> payment of dividends]; or (iv) for any transaction from which the director derived an improper personal benefit. . . .

There has been widespread adoption, with shareholder approval, of amendments to corporate certificates of incorporation to provide the protection contemplated by this provision (and provisions in other states with similar objectives).

Francis v. United Jersey Bank

87 N.J. 15, 432 A.2d 814 (1981).

[Pritchard & Baird Intermediaries Corp. (Pritchard & Baird) was in the business of acting as a reinsurance broker. Reinsurance is the process by which an insurance company that has agreed to insure a risk (the ceding company) assigns all or a portion of that risk to another company (the reinsurer), along with a share of the premium. The broker acts as intermediary. In doing so, it receives funds from ceding companies and is obligated to pay these funds over to the reinsurers. Lillian Pritchard had inherited a 48 percent interest in Pritchard & Baird from her husband, Charles Pritchard, Sr. She was the largest single shareholder and a director. The remaining shares of the corporation were owned by her sons, Charles, Jr. and William, who also served as directors. Charles, Jr. dominated the management of the corporation after the death of his father. Charles, Jr. and William over a period of several years withdrew large sums of money from the corporation in the form of "loans." By the time the corporation finally became bankrupt, the total of the loans was over $12 million. The loans were taken from funds that the corporation was supposed to hold in trust for its clients. In effect, the purported loans were simply misappropriations by the two sons. After the discovery of the misappropriations and the consequent insolvency of the corporation, Mrs. Pritchard died. The present suit is by the trustee in bankruptcy (representing the interests of the various creditors) against Mrs. Pritchard's estate to recover the misappropriated amounts.]

Mrs. Pritchard was not active in the business of Pritchard & Baird and knew virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr. would "take the shirt off my back," Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation.

Warning

After her husband died in December 1973, Mrs. Pritchard became incapacitated and was bedridden for a six-month period. She became listless at this time and started to drink rather heavily. Her physical condition deteriorated, and in 1978 she died. The trial court rejected testimony seeking to exonerate her because she "was old, was grief-stricken at the loss of her husband, sometimes consumed too much alcohol and was psychologically overborne by her sons." 162 N.J.Super. at 371, 392 A.2d 1233. That court found that she was competent to act and that the reason Mrs. Pritchard never knew what her sons "were doing was because she never made the slightest effort to discharge any of her responsibilities as a director of Pritchard & Baird." 162 N.J.Super. at 372, 392 A.2d 1233.

Why not an excuse?

. . . Individual liability of a corporate director for acts of the corporation is a prickly problem. Generally directors are accorded broad immunity and are not insurers of corporate activities. The problem is particularly nettlesome when a third party asserts that a director, because of nonfeasance, is liable for losses caused by acts of insiders, who in this case were officers, directors and shareholders. Determination of the liability of Mrs. Pritchard requires findings that she had a duty to the clients of Pritchard & Baird, that she breached that duty and that her breach was a proximate cause of their losses.

Inaction
1 Duty
2 Breach
3 Cause

The New Jersey Business Corporation Act, which took effect on January 1, 1969, was a comprehensive revision of the statutes relating to business corporations. One section, N.J.S.A. 14A:6–14, concerning a director's general obligation had no counterpart in the old Act. That section makes it incumbent upon directors to

> discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. [N.J.S.A. 14A:6–14]

. . .

Because N.J.S.A. 14A:6–14 is modeled in part upon section 717 of the New York statute, N.Y.Bus.Corp. Law § 717 (McKinney), we consider also the law of New York in interpreting the New Jersey statute. . . .

NY Corp.

Prior to the enactment of section 717, the New York courts, like those of New Jersey, had espoused the principle that directors owed that degree of care that a businessman of ordinary prudence would exercise in the management of his own affairs. . . . In addition to requiring that directors act honestly and in good faith, the New York courts recognized that the nature and extent of reasonable care depended upon the type of corporation, its size and financial resources. Thus, a bank director was held to stricter accountability than the director of an ordinary business.[1]

Prudence

???

. . .

[1] The obligations of directors of banks involve some additional consideration because of their relationship to the public generally and depositors in particular. Statutes impose certain requirements on bank directors. For example, directors of national banks must take an oath that they will diligently and honestly administer the affairs of the bank and will not permit violation of the banking laws. . . .

1

Ignorance no Defense

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. . . . Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act." Ibid.

2 Continuing

Directors are under a continuing obligation to keep informed about the activities of the corporation. . . .

3 willful ignorance

Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect. . . .

4 Monitor

Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. . . .

5 Finances

While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements. . . .

Of some relevance in this case is the circumstance that the financial records disclose the "shareholders' loans." Generally directors are immune from liability if, in good faith,

Reports

> they rely upon the opinion of counsel for the corporation or upon written reports setting forth financial data concerning the corporation and prepared by an independent public accountant or certified public accountant or firm of such accountants or upon financial statements, books of account or reports of the corporation represented to them to be correct by the president, the officer of the corporation having charge of its books of account, or the person presiding at a meeting of the board. [N.J.S.A. 14A:6–14]

Further inquiry

The review of financial statements, however, may give rise to a duty to inquire further into matters revealed by those statements. . . . Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign. . . .

Act 1 informal 2 formal 3 Resign

In certain circumstances, the fulfillment of the duty of a director may call for more than mere objection and resignation. Sometimes a director may be required to seek the advice of counsel. . . . A director may have a duty to take reasonable means to prevent illegal conduct by co-directors; in any appropriate case, this may include threat of suit. . . .

A director's duty of care does not exist in the abstract, but must be considered in relation to specific obligees. In general, the relationship of a corporate director to the corporation and its stockholders is that of a fiduciary. . . . Shareholders have a right to expect that directors will exercise reasonable supervision and control over the policies and practices of a corporation. The institutional integrity of a corporation depends upon the proper discharge by directors of those duties.

While directors may owe a fiduciary duty to creditors also, that obligation generally has not been recognized in the absence of insolvency. . . . With certain corporations, however, directors are deemed to owe a duty to creditors and other third parties even when the corporation is solvent. Although depositors of a bank are considered in some respects to be creditors, courts have recognized that directors may owe them a fiduciary duty. . . . Directors of nonbanking corporations may owe a similar duty when the corporation holds funds of others in trust. . . .

Not generally to creditors absent insolvency

But financial corp holding funds

hmmm...

The most striking circumstances affecting Mrs. Pritchard's duty as a director are the character of the reinsurance industry, the nature of the misappropriated funds and the financial condition of Pritchard & Baird. The hallmark of the reinsurance industry has been the unqualified trust and confidence reposed by ceding companies and reinsurers in reinsurance brokers. Those companies entrust money to reinsurance intermediaries with the justifiable expectation that the funds will be transmitted to the appropriate parties. Consequently, the companies could have assumed rightfully that Mrs. Pritchard, as a director of a reinsurance brokerage corporation, would not sanction the comingling and the conversion of loss and premium funds for the personal use of the principals of Pritchard & Baird.

As a reinsurance broker, Pritchard & Baird received annually as a fiduciary millions of dollars of clients' money which it was under a duty to segregate. To this extent, it resembled a bank rather than a small family business. Accordingly, Mrs. Pritchard's relationship to the clientele of Pritchard & Baird was akin to that of a director of a bank to its depositors. All parties agree that Pritchard & Baird held the misappropriated funds in an implied trust. That trust relationship gave rise to a fiduciary duty to guard the funds with fidelity and good faith. . . .

Duty to segregate — same as fidar?

Necessary to inquire like this?

As a director of a substantial reinsurance brokerage corporation, she should have known that it received annually millions of dollars of loss and premium funds which it held in trust for ceding and reinsurance companies. Mrs. Pritchard should have obtained and read the annual statements of financial condition of Pritchard & Baird. Although she had a right to rely upon financial statements prepared in accordance with N.J.S.A. 14A:6–14, such reliance would not excuse her conduct. The reason is that those statements disclosed on their face the misappropriation of trust funds.

Easy to figure out what going on.

From those statements, she should have realized that, as of January 31, 1970, her sons were withdrawing substantial trust funds under the guise of "Shareholders' Loans." The financial statements for each fiscal year commencing with that of January 31, 1970, disclosed that the working capital deficits and the "loans" were escalating in tandem. Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. Thus, if Mrs. Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to stanch the flow of blood.

In summary, Mrs. Pritchard was charged with the obligation of basic knowledge and supervision of the business of Pritchard & Baird. Under the circumstances, this obligation included reading and understanding financial statements, and making reasonable attempts at detection and prevention of the illegal conduct of other officers and directors. She had a duty to protect the clients of Pritchard & Baird against policies and practices that would result in the misappropriation of money they had entrusted to the corporation. She breached that duty.

IV

Cause?

Nonetheless, the negligence of Mrs. Pritchard does not result in liability unless it is a proximate cause of the loss. . . .

Normal course

Usually a director can absolve himself from liability by informing the other directors of the impropriety and voting for a proper course of action. . . . Conversely, a director who votes for or concurs in certain actions may be "liable to the corporation for the benefit of its creditors or shareholders, to the extent of any injuries suffered by such persons, respectively, as a result of any such action." N.J.S.A. 14A:6–12 (Supp.1981–1982). A director who is present at a board meeting is presumed to concur in corporate action taken at the meeting unless his dissent is entered in the minutes of the meeting or filed promptly after adjournment. N.J.S.A. 14A:6–13. In many, if not most, instances an objecting director whose dissent is noted in accordance with N.J.S.A. 14A:6–13 would be absolved after attempting to persuade fellow directors to follow a different course of action. Cf. *McGlynn* [*v. Schultz,* 90 N.J. Super. 505, 520–521, 218 A.2d 408 (Ch.Div.1966), aff'd 95 N.J.Super. 412, 231 A.2d 386 (App.Div.), cert. den. 50 N.J. 409, 235 A.2d 901 (1967)] (receiver had no case against director who advised president that certain funds should be escrowed, wrote to executive committee to that effect, and objected at special meeting of board of directors); *Selheimer v. Manganese Corp.,* 423 Pa. 563, 572, 584, 224 A.2d 634, 640, 646 (Sup.Ct.1966) (dissenting minority director in publicly held corporation absolved because he did all he could to divert majority directors from their course of conduct by complaining to management, threatening to institute suit and organizing a stockholders' committee).

Even accepting the hypothesis that Mrs. Pritchard might not be liable if she had objected and resigned, there are two significant reasons for holding her liable. First, she did not resign until just before the bankruptcy. Consequently, there is no factual basis for the speculation that the losses would have occurred even if she had objected and resigned. Indeed, the trial court reached the opposite conclusion: "The actions of the sons were so blatantly wrongful that it is hard to see how they could have resisted any moderately firm objection to what they were doing." 162 N.J.Super. at 372, 392 A.2d 1233. Second, the nature of the reinsurance business distinguishes it from most other commercial activities in that reinsurance brokers are encumbered by fiduciary duties owed to third parties. In other corporations, a director's duty normally does not extend beyond the shareholders to third parties.

Really?

2 Super duty

In this case, the scope of Mrs. Pritchard's duties was determined by the precarious financial condition of Pritchard & Baird, its fiduciary relationship to its clients and the implied trust in which it held their funds. Thus viewed, the scope of her duties encompassed all reasonable action to stop the continuing conversion. Her duties extended beyond mere objection and resignation to reasonable attempts to prevent the misappropriation of the trust funds. . . .

Within Pritchard & Baird, several factors contributed to the loss of the funds: comingling of corporate and client monies, conversion of funds by Charles, Jr. and William and dereliction of her duties by Mrs. Pritchard. The wrongdoing of her sons, although the immediate cause of the loss, should not excuse Mrs. Pritchard from her negligence which also was a substantial factor contributing to the loss. . . . Her sons knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect. Her neglect of duty contributed to the climate of corruption; her failure to act contributed to the continuation of that corruption. Consequently, her conduct was a substantial factor contributing to the loss.

Same as causation?

. . .

The judgment of the Appellate Division is affirmed.

PROBLEM

Assume you are a member of the board of directors of a corporation that operates a chain of "health spas." Business has not been good and rents and salaries are high. The corporation is deeply in debt to landlords, suppliers, utilities, and employees. The corporation's method of operation is to require customers to pay a membership fee of $500 for one year, in advance. All the money collected this way within the past year has been spent, except for $5,000 collected within the past week or so. At a regular meeting of the board, the CEO reviews the financial status of the corporation and says that he intends to spend the $5,000 on an advertising campaign that he hopes will turn the business around. If that does not work, there will be no alternative but to close the doors and go out of business, in which case there will be no assets available for creditors or to pay wages owed to employees. A member of the board