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# Corporations - Director Liability - The Standard of Director Liability For a Corporate violation of Section 1982 - Tillman v. Wheaton-Haven Recreation Association

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**Corporations—DIRECTOR LIABILITY—THE STANDARD OF DIRECTOR LIABILITY FOR A CORPORATE VIOLATION OF SECTION 1982—** *Tillman v. Wheaton-Haven Recreation Association*, 517 F.2d 1141 (4th Cir. 1975).

Plaintiff Harry C. Press, a black homeowner residing within the geographical preference area<sup>1</sup> served by the defendant Wheaton-Haven Recreation Association, Inc. (Association) was denied membership in the Association solely on the basis of his race. Plaintiffs Murray and Rosalind Tillman, members of the Association, were denied permission to bring a black guest to the Association swimming pool solely because of the guest's race. Both denials were made pursuant to an admittedly discriminatory policy adopted by the Association's directors and approved by a majority of the members. In October 1969, plaintiffs sued the Association and its directors for compensatory damages and declaratory and injunctive relief under the Civil Rights Acts of 1866, 1870, and 1964.<sup>2</sup> Plaintiffs claimed that valuable property rights available to white residents in the area served by the Association were not available to black residents of the same area.<sup>3</sup> The district court accepted the defendants' argument that it was a "private club" within the meaning of section 201(e) of the Civil Rights Act of 1964,<sup>4</sup> and therefore outside the scope of section 1982.<sup>5</sup> The Fourth Circuit Court of Appeals affirmed.<sup>6</sup> The Supreme Court reversed and remanded, holding that the Association was not a private club and that its discriminatory policies were within the proscriptions of section 1982.<sup>7</sup> On remand, the

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1. The Association's bylaws provide that membership shall be open to bona fide residents (whether home owners or not) of the area within a three-quarter mile radius of the Association's pool. *Tillman v. Wheaton-Haven Recreation Ass'n*, 410 U.S. 431, 433 (1973).

2. 42 U.S.C. §§ 1981, 1982, & 2000a et seq. (1970).

3. Under the Association bylaws, a resident within the preference area received three advantages: 1) he could apply for membership without the recommendation of a current member, 2) he received preference in applying for a membership vacancy, 3) he could pass to a successor-buyer a first option to acquire his (the member-seller's) membership. The plaintiffs argued that these advantages gave white residents of the preference area valuable property rights which were not available to black residents solely because of their race in violation of 42 U.S.C. § 1982 (1970) which reads:

All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property.

4. 42 U.S.C. § 2000a(e) (1970).

5. The district court's opinion was unreported.

6. 451 F.2d 1211 (4th Cir. 1971), *rev'd*, 410 U.S. 431 (1973).

7. *Tillman v. Wheaton-Haven Recreation Ass'n*, 410 U.S. 431, 440 (1973). The Su-

district court assessed compensatory damages, costs, and attorneys' fees against the Association, but absolved the directors of personal liability.<sup>8</sup> Since the directors had obtained two independent opinions of counsel, the court found that they had exercised due diligence in attempting to comply with the law.<sup>9</sup> Seeking to hold the directors personally liable for the damages and costs and for an additional award of attorneys' fees, the plaintiffs appealed again. The Fourth Circuit held the directors jointly liable for the additional attorneys' fees on grounds that ignorance of the law, although engendered by the advice of counsel, was no defense to an action based on section 1982.<sup>10</sup>

## I. BACKGROUND

### A. Corporate Director Liability

The corporate director is in the unenviable position of being exposed to allegations of liability from many sources, including stockholders, corporate creditors, persons outside the corporation, and the corporation itself.<sup>11</sup> Basically, however, director liability is divisible into two major categories. First, a director may be directly liable to the corporation, or derivatively liable to the stockholders as the "owners" of the corporation, for a breach of his fiduciary duty.<sup>12</sup> The director's liability for breach of this fidu-

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preme Court remanded the case to the district court to develop the necessary facts by which to evaluate the claims of the parties "free of the misconception that Wheaton-Haven is exempt from 1981, 1982, and 2000a." *Id.*

8. *Tillman v. Wheaton-Haven Recreation Ass'n*, 367 F. Supp. 860 (D. Md. 1973).

9. *Id.* at 865-66.

10. *Tillman v. Wheaton-Haven Recreation Ass'n*, 517 F.2d 1141 (4th Cir. 1975).

11. Feuer, *Liabilities of Directors and Officers*, 5 N.Y.L.F. 127, 134 (1959) [hereinafter cited as Feuer]; H. FRIEDMAN & H. SCHLAGMAN, *CORPORATE MANAGEMENT GUIDE* § 13.01 (1967) [hereinafter cited as FRIEDMAN]. "No custom or practice can make a directorship a mere position of honor void of responsibility, or cause a name to become a substitute for care and attention." Feuer 134 (quoting *Kavanaugh v. Commonwealth Trust Co.*, 223 N.Y. 103, 106, 119 N.E. 237, 238 (1918); *accord*, *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940)).

12. For example, the following acts would be a breach of the director's fiduciary duty: 1) competing with the corporation; 2) taking advantage of opportunities belonging to the corporation; 3) profiting from inside information; 4) profiting improperly from the sale of corporate stock; 5) making improper loans to directors or officers. FRIEDMAN § 12.01. See also M. FEUER, *PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS* 28 (2d ed. 1974) [hereinafter cited as *PERSONAL LIABILITIES*]; H. HENN, *LAW OF CORPORATIONS* 235 (2d ed. 1970) [hereinafter cited as *HENN*]; W. KNEPPER, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* §§ 1.03, 1.05 (2d ed. 1973) [hereinafter cited as *KNEPPER*]; Isreals, *A New Look at Corporate Directorship*, 24 *BUS. LAW.* 727, 732 (1969).

States are becoming aware of the desirability of imposing fiduciary standards on corporate directors by statute. *PERSONAL LIABILITIES* 30. South Dakota has a representative statute which imposes liability on directors for: 1) making improper dividend

ciary duty is usually defined by a "reasonable man" standard: the director must exercise the degree of care an ordinarily prudent man would exercise in managing his own affairs.<sup>13</sup> In some situations, the "reasonable man" standard has been expanded by the "business judgment rule." Under this rule, directors will not, in areas of managerial discretion, be liable for errors in judgment which were made in good faith, with due diligence, and for the benefit of the corporation.<sup>14</sup> Directors are also generally absolved of liability for reliance on the advice of experts, such as accountants and attorneys, even though the advice may be erroneous.<sup>15</sup>

Director liability in the second category arises from dealings with, or actions against, third persons.<sup>16</sup> This liability usually is

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distributions; 2) improperly acquiring corporate stock; 3) making loans to corporate directors; or 4) commencing business before obtaining minimum capital. S.D. COMPILED LAWS ANN. §§ 47-5-15 to -21 (1967).

13. Comment, *Trends in Corporate Director Liability*, 17 S.D.L. REV. 468, 470-71 (1972). This standard, however, varies according to the particular facts and circumstances of the situation. The factors which should be considered are listed in the leading case of *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940):

It has been said that a director is required to conduct the business of the corporation with the same degree of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance. General rules, however, are not altogether helpful. In the last analysis, whether or not a director has discharged his duty, whether or not he has been negligent, depends upon the facts and circumstances of a particular case, the kind of corporation involved, its size and financial resources, the magnitude of the transaction, and the immediacy of the problem presented. A director is called upon "to bestow the care and skill" which the situation demands.

*Id.* at 678 (citation omitted).

In some jurisdictions, liability for errors in judgment is imposed only for gross negligence. See, e.g., *Holland v. American Founders Life Ins. Co.*, 151 Colo. 69, 75, 376 P.2d 162, 165-66 (1962); *Sellers v. Head*, 261 Ala. 212, 216, 73 So. 2d 747, 750 (1954); *Allied Freightways, Inc. v. Cholfin*, 235 Mass. 630, 634, 91 N.E.2d 765, 768 (1950). For a discussion of the scope of this standard see Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 372-76 (1965) [hereinafter cited as Dyson], and PERSONAL LIABILITIES 29-30.

14. FRIEDMAN § 11.03[3]; KNEPPER § 1.05; PERSONAL LIABILITIES 32-33. *But see* Dyson 367-71. The language most often cited comes from *Pollitz v. Wabash R.R.*, 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912), where the New York Court of Appeals said:

Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests are left solely to their [the directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show what they did was unwise or inexpedient.

15. *Diamond v. Davis*, 62 N.Y.S.2d 181, 191 (Sup. Ct. 1945); *Epstein v. Schenk*, 35 N.Y.S.2d 969, 980-81 (Sup. Ct. 1939); PERSONAL LIABILITIES 96-99; KNEPPER § 1.09.

16. See generally 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 1134 (rev. ed. 1965) [hereinafter cited as FLETCHER]; FRIEDMAN § 13.03.

asserted in one of three situations: 1) when the director attempts to bind the corporation to ultra vires acts, 2) when the director assumes personal liability for a corporate obligation, and 3) when the director commits a tort in the scope and course of his employment.<sup>17</sup> The present case focuses on tortious conduct.

A corporate director is personally liable for his own torts, even though the corporation may also be liable.<sup>18</sup> The director is likewise personally liable for torts of the corporation which he inspires, authorizes, directs, or in which he actively participates or acquiesces.<sup>19</sup> Director liability for tortious acts of the corporation, however, has generally been restricted to cases involving physical injury, rather than pecuniary harm, to third persons.<sup>20</sup>

### B. Section 1982

The statutory provision under which the present case arose, 42 U.S.C. § 1982, is intended to protect all citizens from racially-motivated deprivations of property rights.<sup>21</sup> After a century of applying this statute solely to state action, the United States Supreme Court, in *Jones v. Alfred H. Mayer Co.*,<sup>22</sup> expanded its scope by ruling that a private refusal to sell property to a black because of race was prohibited.<sup>23</sup> The Court justified this expan-

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17. FRIEDMAN § 13.03, at 303.

Liability is also imposed by some federal statutes, including securities legislation, e.g., Securities Act of 1933 §§ 5, 11, 15 U.S.C. §§ 77f, 77k; *Escott v. BarChris Const. Corp.*, 283 F. Supp. 643, 688 (S.D.N.Y. 1968); antitrust and trade statutes, e.g., Sherman Antitrust Act § 1, 15 U.S.C. § 1 (1890); *United States v. Wise*, 370 U.S. 405, 407 (1962); *Forfeiture of Corporate Officers for Violations of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313 (1965); *Rooks, Personal Liabilities of Officers and Directors for Antitrust Violations and Securities Transactions*, 51 ILL. B.J. 626 (1963); and the Internal Revenue Code, e.g., INT. REV. CODE OF 1954, §§ 6671(b), 6672; *United States v. Graham*, 309 F.2d 210 (9th Cir. 1962).

18. FLETCHER § 1135; HENN § 218.

19. *Tedrow v. Deskin*, 265 Md. 546, 550, 290 A.2d 799, 802 (1972). Oft-cited language is found in *Lobato v. Pay Less Drug Stores, Inc.*, 261 F.2d 406 (10th Cir. 1958):

Specific direction or sanction of, or active participation or cooperation in, a positively wrongful act of commission or omission which operates to the injury or prejudice of the complaining party is necessary to generate individual liability in damages of an officer or agent of a corporation for the tort of the corporation.

20. *Macey v. Citizens Nat'l Bank*, 507 S.W.2d 722, 725 (Tex. 1974); RESTATEMENT (SECOND) OF AGENCY, Appendix, Reporter's notes § 357 (1958). *But see Lobato v. Pay Less Drug Stores, Inc.*, 261 F.2d 406 (10th Cir. 1958); *Tedrow v. Deskin*, 265 Md. 546, 290 A.2d 799 (1972).

21. *See generally* 1975 B.Y.U.L. REV. 141.

22. 392 U.S. 409 (1968).

23. The Supreme Court has never considered the actual limitations on the scope of section 1982 when a truly private club has been involved. *Sullivan v. Little Hunting Park, Inc.*, 396 U.S. 229, 236 (1969) and *Tillman v. Wheaton-Haven Recreation Ass'n*, 410 U.S.

sion by stressing the importance of maintaining property rights free of interference from any source, governmental or private.<sup>24</sup>

## II. INSTANT CASE

In the instant case,<sup>25</sup> the directors raised their exercise of due diligence as their primary defense against imposition of liability for violating section 1982.<sup>26</sup> Before adopting the discriminatory policies, the directors had obtained the opinions of two attorneys who independently agreed that the Association's policies would not be illegal.<sup>27</sup> Moreover, these opinions of counsel were initially sustained by both the district court and the Fourth Circuit Court of Appeals. On remand, the district court concluded that reliance on the opinions, although ultimately held erroneous, was justified:

If the director does not know, and if in the exercise of due diligence could not have known that his action was wrongful or illegal, he cannot be held liable for the torts of the corporation. . . .

[T]he defendant directors did not know nor in the exercise of due diligence could not have known that the adoption of racially restrictive policies was illegal.<sup>28</sup>

The majority on the Fourth Circuit panel rejected the defendants' contentions. The court reasoned that a violation of section 1982 constitutes an intentional tort and that due diligence, under general tort law, is a defense only in actions for negligence.<sup>29</sup> Relying on *Aeroglide Corp. v. Zeh*,<sup>30</sup> the court asserted that if a director voluntarily and intentionally causes the corporation to

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431, 438 (1973), involved associations claiming private club status; the Supreme Court, however, rejected those claims. The same thing happened in a section 1981 case, *Daniel v. Paul*, 395 U.S. 298 (1969). Nevertheless, in *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163 (1972), the Supreme Court held that a private club was exempt from the restrictions of section 1983. Since the courts have never treated sections 1981 and 1982 differently from section 1983, the logical conclusion is that truly private clubs are also exempt from the restrictions of sections 1981 and 1982.

24. 392 U.S. at 423-24.

25. *Tillman v. Wheaton-Haven Recreation Ass'n*, 517 F.2d 1141 (4th Cir. 1975).

26. 517 F.2d at 1143. The defendants adopted the reasoning of the district court opinion, 367 F. Supp. 860 (D. Md. 1973), in toto, and added the argument that the issue of director liability was moot, since the satisfaction of a judgment against the corporation released the directors who were the joint tort-feasors, citing *RESTATEMENT OF JUDGMENTS* § 95 (1942). Brief for Appellees at 9-11.

27. 517 F.2d at 1148 (Boreman, J., dissenting).

28. 367 F. Supp. at 865 (citations omitted).

29. 517 F.2d at 1144.

30. 301 F.2d 420 (2d Cir. 1962).

act, he can be held personally liable.<sup>31</sup> The majority justified the imposition of liability on two grounds: 1) the plaintiffs should not be denied the fruits of their victory in the Supreme Court, and 2) anything short of the imposition of liability would allow corporate officials to violate the restrictions of section 1982 with personal impunity.<sup>32</sup>

Senior Circuit Judge Boreman dissented, contending that fault, as evidenced by a "positively wrongful" act, must be present in every tort, whether negligent or intentional, before liability could be imposed. Based on the facts of the instant case, the directors' actions could not be considered "positively wrongful."<sup>33</sup>

### III. ANALYSIS

The major issue in the present case is whether the exercise of due diligence should be a defense in a personal action against directors for corporate violations of section 1982 of the Civil Rights Act of 1866. This case note will examine the court's rationale for rejecting the due diligence defense, discuss the justifications for an alternative standard of liability for corporate directors, and explore some of the implications of the present case for director liability in areas beyond the civil rights context.

#### A. *The Fourth Circuit's Rationale for Rejecting the Due Diligence Defense*

##### 1. *An intentional tort*

In the introductory paragraphs of its analysis, the Fourth Circuit categorized an action under section 1982 as an intentional tort, citing *Curtis v. Loether*.<sup>34</sup> This premise, with the subsequent application of general tort principles, became the primary justification for the court's decision. Although this type of action may be analogous to several forms of common law tort actions,<sup>35</sup> there is very little precedent for treating a section 1982 suit as the equivalent of an intentional tort action. In the absence of a definitive pronouncement by the Supreme Court, the validity of such a categorization is at least debatable.<sup>36</sup> If the majority erred in

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31. 517 F.2d at 1144.

32. *Id.* at 1145.

33. *Id.* at 1150. On a motion for rehearing en banc, which was denied, Judges Russell, Field, and Widener joined in Judge Boreman's dissent. *Id.* at 1154.

34. 415 U.S. 189 (1974).

35. *Id.* at 194; *Rogers v. Loether*, 467 F.2d 1110, 1117 (7th Cir. 1972).

36. See generally Nahmod, *Section 1983 and the Background of Tort Liability*, 50 IND. L.J. 5 (1974).

classifying this action as an intentional tort, the court loses its major justification for disallowing the due diligence defense and imposing liability on the directors.

Even if, however, the majority correctly presumed that a violation of section 1982 is a statutory intentional tort, the unavailability of a due diligence defense cannot be automatically assumed. The plaintiffs sought to impose liability on the directors for a tort of the corporation, a situation dissimilar from the majority of common law tort actions. This difference arguably may or should preclude the blanket adoption and application of *all* general tort principles. In other words, even if a section 1982 action is properly classified as an intentional tort, the due diligence defense may be an appropriate avenue for avoiding liability. The justifications for this position will be discussed in section III, *B*, 1 below.

## 2. *The fruits of victory*

The circuit court's second justification for imposing liability on the Association's directors was to assure to the plaintiffs the fruits of their victory in the Supreme Court.<sup>37</sup> Since the court did not elaborate, one can only speculate as to what the court meant. The court was probably concerned that the money judgment awarded in the district court would be jeopardized unless personal liability was imposed on the directors.

The circuit court's decision in the present case, however, failed to materially affect the plaintiffs' chances for recovery. In a judgment designed to compensate the plaintiffs for their out-of-pocket costs, embarrassment, and humiliation, the district court awarded \$5,356 in compensatory damages, \$2,658.12 in court costs, and \$200 in attorneys' fees, while specifically denying an award of punitive damages.<sup>38</sup> The burden of this award was placed solely on the Association,<sup>39</sup> but the corporation was at all times able and willing to pay all damages, even if a judgment of joint liability were entered.<sup>40</sup> Given these facts, the plaintiffs would not have been deprived of any "fruits" if the court had refused to impose personal liability.

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37. 517 F.2d at 1145.

38. 367 F. Supp. at 864-65; Brief for Appellees at 2.

39. 367 F. Supp. at 866.

40. Brief for Appellees at 7.



### 3. *Deterrence of future violations*

Finally, the court expressed a concern that the application of section 1982 would be severely restricted if liability were not imposed on the directors because the statute could then be violated with impunity.<sup>41</sup> Thus, in an effort to deter future violations, the court subjected the directors to personal liability. The court failed, however, to persuasively demonstrate how its excessively harsh standard, discussed in greater detail below, will deter future violations of the statute more effectively than a less burdensome standard.

#### B. *A Reasonable Standard of Director Liability*

##### 1. *The requirement of fault*

Assuming that a violation of section 1982 does constitute an intentional tort, one is confronted with the threshold consideration raised by Judge Boreman in dissent:

Some element of fault or culpability is present in every tort. Even where the law imposes traditional absolute liability culpability is still a requisite element.<sup>42</sup>

In circumventing this argument, the majority relied upon *Aeroglide Corp. v. Zeh*<sup>43</sup> for the proposition that if the director voluntarily and intentionally caused the corporation to act, that alone is sufficient to impose personal liability; there is no need to additionally establish the director's knowledge of wrongfulness.<sup>44</sup> In *Aeroglide*, a creditor-manufacturer sued a corporation and its directors personally for conversion of a secured asset. The Second Circuit held:

That there was no direct evidence in the record that the directors were aware of Aeroglide's security interests is not determinative. The tort of conversion requires no intent or fault. The determinative question then is whether these directors personally participated in the conversion. . . .<sup>45</sup>

The majority failed to recognize, however, that *Aeroglide* represents a solitary aberration. In all other cases in which direc-

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41. The court specifically said: "The claim that a corporate official may violate 1981 and 1982 with impunity because he exercised due diligence . . . is designed to severely restrict the application of these statutes." 517 F.2d at 1145.

42. 517 F.2d at 1150 (citation omitted).

43. 301 F.2d 420 (2d Cir. 1962).

44. 517 F.2d at 1144.

45. 301 F.2d at 422.

tors have been held liable for corporate torts, the directors were not merely unwitting participants in tortious corporate action; they invariably knew that the action was illegal. For example, in *Patrons State Bank & Trust Co. v. Shapiro*,<sup>46</sup> the president of a bank was sued for conversion. The court imposed liability upon finding that the president knew that his act was illegal.

Shapiro as president wrongfully reassigned the proceeds from one assigned contract to another bank . . . . Shapiro told the officers of the bank that the proceeds from the assigned contracts had not yet been received by the corporation when in fact they had.<sup>47</sup>

Likewise, in *Solo Cup Co. v. Paper Machinery Corp.*,<sup>48</sup> an action alleging the misappropriation of trade secrets, the district court held a corporate vice-president personally liable for the tort. It is apparent throughout the opinion that the court was relying on the fact that the vice-president not only initiated the entire scheme, but did so knowing of its illegality.<sup>49</sup>

In short, the Fourth Circuit disregarded the well-established rule that personal liability is generally imposed only when the directors knew that they were acting unlawfully;<sup>50</sup> the court imposed liability on the directors in the face of their reasonable efforts to ascertain the legality of their actions. Consequently, the directors' liability was identical to the liability that would have been imposed had they acted with the knowledge that their actions were illegal.

## 2. *An excessively harsh standard*

Although the Fourth Circuit attempted to justify the imposition of personal liability as a means of deterring future violations of section 1982, it appears that the court went further than necessary. Because of the strictness of the test, corporations not sub-

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46. 215 Kan. 856, 528 P.2d 1198 (1974).

47. *Id.* at 1204.

48. 240 F. Supp. 126 (D. Wis. 1965).

49. Another case involving director liability for an intentional tort is *Macey v. Citizens Nat'l Bank*, 507 S.W.2d 722 (Tex. 1974) (officer absolved of liability for inducing breach of contract because he acted in good faith).

50. There are numerous cases where liability was imposed because the director should have known a dangerous condition existed or otherwise acted negligently. *See, e.g.*, *Dwyer v. Lanam & Snow Lumber Co.*, 141 Cal. App. 2d 838, 297 P.2d 490 (1956) (president knew high voltage wire was dangerous and yet did nothing); *Allen v. Morris Bldg. Co.*, 360 Mich. 214, 130 N.W.2d 491 (1900) (president willfully participated in grading land which caused water damage to adjacent property).

ject, for one reason or another, to the prohibitions of the Civil Rights Acts may forego plans to adopt similar policies rather than subject their directors to the possibility of personal liability. Thus, the decision in the instant case may *chill* legitimate attempts to limit the size and composition of purely private groups or associations. It may be argued that any such attempts should be disfavored by the law in all cases. Nevertheless, since Congress has seen fit to exempt private associations from the restrictions of the Civil Rights Acts,<sup>51</sup> efforts by the membership of these associations to delineate their composition should be protected.

A hypothetical standard for director liability that can be derived from the facts of the instant case further illustrates the excessive harshness of the Fourth Circuit's standard and the weakness of its "deterrent effect" argument. The directors based their discriminatory decision on the independent opinions of two attorneys, a majority of prior court decisions, and a century of custom.<sup>52</sup> In short, they did all they reasonably could do to insure that their actions were within the bounds of the law. Their conduct demonstrated, in fact, the utmost in diligence. If such conduct, or "utmost diligence," were adopted as the standard for determining personal director liability for corporate torts, directors would be rewarded, with protection from liability, for taking the most reasonably cautious measures within their power. On the other hand, directors would be penalized for, and thus arguably deterred from, exercising anything less than utmost diligence. Indeed, it appears that the deterrent effect of this utmost diligence standard is the *maximum* possible, since the standard punishes, and therefore deters, all avoidable wrongdoing. Obviously, the standard does not reach conduct not reasonably avoidable, but such conduct cannot be deterred by threat of punishment in any event. By way of contrast, the standard applied in the present case does not protect directors from personal liability even though they take all reasonable precautions to avoid wrongdoing. Thus, the standard of the present case is more harsh than the utmost diligence standard posited above. Yet, if the hypothetical utmost diligence standard does indeed have a maximum deterrent effect, the added harshness of the Fourth Circuit's standard—admittedly fashioned for its deterrent effect

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51. 42 U.S.C. § 2000a(e) provides that "[t]he provisions of this subchapter shall not apply to a private club or other establishment not in fact open to the public . . . ." See 6 GA. L. REV. 813 (1972).

52. 517 F.2d 1141, 1151-52 (Boreman, J., dissenting).

—cannot be justified. This additional harshness can only be viewed as excessive, an example of judicial overkill.

### 3. *Reliance on the advice of counsel*

The facts of the instant case highlight a common occurrence in corporate operations. Because most directors have only limited amounts of time to devote to their duties, they are generally unable to be thoroughly familiar with every business, legal, and financial aspect of the corporation. As a result, directors frequently come to rely on the opinions, advice, and work-product of experts.<sup>53</sup> Generally, these specialists are correct in their judgments, but occasionally they make an error. What should be the responsibility of a director when injury results from such an expert's error in judgment? The court in the present case held that the director should be personally liable and that reliance on the advice of experts is no defense.<sup>54</sup> Other courts have resolved this question differently.

For example, in *Blaustein v. Pan American Petroleum & Transport Co.*,<sup>55</sup> a stockholders' derivative action, certain corporate directors were charged with fraudulent and intentional waste of corporate assets, profits, and business opportunities. In pleading the defense of good faith and due diligence, the defendant directors pointed to advice from counsel that the exploration of the business opportunities alleged to have been wasted would have been a violation of the antitrust laws. This factor influenced the court's decision that the directors had acted in good faith and in the honest exercise of their discretion and that no liability should be imposed.<sup>56</sup> Also, in *Gilbert v. Burnside*,<sup>57</sup> corporate directors were sued by stockholders who alleged that the directors wasted the assets of the corporation pursuant to an unlawful reorganization plan. In adopting the plan, the directors had relied on counsel's advice in good faith. The court absolved the directors of liability, holding that "[r]eliance upon advice of counsel is a good defense."<sup>58</sup> Likewise, in *Spirt v. Bechtel*,<sup>59</sup> stockholders sued the corporate directors for breach of their fiduciary duty, alleging

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53. Feuer, *supra* note 11, at 164.

54. 517 F.2d at 1146.

55. 293 N.Y. 281, 56 N.E.2d 705 (1944).

56. *Id.* at 294, 56 N.E.2d at 716.

57. 13 App. Div. 2d 982, 216 N.Y.S.2d 430 (1961).

58. *Id.* at 983, 216 N.Y.S.2d at 432, citing *Blaustein v. Pan Am Petroleum & Transp. Co.*, 293 N.Y. 281, 56 N.E.2d 705 (1944), as authority.

59. 232 F.2d 241 (2d Cir. 1956).

that the directors improperly handled the tax benefits of stock options. Counsel had advised that the directors' method of handling the options, although accruing to the benefit of the directors, was the only proper method. The court said:

Counsel's opinion as to the law (even though erroneous) should, in our opinion, protect the officers acting in reliance upon it.<sup>60</sup>

In each of these cases, the court absolved the corporate directors of liability where they had in good faith relied on the advice of counsel.<sup>61</sup>

Arguably, these cases are not relevant to the present case because each involves an action brought by stockholders rather than by persons outside the corporation. Nevertheless, these cases should be deemed applicable for two important reasons. First, one of the theories on which plaintiffs Murray and Rosalind Tillman asserted director liability was that the directors had improperly depleted the Association's assets and each member's equity by subjecting the corporation to liability under section 1982.<sup>62</sup> In advancing this theory, the Tillmans assumed the position of "stockholders," bringing this case squarely within the reasoning of *Blaustein, Gilbert, and Spirt*.

Second, the issue of reliance on counsel's advice appears to be one of first impression in the context of director liability for corporate torts. Although the court could have analogized to the directors' duty to the corporation and its stockholders, by failing to do so the Fourth Circuit effectively adopted a new and stricter standard of personal director liability. Since the director's duty to the corporation is a fiduciary one, requiring the highest degree of competence, loyalty, and diligence,<sup>63</sup> there would appear to be no sound reason for requiring a director to meet a higher standard in his dealings with persons outside the corporation.

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60. *Id.* at 247. The court cited, as an example, an illustration in RESTATEMENT OF TRUSTS § 201 absolving a trustee of liability because he relied on counsel's opinion as to what investments were legal. *Id.* See PERSONAL LIABILITIES, *supra* note 12, at 96-101.

61. Indeed, it could be argued that directors who do not seek and rely on expert advice should be liable for negligence. See *Litwin v. Allen*, 25 N.Y.S.2d 667, 699 (Sup. Ct. 1940). Directors represent the interests of owners and are expected to comply with the legal requests of those owners. Often, the legality of these requests can be ascertained only by asking expert advisors. In the present case, the directors were trying to adopt a policy approved by a majority of the members. Brief for Appellees at 8-9.

62. Brief for Appellees at 8-9.

63. FRIEDMAN, *supra* note 11, at § 11.01; KNEPPER, *supra* note 12, at § 1.01.

### C. Possible Consequences of the Fourth Circuit's Decision

The previous discussion has attempted to point out the weaknesses of the Fourth Circuit's position and outline some of the reasons a different standard should have been used. This is not to say, however, that the court's ultimate decision was erroneous. The courts have been zealous in their use of the Civil Rights Acts to overcome a long history of racial discrimination, and it should not be forgotten that the instant case arose in a context of racial discrimination. Nevertheless, the possible consequences of the court's decision, if it is applied to cases not dealing with civil rights, are sufficiently undesirable to warrant limiting the decision to that context. Some of those consequences are discussed below.

#### 1. Unreasonable burden on corporate directors

The Securities Act of 1933 is analogous to section 1982 in that it provides protection to purchasers of corporate securities, who are generally outside the corporation, from tortious or fraudulent acts of the corporation and its directors.<sup>64</sup> Section 11 of the Securities Act<sup>65</sup> is designed not so much to compensate the defrauded purchaser as to deter negligence and fraud, by imposing liability upon corporate directors and other persons participating in the illegal distribution of a registered security.<sup>66</sup> Nevertheless, Congress provided a due diligence defense to section 11 actions, because anything less than that would be an imposition of insurer's liability, which would "obviously have imposed an unjust and insurmountable burden on those who have the responsibility for the conduct of the corporate enterprise."<sup>67</sup>

Imposition of such an onerous burden is also a likely consequence of the court's action in the present case. The court stated that directors are liable for injury even though they make every

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64. See *Globus v. Law Research Serv. Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Securities Act of 1933, 15 U.S.C. §§ 77a-aa.

65. 15 U.S.C. § 77k (1933).

66. See *Globus v. Law Research Serv. Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969).

67. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 48 (1959); see 15 U.S.C. § 77k (b), (c). There was a bitter struggle between the Senate and the House over the civil liability that should be imposed on the officers and directors of the registrant. The Senate wanted to impose insurer's liability but acquiesced in the House version which allowed the due diligence defense. Landis, *supra*; H.R. REP. NO. 152, 73d Cong., 1st Sess. 26 (1933). See generally Kroll, *Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of BarChris and Globus*, 24 BUS. LAW. 681, 687-88 (1969).

reasonable effort to be within the bounds of the law. If the court's general language is extended to its logical conclusion, a director will be liable not only for racial discrimination but for every other tort of the corporation as well. The only possible relief may be an indemnification agreement with the corporation, but these are increasingly being held to be against public policy.<sup>68</sup>

## 2. *Effect on the competence of corporate directors*

In describing the conflict between the stockholders' interests and director discretion, one author has noted:

There is a natural inclination to protect a stockholder from the infringement upon his interest caused by the acts of the negligent director. On the other hand it is recognized that the exercise of the director's discretion reflects the competence, aggressiveness, and efficiency of American industry and that to subject the director to personal liability for a mistake in judgment is to intimidate him and to create a highly conservative business climate resulting in failure to exploit opportunities involving more than a small degree of risk. Furthermore, [personal] liability for errors in judgment would tend to discourage able individuals from accepting the position. In this scenario society emerges as the loser.<sup>69</sup>

This language suggests two possible consequences of the circuit court's decision: 1) directors may be forced to adopt a highly conservative attitude,<sup>70</sup> and 2) better qualified individuals will be less willing to serve as corporate directors.<sup>71</sup> The threat of liability will inevitably be a significant concern to the competent individuals needed to fill corporate leadership positions.

## 3. *Effect on attorney-director relationships*

Of additional concern is the possible effect of the instant case on attorney-director relationships. If a director cannot be relieved

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68. See generally FRIEDMAN, *supra* note 12, at § 14.04[2]; Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968); Comment, *supra* note 13, at 478.

69. Comment, *supra* note 13, at 470. See also Dyson, *supra* note 13, at 346-47.

70. See Adkin & Janis, *Some Observations on Liabilities of Corporate Directors*, 20 BUS. LAW. 817, 821 (1965) ("However, if a director acts objectively, carefully (but not necessarily overcautiously) and diligently, his management of the corporation's affairs should be immune from attack.").

On the other hand, directors could adopt extremely liberal policies, disregarding possible personal liabilities since due diligence will not relieve them of liability. Stockholder control makes this possibility unlikely, however.

71. See PERSONAL LIABILITIES, *supra* note 12, at 37.

of liability for relying on counsel's opinion, should the director be indemnified by the attorney who incorrectly interpreted the law?<sup>72</sup> The attorney's function in negotiation and documentation of corporate ventures is a vital one,<sup>73</sup> since corporate directors and presidents may not be trained in the law and cannot reasonably be expected to be personally knowledgeable on all legal matters touching their business affairs. If, however, corporate directors are to be held personally liable, along with the corporation, for relying on the advice and substantiated opinions of corporate attorneys, that important relationship will certainly be undermined. Attorneys will be more reluctant to give unqualified opinions and directors will be equally reluctant to rely on opinions given.

#### IV. CONCLUSION

If the standard of director liability of the present case is narrowly confined to the civil rights context, the decision may have minor impact. But narrow application of the standard is by no means assured. Unless the scope of the case is limited by future decisions, it may be used to impose liability on corporate directors whenever the erroneous advice of experts causes a corporation to breach a contract or commit a trespass. Such an application of the standard, in a nonracial context, is unwarranted and unwise. The holding of the present case should be limited to the peculiar context in which it arose.

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72. For a general discussion of the importance of legal opinions in business transactions, see Fuld, *Legal Opinions in Business Transactions—An Attempt to Bring Some Order Out of Some Chaos*, 28 BUS. LAW. 915 (1973).

73. See generally Bernant, *The Role of the Opinion of Counsel: A Tentative Reevaluation*, 49 CALIF. S.B.J. 132 (1974).