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Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability

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PIERCING THE CORPORATE VEIL, FINANCIAL RESPONSIBILITY, AND THE LIMITS OF LIMITED LIABILITY

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ABSTRACT

Creditors of insolvent corporations often ask courts to "pierce the corporate veil" and hold shareholders personally liable for a corporate obligation. Veil piercing is the most heavily litigated issue in corporate law, yet legal doctrine in this area is notoriously incoherent. Courts typically base their decisions on conclusory references to criteria of doubtful relevance. Results are unpredictable. Similar outcomes are now occurring in cases brought against the owners of various kinds of newly sanctioned limited liability entities, and so a bad situation is only going to get worse. In this Article, I argue that this state of affairs results from a lack of understanding of the policy basis for limited liability. Once a better understanding is achieved, veil piercing can then serve the useful function of distinguishing legitimate from illegitimate reliance on statutory limited liability.

After surveying efficiency rationales for limited liability and finding them unpersuasive, I propose that the best way to understand the purpose of limited liability is as a subsidy designed to encourage business investment. The subsidy comes at the expense of corporate creditors. It is easy to see how this is so as to victims of corporate torts; limited liability requires that they bear their losses to the extent they exceed corporate assets. It is less obvious that shareholders actually gain value from contract creditors, who can insist on compensation ex ante for the increased risk of default that limited liability entails, but even in this context I argue that recent research in behavioral economics suggests that shareholders do benefit at creditors' expense from the statutory limited liability default rule.

However beneficial the limited liability subsidy may be to corporate shareholders and to society more generally, it should not be so broad as to protect illegitimate behavior. In particular, limited liability should not provide the occasion for shareholders to behave opportunistically toward third parties. As to contract creditors, that means imposition of risk that creditors have not agreed to bear, as, for example, when controlling shareholders cause a corporation to incur a debt while having no reasonable basis for believing that it will be repaid. Similarly, when corporations engage in activities likely to injure others, shareholders act opportunistically if they have failed to provide a reasonable amount of compensation, either through liability insurance or cash reserves. As to both contract and tort creditors, the key concern is use of limited liability as a device deliberately or recklessly to extract value from third parties without their consent and without compensation; absent the limited liability

shield, such practices could not be effective because business owners would bear full responsibility for creditor claims. Fairness and efficiency considerations necessitate denial of limited liability in cases of opportunism because the subsidy to investors comes at too great a cost to corporate creditors. In particular, if limited liability is to protect opportunism, the cost of credit is higher for all corporate borrowers because lenders are unable ex ante to discriminate between those who are trustworthy and those who are not. Likewise, tort victims bear too heavy a cost if limited liability shields shareholders who have failed to insure against third party injuries.

Limited liability should instead be limited to situations in which shareholders have managed the business with due regard for bargained-for expectations and potential accident victims. If corporate insolvency has occurred despite the shareholders' reasonable efforts, the limited liability shield should protect them. In other words, the availability of limited liability should depend on whether the controlling shareholders have managed the business in a financially responsible manner. Courts confronted with veil piercing claims thus should tailor the scope of limited liability to those circumstances in which it is warranted according to sound public policy. Deployed in this way, limited liability would protect shareholders from the kinds of losses that should be their primary concern, namely business insolvency due to causes that could not reasonably have been anticipated or prevented: contractual obligations that are unpayable because of developments that were unforeseen when they were undertaken and tort claims that exceed an insurance policy's reasonably chosen coverage limit. Limited to situations like this, limited liability would still provide investors with a significant benefit. It would therefore continue to facilitate corporate law's business subsidization policy, but the cost of that subsidy would be reduced to an amount that respects legitimate creditor and societal interests.

INTRODUCTION

Limited liability is a familiar feature of the law governing business organizations. Long the hallmark of corporate status, limited liability protects a corporation's shareholders from personal responsibility for corporate obligations.[1] This means that a creditor who has a claim arising out of a transaction with the corporation may not look to a shareholder for payment even if the corporation is insolvent. Limited liability is not restricted to corporations. Limited partners in limited partnerships also enjoy similar protection.[2] More recently, a proliferation of new forms of business organization offers limited liability in a number of novel contexts. These include most notably the limited liability company[3] and also the limited liability partnership[4] and limited liability limited partnership.[5]

The institution of limited liability in corporate law has attracted extensive criticism, especially on efficiency grounds. These concerns have led to proposals that limited liability be abolished, at least as to certain types of creditor claims.[6] Yet despite these arguments, limited liability is alive and well. The various new forms of unincorporated business entities all share the limited liability attribute as their principle reason for being. These developments indicate clearly that legislators and policymakers continue to value limited liability despite academics' insistence on its excessive social costs.

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1 *See, e.g.*, MODEL BUS. CORP. ACT § 6.22(b) (2002) ("[A] shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.").

2 *See, e.g.*, REV. UNIF. LTD. P'SHIP ACT § 303(a) (amended 1985) ("[A] limited partner is not liable for the obligations of the partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business.").

3 *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 303(a) (1995) ("[T]he debts, obligations, and liabilities of a limited liability company . . . are solely the debts, obligations, and liabilities of the company.").

4 *See, e.g.*, REV. UNIF. P'SHIP ACT § 306(c) (1997) ("An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership.").

5 *See, e.g.*, UNIF. LTD. P'SHIP ACT OF 2001 § 404(c) (2001) ("An obligation of a limited partnership incurred while the limited partnership is a limited liability limited partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the limited partnership.").

6 *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (proposing rule of pro rata shareholder liability for corporate torts); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991) (criticizing limited liability for corporate torts).

Although corporate statutes speak in general terms about protection of the entity's shareholders from liability for the corporation's obligations,[7] in fact, limited liability has never been as absolute as the statutory texts appear to indicate. Courts have deployed the equitable doctrine of "piercing the corporate veil" whenever they have believed it necessary to impose shareholder liability despite corporate law's promise of limited liability.[8] According to Professor Thompson, this is the single most frequently litigated issue in corporate law.[9]

Veil piercing has been the subject of extensive criticism, and, like limited liability itself, there have been calls for its abolition.[10] Critics have emphasized the apparently unprincipled, ad hoc, and therefore unpredictable manner in which courts have deployed this device.[11] Nevertheless, it remains a prominent feature of corporate law. The same impulses that have led courts to disregard corporate existence to prevent perceived injustice are already resulting in the deployment of corporate law veil-piercing analysis to claims brought by creditors against the owners of the newly created forms of unincorporated limited liability entity.[12] Here, too, the decisions are a product of judicial initiative rather than statutory text.

In this Article, I take for granted the political reality that limited liability is here to stay. At the same time, I also assume that courts will continue from time to time to disregard statutory limited liability and pierce the entity veil to hold business owners personally liable for an obligation of the firm. In light of these assumptions, I seek to bring some order to this severely disheveled area of the law by suggesting some basic principles that courts should consider when entertaining efforts to impose liability on shareholders. I ask us to think seriously about a coherent rationale for limited liability to come to a principled understanding of what its limits ought to be. Veil piercing can then play an

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7 *See, e.g.*, MODEL BUS. CORP. ACT § 6.22(b) (2002) (providing for shareholder limited liability unless liability might be warranted by virtue of the shareholder's own conduct).

8 Robert B. Thompson, *Agency Law and Asset Partitioning*, 71 U. CIN. L. REV. 1321, 1325 (2003).

9 *Id.* at 1325.

10 *See, e.g.*, Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001); Douglas C. Michael, *To Know a Veil*, 26 J. CORP. L. 41 (2001).

11 *See* discussion *infra* Part II.B.

12 *See, e.g.*, Hollowell v. Orleans Reg'l Gen. Hosp. LLC, 217 F.3d 379, 385 n.7 (5th Cir. 2000) (affirming trial court's holding that corporate law of veil piercing applies to creditor claims against LLC members); Ditty v. CheckRite, Ltd., Inc., 973 F. Supp. 1320, 1335–36 (D. Utah 1997) ("[M]ost commentators assume that the [veil-piercing] doctrine applies to limited liability companies."); Kaycee Land & Livestock v. Flahive, 46 P.3d 323, 327 (Wyo. 2002) ("We can discern no reason, in either law or policy, to treat LLCs differently than we treat corporations.").

important role by assuring that shareholders do not enjoy the benefit of the limited liability shield in cases in which protection is inappropriate.

Part I of this Article considers the justifications for statutory limited liability, which on its face is unqualified. Because the rule applies to closely as well as publicly held corporations and to tort as well as contract creditors, limited liability cannot be defended solely on efficiency grounds. Instead, the true policy basis for limited liability seems to be the reallocation of some of the costs of doing business from business owners to those who transact (voluntarily or involuntarily) with the corporation. By requiring creditors to bear some of these costs, the law in effect requires them to subsidize business activity. This policy does not depend on a clear demonstration of efficiency for its legitimacy. Instead, there seems to be little more at work than an unquestioned assumption that the benefits of increased business investment will be worth the social costs.

Courts have recognized that sometimes this subsidization policy can result in behavior by business owners that should not be tolerated.[13] That has been the impetus for development of the "piercing the corporate veil" doctrine that denies the limited liability shield to shareholders under certain circumstances. The problem, however, is that this incoherent body of case law—which hardly deserves the term "doctrine"—has turned out to be an unprincipled hodgepodge of seemingly ad hoc and unpredictable results. I discuss the currently dismal state of veil-piercing law in Part II.

Nonetheless, veil piercing can perform a useful function. Once the appropriate limits of limited liability are understood, veil piercing can police those limits. That understanding, however, depends on a sound sense of the policy basis for limited liability, which I develop in Part III. The key notion is that corporate shareholders should enjoy the limited liability shield only if they have conducted their business in a financially responsible manner. If they have, and the corporation nevertheless has ended up unable to pay its debts, then limited liability is appropriate. However, limited liability can also facilitate opportunistic behavior by shareholders that the law should not endorse.[14] Sound policy should not allow controlling shareholders to use limited liability as a device deliberately or recklessly to extract value from third parties without their consent and without compensation. If shareholders can use limited liability for those ends, the subsidy is too generous. Veil

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13 *See* cases cited *supra* note 12.

14 *See, e.g.*, *infra* Part III.A.2.

piercing therefore allows courts to tailor limited liability to those cases in which it is truly warranted. Part IV elaborates on how courts should deploy veil piercing so as to limit the scope of limited liability to cases of financially responsible behavior.

I. JUSTIFICATIONS FOR LIMITED LIABILITY

A. *Efficiency Rationales*

Scholars have identified several efficiency-based rationales for limited liability. Most obviously, limited liability enables aggregation of large amounts of capital from numerous small investors. If liability were not limited, even a small investment could render a shareholder liable for a substantial corporate obligation. Many people would be reluctant to risk their personal wealth in exchange for the prospect of only a modest return at best; even if the venture proves to be wildly successful, the small shareholder can claim only a small percentage of the corporation's gains.[15] Because even a remote risk of a huge loss may overshadow small gains that are more likely, potential investors may forego investments that have a positive net present value.[16] Limited liability therefore encourages investment that otherwise would not occur.

In addition to facilitating capital formation, limited liability also allows shareholders to reduce risk by holding diversified portfolios. Facing less risk, shareholders are willing to settle for a lower rate of return than they would demand if liability were unlimited. Corporations therefore incur lower capital costs.[17]

Limited liability also saves shareholders the costs involved in attempting to protect themselves from unduly risky corporate behavior. If unlimited liability were the rule, shareholders would need to concern themselves with the possibility of corporate decisions that could expose them to personal liability.

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[15] *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATE LAW 37 (1995). The assumption here is that unlimited liability would be joint and several as in partnership law. If instead liability were pro rata, the risk of loss would be reduced and the disincentive to invest that much less. *See* Hansmann & Kraakman, *supra* note 6, at 1892–94.

[16] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 44 (1991). It is assumed that shareholders are risk averse.

[17] *See, e.g.*, Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262–65 (1967).

This would necessitate efforts to participate actively in control of the business or at least to monitor closely the decisions of the firm's managers.[18] To minimize the costs involved in engaging in these kinds of activities, investors would need to concentrate their capital in one or perhaps a few ventures. Even then these costs could exceed the expected return on a relatively small investment. With limited liability, however, investors need not concern themselves with costly monitoring efforts or participation in management. Instead, they can optimize their returns by making smaller investments in a larger number of companies.[19]

Limited liability also eliminates the need for shareholders to monitor each other. Under a regime of unlimited liability, the likelihood that any single shareholder would have to pay a judgment against an insolvent corporation would depend in part on the resources of the other shareholders.[20] If the majority of the shareholders have modest personal wealth, an affluent shareholder would end up paying a larger share of the judgment out of his own pocket.[21] Shareholders would therefore incur costs in attempting to keep track of both the identities of their fellow shareholders and also their individual wealth.

Finally, limited liability facilitates the transferability of corporate stock. If liability were unlimited, protection of creditor interests would require either a rule prohibiting transfer to low-asset transferees or else a rule exposing the transferor to liability after the transfer.[22] Either rule would interfere with trading activity and could adversely affect the efficient pricing of publicly traded shares if the result is a significant reduction in trading volume.[23]

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[18] EASTERBROOK & FISCHEL, *supra* note 16, at 41–42.

[19] *See* Manne, *supra* note 17, at 262.

[20] *See* Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporate Law*, 30 U. TORONTO L.J. 117, 123–24 (1980).

[21] If, however, the unlimited liability rule were pro rata rather than joint and several, this consideration would not apply. *See* Hansmann & Kraakman, *supra* note 6, at 1906; Leebron, *supra* note 6, at 1578–79. Despite its theoretical appeal, there are serious practical impediments to a pro rata regime. *See* Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992); Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992); *see also* Manne, *supra* note 17, at 262.

[22] *See* Susan E. Woodward, *Limited Liability in the Theory of the Firm,* 141 J. INSTITUTIONAL & THEORETICAL ECON. 601, 602 (1985).

[23] *Id*. at 601–02.

B. Relevance of the Efficiency Rationales

Corporate statutes all confer limited liability in general terms. As long as the shareholder does not do anything to incur personal liability, the limited liability shield promises to be effective. There is no distinction between contract- and tort-based claims or between closely held or public corporations.[24] The enabling acts for the various newer forms of limited liability entity are similarly unequivocal.[25]

Statutory limited liability is unconditional even though corporate governance and ownership structures vary widely, from the closely held firm with few owners to the large public corporation with hundreds of thousands of shareholders.[26] Likewise, limited liability as to contract creditors involves different policy considerations than does limited liability for tort-based claims because relations between a corporation and a contract creditor are consensual while interactions with tort victims generally are not. If one considers the efficiency justifications for limited liability in relation to the range of businesses and types of claims to which it is supposed to apply, it is apparent that the rationales do not apply equally well to all the instances apparently covered by the broad statutory language.

The argument for limited liability may be less compelling as to shareholders of close corporations than as to those of publicly held companies. As noted above, limited liability reduces the need for shareholders to monitor management's risk taking. This is important for public corporation shareholders, for whom monitoring is generally not feasible or cost effective as a practical matter. In any event, these investors prefer to manage risk by investing passively in a diversified portfolio of companies rather than attempting actively to involve themselves in management of one or a few companies. Limited liability therefore facilitates investment in publicly held businesses.

In contrast, however, the typical shareholder in a closely held corporation is more likely to be actively involved in or at least attentive to management decision making, just as the typical partner in a partnership would be.[27] These shareholders often have a large portion of their personal wealth invested in the

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24 *See, e.g.*, sources cited *supra* notes 1–5.

25 *See* sources cited *supra* notes 3–5.

26 *See, e.g.*, sources cited *supra* notes 1–5.

27 *See* EASTERBROOK & FISCHEL, *supra* note 16, at 55–56.

venture and therefore cannot rely on diversification to reduce firm-specific risk.[28] They may also make substantial human capital investments, which by their nature are nondiversifiable. As a practical matter, it is far easier to participate in corporate governance or monitor the activities of the firm's managers in a small-scale enterprise. Thus, the opportunity and the incentive to participate in or monitor the firm's risk-taking activities are real in the close corporation context. These shareholders are much less likely to benefit from the monitoring cost savings that limited liability provides to public corporation shareholders.[29]

The need to monitor the wealth of one's fellow shareholders is also less costly in the close corporation setting, in which the number of shareholders is small and there is often a fair degree of intimacy among the business's owners. In addition, articles of incorporation of closely held firms often include restrictions on the transferability of shares to nonshareholders.[30] Such provisions further reduce the costs involved in monitoring the identity of fellow shareholders. Even if shares are not subject to transferability restrictions, the absence of active markets for close corporation stock generally makes trading infrequent in any event.

Finally, in the close corporation setting statutory limited liability may have only limited practical value. Many creditors, especially banks and other lenders, but also many suppliers, require a personal guarantee from the corporation's shareholders.[31] Trade creditors typically will not request personal guarantees, but may be content with security interests in inventory they have sold to the business and therefore would not seek recovery from the shareholders in any event.[32] Contracting practices thus suggest that, in the close corporation context, limited liability is not necessarily the efficient rule.

Tort creditors, of course, do not have an opportunity to bargain ex ante for personal guarantees or other protections. Judgments can be very large and can easily exceed the assets of the corporation. This kind of risk, however, is

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28 *Id.*

29 *Id.*

30 *See* ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 577 (8th ed. 2003) (share transfer restrictions widely used).

31 WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 142 (8th ed. 2002).

32 ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: UNINCORPORATED BUSINESSES AND CLOSELY HELD CORPORATIONS 319 n.7 (1996).

typically insurable, and given the omnipresent risk of veil piercing in cases of underinsurance, prudent shareholders of closely held firms generally will cause the corporation to purchase liability insurance despite the statutory promise of limited liability.[33] Insurance has the effect of limiting shareholder liability regardless of the statutory rule, again suggesting that statutory limited liability is not necessarily efficient in this context.

In addition to being weaker in the case of the close corporation versus the public one, the case for limited liability is also more problematic for tort claims than for obligations arising out of contract. Limited liability is supposed to allow shareholders to externalize the risk of corporate insolvency that they would otherwise have to bear themselves. However, voluntary creditors who are aware that they are dealing with a limited liability entity can factor that consideration into their decisions about the appropriate interest rate.[34] They can also bargain for personal guarantees, security interests in particular assets, or contractual provisions that limit the corporation's freedom to engage in conduct that would increase the risk of default on their claims. Such protections can include restrictions on distributions, minimum assets requirements, and defined debt equity ratios. Accordingly, bargained-for outcomes may be the same regardless of whether limited liability is the default rule.

Involuntary, or tort, creditors are in a quite different situation. The pedestrian hit by a taxi cab or the victim of a toxic waste spill has not agreed to assume the risk of corporate insolvency and shareholders' limited liability. He has not received ex ante compensation for doing so or had the opportunity to bargain for contractual safeguards. The owners of a limited liability entity therefore are in a position to shift some of the social costs of their business activity onto members of the public who have not agreed to bear those costs. As long as an activity holds some promise of increasing shareholder wealth, limited liability encourages shareholders (or their representatives) to undertake it without regard for the magnitude of possible social costs, which may be far greater than the benefits to the owners themselves.[35] In this respect, limited

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[33] EASTERBROOK & FISCHEL, *supra* note 16, at 48.

[34] *E.g.*, *id.* at 51; Leebron, *supra* note 6, at 1584.

[35] *E.g.*, Leebron, *supra* note 6, at 1605; Nina A. Mendelson, *A Control–Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1233–35 (2002). More specifically, expected return need only exceed the amount of shareholder capital exposed to the risk of creditor claims.

liability for tort claims creates a moral hazard problem and results in inefficient resource allocation decisions.[36]

Generally speaking, economic analysis indicates that limited liability is advantageous for shareholders of public corporations but much less so if the company is closely held. Economic analysis also indicates that it may have limited practical significance in dealings with contract creditors, regardless of whether the debtor corporation is publicly or closely held. As to tort creditors, limited liability creates incentives to externalize costs that exceed any benefits to the shareholders themselves. Corporate law's blanket provision of limited liability, which is also a feature of the statutes authorizing the other forms of limited liability entity, cannot be justified on efficiency grounds alone.

C. Subsidization Through Risk Reallocation

The real policy basis for limited liability does not appear to be efficiency. Instead, the goal seems to be to promote investment by transferring risk from investors to creditors.[37] Commercial activity can generate a range of social benefits, including financial returns to investors, jobs for employees, and desirable products and services for consumers. The general public also benefits from tax revenues and, less directly but no less importantly from the advantages of ongoing technological progress stimulated by competitive markets. Limited liability is an important incentive because individuals will more willingly take on the risk of business failure if their exposure to loss is limited to their actual investment. Limited liability therefore encourages entrepreneurial activity by attempting to shift the risk of corporate insolvency from shareholders to the business's creditors. More often than not creditors will be paid their due and thus will share in the social benefits of commercial enterprise, but sometimes they will have to bear the costs of business bankruptcy. Their losses therefore represent a subsidy that encourages business investment by lowering its cost. The social utility of this policy is simply taken for granted because actual demonstration of its efficiency is technologically impossible.

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36 See *infra* Part III.A.2.c for further discussion.

37 For discussion of nineteenth-century developments, see JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780–1970, at 26–28 (1970).

1. *Contract Creditors*

The risk reallocation or subsidy policy views limited liability as a benefit that the law confers on corporate shareholders. They are relieved of responsibility for their firm's obligations in the event of business failure. According to this view, owners of limited liability entities gain an advantage not available to sole proprietors or partners in general partnerships.

As far as contract creditors are concerned, this assumption appears at first glance to reflect a large measure of economic naiveté. According to orthodox economic theory, in the absence of transaction costs the initial choice between alternative default rules (such as limited liability versus unlimited liability) has no effect on the terms of the agreement reached by the parties.[38] They will bargain to the efficient result in either case and that result will be the same regardless of the initial default rule.[39]

Further, the notion of limited liability as a benefit or subsidy conferred by corporate law upon shareholders disregards the possibility that creditors will factor the risk posed by limited liability (namely, that they will not get paid if the firm fails) into the interest rates they charge to corporate debtors.[40] Creditors, thus, have the ability to make shareholders pay for the benefit, just as shareholders would have to do if unlimited liability were the default rule and it were necessary for them to bargain for an agreement to look only to the assets of the firm for payment. In this respect, limited liability resembles other default rules—like warranties implied in sales of goods transactions or residential leases, or the employer's right to terminate an employee without cause—that appear to improve the position of one class of parties to a common form of transaction but in fact may not. Because limited liability for contractual obligations can only take effect when incorporated into an agreement resulting from bargaining between the parties, creditors cannot be compelled to accept the full cost of limited liability against their will.[41] Accordingly, the initial specification of a default rule will have no effect on the value to the parties of the outcome of their bargain; the choice between alternative rules does not affect the magnitude of the gains from trade or the

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38 R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

39 *See id*. For this argument applied to limited liability, see Roger E. Meiners, James S. Mofsky & Robert D. Tollison, *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351 (1979).

40 *See supra* text accompanying note 34.

41 The same point would apply to mandatory contract rules.

parties' respective shares of that surplus.[42] According to this view, a limited liability default rule does not increase shareholder wealth at the expense of creditors.[43]

A closer look at the matter, however, may validate legislators' intuition that statutory limited liability improves outcomes for shareholders at creditors' expense. Recent research in behavioral economics suggests that the choice between alternative default rules can affect the behavior of parties to a bargain. More specifically, the intended beneficiaries of a default rule[44] may be better off than they would be if the default rule were the opposite. According to this view, those who benefit from a default rule tend to value that benefit more highly than they would if the default rule were the opposite and it were necessary to bargain for the benefit. That phenomenon in turn can result in better outcomes for a rule's beneficiaries. If this is so, the starting point—one default rule or the other—may make a difference in the distribution of the surplus generated by a bargain. Limited liability as to contract creditors may represent a subsidy after all.

The basis for this view is the phenomenon known as the "endowment effect."[45] Numerous experiments have demonstrated that people tend to

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42 *See* Richard Craswell, *Passing on the Cost of Legal Rules: Efficiency and Distribution in Buyer–Seller Relationships*, 43 STAN. L. REV. 361 (1991); Harold Demsetz, *Wealth Distribution and the Ownership of Legal Rights*, 1 J. LEGAL STUD. 223 (1972). In this respect, contractual default rules appear to differ from property entitlements. While the initial assignment of a property entitlement may make no difference as far as the allocation of resources is concerned, that choice typically will have distributional consequences. *See, e.g.*, JULES L. COLEMAN, MARKETS, MORALS, AND THE LAW 71 (1988); A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 14 (3d ed. 2003).

43 *See, e.g.*, DOOLEY, *supra* note 15, at 37 (Where transaction costs are low, "any rule regarding shareholders' liability for firm debts will have little effect on the terms of the transaction because the parties will simply agree to allocate risk and return to suit their individual preferences."); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 412 (6th ed. 2003) (voluntary creditors fully compensated for increased risk of default by higher interest rate).

44 The notion of a default rule's "beneficiary" is based on the fact that default rules typically express a bias in favor of one party to a contract and against the other. For example, the limited liability default rule provides that shareholders enjoy protection from claims of corporate creditors, unless otherwise agreed; or, the at-will rule in employment law provides that employers can discharge employees for any reason, unless otherwise agreed. In this respect, one can speak of one class of contracting parties (shareholders vs. corporate creditors; employers vs. employees) as the beneficiary of the relevant default rule. Of course, default rules can be reversed by agreement of the parties and any benefit may have to be paid for, and so default rule bias does not necessarily confer any actual benefit on its beneficiary. The idea of default rule bias simply expresses the initial tilt or advantage of the rule. For further discussion of "default-rule bias," see David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment At Will Versus Job Security*, 146 U. PA. L. REV. 975, 990–92 (1998).

45 According to Professor Korobkin, Professor Richard Thaler introduced this term. Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227, 1228 n.3 (2003) (citing Richard Thaler,

demand more money if they are selling a piece of property or other entitlement than they would be willing to pay for the same item or right if they did not already own it.[46] These results appear to reflect a more general, well-documented tendency for people to place a higher value on their current status or circumstances than they would place on that same status or circumstances if their condition were different. This disposition is referred to as "status quo bias."[47]

The extensive research documenting the endowment effect has focused primarily on subjects' valuation of property rights or other legal entitlements. Whether the endowment effect also applies to contractual default rules presents a different question. This is so because such rules differ fundamentally from property rights, which provide their owners with the opportunity to enjoy assets or other goods. In contrast, default rules confer no benefits and impose no duties on anyone until they are actually incorporated into a contract with another party. Apart from their inclusion in a contract, default rules confer no entitlements.[48] Despite this difference, experimental evidence indicates that

Toward a Positive Theory of Consumer Choice, 1 J. ECON. BEHAV. & ORG. 39, 44 (1980)). Professor Kennedy referred to the endowment effect phenomenon as "the offer-asking problem." Duncan Kennedy, *Cost–Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387, 401 (1981).

[46] Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); Jack L. Knetsch, *The Endowment Effect and Evidence of Nonreversible Indifference Curves*, 79 AM. ECON. REV. 1277 (1989); Jack L. Knetsch & J.A. Sinden, *Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value*, 99 Q.J. ECON. 507 (1984). For a useful display of experimental results in tabular form, see Kahneman et al., *supra*, at 1327 tbl.1. For general discussions of experimental data on the endowment effect, see John K. Horowitz & Kenneth E. McConnell, *A Review of WTA/WTP Studies*, 44 J. ENVTL. ECON. & MGMT. 426 (2002) (surveying forty-five studies); Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193 (1991); Korobkin, *supra* note 45.

[47] "Status quo bias" is related to the endowment effect but refers to the larger notion that people tend to prefer the way things are now to possible alternative states. Among other things, this idea suggests that an individual who owns an asset is likely to value that asset more highly than if he did not own it and was thinking about buying it. Korobkin, *supra* note 45, at 1228–29 (citing William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988)). For studies, see, e.g., JUDD HAMMACK & GARDNER MALLARD BROWN, JR., WATERFOWL AND WETLANDS 26–27 (1974) (value placed on duck habitat dependent on whether subjects enjoyed the right to hunt ducks or would have to pay to obtain that right); Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOLOGIST 341 (1984) (finding differences in preferences for a job depending on whether subjects held the job or another one); Raymond S. Hartman, Michael J. Doane & Chi-Keung Woo, *Consumer Rationality and the Status Quo*, 106 Q.J. ECON. 141 (1991) (variations in value placed on reliable electrical service depending on whether subjects enjoyed such service or not).

[48] For this reason, Professor Korobkin refers to the benefit expressed in a default rule as a "quasi-endowment," Korobkin, *supra* note 45, at 1270, or "illusory entitlement." Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 631 (1998).

the endowment effect is at work in the valuation of contractual default rules as well as property rights.[49] In the context of this Article, this means that the beneficiary of a default rule may value that contract term (e.g., limited liability) more highly than he would if the default rule were the opposite (unlimited liability) and it were necessary to bargain around the default term to obtain its inverse. This valuation disparity therefore would lead a party to demand more compensation for waiver of a right expressed in a default rule than he would be willing to pay to obtain that right if the default rule were the opposite.

Does the existence of an endowment effect in the context of default rules allow legislators to benefit particular classes of individuals by choosing between alternative defaults? More specifically, is it possible to advantage shareholders at the expense of contract creditors by ordaining a limited liability default rule? The answer to these questions is not yet clearly established. However, the likely existence of an endowment effect encourages the assumption that, under the current limited liability default rule regime, shareholders value that contract term more highly than they would if the default were unlimited liability. If so, it is plausible to suppose that the limited liability default affects the distribution of wealth between shareholders and corporate creditors.

When corporate creditors and shareholders deal with each other, some shareholders and creditors contract around the default, replacing it with shareholders' personal guarantees, while others do not. For those who do, the shareholders receive compensation (in the form of a lower interest rate). Because the limited liability default rule influences shareholders' valuation of that contract term, they should expect to receive compensation for waiver of that right in these cases. This consideration would not be present if the default rule were unlimited liability. As a result, even though the possibility of shareholder personal liability will always mean lower interest rates in comparison to contracts with limited liability, shareholders should end up with a better deal if the default rule is limited liability than if unlimited liability were the default instead.[50]

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[49] Korobkin, *supra* note 48, at 633–47 (describing results of experimental contract negotiations involving several contract terms in light of alternative default rules); Cass R. Sunstein, *Switching the Default Rule*, 77 N.Y.U.L. REV. 106, 113–14 (2002) (describing results of experiment involving negotiation over contract term in context of alternative default rules).

[50] For example, suppose that, under a limited liability default rule, a contract including an unlimited liability term bears a 10% interest rate. In that case, to get to the unlimited liability contract required that the

Again assuming that the default is limited liability, the parties may reach an agreement that includes limited liability rather than contracting around the default rule.[51] In these cases shareholders may also end up better off than if the default were unlimited liability. If unlimited liability were the default, the shareholders would need to bargain and pay for the limited liability shield. Because creditors would place a higher value on unlimited liability if it were the default rule, shareholders would have to pay a premium to persuade creditors to accept limited liability. This premium would not be demanded if the default were limited liability because both parties would behave as if shareholders already "owned" the limited liability term.[52]

Professors Sunstein and Korobkin have suggested that, in complex contracts with several terms, adjustments to other terms of the contract may offset any distributional gains that result from a default rule's bias in favor of one party.[53] For example, if the employment law default rule were discharge for cause only (rather than the law's current employment at-will default), an employee would not have to pay an employer to waive a default-rule-based "entitlement" to discharge employees at will. However, some other term of the contract could be adjusted—such as reduction in the hourly wage or amount of paid vacation—so as to provide the employer with the same value that it would enjoy if employment at will were the default and employees seeking just-cause contracts would have to pay for that benefit. If so, the distributional outcome would be the same regardless of the default rule.[54]

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creditor compensate the shareholders for their "waiver" of the limited liability term expressed in the default rule. Because this consideration would not be present under an unlimited liability default (i.e., no need to pay shareholders to give up their default-rule-based "entitlement" to limited liability), the result should be an interest rate higher than 10%. Shareholders thus are better off under the limited liability default.

51 The endowment effect will tend to make a default term "sticky" because the higher value placed on the term by its beneficiary will make it harder for the parties to reach agreement on the alternative rule. Korobkin, *supra* note 45, at 1272.

52 For example, assume that under an unlimited liability default rule, a contract including limited liability bears a 15% interest rate. In this case, shareholders must pay the creditor to "waive" its potential claim against their personal wealth. Because this factor would not apply under a limited liability default (i.e., there would be no need to pay the creditor to give up its unlimited liability "entitlement"), the result should be an interest rate lower than 15%. Again, shareholders are better off under the limited liability default.

53 Sunstein, *supra* note 49, at 126; Korobkin, *supra* note 45, at 1278.

54 Sunstein, *supra* note 49, at 126 ("If employees are given an entitlement, whether alienable or inalienable, the rest of the contract package is likely to be adjusted accordingly."); Korobkin, *supra* note 45, at 1278 ("If the law provides a just-cause default, and the endowment effect then causes employees to be reluctant to part with it, the likely consequence is a lower salary or fewer other benefits than employees would enjoy under an at-will term.").

The problem with this suggestion is that it may not take the endowment effect seriously enough. For example, if the default rule were unlimited liability and the parties bargain to a contract with limited liability, shareholders must compensate the creditor by some amount *x* for giving up what it perceives as a valuable entitlement. In contrast, however, if the default rule is limited liability and bargaining results in a limited liability contract, the creditor has no expectation or basis for claiming *x* because, in light of the endowment effect, it has not yielded a valuable right. There is no reason for the creditor to expect an identical outcome in both situations because the endowment effect—internalized by both parties regardless of which way the default rule tilts—leads it to view the two scenarios as fundamentally different. That being the case, there is no reason to assume that the creditor, working in the context of a limited liability default, will demand value equivalent to what it would have been able to realize under an unlimited liability default.[55]

There is some empirical support for the endowment effect's distributional impact on bargaining in the context of default rules.[56] In addition, Professor Jolls has shown that, under certain conditions, mandatory contract terms can benefit classes of workers without offsetting declines in wages or levels of employment.[57] To the extent that the endowment effect leads people to behave as if default rules confer entitlements, Professor Jolls's analysis offers some support for the possibility of wealth redistribution through the selection of default rules.

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55 Furthermore, even if the parties did view the two scenarios as identical and therefore warranting identical distributional outcomes, a typical credit transaction differs from the employment contract discussed by Sunstein and Korobkin in ways that probably make it much harder to reach that result. *See* Sunstein, *supra* note 49, at 126; Korobkin, *supra* note 45, at 1278. The credit transaction is partly executed and relatively simple. The creditor has performed its part of the bargain by handing over money or extending credit to the debtor. In return, the debtor has promised future performance in the form of payments of interest and principal. In contrast, the employment agreement is wholly executory and much more complex, consisting of an exchange of promises on a wide range of matters besides price. Credit transactions therefore do not present the same opportunities for adjustment of non-price terms (such as the package of non-wage benefits) to offset an interest rate perceived by the creditor to be too low.

56 Professor Schwab's labor negotiation experiment yielded more valuable outcomes for one party or the other (union versus employer) depending on whether a default rule (governing the employer's right to transfer work to a nonunion plant) favored the union or the employer. Bargaining over wages, number of vacation days, and the employer's right to transfer work, union negotiators obtained better outcomes when the default rule was no-transfer than they did when the default was right-to-transfer. Correspondingly, the employer fared better when the default allowed freedom to transfer. Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237 (1988).

57 Christine Jolls, *Accommodation Mandates*, 53 STAN. L. REV. 223 (2000) (analyzing economic effects of mandates designed to benefit particular classes of employees).

Even with the impressive research on the endowment effect that has been done in recent years, the distributive effects of default rule choice have yet to be conclusively established. Further empirical work is needed, and it will be necessary to attend to the possibility of different results depending on context. What can be said, though, is that there now appears to be a theoretical basis for thinking that the limited liability default rule provides a benefit to shareholders that they would not enjoy under a regime of unlimited liability. There may be something to the notion of subsidy after all.

Even if legislators are correct in believing that limited liability can benefit shareholders in their dealings with the corporation's contract creditors, that benefit can generate social costs beyond the transfer of the risk of corporate insolvency from business owners to creditors. As explained more fully below, limited liability can facilitate shareholder opportunism toward the corporation's contract creditors.[58] Creditors may therefore end up incurring losses that they have not agreed to bear. To the extent that these losses exceed the necessary costs of a reasonable business subsidization policy, the limited liability shield is broader than this rationale warrants.

2. Tort Creditors

The distributional benefits of limited liability are more obvious as to victims of corporate torts. Protection from personal liability allows corporate shareholders to limit their liability for personal injuries and other harms caused by business activity to their capital contributions. To the extent that a business lacks the financial wherewithal to compensate tort claimants fully for their losses, those doing business in the corporate form are able to shift that cost from themselves over to the injured parties. These cases differ from those involving contract creditors because there has been no opportunity for bargaining ex ante. Accordingly, there is no possibility that tort creditors have received compensation for bearing the risk of limited liability. By allowing entrepreneurs to externalize these costs of doing business, limited liability provides a subsidy paid for by uncompensated tort victims.

As with contract creditors, however, it is likely that this policy goes too far and invites behavior that should in fact be discouraged. The incentive to undertake risky activities without worrying about whether social costs exceed private benefits means that shareholders will likely cause their corporations to

[58] *See* discussion *infra* Part III.A.2.a–b.

engage in potentially harmful conduct that they would be reluctant to pursue in the absence of the limited liability shield.[59] Even if limited liability has a desirable role to play in the encouragement of legitimate risk taking, the shield may be also facilitate socially undesirable behavior and to that extent is overbroad.

II. THE CURRENT STATUS OF VEIL-PIERCING DOCTRINE

Statutory limited liability, which on its face applies to close corporations as well as public ones and to tort as well as contract claims, is too broad to be justified solely on efficiency grounds. Its true rationale seems instead to be the encouragement of business investment through risk reallocation. In that sense, limited liability is designed to provide a subsidy for entrepreneurial activity by shifting costs to creditors that business owners would otherwise have to bear themselves.

Despite the generality of corporate law's statutory rule, limited liability has never been as absolute as it purports to be. From time to time, courts acknowledge the need for constraints on the availability of the limited liability shield to prevent shareholders from using it to achieve illegitimate ends. In effect, courts have said that limited liability's subsidy can come at too high a price and, in such cases, have refused to impose its cost on corporate creditors.

To accomplish this objective, courts have fashioned the so-called "piercing the corporate veil" doctrine.[60] Under certain circumstances, courts will disregard or puncture the limited liability shield to hold shareholders personally responsible for obligations the corporation itself lacks the capacity to discharge. Because the same misgivings about the appropriate breadth of statutory limited liability can arise in cases involving the various new forms of limited liability entity, courts have begun the process of developing analogous doctrines for the benefit of creditors bringing claims against business owners in appropriate cases.[61]

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59 *See infra* Part III.A.2.c.

60 Professor Presser's treatise on the subject sheds no light on the origins of the term but does trace its popularity to a seminal law review article published in 1912. *See* STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 1.01 n.7 (2003) (citing I. Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 COLUM. L. REV. 496 (1912)).

61 *See* cases cited *supra* note 12 (noting veil-piercing cases involving limited liability companies).

As it has developed judicially, veil piercing has been the subject of sharp criticism. In this Part, I consider the bases for those criticisms, which are surely justified. I believe, however, that veil piercing could serve a useful function if there were a sound understanding of the policy basis for limited liability. Only with the benefit of such an understanding is it then possible to define clearly the appropriate limits on limited liability. These questions are taken up in Part III.

A. Veil Piercing and Economic Analysis

Judge Easterbrook and Dean Fischel have suggested that the incidence of veil piercing can be explained by reference to efficiency considerations. They write, "[T]he doctrine of piercing the corporate veil, and the distinctions drawn by courts, makes more economic sense than at first appears. The cases may be understood, at least roughly, as attempts to balance the benefits of limited liability against its costs."[62] Even this guarded a statement wildly exaggerates the logic behind the case law in this area.

Courts apparently never hold shareholders of publicly held corporations personally liable for corporate obligations, regardless of the distinction between contract and tort claims.[63] In the few reported cases in which tort claimants have attempted to pierce the veil of public corporations,[64] the opinions pay no attention to the economic arguments against limited liability as to involuntary creditors. This is so even though, as we have seen, thoughtful analysis of the rationale for limited liability would seem to indicate willingness to pierce in cases brought by involuntary creditors because these plaintiffs never agreed to accept the risk of nonpayment due to corporate insolvency and limited shareholder liability.[65] At the same time, economic orthodoxy argues that courts ought generally to respect limited liability where creditors have assumed that risk voluntarily and presumably accepted compensation for doing so. For voluntary creditors, shareholder liability should be possible only if there has been misrepresentation as to corporate status.

In contrast to cases involving publicly held corporations, courts pierce the veil of close corporations with some frequency. Such cases reflect skepticism

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62 EASTERBROOK & FISCHEL, *supra* note 16, at 55.

63 *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1047 (1991).

64 Professor Thompson references nine cases in which courts refused to hold shareholders of publicly held corporations liable for corporate obligations. *Id*. at 1047 n.71.

65 *See supra* Part I.B.

about the need for limited liability in the close corporation setting. However, even as to one-person corporations, reported opinions hold shareholders personally liable only about half the time, and where there is more than one shareholder they do so even less often.[66] Given the doubtful efficiency justification for limited liability in the close corporation context,[67] economic analysis would seem to indicate a much greater willingness to pierce than in fact is the case.

The close corporation cases that do entertain piercing claims generally do not take seriously the distinction between contract and tort claims. As discussed above,[68] the justification for piercing is weaker in the contract setting because of the opportunity for ex ante bargaining over risk allocation. In fact, however, courts disregard the corporate shield more often in contract cases than in tort cases.[69] A number of these contract cases involve shareholder misrepresentation and therefore may warrant disregard of the parties' risk allocation agreement, but most do not.[70] Even if the misrepresentation cases are set to one side, courts still pierce more often in contract than in tort cases.[71] In sum, the actual incidence of veil piercing has little to do with the logic of efficiency.

B. The Unweighted Laundry List

When one attempts to rationalize the piercing cases according to some other set of values, one encounters a dismal morass of repetitive rhetoric masking conclusory evaluation. The cases typically list a series of more or less standard factors. Little if anything is said about how they are to be weighted or which ones are necessary or sufficient by themselves to support a piercing result.[72]

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66 *See* Thompson, *supra* note 63, at 1055.

67 *See supra* Part I.B.

68 *See supra* text accompanying note 34.

69 *See* Thompson, *supra* note 63, at 1068.

70 Courts pierced the corporate veil in 327 of the 779 contract cases in Professor Thompson's data set but cited misrepresentation in only 98 of the cases that held shareholders personally liable. *Id*. at 1069.

71 *Id*. at 1069. Professor Thompson's data indicate the error in Judge Easterbrook and Dean Fischel's assertion that "[c]ourts are more willing to disregard the corporate veil in tort than in contract cases." EASTERBROOK & FISCHEL, *supra* note 16, at 58.

72 According to Professor Presser, the unweighted laundry list approach owes a substantial debt to a treatise, published in 1931, on the liability of parent corporations for the debts of their subsidiaries. *See* PRESSER, *supra* note 60, at § 1:6 (discussing FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS: LIABILITY OF A PARENT CORPORATION FOR THE OBLIGATIONS OF ITS SUBSIDIARY (1931)).

A Fourth Circuit opinion (applying South Carolina law) involving a one-person corporation illustrates the vagueness with which courts have formulated the doctrine in this area:

> [P]roof of plain fraud is not a necessary element in a finding to disregard the corporate entity . . . . [E]qually as well settled . . . is the rule that the mere fact that all or almost all of the corporate stock is owned by one individual or a few individuals, will not afford sufficient grounds for disregarding corporateness. But when substantial ownership of all stock of a corporation in a single individual is combined with other factors clearly supporting disregard of the corporate fiction on grounds of fundamental equity and fairness, courts have experienced "little difficulty" and have shown no hesitancy in applying what is described as the "alter ego" or "instrumentality" theory in order to cast aside the corporate shield and to fasten liability on the individual stockholder . . . .
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> But, in applying the "instrumentality" or "alter ego" doctrine, the courts are concerned with reality and not form, with how the corporation operated and the individual defendant's relationship to that operation . . . . [T]he authorities have indicated certain facts which are to be given substantial weight in this connection. One fact which all the authorities consider significant in the inquiry, and particularly so in the case of the one-man or closely held corporation, is whether the corporation was grossly undercapitalized for the purposes of the corporate undertaking . . . . And, "[t]he obligation to provide adequate capital begins with incorporation and is a continuing obligation thereafter . . . during the corporation's operations." Other factors that are emphasized in the application of the doctrine are failure to observe corporate formalities, non-payment of dividends, the insolvency of the debtor corporation at the time, siphoning of funds of the corporation by the dominant stockholder, non-functioning of other officers or directors, absence of corporate records, and the fact that the corporation is merely a facade for the operations of the dominant stockholder or stockholders. The conclusion to disregard the corporate entity may not, however, rest on a single factor, whether undercapitalization, disregard of corporation's formalities, or what-not, but must involve a number of such factors; in addition, it must present an element of injustice or fundamental unfairness.[73]

[73] DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 684–87 (4th Cir. 1976) (citations and footnotes omitted). For another example of a decision purporting to rely on an unweighted list of six of the factors mentioned in *DeWitt* (some stated in somewhat different language), see *Baatz v. Arrow Bar*:

This passage refers to most of the factors that courts have relied on in this area.[74] Note, however, the lack of guidance as to relative importance. Note also the use of terms—like alter ego, undercapitalization, injustice, and unfairness—that are far from self-defining in this context.

Professor Thompson's extensive study of piercing cases offers some insight into the factors that courts consider relatively more important than others. Aside from misrepresentation, which almost always leads to piercing, the considerations that most often result in denial of limited liability—approximately 90% or more of the time —are that the corporation was a mere "instrumentality" of its shareholders or their "alter ego" or "dummy."[75] A finding that an agency relationship existed between the shareholder defendants and the corporation is similarly significant.[76] However, the plain fact of shareholder control or domination of a close corporation generally is not sufficient by itself to justify piercing the corporate veil, presumably because at least some shareholders inevitably run the business and make the decisions that have resulted in the creditor's loss.[77] Similarly, overlap of identity between shareholders and directors or shareholders and officers is insufficient without more to justify a piercing result.[78]

Other factors that courts typically claim to be significant turn out to be somewhat less important than these. A finding of undercapitalization results in piercing at a rate of seventy-three percent, and only two thirds of cases

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> Factors that indicate injustices and inequitable consequences and allow a court to pierce the corporate veil are:
> 1) fraudulent representation by corporation directors;
> 2) undercapitalization;
> 3) failure to observe corporate formalities;
> 4) absence of corporate records;
> 5) payment by the corporation of individual obligations; or
> 6) use of the corporation to promote fraud, injustice, or illegalities.

452 N.W.2d 138, 141 (S.D. 1990).

[74] One factor not mentioned in this list is an agency relationship between the controlling shareholders and the corporate entity. If the corporation is merely the agent for the shareholder principals, piercing may be warranted as a matter of agency law principles. For discussion, see *infra* Part II.C.1.

[75] *See* Thompson, *supra* note 63, at 1063 tbl.11.

[76] *Id.*

[77] Professor Thompson finds that cases mentioning shareholder domination and control result in piercing only 56.99% of the time. *Id.*

[78] *Id.*

mentioning failure to observe corporate formalities actually end with a judgment against the shareholder defendants.[79]

Even knowing this much, it is still quite difficult to predict when courts will pierce the corporate veil and when not. The unweighted laundry list method, combined with the inherent vagueness of many of the items on the list, gives the cases an ad hoc, fluky aspect. Judge Easterbrook's assessment is apt:

> Such an approach, requiring courts to balance many imponderables, all important but none dispositive and frequently lacking in a common metric to boot, is quite difficult to apply because it avoids formulating a real rule of decision. This keeps people in the dark about the legal consequences of their acts . . . .[80]

In place of careful analysis of the facts and their relevance to well-articulated doctrinal principles and policy considerations, results often seem conclusory and based on the court's instinctive reaction to the morality of the defendant's conduct. Injustice and unfairness are often mentioned but rarely defined.[81] One commentator has referred to this approach as "jurisprudence by metaphor or epithet."[82] Emphasizing veil piercing's lack of clarity and predictability, Judge Easterbrook and Dean Fischel state, "'Piercing' seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled. There is consensus that the whole area of limited liability, and conversely of piercing the corporate veil, is among the most confusing in corporate law."[83]

C. Critique of the Factors

1. Agents, Instrumentalities, and Alter Egos

Epithets or characterizations like "agent," "instrumentality," "alter ego," and "dummy" focus on the quality or nature of the relationship between the corporation and its shareholders. The emphasis is on the fact that one or more controlling shareholders dominate decision making regarding the corporation's

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79 *Id.*

80 Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406, 414 (7th Cir. 1988).

81 *See*, *e.g.*, *supra* text accompanying note 73.

82 PHILIP L. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 8 (1983).

83 Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89 (1985); *see also* William J. Callison, *Rationalizing Limited Liability and Veil Piercing*, 58 BUS. LAW 1063, 1069 ("[I]t is difficult to discern any overarching doctrine that assists in determining when the limited liability veil will be pierced and when it will not.").

business activities. Under the circumstances, justice is said to require that these shareholders be held responsible for third-party losses resulting from their exercise of control. Courts thus use these terms to express a moral intuition that shareholders have somehow acted illegitimately by using their powers of control to cause the creditor's loss.

Two different ideas are actually at work here. First, courts may speak as if the key question is whether the corporate entity *really* has something like a will of its own separate from that of the shareholders or instead is just a mindless lackey faithfully doing the controlling shareholders' bidding. Shareholder liability for corporate obligations may also be thought to turn on whether the corporation *really* has an existence separate from that of its shareholders.

Some cases purport to rely on agency law ideas as a basis for veil piercing.[84] A creditor who has dealt with a corporation rather than its shareholders has suffered a loss that was arguably the result of the shareholders' abuse of their powers of control. In some way, they caused the corporation to default on its contract with the plaintiff. Or perhaps they have managed the corporation in a way that resulted in a physical injury to a third party that cannot be redressed out of the entity's assets. Rather than an independent, autonomous "person" acting on its own and pursuing its own interests, the corporation is seen to be a mere agent or instrumentality—a marionette—of the controlling shareholders, manipulated by them to promote their own advantages at others' expense. As such, the corporation has "no separate mind, will or existence of its own and is but a business conduit for its principal."[85] The shareholders therefore ought to be liable for the harm they have caused.[86]

If the courts in cases like these are serious about a finding of agency, there is no need to consider veil piercing at all. Shareholder liability instead follows from standard agency law principles that hold the principal responsible for the

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84 For a thoughtful exploration of the use and abuse of agency law in veil-piercing cases, see Thompson, *supra* note 8.

85 Zaist v. Olson, 227 A.2d 552, 557 (Conn. 1967) (quoting WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 205 (1963)).

86 *See, e.g.*, Walkovszky v. Carlton, 223 N.E.2d 6, 8 (N.Y. 1966) ("[W]henever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts 'upon the principles of *respondeat superior* applicable even where the agent is a natural person.'") (citation omitted); Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926) ("Dominion may be so complete, interference so obtrusive, that by the general rules of agency the [corporate] parent will be a principal and the subsidiary an agent.") (citation omitted).

acts of the agent.[87] In fact, however, careful attention to those principles may prevent a finding of agency.[88] An agency relationship depends not only on control (or right of control) by one person over another. There is also a requirement that the controlling person manifest assent that the other party shall act on the controlling person's behalf.[89] Evidence bearing on this element often will be lacking, especially in cases in which planners have taken great care to establish the separate identity of parent-subsidiary corporations and scrupulously observed the formalities involved in seemingly independent decision-making processes.[90] In such cases, use of the agency concept is only metaphorical or rhetorical and is relied upon simply to justify a conclusion that, for some other reason, liability should follow from shareholder control.[91]

The agency cases assume the corporation's separate existence but emphasize shareholder control as the basis for finding liability based on a principal-agent relationship. In contrast, other decisions similarly focus on the shareholders' control or domination of the corporation's activities but infer from those facts that the corporation and its shareholders actually have no separate existence or identity. Where justice seems to require that the shareholders be held liable, courts will state that the shareholders' control of the corporation has allowed them to act just as they would if there were no incorporation. The corporation thus is merely their "alter ego" and may be referred to as a "sham"[92] or a "dummy."[93] The emphasis on shareholder control is similar to the agency decisions but a different basis for veil piercing is asserted. That conclusion may be even easier to reach if shareholders have failed to observe the formalities (as to issuance of stock, filings, meetings, and

[87] *See* Robert W. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 983–84 (1971).

[88] *See* Thompson, *supra* note 8, at 1328.

[89] *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2005) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

[90] *See* Thompson, *supra* note 8, at 1331.

[91] *See* Zaist v. Olson, 227 A.2d 552, 557 (Conn. 1967) ("[E]ither an implied agency was meant [by the court below], or the term 'agency' was loosely used, as is sometimes done, to pierce the shield of immunity afforded by the corporate structure in a situation in which the corporate entity has been so controlled and dominated that justice requires liability to be imposed on the real actor.") (citation omitted).

[92] *See, e.g.*, Sonora Diamond Corp. v. Superior Court, 99 Cal. App. 2d 824, 836 (Cal. Ct. App. 2000) ("The alter ego doctrine prevents individuals or other corporations from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds.") (citation omitted).

[93] *See, e.g.*, Frazier v. Bryan Mem'l Hosp. Auth., 775 P.2d 281, 288 (Okla. 1989) (Piercing based on alter ego theory is appropriate where facts indicate that subsidiary corporation was a "dummy" or "mere instrumentality" of the parent.).

decision processes) required of those seeking to do business in the corporate form. In these cases, courts may conclude that shareholders who are actually acting in their own capacity ought to be held accountable because they, rather than some separate corporate entity, are morally responsible for the losses they have brought about. The corporate veil is not so much pierced as its very existence is denied or disclaimed.

While the intuition linking shareholder responsibility to control may be valid under certain circumstances, the rhetoric of agency or "alter ego" is unfortunate. The emphasis on the relationship between the shareholders and the corporation is misplaced. Human agency necessarily lies behind all corporate action or inaction. In close corporations, at least some of the shareholders are almost always involved in control of the business and they naturally will use that control to promote their own interests, just as the partners in a general partnership would. The same is true in the parent-subsidiary context. The fact of control means inevitably that the corporation will not be truly independent from its shareholders even if scrupulous attention is paid to legal formalities establishing separate corporate existence. The search for a corporate "will" or purpose separate from that of its controlling shareholders is absurd. While it might make sense as a matter of abstract logic to have shareholder responsibility turn on the extent to which the shareholders caused the corporation to act as it did, a focus on shareholder control and the ends for which control is exercised invites controversy over facts that will be present to some degree in virtually every case involving a closely held corporation or corporate subsidiary.

Perhaps for this reason, most jurisdictions that employ agency or "alter ego" standards recognize that courts also need to look further and identify what is blameworthy about the defendant's use of control. Therefore, a number of states mandate both a finding of control and the presence of "injustice" or "inequity" to pierce the corporate veil. A leading case from California typifies this approach, requiring proof "(1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow."[94]

[94] Automotriz Del Golfo de Cal. v. Resnick, 306 P.2d 1, 3 (Cal. 1957) (citation omitted). For similar two-part formulations, see, e.g., Belvedere Condominium Unit Owners' Ass'n v. R.E. Roark Cos., 617 N.E.2d 1075, 1085 (Ohio 1993) ("[T]he 'veil' of the corporation can be 'pierced' and individual shareholders held liable for corporate misdeeds when it would be unjust to allow the shareholders to hide behind the fiction of the corporate entity. Courts will permit individual shareholder liability only if the shareholder is

While a finding of control should be a necessary condition for shareholder liability based on veil piercing[95] and courts are also correct to look for wrongful conduct in addition to control, these formulations are inadequate. Without an explanation of what courts mean by injustice or inequity, vague, contestable concepts like these provide virtually no guidance to business planners and managers about the circumstances under which courts will disregard the corporate entity.

Often, courts will include a reference to "fraud" when stating the injustice requirement.[96] Unfortunately, this adds little in the way of analytical clarity. It seems that something other than the technical meaning of fraud is often implied.[97] If the shareholders have defrauded the plaintiff (for example, by denying corporate existence or providing phony personal guarantees), that itself provides a basis for recovery against them without the need for a veil-piercing claim. Instead, fraud is apparently intended in a more general sense to mean bad faith or unfairness rather than just deliberate dishonesty designed to induce reliance.[98] Of course, such usage merely begs the question of what is meant by bad faith or unfairness, terms no more precise than injustice or inequity.

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indistinguishable from or the 'alter ego' of the corporation itself."); State v. Angelo, 800 P.2d 11 (Ariz. Ct. App. 1990) ("The courts may disregard the corporate form in civil cases only when there is unity of interest and ownership between an individual and a corporation, and when disregarding that corporate form is necessary to prevent injustice or fraud."); Terre Du Lac Ass'n, Inc. v. Terre Du Lac, Inc., 737 S.W.2d 206, 218 (Mo. Ct. App. 1987) ("The test for piercing the corporate veil is therefore two-pronged: first, the corporation must be controlled and influenced by persons or by another corporation; second, the evidence must establish that the corporate cloak was used as a subterfuge to defeat public convenience, to justify a wrong, or to perpetuate a fraud.").

95 *See infra* Part IV.A.

96 *See, e.g.*, Kline v. Kline, 305 N.W.2d 297, 298–99 (Mich. Ct. App. 1981) ("Where the corporation is a mere agent or instrumentality of its shareholders or a device to avoid legal obligations, the corporate entity may be ignored . . . . A court may look through the veil of corporate structure to avoid fraud or injustice.") (citations omitted); Employers' Liab. Assurance Corp. v. Lunt, 313 P.2d 393, 395 (Ariz. 1957) ("The corporate fiction will . . . be disregarded upon the concurrence of two circumstances; that is, when the corporation is, in fact, the alter ego of one or a few individuals and when the observance of the corporate form would sanction a fraud or promote injustice.") (citation omitted); State v. Angelo, 800 P.2d 11 (Ariz. Ct. App. 1990); Terre Du Lac Ass'n, Inc. v. Terre Du Lac, Inc., 737 S.W.2d 206 (Mo. Ct. App. 1987).

97 *Black's Law Dictionary* defines "fraud" as "[a]n intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right." BLACK'S LAW DICTIONARY 594 (5th ed. 1979).

98 *Black's Law Dictionary* also informs us that "fraud" can have a more general meaning, being synonymous with "bad faith" and also with "dishonesty, infidelity, faithlessness, perfidy, unfairness, etc." *Id.*

2. *Nonobservance of Corporate Formalities*

Corporation statutes impose a number of requirements on those seeking to take advantage of the corporate form. Issuance of stock for consideration, annual shareholders' meetings, election of directors, appointment of officers by the board, major corporate decision making by means of board resolution, separate corporate books of account, properly documented loans and distributions—all these are legal requirements, regardless of whether there are one, a few, or thousands of shareholders. Obviously there is an element of play acting to all this in the case of close corporations, as the same individuals typically assume the roles of shareholders, directors, and officers, and the lines between personal and corporate assets are often blurry. Nevertheless, courts frequently point to failure to observe corporate formalities as a reason to pierce the corporate veil. Some courts have held that nonobservance by itself is not enough to warrant veil piercing.[99] Other courts treat it as sufficient if the nonobservance is extensive, even if creditors were not misled into believing they were dealing with the shareholders individually rather than with a corporation.[100]

Veil piercing based on failure to observe corporate formalities is problematic because the punishment may not fit the crime. By itself, inattentiveness to the annual shareholders meeting charade, failure to maintain a board of director's minute book, or sloppy record keeping should not warrant potentially crushing personal liability. It makes little sense for shareholders to forfeit their limited liability for such relatively trivial omissions.

Even if the inattention to formalities is pervasive, it is questionable whether that fact alone should be a sufficient basis for veil piercing. The question ought to be whether the controlling shareholders have somehow used their powers of control illegitimately. The answer to that question turns on the way they have managed the business's finances and the effects of those activities on the corporation's creditors. Failure to observe statutory requirements does not necessarily have anything to do with the harm sustained by the corporation's creditors or, by itself, with the question of shareholder responsibility.

The matter may be otherwise if shareholders have deliberately ignored corporate formalities to mislead creditors into believing they were dealing with the shareholders directly rather than with agents of a corporation. For

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[99] *See, e.g.*., Soloman v. W. Hills Dev. Co., 312 N.W.2d 428, 432 (Mich. Ct. App. 1981).

[100] *See, e.g.*, Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509, 512 (Minn. 1979).

example, suppose that the partners in an existing partnership have recently converted their business to a corporation. In dealing with a third party that has extended credit to them previously, the shareholders continue to use the partnership's stationery (which of course does not identify the business as "Inc.") and avoid mentioning that they are acting on behalf of the new corporation. Their intention is to limit the creditor's claim to corporate assets. Meanwhile, the creditor believes that it is still dealing with a partnership and therefore expects to be able to look to the owners individually to satisfy the obligation if the business's assets are insufficient. In a case like this, if the corporation ends up unable to pay the claim and the shareholders deny personal responsibility, the failure to observe corporate formalities will have contributed directly to the creditor's loss and therefore is arguably relevant to the question of shareholder liability.

While nonobservance of corporate formalities may be relevant to shareholder liability if it is a significant factor causing a creditor's loss, there may be no need to assert a veil-piercing claim in such cases. The facts may be sufficient to support a garden-variety fraud claim.[101] Or, fraudulent conveyance doctrine may support liability where shareholders have transferred corporate assets to themselves in disregard of statutory requirements to defeat creditor claims.[102] More creative theories may also obviate a veil-piercing claim. For example, a court might hold the shareholders liable as agents of an undisclosed principal.[103] In short, nonobservance of corporate formalities usually should be irrelevant to the question of shareholder liability. When it does play a role in the creditor's loss, courts should be able to hold shareholders responsible without resorting to veil-piercing analysis.

3. Undercapitalization

Undercapitalization or inadequate capital is the third of the most frequently mentioned factors in the piercing cases.[104] Courts have occasionally stated that

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[101] *See supra* note 97.

[102] *See* ROBERT CHARLES CLARK, CORPORATE LAW 43–44 (1986) (applying fraudulent conveyance principles to cases in which transfer renders debtor insolvent).

[103] *See* Fairbanks v. Chambers, 665 S.W.2d 33, 39–40 (Mo. Ct. App. 1989). Note that here the court turns the more usual characterization of the corporation as the shareholders' agent on its head.

[104] *See generally* William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837 (1982) (analyzing piercing cases based on undercapitalization).

it is a sufficient basis for veil piercing.[105] More often, it is included among the laundry list of factors that are potentially relevant.[106]

When courts speak of undercapitalization, typically the reference is to the amount of capital contributed to the venture when it is launched.[107] In this vein, a leading commentator has written:

> The attempt to do corporate business without providing any sufficient basis of financial responsibilities to creditors . . . will be ineffectual to exempt the stockholders from corporate debts . . . . [S]tockholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is ground for denying the separate entity privilege.[108]

Although the cases are typically unclear on this point, it seems that undercapitalization should be determined according to the amount of equity furnished by the shareholders. Capital contributed in the form of debt is by definition already subject to a creditor's claim and therefore is unavailable to satisfy the claims of others who have extended credit to the corporation but have not been paid.[109]

Influential as this idea might be, taken by itself initial capitalization should be of limited relevance to the question of shareholder liability for corporate obligations. Corporation statutes no longer include requirements for minimal initial capitalization or ongoing levels of capital.[110] Further, emphasis on

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105 *See, e.g.*, Shapoff v. Scull, 222 Cal. App. 3d 1457, 1470 (Ct. App. 1990) ("The requirements of the [alter ego] doctrine may be met where . . . the corporation is undercapitalized in light of its prospective liabilities.") (citation omitted); Serv. Iron Foundry, Inc. v. M.A. Bell Co., 588 P.2d 463, 475 (Kan. Ct. App. 1978); Frigidaire Sales Corp. v. Union Props., Inc., 562 P.2d 244, 247 (Wash. 1977).

106 *See, e.g.*, *supra* note 73 and accompanying text.

107 *See, e.g.*, J.L. Brock Builders, Inc. v. Dahlbeck, 391 N.W.2d 110, 115 (Neb. 1986) ("Inadequate capitalization is measured at the time of formation . . . .") (citation omitted).

108 WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 44.1, at 528 (rev. perm. ed. 1983). This language is a near quotation of a passage in HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 303 (rev. ed. 1946).

109 Where equity is meager, courts may recharacterize shareholder loans as equity or subordinate shareholder claims to those of outside creditors. *See,* e.g., Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958); Abraham v. Lake Forest, Inc., 377 So. 2d 465 (La. Ct. App. 1979); In re Mader's Stores for Men, Inc. v. DeDakis, 254 N.W.2d 171 (Wis. 1977).

110 For a survey of earlier requirements, see Richard A. Booth, *Capital Requirements in United States Corporation Law* 5–7 (Univ. of Md. Sch. of Law Legal Studies Research Paper No. 2005-64, 2005), *available at* http://ssrn.com/abstract=864685.

original contribution of equity capital as a fund for protection of future creditors ignores business realities.

Founders of small businesses often lack the ability to make large capital contributions out of their own funds. Even if they are able to do so, they may prefer to make the most of their contribution in the form of debt rather than equity to reduce tax liability.[111] Debt is also somewhat less risky than equity; if the business fails, shareholders may be better off in relation to outside creditors if their contributions were in the form of loans rather than payment for stock. If the shareholders seek to raise capital from third parties, here, too, they will prefer that those contributions take the form of debt because debt financing allows the business's founders to take advantage of the benefits of leverage; they claim all earnings net of debt service and other expenses, without having to share those gains with other equity investors. In short, practical considerations will often lead responsible business owners to prefer debt financing over equity. A rule of law that imposes personal liability on shareholders because of relatively modest initial equity financing makes no sense.

Further, even a large amount of equity capital contributed to the corporation at the time of formation offers no protection to future creditors if it is subsequently distributed to the shareholders or used to meet payroll or other operating expenses. Similarly, funds invested in firm-specific assets of limited liquidation value also will not be available to satisfy creditor's claims. On the other hand, a relatively modest initial equity contribution may not lead to any problems if the business is able to discharge its obligations out of operating revenues. There is, in other words, no clear connection between the amount of the shareholders' initial equity contribution and the corporation's ability to pay its debts in a timely manner.[112]

If the point of the court's reliance on the undercapitalization idea is that the shareholders are expected not only to contribute initially but also to maintain at

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[111] Subchapter C of the Internal Revenue Code allows corporations to deduct interest payments but not dividend distributions. Corporations eligible to be taxed under Subchapter S generally avoid tax liability, and so this consideration does not apply.

[112] Courts often mention "siphoning" of corporate funds as a basis for piercing. While distributions to shareholders clearly can threaten legitimate creditor interests, piercing seems an unnecessary tool to police that concern. Corporation law statutes already restrict the ability of shareholders to render a firm insolvent through dividend distributions. *See, e.g.*, REV. MODEL BUS. CORP. ACT § 6.40(c) (1985). Fraudulent conveyance principles and bankruptcy law's rules about preferences regulate in this manner as well. The doctrine of equitable subordination may also be relevant. There is no reason for courts to emphasize this factor as a reason for veil piercing.

all times a particular net worth in the corporation for the benefit of corporate creditors, such a requirement would not differ fundamentally from a rule of unlimited liability.[113] Either way, the shareholders would function as personal guarantors of corporate obligations. The cost of such a requirement to the shareholders could be prohibitively high, and the benefit of limited liability as a risk reallocation device would be lost. The threat of veil piercing should not amount to a requirement that all corporations maintain a shareholder-financed insurance fund. As explained below, shareholders can act responsibly toward corporate creditors in other ways.[114]

III. LIMITING LIMITED LIABILITY

Despite its current incoherence, veil piercing can play an important role in ensuring that corporate shareholders do not use limited liability in ways that are inconsistent with sound public policy. We have seen that the rationale for limited liability is subsidization of business investment at the expense of contract and tort creditors.[115] The limited liability default rule benefits shareholders by shifting the costs of accidents and other harms from themselves over to the victims of business activity. Shareholders may also benefit in relation to contract claimants by paying less for limited liability than they would if the default were unlimited liability. Nevertheless, under some circumstances shareholders can use limited liability to facilitate behavior that imposes excessive and unjustifiable costs on creditors that corporate law should not sanction. If it is based on an intelligent understanding of the appropriate limits of limited liability, veil piercing can provide an effective device for policing these kinds of shareholder misconduct.

Courts that have employed veil piercing to hold shareholders liable for corporate obligations recognize that the limited liability shield can be overbroad and therefore should not be respected in all cases. While the legal standard is very vague,[116] the piercing cases reflect a moral intuition that shareholders who abuse limited liability to extract wealth from third parties should be held responsible under certain circumstances. The problem is that the doctrine in this area has developed without thoughtful attention to just what kinds of misbehavior justify disregard of the corporate entity. Instead, the

113 Hackney & Benson, *supra* note 104, at 898.
114 *See infra* Part IV.B.1, C.1.
115 *See supra* Part I.C.
116 *See supra* Part II.B.

various factors discussed above—all of problematic relevance—are simply trotted out in seemingly random ways to justify what appears to be little more than an instinctive sense that the shareholders deserve to be held accountable.

The reason for the doctrinal confusion and unpredictability of results in the veil-piercing cases is the courts' persistent failure to articulate and then base their analysis on a sound understanding of the policy basis for limited liability. Only with a coherent view of the appropriate reasons for limited liability can courts hope to think rationally about the limits that ought to be imposed on its scope.

In this Part, I seek to identify some ideas that might better serve courts striving to make sense of those limits. Part IV will then present a proposal for law reform in more concrete detail. This Part begins with consideration of the reasons why corporations default on their obligations to creditors. It identifies two general categories. One, which I term "ordinary business failure," does not involve illegitimate behavior by shareholders and therefore presents an appropriate circumstance for limited liability protection. Courts should not pierce the corporate veil in these cases. The other category, however, includes various kinds of opportunistic behavior by shareholders who hide behind the limited liability shield to deliberately or recklessly extract value from third parties without compensation. In my view, corporate law should not facilitate this kind of behavior. Part III.C develops the arguments against allowing limited liability to protect shareholders from creditor claims resulting from opportunistic conduct. Abolition of veil piercing and reliance solely on liability for individual misconduct would not adequately prevent inappropriate uses of the limited liability shield.

A. Reasons for Corporate Default

Corporations may find themselves unable to pay their bills or satisfy tort claims for a number of reasons. To grasp the appropriate policy justification for limited liability, we can divide these reasons into two general categories. The first I term "ordinary business failure," using the term "ordinary" to express the notion that sometimes businesses fail for reasons that have nothing to do with the fault of their owners. In fact, the rate of failure for all small businesses is quite high. Many of these are cases of ordinary business failure. In contrast are those cases in which corporate insolvency results from the shareholders' selfishly motivated deliberate or reckless disregard for creditor claims.

1. *Ordinary Business Failure*

Sometimes a corporation ends up being unable to pay contract creditors because of developments that were unforeseen at the time the obligations were incurred. For example, production costs can increase beyond the amount of the shareholders' reasonable expectations. This can be the result of changes in the market for a key input, such as a natural resource. New government regulations can also raise costs unexpectedly. Or, demand for the company's product can decline due to any number of unpredictable reasons. Perhaps a competitor has developed a better product or found a way to produce more cheaply, or maybe technological innovation has rendered an entire product line obsolete. Reduced demand resulting from reasons like these will mean revenues lower than the shareholders reasonably expected.

If cash flow is inadequate, the business may need to resort to assets on hand to pay its creditors in a timely manner. However, even a business with significant net worth may be unable to do so if liquid assets—cash or other assets readily convertible to cash—are insufficient. Capital assets may have limited liquidation value, especially if they are firm specific. Uninsured casualty losses may also deplete a business's asset value after it has incurred an obligation to a third party. If assets and revenues are unavailable, insolvency is inevitable unless the business can find new sources of cash. Short-term borrowing may be one solution,[117] but if the revenue shortfall is due to lasting causes, reliance on more debt will only postpone the inevitable.

A tort judgment resulting in a huge claim against the corporation can also lead to insolvency. The basis for the claim may be an accident that has resulted in a loss much larger than could reasonably have been anticipated. In that case, the corporation's liability insurance policy may be insufficient to satisfy a judgment in favor of the victim.

These scenarios share a common feature. The immediate cause of the corporation's inability to satisfy a claim brought by a contract or tort creditor is not the result of events or circumstances brought about by the owners themselves. A certain amount of risk is involved in any business venture and can never be eliminated entirely. Insolvency resulting from events that reasonable shareholders could not anticipate or the occurrence of which was

[117] *See, e.g.*, PHILIP J. ADELMAN & ALAN M. MARKS, ENTREPRENEURIAL FINANCE: FINANCE FOR SMALL BUSINESS 162–63 (1998) (discussing the establishment of a line of credit to protect against cash flow deficiencies).

reasonably deemed to be a remote possibility are what I have in mind when I refer to "ordinary business failure." In these cases, there is no meaningful sense in which shareholders were at fault in causing the creditor's loss.

2. *Deliberate or Reckless Disregard for Creditors' Claims*

Contrast insolvency due to ordinary business failure with a corporation's inability to satisfy a creditor's claim due to the shareholders' management of the corporation with deliberate or reckless disregard for creditor interests. Shareholders can use their control over a corporation to act opportunistically toward corporate creditors. Opportunism in the contract setting implies deliberate efforts by one party to benefit itself by defeating the bargained-for expectations of the other party.[118] Various tactics are possible. In each case, the corporation's inability to meet its obligations results from the efforts of shareholders deliberately or recklessly imposing losses on creditors that the creditors did not voluntarily accept.

Those who extend credit to a corporation are in a different position than they would be if they were dealing with a sole proprietor or a business whose owners did not enjoy limited liability. This is so because limited liability creates occasions for shareholder opportunism that otherwise would not exist. Owners of a business have the same incentive to maximize profits regardless of whether the firm is organized as a limited liability entity. However, potential creditors of a corporation (or another limited liability entity), who can look only to the entity's assets for satisfaction of their claims, are vulnerable to the risk that shareholders will use their control over a business having separate entity status to shift costs to creditors that they have not agreed to bear. Shareholders can do this by causing the corporation to take actions that benefit the shareholders while reducing the corporation's ability to meet its obligations. Such possibilities do not exist in the absence of limited liability because, if creditors transact directly with the owners of a business rather than with an entity having a legal status separate from that of the owners, they can hold the owners directly accountable for their conduct.

Shareholder opportunism toward third parties can take a number of forms. The common feature in each of these scenarios is the shareholders' ability and incentive to use the corporation to extract value from third parties by means of actions that the shareholders could not get away with if liability were

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[118] *See* POSNER, *supra* note 43, at 93–98 (explaining that the purpose of contract law is to deter opportunistic behavior).

unlimited. In that case, shareholders would have to internalize the costs of business decisions and activities that third parties have not agreed to bear.

a. Ex Ante Opportunism

As to contract creditors, those in control of a corporation may know at the time an obligation is incurred that the corporation will be unable to pay the claim. Inability need not be the result of shareholders' intention to loot the corporation of its assets to enrich themselves. Perhaps the proceeds of a loan will be used to discharge an existing third-party liability under circumstances in which revenue will be insufficient to repay the lender. Or perhaps the business is already losing money but the owners have borrowed to meet operating expenses despite the absence of any reasonable likelihood that the business's decline can be reversed and the debt ultimately discharged.

In cases like these, shareholders cause their corporation to incur indebtedness with knowledge that there is no reasonable likelihood of repayment. Had they faced liability in their own right, the shareholders surely would have been reluctant to do this. However, because the creditor's claims are limited to corporate assets, shareholders have an incentive to borrow even in these situations.

Even if there is no actual knowledge of the corporation's inability to fulfill an obligation, the shareholders can cause the corporation to incur a debt without thinking seriously about whether it will be possible to pay interest and principal when due. A business's owners can buy on credit from a supplier without having paid sufficient attention to the corporation's expected cash flows and current working capital condition. Whether the result of deliberate planning or of reckless disregard for the business's condition and prospects, corporate status may enable the firm's owners to impose these losses on creditors while relying on the limited liability shield to protect their personal wealth.

Shareholders can also act opportunistically by committing the business to high-risk projects that bear a relatively small possibility of rich return. For example, a firm might seek to develop a new product by using borrowed money to fund a new research team. There is a small probability that the investment will eventually generate revenues significantly greater than its cost. There is a significantly larger probability, however, that the project will generate insufficient revenues to pay back the funds borrowed to finance it. If the shareholders were personally liable for the corporation's debt, they would not undertake the project because its expected return is less than its cost. However, with limited liability, they may be willing to cause the corporation to undertake such a project as long as the expected return is greater than the amount of money they have already invested in the business. If the project turns out to be successful, the shareholders reap the rewards. If it fails to generate significant added value, however, limited liability will restrict the lender's claim to corporate assets, even if they are insufficient. Limited liability thus can create an incentive to engage in projects whose costs exceed their expected value.[119]

Such decisions are problematic because the shareholders have caused the corporation to incur an obligation that they know bears a significant likelihood of nonpayment. If they know or should know that this is so and have actively concealed the extent of the risk from the lender, the shareholders have acted opportunistically. Even if there has been no active misrepresentation, the lender can claim to be the victim of opportunism if the shareholders knew that the borrowed funds were to be used for a project whose cost exceeded its expected return.

As long as the firm's owners can conceal from creditors their bad faith intentions or their reckless disregard for the corporation's ability to meet its future obligations, shareholders may be able to obtain credit from lenders who do not appreciate the full magnitude of the risk they have undertaken. Potential lenders may lack knowledge that could lead them to refuse to deal or, should they choose to assume the risk, to demand compensation in the form of an appropriately adjusted interest rate or a security interest. Creditors thus must take the initiative to investigate the creditworthiness of corporate debtors and bear the risk of their own ignorance. Unlimited liability would also require creditor investigation of shareholder wealth, but that rule would not allow business owners to assign specified assets in the firm while protecting

[119] Assume the following facts by way of a simple illustration. The cost of the project to the corporation is $100,000, to be financed by borrowing. There is a 20% probability that the project will return $300,000 and an 80% likelihood that the return will only be $20,000. The shareholders have previously invested $10,000 of their own funds in the business. Even though the expected return on this project is only $76,000 ((.20 x $300,000) + (.80 x $20,000)), which is less than its cost, the shareholders may still decide to go ahead because they stand to lose only the $10,000 they had previously contributed to the firm if the return is insufficient to repay the debt. If, however, liability were unlimited, they would be responsible for the balance due after the business's resources were exhausted and therefore would be required to repay the full $100,000. Since the expected return is only $76,000, the investment would not be rational. For a discussion of the concept of expected return, see KLEIN & COFFEE, *supra* note 31, at 229–30.

the remainder from creditors of the business.[120] By restricting creditor access to shareholder wealth, limited liability increases the cost of failure to obtain full information about the risk of insolvency.

b. Ex Post Opportunism

Even if the shareholders have obligated the corporation to a third party in good faith and they have done so after reasonable analysis of the business's ability to pay the claim, the shareholders may thereafter take actions that increase the risk of default beyond what it was at the time the obligation was incurred. Here, too, limited liability can facilitate shareholder opportunism toward contract creditors.

Controlling shareholders can use their powers of control to "siphon" assets out of the corporation in the form of cash or noncash dividends. The result is that payment of creditor claims is thereafter more heavily dependent on the business's cash flows, and so the risk of default increases. Similarly, loans to shareholders can likewise jeopardize the firm's liquidity and thereby increase the risk of default. Unlimited liability would allow recovery from the shareholders individually in either case, but limited liability interferes with that result.[121]

Shareholders also act opportunistically toward the firm's existing creditors when they commit the corporation to a project with expected return less than its cost. In such cases, as discussed above, the shareholders have incurred a significant risk that the corporation will be unable to repay the debt. If that happens, the lender will look to the corporation's assets for payment. By putting these assets at greater risk, the shareholders have reduced the likelihood that the business's existing creditors will be paid.[122] Such projects thus devalue the rights of existing creditors, who now find themselves holding claims that are worth less than they bargained for and therefore bear too low an interest rate. Here, limited liability allows the business's owners to chase the

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[120] *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000) (discussing the role of law in facilitating the division of assets between owners' personal assets and those of the firm).

[121] Fraudulent conveyance doctrine may provide a basis for shareholder liability if the transfers were made without consideration and result in unreasonably small capital. *See* CLARK, *supra* note 102, at 43–44.

[122] Decisions that increase the risk of insolvency harm all existing creditors. Their vulnerability is compounded if the shareholders cause the corporation to incur additional indebtedness that is senior to existing claims or is secured by a pledge or mortgage of assets that otherwise would be available to apply toward satisfaction of those claims.

low-probability prospect of high returns at the expense of the corporation's creditors by pursuing a course of action that would not be rational if the shareholders were personally liable to the firm's creditors.

c. *Tort Creditors*

Limited liability also encourages opportunistic behavior toward third parties who have not voluntarily extended credit to the corporation. Because the shareholders do not bear personal responsibility for harm that the corporation causes, limited liability encourages shareholders to use the firm to engage in profitable activities that are potentially harmful to third parties. This is so even if the social costs of such behavior are greater than its potential benefits to the shareholders. As in the contract context, the expected value of a project need only exceed the amount of capital that the shareholders have invested in the business and thus stand to lose if a large judgment is entered against the corporation. There is no incentive to minimize accident costs by taking cost-effective precautions or declining to engage in extremely hazardous activities. In contrast, if liability were unlimited, shareholders would be reluctant to assume the risk of large tort judgments that exceed an activity's expected value. Limited liability thus creates a moral hazard problem that otherwise would not exist.[123]

In the scenarios involving contract creditors, shareholders act opportunistically by imposing on claimants risks that they have not agreed to accept and for which they therefore have not received compensation. Opportunism in the tort setting involves a different problem. In that context, there is no bargaining in advance between the corporation and the tort victim, and so there is no question of voluntary acceptance and agreed compensation ex ante. However, if the tortfeasor fully compensates the victim for his or her loss, the victim is no worse off even though the transaction that gave rise to the creditor's claim was nonconsensual.

Limited liability reduces the likelihood that the victim will receive full compensation because the claim is limited to the corporation's assets. Absent limited liability, the shareholders would face the prospect of personal liability in the event of the corporation's inability to pay the claim in full. Shareholders act opportunistically by causing the corporation to engage in activities that have the potential to harm third parties, without providing for compensation out of the corporation's assets or the proceeds of an insurance policy. In other

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[123] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 16, at 49–50; Mendelson, *supra* note 35, at 1233–35.

words, opportunism in the tort context consists of deliberate or reckless externalization of some of the costs of business activity. In contrast, if a third party's injury results in a loss that is greater than could reasonably have been anticipated, the shareholders have not acted opportunistically if they have failed to make advance provision for compensation.

The common feature in both the contract and tort scenarios is the shareholders' ability and incentive to use the corporation to transact with third parties in ways that the shareholders themselves would be unwilling to do if liability were unlimited. If they could be held personally accountable to tort or contract creditors of their business, shareholders would be reluctant to act opportunistically. Third party losses would still occur, but they would be the result of circumstances that the shareholders had no reason to anticipate and for which they therefore cannot be expected to have provided.

B. The Appropriate Scope of Limited Liability

1. The Policy Choice

As discussed above, limited liability is designed to function as a risk allocation device.[124] It shifts the risk of business insolvency from the business's owners to its creditors and therefore imposes on them the burden to take whatever protective measures they deem to be appropriate. In this respect, limited liability can be thought of as a subsidy paid by those who transact with corporations. The purpose of the subsidy is to encourage entrepreneurial activity and investment.

The policy question is, how large should this subsidy be? Should shareholders enjoy exemption from personal liability for corporate obligations in all circumstances? Or, instead, should limited liability be limited, that is, tailored so as to be unavailable if certain conditions are present? These questions are important because the answers in effect determine the magnitude of the risk reallocation and the extent to which third parties can be required to bear the costs of business activity. In particular, the policy question calls for a judgment about the extent to which shareholders will be allowed to act opportunistically and thus deliberately or recklessly impose losses on unwilling third parties.

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[124] *See supra* Part I.C.

If limited liability is to exist at all, it surely is appropriate as a device for protection of shareholders from the costs of ordinary business failure. By definition, in these cases shareholders have attempted in good faith to operate their business with due regard for creditor interests. While seeking to maximize return on their investments of financial and human capital, the shareholders have also accepted credit on the reasonable assumption that the business will be able to pay these claims when they come due. Similarly, they have provided for harm to third parties resulting from business activities either by self-insuring or by purchasing liability insurance. When it turns out that the business cannot pay a claim despite having acted in this manner, this seems to be the kind of paradigmatic loss that limited liability ought to cover. Even owners acting entirely in good faith must fear the possibility of corporate insolvency due to causes over which they have no control. Limited liability protects them from personal financial disaster and therefore is an appropriate device for encouragement of entrepreneurial risk taking that otherwise would not occur.

It is not at all clear that shareholders who behave opportunistically should also enjoy the limited liability shield. In these cases, business owners are either imposing risks on contract creditors who have not agreed to accept those risks or are deliberately or recklessly subjecting members of the public to possible injuries that the corporation cannot compensate. Public policy could endorse protection of shareholders from business failure due to unavoidable events or circumstances without going so far as to extend the limited liability shield to losses resulting from opportunism. Defining the scope of limited liability so broadly as to encompass the latter as well as the former would encourage behavior that arguably ought not to be encouraged. The next section elaborates on the case against a broad conception of limited liability. I then suggest, in Part IV, how veil piercing can be deployed effectively to tailor the scope of limited liability in accordance with sound public policy.

2. *Limiting the Scope of Limited Liability*

a. *Fairness and Efficiency Considerations*

The essence of shareholder opportunism as I have defined the concept here is the use of limited liability to impose costs on third parties without compensation. Shareholders subject contract creditors to a risk of default that is greater than what they think they are agreeing to or have already consented to accept. Both as to contract and tort claimants, shareholders are attempting to extract value from others without paying for it. Ordinarily, of course, the law does not permit, let alone encourage, this sort of behavior and uses terms like fraud or larceny to describe it. Still, one could argue for the lawfulness of such behavior in the corporate law context on the ground that allowance encourages business investment. Incorporation would provide business owners with the prospect of higher returns than would otherwise be available because these kinds of gains would not be possible—or at least would be harder to achieve—if ordinary notions of fair play and efficiency applied.

This defense of limited liability goes too far. Other than by means of the tax system, uncompensated wealth transfers are at least presumptively objectionable. A basic moral intuition demands that people enjoy security of person and property. They should not be deprived of their wealth without consent. If there is no ex ante consent to a welfare-reducing transaction, full compensation ought to be forthcoming as a matter of fundamental fairness. Efficiency considerations are also relevant. Legal rules that make it possible for some people to extract value from others without compensation are inefficient because they encourage expenditure of resources to achieve security and may even result in abandonment of productive activities.[125]

Refusing to extend limited liability to include protection from claims based on opportunism would not eliminate limited liability's efficacy as a subsidy designed to encourage investment in business activity. Immunity from personal liability where corporate insolvency could not reasonably have been anticipated would still represent a significant benefit. The presumption against uncompensated wealth transfers therefore should apply to the definition of the appropriate scope of limited liability.

b. Opportunism and the Cost of Credit

Including within limited liability's protective mantle shareholders who have behaved opportunistically toward existing and potential creditors is also bad policy because it unnecessarily increases the cost of credit to all corporations and their investors. This is so because creditors must factor the risk of opportunism into all of their credit pricing decisions, even though not all borrowers will in fact behave opportunistically.

Contract creditors confronted with the risk of corporate insolvency demand compensation ex ante for taking on the added risk posed by shareholder limited

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125 *See, e.g.*, POSNER, *supra* note 43, at 36.

liability. The higher interest rate paid by the corporation reduces the shareholders' return on their investment. The size of the interest rate differential depends on creditor's assessments of the risk of corporate insolvency in particular situations.

If limited liability is not tailored so as to exclude losses resulting from shareholder opportunism, it will protect shareholders whose corporations default because of their own opportunism as well as those whose corporations are unable to pay their debts despite the shareholders' good faith efforts to manage the business responsibly. In the language of game theory, we can posit two classes of shareholders: a "good" type and a "bad" type.[126] One group is prone toward good faith, honorable business behavior, while the other seeks to make money by extracting value from others without compensation.[127]

Ideally, creditors should adjust their interest rates according to which type of borrower they are dealing with. Corporations managed by good shareholders should pay less for credit than corporations managed by bad ones because the risk of default is lower in the first scenario than in the second. The problem is that, ex ante, it may be impossible for the lender to tell whether those in control of a corporate borrower are likely to engage in behavior designed to benefit themselves at the creditor's expense or whether, instead, the shareholders are motivated by a good faith intention to honor the corporation's obligations. If lenders cannot distinguish good from bad borrowers, they will need to insist on an interest rate that reflects the aggregate risk presented by the overall pool of good and bad borrowers. Good borrowers therefore end up paying more for credit than they would if the interest rate were tailored to them; bad borrowers pay less.[128]

Reputational data can assist the lender in assessing the shareholders' type. Credit reports may be instructive and relatively inexpensive to access. Court records or the experiences of other lenders may also be helpful, but that information will be more costly to obtain. If the corporation is new, however, it and its shareholders may have no credit history. Alternatively, shareholders who have a clean track record may be tempted to act opportunistically if they are unconcerned about the reputational effects of their behavior. Perhaps they have decided to wrap up their business and retire. In short, lenders may be reluctant to rely on reputational data even if it is available.

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126 *See, e.g.*, DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 126 (1994).

127 *Id.* (modeling nonverifiable information as binary).

128 *See infra* notes 133–37 and accompanying text.

Good shareholders have an incentive to signal their type to prospective lenders. For good types to be able effectively to use signaling to distinguish themselves from bad types, they need to identify actions that they can deploy at lower cost to themselves than to the bad types.[129] Some signals, like membership in the local chamber of commerce or a fancy office suite, will not be effective for this reason.

Good shareholders might offer personal guarantees of corporate obligations more cheaply than bad shareholders could do, because by definition they are less likely to cause their corporations to default. In this way, they could signal their type and, even though they would expose themselves to personal liability, they would presumably benefit from the lower interest rate payable by good borrowers. However, this signal, while potentially effective, could come at too great a cost. It would entail forfeiture of limited liability not only for opportunistic default but also for insolvency due to ordinary business failure. Even good shareholders may prefer to pay for limited liability to protect themselves from unavoidable misfortune.

If credible signaling strategies are unavailable in this context, are devices available by which lenders can screen good borrowers from bad ones to price extensions of credit accordingly? One possible screening mechanism, which, as explained below, turns out not to work, could be for lenders to insist on personal guarantees from shareholders. A lender seeking a personal guarantee receives a benefit it would otherwise not enjoy and therefore must pay for it, presumably in the form of a lower interest rate. Borrowers intending to act in good faith toward corporate creditors face a lower risk of corporate insolvency than do shareholders who plan to use control over the corporation to benefit themselves at the expense of the business's creditors. Personal guarantees therefore would be less costly to the first group, who therefore should be willing to accept less compensation (such as a smaller interest rate reduction) than the bad borrowers would. In fact, bad borrowers may be unwilling to agree to a personal guarantee at all. Requiring a personal guarantee therefore could be an effective screening device. If so, lenders would be able to identify

[129] More specifically, the cost differential needs to be greater than the amount by which the bad type can benefit from investment in the signaling strategy. *See generally* John G. Riley, *Silver Signals: Twenty-Five Years of Screening and Signaling*, 39 J. ECON. LIT. 432 (2001) (surveying economic research on screening and signaling).

good borrowers, who would not have to pay a premium for credit resulting from lenders' inability to distinguish good from bad.[130]

In fact, it is not clear that requiring personal guarantees can effectively perform a screening function. Most importantly, self-identification by bad borrowers could result in lenders' refusing to extend credit to them.[131] Lenders facing the prospect of default by corporate borrowers may not consider the right to pursue shareholders' personal wealth to be sufficient protection. At the very least, they would need to obtain assurances of shareholders' financial ability to guarantee the corporation's obligation. If the shareholders have already identified themselves as untrustworthy, any such assurances will lack credibility. Further, the need to take legal action to enforce personal guarantees can significantly reduce their value to creditors. If self-identification by bad borrowers (by demanding more compensation than good borrowers for personal guarantees or perhaps refusing to provide such guarantees at all) threatens to result in refusal to lend, bad borrowers may not be able to afford to self-identify. In that event, lenders' insistence on shareholder guarantees would not serve a screening function. All loans would be made on the same terms, and, as explained below,[132] the existence of bad borrowers would result in good borrowers paying more for credit than would otherwise be necessary.

Requiring personal guarantees also may not work as a screening device because they do not offer attractive benefits to all creditors. Reliance on personal guarantees is costly, potentially requiring investigation of the guarantors' personal wealth, ongoing monitoring of their liquidity, and litigation costs if enforcement is necessary. For many creditors, the value is not worth the cost. Unsecured creditors therefore seek protection from risk by charging a high interest rate across the board. Other creditors, such as mortgage lenders or suppliers of inventory, typically prefer to take a security

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[130] It is also conceivable that lenders can screen good from bad borrowers by reference to the latter group's willingness to pay a relatively higher rate of interest. Willingness to engage in opportunism may allow bad borrowers to earn a higher return, who therefore should be willing to pay more for the funds in question. *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981). However, if bad borrowers were to identify themselves in this way, lenders may refuse to lend, fearing that they will not be repaid. Bad borrowers might therefore be better off offering to pay the same interest rate as the good borrowers.

[131] For a model explaining why some potential borrowers receive credit while others do not, even though they might be willing to pay a higher interest rate or put up more collateral than borrowers who receive loans ("credit rationing"), see *id*. One of the authors' key insights is the negative effect of a higher interest rate on the risk of default and therefore on the lender's expected return. *Id.* at 401–02.

[132] *See infra* notes 133–37 and accompanying text.

interest in particular property. If shareholder guarantees are suitable only for certain classes of creditors, they do not present a general solution to the informational obstacle faced by those who extend credit to corporations.

The screening strategy could fail for yet another reason. Some good borrowers may be exceptionally risk averse and therefore extremely reluctant to expose their personal wealth to the risk of corporate insolvency. In such cases, it may be impossible for lender and shareholders to reach agreement on the amount of the interest rate reduction to be accepted in return for personal guarantees. The shareholders' refusal to agree to a guarantee would not indicate bad faith, but it could be misinterpreted by potential lenders.

If signaling and screening mechanisms are ineffective, lenders cannot tell which type of borrower they are dealing with and therefore cannot price discriminate according to type. That is, they cannot demand a higher interest rate from bad borrowers to compensate for the additional risk that they will not be repaid. Lenders must therefore price their extensions of credit on the assumption that they may be dealing with a bad type. Common knowledge informs them that not all borrowers are bad, however, and so ideally calculation of the appropriate interest rate would require information about the percentages of good and bad types among all borrowers. It would then be possible to compute an average of the interest rates appropriate to each of the two types, weighted according to their incidence in the total population.[133] Because such data do not exist,[134] the amount of the appropriate interest rate differential can only be estimated according to lenders' assumptions about the world. Even so, the point is that all borrowers end up paying this interest rate.[135]

Accordingly, if limited liability protects opportunistic debtors as well as those who act in good faith, good borrowers pay more for credit than they would pay if pricing decisions were based on actual risk of default. Meanwhile, bad borrowers may end up paying a lower rate than they would

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[133] More specifically, a creditor would want to know about the incidence of the full range of borrower behavior because the world does not divide neatly into two discrete categories of "good" borrowers and "bad" ones.

[134] Merely knowing the default rate among a class of borrowers is not sufficiently informative because default can result from a range of causes—some culpable, some unavoidable—despite a borrower's best efforts.

[135] In game theory parlance, this is known as a "pooling equilibrium." *See, e.g.*, BAIRD ET AL., *supra* note 126, at 130. If lenders were able to distinguish the good borrowers from the bad, the result could be two different interest rates (assuming only two categories of borrowers). This is referred to as a "separating equilibrium." *Id.*

pay if their type were identifiable. Broad, untailored limited liability therefore does more than just subsidize business owners at the expense of contract creditors. Good borrowers actually end up subsidizing bad ones.[136]

By limiting the scope of limited liability, the law could address the informational problem that potential creditors confront and thereby reduce the cost of credit for good borrowers. If limited liability were tailored so as to deny protection in cases of corporate default due to shareholder opportunism, creditors would in effect enjoy personal guarantees from bad shareholders without having to bargain for them ex ante. Creditors therefore could charge less for credit, confident in the knowledge that courts will impose liability on shareholders where the corporation's default results from shareholder opportunism rather than business failure due to legitimate risk taking. In other words, they could price extensions of credit as if all debtors were good because they would not need to protect themselves ex ante from the risk of shareholder opportunism by charging everyone an interest rate reflecting the incidence of both good and bad types in the full set of borrowers. If lenders cannot sort bad borrowers from good ex ante, veil piercing would authorize courts to perform that function ex post.

For these reasons, the limited liability shield ought to be tailored so as to deny protection to corporate borrowers that default on their obligations because of shareholder opportunism. Tailored limited liability would give creditors the assurance that they could recover their losses from shareholders when corporate insolvency was due to their deliberate or reckless abuse of their control powers. In contrast, those shareholders who did not behave improperly would be protected from personal liability unless they had agreed ex ante to waive protection in return for appropriate compensation. The result should be a reduction of corporate borrowing costs and a corresponding increase in shareholder returns.[137] That in turn would increase the incentive to

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136 It is an interesting question whether the overall cost of credit is higher than it would be if a separating equilibrium were attainable. Theoretically, it should not be. To see this, assume that half of all borrowers are of the "good" type; for them the appropriate interest rate is 10%. For the remaining "bad" borrowers, assume that the appropriate interest is 14%. If a separating equilibrium is not possible, the interest rate should be 12%. The total amount of interest paid (number of borrowers times interest) should be the same whether the equilibrium is mixed or separating. In fact, creditors lack the data necessary to perform these calculations. Operating more or less in the dark, they will try to obtain as much protection as possible. There is therefore a chance that the mixed equilibrium will end up being higher than it needs to be, say, 12.5 or 13%. In other words, all borrowers would end up paying a premium for the lenders' ignorance.

137 Current veil-piercing law presumably does not have these effects because it is conceptually and doctrinally incoherent and therefore unpredictable in application.

use the corporate form to pursue entrepreneurial projects, which is the underlying policy basis of limited liability in the first place.

c. *Tort Creditors*

Overbroad limited liability presents a different set of issues with respect to tort creditors. Corporate law contemplates that investors doing business as corporations will be able to externalize some of the costs of doing business. Once they have exhausted the resources of a thinly capitalized corporation, judgment creditors have no further recourse against the shareholders' personal wealth, however large the outstanding claim might be. The limited liability shield therefore allows shareholders to engage in potentially profitable activities without regard for externalities. As discussed above,[138] the purpose is to encourage business investment—including investment in activities that have the potential to harm others—that would not occur if investors had to bear the full costs themselves. Presumably, state legislatures have made the judgment that the social benefits of increased business investment outweigh the costs of uncompensated injuries.

The key policy question, again, is the appropriate magnitude of this subsidy. The social cost of limited liability as to tort creditors is potentially extremely high. Mass distribution of products with the capacity to harm their users is one element of this cost. There can be harmful third-party effects on non-users too, as in the case of passive cigarette smoke inhalation. Production and distribution on a large scale can also impose substantial costs on the general public, such as environmental pollution and transportation accidents.

The problem of social cost is compounded by the fact that tort victims—unlike contract creditors—typically lack the opportunity to bargain prior to "transacting" with a limited liability entity. When that is the case, tort claimants have not received appropriate compensation ex ante for accepting the risk that a corporate tortfeasor will cause them harm and then be unable to satisfy a judgment. Tort victims must therefore seek compensation ex post, and if the corporation lacks sufficient resources, they will be left to bear the uncompensated costs of injury themselves.

In light of the social costs of harmful activity, limited liability for tort claims should not be thought of as an all-or-nothing proposition. Academic

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[138] *See supra* Part I.C.

debate has been cast in those terms,[139] but in fact limited liability can and should be tailored so as to provide protection for shareholders in some cases but not in others. If that is to happen, though, the tailoring needs to be done on the basis of well-considered public policy judgments rather than the randomly deployed epithets found in the case law.[140] The key distinction should be about the reasonableness of the corporation's efforts ex ante to provide compensation for potential accident victims, either through liability insurance or self-insurance. A corporation acts reasonably if it provides sufficient compensation for harms likely to occur as a result of its business activities. If it has done this, the shareholders should escape liability even if it turns out ex post that the proceeds of the insurance policy or the amount of the self-insurance fund have proven to be inadequate. In other words, limited liability should protect investors from judgments that are not payable despite the efforts of the corporation to act responsibly. In contrast, an insurance policy with a coverage limit that is unreasonably low in light of the nature of the corporation's business should result in shareholder liability. Similarly, shareholders should be held responsible to tort victims where the corporation has relied on a self-insurance fund that is unreasonably meager. The law should not encourage deliberate or reckless failure to cover the reasonably anticipated costs of doing business by allowing business owners to seek refuge behind the limited liability shield.

Sometimes corporate activity results in greater harm to third parties than the owners of the business could reasonably be expected to have anticipated. Having considered seriously the appropriate coverage limit (or the amount of a self-insurance fund), limited liability should protect business owners if their reasonable efforts prove to be inadequate. If it is to have any bearing at all on tort claims, limited liability surely seems warranted here. By definition, there is no basis for believing that the owners of the business should have managed it differently so as to have prevented the problem. The only way to avoid the loss would have been to overinsure, out of concern for third-party harm of a magnitude that reasonable people would consider unlikely to occur. Even so, business owners know that virtually anything is possible. Without the limited liability shield, the possibility of a massive tort judgment—however remote—would lead prudent people either to overinsure or to decide against engaging in an otherwise profitable business venture. Neither alternative is socially

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[139] *See, e.g.*, Hansmann & Kraakman, *supra* note 6; Leebron, *supra* note 6 (both arguing for unlimited liability as to corporate torts).

[140] *See supra* Part II.B.

desirable. Limited liability in this context thus has the effect of shielding business owners from the costs of the unexpected. Even if restricted to scenarios like this, limited liability would still provide a meaningful benefit and therefore would encourage business investment that otherwise would not occur.

One could imagine a policy that extended limited liability even to situations in which shareholders have knowingly or recklessly imposed costs on third parties without providing compensation. Certainly protection from liability in cases like these would mean a potentially higher return on shareholders' investments. Presumably that should translate into higher rates of entrepreneurial activity. Investors stand to benefit, and there would be third-party gains, too, such as job creation and provision of attractive goods to consumers at lower prices. Despite these benefits, however, efficiency as well as fairness considerations suggest that limited liability should not extend so far. Absent limited liability, investors would restrict themselves to business activities whose potential gains exceed potential third-party harms for which they could be held responsible under tort law doctrines. With liability limited to whatever capital they have contributed to their corporation, shareholders are encouraged to engage in potentially harmful activity even if the costs to third parties are greater than the benefits to themselves. The expected value of such activities need only exceed the amount of capital they have placed at risk in the corporation.[141] Even factoring in potential benefits to nonshareholders, overly broad limited liability ensures that shareholders will engage in business activities without regard to the magnitude of their social costs and the relation of those costs to shareholder and third-party benefits. There is no reason to expect efficient outcomes.

In addition, overly broad limited liability presents questions of basic fairness. Protecting shareholders from responsibility for deliberate or reckless infliction of harm on third parties will result in losses without the opportunity to engage in ex ante bargaining and without the assurance of adequate ex post compensation. Uncompensated personal injury or property damage is justified solely by reference to the instrumental value of increased business investment. Our traditional values generally disapprove of this form of moral argument.

As currently employed by courts, veil piercing in tort cases represents an acknowledgment that tailoring of limited liability so as to reduce its social

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141 *See supra* Part III.A.2.b.

costs is appropriate under certain circumstances. However, courts pierce the corporate veil for the benefit of tort creditors only occasionally and do so on an ad hoc basis with insufficient regard for these larger public policy questions. In the contract context opportunism implies deliberate efforts to use corporate control in ways that thwart the bargained-for expectations of corporate creditors and allow shareholders to extract value beyond that for which they have paid compensation. The operative distinction should turn on judgments about responsible use of control and due regard for legitimate, already established creditor interests. These ideas are developed more fully below.[142] Opportunism implies similar considerations in the tort context. Courts ought to ask whether the shareholders have conducted their business in a manner that irresponsibly shifts the costs of the business to other parties.[143] As with contract creditors, the challenge is to define shareholder responsibility in a way that appropriately mediates the conflicting goals of business subsidization on the one hand and respect for legitimate third-party interests on the other. I confront these challenges below.[144] First, however, it is necessary to consider whether the policy objective advocated here can be achieved without resort to veil piercing.

C. Should Veil Piercing Be Abolished?

One can accept that limited liability should not be respected in all cases involving insolvent corporate debtors without necessarily accepting the need for veil piercing under certain circumstances. Scholars—most recently Professor Bainbridge[145]—have argued that established legal doctrines already exist that provide mechanisms for holding shareholders personally liable to corporate creditors in appropriate cases. According to this view, the law of fraudulent misrepresentation and of fraudulent conveyance are adequate to the task of policing abuse of limited liability and therefore obviate the need for veil piercing.[146] While I share Professor Bainbridge's frustration with current veil-piercing jurisprudence,[147] these doctrines would not adequately address the financial responsibility concerns discussed above.

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142 *See infra* Part IV.B.1.
143 *See infra* Part IV.C.1.
144 *See infra* Part IV.B–C.
145 *See* Bainbridge, *supra* note 10.
146 *See id.* at 517–23. Professor Bainbridge would, however, retain veil piercing in cases involving parent-subsidiary corporations. *Id.* at 534.
147 *See id.* at 506–14 (explaining that veil piercing is a "dysfunctional doctrine").

The doctrines identified by Professor Bainbridge do reach some cases of opportunistic exploitation of limited liability. If a business owner lies about the corporation's current financial condition or future prospects to induce the extension of credit, he may be held liable under ordinary tort principles.[148] Similarly, if shareholders withdraw assets from a corporation to defeat creditor claims on those assets, fraudulent conveyance law may allow creditors to insist that the shareholders return those assets to the corporation.[149]

Actions for misrepresentation and fraudulent conveyance would not, however, reach all of the cases in which shareholders have used limited liability in ways that offend public policy. As argued above,[150] shareholders who cause the corporation to incur debt while knowing that repayment is impossible or highly unlikely arguably should be treated differently from those whose corporations default despite their good faith efforts to manage the business in a financially responsible manner. If so, however, they would not be subject to liability under common law fraud principles if there has been no misrepresentation. Similarly, shareholders also act opportunistically if they commit the corporation to a project with expected return lower than cost. The lender arguably has been dealt with unfairly and the claims of existing creditors are devalued. Again, however, there is no basis for liability based on fraud if there has been no false statement. Nor is there any basis for a fraudulent conveyance claim where the shareholders have not used their control to transfer assets with the intention of defeating creditor claims.

In the tort context, the distinction is between shareholders who cause their corporation to engage in activities that are likely to be harmful to third parties while knowing that the corporation will be unable to pay compensation and those whose corporations end up unable to compensate the victim of a loss so large that it is unreasonable to expect them to have provided for it. Although courts sometimes use the term "fraud" in the loose sense of inequitable conduct in cases like this,[151] in fact there is no basis for a common law fraud claim because no one has been misled. Fraudulent conveyance doctrine also has no bearing here.

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[148] *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 726–29 (5th ed. 1984) (discussing elements of action for deceit).

[149] *See* CLARK, *supra* note 102, at 43–44.

[150] *See supra* Part III.A.2.

[151] *See supra* notes 96–98 and accompanying text.

If one accepts my views about the appropriate limits of limited liability, courts will need to continue to use veil piercing as the mechanism for denial of the limited liability shield in certain circumstances. Common law doctrines of misrepresentation and fraudulent conveyance can effectively police some cases of shareholder abuse but they are not broad enough to do the job completely. The following section develops more fully an approach for the use of veil piercing to tailor the scope of limited liability.

IV. Veil Piercing and Tailored Limited Liability

My proposal is that courts should respect limited liability as long as the shareholders have managed the business in a "financially responsible" manner. If, instead, corporate insolvency is the result of "financially irresponsible" conduct, piercing the corporate veil is appropriate. Once veil piercing is placed on a sound conceptual footing, current objections to the doctrine based on its vagueness and unpredictability will no longer apply.

Financial responsibility means management of the business based on a good faith, reasonable belief that the corporation will be able to satisfy creditor claims in a timely manner. To deal responsibly with contract creditors, at the time the corporation assumes a debt those in control of the business need to have good reasons to believe that the business will be able to meet the obligation when it comes due. Having incurred an obligation, they will also need to manage the business in a way that does not unreasonably increase the risk of corporate default on existing claims. As to potential tort creditors, the shareholders should provide the corporation with the means to satisfy claims that are reasonably likely to occur. Ordinarily they will do so by means of liability insurance.

A. *The Question of Control*

Before elaborating on the meaning of financial responsibility in the contexts of contract and tort creditors, it is first necessary to address the importance of control in relation to questions of shareholder liability. If a court is going to pierce a corporation's limited liability veil, it should only do so as to shareholders who have actually caused the corporation to act in a financially irresponsible manner. This is because the essence of the veil-piercing judgment should be a finding that shareholders have used their control of a corporation so as to shift the costs of a corporation's insolvency over to its creditors in an unreasonable manner. Shareholders who are not at fault in this way should not lose the protection of statutory limited liability.

Unlike partners in a general partnership,[152] corporate shareholders do not participate in control of the firm simply by virtue of their status as such.[153] Instead, they exercise control only indirectly, through their ability to elect members of the corporation's board of directors at the annual meeting.[154] Sometimes one or more shareholders with the voting power to elect the corporation's board will use that prerogative to install themselves in positions of control. They can do this by choosing a board that will appoint them to senior management offices. Even if they are content to rely on others to exercise managerial authority, shareholders with the voting power to determine the composition of the senior management should be treated as if they themselves control the business. Ordinary principles of agency law justify this result.

Majority shareholders should be presumed to control their corporations and therefore should be subject to veil-piercing claims if it can be shown that they have caused the business to be managed in a financially irresponsible manner. One can imagine cases in which a majority shareholder—perhaps for reasons of illness or advanced age—is unable or chooses not to exercise the power that goes with majority interest and has played no role in the selection of management, but such cases probably are rare. Ordinarily, the fact of a substantial investment creates an incentive to exercise control over business decisions. It is also possible that a majority shareholder, even though not actively involved in management or the selection of management, may know or have reason to know that those who are in control are running the business in a financially irresponsible manner.[155] Depending on the circumstances, veil piercing could attach in such cases as well.

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[152] *See* UNIF. P'SHIP ACT § 18(e) (1914).

[153] Some statutes allow election of special close corporation status providing for management by shareholders and elimination of the board of directors. *See, e.g.*, MODEL STATUTORY CLOSE CORP. SUPP. (1984).

[154] *See, e.g.*, REV. MODEL BUS. CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction of . . . its board of directors . . . .").

[155] *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) (director who was also the corporation's largest shareholder neglected her duties because she should have known that her sons were stealing from the corporation).

In contrast, minority shareholders voting on their own normally are unable to influence the outcome of corporate elections.[156] Ordinarily, therefore, they should not be subject to veil-piercing claims. Exceptions should be made, however, in cases in which two or more minority shareholders working in concert are able to determine the outcome of a corporate election. It is also possible to imagine that an individual minority shareholder—perhaps due to family relationships or the passivity of the other shareholders, for example—may be able to select the board or exert influence over a board that has been formally elected by the other shareholders. A minority shareholder may also find himself appointed to a senior management position by those with the power to determine such matters. If there is significant involvement in control, even minority shareholders should be liable for the consequences of financial irresponsibility.

As a practical matter, limiting personal liability to claims against controlling shareholders probably means that most veil-piercing cases will fall into one of two categories. On the one hand are those involving closely held corporations owned by one shareholder or a small number of shareholders one or more of whom is identifiably in control of the business and therefore potentially liable under a veil-piercing theory. The other likely scenario is the claim brought against the corporate parent of a wholly owned or majority-owned subsidiary corporation. In such cases, the parent controls the subsidiary through its ability to elect the latter's board of directors.

A third category involves the more unusual case of the publicly held corporation that is controlled by a single shareholder. If the shares are dispersed widely enough, a percentage interest of less than half—perhaps quite a bit less than half—may be sufficient as a practical matter to determine the outcome of the annual election.[157] Such a shareholder could be a natural person or another corporation. It is also possible that a small number of minority shareholders whose holdings together total less than 50% may nevertheless through joint action control the election of the board. Under the theory proposed in this Article, controlling shareholders of public corporations could also find themselves subject to a veil-piercing claim.

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156 Even cumulative voting will not allow a minority shareholder to elect a majority of the board. A minority shareholder must act in concert with other shareholders if he is to participate in control through the voting process.

157 Many public corporation shareholders do not bother to vote in the annual election. For that reason, a holding of less than a majority can confer control power on its holder.

It is necessary to emphasize that controlling shareholders under any of the three scenarios described above would not necessarily be personally liable for an insolvent corporation's obligations. In this respect my proposal differs from that of Professor Mendelson, who argues in a recent article that the fact of control should itself be sufficient to subject shareholders to personal liability for corporate torts or statutory violations in cases of corporate insolvency.[158] Professor Mendelson emphasizes limited liability's potential to encourage excessive risk taking.[159] Assigning liability to those shareholders who in effect make such decisions forces them to internalize the social costs of corporate activity and thereby eliminates limited liability's moral hazard problem.[160]

As developed further below,[161] Professor Mendelson is correct to emphasize the importance of excessive risk taking. However, she goes too far in threatening controlling shareholders with liability without regard to whether the decision in question was truly an irresponsible one.[162] Professor Mendelson overlooks the possibility that a corporation may inflict losses that are not compensable by the corporation despite the good faith efforts of the controlling shareholders to provide compensation ex ante. If a third party's loss exceeds the amount that reasonably was anticipated when a liability insurance policy was purchased, it is not the result of efforts to take advantage of limited liability. It is instead the incidental by-product of business activity conducted by shareholders who have attempted in good faith to provide compensation for victims of known risks.

It is true that requiring controlling shareholders to compensate third parties will discourage irresponsible risk taking. However, it will also discourage any corporate activity that has the potential to harm third parties in unpredictable ways. Limited liability has a legitimate role to play in the encouragement of business activity by shielding investors from responsibility for injuries that exceed reasonably anticipated limits. Presumably it leads to business investment that otherwise would not occur. Even though particular corporations may end up generating social costs that exceed the sum of shareholder and third-party gains, policymakers might decide reasonably that the aggregate benefit of increased business investment exceeds occasional

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158 *See* Mendelson, *supra* note 35.
159 *Id.* at 1232–35.
160 *Id.* at 1271–72.
161 *See infra* Part IV.C.1.
162 Mendelson, *supra* note 35, at 1249–58.

uncompensated losses caused by firms that generate social costs in excess of social gains.

Under this view of the matter, limited liability for torts can be defensible in certain cases, even if the corporation is controlled by a single shareholder or a group working in concert. In addition to going too far in the case of tort claimants, Professor Mendelson's proposal does not go far enough with regard to possible shareholder liability for contract-based claims because her article takes no position on possible personal liability for such claims.[163] As explained above,[164] limited liability presents moral hazard problems here, too. As with veil-piercing claims based on tort, a finding of control should be required, but control itself, while necessary, should not be sufficient to establish liability.

B. Contract Creditors

1. Financial Responsibility Defined

Courts should not pierce the corporate veil where shareholders have acted responsibly. Financial responsibility in the contract context has two aspects. The first focuses on the shareholders' expectations at the time the corporation assumes an obligation. A court should determine whether the shareholders believed in good faith that the corporation would be able to discharge this obligation in a timely manner. The belief needs also to have been reasonable under the circumstances. Shareholders who have caused their corporation to assume an obligation that it later ends up unable to pay should be able to provide a satisfactory answer to the question, what were you thinking when you made this decision?

At the time an obligation is incurred, responsible decision making requires that managers think carefully about whether the business will be able to handle the obligation in question. Such decisions cannot be made on the basis of impressionistic evaluation, guess work, or mere wishful thinking. Instead, managers need to make thoughtful, well-grounded predictions about the business's future performance. These predictions can be more or less elaborate in form, but ordinarily the managers should generate revenue projections to be

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[163] *See id.* at 1204 n.1.
[164] *See supra* Part III.A.2.

viewed in conjunction with the firm's existing and anticipated liabilities.[165] Sales forecasting is a complex task. Businesses with a track record usually look to recent sales on the assumption that these data provide the most reliable basis for projecting near-term future performance.[166] However, the relevance of trends or cycles and one-time gains or losses within those data can complicate the exercise and require use of reasoned judgment, as can decisions about whether to weight the relatively more recent data more heavily than the relatively more remote.[167] Of course, it will be necessary to take into account the additional (i.e., variable) costs involved in production of additional units.

For the start-up or recently launched business, the absence of a track record makes forecasting even more difficult. Managers must rely on estimates of future sales. It will also be necessary to rely on projections of cost-of-goods sold values and other expenses. Qualitative analysis ordinarily is used, including industry data, market research, and expert opinion.[168]

In deciding whether a business can afford additional indebtedness, it is not enough simply to rely on revenue and cost projections. Pro forma income statements predicting a profitable future may be well-grounded, but liquidity problems could still arise and potentially result in financial distress. Shareholders need to bear in mind that even a profitable corporation may have trouble paying its debts in a timely manner out of its revenues. For example, sales of a retail business may be seasonal or customers may buy on credit; in either case, the business may show increasing revenues but actual cash flow may be uneven. Accordingly, having developed pro forma income statements for future accounting periods, the managers need also to create a pro forma cash budget. This document projects future cash receipts and expenditures on a monthly basis and reveals whether the business will need additional cash to cover cash flow shortfalls.[169] This can be supplied from a bank-financed line of credit or some other source, such as short-term shareholders' loans.[170] If those in control of the business have not thought carefully about cash flow

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[165] For example, the Small Business Administration recommends that prospective borrowers provide projected income and cash flow statements extending two or three years into the future. *See* Small Business Administration, http://www.sba.gov/smallbusinessplanner/start/financestartup/SERV_LOANPROPOSAL.html (last visited Mar. 20, 2007).

[166] *See* ADELMAN & MARKS, *supra* note 117, at 113.

[167] *See id.* at 115–20 (presenting several forecasting models).

[168] *See id.* at 112–14.

[169] *See id.* at 130–31; *see also* WILLIAM D. BYGRAVE, THE PORTABLE MBA IN ENTREPRENEURSHIP 233–34 (1994) (discussing need for detailed "cash forecast").

[170] *See* ADELMAN & MARKS, *supra* note 117, at 131–32, 162–63.

questions and the business later ends up insolvent, a court should not conclude that the decision to incur additional indebtedness was made in a responsible manner.

Financial responsibility is not only a matter of reasonable shareholder expectations about future revenues, expenses, and cash flows as of the time the corporation undertakes a new obligation. Managers must also act responsibly toward creditors during the period between the incurrence of the debt and its maturity. That means that the shareholders should not cause the corporation to engage in conduct that significantly increases the risk of default that each creditor has agreed to assume. Primarily this is a matter of ensuring that the corporation has sufficient liquid working capital.[171] Analysts have traditionally considered a current ratio—the ratio of current assets to current liabilities—of 2:1 to be optimal,[172] but regard must also be paid to liquidity concerns. A firm's working capital can be inadequate if it does not include sufficient liquid assets, especially when inventory or accounts receivable are not regularly and reliably converted into cash.[173] Accordingly, even if a business appears to have an adequate working capital surplus, distributions of cash to shareholders can threaten its ability to meet its current obligations. Incurrence of additional indebtedness can also have this effect if due regard is not paid to liquid working capital. Maintenance of established internal or external short-term financing options may be necessary to protect against cash flow difficulties. In addition, investment of borrowed funds in projects with expected return lower than cost increases the risk that existing creditors will not be paid.[174] Generally speaking, courts should be willing to look closely at behavior that unreasonably reduces the value of creditor's claims.

It is important to bear in mind that financial responsibility in relation to a firm's indebtedness can mean different things under differing circumstances. Responsibility does not demand that shareholders maintain large hordes of cash in the corporation's bank account. Subject to working capital needs, cash ordinarily should be invested in productive assets.[175] Nor does it require them

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171 One text states that small firms "are often undercapitalized and overdependent on uninterrupted cash receipts to pay for recurring expenses." WILLIAM L. MEGGINSON ET AL., SMALL BUSINESS MANAGEMENT: AN ENTREPRENEUR'S GUIDEBOOK (3d ed. 2000).

172 *See, e.g.*, STANLEY SIEGEL & DAVID A. SIEGEL, ACCOUNTING AND FINANCIAL DISCLOSURE 108 (1983). Current assets include cash, marketable securities, accounts receivable, and inventory. *Id.* at 22. Current liabilities are liabilities that must be paid within a year. *Id.* at 23.

173 *See* BYGRAVE, *supra* note 169, at 198–99.

174 *See supra* text accompanying note 122.

175 *See, e.g.*, ADELMAN & MARKS, *supra* note 117, at 142–44.

to manage the business with the aversion to risk of a bank trust officer. No business can flourish without at least some amount of borrowing. Recognizing that reasonable assessments about a corporation's ability to meet its obligations can be more or less aggressive, what counts as responsible behavior in a given situation probably can accommodate a range of choices. Creditors themselves make evaluations of the relative riskiness of various extensions of credit based on a business's financial statements and other data and then adjust interest rates accordingly and require personal guarantees when deemed necessary. The key point simply is that shareholders' decisions about the corporation's ability to repay debts need to be realistic and based on reasonable evaluation of the firm's prospects and challenges, rather than on guess work or wishful thinking. The distinction should be between fact-based assessments of the future and those that are utopian, fantastic, or merely offhand. Optimism, unless excessive under the circumstances, does not necessarily imply irresponsibility because confidence often distinguishes successful entrepreneurs.

Despite the emphasis that it receives in the case law,[176] financial responsibility does not necessarily have anything to do with "adequacy of capitalization." To the extent that they explain their use of the term, courts generally refer to the amount of capital contributed to the business by its shareholders at the time of formation.[177] However, even substantial initial capitalization may be insufficient to prevent insolvency if the firm has taken on large liabilities. Moreover, an otherwise strong balance sheet may signal inability to pay debts if most of the assets are illiquid and cash flows are uncertain. It is also possible that initially substantial capital contributions have been depleted through payment to third parties or distribution to the shareholders. On the other hand, relatively small initial capitalization need not jeopardize a corporation's ability to pay its debts if revenues are robust and reliable. Retained earnings (or reasonably liquid assets purchased by means of earnings) can also compensate for thin initial capitalization.

Certainly the fact that a corporation has ended up insolvent does not itself indicate that the business has been run in a financially irresponsible manner. Managers may reasonably believe that their business will be able to pay its debts, but business failure can still occur despite their best efforts and without

[176] *See supra* Part II.C.3.

[177] *See, e.g.*, J.L. Brock Builders, Inc. v. Dahlbeck, 391 N.W.2d 110, 115 (Neb. 1986) ("Inadequate capitalization is measured at the time of formation." (quoting J-R Grain Co. v. FAC, Inc., 627 F.2d 129, 135 (8th Cir. 1980))).

their having done anything to bring about that outcome. Reasonable assumptions about cash flows and adequacy of working capital may prove to be false due to unanticipated developments. In short, insolvency does not necessarily indicate deliberate misbehavior or careless mismanagement. Courts need to avoid the misleading clarity of hindsight and instead evaluate decisions as of the time they were made.

2. *Creditor Self-Protection?*

One might concede the utility of financial responsibility as a concept but still argue that veil piercing is unnecessary as an enforcement mechanism because contract creditors can protect themselves from these risks by investigation of borrowers' creditworthiness and inclusion of appropriate provisions in their contracts with the corporation. At the time credit is extended, it may be possible to obtain information about a corporation's expected future cash flows and current working capital status by insisting on pro forma financial statements. However, the assumptions and projections that lie behind such information are likely to be complex and therefore very costly to access. Borrowers may also consider some of this information to be confidential. If potential creditors are to be left entirely to their own devices, they would also need detailed information about the industry in which the business operates and about the people who are responsible for its management. The costs to both lender and borrower could be so high as to render the transaction in question unprofitable for both parties.

An alternative would be to eschew efforts to collect all this information and instead simply attempt to price credit according to general assumptions about likely rates of default. However, creditors are generally unable ex ante to distinguish those borrowers who are careless in their undertaking of credit obligations or who are likely to behave opportunistically from those who are responsible and competent.[178] This will lead creditors to demand higher interest rates (perhaps coupled with personal guarantees) from all borrowers than they would demand if discrimination were possible. The increase in the cost of credit for all borrowers indicates the inefficiency of a contract-based solution to the risk of financial irresponsibility.

Furthermore, even if creditors could obtain accurate information about the likelihood of default and adjust the interest rate accordingly, they typically are

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178 *See supra* Part III.B.2.b.

in no position to use ex ante bargaining to secure protection from financial irresponsibility that may occur thereafter. This is so because drafting and monitoring costs are likely to be excessively high. As a practical matter, it is not feasible for a prospective creditor to attempt to draft a contract that includes specific prohibitions on all of the sorts of conduct that might increase the risk of default. Such a contract would need to include provisions requiring maintenance of particular working capital and liquid asset balances. Restrictions on additional borrowing and on distributions to shareholders would also be necessary. All of these provisions would have to be drafted in a way that allows sufficient flexibility for the legitimate needs of a business that ordinarily is attempting to grow and must be able to respond to a range of future exigencies. Insistence on certain dollar amounts, percentages, or ratios is therefore likely to be too rigid. Even if possible, the drafting and negotiation process would certainly be expensive. Standard-form or boilerplate language does not exist to deal with these issues in a close corporation setting.[179]

Elaborate restrictions on the borrower's freedom of action would also require monitoring if they are to be of any value. Because any expenditure, distribution, or borrowing can potentially affect a corporation's ability to pay its debts, effective monitoring would need to be both pervasive and highly intrusive. It seems unlikely that typical borrowers or lenders would be willing to commit to such a costly regime. In addition to transaction and monitoring cost considerations, restrictions on the debtor's freedom of action and intrusions on its privacy will also come at a price. Creditors therefore must expect less compensation (i.e., a lower interest rate) than they might otherwise claim. Added to the drafting, negotiation, and monitoring expenses, this cost will further reduce the net value of any contractual protections that are actually achievable.

Potential transaction and monitoring costs are important because they may be so high as to render contractual self-protection unworthy of the cost. Even if these costs are not prohibitively high, this solution to the problem of creditor irresponsibility will still involve significant expense for both parties and to that extent is inefficient. A tailored approach to limited liability that denies protection to shareholders who have used their power of control irresponsibly is likely to do a better job of protecting creditors from this problem.

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[179] Contrast the public corporation setting, in which elaborate standard form contracts (called indentures) protect the interest of members of the public who lend funds to corporate borrowers by purchasing bonds and other debt securities. *See generally* KLEIN & COFFEE, *supra* note 31, at 242–46.

3. *Example: The* Bartle *Case*

A well-known case illustrates the financial responsibility idea in the piercing context. In the *Bartle* case,[180] a group of World War II veterans had formed a cooperative corporation, Home Owners Cooperative, for the purpose of building homes for themselves and their families. The veterans contributed the land for the project to this corporation. Unable to find a suitable general contractor, they then organized another corporation, called Westerlea Builders, to serve as general contractor. Westerlea was formed as a wholly owned subsidiary of Home Owners. The veterans apparently contributed some cash to the subsidiary initially, but this was soon exhausted. Thereafter, the only funds flowing into Westerlea were those paid by the veterans to Home Owners when they bought the houses; the co-op then transferred these funds to Westerlea. The selling prices for the houses were set solely by reference to actual building costs, which meant that Westerlea's revenues were limited to the precise amounts necessary to pay the subcontractors and suppliers of materials. Westerlea therefore could earn no profits and could accumulate no cash. Once its initial capital had been paid out to creditors, it had no equity. Westerlea was essentially an empty shell serving as a conduit for the flow of funds from the veterans to the subcontractors and suppliers.

Even though Westerlea had no capital reserves, it continued to deal on a credit basis with subcontractors and suppliers. Being wholly dependent on sales of the houses for its revenues, if the veterans should be unable to pay for the completed houses, the revenues would dry up. So, if building and material costs increased to the point that the veterans were no longer able to afford them, Westerlea was certain to default on its obligations. This is precisely what occurred. The creditors therefore sought to pierce the corporate veil of Westerlea, the insolvent corporation with which they had dealt, to hold Westerlea's shareholder (Home Owners) liable. Home Owners, the insolvent debtor corporation's sole shareholder, apparently held title to the land on which the houses were being built and therefore was capable of satisfying a judgment against Westerlea.[181]

The trial court refused to allow the claims against Westerlea's corporate shareholder and the New York state intermediate appellate court and Court of Appeals agreed. The high court concluded a brief majority opinion with this statement:

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[180] Bartle v. Home Owners Coop., Inc., 127 N.E.2d 832 (N.Y. 1955).

[181] *Id.* at 833.

> The law permits the incorporation of a business for the very purpose of escaping personal liability. Generally speaking, the doctrine of "piercing the corporate veil" is invoked "to prevent fraud or to achieve equity." But in the instant case there has been neither fraud, misrepresentation nor illegality. Defendant's purpose in placing its construction operation into a separate corporation was clearly within the limits of our public policy.[182]

Even by the low standards of the veil-piercing cases, this well-known opinion does little more than state an unsupported conclusion. A more thoughtful approach to the facts might have led the New York courts to entertain a different result.

Once Westerlea's modest initial capital had been paid out, it must have been apparent to the shareholders of the corporate parent that Westerlea had no equity and would not accumulate any as long as the veterans paid for the houses at cost. If building costs became too high, payments into Westerlea would cease. Accordingly, as Westerlea continued to deal on credit, the shareholders imposed on the creditors the risk that they would not get paid if the shareholders themselves could not afford the building costs.

Presumably building costs did not rise beyond manageable levels overnight. If, as seems likely, increases were more or less gradual, the veterans must have continued to cause Westerlea to assume obligations even as it became increasingly apparent to them that the risk of nonpayment was growing. They did this while Westerlea had no working capital reserves that it could fall back on in the event that revenues suddenly dried up. There is no indication in the reported opinions that the veterans continued to accept labor and materials intending deliberately not to pay for them.[183] However, even if the veterans believed in good faith that the upward trend in building costs was only temporary and would soon level off or even decline, it is hard to imagine that at some point they did not realize—as costs were continuing to rise—that it would be hard if not impossible to pay the bills. That the cost increases may have been unforeseeable at the time the veterans embarked on the house-building scheme does not alter this conclusion because they continued to accept credit even as the risk of default must have become increasingly obvious.

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[182] *Id.* (citations omitted).
[183] *See id.*

Under these circumstances, the New York courts should have been willing to ask whether the shareholders of the corporate parent acted responsibly. Limited liability should not have protected them from creditor claims unless they had good reasons to believe that they would be able to afford the houses despite rising costs. If not, the continued acceptance of value with no plausible likelihood of payment was irresponsible behavior that corporate law should not be interpreted to encourage.[184] Even if a court were reluctant to hold the veterans themselves personally liable, in this case an intermediate solution was available because the veil-piercing claim, being directed at the debtor's corporate parent, only sought to reach a portion of their wealth, namely their interests in the assets owned by Home Owners.[185]

One might respond that veil piercing was inappropriate in this case because the creditors got what they bargained for. Having voluntarily accepted the risk of nonpayment under these circumstances, they should not have been allowed after the fact to seek recovery from the insolvent debtor's corporate parent or its shareholders. The flaw in this argument is an assumption that the creditors knew the full magnitude of the risk they were undertaking as they continued to extend credit to Westerlea. Whether they would get paid depended ultimately on the ability of the veterans to pay for the houses, which of course was a function of their wealth. Unless the creditors had a reasonably clear idea of the upper limits on the veterans' financial resources, which seems unlikely, courts should not conclude that they knowingly assumed a particular risk of default in return for appropriate compensation.

Nor should they conclude that failure to demand guarantees from the shareholders individually or from Home Owners represented a reasoned decision based on adequate information. To the contrary, it seems unlikely that the creditors had access to information about the veteran's personal finances. Even if they had demanded that the veterans hire accountants to prepare individual financial statements, that information would not itself necessarily have indicated the degree of risk the subcontractors and suppliers were undertaking because such documents would not necessarily have provided information bearing directly on the veteran's future ability to meet

[184] Thought of in this way, the plaintiffs' claim may not have been an all-or-nothing proposition. A court willing to entertain the veil-piercing claim should have considered liability only as to those amounts accepted on credit by Westerlea after the veterans knew or reasonably should have known that they would not be able to pay.

[185] A claim against the veterans themselves would have required the piercing of two corporate veils—Westerlea's and Home Owners'.

higher building costs. Nor would the creditors have occasion to know about the availability to the veterans of financing from another source such as a bank.[186] In fact, Westerlea's continuing willingness to take on indebtedness even as costs were rising could have misled the creditors into believing that the veterans were wealthier than they really were. Although there was no actual misrepresentation, Westerlea's behavior could have been interpreted by the subcontractors and suppliers as an implied assurance that the veterans had the means to buy the houses despite rising costs and thereby make it possible for Westerlea to pay its bills. In short, there was a serious question as to the veterans' financial responsibility. Had the New York courts taken this concept seriously, it is possible that the outcome would have been different.

C. Tort Creditors

1. Financial Responsibility Defined

In its details, the financial responsibility idea means something different as to tort claimants than as to contract creditors, but the core idea is the same. The question in both contexts should be whether those in control of a corporation have opportunistically shifted the risk of corporate insolvency on to third parties. In the contract setting, shareholders act opportunistically if they cause the corporation to incur an obligation that they cannot reasonably expect it will be able to pay or if they increase unreasonably the risk of default on an obligation that was properly entered into. In either case, the point is that creditor losses result from deliberate or careless decisions that render contract creditors vulnerable to risks they have not accepted. Losses result from controlling shareholders' conduct rather than from causes over which they have no control and for which they therefore should not be held accountable.

Potential tort victims are in a similar position. If those in control of a corporation cause it to engage in conduct that is likely to result in injury to third parties, they act irresponsibly if the corporation lacks the means to pay compensation through liability insurance or cash reserves. As with contract creditors whose losses are due to shareholder opportunism, uncompensated tort losses result from shareholder action that harms third parties who have not agreed to bear the risk of those losses. In contrast, managers have not acted

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[186] The creditors may also have assumed that the veterans considered Westerlea and Home Owners to be a single entity even though they were incorporated separately or had created Westerlea to serve as an agent for the corporate principal. In either event, the land owned by the latter would arguably have been available to satisfy their claims.

irresponsibly if they have provided for compensation sufficient to satisfy likely claims, that is, claims that are likely to arise in the normal course of business. Sometimes an injury may occur that involves a loss greater than the shareholders could reasonably have anticipated. As long as the available insurance fund, viewed ex ante, was reasonable in amount when established, limited liability should shield shareholders from liability for losses exceeding the available coverage. Where the failure to anticipate and provide for the unusually large claim was reasonable, injured parties should bear those excess costs themselves. They have not agreed to bear the risk of these losses, but that is the price of the limited liability subsidy. Their situation is analogous to that of the contract creditor unable to collect its claim because of corporate insolvency due to factors beyond the anticipation or control of the shareholders.

This approach to limited liability in the tort context would narrow its scope. It would exclude shareholders who cause their corporations to engage in activities that are likely to harm others but decide as a matter of policy to make no provision for compensation, knowing that the corporation will be unable to satisfy a claim brought by an injured party and intending to hide behind the limited liability shield. The same result would follow if the shareholders have simply failed to pay attention to the need to provide compensation for injured third parties. As the likelihood of harm increases and therefore should be increasingly obvious, failure to consider third-party well-being looks more and more like the result of recklessness or even deliberate planning, even if there was no specific intent to inflict injury upon anyone.[187]

As discussed above, overly broad limited liability encourages excessively risky business behavior.[188] A financial responsibility requirement would reduce social costs while still addressing legitimate shareholder concerns over potentially massive tort liability that is unlikely to occur but is nevertheless theoretically possible. As such, the approach proposed here represents a compromise between unlimited limited liability and a regime of shareholder personal liability for corporate torts. Tort victims would still subsidize business owners, but the subsidy would be limited to losses arising out of unpredictably expensive accidents. Limited liability therefore would still represent a genuine benefit to prospective entrepreneurs who fear being held responsible for third-party losses that they should not reasonably be expected

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[187] *See* KEETON ET AL., *supra* note 148, at 169–70.
[188] *See supra* Part III.A.2.c.

to anticipate. As to those, the magnitude of liability could be enormous but the shareholders were by definition in no position to take appropriate precautions to prevent the loss or obtain insurance to pay for it. "No person can be expected to guard against harm from events which are not reasonably to be anticipated at all . . . ."[189] Protection against these kinds of claims may well be the business owners' greatest concern for the very reason that one cannot foresee all that fate may have in store. Limited liability as to such claims therefore parallels limitation of protection from contract creditors to cases in which corporate insolvency results from business failure that could not be foreseen or prevented despite the owners' good faith, reasonable efforts to manage their business responsibly.

One problem with the concept of financial responsibility proposed here is its meaning in actual cases. How can a court evaluating the matter ex post assess the reasonableness of business owners' decisions to buy no more than a particular level of liability insurance? After all, there is no controversy unless the amount of coverage has proven to be insufficient. Nevertheless, the matter must be analyzed from the point of view of those who made the decision to buy a particular policy as of the time they made it.

The meaning of reasonableness may be more difficult theoretically than in practice. Most of the time, third-party injuries result from risks that are obvious and well-known. Some business activities are virtually certain sooner or later to result in particular kinds of harm. For example, a transportation business relying on motor vehicles eventually will be involved in a traffic accident in which some third party is hurt. Excavation or demolition businesses that use explosives predictably can harm neighbors or bystanders. Food service businesses run the readily apparent risk that they may sell food that will cause sickness. Everyone knows that manufactured products like toys or power tools can harm those who use them. In each of these cases, it should not be difficult to identify a coverage limit sufficient to provide for the kinds of injuries that are likely to occur. If coverage is significantly lower than the cost of a typical accident the situation is not that much different than a complete failure to obtain insurance or otherwise provide for likely tort claims. The reasonableness claims may be implausible on its face.

If there is doubt on the question, it will often be possible to assess shareholders' claim of reasonableness by referring to the practices of other

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[189] KEETON ET AL., *supra* note 148, at 170.

firms in the same line of business. How much liability insurance do they typically carry? If a corporation can show that its insurance decision is in line with those of its peers, those data should provide a strong indicator of reasonableness. Insurance companies would also be a good source of information on this question. Additionally, if a corporation has a history of a particular kind of accident, it would be hard to assert a plausible claim of reasonableness if it does not have a liability policy with a limit high enough to satisfy these claims. If, however, coverage has been sufficient in the past, the fact that a policy fails to provide sufficient funds for an unusually costly claim should not be enough to establish personal liability for the excess amount.

Tailoring limited liability so as to create a de facto reasonable insurance requirement might seem to imply higher costs of doing business than would obtain if limited liability for corporate torts were available without exception. As a practical matter, though, restricting the scope of limited liability in this manner would not significantly raise the costs of doing business for most firms. Entrepreneurs are advised to obtain insurance regardless of whether they are doing business in the corporate form or as a partnership or other entity form that does not provide limited liability.[190] Although corporate statutes include the promise of limited liability, business owners know that courts may pierce the veil if they conclude that equity so requires.[191] Prudent business practice therefore already includes purchase of liability insurance.[192] A rule tailoring limited liability according to the shareholders' financial responsibility thus would not necessarily mean higher costs than would obtain under a regime of unlimited limited liability.[193] What it would do is help courts to understand when to pierce the veil in tort cases in which the corporation has insufficient resources to satisfy a claim.

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[190] *See, e.g.*, BYGRAVE, *supra* note 169, at 311.

[191] *See, e.g.*, Walkovszky v. Carlton, 223 N.E.2d 6, 8 (N.Y. 1966) ("[C]ourts will disregard the corporate form . . . to prevent fraud or to achieve equity.") (citation omitted).

[192] *See* EASTERBROOK & FISCHEL, *supra* note 16, at 47–49.

[193] Professors Hansmann and Kraakman note that most businesses do obtain liability insurance despite limited liability but suggest that underinsurance—purchase of policies with relatively low coverage limits—may be a common strategy. *See* Hansmann & Kraakman, *supra* note 6, at 1889–90. If this intuition were accurate, it is still not clear how much more corporate shareholders would spend if they faced the threat of personal liability for unreasonably low insurance coverage. In any event, it could be argued that this increase in the cost of doing business is justified on distributional grounds (shifting the cost of accidents from victims to shareholders) if limited liability's main objective is to protect shareholders from liability for claims of unexpectedly large magnitude.

The *Radaszewski* case illustrates reliance on insurance as a basis for financial responsibility in the tort context.[194] The plaintiff sustained serious injuries when he was hit by a truck driven by an employee of Contrux, a subsidiary of Telecom Corporation.[195] The corporate tortfeasor was thinly capitalized; the parent had provided most of its capital in the form of debt rather than equity, and the subsidiary apparently operated in a way that did not allow it to retain its own earnings.[196] The court of appeals aptly characterized its balance sheet as "anemic."[197] Applying its interpretation of the case law, the district court concluded that Contrux's undercapitalization warranted veil piercing.[198] The court of appeals disagreed, emphasizing that Contrux had provided compensation for the plaintiff's injury by purchasing a liability insurance policy worth $11,000,000.[199] The appellate court correctly rejected the view that shareholders' limited liability should depend on mechanical analysis of the corporation's balance sheet.[200] Instead, the relevant question should be whether the corporate shareholder responded to a known business risk in a responsible manner.[201] "If the subsidiary is financially responsible, whether by means of insurance or otherwise, the policy behind [the state's veil-piercing rule] is met. Insurance meets this policy just as well, perhaps even better, than a healthy balance sheet."[202]

The *Radaszewski* case also illustrates another benefit of a rule that has the effect of requiring insurance against likely tort claims. Liability insurance makes it possible for groups of actors engaged in the same kind of risky activity to share the costs of losses that actually occur. In contrast, if limited liability is overly broad, the result is concentration of such costs on individual

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194 Radaszewski v. Telecom Corp., 981 F.2d 305 (8th Cir. 1992) (applying Missouri law).

195 *Id*. at 306.

196 *Id*. at 308.

197 *Id*.

198 *Id*.

199 *Id*. at 310.

200 *Id*. at 310–11.

201 *Id*. at 310.

202 *Id.* at 309. In the *Radaszewski* case, the corporate tortfeasor's insurance carrier actually became insolvent some two years after the accident that injured the plaintiff. Insurance can be available to cover accidents that have already occurred, but, understandably, it tends to be very expensive. Should the financial responsibility idea be interpreted to require purchase of insurance after the initial carrier's insolvency? The question bears further analysis, but it would seem that the policy justifications for requiring the shareholders to obtain liability insurance in advance of readily anticipated accidents would not necessarily apply to situations in which it turns out that, after the fact, the corporation is unable to provide compensation because of an insurance carrier's insolvency. A corporation that acts responsibly toward potential tort victims by purchasing insurance should not find itself liable as a result of an unexpected event of this kind. The issue would be otherwise if, at the time a policy is purchased, there is reason to doubt an insurance company's solvency.

injured parties, with potentially crushing results. It is unclear whether imposing responsibility on business owners will actually reduce risk because the availability of insurance can increase the probability or the magnitude of losses from risky behavior.[203] Even so, however, the distributional benefit is apparent.

2. *Example: The* Walkovszky *Case*

Some states have statutory minimum liability insurance requirements for particular kinds of business activity, especially those involving motor vehicles.[204] Federal law similarly mandates minimum insurance coverage for motor carriers operated in interstate commerce.[205] Some have argued that compliance with statutory requirements should be sufficient to defeat a veil-piercing claim even if the amount of the loss far exceeds the policy limit.[206] Thinking about financial responsibility in the manner suggested here should provide ample reason to reject this argument.

A well-known case in which this issue arose is *Walkovszky v. Carlton*.[207] The plaintiff, Walkovszky, was a pedestrian run down by a New York City taxi cab.[208] The cab was owned by a corporation called Seon Cab Corporation that owned it and another cab.[209] Carlton was a shareholder of Seon.[210] He and his associates also owned nine other corporations each of which also owned but two cabs.[211] Together these ten corporations were operated as a single business.[212] Seon's principal asset apparently was a $10,000 insurance policy, which was the minimum liability coverage required by New York law.[213]

Walkovszky sued Seon and the nine other corporations on the theory that together they constituted a single "enterprise entity" and therefore ought to be

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203 *See generally* POLINSKY, *supra* note 42, at 60–61 (discussing moral hazard problem).

204 *See generally* LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 19:4 (1997).

205 *See* 49 C.F.R. § 387 (2002) (requiring insurance coverage or surety bond sufficient to satisfy liability to third parties).

206 *See, e.g.*, *infra* text accompanying note 219.

207 223 N.E.2d 6 (N.Y. 1966).

208 *Id*. at 7.

209 *Id*.

210 *Id*.

211 *Id*.

212 *Id*.

213 The vehicles themselves apparently were heavily mortgaged and their medallions were unavailable to satisfy a tort judgment. *See id*. at 11 (Keating, J., dissenting).

treated as such for liability purposes.[214] This form of veil-piercing claim, which denies the separate entity status of the several corporations sharing common ownership, even if successful, probably would not have yielded adequate recovery. Walkovszky therefore also pursued a different veil-piercing theory, seeking to hold Carlton and Seon's other shareholders personally liable.[215] In this regard, he alleged undercapitalization and also that Carlton "organized, managed, dominated and controlled" this single fractured economic entity.[216]

The New York Court of Appeals affirmed the trial court's dismissal of the complaint for failure to state a claim.[217] The court emphasized the lack of allegations that Carlton and the other shareholders were "actually doing business in their individual capacities, shuttling their personal funds in and out of the corporations 'without regard to formality and to suit their immediate convenience.'"[218] In addition, the court also stressed the fact that Seon had complied with the legislatively imposed insurance requirement:

> The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought . . . . [I]f the insurance coverage required by statute "is inadequate for the protection of the public, the remedy lies not with the courts but with the Legislature."[219]

In this court's view, Seon's controlling shareholder did not act irresponsibly, even though he had operated the corporation with assets clearly insufficient to meet tort claims that were virtually certain to occur.[220] The fact that the corporation had complied with the state's minimum insurance requirement was taken to indicate that the corporation and its shareholders had fully met their obligations to potential tort creditors.[221] To impose additional

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214 *Id.* at 8; *see* Adolf A. Berle, Jr., *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

215 *Walkovszky*, 223 N.E.2d at 8–9.

216 *Id.* at 9.

217 *Id.*

218 *Id.* at 10 (citation omitted). After Walkovszky amended his complaint to reflect the court's opinion, the defendants again moved for dismissal. This time the motion was denied. Walkovszky v. Carlton, 287 N.Y.S.2d 546 (N.Y. App. Div. 1968), *aff'd*, 244 N.E.2d 55 (N.Y. 1968). Thereafter the case presumably settled.

219 *Walkovszky*, 223 N.E.2d at 9 (quoting trial court opinion).

220 *Id.*

221 *Id.*

liability on the shareholders was thought to amount to a usurpation of the legislature's power to define financial responsibility in this context.[222]

A court that takes seriously the idea of financial responsibility as the test for veil-piercing claims should not accept this argument. Instead, it should simply ask whether those in control of a corporation have adequately planned for likely tort claims. The fact that the corporation carries the minimum amount of insurance mandated by state law is not necessarily of any relevance to that question. If the policy amount is insufficient to meet likely claims and other corporate assets cannot make up the deficiency, those in control of the corporation have acted irresponsibly.

Statutory insurance minimums should be viewed as minimums and no more. There are good reasons why a legislature might rationally impose low insurance minimums without believing that the amounts in question would be adequate to satisfy all claims that are reasonably likely to occur. For example, the New York statute referred to in the *Walkovszky* case deals not only with taxicabs but also with any other business that "transport[s] passengers for hire in any motor vehicle or motorcycle . . . ."[223] The risk attendant to the various kinds of activities falling under this broad category varies widely. A New York City taxicab is far more likely to cause serious injury to a pedestrian than is a low-speed golf cart used to transport elderly residents of a rural retirement community. A legislature unable to identify a single policy amount that will suit all the businesses subject to it would presumably err on the low side; requiring some businesses to overinsure raises their costs without any offsetting social benefit. If that is the basis for a statutory amount, it makes no sense to conclude that a legislature intended that that amount fully satisfies the obligations of all businesses involved in the transportation of passengers.[224] The New York courts should have thought more seriously about whether the defendant shareholders managed this business in a financially responsible manner.

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222 *Id.*

223 N.Y. VEH. & TRAF. LAW § 370(1) (McKinney 1996). The current minimum for vehicles having a seating capacity of not more than seven persons is $25,000. § 370(1)(a).

224 It is possible that the statute at issue in *Walkovszky* was written not for the benefit of third parties like Walkovszky who are injured by motor vehicles but instead was intended to protect their passengers. *See* Green Bus Lines v. Ocean Accident & Guar. Corp., 39 N.E.2d 251 (N.Y. 1942). If that is in fact the case, then compliance with the statute has no bearing at all on the question of the shareholders' responsibility to people like Walkovszky.

CONCLUSION

Piercing the corporate veil is a notoriously incoherent area of the law. Courts typically base their decisions on conclusory references to criteria of doubtful relevance. Results are unpredictable. This state of affairs is the result of doctrinal development lacking a clear understanding of the policy basis for limited liability. In the absence of such an understanding, courts have been unable to distinguish in a principled way between situations in which the limited liability shield is appropriate and those in which it is not. Instead they have relied on little more than vaguely articulated notions of unfairness and injustice dressed up in doctrine that is flexible enough to accommodate these intuitions. The same impulses that have led courts to deny limited liability in the corporate context are now producing similar results in cases brought against the owners of newly sanctioned limited liability entities.

Limited liability is best understood as a subsidy designed to encourage business investment. Creditors of corporate debtors take on the risk of corporate insolvency that otherwise would fall upon the firm's owners. Victims of corporate torts must bear their losses to the extent they exceed corporate assets. Legislators thus view limited liability as a benefit conferred on business investors and assume that society is better off despite the costs. The subsidy effect is obvious as to tort creditors. It is less obvious that shareholders actually gain value from contract creditors, who can insist on compensation ex ante for increased risk of default, but even in this context recent research in behavioral economics suggests that shareholders do benefit at creditors' expense from the statutory limited liability default rule.

However beneficial limited liability may be to corporate shareholders and to society more generally, it should not be so broad as to encompass illegitimate behavior. In particular, limited liability should not provide the occasion for shareholders to behave opportunistically toward corporate creditors. As to contract creditors, that means transfer of risk that creditors have not agreed to bear. This can happen at the time an obligation is incurred if the controlling shareholders have no reasonable basis for believing that the debt will be repaid. Opportunism can also take the form of actions that unreasonably increase the risk of default on existing obligations. Tort creditors by definition have not dealt voluntarily with the corporation, and so there is no question of voluntary assumption. In this context, shareholder opportunism involves deliberate or reckless imposition of risk without provision for compensation. As to both contract and tort creditors, the key concern is with controlling shareholders who use limited liability as a device deliberately or recklessly to extract value from third parties without their consent and without compensation; absent the limited liability shield, such practices could not be effective. Fairness and efficiency considerations—especially the harmful impact on the cost of credit—necessitate denial of limited liability in such cases because the subsidy to investors comes at too great a cost to corporate creditors. Limited liability should instead be limited to situations in which shareholders have managed the business with due regard for bargained-for expectations and potential victims of likely accidents. If corporate insolvency has occurred despite the shareholders' reasonable efforts, the limited liability shield should protect them. In other words, the availability of limited liability should depend on whether the controlling shareholders have managed the business in a financially responsible manner.

Veil piercing can provide the means for distinguishing legitimate from illegitimate reliance on statutory limited liability. Both as to tort and contract creditors, judges confronted with veil-piercing claims need to ask how far corporate law's limited liability shield should extend. Should shareholders enjoy broad freedom to shift the costs of their business onto third parties, or should limited liability be restricted to cases in which shareholders have in good faith attempted to manage their business in a way that respects the interests of third parties? If the latter, limited liability would protect controlling shareholders from responsibility for creditor losses that occur despite financially responsible management. It would not extend to insolvency resulting from deliberate opportunism or unreasonable neglect. Veil piercing thus allows courts to narrow the scope of limited liability to those circumstances in which it is warranted according to sound public policy. If the veil-piercing mechanism were deployed in this way, it would protect business investors from the kinds of losses that should be their primary concern, namely business insolvency due to causes that the owners have no reasonable means to anticipate or prevent. As such, limited liability would still provide investors with a significant benefit. It would therefore continue to facilitate corporate law's business subsidization policy, but the cost of that subsidy would be reduced to an amount that respects legitimate societal interests.