Cleveland State Law Review

Volume 9
Issue 3 *Psychiatry and Law (A Symposium)*

Article

1960

Negligent Management of Corporations

Raymond C. Loyer

Recommended Citation

Raymond C. Loyer, Negligent Management of Corporations, 9 Clev.-Marshall L. Rev. 554 (1960)

Negligent Management of Corporations

*Raymond C. Loyer**

THE SUBJECT OF NEGLIGENT MANAGEMENT of corporations is a broad field for one article. Yet, in one article many facets of corporation management can be brought together in one place. A review of the literature reveals that specific matters which relate to negligent management can be found in many widely separated sections of reference works, and piecemeal in separate articles. Most articles seem to explore a particular field of corporate management in which negligence is a small factor.

Negligence in corporate management is not treated differently than negligence in most other fields of activity. Requirement of proof of causal relationship has been preserved even in the statutes of the various states in their attempts to specifically fix responsibility.[1]

Due to widespread use of certain terms by the courts, it is well to distinguish at the beginning the terminology used in practice. Because the directors (and also the officers) of a corporation are usually considered to be in positions of trust (and in some jurisdictions directors are considered to be agents) the terms "misfeasance" and nonfeasance" are frequently used. Both are used in referring to negligence. The distinction is made thus:

> . . . 'Nonfeasance' means the total omission or failure of an agent to enter upon the performance of some distinct duty or undertaking which he has agreed with his principal to do. . . . But if he once begins the performance of such acts and in doing so fails or omits to do certain acts which he should have done, whereby a third person is injured, it is not nonfeasance but misfeasance.[2]

Of course negligence can be read into both terms. Directors can, at the same time and by the same set of facts, be liable to different parties on both counts. Mere acceptance of the position can be called the beginning of performance. Thus misfeasance by way of nonfeasance may be possible.

---

* B.S., John Carroll Univ., third-year student at Cleveland-Marshall Law School.

1 3 Fletcher, Private Corporations 606 (Perm. ed. rev. 1947); 2 Oleck, Modern Corporation Law, chaps. 39, 40 (1959) state by state digests of statutes.

2 26 Words and Phrases 182 (Perm. ed., 1953).

Who Can Be Guilty of Negligent Management

While the history of the subject has rested on the basis that directors of a corporation are the sole managers, there are others in the organization who share the prospect of being held to account in a court of law. Presidents,[3] executive committees,[4] and general managers have been held liable for negligent management. Thus, where a member of management habitually disregards by-laws and rules of executive committees, all the officers may be held liable in negligence for permitting that to go on when losses result from the transactions of the one doing the actual wrong.

The standard of care required of officers appears to be nearly the same as that of directors, yet, unless there is fraud or financial profit made by offending officers, they seldom are held liable.[5] The rule of the "ordinary prudent man" is normally applied. They are charged with the knowledge which could be gained by an ordinary or routine inspection of the company books. As an example of how loosely this rule is applied, a general manager was held liable for his negligence only after it was shown that the company secretary had been overpaying himself for seven years and when discovered by the general manager, was allowed to remain in his position, during which time more money was taken.[6]

There is some difference in the standard of care required of officers from that required of directors. Consideration is given to the subordinate officer's added responsibility for day-to-day operation as opposed to the director's responsibility for overall supervision. A bank president was held liable for not discovering a clever fraud by the bookkeeper. In the same case the directors were found blameless, since only close scrutiny and day-to-day checking could have disclosed the embezzlement.[7]

---

3 Fidelity & Deposit Co. of Maryland v. Wiseman, 103 Tex. 286, 124 S. W. 621 (1910); Doe v. Northwestern Coal & Transportation Co., 78 F. 62 (C. C. Ore. 1896); Carter v. Forbes Lithograph Mfg. Co., 22 Tex. 549, 56 S. W. 227 (1900).

4 Williams v. McKay, 46 N. J. Eq. 25, 18 A. 824 (1889).

5 Commercial Germania Trust & Savings Bank v. Jurgens, 134 La. 755, 64 S. 703 (1913); David Reus Permanent Loan & Savings Co. v. Conrad, 101 Md. 224, 60A 737 (1905); Drucklieb v. Harris, 84 Misc. Rep. 291, 147 N. Y. S. 298 (1914); Killen v. State Bank, 106 Wis. 546, 82 N. W. 536 (1900).

6 Johnson v. Stoughton Wagon Co., 118 Wis. 438, 95 N. W. 394 (1903); Long v. Forbes, 58 Wyo. 533, 136 P. 2d 242 (1943).

7 Bates v. Dresser, 251 U. S. 524 (1920); Milburn v. Martin, 190 Ark. 16, 76 S. W. 2d 952 (1934); Atherton v. Anderson, 86 F. 2d 518 (6th Cir. 1936).

Although subordinate officers are liable for negligent management, directors can take little comfort in that fact. Directors are always the first to be scrutinized when a corporation gets into trouble. Where a committee had made bad investments during the vacation period of the board of directors, the directors were held negligent even though it was shown that directors of like businesses took vacations at that time of the year. They were said to have assumed the risk of negligence while on vacation. The Supreme Court of New York reversed that decision as being too harsh with directors.[8] Generally speaking, however, the directors are liable for negligence through delegation of management powers to committees and subordinates followed by a lack of diligence in supervision of their activities. This was done by a Nebraska court which cited the reversed opinion of the lower New York court, above mentioned, to fix liability on the directors.[9] This aspect of management will be taken up more fully below.

The liability of officers is based on the principles of agency. They are considered agents of the corporation and not of the directors. When the courts describe the authority of corporate officers concerning general activities of management, they confine them strictly to agency rules. Thus older cases viewed the liability of subordinate officers for negligence as governed by the normal rules of agency and required the showing of gross negligence verging on fraud.[10] The modern trend, however, is to treat corporate officers as having a fiduciary relationship toward the corporation closer to that of trustees than to that of agents.[11] This gives rise to some hope for directors that in the future the risk of liability for negligence will be lowered by the process of spreading out the targets for suit.

Director's Relationship to the Corporation

To better understand the various views of a director's liability for negligent management, a look at what relation the

---

8 Kavanaugh v. Commonwealth Trust Co., 147 App. Div. 281, 131 N. Y. S. 1059 (1911).

9 Ashby v. Peters, 128 Neb. 338, 258 N. W. 639 (1935).

10 Cushman v. Cloverland Coal & Mining Co., 170 Ind. 402, 84 N. E. 759 (1908); Patterson v. Stewart, 41 Minn. 84, 42 N. W. 926 (1889); Devlin v. Moore, 64 Ore. 433, 130 P. 35 (1913).

11 Dwyer v. Tracey, 118 F. Supp. 289 (N. D. Ill. 1954); Electronic Development Co. v. Robson, 148 Neb. 526, 28 N. W. 2d 130 (1947); Murphy v. Hanlon, 322 Mass. 683, 79 N. E. 2d 292 (1948).

courts find between the directors and their corporation and stockholders is helpful. Negligence in any field of activity is difficult to define in precise terms of specific actions or inactions. The relation between the injured party and the wrongdoer plays a large role in determining the requirement of *duty*. This is especially true in corporate management, where the injured party is an artificial creature of the law.

The relationships determined by case law leave much to be desired. The cases seem to fall into no set pattern. The older opinions speak in general terms about directors being agents or trustees. Yet, in the same cases the final decisions rendered often are not specifically connected to either term.[12] There appears to have been realization that there is some fiduciary duty between the directors on the one hand and the corporation and stockholders on the other; but the older cases seemed unable to interpret this into general rules of law.

The same uncertainty, or at least questionable nomenclature, exists today. Most modern cases treat directors as having fiduciary duties "like" trustees, because they handle as their own property in which someone else has an interest.[13] This also applies to stockholders as a body.[14] The cases speak of a fiduciary duty owed to minority stockholders; but a stockholder cannot sue for negligent management where the corporation itself could not sue.[15]

Vague analyses and descriptive phrases about this relationship between the director and his corporation are numerous. But usually what is said in one case may cause difficulty to another court if that description is lifted from the context of facts about which the original court was speaking. As happens so often in negligence cases, each case must be considered in the light of its own circumstances. Perhaps one clarifying concept would be for the courts to recognize the double status which directors occupy. This status is well described by a noted text writer as follows:

> To sum up, directors and managing officers, in addition to their function as mere agents, occupy a double position of partial trust; they are *quasi* or *sub modo* trustees for the

[12] Slee v. Bloom, 20 Johns 669 (1838); Cumberland Coal & Iron Co. v. Parish, 42 Md. 598 (1875); Parker v. Nickerson, 112 Mass. 195 (1873).

[13] Hunt v. Cotton States Fertilizer Co., 159 F. 2d 52 (5th Cir. 1947); Palmer v. Chamberlin, 191 F. 2d 532 (5th Cir. 1951).

[14] 3 Fletcher, *op. cit. supra* note 1, at 173.

[15] Kaiser v. Easton, 151 Cal. App. 2d 307, 311 P. 2d 108 (1957).

corporation with respect to corporate property and they are *quasi* or *sub modo* trustees for the stockholders with respect to their shares of stock.[16]

Modern decisions and writers are pushing towards a stricter "trustee-like" relationship. In California the court has applied to corporate directors the same status that is applicable to technical trustees.[17] This is at least a clear designation, and will undoubtedly raise the standard of care required of directors.

The above description should not be lightly extended beyond the field of negligence. Other status-relationships are being employed between directors and their corporation when other aspects of corporate management are considered.[18]

Standard of Care

Negligence in corporate management is not treated very differently than in other activities. In order to find a person negligent, there must be some standard of behavior presupposed which the law requires to be maintained, and proof that this standard was not maintained.[19]

There are some areas of corporate management which the courts have scrupulously regarded as outside their scope of review with regard to setting a standard of care. One is the area of discretionary acts involved in the mechanics of operating a going business. Some writers classify this as the "Business Judgment Rule." The rule simply stated is that the courts will not second guess the directors.[20] To receive the benefit of this rule, all that is required is a showing by the directors that a positive decision to do something was made. If the complainant sets forth a better way of doing whatever was done, or that a possible course of action was not even considered by the directors, the court usually will merely state that the directors are not to be considered perfect and infallible. Also the courts

---

16 4 Pomeroy, Equity Jurisprudence 267 (5th ed. 1941); see Boyd v. Mutual Fire Ass'n., 116 Wis. 155, 94 N. W. 171 (1903).

17 2 Oleck, Modern Corporation Law 735 (1959), citing Calif. Civ. Code § 2230 as discussed in North Confidence Min. & Dev. Co. v. Fitch, 58 Cal. App. 329, 208 P. 328 (1922).

18 3 *Id.,* at 626, speaks of a "fairness" test rather than trustee status test.

19 Prosser, Law of Torts 124 (2d ed. 1955).

20 Casey v. Woodruff, 49 N. Y. S. 2d 625 (Sup. Ct. 1944); Otis & Co. v. Pennsylvania R. R., 61 F. Supp. 905 (E. D. Pa. 1946); McLeod v. Lewis-Clark Hotel Co., 66 Idaho 584, 164 P. 2d 195 (1945); Rous v. Carlisle, 261 App. Div. 432, 26 N. Y. S. 2d 197 (1941); Diston v. Loucks, 62 N. Y. S. 2d 138 (1941); Garvin v. Anderson, 334 Mich. 287, 54 N. W. 2d 667 (1952).

avoid substituting their own judgment on business matters or unduly interfering with the internal affairs of the corporation. There is sense to this, because if it were otherwise, a board of directors would be afraid to make a decision in a controversial matter. Modern problems of group decisions in corporate management are hard enough without making the courts a member of every group.

The idea of the rule is that the mere fact that a decision was made, providing that good faith is exercised by the directors, shows that at least some diligence was applied.[21] Recent decisions have limited this rule with respect to "good faith" decisions of directors. Where their actions are plainly illegal and where the penalty imposed for violation is more than any advantage gained, the rule is not applied.[22]

Another general aspect considered by the courts in determining a standard of care for directors is the size of the corporation. The law does not require the same degree of care to be exercised by directors of small family corporations as it does for large corporations.[23]

The type of business is also considered in determining a standard of care. Banking directors have been held to a higher standard of care than directors in other businesses.[24] This is probably due to the fact that stockholders of banks have been held personally liable for bank debts, and as a result, litigation against directors has suggested itself more readily than in ordinary businesses where stockholders are relatively safe. The trustee analogy has had its chief use in banking cases. The standard of care required by most courts is that degree of care ordinarily used by prudent bankers.[25] *Hun v. Cary*[26] is considered a leading case in determining a standard of care for directors. This was a banking case and the rule involved is considered to be stricter than that applied to directors of other corporations. The

---

21 Otis & Co. v. Pennsylvania R. R. Co., *supra* note 20.

22 Downing v. Howard, 162 F. 2d 654 (3rd Cir. 1947); Abrams v. Allen, 297 N. Y. 52, 74 N. E. 2d 305 (1947); Clayton v. Tarish, 191 Misc. 136, 73 N. Y. S. 2d 727 (1947).

23 Litwin v. Allen, 25 N. Y. S. 2d 667 (1940); Hughes v. W. O. Hughes Coal Co., 175 N. Y. S. 2d 478 (1957).

24 Litwin v. Allen, *supra* note 2; O'Conner v. Bankers Trust Co., 159 Misc. 920, 289 N. Y. S. 252 (1936); Gull v. Corwell, 118 W. Va. 263, 190 S. E. 130 (1937).

25 Litwin v. Allen, *supra* note 23.

26 82 N. Y. 65 (1880).

problem that was considered in this case was that of stating a standard of conduct that would not discourage people from becoming bank directors, nor yet leave depositors at the mercy of careless administration of their savings. A middle course was followed, which laid down the rule that directors must exercise the same degree of care and prudence which men of common prudence would ordinarily exercise in their own affairs. The analogy to trustees found in cases not involving banks is borrowed from banking cases.[27]

The degree of care required of the directors of ordinary business corporations has been stated in many ways. It is generally recognized that each case must be determined in view of all the circumstances of that particular case. What may be no negligence in one case may be actionable negligence in another.

The character of the company, the condition of its business and other relevant facts are taken into consideration. Thus, loaning of money without sufficient security has been held to be actionable negligence when done by directors of a life insurance company, and to be mere poor judgment when done by a loan company.[28]

There are two major views as to what standard of care the law requires. The majority view follows *Hun v. Cary*.[28a] Adoption of that case rule in non-banking cases has produced a rule which requires directors to exercise ordinary care and diligence over the appointment and supervision of corporate officers. As stated in the Uniform Business Corporation Act, Section 33[29]

> The degree of care . . . which ordinarily prudent men (prompted by self interest) would exercise under similar circumstances.

This statement follows the trend of the courts to find a trustee-like relationship between the corporation and directors. It affixes to directors the same responsibility over corporate management which they already have over their own affairs.

The other leading statement of a standard of care requires

---

27 Briggs v. Spaulding, 141 U. S. 132 (1891). This case is a landmark for determining director's liability. It is a banking case, but until recent years was cited in cases and texts as setting the standard of care for directors generally.

28 New Haven Trust Co. v. Doherty, 75 Conn. 555, 54 A. 209 (1903); Williams v. Fidelity Loan & Savings Co., 142 Va. 43, 128 S. E. 615 (1925); Winston v. Gordon, 115 Va. 912, 80 S. E. 756 (1914).

28a See *supra* note 26.

29 9 U. L. A. 186 (1957).

a lesser degree of diligence. It is that degree of care which is expected of ordinarily prudent directors of like business organizations. The usages of the particular business are considered. It is usually stated that, if a director discharges his duties in a manner ordinarily performed by directors of like businesses in that area, he cannot be held guilty of negligence.[30] In jurisdictions following this standard of care, it appears that they do not follow the trustee analogy closely but rather follow the agency type of relationship. This approach seems to be giving way to the higher standard, as there are few recent cases following this rule.[31]

When an opinion states that a factor to be considered is "the spirit of the times," this plainly demonstrates the need for careful analysis of each case before relying on the rules there applied.[32] Therefore, the specific actions which will render directors liable cannot be stated. Some overall aspects of directorship can be discussed with regard to negligence. Thus, ignorance of corporate affairs may render a director liable. In the general supervisory position which he occupies he must keep himself informed of not only the state of business, but also of the activities of the top management of the company. If subordinate officers cause harm to the corporation either through their own negligence or by actual fraud, and the directors could have stopped them, the directors are held to have been negligent when reasonable investigation would have brought such action to light. The director cannot plead ignorance in order to escape liability, because this would put a premium on inactivity. A director is chargeable with any knowledge which would have come to him had he paid reasonable attention to the activities of his subordinates.[33]

Delegation of authority is necessary in the situation of a director, but he is held to have a duty of reasonable supervision. Even jurisdictions following the theory of "agency and gross negligence for liability" have closely scrutinized directors of a corporation in which officers have been loosely supervised. In general, it will be found that the failure of directors to use

---

30 Devlin v. Moore, *supra* note 10.

31 Keck Enterprises v. Braunschweiger, 108 F. Supp. 925 (S. D. Cal. 1952).

32 Williams v. Fidelity Loan & Savings Co., *supra* note 28; Mann v. Commonwealth Bond Corp., 27 F. Supp. 315 (S. D. N. Y. 1938).

33 Van Schaich v. Aron, 170 Misc. 520, 10 N. Y. S. 2d 550 (1939); Cameron v. Kenyon-Connally Commercial Co., 22 Mont. 312, 56 P. 358 (1899).

ordinary care in supervision is viewed as equal to gross neglect of duty.[34]

In banking cases, the theory of imputed knowledge is carried further. In many cases, the president of the bank is left in general charge of the business and has held a position of high trust and confidence for many years. Under these circumstances, the directors will have imputed to them the knowledge of the activities of the president who has done some unauthorized act. In order to protect a third party, the court imputes the knowledge of the unauthorized act to the directors, and then under rules of agency holds that a ratification has taken place or that an apparent agency has been created.[35] These cases may not always be negligence suits, but when the company has lost money through an unauthorized act of a subordinate officer and ratification by neglect is determined, the door is left wide open for a negligence suit against the directors.

Again relying on the rules of agency, the courts have restricted the application of the theory of imputed knowledge. In cases where a special agent hired for a particular purpose has exceeded his authority, the directors are freed from liability on the basis that no apparent authority could be found. Something must put the directors on notice that there is need of their special interest.[36] A recent case has held that when an unauthorized act was reported to the board of directors in a casual manner, no duty upon the individual directors to elicit further facts could be compelled. In this case there was no retention of any benefits of the alleged unauthorized act.[37] A dissent in that case stated that the directors should have been held to know of the unauthorized act through the theory of imputed knowledge, which would amount to treating their inaction as ratification.

Another limitation on the theory of imputed knowledge is made indirectly by the rules of evidence. The accounts and books of a corporation are not *per se* competent evidence on behalf of the corporation in an action against the directors.[38]

---

34 McEwen v. Kelly, 140 Ga. 720, 79 S. E. 777; Griffon v. State, 142 Ga. 636, 83 S. E. 540 (1914); Woodward v. Stewart, 149 Ga. 620, 101 S. E. 749 (1919).

35 Martin v. Webb, 3 S. Ct. 428, 110 U. S. (1884).

36 Edlestone v. Salmon Falls Mfg. Co., 84 N. H. 315, 150 A. 545 (1930).

37 Home Savings Bank v. Gerstenback, 270 Wis. 386, 71 N. W. 2d 347 (1955).

38 Rudd v. Robinson, 126 N. Y. 113, 26 N. E. 1046 (1891).

It would be a dangerous rule to place the burden of close examination of all book entries upon the directors.

The same treatment as above is given to individual directors in cases in which misconduct is charged. The individual director is not chargeable with the loss resulting from the misconduct of other directors unless he had knowledge of such conduct or through his neglect did not know of it.[39] In negligence suits a broad charge of negligence against the board of directors, without charging neglect against an individual director, will be held to be insufficient.[40]

Volumes could be written on the various situations upon which a court could find directors liable for negligence. We speak here only of the general type of supervising management with which directors are most often charged. Most factual situations can be placed under the broad headings of business judgment, attentiveness to corporate affairs, and duty to fellow directors. There is no general rule, which, when followed by a director, will absolve him of liability. Only by exercising honest positive action, using the ordinary intelligence with which he is endowed, can he feel in some way secure. Even if wrong in business, he may at the same time be right in law.

Remedies, Summarized

The chief means of recovery of damages to a corporation through negligence of its management is a stockholder's derivative suit brought in behalf of the corporation. The cause of action usually belongs to the corporation[41] and it is the real party in interest.[42] The corporation is, therefore, a necessary party and must be joined.[43] Since the type of action is brought in a representative capacity by the stockholder, he must show either that the corporation has refused or neglected his demand that it sue in its own behalf or show facts which clearly indicate that such request would have been useless.[44]

The suit is brought in equity, since this type of suit was an invention for want of an adequate remedy at law to redress the

---

39 3 Fletcher *op. cit. supra* note 1, at 639.

40 Fisher v. Graver, 80 F. 590 (S. D. N. Y. 1897).

41 Kavanaugh v. Commonwealth Trust Co., 181 N. Y. 121, 73 N. E. 562 (1905).

42 Rettinger v. Pierpont, 145 Neb. 161, 15 N. W. 2d 393 (1944).

43 Fanchon & Marco v. Paramount Pictures, 202 F. 2d 731 (2d Cir. 1953).

44 Kavanaugh v. Wetmore, 103 App. Div. 95, 92 N. Y. S. 543 (1905).

breach of a fiduciary duty by corporate managers.[45] If there is also an issue which requires a jury and which involves an action at law in addition to the equitable right, under modern liberal rules of practice they may be brought together or separately.[46]

This last point has caused difficulty, for example with regard to the defense of the statute of limitations. It has been held in Ohio that although the derivative action by a stockholder is in equity, the suit if brought by the corporation would have been one at law and thus the statute of limitations applicable to actions at law applies and not the statute applicable to equity.[47]

In order to hold directors liable for negligence, the basis of liability, that is specific conduct producing the loss, must be stated in the pleading with accuracy and clearness. There must be specific allegations against named directors, or else the petition is demurrable.[48] Negligence in general, or simple conclusions that the business was negligently managed, are insufficient.[49]

Judge Learned Hand gave a good review of the requirements necessary in the pleading and proof of a negligence suit against corporate directors in *Barnes v. Andrew*.[50] There must be an existence of a duty; a specific showing of negligence in performing that duty; and a specific loss incurred through such negligence which would have been avoided if reasonable diligence had been observed. The burden of proof of all the points is on the one alleging the negligence.[51]

Modern statutes, while mostly not creating any new liabilities of directors, have broadened the class of people able to sue, but negligence must still be shown in the same manner as at common law.[52]

The common law has generally refused to permit the corporation to pay the legal fees of directors when they have suc-

---

[45] Fanchon & Marco v. Paramount Pictures, *supra* note 43.

[46] *Ibid.*

[47] Jensen v. Republic Steel Corp., 32 Ohio L. Ab. 29 (1939).

[48] American Life Insurance Co. v. Powell, 262 Ala. 560, 80 S. 2d 487 (1955).

[49] *Ibid.*

[50] 298 F. 614 (S. D. N. Y. 1924).

[51] *Ibid.*

[52] Fletcher, *op. cit. supra note* 1, at 880.

cessfully defended themselves in a mismanagement suit. However, many state statutes now permit the corporation to reimburse them. Provisions to this effect also may be found in the by-laws of the company.[53] "Security for suit expense" statutes also are involved in some states.[54]

The matters of pleading and practice in stockholders' actions are too complex to warrant treatment here.[55]

Summary

While by no means exhaustive, this article recounts the main issues involved in negligent management situations. The law appears to be tending to enforce higher standards on the part of directors. Since modern business, in the main, is done by large corporations to which great numbers of people of modest means have entrusted their savings, this direction of the law is to the benefit of modern society.

---

[53] Bishop, Current Status of Corporate Directors, Right to Reimbursement, 69 Harv. L. R. 1062 (1956).

[54] 3 Oleck, Modern Corporation Law 663 (1959).

[55] See texts, such as 3 Oleck, Modern Corporation Law, chap. 63 (1959).