

The conclusion which is to be drawn regarding the suggested qualification of the liberal rule is that the writers, with the possible exception of Professor Williston, have not recognized the distinction, that in a few limited situations protection has been afforded to the bona fide purchaser by restricting the admissibility of parol evidence of an individual usage, but that the decisions do not recognize this qualification expressly. On the basis of the cases it is believed, however, that this qualification may be made since no cases have been found in which the liberal rule has been expressly applied in the case of a bona fide purchaser, while the liberal view has been followed frequently in suits between the immediate parties. It is urged further that the suggested qualification will assume an increasing importance if the liberal rule secures a more universal adoption.

A DEFENSE OF NON-MANAGING DIRECTORS

Outstanding among present day examples of the lag in legal rules behind changing commercial practices is the case presented by non-managing (corporate directors.¹ The rapidity with which business practices are altered, especially the recent changes in the make-up of corporate boards, intensifies the conflict between law and practice. Non-managing directors, a result of the vast dimensions to which corporations have grown, have individually different and more or less limited functions and competencies. They are usually supposed to take little or no part in the general management of their corporations. The law, however, still sees but one type of director—one entrusted with active and constant supervision of all corporate officers and affairs,² and whose duty is sanctioned by strong and absolute civil and penal liabilities.³ Courts and authors alike have refused to recognize the existence of, or at least a justification for, non-managing directors.⁴ A single standard of diligence and liability is imposed upon all.⁵ Thus a non-managing director is considered not as a

¹ The distinction between non-managing and executive or managing directors has been clearly defined in Samuel, *Shareholders' Money*, Append. I, §24(1) (1933).

² *People v. Central Fish Co.*, 117 App. Div. 77, 79, 101 N.Y. Supp. 1108, 1109 (1907); *Hun v. Cary*, 82 N.Y. 65, 74 (1880); Dwight, *Liability of Corporate Directors*, 17 Yale L.J. 33, 36 (1907); Ballantine, *Corporations* 359 (1927); Samuel, *op. cit. supra* note 1, at 141. See also note 5 *infra*.

³ *People v. Mancuso*, 255 N.Y. 463, 469, 175 N.E. 177, 178 (1931); Wormser, *Directors—Figures of Earth*, 1 Brooklyn L. Rev. 28, 30, 35 (1932); Wormser, *Frankenstein, Inc.* 134 (1931). See New York Penal Law 1909, §§ 667 (3)(d), 397 (for bankers specifically); California Penal Code 1872, §§ 568, 572. See also note 5 *infra*.

⁴ *People v. Mancuso*, 255 N.Y. 463, 469; 175 N.E. 177, 178 (1931); Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. 1305 (1934); Wormser, *Directors—Figures of Earth*, 1 Brooklyn L. Rev. 28, 35 (1932); Wormser, *Frankenstein, Inc.* 128 (1931); Dwight, *op. cit. supra* note 2, at 35.

⁵ *Briggs v. Spaulding*, 141 U.S. 132, 147 (1820); *Bowerman v. Hamner*, 250 U.S. 504, 513 (1918); *Allen v. Roydhouse*, 232 Fed. 1010, 1014 (D.C. Pa. 1916); *Morawetz, Corporations*

different director, but as a bad one, forgetful of the uniform duties.⁶ It would seem that the nature of his legal duties should depend upon the extent of the function that it is intended he perform. If those duties conform closely to his practical position, then more stringent enforcement may be expected from the courts.⁷ Under the present legal setup, however, where a court feels the uniform legal duties too onerous for a particular non-managing director, a relaxation of the standards to accomplish justice in his case will, as a result of a failure to draw the proper distinction, create precedent for a similar relaxation for all directors. This development may explain the surprising leniency with which courts often treat managing directors. There can be a sensible harmony between law and practice only when it is recognized that non-managing directors have special functions, and that their failure to participate in tasks not specially assigned to them is not neglect of duty but precisely what is expected of them.

Authors usually enumerate three types of non-managing directors: the adviser, the business-connection, and the so-called "shirt-front director."⁸ Only the first two can be justified as truly beneficial to a corporation; the latter has no real function. Directors of the adviser type are persons of particular personal ability, such as engineers, economists, and attorneys.⁹ Business-connection directors are representatives of a corporation's carrier, its banker, its customers, and the like. A large modern corporation can hardly be without the constant active collaboration of a staff of highly qualified advisers and of

§ 552 (2d ed. 1886); Cook, Corporations § 703 (4th ed. 1898); Thompson, Corporations § 1378 (1895).

This attitude is especially clear, when the standard of care required is defined as that which the directors use in their own affairs. See *People v. Mancuso*, 255 N.Y. 463, 469, 175 N.E. 177, 178 (1931); *In re Brazilian Rubber Plantations & Estates, Ltd.*, [1911] Ch. D. 425; Wormser, Directors—Figures of Earth, 1 Brooklyn L. Rev. 28, 31 (1932); Wormser, Frankenstein, Inc. 125, 134 (1931).

⁶ *Whitfield v. Kern*, 120 N.J. Eq. 115, 125, 184 Atl. 333, 339 (1936); Dwight, *op. cit. supra* note 2, at 33; Wormser, Directors—Figures of Earth, 1 Brooklyn L. Rev., 28, 35 (1932).

Exemplary of this attitude is the identification of non-managing directors with "financial gigolos" and non-active directors. See Samuel, *op. cit. supra* note 1, at 112, 118, 140.

⁷ Wieland, Zu dem Gesetzentwurf zur Revision des Schweizerischen Aktienrechts, in *Zeitschrift für Ausländisches und Internationales Privatrecht* (1929) pp. 82, 85.

This might be achieved by a shift in the burden of proof to directors, requiring each to show that he did not neglect his duties. See Douglas, *op. cit. supra* note 4, at 1327; Dwight, *op. cit. supra* note 2, at 40; Bericht des Vorsitzenden des Ausschusses für Aktienrecht der Akademie für Deutsches Recht, in *Zeitschrift der Akademie für Deutsches Recht* (1934) 33, (1935) 254. This is the German law. German Corporation Act of Feb. 4, 1937 §§ 84(2), 99.

⁸ Samuel, *op. cit. supra* note 1, at 118, 120.

⁹ The very special problem of the investment banker is not herein discussed. See Brandeis, *Other Peoples' Money* (1933).

representatives of its business associates.¹⁰ The good will created by these connections cannot be ignored. These directors keep before the eyes of the managers a miniature picture of the economic world in which the corporation lives; the conference room of the board restores to the managing directors that perspective which is so easily obstructed by the narrow walls of the plant's office.¹¹

The legal reaction toward the presence of these men, however, is almost unanimously unfavorable in this country.¹² Those who stand up vigorously against it seem to be motivated mainly by the narrow conception of directors as general managers; thus non-managing directors are excluded *a priori*. But even those who accept the value of their collaboration adhere to the traditional definition,¹³ and ask that all non-managers be either deprived of their votes or relegated to a sort of advisory board with no power whatsoever.¹⁴ The reason for such a desire is more than the mechanical proposition that "the duty of a director is to direct."¹⁵ It is the fear that these men have not the same interests as the managing directors, but will prefer the interests of themselves or of some other corporation which they may represent.¹⁶ The proposals urged by such directors, however, may actually be advantageous to the corporation, and the variety of interest among the non-managing directors may serve as a real counterbalance for a domineering management.

It seems advisable, too, that the non-managers be voting members of the board. It must be feared that the traditional "goldpiece" would not be sufficient to induce advisers and business-connections to enter a corporation only to be relegated to a position of impotence. More important, the non-managing directors are a power with which to be reckoned, if they have votes.¹⁷ Their real supervision, or its potentiality, over the managing directors would prevent the managers from becoming too independent and careless in their policies. The main benefit of advisers, as compared with technical employees, lies

¹⁰ "One of the best assets of a corporation is the advice and assistance of men of business experience and large business connections upon its board." *Kavanaugh v. Gould*, 147 App. Div. 281, 289, 131 N.Y. Supp. 1059, 1065 (1911). See also Berle and Means, *The Modern Corporation and Private Property* 231, note 15 (1934); Rathenau, *Vom Aktienwesen* 16, 17 (21st ed. 1922). See also Report of the English Company Law Amendment (Wilfred Greene) Committee (1926) No. 46.

¹¹ See Douglas, *op. cit. supra* note 4, at 1313-14.

¹² A more favorable view is attempted in Stevens, *Corporations* 590-91 (1936), and on a very special basis in Douglas, *op. cit. supra* note 4, at 1312-14.

¹³ Wormser, *Frankenstein, Inc.* 136 (1931).

¹⁴ Douglas, *op. cit. supra* note 4, at 1305; Wormser, *op. cit. supra* note 13; Samuel, *op. cit. supra* note 1, at 124.

¹⁵ See *People v. Central Fish Co.*, 117 App. Div. 77, 79, 101 N.Y. Supp. 1108, 9 (1907).

¹⁶ See Samuel, *op. cit. supra* note 1, at 171.

¹⁷ Rathenau, *op. cit. supra* note 10, at 15; Douglas, *op. cit. supra* note 4, at 1307, 1312-1314. *Zeitschrift der Akademie für deutsches Recht* (1934), *op. cit. supra* note 7, at 30.

in their independence of the management.¹⁸ This independence would disappear, even if sufficiently high salaries were paid, for it must be feared that the managing directors would ignore the very existence of those who had no power to make themselves heard. One might still suggest that non-managing directors, even without votes, may exert influence if they have strong enough personalities. That, however, would create power without responsibility. If, to remedy this, it is suggested to impose responsibility proportionate to the influence exerted,¹⁹ the suggestion comes back to the original proposal of a partition of the board, into managing and non-managing directors.²⁰

The main consequence of a recognition of the distinction that exists would be a complete reorientation of directors' duties and liabilities. The changes, of course, should concern only the care and diligence required of them. Fiduciary disqualifications and liability for intentional acts must remain unchanged, the same for all directors. But for directors whose duties are individually different, and relating to certain specified corporate activities only, there would be no general duty to collaborate on all matters. Each non-managing director would be held only for neglect of that for which he was appointed and for active intervention in acts which are outside his competence.²¹ The legal position of non-managing directors would then correspond to their position in fact.²²

Precedent in America, drawing any distinction between managing and non-managing directors is, however, singularly lacking. In one Rhode Island case,²³ a new trial was granted after a directed verdict against a director who was also treasurer, upon a showing that it was well-known that his function was wholly

¹⁸ Douglas, *op. cit. supra* note 4, at 1314; *Zeitschrift der Akademie für Deutsches Recht* (1934), *op. cit. supra* note 7, at 30.

¹⁹ Douglas, *op. cit. supra* note 4, at 1313.

²⁰ The German law goes still further and provides for two wholly separate boards. German Corp. Act of Feb. 4, 1937. The non-managing directors, elected by the shareholders (§ 87), form a board of supervision and elect from outside their membership the board of management which remains responsible toward them (§ 75). Thus they have even more than equality of power.

²¹ But he should not be allowed to restrict his activity to mere attendance at board meetings involving his particular field, as has been suggested in *Dovey v. Cary*, [1901] A.C. 477, 492; *In re City Equitable Fire Ins. Co.*, [1925] Ch. 407, 429. See Samuel, *op. cit. supra* note 1, at 129; *Zeitschrift der Akademie für Deutsches Recht* (1934) *op. cit. supra* note 7, at 254; Evidence given before the English Company Law Amendment Committee (Wilfred Greene) (1926), Question no. 1239.

²² See *Zeitschrift der Akademie für Deutsches Recht* (1934), *op. cit. supra* note 7, at 29.

²³ *Conaty v. Torghen*, 46 R. I. 447, 453, 128 Atl. 338, 341 (1925). See *Kavanaugh v. Gould*, 147 App. Div. 281, 291, 131 N.Y. Supp. 1059, 1066 (1911), where this distinction as to "both . . . duty and liability" was based on an express provision in the by-laws that an executive committee be nominated by the board of directors. This provision was authorized by § 42 of the Banking Laws, Cons. Laws N.Y. 1909, c. 2. See also *Wheeler v. Aiken County Loan & Savings Bank*, 75 Fed. 781, 787 (C.C.S.C. 1896); note 12 *supra*.

ministerial. The court said that an officer or director "is liable for want of reasonable care giving due consideration to the nature of the corporate business, *his own particular duties and the time, place, and circumstances in which he is expected to perform them.*"²⁴ Another distinction, admitted by a few courts, is founded upon the remuneration received by the different directors.²⁵ Although this may help to distinguish managing from non-managing directors, it is of little aid in differentiating among the non-managing directors themselves. Some courts beg the question by saying that directors undertake to have "full competence."²⁶ Other courts hold directors liable only for so much skill as they declared to possess,²⁷ thus accepting as a sufficient excuse the fact that the shareholders knew he was not fully competent when appointed. The decisive factor, however, should not be the degree of competency, but rather the fields in which it is necessary that he be competent. If it is assumed that the situation is one in which he was intended to act, a knowledge on the part of shareholders that he was incompetent should not excuse him.²⁸ One line of cases refused to hold liable non-resident directors for failure to attend meetings,²⁹ but today the non-residence is generally viewed as rather clear evidence of negligence.³⁰ The latter view is in full accord with the current failure to draw any distinctions among directors. The former may well have been based on the idea that the director should not be held liable for a failure to do that which no one intended that he should. In any event, these attempts by a few courts toward differentiating among directors fall short of establishing a genuinely flexible standard.

It is not a change in the degree of care required that is needed, but rather a correlation of the activities to which the present standards³¹ of care should be applied with the expectation of the persons involved. Any change from the fixed law³² on that point could best be made by statute. The English Com-

²⁴ Conaty v. Torghen, 46 R.I. 447, 453, 128 Atl. 338, 341 (1925) (italics added).

²⁵ Jones v. Johnson, 86 Ky. 530, 543, 6 S.W. 582, 585 (1888); First State Bank of Nortonville v. Morton, 146 Ky. 287, 294, 142 S.W. 694, 697 (1912); Dunn v. Kyle, 77 Ky. 134, 142 (1878); Boulicault v. Oriel Glass Co., 283 Mo. 237, 250, 223 S.W. 423, 426 (1920); Spellman, Corporate Directors 536 (1931). *Contra*: Charitable Corp. v. Sutton, 2 Atk. 400, 405 (1742).

²⁶ Warren v. Robison, 19 Utah 289, 300, 57 Pac. 287, 290 (1899); Hun v. Cary, 82 N.Y. 65, 74 (1880).

²⁷ Dunn v. Kyle, 77 Ky. 134, 138 (1879); Story, Bailments § 1820 (8th ed. 1870).

²⁸ Dwight, *op. cit. supra* note 2, at 33. Wormser, *op. cit. supra* note 13, at 128.

²⁹ Wallach v. Billings, 277 Ill. 218, 234, 115 N.E. 382, 388 (1917); noted in 12 Ill. L. Rev. 256 (1917).

³⁰ Bowerman v. Hamner, 250 U.S. 504, 514 (1919); Dwight, *op. cit. supra* note 2, at 39.

³¹ See Allen v. Roydhouse, 232 Fed. 1010, 1014 (D.C. Pa. 1916).

³² Leterman v. Pink, 294 App. Div. 164, 169, 291 N.Y. Supp. 249, 254 (1936); People v. Central Fish Co., 117 App. Div. 77, 79, 101 N.Y. Supp. 1108, 1109 (1907); Ballantine, *op. cit. supra* note 2, at 359.

panies Act of 1929³³ seems to be an excellent example. No differentiations in the English board have been spelled out,³⁴ but the courts have power to exempt from liability any director who can show "that he has acted honestly and reasonably and that having regard to all the circumstances of the case, *including those connected with his appointment*, he ought to be fairly excused from the negligence."³⁵ This solution, it was explained, is required to "meet the case of a director who has been appointed because of his special knowledge for a special purpose and not to direct the business of the Company generally."³⁶ Similar notions have been employed in so many other countries that the distinction between managing and non-managing directors as here described, with its consequences on their different duties and liabilities, may be considered as being, under one form or another, the general rule of European legal system.³⁷

Following in particular the English statute, it would seem best that the law merely formulate the principle, and leave its application in the individual case to the courts, for detailed legislative rules fixing the liability of each possible type of non-managing director would be extremely difficult to establish and even more delicate to apply. Courts have always made this type of inquiry, for they have taken into account in each case the nature of the corporation, its business, the act complained of, and the like.³⁸ It should not, therefore, be too difficult for the inquiry to be extended to the individual position of the accused director himself. Here, of course, lie the main practical difficulties of the proposed system; it will not always be simple to ascertain the functions of a director and to determine whether the act was a part of them. But it is not believed that these difficulties are too great. The main factor of determination must be the conditions attendant upon the appointment of the director. In fact practically every non-managing director enters his office on definite understandings concerning his fitness and his functions.³⁹ These understandings can be shown by various factors: his background, his qualifications, his function in other enterprises, actual work done by him previously in the corporation in question, and the function of the director who preceded him.

³³ 19 and 20 Geo. V, c.23.

³⁴ *Id.* §§ 139 *et seq.*

³⁵ *Id.* § 372(1) (italics added).

³⁶ Report of the English Company Law Amendment (Wilfred Greene) Committee (1926), No. 47.

³⁷ Although the accomplishment of the distinction is universal, the methods used are not uniform, but vary from the rigid German division at one extreme (note 21-23 *supra*) to the highly flexible English system at the other (notes 34-37 *supra*). For a detailed comparative analysis of the foreign methods, see Hallstein, *Die Aktienrechte der Gegenwart* (1931).

³⁸ See *Briggs v. Spaulding*, 141 U.S. 132, 147 (1890); *Conaty v. Torghen*, 46 R.I. 447, 453, 128 Atl. 338, 341 (1925); *Morawetz, op. cit. supra* note 5, § 552.

³⁹ See: Report of the English Company Law Amendment (Wilfred Greene) Committee (1926), No. 47; *Rathenau, op. cit. supra* note 10, at 17.

It is conceivable that as to each non-managing director a statement should be published upon his appointment and included in all prospectuses and reports setting forth the function which he is to serve.⁴⁰ This statement would prove useful to the courts and would operate as notice to the public which might otherwise suppose that the director was intended to direct, supervise, and control in general.⁴¹

With the English Act as an example and its successful operation⁴² for encouragement, it would seem that a similar change in this country to achieve consistency between law and practice merits serious consideration.

⁴⁰ A similar notion has been suggested. Samuel, *op. cit. supra* note 1, at 140-41.

⁴¹ This danger of misplaced reliance has been one of the main arguments of the opponents of the differentiation. See Samuel, *op. cit. supra* note 1, at 124.

⁴² Professor Douglas calls this system "extremely useful in many connections." Douglas, *op. cit. supra* note 4, at 1328, note 63.