Is Owning Stock an Abnormally Dangerous Activity? Shareholder Limited Liability in Tort

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Academics have contested the merits of shareholder limited liability for decades.[1] As part of this discussion, some of limited liability's critics cite tort law to conclude that corporate law erroneously shields shareholders from personal liability.[2] They contend that tort law would not so egregiously allow shareholders to externalize costs onto tort victims who have no control over the type of legal entity that injures them.[3] But tort law does not follow this logic. It does not examine the type of the defendant merely to search for the deepest pockets to find liability.[4] Moreover, corporate officers and directors—not shareholders—control the ability for the corporation to pay its debts as they come due (corporate capitalization).[5]

Given these academic conclusions' inconsistency with tort law and corporate governance, this Article reconsiders whether shareholders would benefit from limited liability in tort and finds that tort law, like the current corporate law regime, would uphold shareholder limited liability. Shareholders would not be strictly liable for corporate torts. Rather, they would only be liable to the extent they failed to use reasonable care. This Article reaches this conclusion by examining a well-known Judge Richard Posner decision which emphasized that strict liability for abnormally dangerous activities is only relevant to activities, not

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1 *See, e.g.*, Paddy Ireland, Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility, 34 CAMBRIDGE J. OF ECON. 837 (2010); Stephanie Blankenburg et al., Limited Liability and the Modern Corporation in Theory and in Practice, 34 CAMBRIDGE J. OF ECON. 821 (2010).

2 *See* discussion *infra* Part II.

3 *See* discussion *infra* Part II.

4 *See* discussion *infra* Part III.

5 *See* discussion *infra* Parts II, IV.

substances.[6] With respect to shareholder personal liability for corporate torts, the relevant activity is corporate capitalization, not the shareholder contribution of equity capital and related limited control rights (the substance). Because a corporation's officers and directors can prevent undercapitalization through the use of due care, negligence—not strict liability—is the appropriate regime for shareholder personal liability.[7] Corporate law understands this intuition by only allowing such liability through the use of piercing the corporate veil, which resembles negligence. Though tort law's conclusions regarding shareholder liability align with corporate law, tort law independently still provides a valuable insight into understanding the hazy doctrine of piercing the corporate veil and corporate purpose more generally. This Article ends with some recommendations for further research.

I. INTRODUCTION

The proper scope of the corporation remains a vigorous debate. Often at its crux is shareholder limited liability. Numerous academics note with suspicion this unique aspect of corporate law which allows shareholders to avoid personal liability to a corporation's creditors.[8] Generally only liable up to their paid-in-capital, though able to reap potentially unlimited gains, shareholders purportedly push corporations to take on excessive risk.[9] These risks are not merely financial (in the form of excess leverage), but even *legal*: if a corporation breaks the law, it is only the corporation—not the shareholders—that pays the penalty or fine.[10] These perverse incentives, coupled with the prevailing belief under shareholder primacy theory that corporate managers have the sole obligation to maximize shareholder profits,[11] have led some scholars to conclude that the corporation is best described in human terms as a psychopath— irresponsible, manipulative, asocial, and unable to feel remorse.[12] Others conclude corporate limited liability

6 Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1174 (7th Cir. 1990).

7 This Article assumes that there has been no election under applicable law for shareholder management of the corporation. See, e.g., DEL. CODE ANN. tit. 8 § 351 (West 2020).

8 *See, e.g.*, David Ciepley, *Beyond Public and Private: Toward a Political Theory of the Corporation*, 107 AM. POL. SCI. REV. 139, 148 (2013).

9 *See* Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1247 (2002).

10 *See* Ciepley, *supra* note 8, at 148.

11 *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

12 *See* JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER 56–57 (2004).

is merely a historical accident, which tort law would not tolerate.[13] Academics claim the defects of the corporation create real consequences for the economy at large and undermine economic growth.[14] With the rise of the shareholder primacy theory, limited liability now poses an even greater risk as corporate management own more stock and stock options.[15] In the eyes of such critics, limited liability is simply a mistake which should be eliminated.[16]

Other academics strenuously contest these conclusions about the corporation and shareholder limited liability.[17] Judge Frank H. Easterbrook and Professor Daniel R. Fischel, for example, defend limited liability noting that it decreases the need to monitor investments and other shareholders, promotes free transfer of shares, allows for market pricing and diversification, and optimizes investment decisions.[18]

So, should shareholders retain limited liability? Or should they instead be unlimitedly personally liable for corporate torts? Would eliminating limited liability deter the purported corporate incentive to externalize costs by encouraging shareholders to monitor corporate activities more closely? Or are shareholders, despite their limited control rights, just too powerless and anonymous to influence managerial decisions?

One need not look further than to the absence of examples of corporations failing to compensate their tort victims to reach the conclusion that limited liability is a phantom problem.[19] Where are all of the uncompensated tort victims if limited liability creates such inexorable danger? The reality is that shareholders are largely unable to use the corporation to externalize costs onto creditors. Other corporate stakeholders, like insurers,

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13 *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) [hereinafter *Toward Unlimited Shareholder Liability for Corporate Torts*]; Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 431–32 (2000) [hereinafter *The Essential Role of Organizational Law*].

14 *See The Essential Role of Organizational Law*, *supra* note 13.

15 *See* Ciepley, *supra* note 8, at 148; *see also* William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV., Sept. 2014, at 3, 4–5.

16 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1880.

17 *See, e.g.*, Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows* (Eur. Corp. Governance Inst., Working Paper No. 342/2017, 2018), http://ssrn.com/abstract_id=2895161.

18 Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94–96 (1985).

19 *See* Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 421 (1992) ("[T]he evidence is hardly overwhelming that limited liability causes a significant increase in a corporation's willingness to engage in risky behavior.").

debtholders and officers and directors, have incentives aligned with any potential tort creditor (that is, a contingent creditor) and are successfully able to police the corporation to such contingent creditor's benefit. This is exactly why share prices in California did not increase after the introduction of limited liability.[20] If cost externalization were possible, those share prices would have increased.

Though concerns about limited liability may only exist in the ivory tower, most critiques of shareholder personal liability have relied on the practical difficulties of shareholder personal liability.[21] None, however, has focused on the theoretical—the truth that tort law actually supports the current corporate law limited liability regime.

Tort law would not hold shareholders personally liable for corporate torts. This becomes obvious when analogizing personal shareholder liability to tort law's strict liability for abnormally hazardous activities. Such strict liability attaches only to activities, not substances. The relevant activity for shareholder personal liability is corporate capitalization, not the contribution of equity capital and limited associated shareholder control rights. A corporation's officers and directors, not its shareholders, control corporate capitalization. Because when officers and directors use due care, corporations are almost certainly able to pay debts—including contingent debts like compensation to potential tort creditors—as they come due, a shareholder would not be strictly liable for corporate torts. A shareholder only becomes liable to the extent he or she controls corporate capitalization and then fails to use reasonable care in doing so. As this Article explains in detail, that is merely to say that a shareholder only faces personal liability when courts pierce the corporate veil—the current corporate law regime.

This Article reaches these conclusions by analyzing whether shareholders would be personally liable in tort law instead of corporate law. Part II discusses recent developments in academic understanding of the corporation and how they should affect the interpretation of prior academic work. Part III introduces strict liability, discusses its relevance to shareholders, and analogizes a well-known strict liability case to the question of shareholder liability for corporate torts. Part IV compares this Article's findings to the current state of corporate law for shareholder

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20 *See* Mark I. Weinstein, *Limited Liability in California 1928–31: It's the Lawyers*, 7 AM. L. & ECON. REV. 439, 440 (2005).

21 See generally Grundfest, *supra* note 19.

liability for corporate torts. Part V reconsiders corporate purpose in light of tort law. In conclusion, Part VI provides some final remarks and suggestions of further relevant research.

II. SHAREHOLDER PERSONAL LIABILITY IN TORT TO THE CORPORATION'S TORT CREDITORS

The most prominent argument for imposing shareholder personal liability for corporate torts proposes liability based on two justifications. One centers around the fact that it is inefficient and unfair as a matter of policy for tort victims to have no control over the type of legal entity that harms. The other supports shareholder liability for corporate torts given their ownership of the corporation and control of its capitalization. These justifications, however, are misguided. First, tortious liability depends not merely on finding the deepest pockets—because a corporation may or may not have the requisite capital—but, rather, on providing proper incentives to control outcomes. Moreover, shareholders neither truly own the corporation nor sufficiently control corporate capitalization to justify their personal liability for corporate acts.

A. The Prominent Argument in Tort Favoring Shareholder Personal Liability

Professors Henry Hansmann and Reinier Kraakman provide a prominent argument for shareholder personal liability.[22] They even posture that corporate limited liability likely is a vestige of a historical accident in the development of corporate law.[23] They argue that it is simply too crude a check. Instead, they advance the theory that, under tort law, shareholders should be personally liable because they are in the best position to avoid and insure against costs.[24]

Their principal rationale is that tort law would find shareholder limited liability inefficient.[25] Limited liability allows shareholders to externalize costs onto society.[26] Unlike corporate contract creditors, a corporation's tort creditors are unable, *ex ante*, to negotiate for shareholder limited liability.[27] Shareholders take advantage of this putative loophole by undercapitalizing.[28]

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22 *The Essential Role of Organizational Law*, *supra* note 13, at 431.
23 *Id.*
24 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1918.
25 *See The Essential Role of Organizational Law*, *supra* note 13, at 431.
26 *Id.*
27 *Id.*
28 *Id.*

In doing so, shareholders not only leave tort creditors uncompensated when the corporation is insolvent, but also succeed in shielding their own personal assets from those creditors.[29] Involuntary creditors are therefore defenseless.[30] Because these involuntary creditors have no control over the type of legal entity that injures them, Hansmann and Kraakman note that it is inefficient, not to mention unfair, to allow the amount a tort victim recovers to depend merely upon the legal form of the organization responsible for their injury.[31] Shareholders benefitting, for instance, "from intentional dumping of toxic wastes, from marketing hazardous products without warnings, or from exposing employees without their knowledge and consent to working conditions known by the firm to pose substantial health risks, should not be able to avoid the resulting costs simply by limiting the capitalization of their firm."[32] Abolishing limited liability would, in their view, force shareholders to face full liability for potential tort losses. Share prices and the cost of equity would decrease and increase, respectively, to account for such liability.[33]

Hansmann and Kraakman suggest replacing shareholder limited liability with a *pro rata* personal liability regime.[34] They caution that, in abolishing limited liability, courts would still need to determine which costs are efficiently and equitably borne by a corporation and its shareholders but note that shareholders would, in at least certain circumstances, be in the best position to avoid and insure against cost.[35] In those situations, the authors submit that shareholders should be personally liable for corporate torts.[36]

The academic literature critiquing Hansmann and Kraakman's proposal have done so largely on practical grounds.[37] Professor Joseph A. Grundfest, for example, contends that capital market participants are sufficiently agile to arbitrage away personal liability for equity ownership.[38] In Grundfest's view, shareholders would first rearrange themselves so that personal

29 *Id.* at 393–94.
30 *Id.*
31 *See The Essential Role of Organizational Law*, *supra* note 13, at 431–32.
32 *Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1917.
33 *See id.* at 1907.
34 *See id.* at 1917–19.
35 *See id.*
36 *See id.*
37 *See, e.g.*, Grundfest, *supra* note 19, at 388 n.3; Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 387 (1992).
38 *See id.* at 390.

assets would be unreachable under a proportionate personal liability regime.[39] Shareholders with personal wealth would only purchase shares of companies with little risk of personal asset exposure.[40] Only persons with little or no personal assets or, more likely, little to no asset exposure, would purchase the equity of riskier firms.[41] Furthermore, were proportionate personal liability implemented at the state level, constitutional limitations on personal jurisdiction would not allow jurisdiction over passive shareholders.[42] Even a statute at the federal level would face problems obtaining personal jurisdiction over foreign defendants given the principles of international comity.[43]

Constitutional problems are compounded by the logistics of collection. Domestic shareholders not party to the original action would attempt to relitigate.[44] The value of shares owned by many shareholders is less than the costs to proceed with an action against them.[45] Enforcing a judgment against a foreign shareholder—or even *identifying* that shareholder—could be impossible.[46] Individuals with personal assets seeking exposure to "riskier" equities could also avoid owning shares altogether through derivatives, which would achieve returns similar to those attained through ownership of traditional shares with limited liability.[47]

Corporations themselves would respond adversely to proportionate personal liability. They would issue less equity in favor of debt and equity-like instruments, like convertible bonds and warrants—all of which lack proportionate personal liability of shares.[48] Intermediaries like investment banks could create structured products to allow the ultimate beneficiaries equity like returns without the concomitant proportionate liability.[49] No amount of regulation would adequately prevent all of these parties from ultimately protecting the shareholder-like party from personal proportionate liability.[50]

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39 *See id.* at 387.
40 *See id.*
41 *See id.*
42 *See id.* at 395.
43 *See id.* at 397.
44 *Id.*
45 *Id.*
46 *Id.* at 398.
47 *Id.* at 402.
48 *Id.* at 409.
49 *Id.* at 408.
50 *Id.* at 416.

Though these critiques merit their own consideration, they do not consider Hansmann and Kraakman's underlying theoretical claim that tort law would not allow shareholder limited liability.[51] This Article considers Hansmann and Kraakman's assumptions about both the corporation and tort law with respect to shareholder limited liability.

B. The Prominent Basis in Tort Favoring Shareholder Personal Liability Relies on Flawed Assumptions about both Tort Law and the Corporation

Hansmann and Kraakman's argument that tort law fails to explain limited liability relies on questionable assumptions about both tort law and the corporation. First, the Restatement of Torts prefers allocative rather than distributive liability.[52] In other words, whether a defendant should be liable in tort—and under which liability regime—should depend on which regime will most effectively control outcomes, not who has the deepest pockets.[53] In determining shareholder personal liability for corporate torts, however, Hansmann and Kraakman argue in favor of liability based on the latter.[54] They contend as a matter of policy that shareholders ought to be personally liable merely because the tort plaintiff has no control over the wealth of the tortfeasor corporation.[55] Indeed, they extrapolate from their position that the amount of damages for shareholder liability should depend on the structure of the particular corporate defendant; shareholders who are corporate parents of a wholly-owned subsidiary should bear greater costs for the subsidiary's torts than shareholders who are natural persons.[56] These rationales are inconsistent with tort doctrine. Tort liability, and the extent of damages for such liability, is not simply based on whether the defendant's shareholders are artificial or natural persons—who could, in theory, be equally as wealthy and equally as culpable.[57]

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51 *See generally, Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13.

52 *See, e.g.*, Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1174, 1181 (7th Cir. 1990).

53 *Id.* at 1181–82.

54 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1916–17.

55 *Id.*

56 *See Toward Unlimited Shareholder Liability for Corporate Torts*, supra note 13, at 1917.

57 *Cf.* Easterbrook & Fischel, *supra* note 18, at 110–11 (arguing courts may be more likely to pierce the veil when the shareholder is a parent corporation of a corporate subsidiary, but only because such a corporate shareholder is more likely to attempt to externalize costs, not because such a corporate shareholder is wealthier than a natural shareholder).

Indeed, judgment-proof natural persons often leave victims uncompensated, yet tort law does not strain to find some nexus to a wealthier party. Rather, as even Hansmann and Kraakman admit, liability should be based on the action in question and which actors are in the best position to avoid the relevant accidents.[58] Hansmann and Kraakman offer no argument for why shareholders are corporate actors in the best position to avoid accidents.

They likely fail to do so because they reach their conclusions based on two related yet problematic theories of the corporation, which incorrectly describe the shareholder's relationship with the corporation. Under Property ("Principal/Agent") Theory, corporations are merely aggregations of shareholders' property.[59] Shareholders are therefore owners of the corporation and principals for whom the corporate officers and directors serve as agents.[60] This statement, however, is more applicable to a partnership where partners function as the sole owners and central contracting parties of the partnership.[61] A modern business corporation, however, meaningfully departs from this construct for two reasons. First, corporate assets and liabilities belong not to shareholders, but to the corporation as a distinct entity. Second, shareholders are not principals to whom the directors owe duties as agents.[62]

Shareholders are not owners because they merely own corporate stock—a contractual obligation between the shareholder and the corporation.[63] This contractual obligation entitles shareholders to own neither the corporation nor its assets.[64] For example, owning Apple shares does not entitle a shareholder to take iPads from an Apple store.[65] The corporation itself, rather, owns itself and its assets. A shareholder's rights with respect to a corporation are therefore not dissimilar to other parties in contract with the corporation, such as debtholders.[66]

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58 *Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1916.

59 LYNN STOUT, *The Economic Nature of The Corporation*, *in* THE OXFORD HANDBOOK OF LAW AND ECONOMICS 337, 345 (Francesco Parisi ed., 2017).

60 *Id.* at 345.

61 David Ciepley, *Member Corporations, Property Corporations, and Constitutional Rights*, 11 LAW & ETHICS OF HUM. RTS. 31, 43 (2017).

62 *Id.*

63 *Id.* at 45.

64 *Id.*

65 LYNN STOUT, THE SHAREHOLDER VALUE MYTH 37 (2012).

66 *Id.* at 37–38.

Shareholders are also not principals to whom the directors owe duties as their agents.[67] A principal must "exist[] prior to, and independent of, the hiring of the agent."[68] In a corporation, however, it is only *after* the firm's incorporator appoints a board of directors to act on the corporation's behalf that the corporation has the power and ability to issue stock to shareholders.[69] Only the corporation and its board exist prior to the alleged principal —the shareholders.[70] Moreover, although shareholders have certain limited rights (to vote on certain corporate matters, sue the corporation, and sell shares), they do not control the corporation's behavior, a key component of agency.[71] To the contrary, the board of directors controls corporate actions.[72]

Hansmann and Kraakman, however, in the vein of Property Theory, treat shareholders as owners and principals of the corporation, and the corporate directors as the shareholders' agents.[73] They note the identical concern that both owners and shareholders may use the corporate form to limit their personal liability.[74] One can only harmonize these statements by arguing that they are in fact, identical—that shareholders are the owners of the corporation. Moreover, their argument suggests shareholder control such that they would, in fact, be principals. They contend that shareholders—not the corporation through its officers and directors—control the corporation's capitalization.[75] Only by ignoring the role of corporate directors are they able to conclude that corporations themselves should have no liability at all if shareholders have insufficient control over corporate managers of the corporation.[76] The board of directors and officers control corporate capitalization, not shareholders.[77] Shareholders

67 *Id.* at 42.

68 *Id.*

69 *Id.*

70 *Id.*

71 *Id.*; *see* RESTATEMENT (THIRD) OF AGENCY § 3.04 (AM. L. INST. 2006).

72 ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 114 (4th ed., 2013).

73 *See The Essential Role of Organizational Law*, *supra* note 13, at 429.

74 *Compare The Essential Role of Organizational Law, supra* note 13, at 431 ("[O]rganizational law is essential to shield owners of an organization from personal liability."), *with Toward Unlimited Shareholder Liability for Corporate Torts, supra* note 13, at 1917 ("Shareholders . . . should not be able to avoid . . . costs simply by limiting the capitalization of their firm.").

75 *See Toward Unlimited Shareholder Liability for Corporate Torts, supra* note 13, at 1919.

76 *Id.* at 1908.

77 It is true that, subsequent to the issuance of shares, shareholders must normally vote on changes to a corporation's bylaws. *See* DEL. CODE ANN. tit. 8, § 109(a) (West 2020). The bylaws include the number of authorized shares a corporation may issue. *See* § 109(b) (Westlaw). One could argue that shareholders could derivatively control corporate

do not decide when to issue (or buy back) equity or debt, issue dividends, when and how to insure for contingent liabilities, or manage the corporation's working capital.[78] These actions fall exclusively within the purview of the corporation's board of directors and its management.[79] Only if one views the shareholder as a principal, can one suggest actual shareholder control of corporate assets—this is simply not the case in the corporation.[80] Finally, Hansmann and Kraakman's remedies also suggest a belief in shareholders as principals.[81] For example, they argue in favor of shareholder personal liability based on the corporation's management's awareness that a plaintiff will file a tort claim against the corporation.[82] Such vicarious liability ought only be imputed to the employee's principal, which is the corporation itself, not the shareholder.

A second theory on which Hansmann and Kraakman may rely is Aggregate Theory, which treats the corporation as an aggregation of natural persons.[83] Under this view, corporations are merely "composed" of human beings: "a form of organization used by human beings to achieve desired ends."[84] Aggregate Theory, similar to Property Theory, crucially fails to distinguish

capitalization by rejecting a corporation's request for an increase in the number of authorized shares so that the corporation could raise equity to provide for adequate corporate capitalization. Such shareholder "control" of capitalization, however, is better described as within the vein of *ultra vires* (that is, notice to shareholders of the scope of the corporation) as opposed to actual control of corporate capitalization. *See* PINTO, *supra* note 72. Indeed, several examples show how such alleged corporate control is illusory. First, articles of incorporation may permit directors to adopt, amend, or repeal bylaws without shareholder approval. *See* § 141 (Westlaw). Second, the corporation (through the board of directors) does not need shareholder approval to purchase insurance (such as a credit default swap) which could achieve results similar to an equity issuance. *See id.* Finally, a corporation's board of directors does not require shareholder approval of a reverse stock split. *See* U.S. SEC. & EXCH. COMM'N, *Reverse Stock Splits*, (Aug. 16, 2020, 1:24 PM), https://www.investor.gov/introduction-investing/investing-basics/glossary/reverse-stock-splits [http://perma.cc/XDT2-PS4V]. A reverse stock split would reduce the number of shares outstanding, thereby allowing the corporation to issue sufficient equity for adequate capitalization. *See id.* Despite shareholders' limited control rights, corporate capitalization ultimately remains in hands of the board of directors, not shareholders.

78 *See* DEL. CODE ANN. tit. 8, §§ 141(c), 351 (West 2020).

79 *Id.* § 141(c).

80 True, such statements may not apply to controlling shareholders, who may derivatively control a corporation and as such are subject to fiduciary duties. *See* Iman Anabtawi & Lynn Stout, *Fiduciary Duties For Activist Shareholders*, 60 STAN. L. REV. 1255, 1269–70 (2008). I discuss strict liability for controlling shareholders in a subsequent section.

81 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1897.

82 *See id.*

83 *See* STOUT, *supra* note 59, at 344–45.

84 Burwell v. Hobby Lobby Stores, Inc., 573 U.S. 682, 706 (2014).

the corporate form, with its separate personality, from partnerships or proprietorships.[85]

In the vein of Aggregate Theory, Hansmann and Kraakman treat the shareholders and the corporation as identical. They note separate yet equivalent concerns that shareholders, corporations, and owners should not be able to use limited liability to externalize costs.[86] These statements, when viewed together, ignore that the corporation is an entity distinct from its shareholders. Consider, for example, Hansmann and Kraakman's concern regarding a corporation's ability to limit its liability.[87] They do not suggest apprehension that a corporation can limit liability through the creation of a subsidiary.[88] Rather, they express a concern that a corporation can limit its liabilities through its own incorporation.[89] Corporations cannot limit liability differently than any natural person. Because a corporation owns itself and is its own principal, it will be vicariously liable for its agents' actions in tort.[90] Hansmann and Kraakman can only argue such corporate use of limited liability by treating the shareholder and corporation as identical.

Although Hansmann and Kraakman's basis for shareholder personal liability may be flawed, this does not necessarily indicate that their conclusions are wrong. Tort law may still suggest shareholder personal liability for corporate torts. The relevant question, as even Hansmann and Kraakman acknowledge, is whether shareholders have enough control over corporate managers to have a significant effect on the probability

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85 *See* STOUT, *supra* note 59, at 345.

86 *Compare The Essential Role of Organizational Law*, *supra* note 13, at 431 ("[O]rganizational law is essential to shield *owners* of an organization from personal liability.") (emphasis added), *with Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1917 ("*Shareholders* . . . should not be able to avoid . . . costs simply by limiting the capitalization of their firm.") (emphasis added), *and Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1919 ("[A]llowing *corporations* to avoid tort liability through the simple device of limited liability seems . . . highly suspect.") (emphasis added).

87 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1919.

88 *See id.*

89 *Id.* ("We do not want to exaggerate our faith in tort law as a means of controlling behavior. It is a very rough and costly mechanism. But it usefully discourages the most severe forms of opportunistic cost externalization. Moreover, if any class of actors is likely to respond rationally to the deterrence incentives created by tort law, it is corporations and their shareholders. Similarly, if tort law is to have any role in shifting risks to low-cost insurers, then using it to shift risks to the equity market makes sense. *Consequently, allowing corporations to avoid tort liability through the simple device of limited liability seems, at the very least, highly suspect*.") (emphasis added).

90 RESTATEMENT (THIRD) OF AGENCY §§ 2.04, 3.04 (AM. L. INST. 2006).

that the corporation will commit a tort.[91] Although shareholders are neither principals nor owners of the corporation, and are distinct from the corporation itself, they do retain some control through their capacity to vote, sue, and sell shares.[92] What amount of control, if any, should render them liable in tort for corporate malfeasance?

III. RECONSIDERING SHAREHOLDER LIMITED LIABILITY IN TORT: INTUITION AND APPLICABILITY OF STRICT LIABILITY AND ABNORMALLY DANGEROUS ACTIVITIES

A. Strict Liability Provides an Appropriate Intuition for Shareholder Personal Liability for Corporate Torts

To answer the question of how tort law would deal with shareholder liability for corporate torts, we must first consider which relevant accident control regime—strict liability or negligence—would apply. Strict liability finds liability regardless of the tortfeasor's use of due care.[93] As such, it is meant to control care and activity levels, whereas negligence—the typical liability regime in tort—controls only care levels.[94] Care level refers to the level of care one can adopt when engaging in an activity, such as driving at a reasonable speed with reasonable caution.[95] Activity level, on the other hand, refers to the extent someone engages in an activity *at all*, such as how often one drives a car.[96] Although negligence and strict liability have the same effect on care levels—both incent an actor to take additional precaution to the extent that it is less than the expected costs of an accident—only a strict liability regime encourages an actor not to engage in the activity at all.[97]

Professor George Fletcher argues that strict liability rules should apply when an actor exposes another to non-reciprocal risks: an asymmetry where an actor's conduct endangers another, but the latter's conduct does not endanger the former.[98]

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91 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1907–08.

92 *See generally*, Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 L. & CONTEMP. PROBS. 215, 216–17 (1999).

93 *See Liability*, BLACK'S LAW DICTIONARY (11th ed. 2019).

94 Keith N. Hylton, *Property Rules, Liability Rules, and Immunity: An Application to Cyberspace*, 87 B.U. L. REV. 1, 10 (2007).

95 *Id.*

96 *Id.*

97 *Id.* at 10–11.

98 *Cf.* PINTO, *supra* note 72, at 250.

Strict liability is alternatively, though similarly, described through a ratio test where the "costs externalized by an activity, even when conducted with reasonable care, substantially exceed the benefits externalized by that activity."[99] For example, two motorists driving past each other present one another with approximately equal risks. This is not the case, however, when a motorist drives past a blasting site and blasts shatter the motorist's window. The use of explosives presents the motorist with a non-reciprocal risk (and costs externalized far greater than benefits externalized), for which the defendant in charge of the blasting site ought to be strictly liable. Strict liability therefore incentivizes blasters not only to consider using proper care in blasting but also to decide where to blast (i.e., away from cars), and to explore the feasibility of using safer substitutes (like a wrecking ball).[100]

Strict liability offers an appropriate analogy to limited liability. First, by focusing on the activity level, it addresses academics' concern that incorporation permits shareholders to externalize too many costs onto society in relation to benefits. Strict liability would hold shareholders liable despite their exercise of reasonable care, thereby discouraging owning stock in a way that mere negligence cannot: incenting shareholders to consider other organizational forms where capital providers are personally liable (i.e., partnerships and proprietorships), or proceed as shareholders (with personal liability) at their own peril.[101]

Second, limited liability presents a non-reciprocal risk. Those persons with whom the corporation comes into contact (including both voluntary and involuntary creditors) are likely natural persons, with an assumed basic level of economic worth and earning capacity. The corporation, on the other hand, is by definition artificial and can easily exist without any such basic assumptions. The corporation could be a shell—completely worthless. Robert Monks aptly noted, "[t]he great problem of having corporate citizens is that they aren't like the rest of us."[102] "As Baron Thurlow in England is supposed to have said, 'they have no soul to save, and they have no body to incarcerate.'"[103] Perhaps this is Hansmann and Kraakman's actual concern

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99 Hylton, *supra* note 94, at 12.

100 *See* Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1174, 1177 (7th Cir. 1990); *see also* Hylton, *supra* note 94, at 12.

101 JOHN L. DIAMOND ET AL., UNDERSTANDING TORTS 249 (5th ed. 2013).

102 THE CORPORATION (Big Picture Media Corp. 2003).

103 *Id.*

regarding the corporate form: not that a corporation may be impecunious per se (because, judgment-proof natural persons similarly may leave uncompensated tort victims), but rather that their artificiality makes them (and their ownership of assets) distinctly unlike natural persons. Strict liability would address this non-reciprocal risk to society.

Third, strict liability still retains a proximate cause analysis.[104] Proximate cause is an additional limitation on a defendant's culpability which requires that the defendant be liable only if their conduct is not only the actual cause of the plaintiff's injury, but is also the cause as a matter of policy.[105] Proximate cause attempts to delimit a defendant's liability to the kind of harm the possibility of which makes the activity abnormally dangerous.[106] For example, in a famous strict liability case, a blasting operator who used reasonable care was not strictly liable to a plaintiff mink rancher whose mother mink trampled its kittens upon the vibrations resulting from the blasting.[107] Proximate cause precluded liability given that the plaintiff's mink ranching was an extraordinary and unusual use of his land.[108]

Conventional proximate cause analysis is consistent with shareholder personal liability. Even Hansmann and Kraakman would limit shareholder liability for corporate torts to tort damages that the corporation's assets cannot cover.[109] Inability to pay tort creditors due to corporate undercapitalization is exactly the type of harm that makes the corporate form dangerous. Specifically, the corporation and its shareholders would use limited liability to externalize costs onto others.

One particular Restatement form of strict liability—liability for abnormally dangerous activities—provides an intuitive framework for owning stock.[110] Although liability for abnormally

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104 *See* RESTATEMENT (SECOND) OF TORTS § 519(2) (AM. LAW INST. 1977).

105 DIAMOND ET AL., *supra* note 101, at 267.

106 RESTATEMENT (SECOND) OF TORTS § 519(2) (AM. LAW INST. 1977).

107 Foster v. Preston Mill Co., 268 P.2d 645, 646 (Wash. 1954).

108 *Id.* at 648.

109 *See Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1891–92.

110 *See* RESTATEMENT (SECOND) OF TORTS §§ 519–20 (AM. LAW. INST. 1977). True, one could argue that one should analyze shareholder strict liability under an analogy to the possession of livestock under the Restatement. How different, after all, is a psychopath from a wild animal? *Cf id.* § 504. My argument that owning stock is not an abnormally dangerous activity, however, would also—just as forcefully—indicate that owning stock under an analogy to livestock is not an activity for which a shareholder is strictly liable. Possessors of livestock are notably not strictly liable if the damages are "brought about by the . . . reckless or negligent conduct of a third person." *Id.* § 504(3)(c). A corporation's

dangerous activities attaches to ownership of tangible property or physical activity,[111] Hansmann and Kraakman argue that "limited liability encourages excessive entry and aggregate overinvestment in unusually hazardous industries"[112]—the exact same types of activities to which strict liability often attaches. Moreover, it is not unthinkable that a court could consider applying theories of strict liability to the ownership of intangible assets—academics have analyzed the possible application of tort doctrine, including strict liability, to such intangible ventures as the provision of Internet services.[113] Given these similarities, would shareholders be liable under this Restatement test? Should owning stock be considered an abnormally dangerous activity (or sufficiently analogous to it)?[114]

B. Is Owning Stock an Abnormally Dangerous Activity? Introducing the Restatement and *Indiana Harbor Belt*

Given the seeming compatibility between theories of strict liability and owning stock, it is worth exploring whether merely owning stock is sufficiently analogous to be considered an abnormally dangerous activity. The Restatement (Second) of Torts (Sections 519–20) gives a guideline for determining whether an activity is abnormally dangerous[115]:

> One who carries on an abnormally dangerous activity is subject to liability for harm to the person, land or chattels of another resulting from the activity, although he has exercised the utmost care to prevent the harm. . . .
>
> . . . .
>
> . . . In determining whether an activity is abnormally dangerous, the following factors are to be considered:

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officers and directors are such third persons.

111 *See id.* § 520 cmt. f (noting that an activity must create a danger of physical harm in order to be abnormally dangerous).

112 *Toward Unlimited Shareholder Liability for Corporate Torts*, *supra* note 13, at 1883.

113 *See*, *e.g.*, Hylton, *supra* note 94, at 16, 28 (analogizing digital code to physical property in order to apply tort doctrine, including strict liability, to Internet-borne injuries).

114 Arguably shareholding's creation of physical harm is too derivative or too intangible to consider it an abnormally dangerous activity. *See* RESTATEMENT (SECOND) OF TORTS § 520 cmt. f (AM. LAW INST. 1977). However, as will become apparent, strict liability for abnormally dangerous activities crucially relies on a distinction between substances and activities. Such a distinction provides a strong analogy to the question of holding shareholders strictly liable for corporate torts and the conclusion that a negligence regime would apply.

115 *See id.* §§ 519–520.

> (a) existence of a high degree of risk of some harm to the person, land or chattels of others;
>
> (b) likelihood that the harm that results from it will be great;
>
> (c) inability to eliminate the risk by the exercise of reasonable care;
>
> (d) extent to which the activity is not a matter of common usage;
>
> (e) inappropriateness of the activity to the place where it is carried on; and
>
> (f) extent to which its value to the community is outweighed by its dangerous attributes.[116]

The Section 520 factors on their face seem to offer mixed guidance.[117] Some support the proposition that owning stock is abnormally dangerous.[118] With regard to factor (c), shareholders (in such capacity) generally cannot eliminate the risk of undercapitalization by the exercise of reasonable care given that the board of directors and other delegated managerial officers control corporate activities, including decisions concerning corporate capitalization.[119] Regarding factors (a) and (b), as mentioned, incorporation incentivizes investment in unusually hazardous industries which are inherently risky and potentially expose the corporation to massive tort liability for physical harm.[120] Moreover (although perhaps not an issue of locality), under factor (e), through analogy, incorporation is clearly not always the appropriate legal entity through which a business firm should conduct its activities.[121] In certain circumstances, such as when a corporation may be undercapitalized,[122] a partnership or proprietorship is clearly preferable in order to limit cost externalization.

Two factors are also unclear. Consider whether corporations are of common usage under factor (d). The Restatement comment on 'common usage' distinguishes between "automobiles [which] have come into such general use that their operation is a matter of common usage," and "the operation of a tank or any other motor vehicle of such size and weight as to be unusually difficult

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116 *Id.*

117 *See id.*

118 *See id.*

119 RESTATEMENT (SECOND) OF TORTS § 520(c).

120 *See* RESTATEMENT (SECOND) OF TORTS § 520(a–b); *see also The Essential Role of Organizational Law*, *supra* note 13, at 423, 431–32.

121 RESTATEMENT (SECOND) OF TORTS § 520(e).

122 A corporation is undercapitalized when it fails "in good faith [to] put at the risk of the business unincumbered [sic] capital reasonably adequate for its prospective liabilities." HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 303 (rev. ed. 1946).

to control safely, or to be likely to damage the ground over which it is driven," which is "abnormally dangerous."[123] Should corporations be considered cars or tanks? One the one hand, if the corporation in fact behaves irresponsibility toward society at large, is it not akin to a tank on the road? On the other, corporations are ubiquitous—undercapitalized corporations arguably less so. Finally, with regards to factor (f), as discussed in the introduction, it is unclear whether incorporation (and therefore limited liability) provides the community more value than the danger it presents. The Section 520 factors on their face are either indeterminate or favor strict liability. Moreover, Section 519 requires that the defendant be in control of the alleged abnormally dangerous activity.[124] Do shareholders, through their limited control rights, have sufficient control over the corporation to be held strictly liable for corporate activity?

Indiana Harbor Belt Railroad Company v. American Cyanamid Co., a well-known strict liability case decided by Judge Richard Posner, helps shed light on both the Section 520 factors and Section 519 control.[125] In *Indiana Harbor Belt*, a chemical manufacturer, American Cyanamid Company ("Cyanamid"), leased a railroad tank car, filled it with a hazardous chemical (acrylonitrile), and shipped it.[126] A Missouri Pacific Railroad train picked up the car.[127] Later, at a small switching line within the Chicago metropolitan area, the switching line employees noticed fluid gushing from the bottom outlet of the car. [128] The Department of Environmental Protection subsequently ordered the switching line to take decontamination measures.[129] The switching line sued Cyanamid for the costs of those measures.[130]

The plaintiff argued that the transportation of acrylonitrile in bulk through the Chicago metropolitan area was an abnormally dangerous activity for which the manufacturer should be held strictly liable.[131] The plaintiff argued that the defendant, as an ordinary manufacturer and passive shipper of hazardous materials, should be incented through strict liability to explore alternative shipping routes through less populated

123 RESTATEMENT (SECOND) OF TORTS § 520 cmt. i (AM. LAW INST. 1977).

124 *See* RESTATEMENT (SECOND) OF TORTS § 519.

125 Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1174 (7th Cir. 1990).

126 *Id.* at 1175 (describing acrylonitrile as "flammable at temperatures above 30 degrees Fahrenheit, highly toxic, and possibly carcinogenic.").

127 *Id.*

128 *Id.*

129 *Id.*

130 *Id.*

131 *Id.* at 1181.

areas.[132] According to the plaintiff's argument, introducing a hazardous chemical into a stream of commerce passing through the Chicago metropolitan area was enough to hold the manufacturer strictly liable.[133]

Judge Posner rejected this argument and, in doing so, elaborated on the Section 520 factors, in particular Section 520(c) (the inability to eliminate the risk by the exercise of reasonable care).[134] In his view, *someone* could have prevented the accident through the use of reasonable care:

> No one suggests . . . that the leak in this case was caused by the *inherent* properties of acrylonitrile. It was caused by carelessness—whether that of the [railroad tank car lessor] in failing to maintain or inspect the car properly, or that of Cyanamid in failing to maintain or inspect it, or that of the Missouri Pacific when it had custody of the car, or that of the switching line itself in failing to notice the ruptured lid, or some combination of these possible failures of care. Accidents that are due to a lack of care can be prevented by taking care; and when a lack of care can . . . be shown in court, such accidents are adequately deterred by the threat of liability for negligence.[135]

Judge Posner held that because proper care of tank cars made the danger of an acrylonitrile spill negligible, there was no compelling reason to move to a regime of strict liability.[136]

Judge Posner also helps us understand the bounds of Section 519 control. Throughout his opinion, Judge Posner emphasized that the relevant activity for determining liability was not the mere manufacture of a dangerous chemical, but rather its transportation.[137] To this end, he contrasted the defendant Cyanamid, the manufacturer-shipper, with the acrylonitrile carrier.[138] Although manufacturer-shippers can, in theory, designate in the bill of lading a route of shipment, shippers cannot be expected to become "students of railroading in order to lay out the safest route by which to ship their goods."[139] They, as manufacturer-shipper, were not the relevant controlling actor best suited to determine whether to reroute hazardous chemicals. That actor was the chemical carrier:

> [U]ltrahazardousness or abnormal dangerousness is, in the contemplation of the law at least, a property not of substances, but of

132 *Id.*
133 *Id.* at 1175–80.
134 *Id.* at 1179.
135 *Id.*
136 *See id.*
137 *See id.* at 1181.
138 *Id.* at 1180.
139 *Id.*

> activities: not of acrylonitrile, but of the transportation of acrylonitrile by rail through populated areas. Natural gas is both flammable and poisonous, but the operation of a natural gas well is not an ultrahazardous activity. . . . [T]he manufacturer of a product is not considered to be engaged in an abnormally dangerous activity merely because the product becomes dangerous when it is handled or used in some way after it leaves his premises, even if the danger is foreseeable. . . . The relevant activity is transportation, not manufacturing and shipping.[140]

For these reasons, the manufacturer-shipper was held to be not strictly liable.[141]

Judge Posner went on to express skepticism that the imposition of strict liability would have actually changed the aggregate expected accident costs.[142] Even putting aside that rerouting would be prohibitively expensive—because new tracks would be needed to avoid metropolitan areas—it would require longer journeys over poorer quality tracks.[143] Though the cost of each individual accident may decrease, the probability of an accident may very well increase.[144]

Judge Posner did, in dicta, note that he could not exclude liability for the *Indiana Harbor Belt* defendant in certain hypothetical scenarios.[145] Were there a less hazardous chemical substitute (non-existent in this case), a manufacturer could be strictly liable for shipment.[146] Such an argument—relying on the inherent properties of acrylonitrile—would encourage the defendant to relocate the shipment or, more likely, reduce its scale by substitution.[147] This would be especially true in a jurisdiction that accepts the Restatement Section 521 view that because common carriers cannot refuse service to a shipper of a lawful commodity, they are exempt from strict liability for the carriage of abnormally dangerous materials.[148] Because of this exemption, the manufacturer is in a stronger relative position to consider whether to reroute its dangerous materials.[149] Moreover, Cyanamid's active participation in the chemical shipment by leasing and filling the tank car and contracting with the tank car

140 *Id.* at 1181 (citations omitted).
141 *See id.*
142 *See id.* at 1179.
143 *See id.* at 1180.
144 *See id.*
145 *See id.* at 1178.
146 *See id.* at 1181.
147 *See id.*
148 *Id.* at 1180.
149 *See id.*

lessee to maintain the tank car indicates that the shipper was sufficiently engaged in the relevant activity of transportation.[150] At the same time, however, Judge Posner noted this active participation may not necessarily indicate that strict liability ought to apply: active participation "imposed upon [Cyanamid] a duty of due care and by doing so brought into play a threat of negligence liability that, for all we know, may provide an adequate regime of accident control in the transportation of this particular chemical."[151]

C. Is Owning Stock an Abnormally Dangerous Activity? Applying the Restatement and *Indiana Harbor Belt*

Indiana Harbor Belt provides valuable insight into whether owning stock is an abnormally dangerous activity. First, *Indiana Harbor Belt* makes clear that factor 520(c) (inability to eliminate the risk by the exercise of reasonable care) refers not just to any individual actor, but rather to that actor in the context of others.[152] In the context of the corporation, there normally *are* actors who can, through the use of reasonable care, mitigate the threat of cost externalization. Those actors are not the corporation's shareholders, but rather its officers and directors. Officers and directors control corporate activities and, most relevant to shareholder personal liability, corporate capitalization.[153] Like the carriers in control of a manufacturer's dangerous chemicals, officers and directors control shareholders' capital. When officers and directors use proper care, the risk that a corporation undercapitalizes and thereby leaves its tort creditors uncompensated becomes negligible.

Judge Posner's comments on adequate control under Section 519 of the Restatement also shed light on the relevant activity necessary for the imposition of strict liability.[154] Just as the manufacture of a volatile chemical merely constitutes the substance and its transportation the relevant activity, in the case of a corporation, stock ownership is the substance and corporate capitalization the activity. The relevant activity in the context of shareholder limited liability is not whether shareholders have provided (manufactured) the substance (capital) to the

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150 *Id.* at 1181. Because the district court and plaintiff's counsel ignored any distinction between a passive and active shipper and merely argued liability based on being the former, the court considered the distinction waived. *Id.*

151 *Id.*

152 *See id.* at 1177; *see also* RESTATEMENT (SECOND) OF TORTS § 520.

153 *See* DEL. CODE ANN. tit. 8 §§ 141–142 (West 2020).

154 Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1177 (7th Cir. 1990).

corporation, but rather how the corporation has decided to deploy capital (including any shareholder capital contribution). Though the manufacturer-shipper has some limited and derivative control over shipment of its chemicals, it ultimately entrusts the carrier to transport those chemicals in a specific manner. Shareholders in such capacity almost identically have limited control rights over their capital contribution but entrust their capital with the corporation's officers and directors with the hope that they will deploy it and obtain an acceptable return on such capital.[155] Even though it may be *foreseeable* that corporate officers and directors would deploy shareholder capital in a way that is dangerous (e.g., by undercapitalizing and externalizing costs onto third parties), shareholders in such capacity do not sufficiently engage in the activity to be strictly liable. Recall that even the decision whether to incorporate a firm (as opposed to creating a partnership) is in the hands of the board of directors, not shareholders.[156] A corporation must be in existence before its shareholders are created.[157] Shareholders are simply the manufacturer-shippers; corporate officers and directors are the carriers.[158]

Judge Posner's concern that strict liability is not applicable to the activity of transportation because it would not result in the desired lowering of expected accident costs rings true here as well.[159] Judge Posner noted that rerouting would increase the length of the journey over poorer track.[160] Just as rerouting would increase the length of the journey, shareholder personal liability would increase the cost of capital for projects.[161] Because raising capital would become more difficult, corporations would be incentivized to attempt identical projects with less capital (i.e., undercapitalize). Just as rerouting may lead to the use of poorer tracks[162], shareholder personal liability may lead to the contribution of inferior capital. Because debtholders retain limited liability, debt would become more favorable than equity, leading to excessive corporate leverage. Relatedly, an adverse selection problem may arise: poorer investors with fewer personal assets to lose will be more likely to invest as shareholders. So even if shareholders are personally liable, they

155 *See generally* DEL. CODE ANN. tit. 8, ch. 1 (West 2020).
156 STOUT, *supra* note 65, at 42.
157 *Id.*
158 *Indiana Harbor Belt*, 916 F.2d at 1177–78.
159 *Id.*
160 *Id.* at 1180.
161 *Id.*
162 *Id.*

may not ultimately have the personal capital available to satisfy tort creditors. Ultimately, it is unlikely that there will be fewer uncompensated tort victims with the imposition of shareholder personal liability.[163]

Although Judge Posner does list in dicta some factors that may have made Cyanamid (the manufacturer-shipper) more likely to be held strictly liable[164], they are not relevant to stock ownership. For example, he mentions the difference between an active and passive shipper.[165] One could argue that controlling or activist shareholders should in this vein be strictly liable given that they have adequate control over the corporation and thereby become more like a chemical carrier. Again, the key question is whether negligence liability would prove an adequate regime of accident control. Ultimately, the corporation's officers and directors still may use due care so as to make such accidents (that is, undercapitalization resulting in the externalization of costs) negligible. Judge Posner also mentions the possibility of strict liability if there were a less dangerous substitute for acrylonitrile and if the carriers were not held strictly liable for carrying lawful goods.[166] Given that capital is fungible and that a corporation may reject certain capital in exchange for shares, an argument for shareholder strict liability based on the availability of less dangerous substitutes is not meaningfully applicable.[167] The clear conclusion from the Restatement and *Indiana Harbor Belt* is that shareholders in tort are not strictly liable when corporations undercapitalize.[168] Negligence—the use of

163 *See generally* Grundfest, *supra* note 19, *passim* (explaining that the imposition of personal liability onto shareholders is easily circumvented and will not have the intended effect of increasing the corporation's duty of care).

164 *See* 916 F.2d at 1180.

165 *Id.* at 1181.

166 *Id.* at 1180.

167 A situation where a shareholder could theoretically be strictly liable for his capital contribution would be if he had contributed not cash, but rather some sort of other asset with such illiquidity or volatility that it was ultimately worthless in the hands of the corporation directly leading to a corporation's undercapitalization. Consider, for example, an exotic derivative product with an active market before the financial crisis which after the crisis became worthless. True, holding such shareholders strictly liable may not be a feasible method of accident avoidance given that directors perhaps breach their duty of care by accepting such capital. Were directors, however, like common carriers—required to accept any type of legal capital for stock—there would be a strong argument for such shareholder strict liability in this limited hypothetical situation. Shareholders could easily avoid the accident (by contributing a liquid, low volatility asset like cash) and the corporation could not (by refusing to accept such capital contribution).

168 *See generally* Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1177 (7th Cir. 1990); RESTATEMENT (SECOND) OF TORTS §§ 519-520.

reasonable care—provides a sufficient regime under which to prevent corporate undercapitalization.

IV. CORPORATE LAW COMPARED

How does corporate law's treatment of shareholder liability differ from the treatment under tort law? Under corporate law, shareholders are generally not personally liable to a corporation's creditors beyond their capital investment in the corporation.[169] This privilege, however, is not absolute.[170] Shareholders may become personally liable for a corporation's liabilities (including to tort creditors) under the equitable doctrine of piercing the corporate veil.[171] Though piercing the corporate veil is a poorly understood and hazy doctrine,[172] creditors successfully do so in certain limited circumstances. First, in all instances, the shareholders exert a high degree of control over the corporation.[173] Second, in the context of a tort claim, courts examine two general categories to determine liability: respect for corporate formalities and corporate capitalization.[174] Courts generally require finding both to pierce the corporate veil.[175]

Corporate formalities, in turn, may be grouped into legal, economic, and operational formalities.[176] Legal formalities include whether to issue stock certificates, hold meetings, elect officers, and document loans and other transactions.[177] Economic formalities refer to whether shareholders intermix their personal affairs with the corporation, such as failing to maintain a separate bank account for the corporation.[178] Operational formalities refer to whether the corporation and shareholder share offices, employees, or otherwise seem to operate identically.[179] To avoid undercapitalization and denial of separate entity privileges, "shareholders should in good faith put at the

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169 *See, e.g*, Model Bus. Corp. Act § 6.22(b) (1985).

170 *See generally,* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

171 *Id.* at 1036.

172 *Id.* at 1036–37.

173 *See* Kinney Shoe Corp. v. Polan, 939 F.2d 209, 212 (4th Cir. 1991).

174 *See id.* When the creditor is a contract creditor, courts often ask whether the debtor misled the contract creditor regarding the corporation's capitalization. *See* Easterbrook & Fischel, *supra* note 18, at 112.

175 *See Kinney Shoe Corp.*, 939 F.2d at 212.

176 *See id.* at 211–12 (grouping the factors identified in *Laya v. Erin Homes, Inc.* into three overarching categories).

177 *See id.*

178 *See id.*

179 *See id.* at 211.

risk of the business unincumbered [sic] capital reasonably adequate for its prospective liabilities."[180]

Analysis of tort law's treatment of limited liability sheds light on the hazy doctrine of piercing the corporate veil. The elements present in piercing the corporate veil perform the same function as those of tortious negligence. In order for a plaintiff to recover in a negligence action, he must establish (1) that the defendant owed the plaintiff a duty, (2) that the defendant breached this duty by failing to use reasonable care, (3) which was the cause-in-fact and proximate cause of (4) plaintiff's losses, or damages.[181] When a shareholder fails to respect corporate formalities and controls the corporation , he *personally* has assumed a duty of care to corporate creditors both actual (i.e., in contract) and contingent (i.e., in tort).[182] When a shareholder further undercapitalizes his corporation, thereby leaving a corporate creditor uncompensated, he breaches this duty by failing to use reasonable care. Such undercapitalization (a properly capitalized corporation would have been able to compensate reasonably the creditor)—the cause-in-fact and proximate cause of the plaintiff's loss—results in shareholder personal liability to the plaintiff creditor for the resulting damages.

True, under this framework, reasonable capitalization would still, at times, leave tort creditors uncompensated. But other corporate creditors (such as debtholders) are frequently left uncompensated. Though contract creditors were able, *ex ante*, to negotiate and price corporate risk, there is no fundamental difference in the price of risk (i.e., the risk of externalized costs) when one negotiates for actual financial debt as compared to appropriately insuring for contingent debt including debt owed to any potential tort creditor. Insurance performs the same *ex ante* function of risk pricing as the contract negotiation. Moreover, tort creditors of non-corporate natural persons are also, at times, ultimately uncompensated. The negligence regime merely forces a corporation—an artificial person—to mimic a natural one. A properly capitalized corporation faces no greater threat to society of externalizing costs than any other natural person. There is therefore no additional need in tort to force on the corporation's shareholders the task of providing the corporation with additional insurance beyond what the corporation reasonably requires.

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180 BALLANTINE, *supra* note 122, at 303.

181 DIAMOND ET AL, *supra* note 101, at 45.

182 Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1269 (2008).

One could argue that when a plaintiff successfully pierces the corporate veil, he normally may pierce the veil as to all shareholders, those more innocent and culpable alike.[183] This, in turn, indicates that hypothetically innocent shareholders are strictly liable for corporate torts and corporate undercapitalization.[184] As an example of a relatively innocent shareholder who would have been held liable, some point to *Minton v. Cavaney*.[185] In that case, two promoters created a corporation to lease a swimming pool but never capitalized it (it never had any assets) and failed to respect corporate formalities, such as issuing stock.[186] Cavaney, an attorney, assisted the two promoters in a temporary capacity as secretary, treasurer, and director of the corporation, likely as an accommodation to his client.[187] When a victim drowned in the pool, her survivors, after winning a judgment against the corporation, sued Cavaney's estate.[188] Although reversed on other grounds, the court would have found Cavaney personally liable, noting that he was to receive one-third of the shares to be issued and that Cavaney kept corporate records in his office.[189]

There are two problems with relying on *Minton* to conclude that innocent shareholders are "strictly liable" for corporate torts. First, when piercing the corporate veil, courts have normally not held truly passive shareholders personally liable.[190] Second, to the extent that relatively innocent shareholders are liable, such liability is within the vein of *Res Ipsa Loquitur*, a negligence claim, not strict liability. Normally, a plaintiff bears the burden of proving each element of a negligence cause of action by a preponderance of the evidence.[191] However, the doctrine of *Res Ipsa Loquitur* allows a plaintiff in limited situations to use circumstantial evidence to establish a defendant's unreasonable conduct.[192] It allows a jury to infer from that circumstantial conduct that a defendant acted unreasonably without any other proof.[193] The circumstantial evidence is crucial to plaintiffs who otherwise would be unable to make specific allegations about

183 PINTO, *supra* note 72, at 58–59.
184 *See id.*
185 *See id.* at 59.
186 Minton v. Cavaney, 56 Cal. 2d 576, 578–79 (1961).
187 *Id.* at 578.
188 *Id.*
189 *Id.* at 580.
190 *See* PINTO, *supra* note 72, at 59–60.
191 DIAMOND ET AL., *supra* note 101, at 73.
192 *Id.*
193 *Id.*

defendant malfeasance.[194] Under the Restatement (Third) of Torts, *Res Ipsa Loquitur* allows the factfinder to "infer that the defendant has been negligent when the accident causing the plaintiff's harm is a type of accident that ordinarily happens as a result of the negligence of a class of actors of which the defendant is the relevant member."[195] Put slightly differently, *Res Ipsa Loquitur* requires that the harm-causing event was probably due to negligence, and that the defendant was probably the culpable party.

The defendant's suggested liability in *Minton* arose in such a way. The harm—the corporation's failure to satisfy a tort creditor's judgment (i.e., undercapitalization)—was due to the board of directors' negligence (failure to use reasonable care in capitalizing the corporation).[196] Moreover, the defendant was probably a culpable party.[197] Judge Roger Traynor noted that "evidence that Cavaney was to receive one-third of the shares to be issued supports an inference that he was an equitable owner, and the evidence that for a time the records of the corporation were kept in Cavaney's office supports an inference that he actively participated in the conduct of the business."[198] The Defendant in *Minton* simply would have been unable to overcome these inferences (i.e., his burden): the defendant's relationship with the promoters and the corporation itself was enough to establish the inference that he had sufficient control (that is, the act was probably negligence) over the corporation to be personally liable to its creditors (that is, he was probably the culpable party).

Indeed, this is exactly a distinction Judge Posner discusses in *Indiana Harbor Belt* to highlight the difference between strict liability and negligence.[199] In *Indiana Harbor Belt*, Judge Posner contrasts *Siegler*, where the court imposed strict liability on a transporter of hazardous materials. There, a gasoline truck blew up, obliterating Plaintiff's decedent and decedent's car. The explosion destroyed the evidence necessary to establish whether the accident had been due to negligence.[200] Though the *Siegler* Plaintiff could have tried to base his claim in negligence through

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194 *Id.*

195 RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 17 (AM. L. INST. 2010).

196 Minton v. Cavaney, 56 Cal. 2d 576, 578, 580 (1961).

197 *Id.* at 580.

198 *Id.* (emphasis added) (citation omitted).

199 *See* Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F. 2d 1174, 1179–80 (7th Cir. 1990).

200 *Id.*

the doctrine of *Res Ipsa Loquitur*, the *Siegler* court turned to strict liability instead of *Res Ipsa Loquitur* because even if the defendant truck driver used all due care, a gasoline truck might well blow up without negligence on the part of the driver.[201] In such a case, a plaintiff would be unable to invoke *Res Ipsa Loquitur*. The Plaintiff switching lines in *Indiana Harbor Belt* did not show such a danger.[202]

Similarly, corporate undercapitalization does not present involuntary creditors with a risk that they could not otherwise prove fault without a strict liability regime. Though corporations may seem at times to "blow up," there is always an evidentiary record (or lack thereof) to show whether a shareholder respected corporate formalities and adequately capitalized the corporation. The piercing the corporate veil regime again follows this logic.

Res Ipsa Loquitur also helps illustrate the scope of piercing the corporate veil. Piercing only occurs within close corporations or within corporate groups, not public companies.[203] As the number of shareholders increase, the less likely it becomes that a court will pierce.[204] This is because, as *Res Ipsa Loquitur* suggests, with an increasing number of shareholders, it becomes more difficult for a tort plaintiff to suggest that the negligent conduct was probably tied to the particular shareholder defendant. Corporate law follows the logic tort law suggests: Shareholders are not strictly liable for corporate undercapitalization. They only become liable to the extent that they assume certain duties through the failure to respect corporate formalities and corporate control and then breach such duties by failing to use reasonable care in capitalizing the corporation.

V. CORPORATE PURPOSE RECONSIDERED

As discussed, the choice of regime between negligence and strict liability is one of comparison between externalized costs and benefits. When an activity externalizes more costs, strict liability ought to apply. When an activity externalizes more benefits, a negligence regime ought to apply.[205] The idea that shareholders ought not be strictly liable for corporate undercapitalization therefore implies that incorporation externalizes more benefits than costs.

201 *Id.*
202 *Id.* at 1179–80.
203 *See* Thompson, *supra* note 170, at 1039.
204 *Id.*
205 *See* Hylton, *supra* note 94, at 14.

What is that externalized benefit? Shareholder provision of capital to corporations allows for the facilitation of optimal investment decisions.[206] Under Modern Portfolio Theory, investors can minimize risk through diversification. This minimization, in turn, allows corporations a lower cost of capital because a corporation's officers and directors need not consider non-systematic risk in making decisions. In a world of unlimited or strict shareholder liability, projects with a positive net present value ("NPV") i.e., those that would benefit society would be rejected because the value of shares would be based not merely on the present value of the corporation's expected future cash flows, but also something irrelevant to the investment decision: shareholder wealth. Piercing the corporate veil—a negligence regime—allows society to undertake NPV positive projects because incorporation allows a project to separate itself from its capital investors and stand on its own merits.[207]

Piercing the corporate veil, however, teaches that although corporations do externalize benefits to society, they still invite shareholder opportunism (that is, externalized costs) when certain shareholders attempt to use the corporate form to artificially limit liabilities to creditors. For this reason, in order for shareholders to truly limit their liability, they must follow corporate formalities and, if acting as a corporate officer and/or director, adequately capitalize the corporation. These actions not only allow the corporation to stand on its own merits, but also relieve the shareholder from a personal duty to corporate creditors. This is because such actions force the corporation to internalize the costs that it would otherwise externalize onto its creditors.

This is why—perhaps ironically—shareholders are only able to limit their liability when there is no *ex ante* value to limited liability. This is the case in a properly functioning corporation. True, *shareholders* may have an incentive to externalize these costs. Other corporate actors, however, have incentives not only *contra* the shareholders but also aligned with contingent (tort) creditors. Those actors typically mute any shareholder incentive to externalize costs. For example, because unsecured debtholders have a claim *pari passu* with a tort creditor, in exchange for debt capital, a debtholder will demand from the borrower and its subsidiaries an affirmative covenant to maintain reasonable

206 *See* Easterbrook & Fischel, *supra* note 18, at 97.

207 Corp. Fin. Inst., *Modern Portfolio Theory (MPT)*, https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/modern-portfolio-theory-mpt/ [http://perma.cc/YE36-L2X5] (last visited Mar. 10, 2021).

insurance.[208] This covenant is ubiquitous with the possible exception of investment-grade borrowers with multi-billion dollar market capitalizations—enough to cover potential losses arising from a corporate tort.[209] Without this covenant, the debtholder faces the material risk that a tort creditor's claim will dilute his or her own. Corporate officers and directors—who not only have a substantial human capital investment in the corporation but also may face personal liability for their action (or inaction)—will also push the corporation to adequately insure so as to protect their human capital investment and personal assets. Even if putatively improperly incentivized by ownership of stock and stock options, risk aversion will lead Corporate Officers and Directors to D&O insurance.[210] In turn, those insurers will increase their premiums in order to account for the costs of bad corporate governance. [211] As such, corporate actors are generally able to force the corporation to internalize otherwise externalized costs.[212]

Piercing the corporate veil is needed when the corporation is not properly functioning—specifically, when other corporate actors are unable to prevent shareholders from successfully attempting to extract value from limited liability.[213] To best understand when piercing the corporate veil applies, consider the relationship between shareholders and actual corporate creditors (namely debtholders), whose relationship can best be explained in terms of option theory. Both shareholders and debtholders have purchased a right to a corporation's future profits and concomitantly made agreements with each other. Debtholders have sold a call option (the right to purchase any increase in a corporation's value) on future profits to shareholders. Shareholders, meanwhile, have bought a put option from debtholders (that is, they have purchased the right to sell the corporation to debtholders). Shareholders pay for this put option

208 *See* MICHAEL BELLUCCI & JEROME MCCLUSKEY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE 339–40 (McGraw-Hill Educ. 2d ed. 2017).

209 *See id.*

210 *See* Lawrence J. Trautman & Kara Altenbaumer-Price, *D&O Insurance: A Primer* 1 AM. U. BUS. L. REV. 337, at 337, 366 (2011-2012).

211 *Id.*

212 *Id.* at 366. Perhaps the existence of more corporate actors—whose self-interest works to police contingent creditor claims—explains why tort creditors are less successful than contract creditors in piercing the corporate veil. *See* Thompson, *supra* note 170, at 1039–40, 1058–59.

213 Other corporate actors are unable to do so only in close corporations or within corporate groups—those places where courts exclusively pierce the corporate veil. *See* Thompson, *supra* note 170, at 1038–39.

through the terms of the corporate debt, including, but not limited to, the debt's interest rate, covenants, and tenor.

In the case of a tort creditor, piercing the corporate veil similarly prohibits shareholders from using the corporate form to obtain a free (or discounted) put option from contingent creditors (including potential tort creditors) with whom the corporation cannot negotiate *ex ante*.[214] It forces the corporation to internalize the risks it poses to tort creditors through some sort of insurance: either through contracting with a third-party insurer or through self-insurance (i.e., additional equity capital). This insurance performs the identical function as the *ex ante* negotiated purchase of a put option, in effect turning those involuntary creditors into voluntary creditors.[215] This is exactly why share prices of California corporations did not meaningfully change with the introduction of limited liability: corporations had already internalized costs so as to make the value of shareholder indemnity for corporate torts negligible.[216]

This understanding, in turn, helps us understand the extent of the NPV analysis discussed previously in the context of piercing the corporate veil. The NPV analysis ought to be performed not at the level of shareholder returns, but rather at the level of the corporate whole. Shareholders cannot use the corporate form to shield themselves artificially from liability to creditors. Said slightly differently, shareholders only risk losing limited liability by attempting to use the corporate form to make an otherwise negative NPV project into a positive one through the externalization of costs onto creditors. Such an action would without the doctrine of piercing the corporate veil (and unlike the California firms previously mentioned) result in an artificially higher share price through the externalization of costs onto others. Piercing the corporate veil allows creditors to make an enterprise stand on its own merits, which in turn requires those culpable shareholders to bear the realized costs of negative NPV projects.[217]

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214 *See* David K. Millon, *Piercing the Corporate Veil, Financial Responsibility, and Limits of Limited Liability*, 56 EMORY L. J. 1305, 1324 (2007).

215 *See* Easterbrook & Fischel, *supra* note 18, at 107–09.

216 *See* Weinstein, *supra* note 20, at 440.

217 This conclusion is analogous to the widely-adopted "Independent Investor" test which determines the eligibility of employee salary deductions under 26 U.S.C. § 162(a)(1). 26 U.S.C.A. § 162(a)(1) (West). Given that employee salaries are deductible but shareholders dividends are not, one who is both a shareholder and employee (usually in a closely-held company) may attempt to disguise a shareholder dividend as an employee salary in order to avoid incurring tax liability. The "Independent Investor" test guides the deductibility of employee-shareholder salaries by asking whether an independent third-party shareholder would accept the corporate stock's rate of return given the employee's

For this reason, in order for shareholders to avail themselves fully of limited liability, the corporation's NPV analysis must consider and adequately discount the costs not only of actual creditors, such as debtholders or trade creditors, but also *contingent* creditors, which include any potential tort creditor. Firms internalizing those risks (through more expensive insurance) will be less incented to engage in excessively risky activity. Moreover, by internalizing such risk, the corporation no longer imposes the risk of cost externalization onto involuntary creditors made possible by corporate undercapitalization.

Finally, this understanding of NPV, which requires that corporations consider not merely their shareholders, but also other corporate stakeholders in investment decisions, supports and augments another theory of the corporation.[218] According to stakeholder welfare theory, in calculating social benefits from corporate activity, the corporation should not focus merely on benefits to equity investors, but rather on other stakeholders like employees, customers, suppliers, and the community.[219] A corporation must, in considering a NPV analysis at the *corporate* level, look to maximize *corporate* welfare because each of these stakeholders is ultimately either an actual or contingent creditor. The corporation and its shareholders are free to maximize profits, but only to the extent that the corporation reasonably considers and mitigates the risks the corporate form presents to all stakeholders through undercapitalization.

VI. CONCLUSION

In this Article, I have argued that tort law would treat shareholder personal liability under a negligence regime and not strict liability, and that a negligence regime closely resembles the current corporate law regime. There are several important conclusions to draw from this argument, namely, that both advocates and critics of shareholder strict liability may be disappointed under a regime of strict shareholder personal liability. Advocates of limited liability may be disappointed by

deducted salary. *See* Exacto Spring Corp. v. Comm'r of Internal Revenue, 196 F.3d 833, 838–39 (7th Cir. 1999). If so, the deduction is presumptively reasonable. *Id.* Just as shareholder-employees are incented to disguise dividends as salaries to avoid tax liability and increase their ultimate returns, an undercapitalizing shareholder foregoes necessary insurance premiums in an attempt to do the same. If, when accounting for reasonable insurance, an independent third-party shareholder would too find the corporate stock's rate of return too low, there could similarly be a presumption that a court should pierce the corporate veil.

218 *See* STOUT, *supra* note 65, at 38.

219 *See* STOUT, *supra* note 59, at 351.

the fact that the costs of capital are unlikely to rise substantially. Corporations can, through their officers and directors, use due care to prevent undercapitalization, just as the vast majority of chemical spills by railroads are preventable by due care. If this statement is true, strict liability should only cause a slight, not substantial, increase in the cost of capital because the incremental liability it would create would also be slight.[220] Similarly, critics of shareholder limited liability may not find strict shareholder personal liability to be the panacea they hope it to be given the only slightly increased incremental liability. Additionally, expected accident costs may not meaningfully change (or even increase), resulting in the same (or greater) incentive to externalize costs under the present regimes of shareholder limited liability.

This investigation presents two ideas for possible further areas of research. First, to the extent piercing the corporate veil differs from an action in negligence, corporate law may unnecessarily invite unwelcome opportunism through the current limited liability regime. Second, recall that Hansmann and Kraakman argue that limited liability is likely a historical accident. Perhaps there is a historical connection between the rise of strict liability and limited liability worthy of further study.

The corporate form ultimately benefits society but invites detrimental opportunism through its potential to externalize costs. Though at first glance it may be appealing to argue that shareholders ought to be personally liable for corporate torts given such potential, corporate law seems to correctly follow tort law in concluding that shareholders are not strictly personally liable for corporate torts—negligence applies; that is, the limited liability regime. Tort law does not justify itself based on finding the deepest pockets, but rather on asking which liability regime best addresses the relevant tort. It suggests that negligence, not strict liability, is the appropriate regime in tort for shareholders of a corporation. Corporate law correctly follows this intuition.

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220 *See* Ind. Harbor Belt R.R. Co. v. Am. Cyanamid Co., 916 F.2d 1174, 1179–80 (7th Cir. 1990).