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The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law

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The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law

Keywords

Corporate tort law, Tort liability, Tort Liability for supervision, Common law negligence claims, Tort-Based liability, Corporate supervision and management, Limited liability

THE CURIOUS CASE OF DIRECTORS’ AND OFFICERS’ LIABILITY FOR SUPERVISION AND MANAGEMENT: EXPLORING THE INTERSECTION OF CORPORATE AND TORT LAW

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INTRODUCTION

Should directors and officers¹ be personally liable in tort for gunshot wounds sustained by a mall patron after management reduced mall security in order to maximize profits? Should directors be personally responsible for failing to install exterior lighting when the failure to do so led to a resident being robbed and attacked in her condominium unit? Should directors and officers be liable for negligently managing underwriting risks or for failing to detect misconduct by employees?

Today, directors and officers can incur personal liability to non-shareholder third parties in all of these and many other instances based on their inadequate management or failure to supervise corporate affairs and subordinates.² Due to the lack of legal protections in this area, corporate directors and officers face personal liability risks that can substantially diminish or eliminate their entire personal wealth. For example, in one case, the president and CEO of a company was held personally liable for over \$132 million for mismanagement.³ Yet, unlike claims that are brought by shareholders, the law governing tort claims by non-shareholder third parties against directors and officers remains an area that is largely neglected by legal scholars.

However, the current approaches to directors' and officers' tort liability for claims involving inadequate supervision and management in the corporate context are in need of repair. Courts faced with tort-based supervision and management cases frequently fail to consider that directors' and officers' duties to supervise and manage generally exist only in relation to the corporation, but not in relation to third parties. In addition, current approaches neglect the separate corporate personality of the corporation, unduly shift the risk of doing business to directors and

1. In this Article, the term "officer" means a corporation's president, chief financial officer, chief accounting officers, vice presidents of principal business units and any person with significant policy-making functions. This wording is roughly in line with the definition of "officer" in Rule 16a-1 under the Securities Exchange Act of 1934, 15 U.S.C. § 78a.

2. See *infra* Part II.

3. *Omaha Indem. Co. v. Royal Am. Managers, Inc.*, 777 F. Supp. 1488, 1492 (W.D. Mo. 1991).

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officers, and undermine the heightened liability protections provided by corporate law.⁴

Moreover, the threat of personal liability for directors and officers is also increasing. On the one hand, courts increasingly rely on a growing body of statutory law that holds directors and officers liable for acts and omissions related to supervision and management, even in the absence of any wrongdoing and solely based on the director's or officer's corporate status and position of authority.⁵ On the other hand, in most cases plaintiffs will attempt to hold directors and officers personally liable when the corporation is insolvent or bankrupt and where the potential individual defendants are wealthy or covered by liability insurance.⁶ Because of the recent financial crisis, scenarios in which corporations are insolvent or forced into bankruptcy are rising.⁷ In addition, it is now also possible to imagine a scenario where an entity that provides directors' and officers' liability insurance becomes insolvent or bankrupt, adding to the increased vulnerability of directors and officers to liability claims.

Typically, cases holding directors and officers liable for supervision and management failures involve closely held corporations.⁸ Consequently, commentators could mistakenly dismiss the issue as largely irrelevant for directors and officers of large publicly held corporations.

Yet, because the rules to assess tort-based liability do not vary with the size or type of corporation that is involved,⁹ directors and officers of public companies can also face considerable risks of personal liability for supervision and management. For example, class action litigants in products liability cases may claim that the board's or management's failure

4. The importance of the issues surrounding directors' and officers' liability has often been downplayed due to director and officer ("D&O") insurance policies or the existence of indemnification agreements between the individual and the corporation. However, protection offered by insurance or indemnification—if in place at all—is incomplete. *See infra* Part IV.C.

5. *See infra* Parts I.D., II.B.

6. In this context, it is helpful for plaintiffs that the stay provision of the Bankruptcy Code, 11 U.S.C. § 362(a)(1) (2000), does not generally apply to solvent directors and officers as co-defendants of a debtor corporation. *See, e.g., Oklahoma Federated Gold and Numismatics, Inc. v. Blodgett*, 24 F.3d 136, 141 (10th Cir. 1994) (noting that tort claims against an officer are not subject to the automatic stay).

7. Moreover, plaintiffs can use suits against directors and officers strategically for their nuisance value and as a tool to exercise added pressure in settlement negotiations.

8. For example, the supervision and management cases cited in Part II of this article all concern directors and officers of closely held corporations. The size of these corporations, however, varies widely and range from a small drinking establishment to a large national food chain.

9. *Compare* *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996) (applying the typically used test under Texas law of whether an officer owed an independent duty of reasonable care to the plaintiff to evaluate claims against the defendant of a closely held corporation), *with* *McCaskey v. Cont'l Airlines, Inc.*, 159 F. Supp. 2d 562, 577 (S.D. Tex. 2001) (applying the same test to the defendant Chief Executive Officer of a publicly held corporation).

to supervise and manage led to their injuries. In fact, plaintiffs continue to bring claims against directors and officers in the context of mass torts¹⁰ and products liability.¹¹ A recent example of directors' and officers' exposure in this regard is provided by a wrongful death class action suit filed against a publicly held manufacturer of a diabetes drug and its directors and officers.¹²

Moreover, the current rapid increase in bank failures has also given rise to tort-based claims against banks' executives and board members, such as lawsuits by uninsured depositors alleging negligent management and oversight.¹³ With financial markets' continuing problems, these types of lawsuits have the potential to evolve into real personal threats to directors and officers, namely if plaintiffs can convince courts to grant them standing to bring their claims directly.¹⁴

Because of the risks to directors' and officers' personal liability for supervision and management, and the shortcomings with the current

10. See Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1, 13 (1986) (noting, however, that payment out of managers' personal assets is a remote risk). For example, at one time during the asbestos related class-action lawsuits against Johns-Manville, there were approximately 1,000 cases pending with past and present directors, officers, and employees of Manville named as defendants, most of which involved claims by Manville employees for failure to warn of potential hazards in the work place. See *In re Johns-Manville Corp.*, 33 B.R. 254, 263 (Bankr. S.D.N.Y. 1983) (staying asbestos injury suits against Johns-Manville managers). Nationwide, the potential damage claims against directors, officer, and employees at the time of the decision were in excess of \$230,000,000. *Id.* at 260.

11. See, e.g., *In re Ephedra Prods. Liab. Litig.*, 478 F. Supp. 2d 624, 634 (S.D.N.Y. 2007) (holding that the sole shareholder, director, and officer of a corporate marketer/seller may be personally liable in toxic-tort products action for consequences of his acts, regardless of any showing that the defendant was the corporation's alter ego). However, courts will be disinclined to allow products liability claims against directors or officers absent a specific showing of an affirmative direction, sanction, participation, or cooperation in the production, inspection, maintenance, or sale of a defective product. See *Lobato v. Pay Less Drug Stores, Inc.*, 261 F.2d 406, 409 (10th Cir. 1958); *Ruzzo v. LaRose Enters.*, 748 A.2d 261, 270 (R.I. 2000). Conversely, it may suffice to incur liability when an executive makes or condones false statements about a product. *Marsh v. Usk Hardware Co.*, 132 P. 241, 247-48 (Wash. 1913).

12. See Complaint for Damages at 3, *Hoffman v. Smithkline Beecham Corp.*, No. BC410935 (Cal. Super. Ct. Mar. 31, 2009), 2009 WL 890200.

13. See Michael R. Smith & Benjamin Lee, *Uninsured-Depositor Litigation: An Emerging Threat to Directors and Officers of Troubled Banks?*, 14 ANDREWS LITIG. REP. 1 (2008).

14. See *id.* Courts have held that creditors may maintain direct actions against directors and officers on the basis of mismanagement if they sustained an identifiable loss peculiar and personal to themselves. However, where misconduct resulted in loss to the corporation and its creditors generally, the right of action belongs to the corporation and must be maintained by it or its receiver. See *Ford Motor Credit Co. v. Minges*, 473 F.2d 918, 921 (4th Cir. 1973); *Finch v. Southside Lincoln-Mercury, Inc.*, 685 N.W.2d 154, 167 (Wis. Ct. App. 2004); *Speer v. Dighton Grain, Inc.*, 624 P.2d 952, 961 (Kan. 1981). There is also debate over the existence of the tort of "deepening insolvency," but that debate is beyond the scope of this article. For a discussion of the merits of "deepening insolvency" claims from a Delaware perspective see *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 205-07 (Del. Ch. 2006) (rejecting the doctrine).

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approaches to imposing liability in these cases, this Article argues that the test for imposing personal liability on directors and officers should be revised. Under the revised approach, courts should focus strictly on the nature of the duty and the officer or director's state of mind. Consequently, under this revised approach, tort-based personal liability for directors and officers for breaches of duties owed to the corporation is limited to cases in which they act fraudulently or with the intention to inflict harm upon third parties. In addition, directors and officers remain liable for breaches of duties owed to third parties provided, however, that their conduct was at least grossly negligent.

Before delving into the revised approach in greater detail, this Article begins by outlining in Part II the general rules governing directors' and officers' liability vis-à-vis non-shareholder third parties for torts committed in their official capacities. Part III describes how courts apply these rules to hold directors and officers liable in tort for failures to supervise and manage corporate affairs and subordinates. Part IV argues that the current approaches for adjudicating tort-based supervision and management claims in the corporate context are, for the most part, inadequate and lack the necessary protections for directors and officers. Finally, Part V explores the revised approach by offering an alternative model of corporate tort liability that is duty-based.

Throughout this Article, the focus will be solely on directors' and officers' tort liability toward non-shareholder third parties in the context of supervision and management.¹⁵ Furthermore, although some of the arguments put forward in this Article in support of the revised liability model may also apply to other legal entities—such as Limited Liability Companies or Limited Liability Partnerships—and their agents, the present discussion will be limited to the liability of directors and officers of corporations.¹⁶

15. Actions by a corporation or shareholders against its directors and officers, claims under securities laws, and criminal law sanctions will not be addressed. For a thorough analysis of managerial liability in the context of fraud on the market, see Jennifer H. Arlen & William J. Carney, *Vicarious Liability For Fraud On Securities Markets: Theory And Evidence*, 1992 U. ILL. L. REV. 691, 720–21 (1992) (proposing a regime of agent liability and criminal enforcement, but distinguishing liability for fraud on the market from other corporate tort liabilities).

16. The practical and doctrinal problems that imposition of personal tort liability on directors and officers creates are not limited to the corporate form. However, the issues are likely to be more prevalent in the case of business forms with limited liability, whether incorporated or not. Limited liability may increase the need for creditors to pursue their claims against directors, officers, LLC managers, or other individuals personally because it can make it more difficult to fully recover from the entity itself. In addition, without limited liability, the problem is also less pronounced, as it is likely that individuals who were held personally liable are in a better position to recover indemnification payments under agreements with their entity, since these indemnification claims will not be wiped out in bankruptcy.

I. AN OVERVIEW OF TORT LIABILITY FOR DIRECTORS AND OFFICERS

Courts tend to impose personal liability on corporate directors and officers for their torts on the basis that an agent, even if acting on someone else's behalf, is personally liable for his or her tortious conduct.¹⁷ Following this general principle, a director¹⁸ or officer remains personally responsible for his own torts, even if committed while acting in the scope of his employment and in his official capacity as director or officer of a corporation.¹⁹ Personal liability attaches even though the director or officer performed the acts for the benefit of the corporation and without personally benefiting thereof.²⁰ If a plaintiff so chooses, he may proceed against the corporation, against the director or officer individually, or against both the individual actor and the corporation.²¹

17. General agency principles posit that an individual is personally liable for all torts he commits, notwithstanding that the person may have acted as an agent or under directions of another. *See* *Bowles v. Ruppel*, 157 F.2d 944, 946 (3d Cir. 1946); RESTATEMENT (THIRD) OF AGENCY § 7.01 (2006); RESTATEMENT (SECOND) OF AGENCY §§ 343–44 (1957). When an agent acts affirmatively and causes physical harm, the rule is clear that the fact that he is acting as an agent does not relieve him from liability. Difficulties sometimes occur with respect to an agent's conduct which results merely in pecuniary loss to the plaintiff and to what can be referred to as nonfeasance or a failure by the agent to perform an act which he ought to do. *See* RESTATEMENT (SECOND) OF TORTS §§ 350–57, Reporter's Notes (2008); *infra* Part I.A.

18. A director is not, by virtue of his position, the corporation's agent (or "employee") for the purposes of vicarious tort liability; rather, a plaintiff must show that the necessary degree of control existed. *Norris v. Sackett*, 665 P.2d 1262, 1263 (Or. Ct. App. 1983). *See also* RESTATEMENT (SECOND) OF AGENCY § 14C cmt. a–b (2006).

19. *See* *Browning-Ferris Indust. of Ill., Inc. v. Ter Maat*, 195 F.3d 953, 956 (7th Cir. 1999); *Coastal Abstract Serv., Inc. v. First Am. Title Ins. Co.*, 173 F.3d 725, 734 (9th Cir. 1999); *Faulk v. Milton*, 268 N.Y.S.2d 844, 847 (N.Y. App. Div. 1966) ("[A] director's common law liability for his tort persists although it may be within the scope of his corporate duties and in furtherance of the objects of the corporation."); *Schaefer v. D & J Produce, Inc.*, 403 N.E.2d 1015, 1019 (Ohio Ct. App. 1978) ("Officers are agents of the corporation and their liability to third persons is governed by the ordinary principles of agency."). On the other hand, deviating from what appears to be a well-settled principle, some courts have posited that absent evidence that an officer of a corporation committed any tort outside the scope of his capacities as officer, he may not be held individually liable. *See, e.g., Cantwell v. City of Boise*, 191 P.3d 205, 216 (Idaho 2008) ("An agent is only liable for actions which are outside its scope of duty to the corporation."); *Bernstein v. Starrett City, Inc.*, 758 N.Y.S.2d 658, 659 (N.Y. App. Div. 2003) (explaining that defendant officer was entitled to summary judgment since he established that he did not act in his individual capacity or commit any tort outside the scope of his capacity as corporation's president); *Kramer v. Twin County Grocers*, 542 N.Y.S.2d 787, 788 (N.Y. App. Div. 1989) (mem.); *see also* *Accuimage Diagnostics Corp. v. Terarecon, Inc.*, 260 F. Supp. 2d 941, 950 (N.D. Cal. 2003) (suggesting that in order to hold a corporate officer personally liable for his tortious acts, plaintiff must allege actionable conduct outside of the scope of the officer's employment); *Rodriguez v. 1414-1422 Ogden Ave. Realty Corp.*, 758 N.Y.S.2d 43, 44 (N.Y. App. Div. 2003) (noting that an action against a corporate president was properly dismissed absent any showing that he had acted in other than his corporate capacity or committed an independent tort).

20. *See, e.g., Huffman v. Poore*, 569 N.W.2d 549, 557–58 (Neb. Ct. App. 1997); *Saltiel v. GSI Consultants, Inc.*, 788 A.2d 268, 273 (N.J. 2002).

21. *See, e.g., Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 580 (Cal. 1986);

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Still, at common law, directors and officers are not personally liable for the torts of a corporation or of any other agent merely because of their position.²² Instead, some additional connection is required.²³ Courts have developed various approaches to test whether a director or officer has a sufficient enough connection to a particular tort to hold him personally liable.²⁴ For the most part, the different theories or approaches overlap to a certain degree and courts can apply combinations or variations of the theories. Nevertheless, the theories can be roughly divided into three approaches: first, and most common, where the court focuses on the defendant's participation in a tort; second, where the court focuses on whether a personal duty was breached; and third, where the court pierces the corporate veil. In addition, directors and officers can incur liability under a plethora of statutory provisions.

A. Focus on Participation

In order to assess liability, courts will typically focus on whether a director or officer participated in the tortious act.²⁵ Courts sometimes refer

Ray-Tek Servs., Inc. v. Parker, 831 N.E.2d 948, 958 (Mass. App. Ct. 2005); Palomino Mills, Inc. v. Davidson Mills Corp., 52 S.E.2d 915, 918–20 (N.C. 1949); Strang v. Hollowell, 387 S.E.2d 664, 666 (N.C. Ct. App. 1990) (holding that an officer's liability is joint and several with his corporate employer). Since a director or officer who committed a tort in his scope of employment will be jointly and severally liable together with the corporation, a plaintiff will not be able to "double dip." In other words, a tort victim can apportion his damages to the director/officer and the corporation or to only one of these parties, but the total amounts recovered must not be larger than his damages.

22. See, e.g., *Bernstein*, 758 N.Y.S.2d at 659 (finding that the defendant officer was entitled to summary judgment because "he did not act in his individual capacity or commit any tort outside the scope of his corporate capacity as president of [the corporation]."); WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 3.13 (7th ed. 2002). Personal liability based on corporate status may, however, be imposed by statute. See *infra* Part I.D.

23. See *Bowling v. Holdeman*, 413 N.E.2d 1010, 1014 (Ind. Ct. App. 1980) (providing that without a connection to the tort liability does not attach simply because the defendant is the president of the company).

24. For a recent comparative overview of approaches to directors' tort liability across various common law jurisdictions, see Helen Anderson, *Directors' Liability for Corporate Faults and Defaults—An International Comparison*, 18 PAC. RIM L. & POL'Y J. 1, 34–44 (2009).

25. E.g., *Bano v. Union Carbide Corp.*, 273 F.3d 120, 133 (2d Cir. 2001); *Steinke v. Beach Bungee, Inc.*, 105 F.3d 192 (4th Cir. 1997); *Indiaweekly.com, L.L.C. v. Nehaflix.com, Inc.*, 596 F. Supp. 2d 497, 507 (D. Conn. 2009); *Lemon v. Harlem Globetrotters Intern., Inc.*, 437 F. Supp. 2d 1089, 1110 (D. Ariz. 2006); *Mill Run Assocs. v. Locke Prop. Co.*, 282 F. Supp.2d 278, 287 (E.D. Pa. 2003) ("[it is a] general, if not universal, rule . . . that an officer of a corporation who takes part in the commission of a tort by the corporation is personally liable therefor . . ."); *Gidwitz v. Stirco, Inc.*, 646 F. Supp. 825, 830 (N.D. Ill. 1986); *T.V. Spano Bldg. Corp. v. Dep't of Natural Res. and Env't Control*, 628 A.2d 53, 61 (Del. 1993); *BTL COM Ltd., Co. v. Vachon*, 628 S.E.2d 690, 695 (Ga. Ct. App. 2006); *Livonia Bldg. Materials Co. v. Harrison Const. Co.*, 742 N.W.2d 140, 144 (Mich. Ct. App. 2007) (per curiam); *State ex rel. The Doe Run Res. Corp. v. Neill*, 128 S.W.3d 502, 505 (Mo. 2004); *Walker v. Anderson*, 232 S.W.3d 899, 918 (Tex. App. 2007); *Consulting Overseas Mgmt. Ltd. v. Shtikel*, 18 P.3d 1144, 1147 (Wash. Ct. App. 2001).

to this as the “participation theory.”²⁶ In a leading case on the issue, *Lobato v. Pay Less Drug Stores*,²⁷ the Tenth Circuit explained the circumstances under which directors and officers may become liable in tort to a third party based on their participation.²⁸ The court explained that, as a rule, a corporate officer or agent is personally liable to third parties if he sanctions, directs or actively participates in the commission of a tort.²⁹ An officer or other corporate agent, the court held, may also be liable for an act or omission from which a tort necessarily follows or may be reasonably expected to follow.³⁰

Participation, in this context, can take many different forms. For instance, it can be sufficient for a director to incur liability if he votes in favor of a board decision, which later results in harm to a third party,³¹ or for a director or officer to be the “guiding spirit” or “central figure” behind a tortious act.³² Furthermore, it may also suffice that a director or officer has constructive knowledge of a tort.³³ Finally, directors and officers can be liable if they “reasonably” should have known that some hazardous condition or activity under their control could injure a third party, but they negligently failed to take or order appropriate action to avoid the harm.³⁴

Some courts limit the application of the participation theory and, drawing upon an old distinction between an agent’s acts of nonfeasance

The focus on participation does not mean that there is no requirement of the breach of a duty. However, the duty requirement is not a central aspect of the analysis. See *infra* note 47.

26. See, e.g., *Bethea v. Bristol Lodge Corp.*, No. Civ. A. 01-612, 2002 WL 31859434, at *14 (E.D. Pa. Dec. 18, 2002); *Wicks v. Milzoco Builders, Inc.*, 470 A.2d 86, 90 (Pa. 1983).

27. 261 F.2d 406, (10th Cir. 1958).

28. See *id.* at 408–09.

29. *Id.*

30. *Id.*

31. See *Frances T. v. Vill. Green Owners Ass’n*, 723 P.2d 573, 586 (Cal. 1986) (en banc) (stating that a director who votes for the commission of a tort is liable even though the act was committed in the name of the corporation).

32. See *Cruz v. Ortho Pharm. Corp.*, 619 F.2d 902, 907 (1st Cir. 1980) (citing *Donsco, Inc. v. Casper Corp.*, 587 F.2d 602, 605–06 (3d Cir. 1978)); *Marks v. Polaroid Corp.*, 237 F.2d 428, 435 (1st Cir. 1956).

33. See *Childs v. Purll*, 882 A.2d 227, 239 (D.C. Cir. 2005) (inferring that the two defendant officers could be held personally liable for their company’s torts because they were the only two officers and ran the company together); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 701 (Tex. App. 2006) (“A corporate officer may be held individually liable for a corporation’s tortious conduct if he knowingly participates in the conduct or has either actual or constructive knowledge of the tortious conduct.”); *Bowling v. Ansted Chrysler-Plymouth-Dodge, Inc.*, 425 S.E.2d 144, 149 (W. Va. 1992) (finding that the defendant officer could be found liable for the corporation’s torts based on constructive knowledge of the culpable conduct). *But see* *Accuimage Diagnostics Corp v. Terarecon, Inc.*, 260 F. Supp. 2d 941, 950 (N.D. Cal. 2003) (“[M]ere knowledge of tortious conduct by the corporation is not enough to hold a director or officer liable for the torts of the corporation absent other ‘unreasonable participation’ in the unlawful conduct by the individual.”).

34. *Frances T.*, 723 P.2d at 584 (discussing directors’ liability).

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and acts of misfeasance or malfeasance,³⁵ hold that a corporate director or officer cannot be personally liable for nonfeasance.³⁶ Under this line of cases, a director or officer is not personally liable for mere omissions or the nonperformance of acts that he had a duty to carry out. Courts sometimes explain that in cases of nonfeasance, the claimed negligence consists only of failing to perform a duty owed to the principal, which is why the person injured has a cause of action only against the principal, but not against the agent.³⁷ Nevertheless, the modern rule is that personal liability can attach regardless of whether the breach was a result of misfeasance or nonfeasance. Thus, courts can impose personal liability for “participation” solely based on failures to act.³⁸

B. Focus on Duty

Both the Restatement (Second) of Agency and the Restatement (Third) of Agency state that, generally, an agent’s breach of a duty owed to the principal is not an independent basis for the agent’s tort liability to a third

35. For a discussion of the distinction between misfeasance, malfeasance, and nonfeasance, see *Atl. Coast Line R. Co. v. Knight*, 171 S.E. 919, 920–24 (Ga. Ct. App. 1933). See also *Haupt v. Miller*, 514 N.W.2d 905, 908–09 (Iowa 1994) (en banc); *Schaefer v. D & J Produce, Inc.*, 403 N.E.2d 1015, 1019–21 (Ohio Ct. App. 1978); *Buck v. Clauson’s Inn at Coonamessett, Inc.*, 211 N.E.2d 349, 351 (Mass. 1965).

36. See *Airlines Reporting Corp. v. Aero Voyagers, Inc.*, 721 F. Supp. 579, 585 (S.D.N.Y. 1989) (finding that the defendants’ failure to supervise the corporation’s employees and failure to learn about the corporation’s financial condition were insufficient bases for imposing liability); *Peguero v. 601 Realty Corp.*, 2009 WL 196314, at *2 (N.Y. App. Div. 2009) (“ . . . personal liability cannot be imposed on a corporate officer for nonfeasance . . . ”); *Lutz Feed Co., Inc. v. Audet & Co., Inc.*, 337 N.Y.S.2d 852, 856 (N.Y. Sup. Ct. 1972) (granting the defendant officer’s motion to dismiss because the complaint alleged only that he failed to act); *Shay v. Flight C Helicopter Serv., Inc.*, 822 A.2d 1, 17–19 (Pa. Super. Ct. 2003) (explaining the difference between misfeasance and nonfeasance); *Brindley v. Woodland Vill. Rest., Inc.*, 652 A.2d 865, 868–70 (Pa. Super. 1995) (characterizing the plaintiff’s claim, which was premised on the unsafe condition of the corporation’s restrooms, as nonfeasance as against the defendant officers).

37. See, e.g., *Mathis v. Yondata Corp.*, 480 N.Y.S.2d 173, 177 (N.Y. Sup. Ct. 1984).

38. See, e.g., *Haupt*, 514 N.W.2d at 909 (“In determining liability of a corporate officer for negligence, it is difficult to logically support a legal distinction that exonerates a corporate officer’s act of nonfeasance while exacting retribution for acts of misfeasance or malfeasance. In practice, applying such labels may be more descriptive and thus conclusory than the facts would justify as a difference. Accordingly, we join the modern trend of jurisdictions applying the general negligence standard, rather than predicating individual corporate officer liability for negligence on a prerequisite finding of misfeasance or malfeasance.”); *Miller v. Muscarelle*, 170 A.2d 437, 446–49 (N.J. Super. Ct. App. Div. 1961) (tracing the historical roots of the distinction between malfeasance and misfeasance, concluding that the distinction today “resolves itself into little more than a totally illogical remnant of the privity doctrine”); *Schaefer v. D & J Produce, Inc.*, 403 N.E.2d 1015, 1020 (Ohio Ct. App. 1978) (“In any event, we question whether any benefit can be derived by attaching the labels ‘misfeasance’ or ‘nonfeasance’ to particular activity.”); *Fields v. Jantec, Inc.*, 857 P.2d 95, 97 (Or. 1993) (en banc) (refusing to distinguish between misfeasance and nonfeasance in evaluating the plaintiff’s claim); *9 to 5 Fashions, Inc. v. Spurney*, 520 So. 2d 1276, 1283 (La. Ct. App. 1988), *rev’d on other grounds*, 538 So. 2d 228 (La. 1989) (holding that an officer’s personal liability is independent of whether the breach of his duties was accomplished through malfeasance, misfeasance or nonfeasance).

party.³⁹ Thus, conduct that breaches an agent's duties to his principal does not necessarily subject the agent to liability to a third party even though the agent's conduct also harms the third party.⁴⁰ Instead, according to the Restatements of Agency, an agent is only subject to tort liability to a third party harmed by his conduct when such conduct constitutes a breach of duty the agent personally owes to the third party.⁴¹

More specifically, the Restatement (Second) of Agency as well as commentary to the Restatement (Third) of Agency distinguish between purely economic harm and physical harm, i.e. between harm to property and harm to persons.⁴² Both Restatements provide that an agent who fails to perform duties owed solely to his or her principal is not liable to a third party who has only suffered harm to his or her economic interests.⁴³ Conversely, an agent may be liable to a third party for physical harm, even if the third party incurs such harm because of the agent's failure to adequately perform his or her duties to the principal.⁴⁴

In accordance with these principles, numerous courts have specifically stressed that, in order to be liable for his or her actions within the corporate context, a director or officer must breach an independent duty of care, which he personally owes to the injured party.⁴⁵ Such specific inquiry as to the existence of a duty has the potential to serve as a protective device for directors and officers carrying out their corporate duties. Courts, however, often recognize the existence of a personal duty based upon the defendant's personal participation in or direction of a tortious act.⁴⁶ As a result, the

39. See RESTATEMENT (THIRD) OF AGENCY § 7.02 (2006); RESTATEMENT (SECOND) OF AGENCY §§ 352, 357 (1984).

40. RESTATEMENT (THIRD) OF AGENCY § 7.02 cmt. b (2006).

41. *Id.* at § 7.02.

42. See RESTATEMENT (THIRD) OF AGENCY § 7.02 cmt. c-d (2006); RESTATEMENT (SECOND) OF AGENCY §§ 352, 357 (1984).

43. See *supra* note 42.

44. See *supra* note 42. In general, the rule of the agent's non-liability for economic loss is an overstatement, given the many instances of liability for economic loss. See *Greg Allen Constr. Co. v. Estelle*, 798 N.E.2d 171, 174–75 (Ind. 2003) (listing examples of situations where liability was premised on economic loss from negligent misrepresentation); *infra* Part II.A (listing examples where liability for economic harm was premised on negligent misrepresentations).

45. *E.g.*, *Lawlor v. District of Columbia*, 758 A.2d 964, 975 (D.C. Cir. 2000); *Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 581 (Cal. 1986) (en banc); *Michaelis v. Benavides*, 71 Cal. Rptr. 2d 776, 778 (Cal. Ct. App. 1998); *Cisneros v. U.D. Registry, Inc.*, 46 Cal. Rptr. 2d 233, 255–56 (Cal. Ct. App. 1995) (duty imposed by statute on company, not officer personally); *White v. Wal-Mart Stores, Inc.*, 918 So. 2d 357, 358 (Fla. Dist. Ct. App. 2005); *West v. Bruner Health Group, Inc.*, 866 So. 2d 260, 269 (La. Ct. App. 2003); *Donnelly v. Handy*, 415 So. 2d 478, 480 (La. Ct. App. 1982) (stating that Louisiana courts have consistently employed a duty-based analysis in determining officers' personal liability for injury to third parties); *Leitch v. Hornsby*, 935 S.W.2d 114, 117 (Tex. 1996).

46. See, *e.g.*, *McCaskey v. Cont'l Airlines, Inc.*, 159 F. Supp. 2d 562, 577 (S.D. Tex. 2001) (requiring the plaintiff to show that the defendant director breached an independent duty of care).

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focus on the existence of a personal duty to the plaintiff can become indistinguishable from a participation-based approach and often does not serve as an added barrier to holding directors or officers personally liable.⁴⁷

Another group of cases that focus on duty uses an alternative inquiry to ascertain personal liability. Under this approach, a director or officer will be liable for a tort where (1) the corporation owed a duty of care to the victim; (2) the corporation delegated that duty to the director or officer; and (3) the director or officer breached the duty of care by his or her own conduct, causing injury to the victim.⁴⁸ While this test also focuses on the existence of a duty, because courts assume that any duty can be delegated to and create additional liabilities for directors and officers, it disregards the existence of internal duties that directors and officers owe only to the corporation. In addition, courts using this test fail to appreciate that delegation of internal duties does not transform them into duties that directors and officers owe to third parties.⁴⁹

C. *Veil Piercing*

A third approach to holding directors and officers personally liable for tortious acts is by piercing the corporate veil.⁵⁰ Under this doctrine, a

47. Granted, courts which focus mainly on whether a director or officer participated in tortious conduct also require that there exists a duty to a third party. *See supra* Part I.A. Indeed, “[w]here there is no duty, there can be no negligence.” *Robillard v. Asahi Chem. Indus. Co.*, 695 A.2d 1087, 1094 (Conn. Super. Ct. 1995) (quoting *Anthony v. Connecticut Co.*, 92 A. 672, 674 (1914)). However, these courts do not explicitly discuss the requirement that the defendant director or officer breaches a duty that he personally owes to the injured party. Thus, it is unclear how these participation-based cases deal with the duty requirement, i.e. whether they implicitly assume that participation in a certain act or whether direct or foreseeable contact by itself creates the necessary duty, whether they work under the assumption that the corporation owed a duty which it then delegated to the individual director or officer, or whether they follow yet another approach.

48. *E.g.*, *Manning v. United Med. Corp. of New Orleans*, 902 So. 2d 406, 410–12 (La. Ct. App. 2005); *Downey v. Callery*, 338 So. 2d 937, 943–944 (La. Ct. App. 1977) (per curiam), *cert. denied*, 431 U.S. 955 (1977); *Saltiel v. GSI Consultants, Inc.*, 788 A.2d 268, 272 (N.J. 2002) (treating the requirement of a duty being delegated to and breached by a director or officer as part of the “participation theory”); *Metuchen Sav. Bank v. Pierini*, 871 A.2d 759, 764 (N.J. Super. Ct. App. Div. 2005); *Schaefer v. D & J Produce, Inc.*, 403 N.E.2d 1015, 1020–21 (Ohio Ct. App. 1978). Courts that use this test have sometimes pointed out that if the defendant’s general responsibility has been delegated with due care to some responsible subordinate or subordinates, he is not himself personally at fault and liable for the negligent performance of this responsibility unless he personally knows or personally should know of its nonperformance or malperformance and has nevertheless failed to cure the risk of harm. *See, e.g., Manning*, 902 So. 2d at 411.

49. *See infra* Part III.A (discussing the distinction between internal and external duties).

50. *See, e.g., Gidwitz v. Stirco, Inc.*, 646 F. Supp. 825, 829–30 (N.D. Ill. 1986) (explaining that where the individual is considered the “alter ego” of the corporation, courts may disregard the separate corporate existence and impose liability on the individual); *Maggio v. Becca Const. Co.*, 644 N.Y.S.2d 802, 803 (N.Y. App. Div. 1996) (granting the defendant’s motion to dismiss because the plaintiff failed to show that the defendant officers treated the corporation as their alter ego). The doctrine is perhaps more commonly known as a tool by which courts may hold shareholders, but not directors or officers, liable for the

separate corporate identity may be disregarded and liability imposed upon an individual if a court finds that the corporation is controlled and operated in a manner that makes it a “mere instrumentality of another” and that the “observance of the fiction of separate existence would, under the circumstances, sanction fraud or promote injustice.”⁵¹ Interestingly, under a veil-piercing approach, courts can find directors and officers personally liable in cases where they did not participate in the tortious acts and where there would be no liability under participation or duty-based theories.⁵²

D. Statutory Liability

In addition to the possibility of incurring liability under general tort and agency theories, directors and officers can be civilly and criminally liable under a growing collection of regulatory statutes. These include the National Banking Act,⁵³ the Federal Food, Drug, and Cosmetic Act,⁵⁴ the Lanham Act,⁵⁵ the Patent Act,⁵⁶ the Copyright Act,⁵⁷ the Sherman Anti-Trust Act,⁵⁸ the Fair Credit Reporting Act,⁵⁹ the Employee Retirement Income Security Act (ERISA),⁶⁰ the Sarbanes-Oxley Act,⁶¹ and the

debts of the corporation. A classic case in point is *Walkovsky v. Carlton*, 223 N.E.2d 6, 8–10 (N.Y. 1966), which discusses the doctrine of piercing the corporate veil within the context of shareholder liability specifically.

51. *Gidwitz*, 646 F. Supp. at 830 (citing *Main Bank of Chicago v. Baker*, 427 N.E.2d 94, 101 (Ill. 1981)); see also *Lambert v. Kazinetz*, 250 F. Supp. 2d 908, 914 (S.D. Ohio 2003).

52. See *Smith v. Hawks*, 355 S.E.2d 669, 675–76 (Ga. Ct. App. 1987) (discussing the “piercing the corporate veil” exception to the general rule of non-liability for a corporate officer who did not participate in tortious conduct).

53. *del Junco v. Conover*, 682 F.2d 1338, 1341–42 (9th Cir. 1982) (explaining that § 93 of the National Banking Act imposes liability on directors for violating, or allowing violations, of the banking laws).

54. *United States v. Park*, 421 U.S. 658, 676–77 (1975) (noting that the Federal Food, Drug and Cosmetic Act holds corporate officials responsible for remedying and preventing violations, including continuing violations, of the Act).

55. *Donsco, Inc. v. Casper Corp.*, 587 F.2d 602, 606 (3d Cir. 1978) (explaining that the principle that a corporate officer is individually liable for torts he personally commits also applies to acts constituting unfair competition).

56. See, e.g., *Hoover Group v. Custom Metalcraft, Inc.*, 84 F.3d 1408, 1412 (Fed. Cir. 1996) (noting that, under the Patent Act, corporate officers are personally liable if they assist with the corporation’s infringement); see also Lynda J. Oswald, *The Personal Liability of Corporate Officers for Patent Infringement*, 44 IDEA 115–17 (2003) (criticizing the erosion of traditional protections provided to corporate officers in the area of patent infringement).

57. *Feder v. Videotrip Corp.*, 697 F. Supp. 1165, 1177 (D. Colo. 1988) (stating that a corporate officer may be held liable if he or she is responsible for the corporation’s copyright infringement).

58. *United States v. Am. Radiator & Std. Sanitary. Corp.*, 433 F.2d 174, 188 (3d Cir. 1970) (noting that a corporate officer is subject to prosecution under § 1 of the Sherman Act whenever he or she knowingly participates in violations of the Act).

59. *Mone v. Dranow*, 945 F.2d 306, 308 (9th Cir. 1991) (per curiam) (noting that federal and state law holds corporate officers are personally liable for their torts even if they were committed on the corporation’s behalf).

60. *Leddy v. Standard Drywall, Inc.*, 875 F.2d 383, 387–88 (2d Cir. 1989) (explaining

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Racketeer Influenced and Corrupt Organizations Act (RICO),⁶² among others. Furthermore, environmental statutes such as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),⁶³ the Resource Conservation and Recovery Act (RCRA),⁶⁴ and others are significant sources of directors' and officers' liability.⁶⁵

The prerequisites for personal liability for tort-like statutory violations vary and depend on the specific statute. However, the various statutory liabilities display some common themes. First, a marked difference between common law liability theories and regulatory statutes that can impose personal liability is that the latter may extend civil and criminal liability without a need to demonstrate intent or negligence.⁶⁶ Second, regulatory statutes may impose liability on "controlling persons" who would normally not be liable under traditional corporate, tort, or agency law principles.⁶⁷ Under these statutes, some federal and state courts impose liability on individual corporate actors through the "responsible corporate officer doctrine,"⁶⁸ a theory of liability separate from piercing the corporate

that a corporate officer with operational control who is directly responsible for a failure to pay statutorily required wages can be personally liable for the shortfall).

61. For example, directors and officers may incur liability under Sarbanes-Oxley's document destruction and whistleblower provisions. *See* Sarbanes-Oxley Act 18 U.S.C. § 1513 et seq.

62. *Lode v. Leonardo*, 557 F. Supp. 675, 680 (N.D. Ill. 1982) ("Congress did not limit the scope of RICO to those involved in what has traditionally been thought of as organized crime.").

63. *See, e.g.,* *Sidney S. Arst Co. v. Pipefitters Welfare Educ. Fund*, 25 F.3d 417, 420–21 (7th Cir. 1994) (adopting an expanded standard of liability under CERCLA); *United States v. Ne. Pharm. & Chem. Co.*, 810 F.2d 726, 743 (8th Cir. 1986) (opining that "construction of CERCLA to impose liability upon only the corporation and not the individual corporate officers and employees who are responsible for making corporate decisions about the handling and disposal of hazardous substances would open an enormous, and clearly unintended, loophole in the statutory scheme"); *New York v. Shore Realty*, 759 F.2d 1032, 1052–53 (2d Cir. 1985) (holding that individuals can be considered "owners" or "operators" under CERCLA).

64. *United States v. Ne. Pharm. & Chem. Co.*, 810 F.2d 726, 745–46 (1986).

65. *See* KNEPPER & BAILEY, *supra* note 22, §§ 10.01–10.06 (summarizing the potential liability corporate directors face in connection with violations of various environmental laws).

66. Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 *VAND. L. REV.* 329, 357 (2004).

67. *Id.*

68. *See, e.g.,* *Comm'r, Dept. of Env'tl. Mgmt. v. RLG, Inc.*, 755 N.E.2d 556, 559 (Ind. 2001) (explaining that an individual, though acting in a corporate capacity as an officer, director, or employee, may be individually liable under Indiana environmental management laws either as a responsible corporate officer, as a direct participant under general legal principles, or under specific statutes or provisions). The responsible officer doctrine is often traced back to *United States v. Dotterweich*, 320 U.S. 277 (1943), where the Supreme Court allowed criminal liability to be imposed on a corporate officer under the Federal Food, Drug, and Cosmetic Act of 1938. *Id.* The Court held that any persons who have a responsible share in the furtherance of the transaction which the Act outlaws could be personally liable. *Id.* at 284–85. The theory has subsequently been applied in the context of criminal as well as civil liability. *See, e.g.,* *People v. Roscoe*, 87 Cal. Rptr. 3d 187, 193 n.4, 195 (Cal. Ct. App. 2008) (utilizing the responsible corporate officer doctrine to impose civil

veil or imposing personal liability for direct participation in tortious conduct.⁶⁹

The responsible corporate officer doctrine holds that a director, officer, or other corporate actor may be personally liable if: (1) the individual is in a position of responsibility which allows the individual to influence corporate policies or activities; (2) there is a nexus between the individual's position and the violation in question such that the individual could have influenced the corporate actions which constituted the violations; and (3) the individual's actions or inactions facilitated the violations.⁷⁰ Courts have usually applied the doctrine in the context of offenses against public welfare related statutes that impose strict liability schemes,⁷¹ such as in the context of violations of federal or state environmental legislation.⁷² However, courts have used the doctrine in various other areas as well.⁷³ In particular, a notable recent development in this regard is evidenced by attempts to enforce actions alleging Foreign Corrupt Practices Act⁷⁴ violations against corporate officials based on a "control person" theory.⁷⁵

II. DIRECTORS' AND OFFICERS' TORT LIABILITY FOR SUPERVISION AND MANAGEMENT

As demonstrated in the preceding section, various approaches exist for determining whether directors and officers can incur personal liability for a myriad of torts committed in their official capacity. This Part focuses on two particular, and often interrelated, types of torts for which directors and officers can be held personally liable: supervision and management of corporate affairs and subordinates. The first section outlines judicial approaches to directors' and officers' tort liability for supervision and

liability, but noting that the distinction between civil and criminal liability is irrelevant).

69. *Celentano v. Rocque*, 923 A.2d 709, 721 n.11 (Conn. 2007) (explaining the rationale for implementing the responsible corporate officer doctrine).

70. *Matter of Dougherty*, 482 N.W.2d 485, 490 (Minn. Ct. App. 1992).

71. See *Microsoft Corp. v. Ion Tech. Corp.*, 484 F. Supp. 2d 955, 962 (D. Minn. 2007) (declining to apply the doctrine to consider liability for copyright infringement); *Celentano*, 923 A.2d at 722–23.

72. E.g., *United States v. Ne. Pharm. & Chem. Co.*, 810 F.2d 726, 743–44 (8th Cir. 1986); *Roscoe*, 87 Cal. Rptr. 3d at 191–95; *Comm'r, Dept. of Envtl. Mgmt.*, 755 N.E.2d at 560–62; *State v. Rollfink*, 475 N.W.2d 575, 580 (Wis. 1991).

73. See, e.g., *Monarch Marking Sys., Inc. v. Duncan Parking Meter Maint. Co.*, No. 82 C 2599, 1986 WL 3625, at *1 (N.D. Ill. Mar. 13, 1986) (anti-trust violation); *Wittenberg v. Gallagher*, No. 1 CA-CV 01-0168, 2001 WL 34048121, at *2 (Ariz. Ct. App. Nov. 20, 2001) (securities violations); *Miller v. Santa Rosa Sales and Mktg., Inc.*, 475 N.W.2d 210, 219–20 (Iowa 1991) (consumer fraud).

74. Pub. L. No. 95-213, 91 Stat 1494 (1977) (codified in scattered sections of 15 U.S.C.).

75. See Kevin LaCroix, *New Exposure for Corporate Officials: Control Person Liability for FCPA Violations*, D&O DIARY, Aug. 24, 2009, <http://www.dandodiary.com/2009/08/articles/foreign-corrupt-practices-act/new-exposure-for-corporate-officials-control-person-liability-for-fcpa-violations>.

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management under common law negligence theories while the second section discusses analogous claims based on statutory provisions.

Interestingly, the rules to assess directors' and officers' tort-based liability for supervision and management do not differ based on the various types of defendants or corporations that are involved. Rather, courts appear to apply the various tests—as used in their respective jurisdiction—regardless of whether the defendant is a director or officer, an inside director or an outside director, or whether the corporation is closely or publicly held.⁷⁶ Yet, the cases reviewed for the purposes of this section—a number too small to be of any empirical relevance—indicate that both the risk of being a defendant and the likelihood of incurring liability in a supervision or management case are higher for officers and inside directors, as opposed to outside directors.⁷⁷

A. Common Law Negligence Claims

Following from the general principle that directors and officers may be liable for torts committed in their corporate capacities, courts can hold directors and officers personally liable for the torts of negligent supervision and management with regard to corporate activities and subordinates.⁷⁸

Methods for ascertaining liability for supervision and management can vary. Some courts analyze these types of claims by inquiring into whether the defendant participated in tortious conduct.⁷⁹ Other courts focus on the requirement of the breach of a personal duty.⁸⁰ Still other courts appear to treat supervision and management related claims as a *sui generis* category of torts, different from general tort liability, based on participation in or

76. Of the cases reviewed for this article, none contained any language that would indicate that courts make such express distinctions. See also *supra* note 9 and accompanying text.

77. This is probably because officers and inside directors are in closer proximity to their corporation's daily business than outside directors, a fact sometimes implicitly acknowledged by courts in their definition of the scope of a defendant's duty. See, e.g., *Lowell Hoyt & Co. v. Detig*, 50 N.E.2d 602, 604 (Ill. App. Ct. 1943) ("The duties [to supervise] of a general manager of a corporation are usually more extensive than those of a mere director.").

78. E.g., *Jabczenski v. S. Pac. Mem. Hosps.*, 579 P.2d 53, 58 (Ariz. Ct. App. 1978); *Smith v. Isaacs*, 777 S.W.2d 912, 914–15 (Ky. 1989); see also RESTATEMENT (SECOND) OF AGENCY § 358(1) (1958) ("The agent of a disclosed or partially disclosed principal is not subject to liability for the conduct of other agents unless he is at fault in appointing, supervising, or cooperating with them."); RESTATEMENT (SECOND) OF TORTS § 877 (1979) (summarizing liability for harm resulting from the directed conduct of another).

79. E.g., *Adel v. Greensprings of Vermont, Inc.*, 363 F. Supp. 2d 692, 700 (D. Vt. 2005); *Omaha Indem. Co. v. Royal Am. Managers, Inc.*, 777 F. Supp. 1488, 1492 (W.D. Mo. 1991); *Detig*, 50 N.E.2d at 603–04; *Smith*, 777 S.W.2d at 914–15.

80. E.g., *Airlines Reporting Corp. v. Aero Voyagers, Inc.*, 721 F. Supp. 579, 585 (S.D.N.Y. 1989); *Shay v. Flight C Helicopter Servs., Inc.*, 822 A.2d 1, 17–19 (Pa. Super. 2003); *Inter-Ocean Cas. Co. v. Leccony Smokeless Fuel Co.*, 17 S.E.2d 51, 53–54 (W.Va. 1941).

knowledge of an illegal act.⁸¹ In these latter cases, the test appears to be simply whether there were negligent supervisory or managerial acts, which led to harm incurred by a third party. In addition, courts may also rely on a combination of the aforementioned approaches.⁸²

Principally, a director or officer cannot be individually liable for negligent supervision or management where the claim relates primarily to a breach of contract, not negligence.⁸³ Nevertheless, there are cases involving successful supervision and management claims against directors and officers, even where there was an underlying agreement between the plaintiffs' and the defendants' respective corporate employers.⁸⁴

In general, the tort of negligent supervision sanctions not an act, but rather an omission. Thus, a director or officer may be liable for failures in the supervision and control of corporate affairs⁸⁵ as well as for torts committed by agents of the corporation if he or she fails to act with due diligence in his or her supervision.⁸⁶ The latter is especially true in cases where there is not only a single, isolated incident, but where the agents' tortious acts occur persistently and continuously for substantial periods of time and the director or officer had the opportunity to discover the wrongful acts.⁸⁷ Similarly, courts can impose liability where directors or officers are negligent in failing to learn of and prevent torts by employees.⁸⁸ Nevertheless, directors and officers are not required to

81. See *Jabczenski*, 579 P.2d at 58 (identifying three distinct bases of personal liability for corporate torts under Arizona law: (1) participation; (2) knowledge amounting to acquiescence, and; (3) negligent management and supervision); *accord* *Avery v. Solargizer Intern., Inc.*, 427 N.W.2d 675, 681 (Minn. Ct. App. 1988) ("Generally, a corporate officer is not liable for torts of the corporation's employees unless he participated in, directed, or was negligent in failing to learn of and prevent the tort.").

82. *E.g.*, *Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 583-86 (Cal. 1986) (en banc) (articulating considerations for determining liability based on various standards).

83. *E.g.*, *Westminster Const. Co., v. Sherman*, 554 N.Y.S.2d 300, 301-02 (N.Y. App. Div. 1990) (mem.) (explaining the limitation of corporate officer liability in the context of contracts).

84. *E.g.*, *Omaha Indem. Co.*, 777 F. Supp. at 1492 (W.D. Mo. 1991); *Sergeants Benevolent Ass'n Annuity Fund v. Renck*, 796 N.Y.S.2d 77, 80-81 (N.Y. App. Div. 2005).

85. *E.g.*, *Cameron v. Kenyon-Connell Commercial Co.*, 56 P. 358, 361 (Mont. 1899) (stating that directors may be liable where they fail to exercise reasonable diligence in the control and supervision of the corporate business); *see also* *Barnes v. Andrews*, 298 F. 614, 616 (S.D.N.Y. 1924) (holding that an allegation that a director failed to devote adequate attention to his company's affairs stated a cause of action in tort where proper attention would have avoided loss).

86. *See, e.g.*, *Air Traffic Conference of Am. v. Marina Travel, Inc.*, 316 S.E.2d 642, 645 (N.C. Ct. App. 1984) (finding insufficient factual support to establish that the defendant neglected to exercise due care in choosing trustworthy employees or that she had fair opportunity to discover a diversion of company proceeds).

87. *See* *Lowell Hoyt & Co. v. Detig*, 50 N.E.2d 602, 603 (Ill. App. Ct. 1943); *Air Traffic Conference of Am.*, 316 S.E.2d at 645.

88. *E.g.*, *Avery v. Solargizer Int'l, Inc.*, 427 N.W.2d 675, 681 (Minn. Ct. App. 1988); *Preston-Thomas Const., Inc. v. Cent. Leasing Corp.*, 518 P.2d 1125, 1127 (Okla. Ct. App. 1973) ("[The e]xistence of circumstances and facts which would arouse the suspicions of an ordinary prudent business man will furnish a basis" for directors' or officers' personal

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personally supervise all of the details of every business transaction.⁸⁹ Instead, directors can delegate the management of the daily business to subordinate officers as long as they do not divest themselves of the duty of general supervision and control of the corporate affairs.⁹⁰

In contrast, the situations in which the rather elusive tort of negligent management may arise are more difficult to describe in general terms. The tort of negligent management can consist both of an action, such as an improper management decision, as well as an omission, such as a failure to properly manage a business or a specific aspect thereof. Often, courts will not even explicitly refer to “negligent management” or “mismanagement” when imposing tort liability based upon alleged managerial failures. It is therefore best to look at some practical examples of cases involving management and supervision claims—which tend to overlap—to trace the contours of these two torts.

With respect to supervision and management cases involving harm to persons, for example, the Montana Supreme Court held that directors could be potentially liable for the death of a person killed by an explosion in their corporate warehouse where the directors did not exercise reasonable diligence in the control and supervision of the corporate business.⁹¹ In another case, the Nebraska Supreme Court found a sufficient cause of action for negligence where an officer failed to properly train and supervise a trenching machine operator because the operator’s action resulted in the plaintiff’s death and the supervisor knew or should have known that the machine operator would perform the job assigned to him negligently.⁹² The Supreme Court of California recognized a cause of action against individual board members of a condominium owner’s non-profit corporation for alleged negligence in the board members’ decision not to provide adequate lighting where an intruder attacked a resident in her condominium unit.⁹³ Similarly, a New York court held that individual

liability if they failed “to make reasonable inquiry and act with due care regarding the suspicions”). *But cf.* *Becker v. Tools & Metals, Inc.*, No. 3:05-CV-0627-L, 2009 WL 577604, at *5 (N.D. Tex. Mar. 5, 2009) (holding that under California law, a corporate officer did not have a legal duty to uncover alleged fraud).

89. *E.g.*, *Myers & Chapman, Inc. v. Thomas G. Evans, Inc.*, 374 S.E.2d 385, 393–94 (N.C. 1988); *Preston-Thomas Const., Inc.*, 518 P.2d at 1127.

90. *Detig*, 50 N.E.2d at 603 (limiting the extent to which a director can delegate responsibility to subordinates).

91. *Cameron v. Kenyon-Connell Commercial Co.*, 56 P. 358, 361 (Mont. 1899). In another case, however, corporate officers were not personally liable for an explosion in their sugar company and resulting damages to employees, neighbors, and an additional non-employee plaintiff in absence of showing of any negligence on their part or any basis for *res ipsa loquitur* inference against them. *Moak v. Link-Belt Co.*, 229 So. 2d 395, 416 (La. Ct. App. 1970), *rev'd in part on other grounds*, 242 So. 2d 515, 520–21 (La. 1970).

92. *Carlson v. Metz*, 532 N.W.2d 631, 634–36 (Neb. 1995).

93. *Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 584–86 (Cal. 1986) (en banc).

officers of companies associated with a shopping mall, who reduced or eliminated security measures to maximize profits, could be personally liable to a patron who sustained injuries during a shooting incident at the mall.⁹⁴ Finally, the Supreme Court of Ohio denied the defendants summary judgment in a case where the plaintiffs claimed that directors who operated a city-owned coliseum, but who failed to implement security measures designed to protect rock concert patrons from a dangerous condition caused by a first-come-first-served seating policy, should be held personally liable.⁹⁵

Negligent supervision and management claims have also found some success in cases involving purely economic loss. For example, the president and CEO of a reinsurance management firm was held personally liable to a reinsurer for the amount of \$132.3 million when he failed to exercise due care in evaluating and monitoring underwriting risks assumed on behalf of the reinsurer.⁹⁶ Possible negligent management and supervision by a school's director and corporate president precluded summary judgment on students' claim that the director should be held personally liable for corporate torts resulting from an employee's alleged misrepresentations relating to education, housing, and job placement assistance to students.⁹⁷ Finally the New York Supreme Court, Appellate Division found a cognizable claim against an investment advisory firm's officers for their alleged mismanagement in relation to investment advice and negligent supervision of a portfolio manager.⁹⁸

There are courts, however, that are clearly disinclined to hold directors and officers personally liable for negligent supervision and management. These courts have concluded, for example, that a failure to supervise or manage does not rise to the level of personal participation necessary to hold a director or officer personally liable.⁹⁹ Courts may also rely on the principle that directors and officers cannot be liable for mere nonfeasance and, by characterizing lack of management and supervision as pure omissions, apply this theory to bar individual liability.¹⁰⁰ The reluctance to

94. *Haire v. Bonelli*, 870 N.Y.S.2d 591, 593 (N.Y. App. Div. 2008).

95. *Bowes v. Cincinnati Riverfront Coliseum, Inc.*, 465 N.E.2d 904, 909–12 (Ohio Ct. App. 1983).

96. *Omaha Indem. Co. v. Royal Am. Managers, Inc.*, 777 F. Supp. 1488, 1492 (W.D. Mo. 1991).

97. *Keams v. Tempe Tech. Inst., Inc.*, 993 F. Supp. 714, 724–26 (D. Ariz. 1997).

98. *Sergeants Benevolent Ass'n Annuity Fund v. Renck*, 796 N.Y.S.2d 77, 80–81 (N.Y. App. Div. 2005).

99. *E.g.*, *Adel v. Greensprings of Vermont, Inc.*, 363 F. Supp. 2d 692, 700 (D. Vt. 2005) (requiring that a corporate officer have either specifically or personally directed or participated in the commission of a tort in order to incur liability).

100. *E.g.*, *Airlines Reporting Corp. v. Aero Voyagers, Inc.*, 721 F. Supp. 579, 585 (S.D.N.Y. 1989) (failing to supervise employees constitutes nonfeasance and a violation of the duty owed to the corporation but does not make corporate officers or directors

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impose liability for nonfeasance is usually coupled with the idea that instances of nonfeasance concern duties which are owed only to the corporation, but not to a third-party tort claimant.¹⁰¹ Finally, courts have declined to impose personal liability for supervision and management, without resorting to the nonfeasance/misfeasance dichotomy, based solely upon the idea that directors and officers owe these duties exclusively to the corporation, independent of whether the underlying alleged misconduct was characterized as an act or omission.¹⁰²

Following these approaches, courts have refused to find directors and officers personally liable for negligent supervision and management in cases such as the following: a corporate president's failure to adequately supervise a subordinate manager responsible for the clean water supply at a condominium complex;¹⁰³ directors' and officers' failure to take deductions from employees' wages to pay premiums on insurance policies in an insolvent corporation;¹⁰⁴ the failure of a helicopter service company's president to supervise the maintenance work of a mechanic that led to a flying accident;¹⁰⁵ and directors' and officers' failure to prevent defalcations by properly supervising corporate employees.¹⁰⁶

B. Statutory Claims

Supervision and management claims can also appear in the context of statutory liability for directors and officers. Although most statutes generally do not include the terms "supervision" or "management," they can impose obligations upon directors and officers that, upon closer examination, strongly resemble directors' and officers' duties to supervise or manage under common law or corporate laws. This is particularly true

personally liable to third parties); *U.S. Liab. Ins. Co. v. Haidinger-Hayes, Inc.*, 463 P.2d 770, 775 (Cal. 1970) (Finding that a corporate president and principal officer was not personally liable for negligent handling of a corporate client's business); *Shay v. Flight C Helicopter Services, Inc.*, 822 A.2d 1, 17-19 (Pa. Super. 2003) (failing to inspect work of subordinate constituted nonfeasance and was not considered a basis to impose personal liability on corporate officer); *Inter-Ocean Cas. Co. v. Lecony Smokeless Fuel Co.*, 17 S.E.2d 51, 53-54 (W.Va. 1941) (holding that in the absence of an active intent to deceive or defraud creditors, the officers and directors will not be liable for simple nonfeasance of a duty to the corporation or fraud in its management or mismanagement in the disposition of money or property); *Webb v. Cash*, 250 P. 1, 5-6 (Wyo. 1926) (finding that in the absence of deliberate or reckless conduct, state bank directors' failure to know of statutory violations did not render the directors' personally liable for the plaintiff's resulting loss).

101. See *Airlines Reporting Corp.*, 721 F. Supp. at 585 (classifying a duty to supervise as a duty owed to a corporation and refusing to extend personal liability to officers or directors for a breach of that duty).

102. E.g., *Donnelly v. Handy*, 415 So. 2d 478, 481 (La. Ct. App. 1982); see also *infra* note 138 and accompanying text.

103. *Adel*, 363 F. Supp. 2d at 700.

104. *Inter-Ocean Cas. Co.*, 17 S.E.2d at 53-54.

105. *Shay*, 822 A.2d at 17-19.

106. *Airlines Reporting Corp.*, 721 F. Supp. at 585.

for statutes that base liability on directors' or officers' control or responsibility for a company or certain aspects of its business operations because under these statutes, the basis of the defendants' liability is, in fact, lack of supervision or management.¹⁰⁷

For example, the "responsible corporate officer" doctrine allows courts to impose personal liability on corporate directors, officers, and other actors based solely on their corporate status and their authority to prevent certain violations of the law.¹⁰⁸ Under the doctrine, even in the absence of an individual's participation in or knowledge of a wrongful act, someone deemed a "responsible corporate officer" can be held liable for acts of corporate subordinates and for failures to prevent or correct such acts.¹⁰⁹

In an early case¹¹⁰ that applied the responsible corporate officer doctrine in the context of the Federal Food, Drug, and Cosmetic Act,¹¹¹ the Supreme Court opined that "individuals who execute the corporate mission"¹¹² have a "positive duty to seek out and remedy violations of [the Act] when they occur" and "a duty to implement measures that will insure that violations will not occur."¹¹³

The court's foregoing characterization of the duties in question is reminiscent of the duties imposed by common law supervision liability, which posits that directors or officers can be liable for failing to detect and prevent tortious conduct by employees. The language of the holding also has a mismanagement dimension, as directors and officers may arguably minimize violations of food and drug regulations by taking the appropriate safety and organizational measures, both of which are dependent upon management decisions.¹¹⁴ In addition, the duty to implement measures to avoid future violations, as described by the court, appears to be analogous to directors' and officers' corporate law oversight duties under cases such

107. See, e.g., *infra* note 110 and accompanying text.

108. See *supra* Part I.D.

109. See *id.*; Glynn, *supra* note 66, at 360 (noting that the doctrine imposes a form of liability on controlling persons that is "akin to vicarious liability"). In at least one case, a corporate officer was personally liable for an environmental offense even though she did not take an active part in the business operations and never set company policy. See *Hawaii v. Kailua Auto Wreckers, Inc.*, 615 P.2d 730, 737-38 (Haw. 1980). Furthermore, the doctrine also appears to create non-delegable duties for corporate managers. In fact, delegation of duties may even bolster a claim that someone was a responsible officer in the sense of the doctrine. As one court has noted: "[S]ince delegation is done by those with a broad range of responsibilities, the delegation shows that the defendant was responsible for the overall operation of [the company's] facility." *State v. Rollfink*, 475 N.W.2d 575, 580 (Wis. 1991).

110. *United States v. Park*, 421 U.S. 658 (1975).

111. Federal Food, Drug, and Cosmetic Act § 301(k), 21 U.S.C. 331(k).

112. *Park*, 421 U.S. at 672.

113. *Id.*

114. See *id.* (Standing for the proposition that the "foresight" and "vigilance" required by *United States v. Dotterweich*, 230 U.S. 277 (1943) will include that "individuals who execute the corporate mission" implement measures that will insure that violations will not occur).

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as *In re Caremark International Inc. Derivative Litigation*¹¹⁵ and its progeny.¹¹⁶

Similar results have occurred in other areas such as violations of intellectual property statutes based on failures in exercising supervision. In one case, a plaintiff brought a copyright infringement action in connection with the alleged use of a travel guide in the production of travel videotapes.¹¹⁷ The court confirmed that plaintiffs could assert a claim for copyright infringement against an officer who participated in his corporation's infringing activities.¹¹⁸ However, the court also went on to explain that such claims need not necessarily allege that the individual had knowledge of and participated in the infringing conduct.¹¹⁹ Instead, a corporate officer who had the right and ability to supervise the infringing activity could be held personally liable.¹²⁰

Similarly, in another case alleging a violation of the Communications Act of 1934,¹²¹ an individual was held liable in her capacity as a corporate officer, director, shareholder, and principal.¹²² In order to establish liability, the plaintiff had to show that the defendant "had a right and ability to supervise the violations, and that she had a strong financial interest in such activities."¹²³

III. PROBLEMS ASSOCIATED WITH TORT-BASED LIABILITY FOR SUPERVISION AND MANAGEMENT

Despite the numerous ways by which directors and officers can be held personally liable for supervision and management failures, augmenting the scope of directors' and officers' duties in these areas poses some problems. To be sure, an enlarged scope of duty for supervision and management can benefit tort victims by increasing the pool of potential defendants and available assets. At the same time, however, an enlarged scope of duty for supervision and management fails to distinguish between the corporation's

115. 698 A.2d 959 (Del. Ch. 1996).

116. *See id.* at 967–68 (holding that boards, regardless of any notice of actual wrongdoing, have a duty to assure themselves that reasonably designed information and reporting systems with regards to "the corporation's compliance with law and its business performance" are in place); *see also* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (en banc), *aff'g*, No. Civ. A. 1570-N, 2006 WL 302558, at *1–2 (Del. Ch. Jan. 26, 2006); *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 122–24 (Del. Ch. 2009).

117. *Feder v. Videotrip Corp.*, 697 F. Supp. 1165, 1167 (D. Colo. 1988).

118. *Id.* at 1177–79.

119. *Id.* at 1179

120. *Id.*

121. 47 U.S.C. § 605 (2006).

122. *J & J Sports Prod., Inc. v. Ribeiro*, 562 F. Supp. 2d 498, 501 (S.D.N.Y. 2008).

123. *See id.* at 501 (quoting *J&J Sports Prod., Inc., v. Meyers*, No. 06 Civ. 5431, 2007 WL 2030288, at *3 (S.D.N.Y. July 16, 2007)).

duties and directors' and officers' duties; fails to align corporate and tort law liability standards; neglects the corporate shield; and misaligns costs and benefits.

A. Distinguishing Between Internal and External Duties

1. Internal versus external duties

Cases holding directors and officers liable in tort for supervision and management, either under common law or based on tort-like statutory violations, share a common trait. They work under the explicit or implicit assumption that directors and officers owe their duties of supervision and management of corporate affairs and subordinates to both the corporation and to third parties.

Consequently, many courts dealing with common law tort claims based on supervision and management treat them like any other tort claim against corporate agents. They ask whether a defendant was a participant in tortious conduct, or, if the particular court treats supervision and management as a separate species of torts, inquire into whether the defendant's conduct was negligent and whether it was the proximate cause of the plaintiff's harm.¹²⁴ If there is a statutory claim, the reasoning can be similar, but the bases for imposing liability can also be much broader. Under certain statutes, it can suffice that a director or officer was in control of a company's business operations in order to impose liability, regardless of any showing of actual participation or negligence.¹²⁵

On reflection, however, these approaches seem inadequate and overbroad for determining tort-based supervision and management claims. In the corporate context courts should, instead, begin by examining whether it was the corporation, the director or officer, or both who owed a duty to the third party. Notably, courts should not assume that a director or officer owed a duty to a third party simply by virtue of his participation in an alleged tort or due to his negligence in carrying out (or failing to carry out) a certain act. Because one can construe almost every aspect of corporate conduct to involve some sort of supervisory or managerial mistake—especially in smaller corporations in which directors and officers are involved in the daily operations—the threshold for holding directors and officers liable in tort is too easily met in the absence of a preliminary duty-focused analysis. Similarly, liability based solely on a defendant's position of authority within a company or control of certain business operations—a form of liability sometimes created by statute or judicial

124. *See supra* Part II.A.

125. *See supra* Part II.B.

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interpretation thereof—is equally inappropriate, since a corporate position of authority by itself should not create any duties to third parties.

Accordingly, rather than only examining participation in an act, negligent conduct of the director or officer, or exercise of control over a business, courts should first examine the nature of the duty that allegedly has been breached and then determine to whom such duty is owed.¹²⁶ Generally, if the breach is of a purely internal duty, the director or officer should not be held liable because the duty is owed to the corporation.¹²⁷

Contrariwise, the director or officer may be held liable for the breach of an external duty because that duty is specifically owed to the third party.¹²⁸ To put it another way, courts must distinguish between a director or officer's fiduciary duties to the corporation (and its shareholders) and a director or officer's duty not to injure third parties under common law tort principles.¹²⁹

Of course, distinguishing between internal and external duties may be a challenging task for courts.¹³⁰ Several considerations may be helpful in this regard. One way to distinguish between internal duties (owed to the corporation) and external duties (owed to third parties) is to link the distinction with the difference between indirect and direct harm. In cases of indirect harm, the director or officer's conduct will not be the final link in the causal chain leading to the third party's injury. Instead, there will be other conduct or other causes that are in closer proximity to the harm actually incurred. In other words, the injury is outside of the "scope" of the specific conduct in question. Since indirect harm is often an indication of the breach of a purely internal duty, only the corporation should be liable to third parties for indirect harm in most cases.¹³¹

126. Of course, legislators may craft statutory provisions that explicitly create certain duties that directors or officers owe to third parties. In cases involving such provisions, courts have to sanction any breaches thereof and analyses of a duty's internal or external nature are superfluous. However, if statutory provisions are open to judicial interpretation as to whether a director or officer is an appropriate defendant and can be liable (or whether only the corporation can be liable), courts should carefully analyze the nature of the duty at question, focusing on the distinction between internal and external duties.

127. *But see infra* Part IV.A (proposing that, in order to mitigate moral hazard problems, directors and officers should remain liable for breaches of internal duties in cases of intentional inflictions of harm).

128. *But see infra* Part IV.B (suggesting a model under which personal liability for breaches of external duties can only be imposed if there is a showing of at least grossly negligent conduct).

129. *See Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 581–82 (Cal. 1986) (en banc).

130. Nevertheless, courts should be mindful of the fact that in the tort context, "duty" remains a relatively flexible and policy-driven concept. *See, e.g., Tarasoff v. Regents of Univ. of Cal.*, 551 P.2d 334, 342 (Cal. 1976) (en banc) ("[L]egal duties are not discoverable facts of nature, but merely conclusory expressions that, in cases of a particular type, liability should be imposed for damage done.").

131. For a similar idea in the context of worker's compensation, see *Steele v. Eaton*, 285

Examples of indirect harm abound. For instance, a failure to prevent tortious conduct or to detect fraud by an employee or a third party, which is a possible breach of the duty to supervise, results in indirect harm. In contrast, it is the employee or the third party's conduct that will result in the direct harm. Indirect harm can also take the form of misguided investment advice, which can result in a possible case of negligent management. In this scenario, it will be market movements or other events, and not the misguided advice *per se*, which will ultimately cause the direct monetary harm.

Internal and external duties can also be distinguished by looking to whether the duty in question is one that is owed by an ordinary individual, not acting as a corporate agent, to a third party.¹³² In short, duties that are not ordinarily owed to third parties are internal duties and thus cannot be the source of personal tortious liability for directors and officers. For example, individuals do not commonly owe third parties a duty to "manage carefully." In fact, it is difficult to imagine mismanagement claims outside of a corporate or business setting. Thus, the duty to manage is not a duty that any individual owes to another party. Consequently, courts should view the duty to manage as a duty that a corporate director or officer owes only to the corporation and the exclusive bearer of an external duty to manage has to be the corporation.

The situation is slightly different in the case of the duty to supervise. For example, the Restatement (Second) of Agency specifically states that an agent may be liable to third parties based on his negligence in supervising other agents appointed by his principal.¹³³ In addition, an individual's duty to supervise is common in various areas of tort law, such as parental or medical liability.¹³⁴ Nevertheless, the duty to supervise arises only in

A.2d 749 (Vt. 1971). In *Steele*, an employee who had suffered an injury during an industrial accident sought recovery from the corporate president, claiming that he was negligent in not providing adequate workplace safety. *Id.* at 751–52. The Supreme Court of Vermont shielded the corporate president (who was not present at the time of the accident) from personal liability, holding that the necessary "immediacy of participation" was not present given that other, intermediate, supervisors were on the scene of the accident. *Id.* at 752–53. The court also stressed that there must have been "acts constituting direct negligence" toward the plaintiff in order to state a successful claim. *Id.* at 751. The "immediacy of participation" or "proximity" test pronounced in *Steele* was later abolished in *Garrity v. Manning*, 671 A.2d 808, 811 (Vt. 1996).

132. For example, a director or officer owes a third party the same duty to exercise due care not to injure that party which any individual person owes to another. The injured party may have a tort cause of action for damages against the director or officer if an injury is sustained as the result of a breach of the duty which the director or officer as an individual owes to the third party. See *Frances T.*, 723 P.2d at 581 n.12 (citing *Saucier v. U.S. Fid. and Guar. Co.*, 280 So. 2d 584, 585–86 (La. App. 1973)).

133. RESTATEMENT (SECOND) OF AGENCY § 358(1) (1958).

134. See, e.g., WILLIAM PROSSER ET AL., *THE LAW OF TORTS* 383–85, 914–15 (5th ed. 1984).

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situations in which an individual is in a position in which he is legally obliged to exercise control over another.¹³⁵

In the case of a director or officer, the obligation to exercise control arises only within the corporate hierarchy. Without the corporation, the director or officer would not have an obligation to exercise control over subordinate employees. For example, unlike the duty not to expose others to unreasonable risks when driving a car, the duty to supervise is not a duty that any individual commonly owes. Accordingly, this is an indication that the duty to supervise also represents a director or officer's internal duty. In sum, both supervision and management are not duties commonly imposed upon the public at large. They are duties that individuals acting as corporate directors and officers¹³⁶ would not have absent the existence of the corporation.¹³⁷

An illustration of the ease with which a court can distinguish between internal and external duties is found in *Donnelly v. Handy*.¹³⁸ The plaintiffs charged a corporate officer, Noble Handy, with negligent supervision and management in connection with a suit arising out of various disputes as to the quality of workmanship under a contract concerning the construction of plaintiffs' residence. The court held that the plaintiffs failed to state a cause of action against Mr. Handy and found that he did not owe a personal

135. *Id.* at 384.

136. Directors' and officers' roles consist in great part of supervision and management. Directors, as part of a corporate board, typically carry out a supervisory or monitoring function and engage in certain (at least in larger corporations, high-level) managerial tasks. *See, e.g.*, AMERICAN BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 11–15 (5th ed. 2007) (enumerating, broadly, the overall responsibilities of corporate directors); STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 195 (2002) (explaining that the monitoring function remains the board's chief role). Officers, on the other hand, are in charge of managing the corporation's daily business as well as exercising certain supervisory functions. *See, e.g.*, THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.01 (1994). In addition, both directors and officers have within their scope, a positive duty to implement appropriate internal controls to monitor legal compliance and business risks. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006), *aff'g*, No. Civ. A. 1570-N, 2006 WL 302558 (Del. Ch. 2006); *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 126 (Del. Ch. 2009) (explaining that directors may be liable "under some set of facts" for failing to properly monitor business risks); *see also Miller v. McDonald*, 385 B.R. 576, 592 (Bankr. Del. 2008) (expanding *In re Caremark* oversight duties to officers).

137. *See Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 582 (Cal. 1986) ("[A] broad application of agency principles to corporate decision-makers would not adequately distinguish the directors' duty of care to third persons, which is quite limited, from their duty to supervise broad areas of corporate activity.").

138. 415 So. 2d 478 (La. Ct. App. 1982). *Donnelly* involved a contract between the plaintiffs and the defendant officer's corporation. The outcome of the case might therefore also be explained as following the principle that contractual claims cannot be brought as tort claims. *See supra* note 83 and accompanying text. The court, however, did not limit its opinion in such manner and specifically addressed the possibility of a successful tort claim against the defendant. Thus, the holding is not limited to claims which arise out of a preexisting contractual relationship.

duty to the plaintiffs to properly supervise, inspect, govern, control, and manage the construction.¹³⁹ The court found that this was a duty owed by the defendant to the corporation exclusively, by virtue of his employment relationship, and by the corporation to the plaintiffs, by virtue of their contract, but not by the defendant to the plaintiffs.¹⁴⁰ Conversely, had the plaintiffs alleged that Mr. Handy had negligently damaged their property, the court found that they would have stated a cause of action.¹⁴¹ However, the court concluded that the allegations of negligent supervision were “of a different nature completely” and did not establish the breach of a personal duty owed to the plaintiffs.¹⁴²

In light of the factors discussed above and in view of supporting case law, it becomes apparent that there are good reasons to treat supervision and management as internal duties, which the directors and officers owe exclusively to the corporation. As a result, courts should not allow non-shareholder third parties to bring claims based on supervision and management, turning these duties into external duties by using tort law. Directors and officers fulfill supervisory and managerial duties,¹⁴³ but they do so within the confines of the corporate framework¹⁴⁴ and arguably based on the understanding that their duties in this respect only exist vis-à-vis the corporation and its shareholders, not third parties.¹⁴⁵ Therefore, extending the duties to supervise and manage the corporation to outsiders represents a troubling and unwarranted augmentation of directors’ and officers’ overall duties.

Courts that apply the rule that corporate agents are not personally liable to third persons for negligence amounting merely to a breach of a duty they owe to the corporation alone are using a prudent approach.¹⁴⁶ However, one important reservation remains regarding the practice of certain courts that use a duty-based approach. It should not matter whether there was an

139. *Donnelly*, 405 So. 2d at 481–82.

140. *Id.*

141. *Id.* at 481.

142. *Id.* at 481–82.

143. *See Steele v. Eaton*, 285 A.2d 749, 752 (Vt. 1971) (holding that the director is only liable if he directly participated in the action or omission which caused injury).

144. In addition, corporate law provides directors and officers with considerable protections from personal liability, whereas ordinary tort law does not provide such protections. *See infra* Part III.B.

145. As an exception, directors of an insolvent corporation may owe fiduciary duties to company creditors. *See North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (creditors of an insolvent corporation can maintain derivative claims against directors for breaches of fiduciary duties); Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 347 (2006).

146. *See, e.g., Donnelly*, 415 So. 2d at 480 (discussing Louisiana’s preference for the “duty analysis” in determining officers’ liability to third parties); *Garrity v. Manning*, 671 A.2d 808, 811 (Vt. 1996) (discussing the duty-based approach in the context of worker’s compensation and the duty to provide a safe workplace).

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act or an omission.¹⁴⁷ Modern courts have rightly rejected the ancient distinction between misfeasance, nonfeasance, and sometimes malfeasance.¹⁴⁸ The duty to supervise or manage remains an internal duty, whether it consists of omissions (such as not having prevented tortious conduct) or positive acts (such as taking a decision which leads to harm to a third party). This approach is preferable because there is no obvious reason to treat omissions differently than actions.

2. *The corporation as exclusive bearer of duties*

Let us assume, as suggested in the preceding section, that supervision and management are purely internal duties, a breach of which cannot lead to a director or officer's personal liability. Does this mean that a third party, injured by inadequate supervision or management by directors or officers, does not have any recourse? No. Instead, the injured third party would have to seek recourse against the corporation instead of directors or officers because the corporation alone bears external duties to supervise and manage.

Of course, as we have already seen, courts do not broadly accept the view that only the corporation itself owes a duty to third parties to avoid harm related to inadequate supervision or management. In fact, the disaccord is deeper and touches upon the fundamental question of how the law attributes tort liability to corporations and other legal entities. In short, the issue in the context of corporate torts is whether: (1) a corporation's liability can only be triggered by a corporate agent's own tortious conduct (exposing the agent to potential individual liability); or (2) whether the corporation can be liable despite the absence of any individual corporate actors' tortious conduct, i.e. solely by virtue of the breach of a duty borne exclusively by the corporation.

There is still a widespread conception that since a corporation can only act through someone acting on its behalf, there must always be an individual who can be made responsible (and held liable together with the corporation) for torts in the corporate context. Fletcher's *Cyclopedia of the Law of Private Corporations* expresses this sentiment as follows: "I have been injured by a wrong done by the corporation; the corporation can act only by officers or agents and hence I should be entitled to recover from the officers or agents who are the wrongdoers."¹⁴⁹ Along these lines, courts often stress that the only way in which a corporation can act is through the

147. See *supra* note 100 (Providing examples of cases that rely on the rule of non-liability for nonfeasance).

148. See *supra* note 38 and accompanying text.

149. 3 WILLIAM MEADE FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1134 (2008).

individuals who act on its behalf and, in turn, conclude that a person injured by a wrong done by the corporation will necessarily be entitled to recover from directors, officers, or other corporate agents linked to the misconduct.¹⁵⁰

However, this view ignores the basic premise of the corporation as a separate entity and is contrary to important developments in the law of torts. There are two distinct means by which the law can attribute tort liability to a corporation: directly or vicariously. In the case of vicarious liability, the corporation is simply liable for its agent's wrongful conduct. Conversely, pursuant to the correct interpretation, holding the corporation directly liable does not require that there must always be an individual liable along with the corporation.

Courts have solved the problem of how to hold a corporation directly liable, independent from tortious conduct by its agents, with the advent of "depersonalized" enterprise liability.¹⁵¹ For example, in the early landmark

150. See, e.g., *Garrity*, 671 A.2d at 811 (noting that in the context of an employee's tort claim against his supervisor "[a] corporation must act through people In all cases, an injured worker can identify a person who is responsible to the corporation for discharging the particular responsibility the worker claims was breached and sue that person rather than the corporation.").

151. In contrast to U.S. law, some civil law countries today still grapple with the concept of the corporation as a separate bearer of liability. See generally Yedidia Z. Stern, *Corporate Criminal Personal Liability: Who is The Corporation?*, 13 J. CORP. L. 125, 126 n.4 (1987). For example, under both German and Swiss law, a corporation can only be liable for another's tortious acts. Corporate liability comes either in the form of (1) vicarious liability, or (2) direct liability. Vicarious liability typically occurs in cases of tortious conduct by lower-level employees. See Bürgerliches Gesetzbuch [BGB] [Civil Code] Aug. 18, 1896, Reichsgesetzblatt [RGBl] 195, as amended, § 831 (Ger.); Schweizerisches Obligationenrecht [OR][Code of Obligations] Mar. 30, 1911, SR 220, art. 55 (Switz.). Direct liability, however, is still imputed through tortious conduct by "managing agents"—such as directors and executive officers—and then treated as the corporation's own conduct. See Bürgerliches Gesetzbuch [BGB] [Civil Code] Aug. 18, 1896, Reichsgesetzblatt [RGBl] 195, as amended, § 31 (Ger.); Schweizerisches Zivilgesetzbuch [ZGB][Civil Code] Dec. 10, 1907, SR 210, art. 55, ¶ 2 (Switz.). Importantly, in both cases, the individual whose conduct is imputed to the corporation remains liable along with the corporation, and a third party can hold both jointly and severally liable. See Gert Brüggemeier, *Unternehmenshaftung – Enterprise Liability: Eine europäische Perspektive?* [*Enterprise Liability: A European Perspective?*], Haftung und Versicherung 165–66 (2004) (Switz.) (German law); Vito Roberto & Martin Petrin, *Organisationsverschulden aus zivilrechtlicher Sicht* [*Civil Liability for Negligent Corporate Organisation*], in VERANTWORTLICHKEIT IM UNTERNEHMEN: ZIVIL- UND STRAFRECHTLICHE PERSPEKTIVEN [CORPORATE LIABILITY – CIVIL AND CRIMINAL LAW PERSPECTIVES] 74 (M.A. Niggli & M. Amstutz, eds., 2007) (Swiss law). Thus, both jurisdictions have not found it possible to hold a corporation (or other legal entity) directly liable without, at least as a theoretical matter, finding the commission of a separate tort by a corporate agent. In contrast, under U.S. tort law, the distinction between lower-level employees and managing agents of a corporation appears to be of relevance in the context of establishing a specific state of mind of a corporate defendant. For example, under California law, one requisite that must be met before a plaintiff may recover exemplary damages from a corporate employer is that the necessary state of mind must be present on the part of an officer, director, or managing agent of the corporation. See CAL. CIV. CODE § 3294(b) (West 2009); see also RESTATEMENT (SECOND)

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products liability decision *MacPherson v. Buick Motor Co.*,¹⁵² Justice Cardozo made the car manufacturer's individual actors disappear behind the corporate shield, treating the corporation as the sole bearer of the duty of care to the third party plaintiff.¹⁵³ Of course, this development is even more remarkable in light of the early rule that corporations could not be liable for torts, directly or vicariously.¹⁵⁴

The holding in *MacPherson* does not suggest that we should treat liability for supervision and management according to products liability principles. Although, where failures to supervise or manage are the result of a collective process, in which plaintiffs cannot identify one or more individuals as the wrongdoers, this could be a feasible approach. Rather, *MacPherson* suggests that the law recognizes that the corporation may be directly and exclusively liable, without a director, officer, or other agent being liable at the same time.¹⁵⁵

OF TORTS § 909 (1979). Nevertheless, at least in the case of punitive damages awards, there is not necessarily a requirement that the evidence establish a *particular* committee or officer of the corporation acted with the necessary state of mind. *See Romo v. Ford Motor Co.*, 122 Cal. Rptr. 2d 139, 157, 158 (Cal. Ct. App. 2002), *vacated by* 123 S. Ct. 2072 (2003), *remanded to* 6 Cal. Rptr. 3d 793 (2003); *see also* Ted C. Craig & Christopher N. Johnson, *When is a Manager a Managing Agent?*, 75 FLA. B.J. 62 (2001) (discussing corporate liability for punitive damages under Florida law).

152. 111 N.E. 1050 (N.Y. 1916).

153. *See id.* at 1055. (“[T]he defendant was not absolved from a duty of inspection . . . [Buick Motor Co.] was a manufacturer of automobiles. It was responsible for the finished product.”). While *McPherson* was still based on liability for negligence, the Supreme Court of California introduced in 1963 the rule of strict products liability. *See Greenman v. Yuba Power Prods., Inc.*, 377 P.2d 897, 900 (Cal. 1963) (en banc). Subsequently, products liability law developed even further, making it possible that, under certain circumstances, liability could not only be shown independent of corporate agents' conduct, but also without proof that the defendant producer, manufacturer, or seller itself was responsible for a defective product. Thus, under the theory of market share liability, an injured person may hold a defendant liable for damages in proportion to its share of the total market for the product. *See, e.g., Brown v. Superior Court*, 751 P.2d 470 (Cal. 1988).

154. *See, e.g., Denver & R. G. Ry. Co. v. Harris*, 122 U.S. 597, 608 (1887) (“it is now perfectly well settled, contrary to the ancient authorities, that a corporation is liable *civiliter* for all torts committed by its servants or agents by authority of the corporation, express or implied.”). *See also* THOMAS M. COOLEY, *LAW OF TORTS* 136–41 (2d ed. 1888) (discussing abandonment of the rule that corporations cannot be liable in tort).

155. This principle is often overlooked by courts. *See, e.g., Sarvis v. Boston Safe Deposit and Trust Co.*, 711 N.E.2d 911, 920 (Mass. App. Ct. 1999) (opining that a corporation's liability is “necessarily vicarious”). Many other courts, of course, do recognize the possibility of a corporation's direct liability. Common examples are a corporation's liability for failure to adequately supervise or train its employees. *See, e.g., Far W. Fin. Corp. v. D & S Co.*, 760 P.2d 399, 402 (Cal. 1988) (en banc) (supervision); *De Vera v. Long Beach Pub. Transp. Co.*, 225 Cal. Rptr. 789, 794 (Cal. Ct. App. 1986) (training). A corporation may also be directly liable for its negligence in instructing, selecting, and controlling an independent contractor under sections 410, 411, and 414 of the Restatement (Second) of Torts. *See, e.g., Gass v. V.I. Tel. Corp.*, 311 F.3d 237, 241 (3d Cir. 2002); *Hinger v. Parker & Parsley Petroleum Co.*, 902 P.2d 1033, 1046 (N.M. Ct. App. 1995).

In other words, agency principles and vicarious liability are not the only doctrinal basis through which courts can attribute the actions of directors and officers to the corporation.¹⁵⁶ Instead, a corporation can be directly liable for its own conduct and the breach of duties that it exclusively owes to third parties. To be sure, even in these cases, one or more individuals acting for the corporation will carry out the acts that constitute a breach of duties of care. These acts, however, will be “added” to the corporation’s duty, resulting together in the corporation’s sole liability.

Thus, while a corporation may well be a “creature of legal fiction,”¹⁵⁷ it is not a precise statement of the law to hold that corporations are “incapable of tortious conduct” by themselves and that they may only be liable for the acts of their agents.¹⁵⁸ The law has proven to be amenable to treating the corporation as more than just the sum of its individual parts, i.e. its agents, but as an aggregate of its individual agents’ acts and their knowledge.¹⁵⁹ As such, the corporation is capable of having its own state of mind, bearing its own duties and being held liable in the absence of an independent tort by an agent. In short, the corporation does, indeed, have a separate personality.¹⁶⁰

Consequently, in instances where only the corporation owes duties to the public at large, but not the directors and officers individually, it is appropriate to limit third party liability to the corporation alone. This is precisely the situation courts face when confronted with claims against directors and officers for failures in supervision and management. In these instances, courts should not look past the corporate shield and should refrain from imposing liability on directors and officers.

156. Nevertheless, many legal systems, including the United States, believe that corporate liability can only be understood through the law of agency. *See Stern, supra* note 151, at 126 (noting, *inter alia*, that the limitation on corporate rights and duties to fit into the substance and rationale of agency law has led to inadequate solutions to the problem of corporate liability for torts).

157. *Lokay v. Lehigh Valley Coop. Farmers*, 492 A.2d 405, 408 (Pa. Super. Ct. 1985).

158. *Id.* at 409.

159. *See, e.g., Gutter v. E.I. Dupont De Nemours*, 124 F. Supp.2d 1291, 1309 (S.D. Fla. 2000) (en banc) (explaining that the knowledge necessary to adversely affect the corporation need not be possessed by a single corporate agent and that the cumulative knowledge of several agents can be imputed to the corporation). *See also Romo v. Ford Motor Co.*, 122 Cal. Rptr. 2d 139, 158 (Cal. Ct. App. 2002), *vacated by* 123 S. Ct. 2072 (2003), *remanded to* 6 Cal. Rptr. 3d 793 (Cal. Ct. App. 2003) (“It is difficult to imagine how corporate malice could be shown in the case of a large corporation except by piecing together knowledge and acts of the corporation’s multitude of managing agents.”).

160. *See Stern, supra* note 151, at 125 (explaining that because a collective body may have a legal personality distinct from its individual members and be the independent subject of legal rights and duties, “the corporation has been able to replace the individual as the principal actor in modern commercial life”).

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B. Failure to Align Corporate Law and Tort Law Liability Standards

Corporate law and tort law differ in many ways, most notably in defining liability standards for third party claims. These differences become most apparent when examining the general defenses and protections that corporate law offers that are not similarly offered under tort law. For instance, in Delaware, the business judgment rule broadly protects directors¹⁶¹ and officers¹⁶² against liability for business decisions. Even if the business judgment rule does not apply, the applicable standard of care is not simple negligence, but gross negligence.¹⁶³ Moreover, *Caremark* allegations of internal control failures can only be successful if plaintiffs can show a conscious abdication of the respective duties.¹⁶⁴ Additionally, directors' liability for shareholders' duty of care claims can be limited or wholly excluded by virtue of exculpatory charter provisions.¹⁶⁵

In contrast, none of these corporate law protections apply to tort claims brought by third party plaintiffs. Tort-based suits for supervision and management ordinarily operate under a simple negligence standard,¹⁶⁶ or, in the case of certain strict liability statutory provisions, do not even require any wrongdoing at all. Neither the business judgment rule¹⁶⁷ nor—at least

161. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) (“[D]irectors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.”); see also Stephen M. Bainbrige, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 88 (2004).

162. See *In re the Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 47 n.38 (Del. 2006) (en banc) (noting that directors and officers are subject to the same fiduciary duties and standards of substantive review). See also *Gantler v. Stephens*, 965 A.2d 695, 708–09 (Del. 2009) (en banc) (clarifying that the fiduciary duties of officers of Delaware corporations are the same as those of directors).

163. See, e.g., *McMullin v. Beran*, 765 A.2d 910, 921 (Del. 2000) (“Director liability for breaching the duty of care ‘is predicated upon concepts of gross negligence.’”).

164. See *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) *aff’g*, No. Civ. A. 1570-N, 2006 WL 302558 (Del. Ch. 2006) (en banc) (explaining that plaintiffs must demonstrate a director’s conscious disregard for his duties as a precondition of oversight liability).

165. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

166. A minority of courts depart from a simple negligence standard in cases involving directors and officers. See *Myers & Chapman, Inc. v. Thomas G. Evans, Inc.*, 374 S.E.2d 385, 393–94 (N.C. 1988) (holding that a director must be grossly negligent in order to be held personally liable for failure to adequately supervise a subordinate); *Preston-Thomas Const., Inc. v. Central Leasing Corp.*, 518 P.2d 1125, 1127 (Okla. Ct. App. 1973) (“The law will not permit an officer or director to escape personal responsibility for his corporation’s intentional malfeasance by preserving a state of ignorance through a gross or willful neglect of duties.”); *Inter-Ocean Cas. Co. v. Leccony Smokeless Fuel Co.*, 17 S.E.2d 51, 53–54 (W. Va. 1941) (holding that in the absence of an active intent to deceive or defraud creditors, the officers and directors will not be liable for simple nonfeasance of duty to the corporation or fraud in its management or mismanagement in the disposition of money or property); *Webb v. Cash*, 250 P. 1, 6 (Wyo. 1926) (holding that state bank directors’ failure to know of condition of bank could not make them liable for resulting loss in absence of deliberate or reckless conduct).

167. See *Frances T. v. Vill. Green Owners Assn.*, 723 P.2d 573, 582 (Cal. 1986)

in case of direct claims—exculpatory charter provisions¹⁶⁸ apply against non-shareholders.

For example under corporate law, absent conscious misconduct, shareholders could not hold board members and officers liable for their failure to detect and prevent employees' torts.¹⁶⁹ Similarly, shareholders would most likely not be able to hold directors and officers liable for alleged mismanagement under corporate laws, since they would probably not be able to overcome the business judgment rule,¹⁷⁰ or, because directors may be exculpated from liability for duty of care breaches by virtue of specific provisions in corporate charters.¹⁷¹ Conversely, in both cases, non-shareholder tort claimants could be successful in a suit against director and officer defendants by demonstrating simple negligence on the part of the defendants.

The unwarranted dichotomy of corporate and tort liability standards has gone mostly unnoticed. A rare exception is Justice Mosk. In a dissenting opinion to a California Supreme Court decision,¹⁷² he argued that courts should hold directors faced with third-party tort claims to the statutory liability standard that governs their internal duties to the corporation, but not to the common law standard.¹⁷³ As Justice Mosk explained, every act or omission by directors necessarily affects both the corporation and third parties.¹⁷⁴ Thus, to hold directors to a higher standard of care insofar as their acts or omissions affect third parties, and to a lower standard insofar as they affect the corporation, is in effect to hold them to the higher

(en banc) (rejecting the assertion that the business judgment rule controls a director's liability to third persons, as the rule only "applies to parties (particularly shareholders and creditors) to whom the directors owe a fiduciary obligation").

168. See *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 794 (Del. Ch. 2004) ("[exculpatory clauses] only restrict third parties to the extent that they seek to enforce rights on behalf of the corporation itself [whereas] . . . [a]ny claims that creditors possess[] themselves against the firm or its directors—such as claims for breach of contract or for common law or statutory torts . . . [are] not barred by the exculpatory charter provision because those claims do not belong to the corporation or its stockholders.").

169. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (en banc) (holding that imposition of oversight liability requires a showing that the directors *knew* that they were not discharging their fiduciary obligations), *aff'g*, No. Civ. A. 1570-N, 2006 WL 302558, at *1–2 (Del. Ch. Jan. 26, 2006).

170. See, e.g., *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052–53 (Del. Ch. 1996) (holding that a derivative claim of corporate losses allegedly sustained by reason of mismanagement not resulting from directly conflicting financial interests or improper motivation is barred by the business judgment rule).

171. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7).

172. *Frances T.*, 723 P.2d 573, 591 (Mosk, J., dissenting).

173. *Id.* at 592–99.

174. *Id.* at 598.

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standard.¹⁷⁵ This is because directors will not be free from liability unless they adhere to the higher standard.¹⁷⁶

In sum, tort-based claims have the ability to undermine the liability protections provided by corporate laws, creating a state of legal uncertainty for directors and officers in the process. Ultimately, the threat of potential tort liability for acts or decisions that would pass muster under corporate law may undercut directors' and officers' decision-making authority.¹⁷⁷ As a result, courts should attempt to mitigate the awkward misalignment of corporate and tort law liability standards. Directors and officers, when faced with tort claims, should not be subject to the ordinary simple negligence standard used in general tort law. Rather, courts should measure their liability according to a different, lower liability standard.¹⁷⁸

C. *The Neglect of the Corporate Shield*

Directors' and officers' personal liability for torts committed in their official capacities raises another important concern. Allowing plaintiffs to hold directors and officers personally and fully liable for supervision and management related torts creates a tension in relation to two defining corporate law principles. The first is the principle of a corporation's separate legal personality, which entails that the law recognizes the corporation as an entity separate and distinct from its shareholders, directors, officers, and other persons who are acting for it.¹⁷⁹ The second is the principle of limited liability, which restricts shareholders' personal liability for the debts and liabilities of the corporation to the extent of their

175. *Id.*

176. *Id.* Justice Mosk's dissenting opinion does not refer to the business judgment rule and its potential applicability in relation to non-shareholders. Nevertheless, the majority of justices assumed that Justice Mosk in his dissenting opinion also advocated that directors should be insulated against third party claims by the business judgment rule. *See id.* at 583 n.15 (characterizing the business judgment rule as a standard of care for corporate directors, not as a judicial abstention doctrine).

177. In corporate law literature, the problem of striking a balance between a board's authority and its accountability to shareholders has been described as a central aspect of corporate law. The issue also lies at the heart of Professor Bainbridge's director primacy theory. *See generally* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003).

178. *See infra* Part IV.

179. *See, e.g.*, Walker v. Anderson, 232 S.W.3d 899, 918 (Tex. App. 2007); STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 25-30 (2008) (discussing the concept of the corporation as person and other models of the corporation). *See also* Jess M. Krannich, *The Corporate "Person": A New Analytical Approach to a Flawed Method of Constitutional Interpretation*, 37 LOY. U. CHI. L.J. 61, 64-90 (2005) (examining the historic use of various corporate metaphors and tracing the development of corporate theory); Michael J. Philips, *Reappraising the Real Entity Theory of the Corporation*, 21 FLA. ST. U. L. REV. 1061, 1063 (1994) (sketching various conceptions of the corporation, concluding that a real entity theory of the corporation is more plausible than its competitors).

investment¹⁸⁰ and insulates corporate agents from contractual claims.¹⁸¹ Together, these principles constitute what I will call the “corporate shield.”

Imposing personal liability on directors and officers for acts undertaken in their corporate capacity, however, undermines both of these principles. The current approach of holding directors and officers liable in tort under general common law principles or statutory provisions therefore begs the question of how it can be reconciled with the notion of the corporate shield.

1. *The corporation as a separate legal personality*

One way of viewing the idea of a corporation’s separate legal personality is to treat persons acting on behalf of the corporation as an embodiment of the corporation itself, disregarding these persons’ individual personality. Thus, only the corporation, not its directors, officers, and other agents—who have acted only as the corporation’s “arms and legs”—should be liable for harm to third parties caused while carrying out their corporate duties. The theory of “alter ego” expresses this sentiment. Under the theory, which has traditionally served as a way of justifying vicarious liability, the

180. See MODEL BUS. CORP. ACT § 6.22(b) (2002). Limited shareholder liability remains a bedrock corporate law principle, even though it has sometimes been contested. See, e.g., Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 391 (1992) (characterizing limited liability as a threat to the animating principles of tort law); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1880 (1991) (arguing that, for involuntary creditors, limited liability prevents tort law’s cost allocating function and advocating pro rata shareholder liability for corporate torts); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1568–69 (1991) (concluding that the case for limited liability has been overestimated and that limited liability may be more justified in closely held firms); Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1271 (2002) (advocating a regime of vicarious liability for corporate torts for shareholders with the capacity to control corporate activity); see also Mark I. Weinstein, *Don’t Buy Shares Without It: Limited Liability Comes to American Express*, 37 J. LEGAL STUD. 189 (2008) (examining the effects of adopting limited liability on the value of American Express shares, finding little effect on the firm’s value). For a comprehensive overview of various aspects of limited liability, see Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001) (analyzing limited liability and its justifications); Daniel R. Kahan, *Shareholder Liability for Corporate Torts: A Historical Perspective*, 97 GEO. L.J. 1085, 1088 (2009) (stating the definition and function of limited liability); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1 (1994) (expanding on how limited liability affects various corporate actors).

181. Directors and officers normally enjoy immunity from contractual claims, if they were acting in good faith and did not commit independent torts. See *In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1263 (S.D.N.Y. 1996); KNEPPER & BAILEY, *supra* note 22, § 6.07[2]. The immunity from contractual claims follows the general rule that an agent who on behalf of his principal enters into a contract with another is not liable under that contract. See RESTATEMENT (SECOND) OF AGENCY § 320 (1958). Note, however, that a contractual obligation may create duties the breach of which will support a tort action. See *Michaelis v. Benavides*, 61 Cal. App. 4th 681, 687 (Cal. Ct. App. 1998); *Fryar v. Westside Habilitation Center, Inc.*, 479 So. 2d 883, 890 (La. 1985); *Canter v. Koehring Co.*, 283 So. 2d 716 (La. 1973) (allowing tort law recovery against a corporate officer or agent in connection with his corporation’s breach of contract).

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agent is the “alter ego” of his principal. Therefore, the principal should be responsible for any losses caused while the agent was acting on his behalf.¹⁸²

Greenauer v. Sheridan-Brennan Realty Co.,¹⁸³ an older New York case, illustrates the alter ego approach.¹⁸⁴ In that case, a corporation was held liable for the death of a third party, caused by an accident on the corporation’s premises.¹⁸⁵ However, the managing officer of the corporate owner who was in charge of repairs, upkeep, and general management of the property, was not held personally liable.¹⁸⁶ The court explained that the officer “acted only for the corporation” and that “his acts were [the corporation’s] acts, and not his own; as an individual he had no authority whatever In that sense only was he its agent.”¹⁸⁷ Similarly, there are other cases that deviate from the general rule and stand for the proposition that corporate officers and other agents are not personally liable where they have not acted outside their corporate capacity.¹⁸⁸

Building upon these ideas a director or officer acting for the corporation should be treated as the embodiment of the corporation itself, making only the latter liable for any misconduct. An alter ego approach can also be useful in cases where the misconduct originates from one or more individually identifiable actors.¹⁸⁹

182. See, e.g., JOHN G. FLEMING, *THE LAW OF TORTS* 409–10 (9th ed. 1998) (clarifying the ideological underpinnings of the employer’s vicarious liability as requiring that “a person who employs others to advance his own economic interest should in fairness be placed under a corresponding liability for losses incurred in the course of the enterprise”).

183. 229 N.Y.S. 719 (N.Y. App. Div. 1928).

184. *Id.*

185. *Id.* at 721.

186. *Id.*

187. *Id.* at 722. Similarly, under UK law, the “organic theory” treats directors and officers as the embodiment of the corporation itself. Thus, the company and the individuals acting for it merge into a single legal entity, and the individual’s acts are disattributed from the individual and attributed to the company. See Ross Grantham, *Attributing Responsibility to Corporate Entities: A Doctrinal Approach*, 19 COMPANIES & SEC. L.J. 168. The organic approach distinguishes between acts of “organs” that are attributed to the corporation and acts of mere agents or subordinate corporate employees, which are not attributed to the corporation. See Stern, *supra* note 151, at 129; see also Yedidia Z. Stern, *Corporate Liability for Unauthorized Contracts—Unification of the Rules of Corporate Representation*, 9 U. PA. J. INT’L BUS. L. 649 (1987).

188. See, e.g., *Cantwell v. City of Boise*, 191 P.3d 205, 216 (Idaho 2008) (“The actions of an agent are the actions of the corporation. An agent is only liable for actions which are outside its scope of duty to the corporation.”); *Rodriguez v. 1414–22 Ogden Ave. Realty Corp.*, 304 A.D.2d 400, 401 (N.Y. App. Div. 2003); *supra* note 19.

189. In contrast, an aggregate view of the corporation—or products liability-inspired approach—would arguably be less helpful in those instances. See *supra* Part III.A.2.

2. *Limited liability for directors and officers?*

Corporations are formed with the intent “to protect individual shareholders, directors, and officers from [personal] liability.”¹⁹⁰ As Professors Hansmann and Kraakman have shown, the essential role of a legal entity is to provide for “asset partitioning,” which includes the corporation’s limited liability feature.¹⁹¹ Today’s rules, however, which allow directors and officers to be held fully liable for supervision, management, and other conduct deemed tortious, deeply compromise the notion of the corporation as a device to limit personal liability. Contrary to the idea of “asset partitioning,” directors’ and officers’ personal liability allows tort creditors to go beyond the “designated pool of assets that are available to satisfy claims by the firm’s creditors.”¹⁹²

This is particularly true in cases where plaintiffs claim that the director or officer defendant “should have known” of tortious conduct by subordinates,¹⁹³ or where statutory liability is based solely on a defendant’s controlling position within a corporation.¹⁹⁴ Both are reminiscent of unwarranted vicarious liability for the conduct of others and create *de facto* nondelegable duties for directors and officers. Specifically, use of the responsible corporate officer doctrine is a departure from the usual protections provided by the law surrounding directors’ and officers’ tort-based liability and represents a considerable augmentation of directors’ and officers’ liability risks.¹⁹⁵

190. See, e.g., *Fine-Cut Diamonds Corp. v. Shetrit*, No. 1283/06 2009 WL 264122, at *3 (N.Y. Sup. Ct. 2009). “Organizing a corporation to avoid personal liability is legitimate. Indeed, it is one of the primary advantages of doing business in the corporate form.” *Hanewald v. Bryan’s Inc.*, 429 N.W.2d 414, 415 (N.D. 1988).

191. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 390 (2000); see also Henry Hansman, et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006).

192. Hansmann & Kraakman, *supra* note 191, at 392–93 (describing typical attributes of legal entities).

193. See, e.g., *Avery v. Solargizer Int’l, Inc.*, 427 N.W.2d 675, 681 (Minn. Ct. App. 1988) (indicating that a director or officer may be found personally liable for negligently failing to prevent the tortious conduct of an employee); *Preston-Thomas Constr., Inc. v. Cent. Leasing Corp.*, 518 P.2d 1125, 1127 (Okla. Civ. App. 1973) (holding that a director or officer will be personally liable for tortious conduct if there is either a duty to know or the means to know, regardless of actual knowledge).

194. See *supra* Parts I.D and II.B.

195. See Tom McMahon & Katie Moertl, *The Erosion of Traditional Corporate Law Doctrines in Environmental Cases*, 3 NAT. RESOURCES & ENV’T 29, 29–31 (1988) (enumerating specific cases pointing toward an expansion of director and officer liability for corporate activity); Mendelson, *supra* note 180, at 1265 (noting that cases under CERCLA have been perceived to be eroding limited liability and other traditional corporate law concepts); but cf. Lynda J. Oswald & Cindy A. Schipani, *CERCLA and the “Erosion” of Traditional Corporate Law Doctrine*, 86 NW. U. L. REV. 259, 329–30 (1992) (concluding that contrary to fears expressed by many commentators, courts have not dismissed general principles of corporate law doctrine in deciding cases against corporate actors for CERCLA violations). In addition, one commentator has pointed out that liability under the responsible corporate officer doctrine

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The fundamental issue is whether the principle of limited liability can be extended to directors and officers in a manner that would protect them from tort claims as long as they acted within their scope of employment. In its current form, limited liability does not preclude directors' and officers' personal liability for their torts and tort-like statutory violations.¹⁹⁶ Today, at least in this respect, tort law trumps corporate law as well as the notions of the corporation's separate personality and limited liability. Thus, for directors and officers, protection under the corporate shield is limited to contractual claims.¹⁹⁷ Why does the law allow for this distinction?

Courts and commentators sometimes explain the narrow protections provided to directors and officers by distinguishing between voluntary contractual creditors and involuntary tort creditors. Arguably, involuntary tort creditors deserve the right to seek recovery from both the corporation and the individual (but not from the shareholders, who are normally protected even against claims by involuntary creditors),¹⁹⁸ because a tort case forces the debtor creditor relationship upon the creditor and there is no element of choice involved.¹⁹⁹ In justifying the doctrine of a corporate

may not be covered by typical D&O liability insurance policies. See Kevin LaCroix, *The Responsible Corporate Officer Doctrine*, D&O DIARY, Jan. 19, 2009, <http://www.dandodiary.com/2009/01/articles/environmental-liability/the-responsible-corporate-officer-doctrine>.

196. See, e.g., *Frances T. v. Vill. Green Owners Ass'n*, 723 P.2d 573, 582–83 (Cal. 1986) (en banc) (noting that the corporate fiction was “never intended to insulate officers from liability for their own tortious conduct”); Thompson, *supra* note 180, at 7.

197. See Thompson, *supra* note 180, at 7. One possible, but narrow, exception to the principle that the corporate shield insulates corporate actors only from contractual claims may be provided by the judicially created fiduciary shield doctrine. The doctrine, if applied by courts, precludes the exercise of personal jurisdiction over nonresident corporate agents or employees who are acting in the forum state in their role as corporate agents or employees. See, e.g., *Giusto v. Ashland Chem. Co.*, 994 F. Supp. 587, 590 (E.D. Pa. 1998) (mem.). Other courts, however, refuse to recognize the doctrine and subject the corporate official to suits for tortious conduct committed in his corporate capacity. See, e.g., *Kreutter v. McFadden Oil Corp.*, 522 N.E.2d 40, 46 (N.Y. 1988).

198. See Thompson, *supra* note 180, at 12–17. Note, however, that shareholders are not shielded from personal liability for their own tortious acts. See, e.g., *Smith v. Isaacs*, 777 S.W.2d 912, 913–14 (Ky. 1989) (noting that a corporate agent is liable for the damage caused by his own personal acts). Specifically, a shareholder may also be held personally liable for negligent acts in managing and supervising the employees of its corporation, if those acts are a contributing factor in causing an injury. See *id.* at 914.

199. See Ross Grantham, *The Limited Liability Of Company Directors* 27–28 (University of Queensland, TC Beirne School of Law Legal Studies Research Paper Series, Research Paper No. 07-03, 2007), available at <http://ssrn.com/abstract=991248>; see also *Axtmann v. Chillemi*, 740 N.W.2d 838, 843–44 (N.D. 2007) (discussing the distinction in the context of veil piercing). The Supreme Court of California has also used the distinction between voluntary and involuntary creditors as an explanation for why the business judgment rule does not apply to non-shareholders. See *Frances T.* 723 P.2d at 582–83 n.14 (“Of course, a tort victim cares little whether the tortfeasor acted in good faith to maximize the interests of the enterprise. Unlike shareholders challenging an unprofitable decision, a tort victim’s exposure to the risk of harm is generally involuntary and

agent's personal liability for his torts, courts and commentators have also emphasized their unwillingness to allow the corporate agent to hide behind the corporate veil, as this would encourage irresponsible behavior and result in unfair outcomes.²⁰⁰

Moreover, some observers have even advocated for significant increases in the personal liability of corporate officials.²⁰¹ In a recent article, Professor Timothy Glynn suggested a system where the highest-ranking corporate official is vicariously liable for all torts and tort-like statutory violations committed within the corporate enterprise.²⁰² Glynn asserts that the model preserves the beneficial effects of limited shareholder liability while also reducing the social costs of limited liability by counteracting its "moral hazard" problem.²⁰³ Under the model, in order to escape personal liability, the highest-ranking "officers will seek to avoid risk and spread the cost of unavoided risk across firm participants."²⁰⁴ For example, the risk-spreading can consist of: setting appropriate prices for the firm's goods and services; monitoring firm activities; maintaining an adequate level of

uncompensated. And unlike the review of business judgments that affect only the pecuniary interests of investors, courts have a long and distinguished record of deciding whether a defendant's personal conduct imposed an unreasonable risk of injury on the plaintiff.").

200. See, e.g., *Grynberg Prod. Corp. v. British Gas, P.L.C.*, 817 F. Supp. 1338, 1350–51 (E.D. Tex. 1993) (mem.); *Frances T.*, 723 P.2d at 581 ("[A] director could inflict injuries upon others and then escape liability behind the shield of his or her representative character, even though the corporation might be insolvent or irresponsible."); Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 361 (2001) (arguing that the imposition of tort liability on directors serves justice and fairness objectives).

201. See Glynn, *supra* note 66, at 396–415; Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148–49 (1980) (suggesting that directors of publicly traded corporations should be vicariously liable for misrepresentations as to the legal and financial status of the company and in cases of claims by involuntary creditors, as "such a rule would minimize the information costs that owners would face in monitoring each other's wealth, would reduce creditors' transaction costs in enforcing claims, and would focus incentives to adopt cost-justified avoidance precautions on that body of persons"); see also Thompson, *supra* note 180, at 27–28, 40–41 (explaining that liability for shareholder-managers can be extended if appropriate consideration is given to possible over-deterrence). Professor Kraakman has also suggested that managerial liability for debts of the company may be useful in certain contexts, namely in order to improve compliance. See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984). In a later article, however, he and Professor Hansmann dismiss the idea of holding directors or controlling officers vicariously liable on efficiency grounds. See Hansmann & Kraakman, *supra* note 180, at 1928–29. Hansmann and Kraakman conclude that where insurance is unavailable, "imposing personal liability for the firm's entire tort losses on its managers would create a powerful incentive to overinvest in safety measures or, what is more likely, to resign." *Id.* at 1929.

202. Glynn, *supra* note 66, at 396–415. By "highest-ranking officer," Glynn refers to a firm's highest-named officer (for example the CEO or corporate president) or any other officer who exercises ultimate executive authority over certain firm activities (for example a CFO or division head) at the time the tortious activity occurs. See *id.* at 397. Directors acting only in their oversight and decision-making capacities and lower-level managers or employees would not be included in the proposed liability regime. *Id.*

203. *Id.* at 398–400.

204. *Id.* at 400.

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retained capital; having indemnification agreements with the firm or its shareholders and; obtaining additional compensation and insurance coverage.²⁰⁵ Thus, Glynn bases his model on the idea that the highest-ranking officer is an “initial risk bear[er]” who passes on any liability to other, “ultimate” loss bearers.²⁰⁶

However, in view of the host of problems associated with directors' and officers' personal liability discussed in Part IV, it is difficult to justify holding directors, officers, or other corporate agents personally liable for their own tortious acts committed in the scope of employment, let alone holding them liable for torts committed by other corporate agents. In fact, a variety of factors all support limitations on personal liability including: the distinction between internal and external duties, the existence of the corporation as a separate legal entity, the idea of aligning corporate and tort law liability standards, the notion of directors and officers as the corporation's alter ego, and the need to attribute the risk of doing business to the corporation.

Returning for the moment to Professor Glynn's model, it is hard to legitimize why, as a default rule, a liability regime should force an officer to risk all of his personal assets and expose him to unlimited liability for corporate torts.²⁰⁷ As a practical matter, even if the officer is able to spread the cost for compensating tort victims to the corporation, shareholders, or an insurer, he can still be a defendant in one or multiple lawsuits against him personally potentially for years to come, even after having left the firm. Worse still, under the model, the officer bears the full risk of the insolvency (or unwillingness to pay) of those who have agreed to indemnify or insure him.²⁰⁸ Hence, in most cases, it is preferable to allocate the initial liability risk to the corporation, alleviating the officer of potentially harsh consequences and leaving it up to internal corporate mechanisms to prevent or reduce corporate torts and misconduct by employees.

Moreover, one commentator has recently made a convincing case that the economic justifications for limited liability for shareholders apply by analogy with equal force to directors.²⁰⁹ For the most part, scholars think of limited shareholders' liability to be economically efficient. By reducing

205. *Id.* at 401, 404.

206. *Id.* at 403–04.

207. Glynn admits that high-ranking officers, under his model, may face significant personal liability. He contends, however, that this residual risk does not render the model inefficient and points to high-ranking officers' superior ability to reduce and spread risks. *Id.* at 404–05.

208. See JAMES A. FANTO, DIRECTORS' AND OFFICERS' LIABILITY § 8:4.1 (2d ed., Release No. 4, Oct. 2009) (discussing problems in indemnification coverage). See also *infra* Part IV.C (discussing the shortcomings of indemnification and D&O insurance).

209. See Grantham, *supra* note 199.

the risk for shareholders, the aggregation of capital is facilitated, thereby encouraging investments in risky, but lucrative ventures.²¹⁰ In addition, limited liability reduces shareholders' need to and costs of monitoring their investment or investment portfolios.²¹¹

By analogy, these reasons also apply to directors and officers. Providing directors and officers with limited liability facilitates the aggregation of "human capital" by helping to recruit well-qualified directors and officers. It also encourages them to invest in riskier, but lucrative projects, and leads to reduced monitoring costs for shareholders.²¹² Consequently, limited liability considerations should apply to directors and officers as well and should represent an additional element in the analysis of the rules governing directors' and officers' tort liability.²¹³

The case for extending limited liability to directors and officers is, from an efficiency standpoint, also supported by an economic analysis of vicarious tort liability. Law and economics theory suggests that in many cases it is inefficient to attribute tort liability to the agent and that instead the principal should bear the liability costs arising out of torts committed in the scope of the agent's employment.²¹⁴ Scholars have argued that a system of exclusive liability for the principal,²¹⁵ such as a corporation,

210. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 97 (1985) (explaining that "increased availability of funds for projects with positive net values is the real benefit of limited liability").

211. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 425 (7th ed. 2007); Easterbrook & Fischel, *supra* note 208, at 94–98 (1985). Paul Halpern and his co-authors find that a limited liability regime is most efficient in cases of large, widely held companies, whereas they argue that liability should extend to shareholders in closely held companies. Halpern et al., *supra* note 201, at 148–49; see also Glynn, *supra* note 66, at 369–76 (outlining potential social costs of limited liability, casting doubt upon the doctrine's efficiency).

212. See Grantham, *supra* note 199, at 19–22.

213. To be sure, the basic theoretical framework that informs contemporary American tort law is already concerned with the foreseeable risks and benefits associated with conduct. See, e.g., RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL HARM (Tentative Draft No. 1, 2001) § 3 cmt. e (discussing the "risk-benefit test" for negligence). Yet, in the corporate context, these considerations do not necessarily result in the provision of adequate protections for directors and officers. Moreover, in the case of the breach of internal duties, see *supra* Part III.A, the risk-benefit balancing approach should be addressed at the level of the corporation as the potential tortfeasor, since directors and officers owe no duty to third parties in such cases and the issue of negligence on their part should not have to be considered at all.

214. See generally Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982) (examining shifting costs between enterprise, agent, and victim); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984) (exploring the efficiency rationale of vicarious liability).

215. Even though classic vicarious liability results in joint and several liability of the principal and the agent, law and economics scholars normally base their analysis on the assumption that a vicarious liability regime in fact results in the exclusive liability of the principal. See Arlen & Carney, *supra* note 15, at 704 (identifying the methodology as

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enhances loss prevention, helps to internalize costs, and facilitates efficient risk allocation.²¹⁶

The classic loss-prevention argument is that an agent may not be in a position to fully compensate a third party for harm caused by his tortious acts. Thus, an agent will not likely use the optimal amount of care because he may be under deterred (because his lack of solvency prevents him from having to compensate the injured party in full) or over deterred (because his personal wealth may be wiped out in case of a judgment against him.)²¹⁷ In any case, it is necessary to make the principal liable for the agent's torts, in order to induce the principal—who is thought to be able to fully compensate the tort victims—to make sure the agent uses the amount of care and preventive measures that are commensurate to the potential harm.²¹⁸

Law and economics theory also suggests that, in order to achieve an optimal volume of production, goods and services have to reflect their true cost to society.²¹⁹ Thus, prices of goods and services should also internalize the liability risks associated with their production.²²⁰ However, cost internalization can only be achieved if the corporation is liable for the torts of its agents.²²¹ Otherwise, such cost could be externalized.²²² Even if we assume that, in the absence of its own liability, the corporation would indemnify its agent for any costs incurred by him, the amounts paid would be lower than the full cost of damages if the agent is not solvent enough to provide full compensation to the tort victim.²²³

commonly used by enterprise liability scholars).

216. See *infra* notes 217–227 and accompanying text.

217. See Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 567 n.9 (1988).

218. Under these circumstances, the investments in loss-prevention will be equal to the amount of potential damages, which is efficient. See, e.g., POSNER, *supra* note 211, at 188; STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 233 (2004); Jennifer H. Arlen & Bentley W. Mcleod, *Beyond Master-Servant: A Critique of Vicarious Liability*, in *EXPLORING TORT LAW* 111–40 (M. Stuart Madden, ed., 2005) (arguing that the scope of vicarious liability should be extended); Kornhauser, *supra* note 214, at 1362; Sykes, *supra* note 214, at 1246. The loss-prevention case is probably weaker when we deal with directors and officers as agents since the corporation arguably cannot exercise the same degree of control over them as it could in the case of lower-level employees.

219. See, e.g., Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 505 (1961) (“[T]he most desirable system of loss distribution under a strict resource-allocation theory is one in which the prices of goods accurately reflect their full cost to society.”).

220. See *id.* at 509 (explaining that economic efficiency requires producers of goods or services to weigh potential liability against potential profit in determining the quantity and price of goods or services produced).

221. See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 172–73 (1987).

222. See *id.*

223. See Sykes, *supra* note 217, at 567.

The principle of loss distribution provides another reason why tort law should allocate liability only to the principal, but not to the agent.²²⁴ Utilitarian and economic theory contend that the corporation, not its agents, are the most appropriate and efficient bearers of liability risks.²²⁵ A corporation can distribute liability costs more efficiently than an individual agent can, as it is in a position to distribute the burden among its shareholders, employees, and customers.²²⁶ In addition, the corporation will be able to insure its liability risks at a cheaper rate than its agents in their individual capacities.²²⁷

In sum, efficiency considerations support the extension of limited liability to directors' and officers' liability for torts. These reasons seem particularly convincing in the context of their liability for supervision and management. The potential damages to third parties in this area can amount to large sums and directors and officers (who may well be wealthy individuals) represent an attractive target for plaintiffs. A heightened real or perceived liability exposure, however, adds to an inefficiently high level of risk aversion on the part of the directors and officers. In case of their actual liability, the additional, unfortunate effects of unlimited liability could potentially include a lack of cost internalization on the part of the corporation and attribution of liability to inefficient risk bearers.

D. Misalignment of Costs and Benefits

Finally, holding directors and officers liable for supervision and management failures touches upon the problem of the alignment of costs (or risks) and benefits. Personal liability for acts undertaken in the official role as director or officer, which consist in great part of supervision and management, shifts the risk of doing business away from the corporation to the directors and officers. As a result, an insolvent or otherwise judgment-

224. See P. S. ATIYAH, *VICARIOUS LIABILITY IN THE LAW OF TORTS* 27 (1967). The potential benefits of loss-distribution are generally undisputed. In contrast, however, commentators have expressed doubts as to whether vicarious liability is actually capable of enhancing internalization of costs and loss-prevention. See *id.* at 25, 27; Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739, 1756 (1996).

225. For the utilitarian perspective, see ATIYAH, *supra* note 224, at 22 (arguing that unlike the majority of the population, employers were well situated to pay for tort damages); Young B. Smith, *Frolic and Detour*, 23 COLUM. L. REV. 444, 456-63 (1923) (contending that distributing losses that are part of the course of industry is more socially expedient than passing off the loss to a few); Harold Laski, *The Basis of Vicarious Liability*, 26 YALE L.J. 105, 112 (1916) (emphasizing vicarious liability as the best social distribution of profit and loss). For a discussion of loss distribution from an efficiency standpoint, see *Fruit v. Schreiner*, 502 P.2d 133, 141 (Ala. 1972).

226. See Sykes, *supra* note 214, at 1235-36.

227. ATIYAH, *supra* note 224, at 25-26.

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proof corporation can potentially externalize some of its liability costs to its agents.

The problem of cost internalization has, as already discussed, received considerable attention in the context of law and economics analysis.²²⁸ However, the idea of cost benefit alignment has also long been a fixture in traditional vicarious liability theory where it serves as probably the most universal justification of why a principal should be liable for the acts of his agents. Under this approach, the principal bears the risks related to doing business and by dividing labor by utilizing agents.²²⁹ As Judge Friendly explained in *Ira S. Bushey & Sons, Inc. v. United States*,²³⁰ an enterprise should not only bear the benefit, but also the typical costs flowing from its activities.²³¹

This idea can be expanded upon by finding that it is the corporation alone—but not the agent, director or officer who is acting in furtherance of the corporation's business—that should bear the liability or risk of doing business. Under this rationale, the corporation should always bear the full cost of its business, and costs should not be shifted towards individuals by making them personally liable for their acts undertaken as agents of the corporation.

In one narrow area of the law, the idea of curbing the liability exposure of directors and officers acting for the benefit of their corporations has already manifested itself. Courts have developed the defense of “economic justification” to shield directors and officers from claims alleging liability for tortious interference with another's contract.²³² In the absence of malice or illegality, the defense immunizes these corporate actors from claims of tortious interference as long as they act in the interest of or for the economic benefit of the company.²³³

Applied to supervision and management claims, courts could employ the theory of “economic justification” to shield directors and officers from

228. See *supra* Part III.C.2.

229. See *Petro-Tech, Inc. v. W. Co. of N. Am.*, 824 F.2d 1349, 1358 (3d Cir. 1987) (explaining the theory of respondeat superior as under section 219 of the Restatement (Second) of Agency by stating that “it would be unjust to permit an employer to gain from the intelligent cooperation of others without being responsible for the mistakes, the errors of judgment and the frailties of those working under his direction and for his benefit”); see also Gregory C. Keating, *The Idea of Fairness in the Law of Enterprise Liability*, 95 MICH. L. REV. 1266, 1329 (1997).

230. 398 F.2d 167 (2d Cir. 1968).

231. *Id.* at 171.

232. See *Foster v. Churchill*, 665 N.E.2d 153, 156–57 (N.Y. 1996).

233. *Id.* at 157–58. See also *9 to 5 Fashions, Inc. v. Spurney*, 538 So. 2d 228, 232 (La. 1989) (recognizing immunity for negligent contractual interference and even intentional interference when acting for the corporation's benefit); *Wampler v. Palmerton*, 439 P.2d 601, 607 (Or. 1968) (declining to extend liability for interference with contract where the defendants acted to benefit the corporation).

personal liability. Supervisory and managerial duties are almost always carried out in the interests of the corporation and any third-party claims flowing from harm caused by supervisory or managerial acts could be defended on the grounds of economic justification. Moreover, tortious interference with contractual claims and claims alleging failures in supervision and management share some key characteristics. Both typically involve allegations that certain acts *within* the corporation led to the plaintiff's harm. Both scenarios normally involve purely indirect harm to the injured party and both include acts representing duties that the actor owed solely to the corporation. Thus, the parallels between these two sets of claims suggest that the defense of economic justification may be equally apt for claims related to supervision and monitoring.

IV. THE EMERGING MODEL

Given that a duty-based inquiry into assessing directors' and officers' liability in tort for supervision and management offers a superior approach than other methods of ascertaining liability, and in light of the problems associated with holding directors and officers liable for supervision and management failures, the current approaches to assessing directors' and officers' liability toward third parties should be revised. This Part details a proposal to reform the current rules for holding directors and officers liable in tort. In short, the proposed model advocates that directors' and officers' tort liability should be limited by distinguishing between internal and external duties and by using strict requirements with regards to the state of mind necessary to hold directors and officers liable. Finally, the last section of this Part will address the model's potential shortcomings.

A. Liability for Intentional Breaches of Internal Duties

Under the proposed model, directors and officers would not be liable for breaches of internal duties owed exclusively to the corporation.²³⁴ Chief among these internal duties are the duties that directors and officers owe to the corporation in the context of supervision and management.²³⁵ Thus, liability for the breach of an internal duty will normally fall only on the

234. This is an approach already adhered to by certain courts. *See, e.g.,* *Donnelly v. Handy*, 415 So. 2d 478, 480 (La. Ct. App. 1982).

235. *See supra* Part III.A.1. In accordance with the modern rule, in defining whether a duty is internal or external, no distinction should be made between a director's or officer's acts and omissions. *See supra* note 38 and accompanying text. However, the scope of the duty owed to the corporation can vary depending on whether the defendant is an inside or outside director. *See supra* note 77. Specifically, courts should take into account that there can be information asymmetries between inside and outside directors.

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corporation through its own direct liability, but not on the individuals who were entrusted with supervisory or management tasks.

Failing to impose liability on directors and officers for breach of internal duties is justified, in part, by the fundamental tort law principle that “without duty, there is no liability.”²³⁶ Moreover, directors and officers discharge their supervisory and managerial tasks within the corporate framework, which offers them considerable protections or even insulates them from liability. These added protections should be extended to tort-based claims.

The idea of limiting liability for breach of internal duty is also buttressed by the notion of the corporate shield, which, as explored above, can be extended to protect directors and officers from tort liability.²³⁷ Moreover, holding directors and officers liable for supervision and management failures goes against efforts to align the costs and benefits of corporate activity. Directors and officers act for the benefit of the corporation and its shareholders. Consequently, the corporation (and, thus, ultimately the shareholders) should bear the liability risks associated with the conduct of corporate agents.²³⁸

Nonetheless, excluding personal liability for directors and officers for their breaches of internal duties can raise issues of moral hazard.²³⁹ Relieved of personal liability risks, directors and officers may increasingly engage in misconduct. To mitigate moral hazard problems, directors and officers should continue to remain liable for the intentional infliction of harm and fraudulent conduct, even if such harm is the result of the breach of an internal duty.²⁴⁰ Thus, a third party would still be able to sue

236. *Robillard v. Asahi Chem. Indus. Co.*, 695 A.2d 1087, 1094 (Conn. Super. Ct. 1995).

237. *See supra* Part III.C.

238. *See supra* Part III.D.

239. The problem has often been discussed in the context of insurance which can create “moral hazard” by reducing an insured party’s incentives to avoid risks which are covered by its insurance. *See, e.g.*, KENNETH J. ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* 212–19 (1971); George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 *YALE L.J.* 1521, 1547 (1987).

240. Some courts have already expressed the idea of holding directors and officers liable only for intentional or willful conduct. *See, e.g.*, *Inter-Ocean Cas. Co. v. Lecony Smokeless Fuel Co.*, 17 S.E.2d 51, 53–54 (W. Va. 1941) (holding that officers and directors will not be liable for simple nonfeasance of a duty to the corporation or mismanagement in the absence of an active intent to deceive or defraud creditors); *Webb v. Cash*, 250 P. 1, 6 (Wyo. 1926) (providing that state bank directors are not liable for failure to know of the critical condition of their bank in absence of deliberate or reckless conduct). Other courts have advocated that liability should be contingent on at least a showing of gross negligence. *See Myers & Chapman, Inc. v. Thomas G. Evans, Inc.*, 374 S.E.2d 385, 393–94 (N.C. 1988) (arguing that a director must be grossly negligent in order to be held personally liable for failure to adequately supervise a subordinate); *Preston-Thomas Constr., Inc. v. Cent. Leasing Corp.*, 518 P.2d 1125, 1127 (Okla. Civ. App. 1973) (“The law will not permit an officer or director to escape personal responsibility for his corporation’s intentional malfeasance by preserving a state of ignorance through a gross or willful neglect of

directors and officers where, for example, the latter either consciously failed to prevent torts by employees or is guilty of intentional acts of mismanagement. In addition, the corporation, if held liable, will be able to take recourse against the director or officer, but only insofar as his conduct—which caused the corporation to incur liability—constituted an intentional tort.²⁴¹

This deviation from an effort to limit personal liability is justified because, apart from moral hazard considerations, directors and officers, like any other person,²⁴² remain under a duty not to commit intentional torts. Under obligations imposed by corporate law, directors and officers are also not relieved from liability for consciously engaging in illegal conduct or otherwise acting in bad faith.²⁴³ Thus, the alignment of corporate and tort law standards is not disturbed by this exception. Moreover, intentional misconduct can be easily and inexpensively prevented by the potential defendants themselves, simply by refraining from such misconduct.

B. Liability for Grossly Negligent Breaches of External Duties

In addition to limiting the personal liability of directors and officers for supervision, management, and other potential breaches of their internal duties, a number of grounds explored in this Article also support limiting directors' and officers' tort liability for breaches of external duties. Granted, agency law does not normally provide any protections to an agent who breaches a duty owed to third parties, despite the fact that he acted for the benefit of and under the directions of someone else.²⁴⁴ However, the traditional concepts of alter ego, where a director or officer can be treated as the embodiment of the corporation, and alignment of costs and benefits,

duties.”). Of course, a persuasive argument can be made that intentional harm will render any underlying duty into an external duty, i.e., that there is no such thing as an intentional breach of internal duties.

241. In general, and absent statutory or contractual provisions which hold otherwise, principals are entitled to be indemnified by their agents to the extent that the principal is required to pay damages owing to acts within the scope of the agent's employment. RESTATEMENT (SECOND) OF AGENCY § 401 cmt. d (1958); see, e.g., *Wilshire Oil Co. of Tex. v. Riffe*, 409 F.2d 1277, 1283–84 (10th Cir. 1969) (holding that officers could be liable to their former corporate employer for expenses and judgments incurred by the corporation if the expense was a result of their individual wrongdoing).

242. See *Blystra v. Fiber Tech Group, Inc.*, 407 F. Supp. 2d 636, 647 (D.N.J. 2005) (equating the duty of directors and officers to the duty of every person to avoid committing intentional torts).

243. See generally Leo E. Strine et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010) (examining the role of good faith in corporate law and, specifically, in the director liability framework).

244. See *supra* note 17. However, there are cases that stand for the proposition that directors and officers should not be liable for simple negligence, see *supra* note 240, or that a corporate agent cannot be held liable for torts committed in the scope of his employment, see *supra* note 19.

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where the corporation is to bear the profits and losses of its business, both support limiting directors' and officers' liability even in cases of breaches of external duties. Moreover, economic analysis of traditional vicarious liability theory also suggests that—notwithstanding any distinction between the nature of the duties in question—holding only the corporation liable, can, in many instances, result in efficiency gains when compared to a regime of individual liability.²⁴⁵

Taken together, these traditional concepts and economic theory tend to justify limiting directors' and officers' liability even when they owe a personal duty to the injured party. In addition, while this Article's focus is on directors and officers, it also appears that the considerations that support added protections from personal tort liability could be further extended to other corporate agents, such as non-managerial employees. These agents, like directors and officers, are an embodiment of their principal, the corporation. Thus, in principle, only the corporation should bear the liability costs arising out of the activities its agents undertake on its behalf. Indeed, the idea of shielding corporate agents from personal liability for breaches of external duties is not utopian, as demonstrated by such rules in certain foreign jurisdictions.²⁴⁶

Nevertheless, this Article will not go so far as to suggest that directors' and officers' tort liability for breaches of external duties should be completely abolished or limited to intentional conduct. The breach of an external duty is different from the breach of an internal duty and, accordingly, their treatment should not be equivalent. External duty breaches normally involve the infliction of direct harm, which results from the breach of a duty that the defendant personally owed to the injured party.²⁴⁷ It is therefore not justified to shield directors and officers from third-party liability for breaches of external duties to the same degree as for breaches of internal duties. In addition, as already discussed in the context

245. See *supra* Part III.C.2.

246. For example, under the law of some Scandinavian countries, liability for torts committed by employees is “channeled” to the principal and plaintiffs can only sue the latter, but not the employees personally. See Christian von Bar, et al., *Vicarious Liability*, in *TOWARDS A EUROPEAN CIVIL CODE* 431, 436 n.29 (2d ed. 1998) (identifying Denmark, Finland, and Sweden as countries that follow this model). Also, other countries, such as France and the Netherlands, have rules in place which shield corporate agents from personal liability for torts in the absence of at least gross negligence. See, Cass. ass. plén. [highest court of ordinary jurisdiction], Feb. 25 2000, J.C.P. 2000, II, 10295, rapport Kessous, note Billiau, D. 2000 (Fr.); BW 6:170 para. 3 (Neth.). In addition, the Dutch Supreme Court has recently held that a corporate director will only be liable in tort if he made a sufficiently “serious mistake.” See Bastiaan F. Assink, *Secondary Director Liability*, *THE DEFINING TENSION*, February 12, 2009, <http://www.thedefiningtension.com/2009/02/no7-secondary-director-liability.html>.

247. See *supra* Part III.A.1.

of internal duties, any liability regime for breaches of external duties has to factor in possible moral hazard problems.

Consequently, in an effort to balance the need to limit liability for breaches of external duties against moral hazard considerations and traditional rules of tort and agency law, courts should apply a lower liability standard to tort cases involving directors and officers. Hence, the proposed model suggests that directors and officers should only be liable for breaches of external duties that involve at least gross negligence.²⁴⁸ In cases involving only simple negligence by directors and officers, the third party may still seek recourse against the corporation, whose vicarious liability for its agents' negligence would remain unchanged.²⁴⁹ This approach increases existing protections provided to directors and officers while, at the same time, preserving strong personal motivations to act carefully when engaged in actions which may cause direct harm to third parties.

C. *Limitations*

The proposed liability model appears to be vulnerable to two main criticisms. First, restricting directors and officers liability to instances of intentional conduct (for internal duties) and grossly negligent conduct (for external duties) may take away important incentives to act in a responsible manner.²⁵⁰ Second, critics could argue that limiting directors' and officers' liability vis-à-vis involuntary tort creditors is inherently unfair as it diminishes the asset pool available for plaintiffs to recover from and could result in tort victims remaining uncompensated.

As to the first problem of moral hazard, restricting directors' and officers' liability for torts in the manner as suggested here would arguably not, by itself, be a reason for encouraging misconduct. Even with a reduced threat of personal liability, alternative monitoring devices such as market pressures and non-legal consequences for bad acts may deter directors and officers. For instance, directors and officers could face loss of employment, reputational risks, and restrictions on future employment.²⁵¹ Furthermore, conduct by agents can be, to some extent, self-controlled. Behavioral theories suggest that a corporate actor would

248. Admittedly, the distinction between simple and gross negligence (and other degrees of culpability) remains murky. Nevertheless, using a gross negligence standard is useful in that it signals that a heightened degree of culpability is necessary to impose liability.

249. In order to preserve the director's or officer's increased protection for cases of external duty breaches, the corporation—if held vicariously liable—could only ask to be indemnified in cases of gross negligence. *See supra* note 241.

250. This is the problem of moral hazard. *See supra* note 239 and accompanying text.

251. *See, e.g.,* BAINBRIDGE, *supra* note 179, at 171–73 (discussing directors' reputational concerns).

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obey his duties out of his own volition and not only out of fear of incurring pecuniary liability.²⁵² In addition, directors and officers have incentives not to pursue activities that could create vicarious tort liability for the corporation as financial harm to the corporation can negatively impact their own compensation and ultimately threaten their jobs and livelihood.²⁵³ Moreover, shifting the risk of doing business from the corporation to its directors and officers is not the appropriate solution for ensuring that they will not engage in wrongdoing.

With regard to the second criticism, a lack of fairness for potential tort victims, it is admittedly true that limiting individual corporate actors' liability increases the chances that a third party may remain uncompensated. If the corporation is insolvent and corporate agents cannot be the subject of any claims, the tort creditor may not have sufficient recourse. Of course, considerable sympathy is aroused for anyone injured by tortious conduct and, from the tort victim's perspective, limiting personal liability could be seen as unfair.²⁵⁴ Still, tort victims' interest in compensation must be weighed against the factors which speak in favor of limiting directors' and officers' personal liability, and the proposal here concludes that, under most circumstances, the interests in limiting directors' and officers' liability outweigh the potential unfairness that tort victims could face.

Finally, critics may point out that directors and officers are already protected from personal liability for third-party tort claims by indemnification and insurance and that, therefore, any changes in this area of the law are moot.²⁵⁵ However, as a practical matter, plaintiffs are most

252. See Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 *BUFF. L. REV.* 811, 857-77 (2003) (discussing the application of altruistic theory in corporate governance); see also Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 *COLUM. L. REV.* 1253, 1291 (1999) ("In the loyalty area, social norms increase efficiency by supplementing the roles of liability rules and monitoring and bonding systems.").

253. See Bainbridge, *supra* note 180, at 533-34; Glynn, *supra* note 66, at 381.

254. In general, limited shareholder liability has been described as immoral and as encouraging an immoral attitude in commercial dealings. See Ben Pettet, *Limited Liability—A Principle for the 21st Century?*, in 48 *CURRENT LEGAL PROBLEMS 1995*, PART 2: *COLLECTED PAPERS* 125, 142-43, 154 (1995).

255. All states have indemnification statutes in place, usually in their corporate laws. See FANTO, *supra* note 208, at § 8:3.1. For example, in suits brought by third parties, Delaware law allows a corporation to indemnify directors and officers for expenses, judgments, fines, and amounts paid in settlement, provided that the director or officer acted in good faith. See *DEL. CODE. ANN.* tit. 8, § 145(b). A corporation must indemnify a director or officer who "has been successful on the merits or otherwise," without regard to whether the director or officer acted in good faith or not. See *id.* § 145(c); *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87, 95 (2d Cir. 1996). In addition to indemnification pursuant to corporate law statutes, a director or officer may have additional indemnification rights under the corporation's charter or bylaws, or under a contractual agreement with the corporation. See FANTO, *supra* note 208, at § 8:3.2. Moreover, corporations can purchase D&O insurance to protect directors and officers from

likely to proceed against directors and officers personally when the corporation is insolvent or bankrupt.²⁵⁶ In these instances, indemnification agreements between directors and officers and the corporation can be worthless. Similarly, experience shows that the protection offered by insurance—if insurance has been purchased at all—is incomplete. Insurance policies contain numerous important exclusions,²⁵⁷ D&O insurers may be reluctant to pay or can become insolvent, and, moreover, the bankruptcy of a corporation can remove some or all of the insurance protections for directors and officers.²⁵⁸ In addition, insurance is capped,²⁵⁹ and disputes between current and former directors (and officers) may lead to disagreement over the proper allocation and distribution of D&O insurance proceeds.²⁶⁰

Finally, even if directors and officers—for example due to insurance coverage or indemnification—are not obliged to make payments themselves, this cannot *per se* serve as an argument against a change in the rules governing directors' and officers' liability, where such changes are supported by doctrinal considerations and tend to produce more efficient overall outcomes.

CONCLUSION

Directors' and officers' liability under corporate and securities laws continues to be a hotly debated subject. Interestingly, however, their liability toward non-shareholder third parties under common tort law and statutory provisions has generated relatively modest scholarly interest.

losses arising out of “wrongful acts” for which they are not indemnified (referred to as “Side A” coverage). See FANTO, *supra* note 208, at § 8:4; Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1801–06 (2007).

256. See FANTO, *supra* note 208, at § 8:4.4[C]. The stay provision of the Bankruptcy Code does generally not apply to solvent directors and officers as codefendants of a debtor corporation. See *supra* note 6.

257. See Dan A. Bailey, *D&O Policy Commentary*, in D&O LIABILITY & INSURANCE IN A SARBANES-OXLEY WORLD 163, 176–85 (2003) (discussing typical D&O policy exclusions). For example, liability under the responsible corporate officer doctrine is not necessarily covered by D&O liability insurance. See *supra* note 195. Two prominent cases, *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319, 347 (S.D.N.Y. 2005) and *In re Enron Corp. Sec. Derivative & “ERISA” Litig.*, 391 F. Supp. 2d 541, 569–70 (S.D. Tex. 2005), very clearly expose some of the weaknesses of D&O insurance.

258. See FANTO, *supra* note 208, at § 8:4.4[I]; Anthony K. Greene, *New Risks for Directors and Officers*, in D&O LIABILITY & INSURANCE IN A SARBANES-OXLEY WORLD 247, 252 (2003) (noting that D&O insurers denied insurance coverage to Enron due to financial misstatements).

259. See Greene, *supra* note 258, at 253 (delineating coverage plans and corresponding policy limits).

260. A recent high-profile example is the dispute over the proceeds of AIG's primary D&O insurance policy. See Kevin LaCroix, *Interpleader: AIG, Greenberg and D&O Policy Proceeds*, D&O DIARY, May 12, 2009, <http://www.dandodiary.com/2009/05/articles/d-o-insurance/interpleader-aig-greenberg-and-do-policy-proceeds>.

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Meanwhile, courts have developed various approaches for imposing on directors and officers tort liability for supervision, management, and other conduct. The case law in this area is plentiful and often difficult to reconcile²⁶¹ and trends such as liability for “controlling persons” have increased directors’ and officers’ liability exposure.

This Article has explored different ideas in support of restricting directors’ and officers’ liability for supervision and management. What has emerged, in the end, is a proposal for a novel model of corporate liability, centered around the nature of directors’ and officers’ duties and with a focus on the individual’s state of mind. Thus, for breaches of internal duties, including supervision and management, directors and officers should not incur personal liability, except where they act with the intention to inflict harm upon third parties. Conversely, directors and officers should remain liable for breaches of external duties, provided, however, that their conduct was at least grossly negligent.

Most importantly, at its core, this Article and the proposed model are based on the belief that modern tort law should not treat individual corporate actors in the same manner as any other individual. Instead, it should account for the fact that directors and officers act on behalf of and for the benefit of the corporation. As a result, to preserve the corporate shield, liability standards in tort law should not conflate the standards imposed on individuals with those imposed on directors and officers.

261. This unsatisfying state of matters is reflected in the title of an article by two California practitioners. See Allen B. Grodsky & B. Alexander Moghaddam, *Making It Personal*, L.A. LAW., Dec. 2004, at 24.