liable to creditors at all except for "direct fraud" and finally held that there was no liability here because there was no negligence, the losses being merely a matter of business judgment. Aside from the negligence point on which the case was decided, the most persuasive factor in the case may have been that the corporation was still in business; in such a case it would seem obvious that the creditors should proceed against the corporation first. If the case is limited to that holding, then the older precedent allowing a creditor suit may still be valid. Much of the opinion indicated hostility toward creditor suit, however, so Texas must be considered doubtful on this point.

Kansas statutes make it a felony to accept deposits in a bank after insolvency and also make the officers and directors civilly liable to harmed

70. See text accompanying notes 17-20 *supra*.

71. ARK. CORP. CODE OF 1869, § 24.

72. Ark. Acts 1927, No. 250.

73. Ark. Acts 1931, No. 255.

74. *Hi-Pro Fish Prod., Inc. v. McClure*, 224 F. Supp. 485 (E.D. Ark. 1963).

75. *Seale v. Baker*, 70 Tex. 283, 7 S.W. 742 (1888).

76. *Conrick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. Civ. App. 1936).

depositors.⁷⁷ Apparently no Kansas cases have been decided involving suit by creditors of nonfinancial corporations, so whether such a statute would have any carry-over effect is uncertain.

It is striking how often the courts considering this question have failed to see the disagreement among the authorities or at least have written their opinions as though the answer was reached by straight-line logic from agreed premises. In *Allen v. Cochran*,⁷⁸ for example, a 1926 Louisiana case, the court started by begging the question, stating that directors are "merely the agents of the corporation." It finished by quoting a passage from *Corpus Juris* that is notable for its dogmatism:

The directors of a bank are liable only to the corporation whose agents they are for violation or negligence of duty; and in the absence of actionable deceit, they are not liable to a creditor of the corporation for loss suffered through the neglect of their official duties.⁷⁹

An Iowa case⁸⁰ stands at the extreme in insulating directors from suit. A trust company had been trustee of an estate, and the successor trustee sued it for mismanagement in handling the funds; here, where there had been direct dealing with the plaintiff's interest and it was not even assumed that the director had acted in good faith, the court held the defendant director not liable on the grounds that *nonfeasance* was not enough. No other case found went so far to protect directors; generally where the wrongdoing is specifically related to the plaintiff's property, he will be granted standing to sue.

Causation

Causation is a ubiquitous problem in the law, and it is the most complex of the issues surrounding director liability for negligence. In law as in other areas of experience, it is never entirely certain what causes what or even what is meant by causing something. We can speculate, of course, that if event A had not happened, event B would not have happened either, but that leads us into a philosophical morass. We cannot run the reel through the projector again minus event A, so our speculation is a purely abstract, logical one, not one concerning reality. What we really mean is that events *like* A are usually followed by events like B; or that events like those preceding B, but with A not present, are *not* usually followed

77. KAN. GEN. STAT. 1949, §§ 9-2010, 9-1915. See *Forbes v. Mohr*, 69 Kan. 342, 76 Pac. 827 (1904).

78. 160 La. 425, 107 So. 292 (1926).

79. 7 C.J. *Banks and Banking* § 169 (1916).

80. *Proksch v. Bettendorf*, 218 Iowa 1376, 259 N.W. 383 (1934).

by events like B. We wrap these conclusions up in simple statements like "The director's reckless investments [A] caused the insolvency [B]." When we look closely, however, each set of events is unique; we have never before encountered a set just like those preceding this particular insolvency. Furthermore, our judgment plays tricks on us: can we really say that reckless investments (events like A) are *usually* followed by insolvency (events like B)? Or, that insolvency is usually preceded by reckless investment? Or, that cautious business practices are seldom followed by insolvency? Probably not, unless we *define* reckless investment as that which is followed by insolvency. And that indicates another logical pitfall, that of misplaced concreteness—or characterization. Often hindsight passes for insight; we call it "recklessness" because it was followed by insolvency. If we had been on the scene, we do not know whether it would have seemed reckless at all.

To compound the problem, the law requires more than but-for causation. It requires that the culpable aspects of the defendant's actions be joined to the damage in a sufficiently close ("proximate") way to allow the imposition of liability. We make no pretense that this is a qualitative judgment; it is purely quantitative and subjective. The law, in the person of judge or jury, decides it with a stiff upper lip because it must be decided, and no one has come up with a better way.

In spite of all this, there are certain types of cases that are not too difficult. These seem to be cases where the acts of the defendant are thought of as positive (as opposed to an omission, where we focus on what he failed to do) and deviant (where we confidently say that people do not normally act that way) and cause an immediate and clear injury. Thus, where X throws a knife at Y, not intending to hit him, but does, we simply do not raise questions such as those above. We are confident that X's negligence "caused" Y's injury.

In the corporate area, such immediate and clear injuries are not the rule. Embezzlement by officers is the only type that is at all common.⁸¹ Normally injuries are financial and indirect—money unduly spent or not received—and only become clear after some time has passed.⁸² That is one way in which corporate negligence raises more difficult causation questions than, say, automobile accidents. Nevertheless, in many corporate cases we are fairly confident of our causation ground. Where a director makes a decision that clearly seems rash or stupid in retrospect and the

81. See, *e.g.*, *Mercer v. Dunscomb*, 239 Pac. 836 (Cal. Dist. Ct. App. 1930); *Minis v. Sharpe*, 198 N.C. 364, 151 S.E. 735 (1930); *Anderson v. Bundy*, 161 Va. 1, 171 S.E. 501 (1933).

82. See, *e.g.*, *Hi-Pro Fish Prod., Inc. v. McClure*, 224 F. Supp. 485 (E.D. Ark. 1963); *Crews v. Garber*, 188 Okla. 570, 111 P.2d 1080 (1941).

damage clearly seems related and measurable, our conclusion that he "caused" the damage leaves us content, however vulnerable the conclusion may be to logical attack. These cases fall nicely into the category of the positive, deviant act.⁸³

Many, perhaps a majority, of the director negligence cases do not, however, contain factors making the causation question "easy." Not only is the damage difficult to isolate and measure accurately, but the negligent conduct consists often of the failure to take the proper action—either not acting at all or acting in a way that shows insufficient prudence. Many cases, for example, have involved the failure of directors to detect and stop the damage being inflicted by a reckless, dishonest, or incompetent managing officer. In such cases the basis for saying that the directors' failure to exercise sufficient supervision "caused" the damage is rather tenuous. Of course, if we imagine a hypothetical director who prudently examines the books of the company and conclude that he would probably find the manager's misdeed, the problem seems simple. But a fallacy lurks here, too. In order to conclude that an omission causes an injury, it is not enough to be able to envision a prudent course of action open to the actor that would have avoided the injury. We must logically show that the *only* prudent (that is, non-culpable) courses of action open to the actor would have avoided the injury. We can not simply mentally subtract an omission from the chain of events; nothing must be replaced with something.

Actually the same principle—that we cannot subtract defendant's culpable act without hypothesizing something in its place—is more obvious in the positive-act cases. In the knife-throwing case, for example, we can subtract the act of throwing the knife and substitute an infinite number of prudent and non-injurious acts that the thrower might have been doing at that moment. If instead of a knife our defendant finds himself holding a bomb about to explode, however, his choice of actions is far more limited; and we are not satisfied to say that his act of throwing caused the injury until we can imagine a prudent, non-injurious course of action that was open to him. In the failure-to-act cases, therefore, logic demands that the plaintiff convince the trier that reasonable prudence in the defendant director's situation would have *dictated* a course of action that would have avoided injury to the corporation or other plaintiffs.

In the light of these formidable obstacles, one might wonder how plaintiffs ever have surmounted the causation problem in holding directors for negligent failure to act. The answer is that policy, to some extent,

83. See, e.g., *Pool v. Pool*, 16 So. 2d 132 (La. App. 1944); *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 8 N.E.2d 895 (1937); *Van Schaick v. Aron*, 170 Misc. 520, 10 N.Y.S.2d 550 (Sup. Ct. 1938).

diverts the thrust of logic. In the Theodore Roosevelt era, one of the many corporate practices that engendered public indignation was the use of figurehead directors whose only function was to lend a prominent name to the enterprise or, at least, to give investors a false reassurance of safety in numbers. One of the earliest and most eloquent expressions of this feeling appears in a 1907 article by Professor Dwight:

The lesson to be gathered from the cases seems to be that, although courts adjure directors to be good and to give some heed to the companies they have honored with their "assistance," at the present time they are not required to be familiar with the operations of the company (*Wakeman v. Dalley*)⁸⁴ they need not attend meetings of the board if inconvenient to do so (*Briggs v. Spaulding*)⁸⁵ they are not responsible for the misconduct of executive officers appointed by themselves (*Wheeler v. Aiken Co. Bank*)⁸⁶ unless, indeed, the wrongdoing is so palpable that it is practically forced upon their attention (*Gibbons v. Anderson*)⁸⁷ and if they persuade two or three of their number to do all the work, the latter alone will be held responsible for a neglect of such duties (*Warren [sic] v. Penoyer*).⁸⁸ Where else in human affairs may be found so admirable a combination of distinction without anxiety, of reward without toil? Would it not be well for the corporation and society at large if penalties that are admitted to be proper in the abstract were insisted upon until the prodigious number of pseudo-directors who are now in evidence were "squeezed out," and a really hard-working director, as distinguished from an officer, became less of an anomaly than he seems under present conditions?⁸⁹ (Footnotes supplied.)

This article was not concerned with the causation issue as such. At the time it was written, most of the cases on director liability had revolved around the question whether directors had the "duty" to attend to the business more than they had.⁹⁰ As it became more widely accepted that directors did have obligations of diligence, holding them liable under a

84. 51 N.Y. 27 (1872).

85. 141 U.S. 132 (1891).

86. 75 Fed. 781 (C.C.D.S.C. 1896).

87. 80 Fed. 345 (C.C.W.D. Mich. 1897).

88. *Warner v. Penoyer*, 91 Fed. 587 (2d Cir. 1898).

89. Dwight, *Liability of Corporate Directors*, 17 *YALE L.J.* 33, 42 (1907).

90. In *Wheeler v. Aiken County Loan & Sav. Bank*, 75 Fed. 781 (C.C.D.S.C. 1896), for example, the court was influenced by the fact that few skilled businessmen could be found in small South Carolina farming towns. It came close to saying that unskilled bank directors in such places were not negligent in entrusting the business to the officers.

negligence theory for losses to the corporation caused by others developed as a way of enforcing this obligation. It was at this point, starting around the First World War, that the defense of lack of causation began to appear.⁹¹ Thus, a policy derived from society's attitude toward corporations collided with a traditional defense from the law of torts.

The policy, on its face, certainly seems to have plenty of moral weight behind it. The board of directors in our corporate system is the final repository of managerial responsibility, and it follows that a director should not be able to avoid these responsibilities by simply staying home and seeing no evil. The director's function is typically a supervisory one, not especially onerous, to see that the officers in command do their job honestly and competently. The public relies on the board to look after its interests, in a sense, and therefore expects directors to be willing to do the minimum required of them. On the other hand, as we have seen, it is difficult to conclude that a given director's staying home was a proximate cause of the corporation's injury. The most practical rule on the causation question may lie somewhere between the extremes of permissive logic and severe policy.

One of the difficulties in analyzing the various courts' positions on the issue of causation is that the issue seems to be mentioned only where the opinion writer feels that it disposes of the case. Thus, a lineup of cases where causation is discussed presents an almost unbroken string of victories for defendant directors.⁹² On the other hand, there are many cases where the facts seem quite similar to those on the above list, and the plaintiff has been successful. It would not be logically or legally sound to say that all these cases "hold" against finding a causation cutoff, since in some the lawyers may have overlooked the defense; and future cases in the same jurisdictions may be decided differently where the argument

91. Aside from *Killen v. State Bank*, 106 Wis. 546, 82 N.W. 536 (1900), which denied director liability for negligence altogether, the earliest case found in which causation was discussed in an appellate opinion was *Virginia-Carolina Chem. Co. v. Ehrich*, 230 Fed. 1005 (E.D.S.C. 1916).

92. See *Hoehn v. Crews*, 144 F.2d 665 (10th Cir. 1944); *Barnes v. Andrews*, 298 Fed. 614 (S.D.N.Y. 1924); *Virginia-Carolina Chem. Co. v. Ehrich*, 230 Fed. 1005 (E.D.S.C. 1916); *Sternberg v. Blaine*, 179 Ark. 448, 17 S.W.2d 286 (1929); *Holland v. American Founders Life Ins. Co.*, 151 Colo. 69, 376 P.2d 162 (1962); *Wallach v. Billings*, 277 Ill. 218, 115 N.E. 382 (1917); *Allied Freightways v. Cholfin*, 325 Mass. 630, 91 N.E.2d 765 (1950); *Hathaway v. Huntley*, 284 Mass. 587, 188 N.E. 616 (1933); *Trembert v. Mott*, 271 Mich. 683, 261 N.W. 109 (1935); *Martin v. Hardy*, 251 Mich. 413, 232 N.W. 197 (1930); *Kavanaugh v. Gould*, 147 App. Div. 281, 131 N.Y.S. 1059 (1911), *rev'd*, 223 N.Y. 103, 119 N.E. 237 (1918); *Henry v. Wellington Tel. Co.*, 76 Ohio App. 77, 63 N.E.2d 233 (1945); *Killen v. State Bank*, 106 Wis. 546, 82 N.W. 536 (1900).

Kavanaugh v. Gould, *supra*, is the only case among the above that was not decided for the defendant director. In that case the New York Court of Appeals reversed the appellate division to send the case to the jury on the issues of negligence and causation.

is properly presented. The cases must nevertheless be given some weight, particularly where inactive directors of no particular skill are involved.⁹³

One well-known causation case is *Allied Freightways v. Cholfin*.⁹⁴ In that case Mrs. Cholfin was a dummy director of a business run solely by her husband. The defalcations consisted of spending corporate funds for the personal needs of the Cholfin's. The Massachusetts Supreme Court exonerated Mrs. Cholfin from liability for all the expenditures, except those from which she benefited personally, on the basis that it was not shown that her neglect was the proximate cause of the bankruptcy. The court pointed out that "she might have been an ordinary housewife with no business experience, so far as anything appears in the evidence," and that she probably couldn't have learned anything from the books of the firm "unless she was skilled in accounting." It also said that even the bookkeeper was not familiar with the details of what she was doing and that although Mrs. Cholfin might have inquired of her husband, it is doubtful whether she could have prevented him from doing what he did. The opinion is thus ambiguous, with at least three possible interpretations of the court's reasons for concluding that Mrs. Cholfin could not have caused the loss: (1) She was unskilled and not capable of understanding the corporation's affairs. (2) The affairs were so tangled that even a normally skilled person could not untangle them. (3) Regardless of what she knew, she did not have the power to influence her husband.

The second interpretation is weakened by the comment that Mrs. Cholfin could have found out about the affairs of the corporation by simply asking her husband; it seems reasonable to assume that a normally prudent director who did not receive a satisfactory explanation from the managing officer would make further inquiry, either on his own or by employing experts. So the case seems to rest on the idea, vaguely expressed, that Mrs. Cholfin did not possess the skill and influence of a normal corporate director. If this is correct, then the case is disturbing. It appears first to assume that there is no requirement of skill; next it

93. For some of the cases in which relatively inactive directors were held liable, see, *Gibbons v. Anderson*, 80 Fed. 345 (C.C.W.D. Mich. 1897); *Vujacich v. Southern Commercial Co.*, 132 Pac. 80 (Cal. Dist. Ct. App. 1913); *Nix v. Miller*, 26 Colo. 203, 57 Pac. 1084 (1899); *Chicago Title & Trust Co. v. Munday*, 297 Ill. 555, 131 N.E. 103 (1921); *Coddington v. Canaday*, 157 Ind. 243, 61 N.E. 567 (1901); *Folsom v. Smith*, 113 Me. 83, 92 Atl. 1003 (1915); *Fisher v. Parr*, 92 Md. 245, 48 Atl. 621 (1901); *Dome Realty Co. v. Rottenberg*, 285 Mass. 324, 189 N.E. 70 (1934); *Whitfield v. Kern*, 122 N.J. Eq. 332, 192 Atl. 48 (1936); *Van Schaick v. Aron*, 170 Misc. 520, 10 N.Y.S.2d 550 (Sup. Ct. 1938); *Broaderick v. Marcus*, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934); *Besselieu v. Brown*, 177 N.C. 65, 97 S.E. 743 (1919); *Anthony v. Jeffress*, 172 N.C. 378, 90 S.E. 414 (1916); *Crews v. Garber*, 188 Okla. 570, 111 P.2d 1080 (1941); *Warren v. Robison*, 19 Utah 289, 57 Pac. 287 (1899); *O'Connor v. First Nat'l Investors' Corp.*, 163 Va. 908, 177 S.E. 852 (1935).

94. 325 Mass. 630, 91 N.E.2d 765 (1950).

reasons that since this director was unskilled she could not have prevented the harm and thus could not be proximately related to it; the final step is to say that since there is no proximate causation, our unskilled director is not liable for want of prudence, either. The lesson for the fraud-minded manager is to arrange for selection of unskilled directors, particularly relatives who have nominal ownership of the family assets; they will not be liable as long as they pay no attention to the business.⁹⁵

An interesting comparison case, from the group finding liability without dealing with causation as such, is *Vujacich v. Southern Commercial Co.*⁹⁶ In that California case a corporation that ostensibly ran a wholesale and retail liquor business was investing its money in a distillery operation. It solicited deposit funds from a group of immigrant laborers for "safekeeping" and used them for its shady investments. When the laborers sued for their lost funds, one of the defendants, the wife of the manager of the liquor business, was apparently a typical dummy director. (The active participants, including her husband, did not appeal.) The court's opinion concerning her duties is worth quoting:

It is true that no directors' meetings were shown ever to have been held, and no evidence was introduced showing that actual knowledge was brought home to director R. E. Hansard [the wife] of the condition of the affairs of the company, or its conduct with respect to the money of plaintiff and his assignors. On the other hand, this appellant did not testify or offer any proof showing that she had no such knowledge, or that she could not have obtained it by the exercise of ordinary diligence as a director of the company. Where the business of receiving deposits by a corporation is so general as it was with the corporation defendant herein, it must be presumed that the directors had full knowledge of the manner in which such moneys were kept or used; and unless a showing is made of some excuse, such as a

95. *Barnes v. Andrews*, 298 Fed. 614 (S.D.N.Y. 1924), raises similar problems. Learned Hand seemed to be mainly concerned with the fact that it was not clear whether any intervention by a director could have prevented the harm, which was caused by dissention and incompetence in management. But in one paragraph Judge Hand noted that he was "not very well-suited by experience for the job he had undertaken," and asked rhetorically, "Can shareholders call him to account for deficiencies which their votes assured him did not disqualify him for his office?" If we accept the main point of the opinion, that it was not shown that the burdens under which this corporation labored could have been lifted by *any* directoral intervention, then it seems very much beside the point to mention this director's deficiencies. Though the emphasis is reversed, *Barnes* raises the same question as *Cholfin*: whether the lack of causation is a function purely of the business situation or is related to the inferior skill of the defendant.

96. 132 Pac. 80 (Cal. Dist. Ct. App. 1913).

protest offered by the director not consenting to the misappropriation and of steps taken by such director to prevent loss from accruing to the depositors, such director becomes personally liable to the persons damaged.⁹⁷

More extreme positions in both directions are possible. In *Wallach v. Billings*, the court seemed to require that the plaintiff allege and prove facts showing direct causation between the defendant director's inattention and the loss to the business.⁹⁸ As discussed above, the proof of absolute causation by an omission is virtually impossible in a real-world situation. On the other hand, though apparently no cases have taken this position, it would be conceivable to have a rule that where directors are proved negligent they become insurers for any loss that occurs during the period of their negligence regardless of causation.

The question that divides most of the cases, however, is whether the special deficiencies of a particular director should be taken into account in determining the proximity of his negligence to the loss. I suggest that they should not and that the question should be: Would a normally competent director, exercising reasonable diligence, have discovered the danger and taken effective steps to prevent the loss? The rule as stated excludes two considerations. First, it is not concerned with the position of a particular director within the corporate structure (that is, whether his influence was such as to change management policy). It is fairly familiar corporate law that a director can absolve himself from liability for improper activities by informing the other directors of the impropriety and suggesting and voting for a proper course of action.⁹⁹ This rule is sound, for otherwise the courts would either hold every director liable for the action of a majority of the board or would invoke the causation cutoff to hold none of them liable, since one director could not overrule the majority. The liability of a director facing a recalcitrant majority would depend entirely on the view the court took and not on what he did himself. It must be assumed, therefore, that if a redeeming course of action is pointed out to the board, the board will take it.

The other negative implication of the suggested rule is that the director's particular qualities should not be considered on the issue of causation. The rule would postulate a hypothetical reasonable director who finds himself in the shoes of the actual director in question at the time that the proved negligent acts begin. Our reasonable director is not a new creation in the case, because he appeared at precisely the same

97. *Id.* at 81.

98. 277 Ill. 218, 229-36, 115 N.E. 382, 386-88 (1917).

99. See text accompanying note 97 *supra*.

point when we were deciding whether the actual director was negligent—an issue separate from and logically prior to the causation issue. If the fact-finder concludes that our reasonable director would have discovered the danger and taken steps to avert the loss (assuming, as discussed above, that the whole board would adopt the reasonable course of action presented to it), then causation is shown. If, on the other hand, it is as likely as not that the reasonable director would not have anticipated or averted the loss, then the defendant is exonerated. What I am suggesting, then, is that we perform the same gedankenexperiment on the causation issue as on the negligence issue; but instead of asking what the reasonable director would have done, we ask whether it would have worked.

This approach would change the result in the *Cholfin* case on the most probable interpretations of the opinion. The fact-finder would ask whether a reasonable director, appearing in Mrs. Cholfin's place on the board at the time her negligence was proved to have begun, would have discovered Mr. Cholfin's improper expenditures and whether he would have prevented the loss to the corporation. It would not ask whether a more diligent housewife would have seen the problem or whether Mr. Cholfin's wife would have enough influence over him to force him to mend his ways. Likewise in *Barnes v. Andrews*,¹⁰⁰ Andrews' managerial deficiencies would not matter; the court would only ask whether the company's troubles were amenable to solution by a reasonable director.

Is this approach too hard on directors? Are we forcing them to warrant their competence to meet an ideal standard of directoral effectiveness? The answer is no, if the usual approach to the issue of negligence is used. For we do not reach the question of effectiveness—of causation—until *after* we have decided that this particular director was negligent (that is, that he failed to take the care that the law expects of him). This separation of the issues of negligence and causation is quite characteristic of our tort law, although it is not logically necessary. Its maintenance means that the fact of injury will not be sufficient to prove negligence; it probably is not even relevant. This is well illustrated by the director-negligence cases. Plaintiffs generally are required to show that the defendant did something overtly below the standard of reasonableness, such as not attending meetings (the most common failing) or accepting the financial statements of the president with no attempt to check their accuracy.¹⁰¹ It is true that some cases have included the word "skill" in

100. 298 Fed. 614 (S.D.N.Y. 1924). See note 95 *supra*.

101. Again the *Vujacich* opinion is instructive. It states that Mrs. Hansard failed to show "that she could not have obtained [knowledge of the misappropriation] by the exercise of ordinary diligence as a director of the company." 132 Pac. at 81. Out of context, this could, of course, be interpreted to mean that a showing of incompetence

their statement of the "ordinary" qualities that the director is supposed to have,¹⁰² but in practice this does not seem to be followed. Again looking at *Cholfin*, the court pointed out there that Mrs. Cholfin in fact did not supervise the business at all, did not examine the books, did not act with due diligence.¹⁰³ The plain implication of this and the other cases is that if she had done so that would have ended the matter. Thus, the cases tacitly agree that a director may be incompetent as long as he is diligent and prudent. But where he is negligent, the better rule is that incompetence is no excuse.

Business Judgment

The idea that directors should not be liable in tort for "mere errors of judgment" has been a recurring theme that began early¹⁰⁴ and has stayed late.¹⁰⁵ Although it is sometimes referred to as the "business judgment rule,"¹⁰⁶ it hardly qualifies as a rule. It seems to have been a reaction to some of the more vigorous pronouncements on the need for director responsibility,¹⁰⁷ a vague idea that directors should not have to fear being sued whenever one of their ventures turns sour. The fear that it represents probably is ungrounded since the courts have shown no inclination to make directors insurers of their sagacity (that is, to fail to require proof of negligence in order to support liability). If the business judgment idea is no more than that a director who makes reasonable mistakes, short of negligence, should not be liable, then it adds nothing to established doctrine. If it says more, its soundness should perhaps be questioned. The concept has actually been used in several different ways which should be distinguished from each other.

In some cases the business judgment idea clearly has been no more than a verbalization of a finding of no negligence. In one case, for example,¹⁰⁸ a bank lent money on the Morris Plan to auto dealers with used cars as security; it had the misfortune to be caught in the 1920

would be exonerating, but the facts and the subsequent language negate that. Mrs. Hansard's failing in the court's eyes is that she did not show ordinary diligence; if she had and had made a protest and taken steps to prevent loss, the implication is that she would have been absolved of liability even if her efforts were unavailing.

102. *E.g.*, *Keck Enterprises, Inc. v. Braunschweiger*, 108 F. Supp. 925, 927 (S.D. Cal. 1952): "such care, skill and diligence in transacting the corporate business as might be expected in his own affairs."

103. 91 N.E.2d at 768.

104. See *Smith v. Prattville Mfg. Co.*, 29 Ala. 603 (1857).

105. See *Security Trust Co. v. Dabney*, 372 S.W.2d 401 (Ky. 1963).

106. Comment, *The Business Judgment Rule: A Guide to Corporate Directors' Liability*, 7 ST. LOUIS U.L.J. 151 (1962); BALLANTINE, CORPORATIONS § 632 (rev. ed. 1946).

107. See articles cited in notes 16 and 89 *supra*.

108. *Williams v. Fidelity Loan & Sav. Co.*, 142 Va. 43, 128 S.E. 615 (1925).

recession. Although the operation seemed rather rash at the time, the court found that it did not amount to actionable negligence—it was a matter of business judgment.¹⁰⁹ This might be thought of as a quantitative finding of no negligence. Other cases have used the concept to express a sort of qualitative judgment by contrasting losses caused by “mere mistakes of judgment” with those caused by directors’ “wilful and intentional departures from duty, their fraudulent breaches of trust, their gross negligence, or their ultra vires acts.”¹¹⁰

Another group of cases seems to use the business judgment concept to weaken the basic idea of negligence liability. Perhaps the causal implication is unwarranted, but at least the judgment language appears in conjunction with a weakened negligence doctrine. The most famous such case is *Spering's Appeal*, where the court said:

[W]hile directors are personally responsible to the shareholders for any losses resulting from fraud, embezzlement or wilful misconduct or breach of trust for their own benefit and not for the benefit of the shareholders, for gross inattention and negligence by which such fraud or misconduct has been perpetrated by agents, officers, or co-directors, yet they are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the power and discretion confided to the managing body.¹¹¹

Like most of the opinions in this area, this one is subject to varying interpretations; possibly it was only making the qualitative distinction referred to above. It seems, however, to say that directors acting within the whole area of management of the business are not liable even for absurdly gross errors of judgment; to the extent that it does, it subtracts from the usual range of liability.¹¹² Similar language appeared in a case almost a century later:

All of the allegations in category B address themselves to the matter of business judgment. Absent fraud, actual or constructive, the courts will not interfere with the management of a private corporation.¹¹³

109. See also *Burckhardt v. Northwestern Nat'l Bank*, 38 F.2d 568 (9th Cir. 1930); *Bailey v. Babcock*, 241 Fed. 501 (W.D. Pa. 1915).

110. 14A C.J. *Corporations* § 1869 (1921), quoted in *Sellers v. Head*, 261 Ala. 212, 73 So. 2d 747 (1954), and *Van Antwerp Realty Corp. v. Cooke*, 230 Ala. 535, 162 So. 97 (1935). See also *Spaulding v. Hotchkiss*, 62 N.Y.S.2d 151, 158 (Sup. Ct. 1946).

111. 71 Pa. 11, 24, 10 Am. Rep. 684 (1872).

112. See *Swentzel v. Penn Bank*, 147 Pa. 140, 23 Atl. 405, 414 (1892).

113. *Security Trust Co. v. Dabney*, 372 S.W.2d 401, 406 (Ky. 1963). See also

Does the business judgment idea have any usefulness at all, or is it just an affective expression of some courts' reluctance to hold directors liable for their failures? It seems that it can be fitted into a scheme of liability, starting with the conclusions reached in the discussion of causation. There it was suggested that once negligence is established, the defendant should not be heard to argue that his negligence cannot be considered the cause of the injury since his incompetence would have prevented him from averting the harm. The only question should be whether a reasonable director in his shoes would have prevented it. The other side of the coin is that the unskilled director is protected by his diligence; as long as he attends to his duties, he will not be found negligent, and the question what the reasonably skilled director would have done never arises.

The latter proposition is necessary to make the former fair, and this is where the business judgment idea can be useful, although most courts have arrived at the requirement of a strict showing of specific negligence without it. The rule can be phrased as: The director who diligently attends to his duties and exercises his best business judgment on the questions facing him will not be considered negligent even if his judgment is faulty. In other words, while the defendant should not be heard to argue that if he had been diligent his action *would have been* ineffective, the plaintiff should not be heard to allege that though the defendant was diligent his action *was* ineffective.

There is some support for this approach in the cases. In *Casey v. Woodruff*, a derivative suit involving a bond issue by the Erie railroad, Judge Shientag said:

A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.¹¹⁴

Although the judge may not have had in mind the precise formulation made in this article, he seemed clearly to be contrasting the director who acts erroneously with the one who does not act at all.¹¹⁵

Fielding v. Allen, 90 F. Supp. 137 (S.D.N.Y. 1951); Holland v. American Founders Life Ins. Co., 151 Colo. 69, 376 P.2d 162 (1962); Foster v. Bowen, 311 Mass. 359, 41 N.E.2d 181 (1942); Rous v. Carlisle, 261 App. Div. 432, 26 N.Y.S.2d 197 (1941), *aff'd*, 290 N.Y. 869, 50 N.E.2d 250 (1943).

114. 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944).

115. See also Hayman v. Morris, 36 N.Y.S.2d 756 (Sup. Ct. 1942); Lynch v Sapiro, 117 N.J. Eq. 485, 176 Atl. 327 (1935).

This approach does leave some loose ends. There are situations where we do want to hold directors liable for their acts, not their omissions—where their negligence is positive, not negative. What about directors such as those in *Hun v. Cary*,¹¹⁶ who, at a time when their bank was doing badly and they should have been retrenching or winding up the business, threw their dwindling resources into an elaborate new building? I think that these cases can be handled within the foregoing guidelines if the distinction between prudence and skill, or the lack of these qualities, is carefully observed.

The only failing that is “forgiven” by the business judgment concept is lack of skill. Lack of prudence may be manifested, as in the usual case, by failing to pay attention to the business at all; but it may also be shown by deliberately taking a longer chance than is reasonable for that particular business. This seems to be the case in *Hun*, and therefore business judgment would not be a defense. It may be objected that skill and prudence can not be neatly separated, that the unskilled director may not be aware of what the prudent course of action is, and that therefore what appears to be lack of prudence may be the result of incompetence, not recklessness. The answer must be that if in *Hun* the directors did take all reasonable steps to ascertain what the prudent course of action was but because of their incompetence were not capable of understanding the answer, then they probably should not be held liable. Such a case would be very rare, however, because a director who is unskilled will normally be held to be aware of his weakness and of the consequent necessity to consult wiser counsel before making important decisions.

The case of *Litwin v. Allen*¹¹⁷ does not fall nicely into the category of conscious recklessness, and it certainly does not involve an omission, yet as in *Hun* the imposition of liability seems proper. There the directors of the Guaranty Trust Company, certainly of the highly skilled variety, bought railroad bonds in the declining market of late 1930 and granted the seller a repurchase option that forced Guaranty to hold them for six months and absorb any capital loss that might occur but that precluded any capital gain if the market should turn strong. The deal was, on its face, inexplicable. No motivation, business or personal, was in evidence, and one can only surmise that the answer lay in the complex interdependencies of high finance in those troubled times. This seems to be a case where negligence was a convenient means to impose liability where a more serious breach, such as disloyalty to the corporation, may have been in the background. Again, however, the business judgment idea is quite

116. 82 N.Y. 65 (1880).

117. 25 N.Y.S. 667 (Sup. Ct. 1940).

properly not applied, for it does not seem to fit the pattern of honest directors doing their best when their best was not good enough.

Standard of Care

At least three-quarters of the jurisdictions use ordinary care as the standard in director negligence cases. More fully, they state the rule as "that care that an ordinarily prudent man gives to his own affairs."¹¹⁸ As discussed above, some courts prefer to put it as the care that an "ordinary director" would devote to the business,¹¹⁹ but no significant difference in result has appeared from the two formulations.

This is not to say that all the courts tend to treat like cases alike. One of the most common settings for a negligence case is a group of inactive directors who leave the management of the business, often a bank, to a managing officer who turns out to be dishonest. Even courts that agree on the verbal standard divide sharply on the question whether failure of the directors to examine the accounts regularly or thoroughly or to employ independent auditors to do it is sufficient basis for their liability to the corporation.¹²⁰ It is probably a safe generalization to say that the standard used by a court does not help much in predicting how it will rule in a particular case.

Some insight may be gained from the cases that deviate from the norm. There is one group of cases that, for one reason or another, seem to deny negligence altogether as a basis of director liability. Within this group, some are really standing to sue cases, holding no liability to creditors for anything short of intentional breaches.¹²¹ One state, Tennessee, has a statute that has been held to preclude director liability for negligence,¹²² although one case circumvented it with a trustee analysis.¹²³ Wisconsin and Kentucky apparently have arrived at the same result, denying director negligence liability generally, by judicial decision.¹²⁴ There are a few other cases that state the business judgment idea so strongly

118. See cases cited note 13 *supra*.

119. See text accompanying notes 13-16 *supra*.

120. *Compare Goff v. Emde*, 32 Ohio App. 216, 167 N.E. 699 (1928), *with O'Connor v. First Nat'l Investors' Corp.*, 163 Va. 908, 177 S.E. 852 (1935).

121. See *Proksch v. Bettendorf*, 218 Iowa 1376, 257 N.W. 383 (1934); *Conrick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. Civ. App. 1936); *Inter-Ocean Cas. Co. v. Lecony Smokeless Fuel Co.*, 123 W. Va. 541, 17 S.E.2d 51 (1941).

122. TENN. CODE ANN. § 45-218 (1955). See *Jones v. First State Bank*, 158 Tenn. 356, 13 S.W.2d 326 (1929). Although the statute only applies to banks, no negligence suits have been brought there against directors of non-financial corporations since 1880.

123. *Duncan v. Williamson*, 18 Tenn. App. 154, 74 S.W.2d 215 (1933).

124. See *Levitan v. Stout*, 97 F. Supp. 105 (W.D. Ky. 1951); *Security Trust Co. v. Dabney*, 372 S.W.2d 401, 406 (Ky. 1963); *Killen v. State Bank*, 106 Wis. 546, 82 N.W. 536 (1900). *But see Kirchdorfer v. Liberty Nat'l Bank & Trust Co.*, 303 Ky. 446, 197 S.W.2d 608 (1946).

that it sounds as if they are ruling out negligence altogether, although they probably are not. For example:

As long as directors act in good faith, in the exercise of what they believe to be good judgment, they cannot be charged with culpability if they err, on the theory that the doctrine or the principles which pertain to ultra vires acts become applicable, or as for negligence.¹²⁵

Although at first glance the judge seems to be saying that good faith is enough, he most probably meant that the conscientious exercise of judgment cannot be called negligence if it is erroneous since he held that no want of prudence was shown.¹²⁶

The second group of cases that deviate from the ordinary care standard consists of those that unequivocally hold to gross negligence as the standard. Just three states, Alabama,¹²⁷ Colorado,¹²⁸ and Massachusetts¹²⁹ seem to have settled into this category, although Massachusetts, uniquely, splits its standard, adhering to ordinary care for financial institutions.¹³⁰ A gross negligence standard originally established was later changed in three other states: Nebraska,¹³¹ Minnesota,¹³² and Pennsylvania.¹³³ Pennsylvania effected the change by a 1933 statute,¹³⁴ and a similar statute was directed at bank directors.¹³⁵ It is unclear whether

125. *Hayman v. Morris*, 36 N.Y.S.2d 756, 772 (Sup. Ct. 1942).

126. *Ibid.* See also *Fielding v. Allen*, 90 F. Supp. 137 (S.D.N.Y. 1951); *Inscho v. Mid-Continent Dev. Co.*, 94 Kan. 370, 146 Pac. 1014 (1915); *Beacon Wool Corp. v. Johnson*, 331 Mass. 274, 119 N.E.2d 195 (1954); *Foster v. Bowen*, 311 Mass. 359, 41 N.E.2d 181 (1942); *Cairns v. Du Pont*, 135 Misc. 278, 238 N.Y.S. 74 (Sup. Ct. 1929).

127. See *Sellers v. Head*, 261 Ala. 212, 73 So. 2d 747 (1954); *Van Antwerp Realty Corp. v. Cooke*, 230 Ala. 535, 162 So. 97 (1935).

128. See *Holland v. American Founders Life Ins. Co.*, 151 Colo. 69, 376 P.2d 162 (1962).

129. See *Allied Freightways v. Cholfin*, 325 Mass. 630, 91 N.E.2d 765 (1950); *Uccello v. Gold'n Foods, Inc.*, 325 Mass. 319, 90 N.E.2d 530 (1950).

130. See *Prudential Trust Co. v. Brown*, 271 Mass. 132, 171 N.E. 42 (1930); *Prudential Trust Co. v. Moore*, 245 Mass. 311, 139 N.E. 645 (1923); *Cosmopolitan Trust Co. v. Mitchell*, 242 Mass. 95, 136 N.E. 403 (1922).

131. Compare *Gerner v. Mosher*, 58 Neb. 135, 78 N.W. 384 (1899), with *Wells v. Carlsen*, 130 Neb. 773, 266 N.W. 618 (1936), and *Ashby v. Peters*, 128 Neb. 338, 258 N.W. 639 (1935), and *Masonic Bldg. Corp. v. Carlsen*, 128 Neb. 108, 258 N.W. 44 (1934).

132. Compare *Patterson v. Minnesota Mfg. Co.*, 41 Minn. 84, 42 N.W. 926 (1889), with *Lake Harriet State Bank v. Venie*, 138 Minn. 339, 165 N.W. 225 (1917).

133. Compare *Swentzel v. Penn Bank*, 147 Pa. 140, 23 Atl. 405 (1892), and *Spering's Appeal*, 71 Pa. 11 (1872), with *Otis & Co. v. Pennsylvania R.R.*, 61 F. Supp. 905 (E.D. Pa. 1945), *aff'd* 155 F.2d 522 (3d Cir. 1946), and *Hunt v. Aufderheide*, 330 Pa. 362, 199 Atl. 345 (1938).

134. "Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs." PA. STAT. tit. 15, § 2852-408 (1936).

135. PA. STAT. tit. 7, § 819-515 (1936).

the bank statute, which omits the "fiduciary relation" and the "personal business affairs" language of the business corporation provision, effectively sets up the same standard.¹³⁶

In a recent case interpreting the Investment Company Act of 1940,¹³⁷ a federal court found counsel "conceding" and itself agreed that lack of prudence would not subject directors to liability; gross negligence was required.¹³⁸ No citation was made to support this position. The only apparent reason for this position is the act itself. It provides that no charter, bylaw, or agreement

shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.¹³⁹

It further provides that the SEC is authorized to bring an action alleging "gross misconduct or gross abuse of trust" by an officer or director and enjoining the person from acting in such capacity.¹⁴⁰ It does not logically follow from either of these provisions that a shareholder should not be able to sue for ordinary negligence. The first section, limiting the scope of exculpatory clauses, certainly implies that such a clause *could* be inserted insulating the directors from ordinary negligence liability; it does not imply that the statute does this of its own force. No such clause was mentioned in the opinion. The language empowering the Commission to enjoin misconduct uses different language entirely and would appear to have no relation to the rights of a shareholder. In the light of the careful regulatory scheme set up by Congress, it seems doubtful that it was intended that these directors should have a lower standard of care than those of an ordinary business corporation.

A third category among the deviant-standard cases is characterized by lip service given to the ordinary care rule with a noticeably lenient decision on the facts. One of the most striking of these is a Maryland case¹⁴¹ in which an officer-director of a wastepaper company, who was also an eighty per cent shareholder, organized another company to manu-

136. See *Chester-Cambridge Bank & Trust Co. v. Rhodes*, 346 Pa. 427, 31 A.2d 128 (1943); Note, 10 U. PITT. L. REV. 370 (1949). No observable differences in result have appeared, however, from these verbal variations.

137. 54 Stat. 789 (1940), 15 U.S.C. §§ 80a-1 to 80a-52 (1958).

138. *Acampora v. Birkland*, 220 F. Supp. 527, 550 (D. Colo. 1963).

139. 54 Stat. 815 (1940), 15 U.S.C. § 80a-17(h)-(i) (1958).

140. 54 Stat. 841 (1940), 15 U.S.C. § 80a-35 (1958).

141. *Burkhart v. Smith*, 161 Md. 398, 157 Atl. 299 (1931).

facture paperboard from the wastepaper company's product. He milked the wastepaper company, whose trustee in bankruptcy was the plaintiff in the case, to keep the manufacturing company going; and both ultimately failed. The court talked variously of fraud, gross breach of trust, and ordinary prudence as the test, then said:

If there is no conscious betrayal of the trust reposed, there must be such neglect or misconduct as amounts to a betrayal of the trust. And we concur with the judge of the lower court in his finding that the facts presented in this case do not justify a finding of either fraud or negligence, or misconduct of the kind described.¹⁴²

*Wallach v. Billings*¹⁴³ is another such case. There the court held that a nonresident director would not be liable for leaving the business in the hands of a manager who broke the bank by large loans to his own interests. No other case was found that supported the position that nonresidence would be a defense to a negligence suit.¹⁴⁴ As mentioned above,¹⁴⁵ the court also took a rather extreme view of causation and held that the pleadings were insufficient in this respect in spite of their allegation that normal attention to the business would have uncovered the losses. A later Illinois case distinguished *Wallach*, however, and adhered to the normal test.¹⁴⁶

As a sort of special case in this lenient group, there have been a few decisions that treated directors benignly because they were small-town or rural types in an area with little skill to be found. These are closely related, of course, to cases like *Cholfin*,¹⁴⁷ where lack of skill is found to affect the causation element. In *Warner v. Penoyer*,¹⁴⁸ for example, honest farmers in upstate New York were held not liable for leaving the bank in the hands of the cashier; the court was of the opinion that supervision in village banks could not be as rigorous as in city banks.¹⁴⁹ As discussed above under causation and business judgment, lack of skill seems

142. *Id.* at 404, 157 Atl. at 301.

143. 277 Ill. 218, 115 N.E. 382 (1917).

144. *Platt Corp. v. Platt*, 42 Misc. 2d 640, 249 N.Y.S.2d 1, 5 (Sup. Ct. 1964), expressly held that nonresident directors' failure to attend meetings was a "tortious act."

145. See text accompanying note 98 *supra*.

146. *Chicago Title & Trust Co. v. Munday*, 297 Ill. 555, 131 N.E. 103 (1921). For other lenient cases, see *Burckhardt v. Northwestern Nat'l Bank*, 38 F.2d 568 (9th Cir. 1930); *Johnson v. Coleman*, 179 Ark. 1087, 20 S.W.2d 186 (1929); *Sweet v. Montpelier Sav. Bank*, 73 Kan. 47, 84 Pac. 542 (1906); *Id.*, 69 Kan. 641, 77 Pac. 538 (1904); *Goff v. Emde*, 32 Ohio App. 216, 167 N.E. 699 (1928).

147. *Allied Freightways v. Cholfin*, 325 Mass. 630, 91 N.E.2d 765 (1950). See text accompanying notes 94-95 *supra*.

148. 91 Fed. 587 (2d Cir. 1898).

149. See also *Wheeler v. Aiken County Loan & Sav. Bank*, 75 Fed. 781 (C.C.D.S.C. 1896); *First State Bank v. Morton*, 146 Ky. 287, 142 S.W. 694 (1912).

a poor excuse for not doing one's best as a director, and one who does his best is not likely to be found liable.

In the last group of deviant-standard cases the decisions are unclear or contradictory. A striking example of self-contradiction is *Keck Enterprises, Inc. v. Braunschweiger*,¹⁵⁰ where the judge said:

It was Braunschweiger's duty as president of the corporation to exercise such care, skill and diligence in transacting the corporate business as might be expected in his own affairs. He cannot be charged with the consequences of mismanagement unless it was so gross as to amount to fraud.¹⁵¹

The first sentence says that he has a duty to be careful; the second denies any liability unless he is dishonest. The only possible way to reconcile the sentences, it seems, is to define mismanagement in such a way as to exclude lack of care, lack of skill, and lack of diligence. I doubt that that is possible. The remainder of the opinion did not clarify the standard since the holding of the case was that the president had acted wisely on the occasion in question. The most common confusion of standards has been the failure to recognize that the counterparts, in normal parlance, of extreme care, ordinary care, and slight care are slight negligence, ordinary negligence, and gross negligence. That is, the absence of ordinary care constitutes ordinary, not gross, negligence. *Keck* may illustrate that type of confusion.¹⁵² Any supreme court is free, I suppose, to redefine even common legal terms to suit its fancy; the problem here is to decide which of the terms has been redefined.¹⁵³

The other main source of uncertainty in standards is the question whether directors should be held for conditions of which they had no knowledge. Cases like *Cholfin* and *Warner*¹⁵⁴ consider the question in regard to directors of limited capacity; a few cases, however, have

150. 108 F. Supp. 925 (S.D. Cal. 1952).

151. *Id.* at 927.

152. See also *Smith v. Prattville Mfg. Co.*, 29 Ala. 503 (1857); *United Soc'y of Shakers v. Underwood*, 72 Ky. (9 Bush) 609 (1893); *Commonwealth v. Anchor Bldg. & Loan Ass'n*, 20 Pa. Super. 101 (1902).

153. New York has a long line of cases adhering to the ordinary-care standard. See, e.g., *Hun v. Cary*, 82 N.Y. 65 (1880); *Scott v. Depeyster*, 1 Edw. Ch. 513 (N.Y. 1832); *Van Schaick v. Aron*, 170 Misc. 520, 10 N.Y.S.2d 550 (Sup. Ct. 1938); *Platt Corp. v. Platt*, 42 Misc.2d 640, 249 N.Y.S.2d 1 (Sup. Ct. 1964). It also has a group of cases that appear to deny or severely limit negligence as a basis of liability. See *Fielding v. Allen*, 90 F. Supp. 137 (S.D.N.Y. 1951); *Schwab v. E. G. Potter Co.*, 87 N.E. 670, 194 N.Y. 409 (1909); *Winter v. Anderson*, 242 App. Div. 430, 275 N.Y.S. 373 (1934); *Hayman v. Morris*, 36 N.Y.S.2d 756 (Sup. Ct. 1942); *Cairns v. Du Pont*, 135 Misc. 278, 238 N.Y.S. 74 (Sup. Ct. 1929). These expressions are largely dicta, however, in cases where negligence is not really at issue and probably reflect judicial impatience at nuisance derivative suits in a busy system.

154. See text accompanying note 147 *supra*.

suggested that no director should be liable in such a case. One court said:

Here persons who were directors in a corporation are sought to be held individually liable for a conversion of property about which they knew nothing, merely because, if they had examined the books of the corporation, they might have ascertained that the conversion had taken place. We cannot lend our assent to the establishment of such a doctrine. It is doubtful, if this were the established law, that responsible persons would be willing to act as corporation directors.¹⁵⁵

Taken literally, such opinions make a distinction between an act and an omission that has never been accepted as part of our law.¹⁵⁶ If a director is indeed negligent, and his negligence is the cause of the harm (within whatever formulation of causation the court accepts), there should be no independent exculpatory significance in the fact that the negligence consisted of a failure to examine the books. I suspect that if pressed these courts would fall back on a finding of no negligence. There has been a tendency of some courts, more noticeable in the older cases than the recent ones, to be repelled by the idea of liability falling on an honest but inactive director. This feeling should be reflected in strict application of the requirement of proof of negligence, however, rather than in a spinning of new doctrines.

155. *Cohen v. Maus*, 297 Pa. 454, 147 Atl. 103, 104 (1929). This case was decided four years before Pennsylvania passed its statute codifying the normal rule. See note 133 *supra*. To the extent that this case limited the liability of directors for ordinary negligence, then, the statute overruled it. But see *Chester-Cambridge Bank & Trust Co. v. Rhodes*, 346 Pa. 427, 31 A.2d 128, 131 (1943), which cited older cases for the proposition that directors are not liable for "nonfeasance;" the case may be construed as merely finding no negligence. Compare *Sweet v. Montpelier Sav. Bank*, 69 Kan. 641, 77 Pac. 538 (1904).

156. See *Platt Corp. v. Platt*, 42 Misc. 2d 640, 646-48, 249 N.Y.S.2d 1, 5-6 (Sup. Ct. 1964).

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