

## PERSONAL LIABILITY OF DIRECTORS FOR CORPORATE MISMANAGEMENT.

The extent to which a personal responsibility will be imposed upon directors is a matter of vital importance to the prospective director, the courts, and the investing public. The prospective director is eager to ascertain the possible liabilities to which he may be subjected; the courts seek to administer a standard of responsibility calculated to harmonize the individual interests of the directors with the public trust which they have assumed; while the investing public, the prospective stockholder, should be assured that those on whose names he relies for the security of his investment will, in fact, supervise the internal management of the corporation.

The conception that directors are *merely* "gratuitous mandatories"<sup>1</sup> is gradually being supplanted by the view that the office of director involves a *fiduciary relation*, for a breach of which liability should be imposed in accordance with the principles underlying the relation of trustee and *cestui que trust*.<sup>2</sup> The present problem is to determine when the jurisdiction of equity over trusts shall be invoked for a breach of this fiduciary duty.<sup>3</sup>

That directors are liable for fraud or gross dereliction of duty is an obvious consequence of the *quasi trusteeship* assumed.<sup>4</sup> It is, however, in those "twilight zone" cases, where directors, being guilty of no fraud or gross negligence, have wrecked the corporation through their honest but reckless and,

<sup>1</sup> Trimble v. American Co., 61 N. J. Eq. 340 (1901).

<sup>2</sup> Morawetz, I Private Corporations, Sec. 516 *et seq.*; Briggs v. Spaulding, 141 U. S. 132 (1890).

<sup>3</sup> Beers v. Bridgeport Bridge Co., 42 Conn. 17 (1875), declaration of dividends; Jackson v. Ludeling, 88 U. S. 616 (1874); Wright v. Oroville Mining Co., 40 Cal. 20 (1870); Hobbs v. Tom Reed Mining Co., 164 Cal. 407 (1913); Heinemann v. Marshall, 117 Mo. Ap. 546 (1905), secret profits; Cumberland Coal & Iron Co. v. Parrish, 42 Md. 598 (1875); Oliver v. Oliver, 118 Ga. 362 (1903); Fisher v. Parr, 92 Md. 245 (1901), standard of care required; Austin City R. R. Co. v. Swisher, 1 W. & W. Civil Cases (Ct. Ap. Sec. 76) 1880.

<sup>4</sup> Hun v. Cary, 82 N. Y. 65 (1880); Miese v. Lorens, 5 Ohio N. P. 307 (1898); Horn Silver Mining Co. v. Ryan, 42 Minn. 196 (1889); Killen v. State Bank, 106 Wis. 546 (1900).

from a business standpoint, absurd mistakes of judgment that courts have divided. The assumption of the duties of a trustee would clearly seem to include a guarantee of the exercise of reasonable business judgment; the conception of directors as trustees would involve liability for a failure to use such judgment irrespective of the "whiteness of the director's soul." On the other hand, the view that no liability should arise in such cases is the logical outgrowth of the conception of directors as *merely* gratuitous mandatories. It is my purpose in the brief scope of this article, to show that the trend of modern law, through the application of an expanded conception of the trusteeship of directors, is complying with the demands of modern business by insisting on the exercise of reasonable care, skill and business judgment in the management of corporate enterprises and will no longer relieve directors who plead honesty but hopeless incapacity.

The leading case in America on the liability of directors for mismanagement is *Spering's Appeal*,<sup>5</sup> in which the opinion is by Justice Sharswood. In that case the financial depression after the Civil War, caused the failure of the National Safety Insurance Trust Company, a Philadelphia bank. The directors, in their effort to save the institution consumed the funds of the company in reckless and improvident investments; loans were made at usurious rates of interest in anticipation of large profits; collateral was sacrificed in a vain attempt to sustain credit; and, in the failure of the directors to assign at a time when a great part of the assets could have been saved, there was a lack of that reasonable business judgment on the part of the directors on which stockholders rely. An action was brought against the directors to recover damages resulting from the improvident investments sanctioned by the board. The court denied relief holding that directors are *merely* gratuitous mandatories and are to be held responsible to the corporation only where their breach of trust is of such a character as to warrant the imputation of fraud or gross negligence amounting to

<sup>5</sup>71 Pa. 11 (1872).

fraud.<sup>6</sup> The court, speaking through Mr. Justice Sharswood, concluded that

"While directors are personally responsible to the stockholders 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 stockholders, for gross inattention and negligence by which such fraud and 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 the course of the opinion the famous English case of *Turquard v. Marshall*<sup>7</sup> is cited with approval. In that case Lord Hatherly, speaking of a loan by the directors of a corporation without security, says:

"It was within the power of the deed to lend to a brother director, and, however foolish the loan might have been, so long as it was within the power of the directors, the court could not interfere and make them liable. They were entrusted with full powers of lending the money. It was part of the business of the concern to trust people with money, and their trusting to an undue extent is not a matter with which they could be fixed, unless there was something more than that alleged, namely, that it was done fraudulently and improperly and not merely by a default of judgment. Whatever may have been the amount lent to anybody, however ridiculous and absurd it would seem, it is a misfortune for the company that they chose such unwise directors; but as long as they kept within the powers of the deed, I could not interfere with the discretion exercised by them."

Thus, in Pennsylvania, under the holding in *Spering's Appeal*, so long as the directors act in good faith, and within the scope of their authority, they cannot be held responsible to the corporation for honest mistakes of judgment no matter how reckless and absurd, when measured by the standard of reasonable prudence and ordinary business judgment.

The case of *Hun v. Cary*<sup>8</sup> stands in dramatic contradiction to the rule laid down by Justice Sharswood in *Spering's Appeal*.

<sup>6</sup> *Spering's Appeal* *ubi supra*, at p. 24.

<sup>7</sup> 38 L. J., Ch. 639 (1869).

<sup>8</sup> 82 N. Y. 65 (1880).

The facts in *Hun v. Cary* in their essential particulars are on all fours with *Spering's Appeal*, the Court of Appeals in New York, however, arriving at an opposite conclusion. In this case the trustees of an insolvent savings bank voted the purchase of an expensive lot in New York City as a site for a new bank building, hoping thereby to induce confidence in the financial standing of the institution and increase its deposits. The insolvent condition of the bank was known to the trustees at the time of the purchase, but there was no suggestion of bad faith on the part of the trustees, their purpose in making the purchase being the mistaken belief as to what constituted the best interests of the corporation. The charter empowered the corporation to purchase a lot requisite for the transaction of the banking business. The purchase was *intra vires*. The court, speaking through Mr. Justice Earl, held that the facts justified a finding that the case was not one of mere error or mistake of judgment on the part of the trustees, but of improvident and reckless extravagance and that the trustees should be held liable for the loss occasioned by such action on their part. *Spering's Appeal* was duly considered by Justice Earl when deciding *Hun v. Cary*, but its soundness squarely denied. In referring to that case he says:

"In *Spering's Appeal*, Justice Sharswood said that directors 'are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they were honest, and provided they are fairly within the scope of the powers and discretion confided to the managing body.' As I understand this language I cannot assent to it as properly defining to any extent the nature of a director's responsibility. Like a mandatory, to whom he has been likened, he is bound not only to exercise proper care and diligence, but ordinary skill and judgment. As he is bound to exercise ordinary skill and judgment he cannot set up that he does not possess them."

The salient facts in *Hun v. Cary* are on "all fours" with those of *Spering's Appeal*, *supra*. In both cases the improvident investment was made in the interest of the corporation; in both cases there was no suggestion of fraud; in both cases the act of the directors was within the powers conferred by the charter; but in *Hun v. Cary* the court held that honest but

reckless improvidence in an *intra vires* transaction is the foundation of liability, whereas in *Spering's Appeal*, it was held that no liability existed in the absence of gross negligence amounting to fraud the court refusing to hold that there could be such gross error of judgment in an *intra vires* transaction as to constitute a liability on the part of the directors who were guilty of it. Thus, in New York, it is held that directors must exercise reasonable prudence and ordinary business judgment, and that reckless mistakes of judgment, although in good faith and within the scope of their powers, will constitute the basis of liability.

The rule of *Spering's Appeal*, is an evolution of the conception that directors are mere "gratuitous mandatories," serving without compensation. It is natural that a court, saturated with this doctrine would look with favor upon a rule calculated to relieve these mandatories except where guilty of flagrant misconduct. The latter part of the nineteenth century, however, witnessed a change in the status of directors. Directorates were coveted positions, the number of boards on which an individual served being an actual business asset. Compensation in many cases was pecuniary, but "indirect benefits" were always an ample consideration. The personnel of directorates is often the greatest inducement to a prospective stockholder. The investing public is lulled into security by the names associated with the undertaking and justice dictates that directors should not, in the event of a crash due in part to their negligence, shield themselves behind the cloak of a gratuitous mandatory who has benefited by his position, but is unwilling to shoulder its burdens. It is the merest sophism to speak of a modern director as a gratuitous mandatory.

The growth of "close corporations," or incorporated partnerships, as a method of conducting business further rebuts the conception of directors as gratuitous mandatories. There is an element of reason underlying the theory that a director in a gigantic corporation is merely a mandatory, but it is folly to extend this doctrine to a corporation where the directors are, in fact, the managing partners receiving lucrative salaries. To

say that such directors are liable only for gross negligence when acting *intra vires*, would be the vindication of a theory at the expense of substantive justice.

The principle that courts will not interfere with the internal management of corporations, or interpose any impediment to the honest exercise of the discretion entrusted to directors, has undoubtedly played an active part in establishing the lenient rule of *Spering's Appeal* that directors are liable only for gross negligence, and not for *intra vires* mistakes of judgment.<sup>9</sup>

The rule which forbids an interference by the courts with the internal management of corporations, is founded in policy and upon the knowledge that neither the machinery of the law, nor the capacity of judges, is such as to control directors in the honest exercise of their discretion. A statement of this rule, however, does not involve the pronouncement of a doctrine such as laid down in *Spering's Appeal* that, for negligence in the internal management of the corporation, there is no liability unless so gross as to approximate fraud. It is one thing for courts to say "we will not interfere with the honest exercise of directorate discretion"; it is quite a different proposition to announce the doctrine that directors are not held to the standard of ordinary care in an *intra vires* transaction and are liable only for gross negligence. The majority of American jurisdictions have adopted this distinction and although holding that no interference by the courts with the honest exercise of directorate discretion will be permitted, have, nevertheless, laid down the rule that whether the act of directors be *intra vires* or *ultra*

<sup>9</sup> Morawetz, Private Corporation, Sec. 243: "So long as the agents of a corporation act honestly within the powers conferred upon them by the charter, they cannot be controlled." Thus, it has been held that, in the absence of fraud, such as an endeavor to "freeze out" a minority stockholder, courts will under no circumstances interfere with the judgment of directors in refusing to declare a dividend. *McNab v. Mfg. Co.*, 69 S. C. 18 (N. Y. 1891); *American Steel Foundries v. Lazaar*, 204 Fed. 204 (1913); *Knapp v. S. Jarvis Adams Co.*, 135 Fed. 1008 (1905), where it is said that "directors of a corporation are impliedly vested with a discretionary power with regard to the time and manner of distributing its profits, and, in the absence of fraud or an abuse of discretion, their action in leaving profits earned in the business instead of distributing them to the stockholders in dividends is legal, and constitutes no violation of the rights of a stockholder." See also Morawetz on Corp., 447; *Wheeler v. Northwestern Sleigh Co.*, 39 Fed. 347 (1889).

*vires* they are held to the standard of ordinary care, skill, and business judgment in the management of the affairs of the corporation.<sup>10</sup> These cases clearly demonstrate that there is nothing inconsistent in holding directors liable for a failure to exercise reasonable judgment and at the same time refusing to interfere with the internal management of the corporation.<sup>11</sup>

The reasons assigned for the rule of *Spering's Appeal*, *viz*: the conception of directors as gratuitous mandatories, and the desire of courts not to interfere with the internal management of corporations, do not, it is submitted, appeal to the intellect as arguments for a standard that relieves directors from the consequences of absurd errors of judgment and holds them liable only where gross negligence or fraud is disclosed.

The rule itself cannot command respect. Gross negligence is the want of slight care and diligence,<sup>12</sup> or the "gross failure to exercise proper care,"<sup>13</sup> and, in some cases, it has been held to involve a degree of wilfulness or intent.<sup>14</sup>

The mere statement of what gross negligence means condemns it as a rule to govern the conduct of directors who hold themselves out to the public as capable business men. It is grotesque to say that a director in an *intra vires* transaction affecting the interests of the stockholders can be as foolish as he desires provided his conduct is not a "gross failure to exercise the proper care," that "*crassa negligentia*" of the civil law; nor would it act as a stimulus to the prospective investor to learn that such a standard of care is all that is required of

<sup>10</sup> *Mutual Redemption Bank v. Hill*, 56 Me. 385 (1868); *Hun v. Cary*, 82 N. Y. 65 (1880); *Brinkerhoff v. Bostwick*, 88 N. Y. 52 (1882); *Delano v. Case*, 121 Ill. 247 (1887); *Marshall v. Farmers Bank*, 85 Va. 676 (1889); *Langunas Nitrate Co. v. Langunas Syndictae* (1899), 2 Chancery 392; *Killon v. Barnes*, 106 Wis. 546 (1900); *Hanna v. Lyon*, 179 N. Y. 107 (1904).

<sup>11</sup> A comparison of *Hun v. Cary*, 82 N. Y. 65 (1880), and *McNab v. Mfg. Co.*, 69 S. C. 18 (N. Y. 1891), both decided in the same jurisdiction, illustrates the above distinction. The former case holds *contra* to *Spering's Appeal*, while in the latter the court refuses to interfere with the exercise of the discretion entrusted to directors.

<sup>12</sup> *Makin v. Paucah R. R. Co.*, 110 Ky. 680 (1901).

<sup>13</sup> *Dolphin v. Worcester Consol. Ry.*, 109 Mass. 280 (1905).

<sup>14</sup> *Rideout v. Winnebago Traction Co.*, 123 Wis. 297 (1904).

those who are represented to the public as directors of the corporation.<sup>15</sup>

Pennsylvania judges have perceived that this rule is opposed to business demands and instead of applying one standard, that of due care to all directorate action, have whittled away the effect of *Spering's Appeal* by refusing to apply its rule to *ultra vires* transactions.<sup>16</sup>

The cases in Pennsylvania seem to demonstrate a desire to avoid the consequences of *Spering's Appeal*. In practically all the cases involving the liability of directors in Pennsylvania, for negligence, decided since 1872, the facts were either such as to excuse the directors on the ground that no absence of due care was shown, or the act was *ultra vires* and the directors held liable on the theory of a breach of trust.

In the case of *Sawentzel v. Penn Bank*,<sup>17</sup> it was sought to hold the directors for the losses occasioned by gigantic oil speculations indulged in by the president with the funds of the bank, although the evidence showed that the fraud could not have been discovered with the use of due care or by the ordinary examination of the books which directors in similar institutions customarily made. The court squarely vindicated the rule of *Spering's Appeal* holding that: "Bank directors being gratuitous mandatories, are only liable for fraud or such gross negligence as amounts to fraud." It is, however, mere *dicta* for a court to announce the doctrine that directors are only liable for gross negligence, where the facts are such as to show that the directors were in the exercise of due care and hence would have escaped liability in any jurisdiction. In *Commonwealth v. Building & Loan Assn.*,<sup>18</sup> there was an attempt to hold the directors responsible for losses occasioned by the declaration of

<sup>15</sup> In accord with *Spering's Appeal*, *supra*: *Godbold v. Mobile Bank*, 11 Ala. 191 (1847); *Witters v. Sowles*, 31 Fed. 1 (1887); *Briggs v. Spaulding*, 141 U. S. 132 (1891); *Gibbins v. Bank of Commerce*, 79 Ill. App. 150 (1898). The language of these cases does not go to the extent of that in *Spering's Appeal* as to honest but absurd mistakes of judgment.

<sup>16</sup> *Loan Society v. Eavanson*, 248 Pa. 407 (1915).

<sup>17</sup> 147 Pa. 140 (1892).

<sup>18</sup> 20 Pa. Super. Ct. 101 (1902).



a dividend when the association was insolvent. The directors had acted on the faith of the report of the financial committee and advice of counsel. The court held that the directors were not liable on the ground that no case of negligence or want of due care was presented. The court adhered to the language of *Spering's Appeal*, but it is submitted the case was not one where the rule could have been involved since even ordinary negligence was not shown, to say nothing of gross negligence within the meaning of the rule.

The case of *Cornell v. Seddinger*<sup>19</sup> indicates the recent tendency of Pennsylvania courts to ignore the rule of *Spering's Appeal*. In this case, the defendants, directors of a shipbuilding company, were compelled to repay to the corporation certain sums paid out of capital as dividends. Reports of the treasurer had been made to the board. Upon these reports the dividends had been declared. On behalf of the directors it was contended that, when they acted in good faith in declaring a dividend out of capital, they were not to be held liable if it develops that the assets were incorrectly stated by the treasurer, or if the assets afterward proved to be worthless. The court was reminded that if a stricter test than that of good faith were imposed, no business man could be induced to act upon any board—exactly the contention which was successfully made by counsel in *Spering's Appeal*. The attention of the court was called to *Spering's Appeal*, *supra*, *Watt's Appeal*,<sup>20</sup> *Swentzel v. Penn Bank*, *supra*, and other cases sustaining the gratuitous mandatory and gross negligence theory. The directors, however, were held liable, Mr. Justice Potter speaking for the court, holding:

"Directors are trustees or quasi trustees of the capital of the company, and liable as trustees for any breach of duty with respect to the application of it. . . . The directors of the shipbuilding company were undoubtedly guilty of a dereliction of duty in that they did not exercise ordinary care as directors."

In this case the standard of due care is announced as the measure of directors' liability. The basis of the opinion is that

<sup>19</sup> 237 Pa. 389 (1912).

<sup>20</sup> 78 Pa. 370 (1875).

the directors declaring dividends out of capital had not exercised ordinary care. It was not deemed necessary to find them guilty of gross negligence or fraud as in *Spering's Appeal*. True, the act in the *Seddinger Case* was *ultra vires*; while that in *Spering's Appeal* was within the powers conferred on the directors by the charter, viz.: investment of the funds of the corporation. It is noteworthy, however, that the court itself makes no such distinction, indicating that in all cases directors, like trustees, must exercise reasonable skill and care in the administration of their *quasi* trust.

The case of the *Loan Society of Philadelphia v. Evanson*<sup>21</sup> is the last authoritative statement of the law of Pennsylvania as to the liability of directors. A bill in equity for an accounting alleging negligence and mismanagement was brought by the corporation against its directors. The capital had been impaired by the declaration of unearned dividends; there was a failure to properly appraise and check the collateral on deposit, and, as a result of lack of ordinary care, there was an over-issue of stock, and fraudulent transactions with one of the customers were permitted. An accounting was decreed on the ground that the directors were liable for a failure to exercise ordinary care. Mr. Justice Mestrezat announcing the decision said:

"The rule generally applied is reasonable and ordinary care, skill and diligence in conducting the business of the corporation . . . This is the standard adopted in this State and the failure to observe it imposes liability on a defaulting director."

The court considers *Spering's Appeal*, but quotes, not its decision, but the *dicta* of Justice Sharswood where he says:

"I have found no judgment or decree which has held directors to account, except when they have themselves been personally guilty of some fraud on the corporation, or have known and connived at some fraud in others, or where such fraud might have been prevented had they given ordinary attention to their duties. I do not mean to say . . . that there might not exist such a case of negligence or of acts clearly *ultra vires* as would make perfectly honest directors personally liable."

<sup>21</sup> 248 Pa. 407 (1915).

It is to be observed that the court in this recent case does not subscribe to the actual holding in *Spering's Appeal*, nor does it quote the passage where Justice Sharswood says that no matter how reckless or absurd the conduct of directors might appear they cannot be held liable for mistakes of judgment in an *intra vires* transaction. Mr. Justice Mestrezat does not qualify the rule of ordinary care so as to apply it only to *ultra vires* transactions; he lays it down as the standard of all directorate action.

Gross negligence was undoubtedly present in the *Evanson Case*, and it would have been decided the same way in 1872. The value of the case is in the rule announced, which, in its generality, is identical with the New York rule of *Hun v. Cary*—the court even citing with approval the New York case of *Childs v. White*,<sup>22</sup> where it is said:

"Directors are bound to use a reasonable degree of care in the performance of those acts which, under the circumstances, prudence would fairly seem to require them to perform."<sup>23</sup>

The foregoing analysis of the decisions in Pennsylvania impels the conclusion that a change has occurred in the standard of care by which the liability of directors is to be judged. The temper of the court has been altered. It would seem that the fraud or gross negligence theory of *Spering's Appeal* has been supplanted by the rule of due care for all directorate action announced in the *Evanson* case in 1915. The *Evanson* case lays down the rule of due care as unequivocally as the case of *Hun v. Cary*, and the writer feels no hesitancy in venturing the opinion that should the facts of *Spering's Appeal* be presented to the present Supreme Court of Pennsylvania, the decision would be in accord with the *Evanson* case and *Hun v. Cary*.<sup>24</sup>

<sup>22</sup> 142 N. Y. Supp. 732 (1913).

<sup>23</sup> The court also cites: *Mutual Building Fund Bank v. Bosseux*, 3 Fed. 817 (1880); *Devlin v. Moore*, 130 Pac. R. 35 (Ore. 1913). These cases do not relieve the directors where there has been a reckless mistake in judgment. See also: *Morse on "Banking,"* p. 117; *Cook "Corporations,"* 7th Ed., Sec. 682; *London Trust Co. v. MacKenzie*, 68 L. T. R. 380 (1893).

<sup>24</sup> Standard of due care applied in following cases whether transaction is *intra vires* or *ultra vires*. *Tooker v. Nat. Sugar Ref. Co.*, 80 N. J. Eq. 305 (1912); *Moses v. Ocoee Bank*, 1 Lea 398 (Tenn. 1878); *Williams v. McKay*,

The present higher standard of directorate liability indicated by the foregoing citations, is, it is submitted, to be attributed to the growing conception that directors occupy a fiduciary position with reference to the corporation,<sup>25</sup> and that their liability is to be judged by standards applicable to express trusteeship. One of the earliest pronouncements of the fiduciary capacity of directors was made in *Hopkins & Johnson's Appeal*,<sup>26</sup> where it was held that directors could not use their knowledge as to the solvency of the corporation to obtain a preference over other creditors, even though their debts were valid.<sup>27</sup>

Such emphatic declaration of the trust relation of director was hardly consistent with a doctrine such as announced in *Spering's Appeal* permitting even reckless and absurd mistakes of judgment if made in good faith. The conception of directors as fiduciaries appears so equitable, and the doctrine of *Spering's Appeal* so unjust to the stockholders, that the result has been an expansion of the trusteeship theory and the necessary modification of the doctrine that gross negligence is the only basis of directorate liability.

The trust relation of directors is emphasized in other phases of the law defining the duties of directors. The law with reference to the right of a director to enter into a contract with his corporation illustrates the jealousy with which the corporation is guarded from manipulation by its directors. The rule precluding a director from obtaining any advantage or secret

40 N. J. Eq. 189 (1885); *Williams v. McDonald*, 42 N. J. Eq. 392 (1886), legality of instruments; *Metropolitan Ry. v. Kneeland*, 120 N. Y. 134 (1890), care in the issue of void notes; *Pierson v. Cronk*, 26 Abb. N. Cas. 251 (N. Y.), 1891. Advice of counsel does not exonerate directors: *Hodge v. N. E. Screw Co.*, 1 R. I. 312 (1859); *French v. Armstrong*, 79 N. J. E. 289 (1912); *General Rubber Co. v. Benedict*, 215 N. Y. 18 (1915). Standard that of ordinary director: *Allen v. Roydhouse*, 232 Fed. 1010 (1916).

<sup>25</sup> *People v. Turnbull*, 93 Cal. 630 (1892); *Power Co. v. Bank*, 224 Fed. 39, 45 (1915).

<sup>26</sup> 90 Pa. 69 (1879).

<sup>27</sup> *Kerstetter's Appeal*, 149 Pa. 148 (1892); *Mueller v. Fire Clay Co.*, 183 Pa. 450 (1898), containing good statement of duties arising out of trusteeship; *Moller v. Fibre Co.*, 187 Pa. 553 (1898); *Hill v. Telephone Mfg. Co.*, 198 Pa. 445 (1901); *Morawetz on Corporations*, Sec. 787. This principle does not prevent a director from enforcing his security or issuing execution where his preference was not the result of an advantage due to his position and the transaction was fair. *Off v. Jack*, 204 Ill. 79 (1903); *Ill. Steel Co. v. O'Donnell*, 156 Ill. 624 (1895).

profit as a result of his position is fundamental.<sup>28</sup> Where, however, a director with full disclosure of facts, *bona fide* contracts with his corporation, it is not so apparent that the mere fact of his relation to the corporation should avoid the contract, although such transactions should be subject to careful scrutiny by the courts.<sup>29</sup>

There is a total absence of harmony in the law in relation to the validity of contracts between directors and their corporations, the state of the authorities on this question being represented by three views, which, for purposes of discrimination, may be referred to as the Massachusetts, New Jersey and English views. In Massachusetts it has been held that where a disinterested quorum authorizes the contract, and the terms are provident and fair, the contract cannot be avoided.<sup>30</sup>

Under the New Jersey rule it is held that the mere fact of the contract's being made between director and his corporation renders the contract voidable at the election of the corporation, the *cestui que trust*.<sup>31</sup>

In *Stewart v. Lehigh Valley R. R. Co.*,<sup>32</sup> it was held that "Such a contract is not void, but voidable, to be avoided at the option of the *cestui que trust* exercised within a reasonable time. It matters not that the contract is a fair one."<sup>33</sup> This rule in fact differs little from the Massachusetts rule, for, if the con-

<sup>28</sup> *Wardell v. Union Pacific Ry. Co.*, 103 U. S. 651 (1880), new company composed of railroad directors to be recipient of advantageous contracts from roads; *Bank v. Downey*, 53 Cal. 466 (1879); *Jones v. Byrne*, 149 Fed. 457 (1906); *Commonwealth T., I. & Trust Co. v. Seltzer*, 227 Pa. 410 (1910); *Symmes v. Union Transit Co.*, 60 Fed. 830, 864 (1894); *Ward v. Davidson*, 89 Mo. 445 (1886); *Blair Town Lot Co. v. Walker*, 50 Iowa 376 (1879); 1 *Perry "Trusts,"* 3d Ed., Sec. 429; *Hayes v. Pierson*, 65 N. J. E. 353 (1890); *Howland v. Corn*, 232 Fed. 35 (1916).

<sup>29</sup> *Union Pac. R. R. v. Credit Mobilier*, 135 Mass. 367 (1883).

<sup>30</sup> *Fort Payne Co. v. Hill*, 174 Mass. 224 (1899); *Hammond's Appeal*, 123 Pa. 503 (1888); *Nye v. Storer*, 168 Mass. 53 (1897); *Leavenworth Co. v. Chicago, etc., R. R. Co.*, 134 U. S. 688 (1889); *Barr v. N. Y., etc., Co.*, 125 N. Y. 263 (1891); *Smith v. Skeary*, 47 Conn. 47 (1879); *German-American Seminary v. Keifer*, 43 Mich. 105 (1880); *Higgins v. Lansingh*, 154 Ill. 301 (1895); *Fillerbrown v. Hayward*, 190 Mass. 472 (1906); *Kantzler v. Bensingher*, 214 Ill. 589 (1905).

<sup>31</sup> *Meeker v. Winthrop Iron Co.*, 17 Fed. 48 (1883).

<sup>32</sup> 38 N. J. Law 505 (1875).

<sup>33</sup> *Gardner v. Butler*, 30 N. J. Eq. 702 (1879); *Twin Lick Oil Co. v. Marbury*, 91 U. S. 587 (1875); *Marcy v. Guanajuato Co.*, 225 Fed. 150 (1915).

tract is fair, it will not be avoided by the corporation although the bare right to do so may exist.

The third and most stringent view is the English rule which holds that the mere fact of his relation incapacitates a director from entering into a contract with his corporation; in short, his fiduciary relation is so emphasized that he is forbidden to enter into any transaction, regardless of its intrinsic fairness, which may render his personal interests antagonistic to the corporation.<sup>34</sup>

In the nature of things there is nothing which should prevent a director's entering into a fair contract with his corporation; to forbid such contracts closes a vast market to the corporation, and may deprive it of advantages which it would otherwise possess. But so engrafted in the English law is the conception of the trusteeship of directors, that Lord Hardwicke eliminates the possibility of a director's using his position for his personal benefit, even where his action will be subject to inquiry by the courts. In *Whelpdale v. Cookson*<sup>35</sup> he says, "It is not enough for the trustee to say 'you cannot prove any fraud,' as it is in his power to conceal it." Also in *Duncombe v. R. R.*,<sup>36</sup> it is said, "The rule is founded on the known weakness of human nature and the peril of permitting any sort of collision between the interests of the individual and his duty as trustee, in his fiduciary character."

The most striking statement of this view is made by Chancellor Kent in the case of *Davoue v. Fanning*<sup>37</sup> where he says:

"Nothing less than incapacity is able to shut the door against temptation where the danger is imminent and the security against discovery great. The wise policy of the law has therefore put the sting of disability into the temptation as a defensive weapon against the strength of the danger which lies in the situation."

On one proposition there is complete harmony in all jurisdictions: the contract must be authorized by a quorum of dis-

<sup>34</sup> *Aberdeen Co. v. Blakie*, 1 Macq. 461 (H. L. 1854); *Pork v. Russell*, 36 Ind. 60 (1871); *Haywood v. Lumber Co.*, 64 Wis. 639 (1885); *Davoue v. Fanning*, 2 Johns Ch. 252 (1816); *Pike Comp. v. Hammons et al.*, 129 Ind. 368 (1891); *Estate of Smythe v. Evans*, 209 Ill. 376 (1904).

<sup>35</sup> 1 Ves. Sr. 9 (Eng. 1747).

<sup>36</sup> 13 Am. & Eng. Railroad Cases, p. 84.

<sup>37</sup> 2 Johns Ch. 252, at p. 270.

interested directors,<sup>38</sup> and even in jurisdictions where the contract is voidable, it may be ratified by the unanimous consent of the stockholders.<sup>39</sup>

These conflicting views regarding the validity of contracts between directors and their corporations are not referred to for the purpose of raising a controversy as to the merits of any one of them. The purpose is to indicate that, whether courts insist that such contracts are void or voidable, or valid, depending upon their terms, they all unite in affirming the proposition that there is a *quasi trust* relation between the director and the corporation, which relation the courts must conserve.

The trusteeship of directors is emphasized not only where the transaction is with the corporation, the *cestui que trust*, but there is also considerable authority extending the fiduciary duty of directors to their dealings with the individual shareholders, the conception being that the direct duties owed to the corporation radiate to the individual stockholders. Thus, the Supreme Court of the United States has subscribed to the view that, under certain circumstances, a director is under a duty to disclose to the shareholder the knowledge which he possesses as to the value of the shares.<sup>40</sup> The weight of American authority, however, subscribes to the barbaric view that a director is under no fiduciary duty to the stockholder with reference to the purchase or sale of stock, and so long as he is guilty of no active misrepresentation, the law permits him to avail himself of the knowledge which he possesses as a director as to the actual value of the shares.<sup>41</sup>

<sup>38</sup> *Coleman v. Second Ave. R. R. Co.*, 38 N. Y. 201 (1867).

<sup>39</sup> *U. S. Steel v. Hodge*, 64 N. J. Eq. 807 (1902); *Mobile Co. v. Gass*, 142 Ala. 520 (1904).

<sup>40</sup> *Strong v. Repide*, 213 U. S. 419 (1908); *Stewart v. Harris*, 69 Kan. 498 (1904).

<sup>41</sup> *Walsh v. Goulden*, 130 Mich. 531 (1902); *Bloom v. Loan Co.*, 152 N. Y. 114 (1897); *O'Neill v. Ternes*, 32 Wash. 528 (1903); *Crowell v. Jackson*, 53 N. J. L. 656 (1891); *Hooker v. Mill & Steel Co.*, 215 Ill. 444 (1905); *Haarstick v. Fox*, 9 Utah 110 (1893); *Commissioners v. Reynolds*, 44 Ind. 509 (1873); *Krumbhaar v. Griffiths*, 151 Pa. 223 (1892); 1 L. R. A. (N. S.) 258; *Cook: Stock and Stockholders*, Secs. 320-351. But otherwise as to sale of control: *Porter v. Healey*, 245 Pa. 427 (1914); *Pa. Sugar Co. v. Am. Sugar Ref. Co.*, 166 Fed. 254 (1908).

The same tendency to hold those in control of corporate enterprises to the exercise of the utmost diligence and good faith in the interests of those subject to their control, finds expression in the law regarding the duties of the majority stockholders to the minority. Just as the powers reposed in directors are regarded as in the nature of a trust in favor of the corporation,<sup>42</sup> so the powers conferred upon the majority stockholders are regarded as a trust in favor of the minority.<sup>43</sup> So emphatic have been the expressions of this trust relation between the majority and minority that a majority interest is more of a liability than an asset. "Dummy directorates," acting as the tools of the majority,<sup>44</sup> disposal of the corporate property for the benefit of the majority at the expense of the minority,<sup>45</sup> fraud in the control of the corporate assets,<sup>46</sup> and numerous other schemes, have been upset at the suit of wronged minority shareholders. The case of *Farmers' Loan & Trust Co. v. N. Y. etc. R. R. Co.*,<sup>47</sup> where the New York Central Railroad bought up a majority interest in the Northern Railroad, a competing line, and thereupon operated the road in the interest of the New York Central and to the detriment of the Northern, compelling foreclosure on the Northern mortgages, contains an able statement of the fiduciary duties of the majority. It is there said:

Thus, whether the courts are passing on the validity of a contract between a director and his corporation, or between a director and an individual stockholder, or whether defining the

"The law requires of the majority stockholders the utmost good faith in their control and management of the corporation as regards the minority, and in this respect, such majority stands in much the same relation toward the minority that the directors sustain to a stockholder."<sup>48</sup>

<sup>42</sup> Lindley: "Companies," p. 530.

<sup>43</sup> *Bradley v. Farwell*, 1 Holmes 433 (U. S. C. C. 1874): "Title to the property is in the corporation, but their power of management, disposition and sale is a trust power, and the same principle applies to the execution of trust power as to the dealing with trust estates." Also, *Hyams v. Calumet & Hecla Mining Co.*, 221 Fed. 529 (1915).

<sup>44</sup> *American Ball Bearing Co. v. Adams*, 222 Fed. 967 (1915).

<sup>45</sup> *Jones v. Missouri-Edison Electric Co.*, 144 Fed. 765 (1906).

<sup>46</sup> *Brewer v. Boston Theatre*, 104 Mass. 378 (1870).

<sup>47</sup> 150 N. Y. 410 (1896).



duties of the majority to the minority, the trend of modern authority is to insist on the existence of a fiduciary relation involving the duties of express trusteeship.<sup>48</sup> With such a wealth of analogy, it is natural that the law, to meet modern business requirements, should seize upon the trusteeship theory to avoid the manifest injustice of the gratuitous mandatory conception of *Spering's Appeal*. It has been my purpose, in this article, to survey briefly the many conflicting views of directorate liability, in the hope that, out of the chaos, we may find some reasonable standard of liability capable of uniform application. It is submitted that the rule of due care, referred to in *Hun v. Cary*, *supra*, should be applied to *all* directorate action and should be the measure of directorate liability whether the act complained of is *intra vires* or *ultra vires*, whether affirmative action, or the reckless and absurd exercise of judgment.

What would be the decision of the present Pennsylvania Supreme Court, were the facts of *Spering's Appeal* once again before it, is a matter of conjecture. In view of the recent opinions in that state unequivocally subscribing to the rule of due care of *Hun v. Cary*, it is submitted that counsel would be assuming a delicate responsibility in advising a prospective director that he is liable for *gross* negligence only and not liable for the consequences of his reckless and absurd mistakes of judgment, if acting in good faith. *Spering's Appeal* may be used as a defensive move after the wreck has occurred, but is not a reliable compass by which to steer.

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<sup>48</sup>Jackson v. Ludeling, 21 Wall. 616 (1874); Menier v. Hoopers Telegraph Works, 9 Ch. Ap. Cas. 350 (1874), excellent statement; Ervin v. Oregon Ry. Co., 20 Fed. 577 (1884); Gamble v. R. C. W. Co., 123 N. Y. 91 (1890); Hinds v. Fishkill Gas Co., 88 N. Y. S. 954 (1904); Sidell v. Missouri, *etc.*, R. R. Co., 78 Fed. 724 (1897); Wright v. Oroville Mining Co., 40 Cal. 20 (1870); Meeker v. Winthrop Iron Co., 17 Fed. 48 (C. C.) (1883); Oliver v. Co., 64 N. J. Eq. 596 (1903); Booth v. Co., 68 N. J. Eq. 536 (1905); Schmid v. Lancaster Ave. Theatre, 244 Pa. St. 373 (1914); Stebbins v. Michigan Wheelbarrow Co., 212 Fed. 19 (1914); Provident Trust Co. v. Geyer, 248 Pa. 423 (1915); Jones v. Mo. Electric Co., 144 Fed. 765 (1906). As to salaries see Althouse v. Cough Co., 227 Pa. 580 (1910).