DIRECTOR LIABILITY:
A CLICHÉ IN NORTH DAKOTA

BRIAN WINROW*

I. INTRODUCTION

The issue of personal accountability within the corporate realm has become a hotly debated topic in response to the seemingly endless cases of corporate corruption.[1] A plethora of cases spearheaded the call for corporate governance reform in order to hold corporate wrongdoers personally and criminally accountable for their malfeasance.[2] The recent corporate governance reform started with the enactment of the Sarbanes-Oxley Act of 2002.[3] The Sarbanes-Oxley Act modified the governance, reporting, and disclosure rules for public companies, and exposed unscrupulous officers to lengthy prison sentences.[4] While the Sarbanes-Oxley Act facilitated the prosecution of numerous corporate officers, directors often emerged unscathed.[5] As a result, the scope of a director's liability has come under scrutiny from scholars, creditors, investors, and legislatures.[6]

In 2007, the North Dakota Legislature enacted the North Dakota Publicly Traded Corporations Act (Act), which added chapter 10-35 to the North Dakota Century Code.[7] The Act permits corporations to elect to be governed under the new "shareholder friendly" statute.[8] The Act provides

---

*Brian Winrow is an Assistant Professor of Business Law with the School of Business at Winona State University. Mr. Winrow was formerly an Assistant Professor at Emporia State University. He graduated from the University of South Dakota with both his J.D. and M.B.A. Prior to commencing his career as an Assistant Professor, he practiced full time in the state of New Mexico.

1. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 928-37 (2003) (reviewing the corporate scandals of 2001, including Enron, WorldCom, and the legislative response of the Sarbanes-Oxley Act).

2. *Id.*

3. *See* Jaclyn Taylor, *Fluke or Failure? Assessing the Sarbanes-Oxley Act After United States v. Scrushy*, 74 UMKC L. REV. 411, 421 (2005).

4. *Id.*

5. *See* Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1627 (2002) (discussing director liability in corporate corruption cases, including Enron).

6. *Id.*

7. *See* N.D. CENT. CODE § 10-35-01 (2007).

8. *See id.* § 10-35-03(1) ("This chapter applies only to a publicly traded corporation meeting the definition of a 'publicly traded corporation' . . . during such time as its articles state that it is governed by this chapter.").

shareholders with enhanced rights and control in the operation and management of the corporation.[9] By enacting this legislation, North Dakota made a significant stride in attempting to gain market share in the lucrative market of serving as a viable state of incorporation for businesses, a label that Delaware has touted for decades.[10] If North Dakota is successful in attracting more corporations to incorporate within the state, especially under the guise of "shareholder friendly" statutes, it will be critical for directors to understand their scope of liability for the actions of the corporation.

The purpose of this Article is to discuss the different forms of director liability in North Dakota, and to compare and contrast the scope of director liability in North Dakota to that of directors in Delaware. Part II of this Article addresses the role of directors, the fiduciary duties directors owe to the corporation and shareholders, and directors' potential internal liability.[11] Part III focuses on the relevant case law within North Dakota and Delaware, as well as surrounding states possessing similar statutes, to ascertain the judicial interpretation and treatment of the respective statutes.[12] Part IV addresses the theory of external liability.[13] In Part IV, the concept of limited liability is discussed, as well as the equitable remedy of piercing the corporate veil.[14] This Article concludes in Part V with an analysis of federal legislation designed to expand the scope of a director's prospective liability.[15]

II. THE ROLE OF THE BOARD OF DIRECTORS

The board of directors fulfills a vital role in the corporate governance of an organization.[16] The board of directors oversees the business affairs and management of the corporation on behalf of the shareholders.[17] The number of directors who sit on the board is set out in either the corporate

---

9. John F. Olson, *Is the Sky Really Falling? Shareholder-Centric Versus Director-Centric Corporate Governance*, 9 TRANSACTIONS: TENN. J. BUS. L. 295, 298 (2008).

10. *Id.*

11. *See infra* Part II (discussing the fiduciary duties a director owes the corporation).

12. *See infra* Part III (discussing corporate constituency statutes as well as the scrutiny afforded to the gross negligence of a director within the respective states).

13. *See infra* Part IV (explaining the scope of internal liability arising from the piercing of the corporate veil).

14. *See infra* Part IV.C.1. (discussing the eight factor balancing test in ascertaining whether a plaintiff can pierce the corporate veil).

15. *See infra* Part V (explaining the purview of the Sarbanes-Oxley Act).

16. *See* Regina F. Burch, *The Myth of the Unbiased Director*, 41 AKRON L. REV. 509, 517 (2008) (discussing the role of a director).

17. N.D. CENT. CODE § 10-19.1-32(1) (2007); *see also* Nadelle Grossman, *Director Compliance With Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. OF CORP. & FIN. L. 393, 400 (2007) (explaining the concept of corporate governance).

bylaws or articles of incorporation.[18] In North Dakota, the board must consist of one or more directors.[19] In carrying out his or her managerial function, a director on the board is entitled to rely on information, opinions, reports, or statements prepared or presented by either officers or employees that the board member believes to be competent.[20] A member of the board of directors may also rely on counsel, public accountants, or other professionals, if a director believes that person is acting within their scope of expertise.[21] Additionally, a committee of the board, acting within the board's designated authority, on which a director does not serve, may be relied upon.[22] While a director has the express authority to rely upon a committee, the board member needs to be cognizant of the prospective liability incurred from the fiduciary nature of the position.

The potential for director liability can arise internally or externally. Internal liability consists of a director's potential liability to the corporation or to the shareholders of the corporation.[23] This theory of liability is based upon a director's fiduciary responsibility owed to the corporation and shareholders.[24] The fiduciary duties include the duty of good faith, care, and loyalty.[25] When a shareholder believes a director has breached his or her fiduciary duty, the shareholder may bring a derivative action against the corporation.[26] A derivative action is used when all the shareholders of a corporation have experienced a similar injury.[27] However, if a shareholder alleges injury independent of all the other shareholders, the shareholder could bring a direct action.[28] The second form of liability, external liability, arises from an aggrieved creditor seeking to pierce the corporate veil.[29] External liability is discussed further in Part IV.

The remainder of Part II focuses on the scope of a director's internal liability. More specifically, section A discusses the fiduciary duties of a

---

18. N.D. CENT. CODE § 10-19.1-33.

19. *Id.*

20. § 10-19.1-50(2)(a).

21. § 10-19.1-50(2)(b).

22. § 10-19.1-50(2)(c).

23. Ohio Drill & Tool Co. v. Johnson, 625 F.2d 738, 742 (6th Cir. 1980).

24. North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007).

25. N.D. CENT. CODE § 10-19.1-50(1).

26. Mark M. Graham, *Delaware Post-Merger Derivative Suit Standing and Demand Requirements: Professional Management Associates, Inc. v. Coss*, 25 J. CORP. L. 631, 648 (2000).

27. Atkins v. Hibernia Corp., 182 F.3d 320, 323 (5th Cir. 1999) (citing Palowsky v. Premier Bancorp, Inc., 597 So. 2d 543, 545 (La. Ct. App. 1992)).

28. *Id.*

29. *See infra* Part IV (stating that creditors and aggrieved third parties can impose liability against a director if they can satisfy the eight factor balancing test to pierce the corporate veil).

director, which are comprised of the duty of good faith, fair dealing, and loyalty.[30] Section B discusses the prospective liability of a director for gross negligence, comparing and contrasting the law in North Dakota and Delaware.[31] Section C focuses on the standard of review against which a director's actions or inactions will be measured.[32] Part II concludes with section D, which focuses on a director's right to indemnification.[33]

A. FIDUCIARY DUTIES

The fiduciary duties of a corporation's directors are generally governed by the law of the state in which the business incorporates.[34] In North Dakota, a director is bound by the fiduciary duties in Section 10-19.1-50 of the North Dakota Century Code.[35] If a director fails to comply with their respective duties the corporation or shareholder may seek monetary damages from a director.[36] Since the directors serve in a position of trust in relation to the corporation and shareholders, they maintain a fiduciary relationship.[37] As fiduciaries, the directors owe the corporation and shareholders legal and ethical duties of good faith, care, and loyalty, which cannot be eliminated within the articles of incorporation.[38]

In Delaware, directors' actions are governed by a statute similar to that of North Dakota.[39] The Delaware statute permits a corporation to adopt a provision designed to eliminate or limit the personal liability of a director for breach of a fiduciary duty as a director.[40] In Delaware, however, a corporation may not eliminate or limit a director's liability for: (i) any breach of a director's duty of loyalty to the corporation or its stockholders; (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) improper payment of dividends; or

---

30. *See infra* Part II.A (comparing and contrasting North Dakota and Delaware law as it pertains to a director's liability for beach of his or her fiduciary duty).

31. *See infra* Part II.B (discussing the liability for gross negligence, and whether that liability can be waived).

32. *See infra* Part II.C (discussing the business judgment rule and ordinary negligence).

33. *See infra* Part II.D (discussing a director's right to be indemnified by the corporation).

34. Potter v. Pohlad, 560 N.W.2d 389, 391 (Minn. Ct. App. 1997).

35. N.D. CENT. CODE § 10-19.1-50(1) (2007).

36. *See id.* § 10-19.1-50(5) (explaining that a director's monetary culpability for breach of fiduciary duty can be eliminated within the articles of incorporation—liability is sought by a shareholder by filing a derivative lawsuit).

37. Andrew D. Shaffer, *Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479, 490 (2000).

38. N.D. CENT. CODE § 10-19.1-50(5)(a)-(b).

39. DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).

40. *Id.*

(iv) any transaction from which a director derived an improper personal benefit.[41]

1. *Duty of Good Faith*

A director has a fiduciary duty to protect the corporation's interests.[42] A director occupies a position of the highest trust and confidence, and the utmost good faith is required in the exercise of the powers conferred on a director.[43] Good faith is defined as honesty in the conduct of an act or transaction.[44] In order to fulfill the duty of good faith, a director must act in a manner in which a director reasonably believes to be in the best interest of the corporation.[45] A director may breach the duty of good faith by engaging in undisclosed transactions with another company in which a director has an interest determined to be unfair to the corporation.[46] Moreover, the directors of a corporation do not have a right to convert the corporation's assets for their own use, or make any self-serving disposition of assets at the expense of the company.[47]

a. North Dakota

The North Dakota Legislature enacted an expansive definition of the best interest of the corporation.[48] The North Dakota Century Code provides directors with a significant amount of latitude in determining whether a particular action is in the corporation's best interest.[49] In North Dakota, a director is entitled to take into consideration the best interests of: (1) the corporation; (2) the corporation's employees, customers, suppliers, and creditors; (3) the economy; (4) societal considerations; and (5) the long- and short-term interests of the corporation and its shareholders.[50] This type of inclusive statute, which, as of 1997 has been adopted in thirty states, is referred to as a corporate constituency statute.[51]

---

41. *See id.*
42. Zakibe v. Ahrens & McCarron, Inc., 28 S.W.3d 373, 382 (Mo. App. 2000).
43. *Id.*
44. N.D. CENT. CODE § 10-19.1-01(29) (2007).
45. *Id.* § 10-19.1-50(1).
46. *Zakibe*, 28 S.W.3d at 382.
47. *Id.*
48. N.D. CENT. CODE § 10-19.1-50(6).
49. *Id.*
50. *Id.*
51. Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85, 95 (1999). As of 1997, the following states had corporate constituency statues: AZ, CT, FL, GA, HI, ID, IL, IN, IA, KY, LA, ME, MA, MN, MI, MS, NE, NV, NJ, NM, NY, ND, OH, OR, PA, RI, SD, TN, TX, VT, WI, and WY. *Id.*

The corporate constituency statutes provide directors greater freedom in executing their fiduciary duties by incorporating a range of statutorily sanctioned factors in the decision-making process.[52] The effect has been to provide the directors with additional justification for pursuing a course of action, thus thwarting the shareholder's attempt to hold a director monetarily culpable for breaching the fiduciary duty of good faith.[53] Corporate constituency statutes expand the traditional notion and understanding of the best interest of the corporation by incorporating extrinsic factors.[54]

While North Dakota has limited case law on corporate constituency, guidance can be found in *Smith v. Citation Manufacturing Company*,[55] an Eighth Circuit case.[56] In *Citation Manufacturing Company*, the defendant, a director for Citation Manufacturing Company, sold to his other corporation $65,000 worth of equipment.[57] A director's other corporation subsequently filed for voluntary bankruptcy prior to paying for the equipment.[58] The investors of Citation Manufacturing Company filed a suit against a director for breach of fiduciary duty.[59] The court opined that the failure of a corporate director to exercise due diligence or good faith in a transaction resulting in loss to a shareholder entitles the shareholder to recoup damages from a director whose negligence caused the loss.[60] A director who negligently causes the loss is liable to the shareholders to the extent of the loss.[61] While North Dakota has conferred the duty of good faith as one of the few fiduciary duties that cannot be waived, Delaware courts have not traditionally recognized a separate duty of good faith.[62]

b. Delaware

In Delaware, the requirement of good faith is ambiguous, stating only that a director must act in the best interests of the shareholders.[63] In an

52. *Id.*
53. *Id.*
54. *Id.*
55. 587 S.W.2d 39 (Ark. 1979).
56. *Citation Mfg. Co.*, 266 Ark. at 39.
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id* at 41.
61. *Id.*
62. Grossman, *supra* note 17, at 409.
63. *Id. See, e.g.*, Barkan v. Amsted Industries, Inc., 567 A.2d 1279, 1286 (Del. 1989) (equating good faith with loyalty); Orman v. Cullman, 794 A.2d 5, 14 n.3 (Del. Ch. 2002) ("[T]he duty to act in 'good faith' is merely a subset of a director's duty of loyalty"); *In re* Gaylord Container Corp. S'holder Litig., 753 A.2d 462, 476 (Del. Ch. 2000) (explaining that good faith is a "fresh" way to refer to the duty of loyalty).

attempt to narrow the definition and clarify the duty of good faith, the Delaware Chancery Court has found two separate types of bad faith.[64] First, the fiduciary duty of good faith can be violated when an inadequate information-gathering process is employed.[65] The emphasis is to focus on a director's requirement to use due diligence in making business decisions.[66] The second type of bad faith occurs when a director makes a decision that exceeds the bounds of reasonable judgment and appears unjustifiable on any ground other than bad faith.[67]

Directors in Delaware, similar to North Dakota, are entitled to retain consultants or other advisors in furtherance of making informed decisions.[68] Directors are protected in their reliance on statements, information, and reports furnished by advisors, so long as they do so in good faith and select the advisors with reasonable care.[69] This permits a director to delegate authority and to rely upon others whom a director reasonably believes to be acting within his or her area of expertise.

2. *Duty of Due Care*

The duty of due care ensures that directors use a methodical and comprehensive information gathering process on which to base their decisions.[70] The duty is intended to promote intelligent and informed decisions on behalf of the corporation.[71] The central focus of the duty of care is procedural review.[72] The duty of care requires directors to act on an informed basis.[73] In accomplishing this objective, directors are expected to attend meetings, read reports, and inquire into alternative methods of action.[74]

---

64. Grossman, *supra* note 17, at 410 (citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996)).

65. Grossman, *supra* note 17, at 410.

66. *Id.*

67. *Id.* (citing *In re J.P. Stevens & Co.*, 542 A.2d at 780-81).

68. DEL. CODE ANN. tit. 8, § 141(e) (2005).

69. *Id.*

70. Kimberly J. Burgess, Comment, *Gaining Perspective: Directors' Duties in the Context of "No-Shop" and "No-Talk" Provisions in Merger Agreements*, 2001 COLUM. BUS. L. REV. 431, 433 (2001).

71. Emerald Partners v. Berlin, 787 A.2d 85, 96 (Del. 2001).

72. *Id.*

73. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

74. *Id.* A board member is entitled to rely on information, opinions, reports, or statements prepared or presented by either officers or employees the board member believes to be competent; counsel, public accountants, or other professionals a director believes is within the person's scope of expertise; or committees of the board acting within its designated authority and on which a director does not serve. However, a director cannot rely upon the above information if a director has knowledge that diminishes or makes the reliance unjustified. *Id.*

a. North Dakota

In North Dakota, the fiduciary duties of good faith and loyalty cannot be waived.[75] While the fiduciary duties of good faith and loyalty are absolute, and cannot be waived, such restrictions are not afforded to the duty of care.[76] As a result, in North Dakota a corporation may limit or reduce the monetary culpability owed by the corporation for the breach of the duty of care.[77] This allows directors to escape liability for failing to maintain the standard of care, if the corporation elects to add a provision to that effect in the articles of incorporation or bylaws.[78]

b. Delaware

Smith v. Van Gorkom[79] best illustrates Delaware's judicial interpretation of the fiduciary duty of care.[80] In *Van Gorkom*, the Delaware Supreme Court held that the board of directors had breached its duty of care by approving a merger without receiving any information as to the merger, with the exception of a statement by the chairman that the merger price was fair.[81] The Court held that such an anemic review violates Delaware's code on the merger of corporations, which requires that the directors make an informed decision prior to approving a merger.[82] More specifically, the directors did not adequately investigate the agreed upon stock price for the merger, were unaware of the intrinsic value of the business, and approved the merger with a mere two hours of deliberations without advance notice.[83]

In Delaware, even if a director breaches the fiduciary duty of care, the director may still avoid monetary damages.[84] This occurs as the corporation is permitted to adopt a provision restricting the personal liability of a director to the corporation or its shareholders for breach of the duty of care.[85] While there are certain fiduciary duties that cannot be limited or

75. N.D. CENT. CODE § 10-19.1-50(5)(a), (b) (2007).

76. *Id.*

77. *Id.* § 10-19.1-50(5).

78. *See id.* (providing that a corporation can limit the scope of the board member's liability by incorporating a provision within the articles of incorporation). The waiver of liability, however, is only applicable for the duty of care and not the duty of loyalty or good faith. *Id.*

79. 488 A.2d 858 (Del. 1985).

80. *Van Gorkom*, 488 A.2d at 893.

81. *Id.*

82. *Id.* at 884; *see also* DEL. CODE. ANN. tit. 8, § 251(b) (2005) (the respective boards must adopt an agreement specifying the terms of the merger, the mode for incorporating the merger, as well as other details pertinent to the merger).

83. *Van Gorkom*, 488 A.2d at 874.

84. DEL. CODE. ANN. tit. 8, § 102(B)(7).

85. *Id.*

waived, the duty of care does not fall within the exception.[86] As a result, a director can escape monetary liability for breaching the duty of care.[87]

3. *Duty of Loyalty*

The third hallmark fiduciary duty is a director's duty of loyalty owed to both the corporation and the shareholders.[88] The duty of loyalty requires that directors avoid transactions in which they have a conflict of interest and will benefit from promoting a particular course of conduct.[89] If a director does engage in a self-serving transaction, it is generally adjudged with strict scrutiny to ensure a director did not violate the duty of loyalty.[90] Subsections a and b discuss how the duty of loyalty is construed in North Dakota and Delaware, respectively.[91]

a. North Dakota

In helping define what is classified as impermissible behavior, North Dakota has articulated the scope of a conflict of interest.[92] A conflict of interest can arise in transactions between a corporation and a director; between the corporation and a director of a related organization; or between the corporation and an organization in which the corporation's director has a material financial interest.[93] Moreover, the scope of the conflict of interest encompasses any member of a director's immediate family.[94] However, even if a transaction which on its face falls within the purview of the definition, will not be void or voidable in three distinct situations.[95] First, a transaction will not be void or voidable if either the transaction was favorable to the corporation at the time it was authorized, approved or ratified.[96] The second situation occurs when the material facts as to the transaction and directors' interest are fully disclosed to all shareholders and the shareholders, with voting authority, by a two-thirds majority approve

86. Lloyd L. Drury, III, *What's the cost of a free pass? A Call for the Re-Assessment of Statutes that Allow for the Elimination of Personal Liability for Directors*, 9 TRANSACTIONS: TENN. J. BUS. L. 99, 129 (2007).

87. *See id.* (stating that companies have exculpatory clauses within the articles waiving director liability for breach of care).

88. DEL. CODE. ANN. tit. 8, § 102(B)(7).

89. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

90. Des Moines Bank & Trust Co. v. Bechtel, 51 N.W.2d 174, 216 (Iowa 1952).

91. *See infra* Parts II.B.3.a-b (discussing the duty of loyalty in North Dakota and Delaware).

92. N.D. CENT. CODE § 10-19.1-51(1) (2007).

93. *Id.*

94. *Id.*

95. *Id.* § 10-19.1-51(2).

96. *Id.* § 10-19.1-51(2)(a).

the transaction.[97] Finally, a transaction will not be void or voidable when the facts of the transactions and directors' interest are fully disclosed to the board, with the board authorizing or approving the transaction with a majority vote.[98]

In *Cookies Food Products, Inc. v. Lakes Warehouse Distributing, Inc.*,[99] an Eighth Circuit case, the court held that as a fiduciary, one may not secure for oneself a business opportunity that in fairness belongs to the corporation.[100] Moreover, the court found that a corporate director may, under proper circumstances, transact business with the corporation including the purchase or sale of property, but it must be done in good faith and with full disclosure of the facts, and with the consent of all parties concerned.[101] Even then, the burden is upon a director to establish his or her good faith, honesty, and fairness.[102] The self-serving transaction, however, will be viewed by the trial court with skepticism and garner close scrutiny, and may be nullified on slight grounds.[103]

b. Delaware

In Delaware**,** the duty of loyalty requires a director to exercise undivided and unselfish loyalty to the corporation and place the best interests of the corporation and its stockholders ahead of any interest of his or her own.[104] To avoid the need for a court determination of the fairness of every challenged interested party transaction, there is a test in Delaware to determine whether an impermissible conflict exists.[105] The test provides that a transaction in which a director has an interest will not be void in one of two instances.[106] The first situation is satisfied if a majority of disinterested directors authorize the transaction.[107] The second method occurs when a majority of stockholders, in good faith, authorizes the transaction after full disclosure.[108] A director is deemed disinterested if he or she does not

97. *Id.* § 10-19.1-51 (2)(b).
98. *See id.* § 10-19.1-51 (2)(c) (providing that a director with the conflict will not be counted in determining whether a quorum existed and shall not vote).
99. 430 N.W.2d 447 (Iowa 1988).
100. *Cookies Food Products, Inc.*, 430 N.W.2d at 452 (citing Rowen v. LeMars Mut. Ins. Co. of Iowa, 282 N.W.2d 639, 660 (Iowa 1979)).
101. *Id.* (citing Des Moines Bank & Trust Co. v. Bechtel, 51 N.W. 2d 174, 216 (Iowa 1952)).
102. Holden v. Construction Mach. Co., 202 N.W.2d 348, 356-57 (Iowa 1972).
103. *Des Moines Bank & Trust Co.*, 51 N.W.2d at 216.
104. Cede & Co. v. United Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
105. *Id.* at 365-66.
106. DEL. CODE ANN. tit. 8, § 144(a) (2007).
107. *Id.*
108. DEL. CODE ANN. tit. 8, § 44(a) (2005).

appear on both sides of a transaction, nor expects to derive a material personal financial benefit from the transaction.[109]

B. GROSS NEGLIGENCE

An interesting question arises in North Dakota as it pertains to the gross negligence of the directors and their exposure to liability. The statutory language in North Dakota permits the corporation to reduce or eliminate a director's liability to the corporation or its shareholders, with the exception of the fiduciary duties of good faith and loyalty, by permitting the corporation to add a provision to that effect in the articles of incorporation.[110] Accordingly, a plain reading of the statute would indicate that a director could avoid internal liability for their tortious conduct while acting in their capacity as a director, if acting in good faith.[111] Such an interpretation would indicate that a director would be immune for his or her gross negligence.

While the North Dakota courts have not addressed a director's scope of culpability for gross negligence, in *John Hancock Capital Growth Management, Inc. v. Aris Corp.*,[112] the Delaware Chancery Court held that the Delaware statute prevents the corporation or shareholders from bringing an action against the directors based upon the gross negligence of the directors.[113] As a result, in Delaware a director who is grossly negligent, but acts in good faith nonetheless, can avoid liability to the shareholders and corporation if the corporation adopted such a provision within the articles of incorporation.[114]

C. STANDARD OF CARE

The general standard by which the fiduciary duties are measured is the objective reasonable person standard.[115] The objective reasonable person standard is expressed as the care an ordinary prudent person in a like position would exercise under similar circumstances.[116] While at first blush it appears that a director will be subjected to the same generic standard proffered in cases involving basic tort law, a more lenient standard has been devised whereby directors are allowed deference in carrying out their

109. *Id.*
110. N.D. CENT. CODE § 10-19.1-51(5) (2007).
111. *Id.*
112. 16 Del. J. Corp. L. 1515 (Del. Ch. 1990).
113. *John Hancock Capital Growth Mgmt, Inc.*, 16 Del. J. Corp. L. at 1519.
114. *Id.*
115. N.D. CENT. CODE § 10-19.1-50(1).
116. *Id.*

duties.[117] This modified standard is commonly referred to as the business judgment rule.[118]

The business judgment rule prohibits judicial inquiry into the actions of the directors made in good faith in furtherance of a lawful and legitimate corporate purpose.[119] The rationale behind the business judgment rule is twofold.[120] First, it safeguards the board's decisions and managerial authority from arbitrary attack.[121] Second, it acknowledges that courts are ill equipped to evaluate what are and must be essentially business judgments that are the responsibility of the corporate directors.[122] These business judgments are based upon their individual capabilities and experiences that peculiarly qualified them for the discharge of that responsibility.[123]

In addition to the business judgment rule, the corporate constituency statute, enacted by the North Dakota Legislature, permits the corporation to eliminate or reduce the monetary liability of directors in relation to the corporation and shareholders.[124] While the general rule permits the limitation or elimination of director liability, there are a few enumerated instances in which a director's liability cannot be limited.[125] They include a director's breach of loyalty;[126] acts or omissions not in good faith;[127] and transactions in which a director received improper personal benefits.[128]

While North Dakota utilizes the business judgment rule in determining whether the directors breached their fiduciary duty, the scope of the directors' actual duty has not been adequately litigated. Therefore, a plausible argument can be made that it only covers "acts" of the directors. In *Red River Wings, Inc. v. Hoot, Inc.*,[129] the North Dakota Supreme Court held that the business judgment rule recognizes the court's limitations as it relates to having to analyze a director's decision.[130] Furthermore, the court

---

117. Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 306-07 (1994) (discussing the standard under ordinary negligence and the business judgment rule).

118. Buckingham v. Weston Village Homeowners Ass'n, 1997 ND 237, ¶ 9, 571 N.W.2d 842, 844.

119. Lill v. Cavalier Rural Elec. Coop., 456 N.W.2d 527, 530 (N.D. 1990) (citing Levandusky v. One Fifth Ave. Apartment Corp., 75 N.Y.2d 530, 554 (N.Y. 1990)).

120. *Levandusky*, 75 N.Y.2d at 539.

121. *Id.*

122. *Id.*

123. *Id.*

124. N.D. CENT. CODE § 10-19.1-50(5) (2007).

125. *Id.*

126. *Id.* § 10-19.1-50(5)(a).

127. *Id.* § 10-19.1-50(5)(b).

128. *Id.* § 10-19.1-50(5)(d).

129. 2008 ND 117, 751 N.W.2d 206.

130. *Red River Wings, Inc.*, ¶ 37, 751 N.W.2d at 222.

held that the business judgment rule prohibits judicial inquiry into the actions of the corporate directors.[131] Absent from the *Red River Wings, Inc.* decision was language incorporating an omission to act by the directors.[132] As a result, an argument could be made that if a director fails to act in a timely manner and such inaction does not rise to a conscious decision to refrain from acting, then the inaction would fall outside the scope of the business judgment rule.

Delaware has adopted the position that absent a conscious decision to refrain from acting, an omission to act falls outside the scope of the business judgment rule.[133] The Delaware statute pertaining to the ordinary standard of care is substantially similar to that of North Dakota.[134] The Delaware Supreme Court has interpreted the Delaware statutes to mean that the business judgment rule is limited to cases of action as opposed to inaction or omissions.[135] Thus, a director that fails to act, and such failure is not a conscious decision to refrain from acting, will be adjudged by the objective reasonable person standard in determining whether a director breached his of her fiduciary duty.[136]

D. INDEMNIFICATION

In North Dakota, a corporation may indemnify a director for expenses and liabilities arising out of a director's duties, if the director acted in good faith, and did not violate his or her duty of loyalty.[137] Similarly, a corporation in Delaware is permitted to indemnify a director for any liability arising out of his or her service as a director for actions in good faith.[138] While indemnification does not absolve a director from liability, it permits a director to be made whole for any loss or damages incurred as a result of a fiduciary duty suit against him or her, so long as indemnification is not statutorily precluded.[139]

---

131. *Id.*
132. *Id.*
133. DEL. CODE ANN. tit. 8, § 102(b)(7) (2005).
134. *Id.*
135. *In re* Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 968 (Del. Ch., 1996).
136. N.D. CENT. CODE § 10-19.1-50(1) (2007).
137. *See id.* § 10-19.1-91(2) (explaining that corporations may indemnify directors if a director did not receive an improper benefit).
138. DEL CODE ANN. tit. 8, § 145(a)-(k) (2005).
139. *Id.*

E. SUMMARY OF INTERNAL LIABILITY

The potential for internal liability for a director in North Dakota appears to be de minimis.[140] The corporation has the authority to limit or reduce personal liability for monetary damages based upon breach of a fiduciary duty owed to either the corporation or shareholders.[141] The corporation is prohibited, however, from reducing or eliminating a director's monetary culpability as it relates to the breach of a fiduciary duty of loyalty, good faith, or receiving improper personal benefits.[142] If a director's act falls outside one of the three exceptions, the director can avoid personal monetary damages for his or her conduct.[143]

If the corporation or shareholder alleges that a director breached either the duty of loyalty, good faith, or obtained an improper personal benefit, the director's conduct will be adjudged against the business judgment rule.[144] While the business judgment rule does not shield a director from liability, there is a presumption that a director acted on an informed basis and in good faith.[145] As a result, it is much more challenging for a corporation or shareholder to rebut the presumption and prevail on their claim.[146] The business judgment rule is inapplicable in cases where a director has abdicated his or her duties or, absent a cognitive decision, failed to act.[147] If a director either abdicated his or her duties or failed to act and that failure was not a conscious decision, then the ordinary reasonable person standard of care would likely apply.[148]

III. COMPARING NORTH DAKOTA AND DELAWARE

North Dakota enacted a broad definition of a director's fiduciary duty, permitting the director to consider numerous other factors in the determination of good faith.[149] In material contrast, the Delaware Legislature did not integrate the corporate constituency statutes enacted by the North Dakota Legislature.[150] Rather, the determination of good faith is left to the

---

140. N.D. CENT. CODE § 10-19.1-50(5).

141. *Id.*

142. *See id.* § 10-19.1-50(5)(a)-(d) (explaining that directors cannot be reimbursed for breaching fiduciary duties of loyalty, good faith, or receiving improper benefits).

143. *Id.*

144. Red River Wings, Inc. v. Hoot, Inc. 2008 ND 117, ¶ 37, 751 N.W.2d 206, 222.

145. Brane v. Roth, 590 N.E. 2d 587, 592-93 (Ind. Ct. App. 1992).

146. *Id.* at 593.

147. *Id.* at 592.

148. N.D. CENT. CODE § 10-19.1-50(1).

149. *Id.* § 10-19.1-50(6).

150. Janette Meredith Wester, *Achieving A Proper Economic Balance: Nonshareholder Constituency Statutes*, 19 STETSON L. REV. 581, 611 (1990).

courts.[151] In deciding the scope of the fiduciary duty of good faith, the Delaware Chancery Courts have held that there are two separate duties inherent within the fiduciary duty.[152] The first duty focuses on the procedural aspect of the information gathering process, centering on a director's requirement to use due diligence in making business decisions.[153] The second type of breach of duty occurs when a director makes a decision that exceeds the bounds of reasonable judgment and appears inexplicable.[154]

While there are material differences in relation to the responsibilities associated with the duty of good faith, there are many similarities between North Dakota and Delaware pertaining to the potential internal liability of the directors. One similarity includes the statutory language pertaining to the fiduciary duty of care and loyalty.[155] In both states, directors are entitled to rely on reports from committees and other professionals acting within their scope of expertise in making decisions.[156] Moreover, the mere appearance of a conflict will not make a transaction void or voidable, and may be cured by a majority vote coupled with full disclosure of the conflict.[157]

Both states have a similar view on director liability for gross negligence. The Delaware Chancery Courts have held that the statutory language permits the corporation to eliminate a director's monetary liability to the corporation and shareholders for acts of gross negligence that do not fall under the purview of bad faith.[158] The statutory language contained within the North Dakota statute is similarly phrased.[159] A plain reading of the North Dakota statute would similarly allow the corporation to eliminate a director's liability for gross negligence.[160] The North Dakota courts, however, have not addressed a director's liability for gross negligence and whether that culpability can be limited or eliminated.

Finally, both states have adopted the business judgment rule as the standard by which to measure a director's actions in a subsequent

151. *Id.*

152. *See* Grossman, *supra* note 17, at 397.

153. *Id.*

154. *Id.* at 410.

155. N.D. CENT. CODE § 10-19.1-50(6) (2007); DEL. CODE ANN. tit. 8, § 141(e) (2005).

156. N.D. CENT. CODE § 10-19.1-50(6); DEL. CODE ANN. tit. 8, § 141(e).

157. N.D. CENT. CODE § 10-19.1-51(2)(b); DEL. CODE ANN. tit. 8, § 144(a).

158. John Hancock Capital Growth Mgmt, Inc., v. Aris Corp., Civ. A. No. 9920, 1990 WL 126656, at *2 (Del. Ch. 1990).

159. N.D. CENT. CODE § 10-19.1-51(5).

160. *See id.* § 10-19.1-51 (prohibiting a corporation from eliminating director liability for breach of good faith, loyalty, or from transactions in which director received direct benefit).

lawsuit.[161] The scope of the business judgment rule in North Dakota is still relatively unknown as a result of the limited case law, as opposed to Delaware which has addressed the scope and application of the rule in several cases.[162] One of the more relevant issues is whether the business judgment rule is the applicable standard in cases of inaction, whereby a director neglects to make a decision.[163] The Delaware courts have concluded that the business judgment rule only applies to actions, and is inapplicable in cases involving inactivity.[164] In that event, the appropriate standard of care would revert to the reasonable person standard.[165]

A. NORTH DAKOTA PUBLICLY TRADED CORPORATIONS ACT

The North Dakota Publicly Traded Corporations Act added chapter 10-35 to the North Dakota Century Code.[166] The Act is applicable to corporations incorporated after July 1, 2007, that elect to be subject to chapter 10-35.[167] The Act provides minority shareholders with increased protections within the corporation.[168] Under the Act, the CEO of the corporation is prohibited from serving as the chair of the board.[169] This serves to increase the independence of the board from the officers and serves as a safeguard against a self-serving rouge director. Moreover, the separation minimizes the appearance of impropriety and helps allow the board to conduct its business in a neutral and impartial manner.[170] A few of the other hallmark changes include mandating reimbursement to shareholders to the extent they are successful in contesting the election of directors;[171] allowing shareholders owning more than five percent of the shares to propose amendments to the articles of incorporation;[172] and imposing limitations on poison pills.[173] In addition, the Act prohibits the articles or bylaws from fixing

---

161. Lill v. Cavalier Rural Elec. Coop., 456 N.W.2d 527, 530 (N.D. 1990) (citing Levandusky v. One Fifth Avenue Apartment Corp., 75 N.Y.2d 530, 554 (N.Y. 1990)).

162. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368 (Del. 1993); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

163. Grossman, *supra* note 17, at 406.

164. *Id.*

165. *Id.*

166. N.D. CENT. CODE § 10-35-01.

167. North Dakota Corporate Governance Council, Explanation of the North Dakota Publicly Corporations Act (2007), *available at* http://ndcgc.org/Reference/Explain405.pdf.

168. *Id.*

169. N.D. CENT. CODE § 10-35-06 (4).

170. *See id.* (requiring a separation between the executive officers and chairman of the board).

171. *Id.* § 10-35-10(1).

172. *Id.* § 10-35-15.

173. *Id.* §§ 10-35-22 to -25.

director's terms in excess of one year and disallowing the staggering of board terms.[174]

B. CONGRUENCY BETWEEN DIRECTOR LIABILITY & THE NORTH DAKOTA PUBLICLY TRADED CORPORATIONS ACT

While the NDPTCA allows corporations the option of being governed under the new legislation, there are inconsistencies with the current interpretation of statutory law, which must be addressed before North Dakota becomes a true shareholder friendly state. In North Dakota, the current status of the law makes it extremely difficult for a shareholder to successfully win an action against a director who breaches a fiduciary duty.[175] First, a director's conduct is measured against the corporate constituency statutes, broadening the definition of the best interest of the corporation by taking a totality approach.[176] Second, the standard by which the conduct is measured is removed from the objective reasonable person standard and is measured against the more liberal subjective standard found in the business judgment rule.[177] The business judgment standard serves as a safeguard from judicial inquiry into the reasonableness of a director's actions.[178] Finally, the shareholder must be cognitive when the corporation is incorporating in North Dakota as it is permissible to limit or eliminate the fiduciary duty, with the exception of the before mentioned duties, making it more difficult to sustain an action against a director.[179]

IV. EXTERNAL LIABILITY

The external liability component of the analysis focuses on the liability of a director to aggrieved parties outside the corporation. As a general rule, directors are shielded from incurring personal liability for the debts of a corporation, which is a fundamental principal of the corporation.[180] However, there are instances in which the aggrieved creditor is permitted to pierce the corporate veil and impose personal liability on the directors in

---

174. *See id.* § 10-35-06 (stating that the limit in regard to director term limits in corporations which do not elect to be governed under the Act is five years).

175. *Id.*

176. *Id.*

177. Levandusky v. One Fifth Ave. Apartment Corp., 75 N.Y.2d 530, 539 (N.Y. 1990).

178. Gevurtz, *supra* note 117, at 306-07 (discussing the standard under ordinary negligence and the business judgment rule).

179. N.D. CENT. CODE § 10-19.1-50(5).

180. Macaluso v. Jenkins, 420 N.E.2d 251, 254 (Ill. App. Ct., 1981).

order to satisfy the judgment against the corporation.[181] The concept of piercing the corporate veil is an equitable remedy by which the court will permit the aggrieved creditor to pierce the limited liability protection.[182] Once a corporate veil is pierced, shareholders and directors are exposed to personal liability for the debts of the corporation.[183] The concept is based upon the bedrock concept of limited liability.[184]

A. LIMITED LIABILITY

The concept of limited liability is a deeply rooted prescript dating back to 1819.[185] The doctrine prescribes that certain forms of entities provide the stakeholders with limited liability in regard to debts and liabilities that arise from the ordinary course of business.[186] The premise for shielding the shareholder from personal liability for the organization's financial responsibilities is based upon the concept that the business is considered a legal fiction and treated as a separate entity under all ordinary circumstances.[187] The result is to sever personal liability to the extent of the shareholder's investment, usually comprised of capital contributions.[188] The scope of the protection withstands claims arising from torts committed by agents or employees of the entrepreneur in the ordinary course of business, as well as debts incurred from the operations of the business.[189] While the limited liability attribute does not shield a director or shareholder from personal liability for his or her own torts, it shields them from personal liability for the acts of their agents that would otherwise have been incurred under the doctrine of respondeat superior.[190]

There are three different business structures that clothe the officers, directors, and investors with the limited liability attribute.[191] Those three business structures are: the corporation, the limited liability corporation, and the different limited liability partnerships.[192] In each of these

181. *Id.* Examples in which an aggrieved creditor may pierce the corporate veil include situations in which fraud was used to commit a transaction, and when a business is grossly undercapitalized. *Id.*

182. *Id.* at 255.

183. *Id.* at 254.

184. Kansas Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 111 (S.D. 1994).

185. *Id.* at 111 n.4.

186. Danks v. Holland, 246 N.W.2d 86, 90 (N.D. 1976).

187. Consumer's Co-op of Walworth County v. Olsen, 419 N.W.2d 211, 213 (Wis. 1988).

188. Escobedo v. BHM Health Assocs., Inc., 818 N.E.2d 930, 932 (Ind. 2004).

189. *Id.*

190. Hagen v. Am. Agency, Inc., 633 N.W.2d 497, 504 (Minn. 2001).

191. Thomas E. Rutledge, *Limited Liability (or not): Reflections on the Holy Grail*, 51 S.D. L. REV. 417, 425-30 (2006).

192. *Id.*

organizations, the investors' liability for the debts of the organization is limited to their respective investments.[193] If the assets of the business are insufficient to satisfy the aggrieved creditor's claims, the directors and investors are generally immune from having their personal assets attached to satisfy the remaining debt.[194] However, if the aggrieved creditor is able to meet the criteria established by the state, the court will impose personal liability based upon the equitable theory of piercing the corporate veil or the concept of treating the organization as an alter ego.[195] Prior to successfully imputing liability to a director, the aggrieved creditor must vicariously attach liability to the corporation.[196] This is accomplished under the concept of respondeat superior.[197]

B. RESPONDEAT SUPERIOR

The concept of respondeat superior is the ascribing of liability for those who hire employees to further the mission of the practice.[198] In order to provide the aggrieved creditor with sufficient resources to address the injury, the creditor is permitted to sue the business under the concept of respondeat superior.[199] This concept is the attribution of liability to an employer for the action of the employee.[200] Under this concept, the injured person imputes liability to the principal for the acts of the agent.[201] The principal is the party that permits a person to act on its behalf while the agent is a person who has authority to act for the principal.[202] In its most rudimentary form, the concept of respondeat superior refers to the employee/employer relationship.[203] The employee serves as the agent while the employer serves as the principal.[204] If the employee has authority to act on behalf of the principal, an agency relationship is created.[205]

193. Danks v. Holland, 246 N.W.2d 86, 90 (N.D. 1976).

194. *Id.*

195. Kansas Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 111 (S.D. 1994).

196. Cooperstein v. Patrician Estates, Inc., 465 N.Y.S.2d 53, 54 (N.Y. App. Div. 1983).

197. *Id.*

198. N.D. CENT. CODE § 3-03-09 (2007); Doan v. City of Bismarck, 2001 ND 152, ¶ 19, 632 N.W.2d 815, 822.

199. Brian P. Winrow, *The Entrepreneurial Executive*, 13 THE ENTREPRENEURIAL EXECUTIVE 63, 64 (2008).

200. *Doan*, ¶ 19, 632 N.W.2d at 822.

201. Zimprich v. Broekel, 519 N.W.2d 588, 590 (N.D. 1994).

202. Milliken Group, Inc. v. Hays Nissan, Inc, 86 S.W.3d 564, 567 (Tenn. Ct. App. 2001).

203. Bradley P. Humphreys, *Assessing the Viability and Virtues of Respondeat Superior for Nonfiduciary Responsibility in ERISA Actions*, 75 U. CHI. L. REV. 1683, 1689 (2008).

204. *Id.*

205. *See* Winrow, *supra* note 200, at 64.

Once the agency relationship is established, vicarious liability is the tool by which personal liability is imputed to the principal.[206] Vicarious liability involves imposing liability on the principal for the wrongful conduct of an agent.[207] In the organizational context, the business incurs vicarious liability for the acts of the agent, assuming the agent had the appropriate authority and was acting within his or her scope of employment.[208] Once the aggrieved party vicariously imputes liability to the business, the creditor can attach the business' assets in satisfaction of the debt.[209] However, if the business has insufficient assets to satisfy the aggrieved party, the creditor may be able to attach the personal assets of the investors.[210] This issue is dependant upon the business structure of the organization. If the business does not contain a limited liability attribute, the creditor can attach the personal assets of the owners.[211] However, if the business contains a limited liability attribute, the creditor is generally prevented from attaching the personal assets of the directors and shareholders.[212] Where the business contains a limited liability attribute, the creditor can only attach the personal assets of investors by successfully piercing the corporate veil.[213]

C. PIERCING THE CORPORATE VEIL

The fundamental premise with respect to the imposition of personal liability imputed to stakeholders in a limited liability entity for the business' debts is that, by legal fiction, the business is a separate entity and is treated as such under all ordinary circumstances.[214] While the presumption in favor of limited liability is not lightly disregarded, there are situations in which piercing the corporate veil is deemed appropriate.[215] A party seeking to disregard the corporate entity bears the burden of showing by a preponderance of the evidence that the business is merely a corporate façade and must be disregarded to prevent fraud or injustice to the plaintiff.[216] Only

206. N.D. CENT. CODE § 3-03-09 (2007).
207. Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328, 334 (Wis. 2004).
208. Fruit v. Schreiner, 502 P.2d 133, 141(Alaska 1972).
209. *Id.*
210. Kansas Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 111 (S.D. 1994).
211. *Id.* at 112.
212. *Id.*
213. *Id.*
214. Consumer's Co-op of Walworth County v. Olsen, 419 N.W.2d 211, 213 (Wis. 1988).
215. *Id.*
216. Lascsak v. Hollingsworth, No. A-04-666, 2006 WL 786455, at *4 (Neb. App. Mar. 28, 2006).

then will courts reluctantly pierce the corporate veil.[217] The determination of whether the business is merely a corporate façade is determined on a case-by-case basis in light of the facts presented.[218]

1. *North Dakota*

North Dakota has adopted a balancing test consisting of several factors in order to ascertain whether a corporation should be pierced.[219] The nine factors considered when determining whether equity demands piercing the corporate veil include: (1) undercapitalization; (2) failure to observe corporate formalities; (3) nonpayment of dividends; (4) insolvency of debtor corporation at the time of the transaction; (5) siphoning of funds by a dominant shareholder; (6) nonfunctioning of directors; (7) absence of corporate records; (8) using the corporate shell as a mere façade to conduct personal transactions; and (9) use of the corporation to promote fraud, injustice, or illegality.[220]

2. *Delaware*

In Delaware, the factors contained within the balancing test are similar to the factors contained within the North Dakota analysis. The Delaware factors include: (1) whether the corporation was adequately capitalized for the corporate undertaking; (2) whether the corporation was solvent; (3) whether dividends were paid; (4) whether adequate records were maintained; (5) whether officers and directors functioned properly; (6) whether the officers and directors complied with corporate formalities; (7) whether the dominant shareholder siphoned corporate funds; and (8) whether the corporation simply functioned as a façade for the dominant shareholder.[221] Each of the factors within the North Dakota and Delaware balancing tests are individually analyzed, starting with undercapitalization, to ascertain the respective scrutiny afforded to the respective component.

a. Undercapitalization

In order to be afforded limited liability protection, shareholders must invest a reasonable amount of capital for the nature of the business involved

---

217. *In re* Estate of Wallen, 633 N.E.2d 1350, 1357 (Ill. App.1994).

218. Inryco, Inc. v. CGR Bldg. Systems, Inc., 780 F.2d 879, 881 (10th Cir. 1986).

219. Hilzendager v. Skwarok, 335 N.W.2d 768, 774 (N.D. 1983).

220. *Id*.

221. Harco Nat'l Ins. Co. v. Green Farms, Inc., CIV. A. No. 1131, 1989 WL 110537, at *4 (Del. Ch. Sept. 19, 1989).

to meet prospective liabilities.[222] If an organization is severely undercapitalized, as measured by the nature and extent of the organization's endeavor, it will serve as a key factor in denying shareholders the defense of limited liability.[223] However, an entity that was sufficiently capitalized at formation but suffers losses is not per se undercapitalized.[224] On the other hand, a business that was adequately capitalized for the initial undertaking may become undercapitalized if the corporation significantly expands the scope of the business without a new infusion of capital.[225]

The weight afforded to the undercapitalization factor differs from state to state.[226] The majority of states have held undercapitalization alone is insufficient to pierce the corporate veil.[227] In these states undercapitalization serves as a mere cog in the analysis, and thus an insufficient basis in and of itself to expose shareholders or directors to personal liability for the debt of the entity.[228] Even the states that require more than insufficient capital to pierce the corporate veil concur that evidence of inadequate capital is a substantial factor in the overall analysis.[229] In contrast, a minority of states will permit the corporate veil to be pierced upon a showing of undercapitalization.[230]

The purpose of this factor is to prohibit an organization that is formed or carries on business without sufficient assets available to meet its financial obligations.[231] In this situation, it would be inequitable to permit the shareholders to escape personal liability to the detriment of the aggrieved creditors.[232] The attempt to do so circumvents the spirit of the law and it is thus, ineffectual to exempt the shareholders from the business' liabilities.[233] As a result, shareholders must risk unencumbered capital reasonably

222. Jablonsky v. Klemm, 377 N.W.2d 560, 566 (N.D. 1985) (citing Briggs Transp. Co. v. Starr Sales Co., 262 N.W.2d 805, 810 (Iowa 1978)).

223. Kansas Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 115 (S.D. 1994).

224. *Id.*

225. Consumer's Co-op of Walworth County v. Olsen, 419 N.W.2d 211, 213 (Wis. 1988).

226. *See* Curtis v. Feurhelm, 335 N.W.2d 575, 576 (S.D. 1983) (finding undercapitalization in South Dakota is a mere factor relevant to piercing the corporate veil); *Consumer's Co-op.*, 419 N.W.2d at 217 (stating that while significant, undercapitalization is not an independently sufficient ground to pierce the corporate veil).

227. Jacobson v. Buffalo Rock Shooters Supply, 664 N.E.2d 328, 332 (Ill. Ct. App. 1996); Sansone v. Moseley, 912 S.W.2d 666, 669 (Mo. Ct. App. 1995); Southern Lumber & Coal v. M. P. Olson Real Estate, 426 N.W.2d 504, 509 (Neb. 1988); Jablonsky v. Klemm, 377 N.W.2d 560, 565 (N.D. 1985); LeRoux's Billyle Supper Club v. Ma, 602 N.E.2d 685, 689 (Ohio Ct. App. 1991); *Consumer's Co-op*, 419 N.W.2d at 213.

228. *See, e.g.*, *Jacobson*, 664 N.E.2d at 332; *Jablonsky*, 377 N.W.2d at 565.

229. *Curtis*, 335 N.W.2d at 576; *Consumer's Co-op.*, 419 N.W.2d at 217.

230. *Sansone*, 912 S.W.2d at 669.

231. *Jablonsky*, 377 N.W.2d at 566.

232. *Id.*

233. *Id.*

adequate to cover the businesses prospective debts.[234] Moreover, if the invested capital is merely illusory in comparison to the potential risks of loss, the court will have sufficient evidence to permit the piercing of the corporate veil.[235] The result would expose the stakeholders to personal liability in order to satisfy an aggrieved creditor.[236]

While North Dakota has not directly addressed the issue, it appears from the limited precedence that North Dakota concurs with the majority of states that undercapitalization only qualifies as a mere cog in the overall balancing test.[237] Moreover, North Dakota adopted the first eight factors of its balancing test from Minnesota.[238] In Minnesota, the courts have held that a number of the factors within the balancing test must be present in order to warrant the piercing of the corporate veil.[239] As a result, in North Dakota, undercapitalization alone is insufficient to warrant the piercing of the corporate veil.[240]

In *Gadsden v. Home Preservation Co.*,[241] the Delaware Chancery Court addressed the issue of inadequate capitalization.[242] Evidence was presented that the defendant signed contracts and issued warranties in the name of the contractor, but the contractor had no assets, as all of the assets and capital were held by the owner.[243] From the businesses inception, and by design, the corporation never had any measurable economic value.[244] The company never received an allocation of initial capitalization, and its stock never had any value.[245] The corporation never owned any assets, including tools, equipment, or inventory.[246] Moreover, the corporation's sole stockholder and employee ensured that the corporation's bank account contained minimal funds.[247] Even though the company had no economic value, it routinely furnished to its customers contracts containing ten- to twenty-year workmanship warranties.[248] The suppliers who were aware of this

---

234. *Id.*
235. *Id.*
236. *Id.*
237. *See generally id.* (finding it was proper to pierce the corporate veil on a number of factors, not just the undercapitalization factor).
238. *Id.* at 564.
239. Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979).
240. *Jablonsky*, 377 N.W.2d at 564.
241. No. Civ.A. 1888, 2004 WL 485468 (Del. Ch. Feb. 20, 2004).
242. *Gadsden*, 2004 WL 485468, at *3.
243. *Id.*
244. *See id.*
245. *Id.* at *4.
246. *Id.*
247. *Id.*
248. *Id.* at *3.

practice refused to extend the corporation credit by requiring the defendant to personally pay for all materials.[249] Unlike those suppliers, the plaintiff, however, was unable to protect herself as she was unaware of these practices.[250] Based upon these facts, the court found that the business was severely undercapitalized, and allowed the plaintiff to pierce the corporate veil, thus imposing personal liability on the plaintiff.[251]

b. Failure to Observe Corporate Formalities

The second factor within the corporate piercing balancing test is the shareholder's failure to observe corporate formalities.[252] The failure to observe the corporate formalities serves as evidence that the limited liability business was a mere instrumentality of the shareholder(s) and was not treated as an entity separate from its owners.[253] In other words, when the shareholder(s) of a business disregard the corporate entity, the courts may follow suit.[254] While corporate formalities must be observed, the mere failure to occasionally follow all the formalities prescribed by law is insufficient to justify the disregarding of the corporate entity.[255] There must either be a pattern or an egregious disregard of the corporate formalities before the court will permit the plaintiff to attach personal liability to the stakeholder.[256] When courts disregard the corporate entity based upon lack of formalities, it is frequently based on cases where adequate records were not maintained and the business neglected to hold any shareholder or director meetings.[257]

As a result, some states have lessened the formality requirement for small businesses. For example, North Dakota has recognized the hardship that the stringent formalities impose on small entities seeking the protection of limited liability, but lacking the size and complexity of a prototypical corporation to warrant such unwavering formalities.[258] In response, North Dakota has lessened some of the more common formalities traditionally found in other states statutes, such as not requiring the corporation to draft

---

249. *Id*. at *4.
250. *Id*.
251. *Id*. at *6.
252. Jablonsky v. Klemm, 377 N.W.2d 560, 563 (N.D. 1985).
253. Cmty. Care Ctrs., Inc. v. Hamilton, 774 N.E.2d 559, 564-65 (Ind. Ct. App. 2002).
254. Kansas Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 115 (S.D. 1994).
255. Curtis v. Feurhelm, 335 N.W.2d 575, 576-77 (S.D. 1983).
256. *Id*.
257. *See* Ted Harrison Oil Co. v. Dokka, 617 N.E.2d 898, 902 (Ill. App. Ct. 1993) (finding the defendant neglected to maintain any records and failed to hold any director of shareholder meetings).
258. *See* N.D. CENT. CODE § 10-19.1-31(1) (2007) (stating bylaws are not required).

bylaws.[259] In Delaware, required formalities include filing separate tax returns, maintaining separate books and not commingling personal funds with corporate funds.[260] Moreover, the Delaware court has held that the failure to maintain adequate records is strong evidence that there was a failure to maintain corporate formalities.[261]

c. Nonpayment of Dividends

The third factor in the balancing test relates to the nonpayment of dividends.[262] While the failure to pay dividends can be construed as evidence of a sinister motive or the business being conducted as the alter ego of its shareholders, it can also serve a legitimate business purpose.[263] When a corporation earns money it is permitted to either make taxable distributions to its stockholders, known as dividends, or it may retain the earnings.[264] When a corporation retains earnings, it is reinvesting the profits into the business.[265] The retained earnings can then be used for legitimate business purposes, including buying back outstanding shares of stock, paying debt, or financing expansion.

d. Insolvency of the Corporation at Time of the Transaction

The fourth factor is whether the corporation was insolvent at the time of the transaction.[266] In *Aiken v. Timm*,[267] the Minnesota Supreme Court held that transactions that occur during a period of insolvency have the appearance of impropriety as they can be used to improperly dispose of assets from valid creditors.[268] According to Delaware case law, "the fact which creates the trust [for the benefit of creditors] is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the

---

259. *Id.*

260. David v. Mast, No. 1369-K, 1999 WL 135244, at *3 (Del. Ch. Mar. 2, 1999).

261. Harco Nat'l Ins. Co. v. Green Farms, Inc., Civ. A. No. 1131, 1989 WL 110537, at *6 (Del. Ch. Sept. 19, 1989).

262. Jablonsky v. Klemm, 377 N.W.2d 560, 563 (N.D. 1985) (citing Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979)).

263. Almac, Inc. v. JRH Dev., Inc., 391 N.W.2d 919, 923 (Minn. Ct. App. 1986) (citing Snyder Electric Co. v. Fleming, 305 N.W.2d 863, 868 (Minn.1981)).

264. *See Snyder Electric Co.*, 305 N.W.2d at 868 (explaining that it is common for closely held corporations to retain earnings).

265. *Id.*

266. *Jablonsky*, 377 N.W.2d at 563.

267. 180 N.W. 234, 235 (Minn. 1920).

268. *Aiken*, 180 N.W. at 235; Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 782-83 (Del. Ch. 2004).

case of solvency."[269] In *Bovay v. H. M. Byllesby & Co.*,[270] the Delaware Chancery Court stated that insolvency occurs when a corporation's assets have sunk below the amount of its debts, as opposed to insolvency due to a statutory filing.[271]

e. Siphoning of Funds by the Dominant Shareholder

The fifth factor in the balancing test is whether the dominant shareholder siphoned funds from the corporation.[272] In the North Dakota landmark case of *Jablonsky v. Klemm*,[273] the North Dakota Supreme Court articulated the type of evidence sufficient to satisfy the siphoning element.[274] In *Jablonsky*, the defendant purchased two incomplete apartment units for less than fair market value, had them completed, and subsequently sold them and retained a profit of $27,000.[275] The evidence established that the defendant's other business furnished carpet and kitchen cabinets for the project and made a thirteen percent profit on the $78,000 in cabinets furnished to the corporation.[276] In its holding, the court noted, "although the amount of siphoning was not large in relation to the total sales of the company, the amount was large in relation to the capital."[277] Finally, the court concluded that the fact the defendant "siphoned" any funds was more significant than the amount.[278]

f. Nonfunctioning of Directors

The sixth factor in the balancing test relates to nonfunctioning of the directors.[279] As previously stated, the role of the directors is to oversee the business affairs of the corporation.[280] Directors help establish the independence between the corporation and the shareholder. In return for their services, directors generally avoid liability for their decisions made in good faith, as well as for the debts of the corporation.[281] The element of a

---

269. Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. 1992) (citing Bovay v. H. M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944)).
270. 38 A.2d 808 (Del. 1944).
271. *Bovay*, 38 A.2d at 813.
272. Jablonsky v. Klemm, 377 N.W.2d 560, 563 (N.D. 1985).
273. 377 N.W.2d 560 (N.D. 1985).
274. *Jablonsky*, 377 N.W.2d at 567.
275. *Id.*
276. *Id.*
277. *Id.*
278. *Id.*
279. *Id.* at 563.
280. N.D. CENT. CODE § 10-19.1-32(1) (2007).
281. Buckingham v. Weston Village Homeowners Ass'n, 1997 ND 237, 571 N.W.2d 842, 844.

nonfunctioning director is often related to the corporate formality factor.[282] Corporate formalities include factors such as holding annual director meetings and actively overseeing the corporation's affairs.[283]

In exchange for limited liability protection, the shareholders must observe appropriate formalities by those controlling a corporation.[284] Observing corporate formalities demonstrates that those in control of a corporation treat the corporation as a separate and distinct entity and have an expectation that the traditional attributes associated with a corporation will be afforded to it.[285] When the formalities are not respected, the legal fiction that is the corporation diminishes and the expectation that others would treat it as a distinct, liability-limiting entity becomes less reasonable.[286]

g. Inadequate Corporate Records

The seventh factor included within the balancing test is whether adequate corporate records were maintained.[287] A corporation must maintain accurate financial and accounting records, as well as minutes from the shareholder and board of director meetings.[288] Failure to maintain these records serves as evidence that the corporation is merely an alter ego of the shareholder.[289] With the advent of hybrid business structures such as the limited liability company and the statutory close corporation, the record keeping requirements have diminished in many of the states that have adopted such legislation.[290] As discussed, some states have abolished the requirement that the corporation elect a board of directors, hold annual shareholder or board of director meetings, and draft bylaws.[291] In these

---

282. Roof Depot v. S.A.I. Constr., No. C2-96-1164, 1996 WL 745279, at *2 (Minn. Ct. App. Dec. 31, 1996).

283. MINN. STAT. § 302A.231, subdiv. 1 (1996).

284. *Id.*

285. David v. Mast, No. 1369-K, 1999 WL 135244, at *2 (Del. Ch. Mar. 2, 1999).

286. *Id.*

287. Jablonsky v. Klemm, 377 N.W.2d 560, 563 (N.D. 1985).

288. N.D. CENT. CODE § 10-19.1-53 (2007).

289. Goldstein v. Mortenson, 113 S.W.3d 769, 781 (Tex. App. 2003).

290. William S. Hochstetler & Mark D. Svejda, *Statutory Needs of Close Corporations-An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?*, 10 J. CORP. L. 849, 997 (1985); *see also* TEX. BUS. CORP. ACT ANN. art. 12.37(F)(1) (Vernon 2007) (stating that under Texas law failure to observe traditional corporate formalities will not be considered in determining whether to impose personal liability); Remillong v. Schneider, 185 N.W.2d 493, 495 (N.D. 1971) (holding that shareholders may waive the requirement of formal board of director meetings).

291. Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DEPAUL BUS. & COM. L.J. 51, 76 (2004).

states, the factors would be reduced to maintaining a record of shareholders, and adequate financial and accounting records.[292]

h. Corporate Shell as Mere Façade for Personal Transactions

The eighth factor included within the balancing test is whether the business is serving as a mere façade for the stakeholder's personal transactions.[293] A corporation is a mere façade when it possesses the corporate shell, but only serves as protection for the transactions of an individual.[294] This issue is highlighted in *Jablonsky*, where the corporation only served as a pass-through corporation for the defendant's personal transactions.[295] In *Jablonsky*, the North Dakota Supreme Court examined whether the corporation had any employees, equipment, or property.[296] The absence of the assets is indicative of a corporation serving as a mere façade.[297] Another consideration is whether the shareholder used corporate funds for personal purposes, or commingled corporate and personal accounts.[298] When a shareholder is paying personal expenses out of corporate accounts, or fails to open a separate account for the corporation, such evidence is indicative of a shareholder that does not treat the entity as a separate being.[299] Courts generally scrutinize activity such as: using business credit cards for both personal and business expenses; using a corporate checking account to pay for personal expenses; and using corporate funds to purchase personal services.[300] The purpose of the analysis under this factor is to avoid the appearance of impropriety and to allow the courts to ascertain the amount of funds associated with the entity to ensure creditors have full access to corporate funds.[301]

The façade factor analyzes the defendant's conduct to determine whether the owner treated the corporation as the owner's alter ego, for the purpose of avoiding liability.[302] It serves as a general analysis of the

292. *Id*. at 66.
293. Jablonsky v. Klemm, 377 N.W.2d 560, 563 (N.D. 1985).
294. *Id*. at 567.
295. *Id*.
296. *Id*.
297. *Id*. at 566.
298. Cmty. Care Ctrs., Inc. v. Hamilton, 774 N.E.2d 559, 568 (Ind. Ct. App. 2002).
299. *Id*.
300. Gilleard v. Nelson, No. 03-1496, 2005 WL 2756042, at *4 (Iowa Ct. App. Oct. 26, 2005).
301. *See id*. (stating that the corporate veil will be pierced to achieve a just and honest result).
302. Mason v. Network of Wilmington, Inc., No. Civ.A. 19434-NC, 2005 WL 1653954, at *3 (Del. Ch. July 1, 2005).

owner's conduct and is often synonymous with fraud or injustice.[303] In the façade analysis, no single factor is dominant, resulting in a holistic analysis.[304]

i. Fraud, Injustice, or Illegality

The final factor in the analysis is whether the corporation was used to further fraud, injustice, or illegality.[305] When the entity is used in a manner that thwarts public sentiment, protects fraud, or defends crime, sufficient reason exists to pierce the corporate veil.[306] However, the showing of inequity must arise from the malfeasance of the corporation.[307] Moreover, the mere breach of a contract is insufficient to hold an individual shareholder personally liable for the monetary obligations of the business.[308] This does not mean the stakeholder is prohibited from forming a limited liability entity to escape personal liability, as the limited liability entity was created for that purpose.[309] Rather, it means the corporation is bound by the constraints of fair play and common decency.[310]

The prohibition against misrepresentation is intended to prevent entrepreneurs from being clothed with limited liability, resulting in unjust enrichment as a consequence of their misdeeds.[311] The act of fraud can be actual or constructive.[312] Actual fraud consists of inducing another party to enter into a contract by intentionally misleading or deceiving the party.[313] In material contrast, constructive fraud consists of a breach of duty absent actual fraudulent intent, which unjustly enriches the breaching party by misleading another to her detriment.[314] North Dakota, however, only requires that some element of unfairness exists.[315] Such a requirement is less stringent than the fraud element.[316]

---

303. *Id.*
304. *Id.*
305. Jablonsky v. Klemm, 377 N.W.2d 560, 563 (N.D. 1985).
306. Kansas Gas & Elec. Co. v. Ross, 521 N.W.2d 107, 112 (S.D. 1994).
307. *Id.* at 113 (citing Greater Kansas City Roofing, 2 F.3d 1047, 1052-53 (10th Cir.1993)).
308. *Id.*
309. *Id.*
310. *Id.*
311. *Id.*
312. Brevet Int'l, Inc. v. Great Plains Luggage Co., 2000 SD 5, ¶ 17, 604 N.W.2d 268, 272 (citing McDonough v. Kahle, 1999 SD 14, ¶ 17, 588 N.W.2d 600, 603; Sperry Corp. v. Schaeffer, 394 N.W.2d 727, 731 (S.D. 1986)).
313. *Id.* (citing S.D. CODIFIED LAWS § 53-4-5 (2008)).
314. *Id.* (citing S.D. CODIFIED LAWS § 53-4-6).
315. Jablonsky v. Klemm, 377 N.W.2d 560, 563-64 (N.D. 1985).
316. *Id.*

V. FEDERAL REGULATORY STATUTES

Prior to the corporate scandals that diminished the public's confidence in corporate America, the issue of corporate governance structures was primarily governed by state law.[317] In the wake of the corporate scandals, the federal government passed legislation implementing requirements pertaining to corporate governance through the enactment of the Sarbanes-Oxley Act of 2002.[318] The Sarbanes-Oxley Act, however, did not expressly preempt state law as the primary source of the corporate governance system.[319] As a result, any right to enforce those mandates is expected to come from state fiduciary duty law, the primary avenue available to stockholders to enforce directors' duties.[320]

VI. CONCLUSION

Even as the issue of corporate responsibility and accountability has been at the forefront of debate, the scope of potential liability incurred by a director in North Dakota appears to be minimal in light of the statutory language and limited case law that has emerged with regard to this issue.[321] North Dakota has adopted broad protections to protect a director from incurring personal liability when acting on behalf of the corporation. Directors are permitted to escape liability for breach of their fiduciary duties, such as the duty of good faith, in corporations that have filed the waiver with their articles of incorporation.[322] In addition, North Dakota has enacted corporate constituency statutes permitting the directors to escape liability by relying on outside reports.[323] Finally, a director's transactions are adjudged under the business judgment rule, thus removing their actions from the ordinary negligence standard of care.[324] While the business judgment rule is not intended to shield a director from liability, it has the

---

317. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 860 (2003) (stating that federal security law plays a supporting role in facilitation of state corporate law).

318. J. Robert Brown Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 375 (2004).

319. *Id.*

320. *Id.*

321. *See infra* Part III (explaining that decisions made by the directors are analyzed under the business judgment rule; moreover, liability for breach of director fiduciary duties can be waived).

322. N.D. CENT. CODE § 10-19.1-50(5)(a), (b) (2007).

323. *Id.* § 10-19.1-50(2).

324. Buckingham v. Weston Village Homeowners Ass'n, 571 N.W.2d 842, 844 (N.D. 1997).

effect of adding another layer of protection against an aggrieved shareholder.[325]

These broad protections afforded to a director are especially interesting in light of the newly enacted North Dakota Publicly Traded Corporations Act.[326] The purpose of this Act was to allow corporations to elect to be governed under the "shareholder friendly" statutes, which provide the shareholders with increased rights within the management and corporate governance of the business.[327] Even while the North Dakota Legislature was able to enact a major overhaul, under which a corporation can elect to be governed, the recourse available to the shareholders for the malfeasance of a director is minimal at best. While the Act does afford shareholders additional rights in the election of directors, it does little to hold directors accountable for breaching their fiduciary duty, or for their negligence.

As it currently stands, the scope of a director's liability in North Dakota is substantially similar to a director's scope of liability in Delaware. In order to achieve its dual objective of providing additional minority shareholder rights, as well as attracting new businesses to incorporate within the state, North Dakota needs to distinguish itself not only with the safeguards afforded to the minority shareholders under the Act, but also by holding directors personally liable for their malfeasance. This can be accomplished by drafting additional statutes restricting the corporation's ability to waive a director's liability and redefining the business judgment rule. These statutes would serve to compliment the Act and serve to make North Dakota a truly shareholder friendly state.

---

325. Mark S. Schwartz, Thomas W. Dunfee & Michael J. Kline, *Tone at the Top: An Ethics Code for Directors?*, 58 J. OF BUS. ETHICS 79, 79 (2005).

326. N.D. CENT. CODE § 10-35-01.

327. *Id.*