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Corporations—Directors and Officers—Standard of Care—Liability for Negligence

In *Selheimer v. Manganese Corp.*,¹ the majority and managing directors of Manganese were sued in a derivative action for negligent, imprudent and careless conduct in the management of the corporation that resulted in loss and ultimate insolvency. The corporation purchased a manganese oxide plant in Paterson, New Jersey from a corporation owned by the majority directors of Manganese. Following this purchase, the defendants caused 200,000 shares of stock to be sold to the public, the sale netting 412,000 dollars for the corporation. The prospectus for this sale stated that the corporation proposed to erect and operate a plant in Pennsylvania where substantial operating activities would be centered and that the corporation had arranged for the purchase of an ideally located plant at Colwyn, Pennsylvania, that would enable the corporation to operate at advantageous freight rates.

In spite of the defendants' knowledge that the Colwyn plant was far superior to the Paterson plant and that the Paterson plant was wholly unsuited for commercial production, they continued to invest money in the Paterson plant. 158,000 dollars was spent on equipment for the plant and, by August 1959, the plant had sustained a loss of 104,000 dollars with total sales of only 2,000 dollars. By August, Manganese's funds had been reduced to only 55,000 dollars out of 412,000 dollars originally available; this amount was not enough to put the Colwyn plant into operation. The Colwyn plant was never used. The assets of Manganese brought only 30,000 dollars upon its going into bankruptcy.²

The chancellor found that the managing directors were careless, imprudent, negligent and wasteful in their conduct, that this conduct caused the losses and insolvency, and that they were liable personally for these losses. The reviewing court, sitting en banc, agreed with the chancellor's finding of negligence, but found that defendants were not liable unless they were guilty of fraud, self-dealing or wanton misconduct and dismissed the complaint. The supreme court rejected

¹ 224 A.2d 634 (Pa. 1966).

² There were other transactions involved in the case but they tended to show some self-dealing by the defendants. These acts are not related to the issue of negligence but rather to the defendants' lack of good faith.

the decree of the court en banc³ and held that the defendants' actions were to be measured by Section 408 of the Business Corporation Law of 1933 which provides:

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 exercise under similar circumstances *in their personal business affairs*. (Emphasis added.)

Under this statute the court affirmed the chancellor's finding of negligence, but reversed and remanded as to the measure of damages. The Pennsylvania director's statute, if literally construed, creates a standard of care which is more stringent than that required at common law or by similar statutes in other states.

The early cases which attempted to define the relation of the director to his corporation and the standard of care required of him in performing his duties vary greatly from state to state.⁴ The relation of the director to the corporation has been characterized as that of agent,⁵ trustee (or quasi trustee),⁶ and gratuitous mandatory.⁷ Courts in the nineteenth century experienced difficulty in determining what this relation was and generally avoided thorough analysis by trying to characterize the relation in terms of well estab-

³ The supreme court said that the court en banc misconstrued *Smith v. Brown-Borhek Co.*, 414 Pa. 325, 200 A.2d 398 (1964) which held that stockholders can ratify negligent acts of directors but not fraudulent or wasteful acts.

⁴ See Annot., 2 A.L.R. 867 (1919) which discusses representative cases and the various positions taken by American courts. See generally BALLANTINE, *CORPORATIONS* §§ 62-72 (Rev. ed. 1946) [hereinafter cited as BALLANTINE]; HORNSTEIN, *CORPORATION LAW AND PRACTICE*, §§ 432-46 (1959) [hereinafter cited as HORNSTEIN].

⁵ See, e.g., *Briggs v. Spaulding*, 141 U.S. 132 (1890); *Hun v. Cary*, 82 N.Y. 65 (1880). See generally Note, 36 NOTRE DAME LAW. 343 (1961); Bennett, *The Louisiana Business Corporation Act of 1928*, 2 LA. L. REV. 597 (1940) [hereinafter cited as Bennett].

⁶ See, e.g., *Hun v. Cary*, 82 N.Y. 65 (1880) (trustees to bank depositors); *Besseliew v. Brown*, 177 N.C. 65, 97 S.E. 743, 2 A.L.R. (1919). See generally Bennett 638; Note, 36 NOTRE DAME LAW. 343 (1961).

⁷ See, e.g., *Swentzel v. Penn Bank*, 147 Pa. 140, 23 Atl. 405 (1892); *Sperling's Appeal*, 71 Pa. 11 (1872). In *Sperling's Appeal* the court said that directors are not technical trustees. "They can only be regarded as mandatories—persons who have gratuitously undertaken to perform certain duties, and who are therefore bound to apply ordinary skill and diligence, but no more." *Id.* at 20-21. See generally Adkins & Janis, *Some Observations on Liabilities of Corporate Directors*, 20 BUS. LAW. 817, 819 (1965) [hereinafter cited as Adkins]; Bennett 638.

lished legal categories. The label "agent" is inappropriate since in reality there is no principal who can control the agent. Trustee is equally inappropriate since the corporation and not the directors have title to the assets.⁸ The gratuitous mandatory label is archaic since it assumes that all directors serve gratuitously and devote little time to the corporation, an assumption no longer true in many cases.⁹ However, all courts recognized that a director is a fiduciary of some sort with the duty to act in good faith and for the benefit of the shareholders rather than himself. The more modern position is simply that a director stands in a fiduciary relation to his corporation¹⁰ and that this position is *sui generis*.¹¹

Judicial attempts to define the standard of care required of directors and the liability for negligent mismanagement resulted in several distinct positions. The least-stringent is that a director is only liable for fraud or gross negligence amounting to fraud. This view is another way of saying that a director must use only slight care and reveals the reluctance of some courts to review the conduct

⁸ Note, 36 NOTRE DAME LAW. 343 (1961).

⁹ See, e.g., *Sperling's Appeal*, 71 Pa. 11 (1872) (Action for negligent mismanagement) (Directors, not being compensated, not held to strict standards of trustee or agent of an estate). For the assertion that "mandatory" is no longer an appropriate label, see *Adkins* 819.

¹⁰ This is evidenced by the wording of several modern directors statutes. IDAHO CODE ANN. § 30-142 (1947); LA. REV. STAT. § 12-36 (1951); N.C. GEN. STAT. § 55-35 (1965); OKLA. STAT. ANN. tit. 18, § 1.34 (1953); PA. STAT. ANN. tit. 15, § 2852-408 (1958); WASH. REV. CODE ANN. § 23.01.360 (1961). In North Carolina, the fiduciary duty runs to the stockholders as well as the corporation. For a discussion of the effect of this, see *Folk, Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N.C.L. REV. 768, 796-97 (1965). These statutes are similar or identical to the MODEL BUSINESS CORPORATION ACT § 33, U.L.A. c. 9. However, only a few states adopted this model act; it was withdrawn by the commissioners in 1957. This act should not be confused with the American Bar Association's Model Business Corporation Act which does not contain a similar provision. It has been used as a model by several states. For a general discussion of the state statutes, see *Adkins* 817.

¹¹ *In re E. C. Warner Co.*, 232 Minn. 207, 45 N.W.2d 388 (1950), 35 MINN. L. REV. 564 (1951). The court, in a proceeding to determine whether directors are entitled to reimbursement for defense of suits against the corporation stated: "Confusion has resulted from a failure to recognize that the position of a director of a corporation, though fiduciary in many respects, is *sui generis* and is not to be confused with the position of that of trustee, quasi-trustee, or agent." *Id.* at 212, 45 N.W.2d at 392. The court further stated that the law of agency and trusts was developed before corporations became of great social importance. It is not possible to fit corporate management into either status and do justice to the necessities of it. *Id.* at 212, 45 N.W.2d at 392.

and judgment of directors.¹² At the other extreme is the view adopted in the Pennsylvania statute that a director must use the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs.¹³ This standard of care is generally considered too strict since it would discourage honest men from serving as directors.¹⁴ The middle and most widely accepted view is that a director must use the same care, skill, diligence and judgment that an ordinarily prudent man would exercise in similar circumstances in like position.¹⁵ This standard is generally considered the most reasonable and workable one since it is flexible enough to be applied to varying circumstances and is strict enough to insure sound management.

Since the late 1920's, eleven states have adopted statutes defining the relation of the director to the corporation and the standard of care required of the director.¹⁶ These statutes are generally very similar to the MODEL BUSINESS CORPORATION ACT § 33, 9 U.L.A. which provides:

¹² See, e.g., *Sperling's Appeal*, 71 Pa. 11 (1872); *Commonwealth v. Anchor Bldg. & Loan Ass'n*, 20 Pa. Super. 101 (1902). The court in *Sperling's Appeal*, held that directors are liable for fraud, gross negligence, and gross inattention to duties which results in the fraud of agents, "yet they are not liable for mistakes of judgment, even though they may be so gross as to appear as 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." 71 Pa. at 24. This case has been criticized as being too lax. See *Hun v. Cary*, 82 N.Y. 65 (1880); BALLANTINE § 63. See generally HORNSTEIN § 446; ANNOT., 2 A.L.R. 867 (1919); Adkins 818-19; Baynes, *The Fiduciary Duty of Management—Concept of the Courts*, 35 U. DET. L.J. 561 (1958) [hereinafter cited as Baynes].

¹³ See, e.g., *Hun v. Cary*, 82 N.Y. 65 (1880) (Bank directors held liable for purchase of expensive building to create illusion of prosperity to community). The court said, "as he is bound to exercise ordinary skill and judgment, he cannot set up that he did not possess them." *Id.* at 74. To the same effect as *Hun*, see *Kavanaugh v. Commonwealth Trust Co.*, 223 N.Y. 103 (1918) (Action for negligent inattention; defendant never attended meetings).

¹⁴ *Swentzel v. Penn Bank*, 147 Pa. 140, 23 Atl. 405 (1892); BALLANTINE § 63; Adkins 818-19. See generally ANNOT., 2 A.L.R. 867 (1919).

¹⁵ See, e.g., *Briggs v. Spaulding*, 141 U.S. 132 (1891); *Barnes v. Andrews*, 298 Fed. 614 (S.D. N.Y. 1924); *Besseliew v. Brown*, 177 N.C. 65, 97 S.E. 743, 2 A.L.R. 867 (1919); *Hunt v. Aufderheide*, 330 Pa. 362, 199 Atl. 345 (1938). See generally BALLANTINE, § 63; Adkins 817; Baynes 561.

¹⁶ 17 IDAHO CODE ANN. § 30-142 (1947); KY. REV. STAT. § 271.365 (1955); LA. REV. STAT. § 12-36 (1951); MICH. STAT. ANN. § 21.47 (1959); MINN. STAT. ANN. § 301.31 (1947); N.Y. Business Corporation Law § 717; N.C. GEN. STAT. § 55-35 (1965); OKLA. STAT. ANN. tit. 18, § 1.34 (1953); PA. STAT. ANN. tit. 15, § 2852-408 (1958); S.C. CODE ANN. tit. 12, § 12-18.13 (Supp. 1966); WASH. REV. CODE ANN. § 23.01.360 (1961).

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 like positions.

According to the commissioner's note to the model act, the standard provided in the act is designed to clear up the conflict among the cases, is believed to represent the weight of authority and is the most fair and practical standard.¹⁷ The state statutes, as a rule, do not change the common law standard but merely codify the generally accepted rule.¹⁸ Pennsylvania, alone, creates a different standard of care by placing the words "in their personal business affairs" in the place of the words "in like positions" in the model act.¹⁹ This change of wording is interpreted in *Selheimer* as changing the common law standard that existed in Pennsylvania before adoption of Section 408.

The court in *Selheimer*, after rejecting the decision of the court en banc to the effect that directors are only liable for losses resulting from fraud, self-dealing or wanton misconduct,²⁰ stated:

This statute mandates a standard of care for directors much more stringent and harsh than the standard enunciated by our courts prior to the passage of the statute. Our case law prior to the statute taught that the directors of a corporation—whether business, banking or otherwise—were held simply to a standard 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. The standard prior to Section

¹⁷ MODEL BUSINESS CORPORATION ACT § 33, at 186.

¹⁸ See, e.g., *Detroit Gray Iron & Steel Foundaries, Inc. v. Martin*, 362 Mich. 205, 106 N.W.2d 793 (1961); *Fulton v. Talbert*, 255 N.C. 183, 120 S.E.2d 410 (1961). For examples of applications and constructions of these statutes, see *Otis & Co. v. Pennsylvania Ry.*, 61 F. Supp. 905 (E.D. Pa. 1945) (Applies PA. BUSINESS CORPORATION ACT § 408); *McLeod v. Lewis-Clark Hotel Co.*, 66 Idaho 584, 164 P.2d 195 (1945); *Pool v. Pool*, 16 So. 2d 132 (La. Ct. App. 1943); *Detroit Gray Iron & Steel Foundaries, Inc. v. Martin*, 363 Mich. 205, 106 N.W.2d 793 (1961); *Scott v. Stanton Heights Corp.*, 388 Pa. 628, 131 A.2d 133 (1957). For a general discussion of these statutes, see *Adkins* 817; *Bennett* 637; Note, 36 NOTRE DAME LAW. 343 (1961).

¹⁹ The statutes in Louisiana, Kentucky, Idaho, North Carolina, Oklahoma, and Washington adopt substantially the wording of the model act. The New York, South Carolina, Michigan and Minnesota statutes employ the model act standard of care but do not state that directors are "deemed to stand in a fiduciary relation." Minnesota, South Carolina and New York merely require the directors to discharge their duties in good faith.

²⁰ See note 4 *supra*.

408 might well be stated as that care, skill and diligence which the ordinary prudent man would exercise under similar circumstances.²¹

In construing Section 408, the court greatly emphasized the legislative background.²² However, after laying this background, the court, on the facts did not reach a result different from that required by the common law rule. The court stated: "In our view, however, regardless of whether we follow the statutory rule or the rule enunciated in our case law prior to the statute, the same result follows in the case at bar."²³ An affirmative answer to the following question was said to be self-evident:

In the absence of fraud, self-dealing, or proof of personal profit or wanton acts of omission or commission, are the directors of a business corporation, who have been imprudent, wasteful, careless and negligent, personally liable, under either the common law or Section 408, where such actions have resulted in corporate losses resulting in the insolvency of the corporation?²⁴

After reviewing the facts, it was concluded that the defendants' actions in respect to the Colwyn plant were not the result of errors of judgment or calculated business risks.²⁵ Nor could their actions be classified as mere negligence. "With the knowledge the defendants had of the unsuitability of the Paterson plant for profitable

²¹ Selheimer v. Manganese Corp., 224 A.2d 634, 641 (Pa. 1966). At this point the court reviewed the leading Pennsylvania cases which developed the common law standard of care, e.g., Hunt v. Aufderheide, 330 Pa. 362, 199 Atl. 345 (1938) (Directors held to same care, skill and diligence ordinarily prudent man would use in similar circumstances); Swentzel v. Penn Bank, 147 Pa. 140, 23 Atl. 405 (1892) (Liable only for fraud or gross negligence amounting to fraud) (Expressly rejects the "own affairs" standard); Sperling's Appeal, 71 Pa. 11 (1872) (Liable only for gross negligence or gross misconduct).

²² 224 A.2d at 642-43. The court said that a certain legislative background must be kept in mind: (1) the phrase "in their personal affairs" was not found in the Model Business Corporation Act, (2) prior to the statute, the case law rejected the standard expressly provided in Section 408, (3) the standard in Section 408 does not represent the majority view, (4) Section 408 imposes on a director of a business corporation a much higher degree of care than the law imposes on a director of a banking or building and loan corporation.

²³ *Id.* at 643.

²⁴ *Id.* at 644.

²⁵ *Id.* at 646. Previously the court stated the generally accepted rule that directors who exercise their judgment in good faith are not liable for errors of judgment or mistakes. *Id.* at 644. This is usually referred to as the business judgment rule; it takes into account that directors of business corporations are expected to take calculated business risks. See generally BALLANTINE §§ 62-72; HORNSTEIN §§ 432-446.

production," their pouring of assets into the Paterson plant was held to defy explanation.²⁶ In fact the defendants' whole pattern of conduct was said to border on willful misconduct and self-dealing since they caused the corporation to pay them unauthorized salaries and to purchase equipment from companies in which the defendants owned an interest.²⁷ Finally, the court agreed with the chancellor that the four majority directors were personally liable for any losses that resulted from their wasteful and negligent actions.²⁸

This case, although clearly establishing that Section 408 differs from and is more stringent than the common law standard of care, does little or nothing to illustrate what the difference is. By holding that the defendants' action was violative of the common law standard (which was none too clear in Pennsylvania) as well as the statutory standard, the court avoided the problem of determining exactly the effect of the words "in their personal business affairs." Admittedly, it would have been of little value for the court to attempt to draw an exact line marking the difference between actionable and blameless conduct, yet, it would have been helpful if the court had given some indication of what the effect of the statute is. As the case stands, it is authority only for the general principle that Section 408 requires greater care than other similar statutes and the common law standard.

As the court recognized, the terminology of the statute is very strict²⁹ and if literally applied might render directorships unattractive.³⁰ A flexible, comparative standard is needed today because circumstances under which directors act will vary greatly from one corporation to another—some directors taking a very active role in management as in *Selheimer*, and some functioning, for the most part, in a broad policy making and advisory capacity characteristic of larger corporations. Negligence is always a question of fact under the circumstances. The court in *Selheimer* recognizes this statement as a guiding general principle;³¹ however, under the

²⁶ 224 A.2d at 646.

²⁷ These facts relate to the issue of breach of the duty to act in good faith and not to the issue of failure to use due care. At the suggestion of defendant *Selheimer*, the board of directors voted to reimburse the corporations for salaries received but they had not been repaid. *Id.* at 638-39. For cases involving breach of fiduciary duty under Section 408, see *id.* at 643.

²⁸ *Id.* at 646.

²⁹ *Id.* at 640, 643.

³⁰ See BALLANTINE § 63; Adkins 819.

³¹ 224 A.2d at 644.

Pennsylvania statute, the court, of necessity, will have less latitude in taking the circumstances of each case into account than will other courts that apply the majority rule. Regardless of the size of the corporation, the nature of it, the number of directorships a particular director holds, the compensation received, or the demands of the director's own affairs, a director in Pennsylvania must always use the care a prudent man uses in his own affairs.³²

Where directors, as is the case in some large and some close corporations, are, in reality, independent, highly paid professional managers, the "own affairs" standard is not completely objectionable; but, this is not the universal situation. In the future should the court find occasion to apply the statute literally and should it reach a result different from the common law, corporations will be forced into employing experienced, professional directors at adequate compensation. Without compensation or a personal interest in the corporation's success, it is unlikely that one would be willing to take on the responsibility of a directorship in a corporation of any complexity.

ALBERT VICTOR WRAY

Corporations—Interested Directors—Fiduciary Duty and the Business Judgment Rule

The business judgment rule is a defense to directors who, in the exercise of their discretionary powers, cause corporate losses through errors in judgment.¹ It is based on the assumption that the directors, elected by the shareholders for this purpose, are in the best position to decide corporate policy and that a court, less familiar with the problems involved, should not substitute its judgment for that of the directors.² The shareholders have no right to appeal to the courts

³² For a criticism of the Pennsylvania statute as too subjective, see Adkins 819. The comments to the NEW YORK BUSINESS CORPORATION LAW § 717 expressly recognizes the need for a flexible, comparative standard of care: "The adoption of the standard prescribed by this section will allow the court to envisage the directors' duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director."

¹ See *Briggs v. Spaulding*, 141 U.S. 132 (1891); *Otis & Co. v. Pennsylvania R.R.*, 61 F. Supp. 905 (E.D.Pa. 1945), *aff'd per curiam* 155 F.2d 522 (3d Cir. 1946); *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 8 N.E.2d 895 (1937); *Abrams v. Allen*, 297 N.Y. 52, 74 N.E.2d 305 (1947).

² See *Coffman v. Maryland Publishing Co.*, 167 Md. 275, 173 Atl. 248