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COMMENTS

CORPORATIONS — LIABILITY OF DIRECTORS TO CREDITORS FOR NEGLIGENT MANAGEMENT — There is much confusion in the cases concerning a director's liability to a creditor for negligent management of the corporation.[1] A clearer answer might be indicated by an examination of analogous situations involving individuals instead of corporations. It adds confusion to the law to have a different rule for a corporation than for a human being, and such a result should be avoided unless separate treatment is required by something inherent in the corporation. The least that can happen if a court thinks along these lines is that it will be more likely to know what it is doing.

An agent's negligent management of an enterprise entrusted to him by a human principal may cause the principal's insolvency just as a director's negligent management causes the corporation's insol-

[1] This discussion is not concerned with statutory liability, for which see 3 FLETCHER, CORPORATIONS, perm. ed., 678 (1931). Probably the best discussion of the case law is found in 82 UNIV. PA. L. REV. 364 (1934). Also see 3 FLETCHER, op. cit., 621-634, and annotations in 45 L. R. A. (N. S.) 421 (1913) and 50 A. L. R. 462 (1927).

vency. The agent is not liable to the human principal's creditors merely for failing in his duty to the principal.[2] And a creditor's bill will not ordinarily reach the human principal's cause of action against the agent.[3] The most such creditor can hope for is that the claim against the agent will go to principal's trustee in bankruptcy as one arising from injury to property.[4] To give analogous remedies to a creditor of a corporation whose directors were negligent, we would say they were liable only at the suit of a receiver or trustee in bankruptcy for the corporation. Is there anything in the nature of a corporation which makes a different result desirable?

The courts which have permitted recovery against the directors otherwise than in a receivership or bankruptcy proceeding have probably been impressed by the fact that whereas a human principal's self-interest will make him hold the agent to account, the corporation may be in the control of the very directors against whom the action would be brought.[5] But since the directors' knowledge that insolvency and receivership will bring accountability is a strong incentive to diligence, how important is the inhibition of the corporation to call the directors to account? Is it important enough that we should avoid it by making the way clear for a creditors' race of diligence, by forcing a much more difficult measure of damages upon the court,[6] and by introducing all

[2] "A third person who suffers loss because an agent fails to perform his duties to the principal has not, merely because of such fact, a cause of action against the agent. If such person has a cause of action in tort against an agent who has not contracted with him and holds nothing for him, it is because the agent has caused him harm by conduct which is tortious irrespective of an agency relationship." AGENCY RESTATEMENT 773 (1933); Delaney v. Rochereau, 34 La. Ann. 1123, 44 Am. Rep. 456 (1882).

[3] "It is probably the majority rule that, in the absence of statutory authority, a creditor's bill cannot reach the *choses in action* of the judgment debtor, unless the case presents some independent ground of equity jurisdiction, such as fraud, trust, or the like." 5 POMEROY, EQUITY JURISPRUDENCE, 4th ed., 5097 (1919).

[4] There seems to be no case involving this sort of claim, but it would probably come within the language of the Bankruptcy Act, "rights of action arising upon contracts or from the unlawful taking or detention of, or injury to, his property." 30 Stat. L. 566, 11 U. S. C. § 110 (1898). The cases seem to exclude nothing but actions for personal injuries.

[5] "It is true that a better reason can be brought forward why a creditor of a corporation should be allowed to pursue property belonging to it in the hands of a party who procured the property by fraud, than can be given for allowing the creditor of an individual to do so; for an individual can always exercise his right to seek redress against a fraud; whereas a corporation may be under the control of directors or trustees, who are interested in taking no step to redress the wrong." Heineman v. Marshall, 117 Mo. App. 546 at 554, 92 S. W. 1131 (1906).

[6] When the receiver distributes whatever has been recovered from the directors among the creditors, it is not necessary to determine how much a particular creditor is injured by a director's negligence.

the complexity which would result when creditors (suing either in their own right or the corporation's right) interfere in the affairs of a going concern? The only possible situation in which such results would be justified is that where the corporation's claim against the directors is destroyed so that it is not available to the receiver.

The writer has found no case in which it was argued that the cause of action had been destroyed by release, waiver, ratification, etc., on the part of the corporation,[7] but it would be interesting to speculate as to how such a contention would work out. The cases involving corporate approval of directors' acts (such as execution of contracts or purchase, sale, or conveyance of property) are not in point because in the nature of things an injured party does not ratify or approve a tort—if anything, he releases his cause of action for the tort. A release of a cause of action cannot be the result of "acquiescence with knowledge," but must be based upon a deliberately formed contract supported by seal or consideration.

If the injured party is a corporation, the release will be given by the board of directors, which has general control over corporate actions,[8] and the stockholders would have no direct voice in such a matter. Even if there is the necessary seal or consideration to make the release effective, it is voidable if, as is probable, the individuals who voted as directors were the ones who took the release.[9] In that case, there is still the possibility of approval by the stockholders—by a simple majority if there is involved merely the technical breach of directors dealing with themselves; [10] or by a unanimous vote if the consideration taken for the release is so small that there is wasting of assets or fraud.[11]

But even in the case of stockholder approval, the creditors can preserve the cause of action by showing that the approval was with fraudu-

[7] The absence of such cases, in itself, indicates that a court should not be influenced greatly by a fear that the corporation's right against the directors for negligence will be cut off.

[8] 9 FLETCHER, CORPORATIONS, perm. ed., § 4219 (1931).

[9] If the board giving the release is composed of individuals different from those guilty of negligence, there is an active self-interest as in the case of a human principal. The same thing is true if the approving stockholders are not the guilty directors. It is a less active, because more remote, self-interest, but it certainly provides a further argument for refusing creditors any remedies except through the receiver.

[10] 2 FLETCHER, CORPORATIONS, perm. ed., § 764 (1931); Pruitt v. Westbrook, (Tex. Civ. App. 1928), 11 S. W. (2d) 562; Pollitz v. Wabash R. R., 207 N. Y. 113, 100 N. E. 721 (1912); Russell v. Patterson, 232 Pa. 113, 81 A. 136 (1911).

[11] 2 FLETCHER, CORPORATIONS, perm. ed., § 764 (1931); Farmers Loan & Trust Co. v. New York & Northern R. R., 150 N. Y. 410, 44 N. E. 1043, 34 L. R. A. 76 (1896); Klein v. Independent Brewing Co., 231 Ill. 594, 83 N. E. 434 (1907); Hodgman v. Atlantic Refining Co., (D. C. Del. 1924) 300 F. 590.

lent intent as to the creditors.[12] This should be easy to show because directors who have been held to be negligent in the management of the corporation are not likely to think of executing a release until they are definitely trying to save themselves from the creditors of the corporation.

However, if the release is given long enough before the insolvency to make it difficult to prove a fraud as to creditors, it will also be so early that the creditors were not appreciably harmed because the corporation had sufficient assets at that time to pay all the creditors. That is, the more easy it is for the directors and stockholders to deprive creditors of their remedy through the receiver, the less possibility there is of creditors' being harmed by directors' conduct. The result is that a creditor who needs a remedy against the director almost certainly has it through the receiver, and there is no justification for treating directors of a corporation any differently from an agent of a human principal so far as liability to creditors is concerned.

C. R. H.

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[12] McCandless v. Furlaud, 295 U. S. 726, 56 S. Ct. 41 (1935), and cases cited.