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## Book Review of Personal Liabilities of Corporate officers and Directors

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PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS. By MORTIMER FEUER. Revised Edition by Joseph F. Johnstone, Jr. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1974. Pp. 240. \$22.95

SUMNER MARCUS\*

Potential personal liability of corporate directors and officers has increased substantially since 1961 when the original edition of this book was published by the late Mortimer Feuer.<sup>1</sup> This increased exposure has been due in large measure to expansive applications of the federal securities acts to directors and officers<sup>2</sup> and to the increased availability of the federal class action pursuant to the promulgation in 1966 of the revised rule 23 of the Federal Rules of Civil Procedure.<sup>3</sup> At the same time state legislatures have attempted during this period to allow corporations to insulate more effectively their directors and officers from potential liability through indemnification and insurance arrangements.<sup>4</sup>

There also is a tendency for management of some publicly held corporations to consider seriously how the corporate structure might

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1. M. FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS (1961). The director's plight has been described as follows:

An individual director, of course, cannot be expected to be an expert in the provisions of the Securities Acts, the [Securities and Exchange Commission] regulations, the Antitrust laws, relevant state laws, legal and extralegal precedents involving direct and derivative types of liability, and the business itself to boot. He must set himself a guideline that makes up in breadth what it may lack in precision. For example,  $P - SE = Pm$  seems a good rule to follow—freely translated, it says that inquiry times involvement times involvement without self-enrichment leads to Peace of Mind. The difficulty is that such a formula stops short of disclosing the depth of information and involvement expected of the director today.

Estes, *Outside Directors: More Vulnerable than Ever*, 51 HARV. BUS. REV., Jan.-Feb. 1973, at 108.

2. Among the most notable developments in this regard have been the decisions in SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *on remand*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971), *on remand*, 331 F. Supp. 671 (S.D.N.Y. 1971); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

3. FED. R. CIV. P. 23.

4. See, e.g., CAL. COMM. CODE § 830 (West Supp. 1974); N.Y. BUS. CORP. LAW § 722 (McKinney Supp. 1974).

be modified to enable outside directors to perform their duties more knowledgeably and more independently.<sup>5</sup> Students of the corporation are beginning to recognize that the present methods of utilizing outside directors deny management the benefits of the wisdom and broader perspectives of such directors and that this deprivation is prejudicial to the interests of both the corporation and the society which has assigned such an important role to the corporation.<sup>6</sup>

These and other developments justified, indeed required, a revision of the Feuer work. The new edition is largely an updated version of the original; although Joseph F. Johnstone, Jr., has substantially rewritten several chapters and added new ones, there is no alteration of the essential structure of the first edition. A review of the Johnstone edition therefore must consider the merits and shortcomings of the earlier work as well as the treatment of developments in public policy relating to officers and directors since 1961.

The first edition was addressed to "corporate executives" and "lawyers who advised them" and was intended to answer questions concerning directors' and officers' liabilities "which concern them so directly and intimately." Its author emphasized, however, at the outset: "It is not our purpose . . . even obliquely to suggest that the corporate director or officer undertake to act as his own lawyer in any given situation . . . . [T]his book shall have served its purpose if it conveys sufficient understanding of the corporate fiduciary concept in its varied applications to create an awareness of possible pitfalls in action contemplated, and fosters, when the need arises, appreciative acceptance of legal advice sought and offered."<sup>7</sup> This statement of purpose is repeated almost verbatim in the new edition, but the disclaimer is reinforced by a "further word of caution," namely that the relevant law is "undergoing rapid development at the present time, particularly in the area covered by the federal securities laws" and that existing laws and proposed changes are being reviewed by state legislatures, Congress, and private groups such as the American Law Institute.<sup>8</sup> The significance of the cau-

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5. See, e.g., Cabot, *Actions for Individual Directors*, BUS. & SOC'Y REV., Winter 1974-75, at 70; Estes, *Outside Directors: More Vulnerable than Ever*, 61 HARV. BUS. REV., Jan.-Feb. 1973, at 107.

6. See Address by A.A. Sommer, Jr., Colo. Ass'n of Corporate Counsel, Feb. 21, 1974, in CCH FED. SEC. L. REP. ¶ 79,669, at 83,802-03.

7. M. FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* at vii (1961).

8. *Id.* at 2.

9. M. FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* 11 (2d ed. J. Johnstone 1974).

tionary note is made clear: "These considerations make it all the more important for directors and officers to consult their own counsel when problems arise."<sup>10</sup>

Accordingly, the first question must be whether it is possible to compile meaningful information about the potential liabilities of a director or officer which will not only assist him in decisionmaking, but at the same time alert him to the occasions when he should seek the advice of counsel. A second question concerns whether a book that succeeds in such an effort also can be of value to the lawyer whose advice may be sought. Whenever a lawyer seeks by means of a text to instruct a layman about a field of the law of average or above average complexity, he is likely to find himself steering a tricky course between oversimplification and the preoccupation with legal technicalities that is so characteristic of legal literature. If he steers a reasonably successful course for the lay reader, he is almost certain to be off course from the perspective of his legal audience. This revision of the Feuer book has not wholly avoided these hazards, but in many respects it does accomplish both tasks.

The organization of the book leads the lay reader logically through the basic legal concepts that are significant for the corporate fiduciary. After first examining the duties which an individual owes a corporation, its stockholders, and its creditors generally, the book's structure then emphasizes specific areas of possible personal liability for the director or officer. These include executive compensation agreements, the appropriation of corporate opportunities, competition with the corporation, dividend payments by the corporation, charitable contributions by the corporation, transactions in the corporation's securities, and the illegal actions of other directors and officers taken on behalf of the corporation. Not only does the book explain the many ways in which officers and directors may be exposed to liability, it also suggests ways for them to protect themselves from liability. It discusses the potentialities and limitations of indemnification arrangements, insurance, and education by corporate legal counsel as methods for reducing these liabilities. The revised edition goes somewhat beyond the legal liabilities of directors and officers by discussing also their social responsibilities.

Most of the 20 relatively brief chapters of the book start with a series of succinct statements concerning the topic of the chapter and

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10. *Id.*

its importance for the corporate officer and director. An often successful effort is made to explain the rationale for the applicable legal principles in terms that should be understandable to the layman without offending by their simplicity the legally trained reader. Among the more successful chapters are those dealing with the use of corporate funds in proxy contests, the application of the Securities Act of 1933<sup>11</sup> to securities distribution and trading, and stockholder derivative and class actions. These summarize at the outset all the relevant matters which should be of principal concern to the officer or director in planning his course of conduct and only later introduce the more subtle issues that necessarily are of greater concern to the lawyer and that may be omitted by the lay reader. The chapter on conflicts of interest in both editions, however, is likely to confuse the lay reader by introducing sophisticated legal concepts without providing a sufficient explanation. Confusion is compounded because the chapter attempts to address all possible permutations of the laws of the 50 states without providing the reader a ready means for finding the law of the state that most concerns him.

The chapter dealing with rule 10b-5<sup>12</sup> and particularly with its application in the *Texas Gulf Sulphur* litigation<sup>13</sup> serves the desirable purpose of alerting the corporate officer or director to the dangers of both insider trading and participation in the issuance of unintentionally false corporate statements. The effectiveness of this chapter is diminished by a somewhat confusing mixture of analysis of existing potential liability and public policy proposals designed to reduce such liability in connection with securities transactions in general. While the author is to be commended for advocating the public policies that he believes will best serve the interests of corporations and their officers and directors, his readers, whatever their expertise, would benefit more from a precise analysis of the law existing when the book went to press and from a pocket supplement to report subsequent developments.<sup>14</sup>

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11. 15 U.S.C. §§ 77a-77aa (1970).

12. 17 C.F.R. § 240.10b-5 (1974).

13. *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *on remand*, 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971), *on remand*, 331 F. Supp. 671 (S.D.N.Y. 1971).

14. The need for some means of updating the book was apparent almost as soon as the book appeared. The inability to include any reference to the final step taken by the Supreme Court

Despite this criticism, it is only fair to state that even lawyers may find the revised edition, with its emphasis upon the numerous developments in the pertinent law since 1961, an excellent introduction to a dynamic subject. In this short, but comprehensive book, one can become acquainted with the newly emerging responsibilities of both the lawyer as director, and of his client as director, to the extent that these duties have been sketched out thus far in the leading decisions of federal and state courts.<sup>15</sup> The task of revising the original edition to reflect more recent decisions that significantly affect or alter the personal liability of corporate officers and directors generally has been accomplished well, although Johnstone's limited perspective rendered less successful his attempts to address the new aspects of social responsibility and to suggest methods for reducing exposure to liability.

His penultimate chapter is designed to deal with "the practical measures that are available to protect directors and officers against liability."<sup>16</sup> Adequate treatment is given to the potentialities and possible pitfalls in relation to indemnification and to directors' and officers' liability insurance. Johnstone suggests how corporate counsel may help educate directors and officers as to their conduct under the antitrust and other laws, and he emphasizes in light of *Escott v. BarChris Construction Corp.*<sup>17</sup> the importance of establishing a record of "due diligence" to avoid liability in connection with inaccurate registration statements.<sup>18</sup> One may ask, however, whether Johnstone has placed the outside director sufficiently on notice of the possibility that he may be held liable in the future for other types of erroneous information disseminated in connection with the sale of securities when the director has been negligent in ferreting out the truth.<sup>19</sup> The fault goes beyond the question of whether John-

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mars an otherwise excellent discussion of the class action issues raised in the *Eisen* litigation. *Eisen v. Carlisle & Jacquelin*, 41 F.R.D. 147 (S.D.N.Y.), *motion to dismiss appeal denied*, 370 F.2d 119 (2d Cir. 1966), *cert. denied*, 386 U.S. 1035 (1967), *rev'd*, 391 F.2d 555 (2d Cir. 1968), *on remand*, 50 F.R.D. 471 (S.D.N.Y. 1970), 52 F.R.D. 253 (S.D.N.Y. 1971), 54 F.R.D. 565 (S.D.N.Y. 1972), *rev'd*, 479 F.2d 1005 (2d Cir. 1973), *vacated*, 94 S. Ct. 2140 (1974).

15. See note 2 *supra*.

16. M. FEUER, *supra* note 9, at 204.

17. 233 F. Supp. 643 (S.D.N.Y. 1968).

18. M. FEUER, *supra* note 9, at 213.

19. As SEC Commissioner Sommer has aptly pointed out, some members of the corporate bar have tended to take too much comfort from the closely decided case of *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), and to assume that directors will be held responsible only for the dissemination of information known to be erroneous or which was disseminated

stone has evaluated legal trends adequately.

Regardless of the precise turns that may be taken in the next few years by the law relating to personal liability of directors and officers, a socially responsible corporation and its outside directors might wish to be certain that the directors are in a position to ensure the quality of the management of the corporation through deliberate appraisal of management's performance. As some experienced directors have begun to note,<sup>20</sup> such an appraisal requires that the directors are aware of management's goals, that they have the opportunity to review periodically these management objectives, and that they have access to the information needed to evaluate management's success in attaining its goals. Successful reduction of the potential personal liability of corporate directors involves more than the liberalization of indemnification procedures and the purchase of insurance; it is equally important that directors have a real opportunity to exercise the independent judgment for which they presumably have been selected.

In the last chapter, the author shifts his focus from actual and potential legal liabilities to the social responsibilities of officers and directors. Among these responsibilities according to both editions of the book, is a need for managers of "very large" national and international corporations to consider often questions involving the "public interest" along with the corporation's economic advantage.<sup>21</sup> In the original edition Feuer felt no obligation to make more than a passing reference to the concept of the social responsibility of managers, an unsurprising conclusion since the literature of the subject at that time had been characterized for the most part by an abundance of rhetoric and a dearth of meaningful analysis.<sup>22</sup> By the time of the Johnstone revision, however, the literature of social responsibility was growing rapidly in both volume and analytical content. Johnstone's failure to expand the treatment of the subject accordingly was one of the several challenges he failed to meet.

Throughout the book, there are abundant citations of cases and some citations of books and articles for the various propositions

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recklessly. Address by A.A. Sommer, *supra* note 6, at 83,804-06. His view has been at least partially vindicated by the espousal of a "flexible duty standard" approach by another court of appeals in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

20. See Cabot, *supra* note 5; Estes, *supra* note 5.

21. M. FEUER, *supra* note 9, at 216, 217.

22. See Cheit, *The New Place of Business: Why Managers Cultivate Social Responsibility*, in *THE BUSINESS ESTABLISHMENT* 152, 158-61 (E. Cheit ed. 1964).

stated. Although the citations are not exhaustive, they generally are adequate to satisfy at least the needs of the lay reader. The author also is careful to reflect significant differences of opinion concerning many of the topics discussed. When he turns his attention to the very complex subject of social responsibility, however, about which opinions not only differ but are strongly held, the author chooses to pontificate rather than to acquaint the reader fully with the various approaches in the literature. Even more serious is the failure to refer the reader to additional sources which might help him resolve the issues for himself.<sup>23</sup>

Like that of many other commentators on corporate social responsibility, the basic shortcoming of Johnstone's approach is that it is confused and of little help operationally to corporate managers. While stating that managers have "an ultimate responsibility" for maintaining "our economic heritage" which "the fiduciary principle, and the laws of collective bargaining and fair trading, do not begin to reach," he attacks "the new critics" who are "demanding that corporations devote a substantial part of their energies and resources to social goals which have nothing to do with making a profit."<sup>24</sup> Having established this seemingly neat dichotomy of for-profit and not-for-profit activities, the author acknowledges corporate responsibility for product safety, environmental protection, and "good citizenship,"<sup>25</sup> but asserts that this responsibility "does not mean that corporate managers must undertake to cure all the nation's ills with the stockholders' money."<sup>26</sup> Sketching this nebulous line between those socially responsible actions that are appropriate and those that are not is of doubtful utility. This failure is a particularly unfortunate conclusion for a book the principal purpose of which is to guide managers in carrying out their managerial function.

Nonetheless the book must be given good marks overall for the

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23. The following illustrate the improved quality of this literature in recent years and suggest the wide range of views regarding the subject: K. ANDREWS, *THE CONCEPT OF CORPORATE STRATEGY* 118-77 (1971); *THE CORPORATE DILEMMA* (D. Votaw & S. Sethi eds. 1973); Blumberg, *Corporate Responsibility and the Social Crisis*, 50 B.U.L. REV. 157 (1970); Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248 (1969); Manne, *The Limits and Rationale of Corporate Altruism*, 59 VA. L. REV. 708 (1973).

24. M. FEUER, *supra* note 9, at 217.

25. *Id.* at 218.

26. *Id.*

way in which it explicates the nature and magnitude of the legal pitfalls confronting the corporate director or manager who attempts to fulfill his duties to the corporation and to make personal decisions in contiguous, perhaps conflicting, areas. Apart from the insights that a reader, however well informed, may gain from a lucid exposition of fundamental principles, the lawyer will find this book valuable as a framework for consultations with his client; he might well consider having the client read it as a prelude to consultation and to alert him to the increasing hazards awaiting the corporate manager and particularly the outside director.