PIERCING THE VEIL OF LIMITED LIABILITY

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I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times. . . . Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it.[1]

Nicholas Murray Butler
President
Columbia University, 1911

LEGAL SCHOLARS have long been enthralled with the concept of limited-liability corporations. Butler's view of the importance of limited liability for shareholders may be overly enthusiastic; but he did not stand alone in his belief that limited liability was a highly important legal device. One of Butler's contemporaries, President Eliot of Harvard, regarded limited liability as "the corporation's most precious characteristic" and "by far the most effective legal invention . . . made in the nineteenth century." [2]

The view that limited liability is of central importance to the corporate form of organization has persisted over the years. Scholarly studies of corporations have retained that view. "In the historical development of the corporation probably no single atrribute has been more significant than that of limited liability." [3] "This attribute of limited liability . . . is regarded by most persons as the greatest advantage of incorporation. Indeed, many immigrants doubtless possess full knowledge of this fact before coming within hailing distance of the

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1. W. Fletcher, 1 Cyclopedia of the Law of Private Corporations § 21 (1917).

2. Cataldo, *Limited Liability With One Man Companies and Subsidiary Corporations*, 18 Law & Contemp. Prob. 473 (1953).

3. Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 Harv. L. Rev. 1373, 1376 (1938).

Statue of Liberty."[4] Leading treatises on corporation law pay homage to the perceived importance of limited liability. "In practical importance this feature [limited liability] for over a century has outranked all the other consequences [of incorporation] . . . ."[5] "Limited liability is probably the most attractive feature of the corporation . . . ."[6] "This [limited liability] is sometimes said to be the most essential privilege, [of incorporation] . . . ."[7] The treatment of the subject in casebooks is similar. "The hallmark of the corporation is limited liability. This is usually the central reason for incorporation."[8] Legal writers in the journals still proclaim the rule of limited liability to be of central importance.[9] According to a leading contemporary legal historian, "[t]he tradition has substance and has gained more substance with time."[10]

We do not fully accept any position developed to date with respect to limited liability. This paper proposes to "pierce the veil" of limited liability. It is a challenge to the established position that limited liability is critically important to the corporate form of organization and that it necessarily produces desirable results. We do not argue that on balance the rule is less desirable than one of unlimited liability; rather we question whether the rule has any significant impact at all. A rule of unlimited liability will be examined as a possible alternative to the current rule, and although it will be argued that such an alternative may offer a greater range of contractual possibilities, we do not suggest that there is a compelling *a priori* reason to change it.

Employing an important economic principle of liability (the "Coase Theorem"), the paper will explain in economic terms why the rule of limited liability, compared to any other rule, makes little difference in the allocative outcome in the market for loanable funds. The discussion proceeds by use of a model of voluntary contracting in the credit market. It will be shown that limited liability does not yield inequitable or inefficient results in the credit market. The arguments developed by Professors Manne and Posner and others, that limited liability saves transaction costs and generates other benefits for the credit market, will be questioned. Finally, the more difficult issue of

4. I. WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS 14 (1929).

5. G. HORNSTEIN, 1 CORPORATION LAW AND PRACTICE § 20 (1959).

6. H. HENN, LAW OF CORPORATIONS 96 (2d ed. 1970).

7. H. BALLANTINE, LAW OF CORPORATIONS 4 (rev. ed. 1946).

8. H. SOWARDS, CORPORATION LAW 2-2 (1974).

9. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1978).

10. J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION 26 (1970).

involuntary creditors, which has frequently been viewed as an equity problem, will be considered from the standpoint of economic efficiency.

THE RULE OF LIMITED LIABILITY

Essentially, limited liability means that shareholders of a corporation are under no obligation to the corporation or its creditors other than to pay full consideration for shares.[11] In the past, there were some particularized exceptions to this rule, such as liability on shareholders of a bankrupt corporation for unpaid labor claims. But these deviations have for the most part disappeared in favor of general rules establishing broad standards for disregarding corporateness.[12] The current statutory or constitutional exceptions to limited liability usually deal with acts that are often accomplished in a fraudulent manner—such as issuance of watered stock, unauthorized withdrawals of capital, or issuance of unlawful dividends.[13]

The protection of corporateness may be lost because of either defects in formation or wrongdoing in the operation of a corporation. In both situations, the law does not permit shareholders to use the corporation as a shield against personal liability. With respect to defects in formation, there are three concepts that come to bear—*de jure* status, *de facto* incorporation, and incorporation by estoppel. When there is substantial compliance with the legal prescription for incorporation, there is a so-called *de jure* corporation—in other words, one that is fully protected against attacks on its corporateness.[14] *De jure* status shields shareholders from direct attacks by the state and from collateral attacks by creditors. When there has been a "colorable" attempt to comply with the state law requirements for incorporation, and there has been some use of corporate privileges, then, although the *de jure* test may not have been met technically, *de facto* status may nonetheless exist.[15] This means that a firm's corporateness is only open to direct attack by the state and not collaterally by a creditor of the firm. Even if a firm fails to meet the *de facto* or *de jure* standards, the courts may conclude that a corporation may exist by estoppel.

11. 1 MODEL BUS. CORP. ACT ANN. 2d § 25 ¶ 1 (1971).

12. *Id.* ¶¶ 2-3.

13. *Id.*

14. *See* H. HENN, *supra* note 6, at 238-50, for a discussion of defects in formation of the corporation.

15. According to N. LATTIN, THE LAW OF CORPORATIONS § 57 (2d ed. 1971), "colorable" compliance has never been adequately defined by the courts, but means roughly that there had been reasonable closeness to substantial compliance, and that there has been an exercise of corporate powers. For the court to find a *de facto* corporation, good faith is essential. *See* United Sewing Mach. Distrib., Inc. v. Calhoun, 231 Miss. 390, 95 So. 2d 453 (1957); Culkin v. Hillside Restaurant, Inc., 126 N.J. Eq. 97, 8 A.2d 173 (1939).

This occurs where the parties have behaved as if the firm is indeed a corporation.[16] It should be recognized that problems stemming from mistakes in the formation of a corporation are now quite rare, given the standardization and simplification of the incorporation process.

More commonly, corporateness is lost when corporations that have been organized in a technically correct manner have been used by individuals to commit certain wrongful acts, which are deemed by the courts to be of sufficient magnitude to warrant the imposition of personal accountability. Unlike creditors of a sole proprietorship or partnership, for whom all personal assets of the proprietor or general partner are generally available to satisfy claims, corporate creditors will usually be able to capture only those funds invested directly in the corporation and not shareholder wealth kept out of the firm.[17] However, as indicated, this general rule [18] will be disregarded "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime . . . ." [19] Then the corporation will be regarded as an association of persons.[20]

A crucial condition for the recognition of limited liability is adequate capitalization of the corporation.[21] Although no court has formulated a set of concrete criteria for determining adequate capitalization, the test for sufficient capital, which usually looks to the initial and not continuing capital of the firm, is generally defined to mean capital sufficient to meet the reasonable requirements of the business in question.[22] In 1957, the California Supreme Court said that "the proper rule is that inadequate financing, where such appears, is a factor, and an important factor, in determining whether to remove the insulation to stockholders normally created by the corporate method of

16. Collateral attack is denied in such cases, although no corporation exists. Circumstances and equities of each particular case control. *See* Cranson v. International Business Mach. Co., 234 Md. 477; 200 A.2d 33 (1964); Lowell-Woodward Hardware Co. v. Woods, 104 Kan. 729, 180 P. 734 (1919).

17. Some states allow for partnership associations with limited liability. *See* N. LATTIN, *supra* note 15, at 45.

18. "Limited liability is the rule, not the exception . . . ." Anderson v. Abbott, 321 U.S. 349, 362 (1944).

19. United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (E.D. Wis. 1905). *See also* United States v. Reading Co., 253 U.S. 26 (1920); Reynolds Pallet & Box Co. v. NLRB, 324 F.2d 833 (6th Cir. 1963).

20. Gillespie, *Thin Corporate Line: Loss of Limited Liability*, 45 N.D. L. REV. 363 (1969); Kaufer, *Pleading Facts Sufficient to Disregard the Corporate Entity*, 40 L.A.B. BULL. 131 (1965); Samuels, *Lifting the Veil*, J. BUS. L. 107 (1964); Hughes, *Piercing the Veil: A Clue to Legal Thought*, 11 U. KAN. L. REV. 527 (1963); Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 342 (1947); Latty, *The Corporate Entity as a Solvent of Legal Problems*, 34 MICH. L. REV. 597 (1936).

21. N. LATTIN, *supra* note 15, at 73; Dye, *Inadequate Capitalization as a Basis for Shareholder Liability*, 45 S. CAL. L. REV. 823 (1972).

22. *See* Arnold v. Phillips, 117 F.2d 497 (5th Cir.), *cert. denied*, 313 U.S. 583 (1941); Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942); Ohio Edison Co. v. Warner Coal Corp., 79 Ohio App. 437, 72 N.E.2d 487 (1946).

operation."[23] In practice, inadequate capitalization is frequently found to be violative of corporate standards where it occurs in combination with some objectionable forms of behavior,[24] such as where the formalities attending the corporation as a separate entity are not observed and the corporation is used as the so-called "alter ego" of its shareholders.

But, at least in California, it has been suggested that inadequate capitalization may itself in some cases be a sufficient basis for disregarding corporateness.[25] In *Minton v. Cavaney*,[26] plaintiffs' daughter drowned in a public swimming pool operated by a corporation which leased the swimming pool from its individual owner. No assets were ever put into the corporation, and the commissioner of corporations refused to permit the issuance of shares of stock. Cavaney—the corporation's secretary, treasurer, a director (and, by the way, attorney who organized the corporation)—was held liable because the firm's capital was trivial compared to the risks inherent in that enterprise.[27] Cases since *Minton*, in California and elsewhere, stress, however, that inadequate capitalization is only one factor to be considered along with others in determining whether shareholders, directors or officers should be held personally responsible for the obligations of the firm.[28]

Other circumstances which have led to the loss of limited liability have sometimes arisen in the case of one-man or subsidiary corporations, and involve a failure to carefully distinguish between the individual or dominant shareholder and the firm itself.[29] For example, when an individual abuses the separate financial integrity of the firm, the courts will deny him the benefits stemming from limited liability.[30] However, the privilege is not usually lost merely because the corporation's assets are monetarily small or because a shareholder uses corporate property for private purposes, so long as the rights of creditors are not violated.[31] Fraud or some other wrongful act suggesting fraud

23. Automotriz Del Golfo De Cal. v. Resnick, 47 Cal. 2d 792, 797, 306 P.2d 1, 4 (1957) (citing Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 486, 197 P.2d 167, 174 (1948)).

24. Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (1970).

25. CALIFORNIA CONTINUING EDUC. OF THE BAR, CLOSELY HELD CORPORATIONS 6 (1977).

26. 56 Cal. 2d 576, 15 Cal. Rptr. 641, 364 P.2d 473 (1961).

27. *Id.* at 579, 15 Cal. Rptr. at 643, 364 P.2d at 475.

28. Pearl v. Shore, 17 Cal. App. 3d 608, 95 Cal. Rptr. 157 (1971); Harris v. Curtis, 8 Cal. App. 2d 837, 87 Cal. Rptr. 614 (1970). *See also* Associates Dev. Corp. v. Air Control Prod., Inc., 392 S.W.2d 542 (Tex. Civ. App. 1965).

29. *See* H. BALLANTINE, *supra* note 7, at 298. *See generally* Fuller, *supra* note 3; Cataldo, *supra* note 2.

30. Segan Constr. Corp. v. Nor-West Builders, Inc., 274 F. Supp. 691 (D. Conn. 1967); Schoenberg v. Romike Properties, 251 Cal. App. 2d 154, 59 Cal. Rptr. 359 (1967); Platt v. Billingsley, 234 Cal. App. 2d 577, 44 Cal. Rptr. 476 (1965).

31. Colorado Fed. Sav. & Loan Ass'n v. Beery, 141 Colo. 45, 347 P.2d 146 (1959); State v. Stites, 5 Utah 2d 101, 297 P.2d 227 (1956); Telis v. Telis, 132 N.J. Eq. 25, 26 A.2d 249 (1942).

is usually present when the courts find shareholders unlimitedly liable under these circumstances.

Problems arising from subsidiary and other affiliated corporations, where a parent corporation has a controlling interest, are similar to those associated with the one-man corporation.[32] Several commentators have noted the general standards necessary to insulate the parent from its subsidiaries liabilities:[33]

> a) separate financial arrangements for each firm, sufficient to meet the normal obligations foreseeable in the business undertaken—in other words, adequate capitalization;
>
> b) no intermingling of business records, accounts, property, transactions and employees;
>
> c) separate observation of certain corporate formalities, such as meetings of the boards of directors;
>
> d) care not to represent to and possibly mislead the public that the enterprises are unified beyond their real relationship.

The courts look generally to see whether the corporate privilege has been used in good faith for legitimate business purposes. If one corporation dominates another sufficiently, the firms may be treated as one.[34] Thus, subsidiary situations and close corporations are essentially treated similarly. It is usually a factual question—in both situations—revolving around the degree to which the principal players have dominated the firm.

These points are well illustrated by the "Deep Rock" doctrine, named after a leading case that carved out an exception to the limited liability rule.[35] Under this doctrine, the claims of creditors who are also shareholders may be subordinated to the claims of other creditors in insolvency or reorganization proceedings, when the court finds that the shareholder-creditor has violated certain proprieties necessary to the maintenance of separate corporate integrity.[36] If a parent or major stockholder has abused its dominant position, its claim may be subordinated. Otherwise, legitimate transactions between the dominant

32. *See generally* N. LATTIN, *supra* note 15, at 100; Landers, *supra* note 9; Berle, *Subsidiary Corporations and Credit Manipulation*, 41 HARV. L. REV. 874 (1928).

33. Douglas & Shanks, *Insulation From Liability Through Subsidiary Corporations*, 39 YALE L.J. 193, 196-97 (1929); Cataldo, *supra* note 2, at 492-98.

34. Van Pelt v. Paull, 6 Mich. App. 618, 150 N.W.2d 185 (1967); Markow v. Alcock, 356 F.2d 194 (5th Cir. 1966); Wyoming Constr. Co. v. Western Cas. & Sur. Co., 275 F.2d 97 (10th Cir.), *cert. denied*, 362 U.S. 976 (1960).

35. Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939).

36. *See* Landers, *supra* note 9, at 597-606; N. LATTIN, *supra* note 15, at 90; H. HENN, *supra* note 6, at 268.

shareholder and the corporation will be upheld and the usual priority will prevail in determining the order of claims.[37]

Although subordination cases, such as *Deep Rock,* are described in terms of fairness, they usually have underlying facts suggesting fraud, commingling of funds, or undercapitalization.[38] In *Deep Rock,* the parent undercapitalized its subsidiary, heavily indebting the subsidiary to the parent.[39] Mismanagement led to insolvency. During reorganization proceedings the parent declared its claim, based upon an open account, to be superior to claims of the other creditors. The court rejected this argument and subordinated the claim of the parent not only to claims of other creditors of the subsidiary but also to those of its preferred shareholders. Although this case had a shocking impact initially, the "fairness" test of that case, and that of its companion, *Pepper v. Litton,*[40] were not so revolutionary as then perceived. Indeed, one need not stretch very hard to explain the facts in both cases in terms of common law fraud.[41]

CURRENT VIEWS ON LIMITED LIABILITY

But for the generally recognized exceptions already mentioned, the limited liability rule appears to be as firmly embedded as ever as a landmark institution. Many writers continue to be convinced of the central importance of limited liability, although the enthusiasm is more tempered today than it was in the past. It is peculiar that this view should have persisted despite weaknesses in the argument that were observed long before this article. Arthur Stone Dewing recognized in his leading treatise years ago that limited liability is "not a necessary characteristic" of the corporation.[42] Rather, according to Dewing, "limited liability is merely one of the various legal attributes which, for reasons of social expediency, it seems desirable to attach to the modern corporation."[43]

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37. Bass v. Shutan, 259 F.2d 561 (9th Cir. 1958).

38. Landers, *supra* note 9, at 598, 635-36.

39. According to one commentator, in this case the manipulations which occurred "put the parent in a position to milk the subsidiary through leased facilities and other devices." Krotinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent Subsidiary Law,* 42 COLUM. L. REV. 1124, 1128 (1942).

40. 308 U.S. 295 (1939).

41. *See, e.g.,* Albert Richards Co. v. The Mayfair, Inc., 287 Mass. 280, 191 N.E. 430 (1934); Dollar Cleansers & Dyers, Inc. v. McGregor, 163 Md. 105, 161 A. 159 (1932); Centmont Corp. v. Marsch, 68 F.2d 460 (1st Cir. 1933), *cert. denied,* 291 U.S. 680 (1934).

42. A. DEWING, 1 FINANCIAL POLICY OF CORPORATIONS 14 (5th ed. 1953). Our position may, in fact, have been understood by Dewing, but he failed to develop an explanation for his position.

43. *Id.*

Aside from its importance as a device that has fostered the aggregation of capital and growth of business, limited liability has generated other kinds of comments in legal journals[44] and the popular press,[45] focusing on perceived social ills caused by the rule. The criticism offered most frequently is that the ability of a corporation to protect personal assets or those of a parent corporation leads to certain abuses, especially in the case of one-man and subsidiary corporations. Critics charge that because of limited liability creditors have fewer assets to reach in the event of insolvency.[46] It is claimed that subsidiaries are often "undercapitalized" entities, which allow parent corporations to avoid bearing the full risk involved in novel ventures.[47] It is suggested that such behavior results in the costs of a risky operation being wrongly placed on creditors and the general public. Finally, the charge is made that the legal protection available to creditors, such as the law of fraudulent conveyances, is inadequate.[48]

A few commentators have defended the rule of limited liability against some of these attacks. Professor Manne was probably the first person to develop a logical explanation for the existence of the institution.[49] He maintained that limited liability is an efficient rule, encouraging investment by many individuals in many enterprises "without risking a disastrous loss if any corporation in which they have invested becomes insolvent."[50] In other words, the rule facilitated diversification of risk. Furthermore, he argued, the rule promotes efficiency because it is less costly for the creditors of a corporation to assess the risks of investment than it is for many small shareholders.

Professor Manne concluded that a contrary rule could be expected to generate undesirable anti-competitive effects, since the ownership of corporations would be more concentrated and costly to change, resulting in longer tenure for inefficient management.[51] Professor Posner recently further developed the rationale for limited liability, asserting that it "facilitates a form of transaction advantageous to both investors and creditors; in its absence the supply of investment and the demand

44. *See* Berle, *supra* note 32; Douglas & Shanks, *supra* note 33; Fuller, *supra* note 3; Cataldo, *supra* note 2; Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190 (1967); Dye, *supra* note 21; Landers, *supra* note 9.

45. Meginniss, *Limited Liability?*, ERGO, Dec. 3, 1969; REASON (interview with Nicholas Von Hoffman), August 1976, at 16.

46. Cataldo, *supra* note 2, at 488.

47. Landers, *supra* note 9, at 592-93.

48. *Id.* at 594-96.

49. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).

50. *Id.* at 262.

51. *Id.* at 262-65.

for credit might be much smaller than they are." [52] Manne and Posner note that limited liability may produce some undesirable results with respect to involuntary creditors who may suffer because of the rule. Unlike voluntary creditors who can contract around the rule, involuntary creditors have no choice.[53] However, Posner contends that limited liability is socially efficient—the undesirable situation of a few tort creditors is outweighed by the benefits from reduced transaction costs and the stimulus to investment. The problem could be avoided, he suggests, by requiring every corporation "engaged in dangerous activity to post a bond equal to the highest reasonable estimate of the probable extent of its tort liability." [54]

LIMITED LIABILITY AND VOLUNTARY CREDITORS

The purpose of this paper is to carry the discussion further and to suggest that, while it may not be desirable to change the rule of limited liability, the economic consequences of a rule of unlimited liability would probably have been little different from what we observe under the existing arrangement. Our analysis will be centered around an important argument originated by Professor Coase.[55] The essence of the Coase Theorem is that, in the absence of transaction and enforcement costs and income effects, the allocative results are invariant to changes in the property rights structure.[56] In the current context, this means that, unless the costs of doing business are substantially different under a rule other than limited liability, the rule of limited liability produces no important differences in the allocative outcome in

52. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 503 (1976).

53. *Id.* at 506-07; Manne, *supra* note 49, at 263. For a recent extension which partially discusses this, *see also* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANCIAL ECON. 305, 331 (1976).

54. Posner, *supra* note 52, at 520.

55. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

56. A condensed version of Coase's analysis is offered by Professor Posner in his ECONOMIC ANALYSIS OF LAW, 16-21 (1973). It can be partially explained by the following example. Suppose a railroad running through a farmer's land has the right to emit sparks. The cost to the railroad of using spark-arresting equipment is $100. The loss of crops to the farmer, because he must plant farther away from the tracks, is $50. Because it is only worth $50 to the farmer not to have sparks emitted, but the cost of prevention is $100, the railroad will emit sparks because the farmer will not find it worthwhile to prevent the sparks. If the railroad were liable to the farmer for any damages caused by sparks, and because the spark prevention would cost $100, it will be worth their while to pay the farmer between $50 and $100 to not plant his crops close to the railroad. Hence, no matter who has the property rights the result is the same; the railroad will emit sparks and the farmer will not plant close to the tracks. The principle is the same if the spark prevention equipment costs $50 and the damage to the crops was worth $100. In that case, no matter who has the rights the spark preventing equipment will be installed. The economically efficient result will emerge no matter what the rights, so long as the transaction costs are not significant, that is, if the farmer and the railroad can bargain at no cost, or at least at a cost low enough not to exceed the gains from bargaining.

the credit market than would any other rule of liability. That is, economic efficiency is not affected. Since bargaining in credit markets is typically conducted in negotiated transactions, we expect that the costs of bargaining will be roughly equivalent with or without limited liability.

An intuitive explanation based on economic theory helps explain why the rule of limited liability makes little difference in the market for loanable funds. For ease of illustration, consider the sole proprietor who organizes a corporation with little capital. This situation is one that has concerned many legal commentators. Assume that this individual, having a net worth of $110,000 capitalizes the corporation with only $10,000. Prior to incorporation, his creditors could reach $110,000 in assets. After incorporation, assuming there are no defects in organization and that the courts recognize the new organization as a valid corporation, corporate creditors would only be able to reach $10,000 in assets. Under these circumstances, creditors are said to be more likely to absorb a loss than they would if the individual remained a sole proprietor.[57]

In fact, however, the limited liability rule would not produce such consequences. If the individual as a sole proprietor attempted to borrow $50,000, a creditor in assessing the risks of the loan would consider such factors as likelihood of default, past credit record, other debts, value of personal assets, and interest rate.[58] Given the opportunity to weigh all these considerations (and ignoring possible problems stemming from the usury laws), a creditor might offer the individual the money for fifteen percent annual interest for ten years. The creditor and debtor would then sign an agreement, or the debtor would look elsewhere for more favorable terms. An agreement would, of course, specify the terms of the debt including a list of assets collateralized for the loan.[59]

If the same individual, operating as a corporation, went to the same creditor for the loan, the creditor would weigh the same factors in deciding whether to extend credit to the corporation and on what terms the loan would be offered. The creditor might possibly offer the loan on identical terms, regardless of whether the debtor borrows as a corporation or as a proprietor. However, the creditor could also negotiate for different terms. For example, he could insist that the assets of the corporation *and* the assets of the individual collateralize

57. *See* Landers, *supra* note 9, at 592-93.

58. *Cf.* Jones, *Financing Small Business, in* V. NORDIN, CREATIVE BUSINESS FINANCING 55-60 (1968).

59. *See generally* Quist, *Banking,* in V. NORDIN, *supra* note 58, at 333-42.

the transaction.[60] Because of the arm's-length nature of credit market negotiations, we expect the same loan to emerge in a competitive market for credit, regardless of the juridical nature of the debtor firm.[61]

If a creditor demands less collateral of a corporation than he would if he had loaned to a sole proprietorship, he may be more likely to incur a loss than he would had the debtor engaged in business as a sole proprietor. However, this result merely reflects the poor judgment of a particular creditor rather than a defect in the liability rule.[62] Under any liability rule, a creditor with poor judgment is likely to be less profitable than more astute lenders. In such cases, there are net transfers of wealth from creditors to debtors. However, society as a whole is not harmed any more than would be the case if the debtor, rather than the creditor, sustained the loss.

In most cases, the bad judgment of a creditor will be quickly accounted for in the credit market. Many debt instruments are negotiable and many are negotiated. When a prospective purchaser of a debt instrument notices that it is inadequately backed by collateral, he will offer less money for the instrument than if it had been more securely collateralized. Information about the value of loans thus signals creditors to demand greater collateral or discount the negotiable instrument.

In sum, we argue that credit terms are invariant to the legal definition of the firm. Accordingly, limited liability status offers no advantage in the credit market. Because each loan is made on an individual basis and because the interest rate is tailored to each loan, it must be recognized that the collateral may vary for each loan no matter what the liability rule. When an individual contracts to limit his liability or has it limited by law, market conditions force him to pay a price for the limited liability. Protection for some of his assets is insurance for which he pays a premium. Although some individuals may prefer to purchase insurance for some assets by paying a higher

60. *Cf.* W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING § 1.2 (1975).

61. Frequently, creditors will insist that an individual incorporate as part of a loan agreement. If limited liability reduced creditors' chances of repayment, it would be unlikely that they would find the corporate form of organization preferable to the proprietorship. The corporate form of existence will avoid certain probate problems and has other advantages which creditors believe to create net benefits. This is primarily due to perpetual life of corporations, unlike proprietorships which terminate upon the death of the proprietor, thereby placing the debts of the proprietor into his estate.

62. Similarly, carelessness on the part of the creditor can yield effective limited liability for the proprietor. For example, if the debtor holds property jointly with his wife, which is common, and the creditor fails to obtain her agreement to collateralization of the property in question, the collateral is ineffective, and the liability of the proprietor has thus been limited. *See* C. SMITH & R. BOYER, SURVEY OF THE LAW OF PROPERTY 56-7 (2d ed. 1971).

interest rate, the real cost of credit is a function of the nature of the collateral and not of the liability rule governing default.

Though it is difficult to test our logic empirically, one bit of evidence derives from the history of incorporation in Massachusetts. Prior to the general incorporation act of 1851, incorporation required a petition to the legislature for a special act granting a charter. According to one student of the era: "[s]uch grants were very numerous, and it would appear that few petitions for industrial incorporation were rejected." [63] Assuming that to be the case, there is no reason to suspect that there was a difference in the degree of difficulty in obtaining a corporate charter in the 1820s, when there was unlimited liability, than there was after 1829 when limited liability accompanied the charter. Thus, if limited liability were a valuable asset to a business firm, one would expect to see an increase in the number of incorporations when limited liability was included in charters of incorporation. From 1809 through 1829, when unlimited liability accompanied corporate charters, there was an average of nine and one-half charters granted per year.[64] From 1830, when limited liability accompanied charters, through 1845 (the last year for which data were available), there was an average of nine charters granted per year. The change in the liability rule apparently had no effect on the number of incorporations, which is precisely our point.[65]

TRANSACTION COSTS

Some writers on corporations have recognized that limited liability does not eliminate risk, but merely shifts it.[66] However, they often go on to argue that the real reason for limited liability is that it economizes on certain transaction costs. That is, if limited liability were not the rule, stockholders would behave differently. Because they would be subject to the risk of losing individual assets should a corporation become insolvent, stockholders, according to this argument,

63. Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351, 1370-71 (1948).

64. C. WARE, EARLY NEW ENGLAND COTTON MANUFACTURE 147-48, App. A (reissued 1966).

65. A reading of numerous sources does not reveal clearly to us why limited liability was introduced by statute. There does not appear to have been pressure by businessmen for its adoption. "Limited liability . . . was only infrequently invoked as a reason for incorporation. Though it has made its appearance in the seventeenth century, it was seldom introduced into the calculations of lawyers who advised business clients under the Bubble Act during the eighteenth century." H. PURDY, M. LINDAHL & W. CARTER, CORPORATE CONCENTRATION AND PUBLIC POLICY 42-43 (2d ed. 1950). "It is clear that the eighteenth century businessman prized this advantage (limited liability) far less than we have thought." S. LIVERMORE, EARLY AMERICAN LAND COMPANIES 262 (1939).

66. Manne, *supra* note 49, at 262.

would invest more time and effort in monitoring the behavior of managers and keeping track of the wealth position of other stockholders. "It is easily conceivable that the costs of so doing would, in the aggregate, be much higher than simply paying a premium in the form of higher interest rates to the creditors of [the corporation] in return for their acceptance of a contract which grants limited liability to the shareholders." [67]

We do not find these arguments convincing. First, there is little incentive for stockholders to intervene directly in management activities, regardless of the liability rule. Share prices vary with the investment risk and thus embody all the information, aside from undisclosed inside information, that investors need to make investment decisions. Information on stock prices, which reflect the collective expectations of investors with respect to publicly traded securities, eliminates the need for any single shareholder to expend his resources in predicting the future position of a corporation in which he invests [68] (assuming the use of inside information is prohibited).[69] This holds true under any liability rule.

Next, with respect to monitoring the wealth position of other stockholders, it is unlikely that creditors under a rule of unlimited liability would pursue claims against all shareholders. The jurisdictional and venue problems in bringing a *single* action against a multitude of shareholders, in the case of a publicly held corporation, would probably generate litigation costs higher than most creditors would be willing to pay.[70]

Finally, with respect to Posner's claim that the costs of contracting around a rule of unlimited liability would be higher than those associated with the existing rule of limited liability,[71] no theoretical or empirical basis has been developed for that assertion. Although there may be more cases where contractual arrangements would be called for under a rule of unlimited liability, there is little reason to believe that the net costs of those additional contracts would, in fact, be significant. Contracts which are individually drawn, as in the case of individually

67. Jensen & Meckling, *supra* note 53, at 331; *see also* Posner, *supra* note 52, at 506-07, 511-12, 515-16.

68. This would be even more so were there not the restrictions on insider trading. *See* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1967). *See* H. MANNE & E. SOLOMON, WALL STREET IN TRANSITION (1974) for a survey of the efficient market hypothesis. *See also* J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE Ch. 4 (1973).

69. Inside information is, of course, useful and valuable, but we assume for argument only that rule 10b-5 prohibiting its use is effective. 17 C.F.R. § 240.10b (1977).

70. *Cf.* R. FIELD & B. KAPLAN, CIVIL PROCEDURE pt. 5 (3d ed. 1973).

71. Posner, *supra* note 52, at 506-07.

bargained loans, cost more to draw than do standardized contracts. Since the number of individually negotiated loans probably would not change under a rule of unlimited liability, the only predictable change would be the form of standardized contracts. Assuming that many shareholders opted for limited liability, whenever they purchased stock they would simply sign contracts limiting liability to the extent of their investment. The limitation on liability would be effective, as long as creditors of the corporation also contracted with it based on that arrangement. Such contracts would quickly emerge as standard forms costing only a few pennies to print and sign. The terms of liability might even be imprinted on stock certificates. As long as the courts enforced such limitation contracts, a rule of unlimited liability would not lead to significant changes in transaction costs. Likewise, it would not cause any basic change in the pattern of investments (although the forms of organizations might differ).

The basis of the argument is simply that the primary reasons for the existence of the corporate form of doing business are not related to the rule of limited liability. A major consideration from the standpoint of the investor is the ability to exchange ownership rights in the corporation cheaply and efficiently. Other efficiency-related attributes of corporations make it preferable to other business organizations. The desirable corporate qualities of perpetual life, general ease of transferability for ownership interests, availability of capital from the sale of different kinds of securities, specialization of management without shareholder participation, rule by the majority or any specified percentage, and so on remain viable under any rule of shareholder liability. To be sure, these attributes or variations of them can be created contractually for any other organization such as a partnership. However, they are available at a lower cost to corporations because of their institutionalization. These attributes, to say nothing of tax considerations, are often determinative in the choice of what business entity[72] is to be employed. Thus, contractual freedom makes a statutory rule of limited liability irrelevant.

LIMITED LIABILITY AND INVOLUNTARY CREDITORS

A feature of limited liability that is decried as producing inequitable results arises in connection with involuntary (tort) creditors.[73] The major problems are purported to occur in connection with

72. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 24-27 (3d ed. 1971).

73. The assault on limited liability with respect to this point has been nearly uniform by commentators from all perspectives. *See* Manne, *supra* note 49, at 263; Posner, *supra* note 52, at 519-21; Cataldo, *supra* note 2, at 477-78; Note, *supra* note 44; Dye, *supra* note 21, at 836-40.

one-man or closely-held corporations. In those situations, an individual who may have been fully responsible as a sole proprietor is able to set a self-serving limitation on his liability by the extent of his investment in the company. If such an individual contributes fewer assets to his corporation than would be exposed to creditors had the business been conducted as a proprietorship, it is argued that involuntary creditors are disadvantaged by their inability to reach assets that would otherwise be available to satisfy a judgment against the business.[74] The main problem in such situations is usually expressed in terms of "undercapitalization." For example, one writer recently complained that "[s]tate corporation statutes clearly do not require corporate entities to be adequately capitalized as a prerequisite to engaging in most types of business activities . . . ." [75] The import of this view is that entrepreneurs are able to protect their assets from tort victims by incorporating. Thus, the costs of doing business are shifted to potential tort victims and, through them, to the public.[76] It is also argued, correctly, that tort creditors, unlike contract creditors, are not consensual parties and cannot be said to have contractually assumed the risks flowing from inadequate capitalization.[77] Limited liability is, therefore, said to "invite financial irresponsibility." [78]

To examine this argument, let us consider a controversial case. In *Walkovszyk v. Carlton*,[79] plaintiff was struck by a taxi owned by the Seon Cab Corp.[80] Severely injured, the plaintiff sued for $½ million compensatory damages. The defendant corporation was insured for only $10,000 which was the minimum insurance required by state law. In addition to the insurance, the corporation's assets consisted of only two taxicabs of little value. The sole shareholder of the corporation owned all the stock in nine other corporations, each with two taxis and minimum insurance Clearly the individual shareholder placed his cabs in separate corporations to limit overall exposure to accident liability. The court held that there was adequate capitalization and that the New York law regarding incorporation had been satisfied. Since the plaintiff failed to present any reason other than an intentional plan to limit liability, the court refused to hold the shareholder individually liable. Thus, the taxicab corporation was afforded the same right, under the circumstances, to limited liability as a larger,

74. Fuller, *supra* note 3, at 1379-83.
75. Landers, *supra* note 9, at 592.
76. *Id.* at 593.
77. Dye, *supra* note 21, at 836-40.
78. Note, *supra* note 44, at 1191.
79. 18 N.Y.2d 414, 223 N.E.2d 6 (N.Y. 1966).
80. *See* Note, *supra* note 44, for a discussion of this case and similar ones.

more heavily financed corporation. There are, however, other cases with opposite holdings on somewhat comparable facts.[81]

The key question that is to be considered with respect to tort creditors in all such cases is whether the existence of "undercapitalization" poses a particularly undesirable situation. In analyzing that question, it should be noted that "undercapitalization" is not peculiar to corporations. A proprietorship or partnership can be "undercapitalized" in the sense that it may be unable to pay tort claims. The real concern of the critics of cases like *Walkovszky* seems to be with the current asset value of a corporation at the time a claim is perfected, not with its initial capitalization. Accordingly, the real issue becomes one of "underinsurance."

"Underinsurance" for our purposes can be defined as a situation in which a tort claim arises that cannot be satisfied by the assets of the corporation, whether the corporation self-insures or purchases coverage from an insurance carrier. A corporation that is not "undercapitalized," may be "underinsured," or a corporation that is not "underinsured" may be "undercapitalized." What constitutes adequate insurance or adequate capital is predicated upon many contingent factors and is often viewed differently *ex post facto* from the manner in which it was assessed *ex ante*. The impossibility of anticipating all liability and business factors accurately necessarily precludes any perfect resolution to the problem. A taxicab corporation of low net asset value, no matter how many cabs it owned, would have little use for insurance against tort claims, whereas a taxicab corporation of high net asset value, no matter how many cabs it owned, would have an incentive to purchase some insurance.[82] In a competitive taxi market, the difference in insurance costs in these two cases results in lower fares being charged by cabs with less insurance.

The central factor is the cost of insurance which is unavoidable no matter how the insurance is provided. An individual may ride in an adequately insured cab and pay the extra insurance cost in the form of higher fare. Or, he may bear the insurance cost or risk directly and thus place himself in the position of being a self-insurer. In this case, he rides in the uninsured cab and pays a lower fare, although the real cost of riding in cabs is equivalent in both cases.[83]

81. *See* Mull v. Colt Co., 31 F.R.D. 154 (S.D.N.Y. 1962); Mangan v. Terminal Transp. System, 247 App. Div. 853, 286 N.Y.S. 666 (3d Dep't 1936).

82. The incentive to purchase insurance according to the net asset value of the firm is, of course, only one factor considered in the decision to purchase insurance. The price of insurance and the risks involved are also considered.

83. In fact, since most taxi cabs are subject to regulated fares, this result does not emerge. The price differences would be expected to emerge in a purely competitive market.

Modern society is comprised of innumerable risk and risk-shifting activities at all levels of human interaction. By what is undertaken in any given circumstance, the individual inadvertently or intentionally decides which risks he will bear himself and which risks he will cover with insurance. This is the case with regard to involuntary creditors of corporations. The effect of a rule of limited liability may result in the issuance of fewer formal insurance policies but not ultimately less insurance. In this sense, most of the commentators have missed essential points regarding the effect of limited liability on involuntary creditors.

CONCLUDING REMARKS

The purpose of this commentary is to clarify what we find to be a rather confused state of thinking regarding the impact of limited liability on voluntary and involuntary creditors of corporations. Our argument, with respect to voluntary creditors, is that free contracting in the credit market vitiates the impact of any rule of liability on credit terms. Following Professor Coase's famous argument, credit terms should not change under different rules governing liability. Though our argument about limited liability and voluntary creditors is not generally recognized, it is not a new one.[84] We have also presented arguments to the effect that limited liability does not reduce transaction costs for corporate investors. This discussion is distinct from the treatment of this issue in the existing literature. Finally, we argue that limited liability does not arbitrarily impose unwarranted costs on involuntary creditors. The argument, that firms may be "undercapitalized", reduces logically to a question of whether producers purchase formal contracts of insurance against tort contingencies and reflect the extra costs in higher prices, or whether consumers bear the tort risk themselves and pay lower prices as a result. The main point is that insurance is not free in either case. While limited liability may have produced a particular institutional structure for the way in which insurance is provided, it has not led to less real insurance than would exist under another rule. Which system is more efficient in a given case is essentially an empirical question based on the particular facts.

84. Manne, *supra* note 49, was the first to fully develop this argument.