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Corporations - Standard of Care for Directors and Officers - Pennsylvania Business Corporation Law § 408

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CORPORATIONS—Standard of care for directors and officers—Pennsylvania Business Corporation Law § 408—The Supreme Court of Pennsylvania has held that Section 408 imposes on the directors and officers of a business corporation a degree of care significantly higher than that existing prior to its enactment.

Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966).

Plaintiff-appellants, stockholders of the Manganese Corporation of America (hereinafter referred to as Manganese), brought a derivative suit in equity against Manganese and its officers and directors. After suit was begun, Selheimer, a minority director of Manganese, was severed as a party plaintiff and joined as a defendant. The plaintiffs alleged that mismanagement of Manganese by the defendants had resulted in a loss of approximately $400,000 of the corporation's assets and contended that the defendants were personally liable for the loss because their actions violated the standard of care established in Section 408 of the Pennsylvania Business Corporation Law. Section 408 states:

> Officers and directors shall be deemed to stand in a fiduciary relation to the corporation, and shall discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs.[1]

The Chancellor in Common Pleas Court found for the plaintiffs and ordered the defendants to reimburse the receiver of Manganese for the loss. Defendants filed exceptions which were sustained by the court en banc in a 2-1 decision and this appeal by plaintiffs followed. Defendant Gillan appealed the dismissal of the original defendants' complaint against the additional defendant, Selheimer.

The Supreme Court of Pennsylvania in a 6-0 decision reversed and remanded. The opinion, written by Justice Jones, is significant for its interpretation of Section 408 of the Pennsylvania Business Corporation Law.

Before proceeding to the holding, a review of the facts is desirable. In 1958 defendants Himfar and Kusner formed a corporation named Mangamex, Inc. (hereinafter referred to as Mangamex) to produce manganese oxide at a New Jersey plant. Originally Himfar and Kusner were the only stockholders in Mangamex but defendants Pie and Gillan subsequently acquired Mangamex stock. In January 1959 Himfar, Kusner, Pie, and Gillan (through nominees) formed Manganese, a Pennsylvania corpo-

1. PA. STAT. ANN. tit. 15, § 2852-408. Since the *Selheimer* decision this section has been renumbered as tit. 15, § 1408 (1967).

ration. Manganese's authorized capital structure consisted of 400,000 shares of Class A, $2 par, stock and 200,000 share of Class B, 20¢ par, stock. Class A stockholders could elect three directors and Class B four directors. Himfar, Kusner, Pie, and Gillan were designated as the first directors in Manganese's articles of incorporation. At the first directors' meeting these four approved a plan whereby Manganese would purchase Mangamex's assets ($91,500) and assume its indebtedness ($10,000) in exchange for all of Manganese's Class B stock and such a transfer subsequently occurred. Mangamex then distributed its Manganese B stock to Himfar, Kusner, Pie, and Gillan, its four stockholders. Next Manganese made a public offering of 200,000 of its Class A shares at $3 per share. This offering, which netted Manganese $412,914.50, was not registered with the Securities and Exchange Commission because the Securities Act of 1933 provided that an offering was exempted from the registration provisions of the Act if the entire issue was sold to the residents of one state and if the corporation issuing the stock was doing business in that state.[2] The offering prospectus stated that Manganese intended to operate a Colwyn, Pa. plant where the substantial operating activities would be located.[3] Prior to the public offering of the Class A stock defendant Selheimer had been elected a minority director of Manganese by those holding Class A stock at that time. In March 1959 Manganese paid $10,000 as a down payment on the Colwyn, Pa. plant site, final settlement to occur before September 1, 1959. The supreme court found that the directors and officers of Manganese knew that their New Jersey plant could not be operated profitably but despite this knowledge they continued to spend such large sums on its operation that when the Colwyn plant was purchased in August 1959 only $55,000 of the $412,000 realized from the Class A stock offering remained. The court found that "this amount was patently insufficient to establish the originally projected plant in Colwyn."[4] After Manganese went into bankruptcy in October 1960, the receiver salvaged only $30,000.

After reviewing these facts Justice Jones examines Section 408 and states:

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2. The Securities Act of 1933 registration provisions do not apply to:

> Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory. 15 U.S.C.A. § 77c(a)(11) (1963).

3. The pertinent portion of the prospectus appears in n. 24, at 583 of 423 Pa. 563, and at 645 of 224 A.2d 634 (1966). The court took note of this "token" compliance with the federal statute, *supra* note 2, one of many factors which militated against the defendant appellees, see 423 Pa. at 583-84, 224 A.2d at 645-46.

4. 423 Pa. at 571, 224 A.2d at 639.

> This statute mandates a standard of care for directors much more stringent and harsh than the standard enunciated by our courts prior to the passage of the statute. Our case law prior to the statute taught that the directors of corporations—whether business, banking, or otherwise—were held simply to a standard of ordinary care and diligence and that, absent fraud or gross negligence amounting to fraud, such directors would not be personally liable for their actions. The standard prior to Section 408 might well be stated as that care, skill and diligence which the ordinary prudent man would exercise in similar circumstances.[5]

In his discussion of Section 408 Justice Jones notes (1) that the critical phrase "in their personal business affairs" was not contained in the Uniform Model Business Corporation Act[6] but was added at the suggestion of a committee of the Pennsylvania Bar Association,[7] (2) that prior to enactment the supreme court had expressly rejected the Section 408 standard of care,[8] (3) that the Section 408 standard represents the minority view in the United States,[9] and (4) that the Section 408 standard imposes a "much higher"[10] degree of care on the directors of business corporations than imposed by statute or case law on the directors of banking corporations[11] or on the directors of building and loan corporations.[12] Justice Jones

5. *Id.* at 573-74, 224 A.2d at 640-41. Justice Jones documents this statement with several cases: Hunt v. Aufderheide, 330 Pa. 362, 199 Atl. 345 (1938) where the conduct in question had occurred prior to 1933, the year Section 408 went into effect, Swentzel v. Penn Bank, 147 Pa. 140, 23 Atl. 405 (1892), Spering's Appeal, 71 Pa. 11, 10 Am. Rep. 684 (1872). See also the excellent discussion in B. SEGAL, PENNSYLVANIA BANKING AND BUILDING & LOAN LAW, Vol. 1, § 402, p. 362 (1941).

6. 9 U.L.A., p. 186-87.

7. See B. SEGAL, *supra* note 5, Vol. 1, § 402, p. 362.

8. Swentzel v. Penn Bank, 147 Pa. 140, 150, 23 Atl. 405, 414 (1892).

9. For this proposition Justice Jones cities: Briggs v. Spaulding, 141 U.S. 132 (1891), Stone v. Rottman 183 Mo. 552, 82 S.W. 76 (1904), Forest of Dean Coal Mining Co., 10 Ch. Div. 450, 451 (1878).

10. 423 Pa. at 578, 224 A.2d at 643.

11. The Banking Code of 1965 provides: "Directors, trustees and officers of an institution shall discharge the duties of their respective positions in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." PA. STAT. ANN. tit. 7, § 1411 (1967). This language is identical to that found in the prior banking code. This language appears to be a codification of the case law standard, see note 5, *supra*, and accompanying text.

12. The Building and Loan Code of 1933, PA. STAT. ANN. tit. 15, §§ 1074-1 to 1074-1303 (since the *Selheimer* decision the Code has been renumbered as §§ 5001 to 6303 (1967)) has no provision relating to the standard of care of directors and officers, thus these men are governed by the case law standard, note 5 *supra* and accompanying text. See the discussion in B. SEGAL, PENNSYLVANIA BANKING AND BUILDING & LOAN LAW, Vol. 1, § 402, p. 362 (1941).

recognized that Section 408 "may well render unattractive positions as directors of business corporations,"[13] but that "regardless of our doubts as to the wisdom of the rule"[14] the supreme court was bound to follow the dictates of the legislature, any change being the legislature's prerogative.

Justice Jones held that under either the Section 408 standard or under the case law standard existing prior to its enactment the directors of a business corporation would be personally liable when they "have been imprudent, wasteful, careless, and negligent. . . ."[15] and such actions have resulted in the insolvency of the corporation despite "the absence of fraud, self-dealing, or proof of personal profit or wanton acts of omission and commission. . . ."[16] on the part of the directors. Both the Chancellor and the court en banc had found defendants' actions to be imprudent, wasteful, careless, and negligent. However, the court en banc had interpreted the supreme court's opinion in *Smith v. Brown-Borhek Co.*[17] to require a showing of fraud, self-dealing or personal profit or wanton omission or commission before personal liability could be imposed. In *Smith* the supreme court said that director conduct not amounting to fraud, self-dealing or personal profit or wanton omission or commission could be ratified by a majority vote of the stockholders[18] and since the plaintiff had failed to allege such conduct he was barred from proceeding since stockholder ratification had occurred. In *Selheimer* the supreme court decided that the court en banc was incorrect in concluding that the case at bar was controlled by the *Smith* decision saying that "[a] study of *Smith* completely negatives . . . [this] . . . conclusion. . . ."[19] Justice Jones then states:

> The rule is well settled that "[c]ourts are reluctant to interfere in the internal management of a corporation, since that is a matter for the discretion and judgment of the directors and stockholders, unless a minority stockholder's rights are jeopardized or injured by fraud or *waste* of company assets, or an over-reaching, actual or legal: [citing authorities]." . . . .[20]

13. 423 Pa. at 578, 224 A.2d at 643.

14. *Id.*

15. *Id.* at 580, 224 A.2d at 644.

16. *Id.*

17. 414 Pa. 325, 200 A.2d 398 (1964).

18. The court quoted with approval the following language from Lowman v. Harvey R. Pierce Co., 276 Pa. 382, 386, 120 Atl. 404, 406 (1923), "the majority stockholder may not, as against the corporation and minority stockholder, dissipate or waste its funds, or fraudulently dispose of them in any way, either by ratifying the action of the board of directors in voting themselves illegal salaries, or by any other [similar] act." Smith v. Brown-Borhek Co., 414 Pa. 325, 331, 200 A.2d 398, 400 (1964).

19. 423 Pa. at 580, 224 A.2d at 644.

20. *Id.* at 581, 224 A.2d at 644.

After reviewing the record in light of this rule Justice Jones concludes, "This record indicates clearly that the defendants, as the controlling directors and officers, wasted and dissipated Manganese's assets. Their actions constituted negligence such as was inimical to the corporation and the other stockholders of the corporation."[21] and thus they were personally liable under either the Section 408 standard or under the case law standard that existed prior to its enactment.

The court also found that the additional defendant Selheimer should not be held liable because the record supported his contention that he had protested the defendant's conduct and had converted his protests into actions against the defendants.

The court remanded the case because it felt that the Chancellor had erred in concluding that all of Manganese's losses were due to defendant's conduct. The court concluded that "the nexus between Manganese's losses and defendents' negligent and wasteful actions must act as the basis for reimbursement. To establish such relationship the matter must be remanded. . . ."[22]

The case law standard ("that care, skill and diligence which the ordinary prudent man would exercise in similar circumstances"[23]) required only that a director emulate the ordinary prudent director. Thus, this standard was fixed by whatever the current practices of directors were. If the ordinary prudent director was willing to take substantial risks, this behavior set the case law standard despite the fact that in his personal business affairs the director never would have assumed such risks. Under the Section 408 standard ("that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in their personal business affairs")[24] the director can no longer justify his actions by looking to the conduct of other directors. Under Section 408 his conduct as a director will be measured by his performance in his personal business *under similar circumstances*. The phrase "under similar circumstances" encompasses both (1) the fact situation presented to the director *and* (2) the limitations of the director position, *e.g.*, time. Thus, while the Section 408 standard is obviously more stringent than that which existed prior to its enactment, it does not require a director to be excessively diligent. It is submitted that the investing public is entitled to the protection of a Section 408 standard.

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21. *Id.* at 585, 224 A.2d at 646.

22. *Id.* at 586, 224 A.2d at 647.

23. See note 5 *supra*, and accompanying text.

24. See note 1 *supra*, and accompanying text.