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Corporations--Directors' Liability to Corporate Creditors for Negligent Mismanagement

Paul R. Rice
West Virginia University College of Law

> applicable to corporate agents as to agents of natural persons . . . .[5]

Therefore, as an agent, the directors are only liable to the corporation, its principal, for negligence in carrying out the fiduciary duty owed to it.

This view contends, for practicality, that it would be unwise to find a duty and impose this liability on directors because: (1) each individual creditor would be allowed to bring his own action, thereby resulting in a vast multiplicity of suits on each individual wrong;[6] (2) there would exist the extremely burdensome problem of taking account of all the corporate property and debts, then deciding how far its ability to pay these debts has been destroyed by the directors' negligent mismanagement, and then apportioning among the creditors the damages which each director must pay; (3) the rights of the individual creditors of each director and the additional liability which the directors have to the stockholders would ultimately be injured if not destroyed;[7] (4) it would be detrimental to the overall public interest because few responsible men would assume such positions due to this possible liability[8] and (5) as the principal case stresses, if the creditors were allowed to recover from the directors, then double liability would be imposed on them, for this would not bar the right of action which the stockholders would have.

The second approach, to which the above arguments are directed, is based upon the theory that the directors are in a relationship of trustee to the corporate creditors as well as to the corporation, and therefore, any injury which is caused by them, due either to their misconduct or gross negligence, is actionable by each creditor individually.[9]

The principal case criticizes this theory of the directors acting in a capacity of trustee for the creditors. The court points out that by acting as a trustee for both the creditors and the corporation an

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[5] Clark v. Lawrence, 5 Fed. Cas. 888 (No. 2,827) (D. Mass. 1856).
[6] Abbott v. Merriam, 8 Cushing 588 (Mass. 1851).
[7] Annot., 50 A.L.R. 462, 463-464 (1927).
[8] Zinn v. Mendel, 9 W. Va. 580 (1876).
[9] Delano v. Case, 121 Ill. 247, 12 N.E. 676 (1887).

irreconcilable conflict of duty arises because the creditors are asserting claims against the corporation and ultimately a breach of duty to one or the other will occur.

This observation certainly has merit,[10] but, why is it necessary to categorize into a *legal pigeon-hole* this relationship between corporate directors and creditors? Could we not just as easily find a duty owed by the directors upon the theory that the directors can foresee injury to the creditors if the corporation is managed in a negligent manner?[11] Before we can answer this policy question of whether corporate creditors are within the zone of foreseeable risk we must consider the practical criticisms enumerated by the proponents of the agency theory. After doing this one may question the advisability of any approach which would establish a duty upon the directors.

The first criticism suggested was that a multiplicity of suits would result as to each individual wrong if each individual creditor were allowed to bring his own action. One writer in discussing the "trust fund doctrine" which finds a duty owed to the creditors by the directors, concludes,

> [I]f . . . the individual creditor who has been injured as a remote result of the defendant's negligence is allowed to recover for an injury not peculiar to himself without joining the corporation, or its receiver, litigation will be increased with the probable result that in such cases the aggressive creditors, . . . will be enabled to attach the available assets of the tortfeaser leaving the others to such recovery as may be had from the corporate assets left in the hands of receivers.[12]

This appears to be a valid criticism because there is apparently no way by which the directors can force all the creditors into bringing one action and binding them. Rule 23 (a) of the Federal

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[10] 3 FLETCHER, *op. cit. supra* note 4, at 881.

[11] This is the doctrine put forth in the case of *Palsgraf* v. *Long Island R. Co.*, 248 N.Y. 339, 162 N.E. 99 (1928), *i.e.*, culpable negligence is a matter of relation between the parties which is founded upon the foreseeability of injury to the parties actually injured. West Virginia is in accord with this doctrine.

[12] 8 N.C.L. REV. 459, 462 (1929-1930).

Rules of Civil Procedure[13] and of the West Virginia Rules of Civil Procedure[14] provides for class actions, but, because of the lack of a unity of interests between the parties,[15] a spurious class suit would be the only class action applicable (there being common questions of law or fact affecting the several rights involved). This would not, however, be of any help in relieving the problem of multiplicity of suits since the decree in the spurious class action would not be binding on those who would chose not to be a voluntary party to it.[16]

This criticism also suggests that not only will there be a multiplicity of suits, but also a frequent occurrence of the problem. However, if the situations which give rise to liability are limited to "gross negligence", as has been done in several cases,[17] then possibly this criticism and other criticisms could be avoided.

This term "gross negligence" has been given a variety of meanings from "anything [which is] less diligence than that exercised by a prudent man about his own affairs to that 'degree of inattention and want of care indicative either of wilfull wrecklessness, or intent to defraud or permit others to defraud.'"[18] If this latter interpretation were adopted, then liability would not be greatly expanded from that which has always existed at common law for tortious acts such as misrepresentation.

If the directors are held liable only when they are grossly negligent, then the additional criticism that too great a duty will be placed on the directors in performing their functions, which will

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[13] FED. R. CIV. P. 23 (a).

[14] W. VA. R. CIV. P. 23 (a).

[15] 3 MOORE, FEDERAL PRACTICE § 23.08 (2d ed. 1966).

[16] First Nat'l. Bank of Florence v. Edwards, 134 S.C. 348, 132 S.E. 824 (1926); 3 MOORE, FEDERAL PRACTICE § 23.11 [3] (2d ed. 1966).

[17] Tate v. Bates, 118 N.C. 287, 24 S.E. 482 (1892) and Anthony v. Jeffress, 172 N.C. 378, 90 S.E. 414 (1916). Many of the cases which found a duty owed by the directors to creditors involved bank directors and depositors. This is significant because, even though the depositor is technically the same as a creditor, the general rules with respect to bank directors being liable for their negligent management of the corporation's affairs are not altogether applicable to officers and directors of private corporations. Lillian Knitting Mills Co. v. Earle, 237 N.C. 97, 74 S.E.2d 351 (1953). The reason for the basic distinction between bank directors and private corporation directors, as stated in the case of *Delano v. Case*, 121 Ill. 247, 12 N.E. 676 (1887) is the high character of the directory for integrity and business capacity which thereby results in a high degree of confidence reposed in the bank by the public.

[18] Note, *Liability of Directors for Negligent Management*, 82 U. PA. L. REV. 364 (1933).

result in a less responsible group of individuals assuming such positions, has no validity. One can hardly say that requiring individuals, regardless of what position they fill, to avoid being wilfully wreckless, is going to impose such a burden of risk that it would be too dangerous for one to assume such a position. On the contrary, its effect would probably be to increase the professional responsibility of directors to the extent that hasty and wreckless decisions would not be made without first considering the consequences to all concerned.

If an action were allowed, the determination of the extent to which the directors' negligent mismanagement injured the corporation's ability to pay its obligations, especially if insolvency existed initially, would be extremely difficult. To complicate matters even further, each separate action would not be bound by the total measure of damages found in any previous action, from which each creditor's pro rata share would be taken.[19] Of course, if insolvency did not exist before the negligent acts complained of, then this would not be as severe a problem, for the total measure of damages from which each individual creditor's share would be taken would be the amount by which the corporation has been made insolvent.

The criticism that injury is possible to the rights of the individual creditors of each director is a valid argument. But is not this possibility always true of any judgment which is rendered against one who injures another? The criticism that the stockholders' rights against the directors would be impared is not realistic. Even though they have an action available as a corporate group, through a stockholders' derivative action, the creditors still have their derivative rights which will take preference.[20] Therefore, all that we would be doing is allowing the individual creditors to achieve directly what they are now achieving indirectly.[21]

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[19] Since these would be individual actions on separate claims and not a single class action there would be no need for a relationship between the damages in any two actions.

[20] "The misconduct of the directors, causing corporate insolvency, whether malfeasance or nonfeasance, gives rise to a cause of action belonging to the corporate group and constituting an asset available for all corporate creditors." STEVENS, CORPORATIONS §§ 152-154, at 721 (2d ed. 1949).

[21] This indirect manner of receiving payment can arise not only by way of preference in the proceeds from a stockholders' derivative action but also by way of a creditor's bill, See note 24 infra.

Having established that the stockholders' derivative rights will not be impaired, there still remains the argument of the principal case that double liability may be imposed on the directors. It is true that the stockholders or corporate group will still have its right of action against the directors, but simply having a right of action does not mean double liability. Double liability does not occur until the same damages have been paid twice, and this is possibly where this argument fails. After the creditors have collected their damages, it is suggested that the measure of damages in a subsequent stockholders' derivative action (or an action by a receiver if one has been appointed) should be reduced according to those creditors' recoveries. This is because the actual amount which the corporation would otherwise have netted from the stockholders' derivative action (if no individual creditor's actions were allowed) would be diminished by the claims of the creditors which are given priority in payment. However, other problems might arise with respect to damages.

What if the stockholders bring their derivative action before some of the creditors have brought their action? Will these creditors be bound by the amount of damages the stockholders received from which to settle their claims or can they choose to bring their own action? If the answer is that they are bound, then possibly the creditors who sued first are given an advantage. However, if they are not bound then will the directors in fact incur double liability, or will they be permitted to recover a portion of the previous damages paid to the corporation, or will those previous damages paid to the corporation reduce the damages in the succeeding actions by creditors according to those creditors' pro rata share of them? These are problems which remain unanswered and must be dealt with if a duty is to be owed by corporate directors to corporate creditors, either by the trust theory or the foreseeable injury approach suggested earlier in the article.

West Virginia's most recent decision on this problem is *Inter-Ocean Casualty Co. v. Leccony*,[22] where the court held that

> [I]n this state it is well settled that the creditor of a moneyed corporation cannot maintain an action at law against the

[22] 123 W. Va. 541, 17 S.E.2d 51 (1941).

> directors thereof for simple nonfeasance of duty to the corporation or fraud in its management or mismanagement in the disposition of the money or property of the corporation in the absence of an active intent to deceive or defraud the plaintiff.[23]

The duty which the trust theory and the foreseeable injury approach would impose on the directors of a corporation to its creditors has not been looked on with favor by our courts. These theories, even though limited to those cases where "gross negligence" has caused or increased insolvency, pose significant problems with respect to multiplicity of suits and the determination of damages. Therefore, it is felt that the majority of courts, including West Virginia, have justifiably rejected individual actions by corporate creditors against corporate directors when the directors have negligently mismanaged the corporation's affairs.[24]

Paul R. Rice

Criminal Law—Self-Defense—Justification Needed for Use of Deadly Force

D, alone in her home with her children, heard an intruder at her window. Alarmed, she went across the street and telephoned the sheriff's office, where her husband was employed. After her husband arrived on the scene, he showed her how to use a shotgun, and then returned to his duties. Later, *D* noticed the blind and draperies moving in her T.V. room. She also heard the window being raised slowly. Taking the gun in hand, she arose and fired in the direction of the window. The resulting blast mortally wounded the deceased, who was in the line of fire. Upon trial for murder, *D* relied on self-defense. After conviction for second

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[23] *Id.* at 545, 17 S.E. at 53.

[24] An equitable creditor's bill may permit the creditors to sue the negligent directors as a class after the corporation has become insolvent and a demand has been made on the stockholders or receiver to take action against the directors and it has been refused. Ellis v. H. P. Gates Merchantile Co., 103 Miss. 560, 60 So. 649 (1913). See generally, 3 FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS, § 1183 (1965) and Annot., 50 A.L.R. 462, 473 (1927). This is an asset of the corporation and the creditors can sue in the right of the corporation. Browne v. Hammett, 133 S.C. 446, 131 S.E. 612 (1926).