Northwestern University Law Review

Printed in U.S.A.
Vol. 89, No. 1

LIMITED LIABILITY AND THE EFFICIENT ALLOCATION OF RESOURCES

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I. INTRODUCTION

The conventional wisdom is that limited liability is the primary advantage of doing business as a corporation.[1] The corporate form allows investors to invest their capital without risking loss beyond the amount of the investment.[2] If the business fails, the investor cannot be called upon to make good on its excess obligations (unless the privilege of incorporation has been so abused that a court is persuaded to pierce the corporate veil).[3] In contrast, a partner in a partnership may be held personally liable for partnership obligations if the partnership is unable, or unwilling, to pay.[4]

Limited liability is a curious institution. In the twentieth century, courts have extended liability on the theory that a business should bear its costs.[5] For example, manufacturers are liable for injuries caused by their products—in many cases regardless of whether the injury was foreseeable or a result of a defect in the product.[6] Similarly, employers are vicariously liable for the injurious acts of employees who are acting within the scope of their employment irrespective

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1 *See* WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 66-67 (6th ed. 1988); ROBERT C. CLARK, CORPORATE LAW § 1.2.1 (1986); ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS § 13.8 (1989); WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 140-42 (5th ed. 1993).

2 *See* MODEL BUSINESS CORP. ACT § 6.22 (1984); *see also* MODEL STATUTORY CLOSE CORP. SUPPLEMENT § 25 (1984) (preserving limited liability even where corporate formalities have been dispensed with).

3 *See generally* CLARK, *supra* note 1, §§ 2.1-2.6 (discussing grounds for piercing the corporate veil); STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL 1-1 to 1-58 (1991) (also considering grounds for piercing); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991) (setting forth empirical evidence as to grounds cited by courts in piercing cases).

4 UNIF. PARTNERSHIP ACT §§ 18(a), 40(d) (1992).

5 *See* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991); *see, e.g.*, Ira S. Bushey & Sons, Inc. v. United States, 398 F.2d 167 (2d Cir. 1968).

6 *See generally* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY 11-14 (Preliminary Draft No. 1, 1993) (discussing policy justifications for strict liability without fault); W. PAGE KEETON ET AL., PROSSER & KEETON ON TORTS §§ 95-104A (5th ed. 1984) [hereinafter PROSSER & KEETON] (discussing various theories of products liability).

of whether the employer could have taken steps to prevent the harm.[7] In other words, business liability premised on negligence or fault has given way to the idea that a business should be liable because it is in a better position to bear the cost of injuries associated with it than are the random victims.[8] Indeed, products liability and vicarious liability are sometimes collectively referred to as "enterprise liability."[9]

Enterprise liability is not based on the simple-minded notion that corporations tend to have deep pockets or on any notion of social engineering or distributive justice. Rather, enterprise liability is based on the idea that the company which does not bear the full cost of its products will be able to sell its products too cheaply and will therefore be too profitable. Such a company will attract too much investment and will be able to command too much of society's resources, depriving other enterprises of those resources. In other words, enterprise liability is intended to remedy a market failure that, if unchecked, would allow businesses to avoid some of their costs. Enterprise liability is based on the idea that a business should internalize its externalities and that the free market should control the allocation of resources.[10]

Limited liability for corporations appears to be inconsistent with the notion of enterprise liability. What sense does it make to hold businesses liable for a wider range of costs and at the same time allow the owners of those businesses to escape liability when the business cannot pay? Indeed, some commentators have argued that limited liability should be abolished.[11] Yet limited liability has been remarkably

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7 *See* PROSSER & KEETON, *supra* note 6, §§ 69-71.

8 *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 6.6 (3d ed. 1986).

9 *See, e.g.*, Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); *see also* C. Robert Morris, Jr., *Enterprise Liability and the Actuarial Process—The Insignificance of Foresight*, 70 YALE L.J. 554 (1961).

10 *See* Calabresi, *supra* note 9, *passim*; Kornhauser, *supra* note 9, *passim*; Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563 (1988) [hereinafter Sykes, *Boundaries*]; Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984) [hereinafter Sykes, *Economics*]; *see also* Clarence Morris, *The Torts of an Independent Contractor*, 29 ILL. L. REV. 339 (1935) (suggesting—quite radically for the time it was written—that principals should be liable to third parties for the torts of independent contractors hired in connection with the business of the principal).

11 *See* PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS 681-92 (1987) (arguing that limited liability is unjustified for affiliated corporations); Theresa A. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 VAND. L. REV. 1387 (stating that a feminist generally would disapprove of limited liability); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (stating that "there may be no persuasive reason to prefer limited liability over a regime of unlimited pro rata shareholder liability for corporate torts"); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE

resistant to the trend toward enterprise liability. Thus, other commentators have sought to explain how limited liability can be consistent with economic efficiency.[12]

The thesis of this Article is that limited liability does indeed make economic sense, but not for the reasons that heretofore have been advanced in its defense. First, this Article sets forth and refutes the economic arguments that have been offered in defense of limited lia-

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L.J. 857 (1984) (arguing that limited liability allows too much corporate risk externalization); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975) (suggesting restrictions on limited liability between parent and subsidiary companies); Leebron, *supra* note 5, *passim* (advocating abrogation of limited liability for corporate subsidiaries).

12 *See* POSNER, *supra* note 8, § 14.3; Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80 (1991) (arguing that limited liability contracts generally are efficient across the spectrum of limited liability firms); *see also* Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148 (1992) [hereinafter Presser, *Thwarting the Killing*] (offering historical explanation for limited liability as in furtherance of democratic ideals).

Limited liability has always been somewhat mystifying to legal scholars. Early efforts to justify limited liability tended to focus on the need to subsidize economic growth. These arguments are no longer satisfying, if they ever were, not only because of increased sensitivity to social costs, but also because of the rather random way in which limited liability redistributes those costs. Henry B. Hansmann, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994) [hereinafter Hansmann, AALS Annual Meeting (1994)]. Thus Hansmann together with Reinier H. Kraakman have suggested that most of the more recent arguments in favor of limited liability have been concocted after the fact from the notion that because we have limited liability there must be a pretty good reason for it. *Id.*

As Robert Thompson and Larry Ribstein note, however, the institution of limited liability seems to be expanding rather than contracting (at least in some areas). Witness the recent explosive growth of limited liability companies. Larry E. Ribstein, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994); Robert B. Thompson, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994) [hereinafter Thompson, AALS Annual Meeting (1994)]. On the other hand, the corporate veil affords little protection in many areas such as environmental regulation. *See* Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 24-29 (1994) [hereinafter Thompson, *Unpacking Limited Liability*] (finding that courts apply statutes like CERCLA to hold corporate managers liable for the environmental damages created by their corporation but only if the manager directly participated in the damaging act or if the manager has an ownership interest in the corporation).

In fact, limited liability may be best explained as a historical accident. Undoubtedly, legislatures and courts recognized early on that it would be unwieldy to hold shareholders of large public companies individually liable. Moreover, there were few if any tort claims that could have bankrupted a large public company until quite recently. But these days the corporate form is no longer the exclusive province of the large public firm. The corporate form has become the form of choice even for the smallest businesses. *See* Stephen B. Presser, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994) [hereinafter Presser, AALS Annual Meeting (1994)] (arguing along somewhat similar lines that limited liability is no accident, but rather is (and was) prompted by democratic or populist ideals, that is, as a way of allowing the unmonied into business).

bility. As will be seen, these arguments focus primarily on publicly held corporations even though limited liability seldom matters to investors in such corporations. Second, the Article analyzes the function of limited liability in the context in which it counts the most, namely, in a one-person start-up business. It concludes that limited liability seldom insulates shareholders from personal liability even in this context for two reasons: (1) contract creditors will often negotiate for personal guarantees, and (2) tort creditors will almost always be able to show that shareholder-operators participated in any wrongful acts. Third, the Article offers a justification for limited liability based on the idea that contract creditors may refuse to negotiate with shareholders without it, preferring instead to retain access to all of a shareholder's wealth in the event of default and precluding the shareholder from deciding how much to invest in a venture. Finally, the Article reconsiders the legal doctrine surrounding piercing the corporate veil in light of the rationale for limited liability and concludes that the remedy is justified only when the corporate form is used to perpetrate fraud or intentional harm.

II. The Traditional Argument for Limited Liability

The traditional argument for limited liability is quite simple: without it investors would not invest in stock. It would simply be too risky to put one's money into a venture over which one has virtually no control if one could be held personally liable for a still greater contribution in the event the business failed and could not pay its bills. Without limited liability, larger corporations would not evolve, and ventures that require more capital than can be raised from a small number of involved investors would never be undertaken.

The problem with this argument is obvious. The argument is based on the notion that investors will not invest if they are required to take all the risk of the investment. It amounts to little more than the idea that investors will invest more if they are subsidized by relief from some of the costs that attend the ventures in which they invest. The traditional argument flies in the face of the notion that an enterprise should bear its costs. The essence of the argument is that some ventures will not be undertaken if their full cost must be borne, whereas the resource allocation argument concludes that is precisely what the result should be.

A. Economic Gloss on the Traditional Argument

Despite the arguments against limited liability, scholars of law and economics have offered six reasons for limited liability, which they assert are consistent with the goal of efficient resource allocation. These arguments have been aptly summarized by Frank Easterbrook

and Daniel Fischel,[13] though, as they are quick to point out, some of the arguments were first developed by others.

First, Easterbrook and Fischel argue that limited liability decreases investors' need to monitor management.[14] If the investor bears the risk of unlimited liability, he cannot afford to ignore the management of the business. But if he must monitor management, by learning about the business and periodically collecting and analyzing information, the costs of monitoring might outweigh the return available and the investment simply will not be made. Moreover, if investors engage in duplicative monitoring, the aggregate costs of monitoring the business will be far greater than if investors delegate the task to a single monitor.[15] Yet scattered investors find it very difficult and expensive to communicate with each other and coordinate their activities.[16] Thus, it seems likely that a rule of unlimited liability would generate more costs than benefits.

Second, Easterbrook and Fischel argue that, without limited liability, shareholders would need to monitor other shareholders.[17] Under partnership law, partners must make up any shortfall from other partners who are insolvent or who otherwise escape paying a partnership debt.[18] If the rule were the same for corporations, shareholders would also need to worry about whether other shareholders are able to bear their share. The risk of investing in a given business would be determined not only by the risk of the venture itself but also by the creditworthiness of the other investors.

Third, Easterbrook and Fischel argue that limited liability allows for the free transfer of shares, which allows a liquid market to arise and in turn provides a disciplinary effect on management.[19] Because shareholders value liquidity, shares themselves are more valuable than if they were illiquid. If shareholders were potentially liable for the excess obligations of the corporation selling shares would be exceedingly difficult because potential purchasers would be forced to educate themselves not only about the profit prospects of the business but also about its potential for visiting excess liabilities on its shareholders. In short, the need to monitor management as well as other shareholders

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13 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 40-62 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

14 Easterbrook & Fischel, *supra* note 13, at 94-95.

15 For a notable case in which the Delaware Supreme Court seems to have based its holding at least in part on this sort of efficiency, see Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

16 On the problem of shareholder coordination generally, see EASTERBROOK & FISCHEL, *supra* note 13, at 177-81.

17 Easterbrook & Fischel, *supra* note 13, at 95.

18 UNIF. PARTNERSHIP ACT § 40(d) (1992).

19 Easterbrook & Fischel, *supra* note 13, at 95-96.

would not only increase the cost of investing but would also preclude an active secondary market from arising.[20]

Fourth, Easterbrook and Fischel, following the lead of Halpern, Trebilcock and Turnbull, argue that limited liability allows an efficient market to arise.[21] If investors were potentially liable for amounts in excess of their investment, stock prices would be determined not only by the prospect of profit but also by the prospect of losses. Thus, stock prices would be determined in part by the wealth of individual investors and their ability to bear additional losses.

Fifth, Easterbrook and Fischel argue, as did Henry Manne before them, that limited liability allows investors to diversify.[22] Through diversification, investors can eliminate company-specific risk. Thus, they are more willing to invest.[23] Investor demand reduces the cost of capital by enabling companies to pay a lower rate of return.[24] In other words, with diversification, capital is more cheaply available than it otherwise would be. But diversification, it is argued, is possible only with limited liability. With unlimited liability, investors must monitor management and other shareholders in order to minimize the risk of personal liability, and it would be extremely difficult and expensive to monitor all the companies in a diversified portfolio.[25]

Finally, Easterbrook and Fischel argue that limited liability allows corporate managers to invest in riskier projects that offer greater rewards.[26] Diversified investors with limited liability are willing to undertake the risk that some corporations will lose money, or even become bankrupt, as long as the potential rewards for taking such risks are large enough.

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20 *See* Leebron, *supra* note 5, at 1608-10.

21 Easterbrook & Fischel, *supra* note 13, at 96; *see* Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117 (1980).

22 Easterbrook & Fischel, *supra* note 13, at 96-97; Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).

23 *See* JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE 13-32 (2d ed. 1985). The lower the risk, the more valuable the return. *Id.*

24 *See id.*

25 On the other hand, although some commentators argue that it is important to be fully diversified (and thus to "buy the market"), others argue that a modest amount of diversification (consisting of as few as ten different stocks) is perfectly adequate. *Compare* POSNER, *supra* note 8, § 15.1 *with* EASTERBROOK & FISCHEL, *supra* note 13, at 122 n.6.

26 Easterbrook & Fischel, *supra* note 13, at 97.

Consider the following two investments. Both require a $1000 investment, and the returns shown include the return of capital (if any):

	INVESTMENT A		
	Return	Probability	Product
Worst Case	$1000	.50	$500
Best Case	$1200	.50	$600
Weighted Average			$1100
Expected Rate of Return:	(1100-1000)/1000 or 10%		

	INVESTMENT B		
	Return	Probability	Product
Worst Case	($2000)	.10	($200)
Best Case	$3000	.90	$2700
Weighted Average			$2500
Expected Rate of Return:	(2500-1000)/1000 or 150%		

Clearly, Investment B is superior to Investment A. Nevertheless, Investment B carries with it the possibility that the investor will be called upon to contribute an additional $2000, while with Investment A an investor will never do worse than break even. With a rule of unlimited liability, investors might be unwilling to have management undertake such projects as Investment B even though the potential return justifies taking the risk. Thus, limited liability allows management to manage free of constraints that otherwise would likely be imposed by shareholders fearful of personal liability. And projects that make economic sense will not be foregone because of the risk aversion of individual shareholders.[27]

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[27] This argument is the same one that has been advanced for why corporate boards should not be seen as owing a fiduciary duty to creditors. William A. Klein & John C. Coffee, Jr., Business Organization and Finance 255-63 (5th ed. 1993); *see also* James J. Hanks, Jr., *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come*, 3 INSIGHTS, Dec. 1989, at 20 (cataloguing additional sources of conflict). Because creditors typically do not share financial returns beyond the fixed payment they have agreed to accept, they clearly would prefer the firm to pursue Investment A, which carries no risk that they will not be paid. There is no upside for creditors in Investment B, and there is no reason to take the added risk. If management was a fiduciary of creditors as well as shareholders, creditors could argue that management was in breach of its fiduciary duty by choosing Investment B, while shareholders could make the same argument if management chose Investment A. In the end, management would always be in breach or fiduciary duty would need to be watered down so that it afforded even less protection than it currently does.

The argument that limited liability allows the firm to undertake riskier projects assumes that investors are diversified. An undiversified investor would be reluctant to risk the loss of her investment. So, even with a rule of limited liability, an undiversified investor might well prefer Investment A. With diversification, however, the investor becomes indifferent to the occasional loss. For example, if there were ten companies with risk profiles like Investment B, one would expect nine out of ten to enjoy best case scenarios and one out of ten to suffer worst case scenarios. Even if two or three firms suffer worst case outcomes, the overall return remains well in

B. Why the Economic Arguments Must Fail

None of the arguments in favor of limited liability is ultimately persuasive. All six are based on the idea that investors would not invest if they were not either relieved of some of the costs of investment or offered benefits in addition to the investment's return. As will be seen, there is simply no reason to think that either proposition is true.

The arguments that are based on the need to monitor management and other shareholders are perhaps most egregious in their reliance on the supposed need for subsidies. Reduced to their essence, these arguments say that because the true cost of investing will sometimes exceed the benefit, some of the cost should be borne by others. This is equivalent to saying that investors need to be subsidized in order to induce them to invest.

Moreover, the problem of shareholder communication and coordination is largely illusory in this context. If shareholders needed someone to monitor management, management itself, recognizing that it cannot otherwise raise capital as cheaply, would arrange for an outside monitor to avoid duplicative costs. Indeed, such monitors are already in place in the guise of stock exchanges, accountants, underwriters, bond rating agencies, and law firms. The fact that corporations pay significant fees for the services of such agencies under the current regime of limited liability attests to the likelihood that they would do the same if necessary because of a rule of unlimited liability.[28]

The arguments that a market can only become liquid and efficient with limited liability are derivatives of the arguments for the need to monitor management and other shareholders. These arguments are premised on the idea that the same worries will hamper trading by *potential* investors. To the extent such concerns are eliminated for original investors, they are also eliminated for trading partners.[29]

The arguments based on liquidity and efficiency are distinct from the argument that differences in shareholder wealth will render the market less efficient because investors have differing abilities to bear losses. The problem with the latter is that it assumes away the profit-

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excess of what is available with Investment A. And with greater diversification, the odds of divergence become very small.

[28] It is even conceivable that some form of insurance might be offered against the possibility of excess liability.

[29] These arguments differ from the simple argument based on the cost of monitoring in that a liquid and efficient market constitutes a net benefit for investors rather than relief from a cost. In other words, even if a given investment makes economic sense, an investor will still prefer an investment that is liquid and efficiently priced to one that is not. In the end, however, lower cost and higher benefit are the same thing, and one would expect issuing corporations to exact some of the benefits of liquidity and efficiency, if they can be expected to obtain, by paying a lower return.

side differences among investors caused by differences in the marginal utility of investment returns and in tax status. Even under a rule of limited liability, investors have different preferences for returns and the form in which they are paid. It may be that investors, who are naturally risk-averse, are *more* worried about losses than they are about profit-side preferences. However, there is no reason to think that the trading markets, which seem to function perfectly well in the presence of disparate profit-side preferences, would be unable to cope with similarly disparate loss-side preferences.[30]

The argument that unlimited liability would prevent shareholders from diversifying is simply wrong. If anything, just the opposite is true: a rule of unlimited liability would force investors to diversify.[31] The more diversified a shareholder, the smaller the impact of excess losses from any one business failure.[32] Moreover, given that on the average a business makes more money than it loses, diversification will ordinarily protect shareholders from out-of-pocket losses.[33] That is, excess losses will simply net out against gains.[34]

Finally, the argument that unlimited liability would prevent corporations from undertaking sensible but risky ventures is also answered by shareholder diversification. As long as shareholders are diversified—and there is every reason to think they would be diversified under a rule of unlimited liability—there is no reason to think that they would object to sensible but risky ventures at the corporation level. Occasional losses will tend to be offset by occasional gains, and on balance, return will be enhanced. Unlimited liability once again drops out of the picture.

In fact, shareholder diversification provides a refutation for the other five arguments for limited liability. In every case, diversification insulates shareholders from losses, and there is no reason to think shareholders will fail to diversify.

In all fairness, the standard arguments for limited liability are based on the (correct) empirical claim that on balance corporations create more wealth than they destroy. And while it is regrettable that third-party creditors must sometimes suffer, the benefits outweigh these unfortunately distributed costs. In other words, the central argument of law and economics scholars may be that the move to lim-

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30 *See infra* note 51 (discussing clientele effect).

31 *See* Leebron, *supra* note 5, at 1595-1600.

32 This assumes investors would only be liable for a pro rata share of excess losses.

33 It is worth noting that over the long haul (1926-1981) the (geometric) average return on common stocks has been about 9% (adjusted for inflation). *See* LORIE ET AL., *supra* note 23, at 16-17.

34 *See generally* Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992) (discussing various mechanisms by which capital markets will redistribute risk of excess loss).

ited liability is Kaldor-Hicks efficient rather than Pareto-superior.[35] But in a world of diversified shareholders, it is difficult to see why there is any need to transfer the cost of business failures to third-party creditors.

C. Some Additional Arguments and Why They Fail

Although the arguments of law and economics scholars fail to overcome the arguments against limited liability, they do suggest additional lines of argument that have some merit.

First, the creditors who lose from a corporate bankruptcy are often other corporations whose stock is owned by the same diversified investors who gain from escaping potential liabilities. For example, a diversified investor who invests both in a borrower company and a lender bank would, in the event of the bankruptcy of the borrower company, avoid losses beyond the amount of the initial investment but might suffer some or all (or indeed more) of those losses in the form of a decrease in the value of the bank stock. Thus, investors in publicly traded corporations—at least diversified investors—do in fact suffer the equivalent of unlimited liability because they endure losses in other stocks when one of the companies in which they have invested becomes bankrupt. This suggests that investors would be largely indifferent to a change in the law that imposes unlimited liability. So why change the rules?

In fact, investors may even prefer to be able to design their portfolios to maximize or minimize exposure to losses from the bankruptcies of other companies, and investors may be better off because they choose from a wider variety of investments under a rule of limited liability than under a rule of unlimited liability. In other words, limited liability is a way of breaking up an investment in a single company into profit and loss tranches in much the same way that debt instruments are often sliced and diced into various parts.[36] But this argument should not be overemphasized. Traders may just as easily trade on the risk of excess losses if those losses remain bundled with the corporations generating them.

Second, limited liability may allow corporations to create different classes of stock for investors with different preferences. For example, it is difficult to imagine how one could sell preferred stock, which tends to be attractive to investors with fairly conservative investment

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[35] A Pareto-superior transaction is one that makes at least one person better off and no one worse off while a Kaldor-Hicks efficient transaction is one that makes the population better off as a whole even though some individuals are worse off. *See* POSNER, *supra* note 8, § 1.2.

[36] Although such instruments were heretofore derived primarily from debt securities, they have increasingly been used in connection with preferred stock, so much so that Congress has added a provision to the Internal Revenue Code expressly dealing with stripped preferred stock. I.R.C. § 305(e) (CCH Supp. 1994).

goals, if such investors were required to bear the same risk as investors in common stock.[37]

Admittedly, this is a rather hypothetical argument in that preferred stock has grown up in an environment in which limited liability is freely available. Yet there are few if any cases of piercing the corporate veil in which preferred stockholders have been held personally liable for the excess debts of the corporation.[38]

The problem with this argument is that it would be perfectly easy to exempt preferred stock from a rule of unlimited liability. Indeed, a rule of unlimited liability might well generate a net gain for investors in that it would make preferred stock and common stock more distinctly different investments than they currently are. Thus, investors would be better able to assume the level of risk they desire.

Moreover, there is a sense in which the market already allows investors to achieve higher levels of risk. An investor who invests in a diversified portfolio takes little if any risk in connection with the fortunes of individual companies. Thus, an investor who desires to take such risks may do so by choosing not to diversify them away. To be sure, an investor cannot assume the risk of losses beyond the amount invested (other than by buying on margin), but he can easily assume a much greater risk of loss than a fully diversified investor.

These possibilities suggest a third line of argument. A rule of unlimited liability may make trading in individual stocks much riskier than it currently is. Risky trading coupled with investors' incentives to diversify would lead to a thinner market for, and inefficient pricing of, individual stocks, even though the market as a whole might remain quite efficient.

The simple response is that even in the absence of unlimited liability, the rational investor has ample reason to diversify. By diversifying, an investor can eliminate half or more of the risk that goes with investing in single stocks without sacrificing any of the return.[39] Indeed, the logic of diversification has led many investors to invest in mutual funds and other forms of pooled investments. Thus, there is reason to believe that the market for individual stocks has become thinner and thus more volatile in recent years under the current re-

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[37] *See* Eugene Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

[38] Indeed, there are notable cases in which the courts have pierced the corporate veil for the benefit of preferred stock holders. *See, e.g.*, Todd v. Southland Broadcasting Co., 231 F.2d 225 (5th Cir. 1956); Nichols & Co. v. Secretary of Agric. (Deep Rock case), 131 F.2d 651 (1st Cir. 1942). *But see* FDIC v. Ahmodovar, 671 F. Supp. 851 (D.P.R. 1987) (holding that preferred stock was apparently part of scheme to siphon off assets).

[39] *See* LORIE ET AL., *supra* note 23, at 21-24.

gime of limited liability.[40] But there is also reason to believe that thinner markets generate more trading opportunities and that traders are ready to take advantage of them.[41] In short, although a rule of unlimited liability might make it somewhat riskier to trade in single stocks, there is no reason to think that the market will not take care of the situation.

A fourth argument for limited liability—albeit a weak one based largely on historical accident—is that it avoids some of the excesses of partnership law. In some jurisdictions, partners may be held liable for partnership debts even though partnership assets have not been exhausted.[42] Even in jurisdictions that have abandoned the rule, it remains the rule that partners are liable for other partners' unpaid share of excess debts.[43]

There are two answers to this argument. First, the fact that partnership law is flawed is no reason to overcompensate with an equally bad rule for corporations. For example, it would be perfectly easy to set down a rule that says corporate assets must be depleted first.[44] Second, even with limited liability, it is quite possible for a shareholder who is involved in a wrongful act on behalf of the corporation to be held personally liable. And because such liability is joint and several, it is also possible for such a shareholder to be required to pay damages even if the corporation is not.

The argument from historical accident, however, suggests a fifth line of argument based on practical considerations. If unlimited liability were the rule, who would bear the risk of liability after a transfer of the shares and what proportion of the liability would be borne by each shareholder? The selling shareholder could remain liable as under partnership law (and as under corporation law with respect to the ini-

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40 However, there is also evidence that conflicts with this belief. For a thorough discussion of the evidence on volatility, see Richard A. Booth, *The Uncertain Case for Regulating Program Trading*, 1994 COLUM. BUS. L. REV. 15-19.

41 *Id.* at 19-23.

42 *See* James R. Richardson, *Creditors' Rights and the Partnership*, 40 KY. L.J. 243, 254-57 (1951). For an opinion and a dissent outlining the arguments against and for this rule, see Horn's Crane Serv. v. Prior, 152 N.W.2d 421 (Neb. 1967). The revised Uniform Partnership Act requires that partnership assets be exhausted first. UNIF. PARTNERSHIP ACT § 307(c) (1993).

43 *See* UNIF. PARTNERSHIP ACT §§ 18(a), 40(d) (1992). Moreover, and more extreme, partners are jointly and severally liable for partnership obligations in tort, *see id.* §§ 13-15, and many states have extended joint and several liability to all partnership obligations. Partners are jointly and severally liable for all partnership obligations under the revised Uniform Partnership Act. UNIF. PARTNERSHIP ACT § 306 (1993).

44 This flaw of partnership law is one of the prime motivations for the movement to revise the Uniform Partnership Act. *See* UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, American Bar Association, *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121, 143 (1987) (arguing that partnership assets should be exhausted prior to judgment on partner liability).

tial payment for shares) or liability might travel with the shares.[45] Shareholders might be liable only for their pro rata share of excess losses as under the corporate model or they might also be liable for their pro rata share of amounts not paid by other shareholders as under partnership law.[46] And if shareholders are liable only for their pro rata share, would any provision (in the nature of a bond) be required against the possibility of unpaid claims? These issues need to be addressed, and there is no reason to believe that they cannot be answered. Indeed, what is more important than the answer itself is that these questions be answered one way or the other so that investors can plan their affairs.[47]

Perhaps a more serious question is how creditors would collect on such obligations.[48] It may be that the cost of collecting a judgment would be so exorbitant that, even with unlimited liability, creditors would only go after the biggest shareholders. On the other hand, a mechanism is already in place to require investors to post security in connection with their investments. Many investors leave their shares on deposit with their brokers anyway. Moreover, investors who invest on margin—those investors who borrow part of the purchase price—are required to leave their stock on deposit and to maintain a certain level of equity in their accounts.[49] A similar practice is standard in the futures markets where investors are often called on to contribute more cash in order to maintain an open position that has changed adversely in price.[50] In short, there is little reason to believe that such

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45 *See* UNIF. PARTNERSHIP ACT § 36 (1992); MODEL BUSINESS CORP. ACT § 6.22 (1984).

46 *See* UNIF. PARTNERSHIP ACT §§ 18(a), 40(d) (1992); MODEL BUSINESS CORP. ACT § 2.04 (1984). *See generally* Leebron, *supra* note 5, at 1610-11 (outlining possible liability scenarios in the event of unlimited liability). No one has seriously proposed a return to the partnership model of joint and several liability. And no one seems to favor a return to individual liability for contract claims. Even Hansmann and Kraakman vigorously support the idea of limited liability in the context of voluntary creditors. Hansmann, AALS Annual Meeting (1994), *supra* note 12. Yet, a regime of pro rata individual liability would not assure that tort creditors would always be paid in full. There will always be shareholders who are judgment proof, either because they cannot be reached by legal process or because they simply do not have the wealth beyond their stock holdings to pay anything more. Moreover, it may be so expensive for creditors to pursue noninstitutional shareholders that often they simply will forgo any effort at such recovery. This suggests that what Hansmann and Kraakman have in mind (at least in its practical effect) is unlimited liability only for institutional shareholders. *See id.*; *see also infra* note 92.

47 *See, e.g.*, William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898 (1993) (arguing that well-defined property rights provide the most efficient legal system because they facilitate exchange).

48 *See generally* Janet C. Alexander, *Unlimited Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992) (arguing that procedural impediments to collection make unlimited liability impractical); Henry Hansmann & Reinier Kraakman, *A Procedural Focus on Unlimited Shareholder Liability*, 106 HARV. L. REV. 446 (1992) (arguing that procedural barriers should not overwhelm substantive reasons for rejecting limited liability).

49 *See* HAMILTON, *supra* note 1, § 18.16.

50 *Id.* § 20.4.

practical considerations would preclude instituting a system of unlimited shareholder liability.[51]

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[51] As Hansmann and Kraakman recognize, enforcement and collection is the real issue in any regime in which shareholders are to be held liable for the excess losses of corporations in which they hold shares. Hansmann, AALS Annual Meeting (1994), *supra* note 12; Reinier H. Kraakman, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994) [hereinafter Kraakman, AALS Annual Meeting (1994)]. For the obvious problem of foreign stockholders, they propose to limit stock holdings in United States firms to United States residents and those subject to personal jurisdiction by treaty, agreement or otherwise. A more serious problem, which they dub the "high-roller" problem, would arise if risky portions of a firm's business were to be sold off to low net-worth individuals who would have less to lose in the event of bankruptcy. The solution that Hansmann and Kraakman propose here is simply to require some substantial percentage of stock to be held by well-diversified institutional investors or other high net-worth stockholders. Hansmann, AALS Annual Meeting (1994), *supra* note 12; Kraakman, AALS Annual Meeting (1994), *supra*.

Joseph Grundfest and Janet Cooper Alexander have argued, in response to the excuse thesis and against the enforcement mechanisms proposed by Hansmann and Kraakman, that even if one were to impose (or reimpose) unlimited liability, the capital markets would find a way to get limited liability back. *See* Joseph A. Grundfest, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994). Specifically, they argue that the stock of firms entailing significant risk of loss in excess of net worth would flow to investors who cannot be reached by legal process. In other words, excessively risky firms would develop a clientele of investors. (An argument based on a similar clientele effect has been offered as a possible reason why some companies pay dividends and others do not, though it has received mixed reviews in that context. *See* Richard A. Booth, *Junk Bonds, the Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553.) To carry the process a step further, investors who find that their portfolios have become overloaded with excessively risky securities will be able to enter into private contracts with other investors who are underloaded with such securities to swap part of the higher, riskier return for part of the lower, safer return. In the end, nothing will have changed—including the price of the shares. The gist of this argument is why bother to reform a system that will mutate into the old system anyway?

It is unclear, however, that the debate needs to be carried on in the rarified atmosphere of the international market for derivative instruments, inasmuch as the forces of diversification may already have taken care of the problem. As Hansmann and Kraakman point out, the ultimate reason they propose the repeal of limited liability in tort is to harness the forces of the capital markets to monitor for social costs. Thus they expect their rule to have a tendency to cause stock prices to drop, and managers will seek to counteract this tendency by buying insurance, adding to capital, or indeed increasing the safety of their products and operations. *See* Hansmann, AALS Annual Meeting (1994), *supra* note 12; Kraakman, AALS Annual Meeting (1994), *supra*. All of this boils down to one essential idea: unlimited liability will cause undercapitalized companies to increase their capital to the point that they will have provided for the costs—both private and social—for which it is possible to plan.

The commentators seem to have missed the primary significance of undercapitalization however. Undercapitalization means that a company offers its investors above market returns. In other words, if a company were adequately capitalized, its returns would be spread over more investors and would be reduced back to levels consistent with the market rate for the risk involved. Thus, undercapitalized companies tend to attract additional investment precisely because they are undercapitalized.

III. Limited Liability and the Close Corporation

The fundamental problem with the arguments for limited liability advanced up to now is that they focus on publicly traded companies. This is a peculiar focus in that publicly traded corporations are generally thought of as having deep pockets.[52] If limited liability is unimportant in the context of a publicly traded corporation, it must be justified, if at all, with regard to closely held corporations.[53] Yet, it would seem that the problems generated by limited liability are more serious in the context of the closely held corporation. That is, a closely held corporation—and particularly a small start-up operation—is much more likely to become bankrupt and to leave creditors holding the bag.

The answer to this puzzle is that limited liability is not ultimately about limiting liability. Limited liability is a means to an end, not an end in itself. It is a contracting device that has the effect of forcing creditors to bargain for additional security, such as a personal guarantee.

Consider a one-person operation such as a small trucking company. Suppose that an entrepreneur—call him Ace—has the idea to buy a truck and to go into business for himself under the name of Ace Trucking Company. He will be the sole employee of the company. He will do the driving and the maintenance. He will load and unload the truck. He will keep the books, answer the phone, take the orders, and arrange for the advertising. Ace has heard that, by incorporating, he can get limited liability and protect himself against the possibility of bankruptcy.

How much of a benefit is limited liability in the context of a one-person start-up operation such as Ace Trucking Company? Not much. Voluntary creditors, parties who contract with the corporation, will

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52 That is, most plaintiffs prefer to sue large corporations because they are more likely to be able to pay.

53 *See* Presser, *Thwarting the Killing*, *supra* note 12, *passim* (arguing that limited liability was originally implemented as a method of helping the small investor); *see also* Leebron, *supra* note 5, at 1626-36 (arguing that limited liability is important in the close corporation context). It is important to recognize that limited liability is not peculiar to the corporate form. *See* Easterbrook & Fischel, *supra* note 13, at 90. Under common-law agency principles, an agent cannot ordinarily be held liable by virtue of entering into a contract on behalf of a disclosed principal. Restatement (Second) of Agency § 320 (1958). Similarly, one who is employed as a manager by a noncorporate firm such as a partnership is protected to the same extent as one who is hired by a corporation with respect to the liability to involuntary creditors except, of course, to the extent the manager is also an equity investor in the firm. *See* Cary & Eisenberg, *supra* note 1, at 66-67. Moreover, the UPA itself recognizes that one may lend money to a partnership without becoming a partner. Unif. Partnership Act § 7(4) (1992); *see* Martin v. Peyton, 158 N.E. 77 (N.Y. 1927). Similarly, it is quite clear that even a controlling shareholder may lend money to a corporation as a long-term investment. Indeed, a considerable body of tax law distinguishes between ordinary debt and debt that rises to the level of a security. *See, e.g.*, D'Angelo Associates, Inc. v. Commissioner, 70 T.C. 121 (1978).

likely insist on a personal guarantee from the principal. For example, if Ace tries to get a loan to buy a truck, the bank will probably insist that he sign the note in his personal capacity as well as for the corporation.

But what about involuntary creditors, those who are injured by the wrongful acts of the corporation? It is often supposed that involuntary creditors such as tort claimants are the real losers from limited liability, but that is not clearly so.[54] In a one-person operation such as Ace Trucking Company in which the sole shareholder is an active participant in the business of the corporation, the shareholder is personally liable for damages inflicted on innocent bystanders, not because he is a shareholder but because he committed a tort.

The rule is the same as it is in the context of a simple employer and employee relationship. Of course, an employer is liable for damages caused by an employee acting within the scope of employment,[55] and in most cases a plaintiff would choose to pursue the employer because the employer is more likely to be able to pay. But the employer's liability does not preclude the employee's liability.[56] Indeed, employers are entitled to be indemnified by employees to the extent that the employer is required to pay damages owing to the acts of the employee even if they are within the scope of the business.[57] Thus, limited liability affords little protection to the shareholder in a one-person corporation.

Limited liability may afford some protection in a corporation with non-shareholder employees. However, even here the protection afforded is not extensive. To the extent that the owner of the corporation exercises the authority to hire and fire, establishes rules of conduct, and supervises the activities of employees, he may be held liable for negligence in performing those functions.[58] Thus, it is still unclear that limited liability constitutes a subsidy for somewhat larger private

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[54] *See* Leebron, *supra* note 5, at 1600-05 (arguing that insurance may bear part of claimants' costs). Indeed, in a recent study of piercing the corporate veil cases, Robert Thompson found that most such cases involved claims by contract creditors rather than tort creditors. Thompson, *supra* note 3, at 1058 tbl. 9.

[55] RESTATEMENT (SECOND) OF AGENCY § 219 (1958) (indicating circumstances in which a master is liable for the torts of his servants).

[56] *See* WARREN A. SEAVEY, HANDBOOK OF THE LAW OF AGENCY § 129 (1964) (citing cases which indicate that the command of a principal does not excuse an agent from liability for tortious conduct).

[57] RESTATEMENT (SECOND) OF AGENCY § 401 cmt. d (1958).

[58] *See* RESTATEMENT (SECOND) OF AGENCY § 213 (1958). *See generally* Thompson, *Unpacking Limited Liability*, *supra* note 12, *passim* (finding that courts will impose liability for violations of statutes with a "federal purpose" like CERCLA and ERISA on individuals who have an ownership interest in the corporation and exercise some control over the corporation's actions); Christine W. Booth, Note, *Real Persons, Corporate Persons, and Vicarious Liability*, 38 CASE W. RES. L. REV. 453 (1988) (describing and criticizing a growing line of cases that hold corporate officers vicariously liable for damages created by the corporations they govern).

companies. That is, it is unclear that small multi-employee firms are likely to take advantage of limited liability by hiring employees to perform jobs that would otherwise be performed by shareholder-owners.

Moreover, if one considers the factors that a shareholder-manager must consider before deciding to hire an employee and to delegate a portion of the operation, it seems all the more unlikely that limited liability will motivate entrepreneurs to behave differently than they otherwise would. The shareholder-manager must consider all of the familiar agency costs.[59] An owner who hires employees to do some or all of the firm's business cannot ordinarily hope to enjoy as high a rate of return in connection with work handled by employees. Employees simply are not as enthusiastic as owners. Moreover, employees are likely to be less careful than owners. Thus, in order to justify hiring an employee, the prospect of profit must be great enough not only to justify the investment itself but also to overcome the increased prospect of losses.

To be sure, situations may occur in which the prospect of profit is sufficiently large to outweigh the possibility of losses even exceeding the net worth of the business. A business opportunity may make economic sense even though it carries with it the possibility of losses that exceed the amount of the investment. All that matters is that the prospect of profit exceed the prospect of loss (as adjusted for risk).[60] Indeed, one of the usual arguments for limited liability is that such projects may be foregone. Critics of limited liability, on the other hand, argue precisely the opposite: that with limited liability, shareholders may be tempted to undertake such projects because the risk of loss can be foisted on third-party creditors.

Both sides are wrong. It is highly unlikely that the owner of a small business would take such risks even with the protection of limited liability. In most cases, the owner of a small business has a substantial proportion of his wealth tied up in the business. In other words, small business owners tend to be undiversified (or at least underdiversified). Hence, it is quite unlikely that a small business owner will "bet the farm" on a risky opportunity that carries the prospect of losses exceeding the value of the business even if the odds indicate that the bet makes economic sense.[61]

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[59] *See* KLEIN & COFFEE, *supra* note 1, at 355-61. The classic work on agency costs is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[60] *See* KLEIN & COFFEE, *supra* note 1, at 256-58 (indicating the attractiveness of an investment should be determined by adding the products of every possible return on an investment and the chance of that outcome occurring); *See supra* text accompanying notes 26-27.

[61] *See* Leebron, *supra* note 5, at 1626-36 (discussing the amount invested by small business owners and their disincentives to take risks). Interestingly, the involvement of diversified venture capitalists may have the effect of increasing the risk-taking tendency of small businesses who resort to such sources to raise capital. *See* George W. Dent, Jr., *Venture Capital and the*

In short, limited liability is unlikely to cause a small business to undertake risky ventures, at least until such a time as the controlling shareholders are capable of diversifying their investment. Therefore, the ill effects of limited liability are not likely to set in until the company is large enough to be publicly traded. Even then, the fortunes of its managers are likely to be so thoroughly intertwined with the performance of the company's stock, whether because of a large ownership stake or compensation tied to stock performance, that they will be distinctly more risk averse on behalf of the corporation than a diversified shareholder would be.[62]

IV. Limited Liability and Barriers to Contract

One might say that the argument up to this point proves too much. If limited liability has no impact then who needs it? The answer is that the central justification for limited liability lies with voluntary creditors. Simply stated, limited liability is a contracting device; it is a means of shifting the burden to negotiate for personal liability to creditors. In the absence of limited liability, it would be up to small business owners to negotiate for any limitation on their personal liability. But with limited liability, creditors must negotiate for personal exposure of business owners. In other words, limited liability eliminates a barrier to contracting by putting the burden on the creditor to protect himself rather than forcing the entrepreneur to specify the limits of liability.[63]

Although this may seem to be an insignificant shift in bargaining power, it is in fact important. If the presumption is that small business owners are personally liable for the debts of their business, creditors are unlikely to agree to anything less. As a general rule, creditors have a much more powerful bargaining position than small business owners.[64] The small business owner who attempts to negotiate for some limitation on liability is unlikely to get very far.

Standing alone, unequal bargaining power is hardly a justification for limited liability. Bargaining power, like other assets, is valuable and should not lightly be reallocated. However, there is more to the story. If small business owners cannot ordinarily negotiate for limitations on personal liability, they are effectively precluded from decid-

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Future of Corporate Finance, 70 Wash. U. L.Q. 1029, 1034 (1992) (arguing that those companies that use venture capital are often involved in exceedingly risky ventures).

62 *See* Alfred Rappaport, Creating Shareholder Value 6-9 (1986) (identifying four factors that induce the management of a public corporation to pursue shareholder objectives: ownership of stock, compensation tied to shareholder performance, the threat of takeovers, and the market for corporate executives).

63 *See* Posner, *supra* note 8, § 3.5 (discussing the consequences of an initial assignment of rights in the presence of transaction costs).

64 *See, e.g.*, Easterbrook & Fischel, *supra* note 13, at 98-101.

ing how much of their wealth to put at risk for a contemplated business venture. In the absence of limited liability, they must risk all or nothing. The notion that a small business owner should be prevented from planning how much capital to put at risk is so absurd that it hardly needs to be argued down. Yet that is the practical result of a rule of unlimited liability.[65]

Moreover, many small business owners fail to think about how much they want to put at risk in a given venture. Limited liability relieves them of the need to plan. It forces creditors to undertake to educate small business owners about the risks of business. Thus, one of the side benefits of limited liability is that creditors must raise the issue of risk.

Admittedly, information about risk and the risk-return trade-off is also a valuable asset. It might be argued that creditors should not be forced to share it with debtors for free. However, creditors are perfectly free to charge for the service and presumably do so, at least implicitly. Moreover, it is a bit peculiar to object to a bargaining mechanism designed to induce the sharing of information that would likely be shared anyway given the classic assumption that a competitive market involves fully informed actors. In addition, it is often cheaper for creditors to determine how much security is necessary than it is for debtors to do so.[66] Small business owners are often not in a good position to assess business risk. Under a regime of limited liability, potential creditors bear the burden to specify how much security—or capital—is required and thus must implicitly share information regarding business practices that may be vital to the entrepreneur's success. Sharing of information does not necessarily cost the creditor, given that successful debtors mean better business for creditors.

Finally, a rule of unlimited liability would constitute a windfall to creditors. Creditors can diversify their investments like other investors. They typically extend credit to an array of debtors. For a well-diversified creditor, the relative cost of any default is slight. Indeed, such a creditor expects a certain number of defaults and has built the cost of absorbing them into the cost of credit.

The ability of creditors to diversify suggests that, in the absence of barriers to contracting, debtors would pay creditors to bear the risk of default (or at least the risk of good faith default), and creditors would be largely indifferent to bearing such a risk.[67] In other words, the creditor is in a better position to bear the cost of default than is the debtor. But in the absence of limited liability, creditors have no

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65 *See* Presser, AALS Annual Meeting (1994), *supra* note 12.

66 POSNER, *supra* note 8, § 14.3.

67 *Id.*

incentive to bargain with debtors over the benefits of diversification. Admittedly, competition may well drive creditors to charge a rate of interest as low as the rate of diversified lending anyway. If so, nothing would seem to be lost by formally shifting the burden to creditors to seek shareholder guarantees through a rule of limited liability. And something might be gained if credit markets under a rule of unlimited liability were not in fact competitive.

The argument made here for limited liability is much the same as one advanced for employer liability under *respondeat superior*.[68] Employers as a class tend to be better able to bear the cost of accidents occurring within the scope of business because they are able to spread the cost over time and over a number of employees. An employee with the choice of self-insuring or accepting slightly lower wages will ordinarily choose lower wages even if her net income over the long haul is the same. Employees are risk averse like other economic actors.[69] Other things equal, they prefer steady and predictable income over the same amount of income received in unpredictable amounts. Employers who have a number of employees are largely indifferent between paying higher wages to self-insuring employees and paying lower wages while assuming the responsibility to pay for accidents. In the real world, of course, accidents are not perfectly predictable even over large groups of employees. But the incentive to bargain remains strong, even if employers and employees must adjust for some level of uncertainty. Indeed, the incentive to bargain may be even greater with uncertainty because employers will often be able to assess risks more accurately than will scattered employees who realize they do not appreciate the full scope of the business' operations.[70]

The ultimate rationale for employee liability is that it overcomes the perverse incentives of employer and employee not to enter a bargain even though the bargain makes economic sense. If the employee is judgment proof and cannot pay damages when they arise, the employer and the employee can increase their collective wealth by leav-

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[68] *See* Kornhauser, *supra* note 9, *passim* (distinguishing between vicarious and non-vicarious liability); Sykes, *Boundaries*, *supra* note 10, *passim* (discussing the economic theory of contracting in principal-agent relationships).

[69] *See* KLEIN & COFFEE, *supra* note 1, at 233-34 (describing "the overwhelming majority of people" as risk averse in their major investment decisions). I once proved this point to myself by accepting an employer's offer to issue my paychecks over 10 months rather than 12 months. I switched back to the conventional system after one summer without pay.

[70] *See* William O. Douglas, *Vicarious Liability and the Administration of Risk*, 38 YALE L.J. 584, 585-94 (1929) (discussing "entrepreneur theory" and the idea of adding liability as another business cost); Young B. Smith, *Frolic and Detour*, 23 COLUM. L. REV. 444 (1923) (discussing risk assessment by employers in employee-agent liability). *See generally* Calabresi, *supra* note 9, *passim* (arguing that resource allocation allows employers to incorporate all costs); Kornhauser, *supra* note 9, *passim* (arguing that in some cases assignment of liability should be to employers); Sykes, *Boundaries*, *supra* note 10, *passim* (combining the economic theory of incentive contracting with an economic interpretation of causation requirements in tort law).

ing liability for accidents with the employee and walking away from the bill.[71] In other words, the employer would be able to pay higher wages and the supposedly self-insuring employee would not be required to pay the damages.[72] Such strategizing often leads employers to hire uninsured independent contractors to perform hazardous tasks and has led the courts to develop exceptions to the general rule that one who hires an independent contractor will not be held vicariously liable.[73]

The analogy between vicarious liability for employers and limited liability for investors is not perfect. Obviously, creditors do not bank on the insolvency of those to whom they extend credit. They may, however, effectively reduce a borrower's "wages" while attempting to avoid paying for his "accidents." That is, in the absence of limited liability, creditors may build into the cost of credit compensation for predictable, though uncontrollable, insolvencies and then seek to hold investors personally liable anyway. Admittedly, creditors may be able to extract excessive guarantees even with a rule of limited liability. But with limited liability, small business owners have at least a fighting chance.[74]

One final justification for limited liability is that it separates the risk of foreseeable events from the risk of random events. In other words, limited liability may serve to protect investors from liability for extraordinary losses. A shareholder who is actively involved in management will remain largely exposed to liability for accidents that are within his control to prevent. But to the extent that the corporation is held liable for events that are unforeseeable or uncontrollable, society is no worse off than it would have been. On the other hand, if the corporation knowingly foisted risks on third parties, the shareholders may well be liable anyway for all the reasons that shareholders of small companies are often liable, that is, for all the reasons that the courts will pierce the corporate veil. Still, to the extent that the corpo-

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71 *See* Sykes, *Boundaries*, *supra* note 10, at 567-69 (discussing negotiation for assumption of liability between employer and employee); Sykes, *Economics*, *supra* note 10, at 1241-42 (arguing that the principal and agent can work together to use the agent's insolvency to their mutual advantage in liability cases).

72 How the gain is split between the two is unimportant. *See* Sykes, *Boundaries*, *supra* note 10, at 567-69; Sykes, *Economics*, *supra* note 10, at 1241-42; *see also* EASTERBROOK & FISCHEL, *supra* note 13, at 109-24.

73 *See, e.g.*, Becker v. Interstate Properties, 569 F.2d 1203 (3d Cir. 1977), *cert. denied*, 436 U.S. 406 (1978) (holding that large well-capitalized construction companies that employ underinsured subcontractors can be liable for injuries to subcontractors' employees).

74 It has been suggested that in most cases creditors will in fact insist on an unlimited personal guarantee. Even if that is so, a business owner will likely be able to limit the time over which the guarantee lasts. It is difficult to imagine a potential creditor who in good faith is otherwise willing to do business with the potential debtor, but would not agree to some limitation of liability, albeit in extreme circumstances.

ration may be held liable without negligence (as in a products liability case), a sole shareholder may be insulated from personal liability.[75]

V. Piercing the Corporate Veil

Limited liability is not costless. There is a moral hazard.[76] With limited liability, some business people will be tempted to cheat their creditors by obtaining credit when they know they are unlikely to be able to repay or to cheat their customers and innocent third parties by knowingly selling dangerous products and services without adequate capital or insurance. Thus, there must be limits on limited liability. Voluntary creditors are free to seek personal guarantees and other protection. Even when they do not do so, the remedy of piercing the corporate veil remains for them and for involuntary creditors.[77]

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75 Although it is difficult to justify in any principled way, theories of enterprise liability are seldom applied to individuals. *See* Prosser & Keeton, *supra* note 6, § 100. Nevertheless, it is individual owners and managers who ultimately benefit from the profits generated. Of course, limited liability pre-dates such developments as products liability. Thus, it is a bit disingenuous to argue that such doctrines provide any explanation for why we have limited liability.

As more than one commentator has argued, limited liability seems to impose business risks randomly on third parties, which is peculiar in a world in which insurance is readily available. Hansmann, AALS Annual Meeting (1994), *supra* note 12; Theresa A. Gabaldon, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994). In fact, the argument that we should require businesses to buy adequate insurance may go far to explain why we have limited liability. Just how much insurance is enough? One can always concoct a situation in which a given amount of insurance is insufficient to cover the cost. Does that mean that the company is underinsured?—not unless the rule is to be that every company must be infinitely insured. By the same token, the fact that a company turns out not to have enough wealth to pay off all of its tort claimants does not necessarily mean that the company was undercapitalized. In short, those who argue that we should require adequate insurance, by virtue of undertaking to determine what is adequate, endorse some ultimate limit on liability, at least by implication.

76 *See* Easterbrook & Fischel, *supra* note 13, at 103-17.

77 On first impression, it is curious that the courts would be as willing as they seem to be to ignore the mandate of limited liability for corporate shareholders (which has now been reduced to statute in most if not all jurisdictions) and order piercing of the corporate veil. On reflection, however, piercing the corporate veil may be a bit of a misnomer, and there may be nothing particularly inconsistent with statutory law about it. After all, a corporation is a person in the eyes of the law. And as a person, it is entirely possible for another person, say a controlling shareholder, to make the corporate person an agent. Thus, piercing the corporate veil may be nothing more than a special case of employer liability. *See infra* text accompanying note 96. This may well explain why piercing the corporate veil seems often to be treated as outside the mainstream of corporation law. *See* Thompson, AALS Annual Meeting (1994), *supra* note 12.

Robert Thompson has noted that piercing the corporate veil is the flip side of the de facto corporation doctrine—in which business entities may be accorded the status of corporateness even though the formalities of incorporation have not been observed. *Id.* In other words, declaring a firm to be a de facto corporation is the equivalent of granting it limited liability or the reverse of piercing the corporate veil. While one may also view the de facto corporation doctrine as in contravention of statutory law, it is also possible to see it as a vestige of the common law corporation. That is, modern corporation law may be viewed as in the nature of a safe harbor statute. In any event, corporation law has lightened up considerably on the subject of the

But the fact that a judicial remedy is available begs the question. The question is *when* should it be available? The law has never been very clear about what is the standard for piercing the corporate veil. Some courts have required proof approaching fraud.[78] Others have required little more than a showing that the corporation was undercapitalized.[79]

Clearly, the law regarding piercing the corporate veil should be consistent with the reasons for granting limited liability. If the primary (and perhaps only) reason for limited liability is to eliminate a barrier to contracting and not to protect or subsidize entrepreneurs, the test for piercing should reflect that goal. Thus, creditors should be left to whatever protection they have negotiated, and undercapitalization should never be grounds for piercing the corporate veil unless the corporation's capitalization has been positively misrepresented.[80] Furthermore, if the primary purpose of limited liability is eliminating barriers to contract, limited liability should not protect business owners *beyond* the deal they cut with their creditors. The problem is that the terms of the deal are often not spelled out in complete detail.

For example, even if the creditor takes the utmost care to assure that the debtor invests sufficient capital at the outset, the creditor often fails to exact assurances that the business will *remain* adequately

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de facto corporation. While the old Model Business Corporation Act declared the principals in such a firm strictly liable (jointly and severally), the Revised Model Business Corporation Act deems the principals liable only if they did business as a corporation knowing that none had been formed. *Compare* MODEL BUSINESS CORP. ACT § 146 (1969) *with* MODEL BUSINESS CORP. ACT § 2.04 (1984).

78 *See, e.g.*, Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966).

79 *See, e.g.*, Minton v. Cavaney, 364 P.2d 473 (Cal. 1961). Robert Thompson, who recently conducted an empirical study of 1,600 piercing cases, has declared that the law governing such decisions is as confused as it ever has been even though such cases may be among the most commonly litigated in corporation law. Thompson, AALS Annual Meeting (1994), *supra* note 12. Thompson professes surprise that we continue to allow judges to decide such cases after the fact on the basis of ill-defined principles. *Id.* (For the results of Thompson's study, see Thompson, *supra* note 3, *passim*.) Fred McChesney has concurred, though he asserts that statistical evidence indicates there are a limited number of factors that are highly predictive of when the courts will grant de facto corporation status. Fred S. McChesney, Remarks at the Annual Meeting of the Association of American Law Schools Section on Business Associations (Jan. 7, 1994). He suggests that much of the confusion over the law of piercing the corporate veil may be attributable to the fact that legal scholars are generally not willing to engage in empirical research. *Id.* Leaving aside the question of whether piercing doctrine may accurately be seen as part of corporation law (not that it is clear that it makes much difference), the value of statistics is unclear in this connection. If piercing the corporate veil is seen as an ex post remedy for yet-to-be-seen ways of cheating creditors, then it would be contradictory to suggest that the courts should limit themselves to declaring the remedy only in situations in which they have declared the remedy in the past. To do so would be rather like a fashion designer basing next season's clothing on a public opinion poll about current fashions.

80 *See* William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 883-90 (1982) (arguing that undercapitalization alone is not sufficient to pierce the corporate veil).

capitalized.[81] Corporation law provides no assurances in this regard. Many jurisdictions have eliminated the meager (and unreliable) security provided by par value and stated capital requirements.[82] All that remains are the provisions precluding distributions that are in excess of net assets or that render the corporation unable to pay its bills as they become due together with the general protection of fraudulent conveyance law (which are essentially to the same effect).[83] The question becomes whether creditors should have any protection beyond those afforded by these statutes.

The simple answer is that, if there is a statute, the courts have no business adding to the standard set down by the legislature.[84] On the other hand, and speaking quite roughly, the typical statutes apply only in situations in which the corporation has either made an illegal distribution or has parted with its property for inadequate consideration and then only to the extent that the distribution or other disposition was illegal.[85] They afford no relief to the creditor who is damaged by negligent or reckless management of the debtor business.[86]

One of the creditor's most important forms of security is the assurance that the owner has every incentive to make the business profitable because the owner has significant assets at risk.[87] Thus, it might be argued that creditors should be seen as third-party beneficiaries of the duty of care management owes to its shareholders.[88] For the most part, creditors who have asserted such claims have failed to carry the day. The courts have rejected attempts to pierce the corporate veil on the grounds that the shareholders milked the corporation of all its profits or ran it in such a way as to preclude the possibility of its making a profit.[89]

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81 *See* CLARK, *supra* note 1, §§ 2.1-2.2, 2.5-2.6; Robert C. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977) (discussing obligations of corporations to debtors under fraudulent conveyance law).

82 *See* MODEL BUSINESS CORP. ACT § 6.21 cmt. (1984).

83 *See* Clark, *supra* note 81, *passim*.

84 *See, e.g.*, Walkovszky v. Carlton, 223 N.E.2d 6, 9 (N.Y. 1966) (arguing that courts cannot provide additional remedies when the legislature fails to require sufficient liability insurance).

85 *See* CLARK, *supra* note 1, §§ 2.1-2.2.

86 *See* Hackney & Benson, *supra* note 80, at 851-54 (observing that state laws require only minimal capitalization).

87 *See* KLEIN & COFFEE, *supra* note 1, at 53-62 (considering why lenders want their borrowers to have an equity cushion).

88 *See* Bartle v. Home Owners Coop., 127 N.E.2d 832 (N.Y. 1955) (exemplifying a case in which creditors were not unjustly enriched when corporate shareholders' interests were at stake).

89 *See* Kamin v. American Express Co., 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976) (arguing that mere bad business decisions are not enough to create liability). *But see* Joy v. North, 692 F.2d 880 (2d Cir. 1982) (indicating failure to run a business in a profitable manner may provide a cause of action); Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940) (holding directors liable for their ultra vires acts that used corporate earnings).

Though the third-party beneficiary argument has some appeal, the actions of management should not be judged according to their consistency with creditor concerns, no matter how broadly interpreted.[90] An inherent conflict of interest exists between the two groups.[91] Creditors enjoy only a fixed return. Shareholders are entitled to a residual return, everything that is left over after fixed claims are paid. This conflict of interest can lead shareholders to prefer riskier strategies than creditors would like. Creditors are only concerned that they be paid the fixed amount they are owed. Shareholders, and especially diversified shareholders, are more interested in maximizing their return, even if it means a somewhat enhanced risk that creditors will not be paid. Thus, creditors will often argue that business decisions that were consistent with shareholder interests were nonetheless damaging to creditor interests.[92]

At least a few cases exist in which the courts have held directors of insolvent corporations liable for mismanagement—the practical effect of which is to allow the creditors to recover.[93] Thus, creditors do seem to enjoy some residual benefit from the duty of care, but only to the extent that shareholders would benefit. In other words, a creditor may ultimately recover through the mechanism of bankruptcy proceedings if a corporation is so badly managed that a shareholder would have had a cause of action. But that is quite different from saying that creditors are owed a fiduciary duty.

Finally, what should be the rule regarding involuntary creditors? Generally speaking, involuntary creditors are less worrisome than voluntary creditors because limited liability affords no protection to participants in tortious acts. Moreover, voluntary creditors will help

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90 Indeed, most states prohibit the assertion of derivative claims on behalf of the corporation by creditors. *See, e.g.*, MODEL BUSINESS CORP. ACT § 7.41 cmt. (1984).

91 *See* KLEIN & COFFEE, *supra* note 1, at 255-63 (indicating three major areas of management-creditor conflict are (i) the choice of the riskiness of investments; (ii) the decision to invest additional capital; and (iii) the decision whether to pay dividends); *see also* Easterbrook & Fischel, *supra* note 13, at 103-17 (noting that creditors face the risk of nonpayment and the risk that equity holders will increase risk of business); Leebron, *supra* note 5, at 1587-95 (outlining conflicts between shareholders and creditors).

92 The Hansmann-Kraakman proposal, *see supra* note 51, may be viewed as a natural outgrowth of the increasing dominance of institutional investors. Because institutional investors tend to be extremely well-diversified (while individual investors tend not to be), unlimited liability may now be "affordable" because the cost falls primarily on institutional investors (whereas it would have created unacceptable risks for individual investors). Moreover, because well-diversified institutional investors may cause the companies they "passively control" to assume more risk, unlimited liability may be seen as a sort of quid pro quo for the higher returns such investors enjoy. On the other hand, to the extent that only institutional investors would be held liable in practice under an unlimited liability regime, there is a danger that they will end up paying twice for the same losses. *See supra* note 46.

93 *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) (holding directors liable to third party for damages where directors were uninformed).

assure that debtor companies are sufficiently capitalized for tort claims because judgment creditors are generally paid ahead of other creditors.[94]

Nevertheless, limited liability may be used to insulate investors from losses from activities that may be profitable in the short run, but are likely to bankrupt the business in the end. In such cases, the law should treat business owners in the same fashion as it handles principals who hire independent contractors to engage in ultrahazardous activities.[95] In that situation, the law ignores the formalities of the relationship to the extent that an independent contractor is hired because the independent contractor is insolvent.

The same result should obtain when the corporate form is used to insulate business owners from known risks. And for the most part it seems that it does. As Judge Cardozo pointed out long ago, the law of piercing the corporate veil is nothing more than the law of *respondeat superior* as applied to a corporation that has assumed the role of an employee of its shareholders.[96] Admittedly, this is not a completely satisfying answer to the question of when to pierce the corporate veil because the law of *respondeat superior* is itself notoriously ephemeral. Nevertheless, it is a step in the right direction to know why we have limited liability and how it can be abused.

VI. Conclusion

The ready availability of limited liability through the corporate form may seem to be a curious institution in an age of expanding enterprise liability based on notions of resource allocation. It is not. Indeed, limited liability is ultimately justified by many of the same considerations that justify enterprise liability. The primary purpose of limited liability is to eliminate an important barrier to contracting between corporations and their creditors. When viewed in this light, it is much easier to understand the mysterious doctrine of piercing the corporate veil.

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[94] *See* U.C.C. § 9-104(h) (1990) (stating that judgment creditors are not governed by priorities set forth in U.C.C.). To be sure, tort claimants who have not reduced their claims to judgment may be forced to share with unsecured creditors and thus paid last (if at all). The (empirical) question is whether most tort claimants are able to reduce their claims to judgment before secured financial creditors are able to have their claims paid. Thus, the question would seem to be one primarily of bankruptcy law and procedure.

[95] Restatement (Second) of Torts § 416 (1965).

[96] Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 60 (1926). Indeed, there may be few if any cases of piercing the corporate veil that cannot be explained as instances of vicarious liability of employer-shareholders for the acts of employee-corporations.