This week we look at some fundamental attributes of the US corporation – part of its DNA -- that undermine the corporation’s sustainability. These attributes impede the corporation’s ability to serve as an instrument to provide for current social needs while also assuring that future generations can meet their needs. Today’s readings focus on the first such attribute of the corporation: the rule that contributes to externalization of firm costs -- limited liability.

The first reading from the student book (which you had read from last week) gives you an introduction to corporate limited liability in the United States. You’ll find it interesting to learn about the nature and history of limited liability, as well as the justifications for protecting shareholders from business losses beyond their investment. You’ll want to consider how limited liability changes the calculus for business managers when taking business risks. You’ll also want to consider whether and how the exceptions to limited liability, especially “piercing the corporate veil,” change this calculus.

The next reading is from an academic study of almost 3,000 cases in which corporate creditors sought to pierce the corporate veil and make shareholders liable for corporate losses. The article is interesting at many levels. First, it’s remarkable that somebody would read and statistically analyze 3,000 court decisions to find judicial patterns and tendencies – a new kind of “common law” analysis! Second, you’ll find it interesting that fraud and misrepresentation have been important factors in whether to impose shareholder liability, and you should ask why. Third, you’ll notice that piercing has never happened in US public corporations – ever!

The final reading is from another law review article, this one by two Harvard law professors who propose that shareholders in US corporations, including public corporations, should pay when the corporation is unable to pay the claims of corporation’s involuntary creditors – such as people hurt by a massive oil spill. You will want to consider whether the proposal is feasible. You will also want to consider why the proposal has not gained any support.

Readings:
- E&E 28 (Limited Liability)
- Oh, Veil Piercing (2010)
- Hansmann & Kraakman, Unlimited Shareholder Liability (1991)
Rule of Limited Liability

Limited liability is a fundamental aspect of the corporation. It allows corporate participants to separate business assets from personal assets—leaving corporate creditors with recourse only against the assets of the corporation. It thus creates a nonrecourse relationship that externalizes the risk of business failure by moving it from insiders to outsiders.

Limited liability is not absolute, and corporate law gives corporate creditors a variety of protections against insider opportunism. Other chapters in this part describe these protections:

- liability of promoters during the incorporation process (Chapter 29)
- corporate liability based on the actions of corporate agents (Chapter 30)
- limitations on corporate distributions to shareholders (Chapter 31)
- protection of creditors under the judicial doctrine of “piercing the corporate veil,” which disregards limited liability to impose personal liability on corporate shareholders and managers in special circumstances (Chapter 32)
- liability of corporate insiders under noncorporate regulatory schemes (Chapter 33)

This chapter explains limited liability (§28.1) and describes the history of corporate limited liability and its recent extension to other business organizations (§28.2).

§28.1 CORPORATE LIMITED LIABILITY

The modern corporation separates business assets from the personal assets of corporate participants. This means a corporate participant’s liability for corporate obligations is limited to that person’s investment in the corporation. By statute, a shareholder (equity investor) is not liable for corporate obligations beyond her investment. MBCA §6.22; Del. GCL §102(b)(6). The rule also applies to other corporate participants—such as lenders (debt investors), managers, and employees. In the normal course, none is liable for corporate obligations. Courts recognize limited liability even if it is the motivating reason for incorporation.

Limited liability is a default rule; it applies absent an agreement otherwise. Outsiders can demand that insiders assume contractual responsibility for corporate obligations. For example, bank lenders often require personal guarantees from shareholders before extending credit to closely held corporations. And suppliers sometimes insist on officers signing corporate contracts both in the corporate name and personally. But absent an assumption of personal liability, the rule is that corporate participants are not personally liable for corporate obligations. That is, outsiders are assumed to accept a nonrecourse relationship with corporate insiders.
Reasons for Limited Liability

Why the rule of limited liability? There are a number of explanations—

- **Capital formation.** The corporation, by limiting losses to the amount invested, allows investors to finance a business without risking their other assets. It reduces the need for investors to investigate and monitor whether the business will expose them to personal liability. Limited liability encourages investors to choose to invest in desirable, though risky, enterprises.

- **Management risk taking.** Without the promise of limited liability, shareholders might discourage and managers might be reluctant to undertake high-risk projects, even when the project promises net positive returns (expected gains exceed expected losses). Limited liability encourages desirable risk taking.

- **Investment diversification.** Limited liability permits investors to invest in many businesses—to diversify—without exposing their other assets to unlimited liability with each new investment. Diversification stimulates capital formation since it is often easier to raise capital through many small investments than from only a few large ones. Diversification spreads out investment risk, further reducing the need for investors to investigate and monitor the business in which they invest. Limited liability thus reduces the costs of investing.

- **Trading on stock markets.** Stock markets are important for modern business. They make capital formation easier, reveal enterprise value through market prices, and provide a place to buy corporate control. How is limited liability related to stock trading? If limited liability did not exist, wealthy investors (with more to lose and more likely to be sued) would assign a lower value to identical securities than would poor investors (with less to lose and less likely to be sued). That is, the greater liability risk would reduce the securities’ net value for the wealthy investors, but not poor investors. With limited liability, however, all corporate investors are shielded equally, and securities valuation does not depend on their individual willingness to risk other assets. That is, limited liability renders securities fungible regardless of who owns them and thus makes possible public stock trading.

Allocation of Risk

Why would those who voluntarily deal with the corporation, such as contract creditors, accept the rule that their only recourse is to the business assets? For voluntary creditors, such as lenders and trade creditors, the default rule of limited liability may well represent what these parties would have agreed to anyway. These outsiders (who extend credit to many businesses) generally are more diversified and better able to bear the risks of business failure. To reflect this risk, voluntary creditors often increase the cost of credit to incorporated businesses or demand contractual stipulations (such as debt limits or limits on distributions to insiders) to bolster the business’s creditworthiness.

But remember that limited liability also allocates the risk of business failure to involuntary creditors—that is, outsiders who did not choose to become a creditor, such as tort creditors. Why should limited liability be the default rule for those who did not choose to bear the risk of the
corporation’s insolvency? For involuntary creditors, the case for limited liability is more tenuous. Many corporate creditors have no opportunity to demand higher returns to compensate for the risks they assume. Realistically, these creditors cannot protect themselves by negotiating contractual protections before dealing with the corporation. Are these outsiders better risk bearers than corporate insiders? Some commentators, who urge a dismantling of limited liability for involuntary creditors, say no. They point out that insiders, shielded by limited liability, do not internalize the costs of accidents or excessive risk taking. They assert insiders (acting for shareholders) are in a better position to have the corporation purchase insurance and avoid high-risk business strategies. See Hansmann & Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 Yale L.J. 1879 (1991). Critics of this idea wonder whether a rule of pro rata vicarious liability in public corporations would be administrable or enforceable. Others imagine ways in which investors might avoid direct shareholder status, while still retaining a financial interest in the corporation’s performance.

Despite this arguably inefficient and unfair allocation of risk, limited liability remains a centerpiece of the U.S. capitalist system that encourages entrepreneurialism and widespread public investment. That is, there appears to be a broad consensus that the benefits of limited liability outweigh its costs. In addition, there are also questions (particularly in public corporations) whether a scheme of shareholder liability would actually discourage untoward corporate risk taking. Without a clearly better alternative, limited liability remains the rule.

Choice of Law

Corporate limited liability, and its exceptions, are relatively uniform across U.S. jurisdictions. Nonetheless, the issue sometimes arises: What state law provides the rules that govern insiders’ liability to outsiders? There is no clear consensus. Generally, courts assume that the rule of limited liability and statutory limitations on corporate distributions are internal affairs governed by the law of the state of incorporation. This logic has been extended to piercing cases, in which creditors seek to have the court disregard the rule of limited liability. See Fletcher v. Atex, 68 F.3d 1451 (2d Cir. 1995) (interpreting New York choice-of-law rule in case of parent-subsidiary piercing according to law of state of incorporation).

This approach, borrowed from the “internal affairs doctrine” for disputes among shareholders and managers (see §3.2.1), makes sense in contracts cases in which creditors dissatisfied with the incorporating state’s default rules on limited liability can negotiate different terms. In tort cases, however, it can be argued that the state law with the most significant relationship to the parties and the occurrence should balance the policies of limited liability and tort compensation and deterrence. See Yoder v. Honeywell, Inc., 104 F.3d 1215 (10th Cir. 1997) (interpreting New York choice-of-law rule in case of parent-subsidiary piercing under law of place of injury). Tort victims do not choose the corporation with which they deal, and the choice by shareholders and managers of a particular state of incorporation should not be binding on them.

§28.2 HISTORY OF LIMITED LIABILITY

Corporate limited liability is not inherent to the corporation. Originally, corporate law in the United States did not create limited liability for corporate shareholders. In the earliest U.S. corporations, shareholders were assumed to be liable for corporate obligations on the same basis as partners. But
as shareholder investment became more widespread, judicial attitudes shifted and corporate statutes in the mid-1800s began to provide various limits on shareholder liability.

At first, the corporate form and limited liability were reserved for larger businesses that obtained special legislative charters. Limited liability encouraged investment by passive investors unwilling to bear the monitoring burden implicit in a full-liability partnership. But in early U.S. corporations limited liability was not always complete. Often shareholders remained liable for additional capital assessments (or calls) equal to a stated multiple of their original investment. For example, between the Civil War and the era of deposit insurance in the 1930s, bank shareholders were liable to pay up to the par value of their shares to satisfy outstanding claims if the bank failed. This regime of double liability assured bank depositors an additional capital cushion and led shareholders to insist that bank managers exercise prudent banking practices and quickly liquidate a troubled bank. Macey & Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 Wake Forest L. Rev. 31 (1992) (finding that 50.8 percent of shareholder assessments ultimately were paid).

By the end of the nineteenth century, however, limited liability was the rule for nonfinancial companies incorporated under general incorporation statutes. Although California applied a rule of pro rata liability for shareholders during a period of dramatic state growth (from 1849 to 1931), complete limited liability for corporate shareholders was the norm for twentieth-century U.S. corporations. As a partial substitute for recourse against corporate shareholders, many corporate statutes imposed minimum capital requirements before a corporation could start business. But these minima were not significant ($500 to $1,000) and today have been abandoned.

**Limited Liability Entities**

Even more interesting has been the recent U.S. history of limited liability for noncorporate entities. As recently as the 1980s, U.S. business organizations fell into three categories—

- corporations for big businesses managed by professional executives and funded by public investors who enjoyed immunity from personal liability
- partnerships for small (often informal) businesses managed by partners who assumed personal liability for business obligations
- hybrid “incorporated partnerships” (such as closely held corporations and limited partnerships) that combined corporate-style limited liability and partnership-style management.

Limited liability was largely the province of the corporation. But in 1979 the Wyoming legislature approved a *limited liability company* statute. The LLC invention had been born of necessity. An oil and gas exploration venture, making plans to drill for oil in Wyoming, wanted an investment vehicle that combined (1) limited liability for venture participants, who included *active, foreign investors*, and (2) flow-through tax treatment. Neither a partnership nor a corporation worked. (Recall that a Subchapter S corporation cannot have non-U.S. investors—see §2.3.3.) The company had had earlier experience with projects organized as Panamanian “sociedades de responsabilidad limitada” (translated “companies of limited liability”), and its lawyers drafted a bill for the Wyoming legislature to accommodate the international investors. When in 1988 the IRS clarified
that state LLC statutes following the Wyoming formula would be classified as flow-through partnerships, the LLC revolution exploded. Within eight years, every state offered an LLC choice.

Joining the LLC on the “alphabet soup” menu of state-offered business organizations has been a slew of other limited liability entities. Today, depending on the state, a business can be formed as a limited liability partnership (LLP), a limited liability limited partnership (LLLP), a limited partnership association (LPA), or a professional limited liability company (PLLP). In each case, the rights and duties of the participants (including their liability to outsiders) arise conceptually from their agreement. For some, this revolution has signaled the death of liability. See LoPucki, The Death of Liability, 106 Yale L.J. 1 (1996) (arguing that secured-debt and ownership structures have permitted businesses to avoid liability). Others have pointed out that today no well-structured business need risk exposing its participants to personal liability.

Nonetheless, limited liability is not complete. The limited liability statutes uniformly contain limitations on payments to owners, modeled on the corporate restrictions on dividends and other distributions to shareholders. See §31.2. Many statutes contemplate the possibility in appropriate cases that courts may “pierce the entity veil,” a concept built on corporate law principles. See §32.1. And for entities intended for use by professionals—particularly, limited liability partnerships—many statutes retain rules of vicarious liability. For example, in Texas (the state that first enacted a limited liability partnership statute) partners are not liable for the firm’s contractual or tort liability, unless a tort was committed by a person working under the “supervision or direction” of the partner and the partner (1) was directly involved in the wrongful activity or (2) knew of it and failed to prevent or cure it. Tex. Rev. Civ. Stat. Ann. art. 6132b §3.08. The statutes clarify, moreover, that the limited liability provisions do not affect the liability of a partner for his own misconduct.

As use of noncorporate limited liability entities has grown, courts have applied principles from agency and corporate law to determine the scope of limited liability. For example, LLC members are individually liable to third parties if they fail to disclose they are acting on behalf of an LLC. See Water, Waste & Land v. Lanham, 955 P.2d 997 (Colo. 1998) (citing “long-established” principles of agency and corporate law to find that initials on business card, without LLC designation, were insufficient to give notice to third party that he was dealing with LLC). And members of LLCs have been subject to piercing liability on the same basis as participants in a corporation. See Kaycee Land & Livestock v. Flahive, 46 P.3d 323 (Wy. 2002) (despite silence in LLC statute).
VEIL-PIERCING

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89 Texas L. Rev. 81 (2010)

ABSTRACT: From its inception veil-piercing has been a scourge on corporate law. Exactly when the veil of limited liability can and will be circumvented to reach into a shareholder’s own assets has befuddled courts, litigants, and scholars alike. And the doctrine has been bedeviled by empirical evidence of a chasm between the theory and practice of veil-piercing; notably, veil-piercing claims inexplicably seem to prevail more often in Contract than Tort, a finding that flouts the engrained distinction between voluntary and involuntary creditors.

With a dataset of 2908 cases from 1658 to 2006 this study presents the most comprehensive portrait of veil-piercing decisions yet. Unlike predecessors, this study examines Fraud, a long-suspected accessory to veil-piercing, as well as specific sub-claims in Contract, Tort, and Fraud to provide a fine-grained portrait of voluntary and involuntary creditors. And this study analyzes the rationales instrumental to a piercing decision.

The findings largely comport with our legal intuitions. The most successful civil veil-piercing claims lie in Fraud or involve specific evidence of fraud or misrepresentation. Further, claims not only prevail more often in Tort than Contract, but adhere to the voluntary-involuntary creditor distinction. Surprisingly, though, veil-piercing presents a greater risk to individual shareholders than corporate groups.

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For as long as limited liability has existed, courts have disregarded the form of malfeasant corporate entities to access a shareholder’s own assets. With characteristic flair, Wormser declared that “the refusal of the courts to allow quiddits and quillets to stand in the way of justice is nowhere better exemplified [than by veil-piercing] -- Our Lady of the Common Law.”

Lady Justice has worked with metaphors. At the turn of the last century, courts borrowing from agency law used imagery of a corporate “alter ego” and “instrumentality” to adjudicate veil-piercing claims. Justice Cardozo cautioned that “metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.”

Cardozo’s fear has proven to be prophetic. The inherent imprecision in metaphors has resulted in a doctrinal mess. Courts have resorted to compiling ever-expanding lists of fact-specific factors: domination and control, failure to observe corporate formalities, the presence of an involuntary creditor, the commingling of assets, confusion of affairs, perpetuation of a fraud, and so on.
Almost two decades ago, Robert Thompson conducted a pioneering content analysis of approximately 1,600 federal and state veil-piercing cases. Despite the oft-expressed judicial presumption respecting the separation between a corporation and its shareholders, Thompson found that veil-piercing claims succeeded 40.2% of the time, and exclusively in close corporations. Further, veil-piercing occurred far less often against corporate parents than individual shareholders. Surprisingly, success was not highly correlated with evidence of shareholder domination, a failure to observe corporate formalities—such as conducting meetings or keeping records—or inadequate capitalization. Most notably, Thompson found that veil-piercing claims arose and prevailed more often in Contract than Tort cases – even though nearly “every commentator” has concluded the inability of involuntary creditors to bargain or insure themselves against risk makes veil-piercing more compelling in Tort than Contract cases.

The discrepancy Contract and Tort cases may arise from a factor omitted in the Thompson study: Fraud. How does Fraud affect Contract or Tort cases? The present study seeks to answer the question. Using a dataset constructed from 1658 through 2006, thus adding twenty-one years to the time frame examined by Thompson, this study looks at 2,908 federal and state cases.

The results largely confirm our legal intuitions about veil-piercing. Federal and state courts pierce almost 50% of the time and only the veil of close corporations. As expected, the most successful civil veil-piercing claims are grounded in Fraud or supported by specific evidence of fraud or misrepresentation. Moreover, veil-piercing claims prevail more often in Tort than Contract, reversing the counterintuitive asymmetry found by Thompson’s study – thus confirming what commentators, courts, and practitioners have long believed. Similarly, quite predictable suspects comprise the most common instrumental factors: commingling, control or domination, injustice or unfairness, fraud or misrepresentation, and inadequate capitalization.

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The following are charts from the article.
Table 4. Veil-Piercing by Shareholder Type and Jurisdiction

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Table 7. Veil-Piercing by Claim and Jurisdiction

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Table 15. Veil-Piercing by Creditor and Shareholder Type

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TOWARD UNLIMITED SHAREHOLDER LIABILITY FOR CORPORATE TORTS

Henry Hansmann
Reinier Kraakman

100 Yale L. J. 1879 (1991)

INTRODUCTION

Limited liability in tort has been the prevailing rule for corporations in the United States, as elsewhere, for more than a century. This rule is generally acknowledged to create incentives for excessive risk-taking by permitting corporations to avoid the full costs of their activities. Nevertheless, these incentives are conventionally assumed to be the price of securing efficient capital financing for corporations.

We argue, contrary to the prevailing view, that limited liability in tort cannot be rationalized for either closely-held or publicly-traded corporations on the strength of the conventional arguments offered on its behalf. In fact, there may be no persuasive reasons to prefer limited liability over a regime of unlimited pro rata shareholder liability for corporate torts.

Changes in technology, knowledge, liability rules, and procedures for mass tort litigation have for the first time raised the prospect of tort claims that exceed the net worth of even very large corporations. Environmental harms, such as oil spills or the release of toxic materials, are one potential source of massive liability; hazardous products and carcinogens in the workplace are others.

Part I compares liability regimes and the special problems presented by publicly-traded firms. Part II reviews liability evasion strategies that might distort the incentive effects of unlimited liability. Part III emphasizes that, in contrast to the conventional analysis, shareholder liability should be viewed as a problem of tort law and not as a problem of corporate law. We also note that limited liability should be retained as the basic rule for contractual creditors, and we discuss the problems of distinguishing between tort creditors and contract creditors. Part IV examines prior experience with unlimited liability and the historical evolution of limited liability. Finally, Part V explains why more modest reforms, such as expanded director and officer liability for corporate torts, mandatory insurance, or more liberal veil-piercing, appear inferior to a general regime of unlimited shareholder liability.

I. PUBLICLY-TRADED CORPORATIONS

Limited liability gives the managers of publicly-traded corporations an incentive to assume too much risk, just as it does the shareholders of closely-held firms. However, the public corporation adds several novel elements to the comparison of liability regimes. The traditional view is that passive public shareholders—and the need to maintain an efficient market for shares—make unlimited liability less appropriate for public firms than for closely-held firms.
A. Designing an Unlimited Liability Rule

Is unlimited liability feasible for public corporations? Several commentators have questioned whether any unlimited liability regime can obtain meaningful recovery from widely dispersed shareholders without sacrificing the liquidity of the securities market. We believe that such a regime is clearly feasible: a well crafted rule of unlimited liability would neither impair the marketability of securities nor impose excessive collection costs.

It might be argued that, even if feasible, unlimited liability in tort for publicly-traded corporations is unnecessary, since relatively few publicly-traded firms have been bankrupted by tort liability. [This article was written before Enron and WorldCom, two of the largest US firms with pre-bankruptcy assets totaling $173 billion, went bankrupt in the early 2000s.] There are, however, important reasons for extending an unlimited liability regime to publicly-traded firms.

1. When Should Liability Attach to Shareholders?

An administrable rule of unlimited liability for the public firm must specify both a measure of shareholder liability and the point at which freely-trading stock imposes personal liability on its holders. The most plausible measure of shareholder liability is a rule of pro rata liability for any excess tort damages that the firm’s estate fails to satisfy. The more difficult problem is selecting the timing rule that determines which shareholders become liable after a tort occurs.

The choice of a timing rule in determining when excess liability attaches to shareholders inevitably involves a conflict between administrative complexity and opportunities for evasion. An “occurrence” rule, under which liability attaches to persons who are shareholders at the time a tort occurs, is the most difficult rule for shareholders to evade but also the most difficult to administer. A “judgment” rule that attaches residual liability only to those persons who are shareholders at the time of judgment is the simplest to administer but creates widespread opportunities for evasion. A variety of considerations suggest that a reasonable compromise is a modified version of a “claims-made” rule, which attaches liability to persons who are shareholders when information reveals a tort claim will be filed.

The information-based rule we propose would permit shares of an affected company to resume trading unencumbered by outstanding personal liability shortly after management announced a liability date. Thus, new investors and old shareholders could trade in a liquid market without reallocating liability for actual or anticipated tort claims, which would remain firmly attached to the old shareholders who had held stock as of the liability date.

2. The Costs of Collection

Is recovering from numerous public shareholders prohibitively costly? Very large collection costs would make unlimited liability less attractive not only because they would be wasteful, but also because they would lower settlement values and hence reduce the deterrent effect of tort rules. We believe that collection costs are unlikely to be prohibitive in this sense.
One reason is that shareholders would rarely be forced into insolvency. Equity holdings today are already highly concentrated in the hands of wealthy institutions and individuals. Beyond this, assessments against shareholders would seldom exceed the assets of even a modest investor. It seems unlikely that even a catastrophic liability judgment would impose costs exceeding a publicly-traded firm’s value by more than, say, a multiple of five. Thus, an unlucky small shareholder who had placed 5% of a $100,000 portfolio in the stock of such a firm would stand to lose $25,000, or 25% of her portfolio’s value, in a worst case scenario. A large institution with 0.20% its assets invested in the same stock would lose 1% of its asset value. Although such losses would be serious, they would hardly be beyond the pale of ordinary market fluctuations.

Given that shareholders would be able to pay, the mechanics of collection need not be excessively costly. A court could clearly administer the collection effort: bankruptcy trustees already collect accounts receivable from hundreds or thousands of debtors of bankrupt firms. Since share ownership on the liability dates would presumably be the chief legal issue in most collection efforts, few shareholders could successfully contest their assessments. Wealthy individuals and institutions would have little to gain from litigating separately to contest their assessments because they would be pursued in any event.

B. Costs Imposed by Unlimited Liability on the Securities Market

Even more than the purported difficulties of designing an administrative regime of unlimited liability for public corporations, the decisive objection to unlimited liability, in the view of many commentators, has always been the burden that unlimited liability might impose on the cost of equity for public firms.

There is no doubt that unlimited liability, as we have described it, would increase the cost of equity. Indeed, the purpose of unlimited liability is to make share prices reflect tort costs. Yet the literature suggests that, beyond internalizing tort losses, unlimited liability might generate additional costs by (1) impairing the market’s capacity to diversify risk and to value shares, (2) altering the identities and investment strategies of shareholders, and (3) inducing market participants to monitor excessively. The magnitude of these additional costs, however, turns chiefly on the choice between a joint and several or a pro rata liability rule. If shareholders faced joint and several personal liability for all corporate debts, these costs might be very large. But, they should be much smaller if shareholder liability is restricted to tort judgments and governed by a pro rata rule.

1. Diversified Portfolios and Market Prices

The claim that unlimited liability might distort share prices or prevent shareholders from diversifying risk is persuasive only under a joint and several liability rule. Under a pro rata rule, shares would have the same expected value for all shareholders. Although individual stocks would be riskier under such a rule, the additional risk would be no more difficult to diversify than the risk of tort liability is today. Given that a pro rata rule would leave shares with the same expected value for all investors and also permit full diversification of tort risks, it should not affect the efficiency of market pricing. Risk-averse small investors with too little capital to diversify fully under an
unlimited liability regime could shift their investments at very little cost to mutual funds or corporate debt. Moreover, the infrequency of catastrophic torts suggests that a pro rata rule would impose relatively small expected costs, even on undiversified investors, except when corporate activities are extremely risky—which is precisely when an unlimited liability regime is needed to prevent corporations from externalizing large costs.

It is sometimes argued that, regardless of how remote the probability of a substantial judgment against them, the mere prospect of unlimited personal liability would cause many individual stockholders to abandon the equity markets entirely in favor of fixed-return securities, with the arguable consequence of impairing the liquidity of the markets. But such behavior seems as unlikely as it would be irrational. For example, under current law, every time a person drives an automobile she exposes herself to unlimited tort liability. Yet nearly all adults regularly drive automobiles, and casual empiricism suggests that few individuals even feel it worthwhile to purchase liability insurance that has exceptionally high coverage limits.

2. Shareholder Investment Strategies

More subtle critics of unlimited liability have argued that its adoption might adversely influence shareholder investment strategies on two other levels. First, a defective collection mechanism that favored small shareholders over large shareholders might discourage investment intermediaries such as mutual funds and lead wealthy shareholders to abandon risky industries. Second, unlimited liability might encourage wealthy shareholders to “overdiversify” by eschewing large stock positions, hence reducing the frequency of control transactions and depriving all shareholders of the services of sophisticated monitors.

Under a pro rata rule, however, both of these concerns seem minor relative to the beneficial incentive effects of unlimited liability. If collection from dispersed shareholders is feasible, as we have argued, there would be little reason for wealthy shareholders to prefer less risky firms or for small shareholders to withdraw from mutual funds. If anything, investing in a broadly diversified portfolio such as a mutual fund would become more attractive for small shareholders. On the other hand, a pro rata rule clearly would increase a risk-averse investor's cost of accumulating a large holding in a risky corporation relative to the investor's cost of holding a diversified portfolio.

3. Excessive Monitoring costs

A final claim often made in defense of the status quo is that unlimited liability would generate excessive monitoring of both management and shareholders by all participants in public corporations. This claim would be plausible if each shareholder were liable for all corporate debts as they would be under a joint and several rule: in that case, the risks borne by each individual shareholder or creditor would depend in part on fluctuations in the aggregate wealth of all shareholders. All shareholders would then have a personal stake in knowing about the personal assets of other shareholders who entered or exited the firm.

Yet, this monitoring argument fails against a rule of pro rata liability for tort losses. Under such a rule, a shareholder's risk would depend only on the size of her own investment rather than on the
wealth of other shareholders. Furthermore, contract creditors would not rely on the wealth of shareholders at all. Thus, the only effect of pro rata liability would be a marginal increase in shareholder incentives to monitor the enterprise’s expected tort losses. Although this additional monitoring would not differ in kind from what shareholders already do, it would encourage managers to consider the full social costs of investment decisions. Additional monitoring would cost more on the margin, but it would be no more duplicative or socially wasteful than the attention that shareholders already devote to all other matters affecting the value of the firm. Indeed, tort risks might even be less costly to monitor than other business risks. A developed industry of expert monitors—liability insurers—already sells assessments of liability risk, with or without the benefit of insurance. These same firms might easily collectivize the costs of evaluating liability risks for the public market.

C. Management's Incentives to Take Care

Given that unlimited liability is feasible for public firms, we must still ask whether it can significantly improve their incentives to take care. In particular, will the managers of publicly-traded firms be responsive to the incentives created by unlimited liability? The disparate shareholders of most public corporations seldom exercise direct control over corporate policy. [This was written before the new age of “institutional shareholder activism” and the era of shareholder involvement through “say on pay.”] Why, then, should we expect the managers of public corporations to respond to liability imposed on shareholders?

One answer is that a variety of market mechanisms press corporate managers to be responsive to shareholder welfare as this is reflected in share prices. If shareholders faced full liability for potential tort losses, share prices would incorporate available information about the full extent of these possible losses. Managers, in turn, would then have as much incentive to consider the full expected social costs of corporate torts as they now have to weigh all other costs to the firm that shareholders presently bear as a matter of course. Moreover, shareholders who faced contingent liability would presumably demand—and managers as well as outside analysts would presumably supply—far more information about the riskiness of corporate policies, precisely because this information would have greater importance in valuing shares. This additional information, especially when it came from market sources outside the firm, would further enhance management’s incentive to consider the tort risks associated with its policies.

On the other hand, the problem may not be that managers will respond too little to expected liability costs but, conversely, that they will respond too much. Yet, even today, large public corporations insure heavily against tort liability under the existing limited liability regime. Although there are other possible explanations, such insurance may be evidence of managerial risk aversion. Managers cannot diversify their investment of firm-specific human capital in the corporation. Consequently, if managers expect large, uninsured tort losses to threaten their jobs, they may manage in a risk-averse manner in order to lower the probability of such losses—and, in particular, of losses that might induce bankruptcy.

Managers who are risk averse in this fashion, it might be feared, would be overdeterred by unlimited liability. Further, with respect to both near-term and long-term risks, managerial
decisionmaking is commonly shaped in important part by market-based performance incentives that work to align management's interests with those of shareholders. If necessary, the compensation incentives that offset management's risk aversion today could be strengthened under an unlimited liability regime. Even if such an adaptation of compensation terms were necessary, it would not be large because unlimited liability would have its primary incentive effect on shareholders rather than on managers.

II. INCENTIVES TO EVADE LIABILITY

Thus far we have focused primarily on the costs that unlimited liability might impose on existing shareholders and corporations, largely because these costs are at the heart of the conventional defense of limited liability. Yet these are not the only potential costs associated with unlimited liability. Probably more serious, and more difficult to assess when comparing limited and unlimited liability, are the social costs that might arise from shareholders' increased incentives to avoid liability under an unlimited liability regime.

Whatever the rule for corporations, individuals always have the advantage of the limits on personal liability available through individual bankruptcy. This option preserves strategies for evading tort liability under a regime of unlimited shareholder liability just as it does under the existing regime of limited liability. It would leave open three liability evasion strategies that are presently available for unincorporated individuals or partnerships: (1) hiding personal assets or shifting shares; (2) shifting from equity to debt financing; and (3) disaggregating industry.

A. Hiding Assets and Shifting Shares

As we have previously observed, unlimited liability would increase the incentives for individual shareholders to minimize holdings of personal assets exposed to tort judgments. Tactics of this sort could rely on shifting assets by, for example, passing title to other family members, spending more on present consumption, or increasing the amount of wealth held in pension funds. Alternatively, such tactics could attempt to insulate assets by shifting share ownership—for example, by donating all stock in a risky corporation to a trust for the benefit of one's children. Tactics of either sort would blunt the ability of unlimited liability to increase care-taking and could also lead to distorted patterns of consumption and investment.

The potential importance of these problems is an empirical question that is difficult to answer a priori. But there is reason to believe that they would not be serious. They should have little effect on shareholders in publicly-traded firms, who generally have too small a fraction of their assets invested in any single firm to have an incentive to rearrange their personal finances in response to the threat of excess tort liability. Moreover, the law already constrains the most opportunistic tactics of this sort, through “look through” principles that could be applied in this context.

B. Debt as an Evasion Strategy

Not only shareholders but also debt-holders enjoy limited liability under existing law. Since there are persuasive reasons not to extend mandatory unlimited liability to bona fide corporate
debt, heavy reliance on debt financing opens a second strategy for evading tort judgments under a regime of unlimited liability. For example, a low-asset shareholder might raise debt financing to capitalize a start-up venture in a risky line of business. These strategies create a “high-roller problem”—a term we use to emphasize the central role of the low-asset shareholders ("high rollers") who undertake to hold the risky equity.

The critical question is whether there are enough high-rollers to take possession of any significant fraction of most industries, or even of most unusually hazardous industries. We strongly doubt that there are, particularly because many companies undertaking hazardous activities, such as manufacturing of chemicals and pharmaceuticals, commonly require extensive investments in firm-specific capital—that is, in specialized plant and equipment that cannot be redeployed elsewhere without a substantial loss in value. Since such investments provide poor collateral, debt financing would be costly or impossible to obtain, which means that a would-be high-rolling owner would have to provide a substantial fraction of the necessary capital herself. The potential supply of such very wealthy high rollers is likely to be particularly limited.

In addition, under a regime of unlimited liability, courts would retain the option of recharacterizing, as constructive equity, ostensible debt financing that served as an obvious liability shield, thus making the debtholders as well as the shareholders bear unlimited liability for corporate torts. Truly opportunistic uses of debt financing to avoid tort liability are likely to be highly conspicuous and easily isolated by the courts. Moreover, the mere threat that debt could be recharacterized in extreme cases might create sufficient legal risk to deter lenders from financing most would-be high rollers.

C. Disaggregation of Industry as an Evasion Strategy

A more serious variant of increasing leverage would arise if, in response to unlimited liability, large companies were to sell off their hazardous activities piecemeal to small firms that were separately owned by different high rollers. Thus, a large oil company, rather than continuing to ship its oil in tankers that it owns and operates through subsidiary corporations, might sell each of its tankers to a separate individual who would then contract with the company to ship its oil. Such a disaggregation strategy might impose significant efficiency costs through lost economies of scale or scope. These costs could arise, for example, if a large oil company that sold its fleet of 100 tankers were a more efficient manager of those ships than 100 individual high rollers could be.

Once again, however, there are several reasons to believe that evasion through disaggregation would not constitute a serious threat. First, only a small number of companies are likely to perceive profitable opportunities for inefficient disaggregation. As we have previously argued, the supply of high rollers with just the right characteristics to own and operate, say, individual oil tankers or pharmaceutical plants is likely to be limited. In addition, the demand for high rollers is also likely to be limited. An incentive for disaggregation in any given case would not arise under unlimited liability unless the resulting inefficiencies, including lost economies of scale or quality of management, were smaller than the private gains from avoiding potential tort liability. If they were not, a parent firm would choose to retain ownership of the risky asset in question rather than selling it. Thus, the range of cases in which the disaggregation strategy might be worthwhile should
be relatively narrow.

III. SHAREHOLDER LIABILITY AS A PROBLEM OF TORT LAW

In the past, limited liability has generally been seen as a problem of corporate law. The efficiency of the capital markets, it was argued, would be seriously damaged if shareholders were exposed to personal liability for corporate torts. Consequently, the formal boundaries of the corporation that have been established for purposes of contractual rights should also be respected in tort. One of the principal points we wish to make is that this is not so. As we have argued above, the capital markets, and in particular the stock market, would continue to function efficiently with unlimited shareholder liability. Rather, shareholder liability should be seen as a standard problem of tort law. Viewed this way, the right question is simply: When are a corporation's shareholders cheaper cost avoiders and/or cheaper insurers than the persons who may be injured by the corporation's activities?

[The authors then consider how shareholders may be better bearers of risk than tort victims, how limited liability still can be preserved for contract creditors (who can always contract for protections against firm insolvency), and how courts can distinguish between voluntary creditors and involuntary creditors. In summary, the authors argue that corporate management should not be permitted to unilaterally to determine how much the corporation and its shareholders will be exposed to potential tort claims.]

IV. EXPERIENCE WITH UNLIMITED LIABILITY

It is common today to think of limited liability as an integral part of the corporate form and therefore to feel that abolishing limited liability, even in tort, would be recklessly revolutionary. But limited liability evolved over the past 150 years and did not become universal even in the United States until about fifty years ago.

Blumberg has recently offered an extensive and thoughtful survey of the historical experience with unlimited liability. As he points out, in England prior to 1844, manufacturing firms had difficulty obtaining corporate charters. Consequently, large manufacturing firms were commonly formed as unincorporated joint stock companies with transferable shares. Indeed, an active public market in the shares of such companies developed as early as the seventeenth century. These firms had roughly the legal characteristics of a large partnership, including unlimited joint and several liability for all corporate obligations. Then, between 1844 and 1855, joint stock companies were permitted to incorporate but had to retain unlimited liability. Only after 1855 was incorporation with limited liability generally available.

Similarly, although American states freely granted corporate charters by the beginning of the nineteenth century, for the first several decades of that century a number of states imposed unlimited liability on manufacturing corporations. Nevertheless, many manufacturing firms incorporated in this period. Moreover, states that were slow in adopting limited liability, such as Massachusetts (1830) and Rhode Island (1849), did not appear to suffer a conspicuous disadvantage in industrial development in comparison to neighboring states, such as Connecticut.
and New Hampshire, which adopted limited liability earlier. And, although most American states had adopted limited liability for corporations in general by the 1850s, California imposed unlimited pro rata liability by statute on the shareholders of both domestic and foreign corporations from statehood in 1849 until 1931, evidently without crippling industrial and commercial development.

Even after discarding unlimited liability, many states provided for double or triple shareholder liability for corporate debts throughout the nineteenth century—liability that, at least originally, extended to tort creditors as well. Similarly, most states, as well as federal banking legislation, imposed double liability on the shareholders of banks until the 1930s. An efficient mechanism, in the form of a procedure in equity termed the "creditors' bill," ultimately evolved to provide a means for obtaining a collective judgment, good against all shareholders, that was res judicata in other jurisdictions and subject only to personal defenses such as the number of shares actually held.

This extensive experience suggests that a regime of unlimited liability is administrable and that corporations with publicly-traded shares can survive and prosper under it. Prospective shareholders will not all be scared away. To be sure, tort liability for shareholders was evidently rare in the period involved. But historically unlimited liability generally extended to contract as well as tort, and contractual liability for shareholders was presumably a serious prospect. Moreover, in the past, unlimited liability regimes for joint stock companies often employed joint and several rather than pro rata liability. If such a regime is viable, presumably a regime involving unlimited liability only in tort, and with pro rata liability, is much more so.

V. THE ALTERNATIVES TO UNLIMITED LIABILITY

Despite the attractions of unlimited liability as a means of regulating safety and investment incentives, the possibility remains that alternative legal reforms could achieve the same effects at lower cost. Indeed, most commentators who question the incentive effects of limited liability recommend reforms short of imposing unlimited liability on all shareholders. The most commonly mentioned reforms fall into three categories: "coverage-oriented" reforms, which seek to guarantee that firms have adequate resources to satisfy tort judgments; "liability-shifting" reforms, which shift responsibility for the firm's excess tort liability to contractual participants in the firm other than its shareholders; and "veil piercing" reforms, which broaden the categories of cases in which courts disregard the corporate boundaries. Although all three genres of reform could mitigate the perverse effects of limited liability, there are strong reasons to believe that none would prove as effective as an unlimited liability regime.

A. Coverage-Oriented Alternatives

[The authors then explain that coverage-oriented alternatives to unlimited liability (such as establishing fixed insurance coverage or capitalization levels for firms) would be difficult to set and some firms would be over-covered and others under-covered.

The hazardous waste disposal industry offers evidence that such a combined strategy can be effective. In the 1970's, this industry was characterized by numerous small firms with minimal capitalization—that is, by a financial structure that seemed transparently chosen to minimize
liability. Then, in 1976, the Resource Conservation and Recovery Act (RCRA) imposed financial responsibility requirements on the industry in the form of minimum asset levels and/or liability insurance coverage, and also increased asset levels by requiring firms to deploy capital-intensive technologies. Subsequently, the Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA) extended liability to “owners” and “operators” of hazardous waste facilities, which, in various circumstances, courts have interpreted to include customers, lenders, corporate parents, and other affiliated actors—hence imposing a diluted form of de facto unlimited liability. As a consequence, subsidiarization has lost much of its value as a tactic for evading liability. The combined effect has been to transform the industry into one characterized by a smaller number of firms, each of which is relatively large and has substantial equity capitalization.

B. Liability-Shifting Reforms

Similarly, alternatives to unlimited liability that would shift liability to participants in the firm other than shareholders do not seem promising. One commonly proposed alternative of this type would hold directors or controlling officers personally liable for any portion of a tort judgment that exceeds the firm’s assets. Important difficulties would arise, however, if insurance were unavailable or prospective tort losses were very large relative to the personal assets of the liability targets. In the absence of insurance, imposing personal liability for the firm’s entire tort losses on its managers would create a powerful incentive to overinvest in safety measures or, what is more likely, to resign. Alternatively, if potential tort losses were quite large relative to personal assets, this rule might generate the opposite incentive: in exchange for a very high salary, a manager might be willing to have his firm undertake extremely risky activities because he would be judgment proof in the event of an accident.

C. Veil-Piercing Reforms

Finally, rather than going so far as to abolish limited liability in general, many commentators find it tempting to move only part way to unlimited liability by simply broadening the class of cases in which the courts pierce the corporate veil. At present, the boundaries of that class are quite narrow and the doctrine that determines those boundaries is vague and largely unprincipled.

In short, any intermediate stopping point will be arbitrary and will provide a strong incentive for many corporations to position themselves just on the far side of that point, thus distorting the organization of enterprise while still permitting substantial externalization of costs. The only coherent and effective approach is to go all the way and adopt a general rule of unlimited liability.

VI. CONCLUSION

Our analysis indicates that the most common arguments offered on behalf of limited liability—arguments that turn on characteristics that are specific to corporate tortfeasors and the special concerns of corporate law—are largely unpersuasive. There is no reason to suppose that unlimited liability would discourage shareholder investment except in firms that, under the prevailing norms of tort law, impose net costs on society. Even in the case of publicly-held corporations, unlimited liability would not burden the capital markets except, again, to the extent that it would lower share
prices to reflect the full social costs of corporate activities. Moreover, nothing about the ownership structure of the corporation, including the larger publicly-held corporation, presents insurmountable obstacles to the judicial administration of an unlimited liability rule. Although a workable rule would call for a number of refinements to accommodate the exigencies of freely-trading shares, our preliminary sketch of a regime of unlimited liability suggests many of the appropriate adaptations.