1. Introduction

1.1 INTRODUCTION

The corporation is central to our society. Most Americans work for corporations of various sizes and kinds, from Wal-Mart to the local nail salon, and corporations of one type or another produce nearly everything we consume, from food to culture. It is probably hard to imagine anything you buy or sell that does not involve a corporation directly or indirectly. Thousands of corporations are involved in the average person’s daily activities, most of which are hidden from view—from down in the supply chain for goods and services. The reach of the modern corporation extends far beyond commerce, however, as hospitals, churches, unions, social organizations, political organizations, and cities and towns are almost always organized as corporations as well.

However, it was not always this way. For many thousands of years, individuals who needed goods and services produced them for themselves, sometimes as part of a family group or, more recently, in various hierarchical structures, such as those found in feudal Europe. The result was widespread poverty and disease, as well as low levels of productivity and innovation.

The central problem was that risk taking and collaboration, the two most important features of modern capitalism, and thus wealth, were inhibited when using other forms of organizing activities, such as sole proprietorships. The modern corporation is unrivaled in its ability to allow individuals to collaborate across individuals, family units, or states. Introduced by the Dutch in the seventeenth century, the corporation has enabled production of goods and services with incredible efficiency, thereby increasing human welfare at increasingly lower costs.1 Over the past several hundred years, corporate capitalism been responsible for improving living standards in previously unimaginable ways—life expectancy in the capitalist West has doubled since 1900, and average global

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1 For a concise and accessible overview of the history of the corporate form and its contributions to social development, see Adrian Wooldridge & John Micklethwait, The Company: A Short History of a Revolutionary Idea (2003).
incomes have increased several fold over the same period. In just the past two decades, the adoption of capitalist ideas—private property and voluntary exchange enforced through contract—in China has lifted several hundred million people out of poverty.

The key feature of the corporation that makes it such an attractive form of human cooperation and collaboration is limited liability. By allowing those who form the corporation to limit their downside risk to the amount they invest in the corporation, more risks can be taken and at lower cost. It also prevents wasteful fights among corporate participants (e.g., shareholders, workers, managers etc.) about who should be responsible for corporate liabilities.

The central importance of the doctrine of limited liability was boldly declared in a 1911 speech by the President of Columbia University, Nicholas Murray: “I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times. … Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it.” Ideas matter, of course, and President Murray was certainly not intending to run down the high-thinkers in his employ, or the intellectual shoulders on which they stood. His point was merely that ideas alone are worth far less in the absence of a way of turning them into valuable goods and services for as many individuals as possible. The limited liability corporation is the greatest means yet discovered (and likely to ever be discovered) to accomplish this objective.

Not everyone shares that high opinion of the corporation, of course. In the early years of the American Republic, Thomas Jefferson and his followers were agrarians deeply suspicious of the corporate form. Jefferson railed against the “aristocracy of our moneyed corporations,” because he argued they “know … no country, and feel … no passion or principle but that of gain.” Over the years, many scholars and corporate critics have argued (under the “concession theory”) that corporations owe their existence to the state, and therefore should be subservient to direct political control. The suspicion was that if left unchecked, corporate

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power would degrade individuals, culture, and ultimately democracy. Much more recently the Occupy Wall Street and related anti-capitalist movements likewise have viewed the corporate form with disdain and fear. In the 2004 documentary *The Corporation: The Pathological Pursuit of Profit and Power*, for example, the profit-oriented multinational corporation is unfavorably compared to the psychological profile of a sociopath.5

Limited liability undoubtedly motivates many such critics.6 This criticism is not unwarranted. Despite its obvious benefits in encouraging socially productive risk taking, limited liability has social costs as well. In particular, it allows corporations to externalize a certain amount of costs and risks onto third parties. For instance, if a taxi company has only $100,000 in assets, including vehicles and insurance, but causes $200,000 in damages when it negligently injures a pedestrian, $100,000 of the losses will be borne by others. The victim may bear the loss, or the victim’s insurance company, or the government. The key point, however, is that the taxi company makes all the upside in good states of the world, but is able to externalize some of the costs on others in bad states. This is the cost of limited liability, and if left unchecked, it could undermine the social function corporations serve.

The law is not blind to this problem. To reduce this cost, corporate law recognizes a doctrine known as “piercing the corporate veil” that provides an exception to the general rule of limited liability of shareholders. The idea is to establish legal rules that strike the optimal balance between encouraging risk taking and permitting excessive risks to be externalized onto others. As we explain in detail in the chapters that follow, exceptions to limited liability exist in the law of every state and most developed countries. But despite the universality of the doctrine, the law is not at all clear. The principles for invoking veil piercing are uncertain and highly contestable.

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Wherever there is ambiguity and high stakes, lawyers flourish, and veil piercing is no exception. Veil piercing is one of business law’s most unpredictable doctrines. Although based on general statutes, piercing is an equitable action, with the exact contours of the doctrine thus depending on the facts of a particular case and the preferences of individual judges or juries. Consequently, predicting when the veil of limited liability will be disregarded is like predicting lightning—strikes are more likely when certain conditions are present (e.g., dark clouds) but still rare and hard to identify in advance.

This uncertainty is made worse by the high stakes of these cases. Veil piercing allows creditors to satisfy their claims out of the personal assets of shareholders. Since liabilities from corporate wrongdoing can be huge relative to individual shareholder wealth, and since shareholders used the corporate form precisely to shield their personal assets, the risk from piercing is one of the most significant risks in forming a business. Lawyers are therefore vital from an ex ante or transactional planning perspective. The risk of veil piercing requires lawyers to exercise some care in forming the corporation and advising the client as to its conduct.7 If this fails, lawyers again serve a vital role in litigation to make arguments that reduce the probability the court will exercise its equitable powers to cast limited liability aside.

Although it is the relatively narrow doctrine of veil piercing that thus drives most legal work in this area, that doctrine is inextricably linked with the predicate principle of limited liability. The policy debates about corporate conduct are also couched in terms of the value of limited liability generally or in particular contexts. Accordingly, we cannot understand one without understanding the other. And we cannot put down a marker on either side of the debate about corporate power without a deep understanding of the foundational legal principles on which corporate power is built.

To understand limited liability (and thus veil piercing), it is necessary to consider briefly the more general concept of corporate separateness.

7 Having said that, it is critical to stress that veil piercing is the exception, not the rule. The law permits incorporation of a business for the very purpose of avoiding personal liability. See, e.g., Bartle v. Home Owners Coop., 127 N.E.2d 832, 833 (N.Y. 1955). The equitable exception obviously could swallow the legal rule quite easily unless courts are careful to permit veil piercing only in certain egregious cases. Accordingly, many decisions in this area state that courts will pierce the veil only reluctantly. See, e.g., Dewitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 683 (4th Cir. 1976).
1.2 CORPORATE SEPARATENESS

When individuals form a corporation, they are creating a distinct and separate legal entity. Section 106 of the Delaware General Corporation Law (DGCL) illustrates this concept by declaring the creation of a “body corporate” upon filing of the appropriate forms with the Delaware Secretary of State. Thus, although Baron Thurlow, Lord Chancellor of England, was correct when he noted that a corporation “has no soul to be damned, and no body to be kicked,” the act of incorporation undoubtedly creates an entity separate from the individuals who form it or who come to manage or work for it. Federal statutory and constitutional law also recognizes this point, deeming corporate entities to be “legal persons” for a variety of purposes.

A corporation, such as Microsoft, ExxonMobil, or the City of Chicago, is therefore declared to be an entity, but in reality, it is just a fiction. The law creates the fictional entity merely as a means of facilitating a less costly, and more efficient mechanism for individual humans to produce things, whether it is making computers, publishing ideas, or providing public goods, like schools and parks for citizens. After all, all corporate acts are really the acts of individual humans, whether it is the managers, workers, or investors who are the typical stakeholders in individual firms.

The related concepts of corporate separateness and corporate personhood serve several functions. Understanding these is essential to formulating a coherent view of veil piercing.

1.3 LEGAL PERSONHOOD

The first implication of corporate separateness is that corporations have a legally recognized personhood separate and distinct from its shareholders.

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9 See, e.g., Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2769 (2014) (holding that the term “person” as used in the Religious Freedom Restoration Act includes not only natural persons and nonprofit corporations, but also for-profit corporations); First Nat. City Bank v. Banco Para El Comercio Exterior de Cuba, 462 U.S. 611, 625 (1983) (Separate legal personality has been described as “an almost indispensable aspect of the public corporation.”); see generally Jay B. Kesten, Shareholder Political Primacy, 10 Va. L. & Bus. Rev. 161, 169 (2016) (noting that “the law has long treated corporations as legal ‘persons’ for most purposes, including eligibility for many (though not all) constitutional protections.”).
and other stakeholders. While a corporation has no real physical existence—it is really just a label the law creates—it is nonetheless treated as a legally distinct “person” that can act through its employees when they spill oil, manufacture faulty cars, or mislabel food. This is a neat trick that saves everyone from plaintiffs to chief executive officers (CEOs) a lot of hassle in asserting and defending their rights. Only the “corporation” needs to show up in court, whether it is to defend against alleged misconduct of its agents or assert the rights of the real people who comprise it. In essence, creating a separate legal entity means that individuals who constitute the corporation are agreeing that the corporation will represent their interests that are implicated by the corporation’s activities and that they will not assert their own interests that are so implicated. For instance, if the government seizes land owned by the corporation, and does not compensate the corporation, it is ultimately the shareholders of the corporation who are harmed—the corporation is now worth less. But it is the corporation that will assert the shareholders’ rights protected by the Fifth Amendment’s takings clause, instead of the individual shareholders asserting these collectively or individually.

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10 See Cook Cty., Ill. v. U.S. ex rel. Chandler, 538 U.S. 119, 127 n.7 (2003) (“While the liability of quasi corporations at common law may have differed from that of municipal corporations … both were treated equally as legal ‘persons.’”).

11 See Trustees of Dartmouth Coll. v. Woodward, 17 U.S. 518, 667–8 (1819) (observing that: “a corporation may sue and be sued by its own members, and may contract with them in the same manner, as with any strangers.”).

12 As the Second Circuit has observed:

The protection against targeted economic injury in the Takings Clause is fully applicable to corporations. … For both the Takings Clause and the Bill of Attainder Clauses, if the protections did not extend to corporations, their protections would be significantly undermined for individuals. When a corporation suffers an economic injury, its shareholders suffer the same economic injury. In order to protect shareholders from the economic injuries prohibited by the Takings Clause and the Bill of Attainder Clauses, corporations must be allowed to raise the clauses directly.

Consol. Edison Co. of New York v. Pataki, 292 F.3d 338, 348 (2d Cir. 2002). See also Russian Volunteer Fleet v. United States, 282 U.S. 481, 489 (1931) (holding that a Russian corporation “was entitled to the protection of the Fifth Amendment of the Federal Constitution”).
1.4 ENTITY SHIELDING

The second implication of incorporation is that, by creating a separate legal entity, the assets of the business are separated from the assets of the individual investors or owners. The corporate form prevents a personal creditor of one of the business’ owners from reaching the assets of the business if the owner defaults on a personal debt:13

‘Affirmative asset partitioning,’ or what [some scholars] call ‘entity shielding,’ protects the business entity from attempts by owners or their creditors to compel distributions or liquidation and thereby impede the creation of going concern value. Entity shielding helps ensure that business decisions are made by designated managers or collectively by the owners and therefore serve the firm’s purposes rather than those of the individual owners.14

Entity shielding (the now more accepted term) is closely related to the concept of asset lock-in. The latter term refers to rules that impede an owner of the business from withdrawing his or her capital contributions at will.15 In other words, once investors form a firm and agree to pool their resources together to accomplish a particular end, they cannot withdraw these assets at will. To do so would subject the firm to defeasance at any time, and therefore make long-term, capital intensive investments far riskier and costly. Once a corporation is formed, it becomes a legally separate and distinct entity with its own rights and obligations. Respecting this separateness, as we will see, is a crucial feature of what it means to be a corporation and is essential to courts respecting the veil of limited liability. The cleavage is clear: corporate assets are for corporate purposes; individual assets are for individual purposes.

In partnership law, an at-will partnership provides very limited asset lock-in, because one or more partners may always exit the partnership via a unilateral dissolution, taking their share of firm assets with them, unless constrained in the partnership agreement. In contrast, because corporate

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Limited liability

law sharply limits the circumstances under which a shareholder can exit the firm by removing his capital contribution, the corporate form functions as a lobster trap—it is easy to get in, but hard to get out.

Entity shielding also can be thought of as impeding personal creditors of a business’ owners from reaching assets of the business. In the United States, corporate and bankruptcy law work together to provide a strong form of entity shielding by giving the corporation’s creditors a prior claim on corporate assets, and precluding personal creditors of shareholders from forcing a liquidation of the corporation. Again, the rules clearly separate the corporate from the personal. This promotes clarity and certainty, and thus lowers transaction costs. It also encourages parties to use contracts to clearly delineate any deviation from the rules. If one is dealing with a corporation, one knows the limits of the assets available to pay any liabilities, and therefore can contract for extra protection if need be. (Of course, as we will see, this argument works much better when

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16 Under state law, there are three basic ways in which a corporation may be dissolved, none of which can be effected by shareholders acting alone. Voluntary dissolution of a corporation requires a two-step process in which the board of directors recommends dissolution, and the shareholders then vote to approve that proposal. Because board of director approval is a prerequisite to the shareholder vote, the shareholders lack power to initiate a voluntary dissolution. See MBCA § 14.02 (describing the voluntary dissolution process). Administrative dissolution can be effected by the proper department of the state of incorporation for various infractions, such as failure to pay franchise taxes when due or failing to file required reports. See MBCA §§ 14.20–14.21 (describing grounds and process, respectively, for administrative dissolution of a corporation). A court may order involuntary dissolution of a corporation on application of, inter alia, the shareholders where there has been deadlock or various forms of misconduct by the board of directors. See MBCA § 14.30 (defining who may seek an order of dissolution and on what grounds).

17 As one commentator explained:

 Corporations have often been likened to a lobster trap. A lobster trap is designed so that the lobster has an easy time getting into the trap but has a very difficult, if not impossible time getting back out. Similarly, it is easy to transfer property to a corporation … . However, taking property out of a corporation almost invariably involves paying taxes either on dividends or income at both the corporate and shareholder level in the event of a liquidation.


parties can actually contract: you can’t write a contract with a taxi right before it runs you over!

1.5 LIMITED LIABILITY

The final implication, and the most important for the purposes of this book, is that of limited liability. The body corporate not only protects firm assets from shareholders’ debts, but also protects shareholders from liabilities arising from corporate activities. This means voluntary creditors (such as those who lend to a firm) and involuntary creditors (such as victims of torts or other corporate wrongdoing) can satisfy their claims only against assets of the firm. If a firm fails, a shareholder’s losses thus are limited to the amount the shareholder has invested in the firm—i.e. the amount the shareholder initially paid to purchase his or her stock. In the hypothetical taxi case above, if the accident causes the firm to go bankrupt, the shareholders lose their entire equity stake in the firm, but do not have to pay for the damages beyond that amount.

A typical statutory formulation of the doctrine is found in Model Business Corporation Act (MBCA) § 6.22(b): “Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.”

Limited liability is also known as defensive asset partitioning or owner shielding. Owners are protected from corporate liabilities; corporate assets are available for corporate debts.

19 Model Business Corporation Act § 6.22(b) (hereinafter cited as MBCA). The MBCA is a model statute drafted and maintained by the Corporate Law Committee of the Business Law Section of the American Bar Association. The MBCA was first promulgated in 1950. A significantly revised edition was published in 1969, and was adopted in whole or in large part by about 35 states. A second complete revision was promulgated in 1984 MBCA and has been frequently amended to remain up to date. The current version of the MBCA has been adopted in whole or substantial part by 31 states. Commercially important holdouts include California, Delaware, and New York.

20 See Larry E. Ribstein, Reverse Limited Liability and the Design of Business Associations, 30 Del. J. Corp. L. 199, 202 (2005) (explaining that limited liability entities, such as corporations, “can be viewed as ways of ‘partitioning’ business assets from the debts of individual owners and individuals’ assets from the debts of their businesses, which functions are referred to as ‘affirmative and defensive asset partitioning’ respectively”).
We take this idea for granted today, but if you think about it for a minute, this is a radical idea. While it might make sense for a day-trader who owns a few shares of British Petroleum at a particular moment not be personally on the hook for a proportional share of the damages from the Deepwater Horizon oil spill, there are several conceptual leaps necessary to be comfortable with that conclusion. It would be possible, although perhaps not ideal, to run a system with shareholder liability, and throughout the book, we will reexamine the wisdom of limited liability. Some scholars have advocated such a move, and we will look at these arguments as well in Chapter 3. But the idea of limiting liability of shareholders in large public companies, especially when those shareholders are individuals with modest means, is fairly uncontroversial.

While it might be sensible to limit BP’s liabilities to the assets of BP, as opposed to all of its shareholders, the argument for limited liability is much weaker for smaller companies, where the difference between the shareholders and those managing the firm is much less than in the case of the publicly traded corporation. However, every corporation starts out small and with unity of ownership and control, and there are no easy answers to when the doctrine of limited liability should kick in or be rolled back. Therefore, as a policy matter, limited liability is extended to all corporations, regardless of size, design, activity, or management approach. This blanket rule is then rolled back in cases in which courts deem veil piercing appropriate.

More formally, one can imagine four cases, in which the question of limited liability arises. The two-by-two matrix shown in Table 1.1 describes these cases: public companies with liabilities arising from contracts; public companies with liabilities arising from accidents or torts; closely held firms with liabilities arising from contracts; and closely held firms with liabilities arising from accidents or torts.

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<th>Contract creditor</th>
<th>Tort creditor</th>
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<td>Public corporation</td>
<td>Very high</td>
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<td>Close corporation</td>
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The question in each of these scenarios is whether the parties—the corporation and the party to whom the liability is owed—would have agreed to limit the liability of the corporation’s shareholders prior to the
liability arising. Looking at it from this ex ante perspective allows us to estimate the optimal rule.

In all these cases, we can assume that shareholders would prefer limited liability: as residual owners they prefer riskier projects with a bigger upside since they do not share the downside risk. Similarly, creditors would prefer unlimited liability, since this maximizes their chance of being repaid and reduces the incentives of shareholders and their manager agents to take excessive risks.

In the first case, the contract creditor and the publicly traded firm, the bargain for limited liability can be justified on the theory that shareholder power to direct firm project choice is very limited, and so the incentive and ability to externalize costs of risky ventures onto others is limited, while creditors may be cheaper monitors of corporate decisions through the use of debt covenants and their repeat-player nature. If creditors wanted to collect personally from individual shareholders, they would have to monitor these shareholders’ decisions regarding their private wealth, as well as have to engage in costly efforts to collect from millions of shareholders in the event of a default. Therefore, one can imagine creditors accept the role as monitor with limited liability regime in return for prior claim on the corporation’s assets in the event of bankruptcy.

In the second case, of the contract creditor and the closely held firm, the argument for limited liability is more difficult. Shareholders are much more likely to be in control in these firms, so there is an increased risk of shareholders making decisions that externalize costs onto others as a result of a limited liability regime. In addition, because of low numbers of shareholders, creditors would face low monitoring and collection costs. For these reasons, it is therefore, not surprising that creditors often require shareholders/managers of closely held firms to execute personal liability agreements that are effectively a repeal of the limited liability rule. This relatively easy workaround explains why the default rule in these cases is limited liability. The default rule is clear and provides certainty for all parties contracting with the corporation, and workarounds will be respected. In addition, the line-drawing problem that would arise by trying to craft another default rule would be significant—how closely held is closely held enough to rebut the normal limited liability rule? So the default rule in this case looks like a penalty default: parties are encouraged to bargain around a rule that may be plainly inferior in most cases.

In the third case, tort creditors of a publicly held corporation, the argument for limited liability is also on somewhat weak ground. The ground is sufficiently unstable that legal scholars have proposed pro rata tort liability for shareholders, as was the law in important jurisdictions
such as California well into the twentieth century.\textsuperscript{21} So what is the argument for limited liability? The strongest argument turns on administration and the costs noted above for closely held firms. Shareholder liability would raise messy issues of personal jurisdiction for out-of-state/country shareholders, and would require constant monitoring of shareholders’ assets (as well as costly shielding of these assets by shareholders hoping to avoid liability) and would involve costly collection procedures, and would lead to socially wasteful shielding on the part of shareholders. Moreover, there are alternative means of policing potential misconduct against a background rule of limited liability. Government regulators police many torts committed by large corporations, including using ex ante regulations, and civil or criminal sanctions against firms and/or individual managers. In addition, managers of corporations operate in a market for labor in which reputation is an important component. Moreover, there are other legal doctrines, including enterprise liability (discussed below) and environmental liability under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) that help reduce the risk of externalization of costs onto others. Finally, most publicly traded firms are in the public spotlight, and may internalize liabilities, even when they could legally be put on others. For instance, Chrysler voluntarily paid many tort liabilities after its bankruptcy (which wiped them clean) in order to maintain a good reputation with consumers.

The fourth and final case, tort creditors of closely held corporations, is the hardest in which to justify a limited liability rule default. Unlike the case of the publicly traded corporation, shareholders are likely in control, and the problems of enforcement and monitoring of diffuse shareholders are less severe. The best argument in favor of limited liability is that it would be difficult to draw a sensible line between firms that should be subject to unlimited liability and those that should have limited liability. Extreme cases—a single shareholder of a taxi company and global multinational—are easy to define, but in between there is no principled reason to draw the line at five, or ten, or even 1000 shareholders. The better approach would be to adjudicate the issue based on all the facts and circumstances of a particular case—this is what courts do, more or less, in veil piercing cases. As we will see, however, the doctrine is not

\textsuperscript{21} See Mark I. Weinstein, Share Price Changes and the Arrival of Limited Liability in California, 32 J. Legal Stud. 1, 2 (2003) (“Prior to 1931, California law provided pro rata unlimited liability for shareholders of California corporations.”).
limited to cases of tort, or sensibly tied to the policy justifications that animate its existence in the first place.

1.6 THE IMPORTANCE OF LIMITED LIABILITY

Although some leading scholars claim that entity shielding rather than limited liability (or owner shielding) is the essential attribute of corporate law, the importance of limited liability to the development and success of the corporate form should not be minimized. Corporations account for about one-fifth of all business entities in the US and bring in about 90 percent of all business receipts. The dominance thus achieved by the corporate form over the alternative business organization that until recently was its chief rival—the partnership—likely would not have happened but for limited liability.

The other key features of the corporate form—that is, asset lock-in, centralized management, and free transferability of ownership interests—could be achieved in other forms of business association. For instance, a partnership could use a mixture of internal operating agreements and contracts with key external stakeholders to replicate these corporate features. In contrast, as Larry Ribstein has persuasively argued, “partnerships could not easily contract for” limited liability “as they would have to include the creditors in these contracts. With many creditors this may be very costly, and with involuntary creditors it is impossible.”

Think again about the pedestrian run over by the taxi. It might be true that the optimal rule before the accident is to give the taxi company limited liability, such that all pedestrians would agree to it before they knew whether they would be hit or not, but this is not a bargain that is possible in the absence in a legal default of limited liability.

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22 See, e.g., Hansmann & Kraakman, supra note 13, at 437 (arguing that affirmative asset partitioning “is the only important feature of modern firms for which substitutes could not be crafted, at any price that is even remotely conceivable, using just the basic tools of contract, property, and agency law”).

23 To be sure, there are now many alternative forms of business organizations that provide limited liability, such as the limited liability partnership, the limited partnership, the limited liability partnership, and the limited liability company. Except for the limited partnership, however, these are all recent creations that were unavailable when the corporate form became dominant in the nineteenth century. See Larry E. Ribstein, The Rise of the Uncorporation 119–33 (2010) (tracing the recent history of unincorporated entities).

24 Ribstein, supra note 23, at 76–9.

25 Id. at 79.
The problem arises because the default rules of partnership law provide no limitation on the potential liability partners face for obligations of the firm. Under the Uniform Partnership Act (1914) each partner is jointly and severally liable for a tort or breach of trust committed by another partner if committed within the scope of the firm’s business. In addition, each partner is jointly liable for all other partnership debts and obligations.\(^{26}\) The UPA (1997) rules are the same, except that partners are jointly and severally liable for both types of obligations.\(^{27}\) This problem is further compounded by the fact that each, and every partner is an agent of the partnership with respect to its business, and thus can enter into contracts binding the entire partnership.\(^{28}\) Finally, because the partnership can be held liable for the acts of its non-partner agents, the individual partners are on the hook for any such liabilities. All of these potential sources of liability are unlimited, so that each partner could be forced to pay her or his share of a partnership obligation to the full extent of her or his personal assets.

To be sure, if corporations had remained small, localized businesses, limited liability might not have given the corporate form a decisive advantage over the partnership. On the one hand, the limited liability doctrine often fails to provide closely held corporation shareholders with complete protection. Many contract creditors, for example, insist that shareholders of a closely held corporation guarantee the firm’s debts. Contracts modifying limited liability are possible, as in this case. In addition, the common law doctrine of veil piercing enables courts to impose personal liability on shareholders (and members of a LLC) in appropriate cases. On the other hand, adequate capital reserves and insurance can provide partners with substantial protection despite their nominally unlimited liability.

Instead, limited liability became an essential feature and a driver in the success of the corporate form due to the convergence of two trends in the nineteenth century.\(^{29}\) The first was the growth of very large

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\(^{26}\) UPA (1914) § 15.

\(^{27}\) UPA (1997) § 306.

\(^{28}\) UPA (1914) § 9; UPA (1997) § 301. About half the states have now created a variant on the general partnership called the limited liability partnership (LLP). The LLP essentially is a general partnership except that it provides limited liability for all partners (in most states for tort claims only).

\(^{29}\) “In an editorial the *Economist* (1926, p. 1053) opined that the ‘nameless inventor of limited liability’ was as important to economic development in the nineteenth century as ‘Watt and Stevenson.’ This is high praise indeed, as Watt invented the steam engine and Stevenson invented the railroad locomotive.”

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corporations—especially the transcontinental railroads of the mid-nineteenth century—with many thousands of geographically dispersed shareholders, creditors, and other stakeholders. The second factor was the growth of enterprise liability, at first in contracts and torts, and later in a host of regulatory contexts that exposed businesses to exponentially increasing liability risks. The second factor made running a large enterprise as a partnership untenably risky for its owners, while the first made it unmanageable for creditors and other stakeholders to contract for personal liability on the part of the enterprise’s owners. Taken together, these factors made the limited liability corporation the dominant business organization of the industrial era. Only through a corporation was it possible for founders of a business to raise the enormous amounts of capital necessary to finance the vast enterprises of the Second Industrial Revolution by selling shares to a great many investors who could put a portion of their savings into the enterprise without fearing that their entire net worth was thereby put at risk.

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30 See Glenn D. West & Natalie A. Smeltzer, Protecting the Integrity of the Entity-Specific Contract: The ‘No Recourse Against Others’ Clause-Missing or Ineffective Boilerplate?, 67 Bus. L. 39, 43 (2011) (noting “there was general acceptance of the need for limited liability for railroads” during the nineteenth century).

31 See Larry E. Ribstein, Should History Lock in Lock-in?, 41 Tulsa L. Rev. 523, 535 (2006) (explaining that “limited liability alone might not have been particularly important to firms before enterprise liability and the demise of contractual privity rules at the end of the nineteenth and beginning of the twentieth century”); Larry E. Ribstein, Why Corporations?, 1 Berkeley Bus. L. J. 183, 193 (2004) (“Prior to the development of enterprise liability, limited liability probably was not an important corporate feature.”).

32 See Weinstein, supra note 29, at 193 (“Because limited liability makes it less risky for passive investors to invest in the enterprise and to diversify their investments across enterprises, it is easier for entrepreneurs to raise sufficient capital to form enterprises on the scale of that required by modern industrial technologies.”); see also Phillip I. Blumberg, Accountability of Multinational Corporations: The Barriers Presented by Concepts of the Corporate Juridical Entity, 24 Hastings Int’l & Comp. L. Rev. 297, 301 (2001) (arguing that limited liability arose “as a result of the pressures on the growing corporations of the first half of the nineteenth century to raise the capital required to take advantage of the emerging technology of the times”); Henry G. Manne, Our Two Corporation Systems: Law and Economics, 53 Va. L. Rev. 259, 262 (1967) (“Limited liability is probably an essential aspect of a large corporate system with widespread public participation.”).
1.7 THE EXCEPTIONS TO LIMITED LIABILITY

As we have seen, the law grants an exception to the normal default rule of limited liability when it is clear that the costs of limited liability exceed the benefits. This reversal from the general case is most likely in the case of tort claims against closely held corporations, and we will see that this is where veil piercing is invoked most often and most easily. But limited liability is only a default rule, so it is modifiable not only by courts but by the parties themselves—shareholders can contract around the default rule.

MBCA § 6.22’s statement of the limited liability rule contains these two exceptions: “(b) Unless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.”

The first and far less important one allows a corporation to opt out of limited liability in whole or in part by including an appropriate provision in its articles of incorporation. It is difficult to imagine circumstances that would prompt an ordinary business corporation to avail itself of that option. As noted above, shareholders likely prefer limited liability in every state of the world, except when creditors (e.g., a bank lending to a start-up) demand a contractual waiver. And, even in those cases, this can be achieved in a limited scope through a specific contract—that is, waiving limited liability for this particular potential creditor—instead of through a charter amendment. In very isolated instances, however, companies doing business outside the United States may be subject to foreign tax or regulatory laws that require the shareholders—especially close corporations—to waive limited liability to a specified extent.

Instead it is the latter proviso that does important work by allowing personal liability to be assumed by shareholders “voluntarily or otherwise.” A shareholder, for example, voluntarily may assume liability through a personal guaranty. Alternatively, personal liability may be involuntarily thrust upon a shareholder under the equitable remedy known as piercing the corporate veil.

The ‘veil’ of the ‘corporate fiction’ or the ‘artificial personality’ of the corporation is ‘pierced’ and the individual or corporate shareholder exposed to personal or corporate liability, as the case may be, when a court determines that the debt in question is not really a debt of the corporation, but ought, in

33 Model Business Corporation Act § 6.22 cmt.
fairness, to be viewed as a debt of the individual or corporate shareholder or shareholders.34

Or, as a seminal 1912 law review article put it:

When the conception of corporate entity is employed to defraud creditors, to evade an existing obligation, to circumvent a statute, to achieve or perpetuate monopoly, or to protect knavery or crime, the courts will draw aside the web [i.e. veil] of entity, will regard the corporate company as an association of live, up-and-doing, men and women shareholders, and will do justice between real persons.35

As noted above, veil piercing is where most of the legal action takes place. Unfortunately, the law in this area is a mess. There is no uniformity, as there are multiple standards in use that differ significantly from state to state. Worse yet, none of those standards provide anything remotely resembling a bright line rule. The result has been uncertainty and lack of predictability, increasing transaction costs for small businesses. At the same time, however, there is no evidence that veil piercing has been rigorously applied to effect socially beneficial policy outcomes. Judges typically seem to be concerned more with the facts and equities of the specific case at bar, than with the implications of personal shareholder liability for society at large. Accordingly, an important goal of this text is not just to set out the law of veil piercing, but also to propose alternatives that would provide greater ex ante certainty and easier ex post administration.

1.8 PLAN OF THE WORK

Our analysis starts with the history and theory of limited liability. When did the law first adopt limited liability as a core element of the corporate form? Why did it do so? In answering the latter question, we adopt the standard law and economics conception of the corporation as a nexus of contracts, which leads us to a conception of limited liability as one of the

34 Stephen B. Presser, Piercing the Corporate Veil § 1.01 at 1–6 (1991 and supp.) (nb. footnotes and emphasis omitted). Shareholders may also face personal liability in connection with watered stock or unlawful dividends. In some states, special statutory provisions impose personal liability on shareholders with respect to certain corporate debts. New York and Wisconsin, for example, do so with respect to employee wages. Id.

35 I. Maurice Wormser, Piercing the Veil of Corporate Entity, 12 Colum. L. Rev. 496, 517 (1912).
default rules making up the standard form contract provided by corporate law. The core theoretical problem thus becomes determining why society offers limited liability (as opposed to joint and several or pro rata shareholder liability) as the default rule.

We then turn to an extended analysis of veil piercing and related doctrines. Our focus here is on US law because that is the legal system we know best, but include a comparative law chapter on the rules in both common and civil law countries. In addition, while our focus is on piercing the corporate veil, we also include a chapter on the increasingly important issue of piercing the veil of unincorporated entities, especially the limited liability company (LLC).

We conclude with some thoughts on law reform. Veil piercing tries to do too much. Allocating liability within a corporate group controlled by a publicly held corporation involves far different policy considerations than does holding liable the individual shareholders of a closely held corporation. These tasks should be unbundled. Intra-corporate group liability issues should be dealt with as a species of enterprise liability, while the liability of individual shareholders is the proper subject of veil piercing law.

So defined and delimited, the survival of veil piercing is difficult—if not impossible—to defend. A standard academic move treats veil piercing as a safety valve allowing courts to address cases in which the externalities associated with limited liability seem excessive. In doing so, veil piercing is called upon to achieve such lofty goals as leading shareholders to optimally internalize risk, while not deterring capital formation and economic growth, while promoting populist notions of economic democracy. The task is untenable. Veil piercing is rare, unprincipled, and arbitrary. The doctrine needs to be reformed in ways that will refocus judicial analysis on the appropriate question—did the defendant-shareholder do anything for which he or she should be held directly liable? Did the shareholder commit fraud, which led a creditor to forego contractual protections? Did the shareholder use fraudulent transfers or insider preferences to siphon funds out of the corporation?