CHAPTER VI: THE DIVERGENCE OF INTEREST BETWEEN OWNERSHIP AND CONTROL

THE FOREGOING chapters have indicated that the corporate system tends to develop a division of the functions formerly accorded to ownership. This calls for an examination of the exact nature of these functions; the inter-relation of the groups performing them; and the new position which these groups hold in the community at large.

In discussing problems of enterprise it is possible to distinguish between three functions: that of having interests in an enterprise, that of having power over it, and that of acting with respect to it. A single individual may fulfill, in varying degrees, any one or more of these functions.

Before the industrial revolution the owner-worker performed all three, as do most farmers today. But during the nineteenth century the bulk of industrial production came to be carried on by enterprises in which a division had occurred, the owner fulfilling the first two functions while the latter was in large measure performed by a separate group, the hired managers. Under such a system of production, the owners were distinguished primarily by the fact that they were *in a position* both to manage an enterprise or delegate its management and to receive any profits or benefits which might accrue. The managers on the other hand were distinguished primarily by the fact that they operated an enterprise, presumably in the interests of the owners. The difference between ownership and management was thus in part one between position and action. An owner who remained completely quiescent towards his enterprise would nevertheless remain an owner. His title was not applied because he acted or was expected to act. Indeed, when the owner acted, as for instance in hiring a manager or giving him directions, to that extent the owner managed his own enterprise. On the other hand, it is difficult to think of applying the title "manager" to an individual who had been entirely quiescent.

Under the corporate system, the second function, that of having power over an enterprise, has become separated from the first. The position of the owner has been reduced to that of having a set of legal and factual interests in the enterprise while the group which we have called control, are in the position of having legal and factual powers over it.

In distinguishing between the interests of ownership and the powers of control, it is necessary to keep in mind the fact that, as there are many individuals having interests in an enterprise who are not customarily thought of as owners, so there may be many individuals having a measure of power over it who should not be thought of as in control. In the present study we have treated the stockholders of a corporation as its owners. When speaking of the ownership of all corporations, the bondholders are often included with the stockholders as part owners. The economist does not hesitate for certain purposes to class an employee with wages due him as temporarily a part owner. All of these groups have interests in the enterprise. Yet a laborer who has a very real interest in a business in so far as it can continue to give him employment is not regarded as part owner. Nor is a customer so included though he has a very real interest in a store to the extent that it can continue to give him good services. Of the whole complex of individuals having interests in an enterprise, only those are called owners who have major interests and, before the law, only those who hold legal title. Similarly, the term control must be limited for practical purposes to those who hold the major elements of power over an enterprise, keeping in mind, however, that a multitude of individuals may exercise a degree of power over the activities of an enterprise without holding sufficient power to warrant their inclusion in "control."

Turning then to the two new groups created out of a former single group,—the owners without appreciable control and the control without appreciable ownership, we must ask what are the relations between them and how may these be expected to affect the conduct of enterprise. When the owner was also in control of his enterprise he could operate it in his own interest and the philosophy surrounding the institution of private property has assumed that he would do so. This assumption has been carried over to present conditions and it is still expected that enterprise will be operated in the interests of the owners. But have we any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of the owners? The answer to this question will depend on the degree to which the self-interest of those in control may run parallel to the interests of ownership and, insofar as they differ, on the checks on the use of power which may be established by political, economic, or social conditions.

The corporate stockholder has certain well-defined interests in the operation of the company, in the distribution of income, and in the public security markets. In general, it is to his interest, first that the company should be made to earn the maximum profit compatible with a reasonable degree of risk; second, that as large a proportion of these profits should be distributed as the best interests of the business permit, and that nothing should happen to impair his right to receive his equitable share of those profits which are distributed; and finally, that his stock should remain freely marketable at a fair price. In addition to these the stockholder has other but less important interests such as redemption rights, conversion privileges, corporate publicity, etc. However, the three mentioned above usually so far overshadow his other interests as alone to require consideration here.

The interests of control are not so easily discovered. Is control likely to want to run the corporation to produce the maximum profit at the minimum risk; is it likely to want to distribute those profits generously and equitably among the owners; and is it likely to want to maintain market conditions favorable to the investor? An attempt to answer these questions would raise the whole question of the nature of the phenomenon of "control." We must know the controlling individual's aims before we can analyze his desires. Are we to assume for him what has been assumed in the past with regard to the owner of enterprise, that his major aim is *personal profits*? Or must we expect him to seek some other end—prestige, power, or the gratification of professional zeal?

If we are to assume that the desire for *personal profit* is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group. In the operation of the corporation, the controlling group even if they own a large block of stock, can serve their own pockets better by profiting at the expense of the company than by making profits for it. If such persons can make a profit of a million dollars from a sale of property to the corporation, they can afford to suffer a loss of $600,000 through the ownership of 60 per cent of the stock, since the transaction will still net them $400,000 and the remaining stockholders will shoulder the corresponding loss. As their proportion of the holdings decrease, and both profits and losses of the company accrue less and less to them, the opportunities of profiting at the expense of the corporation appear more directly to their benefit. When their holdings amount to only such fractional per cents as the holdings of the management in management-controlled corporations, profits at the expense of the corporation become practically clear gain to the persons in control and the interests of a profit-seeking control run directly counter to the interests of the owners.

In the past, this adverse interest appears sometimes to have taken the extreme form of wrecking a corporation for the profit of those in control. Between 1900 and 1915 various railroads were brought into the hands of receivers as a result of financial mismanagement, apparently designed largely for the benefit of the controlling group, while heavy losses were sustained by the security holders.[1]

Such direct profits at the expense of a corporation are made difficult under present laws and judicial interpretations, but there are numerous less direct ways in which at least part of the profits of a corporation can be diverted for the benefit of those in control. Profits may be shifted from a parent corporation to a subsidiary in which the controlling group have a large interest. Particularly profitable business may be diverted to a second corporation largely owned by the controlling group. In many other ways it is possible to divert profits which would otherwise be made by the corporation into the hands of a group in control. When it comes to the questions of distributing such profits as are made, self-seeking control may strive to divert profits from one class of stock to another, if, as frequently occurs, it holds interests in the latter issue. In market operations, such control may use "inside information" to buy low from present stockholders and sell high to future stockholders. It may have slight interest in maintaining conditions in which a reasonable market price is established. On the contrary it may issue financial statements of a misleading character or distribute informal news items which further its own market manipulations. We must conclude, therefore, that the interests of ownership and control are in large measure opposed *if* the interests of the latter grow primarily out of the desire for personal monetary gain.

Into the other motives which might inspire action on the part of control it will not profit us to go, though speculation in that sphere is tempting. If those in control of a corporation reinvested its profits

[1] See

Chicago & Alton Railway Co.	12 I. C. C.	295—1907
Pere Marquette Railway Co.	44 I. C. C.	1—1914
Chicago, Rock Island & Pacific	36 I. C. C.	43—1915
New York, New Haven & Hartford	31 I. C. C.	32—1914
St. Louis & San Francisco Ry. Co.	29 I. C. C.	139—1914

All of these roads went into receivership or were in financial difficulties as a direct or indirect result of financial management of highly questionable sort.

in an effort to enlarge their own power, their interests might run directly counter to those of the "owners." Such an opposition of interest would also arise if, out of professional pride, the control should maintain labor standards above those required by competitive conditions and business foresight or should improve quality above the point which, over a period, is likely to yield optimum returns to the stockholders. The fact that both of these actions would benefit other groups which are essential to the existence of corporate enterprise and which for some purposes should be regarded as part of the enterprise, does not change their character of opposition to the interests of ownership. Under other motives the interests of owner and control may run parallel, as when control seeks the prestige of "success" and profits for the controlled enterprise is the current measure of success. Suffice it here to realize that where the bulk of the profits of enterprise are scheduled to go to owners who are individuals other than those in control, the interests of the latter are as likely as not to be at variance with those of ownership and that the controlling group is in a position to serve its own interests.

In examining the break up of the old concept that was property and the old unity that was private enterprise, it is therefore evident that we are dealing not only with distinct but often with opposing groups, ownership on the one side, control on the other—a control which tends to move further and further away from ownership and ultimately to lie in the hands of the management itself, a management capable of perpetuating its own position. The concentration of economic power separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating "owners" to the position of those who supply the means whereby the new princes may exercies their power.

The recognition that industry has come to be dominated by these economic autocrats must bring with it a realization of the hollowness of the familiar statement that economic enterprise in America is a matter of individual initiative. To the dozen or so men in control, there is room for such initiative. For the tens and even hundreds of thousands of workers and of owners in a single enterprise, individual initiative no longer exists. Their activity is group activity on a scale so large that the individual, except he be in a position of control, has dropped into relative insignificance. At the same time the problems of control have become problems in economic government.

CHAPTER V: THE LEGAL POSITION OF MANAGEMENT [1]

"MANAGEMENT" may be defined as that body of men who, in law, have formally assumed the duties of exercising domination over the corporate business and assets. It thus derives its position from a legal title of some sort. Universally, under the American system of law, managers consist of a board of directors and the senior officers of the corporation. The board of directors commonly secures its legal title to office through election by the stockholders or those of them who, under the corporate charter, are accorded a vote. This is not universal. In some States provision can legally be made for election of directors by bondholders and by employees.[2] But such permission is not usually availed of. Corporations having directors elected either by the employees or by bondholders, though by no means unknown, are rare indeed.

The law holds the management to certain standards of conduct. This is the legal link between ownership and management. As separation of ownership from management becomes factually greater, or is more thoroughly accomplished by legal devices, it becomes increasingly the only reason why expectations that corporate securities are

[1] The law of management has been elaborately explored by text-writers almost from the beginning of corporate history. See Morawetz: "Corporations," especially Section 519; H. H. Spellman: "A Treatise on the Principles of Law Governing Corporate Directors," (New York, 1931) which is the latest collection of substantially all of the decisions on the point and which is a good and authoritative statement of the liability. See also Cook on Corporations, Sections 643–666; 14A Corpus Juris, Pages 49–243 and especially Sections 1887–1893. This chapter is merely a concise summary of the rules as they bear on the problems envisaged in this book.

[2] See for instance General Corporation Law of Delaware, Section 29 (Paragraph 2)—Certificate of Incorporation may confer on holders of bonds or debentures whether or not secured, the power to vote in the same manner as the stockholders.

worth having, can be enforced by the shareholders. If the situation ever arises that a management is, in fact, not chosen by its security holders, and has no duties towards the security holders recognized at law or enforceable through legal means, then the security holder has a piece of paper representing a capital contribution, which is valuable only as the good nature or the good faith or the economic advantage of the men actually in charge of the corporate affairs lead them to make it so. We thus are led to conclude the strength of law in this regard is the only enforceable safeguard which a security owner really has.

The law governing the duties of a management towards security owners is perhaps the only section of corporate jurisprudence which has not undergone a sustained weakening process. To some extent, as will appear, it has been cut into by statutes and charter provisions of one or another kind. But, in the main, the rules of conduct applicable to managements were developed out of the common law and not out of statute; which may perhaps account for their development along lines which seem, to the detached observer, more healthy than those of the statutes. Humanly speaking, the common law, though often laggard, is both flexible and realistic; in the last analysis judges when presented with situations which seem to demand a remedy, will, if untrammeled by statute, usually attempt to find a solution.

The three main rules of conduct which the law has developed are: (1) a decent amount of attention to business; (2) fidelity to the interests of the corporation; (3) at least reasonable business prudence.

In applying these rules a distinction must be taken which invariably irritates the layman and is today, for the first time, giving some pause for thought for lawyers. This is the ancient metaphysical squabble between loyalty to the "corporation" and loyalty to the stockholders or security holders, as the case may be. The law sums up the three rules above mentioned by saying that the management stands in a "fiduciary" capacity towards the corporation. Since the corporation is a distinct legal identity, separate and apart from stockholders, it may become necessary to determine whether a director can be honest and faithful with regard to the whole corporation at the same time that he is taking a hostile position towards an individual shareholder. And on this a dispute is at present going forward in the law which has, as yet, reached no solution.[8] The general lines of it may be indicated here.

[8] It is a theory of A.A.B. that the dispute probably could be solved by a closer analysis of the relief asked.

Where a director violates his duties towards the corporation, say by causing the corporation to enter a transaction in which the director is personally

A director, let us say, owns property, and without disclosing that he owns it, induces the corporation to buy it at an unfair price. The corporation is thereby injured; it has paid for property more than it is worth and has done so owing to the influence of one of the very men who is supposed to forward its interests. Legally, the law condemns the action of this director and permits the corporation either to set aside the transaction making him give back the price he received and returning him his property; or to make him pay the damage which his corporation suffered.[4] It is plain that there has been a damage to the corporation as such; its treasury is impoverished by the over-price paid.

Let us suppose the same director, however, owning a block of shares of stock in the corporation. He knows that the corporation has just run into an unexpected stroke of good fortune—perhaps has struck an oil well on its land, many times increasing the present value of its assets. He finds another shareholder who does not know the good news and buys his stock from him. Presently the information comes out;

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interested, a wrong is done to the corporation—it has paid for property or services more than they are worth. This damages the shareholders by reducing the corporate assets or earnings. When the Courts say that relief can only be had on behalf of the corporation, what is really meant is that relief for all of the individuals who have suffered loss can best be worked out by giving damages to the corporation. This repletes the corporate funds which automatically accrue to the shareholders. In this view the refusal of the law to consider the complaint of an individual shareholder ought to be taken not as a denial of his right to relief, but as a device of procedure to insure that the relief reaches all stockholders ratably.

Some cases raise situations where the directors have harmed the corporation, though there is no apparent loss to the corporation itself. The ill-fated Bank of United States did this when it organized an affiliate corporation whose stock was sold to the Bank of the United States shareholders, the directors and officers of the Bank of the United States retaining for themselves a large block of the affiliates' stock for which they paid little or nothing. The affiliate was designed to exploit opportunities open to the Bank. Since these opportunities did not appear as balance sheet items it was not easy to point out any definite damage to the Bank. Obviously, however, the Bank had not made profits which otherwise it might have made. This is one of the many phases of litigation still overhanging the liquidation of the Bank of United States in New York.

[4] *Aberdeen Railway Co. v. Blaikie Brothers* (House of Lords 1854) 1 Macqueen's App. Cas. 461. The rules of law have developed from various bases but they reach about the same result. One group of cases holds that where a director is interested the transaction is voidable without regard to fairness: this is the federal rule—*Wardell v. Railroad Co.* (1880) 103 U. S. 651; *Cleveland-Cliffs Iron Co. v. Arctic Iron Co.*, 261 Federal 15. To the same effect is *Robotham v. Prudential Insurance Co.* (1903) 64 N. J. Eq. 673; New York, *Jacobson v. Brooklyn Lumber Co.* (1906) 184 N. Y. 152; California, *San Diego Railway Co. v. Pacific Beach Co.* (1896) 112 Cal. 53. Other cases hold that the transaction will be upset if in fact unfair to the corporation—which means that the Court will substitute its

the stock rises in value to accord with the changed situation, and the director has a handsome profit on the operation. Here the corporation, as such, has not suffered a single item of loss. Nothing that the director did has changed its position in the slightest; a set of shares have changed hands, but its own balance sheet is not changed. Its assets are just as great. The director has made his profit, not at the expense of the corporation, but at the expense of one of the stockholders. As in the previous case, he has done this by taking advantage of his position as one of the managers of the corporation; in the former case as director he induced the corporation to purchase, in the latter case he used for his own benefit information which came to him strictly as a member of its board of directors. Yet in the second case a majority of decisions proceed on the theory that the director is a fiduciary for the corporation only; that he has no fiduciary obligations towards the stockholder; that he deals with the stockholder at arm's length as he would any outsider; and that he is entitled to keep his profit.[5] In

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judgment for that of the Board of Directors; *Smith v. Wells Manufacturing Co.*, 148 Indiana 333 (1807); *General Investment Co. v. Bethlehem Steel Corporation*, 87 N. J. Eq. 234. The final rule in New York seems at length to have crystallized on the theory that if the transaction is unjust it will be upset; otherwise not. See *Globe Woolen Co. v. Utica Gas & Electric Co.*, 224 N. Y. 483 (1918). Judge Cardozo writing for the Court observed, "A trustee may not cling to contracts thus won unless their terms are fair and just." This case is interesting from another point of view since a dominant stockholder was involved and the question of "control" thus came up. The Court's remark "a dominating influence may be exerted in other ways than by a vote" is illuminating.

The question of interlocking directors has given a good deal of difficulty. Here, of course, a director owes a double loyalty. If the two corporations contract (this was the situation in the *Globe Woolen Co. v. Utica Gas & Electric Co.* case and the *Cleveland-Cliffs Iron Co. v. Arctic Iron Co.* case, above) the general rule is that the eventual contract may be voidable only if in fact it is unfair. An interesting note on this point is found in Canfield and Wormser's "Cases on Private Corporations," pages 464, 465. The only conclusion that can be drawn is that in fact, courts try to evaluate the situation, upsetting the transaction if it is obviously unfair and allowing it to stand where it is fair.

[5] *Carpenter v. Danforth*, 52 Barbour (N. Y.) 581; *Board of Commissioners v. Reynolds* (1873) 44 Indiana 509; *Strong v. Repide*, 213 U. S. 419 (1908), but in this case it was held that there were special circumstances which entitled the stockholders to relief since they had virtually appointed the offending director their individual agent. Contra: See *Oliver v. Oliver*, 118 Georgia 362 (1903) squarely holding that in purchase and sale of stock a director was liable to a stockholder where he had failed to communicate important information to that stockholder.

There is real confusion of thought here. The instinct of the Courts against permitting a stockholder to sue a director for the stockholder's individual loss was probably due to a fear of many actions and to the idea that relief should be worked out through the corporation. Thus where the New York Central Railroad Co. controlled the Board of Directors of the New York & Northern Railother words, the director represents only an aggregate of the interests pooled under the corporate machinery; he has no duties to any of the participants.

To laymen this distinction is neither particularly plain nor particularly healthy.[6] That director was chosen presumably to represent the

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road Co. and wrecked the latter (See *Farmers' Loan & Trust Co. v. New York & Northern Railway Co.*, 150 N. Y. 410–1896) by routing traffic over the New York Central line, and, despite an opinion unfavorable to its conduct, succeeded in getting control of the road by foreclosing second mortgage bonds which had been purchased for the purpose, a shareholder sued to recoup his personal losses. The Courts declined to permit him to recover insisting that the relief must be worked out through the corporation, *Niles v. New York Central Railroad Co.*, 176 N. Y. 119 (1903), the Court saying "True, that plaintiff has suffered a depreciation in the value of his stock as a result of the wrong, and in this respect the injury was personal to the holders of the stock. But every stockholder has suffered from the same wrong, and, if the plaintiff can maintain an action for the recovery of the damages sustained by him, every stockholder must be accorded the same right. The injury, however, resulting from the wrong was, as we have seen, to the corporation."

On the other hand, there are a whole set of injuries which may be done to the shareholder without reference to the corporation, for which the corporation has no cause of action and needs no remedy. Falsifying accounts so that the shareholder is led to pay a higher price than the stock is worth for instance; See *Ottinger v. Bennett*, 144 N. Y. App. Div. 525, affirmed 203 N. Y. 554 (1911); *Walsham v. Stainton*, 1 De Gex J. & S. 678 (1863), though that was a close corporation.

But the majority view in the cases holds that a director, while liable for fraud like any other individual, is not under any enhanced duties to the shareholders of his own company; see *Connolly v. Shannon*, 105 N. J. Eq. 155 (1929).

The result as against the individual shareholder is that the director has no duties which are not imposed on any other individual. If he harms the corporation presumably the corporation can recover; and the corporation can be made to recover by a minority stockholder.

[6] It would seem that the Director, along with his power, acquired a good deal of information, which might be extremely valuable on occasion. This information he acquires only in his capacity as a manager of the corporation. Ethically it would seem plain that the information and any advantage from it belonged to the shareholders rather than to the director personally.

Some corporations rigidly decline to permit anyone connected with the institution to speculate in stock of the corporation, so that this information may not be unconscionably availed of. Others go to the opposite extreme, having lists of individuals to whom important information is relayed in sufficient time to permit action.

Mr. Newton D. Baker is said to have declared at one time that a director ought not to be allowed to have stock holdings in a corporation he directs; the temptations were too great. The real difficulty probably lies with a lack of adequate system of payment to the corporate directors. The director's fee does not remotely compensate for successful and faithful management. Not unnaturally directors feel they are entitled to reap some profit. If capitalizing on information is the simplest mode afforded it is beyond human nature to expect that it will not be used. The ultimate solution would seem to be an honest and fully disclosed profit sharing scheme of some kind, such as that recently adopted by the Standard Oil Company of New Jersey.

interests of everybody; and to forward and protect them. It is of no interest to the shareholder that the director may be the ablest of individuals in managing the corporate business, if the use he makes of his ability is to deprive the stockholder individually of the fruits of his management. A minority of courts in the United States adopt the view that the director may not use his position to advantage himself against the interests of any of his shareholders; if he proposes to deal with them he must disclose what he knows, so that the stockholder is at least as able to deal intelligently as is the director himself.[7] The theory is that the information on which the director is acting is not the private property of the director, but is given to him for the benefit of everyone; in a word, that the director is a fiduciary for all of the individuals concerned as well as for the mythical corporate entity as a whole. With this latter view the writers agree; but it is not generally accepted. A compromise view, held by the Federal and some other courts, is to the effect that where the circumstances are peculiar, and special facts make it inequitable for the director to act at the expense of the stockholder, he may be held liable; and this view seems likely in the end to supersede the older law on the subject.[8] Yet at present, any fair statement of the law would have to be based on the theory that the fiduciary duties of the director were limited to the corporation; and that if, by reason of his position, he can without deception but equally without disclosure take advantage of a shareholder without depleting the corporate assets, he may do so.

Business men are not so clear about this distinction. It is probably generally true that managements do take advantage of the shareholders individually, particularly along the lines of purchase and sale of stock dictated by their fiduciary knowledge of the corporation's affairs.[9]

[7] *Oliver v. Oliver*, 118 Georgia 362; see for a discussion of the conflicting rules 14A Corpus Juris, page 128 (1896); Fletcher's Encyclopædia of Corporations, Volume 4, Section 2464.

[8] *Strong v. Repide*, 213 U. S. 419 (1908); *Stewart v. Harris*, 69 Kansas 498.

[9] One of the writers attended a conference at which the President of a corporation was working out plans for the redemption of the preferred stock of the corporation then selling at about $60. The redemption price was $110. The writer asked whether this should not be submitted at once to the Board of Directors. The President observed that he did not feel himself at liberty to do so until he could make public announcement of the redemption plans simultaneously with the Directors' meeting. Otherwise he feared certain of his Directors would go into the market and purchase all of the stock possible at a low price for the purpose of taking advantage of the higher redemption price. This perhaps accounts for Judge Gary's famous policy with the United States Steel Directors of insisting that notice of dividends should be sent out over the stock ticker before the meeting at which the dividend had been announced was adjourned.

There is no great disagreement about the ethics of the transaction. Managements engaged in this kind of business do not enjoy having it divulged. And when business men dislike to have their methods disclosed, even after the fact, it is usually sound to conclude that their ethical judgment is against it.

As yet this ethical feeling has not (save in the minority of States referred to above) injected itself into the law; and, at the moment, the stockholder as an individual, when coping with his management, must rely on the conscience of the men involved.

Starting then from the proposition that the fiduciary duty of the mangement is limited to the corporation, i.e., that they are pledged to adhere to standards of conduct which do not deplete the assets or earnings of the company—it will appear that the law has gone to great lengths to insure a clean standard—fidelity, industry and business sense on the part of the management. In the classic case on the subject Judge Allen of New York observed that "No principle is better settled than that a person having a duty to perform for others cannot act in the same matter for his own benefit" (*Abbott v. American Hard Rubber Co.*, 33 Barbour 578) and this rule, laid down in 1861, remains no less valid today. So, whenever a director finds his own interests in conflict with that of his corporation, it is his duty to exercise no influence on the corporation in the transaction; if he does so, he places himself in an exposed position which most men do not care to assume.

In like manner, a measure of ordinary business sense is required of managers; and directors or officers not having it, or possessing it and not exercising it, are liable personally for the resulting damages. Another rule in the common law, was set out in another old case, "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," (Earl, J. in *Hun v. Cary*, 82 N. Y. 65, 1880), and this rule likewise remains in active force.[10] It took a little time for the

[10] In 1742 an English Lord Chancellor said of corporate directors "By accepting 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. . . ."

"If upon inquiry before the Master, there should appear to be a supine negligence in all of them, by which a gross complicated loss happens, I will never determine that they are not all guilty." (*The Charitable Corporation v. Sutton*, 2 Atk. 400); See *Briggs v. Spaulding*, 141 U. S. 132 (1890)—Fuller, C. J.—"It is perhaps unnecessary to attempt to define with precision the degree of care and prudence which directors must exercise in the performance of their duties. The law to get over the idea that if a man acted in good faith and had not himself tried to defraud the corporation, he could not be held liable except for "gross" negligence or inattention to duty. But that hurdle was passed a full half century ago; and the rule today is unquestioned.[11] However honest he may be, he must be reasonably careful and reasonably able. It is true that as the law can find no definite standard of ability in business matters (this quality not being as yet the subject of accurate measurement), the best it can do is to leave to a jury in each case to decide whether the manager accused of incompetence was reasonably able. But after the fact, where the result has been catastrophic, juries are more likely to err on the severe than on the lenient side in dealing with the director attacked.[12]

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degree of care required depends upon the subject to which it is to be applied, and each case has to be determined in view of all the circumstances. They are not insurers of the fidelity of the agents whom they have appointed, who are not their agents but the agents of the corporation; and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the business with attention or in neglecting to use proper care in the appointment of agents." See also *Gibbons v. Anderson* (1897) 80 Fed. 345; see also "Liability of the Inactive Corporate Director" 8 Columbia Law Review 18–26.

[11] The theory that directors were liable for only "gross negligence" and not for "slight negligence" was demolished by Mr. Justice Bradley, in *Railroad Co. v. Lockwood,* 17 Wall. 357, 382 (United States Supreme Court). Mr. Justice Bradley came to the conclusion that "negligence" means simply "failure to bestow the care and skill which the situation demands"; Chief Justice Fuller amplified this by saying that the degree of care to which directors are bound is that which ordinarily prudent and diligent men would exercise under similar circumstances.

Even in those days the argument that to require diligence of directors would prevent "gentlemen of property and means" from accepting directorships was put forward as a reason why the courts should be lenient. Of course, the answer was that if gentlemen of property and means did not propose to run the business with care they were not acceptable directors; and Chief Justice Fuller in the opinion quoted above so held.

There is a corollary to the rule. If damages are to be recovered from a director for not attending to his job "the plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss and what loss it would have avoided" (Learned Hand, J. in *Barnes v. Andrews,* 298 Fed. 614 (1924).) An interesting compilation of the historical source of material is contained in Canfield and Wormser's "Cases on Private Corporations" (Second Edition, Indianapolis, 1925—pages 449–451).

[12] These cases invariably are judged as a result of hindsight rather than foresight which presents a real difficulty. Of course, the test whether an action taken by the Directors was fair must be made as of the time when they acted. The dangers in the situation have led to the inclusion of clauses in corporate charters attempting to relieve Directors in large measure. Pullman Company's charter for example provides:

"*Thirteenth:* No contract or other transaction entered into by the Corporation shall be affected by the fact that any director of the Corporation in any

Similarly, perhaps as a variant from the preceding one, our manager must attend to his job. This disposes summarily of the inactive gentleman who has lent his name to the board of directors with the understanding that he would not take any real part in management. Mr. George Jay Gould found himself in this unhappy position by assuming office as director of the Commonwealth Trust Co. in 1902, with the distinct understanding that he was not expected to attend meetings or take active part in the company's affairs. Reckless operations by the active men in charge led the bank to collapse a few months later; and one of the stockholders sued Mr. Gould to make good the corporate losses. The court observed that what was required of a director for the reasonable exercise of his powers was a question of fact; and directed that the Trial Court ascertain whether as a matter of fact Mr. Gould's participation in the bank's affairs lived up to "reasonable care" under the particular circumstances. This apparently left the burden on Mr. Gould to prove that he had acted as a sensible bank director.[13]

This situation raises many nice questions of conduct. It is not always easy for directors who may have large affairs to remain wholly disinterested in the transaction of the corporation's business. Of late a situation has arisen with which the law has not yet attempted to cope. Where a single individual finds himself a director of two companies whose policies conflict, he may have some difficult choices to make. In strict ethics the business community regards it his duty to

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way is interested in, or connected with, any party to such contract or transaction, or himself is a party to such contract or transaction, provided that such contract or transaction shall be approved by a majority of the directors present at the meeting of the Board or of the Committee authorizing or confirming such contract or transaction, which majority shall consist of directors not so interested or connected. Any contract, transaction or act of the Corporation or of the Board of Directors or any Committee, which shall be ratified by a majority of a quorum of the stockholders at any annual meeting, or at any special meeting called for such purpose, shall be as valid and as binding as though ratified by every stockholder of the Corporation."

This is a Delaware charter. A similar clause appears in the charter of the United Corporation. The charter of the Dodge Brothers Inc., a Maryland corporation, went even further, providing that a Director should not be liable for secret profits even though he had failed to disclose to his fellow Directors that he was interested in the transaction on which he voted. It is highly doubtful whether these clauses of absolution have any great effect when a case comes up. Similar clauses limiting the liability of trustees have been restricted in effect by the courts.

[13] *Kavanaugh v. Gould,* 223 N. Y. 103 (1918)—apparently the case was settled out of court afterward. What had happened was that the President of the Bank sank a large portion of the Bank's funds in the U. S. Ship Building Company whose bonds subsequently became valueless.

solve the situation according to the best business sense he may have. A still nicer feeling on the subject might lead him to resign from one of the two directorates. But the latter alternative may not be to the best interest of either of his corporations, since the very existence of a representative of a conflicting interest on the board of a competing or adverse company may supply a channel of communication by which the difficulty can ultimately be solved to the best advantage of both.[14] So far as the law can be worked out from analogous situations it would seem that his position is dangerous; and indeed, men try to avoid it. From a business point of view the result is the final test; if what he does on the whole makes for a sound development of both companies, the fact that he acts for two adverse interests at the same time is rather to his credit than otherwise.[15] The one ethical point on which every one is agreed is that the adverse interest, if any, must be disclosed. There appears to be a general feeling that where a man represents adverse interests without letting that fact be known, he has created a situation so dangerous as not to be tolerated in the business community.

There is, however, a range of neutral activity in which the management of a corporation, without acting adversely to the corporation, may nevertheless benefit itself. Control of the corporate assets may and not infrequently does permit a management to do favors for its friends without injuring the corporation. Thus, they can place the

[14] Such a situation came up in connection with the financing of the United States Steel Corporation. There the Steel Company floated a bond issue of $100,000,000 through J. P. Morgan & Co. Fifteen of the twenty-four members of the Board of Directors were members of the bankers' syndicate which Morgan got up to handle the issue. An injunction was granted by the trial court which was reversed on appeal, the court finding that the transaction was voidable but not void; that there was full disclosure; that the interconnecting directorships helped rather than hindered the contract and that it had been ratified anyhow. See *United States Steel Corporation v. Hodge,* 64 N. J. Eq. 807 (1903).

[15] The writers feel that the charge that directors are interested on both sides of the transaction is entirely too loosely made in the financial community. A director, especially if he is an important man financially, will have a dozen or more interests all going at once. In many cases the action taken by him in one corporation is necessarily more or less adverse to the interests of other corporations in which he may be interested. Yet, in a number of cases known to the writers, the directors have scrupulously ignored their own interests. The real problems arise where the director is an important factor in the "control" of two corporations at once. There, it would be almost beyond possibility for him not to consider the possibilities of both situations before casting a vote or inducing an action. Many directors are elected frankly because they have interests in other corporations whose activities may complement those of the corporation electing him. In other words, the corporations expect to transact business with each other or in the same field, to their mutual advantage; and the very duality of interest of the director is thus turned to the advantage of both.

corporation's funds in a bank friendly to them. If the bank is safe and if the terms on which the deposit account is arranged are those prevailing in an open and competitive market, there may be no injury to the corporation. Yet the directors themselves may have profited by the transaction since they have steered business towards their friends, and may themselves expect reciprocal favors later on.[16] This kind of problem is recurrent. The business community, on a purely realistic basis, appears to take the view that if the corporation is not hurt there can be no objection. Actually, the shareholders of the corporation may be adversely affected by this favoritism. Yet such injury to the stockholders is on the very periphery of the area of legal control. Development in this direction lies almost entirely in the future.

It was observed at the outset that management normally proceeded from the election of directors by all or some of the stockholders. But the increasing numbers of these, and their unorganized dispersion, almost necessarily implies a mediary group, analogous to a political "boss." Such groups have appeared; they are called by the financial community "control." And this extra-legal, or at least separate group, so far conditions management, that it deserves a separate analysis.

[16] Most Banks have two classes of directors. One class is made up of bankers. The other consists of business men who may be able because of their business affiliations to shift accounts and banking transactions towards the Bank. These connections are openly known and are perfectly well understood. The director himself gains power. But his corporation may obtain assistance through having "friends at court" in the Bank; and the Bank is strengthened by the connection with a business enterprise. The situation has its dangers but it also has its advantages; in the business view the advantages outweigh the dangers.