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DEGREE OF DILIGENCE A DIRECTOR MUST EXERCISE TO AVOID LIABILITY TO THE CORPORATION

"A corporation is an imaginary being. It has no mind but the mind of its servants; it has no voice but the voice of its servants; and it has no hands with which to act but the hands of its servants. All its schemes of mischief, as well as its schemes of public enterprise, are conceived by human minds and executed by human hands; and these minds and hands are its servants' minds and hands."¹ A corporation can, therefore, act only through the agency or intervention of human beings. Directors are the exclusive, executive representatives of the corporation, and in them is vested the management of the ordinary corporate affairs.² While directors are often spoken of as trustees of the corporation,³ their true relation to it is that of its agents. The Court in *Wallace vs. Lincoln Sav. Bank*, 89 Tenn. 630, 15 S. W. 488, says:

Directors are not express trustees. The language of Special Judge Ingersol in *Shea vs. Mabry*, 1 Lea (Tenn.) 319, that "directors are trustees," etc., is rhetorically sound, but technically inexact; it is a statement often found in opinions, but is true only to a limited extent. They are mandatories; they are agents; they are trustees in the sense that every agent is a trustee for his principal, and bound to exercise diligence and good faith; they do not hold the legal title and more often than otherwise are not the officers of the corporation having possession of the corporate property; they are equally interested with those they represent; they more nearly represent the managing partners in a business firm than a technical trustee. At most they are implied trustees in whose favor the statutes of limitations do run.⁴

The directors as executive agents of the corporation, like all agents, occupy a fiduciary relation demanding obedience, diligence and good faith, and, if they are guilty of misfeasance or malfeasance, the corporation may at once bring an action at law to enforce any such violation of duty.

This article will be confined to a discussion of the obligation of directors to exercise diligence in the performance of their duties, with special reference to what degree of care and diligence they must exercise to avoid liability to the corporation for losses sustained through their negligence.

¹ *Goddard vs. Grand Trunk Ry. of Canada*, 57 Me. 202, 2 Am. Rep. 39.

² *McKee vs. Chautauqua Assembly*, 130 Fed. 536.

³ *Cook vs. Berlin Woolen Mill Co.*, 43 Wis. 433.

⁴ See article "Relation of the Directors to the Corporation and the Stockholders"; 5 *Marquette Law Rev.*, 169.

RULES OF AGENCY APPLICABLE TO DIRECTORS

In general it may be said that all the rules applicable to the liability of agents to their principals apply to directors as agents of the corporation. Says Hamersly, J., in *New Haven Trust Co. vs. Doherty*, 75 Conn. 555, 54 Atl. 209, 96 Am. St. Rep. 239:

A director of a stock corporation when acting for it in the conduct of its business, is its agent. . . . Like every agent, he may be personally responsible to his principal for negligence or misconduct in conducting the business intrusted to him. . . . But there is no general rule of liability for wrongful neglect in the exercise of such agency, applicable to directors as a class by themselves independently of the law which prescribes and defines the duties and liabilities of agents. The duties and liabilities of directors must depend in each case upon the terms of their agency and the particular circumstances of the case.

Pinney, J., in *North Hudson Mut. Building and Loan Ass'n vs. Childs*, 82 Wis. 460, 52 N. W. 600, says:

The liability of officers to the corporation for damages caused by negligent or unauthorized acts rests upon the common-law rule which renders every agent liable who violates his authority or neglects his duty to the damage of his principal.

According to the law of agency, an agent receiving compensation must exercise ordinary care; a gratuitous agent or one serving without pay is only required to exercise slight care or as it is sometimes stated he is only liable for gross negligence. If, however, a person, such as a physician or lawyer, holds himself out to the public as possessing special skill, he must exercise ordinary care and skill in every case of which he assumes the charge, whether in the particular case he has received compensation or not.

A director or other fiduciary officer of a corporation presumptively serves without compensation, and, in the absence of an express contract, he cannot recover for services performed on an implied contract.⁵ Hence, a director may generally be considered as a gratuitous agent.

In the United States there are three lines of authority as to the degree of care a director must exercise to avoid liability.

First, in a few states, a director like a gratuitous agent is only obliged to exercise slight care.

Second, in about ten states, directors, considered in the light of agents undertaking to perform acts requiring special skill and

⁵ *Lowe vs. Ring*, 123 Wis. 370.

knowledge, are bound to manage the affairs of the corporation using ordinary care defined as the same degree of care and prudence which is generally exercised by business men in the management of their own affairs, regardless of whether they are gratuitous directors or receive compensation for their services.

Third, in most of the states, directors must exercise ordinary care defined as that degree of care which ordinarily prudent men would exercise under similar circumstances.

SLIGHT CARE AS A TEST OF THE CARE DIRECTORS MUST EXERCISE

The courts have in many instances attempted to define the degree of diligence required of directors and other corporate officers, to absolve them from liability for negligence. Diligence may be defined as "such care and prudence as is usually exercised by persons of common or average care and prudence, measured in any given case by the circumstances, and the graver, more important or valuable the interests involved, and the more imminent the peril, the more is the vigilance required to constitute diligence."⁶ The degree of care depends on the nature of the trust, duty or subject in hand. Hence, if the trust confided, or duty imposed, require delicate handling or skilful manipulation, the requisite degree of diligence rises in proportion to the delicacy which attends the service.

A greater watchfulness and care are required in the proper custody and preservation of a diamond, than need be bestowed on chattels of ordinary value; greater skill and diligence are exacted in the driving of a steam-locomotive than in driving an ordinary road-wagon.⁷ Furthermore, what would be slight neglect in the care exercised in managing an ordinary corporation might be gross neglect in the management of a savings bank intrusted with the savings of a multitude of poor people, depending for its life upon credit and liable to be wrecked by the breath of suspicion.⁸ And hence, what would amount to the requisite diligence at one time, in one situation, and under one set of circumstances, might not amount to it at another. Whether a given statement of facts constitutes negligence is generally a question to be determined by a jury, or by a court exercising the functions of a jury; and it is difficult in most cases, to decide in advance, or to

⁶ *Diligence*, 18 C. J., Page 1039.

⁷ *Carter vs. Chambers*, 79 Ala. 223, 230.

⁸ *Hun vs. Cary*, 82 N. Y. 65, 37 Am. Rep. 546.

formulate tests for deciding as a matter of law, whether directors or other officers have been guilty of that degree of negligence which will render them liable to the corporation.

All courts agree on the following propositions:

First, that a director is not bound to exercise the highest possible degree of care—a rule applicable to all agents.⁹ A director, however, may be obliged to exercise the greatest possible degree of care if he expressly agrees to do so.

Second, that a director in the exercise of his discretionary power as a director is not liable for an error of judgment. In the language of Mr. Morawetz: "Directors merely undertake to make honest use of such judgment as they possess. They do not insure the correctness of their judgment; and they cannot be charged with the consequences of an honest error of judgment or accidental mistake in the exercise of their discretionary powers."¹⁰

Third, that a director is liable in any event for gross negligence resulting from failure to exercise slight care.

A gratuitous agent or a gratuitous bailee is only liable for gross negligence. And a few courts applying these rules of agency and bailments hold that a director should not be held to a greater degree of care inasmuch as directors *prima facie* serve without compensation, and, therefore, are in fact gratuitous agents or mandataries. "These directors serve without pay. They were selected by their fellow stockholders to manage gratuitously the affairs of the association in which they and the other stockholders were jointly interested. * * * When they have acted fairly, and have not been guilty of gross neglect or gross inattention, they should not be held liable. The rule applicable to mandataries is sufficiently stringent for such cases, and is a reasonable one. They should be held liable only in case of fraud, gross negligence or misuser."¹¹

It appears that the term "gross negligence" is not uniformly interpreted. By "gross negligence" some courts intend to signify no more than want of that care and attention which men of common prudence ordinarily give to their affairs,¹² while other courts understand the same words as implying that degree of in-

⁹ I *Mechem*, Agency (2nd Ed.), Sect. 1278.

¹⁰ I *Morawetz*, Corporations, Sec. 553.

¹¹ *Citizens' Building, Loan and Savings Ass'n vs. Coriell*, 34 N. J. Eq. 383, 392.

¹² *Hum vs. Cary*, Supra.

attention and want of care indicative either of wilful recklessness, or intent to defraud or permit others to defraud.¹³ Allow me to quote Justice Lumpkin in *McEwen vs. Kelly*, 140 Ga. 720, 79 S. E. 777:

Some courts have declared that they are only liable for gross negligence or breach of duty resulting in injury. But in some, probably most, of the cases so declaring, it will be found that the failure of directors to use ordinary care in supervision has been treated as amounting to gross negligence.

CARE REQUIRED AS THAT WHICH MEN OF ORDINARY PRUDENCE
EXERCISE IN REGARD TO THEIR OWN AFFAIRS—
THE NEW YORK RULE

In most jurisdictions directors must exercise ordinary or reasonable diligence to avoid liability. Ordinary diligence has been defined as that degree of care and prudence which a discreet and cautious person would use in his own affairs were the whole loss or risk to be his own; or such diligence as an ordinary prudent and diligent person would exercise under similar circumstances.¹⁴ The Wisconsin Supreme Court defines ordinary care as such care as the great mass of mankind ordinarily use in the same or similar circumstances; and ordinary negligence as the want of such care as men of ordinary prudence observe in and about their affairs, or in other words, the want of such care as the great mass of mankind observe under similar circumstances.¹⁵

In the law of agency, bailments and negligence in general, it appears that there is no difference between the ordinary care which a careful person exercises in his own affairs and the ordinary care which a cautious person employs under similar circumstances.

As applied to the care which directors must exercise, ordinary care defined as that care which a prudent man would exercise under similar circumstances is a greater degree of care than slight care, but not so great a degree of care as that ordinary care which a cautious person would exercise in the conduct of his own affairs.

Permit me to quote Judge Earl in *Hun vs. Cary*, 82 N. Y. 65, 37 Am. Rep. 546:

That trustees of corporations are bound to use some diligence in the discharge of their duties cannot be disputed. All the authorities so hold.

¹³ *King vs. Livingston Mfg. Co.*, 192 Ala. 269, 277, 68 S. 897.

¹⁴ *Diligence*, 18 C. J., p. 1040.

¹⁵ *Dreher vs. Fitchburg*, 22 Wis. 675.

What degree of care and diligence are they bound to exercise? Not the highest degree, not such as a very vigilant or extremely careful person would exercise. If such were required, it would be difficult to find trustees who would incur the responsibility of such positions. It would not be proper to answer the question by saying the lowest degree. Few persons would be willing to deposit money in savings banks, or to take stock in corporations, with the understanding that the directors were bound only to exercise slight care, such as inattentive persons would give to their own business, in the management of the large and important interests committed to their hands. When one deposits money in a savings bank, or takes stock in a corporation, thus divesting himself of the immediate control of his property, he expects and has a right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trusts committed to them—the same degree of care and prudence that men prompted by self interest generally exercise in their own affairs. When one voluntarily takes the position of trustee or director of a corporation, good faith, exact justice, and public policy unite in requiring of him such a degree of care and prudence, and it is a gross breach of duty—*crassa negligentia*—not to bestow them.

If a director is recompensed for his services he must exercise that ordinary care which an agent of a private person would use. On principle it would seem that a gratuitous director should be held to that same degree of care. It requires special skill and knowledge to adequately perform the duties of a director just as it requires special skill and knowledge to perform the duties of a doctor or lawyer. Professional men in general must exercise the ordinary skill of professional men in their particular line of endeavor to escape liability regardless of whether they are paid or not. Persons are under no obligation to become directors of a corporation. If they voluntarily accept the responsibilities of directors, they impliedly assume that they have the requisite degree of skill and knowledge to properly perform the duties of directors, and that they will use ordinary care in such performance. Allow me to quote Judge Earl in *Hun vs. Cary*, *supra*, at page 74:

One who voluntarily takes the position of director, and invites confidence in that relation, undertakes, like a mandatory, with those whom he represents or for whom he acts, that he possesses at least ordinary knowledge and skill, and that he will bring them to bear in the discharge of his duties. Such is the rule applicable to public officers, to professional men and to mechanics, and such is the rule which must be applicable to every person who undertakes to act for another in a situation or employment requiring skill and knowledge; and it matters not that the service is to be rendered gratuitously.

From their quasi public position, and the magnitude of the interests committed to their care, there would be no impropriety in exacting of directors a higher degree of prudence and care than that which is required of the agents of private persons. This, however, has not been done in any of the decided cases. The farthest that any of the cases go is to require of directors substantially the same degree of attention, prudence and skill that would be expected if they had agreed to perform duties of like nature for private persons.¹⁶ Among the states that follow this rule are Iowa, Maryland, Michigan, Minnesota, New Jersey, Rhode Island, Texas, Utah and Virginia.¹⁷

CARE REQUIRED OF DIRECTOR AS THAT OF ORDINARILY PRUDENT
MAN UNDER SIMILAR CIRCUMSTANCES—THE
WISCONSIN RULE

On the other hand, it is held in the Federal courts, in Wisconsin, and in most of the states, that the degree of care required of a director is not the same ordinary care that he takes of his own affairs but is the ordinary care of a director of a corporation in a like business, or, as it is generally put, the degree of care an ordinarily prudent man would exercise under similar circumstances. Judge Sharswood in *Spering's Appeal*, 71 Penn. St. 11, 20, says:

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. . . . But it is evident that gentlemen selected by the stockholders from their own body ought not to be judged by the same strict standard as the agent or trustee of a private estate.

In *Rankin vs. Cooper*, 149 Fed. 1010, the care required of directors was laid down as follows:

It is the duty of directors of a national bank to exercise reasonable control and supervision over its affairs, and to use ordinary care and diligence in ascertaining the condition of its business, which is such care as an ordinarily prudent and diligent man would exercise in view of all the circumstances.

Directors of a national bank are not insurers of the fidelity and proper conduct of its executive officers, and are not responsible for losses resulting from the wrongful acts or omissions of such officers, provided they have exercised ordinary care in the exercise of their own duties as directors.

¹⁶ See Note in 17 Am. St. Rep. 95.

¹⁷ 4 *Fletcher Cyclopaedia Corporations*, Par. 2450.

If nothing has come to the knowledge of the directors of a national bank to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution, is all that is required of them, but if, on the other hand, they know, or by the exercise of ordinary care should know, any facts which should awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the danger to be avoided is required, and a failure to exercise such care makes them responsible.

Directors of a national bank are not expected to watch the routine of every day's business, but they should have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally know of and give direction to its important and general affairs.

In *Swentzel vs. Penn. Bank*, 147 Pa. St. 140, 23 Atl. 145, it was held that "the degree of care required of bank directors who receive no compensation for their services and whose principal business is to assist in discounting paper is not that which they take of their own affairs but the ordinary care of bank directors in the business of the bank."

In the leading case of *North Hudson Mutual Building and Loan Ass'n vs. Childs*, 82 Wis. 460, at page 476, Judge Pinney lays down the Wisconsin rule:

That as they (*directors*) render their services gratuitously, they are not to be held to the degree of responsibility of bailees for hire, or expected to devote their whole time and attention to their duties; that they are not, in the absence of any element of positive misfeasance, and solely on the ground of passive negligence, to be held liable, unless their negligence is gross or they are fairly subject to the imputation of a want of good faith.

It is to be remembered that they have the same interests to protect and subserve as other stockholders, and self-interest naturally prompts them to look after their own, and the degree of care they are bound to exercise is that which ordinarily prudent and diligent men would exercise under similar circumstances in respect to a like gratuitous employment, regard being had to the usages of business and the circumstances of each particular case; that they are not liable, in the absence of fraud or intentional breach of trust, for negligence, mistakes of judgment, and bad management in making investments on doubtful or insufficient security. Where they have not profited personally by their bad management, or appropriated any of the property of the corporation to their own use, courts of equity treat them with indulgence. Were a more rigid rule to be applied, it would be difficult to get men of character and pecuniary responsibility to fill such positions. These views are applicable, we think, to the case of all officers serving and acting within the scope of their authority gratuitously or practically so. The rule of liability in case of service for reward is well understood, and need not be repeated.

In *Killen vs. Barnes*, 106 Wis. 546 at page 574, the Court speaking through Judge Marshall, by way of *dicta*, considers the foregoing rule as too lenient. The Wisconsin rule is declared to be as liberal, if not the most liberal rule, that can be found in the books. The rule laid down in *North Hudson Mut. Bldg. and Loan Ass'n vs. Childs*, *supra*, however, is affirmed under the doctrine of *stare decisis*.

In summary it may be concluded that: 1. Directors more nearly resemble agents than trustees of the corporation. 2. As such, the rules of agency in general apply to them. 3. In three or four states, directors are liable only for gross negligence. 4. In New York and a few other states directors, to escape liability, must exercise that diligence which the ordinary prudent man gives to his own affairs. This it is submitted, appears to be the best reasoned and the logical rule. 5. In Wisconsin and the majority of the states, directors are not held to such a strict rule; they are bound only to exercise that care which an ordinary cautious man would exercise under similar circumstances.

ROBERT J. KELLER, '24.