1990

The Corporate Director's Duty of Care: Riddles Wisely Expounded

Norwood Beveridge

THE CORPORATE DIRECTOR'S DUTY OF CARE: RIDDLES WISELY EXPOUNDED*

By Norwood P. Beveridge, Jr.†

I. INTRODUCTION

The following standards for personal liability of corporate directors have been propounded within recent years:

New Jersey: Ordinary Negligence

"Thus, recognition of a duty of a director to those for whom a corporation holds funds in trust may be viewed as another application of the general rule that a director's duty is that of an ordinary prudent person under the circumstances."[1]

Delaware: Gross Negligence

"We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[2]

Texas: Fraud

"Texas courts to this day will not impose liability upon a noninterested

---

* Child, *The English and Scottish Popular Ballads*, Ballad 1 at 1 (1882).

† Associate Professor of Law, Oklahoma City University. A.B., LL.B., Harvard; LL.M., New York University. Professor Beveridge is a former member of the American Bar Association Committee on Corporate Law Departments and Chief Legal Officer of a New York Stock Exchange listed manufacturing corporation. This article was made possible by a research grant from the Kerr Foundation at Oklahoma City University. The author gratefully acknowledges the constructive counsel of Assistant Professor John W. Teeter, Jr., of St. Mary's University of San Antonio School of Law and the research assistance and advice of Margie R. Dickinson, Esq. of the California Bar.

1. Francis v. United Jersey Bank, 87 N.J. 15, 37, 432 A.2d 814, 825 (1981). The court was applying New Jersey law to a New York corporation. *Id.* at 27-28, 432 A.2d at 820. The two states have virtually identical statutory standards; the New Jersey statute provides as follows: "Directors and members of any committee designated by the board shall discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent people would exercise under similar circumstances in like positions." N.J. STAT. ANN. § 14A: 6-14(1) (West Supp. 1991); *compare* N.Y. BUS. CORP. L. § 717(a) (McKinney Supp. 1991). This is the most common statutory formulation, following the Revised Model Business Corp. Act § 8.30 (1984). Some states, such as Delaware, do not have a statutory standard. *See* E. BRODSKY & M. ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES, AND LIABILITIES § 2.04 (1984 & 1991 Cum. Supp.) (listing state standards).

2. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (citing Aronson v. Lewis, 473 A.2d 805 (Del. 1984)). A few years earlier, two of the most expert observers of the corporate scene had concluded that Delaware law did not require a finding of gross negligence. *See* Arsht & Hinsey, *Codified Standard—Same Harbor but Charted Channel: A Response*, 35 BUS. LAW. 947, 950 (1980).

corporate director unless the challenged action is ultra vires or is tainted by fraud."[3]

This perplexing conflict in standards for the conduct of corporate directors has existed for as long as anyone can remember. It is made more mystifying, if possible, by the long-standing conclusion of the experts that it is irrelevant which standard is applied since courts always reach the same result under the facts.[4]

The fact that even in the same jurisdiction there is no clear understanding of the applicable standard is less tolerable. The ALI Corporate Governance Project includes New York and Delaware as two of the states in which the case law is unclear as to the duty of care standard.[5] Even though Delaware has now explicitly adopted the gross negligence standard, its meaning is still undefined.[6] Furthermore, the Court of Chancery of Delaware has announced that while gross negligence is the standard to be applied to director deliberations and decisions, ordinary negligence is the standard to be applied to director inaction.[7]

The purpose of this article is to supply a means for the translation of these ancient expressions — ordinary negligence, gross negligence, and fraud — into modern English. While it is impossible to reconcile all of the authorities, two propositions emerge from an examination of three hundred years of legal history. The first of these is: 1. When the term "gross negligence" is used in the context of director liability, its common

3. Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984). Only two years earlier in Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1982), *cert. denied*, 464 U.S. 920 (1983), the same court had held that Texas law required a corporate director to exercise the care of a person of ordinary prudence under the circumstances. *But see* Comment, *Director Liability Under the Business Judgment Rule: Fact or Fiction?*, 35 Sw. L.J. 775, 798-99 (1981) (concluding that fraud is required in Texas). This comment later influenced the court in Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707 (5th Cir. 1984). *Id.* at 719 n.5; *see also* Stern v. General Elec. Co., 924 F.2d 472 (2d Cir. 1991) (fraud or bad faith must be alleged under New York law to overcome the business judgment rule).

4. *See* H. BALLANTINE, BALLANTINE ON CORPORATIONS 157-59 (1946). Professor Ballantine's observations are repeated not only from the earlier edition of his book, BALLANTINE ON CORPORATIONS 360-62 (3d ed. 1927), but also from an earlier work, W. CLARK & W. MARSHALL, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 2273-76 (1901). *See also* Veasey & Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 928 (1980). The American Law Institute (ALI) reached the same conclusion in 1985. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 14 (Tent. Draft No. 4, Apr. 12, 1985) (same legal result would be reached under each of these formulations).

5. American Law Institute, *supra* note 4, at 33, 41.

6. *See* Note, *Evaluating the New Director Exculpation Statutes*, 73 CORNELL L. REV. 786, 792 (1988). *See generally* Veasey & Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483 (1985).

7. Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 972 (Del. Ch. 1986), *reargument denied*, 13 DEL. J. L. CORP. L. 1210, 1217 (Del. Ch. Dec. 17, 1987).

and usual meaning is failure to use the care of an ordinarily prudent person under the circumstances. It is, in other words, the same standard as that which is usually referred to as "ordinary negligence."

The reasons for this situation will be explained later, but the truth of the proposition itself has been acknowledged many times. For example, in the venerable case of *Hun v. Cary*,[8] the New York Court of Appeals stated that, "It is true that authorities are found which hold that trustees [directors] are liable only for *crassa negligentia*, which literally means gross negligence; but that phrase has been defined to mean the absence of ordinary care and diligence adequate to the particular case."[9]

The same rule was announced by the Supreme Court of Tennessee a decade later in *Wallace v. Lincoln Savings Bank*.[10] The *Wallace* court stated, "The diligence required from them [directors] has been defined as that exercised by prudent men about their own affairs, being that degree of diligence characterized as 'ordinary.' If a less degree of diligence is exercised, the negligence is gross, and for losses consequent he is liable."[11]

The second proposition has the same origins as the first, concerning what is meant by "fraud" in the area of director liability. Fraud is an intentional tort in its common-law sense and, therefore, irrelevant to director liability for negligence, an unintentional tort. However, constructive fraud is not an intentional tort, and the second proposition may therefore be stated as follows: 2. When the term "fraud" is used to refer to director negligence, it is used in the sense of constructive fraud, not a standard separate from the gross negligence standard, but a part of it, as in the phrase *culpa lata dolo aequiparatur*.[12]

With these two propositions established, this article will examine the historical underpinnings of standards for director conduct and their significance for modern corporation law.

---

8. 82 N.Y. 65, 37 Am. Rep. 546 (1880).

9. *Id.* at 72, 37 Am. Rep. at 548-49.

10. 89 Tenn. 630, 15 S.W. 448 (1891).

11. *Id.* at 652-53, 15 S.W. at 454; *accord* Warren v. Robison, 19 Utah 289, 57 P. 287 (1899) (ordinary care standard). The observation that gross negligence means ordinary negligence in the director liability cases was made in S. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS 279-80 (2d ed. 1909) and in Note, *Liability of the Directors of a Corporation to the Corporation*, 55 L.R.A. 751, 754 (1902). It is also noted in 3A FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1034, at 30 (perm. ed. 1986). Professor Dyson treats this as confusion, but its roots go deeper. Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 375 (1965).

12. Gross negligence is held equivalent to intentional wrong. BLACK'S LAW DICTIONARY 379 (6th ed. 1990). *See* Gimbel v. Signal Cos., 316 A.2d 599, 610 (Del. Ch.), *aff'd per curiam*, 316 A.2d 619 (Del. 1974).

II. Mandataries and Gratuitous Bailees

The concept of gross negligence arose in the law of mandataries and gratuitous bailees,[13] to whom corporate directors, usually uncompensated at that time, were likened in many of the nineteenth century cases.[14] The seminal case in this area was *Coggs v. Bernard*,[15] in which the defendant had undertaken, without compensation, to move casks of brandy belonging to the plaintiff and then had negligently broken a cask, spilling the brandy. Lord Holt took the occasion to announce six distinct species of bailment and the rules for liability in each, although only the sixth species was *sub judice*. In speaking of the liability of the gratuitous bailee-depositary, Lord Holt opined as follows:

> As to the first sort, where a man takes goods in his custody to keep for the use of the bailor, I shall consider, for what things such a bailee is answerable. He is not answerable, if they are stole without any fault in him, neither will a common neglect make him chargeable, but he must be guilty of some gross neglect. . . . For if he keeps the goods in such a case with an ordinary care, he has performed the trust reposed in him. . . . For if he keeps the goods bailed to him, but as he keeps his own, though he keeps his own but negligently, yet he is not chargeable for them, for the keeping them as he keeps his own, is an argument of honesty. . . . So that a bailee is not chargeable without an apparent gross neglect. And if there is such a gross neglect, it is looked upon as an evidence of fraud. . . . [I]f the bailee be guilty of gross negligence, he will be chargeable, but not for any ordinary neglect.[16]

---

13. *See generally* Elliot, *The Three Degrees of Negligence*, 6 S. Cal. L. Rev. 91 (1933); Green, *High Care and Gross Negligence*, 23 Ill. L. Rev. 4 (1929); Green, *The Three Degrees of Negligence*, 8 Amer. L. Rev. 649 (1874).

14. *See* Briggs v. Spaulding, 141 U.S. 132 (1891); Dunn's Adm'r v. Kyle's Ex'r, 77 Ky. (14 Bush) 134 (1878) (mandataries); Swentzel v. Penn Bank, 147 Pa. 140, 23 A. 405 (1892) (gratuitous mandataries); Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829) (agents or mandataries); Citizens Build. Loan & Sav. Assoc. v. Coriell, 34 N.J. Eq. 383 (1881) (mandataries); 7 Ruling Cases *Corporations*, § 455, at 475-76 (1896); G. Reinhard, A Treatise on the Law of Agency in Contract and Tort 207 (1902); T. Shearman & A. Redfield, A Treatise on the Law of Negligence 449-50 (W. Hein 2d ed. 1980) (4th ed. 1888) (trustees and gratuitous bailees); S. Thompson, *supra* note 11, at § 1267, at 268-69.

15. 2 Ld. Raym. 909, 92 Eng. Rep. 107 (K.B. 1703).

16. *Id.* at 914-16, 92 Eng. Rep. at 110-11. *Coggs v. Bernard* repudiated the holding in Southcote's Case, 76 Eng. Rep. 1061 (K.B. 1601), in which the court held that the gratuitous bailee was an insurer against theft unless he had had the foresight to take the goods only by a special acceptance to keep them as safe as he would his own. Lord Gould opined in *Coggs* that this was "a thing no man living that is not a lawyer could think of." 2 Ld. Raym. at 911, 92 Eng. Rep. at 107-08. Lord Powell agreed with Lord Gould, saying, "There are many lawyers don't know that difference, or however it may be with them, half mankind never heard of it." *Id.* at 913, 92 Eng. Rep. 109. The six sorts of bailments are catalogued as follows:

> The first sort of bailment is, a bare naked bailment of goods, delivered by one man to another to keep for the use of the bailor; and this I call a depositum, and it is that sort of bailment which is mentioned in *Southcote's [C]ase*. The second sort is, when goods or chattels that are useful, are lent to a friend gratis, to be used by him; and this is

There is more than one ambiguity here. In the first instance, Lord Holt says the gratuitous bailee is liable only for gross neglect; he later says the gratuitous bailee should use ordinary care; and finally, he says the duty is discharged if the gratuitous bailee uses the care he uses on his own goods. Thus were the seeds of confusion sown.

With respect to the defendant in the case, the gratuitous bailee-mandatary, Lord Holt stated the following in finding him liable:

> As to the sixth sort of bailment, it is to be taken, that the bailee is to have no reward for his pains, but yet that by his ill management the goods are spoiled. . . . Then the bailee having undertaken to manage the goods, and having managed them ill, and so by his neglect a damage has happened to the bailor, which is the case in question, what will you call this? In Bracton, lib. 3, 100, it is called mandatum. It is an obligation which arises ex mandato. It is what we call in English an acting by commission. And if a man acts by commission for another gratis, and in the executing his commission behaves himself negligently, he is answerable. . . .
>
> The reasons are, first, because in such a case, a neglect is a deceipt to the bailor. For when he intrusts the bailee upon his undertaking to be careful, he has put a fraud upon the plaintiff by being negligent, his pretence of care being the persuasion that induced the plaintiff to trust him. . . .
>
> But secondly it is objected, that there is no consideration to ground this promise upon, and therefore the undertaking is but nudum pactum. But to this I answer, that the owner's trusting him with the goods is a sufficient consideration to oblige him to a careful management.[17]

There are further ambiguities. Unlike the gratuitous bailee-depositary, the gratuitous bailee-mandatary is held to answer for "neglect," not "gross neglect." However, his neglect is also held to be a fraud on the

---

> called commodatum, because the thing is to be restored in specie. The third sort is, when goods are left with the bailee to be used by him for hire; this is called locatio et conductio, and the lender is called locator, and the borrower conductor. The fourth sort is, when goods or chattels are delivered to another as a pawn, to be a security for him for money borrowed of him by the bailor; and this called in Latin vadium, and in English a pawn or a pledge. The fifth sort is when goods or chattels are delivered to be carried, or something is to be done about them for a reward to be paid by the person who delivers them to the bailee, who is to do the thing about them. The sixth sort is when there is a delivery of goods or chattels to somebody, who is to carry them, or do something about them gratis, without any reward for such his work or carriage, which is this present case.

Id. at 913-14, 92 Eng. Rep. at 109. The standards of conduct for numbers two through five, respectively, are: strictest care and diligence, utmost care, ordinary care, and, if a common carrier, then to answer at all events but acts of God or the King's enemies, but if a private person, then reasonable care. *Id.* at 916-20, 92 Eng. Rep. at 916-20, 92 Eng. Rep. at 111-13.

17. *Id.* at 919-20, 92 Eng. Rep. 113.

bailor. After this uncertain beginning, disputes and dissention continued to prevail in this area.

Writing in 1766, Blackstone, in his *Commentaries*, had the following to say of the gratuitous bailee-depositary:

> But now the law seems to be settled, that such a general bailment will not charge the bailee with any loss, unless it happens by gross neglect, which is an evidence of fraud: but, if he undertakes specially to keep the goods safely and securely, he is bound to take the same care of them, as a prudent man would take of his own.[18]

In 1781, Sir William Jones published his celebrated *Essay on the Law of Bailments*,[19] in which he defined five types of bailments, the first two being the ones under discussion: "1. DEPOSITUM, which is a naked bailment, without reward, of goods to be *kept* for the bailor. 2. MANDATUM, or *commission*; when the mandatary undertakes, without recompence, to *do some act* about the things bailed, or simply to *carry* them."[20]

Sir William defined three degrees of neglect, as follows:

> ORDINARY *neglect* is the *omission* of that *care* which *every man of common prudence, and capable of governing a family* takes of *his own* concerns[;] . . . GROSS *neglect* is the *want* of that care which *every man of common sense, how inattentive soever*, takes of *his own* property[;] . . . SLIGHT neglect is the *omission* of that *diligence* which *very circumspect and thoughtful persons* use in securing *their own* goods and chattels.[21]

Finally, Sir William deduces propositions as to the degree of care required of depositaries and mandataries:

> A DEPOSITARY is responsible only for GROSS neglect; or, in other words, for a *violation of good faith*[;] . . . A DEPOSITARY, whose character is known to his depositor, shall not answer for *mere neglect*, if he take *no better care of his own* goods, and *they also* be spoiled or destroyed[;] . . . A MANDATARY *to carry* is responsible only for GROSS

18. 2 W. BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND *452.

19. W. JONES, AN ESSAY ON THE LAW OF BAILMENTS (Garland ed. 1978) (Dilly ed. 1781).

20. *Id*. at 35-36. Sir William combines Lord Holt's third and fifth bailments into one. The other three are:

> 3. COMMODATUM, or *loan for use*; when goods are bailed, without pay, to be *used* for a certain time by the bailee. 4. PIGNORI ACCEPTUM; when a thing is bailed by a debtor to his creditor in *pledge*, or as a security for the debt. 5. LOCATUM, or *hiring*, which is always for *a reward*; and this bailment is either, 1. *locatio rei*, by which the hirer gains the temporary use of *the thing*; or, 2. *locatio operis faciendi*, when *work* and *labour*, or *care* and *pains*, are to be performed or bestowed on the thing delivered; or, 3. *locatio operis mercium vehendarum*, when goods are bailed for the purpose of being *carried* from place to place, either to a *publick* carrier, or to a *private* person.

Id.

21. *Id*. at 118-19.

> neglect, or *a breach of good faith*[;] . . . A MANDATARY *to perform a work* is bound to use *a degree of diligence adequate to the performance of it.*[22]

To these propositions, Sir William adds the following exceptions: "A man, who *spontaneously* and *officiously* engages to *keep*, or to *carry*, the goods of another, though *without reward*, must answer for SLIGHT neglect. . . .

. . . If a man, through *strong persuasion* and with *relectance*, undertake the execution of a MANDATE, no more can be required of him than *a fair exertion of his ability*."[23]

Joseph Story placed the finishing touches on this already tottering structure in 1832, in his *Commentaries on the Law of Bailments*.[24] He expressed the opinion that the Essay of Sir William Jones, while deserving of great praise, was very imperfect in its details and occasionally quite erroneous in its principles.[25] Professor Story next set out his own definitions and principles in this work:

1. A deposit is commonly defined to be a naked bailment of goods to be kept for the bailor without recompense, and to be returned when the bailor shall require it.

2. A mandate is commonly defined to be a bailment of goods without reward, to be carried from place to place, or to have some act performed about them.[26]

Story defined three degrees of diligence:

> [T]hat may be said to be common or ordinary diligence, in the sense of the law, which men of common prudence generally exercise about their own affairs in the age and country in which they live.[27]
>
> . . . High, or great diligence is of course extraordinary diligence, or that which very prudent persons take of their own concerns . . . . [L]ow, or slight diligence is that which persons of less than common prudence, or indeed of any prudence at all, take of their own concerns.[28]

Story also defined three degrees of negligence: "Ordinary negligence may be defined to be the want of ordinary diligence, and slight negligence to be the want of great diligence, and gross negligence to be the want of slight diligence."[29] Applying these principles to the gratuitous bailee,

---

22. *Id.* at 120.
23. *Id.* at 121.
24. J. STORY, COMMENTARIES ON THE LAW OF BAILMENTS (6th ed. 1856).
25. *Id.* at ix.
26. J. STORY, *supra* note 24, at 8.
27. J. STORY, *supra* note 24, at 14.
28. J. STORY, *supra* note 24, at 16.
29. J. STORY, *supra* note 24, at 17. Story said of this last category:

> In respect to gross negligence, it is often said, that it is equivalent to fraud, and is evidence of fraud. That it may, in certain cases, afford a presumption of fraud, and,

Story announced the following rule: When the bailment is for the sole benefit of the bailor, the law requires only slight diligence on the part of the bailee, and of course makes him answerable only for gross neglect.[30]

Story then discusses the depositary's responsibilities:

> The general rule, then, being, that the depositary is bound to reasonable care, proportioned, indeed, to the nature and value of the article, and the danger of loss, and the measure of that care being slight diligence, the result that he is generally liable for gross negligence only. If he takes the same care of the goods bailed as of his own, that ordinarily will repel the presumption of gross negligence; but he may still be chargeable, if the negligence is such, as even persons of slight diligence would not be guilty of. In short, he must exert the common diligence used by, and required of, depositaries in general; and he cannot exempt himself from the consequences of omitting such diligence, unless he can deduce a more limited liability from all the circumstances of his own particular case.[31]

According to Story, the mandate is in the same class as the deposit.[32] The duty of the mandatary is as follows: "According to the general principles, which have been already stated, a mandatary, as the contract is wholly gratuitous and for the benefit of the mandator, is bound only to slight diligence, and of course is responsible only for gross neglect."[33]

Story disagreed with Jones' assertion that the mandatary was bound to

---

> indeed, that in very gross cases it may approach so near, as to be almost undistinguishable from it, may be admitted, especially when the facts seem hardly consistent with any honest intention. But that generally gross negligence and fraud are convertible terms, is a doctrine not supported by any just inference from the authorities in the common law.

J. STORY, *supra* note 24, at 19-20. He stated further,

> But after all, it may admit of question, whether in the Roman Law the word dolus was used in the intense sense of the word fraud, (that is, intentional fraud), in our law, or whether it meant any thing more than a breach of that good faith, which is required by law of the bailee, and thus approached nearer to what we are accustomed to call constructive fraud, or such acts or omissions as operate as a deception upon the other party, or violate the just confidence reposed by him, whether there be a deceitful intent, malus animus, or not.

J. STORY, *supra* note 24, at 21.

30. J. STORY, *supra* note 24, at 26.

31. J. STORY, *supra* note 24, at 75-76. Story also says of the depositary: "The true way of putting cases of this nature is, to consider whether the party has omitted that care which bailees without reward are usually understood to take of property of the like nature." J. STORY, *supra* note 24, at 66. He further states that,

> The proof must be strong, which will justify an inference that the bailee is at liberty to take less care of the thing bailed than of his own. And in many cases, a higher diligence may properly be exacted than the bailee is accustomed to take of his property, especially if his character in this respect is not thoroughly known to the bailor.

J. STORY, *supra* note 24, at 76.

32. J. STORY, *supra* note 24, at 144.

33. J. STORY, *supra* note 24, at 172.

have the skills for a successful performance in order to perform work. Story stated:

> The true rule of the common law would seem, therefore, to be, that a mandatary, who acts gratuitously in a case, where his situation or employment does not naturally or necessarily imply any particular knowledge or professional skill, is responsible only for bad faith or gross negligence. If he has the qualifications necessary for the discharge of the ordinary duties of the trust which he undertakes, and he fairly exercises them, he will not be responsible for any errors of conduct or action, into which a man of ordinary prudence might have fallen. If his situation or employment does imply ordinary skill, or knowledge adequate to the undertaking, he will be responsible for any losses or injuries resulting from the want of the exercise of such skill or knowledge. If he is known to possess no particular skill or knowledge, and yet undertakes to do the best which he can under the circumstances, all that is required of him is the fair exercise of his knowledge, and judgment, and capacity.[34]

Story remarks that the case of *Percy v. Millaudon*,[35] is quite consistent with his views:

> A very important question recently arose, and was decided, in Louisiana, as to the responsibility of the directors of a bank (who are there treated as falling within the predicament of mandataries) to the stockholders, for any losses sustained by the latter in the course of the management of the concerns of the bank. The doctrine established on that occasion was, that the directors of a bank are bound to the exercise of ordinary diligence and attention in the discharge of their official duties; and if they are guilty of gross negligence or misconduct in the management of the business and property of the bank, they are in their private capacities responsible to the stockholders for any losses occasioned thereby. But for mere errors of judgment, unless of the grossest kind, they are not responsible.[36]

In a later edition of Chancellor Kent's *Commentaries*, the author agrees with Story's conclusions on the duties of the mandatary:

> A bailee, who acts gratuitously, in a case in which neither his situation nor employment necessarily implied any particular knowledge or professional skill, is held to be responsible only for bad faith or gross negligence. . . . If, however, the business to be transacted presupposes the exercise of a particular kind of knowledge, and a person accepts the office of mandatary, totally ignorant of the subject, then it has been said that he cannot excuse himself on the ground that he discharged his

34. J. STORY, *supra* note 24, at 180; *see* T. BEVEN, NEGLIGENCE IN LAW 937-43 (4th ed. 1928).

35. 8 Mart. (n.s.) 68 (La. 1829).

36. J. STORY, *supra* note 24, at 184.

> trust with fidelity and care. . . . But if the agent has the qualifications necessary for a discharge of the ordinary duties of the trust imposed, it is sufficient to exempt him from responsibility for errors into which a man of ordinary prudence might have fallen.[37]

The result of all of this pseudo-learning on the law of gratuitous bailees and mandataries was quite predictable, creating general confusion.[38] The United States Supreme Court summed up the situation quite ably in 1853:

> The theory that there are three degrees of negligence, described by the terms slight, ordinary, and gross, has been introduced into the common law from some of the commentators on the Roman law. It may be doubted if these terms can be usefully applied in practice. Their meaning is not fixed, or capable of being so. One degree, thus described, not only may be confounded with another, but it is quite impracticable exactly to distinguish them. . . . It may be added that some of the ablest commentators on the Roman law, and on the civil code of France, have wholly repudiated this theory of three degrees of diligence, as unfounded in principles of natural justice, useless in practice, and presenting inextricable embarrassments and difficulties. . . .
>
> It is also settled that if the occupation or employment be one requiring skill, the failure to exert that needful skill, either because it is not possessed, or from inattention, is gross negligence. . . . Mr. Justice Story, although he controverts the doctrine of Pothier, that any negligence renders a gratuitous bailee responsible for the loss occasioned by his fault, and also the distinction made by Sir William Jones, between an undertaking to carry and an undertaking to do work, yet admits that the responsibility exists when there is a want of due skill, or an omission to exercise it. And the same may be said of Mr. Justice Porter, in *Percy v. Millaudon*.[39]

David Dudley Field propounded his own version of the doctrine of

---

37. 2 J. KENT, COMMENTARIES ON AMERICAN LAW 572-73 (14th ed. 1896). Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829), is again cited in support of this last proposition.

38. *See* Annotation, *Duty and Liability of Gratuitous Bailee or Mandatary*, 96 A.L.R. 909 (1935) [hereinafter 1935 A.L.R.]; Annotation, *Duty and Liability of Gratuitous Bailee or Mandatary*, 4 A.L.R. 1196 (1919) [hereinafter 1919 A.L.R.]. The author of the earlier annotation expressed his view as follows:

> The expression that a gratuitous bailee is liable only for gross negligence, though useful in a minor way as marking the fact that a distinction exists between the liability of a gratuitous bailee and of a bailee for hire, is empty as a bass drum, and has about as much to do with the decision of the cases as that instrument has to do with carrying the tune.

1919 A.L.R., *supra*, at 1200.

39. Steamboat New World v. King, 57 U.S. (16 How.) 469, 474-75 (1853). Mr. Justice Story's editor was not swayed by this criticism, hewing to the theme that degrees of negligence are the "foundation of the law of bailments." J. STORY, *supra* note 24, at 18.

degrees of negligence in 1865,[40] and while Field's draft of the civil code was not adopted in New York, the statutes of Oklahoma even today reflect his views:

> § 3. Degrees of care
>
> There are three degrees of care and of diligence, namely, slight, ordinary and great. The latter includes the former.
>
> § 4. Degrees of care defined
>
> Slight care or diligence is such as persons of ordinary prudence usually exercise about their own affairs of slight importance; ordinary care or diligence is such as they usually exercise about their own affairs of ordinary importance; and great care or diligence is such as they usually exercise about their own affairs of great importance.
>
> § 5. Degrees of negligence
>
> There are three degrees of negligence, namely, slight, ordinary and gross. The latter includes the former.
>
> § 6. Degrees of negligence defined
>
> Slight negligence consists in the want of great care and diligence; ordinary negligence in the want of ordinary care and diligence; and gross negligence in the want of slight care and diligence.[41]

The Oklahoma cases interpreting this statute hold that gross negligence is conduct that is "so flagrant, so deliberate, or so reckless that it is removed from the realm of mere negligence."[42] In the area of liability of corporate directors, Oklahoma enacted the Delaware General Corporation Law in 1986 and will presumably follow Delaware's lead on this subject.[43] Under the former Oklahoma Business Corporation Act, the standard was the "prudent man" standard of the Model Act.[44]

The subject of gratuitous bailees may be summed up as follows: "While the degree of care owing from a gratuitous bailee has been the subject of much discussion, probably no other legal principle remains in a state of greater obscurity and confusion, though in recent cases some progress has been made toward solving the question."[45]

Thus, many courts applying the gross negligence standard for gratuitous bailees interpreted it to mean the absence of slight care, that care

---

40. Elliott, *supra* note 13, at 127.

41. OKLA. STAT. ANN. tit. 25, §§ 3-6 (West 1987). Oklahoma also provides by statute that a gratuitous bailee must use at least slight care. OKLA. STAT. ANN. tit. 15, § 463 (West 1966). Other states also have statutory definitions of care. *See* CAL. CIV. CODE §§ 1815-1817, 1886-1888, 1928 (West 1985); MONT. CODE ANN. §§ 70-6-203, 70-6-302 (1989); N.D. CENT. CODE § 60-01-08 (1985).

42. Fox v. Oklahoma Memorial Hosp., 774 P.2d 459, 461 (Okla. 1989).

43. OKLA. STAT. ANN. tit. 18, §§ 1001-1144 (West 1986 & Supp. 1991).

44. Hoye v. Meek, 795 F.2d 893 (10th Cir. 1986) (interpreting OKLA. STAT. ANN. tit. 18, § 1.34(b) (repealed 1986)).

45. 8 AM. JUR. 2D *Bailments* § 224 (1980).

which even the most inattentive and thoughtless of men never fail to take of their own affairs.[46] Other courts construed the gross negligence standard as a lack of such care as the bailee was accustomed to use in his own affairs.[47] Still others held that gross negligence was the absence of the care which a reasonably prudent person would use toward his own property.[48] Some jurisdictions have used "gross negligence" to mean more than one thing.[49]

An English court has said that the expression "gross negligence" is always misleading and should never be used in connection with any matter to which the common law relates, except manslaughter.[50] Some American courts have abandoned the use of the term in bailment cases altogether, adopting instead the standard of the care of a person of common prudence under the circumstances.[51] Other American courts have refused to relinquish the concept. The Supreme Court of Pennsylvania, for example, has stated rather stiffly that it joins Sir William Jones in his views that these standards of care are consistent with "natural reason, good morals, and sound policy."[52]

Both the first and second Restatements of Torts are based only on the concept of care of a reasonable man under like circumstances, not on any

46. *See* Lobenstein v. Pritchett, 8 Kan. 213, 214 (1871) (such care as the "habitually careless and negligent usually exercise"); Dudley v. Camden & Phila. Ferry Co., 42 N.J.L. 25, 28, 36 Am. Rep. 501, 504 (1880) ("most inattentive and thoughtless of men"); Tompkins v. Saltmarsh, 15 Serg. & Rawle 275, 279 (Pa. 1826) ("most inattentive and thoughtless of men").

47. *See* Foster v. Essex Bank, 17 Mass. 479, 9 Am. Dec. 168 (1821); Boyd v. Harrison State Bank, 102 Mont. 94, 56 P.2d 724 (1936); Hershey v. Happy Days Boating Co., 52 Ohio App. 2d 95, 368 N.E.2d 318 (1976); Wetmore v. B.W. Hooker Co., 111 Vt. 519, 18 A.2d 181 (1941).

48. *See* Preston v. Prather, 137 U.S. 604 (1891); Miles v. Int'l Hotel Co., 289 Ill. 320, 124 N.E. 599 (1919); Conner v. Winton, 8 Ind. 315, 65 Am. Dec. 761 (1856); Mickey v. Sears, Roebuck & Co., 196 Md. 326, 76 A.2d 350 (1950); E.O. Stanard Milling Co. v. White Line Cent. Transit Co., 122 Mo. 258, 26 S.W. 704 (1894); Colyar v. Taylor, 41 Tenn. (1 Cold.) 372 (1860); Fulton v. Alexander, 21 Tex. 148 (1858).

49. *See* Yong-Myun Rho v. Ambach, 74 N.Y.2d 318, 546 N.E.2d 188, 546 N.Y.S.2d 1005 (1989) (physician's gross negligence is negligence of egregious proportions); Food Pageant, Inc. v. Consolidated Edison Co., 54 N.Y.2d 167, 429 N.E.2d 738, 445 N.Y.S.2d 60 (1981) (public utility gross negligence is failure to exercise even slight care); Dalton v. Hamilton Hotel Operating Co., 242 N.Y. 481, 152 N.E. 268 (1926) (absence of slight care); First Nat'l Bank of Lyons v. Ocean Nat'l Bank, 60 N.Y. 278, 19 Am. Rep. 181 (1875) (absence of prudent man care).

50. *See* Pentecost v. London District Auditor, 2 K.B. 759, 764 (1951); J. CHARLESWORTH & R. PERCY, CHARLESWORTH & PERCY ON NEGLIGENCE 8-9 (7th ed. 1983).

51. *See* Christensen v. Hoover, 643 P.2d 525 (Colo. 1982); National Broad. Co. v. Rose, 153 Conn. 219, 215 A.2d 123 (1965); Koennecke v. Waxwing Cedar Prod., Ltd., 273 Or. 639, 543 P.2d 669 (1975).

52. Ferrick Excav. & Grading Co. v. Senger Trucking Co., 506 Pa. 181, 194 n.2, 484 A.2d 744, 750 n.2 (1984); *see also* Morris v. Hamilton, 225 Va. 372, 302 S.E.2d 51 (1983) (gross negligence is such a degree of negligence as would shock fair-minded persons).

degrees of care or negligence.[53] The same is true of the Restatements of Agency, which posit the duty of care of a gratuitous agent as follows: "Unless otherwise agreed, a gratuitous agent is under a duty to the principal to act with the care and skill which is required of persons not agents performing similar gratuitous undertakings for others."[54]

Not all of the early cases likened directors to mandataries. Many cases likened them to trustees. At least one early decision avoided the gross negligence problem by holding that since directors were stockholders and, therefore, had an interest in the company, they were bailees for mutual benefit and were bound to answer for ordinary neglect.[55]

III. TRUSTEES

One of the earliest cases on director liability, *Charitable Corp. v. Sutton*,[56] while stating that directors are agents, also referred to them as trustees:

> By accepting of a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it, but that it was merely *honorary* (ante, 60); and therefore they are within the case of common trustees. *Vide* Coggs v. Bernard, 1 Salk. 26.[57]

Thompson refers to the "trustee" cases as the best line of authorities, although it is clear that directors are not technically trustees:

> Another and larger class of cases, and perhaps the best line of authorities, state what is certainly the better doctrine and place the directors of corporations in the relation of trustees to the corporation and stockholders . . . . They are bound to manage the affairs of the company with

---

53. F. HARPER, F. JAMES & O. GRAY, THE LAW OF TORTS 500 n.3 (2d ed. 1986); RESTATEMENT (SECOND) OF TORTS § 283 (1965).

54. RESTATEMENT (SECOND) OF AGENCY § 379 (1958). Comment e explains that the liability of gratuitous agents is determined under the standards of sections 323 and 324 of the RESTATEMENT (SECOND) OF TORTS (1965), in which ordinary care is required unless a lesser degree of care is agreed upon. The RESTATEMENT (SECOND) OF AGENCY § 378 (1958) also tries to clarify the common-law doctrine that while gratuitous agents can be held liable for negligent performance, they cannot be held liable for nonperformance, as enunciated in Thorne v. Deas, 4 Johns. 84 (N.Y. 1809). *See* Lawrence v. Francis, 223 Ark. 584, 267 S.W. 2d 306 (1954) (insurance agent held liable for failure to place insurance despite defense of lack of consideration); RESTATEMENT OF AGENCY § 378 (1933); W. SEAVEY, STUDIES IN AGENCY 386-95 (1949); Bohlen, *Discussion of the Restatement of Torts, Proposed Final Draft No. 2*, 11 A.L.I. PROC. 584-88 (1933); Annotation, *Liability of One Who Undertakes to Pay Insurance Premiums for Another*, 12 A.L.R. 222 (1921).

55. Scott v. Depeyster, 1 Edw. Ch. 513 (N.Y. Ch. 1832); J. ANGELL & S. AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 307 (1846).

56. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

57. *Id.* at 406, 26 Eng. Rep. at 645; *see In re* Faure Elec. Accum. Co., 40 Ch. D. 141, 150-51 (1888) (managing agents and quasi-trustees); *cf.* Overend & Gurney Co. v. Gibb, 5 Eng. & Irish App. 480, 502 (1872) (directors are more agents than trustees; they are mandataries).

> the same degree of care and prudence which is generally exercised by business men in the management of their own affairs, and the fact of the service without compensation does not permit a less degree of activity.[58]

The RESTATEMENT (SECOND) OF TRUSTS (1959) sets out the usual trustee's standard of care:

> The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill.[59]

There has been much discussion about the question of whether the "own property" language sets a higher standard than that of a man of ordinary prudence "under similar circumstances in like positions." Professor Scott, the Reporter for the Second Restatement of Trusts, believed that the two standards were the same. He preferred the "own property" language because he considered the other language circular, that a trustee should act like a prudent trustee.[60] In the gratuitous-bailee cases, the two standards are used interchangeably. Originally, the "own property" standard was intended as a lower, not a higher, standard where the character of the bailee for carelessness was known to the bailor.

In corporation cases, it has been suggested that businessmen exercise a higher degree of care in their own affairs than they do in the affairs of others.[61] However, the American Law Institute has concluded that the two standards are about the same,[62] and this is certainly the case. The Supreme Court of Pennsylvania did say that the "personal business affairs" language of the pre-1968 Pennsylvania Business Corporation Law standard for directors was "much more stringent and harsh" than the

58. S. THOMPSON, *supra* note 11, at §§ 1268-70. Many cases hold directors to be trustees. *See* Delano v. Case, 121 Ill. 247, 12 N.E. 676 (1887); United Soc'y of Shakers v. Underwood, 72 Ky. (9 Bush) 609, 15 Am. Rep. 731 (1873); Brinckerhoff v. Bostwick, 88 N.Y. 52, *app. dismissed*, 106 U.S. 3 (1882); Hun v. Cary, 82 N.Y. 65, 37 Am. Rep. 546 (1880). *But see* Briggs v. Spaulding, 141 U.S. 132, 147 (1891) (directors are not trustees in any technical sense); Williams v. Fidelity Loan & Sav. Co., 142 Va. 43, 128 S.E. 615, 624 (1925) (director is agent, not trustee).

59. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

60. A. SCOTT, THE LAW OF TRUSTS § 174, at 925 (1939).

61. In 1776, Adam Smith said that negligence and profusion must always prevail in the management of a large corporation: "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own." A. SMITH, THE WEALTH OF NATIONS, bk. V, ch. 1, 264-65 (1776).

62. American Law Institute, *supra* note 4, at 30-31.

common-law standard. The court's interpretation of the standard did not affect the holding of the case, however, since the court found that the directors would be liable under either standard.[63] Both the Securities Act of 1933 and the Securities Exchange Act of 1934 use the "own property" or "own affairs" standard, but no one has ever addressed that fact.[64]

Actually, many, if not most, of the directors in the liability cases were acting in their own affairs since they were shareholders of the corporation. In the case of the largest corporations, the "personal affairs" standard may be completely inappropriate. We simply do not have enough experience with owner-managers of enormous enterprises to know whether we want a director to act as if he owned the company. Experience with men like Henry Ford, J. Paul Getty, or Howard Hughes teaches that such men may behave in ways which are quite arbitrary and autocratic, if not bizarre. Directors should be treated like other professional persons. We do not expect a doctor to treat his patients as he would himself; many doctors are known to be quite careless in matters of their own health. We certainly do not want lawyers to treat their clients' affairs with the same care they treat their own, their carelessness in that regard being proverbial.[65]

IV. Professional Persons and the Business Judgment Rule

We have seen that historically, the use of the term "gross negligence" in director liability cases was traceable to the classification of the director as a mandatary, as to whom "gross negligence" meant simply the failure to have and to exercise the care and skill of a reasonably prudent person under the circumstances. However, there is another explanation for the use of the term gross negligence in these cases, and it concerns the law of liability of professionals in general.

While professional persons such as lawyers and doctors are bound to possess a minimum of special knowledge and ability, and to exercise due care, they are not liable if they make an error of judgment which a rea-

63. Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634, 640 (1966); *see* Wolf v. Fried, 473 Pa. 26, 373 A.2d 734 (1977). The legislature amended the statute in 1968 to substitute the "similar circumstances" language. *Id.* at 735 n.5. In a prior case, without comment, the court applied a very traditional business judgment rule analysis to the old "personal business affairs" standard and exonerated the directors. Smith v. Brown-Borhek Co., 414 Pa. 325, 200 A.2d 398, 400-02 (1964).

64. Securities Act of 1933 § 11(c), 15 U.S.C. § 77k(c) (1988); Securities Exchange Act of 1934 § 13(b)(7), 15 U.S.C. § 78m(b)(7) (1988). Professor Loss explained that the 1933 Act language was borrowed from the *Restatement of Trusts* and the English Companies Act. L. Loss, Securities Regulation 1726 (2d ed. 1961).

65. T. Shearman & A. Redfield, A Treatise on the Law of Negligence 1467 (rev. ed. 1941).

sonably prudent lawyer or doctor might make.[66] The required degree of professional skill, unless another degree is represented or agreed upon, is not the skill of the average lawyer or doctor, but the minimum common skill of members of the profession in good standing. If it were otherwise, half of the members of any profession would be incompetent to practice.[67] In a California case, a client sued his attorney for malpractice for withdrawing from representation because the attorney felt the client's suit lacked merit. After first holding that an attorney has a public obligation not to assert nonmeritorious claims, the court stated:

> When apparent conflict exists between the attorney's duty to his client on the one hand and his public obligation on the other, it is not sufficient to show that some or many prudent attorneys would not have made the mistake. The attorney's choice to honor the public obligation must be shown to have been so manifestly erroneous that no prudent attorney would have done so.[68]

This formulation is identical to the doctrine of corporate waste: "A transaction constitutes a 'waste of corporate assets' if its terms are such that no person of ordinary sound business judgment would say that the consideration received by the corporation was a fair exchange for what was given by the corporation."[69]

It is not a coincidence that historically the standard for liability of attorneys for malpractice was said to be "gross negligence," or its equivalents *lata culpa* or *crassa negligentia*, both in England[70] and in the United States until recent years.[71] Like corporate directors, attorneys were held to a standard of ordinary or reasonable care and skill, whether compensated or uncompensated, and "gross negligence" was held to mean only the failure to have or to use ordinary care and skill.[72] The reason for this standard was explained in *Pitt v. Yalden*,[73] by the Lord

---

66. *See* 1 R. MALLEN & J. SMITH, LEGAL MALPRACTICE 811-14 (3d ed. 1989); J. MIRABEL & H. LEVY, THE LAW OF NEGLIGENCE 446-47 (1962); W. PROSSER & W. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS 185-87 (5th ed. 1984); T. ROADY & W. ANDERSEN, PROFESSIONAL NEGLIGENCE 226-27 (1960).

67. *See* W. PROSSER & W. KEETON, *supra* note 66, at 187; R. MALLEN & J. SMITH, *supra* note 66, at 857-63.

68. Kirsch v. Duryea, 21 Cal. 3d 303, 309, 578 P.2d 935, 939, 146 Cal. Rptr. 218, 222 (1978).

69. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 1.34, at 83 (Discuss. Draft No. 2, Apr. 20, 1989).

70. *See* Pitt v. Yalden, 4 Burr. 2060, 98 Eng. Rep. 74 (K.B. 1767); T. BEVEN, NEGLIGENCE IN LAW 36-37 (3d ed. 1908); W. BOWSTEAD, A DIGEST OF THE LAW OF AGENCY 108-09 (10th ed. 1944).

71. Pennington v. Yell, 11 Ark. 212, 52 Am. Dec. 262 (1850); *see* R. MALLEN & J. SMITH, *supra* note 66, at 884-87; 7 AM. JUR. 2D *Attorneys at Law* § 199, at 249 (1980); 7A C.J.S. *Attorney and Client* § 255, at 463 (1980).

72. *See supra* note 71.

73. 98 Eng. Rep. 74, 76 (K.B. 1767).

Chief Justice Wilmont, quoted by Lord Mansfield: "[H]e thought it very hard, and not at all reasonable, that an attorney should be made answerable for [his client's uncollected] debt upon account of a mere involuntary undesigned mistake in a nice point of practice."

Some courts and commentators express hostility to the business judgment rule. The United States Court of Appeals for the Second Circuit in *Joy v. North*[74] stated:

> Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation.[75]

Appellate judges, who frequently make errors of judgment, should have a better understanding of the problem. Tort defendants are held liable for conduct that is unreasonable.[76] Making an error of judgment while exercising due care is not unreasonable conduct and, therefore, is not negligence. But, nevertheless, we tend to perceive persons who make errors of judgment as negligent, even though they are not necessarily negligent.[77] Therefore, a director held liable for an error of judgment is considered guilty of gross negligence but is actually guilty of a gross error of judgment, one which no reasonably prudent person would have made.[78] The Delaware Supreme Court has used the terms "abuse of discretion" and "gross abuse of discretion" interchangeably as a definition of "gross negligence."[79] A director who makes an error of judgment in the exercise of due care is not guilty of an abuse of discretion. A director who makes a gross error of judgment, one which no reasonably prudent person would make, is guilty of an abuse of discretion, not a gross abuse of discretion.

S. Samuel Arsht has said that the primary function of the business judgment rule may be simply to give directors the same latitude that professionals are given in malpractice suits.[80] The Supreme Court of Louisi-

74. 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

75. *Id.* at 885.

76. W. PROSSER & W. KEETON, *supra* note 66, at 170.

77. *See* Jardel Co. v. Hughes, 523 A.2d 518, 531 (Del. 1987) (error of judgment is negligence).

78. *See* Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988) (lack of director care must amount to corporate waste for liability to attach).

79. Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984).

80. Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97 (1979). *See generally* D. BLOCK, N. BARTON & S. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 12-26 (3d ed. 1989). *But see* Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945 (1990) (business judgment rule is much broader).

ana in *Percy v. Millaudon* expressed the rule as follows:

> The test of responsibility, therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the agent is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.[81]

The Supreme Court of Rhode Island said in *Hodges v. New England Screw Co.*,[82] "If, on the other hand, the mistake be such as the directors might well make, notwithstanding the exercise of proper care, and if they acted in good faith and for the benefit of the screw company, they ought not to be liable."[83]

The ALI, in its formulation of the business judgment rule, has said that the judgment need only be "rational" as opposed to "reasonable," and that this formulation is supported by the cases and gives the director a significantly wider range of discretion.[84] There is no reason to believe that the two words have a different meaning in the context of director liabilty.[85] Both words have been used to mean the same thing — that the judgment was one a reasonably prudent person could have made.

The question has been asked why courts regularly state that they are not competent to review business decisions, even though they routinely review the decisions of every other professional in malpractice cases through expert testimony.[86] The answer is that courts do review business decisions to determine whether they constitute corporate waste or abuse of discretion, but they have not used expert testimony as to what the directors should have done presumably because the question is what a reasonably prudent person, not an expert, would have done.[87] Expert testimony is required to explain the business and financial setting of the challenged decision. It was not appropriate for the Delaware Supreme Court in *Smith v. Van Gorkom*,[88] in effect, to conduct a trial de novo at

---

81. 8 Mart. (n.s.) 68, 78 (La. 1829).

82. 1 R.I. 312, 53 Am. Dec. 624, *on reh'g*, 3 R.I. 9 (1853).

83. *Id.* at 346, 53 Am. Dec. at 630; *see also* Godbold v. Branch Bank at Mobile, 11 Ala. 191, 199, 46 Am. Dec. 211 (1847) (only liable for such gross error as to impute ignorance or fraud).

84. American Law Institute, *supra* note 4, at 4.01(c).

85. *See* Levandusky v. One Fifth Ave. Apt. Corp., 75 N.Y.2d 530, 553 N.E.2d 1317, 1324, 554 N.Y.S.2d 807, 814 (1990) (elusive semantical distinction). The leading Delaware case uses the two words interchangeably. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); *cf.* Air Line Pilots Ass'n, Int'l v. O'Neil, 111 S. Ct. 1127, 1134-35 (1991) (duty of labor union, like that of corporate director, is satisfied unless decision is irrational and outside a wide range of reasonableness).

86. Sargent, *Two Cheers for the Maryland Director and Officer Liablity Statute*, 18 U. BALT. L. REV. 278, 288 (1989).

87. Panter v. Marshall Field & Co., 646 F.2d 271, 293 n.6 (7th Cir.) (expert testimony on board action properly excluded), *cert. denied*, 454 U.S. 1092 (1981).

88. 488 A.2d 858 (Del. 1985).

the appellate level without the benefit of any live testimony at all, expert or otherwise, and in the process set down standards for the conduct of board meetings and extraordinary corporate transactions which astounded much of the corporate bar.[89]

Bayless Manning is certainly correct when he says that courts and commentators do not seem to have a very clear idea of what corporate directors do.[90] To a businessperson, saying that the business judgment rule does not provide protection against charges of inaction since no decision was made has an air of unreality about it.[91] Deciding what problems or potential problems to investigate and how far to investigate them is not only a business decision, but is the most common business decision, and one that every businessperson must make many times a day.

The courts have held that a "conscious decision to refrain from acting" is protected by the rule, while a failure-to-act case is not.[92] This leads to the result that in a failure-to-act case such as *Graham v. Allis-Chalmers Manufacturing Co.*,[93] where the board was charged with failure to take steps to uncover antitrust violations at the company, the court is compelled to pose the test as follows:

> If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.[94]

If the court had used the language of the business judgment rule, the test would have been whether the situation was such that no reasonably pru-

89. *See* Van Gorkom, *The "Big Bang" for Director Liability: The Chairman's Report*, 12 DIRECTORS & BOARDS 17, 20 (1987) (decision shows "serious lack of understanding of even the basic functioning of the business and financial worlds"). There were three experienced corporate lawyers present at that meeting of the Trans Union Board: William Browder, Director and Vice President-Legal, William Moore, General Counsel, and James Brennan, Esq., Special Transaction Counsel. Two of the other directors, Van Gorkom and William B. Johnson, were also law graduates. *Smith*, 488 A.2d at 865, 867-68, 874, 894. The case seems flatly inconsistent with later cases, such as Barkan v. Amsted Indus., 567 A.2d 1279 (Del. 1989), where a management buyout was treated very gently although no market test had been conducted to test the price.

90. Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

91. *Id.* at 1494; *see* Citron v. Fairchild Camera & Instrument Corp., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,104 (Del. Ch. May 19, 1988) (question of how much information to gather before decision is itself a business decision), *aff'd*, 569 A.2d 53 (Del. 1989). A board decision to delegate authority is itself a protected business judgment. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985).

92. Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

93. 41 Del. Ch. 78, 188 A.2d 125 (Del. 1963).

94. *Id.* at 85, 188 A.2d at 130.

dent person would have failed to take such steps as would have uncovered the price-fixing conspiracy and prevented harm to the corporation.

It seems strange that a few years ago Professor Scott could have concluded that "the duty of care cause of action seems to accomplish very little."[95] It is also surprising that the duty of care should recently be described as "aspirational," the authors concluding that "whole categories of business decisions are simply not reviewable."[96] While there is a wide latitude for action, it is not true that a dividend policy, for instance, could never be held to be irrational.[97]

The Delaware Supreme Court has recently stated that the business judgment rule operates both as a procedural guide for litigants and a substantive rule of law.[98] As a rule of evidence, it creates a presumption that the directors acted on an informed basis, in good faith, and with an honest belief that the action taken was in the best interest of the company. As a substantive rule of law, it provides that the directors will not be held liable, nor will their decision be disturbed, unless the plaintiff rebuts the presumption by proving director self-interest, lack of good faith, or violation of the duty of care.[99]

However, there is no case law to support Joseph Hinsey's distinction between the business judgment rule and the business judgment doctrine.[100] Hinsey's statement that a director may escape liability if he believed in good faith that he could make a sufficiently informed business judgment, although an ordinarily prudent person would have done more to become better informed is disproved by *Smith v. Van Gorkom*, where the court specifically found no issue of good faith but still found the directors liable for gross negligence, actually gross error of judgment.[101] Hinsey proposes that the business judgment rule will shield the director who acts in good faith from personal liability, while the business judgment doctrine will allow a court to strike down the judgment of the di-

95. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 947 (1983).

96. Dooley & Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 521 (1989).

97. *See* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (failure to declare dividends improper where no resulting benefit to stockholders); *cf.* Smith v. Atlantic Prop., Inc., 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981) (director voting against dividend liable to corporation for resulting accumulated earnings tax).

98. Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53 (Del. 1989).

99. *Id.* at 64.

100. Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 614 (1984). The Ohio Supreme Court adopted Mr. Hinsey's terminology, but did so in an intrinsic fairness case, and held the business judgment rule inapplicable. *See* Gries Sports Enter., Inc. v. Cleveland Browns Football, 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986).

101. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

rectors if their decision is grossly erroneous. We have now achieved that result through the new statutes which allow provisions in the certificate of incorporation protecting the director who acts in good faith, but not the decision.[102]

The Delaware Supreme Court used Mr. Hinsey's business judgment doctrine terminology in the *Mills Acquisition Co. v. Macmillan* case,[103] which involved a transactional justification situation, an attack on the judgment itself and not the directors personally. However, in refusing to protect the decision, the court said that while it was not passing on the independent directors' personal liability, it had no doubt that their actions were breaches of their fundamental duties of loyalty and care.[104]

Stephen Radin has suggested that the doctrine/rule distinction is supported by *Gimbel v. Signal Companies*,[105] but that is not the holding of the case.[106] In *Gimbel*, Chancellor Quillen enjoined a sale of corporate assets by the Signal board despite the fact that he did not find any showing of director self-interest, lack of good faith, or improper method of informing themselves. His decision was based on allegations that the price for the assets was grossly inadequate. The Chancellor's tentative finding on the motion for preliminary injunction, therefore, was that the plaintiff had a reasonable prospect of success on the merits to prove that the Signal directors acted without the bounds of reason and recklessly in approving the sale.[107] The court stated that "[t]here are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price."[108] This is the same as the doctrine of corporate waste.[109]

It would be a rather strange philosophy to hold a corporate director liable for money damages if he does not have enough sense to follow proper procedures,[110] but not to hold him liable if he does not have

102. *See* Comment, *Director and Officer Liability: State Legislative Reaction to* Smith v. Van Gorkom, 22 CREIGHTON L. REV. 747 (1989).

103. Mills Acquis. Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 n.32 (Del. 1988). The court had stated earlier that its decisions in transactional justification cases had used the business judgment rule formulation, but that this included the concept of the doctrine. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 180 n.10 (Del. 1986).

104. *Mills Acquis. Co.*, 559 A.2d at 1284 n.32.

105. 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

106. Radin, *The Director's Duty of Care Three Years After* Smith v. Van Gorkom, 39 HASTINGS L.J. 707, 730-31 (1988).

107. *Gimbel*, 316 A.2d at 615.

108. *Id.* at 610.

109. *See* Richland v. Crandall, 262 F. Supp. 538 (S.D.N.Y. 1967) (no proof that price in sale of all corporate assets was so grossly inadequate as to be proof of fraud).

110. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). It has been suggested that the *Van Gorkom* case overruled the *Gimbel* decision. *See* Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505, 521 (1985). There is, however, no evidence that that is true.

enough sense to understand and act on the information once he has it. The Court of Chancery of Delaware recently held that if a board of directors acts in good faith and with due care, there is no residual power in the court to review the substantive decision for rationality.[111] The court said that doing so would be a way of inferring bad faith.[112] However, gross error of judgment may be made in perfect good faith; that was the holding of *Van Gorkom* and the entire premise behind the new Delaware director protection statute, which only shelters errors of judgment made in good faith.[113]

The Delaware Supreme Court held recently that proper business judgment requires both substantive due care, as in purchase terms, and procedural due care, as in an informed decision.[114] In that case, the court dismissed a shareholders derivative suit challenging the buyout of H. Ross Perot by General Motors, holding that prior demand on the General Motors Board of Directors would not be excused since the complaints did not raise a reasonable doubt that the board's decision constituted corporate waste.

The court, in another recent case,[115] also rejected scholarly suggestions that in applying the business judgment rule to a board's decision to oppose a tender offer for corporate control, the court would not examine the substantive decision itself if the board's deliberative process was found not to be wanting in objectivity, good faith, or deliberateness.[116] The court said that in reviewing board action under the rule, the issues are independence, reasonableness of the investigation, and good faith, but it added that if the requirements of the rule are met, the decision will be respected by the courts "absent an abuse of discretion."[117]

111. *In re* RJR Nabisco, Inc. Shareholders Litigation, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 94,194 (Del. Ch. Jan. 31, 1989), *appeal denied*, 556 A.2d 1070 (Del. 1989).

112. *Id.* at 91,710 n.13 (citing *In re* J.P. Stevens & Co. Shareholders Litigation, 542 A.2d 770 (Del. Ch. 1988)).

113. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).

114. Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988). In *Aronson v. Lewis*, the court said that directors have a duty to inform themselves of all material information reasonably available and said further, "Having become so informed, they must then act with requisite care in the discharge of their duties." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). In the analagous situation of interested director contracts approved by disinterested directors or stockholders, it seems to be agreed that the contract can still be challenged for waste. *See* D. BLACK, N. BARTON & S. RADIN, *supra* note 80, at 82.

115. Paramount Communication, Inc. v. Time, Inc., 571 A.2d 1140, 1154 n.18 (Del. 1989).

116. The court referred specifically to Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315 (1987).

117. Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990).

V. Efficacy of the Duty of Care Standard

Scholarship in this area of the law has suffered for years from the effects of a rather off-hand remark by Professor Joseph W. Bishop, Jr. in 1968. He stated that he could find very few cases in which directors of industrial corporations had been held liable for breach of the duty of care.[118] This clever turn of phrase about needles in a haystack has been cited ever since as proof that the duty of care is not a significant protection against incompetence and gross negligence in the board room.[119] As an article of faith, it falls into the same category as assertions that the courts and legislatures are unfairly inhibiting the plaintiffs' bar in the area of stockholder derivative suits.[120] Only recently have some commentators begun to notice that there is actually a great deal of successful litigation against corporate officers and directors for duty of care violations.[121]

The 1989 Wyatt Directors & Officers [D & O] Liability Survey of

---

118. Professor Bishop said, "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L. J. 1078, 1099 (1968).

119. *See* Bradley & Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 22 (1989) ("courts rarely hold the corporate director liable for mere negligence"); Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505 (1985) ("rarely have individual directors been held liable"); Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983) ("cases that assess damages against negligent management are rare to the point of becoming an endangered species"); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit*, 75 NW. U. L. REV. 96, 103 (1980) ("courts rarely hold directors liable for negligence alone").

120. *See* Dent, *supra* note 119, at 103; Hornstein, *The Death Knell of Stockholders' Derivative Suits in New York*, 32 CALIF. L. REV. 123 (1944); Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306 (1980). *But see* F. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS (1944); Note, *Security for Expenses Legislation — Summary, Analysis, and Critique*, 52 COLUM. L. REV. 267 (1952). The reaction of the Delaware Supreme Court to this academic jawboning has been to bolster the authority of the special litigation committee by holding that the court does not have to review that committee's substantive decision. *See* Kaplan v. Wyatt, 499 A.2d 1184 (Del. 1985). The court has also made stricter the requirements for pre-suit demand on the board of directors in a derivative action. *See* Spiegel v. Buntrock, 571 A.2d 767 (Del. 1990); Grobow v. Perot, 539 A.2d 180 (Del. 1988).

121. *See* Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1208 (1988) ("unusually large number of suits"); Note, *Of Synergies of Evidence and Section 402(b)(1): Hanson Trust, Revlon, Van Gorkom, and the Imminent Demise of the First Wave of Corporate Director Liability Statutes*, 52 ALB. L. REV. 559 (1988) ("unusual number of lawsuits"); Note, *New York's Response to the Director and Officer Liability Crisis: A Need to Reexamine the Importance of D & O Insurance*, 54 BROOKLYN L. REV. 1305 (1989) ("an alarming amount of litigation"); *Introduction, Special Project: Director and Officer Liability*, 40 VAND. L. REV. 601, 601 (1987) ("unprecedented damage awards").

claims made during the period from 1980 to 1988 in a sampling of 1,537 organizations showed the following: overall D & O claim frequency generally is rising between five and fifteen percent per year; business corporations with assets over $1 billion had on the average .878 claims during the nine year period; the ultimate total claim cost, including defense costs of $1,299,000, for the average D & O claim brought in 1989 is estimated at $3,466,000; more than half of all claims made against directors and officers are closed without payment to the claimant; shareholder suits comprised fifty-two percent of the claims by count and eighty-two percent of the dollars paid; about half of the shareholder claims were derivative suits; and about fifteen percent of all claims result in payment to the claimant of over $1 million, and about five percent result in payment over $10 million.[122]

If we want to know whether the duty of care is an effective check against management negligence, there is no justification for limiting the inquiry to industrial corporations or to derivative suits. A comprehensive study should include all corporations, whether manufacturing, service, or financial, and all suits based on breaches of duty of care, whether shareholder derivative, class action, or direct suit by the corporation, or its receiver or trustee in bankruptcy, or a creditor of the corporation. The history of the duty of care in this country was written in the bank cases, and while there is some authority for the proposition that bank directors are held to a higher standard than other directors,[123] the true significance of those cases appears to be that the nature of the banking business may require a more conservative management and a greater involvement by the directors in the operations of the business than is the case with other corporations.[124]

There can be no dispute that there exists a very substantial body of case law upholding suits against bank directors for violation of the duty of care, enough to satisfy the most sanguinary disposition.[125]The number

122. WYATT D & O LIABILITY SURVEY SUMMARY (Jan. 1990) [hereinafter SURVEY]. The survey reports a total of 311 shareholder claims out of 625 total claims. The largest number of shareholder claims (139) arose in cases of merger, acquisition, and divestment. Other significant areas were financial reporting (47), conflict of interest (14), and dishonesty and fraud (14). SURVEY, at 37. The upward trend in the number of shareholder suits continues. *See* Gayelin & Pollock, *Suits Against Corporate Directors and Officers Rose Again in 1990*, Wall St. J., Jan. 15, 1991, at B4, col. 2.

123. T. RICE, J. COOPER & W. SCHLICHTING, 1 BANKING LAW 6-15 (cum. supp. Feb. 1990).

124. Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 344 (1965) (law of director negligence same for bank and non-bank directors); American Law Institute, *supra*, note 4, at 42-43 (no sensible distinction can be drawn between financial and industrial corporations).

125. *See* FSLIC v. Ticktin, 490 U.S. 82 (1989); Hoye v. Meek, 795 F.2d 893 (10th Cir. 1986) ($1.4 million judgment); Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460

of bank and thrift institution director-liability cases has increased in recent years, and can be expected to increase further due to the record number of institution failures.[126] Section 212(k) of the Financial Institutions, Reform, Recovery and Enforcement Act of 1989 provides that actions may be brought against directors of insured depository institutions for gross negligence, superseding state law in this regard.[127] In a recent report on the more than five hundred suits which the Federal Deposit Insurance Company (FDIC) has pending against directors, officers, accountants, lawyers, and other professionals due to bank and thrift failures, the director of the FDIC Office of Corporate Communications stated that director and officer liability for fraud and mismanagement has been aggressively pursued in all cases.[128]

With respect to nonbanking cases, there are actually many such cases upholding a complaint of duty of care violation.[129]

U.S. 1051 (1983); Gamble v. Brown, 29 F.2d 366 (4th Cir. 1928), *cert. denied,* 279 U.S. 839 (1929); Seafirst Corp. v. Jenkins, 644 F. Supp. 1152 (W. D. Wash. 1986); Bank of Commerce v. Goolsby, 129 Ark. 416, 196 S.W. 803 (1917); Delano v. Case, 121 Ill. 247, 12 N.E. 676 (1887); United Soc'y of Shakers v. Underwood, 72 Ky. (9 Bush) 609, 15 Am. Rep. 731 (1873); Percy v. Millaudon, 8 Mart. (n.s.) 68 (La. 1829); Bank of Mutual Redemption v. Hill, 56 Me. 385, 96 Am. Dec. 470 (1868); Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (N.J. Ch. 1901); Roseville Trust Co. v. Mott, 93 N.J. Eq. 229, 107 A. 462 (N.J. Ch. 1919); Citizens Build. Assoc. v. Coriell, 34 N.J. Eq. 383 (1881); Brinckerhoff v. Bostwick, 88 N.Y. 52 (1882); Hun v. Cary, 82 N.Y. 65, 37 Am. Rep. 546 (1880); Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940); Broderick v. Marcus, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934); Seale v. Baker, 70 Tex. 283, 7 S.W. 742 (1888); Warren v. Robison, 19 Utah 289, 57 P. 287 (1899); Anderson v. Bundy, 161 Va. 1, 171 S.E. 501 (1933); Marshall v. Farmers' and Mechanics' Sav. Bank, 85 Va. 676, 8 S.E. 586 (1889); Elliott v. Farmers Bank of Philippi, 61 W. Va. 641, 57 S.E. 242 (1907). The bank cases are collected in a 121 page report in Annotation, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R.3d 941 (1969).

126. *See* Grace, *Why FSLIC Sues, reprinted in* REPRESENTING CLIENTS IN FAILING FINANCIAL INSTITUTION INVESTIGATIONS 109-10 (1988) (suit is certain for gross negligence or fraud); Scott, *Never Again: The S&L Bailout Bill*, 45 BUS. LAW. 1883 (1990); Comment, *FDIC and FSLIC Pursuit of Claims Against Officers, Directors, and Others Involved With Failed Lenders*, 58 MISS. L.J. 89 (1988).

127. Act of Aug. 9, 1989, Pub. L. No. 101-73, 1989 U.S. CODE CONG. & ADMIN. NEWS (103 Stat.) 183; T. RICE, J. COOPER & W. SCHLICHTING, *supra* note 116, at 6-9; Sczudlo & Dederick, *Directors' and Officers' Liability Considerations After the Financial Institutions Reform, Recovery and Enforcement Act of 1989, in* DIRECTORS' AND OFFICERS' LIABILITY INSURANCE 1990 126 (1990).

128. N.Y. Times, July 11, 1990, at A14, col. 4.

129. *See* Air Line Pilots Ass'n, Int'l v. UAL Corp., 897 F.2d 1394 (7th Cir. 1990) (antitakeover measures invalid due to lack of informed decision); Sandberg v. Virginia Bankshares, Inc., 891 F.2d 1112 (4th Cir. 1989) (directors liable for bad faith), *rev'd in part*, 111 S. Ct. 2749 (1991); Levy v. National Union Fire Ins. Co., 889 F.2d 433 (2d Cir. 1989) (directors of Crazy Eddie audio stores denied D & O insurance coverage); Louisiana World Expo. v. Federal Ins. Co., 864 F.2d 1147 (5th Cir. 1989) (directors of nonprofit exposition company held to for-profit corporation gross negligence standard); Hanson Trust v. ML SCM Acquis., Inc., 781 F.2d 264 (2d Cir. 1986) (directors' grant of lockup option in takeover contest breached duty of care); Meyers v. Moody, 693 F.2d 1196 (5th Cir. 1982) (director and majority shareholders of

VI. CONCLUSION

The confusion in terminology for director duty of care standards in the

insurance company liable for gross mismanagement), *cert. denied*, 464 U.S. 920 (1983); McDonnell v. American Leduc Petrol., Ltd., 491 F.2d 380 (2d Cir. 1974) (director and officer of loan company liable for negligence); DePinto v. Provident Sec. Life Ins. Co., 374 F.2d 37 (9th Cir.) (director held liable for insurance company losses), *cert. denied*, 389 U.S. 822 (1967); Keyser v. Commonwealth Nat'l Fin. Corp., 675 F. Supp. 238 (M.D. Pa. 1987) (directors sued for negligence in approving merger in takeover situation); Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209 (S.D. Ohio) (poison pill enjoined due to lack of informed decision), *aff'd without op.*, 815 F.2d 76 (6th Cir. 1987); Stern v. Lucy Webb Hayes Nat'l Train. School for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974) (director/trustees of charitable hospital held to business corporate standards and held to have breached duty of supervision); Heit v. Bixby, 276 F. Supp. 217 (E.D. Mo. 1967) (directors liable for failure to prevent looting of insurance subsidiaries); *In re* Western World Funding, Inc., 52 B.R. 743 (Bankr. D. Nev. 1985) ($2.9 million judgment against director and officer for failure to prevent waste of corporate assets), *aff'd in part, rev'd in part*, Buchanan Insurance Serv. v. Henderson, 1990 WL 306010 (D. Nev. Oct. 12, 1990); International Banknote Co. v. Muller, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,418 (S.D.N.Y. May 2, 1989) (amendments to bylaws in proxy contest enjoined due to lack of informed decision); Van Antwerp Realty Corp. v. Cooke, 230 Ala. 535, 162 So. 97 (1935) (directors charged with self-dealing and waste); King v. Livingston Mfg. Co., 192 Ala. 269, 68 So. 897 (1915) (directors of manufacturing company held liable to stock purchaser); Neall v. Hill, 16 Cal. 145, 76 Am. Dec. 508 (1860) (stockholder may sue trustees of water company for gross negligence); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986) (complaint upheld against directors of time-sharing corporation for wrongful rejection of tender offer); Nix v. Miller, 26 Colo. 203, 57 P. 1084 (1899) (director of merchandising company liable to creditor for gross neglect); Mills Acquis. Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1988) (intrinsic fairness test applied where disinterested directors fail in oversight duties); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986) (board conduct of auction for corporation violated duties of care and loyalty); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors liable for gross negligence in approving cashout merger); Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1337-40 (Del. Ch. 1987) (board of controlled subsidiary violated duty of care in cash-out merger); Lewis v. Aronson, C.A. No. 85-6919, slip op. (Del. Ch. May 1, 1985) (directors may be sued for waste in employment contract); Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.) (injunction against asset sale for grossly inadequate consideration), *aff'd per curiam*, 316 A.2d 619 (Del. 1974); Penn Mart Realty Co. v. Becker, 298 A.2d 349 (Del. Ch. 1972) (directors sued for wasting corporate assets); Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (1961) (nonaffiliated directors may be sued for not preventing wasteful investment advisory fees); Rowen v. Le Mars Mut. Ins. Co., 282 N.W.2d 639 (Iowa 1979) (directors liable for not preventing improper sale of control of insurance company); Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 8 N.E.2d 895 (1937) (directors of investment company liable for gross negligence); Dinsmore v. Jacobson, 242 Mich. 192, 218 N.W. 700 (1928) (directors liable to bond purchaser for negligent management); Horn Silver Min. Co. v. Ryan, 42 Minn. 196, 44 N.W. 56 (1889) (director liable for misfeasance and culpable negligence); Doyle v. Union Ins. Co., 202 Neb. 599, 277 N.W.2d 36 (1979) (directors liable for failure to prevent self-dealing by insurance company president); Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981) ($10.3 million judgment against estate of deceased director liable for failure to prevent waste of corporate assets); New York Credit Men's Adjustment Bureau Inc. v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953) (directors sued for waste in sale of corporate assets); Ludlam v. Riverhead Bond & Mortgage Corp., 244 A.D. 113, 278 N.Y.S. 487 (N.Y. App. Div. 1935) (directors may be sued for waste in stock commission payments); Tri-Bullion Smelting & Devel. Co. v. Curtis, 186 A.D. 613, 174 N.Y.S. 830 (N.Y. App. Div. 1919) (directors of mining company liable for failure to prevent misappropriations by corporate treasurer), *aff'd per curiam*, 230 N.Y. 629, 130 N.E. 921 (1921); Syracuse Television, Inc. v. Channel 9, Syracuse, Inc., 51 Misc. 2d 188, 273 N.Y.S.2d cases can largely be explained by the tendency in the early cases to put directors in the category of mandataries and by the tendency of courts to use the term "gross negligence" when they actually mean "gross error of judgment." Since directors currently are compensated for their services,[130] they should, in any event, be held to the ordinary care standard of paid agents. However, the historical standard for unpaid agents was that of a reasonable person under the circumstances, and unpaid agents were also required to have some reasonable qualifications for the job undertaken unless a lesser standard of care was agreed upon. The argument that there are not enough successful director liability cases is not supported by the facts and, in any event, is irrelevant. Directors do not represent themselves to be infallible, and they should not be held to a higher standard than other business or professional persons.

---

16 (N.Y. Sup. Ct. 1966) (directors sued for corporate waste); Clayton v. Farish, 191 Misc. 136, 73 N.Y.S.2d 727 (N.Y. Sup. Ct. 1947) (directors liable for fraud and negligence resulting in corporate waste); Watkins v. Watkins & Turner Lumber Co., 17 Misc. 227, 40 N.Y.S. 1042 (N.Y. Sup. Ct.) (directors sued for failure to prevent self-dealing by other directors), *aff'd*, 11 A.D. 517, 43 N.Y.S. 41 (N.Y. App. Div. 1896); Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832) (directors of coal company sued for waste in stock speculation with corporate funds); Anthony v. Jeffress, 172 N.C. 378, 90 S.E. 414 (1916) (directors of trading company sued by creditor for mismanagement); Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966) (directors liable for gross mismanagement); Loan Soc'y of Phila. v. Eavenson, 248 Pa. 407, 94 A. 121 (1915) (directors of loan company liable for gross neglect); Cornell v. Seddinger, 237 Pa. 389, 85 A. 446 (1912) (directors of shipbuilding company, negligent to rely on incorrect treasurer's reports, liable for improper dividends); McCollum v. Dollar, 213 S.W. 259 (Tex. 1919) (directors liable to creditor for failure to prevent conversion of proceeds of cotton); FMA Acceptance Co. v. Leatherby Ins. Co., 594 P.2d 1332 (Utah 1979) (directors and officers of insurance company liable to creditor for mismanagement); Charitable Corp. v. Sutton, 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742) (directors of loan company liable for negligent supervision); Annotation, *Duty of Corporate Directors to Exercise "Informed" Judgment in Recommending Responses to Merger or Tender Offers*, 46 A.L.R.4th 887 (1986); Annotation, *Liability of Corporate Directors or Officers for Negligence in Permitting Conversion of Property of Third Persons by Corporation*, 29 A.L.R.3d 660 (1970); Annotation, *Right of Creditor of Corporation to Maintain Personal Action Against Directors or Officers for Mismanagement*, 50 A.L.R. 462 (1927). The ALI reported that since the turn of the century, there have been about thirty appellate decisions which found violations of director duty of care. *See* American Law Institute, *supra* note 4, at 28-29.

130. A typical manufacturing corporation with over $3 billion in annual sales will have a board with thirteen members, a majority of whom are nonemployees who have no potential conflict of affiliation, such as customer or supplier, with the corporation. The board will meet nine times a year, with meetings lasting about three hours. The board will have five board committees, with a membership of five directors each, usually the audit, compensation, executive, nominating, and finance committees, who will meet three times a year. The outside directors will be paid a total compensation of $35,000-$45,000 per year. *See* The Conference Board, Research Report No. 940, Membership and Organization of Corporate Boards (1990); The Conference Board, Research Report No. 936, Corporate Directors' Compensation (1990).