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Directors Personal Liability for Corporate Fault in the United States

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Chapter 12

United States of America

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1 Introduction

This chapter addresses the liability of directors under laws in the United States of America for misconduct or illegal actions taken by a corporation. The reader may find this liability to be a rare phenomenon when compared to the liability faced by directors in the other jurisdictions surveyed in this volume. Unlike some jurisdictions in the world, US federal and state laws do not impose broad duties on directors that would hold these individuals generally liable by virtue of their directorial position for all violations of the law or harmful acts to third parties committed by the corporations they oversee.

Instead, potential director liability for corporate misconduct, where it does exist in the United States, flows along four narrower legal channels. First, a director may be liable to creditors for violations of rather mechanical state corporation statutes[1] designed to protect creditors. These violations include liability for obligations of a

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1 In the United States, corporate law has generally been a matter of state not federal law, but exceptions abound; most notably, the Sarbanes Oxley Act, Pub. L. No. 107–204, 116 Stat. 745 (2002), represented a new involvement of federal law and regulation in issues of corporate governance. For a sampling of different scholarly views on the Act's 'federalization' of corporate governance, *see* S.M. Bainbridge 'The Creeping Federalization of Corporate Law' (2003) 26 *Regulation*, 32; and R.B. Ahdieh, 'From "Federalization" to "Mixed Governance" in Corporate Law: a Defense of Sarbanes Oxley' (2005) 53 *Buffalo Law Review*, 721.

defectively incorporated entity and prohibitions on corporations paying dividends to, or repurchasing shares from, shareholders when the corporation has insufficient capital.[2]

This liability contrasts with the second source of liability for directors – when a court pierces a corporation's veil. Whereas the first form of liability involves statutory, mechanical and rather uninteresting legal questions for courts (e.g. was a corporation properly formed, or were payments to shareholders made from proper specified sources of capital), piercing the corporate veil represents common law[3] in its most inchoate and perplexing form. US courts base decisions to pierce the corporate veil on a multitude of factors and employ rhetorical devices such as inquiring whether the corporation was the 'alter ego' of a defendant, that are more conclusive than explanatory in nature. The muddied analytical foundation of veil piercing frustrates predictions about when courts will impose the severe sanction of disregarding the limited liability protections of the corporate form. Yet, US courts remain reluctant to pierce a corporation's veil in general, and instances in which a court has pierced the veil to find a director or corporate officer liable, rather than a corporate or individual shareholder, are rarer still.[4]

But, directors may be liable for tortious acts by a corporation even absent veil piercing under the third channel of liability: according to principles of agency law, directors are directly liable for those torts committed by the corporation in which the director participated.[5] These principles hold that an agent of a corporation who commits or participates in a tort may not escape liability merely because the agent was acting on behalf of a corporation.[6]

This direct liability/agency/participation theory has also influenced the interpretation and drafting of many federal and state statutes. Thus, directors may also incur liability for corporate statutory violations in which they participated

2 *See* Part 2 below.

3 Law in the United States, like England, is originally based on the common law. The US Constitution, however, is the supreme law of the land and the source of all federal statutes. US Const. art. VI, cl. 2. The principal sources of law in the United States are the Constitution, federal statutes, federal administrative regulations, state constitutions, state statutes, state administrative regulations, municipal ordinances and regulations and common law, including case law. For a historical introduction to US law, *see* L. M. Friedman, *A History of American Law* (3rd edn, New York, Touchstone, 2005).

The interaction of common and statutory law is one of interesting subtexts of this chapter. In interpreting whether a statute imposes liability on directors (or officers), US courts face the choice of whether silences and ambiguities in the statutory text should be interpreted so as not to conflict with common law norms or whether such an interpretation would frustrate a statute with broad remedial purposes. *See* notes 98–100 below and accompanying text.

4 *See* n. 31 below and accompanying text.

5 Some courts and commentators have erroneously conflated this agency theory of liability with veil piercing. *See* notes 113 and 125 below.

6 Restatement (Third) of Agency § 7.01.

provided that the statute in question at least includes individuals in the definition of 'persons' who may be found liable. Some federal and state statutes go a step further and specifically include directors in the list of potentially liable persons.[7] With respect to either a statutory violation or a common law tort by a corporation, the agency theory raises the question of how direct and extensive is a director's participation before he or she incurs personal liability. In a number of statutory contexts, courts have ruled that directors (and officers) must directly participate for liability to attach.[8]

However, another doctrinal strain might hold directors (and officers) liable for corporate violations of certain statutes if the directors merely have the ability to control the corporate conduct that leads to the violation. Directors would be liable under this fourth theory, labelled the 'responsible corporate officer doctrine,' even absent their participation in, or, in some cases, knowledge of, a statutory violation.[9] Many courts have rejected applying this doctrine to new statutes without clear statutory language, due to, among other reasons, constitutional concerns about due process of law for individual defendants.[10] Other courts have narrowed the scope of the doctrine by, *inter alia,* requiring that a director (or officer) have control over a specific corporate activity that violated a statute as opposed to general power to oversee a corporation in order for liability to attach.[11] Narrowing the scope of liability brings this doctrine and the interpretation of statutes, more in line with the common law agency theory of liability, but at the cost of circumscribing the remedial nature of statutes and lowering the deterrence effect on directors.[12]

This chapter proceeds as follows. Part 2 briefly discusses liability of directors under the first legal channel described above, i.e. liability for violations of various mechanical provisions of state corporation statutes designed to protect creditors. Part 3 then briefly outlines the piercing the corporate veil doctrine in the United States, particularly as it applies to directors. Part 4 then analyzes the direct liability/agency/participation theory for director liability and looks at how legislatures and courts have applied this theory to statutory violations. Part 5 analyzes the development of the responsible corporate officer doctrine in the United States.

Part 6 provides a case study of one of the most important yet confusing federal statutes that imposes potential massive liability on directors – the Comprehensive Environmental Response, Compensation and Liability Act ('CERCLA').[13] An analysis of case law under CERCLA demonstrates not only how courts easily confuse and conflate veil piercing with agency theories, but, moreover, how statutes

7 *See* n. 56 below and accompanying text.

8 *See* notes 63, 65, and 105 below and accompanying text.

9 *See* Part 5 below.

10 *See* Part 7.1 below.

11 *See* Parts 5 and 6 below.

12 *See* Part 7.2 below.

13 42 United States Code §§ 9601–9675 (2008).

and their judicial interpretations have often defied easy categorization into either the third channel of liability – agency theories – or the fourth – the responsible corporate officer doctrine.

Part 7 then concludes by summarizing themes in the previous Parts and attempting to answer the questions of why. The question is twofold: why certain statutes and legal doctrines impose liability on directors while others do not, and why director liability is relatively uncommon in the United States compared to other jurisdictions surveyed in this volume. In order to accomplish this, Part 7 outlines some of the principle policy considerations behind US laws that hold or refuse to hold directors liable for corporate misconduct. In particular, Part 7 analyzes how the rules on director liability create a perverse disincentive for directors to actively monitor and seek out legal violations.

Part 7.1 briefly notes due process concerns and normative arguments for and against director liability. Part 7.2 first offers a public choice explanation for the structure of US laws that lead to the rarity of director liability. It then provides a broad brush analysis of certain efficiency considerations for director liability rules, including the effects of director liability on deterrence of misconduct, delegation within a corporation, and the market for directors. Part 7.3 explores another economic consideration for director liability, risk-spreading, and analyzes the effects of insurance and indemnification of directors by the corporation as allowed under US corporate law. Part 7.4 investigates whether corporate law and securities law counter the perverse disincentive created by director liability rules with respect to not policing corporate misconduct. Part 7.4 concludes that the fiduciary duties of directors serve as only the mildest corrective to this disincentive, but securities law liability for directors, including controversial provisions of the federal Sarbanes Oxley Act, may prove a more effective counterweight.

But, before delving into this chapter, it is important to note potential sources of director liability on which this chapter does *not* focus; this chapter does not address the liability of directors to shareholders or to the corporation itself. Accordingly, this chapter does not discuss liability for breaches of the fiduciary duties directors owe to shareholders. Likewise, the chapter does not address the liability of directors when US law extends fiduciary duties to creditors while a corporation is insolvent.[14]

14 For an article summarizing these fiduciary duties to creditors and arguing that they should be triggered upon filing of a formal bankruptcy petition rather than upon 'insolvency', *see* H.T.C. Hu and J.L. Westbrook, 'Abolition of the Corporate Duty to Creditors' (2007) 107 *Columbia Law Review*, 1321.

Director liability for fiduciary duties to creditors has become a heated topic, as prominent and controversial judicial opinions have held that director may begin owing fiduciary duties to creditors when a corporation approaches insolvency but has not yet become insolvent. *See,* e.g. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*. 1991 WL 277613 (Del.Ch. 30 December 1991) (unpublished opinion), *reprinted in* (1992) 17 *Delaware Journal of Corporate Law,* 1099. *See* also P.M. Jones and K.H. Harris, 'Chicken Little Was Wrong (Again): Perceived Trends in the Delaware Corporate Law of Fiduciary Duties and

Nevertheless, the extension of fiduciary duties to creditors during a corporation's insolvency may represent the functional equivalent of laws in other jurisdictions in the world that hold directors liable for a corporation trading during insolvency.

For the same reason, this chapter does not delve into director liability to shareholders under federal and state securities laws. However, in Part 7.3, this chapter does discuss the federal securities laws that impose responsibilities on directors to monitor corporate misconduct.

2 Violations of State Corporation Statutes

Other than liabilities that directors voluntarily assume when they personally guarantee obligations of a corporation, the most direct source of director liability comes from mechanical provisions in state corporation statutes designed to protect. Examples of these forms of individual liability for directors include the following:

(1) obligations incurred by directors ostensibly on behalf of a corporation either before incorporation or in the case of a defective incorporation;[15]

(2) state corporations statutes that impose liability on directors for *ultra vires* acts by a corporation (i.e. acts not within those powers of a corporation specified in its articles or certificate of incorporation);[16]

(3) state corporations statutes that hold directors liable to creditors for authorizing the payment of dividends to shareholders or the redemption of stock if the corporation has insufficient capital;[17]

(4) state corporation statutes that prohibit certain loans to directors;[18] and

(5) state corporations statutes that prohibit dissolution of a corporation unless provisions have been made for obligations of the corporation.[19]

Standing in the Zone of Insolvency' (2007) 16 *Journal of Bankruptcy Law & Practice*, 2 Art. 2.

15 *See*, e.g. *Daniel A. Pouwels & Associates, Inc. v. Fiumara*, 233 So.2d 16 (La. App. 4 Cir. 1970) (officers and directors liable for debts incurred before incorporation); *Murphy v. Crosland*, 886 P.2d 74 (Utah App. 1994)(State corporation statute imposes liability on all persons who act on behalf of a corporation that has not been properly incorporated or that has been suspended).

16 For example, 8 Del. C. § 124(2) (2008).

17 For example, the Delaware General Corporations Law holds those directors who wilfully or negligently violate the statute's prohibitions on declaring and paying dividends or redeeming or repurchasing stock unless the corporation has sufficient capital liable to the corporation and creditors. 8 Del. C. §§ 160, 173, 174 (2008). *See* also New York Business Corporations Law §§ 510, 513, 719(a)(1–3) (2008).

18 For example, N.Y. Bus. Corp. Law, §§ 714, 719(a)(4)(2008).

19 *Ibid.* § 719(a)(3) (2008) (holding directors jointly and severally liable to the corporation for the benefit of shareholders and creditors for distributing assets to shareholders after dissolution 'without paying or adequately providing for all known liabilities of the corporation').

All of these forms of liability in this Part 2 arise from a fairly straightforward judicial application of statutory provisions. Yet the mechanical nature of these rules means that directors may sidestep liability fairly easily. For example, to avoid liability before proper incorporation, directors need only wait until the fairly simple steps of incorporation are taken before entering into contracts on behalf of the corporation. Directors face no risk from a corporation committing an *ultra vires* act if the articles of incorporation merely state that the corporation has all powers permitted by law.[20] Many statutes that restrict the company from paying dividends to, or repurchasing shares from, shareholders, except out of certain sources of capital, also give the directors significant leeway in setting the level of that capital by changing the par value of shares or determining what portion of shares issued for consideration other than cash, shall constitute capital.[21] Finally, creditor-friendly statutory restrictions on dissolution are not triggered if the corporation never formally dissolves.

Some states may have more restrictive corporation statutes that are more protective of creditors. But, it must be underscored that, in the United States, businesses have great latitude in choosing the state under whose laws they wish to incorporate.[22] This has led many larger businesses to choose to incorporate in jurisdictions, such as Delaware, whose corporation statutes are less restrictive and more protective of management. This federalism in US corporate law has also generated a longstanding debate over whether the competition among states to develop laws that attract incorporations leads to a 'race to the bottom' or a 'race to the top.'[23]

3 Veil Piercing and Director Liability

By contrast with those mechanical provisions of corporation states, veil piercing is an equitable, common law doctrine, which presents judges both great flexibility and amorphous standards.[24] When judges pierce the veil in the United States, they disregard both the legal status of a corporation as an entity separate from its shareholders – or, in some cases, from its officers or directors – and the limited

20 Model Business Corporation Act, § 3.04, Historical Background Note 1 ('Most of this [*ultra vires*] litigation was avoidable in the sense that appropriate provisions in the original articles of incorporation or appropriate amendments to them broadening the scope of the purpose of the corporation would have validated the transactions in question') .

21 *See* e.g. 8 Del. C. § 154 (2008).

22 For example, a business that conducts all of its operations and has its headquarters in one state can incorporate under the laws of another state. *See* F.A. Gevurtz, *Corporation Law* (St. Paul, Minn. West, 2000) § 1.2.

23 For an analysis of this debate, *see* L.A. Bebchuk, 'Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law' (1992) 105 *Harvard Law Review,* 1435.

24 R.B. Thompson, 'Piercing the Veil: Is Common Law the Problem?' (2005) 37 *Connecticut Law Review,* 619.

liability concomitant with that separation.[25] The defendants thus lose the principal benefit of the corporate form – the limitation of their liability for the obligations of the corporation to the amount of capital the defendants contributed.[26]

Scholars have labelled veil piercing as the most heavily litigated issue in all of US corporate law,[27] and have surmised that it occurs more frequently in the United States that in other countries.[28] Even so, scholars have also compared the risk of a corporation having the limited liability of its shareholders retracted to the chance of a person being struck by lightning.[29] Publicly traded corporations have not suffered veil piercing.[30]

Moreover, empirical research demonstrates that equity owners – particularly parent corporations rather than natural person shareholders – and not directors or officers, represent the overwhelming majority of the targets of veil piercing.[31] It is true that cases in some states have held that a defendant need not own shares in a corporation to be held liable for a corporation's obligations under veil piercing.[32] There are also cases in which veil piercing doctrines subjected to liability directors

25 For an excellent empirical survey of veil piercing in the United States, *see* R.B. Thompson, 'Piercing the Corporate Veil: an Empirical Study' (1991) 76 *Cornell Law Review,* 1036.

26 S.B. Presser, *Piercing the Corporate Veil* (New York, C. Boardman, 1991), § 1.01.

27 *See* n. 25 above at 1036.

28 *See* n. 24 above at 619.

29 F.H. Easterbrook and D.R. Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review*, 89, 109 (characterizing veil piercing as 'rare, severe and unprincipled').

30 See n. 25 above at 1039.

31 For an empirical survey of 1,600 veil piercing cases, *see* n. 25 at 1058; F.H. O'Neil and R.B. Thompson, *O'Neal's Close Corporation: Law and Practice* (3rd edn, New York, Clark Boardman Callaghan, 1992) § 111 n. 2. Professor Thompson reports that in only ten of the subset of cases in his survey not involving piercing between parent and subsidiary corporations did a plaintiff seek to hold a natural person liable for participating in the tort. In only 15 additional cases, all involving close corporations, did plaintiffs seek to hold a natural person liable even if he or she was not directly involved in the tort. Moreover, suits against natural persons were even rarer in cases in which the defendant corporation was not insolvent. *See* R.B. Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' (1994) 47 *Vanderbilt Law Review*, 1, 10–11.

32 Non-shareholder defendants could be liable under veil piercing when they exercise extensive control over a corporation such that courts deem them to be the true owners of the corporation under the doctrine of 'equitable ownership'. *See,* e.g. *Freeman v. Complex Computing,* 119 F.3d 1044, 1051 (2nd Cir. 1997); *Lally v. Catskill Airways, Inc.* 198 A.D.2d 643 *at* 645, 603 N.Y.S.2d 619 *at* 621 (3rd Dep't 1993); *In re MacDonald*, 114 B.R. 326 *at* 332–33 (D. Mass. 1990).

A small minority of cases go a step further and label stock ownership as merely one factor that courts look at in deciding whether the veil should be pierced. E.g. *Angelo Tomasso, Inc. v. Armor Construction & Paving, Inc.*, 187 Conn. 544 *at* 556–57, 446 A.2d 406 *at* 412 (1982).

who were not also shareholders.[33] But, again, these represent a small and relatively uninteresting fraction of the total body of veil piercing case law.[34]

Veil piercing arises most frequently in the context of either liability of a parent corporation for a subsidiary or a closely held corporation in which the controlling (or sole) shareholder also serves as an officer and director.[35] This frequent overlap of status in close corporations makes it difficult to untangle case law and articulate conditions for when director status alone creates a veil piercing risk. There is nothing to suggest that a different legal standard applies to directors other than the general standards courts apply in all veil piercing cases.

However, it is difficult to articulate even the general standards for veil piercing. American scholars have lamented the deep theoretical incoherence of piercing the corporate veil case law.[36] This incoherence stems in part from the fact that veil piercing, like most of corporate law in the country, is a creature of state law and therefore differs in each of the 50 states. Furthermore, the fact that veil piercing is, again, a matter of common law further complicates the analysis.[37]

The common law approach has led many courts to base decisions to pierce or not to pierce based on multi-factor tests without articulating the weight given to individual factors.[38] Some of the more common factors cited by courts include the following:[39]

(1) was the corporation the 'alter ego' or 'mere instrumentality' of the plaintiff?;[40]

33 For example, *Macaluso v. Jenkins*, 420 N.E.2d 251 (Ill. App. 1981) (director of non-profit corporation may be found liable under veil piercing).

34 *Cf.* n. 31 above.

35 Thompson, n. 25 above at 1047–48. *Cf.* O'Neal and Thompson n. 31 above at § 1.08 at 32 (describing how closely-held corporations concentrate both control and ownership/risk-bearing in one set of actors, namely shareholder managers).

36 For example, Easterbrook and Fischel, n. 29 above; F.A. Gevurtz, 'Piercing Piercing: an Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil' (1997) 76 *Oregon Law Review*, 853.

37 Thompson, n. 24 above (analyzing whether the fact that veil piercing is a matter of common law contributes to its theoretical incoherency). Texas represents one partial exception to a pure common law approach to veil piercing, in that the legislature of that state at least codified which factors *cannot* be used by a court to pierce a Texas corporation's veil. *See* Tex. Bus. Corp. Act Art. 2.21 (2008).

38 Gevurtz, n. 36 above at 856–58 (criticizing this 'template approach').

39 For an empirical study showing the frequency that each of these individual factors was mentioned in cases in which courts pierced the veil, *see* n. 25 above at 1064–68.

40 Under this test, if there is a sufficient 'unity of interest' among the shareholder (or, in some cases officer or director) and the corporation, such that a corporation is merely the 'alter ego' of the individual, a court may pierce the veil and allow the plaintiff to look to the assets of the shareholder (or officer or director). The canonical case for this test is *Walkovsky v. Carlton*, 18 N.Y.2d 414; 276 N.Y.S.2d 585; 223 N.E.2d. 6 (1966). Scholars have criticized this factor for representing more of a rhetorical conclusion to whether defendants are liable

(2) defendant's 'domination and control' of the corporation;[41]
(3) undercapitalization of the corporation;[42]
(4) fraud or misrepresentation by the defendant;[43]
(5) failure to observe corporate formalities; [44] and
(6) commingling of defendant's assets with the corporation.[45]

Many courts employ additional factors in deciding whether to pierce the veil of a subsidiary corporation and hold the parent corporation liable. These additional factors include whether the two corporations have overlapping management (including officers and directors), shareholders, offices or business operations.[46]

American scholars have criticized courts for failing to apply this grab bag of factors in a coherent manner and to offer a clear rationale for why some defendants are held liable for a corporation's obligations while others are able to take advantage of the corporate form and externalize the costs of operations onto creditors. In particular, the messy *ad hoc* application of the loose veil piercing factors does not clearly distinguish between contract creditors, who may have been able to bargain to avoid the loss created by a corporation, and involuntary tort creditors, who had no opportunity to bargain.[47]

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than a reasoned explanation of when the veil will be pierced. Courts also employ similar rhetorical devices such as labelling the corporation as a 'shell' or 'sham.' Gevurtz, n. 36 above at 855.

41 E.g. *Zaist v.Olson*, A.2d 552, *at* 558 (Conn. 1967).

42 Some courts look to whether the corporation was inadequately capitalized when compared to probable liabilities, but also find that undercapitalization alone is not a sufficient justification for piercing. R.C. Clark, *Corporate Law* (New York, Aspen Law and Business, 1986) § 2.4.1. This, of course, raises the question of how to measure undercapitalization.

43 For example, *Sea-Land Services, Inc. v. Pepper Source*, 941 F.2d 519 (7th Cir. 1991) (applying Illinois law). In several states, this fraud test is diluted and a plaintiff need merely show that failing to pierce the veil would promote 'inequity.' *See,* e.g. *Kinney Shoe Corporation v. Polan*, 939 F.2d 209 (4th Cir. 1991) (applying West Virginia law).

44 Courts often base their veil piercing decision in part on the failure of defendants to follow formalities in operating a corporation, such as holding required meetings of directors and shareholders, keeping records and filing annual reports. *See* J.D. Cox and T.L. Hazen, *Cox & Hazen on Corporations* (New York, Aspen, 2003) § 7.09.

45 *Ibid.*

46 For an in-depth exploration of the law of piercing in the context of parents and subsidiaries, *see* P.I. Blumberg, *The Law of Corporate Groups: Problems of Parent and Subsidiary Corporations Under Statutory Law of General Application* (New York, Little Brown,1989).

47 For example, Gevurtz, n. 36 above at 858–59 (surveying arguments on why veil piercing should distinguish between contract and tort creditors); R.W. Hamilton, 'The Corporate Entity' (1971) 49 *Texas Law Review,* 979, 984 (1971) (arguing for applying this distinction to rationalize veil piercing).

4 Direct Liability/Agency/Participation Theories

The rarity of veil piercing liability does not immunize directors, as the common law principles of agency present a distinct source of liability for directors.[48] Under common law, directors are liable for torts that they commit or participate in, even if they are acting on behalf of a corporation.[49] Similarly, acting on behalf of a corporation does not insulate directors and officers from criminal liability for crimes they commit.[50] By contrast, directors and agents of a corporation are liable for contracts they enter into on behalf of the corporation only when they do not disclose the identity of their principal, i.e. they do not tell the contractual counterparty that they are contracting on behalf of a corporation or specify the identity of the corporation.[51]

Under this theory, derived from agency law on tort liability, courts have found that directors may be held liable for participating in corporate torts and crimes in a range of contexts, ranging from misappropriation of trade secrets[52] to common law fraud and conspiracy.[53]

This theory of director liability extends beyond common law to statutory violations by a corporation. In interpreting a range of federal statutes, federal courts have repeatedly found that individuals, including directors, officers, and employees, can be criminally and civilly liable for statutory violations committed for the benefit of the corporation.[54] But, for a director to be liable, the statute must, at a minimum,

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48 Restatement (Third) of Agency § 7.01 summarizes the common law rules thus:

> An agent is subject to liability to a third party harmed by the agent's tortious conduct. Unless an applicable statute provides otherwise, an actor remains subject to liability although the actor acts as an agent or an employee, with actual or apparent authority, or within the scope of employment.

The official comments to that section clarify that that rule applies equally to agents of a corporation regardless of whether a court has or has not pierced the corporation's veil. Restatement (Third) of Agency § 7.01(d). Case law clarifies that directors are liable for torts in which they participate. *See* n. 52–53 below. Comment (d) to the Restatement clarifies that directors are liable, this despite the fact that they technically may not be agents of a corporation. *Cf.* Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' n. 31 above at 8.

49 E.g. *Dawson v. Withycombe*, 216 Ariz. 84 *at* 101–02 (Ariz. App. Div. 2007); *see* also cases cited in W.M. Fletcher, *Cyclopedia of the Law of Corporations*, Vol. 3A (Eagan, Minn. Thomson West, 2007), § 1137.

50 Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' n. 31 above at 7.

51 Compare Restatement (Third) Agency § 6.01 (agent is not party to a contract when the principal is disclosed unless otherwise agreed) with §§ 6.02 and 6.03 (agent is liable for contractual obligations entered into on behalf of undisclosed or unidentified principals).

52 *PMC, Inc. v. Kadisha*, 93 Cal.Rptr.2d 663 *at* 678 (Ct.App. 2000).

53 *New Crawford Valley, Ltd. v Benedict*, 877 P.2d. 1363 *at* 1368 (Colo. App. 1993).

54 J.K. Strader, *Understanding White Collar Crime* (Newark, N.J., LexisNexis, 2006), § 2.07(a); H. First, 'General Principles Governing the Criminal Liability of Corporations,

include natural persons in the definition of the potentially liable, 'persons'.[55] Other statutes are more direct and specifically include 'directors' in a list of those who may be found liable.[56]

An exhaustive list of federal and state statutes under which directors have been or could be found liable is beyond the scope of this chapter. Suffice it to say that courts have found that directors may be been found civilly or criminally liable for authorizing or participating in the violations of statutes in a wide range of substantive areas of the law including the following: antitrust,[57] civil rights,[58] employee benefits,[59] mining regulations,[60] oil export restrictions,[61] and tax collection.[62]

The potential for director liability for participating in torts or statutory violations by a corporation raises the question of how actively the director must participate for liability to attach. Increasingly, the answer is that participation must be fairly direct. There is a continuum of potential participation ranging from a director committing the tort or violation herself or himself, to ordering a subordinate in the corporation to commit the tort or violation, to authorizing the commission, to mere knowledge of the commission, to constructive knowledge and constructive participation by virtue of the director's position, to strict liability.

Courts face little difficulty in finding liability in the case of a director committing, ordering or authorizing a tort or statutory violation.[63] Strict liability and constructive knowledge or participation by virtue of a director's position, discussed in Part 5

Their Employees and Officers', in *White Collar Crime: Business and Regulatory Offenses*, O. Obermaier and R. Morvillo (eds) (New York, Law Journal Press, 2006), § 5.04(1).

In a seminal case which involved antitrust law, the Supreme Court found that a corporate officer could be criminally liable for violations of the Sherman Act notwithstanding the fact that the officer acted on behalf of a corporation. *U.S. v. Wise*, 370 U.S. 405 (1962).

55 For one example of a statute that lists individuals – but does not specify directors – as potentially liable persons and that has been interpreted to find directors liable, *see* the federal Food, Drug and Cosmetic Act analyzed in note 74 below.

56 E.g. 15 U.S.C. § 24 (2008) ('[w]henever a corporation shall violate any of the ... antitrust laws, such violation shall be deemed to be also that of the individual directors, officers, or agents of such corporation who shall have authorized, ordered, or done any of the acts constituting in whole or in part such violation').

57 *U.S. v. Wise*, 370 US 405 *at* 411–14 (1962)(finding officers could be held criminally liable for violations of predecessor statute cited in n. 56 above, even if they acted on behalf of the corporation).

58 *Tillman v. Wheaton-Haven Recreation Association, Inc*. 517 F.2d 1141 (4th Cir. 1975) (directors of community swimming pool liable for discrimination in violation of federal civil rights statutes).

59 O'Neal and Thompson, n. 31 above at § 1.12.

60 E.g. *Commonwealth v. Evans*, 45 SW.3d 442 *at* 443 (Ky. 2001).

61 *Citronelle-Mobile Gathering, Inc. v. Herrington,* 826 F.2d 16 *at* 25 (Temp. Emer. Ct. App. 1987), *cert. denied*, 484 US 943 (1987) (holding individual who was director, officer and shareholder could be found liable under price control statute).

62 O'Neal and Thompson, n. 31 above at § 8.22 n. 13–14.

63 Fletcher n. 49 above at § 1137.

below are much rarer phenomena. Many courts have ruled that liability of directors for corporate torts requires direct participation or negligence.[64] Courts are reluctant to bootstrap negligence theories into imposing liability on a director solely by virtue of their directorial position.[65]

Intent is often a necessary element for liability to attach. Many traditional tort causes of action[66] and many, but certainly not all, statutes[67] imposing civil liability require *scienter* – or intent or knowledge of wrongdoing – as an element of that liability. Criminal statutes almost always require that the prosecutors prove that the defendant possessed *mens rea* for conviction.[68] *Mens rea* in a given criminal statute might take one of the following four forms according to the simplified rubric of the Model Penal Code: intention or purpose,[69] knowledge,[70] recklessness,[71] or negligence.[72]

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64 For example, *Frances T. v. Village Green Owners Association*, 42 Cal.3d 490 (1986). In that case, the California Supreme Court announced the following standard:

> to maintain a tort claim against a director in his or her personal capacity, a plaintiff must first show that the director specifically authorized, directed or participated in the allegedly tortuous conduct; or that although they specifically knew or reasonably should have known that some hazardous condition or activity under their control could injure the plaintiff, they negligently failed to take or order appropriate action to avoid the harm. *Ibid. at* 508–9.

See also, *K&G Oil Tool & Serv. Co. v. G&G Fishing Tool Serv.* 158 Tex. 594 (1958) *cert. denied,* 358 US 898 (1958) (stating, in the context of alleged trade secret theft, that Texas law requires that directors or officers are not liable for corporate misconduct by virtue of their office, but only if they are 'personally connected' or participated in the misconduct); *Escude Cruz v. Ortho Pharmaceutical Corp.*, 619 F.2d 902 (C.A. Puerto Rico 1980).

65 R.G. Dennis, 'Liability of Officers, Directors and Stockholders under CERCLA: the Case for Adopting State Law' (1991) 36 *Villanova Law Review,* 1367, 1413–17; O'Neal and Thompson, n. 31 above at § 8.22.

66 Fraudulent misrepresentation represents one example. Restatement (Second) of Torts, § 526.

67 *See* e.g. *U.S. ex rel. Wilkins v. North American Const. Corp.* 173 F. Supp.2d. 601 (S.D. Tex. 2001) (discussing scienter requirement under False Claims Act).

68 Strader, n. 54 above at § 2.07(b).

69 The Model Penal code sets forth the following definition for purposeful intent, which would be used to interpret statutes that require, as a *mens rea* standard, that the defendant act 'purposefully': A person acts purposely with respect to a material element of an offense when: (i) if the element involves the nature of his conduct or a result thereof, it is his conscious object to engage in conduct of that nature or to cause such a result; and (ii) if the element involves the attendant circumstances, he is aware of the existence of such circumstances or he believes or hopes that they exist. Model Penal Code § 2.02(2)(a).

70 The Model Penal code sets forth the following definition for knowledge, which would be used to interpret statutes that require, as a *mens rea* standard, that the defendant act 'knowingly': A person acts knowingly with respect to a material element of an offense when: (i) if the element involves the nature of his conduct or the attendant circumstances, he is aware that his conduct is of that nature or that such circumstances exist; and (ii) if the element involves a result of his conduct, he is aware that it is practically certain that his conduct will cause such a result. *Ibid.* at § 2.02(2)(b).

Scienter and other *mens rea* requirements severely limit the threat of liability for directors of large, non-closely held corporations as state corporate law typically allows corporations to delegate management responsibilities to a corporation's officers, including in bylaw provisions.[73] Boards may thus legally delegate extensive responsibility for oversight of day to day operations to officers and employees. Thus, in a modern corporation, directors may be well insulated from participating or knowing about the corporate decisions that violate the law.

5 The Responsible Corporate Officer Doctrine

A distinct line of cases, however, has removed the *scienter* and *mens rea* requirements and opened up the possibility of strict liability for directors and officers of corporations for violations of certain statutes. These cases fall under the umbrella of the 'responsible corporate officer' doctrine, which emerged from a seminal 1943 US Supreme Court case, *US v. Dotterweich*.[74] In the wake of *Dotterweich*, federal

71 The Model Penal code sets forth the following definition for recklessness, which would be used to interpret statutes that require, as a *mens rea* standard, that the defendant act 'recklessly': A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation. *Ibid.* at § 2.02(2)(c).

72 The Model Penal code sets forth the following definition for negligence, which would be used to interpret statutes that require, as a *mens rea* standard, that the defendant act 'negligently': A person acts negligently with respect to a material element of an offense when he should be aware of a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such a nature and degree that the actor's failure to perceive it, considering the nature and purpose of his conduct and the circumstances known to him, involves a gross deviation from the standard of care that a reasonable person would observe in the actor's situation. *Ibid*. at § 2.02(2)(d).

73 For example, 8 Del. C. § 142(a) (2008).

74 320 US 277, 64 S. Ct. 134, 88 L. Ed. 48. In *Dotterweich*, the Supreme Court held that a president and general manager of a corporation could be found guilty of a misdemeanour violation of the Federal Food, Drug, and Cosmetic Act, 52 Stat. 1040, which criminalized the adulteration or misbranding of drugs introduced into interstate commerce. 320 US *at* 278 citing 52 Stat. 1040, §§ 301, 303. The Court noted that that Act dispensed with common requirements of *mens rea* and, instead, imposed a strict liability standard on any 'person' who violated the Act's prohibition on adulteration and misbranding. 320 US *at* 280–81. The Act defined 'person' to include a corporation. *Ibid. at* 281 citing 52 Stat. 1040, §§ 201(e), 303.

The Court noted the evolution of its analysis in earlier cases that the actions and state of mind of a corporation's officers and agents could be imputed to a corporation such that a corporation could be held criminally liable. 320 US *at* 281–82 citing *New York Central & H.R.R. Co. v. United States*, 212 US 481, (1909). *Dotterweich* confronted that issue in reverse. The Court interpreted the Act to impose liability on an officer 'otherwise innocent' who stood 'in responsible relation' to a violation of the Act. 320 US *at* 281.

A contrary holding, the Court reasoned, would have run counter to the purposes of the Act, and would hold no individual accountable except in cases in which the corporate veil would be pierced. *Ibid. at* 282. (holding that a narrow interpretation of the Act would mean that 'the and state courts have interpreted a range of different statutes to impose liability on those 'officers' – including in some cases directors[75] (as well as other corporate employees) – who have a 'responsible relationship to', or a 'responsible share of', a violation of the statute by a corporation.[76]

The 1975 Supreme Court case *US v. Park* represented a particular milestone and perhaps the high water mark of the responsible corporate officer doctrine. The *Park* Court found that the same food, drug and cosmetic statute at issue in *Dotterweich* did not require 'awareness of some wrongdoing' because that statute reflected a policy decision by Congress to impose 'not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure the violations will not occur.'[77] In *Park*, the Court upheld the trial conviction of the chief executive officer of a corporation that violated the statute and held that:

> the Government establishes a *prima facie* case when it introduces evidence sufficient to warrant a finding by the trier of the facts that the defendant had, by reason of his position in the corporation, responsibility and authority either to prevent in the first instance, or promptly to correct, the violation complained of, and that he failed to do so.[78]

The Court looked to the corporation's bylaws – including a general provision that the chief executive officer 'shall, subject to the board of directors, have general and active supervision of the affairs, business, offices and employees of the company'

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penalties of the law could be imposed only in the rare case where the corporation is merely an individual's alter ego.').

The Court found that a determination whether an officer or agent of the corporation would be criminally liable depended on 'evidence produced at trial' that the individual had 'a responsible share in the furtherance of the transaction which the statute outlaws.' *Ibid. at* 284. The Court refused to 'indicate by way of illustration the class of employees which stands in such a responsible relation,' as such an attempt would be 'treacherous' and 'mischievous futility.' *Ibid.* Rather, the Court entrusted such determination to 'the good sense of prosecutors, the wise guidance of trial judges, and the ultimate judgment of juries.', *Ibid.*

This holding provoked a sharp dissent from four justices. The dissent found that only the 'clear and unambiguous' imposition of strict liability in a statute can justify holding officers responsible for criminal actions of a corporation without the officers having intent or knowledge of wrongdoing. 320 US *at* 286 (J. Murphy, dissenting) (citing 'a fundamental principle of Anglo-Saxon jurisprudence that guilt is personal'.). The dissent found such clear and ambiguous language lacking in the statute in question. *Ibid. at* 287–93.

75 'Responsible corporate officers' are not limited to 'officers' as defined in state corporation statutes, but may include directors and other agents of the corporation, provided they meet the relevant standards. *See* n. 94 below and accompanying text.

76 In *U.S. v. Park*, the US Supreme Court articulated the 'responsible share' standard as the touchstone for when an officer or director may be held liable under the responsible corporate officer doctrine, 421 US 658 (1975).

77 *Ibid. at* 672–73.

78 *Ibid. at* 673–74.

– to find that the officer indeed had a responsible share of the violation.[79] This ruling came despite testimony that the corporate organizational structure delegated operational responsibilities to other officers and departments.[80]

Subsequent federal court decisions have applied this responsible corporate officer doctrine to federal statutes in a number of substantive fields, including the following: hazardous waste clean-up,[81] water pollution,[82] tax law,[83] controlled substances[84] and petroleum allocation.[85] Plaintiffs have also sought, with mixed success, to apply the doctrine to federal employee benefits law litigation over the failure by corporations to contribute to employee pension funds.[86] In addition, state courts have also applied this federal doctrine to state statutes, including in the following areas of law: water pollution,[87] waste disposal,[88] building safety codes,[89] pension contributions,[90] state securities fraud,[91] consumer fraud[92] and state sales taxes.[93]

Despite its name, the doctrine may apply to directors as well as officers.[94] Nevertheless, a rough survey of the cases reveals that those instances where a director

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79 *Ibid. at* 663.

80 The jury convicted the chief executive officer despite his testimony that (i) the 'company had an organizational structure for responsibilities . . . according to which different phases of its operation,' including sanitation 'were assigned to individuals who, in turn, have staff and departments under them'; (ii) he investigated reported violations; and (iii) he ordered corrective steps when he learned of these violations. *Ibid.* (internal quotation marks omitted).

81 *See* Part 6 below.

82 *U.S. v. Ming Hong*, 242 F.3d 528 (4th Cir. 2001)(applying doctrine to Clean Water Act).

83 *Thomsen v. U.S.*, 887 F.2d 12 (1st Cir. 1989)(holding treasurer and vice-president of closely held corporation liable as 'responsible person' for failure to remit taxes to government).

84 *U.S. v. Hodges X-Ray, Inc.*, 759 F.2d 557 (6th Cir. 1985).

85 *U.S. v. Gulf Oil Corp.*, 408 F. Supp. 450 (W.D. Pa 1975).

86 Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' n. 31 above at 24.

87 *State, Dep't of Environmental Protection v. Standard Tank Cleaning Corp.*, 284 N.J. Super. 381 (App. Div. 1995); *BEC Corp. v. Dep't of Environmental Protection*, 256 Conn. 602 (2001); *State, Dep't of Ecology v. Lundgren*, 94 Wash. App. 236 (Div. 2 1999); B.J. Monachino 'Courts May Find Individuals Liable for Environmental Offenses without Piercing Corporate Shield' (May, 2000) 72 *New York State Bar Journal* 22, 33.

88 *Commissioner, Dept. of Environmental Management v. RLG, Inc.*, 755 N.E.2d 556 (Ind. 2001); *In Matter of Dougherty*, 482 N.W.2d 485 (Minn. Ct. App. 1992); *People v. Matthews*, 7 Ca. App. 4th 1052 (2d Dist 1992).

89 *People ex rel. Volberg v. Durch*, 530 N.Y.S.2d 956 (1988).

90 O'Neal and Thompson, n. 31 above at §8.22.

91 *Wittenberg v. Gallagher*, 2001 WL 34048121 (Ariz. Ct. App. Div. 1 2001).

92 *State ex rel. Miller v. Santa Rosa Sales and Marketing, Inc.*, 475 N.W.2d 210 (Iowa 1991).

93 *State v. Longstreet*, 536 S.W.2d 185 (Mo. Ct. App. 1976).

94 *Commission, Dept. of Environmental Management v. RLG, Inc.*, 755 N.E.2d 556 (Ind. 2001); *Paper-Allied-Industrial, Chemical and Energy Workers Intern. Union v. Sherman Lumber Co.*, 2001 WL 1719233 (Me. Super. Ct. 2001).

who was not also an officer of the corporation has been found civilly or criminally liable under the responsible corporate officer doctrine represent a relatively small fraction of the total. Part of the explanation for this may be prosecutorial decisions to pursue cases against officers who are more directly involved in statutory violations. But, a more compelling explanation, explained further below, is that courts subsequent to *Park* have taken a much narrower view of when a director or officer has responsibility for a violation.

Indeed, *Dotterweich* and *Park* left two important questions unanswered. First, to which statutes would the responsible corporate officer doctrine apply, and second, under what circumstances could a director have a 'responsible share' in a statutory violation and thus be a 'responsible corporate officer'?

With respect to the first question, recent cases indicate that federal courts will demand that the language of a statute be very explicit for the responsible corporate officer doctrine to apply. In the 2003 decision in *Meyer v. Holley*,[95] the US Supreme Court rejected a contention that the federal Fair Housing Act[96] imposed liability on the sole shareholder and president of a real estate corporation for an employee's violation of that statute's prohibition on housing discrimination practices.[97] The Court focused on the language of the statute and a related agency regulation and found neither explicitly created liability for an officer or sole shareholder of a corporation.[98] Moreover, the Court characterized *Dotterweich* as applying 'unusually strict' and 'non-traditional' rules of vicarious liability, and underscored that the Court would apply such rules only 'where Congress has specified that such

In *U.S. v. Ming Hong*, the Fourth Circuit found that even a person who was not a formal officer or director of a corporation, could be held liable for violations of the Clean Water Act as a 'responsible corporate officer.' 242 F.3d 528 *at* 531 (4th Cir. 2001) ('the gravamen of liability as a responsible corporate officer is not one's corporate title or lack thereof; rather, the pertinent question is whether the defendant bore such a relationship to the corporation that it is appropriate to hold him criminally liable for failing to prevent the charged violations of the [Clean Water Act]'). The Court found that, despite the fact that the defendant 'avoided any formal association' with the corporation that violated the statute and that he 'was not identified as an officer of the company,' he 'substantially controlled corporate operations.' *Ibid. at* 530 *at* 532.

95 537 U.S. 280 (2003).

96 42 U.S.C. § 3601 *et seq*. (2008).

97 *Meyer*, 537 U.S. *at* 289–91.

98 *Ibid. at* 286–88. The court found that the language in the agency regulation would hold the corporation but not the sole-shareholder/president personally liable. The regulation said that complaints to the agency that the statute was violated may be filed, against any person who directs or controls, or has the right to direct or control, the conduct of another person with respect to any aspect of the sale of dwellings … *if that other person, acting within the scope of his or her authority as employee or agent of the directing or controlling person* has engaged … in a discriminatory housing practice. *Ibid. at* 288 *citing* 24 CFR §103.20(b) (1999) (repealed)(emphasis in the court opinion not in the regulation).

Thus, for a shareholder, director or officer to be liable, the employee would have had to have been acting as agent for that shareholder, director or officer rather than for the corporation.

was its intent.'[99] Thus, *Meyer* signalled that federal courts should not apply the corporate responsible officer doctrine in the absence of clear Congressional intent; clear statutory language is necessary to dispense with *mens rea* and hold directors and officers strictly liable for corporate misconduct.[100]

Although *Meyer* signals that federal courts will not extend liberally the responsible corporate officer doctrine to new statutes, it does not roll back existing case law applying the doctrine to specific federal statutes, nor does it affect interpretation and application of the doctrine by state courts to state statutes. Moreover, in an interesting cross-pollination of common law and statute, a number of federal and state statutes have explicitly incorporated the doctrine by including 'responsible corporate officers' or similar concepts in the definition of persons liable. Among the federal statutes in this category are the following: provisions in the tax code,[101] the Clean Water Act[102] and the Clean Air Act.[103] (In addition, federal securities laws include provisions holding 'control persons' liable for certain violations.[104])

Just as *Meyer* constricted the criteria for application of the doctrine to statutes, so too, with respect to the second question, have recent federal cases narrowed the criteria for who may be a responsible corporate officer. These cases have taken a much more restrictive view of when a director or officer has a 'responsible share' of a violation, by requiring that the director or officer have more direct oversight of the specific operations of a corporation that led to the violation.[105] These cases represent a significant reversal in course from *Park*, which suggests that, if directors have ultimate responsibility for all the affairs of a corporation, they might be liable, even if they delegated supervisory responsibility for specific areas of the business to officers and others.[106]

This reversal means that, in determining whether a director had a 'responsible share' of a violation, a court might give less weight than *Park* did to evaluating an individual's general authority under both the statute under which the corporation is

99 *Meyer*, 537 U.S. *at* 287, 289.

100 *Cf. United States v. MacDonald & Watson Waste Oil Company*, 933 F.2d 35 (1st Cir. 1991) (holding that explicit 'knowing' requirement for criminal liability under hazardous waste disposal statute could not be obviated by responsible corporate officer doctrine).

101 More specifically, the tax code imposes liability on 'responsible persons' for failure to pay employment taxes. 26 USC §§ 6671, 6672 (2008). For a case in which a director, who had substantial operational control over a corporation's finances (including the ability to borrow money on behalf of the entity), was held liable under this statute, *see Jenson v. U.S.*, 23 F.3d 1393 (8th Cir. 1994).

102 33 USC § 1319(c)(6) (2008).

103 42 USC § 7413(h) (2008).

104 15 USC § 77–o (2008).

105 Strader, n. 54 above at §7.02(c) ('a "responsible" corporate officer is one who possessed supervisory responsibilities for the matter in question.').

106 *See* n. 79–80 above and accompanying text.

organized, and the corporation's certificate of incorporation and bylaws.[107] A court would likely focus more on whether statutes and a corporation's organizational documents task a director with more direct oversight of the particular area of a corporation's operations involved in legal misconduct. Moreover, a court might look at actual day-to-day activities and responsibilities of a director.

6 A Case Study: CERCLA

CERCLA presents one of the single most significant statutory sources of potential liability for directors. This act also has spawned the most extensive and convoluted case law on director and officer statutory liability, and thus represents an ideal lens with which to compare veil piercing, agency and responsible corporate officer theories.

This statute, which Congress passed in 1980 in the wake of the Love Canal disaster, regulates the clean-up of land contaminated by hazardous waste, also known as 'Superfund' sites.[108] To pay for this clean-up, CERCLA holds strictly liable persons who:

(1) currently own or operate a facility where hazardous substances have been released into the environment;
(2) formerly owned or operated a facility when hazardous substances were disposed of at that facility; or
(3) generated or arranged for disposal or treatment of a hazardous substance that was released into the environment.[109]

Liability, once it attaches to these persons, is strict, joint and several.[110] Under the Act, 'persons' includes individuals, corporations and other business entities.[111] But, the Act defines both 'owner' and 'operator' only in a tautological manner.[112]

Thus federal courts have been forced into the breach to define these terms and determine when individual defendants – directors, officers, employees and agents

107 Although many state corporations statutes vest the responsibility of managing the business and affairs of a corporation in the board, statutes also provide that the certificate of incorporation or bylaws may give significant managerial responsibility to officers. *See,* e.g. 8 Del. C. §§ 109, 141 (2008).

108 For background on CERCLA and a recent analysis of the state of the responsible corporate officer doctrine under the statute in the wake of the *Bestfoods* case (analyzed below) *see* B. Moore 'The Corporate Officer as CERCLA Operator: Applying the Holding in *United States v. Bestfoods* to the Determination of Officer Liability' (1999) 12 *Tulane Environmental Law Journal*, 519.

109 42 USC § 9607(a)(1)–(3)(2008).

110 Moore, n. 108 above at 526.

111 42 USC § 9601(21)(2008).

112 42 USC § 9601(20)(A)(ii)(2008).

– may be liable as 'owners' or 'operators' (or in some cases as 'arrangers') for the CERCLA violations of a corporation. In doing so, federal courts have applied – often confusing and conflating – each of the veil piercing, direct liability/agency/participation and responsible corporate officer doctrines.[113]

Within direct liability CERCLA theories for holding directors, officers and shareholders liable, courts have historically taken wildly different approaches. The most common approach has been to hold directors, officers and shareholders liable as 'operators' for CERCLA violations in which they directly participate.[114] But, several federal trial and appellate courts went a step further and held that directors and officers could be liable for violations of the statute if they had the 'capacity to control' those operations in the facility that led to the violations, regardless of whether they knew or directly participated in violations.[115]

A few courts went yet further by 'eliminating the requirement that the particular harm in question have any relation to areas within such person's capacity to control.'[116] One scholar argues that a series of cases pushed the envelope and 'focused on the defendant's general participation in the management of the facility, or even the management of the corporation.'[117] In describing this progression, this scholar noted, '[c]ompletely lost… are the concepts of active participation in the management of the facility or personal participation in the wrongful act that caused the damage.'[118]

This difference between the 'direct participation' and 'capacity to control' theories of CERCLA case law parallels the differences between the 'direct liability/participation' theory of liability and the 'responsible corporate officer' doctrine outlined in Parts 4 and 5 of this chapter. At the same time, the range of CERCLA standards on 'capacity to control' mirrors the spectrum in the 'responsible officer' doctrine with respect to the question of how particularized must a responsible officer's oversight responsibilities be for he or she to have liability for a statutory violation. However, characterizing CERCLA cases on a continuum also masks the

113 *See* Dennis, n. 65 at 1375–1410. Dennis analyzes how courts have confused veil piercing with direct participation theories, by seeming to imply that direct participation is a method to pierce the veil. *Ibid.* at 1377, n. 40 *citing NEPACCO I*, 579 F. Supp. 823 (W.D. Mo. 1984), *aff'd in part, rev'd in part*, 810 F.2d 726 (8th Cir. 1986), *cert. denied*, 484 US 848 (1987).

114 Moore, n. 108 above at 526–28; L.J. Oswald and C.A. Schipani, 'CERCLA and the "Erosion" of Traditional Corporate Law Doctrine' (1992) 86 *Northwestern University Law Review*, 259 (1992); C.A. Schipani, 'Integrating Corporate Law Principles with CERCLA Liability for Environmental Hazards' (1993) 18 *Delaware Journal of Corporate Law*, 1, 5.

115 This is also known as the 'authority to control' test. *See* Moore, n. 108 above at 533–40. Moore distinguishes cases in which courts based director and officer liability determination on whether the individual had 'actual control' over hazardous substances from those that used an 'authority to control' test. *Ibid.* at 529–40.

116 Dennis, n. 65 above at 1387–88.

117 *Ibid.* at 1388.

118 *Ibid.* at 1389.

fact that many of the cases lacked logical coherency and may fall at once on various points on the spectrum.[119]

In 1998, the Supreme Court re-entered the fray over CERCLA in *U.S. v. Bestfoods;*[120] and provided much needed clarity to the analysis of the three doctrines: veil piercing, direct liability/participation liability and responsible corporate officer liability. Even though the case involved liability of a parent corporation for a subsidiary, its holdings would likely also apply to director and officer liability under the statute. Three findings stand out – first, the *Bestfoods* opinion held that a parent corporation could be liable as an owner or operator under CERCLA under a veil piercing theory, but only if the common law rules for veil piercing apply; the statute did not create a new veil piercing standard.[121]

Second, the opinion clarified that a parent may be liable, even absent veil piercing, under a direct participation theory.[122] The Court thus underscored the critical distinction between veil piercing and agency/participation theories outlined in this chapter. But, *Bestfoods* held that for a parent corporation to be liable under CERCLA, it must participate directly in the operation of the violating *facility*, not merely in the operations of the violating *subsidiary*.[123] Mere overlap of directors between the parent and subsidiary is insufficient to find direct participation, as the Court reasoned,

> [a]ctivities that involve the facility but which are consistent with the parent's investor status, such as monitoring of the subsidiary's performance, supervision of the subsidiary's performance, supervision of the subsidiary's finance and capital budget decisions, and articulation of general policies and procedures, should not give rise to direct liability.[124]

Again, *Bestfoods* analyzed parent/subsidiary liability, but it nevertheless sends a strong signal as to how the Court would rule on matters of the liability of individual directors and officers under CERCLA. The Court was unequivocal that liability as an 'operator' under a participation theory required very direct participation in the operation of the facility, not of the corporation as a whole. For directors to be liable as operators, it would seem they too would need to have directly participated in operating the facility.[125]

119 *Ibid.* at 1376.

120 524 US 51 (1998).

121 *Ibid. at* 62–64. The Court recited some of the usual tests for veil piercing, but did not specify the weight that would be given to each nor did it settle whether state or federal common law on veil piercing should apply in CERCLA veil piercing cases. *Ibid. at* 64.

122 *Ibid. at* 64-65.

123 *Ibid. at* 67-68.

124 *Ibid. at* 72 (internal quotations and citations omitted).

125 Some courts and scholars have also made this conclusion. *See* Moore, n. 108 above at 544–50 *citing U.S. v. Green*, 33 F. Supp.2d 203, 217 (W.D.N.Y. 1998). Moore also notes that some

7 Conclusion: Towards an Explanation for the Structure of Director Liability Rules in the United States

Bestfoods serves as a bellwether for the current state of the three most important sources of director liability outlined in this chapter. Veil piercing continues as an important corporate law doctrine, but continues to suffer from uncertainty as to its core principles. Complicating the analysis, cases in which directors have been held liable under veil piercing without also being shareholders and officers remain rare.

Directors also face liability for torts and statutory violations in which they participate, but courts increasingly require fairly direct participation for liability to attach. The responsible corporate officer doctrine survives as an alternative source of liability for directors and courts may dispense with requirements that directors have actual knowledge of, or intent to commit misconduct. Yet federal courts appear unwilling to extend this doctrine to new statutes absent clear statutory language. Even within the responsible corporate officer doctrine, courts have moved to requiring that directors and officers have fairly particularized oversight responsibility for the specific operations that led to a violation for liability to attach.

Several deeper legal trends and themes lie underneath the movement in these three doctrines. First, director liability under both participation and responsible corporate officer doctrines appears to be a more significant risk in closely held corporations in which directors are also often officers and shareholders and are much more involved in the daily affairs of the corporation.[126] This parallels veil piercing, which, as noted above, does not occur in the context of publicly traded corporations.[127]

Second, courts appear less creative in invoking criminal liability rather than civil; for example, courts are much less willing to dispense with the core criminal law requirement of *mens rea* than they are with civil law *scienter*.[128] Third, there is a continued movement of federal courts towards a strict construction of statutes and away from implying remedies.[129] This movement has given new vitality to the canon of statutory construction which says that judges must strictly construe statutes

courts seem to have misinterpreted *Bestfoods* to mean that directors and officers can only be liable when the corporate veil is pierced. *Ibid. at* 547 citing *Browning-Ferris Indus. v. Ter Maat*, 13 F.Supp.2d 756, 763–65 (N.D.Ill. 1998).

126 O'Neal and Thompson, n. 31 above at § 1.12.

127 *See* n. 30 above and accompanying text.

128 *See MacDonald & Watson*, 933 F.2d 35 at 51–52 (expressing less willingness in context of criminal statutes to use responsible corporate officer doctrine to override explicit knowledge requirements for individual liability).

129 For a historical analysis of the evolution of statutory interpretation in the United States, *see* W.D. Popkin, *Statutes in Court: the History and Theory of Statutory Interpretation* (Durham, Duke University Press, 1999). Popkin describes the dominant mode of statutory interpretation in the twentieth century up until the 1960s as 'purposive', but then describes a shift to 'modern textualism' that looked to reduce the interpretative role of judges. *Ibid.* at 115–188.

that derogate from common law – which usually means pre-20th century common law.[130] At the same time, the dominant view looks to limit mid-20th century case law interpreting statutes (itself a form of common law) where courts were more willing to see in statutes evidence of legislative intent to provide remedies where the common law was insufficient.

These judicial trends cannot deny that statutes in a few areas of law, most notably environmental law, have explicit and historically novel provisions to hold directors and officers liable for corporate misconduct. These trends have also not reversed earlier novel judicial interpretations finding individual liability under certain food and drug statutes.

But, what explains why these substantive areas of the law are more open to director liability? Perhaps statutes in these areas merely reflect the more progressive eras in which they were enacted or public demand for legal redress in the wake of corporate scandals. Alternatively, it might be that the harms addressed by these statutes are greater in magnitude and affect a greater number of people, and, therefore, greater deterrence of directors and officers is warranted. Indeed, courts have often remarked that the strict liability regime of the responsible corporate officer doctrine applies only to a narrow class of 'public welfare' statutes.[131]

But, directors and officers might also face more liability under environmental law than, say, employee benefits law[132] for the same efficiency reasons that scholars advocate differing standards for tort and contract creditors in veil piercing cases: the victims of environmental liability have far less ability to avoid and bargain out of losses and thus bear a clearer resemblance to tort creditors.

In any event, various legal doctrines together ensure that directors face far less liability for corporate misconduct than in other countries surveyed in this volume. Why is this? This may reflect the structure of US corporate law which not only gives directors great discretion in making decisions, but allows them to delegate more responsibility to officers and employees of the corporation. Directors of US corporations may thus be more removed from much of corporate decision-making and thus more insulated from liability for corporate misconduct than directors of corporations in other countries.

130 For scholarship explaining and supporting this canon, *see,* e.g. J.R. Stoner Jr, 'The Idiom of Common Law in the Formation of Judicial Power' in *The Supreme Court and American Constitutionalism*, B.P. Wilson and K. Masugi (eds) (Lanham, MD, Rowman and Littlefield, 1998).

131 E.g. *Celentano v. Rocque*, 282 Conn. 645, 671 (2007).

132 Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' n. 31 above at 28–29 (noting that pension cases appear to require more direct participation by an individual for liability compared to CERCLA cases and speculating this is because collective labour bargaining means 'there would have been some theoretical chance to bargain for individual liability'). *See* also Dennis, n. 65 above at 1394–96 (citing numerous ERISA cases rejecting individual liability).

Yet, that is a descriptive, not a normative statement, and does not answer the question of why US law gives directors greater insulation from decision-making and liability. It only raises the question – why should US law *not* expect directors to take a more active role in preventing at least the most serious forms of corporate misconduct?

The structure of the rules for holding directors liable creates a disincentive for directors to actively monitor and police corporate operations for potential legal misconduct. As noted above, many criminal and civil statutes require knowledge by a defendant of a legal violation for liability to attach to that individual.[133] Even under strict liability statutes, application of the responsible corporate officer doctrine to a director generally requires the director to have oversight responsibility for the particular operations of the business that violated the statute.[134] Directors may, therefore, be reluctant to monitor operations with a high risk of statutory violations for fear of being held liable for this misconduct by virtue of their knowledge or management. The extent to which these perverse incentives actually change director behaviour requires empirical study.[135]

On the other hand, holding directors liable for corporate misconduct would create an incentive for them to detect and reduce the level of corporate lawbreaking. Considered in isolation, this incentive would be clearly desirable. But, director liability also comes with costs. Part 7.1 sketches due process and normative arguments with respect to not holding directors liable. Part 7.2 considers economic explanations – both public choice and efficiency – for why directors are not held liable more often. Part 7.3 outlines the effects of director liability on risk-spreading and, conversely, the impact of corporate insurance and indemnification on rules imposing director liability. Part 7.4 analyzes the extent to which corporate and securities laws serve as a counterweight to the disincentive for directors to monitor created the by the rules described above in this chapter. Part 7.5 offers a concluding analysis.

7.1. Due Process and Normative Arguments

Concern for the constitutional due process of individuals clearly animates the legislative and judicial reluctance to hold directors and officers liable in the absent direct knowledge or participation in corporate misconduct. Strict liability and the responsible corporate officer doctrine are the exceptions not the norms. This due

133 *See* n. 66–70 above and accompanying text.

134 *See* n. 105 above and accompanying text.

135 One potential way to measure these disincentives would be to compare corporate governance metrics (such as those created by investor activist groups) for companies in an industry with higher potential director liability due to statute (for example, hazardous waste disposal companies with CERCLA exposure) with a control group of companies.

process concern is particularly intense in criminal law cases, as deep norms embedded in criminal law require that criminal liability match individual culpability.[136]

But, this does not necessarily end the analysis of why directors are not held liable. One could imagine a set of rules that would hold directors liable even absent direct participation or knowledge and that would nonetheless accord with norms of culpability, *if* the background expectation of corporate law was that directors should be actively involved in corporate decision-making and monitoring of misconduct.

7.2 Economic Arguments: Rent-seeking, Deterrence, Delegation and the Market for Directors

The question then becomes, why does US corporate law not expect this level of engagement from directors? One economic explanation rooted in public choice theory is that directors and other corporate managers have engaged in rent-seeking behaviour to take advantage of legal rules to insulate themselves. Under this explanation, directors and corporate management in general have chosen to incorporate (or move the state of incorporation) in states whose laws provide them with maximum flexibility in decision-making and delegation. This not only insulates directors and officers from liability to shareholders, but has the collateral benefit of reducing their responsibility for corporate misconduct affecting third parties or the public. This explanation represents a version of the 'race to the bottom' theory of the competition among states for incorporations.[137] Moreover, directors and management can use the resources of the corporation available to them to influence the development of the law, including through corporate campaign contributions.

In an altogether different intellectual vein, one could take seriously the idea that economic efficiency shapes not only corporate law, but the rules for director liability outlined above. Applying economic logic, the law should hold directors (and officers) liable for corporate misconduct only when liability actually deters that misconduct. But, holding directors liable may lead to over-deterrence if directors cannot efficiently bear risk.[138] Moreover, if directors have little direct control over the operations of a corporation that cause social loss, then it would be severely inefficient to hold them liable for those losses.

Again, this begs the question of whether the hierarchy of corporate decision-making in which directors are not intimately involved in operations should be taken as immutable. If directors were held liable, they would likely become much more involved in corporate decision-making to detect and thwart misconduct in order to mitigate their legal exposure as individuals. This would undoubtedly reduce the incidence and magnitude of corporate misconduct.

136 Strader, n. 54 above at § 2.07(b).

137 *See* n. 23 above and accompanying text.

138 Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' n. 31 above at 27.

It would also come with several costs. First, directors may become much more risk averse in their decisions. The extent of this risk aversion and whether it would lead to suboptimal decision-making or merely remedy a moral hazard of directors remains an open question and warrants further empirical study. Second and similarly, increased liability might encourage directors to micromanage their subordinates, thereby erasing the efficiency gains of delegation within the firm. The extent to which this would happen and the net social loss that would occur if it did, again, require empirical research in order to move beyond theoretical speculation.

Third, increased liability might simply drive individuals out of the market for directors. Even worse, it might create a 'lemons' problem by driving more risk averse, cautious and law-abiding persons out of the market for directors and leaving the pool for directorships full of more aggressive and less scrupulous individuals.

These theoretical costs of increasing director liability for corporate torts and statutory violations mirror the arguments made against increasing director liability to shareholders under either fiduciary duties of corporate law or securities law. Nevertheless, even scholarly arguments on the effects of increased director liability on the market for directors often represent theoretical assertions or are based largely on anecdote; sound empirical validation of these assertions remains a work in progress.[139] But, as with any empirical research in corporate and financial law, untangling the skein of causal links proves extremely difficult.

7.3 Risk-spreading, Insurance and Indemnification

The effects of liability on director incentives – including the deterrence value of liability rules – are blunted to the extent directors are indemnified or insured for that liability. Most state corporation statutes allow corporations to indemnify directors for civil and criminal liability. For lawsuits, other than those involving liability to the corporation and shareholders, the corporation typically may pay not only a director's expenses (such as attorneys' fees), but judgments, fines and settlement amounts as well. Statutory conditions for indemnification in these cases are often not particularly onerous. For example, Delaware law allows corporations to indemnify a director so long as he or she:

139 For a sample of arguments in the literature of the effects of increased liability on the market for directors, *see* A. Hamdani and R. Kraakman, 'Rewarding Outside Directors' (2007) 105 *Michigan Law Review*, 1677, 1690; B. Black, 'Outside Director Liability' (2006) 58 *Stanford Law Review* 1055, 1058 (2006) citing R. Romano, 'What Went Wrong with Directors' and Officers' Liability Insurance?' (1989) 14 *Delaware Journal of Corporate Law*, 1, 1-2.

Several studies have attempted to measure the effects of liability on the market through surveys; e.g. J. Sarra, 'Corporate Governance in Global Capital Markets: Canadian and International Developments' (2002) 76 *Tulane Law Review* 1691, 1700 (2002) (critiquing one such survey). Survey research presents obvious biases.

> acted in good faith and in a manner [the director] reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the [director's] conduct was unlawful.[140]

Moreover, corporations may purchase insurance for directors to cover those liabilities that corporations may be statutorily prohibited from indemnifying.[141] Of course, corporate insolvency can limit the value of indemnification and directors and officers' insurance policies have coverage limitations that may leave directors exposed for breaches of certain laws or for intentional misconduct; many insurance companies explicitly carve out CERCLA liability from coverage under director and officer policies.[142]

The presence or absence of indemnification and insurance complicates that analysis of another economic objective, risk-spreading. Risk-spreading reflects the objective of allocating losses to a party that can most bear the losses most efficiently. In other words, losses should be allocated to the best 'insurer'. Often the party that can best bear losses is the one that can pass losses on to a wide number of other persons.[143] Scholars have argued that risk-spreading argues against holding directors and officers liable, as individuals are less able to diversify away this liability.[144] This conclusion would change though if directors benefited from indemnification or insurance, which would allow risks to be spread to the corporation and insurance providers.

On the other hand, risk-spreading *via* indemnification and insurance creates the potential for moral hazard and compromises the deterrence value of director liability. Indemnification and insurance also pose agency costs as directors seek to pass to shareholders losses for misconduct. Moreover, risk-spreading obtained through director liability with indemnification and insurance raises the question of whether the same result could be achieved more directly by holding the corporation liable and dispensing with director liability altogether.

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140 8 Del. C. § 145(a). Compare this to §145(b) which allows a corporation to indemnify directors for actions 'by or in the right of the corporation' but excludes indemnification if the director is adjudged liable.

141 E.g. 8 Del. C. § 145(g). Many statutes, including CERCLA, allow corporations to indemnify individuals. *See* e.g. *U.S. v. Lowe*, 29 F.3d 1005 (5th Cir. 1994).

142 W.S. Biel, 'Comment: Whistling Past the Waste Site: Directors' and Officers' Personal Liability for Environmental Decisions and the Role of Liability Insurance Coverage' (1991) 140 *University of Pennsylvania Law Review*, 241.

143 Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' n. 31 above at 3.

144 *Ibid.* at 3–4.

7.4 Corporate and Securities Law Counterweights to the Disincentives to Director Monitoring.

To the extent that the director liability rules outlined in this chapter do create a disincentive for directors to closely supervise businesses and correct illegal acts, US corporate law presents only a mild corrective. Historically, the fiduciary duty of care has imposed a general obligation on directors to attend meetings, become familiar with the nature of the corporation's business and monitor its operations.[145] But, liability for duty of care obligations is blunted by deference directors are given under the business judgment rule.[146]

However, over a decade ago, the Delaware Court of Chancery (arguably the most influential state court for corporate law) increased the duties of directors to monitor corporate operations for potential illegal conduct in the *In re Caremark International Inc. Derivative Litigation* case.[147] *Caremark* articulated two obligations of boards of Delaware corporations. First, boards must monitor the corporation to ensure that it is complying with the law. This obligation includes responsibility for designing management and information systems that ensure that employees detect and report non-compliance with the law to superiors and that information on non-compliance percolates up to the board.[148] Second, the Board must sift through the information

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145 *See,* e.g. *Francis v. United Jersey Bank*, 87 NJ 15 (1981).

146 Professor Clark explains the deference courts give to business decisions of directors and officers in the face of lawsuits alleging duty of care violations thus, the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment – even for judgments that appear to have been clear mistakes – unless certain exceptions apply. Clark, n. 42 above at 123.

Clark then elaborates that these exceptions consist of acts by the directors that constitute fraud, illegality and conflict of interest or, according to some courts and scholars and in limited circumstances, gross negligence. *Ibid.* at 124.

147 698 A.2d 959 (Del. Ch.1996). For a comprehensive analysis of *Caremark* and its progeny, *see* H.A. Sale, 'Monitoring Caremark's Good Faith' (2007) 32 *Delaware Journal of Corporate Law*, 719.

148 The Chancery Court opinion set the standard for when a board breached its duty to monitor. The opinion found that a board of directors could not, satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance. *Caremark*, 698 A.2d *at* 970.

At the same time, the opinion indicated that courts would be deferential as to the design of information systems, particularly as to the extent of information that would be reported up the ladder to the board.

Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably it receives and make further investigation if the information suggests problems[149] – what a later case labelled 'red flags' – [150] or otherwise face possible liability to shareholders for losses from the corporation's non-compliance with laws.[151] In this later case, *Stone v. Ritter*, the Delaware Supreme Court (a higher court than the Chancery Court) not only affirmed *Caremark*, it framed the *Caremark* duties as good faith obligations that implicated the duty of loyalty to shareholders. This marks a critical turn, as courts defer much less to decisions to directors involving the duty of loyalty compared to decisions challenged under the duty of care.[152]

However, the effect of the *Caremark* decision on director liability for corporate violations of the law is tempered in a number of respects. First, Delaware courts have indicated that they will defer to the business judgment of directors and management in how compliance systems are designed and how much information is channelled to directors.[153] The tension between this business judgment deference and the language of *Stone* invoking 'good faith' and the duty of loyalty remains to be resolved in future cases. In any event, the requirement of compliance systems does not mean that the board must have detailed knowledge of all aspects of a corporation's operations.[154] Moreover, *Caremark* duties run to shareholders and do not create director liability to the government or third parties. Together, these limitations strongly suggest that a board could satisfy its *Caremark* duties without becoming actively involved enough in corporate operations to trigger liability to the government or third parties under veil piercing, direct participation or responsible corporate officer theories.

Nevertheless, federal securities laws serve as a backstop to corporate law duties; securities law increases the incentives and abilities of directors of public corporations to monitor the activities and potential legal violations of their corporations in two ways. First, securities law creates demand by directors for information about potential corporate misconduct; directors of public companies have a great incentive to monitor corporate operations due to federal securities laws that impose liability on directors for the accuracy of a company's disclosure.[155] In addition to general

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to detect acts material to the corporation's compliance with the law. But it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility. *Ibid.*

149 *Ibid. See* Sale, n. 146 above at 752–53.

150 *Stone v. Ritter*, 911 A.2d 362 *at* 364 (Del. 2006).

151 *Caremark*, 698 A.2d *at* 370.

152 *Stone*, 911 A.2d *at* 370; Sale, n. 146 above at 730.

153 *See* n. 147 above.

154 Sale, n. 146 above at 732 *citing Stone*, 911 A.2d *at* 368.

155 Of particular note, s. 11 of the Securities Act of 1933 imposes liability on directors for any material inaccuracies in a corporation's registration statement filed with the Securities and Exchange Commission and disclosed to investors. 15 USC § 77k(a)(2–3) (2008).

antifraud rules, federal securities regulations require intensive disclosure about, among other things, a public company's operations and legal risks.[156] Therefore, in order to avail them of the due diligence defence to various forms of disclosure liability, directors must then reasonably inform themselves of potential misconduct and legal violations by the corporation.[157]

Second, recent securities laws have addressed the supply of information to directors regarding corporate misconduct. The 2002 Sarbanes Oxley Act represented a significant entry of federal law into corporate governance, historically the province of state law.[158] The Act and SEC regulations promulgated under the Act addressed the supply of information to boards regarding corporate misconduct in several ways. Most notably, the Act and subsequent regulations mandated that public companies assess and certify the adequacy of their internal disclosure and control systems. Under section 302 of the Act, executive officers of publicly registered corporations are required to certify the adequacy of internal financial reporting systems,[159] and similarly, under section 404, management and auditors of those corporations are required to issue a report on the adequacy of internal control over financial reporting.[160]

Section 404 has proven the most controversial provision in the Act, as many companies have complained about the expense of investigating and redesigning internal control systems without regard to the potential magnitude of fraud that must be interdicted.[161] Beyond internal controls, the Sarbanes Oxley Act and regulations also include a set of reporting standards and whistleblower protections designed to encourage employees and agents of a public corporation (including lawyers) to report fraud 'up the ladder' in the corporation and ultimately to the board of directors.[162]

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156 For example, public companies must disclose to investors pending legal proceedings. *See* 17 CFR § 229.103 (2007).

157 For example, s. 11 offers directors a defence to liability if, after performing due diligence, they reasonably believed that the registration statement was materially accurate. 15 USC § 77k(b).

158 For an exploration of the linkages between federal securities laws and state corporate law duties before Sarbanes Oxley, including how securities law incorporated fiduciary duty concepts, *see* D.C. Langevoort, 'The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability' (2001) 89 *Georgetown Law Journal,* 797. For scholarly debate on the 'federalization' of corporate governance via the Sarbanes Oxley Act, *see* sources at n. 1 above.

159 15 USC § 7241(a)(4)–(6) (2008) (requiring that the SEC pass regulations requiring certifications from executives on internal controls).

160 15 USC § 7262 (2008) (requiring that the SEC pass regulations specifying information in the required, the reports). *See* also 17 CFR §§ 210, 228, 229, 240, 249, 270, 274 (2007) (SEC rules responding to statutory mandate under ss 302 and 404).

161 'Sarbanes Oxley: Five Years Under the Thumb' (26 July 2007) *Economist*.

162 E.g. 17 CFR § 205 (2007) (setting standards for conduct for attorneys appearing before the SEC).

Although the above provisions generally relate directly to financial disclosure, legal risks beyond financial fraud impact a company's financial reporting, and thus these laws and regulations can improve the flow of information to the board on legal compliance in general.

7.5 Concluding Analysis

Whether corporate or securities law create optimal incentives for directors to monitor misconduct represents one of the most intense areas of scholarly and policy debate in US business law. This debate mirrors the questions posed earlier in Part 7 on the impact of veil piercing, direct participation and responsible corporate officer standards on director behaviour. Again, the effects of different director liability rules on optimal monitoring and deterrence of corporate misconduct, risk-spreading, decision-making and delegation of decisions, and the market for directors remain open to empirical study. It may be extremely optimistic to expect conclusive answers to any of these questions in the near future.

Yet, it is striking that the phrasing of these questions, the structure of director liability rules in this chapter, and the way courts talk about these rules reflect certain values embedded both in US corporate law and in the way corporate law intersects with public law. Efficiency concerns take centre stage, and particularly concerns about efficiency *within* the corporation. Shareholders occupy a privileged position in American law. Indeed, scholars have long remarked how corporate limited liability represents a form of subsidy paid by tort creditors to shareholders to encourage capital formation.[163] So too does the rule structure that makes liability of directors for corporate misconduct relatively rare, a representation of an implicit high valuation of the economic activity generated by the corporate form compared to the costs borne by the public from torts and violations of environmental and other public laws.

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163 L. Ribstein, 'Limited Liability and Theories of the Corporation' (1991) 50 *Maryland Law Review,* 80, 94 (describing this as the 'externalities hypothesis').