CORPORATIONS—OFFICERS AND DIRECTORS—FIGUREHEAD DIRECTOR LIABLE FOR CO-DIRECTOR'S MISAPPROPRIATION OF FUNDS—*Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981).

The trend in corporate director liability cases has been to find negligent directors not liable for corporate losses.[1] Analysis has generally focused on whether a director's breach of his fiduciary duty to the corporation was the proximate cause of the losses.[2] A recent New Jersey Supreme Court case which may reverse this trend is *Francis v. United Jersey Bank.*[3] In *Francis*, Lillian Pritchard was a director and majority shareholder of Pritchard and Baird,[4] a closely-held corporation doing business as a reinsurance broker.[5] The company had four directors, Charles Pritchard, Sr., his wife, Lillian, and their sons, Charles, Jr. and William.[6] Charles, Sr. died in 1973,[7] but before his death, he started taking "loans" from corporate funds for his personal use, a practice that eventually led to the corporation's dissolution.[8] Taking these loans was possible because of the unique nature of the reinsurance industry.[9]

---

[1] Goldstein & Shepherd, *Directors' Duties and Liabilities Under the Securities Acts and Corporation Law*, 36 WASH. & LEE L. REV. 759, 781 n.163 (1979); *see* notes 69 & 117 *infra* and accompanying text.

[2] Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 358-67 (1965).

[3] 87 N.J. 15, 432 A.2d 814 (1981).

[4] *Id.* at 23, 432 A.2d at 818. Although Pritchard and Baird initially operated as a partnership, it later formed several corporations: Pritchard and Baird Intermediaries Corp., Pritchard and Baird, Inc., P & B Intermediaries Corp., and P & B Inc. Brief for Appellant at 2, Francis v. United Jersey Bank, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979). The court considered the activities of only one entity, Pritchard and Baird Intermediaries Corp., since proofs in support of prior judgments related only to that corporation.

[5] 87 N.J. at 22, 432 A.2d at 817. Black's Law Dictionary defines reinsurance as:

> A contract by which an insurer procures a third person to insure him against loss or liability by reason of original insurance. A contract that one insurer makes with another to protect the latter from a risk already assumed. It binds the reinsurer to pay to the reinsured the whole loss sustained in respect to the subject of the insurance to the extent to which he is reinsured.

BLACK'S LAW DICTIONARY 1157 (5th ed. 1979).

[6] 87 N.J. at 23, 432 A.2d at 818. George and Marjorie Baird were part of the original group of directors, but they eventually sold their shares to the Pritchards. *Id.*

[7] *Id.* Lillian Pritchard inherited the bulk of her husband's estate, including his share in the corporation, thus, becoming the largest shareholder. *Id.*

[8] Under the guise of shareholder loans, Charles, Sr. withdrew funds as compensation for unpaid salaries and commissions. During his reign, however, these "loans" were repaid out of corporate profits at the end of each fiscal year. Francis v. United Jersey Bank, 162 N.J. Super. 355, 362-63, 392 A.2d 1233, 1237 (Law Div. 1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981).

[9] 87 N.J. at 24, 432 A.2d at 818.

Reinsurance is a method of spreading the risk among several insurance companies. One insurer may wish to protect itself on a large policy by selling a part of the underlying risk to other insurance companies, thereby reinsuring itself.[10] A reinsurance broker acts as an intermediary, arranging transactions between the companies.[11] The procedure for payment is that the insurance company wishing to spread the risk sends the premium to the broker who deducts his brokerage fee and forwards the balance to the various companies sharing the risk.[12] When a loss occurs, funds are transferred in reverse order.[13]

Although the accepted practice of the industry is to separate insurance funds from those of the broker's general accounts, Pritchard and Baird maintained only one account.[14] By doing so, Charles, Sr., was able to make payments to himself from the insurance funds, and repay them at the end of the year out of corporate profits.[15] By 1971, when Charles, Sr. had ceased his active involvement in the company, Charles, Jr. and William not only continued this method of operating, but also began to take increasing amounts from the corporation which they were unable to repay.[16] By 1975 the payments exceeded the corporate revenues to such an extent that the corporation went bankrupt.[17] The trustees in bankruptcy[18] sued the director sons for the

---

[10] *Id.* at 22-23, 432 A.2d at 817-18. The various insurance companies do not communicate with each other; they rely solely on the integrity and honesty of the reinsurance broker to forward funds when they become due. *Id.* at 22, 432 A.2d at 817. Also, the reinsurance industry is not regulated by the government. Francis v. United Jersey Bank, 162 N.J. Super. 355, 361, 392 A.2d 1233, 1236 (Law Div. 1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981). All these factors combine to make the business of reinsurance unique in that the broker has unilateral, unchecked control over large sums of money belonging to others. *Id.*

[11] 87 N.J. at 22, 432 A.2d at 817.

[12] *Id.*

[13] Brief for Appellee at 13, Francis v. United Jersey Bank, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979).

[14] 87 N.J. at 23-24, 432 A.2d at 818-19.

[15] *Id.* at 24, 432 A.2d at 818.

[16] *Id.* At the end of 1970, William had withdrawn $207,329 in cash, and Charles, Jr., $230,932. These amounts were in addition to salary or any other legal earnings or profits. Other family members benefitted from the loans. Charles, Sr. received $189,194.17 from 1970 to 1973. Loans to Lillian Pritchard from 1973 to 1975 totalled $33,000. Lillian Overcash, Mrs. Pritchard's daughter, received $123,156.51 from 1970 to 1975. Francis v. United Jersey Bank, 162 N.J. Super. 355, 364, 392 A.2d 1233, 1237-38 (Law Div. 1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981).

[17] 87 N.J. at 24, 432 A.2d at 818. By 1975, the loans amounted to a total of $12,333,514.47. Pritchard and Baird filed for bankruptcy on December 4, 1975, and it was adjudicated bankrupt on January 28, 1976. Brief for Appellee at 7-8, Francis v. United Jersey Bank, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979). Separate bankruptcy proceedings are being litigated against Charles, Jr. and William. 87 N.J. at 21, 432 A.2d at 816.

[18] Plaintiffs John J. Francis, George R. Ladner (later substituted by Hugh P. Francis) and J. Raymond Berry were trustees in bankruptcy for all four of the Pritchard and Baird companies.

losses, as well as the estate of Mrs. Pritchard, although she never actively participated in these transactions or any form of corporate decision-making.[19]

The trial court held that the payments constituted fraudulent conveyances under state law.[20] Furthermore, in failing to discover and prevent her sons' wrongdoing, Mrs. Pritchard was found liable because her negligence caused the creditors and customers of Pritchard and Baird to suffer monetary losses.[21] The court entered judgment against her estate in the amount of $10,355,736.91 plus interest.[22]

The appellate division affirmed as to Mrs. Pritchard's liability, but disagreed with the lower court's interpretation of the payments as fraudulent conveyances.[23] In a *per curiam* opinion, the court charac-

---

They filed their complaint on April 26, 1976 against Charles, Jr., Lillian Pritchard, Lillian Overcash, Deborah and William Pritchard (children of Lillian Overcash), individually, and Charles, Jr., and William and Lillian Pritchard as executors of Charles, Sr.'s estate. Brief for Appellee at 203, Francis v. United Jersey Bank, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979). United Jersey Bank was joined as administrator of Charles, Sr.'s estate (replacing Charles, Jr., William, and Lillian). 87 N.J. at 20, 432 A.2d at 816.

Lillian Pritchard died after commencement of the initial suit. As executrix of her mother's estate, Lillian Overcash was substituted as defendant. Lillian Overcash was thus liable in two capacities: as executrix and as an individual. *Id.*

[19] 87 N.J. at 26, 432 A.2d at 820. The trustees later terminated their suit in state court against Charles, Jr. and William since they had declared bankruptcy and remedies were being sought during their bankruptcy proceedings. Francis v. United Jersey Bank, 162 N.J. Super. 355, 365, 392 A.2d 1233, 1238 (Law Div. 1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981). In a prior action, the trustees obtained an indictment by the state grand jury against Charles, Jr. and William for misappropriation of corporate funds under N.J. STAT. ANN. § 2A:102-3 (West 1969) and as to Charles, Jr., embezzlement under N.J. STAT. ANN. § 2A:102-5 (West 1969). State v. Pritchard, 79 N.J. 462, 401 A.2d 219 (1978).

[20] N.J. STAT. ANN. § 25:2-10 (West 1940); Francis v. United Jersey Bank, 162 N.J. Super. 355, 367 (Law Div. 1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981). The provision governing fraudulent conveyances states: "Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without fair consideration." N.J. STAT. ANN. § 25:2-10. The court also found that Charles, Jr. and William had an intent to defraud. 162 N.J. Super. at 367, 392 A.2d at 1239. As a result of these findings, the Pritchard and Baird creditors were entitled to the amount of the payments made to members of the Pritchard family. Thus, since the trustees in bankruptcy represented the creditors, they had a right to a money judgment against respondents. *Id.* at 368, 392 A.2d at 1239.

[21] Francis v. United Jersey Bank, 162 N.J. Super. 355, 374, 392 A.2d 1233, 1242 (Law Div. 1978), *aff'd*, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981).

[22] *Id.* The trial court held Charles, Sr.'s estate liable in the amount of $357,648.17 plus prejudgment interest of $86,297.00, for a total of $443,945.17. Lillian Overcash individually was held liable for $123,156.51 plus interest of $34,573.47, for a total of $157,729.98. Brief for Appellee at 4-5, Francis v. United Jersey Bank, 171 N.J. Super. 34, 407 A.2d 1253 (App. Div. 1979).

[23] Francis v. United Jersey Bank, 171 N.J. Super. 35, 35-36, 407 A.2d 1253, 1254 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981).

terized the payments as an unlawful conversion of trust funds,[24] and noted that the result would be the same regardless of the analysis employed.[25]

The supreme court agreed with the appellate division's classification of the payments as trust funds, and granted certification solely to the issue of Mrs. Pritchard's liability.[26] Its inquiry was limited to "whether a corporate director is personally liable in negligence for the failure to prevent the misappropriation of trust funds by other directors who were also officers and shareholders of the corporation."[27] In *Francis*, the supreme court affirmed the lower courts' opinions and held that Mrs. Pritchard's negligence as a director was the proximate cause of plaintiffs' losses caused by the misappropriation of funds by her sons.[28]

Historically, many of the earliest cases discussing director liability involved banks, savings institutions, and trust companies.[29] In the 1872 case of *Spering's Appeal*,[30] directors of an insurance and trust company[31] were sued for the losses incurred by "fraudulent mismanagement" of company affairs.[32] In ascertaining a director's responsibilities to his stockholders, the Pennsylvania Supreme Court stated that directors are only trustees in the sense that they are bailees or agents assigned to the task of managing another's property.[33] Consequently, they are "regarded as mandatories"—"persons who have

---

[24] 87 N.J. at 21, 432 A.2d at 817.

[25] Francis v. United Jersey Bank, 171 N.J. Super. 35, 36, 407 A.2d 1253, 1254 (App. Div. 1979), *aff'd*, 87 N.J. 15, 432 A.2d 814 (1981).

[26] Francis v. United Jersey Bank, 82 N.J. 285, 412 A.2d 791 (1980).

[27] 87 N.J. at 20, 432 A.2d at 817.

[28] *Id.* at 45, 432 A.2d at 829.

[29] *E.g.*, Preston v. Prather, 137 U.S. 694 (1890) (directors of bank liable for gross negligence for failure to supervise dishonest cashier); LaMonte v. Mott, 93 N.J. Eq. 229, 107 A. 462 (1921) (directors of trust company held liable for negligently conducting business); Williams v. McKay, 46 N.J. Eq. 25, 18 A. 824 (Ch. 1889) (managers of savings bank held liable for failure to reasonably supervise officers of bank according to its charters); Wilkinson v. Dodd, 42 N.J. Eq. 234, 7 A. 327 (Ch. 1886), *aff'd*, 42 N.J. Eq. 647, 9 A. 685 (1887) (managers of savings institution held liable for losses from illegal loans); Kavanaugh v. Gould, 223 N.Y. 103, 119 N.E. 237 (1918) (director of trust company who was not knowledgeable in company's affairs and did nothing as to his directorial duties cannot be held negligent as matter of law). *See generally* Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157, 163 (1970).

[30] 71 Pa. 11 (1872).

[31] The company was originally involved in life insurance and the savings fund business; after 1850, the life insurance aspect of the business was transferred and the savings fund became the primary business of the company. *Id.* at 12. Thus, the opinion is analyzed with the bank cases.

[32] *Id.* The alleged impropriety by the company's directors occurred over a period of ten years and involved such incidents as wasteful investments, over-valuation of assets to show profits, and not enforcing unpaid stock subscriptions. *Id.* at 13.

[33] *Id.* at 20-21.

gratuitously undertaken to perform certain duties, and who are therefore bound to apply ordinary skill and diligence, but no more."[34]

The *Spering's Appeal* court noted that prior case law characterized three situations where directors may be held accountable for their actions: first, when they have personally perpetrated fraud on the corporation; second, when they have known or colluded in perpetrating the deception in others; and third, when the wrongdoing may have been forestalled if they had performed their duties with ordinary diligence.[35] None of these situations were applicable to the directors in *Spering's Appeal*, however, because they had merely invested unwisely.[36] The court asserted that directors should not be held liable for "mistakes of judgment."[37] This concept has come to be known as the "business judgment rule."[38]

In the same spirit as *Spering's Appeal*, the United States Supreme Court in *Briggs v. Spaulding*[39] exonerated four bank directors when

---

[34] *Id.*

[35] *Id.*

[36] *Id.* at 20.

[37] *Id.* at 24.

[38] Dyson, *supra* note 2, at 367-71. The business judgment rule is employed as a defense by directors under which liability cannot be imposed for mere faulty judgment. *Id.* at 367. Dyson refers to the business judgment rule as a "weakened negligence doctrine." *Id.* at 368. The rule is succinctly summarized by Judge Sharswood in this often-quoted passage:

> [W]hile directors are personally responsible to the stockholders for any losses resulting from fraud, embezzlement or willful misconduct or breach of trust for their own benefit and not for the benefit of the stockholders, 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 powers and discretion confided to the managing body.

In re Spering's Appeal, 71 Pa. at 24.

The reluctance on the part of the *Spering* court to hold the directors to a higher duty of care may be a reflection of the times for it would deter "gentlemen of character and responsibility" from accepting positions as directors. The result would be disastrous because many of the earlier banks needed the reputation of its directors to attract clients. Briggs v. Spaulding, 141 U.S. 132, 174 (1891).

The rationale for the rule is that the courts "should not interfere with the corporation's internal management by substituting its judgment for the board's." Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U. L. Rev. 1341, 1346 n.29 (1977); *see, e.g.*, Otis & Co. v. Pennsylvania R. Co., 61 F. Supp. 905, 911 (E.D. Pa. 1945); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (dictum); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928); Shlensky v. Wrigley, 95 Ill. App. 2d 173, 178, 237 N.E.2d 776, 779 (1968); Helfman v. American Light & Traction Co., 121 N.J. Eq. 1, 20, 187 A. 540, 550 (Ch. 1936). *See generally* Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93 (1979); Lewis, *supra* note 29; Comment, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 Geo. Wash. L. Rev. 562 (1967).

[39] 141 U.S. 132 (1891).

the bank's president caused the bank's insolvency by extending loans to bad credit risks.[40] In analyzing the duties of bank directors, the court stated that such directors should be more than mere figureheads; they "must exercise [the] ordinary care and prudence"[41] necessary depending upon the particular circumstances involved. Bank directors were entitled to leave much of the administration of the business to the managing officers, whose relationship to the corporation was that of agency.[42] A director's duty, therefore, was classified as one of proper control over the corporation's agents,[43] but not as an "insurer of the fidelity of [his] agents."[44] This theory relieved bank directors of liability for losses caused by their officers unless their own negligence precipitated the corporate loss. The court recognized that a director could be found negligent if he became suspicious of some wrongdoing but did nothing to stop it. A director was not required to assume the dishonesty of his officers without reason, however.[45] Thus, the business judgment rule was applicable to a director's relationship to his officers and an honest director would only be liable if ordinary attention would have uncovered the fraud.[46]

Relating this standard of care to the facts in *Briggs*, the court asserted that unless the directors were "grossly inattentive" in their duties they should not be held liable.[47] The court then applied the "proper diligence" standard subjectively, and found the directors who had done virtually nothing in their positions not to be liable because they could not have prevented the bank's insolvency.[48] What would have constituted "grossly inattentive" to the majority is not clear and appears to be the point of the dissent.[49] Although the dissent em-

[40] *Id.* at 137, 147.

[41] *Id.* at 165.

[42] *Id.*

[43] *Id.* at 147.

[44] *Id.; see* McConnell v. Combination Mining & Milling Co., 31 Mont. 563, 573, 79 P. 248, 251 (1905); Weidner v. Engelhart, 176 N.W. 2d 509, 518 (N.D. 1970); Selheimer v. Manganese Corp. of America, 423 Pa. 563, 581, 224 A.2d 634, 644 (1966).

[45] 141 U.S. at 162.

[46] *Id.* at 149.

[47] *Id.* at 165-66. The Court found that the bank was already insolvent at the time the directors were elected to the board. Since the directors were not aware of this fact, their duty did not extend to a thorough examination of the books to discover the bank's insolvency in the absence of any reasonable suspicion. *Id.* at 154. The Court held that such an inspection would have amounted to an "extraordinary degree of care" on the director's part. *Id.* at 162.

[48] *Id.* at 152-58.

[49] *Id.* at 169 (Harlan, J., dissenting). Commentators have viewed the *Briggs* dissent as a much sounder argument than that of the majority, and it is more often quoted as the correct standard. *See* 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1085, at 107-08 (1963); Dwight, *Liability of Corporate Directors*, 17 YALE L.J. 33, 38 (1939).

braced the same standard as the majority, it would have applied it more objectively. The dissent found the individual qualities of the directors and whether they could have prevented the bank's insolvency to be irrelevant to the court's analysis.[50] The mere fact that the directors breached their duties as directors would have been sufficient for the dissent to impose liability.[51]

Furthermore, the dissent noted that if directors were permitted to abdicate their responsibilities, the purpose of maintaining a board of directors would be defeated, inasmuch as creditors and stockholders would no longer maintain confidence in the business.[52] This reasoning of limiting director responsibility was similar to that used in *Spering's Appeal*, but resulted in a different outcome. Whereas the *Spering's Appeal* court reasoned that too much director responsibility would deter men of stature from becoming directors and result in loss of client confidence in the business, the *Briggs* dissent argued that too little director responsibility would have much the same result.[53]

Ten years after *Briggs*, the New Jersey Supreme Court in *Campbell v. Watson*[54] examined a situation similar to that involved in *Briggs*, but held the directors liable in failing to discover improper loans.[55] The *Briggs* standard of care, namely that a person must exercise ordinary and proper care in the absence of anything arousing suspicion, was altered in *Campbell* to a duty of "such care and diligence . . . as experience has shown is at once proper as well as

---

[50] 141 U.S. at 166 (Harlan, J., dissenting). The dissent noted that these directors completely ignored the conduct of the bank's president, who managed the business. *Id.* Two of the directors had signed comptroller reports that were "false and fraudulent" without checking their accuracy. *Id.* at 167 (Harlan, J., dissenting).

[51] *Id.* at 174 (Harlan, J., dissenting).

[52] *Id.*

[53] *In re* Spering's Appeal, 71 Pa. at 21. This fear that a higher duty would be such a substantial threat of personal liability that the best qualified people would refuse to serve as directors has been expressed by later courts and commentators. *E.g.*, Smith v. Brown-Borhek Co., 414 Pa. 325, 333, 200 A.2d 398, 401 (1964); E. McSweeney, Managing the Managers 105, 106 (1978); Soderquist, *supra* note 38, at 1349-50; Symposium, *The Greening of the Board Room: Reflections on Corporate Responsibility*, 10 Colum. J.L. & Soc. Prob. 15, 23-24 (1973) (statement of Professor Harvey J. Goldschmid); Comment, *Factors That Limit the Negligence Liability of a Corporate Executive or Director*, 1967 U. Ill. L.F. 341, 343.

One commentator has suggested that in order to attract qualified directors, "workable tasks" should be mandated, thereby avoiding the confusing duty of care standard which the law now provides. Dent, *The Revolution in Corporate Governance, The Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. Rev. 623, 654 (1981).

[54] 62 N.J. Eq. 396, 50 A. 120 (Ch. 1901).

[55] *Id.* at 451, 50 A. at 142.

practicable, and as is exercised by other experienced directors, and as is required by their charter and by-laws."[56]

Although this rule appeared to be similar to that in *Briggs*, the *Campbell* court interpreted due diligence to encompass a duty on the part of the director to inspect the books and to become familiar with the "mode of supervision" practiced by his officers.[57] If he were ignorant of the way affairs were managed or what the by-laws required, the director would be bound to inquire of others and acquaint himself as to those duties.[58] In *Campbell*, the cashier's embezzlements could easily have been detected by a simple comparison of the books. Because no such attempt was made by the directors,[59] they became liable for the losses.[60] Thus, while both courts appear to have set forth an objective standard, *Briggs* allowed the defendants a good faith defense since the court believed that there was nothing the directors could have done to prevent the bank's insolvency, whereas *Campbell* applied a more stringent application of the standard and observed that if the directors had applied even the slightest attention to their duties, the losses could have been prevented.[61]

Although *Campbell* put forth a number of important principles, it especially illustrates two basic concepts of directorial liability: negligence and causation. If a director were to fall below the ordinary skill and prudence standard, he would be negligent in his duties as a director. Because the directors in *Campbell* failed to inspect the bank's books and to supervise the corrupt cashier, they were negligent because that was what an ordinary and prudent director should have done.[62] But a director could not be held liable for corporate losses

---

[56] *Id.* at 426, 50 A. at 132. The court said specifically that the *Briggs* ruling did not reach the *Campbell* case, but it did find the dissent in *Briggs* to be a more convincing argument. *Id.* at 439, 50 A. at 137.

[57] *Id.* at 409, 50 A. at 125. The *Campbell* court required an inspection of the books because there seemed to be so many dishonest officers in the banking industry who had discovered numerous ways to steal from the company that the directors could no longer blindly trust them. *Id.*

[58] *Id.* at 415-16, 50 A. at 128.

[59] *Id.* at 411, 50 A. at 128.

[60] *Id.* at 419-20, 50 A. at 130; *cf.* LaMonte v. Mott, 93 N.J. Eq. 229, 107 A. 462 (Ch. 1921) (directors exonerated because they had made honest effort to perform their duty).

[61] 62 N.J. Eq. at 419, 50 A. at 129. *But see* Hun v. Cary, 82 N.Y. 65 (1880). *Hun* represents the high water mark where directors were held liable for real estate investments which the bank couldn't afford and which rendered the bank insolvent. Some commentators have noted that *Hun* sets a higher standard of conduct than the average. Cary & Harris, *Standards of Conduct Under Common Law, Present Day Statutes and the Model Act*, 27 Bus. LAW. 61 (1972). One commentator noted that the *Briggs* court's attitude of "good humored tolerance" as opposed to the sternness of *Hun* is even more notable in light of the fact that the *Briggs* defendants were bank directors, traditionally held to a stricter standard. Soderquist, *supra* note 38, at 1347.

[62] 62 N.J. Eq. at 451-53, 50 A. at 142-43.

unless his negligence caused the losses.[63] The *Campbell* court held that the directors' omissions directly caused the bank's losses, because if they had been diligent the losses would not have occurred.[64]

Although *Briggs* and *Campbell* involved the liability of bank directors, their rules are equally applicable to other corporate directors.[65] *Briggs* in particular has been cited more often than any other case on this issue.[66] Traditionally bank directors have been held to a stricter standard of care,[67] but case law suggests that a lesser duty is required of directors of non-banking corporations.[68] The trend after the early bank cases has been an almost consistent string of victories for non-banking directors.[69] The courts have found either that the director did not have knowledge of or participate in the wrongful acts of co-directors and officers,[70] or that the plaintiff failed to prove that defendant's negligence was the actual cause of the corporate losses.[71]

A case which exemplifies this trend is *Barnes v. Andrews*,[72] where the director of an auto parts company was found liable for

---

[63] *Id.* at 405, 50 A. at 124.

[64] *Id.* at 420, 50 A. at 130.

[65] W. FLETCHER, *supra* note 49, § 1085, at 106. *But see* Lewis, *supra* note 29, at 163.

[66] W. FLETCHER, *supra* note 49, § 1085, at 106.

[67] *E.g.*, Gamble v. Brown, 29 F.2d 366, 370 (4th Cir. 1928), *cert. denied*, 279 U.S. 839 (1929); Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940).

[68] Martin, *Federal Regulation of Real Estate Investment Trusts: A Legislative Proposal*, 127 U. PA. L. REV. 316, 330 (1978); Soderquist, *supra* note 38, at 1347. "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). *Contra* H. BALLANTINE, BALLANTINE ON CORPORATIONS § 63a, at 161 (1946) (improbable that bank directors are held to higher degree of care but are merely required to give reasonable attention to their affairs). *See generally* W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 525-27 (4th ed. 1969); W. FLETCHER, *supra* note 49, § 1068, at 84.

[69] Goldstein & Shepherd, *supra* note 1, at 781; *see, e.g.*, Hoehn v. Crews, 144 F.2d 665 (10th Cir. 1944), *aff'd*, 324 U.S. 200 (1945); Holand v. American Founders Life Ins. Co., 151 Colo. 69, 376 P.2d 162 (1962); Hathaway v. Huntley, 284 Mass. 587, 188 N.E. 616 (1933). In cases where the courts have found directors of industrial corporations liable, the opinions suggest that the courts suspected the "defendants' conduct was more duplicitous than negligent." Soderquist, *supra* note 38, at 1348.

[70] Berman v. LeBeau Inter-America, Inc., 509 F. Supp. 156 (S.D.N.Y. 1981) (director and officer who was not allowed to participate in finances of company held not liable for payments made in alleged gross disregard of duty).

[71] Hoehn v. Crews, 144 F.2d 665 (10th Cir. 1944), *aff'd*, 324 U.S. 200 (1945) (bank directors' failure to publish notice of liquidation was proximate cause of losses); Allied Freightways, Inc. v. Cholfin, 325 Mass. 630, 91 N.E.2d 765 (1950) (director who could not have discovered misappropriations and who could not have stopped her husband from making such payments held not liable).

[72] 298 F. 614 (S.D.N.Y. 1924).

"misprision of office,"[73] but was not found to have caused the corporate losses.[74] Judge Learned Hand, writing for the court, noted that although directors are not expected to participate personally in the everyday affairs of the business, they should do more than be content with general responses from subordinates that "the business looks promising."[75] The burden is on the plaintiff to show that if the defendant had performed his duties the loss could have been avoided.[76] The court noted that no evidence had been put forth by the plaintiff to indicate that defendant's neglect was the proximate cause of the losses. Furthermore, the amount of the loss could not be ascertained.[77]

In determining liability, the courts have been lenient with respect to directors of corporations in the absence of some form of active mismanagement, fraud or self-dealing.[78] In *Allied Freightways v. Cholfin*,[79] for instance, the receivers of a trucking business brought an action against Mrs. Cholfin, a non-participating director of a business operated solely by her husband, alleging that the Cholfins spent corporate funds to pay for their personal debts.[80] The court held that Mrs. Cholfin was not responsible for her husband's actions, however, since she did not actually participate with her husband in the cash

---

[73] *Id.* at 615. Misprision of office is a failure to become more intimately involved in corporate affairs.

[74] *Id.* at 618. The company had lost a large amount of money due to bad business decisions and general misadministration during the defendant's eight-month term of office. *Id.* at 617.

[75] *Id.* at 616; *see* Briggs v. Spaulding, 141 U.S. at 166 (Harlan, J., dissenting).

[76] 298 F. at 616. The court iterated that if the *Barnes* situation had been a question of an illegal loan, a protest by the defendant might have been sufficient to stop it. But when a corporation such as the one in *Barnes* suffers from general mismanagement and/or business incapacity, it is not possible to conclude that the actions of a single director could have prevented the losses. *Id.* The court stopped short of requiring defendant to "read the circulars sent out to prospective purchasers and test them against the facts." *Id.* at 620. To do so would be to require of him a "detailed supervision of the business" which is too time-consuming and would result in no one accepting a directorate. *Id.; see* note 53 *supra* and accompanying text.

Some commentators have referred to the *Cholfin* standard as requiring "gross negligence" for director liability, as opposed to "ordinary negligence." *Cf.* Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 411, 8 N.E.2d 895, 904 (1937) ("clear and gross negligence" standard controlling if director acting in good faith). *See generally* Martin, *supra* note 68, at 330. This standard has been severely criticized. N. LATTIN, THE LAW OF CORPORATIONS § 78, at 274 (2d ed. 1971).

[77] 298 F. at 616. In discussing the directors lack of skill in the disposition of the causation issue, Judge Hand left open the question whether lack of causation was related to the business situation as well as to the inadequate skills of the defendants. Dyson, *supra* note 2, at 364 n.95.

[78] Berman v. LeBeau Inter-America, Inc., 509 F. Supp. 156 (S.D.N.Y. 1981); W. FLETCHER, *supra* note 49, § 1349, at 632; *see, e.g.*, Components for Research, Inc. v. Isolation Prods., Inc., 241 Cal. App.2d 726, 729, 50 Cal. Rptr. 829, 831 (1966); Guth v. Loft, Inc., 23 Del. Ch. 255, 282-83, 5 A.2d 503, 515 (1939); Litwin v. Allen, 25 N.Y.S.2d 667, 677-78 (Sup. Ct. 1940).

[79] 325 Mass. 630, 91 N.E.2d 765 (1950).

[80] *Id.* at 631, 91 N.E.2d at 766.

withdrawals, and might have been an "ordinary housewife with no business experience."[81] Although Mrs. Cholfin may have been under a duty to inspect the books, the court concluded that it was unlikely that she would have derived much information from them. Even if she had, she probably could not have persuaded her husband to change his course of action.[82] Although Mrs. Cholfin was negligent in performing her duties as a director, her negligence was not the proximate cause of the losses. Implicit in the court's ruling was the suggestion that even if Mrs. Cholfin had been diligent, she was neither skilled enough nor persuasive enough to have prevented the losses.[83] Thus, by analyzing the particular abilities of Mrs. Cholfin, the court applied a subjective standard in its finding of no causation.

In an attempt to clarify the duties of directors, states began to adopt statutes which codified common law.[84] The courts were then left to interpret the individual statutes. One case, *Selheimer v. Manganese Corp. of America*,[85] was a stockholders' derivative suit in equity brought against the directors for mismanagement of funds resulting in a loss to the corporation.[86] Section 408 of the Pennsylvania Business Corporation law[87] provided that directors have a fiduciary relationship to the corporation, and that they should exercise that degree of "diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs."[88] The issue before the court was whether the directors of a corporation who had been " imprudent, wasteful, careless, and negli-

---

[81] *Id.* at 633, 636, 91 N.E.2d at 768-69. Mrs. Cholfin was liable for misspent corporate funds which benefitted her personally. *Id.*

[82] *Id.*

[83] *Id. Cholfin* represents the general rule, applied in a number of jurisdictions, that a director is not liable for losses that he or she could not have prevented by being diligent. *See* Goldstein & Shepherd, *supra* note 1, at 759 n.161; *cf.* Barnes v. Andrews, 298 F. at 616-18 (proximate cause not established when it could not be shown that director could have prevented collapse of business due to general mismanagement).

[84] G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 433, at 530 (1959). Portions of the Model Business Corporation Act of 1960 have been adopted by most of the fifty states. Almost all of the states have taken the form of the New York and Pennsylvania statutes concerning duty of care on the part of directors. Cary & Harris, *supra* note 61, at 64. The New York statute reads: "Directors and officers shall discharge their duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." N.Y. BUS. CORP. LAW § 717 (McKinney 1963).

[85] 423 Pa. 563, 224 A.2d 634 (1966).

[86] *Id.* at 565-66, 224 A.2d at 636-37. Defendants poured money into a plant that they allegedly knew was unproductive, and failed to utilize another plant. *Id.*

[87] Act of May 5, 1933, P.L. No. 364, art. IV, § 408 (amended 1966). Within a few weeks of the *Selheimer* decision, the Pennsylvania legislature struck the last five words of the statute so as to have it read: "with that care which ordinarily prudent men would exercise under similar circumstances." PA. STAT. ANN. tit. 15, § 1408 (Purdon 1966).

[88] PA. STAT. ANN. tit. 15, § 1408 (Purdon 1966).

gent" could be personally liable for losses that resulted in insolvency under section 408.[89] The court answered in the affirmative, noting that the insolvency was due to gross mismanagement, the assets having shrunk from $400,000 to $30,000.[90] Thus, the court interpreted the statute as being harsher and stricter than the prevailing majority view at the time.[91]

Against the backdrop of the early bank cases, as well as *Cholfin* and the line of cases that followed, the Supreme Court of New Jersey decided *Francis v. United Jersey Bank*.[92] Justice Pollock, speaking for a unanimous court, began his discussion with the general proposition that in order to find Mrs. Pritchard liable the court must find that there was a duty to the corporation's customers, that there was a breach of that duty, and that this breach was the proximate cause of corporate losses.[93]

In examining relevant case law[94] and applicable statutory law,[95] the *Francis* court found that the duty of corporate directors was "to act as ordinarily prudent persons under similar circumstances in like positions."[96] Such a standard serves as a "wellspring from which those more specific duties flow."[97] The duties of a corporate director

[89] 423 Pa. at 570, 224 A.2d at 639.

[90] *Id.* at 582, 224 A.2d at 645. It is important to note that plaintiff Selheimer, who was also a director of the company and a defendant, was absolved of liability because he had taken steps to stop the actions of the directors by threatening suit and organizing a stockholder's protective committee. *Id.* The court viewed the director's effort to stop co-directors from acting wrongfully as fulfilling one's duty as a director, and, therefore, no breach occurred. *See* Dodd v. Wilkinson, 42 N.J. Eq. 647, 651, 9 A. 685, 687 (1887); Williams v. Riley, 34 N.J. Eq. 398, 401 (Ch. 1881).

[91] 423 Pa. at 573, 224 A.2d at 640. Case law prior to the statute had stated that the standard was one of "ordinary care and diligence and that absent fraud or gross negligence amounting to fraud, such directors would not be personally liable for their actions." *Id.* at 573-74, 224 A.2d at 640-41.

[92] 87 N.J. 15, 432 A.2d 814 (1981).

[93] *Id.* at 28, 432 A.2d at 820. An initial determination for the court was whether or not New Jersey law was applicable in this case despite the fact that P & B was a New York corporation. *Id.* at 27, 432 A.2d at 820. The court, relying on the trial court record, held that since New Jersey had more significant relationships to the parties and the transactions than New York, New Jersey law should apply. *Id.*

[94] Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (Ch. 1901).

[95] N.J. STAT. ANN. § 14A:6-14 (West 1969) obliges directors to "discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." In analyzing duty of care, the court examined case law prior to the enactment of the New Jersey statute. *See* Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (Ch. 1901). Because of the statute's derivation from N.Y. BUS. CORP. LAW § 717 (McKinney 1963), the court included New York case law in its discussion. An important aspect of section 717, noted by the court, is that it is an attempt to apply a uniform standard to public and closely held corporations. 87 N.J. at 30, 432 A.2d at 821.

[96] 87 N.J. at 28, 432 A.2d at 820.

[97] *Id.* at 31, 432 A.2d at 821. One commentator has remarked that state law serves as the source for corporate directors' powers, but that most of a director's duties and liabilities are derived from common law, not statutes. Goldstein & Shepherd, *supra* note 1, at 774.

can be expanded or limited depending upon the special circumstances of each case. The court observed that there are a few basic obligations applicable to most directors. First, a director must have an elementary understanding of the corporation's business, which would include familiarity with business essentials.[98] Second, a director must maintain a supervisory role to comply with the required degree of care. Ignorance of improper activities by others is not a valid defense.[99] Finally, a director, while not required to inspect the daily activities of the corporation, must attend board meetings, regularly review financial statements, and inquire, if necessary, into the affairs disclosed by the statements.[100] Additionally, once a director becomes aware of an "illegal course of action," he may be under a duty to object, resign,[101] or consult legal counsel.[102] In some situations, a director may even be obligated to threaten to file a lawsuit.[103]

In analyzing the duties that a director owes to the corporation, the court noted that dummy or figurehead directors are "anachronisms;" hence, "all directors are responsible for managing the business and affairs of the corporation."[104] Although in general directors owe a fiduciary duty only to the corporation, the court distinguished particular corporations that may owe duties to third parties and creditors.[105] Banks are one example in which a director owes a fiduciary duty to depositors as creditors; another example is a non-banking corporation which holds funds in trust.[106] In the latter group, direc-

---

[98] 87 N.J. at 31, 432 A.2d at 821-22 (citing Campbell v. Watson, 62 N.J. Eq. at 416, 50 A. at 128); *see* Feuer, *Liabilties of Directors and Officers*, 5 N.Y.L.F. 127, 133 (1959) (citing Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1928)). *See also* Lewis, *supra* note 29, at 100.

[99] 87 N.J. at 31, 432 A.2d at 822.

[100] Atherton v. Anderson, 99 F.2d 887, 890 (6th Cir. 1938); 87 N.J. at 32-33, 432 A.2d at 822 (citing Corsicana Nat'l Bank v. Johnson, 251 U.S. 68, 71 (1919)); LaMonte v. Mott, 93 N.J. Eq. 229, 259, 107 A. 462, 467 (1921).

[101] 87 N.J. at 33, 432 A.2d at 823 (citing Dodd v. Wilkinson, 42 N.J. Eq. 647, 651, 9 A. 685, 687 (1887)).

[102] *Id.* at 33-34, 432 A.2d at 823. Failure to seek legal counsel has led to a finding that management was negligent. *See, e.g.*, Gerdes v. Reynolds, 28 N.Y.S.2d 622, 658 (Sup. Ct. 1941); Litwin v. Allen, 25 N.Y.S.2d 667, 699 (Sup. Ct. 1940); Vance v. Phoenix Ins. Co., 72 Tenn. 385, 391 (1880); W. FLETCHER, *supra* note 49, § 1027, at 588. *See generally* Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976).

[103] 87 N.J. at 34, 432 A.2d at 823 (citing Selheimer v. Manganese Corp. of America, 423 Pa. at 572, 584, 224 A.2d at 640, 646).

[104] 87 N.J. at 34, 432 A.2d at 823-24; *see, e.g.*, Williams v. McKay, 46 N.J. Eq. 25, 18 A. 824 (Ch. 1889); Barr v. Wackman, 36 N.Y.2d 371, 329 N.E.2d 180, 368 N.Y.S.2d 497 (1975); Kavanaugh v. Gould, 223 N.Y. 103, 119 N.E. 237 (1918); Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (Ch. 1901).

[105] 87 N.J. at 36, 432 A.2d at 824. The court noted that directors do not have a duty to creditors in the absence of insolvency. *Id.*

[106] *Id.*

tors have traditionally not been held liable if they did not actively participate in converting the trust funds of a corporation or know of the activity.[107] The *Francis* court specifically rejected this contention,[108] stating that directors of corporations holding funds in trust owe a particular duty to its beneficiaries similar to that which is owed to depositors by a bank director. The beneficiary can expect that a corporate director in his fiduciary capacity will act with "ordinary prudence" in relation to the funds.[109]

Consequently, the court, viewing Pritchard & Baird as a reinsurance broker, made the following conclusions: First, that Pritchard & Baird was analogous to a bank because it held millions of dollars in trust for other companies; second, that Mrs. Pritchard's relationship to her clients was equivalent to that of a bank director with respect to his depositors; third, that since the misappropriated funds were held in an implied trust, the trust relationship between Mrs. Pritchard and her clients produced a "fiduciary duty to guard the funds with fidelity and good faith;" and fourth, that the customers of Pritchard & Baird could reasonably presume that Mrs. Pritchard, being a fiduciary director, would not have permitted or ratified the commingling and conversion of insurance proceeds.[110]

Applying the foregoing analysis, the court found that Mrs. Pritchard had breached her duty as a director on several grounds: she should have known that Pritchard & Baird held millions of dollars for other companies; she should have read the company's financial statements;[111] and she should have made attempts to ferret out or prevent the illegal acts of her co-directors.[112] Although she had a right to rely on the content of the financial statements,[113] she should not be excused

---

[107] *Id.* at 36-37, 432 A.2d at 824-25; *accord*, Berman v. LeBeau Inter-America, Inc., 509 F. Supp. 156 (S.D.N.Y. 1981); Taylor v. Alston, 79 N.M. 643, 447 P.2d 523 (1968).

[108] 87 N.J. at 37, 432 A.2d at 825. In so holding, the court overruled three New Jersey cases to the extent that the cases support the proposition that directors are not liable unless they actively participate in the conversion of trust funds: Ark-Tenn Distrib. Corp. v. Breidt, 209 F.2d 359 (3d Cir. 1954); General Films, Inc. v. Sanco Gen. Mfg. Corp., 153 N.J. Super. 369, 379 A.2d 1042 (App. Div. 1977); McGlynn v. Schultz, 90 N.J. Super. 505, 218 A.2d 408 (Ch. Div. 1966), *aff'd*, 95 N.J. Super. 412, 231 A.2d 386 (App. Div. 1967), *certif. denied*, 50 N.J. 409, 235 A.2d 901 (1967); *see* note 146 *infra*.

[109] 87 N.J. at 37, 432 A.2d at 825. Justice Pollock observed that the fiduciary duty which the court recognized for those directors of corporations holding funds in trust was another "application of the general rule that a director's duty is that of an ordinary prudent person under the circumstances." *Id.*

[110] *Id.* at 38, 432 A.2d at 825.

[111] *Id.*

[112] *Id.* at 39, 432 A.2d at 826.

[113] N.J. STAT. ANN. § 14A:6-14 (West 1968) provides:

> [D]irectors shall not be liable if acting in good faith, they rely upon the opinion of counsel for the corporation or upon written reports setting forth financial data

from liability because they revealed on their face that her sons were essentially stealing from the corporation.[114]

Concluding its analysis, the court focused on the issue of causation. Although Mrs. Pritchard was held to be negligent in her duty as a director, the court observed that such negligence does not necessarily make her liable for corporate losses unless her act or failure to act was a proximate cause of such losses.[115] The court iterated that Mrs. Pritchard could only be held liable upon a showing by plaintiff that specific losses were incurred and that these losses could have been prevented had the director performed her duty.[116] The court's discussion of proximate cause was the key element of the case because directors similarly situated to Mrs. Pritchard have usually been held to have breached their duty of care, but have not been held liable for losses as a result of that breach.[117]

Because the instant case involved an act of nonfeasance, the court's analysis focused on the "reasonable steps" Mrs. Pritchard should have taken and whether or not performance of those steps would have succeeded in avoiding the loss.[118] Her duties were defined by the critical financial condition of Pritchard & Baird and the special fiduciary relationship which the corporation had to its clients. The parameters of these duties comprised all reasonable courses of

---

> concerning the corporation . . . or upon financial statements, books of account or reports of the corporation represented to them to be correct by the president, the officer of the corporation having charge of its books of account.

Id.; *see* Dent, *supra* note 53, at 649.

[114] 87 N.J. at 38, 432 A.2d at 825-26. The financial statements from January 31, 1970 and onward reveal that the "shareholder's loans" and working capital deficits were metastisizing at a rapid rate. A superficial reading of the statement by anyone would have revealed that the sons were "bleeding" the corporation to death. *Id.* at 39, 432 A.2d at 826.

[115] *Id.*

[116] *Id.* (citing G. HORNSTEIN, *supra* note 84, § 446, at 566) The burden of proving a director's lack of due diligence is on the plaintiff. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01, comment b (1982) (tentative draft No. 1).

[117] *See, e.g.*, Allied Freightways v. Cholfin, 325 Mass. 630, 91 N.E.2d 765 (1950). The court distinguished Mrs. Pritchard's situation from that of the director in Barnes v. Andrews, 298 F. 614 (S.D.N.Y. 1924). The director in *Barnes* was exonerated even though he had breached his duty as a director due to "general mismanagement, business incapacity or bad judgment." *Id.* at 616-17. In such a case, it was impossible for a plaintiff to prove what specific losses could have been avoided if the director had performed his duty. *Barnes* distinguished between general mismanagement cases and cases in which a director failed to stop an "illegal loan," inferring that liability should be imposed on the latter. 87 N.J. at 41, 432 A.2d at 827.

Plaintiffs have rarely been able to prove proximate cause in the absence of board approval of definite transactions. Because directors have been traditionally required to do very little, proof that their breach has led to an identifiable loss is difficult. Proof of proximate cause has "weakened the director's duty of care." Dent, *supra* note 53, at 652.

Generally, courts have distinguished between misfeasance and nonfeasance, holding directors personally liable for fraud, self-dealing or active mismanagement, while hardly ever doing so for a director's failure to direct. Soderquist, *supra* note 38, at 1346.

[118] 87 N.J. at 40, 432 A.2d at 826.

action to stop the misappropriation of funds.[119] The most likely action she could have taken would have been to object and resign, but the court said that even if she had, she still would have been held liable. The court found two reasons for so concluding. First, Mrs. Pritchard did not resign until immediately prior to the bankruptcy, thus, there was no factual support for the proposition that if she had objected and resigned the losses would not have occurred. Second, because of the character of the reinsurance business, it is distinguishable from other kinds of corporations in that reinsurance brokers owe fiduciary duties to third parties, not just to shareholders.[120]

Therefore, Mrs. Pritchard had a duty to do more than object and resign.[121] She had a duty to consult counsel and to threaten the corporation with a lawsuit.[122] According to the court, her conduct was a proximate cause of the conversion of trust funds because her negligence was a "substantial factor contributing to the loss."[123] Because her sons knew that she was neither examining their conduct nor reviewing the financial statements, they were able to "spawn their fraud in the backwater of her neglect."[124] Mrs. Pritchard was held personally liable as a matter of law because her negligence contributed to a "climate of corruption" which was allowed to continue because she failed in her duties as a director.[125]

The *Francis* holding which imposes personal liability on a director for the conversion of trust funds when the director has neither participated in the illegal act nor been aware of its existence, reflects the New Jersey Supreme Court's efforts to deter the practice of figurehead directors. Even in light of the well established principle that figurehead directors should not be afforded protection,[126] most courts still have been inconsistent in finding such directors liable.[127] The

---

[119] *Id.* at 41, 432 A.2d at 827. Directors have a duty to "make reasonable inquiry when acting upon corporate transactions." PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01(b) (1982) (tentative draft No. 1).

[120] 87 N.J. at 40-41, 432 A.2d at 827.

[121] *Id.* at 45, 432 A.2d at 829.

[122] *Id.* The court is in agreement with some commentators who propose that reliance on counsel should satisfy the "modicum of diligence" required under the business judgment rule, absent bad faith and self-dealing. Hawes & Herrard, *supra* note 102, at 42.

[123] 87 N.J. at 44, 432 A.2d at 829 (citing Restatement (Second) of Torts § 442B, comment b (1966)). Prosser states that "[l]egal responsibility must be limited to those causes which are so closely connected with the result and of such significance that the law is justified in imposing liability." W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 41, at 237 (4th ed. 1971).

[124] 87 N.J. at 44, 432 A.2d at 829.

[125] *Id.*

[126] 87 N.J. at 34, 432 A.2d at 823. The court labeled such figurehead directors "anachronisms with no place in New Jersey law." *Id.*; *see* note 104 *supra* and accompanying text. *See also* Campbell v. Watson, 62 N.J. Eq. at 443, 50 A. at 139; Williams v. McKay, 46 N.J. Eq. 25, 57-58, 18 A. at 836 (Ch. 1889).

[127] Soderquist, *supra* note 38, at 1346.

inconsistency stems from whether a court uses a subjective or an objective standard to determine a director's duty of care to the corporation and the proximate causation of his negligence to the corporate losses.[128]

The *Francis* court apparently applied a reasonable director test[129] to reinsurance directors, which is similar to the objective standard applicable to directors of banking institutions.[130] In utilizing this test, the court drew an analogy between banks and reinsurance brokers. This analogy is possible because New Jersey statutory law[131] and case law[132] allow the court to consider similarities of responsibilities assumed by directors in different industries in its determination of liability.[133] The analogy is necessary because application of an objective test has failed to impose a duty on directors towards their creditors.[134] *Francis* overcomes this problem by finding that a reinsurance broker's director has a duty to creditors just as banks owe a duty to their depositors.[135]

The issue of proximate causation arises primarily in cases of omission.[136] *Francis* and *Cholfin* represent similar factual circumstances with divergent results.[137] Although Mrs. Cholfin was found

---

[128] Which standard to apply has been the question that divides most of the cases on director liability. W. FLETCHER, *supra* note 49, § 1065, at 106; Dyson, *supra* note 2, at 362.

[129] Actually, the "reasonable director" test was first articulated in Briggs v. Spaulding, 141 U.S. 132 (1891), as "the degree of care to which these [directors] were bound is that which ordinarily prudent and diligent men would exercise under similar circumstances and in determining that the restrictions of the statute and the usages of business should be taken into account." *Id.* at 152. Although the test is an objective one, the court exonerated the Briggs directors because there was no proximate causation. Other courts have adopted a similar standard. *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963); Department of Banking v. Calburn, 188 Neb. 500, 504-05, 198 N.W.2d 69, 73 (1972); Syracuse Television, Inc. v. Channel 9, Syracuse, Inc., 51 Misc. 2d 188, 196, 273 N.Y.S.2d 16, 27 (Sup. Ct. 1966); Olin Mathieson Chem. Corp. v. Planters Corp., 236 S.C. 318, 328, 114 S.E.2d 321, 326 (1960); W. FLETCHER, *supra* note 49, § 1038, at 34-35. This standard is embodied in several statutes. *E.g.*, LA. REV. STAT. ANN. § 12:91 (West 1969); N.Y. BUS. CORP. LAW § 717 (McKinney 1963); OKLA. STAT. ANN. tit. 18, § 1.34(b) (West 1953). *Briggs* has been criticized "for the reason that it lays down fair rules and then proceeds to look at the whole matter from the viewpoint of the individual directors." W. FLETCHER, *supra* note 49, § 1085, at 107-08.

[130] 87 N.J. at 36, 432 A.2d at 824.

[131] N.J. STAT. ANN. §14A:6-14 (West 1969); *see* note 96 *supra*.

[132] 87 N.J. at 28, 432 A.2d at 820; *see* note 95 *supra*.

[133] 87 N.J. at 31, 432 A.2d at 821.

[134] *Id.* at 36, 432 A.2d at 824 (citing Whitfield v. Kern, 122 N.J. Eq. 332, 342, 345, 192 A. 48, 54, 55 (1937)).

[135] 87 N.J. at 36, 432 A.2d at 824.

[136] *Id.* at 40, 432 A.2d at 826. *See also* Dyson, *supra* note 2, at 361-64, 373-74.

[137] Both involved a housewife whose family members controlled the company's funds and misappropriated them without the knowledge of their co-directors. Both were negligent as directors, and yet, only Mrs. Pritchard was found to be the proximate cause of the company's losses. 87 N.J. at 45, 432 A.2d at 833.

to have been negligent as a director, she was not held liable because her omissions were not the proximate cause of the losses.[138] In assessing proximate cause, the *Cholfin* court applied a subjective standard[139] by looking at the particular qualities of the individual director to see if she could have changed the co-directors' actions. If Mrs. Cholfin could have stopped the wrongdoing, a causal link would be established and she would be held liable as a director.[140]

Although the *Francis* court gave an aura of subjectivity to the law by indicating that the particular facts of each case must be considered, it would be far-reaching to suggest that *Francis* used the same subjective standard as *Cholfin*. Instead of asking whether a reasonable person with Mrs. Pritchard's qualities could have prevented the losses, the *Francis* court asked whether a reasonable director similarly situated could have discovered the conversion and taken adequate steps to prevent it. By invoking an objective standard,[141] *Francis* has initiated a trend toward holding directors responsible for a higher standard of care regardless of their personal skills. Also, under *Francis*, a director has a duty to threaten the corporation with a lawsuit, if necessary, to deter the wrongful actions.[142] By expanding the responsibilities of directors through an increased duty of care, the number of directors found liable should increase. Conversely, however, if *Francis* clears the boardroom of figurehead directors, thereby elevating the quality of directors, fewer may be found liable.

---

[138] *Cholfin*, 325 Mass. at 635, 91 N.E.2d at 768-69; *see* note 83 *supra*.

[139] This standard has been adopted by several courts. *E.g.*, McDonnell v. American Leduc Petroleums, Ltd., 491 F.2d 380, 383 (2d Cir. 1974); Phoenix Sav. & Loan, Inc. v. Aetna Cas. & Sur. Co., 427 F.2d 862, 868 (4th Cir. 1970); Bellis v. Thal, 373 F. Supp. 120, 123 (E.D. Pa. 1974), *aff'd mem.*, 510 F.2d 969 (3d Cir. 1975); Nanfitor v. Tekseed Hybrid Co., 341 F. Supp. 240, 244 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 711 (N.D. Ill. 1969).

The test has been criticized as allowing a court "to indulge in subjective considerations in assessing director liability." Adkins & Janis, *Some Observations on Liabilities of Corporate Directors*, 20 Bus. Law. 817, 820 (1965). *See also* Note, *Liability of Directors to Shareholders for Negligence under American Law and their Indemnification*, 16 McGill L.J. 323, 336-37 (1970).

[140] In contrast, Mrs. Cholfin's omission was not a cause of the losses because her husband would have acted as he did whether his wife was diligent or not. 325 Mass. at 633, 91 N.E.2d at 768. Mrs. Pritchard's negligence was found to be the proximate cause of the losses because she could have stopped her sons from what they were doing. 87 N.J. at 45, 432 A.2d at 833. Also, she should have known that the financial statements showed on their face the corporation's status, and the court does not consider it a matter of special expertise or diligence in requiring her to do so. *Id.* at 38, 432 A.2d at 825. In *Cholfin*, however, the court did not think Mrs. Cholfin was skilled enough in accounting to learn anything from the company's books. 325 Mass. at 633, 91 N.E.2d at 768.

[141] *See* note 129 *supra*.

[142] 87 N.J. at 45, 432 A.2d at 833.

The *Francis* court stated that whether or not a situation would require a director to threaten a lawsuit against co-directors would "best be left to case-by-case determinations."[143] The effect of *Francis* on non-banking corporations would then be limited, for these corporations generally owe no duty to creditors.[144] In effect, by distinguishing a reinsurance corporation from other non-banking corporations the court may have narrowed its holding to the reinsurance industry exclusively, and the *Francis* facts particularly.[145] Support for this view draws strength from a possible motive the court may have had in holding Mrs. Pritchard liable. No matter which standard was applied, the court may have sought to find Mrs. Pritchard liable so as to hold liable the actual wrongdoer, Charles Pritchard, Sr. It was he who initiated the practice of taking corporate funds for personal use and who had appointed his wife as a director without informing her of the duties involved. Indeed, it was his negligence as a director that was the proximate cause of the corporate losses, and since Mrs. Pritchard inherited her husband's estate the court may have been indirectly imposing liability on the real tortfeasor.

Whether or not the *Francis* decision will affect non-trust related corporations is not clear. The court does, however, explicitly overrule New Jersey case law which held that for directors to be liable, they must "actively participate in the conversion of trust funds."[146] Fur-

---

[143] *Id.* The courts have always argued that negligence is a "question of fact to be determined under all the circumstances." This approach gives courts great leeway in determining what circumstances are significant and relevant. Briggs v. Spaulding, 141 U.S. at 15; Soderquist, *supra* note 38, at 1346; *see* Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940).

[144] 87 N.J. at 36, 432 A.2d at 824.

[145] The court frequently noted throughout its opinion that a determination of Mrs. Pritchard's duty was influenced by the special characteristics of the reinsurance industry, especially the fact that the corporation closely resembled a bank. *Id.* at 36, 432 A.2d at 824.

[146] *Id.* at 37, 432 A.2d at 825. The *Francis* court overruled three New Jersey cases to the extent that they held liable nominal directors who actively participated in wrongdoing.

In Ark-Tenn Distribution Corp. v. Breidt, 209 F.2d 359 (3d Cir. 1954), plaintiff and defendant director's corporations had entered into a contract in which the latter would supply vending machines to the former for $5 a machine. Plaintiff gave defendant $5,000 to be held in trust during the period of the agreement, and defendants were to deduct $5 for each machine and return the remaining money to plaintiffs. Defendants defaulted on the contract and plaintiffs obtained a judgment to recover the remaining portion of the fund, $4,875. *Id.* at 360. The lower court held that the $5,000 fund was held in trust, that a conversion occurred when plaintiffs' funds were commingled with other corporate assets of defendants, and that Harry Breidt as president was a "dummy officer" of Vendors, who did not participate in the company's operation and had no knowledge of the conversion or any opportunity to discover it. Jacob Breidt, as treasurer, however, was directly liable for the losses because he was in control of the company's operations. *Id.*

In McGlynn v. Schultz, 90 N.J. Super. 505, 218 A.2d 408 (Ch. Div. 1966), *aff'd*, 95 N.J. Super. 412, 231 A.2d 386 (App. Div. 1967), *certif. denied*, 50 N.J. 409, 235 A.2d 901 (1967), the court found one of the directors of the publicly-held corporation not liable because he lived out of thermore, the court acknowledged that the New Jersey statute which was modeled on a New York statute was intended to effectuate a uniform standard for all corporations.[147] Thus, it can be said that *Francis* conveys a message to corporate directors in general that all reasonable efforts must be made to stop co-director wrongdoing. Unfortunately, *Francis* offers little guidance for directors as to what that standard of reasonableness entails.

Margaret A. Wilson

---

state and was not present at any of the directors' meetings. Citing *Ark-Tenn*, the court noted that he did not exercise any of the functions normally reserved to directors, nor was he in a position to know the intimate details of the corporation's business. *Id.* at 509, 218 A.2d at 411. Despite the fact that the remaining defendant-directors relied on the advice of counsel in failing to segregate funds, the court found that their good faith defense was not sufficient in a conversion action. *Id.* at 519. The court held the remaining directors liable on the theory that any officer or director who actually participated by aiding, instigating or assisting in a conversion of trust funds was liable. *Id.* at 527.

In General Films, Inc. v. Sanco Gen. Mfg. Corp., 153 N.J. Super. 369, 379 A.2d 1042 (App. Div. 1977), defendant corporation was a broker of plastic materials and its directors were a husband and wife, the latter being the sole stockholder. The Company received a sum of money from plaintiffs to purchase materials, but the materials were unavailable and were never sent. The husband, however, subsequently used the money to pay personal expenses. Plaintiffs sued for the return of the full amount and the court, employing an implied trust theory, found the husband liable for the losses, while exonerating his wife on the grounds that she was a "figurehead" director, and not liable unless she actively participated in the conversion. *Id.* at 372, 379 A.2d at 1044.

[147] 87 N.J. at 30, 432 A.2d at 821; *see* note 95 *supra*.