A CONTROL-BASED APPROACH TO SHAREHOLDER LIABILITY

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There is little disagreement that shareholder limited liability can encourage socially
costly corporate activity – risky activity selected because the corporation and its

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shareholders do not bear all the expected costs of the activity. While the size of this externality remains to be quantified, individuals engaging in risky business enterprises are regularly advised to create corporations precisely for the purpose of shielding their assets, and corporations engaging in risky activities are advised to create subsidiaries for the same purpose. Even given the very limited opportunities for “piercing the corporate veil,” thousands of corporate tort victims have spent money litigating, trying to obtain compensation from shareholders in cases where corporate assets and insurance may be inadequate to cover injury costs.

Commentary on shareholder limited liability essentially falls into two camps. Some defend current limited liability rules against all comers. Others propose to abandon it altogether in the case of tort and statutory violations and substitute a scheme of unlimited shareholder liability divided among shareholders pro rata.

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2 See Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 Yale L.J. 1879, 1880 (1991) (excess risk-taking is “conventionally assumed to be the price of securing efficient capital financing for corporations”); Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. Law 573, 576 (1986) (“even economists convinced of the utility of limited liability . . . concede that limited liability raises serious problems because it enables the enterprise to externalize its costs”); Paul Halpern, Michael Trebilcock, and Stuart Turnbull, An Economic Analysis of Limited Liability in Corporation Law, 30 U. Toronto L.J. 117, 126 (1980) (“it is claimed that a limited liability regime is inefficient because it [creates] incentives for excessive (inefficient) allocations of social resources to risky economic activities”). This recognition has yet to cause any significant change in judicial willingness to honor limited liability principles. E.g. Browning-Ferris Industries, Inc. v. Ter Maat, 195 F.3d 953, 960 (7th Cir. 1999) (the argument that enterprises “should be prevented from externalizing the costs” of potentially hazardous activities “has not carried the day in any jurisdiction that we are aware of”) (Posner, C.J.), cert. denied, 120 S. Ct. 1832 (2000).

3 See infra Sections III(A), III(B).

4 See infra page 47.

5 See, e.g., Frank Easterbrook & Daniel Fischel, Economic Structure of Corporate Law ch. 2 (1991); Frank Easterbrook & Daniel Fischel, Limited Liability and the Corporation, 52 U. Chi. L. Rev. 89 (1985); infra Section II.

6 See, e.g., Hansmann & Kraakman, supra note 2. A third smaller group argues that limited liability should be abandoned only for certain categories of corporations, either closely-held corporations or corporations that are wholly owned by a parent corporation. E.g., Paul Halpern,
Both groups, however, focus on the corporation as the unit. Inexplicably, neither of the regimes seems to fully account for qualitative differences among shareholders. These qualitative differences include access to information and the ability to influence management decisions, as well as opportunities for control shareholders to gain special benefits from corporate activity. A shareholder liability regime’s consequences can differ significantly depending on these qualitative shareholder differences. For example, limited liability’s articulated benefit of reducing transaction costs differs substantially depending on the shareholder’s identity. A shareholder with only a tiny proportion of a corporation’s shares and limited access to information might indeed save significant transaction costs under a limited liability regime. However, transaction costs savings may be less significant – or lacking altogether – when the shareholder is a parent corporation or a shareholder that otherwise can control corporate affairs.

The moral hazard created by limited liability for a corporation to overinvest in excessively risky activity also varies depending on shareholder characteristics. A control shareholder will be most able and most inclined to influence a corporation to take excess risks. However, neither the limited liability regime nor the pro rata regime adequately accounts for the differences in incentives and transaction costs that can face different shareholders in a single corporation.

A control-based liability regime would take a different approach to limited liability’s moral hazard by focusing vicarious liability only on the shareholder with the capacity to control the corporation. Such a shareholder would bear full responsibility for

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7 See infra text accompanying notes 281-300.
corporate torts or statutory violations when liability exceeds corporate assets. A control-based regime thereby would respond to the greater incentive for excess risk-taking resulting from the presence of a control shareholder. It also would address a potential shortcoming of the pro rata unlimited liability regime, the prospect that incentives faced by control shareholders under it might well be inadequate to deter excess corporate risk-taking. At the same time, because it would not treat shareholders identically, a control-based liability regime could preserve potential efficiencies created by limited liability for truly small shareholders, such as reductions in transaction costs. A control-based liability regime is not without its own disadvantages, including overdeterrence of some socially beneficial activities that cannot be insured—and the possible imposition of transaction costs resulting from the use of a rule to define liability rather than a detailed standard. Definitively resolving the relative size of these effects requires further empirical investigation into issues such as the value of control and the location and significance of transaction costs. Nonetheless, because a control-based liability regime more explicitly responds to differences among shareholders and appears most likely to compel corporations to internalize the costs of their risky activities, it deserves serious consideration.

A control-based liability regime deserves serious consideration for pragmatic reasons as well. Implementation would be comparatively straightforward. Of course, retaining the status quo is generally easiest—but that would also mean retaining the undiluted moral hazard of limited liability. However, compared with a pro rata liability regime, a control-based liability regime could be more easily adopted. Congress or state legislatures could pass statutes imposing such a regime, but courts could also implement it by simply building on the common law rules of veil piercing.⁸

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⁸ Both issues of transition rules and whether such a step would best be taken at the state or federal level are beyond the scope of this paper. E.g., Janet Cooper Alexander, Unlimited Shareholder Liability Through a Procedural Lens, 106 Harv. L. Rev. 387, 389 (1992) (arguing that expansion of vicarious liability by state statute would present claimants with significant procedural difficulties).
Part I of this article briefly summarizes the history of the limited liability regime and discusses how limited liability arose separately from a host of other features typically associated with an independent corporate form. Part II outlines prevailing justifications for limited liability and discusses how the major justifications for limited liability – limited liability as a mark of corporate independence and limited liability as an efficient investment incentive – critically depend on positing a “typical” corporation as one owned by numerous “small” shareholders and a “typical” shareholder that is an individual without great wealth or the ability to control the corporation. It then questions the justifications in view of current data regarding corporate equity holders and the distribution of ownership in domestic private and public corporations. Part III discusses limited liability’s “moral hazard” and how it is exacerbated by the presence, within a corporation’s ownership, of a controlling shareholder. It also responds to arguments that other aspects of the current legal system may tend to blunt the moral hazard. Part IV outlines the basic framework of a control-based liability regime, which would impose liability on a shareholder that possesses the capacity to control a corporation. It then compares the control-based regime to limited liability and to a pro rata regime of shareholder liability. Part IV concludes that the pro rata rule would inadequately address limited liability’s moral hazard. Because a control shareholder can obtain value from corporate operations in excess of the shareholder’s pro rata share, the shareholder would still face incentives to encourage a corporation to underinsure and to take excess risks. Further, substantial transaction costs are likely to hinder plaintiffs from obtaining full compensation, under a pro rata regime, from multiple corporate shareholders. A capacity to control regime is likely to better assure that corporations internalize the costs of risky corporate activity, including by insuring adequately. Part IV also analyzes the potential disadvantages of a control-based liability regime, including the prospect that when insurance is unavailable, shareholders might turn away from socially beneficial corporate opportunities.
I. A Brief History of the Limited Liability Regime

Currently, limited liability for corporate shareholders is a critical member of the small group of features (including a separate legal existence and a capacity to act separate from the identity and actions of its owners) that historically has distinguished corporations from other forms of business organization, such as sole proprietorships or partnerships.\(^9\) The corporation has become the dominant form of business organization in this country. The overwhelming bulk of business in the United States is done by entities organized as corporations. Business done in the corporate form amounted to eleven trillion dollars worth of receipts, compared with 1.3 trillion dollars of receipts attributable to partnerships and sole proprietorships combined.\(^10\) The presumed availability of limited liability for shareholders could well be a reason for the dominance of the corporate form. According to some commentators, limited liability "is regarded by most persons as the greatest advantage of incorporation" and "perhaps the distinguishing feature" of corporate law.\(^11\)

\(^9\) Corporations have a legal existence and a capacity to act separate from the identity and actions of its owners, as well as continuous succession (an existence separate from the changes in its membership), unified management, the power to sue and be sued, and to take or convey property in the corporate name. Machen, 24 Harv. L. Rev. at 352. See Joseph Davis, Essays in the Earlier History of American Corporations vol. I, at 5 (1917) (a corporation was "[as early as the American colonial period], as now, a group of individuals authorized by law to act as a unit").

\(^10\) In 1993, at least 3.9 million corporations filed tax returns with the IRS. See US Internal Revenue Service, Statistics of Income ch. 17, table 833. In the same year, the IRS received 1.4 million returns from partnerships and 15 million returns from proprietorships. Although more sole proprietorship returns were filed than corporation returns, the vast majority (over 2/3) of the sole proprietors reported receipts of under $25,000. Further, the total number of corporate tax returns understates the number of domestic corporations, since some groups of corporations file a single consolidated tax return. The overwhelming majority of corporations are not publicly traded. For example, the New York Stock Exchange lists just over 3,000 corporations – less than 0.1% of the total number of corporations that filed tax returns with the IRS. See New York Stock Exchange Fact Book: 1998 Data 4 (1999).

It has not always been so. Limited liability for corporate shareholders arose separately from and later than the other characteristic corporate features. Early corporate charters generally conferred on the corporation an independent legal status and the capacity to take legally binding action. However, that independent legal status was not always accompanied by limited liability. Not until the 1800s did the charters that states granted to corporations first begin to mention shareholder liability. Early corporate charters did not discuss liability at all. For some time, at least a few states, including Maine, Massachusetts, and Rhode Island, granted corporate charters with the express proviso that shareholders would be fully liable -- apparently on the theory that unlimited liability would best assure economic growth and development because creditors would be

liability for the shareholders”). See also James B. Zimpritch, Maine Corporation Law & Practice § 4.5 at 65 (1993) (“A principal purpose in most incorporations is to obtain limited shareholder liability ...”); Lynn LoPucki, Virtual Judgment Proofing, 107 Yale L.J. 1413, 1427 (1998) (“Limiting liability is widely understood to be the principal reason for the separate incorporation of subsidiaries.”); Richard Lipsey, Peter Steiner, et al. Economics 174 (1990) (“From a stockholder’s viewpoint, the most important aspect of the corporation is its limited liability.”). Limited liability is also characterizing new forms of organization, such as the Limited Liability Partnership ( LLP) and the Limited Liability Company (LLC).

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12 James Hurst, The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970 19 (1970); see id. at 26 (“On balance, and from the outset, the corporation was an instrument to provide firm central direction for the enterprising use of pooled assets.”); Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. at 588 (businessmen used the corporate form “primarily to achieve perpetuity of existence and ready transferability of shares”).

The ability to take legally binding action was not always vested in a board of directors, but sometimes was dependent on significant shareholder involvement. See Hurst at 25 (giving examples; “courts were at first hesitant to recognize implied powers in boards of directors”); Morton Horwitz, The Transformation of American Law 1870-1960 (1992), at 95.

13 English corporation law similarly did not consider limited liability, at the outset, to be “among the essential attributes of the corporation.” See Blumberg, 11 J. Corp. Law at 580 (discussing Coke, Blackstone, and Kyd).

14 E. Merrick Dodd, The Evolution of Limited Liability in American Industry: Massachusetts, 61 Harv. L. Rev. 1351, 1356 (1948) (“[E]ven in England, the evidence as to what the men of the eighteenth century thought on this subject [limited liability] is extremely meager and in the United States it is almost nonexistent.”). But see Joseph Davis, Essays in the Earlier History of American Corporations, vol. I, at 5 (“Normally [corporate] property was not liable for obligations of members, and their private property was likewise not subject to be taken to pay debts of the corporation.”)
assured of repayment and consequently would loan more capital.\textsuperscript{15}

A few states then decided that limited liability, rather than unlimited liability, would better encourage economic growth. Although limited liability would not reassure creditors, it would encourage corporate investment.\textsuperscript{16} By 1840, most state legislatures had determined that the "furthering of capital formation could best be accomplished by encouraging shareholders to invest through limiting their liability."\textsuperscript{17} One perceived target of these incentives was apparently the "small-scale entrepreneur,"\textsuperscript{18} but large-scale industrialists probably pressured the political process for limited liability.\textsuperscript{19} By the late 1800s, most states had begun to grant at least some limited liability corporate charters.\textsuperscript{20} Limited shareholder liability, rather than unlimited liability, was the preferred incentive for investment in corporations.\textsuperscript{21}

Despite the move toward adopting some form of limited liability for corporate


\textsuperscript{16} Evidence on whether the change in approach actually did encourage investment during the early period is mixed. For example, "Rhode Island . . . adhered to the full liability principle until 1847 without thereby losing its position as the second state in the union in the value of its cotton textile products." Dodd, 61 Harv. L. Rev. at 1376.


\textsuperscript{18} Presser, 87 Nw. U. L. Rev. at 155; see also Paul Halpern, Michael Trebilcock & Stuart Turnbull, An Economic Analysis of Limited Liability in Corporation Law, 30 U. Toronto L.J. 117, 118 (1980) (limited liability supporters in England argued that middle and working classes would be encouraged to invest).


\textsuperscript{20} See Dodd at 1376.

\textsuperscript{21} See Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. at 604 (limited liability was “intended to stimulate economic activity by encouraging widespread investment in corporate shares”).
shareholders, shareholder limited liability was far from fully established until the early part of the twentieth century.\textsuperscript{22} Prior to this time, many states had enacted provisions expressly holding shareholders liable for more than the value of their shares.\textsuperscript{23} Through this period, the corporation was still perceived as not dissimilar to a partnership, in the sense that a corporation could be seen as a group of shareholders acting in concert, rather than entity \textit{sui generis}.\textsuperscript{24} Consequently, the distinction between corporate shareholder liability and the liability of a member of a partnership was largely a matter of degree.\textsuperscript{25}

Now, however, the overwhelming majority of state corporation statutes, which provide the "default terms" under which companies may incorporate, include express limitations on shareholder liability. Section 6.22 of the Model Business Corporation Act specifies that the shareholder's obligation to the corporation is solely to "pay the consideration for which the shares were authorized to be issued . . . ."\textsuperscript{26} A shareholder 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."\textsuperscript{27}

\textsuperscript{22} \textit{Compare} Thomas Frost, \textit{A Treatise on the Incorporation and Organization of Corporations} 34 (1908) ("It has been the rule of the courts from time immemorial to recognize the power of the corporations to sue and be sued . . . as incident to such corporate existence.") with id. at 75 (noting special requirements in several states before stockholders may avoid personal liability for corporate debts).

\textsuperscript{23} \textit{See} Hurst at 27 (shareholders in industrial states sometimes faced double their investment or more in liability for particular debts); Morton Horwitz, \textit{The Transformation of American Law, 1870-1960} 94 (1992) ("truly limited shareholder liability was far from the norm in America even as late as 1900"). The common law had, however, "evolved to the point of presuming limited shareholder liability in the absence of any legislative rule" by the mid-1800s. \textit{Id}.

\textsuperscript{24} For example, Professor Horwitz notes that in the 1880s, a corporation could not sell its assets without unanimous shareholder consent. \textit{Horwitz} at 88.

\textsuperscript{25} \textit{Horwitz} at 94.

\textsuperscript{26} \textit{See} Model Business Corporation Act § 6.22(a).

\textsuperscript{27} \textit{See} Model Business Corporation Act § 6.22(b). This section of the Model Business Corporation Act has been adopted in Arkansas, Georgia, Indiana, Kentucky, Mississippi, Montana, New Hampshire, North Carolina, Tennessee, South Carolina, Utah, and Wyoming. Iowa's statute
II. Prevailing Justifications for Limited Liability

As seen above, limited liability for shareholders is not intrinsic to the existence of a separate corporate form. It arose later than the other attributes of the corporate form and must be assessed on its own merits. The historical evidence suggests that limited liability was developed as a broad-based subsidy for investment. As a subsidy for investing in the American economy, it is currently perceived to be extremely successful. However, limited liability also distorts investment incentives, by permitting companies to externalize the costs of risky activity.

Perhaps in part because of the potential size of the resulting externality, commentators have sought to justify this distortion on grounds other than the need for an investment subsidy. The justifications fall into two general categories. The first seeks to defend shareholder limited liability as linked to the corporation’s status as a freestanding

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28 See supra pages 7-8; see also Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law 44 (1991) (“The increased availability of funds for projects with positive net present values is the real benefit of limited liability.”).

entity and its operation of an enterprise that is distinct from the individual shareholder and its activities. The second makes claims of economic efficiency for limited liability. Both categories of justification have important shortcomings. Further, both justifications depend critically on assumptions regarding the characteristics of the “typical small shareholder” and the “typical large corporation.” They posit a “typical corporation” that is owned by numerous “small corporate shareholders,” without great wealth, and without the ability to easily monitor or influence the corporation. And they posit a “typical shareholder” who is an individual, not a large institution, and who neither is wealthy nor can control the corporation. However, the reality is that neither the “typical large corporation” nor the “typical shareholder” is the norm.

A. Limited liability as a mark of corporate “independence”

The first category of justification – the attempt to connect the corporation’s independent legal status with shareholder limited liability – is essentially the following: The corporation exists as an independent viable legal entity, an “artificial person” with its own ongoing enterprise. It is “independent” of its shareholders in the sense that corporate activities are distinct from shareholder activities and a change in shareholder ownership will not necessarily have a material effect on the corporate enterprise. So, the corporation’s debts should not be those of the shareholder. In other words, "the state's approval of the

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30 This type of entity theory of corporations emerged in the early part of this century, positing that corporations exist separate and apart from individual shareholders and from the state. See Morton Horwitz, The Transformation of American Law 100-06 (1992).


32 Natural persons have limited liability in the sense that courts will only enforce a liability judgment against a person’s property, and a person retains the ability to work, an important income-producing asset, even after declaring bankruptcy. See Lynn LoPucki, The Death of Liability, 106 Yale L. J. 1, 9 & nn. 21-22 (1996) ("imprisonment for debt offends deeply held American values").
corporate form sets up a prima facie case that the assets, liabilities, and operations of the corporation are those of the enterprise.\textsuperscript{33} If a corporation cannot pay a judgment, the court should not seek any further options for execution of the judgment apart from the corporation itself.

While this justification does not currently receive much attention in the academic literature, it continues to resonate in judicial opinions.\textsuperscript{34} The justification has a number of problems. First, limited liability is not necessary to the success of a corporation as an independent legal entity. In this respect, limited liability seems different from some other characteristic corporate features. For example, the capacity to sue and to be sued, is necessary for the corporation to credibly enter into legally binding agreements. That ability seems critical to the corporation’s potential success as an independent legal entity.

History confirms the irrelevance of limited liability to corporate “independence.” Limited liability for shareholders arose separately from the development of the corporation as a freestanding legal entity.\textsuperscript{35} A corporation's capacity to act separately from its shareholders, to enter into legally binding agreements, or to bring a lawsuit, is not at all

\begin{footnotes}
33 \hspace{1em} A.A. Berle, \textit{The Theory of Enterprise Entity}, 47 Colum. L. Rev. 343 (1947). Berle's language evokes the historical strain in corporation theory that sees the corporation as a creature of the state. See \textit{e.g.}, Horwitz at 72 (discussing “grant” theory of corporation in nineteenth century American and view that corporation is “entity created by the state”).

34 \hspace{1em} \textit{E.g. Castleberry v. Branscum}, 721 S.W.2d 270, 272 (Tex. 1986) (“the separateness of the corporation has ceased”); \textit{Louisiana-Pacific v. ASARCO, Inc.}, 5 F.3d 431 (9th Cir. 1993) (discussing termination of shareholder liability after corporate dissolution).

35 \hspace{1em} A "considerable period of time elapsed [both in Great Britain and in the United States] between acceptance of the separate legal personality of the corporation . . . and the widespread adoption of the principle of limited liability." Ronald Aronovsky & Lynn Fuller, \textit{Liability of Parent Corporations for Hazardous Substance Releases under CERCLA}, 24 U.S.F.L. Rev. 421, 429-30 (1990); Philip I. Blumberg, \textit{The Law of Corporate Groups} 10 (1987) (“for several decades, we had a remarkable juxtaposition of conflicting legal rules on limited liability in neighboring states”). \textit{See supra} text accompanying notes \textsuperscript{____}.\
\end{footnotes}
dependent on whether shareholders have limited liability.\textsuperscript{36} That a court might, for example, pierce the corporate veil and hold a shareholder responsible for a corporate debt in no way impairs the corporation’s ability to act. As Easterbrook and Fischel have pointed out, limited liability is an “attribute of the investment rather than of ‘the corporation.’”\textsuperscript{37}

Limited shareholder liability cannot be assumed to be appropriate simply because it is desirable for a corporation to have independent legal status and the ability to enter into legally binding actions. The argument then becomes essentially rhetorical: a corporation is like a natural person, so, like a natural person, it should have sole responsibility for its actions. The analogy is, however, highly imperfect.\textsuperscript{38}

Simply stated, however, the corporation and a particular shareholder may not actually be independent. The “rhetorical” justification is strongest for the corporation composed of numerous individual shareholders, each of which individually holds only a tiny

\textsuperscript{36} E.g. Hansmann & Kraakman (recommending replacement of limited liability with proportional liability for all shareholders; arguing that public stock exchanges will be facilitated under proportional liability scheme).

\textsuperscript{37} Easterbrook & Fischel, Economic Structure of Corporate Law 11-12. This principle is fairly obviously illustrated by the fact that a court’s piercing of a corporate veil to hold a shareholder responsible does not destroy the corporation’s legal capacity to act. See Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. at 595 (limited liability arose as a “political response to economic and political pressures, rather than as a necessary consequence of the entity concept”).

\textsuperscript{38} As discussed below, courts will pierce the corporate veil when a shareholder uses the corporation as its alter ego, reasoning that a shareholder cannot simultaneously assert the “rhetorical” argument – that the corporation is independent and thus the shareholder should not have responsibility for corporate debts – and simultaneously use the corporation as an instrumentality for the shareholder’s business. In the early 1800s, Justice Taney made this connection, arguing that individual shareholders could not simultaneously carry on business in the corporate name and try to avoid liability for corporate acts. Bank of Augusta v. Earle, 38 US (13 Pet.) 519, 586 (1839). See also Horwitz at 76 (discussing Bank of Augusta). However, as discussed below, current law allows many shareholders both to indirectly carry on business in the corporate name and to avoid liability.

In any event, the “converse” proposition must be separately evaluated – that, as a rule, the holder of equity shares should have only limited responsibility for the “independent” corporation. It must be especially closely evaluated under circumstances where the shareholder can exert control over the corporation to accomplish the shareholder’s objectives.
percentage of shares – the “Berle-Means” corporation. Berle and Means discuss the phenomenon of this corporation, which, they argue, is controlled by its managers. The corporation’s connections with its shareholders are distant. The shareholders may have limited ability to influence corporate management as a general matter, and virtually no ability to influence particular operational or financial decisions. The corporation’s managers make the critical decisions. This presents the strongest case for treating a corporation as “independent” and its liabilities as its own, and no one else’s.

For the many companies wholly owned by a parent or by a very few companies or individuals, the argument vastly oversimplifies, or even misrepresents, the reality of the corporate enterprise. Such a shareholder or shareholders may possess considerable potential or actual influence over the corporation’s activities. Such a shareholder may be able to control capital investments, dividend payments, and operational decisions. Although the shareholder may not be able to directly bind the corporation, the practical reality is that the shareholder and corporation are not very separate. The corporate form is relatively manipulable and controllable. The shareholder can, at the outset, incorporate the corporation to limit the shareholder’s assets at risk from the corporation’s activities; the shareholder can also, through membership on or control over the board of the directors, see that the corporation is operated to pay dividends promptly and to keep assets separate, through, for example, the payment of dividends or the use of subsidiaries, from

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40 For such corporations, management is primarily conducted by the corporation’s officers and other managers, and the law grants shareholders only minimal checks on manager decisionmaking. For example, in shareholder derivative actions, the “business judgment rule” accords significant latitude to corporate managers. Implicit in that rule is the concept that corporate decisions are those of the corporation; the managers possess some autonomy relative to shareholder desires. E.g., In re Caremark, 698 A.2d 959 (Del. Ch. 1996).

risky corporate activities.\textsuperscript{42} Thus, for the sole shareholder or the few shareholders, the corporation seems far from “independent” and the rhetorical justification of limited liability lacks force.\textsuperscript{43}

In the last couple of decades, the reality of corporate ownership has departed from the hypothesized “Berle-Means” corporation. A substantial number of American corporations have significantly concentrated ownership or else are susceptible to direct control by particular shareholders. While empirical research in this area is far from exhaustive, several pieces of evidence support this conclusion. First, nearly half the corporate income tax returns filed with the IRS are S Corporation returns.\textsuperscript{44} Chapter S Corporations must be completely owned by 75 or fewer individual shareholders to qualify for special tax treatment.\textsuperscript{45} Over 90\% of S Corporations are owned by 3 or fewer

\begin{itemize}
\item \textsuperscript{42} That the corporation is, of course, not a natural person bears on the corporation’s incentives to bear responsibility for its actions. The question might be asked, for example, why limited liability for a taxicab accident, where the taxicab is one of two cabs owned by a corporation, should be treated any differently from personal liability for an accident involving a privately-owned car. See infra page 60 (discussing Walkovsky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6 (1966)). There are critical differences, however, between the artificial corporate entity and personal liability. In the privately-owned car accident, the car owner is fully liable for the cost of the accident up to the amount of all the car owner's assets, even after any insurance has been exhausted. The corporation is not a person; instead, it is an entity created by people that generally have other available assets that they wish to protect from risks of the corporation’s business. As noted in the text, the corporate entity's assets are far more easily manipulated to reduce exposure to a judgment, especially judgments likely to be owed to "involuntary" creditors. For example, in Walkovsky, the sole shareholder of the several taxicab corporations had them constantly pay dividends to him, which effectively limited corporate ability to pay tort judgments. “[A]ll income was continually drained out of the corporations for the same purpose.” 223 N.E.2d at 11. Because a natural person would thereby lose the use of the assets, a natural person is less likely to transfer away all his or her assets to avoid liability.
\item \textsuperscript{43} See, e.g., pages 49-50 (discussing Ventron case, in which parent exercised control over subsidiary to pay itself dividend of more than 75\% of land held by subsidiary).
\item \textsuperscript{45} Myron Scholes et al., Taxes & Business Strategy 80 (2002).
\end{itemize}
shareholders. More generally, approximately 60% of close corporations, both “S” and “C” corporations, have a shareholder that owns 51% or more of the equity. 79% of close corporations have a shareholder that holds 50% or more of the equity. Of active corporations filing tax returns with the IRS in 1994, 74% reported that they received dividends from a company in which they held 20% or more of the equity.

Second, in the largest publicly-traded corporations, despite stock exchange requirements of significant numbers of shareholders, stock ownership is often concentrated. Harold Demsetz has reported that, “roughly speaking, about 50% of large corporations fall into the owner-controlled category.” Two economists have located over 650 publicly traded companies with majority shareholders. While the study did not also specifically identify companies with a minority shareholder possessing a significant

46 Less than 10% of S Corporations had 4 or more shareholders. 99% had 10 or fewer shareholders. See S. Wittman & R. Grant, S Corporation Returns, Internal Revenue Service, Statistics of Income Bulletin 42 (Spring 1999).


48 Of 4.3 million active corporation returns, 3.1 million reported that they received dividends from domestic corporations in which they owned 20% or more of the equity. See Internal Revenue Service Statistics of Income, 1994 Corporation Income Tax Returns Table 20 (1997). [Data may undercount subsidiaries because consolidated reporting is permitted for 95%-owned subsidiaries.]


50 Harold Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J. L. & Econ. 375, 388 (1983). Although Demsetz reaches a conclusion on the presence of ownership control, he is quite unclear as to the precise criteria for “owner-controlled.” He observes that the term could refer to the satisfaction of any of a number of different standards, ranging from looking at the percent of outstanding shares held by the largest shareholder to looking at the percentage held by the twenty largest shareholders, and the “numbers so identified varies inversely with the toughness of the criterion adopted.”
portion of equity – enough to confer on the shareholder the capacity to control the
corporation -- the data is strongly suggestive that a substantial number of public
corporations are likely to be far from the Berle- Means ideal. 51 On the other hand, a recent
study has found that only 10% of forty selected publicly-held corporations have a
shareholder with a 20% or larger ownership block. 52

Third, wholly and mostly-owned subsidiaries are obviously far from independent
of their parent corporations. Seventy-five percent of corporate subsidiaries are wholly-
owned. 53 Because parent corporations and their subsidiaries very often file consolidated
tax returns, it is extremely difficult to estimate the amount of economic activity attributable
to corporate subsidiaries, but in view of the large numbers of corporate subsidiaries, it is
probably quite significant. Twenty-two firms randomly selected by James J. White from
the petroleum, chemical, and pharmaceutical industries had, in 1996, on average, 80

51 Holderness & Sheehan, The role of majority shareholders in publicly held corporations, 20
95% or more, in order to exclude wholly-owned subsidiaries. Id. at 320. To provide some context for
Holderness and Sheehan’s figures, approximately 8600 companies are currently listed on the three
major stock exchanges – the New York Stock Exchange, the American Stock Exchange, and NASDAQ.
These do include non- US companies. See NASDAQ in Black and White at 4-4 (1999); New York Stock
Exchange Fact Book: 1998 Data 4 (3,114 NYSE-listed companies, including 379 non-US companies;
domestic operating companies had global market capitalization of $10.3 trillion). Holderness and
Sheehan apparently did not search for companies with a shareholder with capacity to control that held
less than 51% of shares.

52 See Mark Roe, Political Preconditions to Separating Ownership from Corporate Control, 53
Stan. L. Rev. 539, 562, 604 (2000). The firms Roe selected were the twenty largest publicly-held firms
and the first twenty publicly-held firms with market capitalization above $500 million. As Roe notes,
“perhaps there is a size beyond which only public firms can exist, because, for example, private parties
lack the wealth to take on a major ownership interest.” Id. at 563.

53 See David Leebron, Limited Liability, Tort Victims, and Creditors, 91 Colum. L. Rev. 1565, 1620
(1991) (citing Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. 573, 626 (1986)).
See also David Leebron, Games Corporations Play: A Theory of Tender Offers, 61 N.Y.U.L. Rev. 153,
162 n. 35 (1986) (the vast majority of corporate acquisitions by tender offer result in ownership of the
entire equity).
Current data on the structure of corporate ownership, while not conclusive, is suggestive that most corporations take the form of having one or a few controlling shareholders. Further, a good deal of corporate economic activity likely also is attributable to corporations that fit the “controlling shareholder” form. So, even if ownership and control are not vested in exactly the same entities, they are closely linked in a substantial number of American corporations, comprising a major share of economic activity. It seems questionable, therefore, to adopt a legal theory that treats every single corporation’s liabilities as its own and not those of its shareholders based on an assumption that the corporation is “independent” of its shareholders.

B. Limited liability as an efficient investment incentive

The second category of justifications is efficiency-based: limited liability not only encourages investment in socially beneficial activities, but, by addressing market imperfections, encourages a level of investment that is efficient. As the argument goes, limited liability efficiently facilitates economic investment in two ways: (1) by permitting the "efficient" separation of "capital" from "skill," thereby saving information costs; and (2) by correcting risk-aversion among shareholders.

According to the information-costs justification, limited liability enables individuals with small amounts of money, but without the skill or the information to manage a business directly, to invest in the enterprises of others. Without limited liability, such an investor


55 A variant of this justification is that limited liability is worthwhile because it encourages people to "take risks." Risk-taking per se is not beneficial, however. It is warranted only if the risk taken is to engage in an activity whose expected social benefits, on the margin, outweigh its expected social costs. As discussed infra, limited liability may encourage harmful investment in risky activities that impose excessive social costs.

could risk losing substantial amounts -- perhaps the entire investment portfolio -- if any single investment went truly sour. Without limited liability, an investor would have to manage his or her risks by carefully monitoring the corporation’s activities, including not only information regarding the corporation’s potential earnings and the impact of new investment on those earnings, but also information regarding the potential liability risks faced by the corporation and the shareholder’s possible financial exposure in the event of such liability.\(^\text{57}\) However, such an investor could find acquiring detailed information regarding individual company operations to be quite costly.\(^\text{58}\) The investor would incur the “costs of obtaining, analyzing, and acting on information,” and “beyond a certain point, more monitoring is not worth the cost.”\(^\text{59}\) Faced with high monitoring costs, on one hand, and an unknown (but potentially significant) risk of losing all his or her assets from a bad investment on the other, the individual investor might choose to forego all investment, including “worthwhile” investment choices (those defined as possessing positive net present value). Under this theory, limited liability enhances efficiency because it reduces the costs resulting from these market imperfections. Rather than incurring transaction costs monitoring the corporation’s activities, the investor with limited liability can manage risk by dispensing with expensive monitoring and instead making more numerous, smaller investments, and diversifying them.\(^\text{60}\)

\(^{57}\) See Halpern, Trebilcock, and Turnbull, 30 U. Toronto L.J. at 136 (noting that under unlimited liability shareholders also must monitor each others’ wealth).


\(^{59}\) Easterbrook & Fischel, 52 U. Chi. L. Rev. at 94.

\(^{60}\) Similarly, because a shareholder’s exposure under limited liability would not depend on the wealth held by other shareholders, limited liability reduces the information-gathering costs that would be entailed by the need to monitor other shareholders. Easterbrook & Fischel, 52 U. Chi. L. Rev. at 94. Easterbrook and Fischel describe the need to monitor wealth of other shareholders under a rule of joint unlimited liability. As others have noted, such costs also can be eliminated under a rule of pro rata
The second efficiency advantage, according to this theory, is that limited liability “corrects” excessive risk-aversion on the part of individual investors. These investors might suffer an additional cost "resulting from the uncertainty about whether a loss will occur." According to the risk-aversion justification, the individual investor will not make socially worthwhile investments (those defined to have "positive net present value"), because s/he will be averse to the risk of losing all her/his assets, no matter how small the risk. Limited liability would "correct" for this risk-aversion. The theory here is that from the standpoint of increasing total social utility, the risk-averse individual investor should not be the one to bear the risks of the corporate activity, because the investor would spend too much, either directly or in the form of foregone opportunities, on reducing those risks relative to others that could bear the risks. By shifting those risks elsewhere,
A limited liability rule reduces the cost of risk-bearing to a shareholder and the cost of capital and increases the availability of funds for “projects with positive net values.”\footnote{See Frank Easterbrook and Daniel Fischel, The Economic Structure of Corporate Law 45 (argument that limited liability’s benefits to shareholders will be exactly offset by detriment to creditors depends on assumption that “risk is borne equally well by creditors and stockholders”).} Again, the efficiency justifications depend critically on an assumption that the “normal” holder of corporate equity is an individual that holds a tiny fraction of corporate equity and faces significant obstacles to obtaining information about corporate operations.

Consider the assumption underlying the information costs justification first, which is that the shareholder faces significant obstacles to obtaining information about corporate operations. However, parent corporations and other shareholders with a significant ownership share do not in fact face significant costs associated with monitoring management. Information about the business is readily available and comparatively cheap.\footnote{See Easterbrook & Fischel, The Economic Structure of Corporate Law 44.} For example, in \textit{Department of Env. Prot. v. Ventron Corp.},\footnote{94 N.J. 473, 484 (1983).} a parent company known as Velsicol, incorporated a subsidiary, Wood Ridge, for the sole purpose of purchasing and continuing the operation of a mercury processing plant. The case concerned responsibility for the multimillion-dollar cost of cleaning up the plant’s extensive

\begin{quote}
\textit{The parent as sole shareholder is almost invariably engaged in the managerial functions of establishing policy, determining budget, providing administrative support, and participating in the decisionmaking of the subsidiary corporation.”} Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. Law at 623.
\end{quote}
mercury contamination of a tidal estuary of the Hackensack River. The parent company had “constant involvement” with the subsidiary’s day-to-day operations; parent company employees were on the subsidiary's board of directors and attended monthly board meetings, at which they monitored the minutiae of the subsidiary's business, including the details of the daily operations -- "personnel practices, sales efforts, and production." The parent clearly faced no significant obstacles to the acquisition of information about environmental risk arising out of the subsidiary’s operations.

Even when it does not hold a controlling position in a corporation, an institutional shareholder, such as a corporation, bank, mutual fund, pension fund, or insurance company, will generally be relatively proficient in obtaining corporate information, analyzing it, and participating in corporate governance. An institutional shareholder’s information costs are likely to be fairly low even if it does not occupy a position of potential or actual control in the corporation.

In short, the shareholder to which the information costs justification primarily applies is the individual shareholder with a small share of equity, who could indeed incur expense in acquiring and analyzing the information necessary to evaluate a corporation’s operations.

Now consider the risk-aversion correction justification. First, it is worth reiterating

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68 See 94 N.J. at 484 (“for a stretch of several thousand feet, the concentration of mercury . . . is the highest found in fresh water sediments in the world.”).

69 94 N.J. at 484. See also Blumberg, 11 J. Corp. L. at 624 (“full information about the subsidiary’s operations is always available to the parent corporation”). Institutional investors also are likely to have ready access to information. E.g. Edward Rock, Institutional Shareholder Activism, 79 Geo. L.J. 445, 450 (1991) (“The heads of public employee pension funds have become high profile players in the corporate governance process . . . .At the same time, consultants have emerged who advise, encourage, and organize institutional investors.”).

70 E.g. Bernard Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 571 (“major public pension funds have gone beyond voting against management proposals, and are offering their own corporate governance proposals”).
that limited liability does not address risk-aversion by reducing risk. Limited liability shifts
risk. In the case of corporate tort and statutory liability, limited liability shifts much of the
risk of hazardous corporate activity from shareholders to tort victims and the community
at large. Generally, this type of risk-shifting will improve social welfare (measured as total
social utility) only if two conditions are satisfied.\footnote{71} First, the individual shareholder must
be no better placed either to monitor or to influence the direction of risky corporate activity
than a tort victim.\footnote{72} Otherwise the cost of the injury would not be borne by the “cheapest
cost avoider.” Second, to the extent limited liability shifts the bulk of costs (beyond those
payable from corporate assets)\footnote{73} from a shareholder to a tort victim, the victim must be
less risk-averse than the individual shareholder – and thus more able – or more willing --
to bear the risks associated with a particular corporate activity.\footnote{74}

Except in the case of the individual shareholder holding a small share of equity, both
conditions are unlikely to be satisfied simultaneously. Regarding the ability to
anticipate or to avert an injury, a tort victim likely will be poorly placed relative to a
corporate shareholder to anticipate, monitor, or influence corporate activity that might

\footnote{71} The following analysis draws in significant part from Steven Shavell’s compelling analysis. See Steven Shavell, Economic Analysis of Accident Law (1987).

\footnote{72} See Steven Shavell, Economic Analysis of Accident Law 175-76 (1987). Social welfare also will not be improved by the shifting of risk if the party that would have borne the risk could have procured insurance to spread it. See Steven Shavell, Economic Analysis of Accident Law 176 n. 17 (1987) (to the extent that shareholders could purchase liability insurance in the absence of limited liability, “it is not clear that protection of risk-averse shareholder against risk should be considered an affirmative advantage of limited liability”). While some risks are difficult to insure, so-called “comprehensive general liability insurance” is a standard type of policy; see also Kenneth G. Abraham, Environmental Liability Insurance Law (1991).

\footnote{73} See Steven Shavell, Economic Analysis of Accident Law 191 n. 6 (1987) (“It is never optimal for the entire loss to be shifted from one risk-averse party to a second.”). There is some risk sharing under limited liability, in the sense that the shareholders of a corporation run the risk that their shares will decline in value as a corporation pays a tort loss. However, the risk of losses beyond what can be paid from corporate assets is borne by the victim of the tort or statutory violation.

\footnote{74} E.g. Janet Cooper Alexander, 106 Harv. L. Rev. at 390 (“Limited liability is said to produce a net gain to society because the rule shifts risk to better risk bearers. . . .”).
result in injury.\textsuperscript{75} As discussed above, a corporate shareholder with a large share of equity can cheaply monitor risky corporate activity and influence it. Institutional holders of a small proportion of shares, even if they are unable to significantly influence corporation direction, will find obtaining and analyzing information relatively inexpensive. That a corporate shareholder is better placed to monitor or influence the direction of hazardous corporate activity makes the shareholder better suited to bear the risk of that activity than a potential tort victim.

The strongest case for shifting the risk is in the case of a corporate shareholder holding only a tiny fraction of equity – the holder of two hundred shares of General Motors. Even given the information costs facing such a shareholder, though, it probably still will be more able to anticipate possibly injurious corporate activity than a tort victim, and to elect not to invest in that activity.

So, with the possible exception of the shareholder with a tiny fraction of equity, a corporate shareholder generally can better anticipate or avert an injury from corporate activity than a tort victim can. This fact alone makes it inefficient to shift the risk of a hazardous corporate activity from a shareholder to a potential tort victim.

However, it is worth noting that the second condition for an efficient shifting of risk is also in question. There seems to be no reason that tort victims would be better across the board at bearing risk than corporate shareholders.\textsuperscript{76} Here, the story is considerably more complex, and drawing conclusions probably would require extensive empirical

\textsuperscript{75} This assumption might not fit business torts well, such as tortious interference with contractual relations. For those torts, the tort victim very often is someone with a course of dealings with the corporation that could potentially anticipate risks from corporate activity.

\textsuperscript{76} The following analysis takes as a given that efficiency is the criterion against which to measure limited liability’s effects. Distributional consequences, although they are not a traditional focus of law and economics analyses, weigh against limited liability. The distributional concern is that individuals that benefit from corporate activity may be able to shift some of its costs to others that receive no benefit from the corporate activity.
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research.

At best, the assumption that tort victims bear risk better than shareholders seems highly oversimplified. It is hard to generalize about the risk preferences of tort victims – a victim’s relative risk tolerance may depend, among other things, on the type of injury from the tort (whether it is injury to property, person, or the environment) and the total costs of the tort imposed on the individual relative to the individual’s wealth.\footnote{77} Moreover, due to the substantial debates on how to value them, environmental injuries and severe health injuries (i.e., death) do not fall at all neatly into such a framework.\footnote{78}

At the risk of severely understating the situation, especially where environmental injuries and loss of human life are concerned, however, one could certainly say that a wealthy individual, who perhaps might bear a given risk better than a poor individual because the potential loss would constitute a smaller portion of the portfolio, probably is no more likely than the rest of the population to be a tort victim. Given that, one cannot assume that an uncompensated tort would affect only a small portion of a tort victim’s portfolio. Consequently, it is difficult to assume that victims of torts and statutory violations are, as a group, risk-neutral or risk-preferring.

Nor can it readily be assumed that a tort victim is relatively less risk-averse than a corporate shareholder.\footnote{79} First, take the large shareholder with the capacity to control.

\begin{footnotes}
\footnote{77}{When a tort is suffered by multiple individuals or a community (as with a plane crash or an environmental injury), an individual’s particular loss might not constitute the entire loss for which the tortfeasor is responsible.}
\footnote{78}{The debate over the appropriateness of valuing human life is a well-known one and need not be further discussed here. In the environmental context, there is an ongoing debate regarding whether the appropriate measure of social welfare should be a summation of individual preferences, \textit{e.g.}, David Driesen, \textit{The Societal Cost of Environmental Regulation: Beyond Administrative Cost-Benefit Analysis}, 24 Ecology L.Q. 545, 579 (1997).}
\footnote{79}{For simplicity, this analysis assumes that the victim of the potential corporate tort is a single individual. There is no reason to think that in cases of collective injury, such as environmental torts, that a community either will be able to more readily predict and avoid the particular injury or will be less risk-averse and thus better able to bear a particular risk than the tortfeasor. However, the analysis}}
As noted above, whether the shareholder is an individual or a corporation, the shareholder clearly will be in a superior position relative to the tort victim to observe or influence the corporation’s risky activities. Regarding the shareholder’s risk-tolerance, assume further that the shareholder is a corporation (including a parent corporation), or perhaps another institutional investor. Such a shareholder generally will be risk-neutral. For example, a parent company can spread the loss among its shareholders or more easily obtain insurance. Even in the case of the most conservative institutions, such as private pension funds, institutions will still be comparatively less risk-averse than an individual. Institutional and corporate investors also are likely to have larger portfolios that can be diversified easily, even in the absence of limited liability. Consequently, shifting risk from such a shareholder to a potentially risk-averse individual victim of a tort will reduce social utility, since the tort victim likely is a poorer risk-bearer.

Now consider a control shareholder that is an individual. Again, the shareholder will be in a superior position, relative to a tort victim, to observe or influence the corporation’s risky activities. For a given risk of injury, the individual shareholder’s risk-

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80 Institutional investors hold approximately half of the corporate equities in the United States. See New York Stock Exchange Fact Book: 1998 Data 60. Institutional investors other than mutual funds accounted for close to 40% of the total holdings. Id.

81 See Hansmann & Kraakman, 100 Yale L.J. at 1880 n. 6 (parent corporations are likely to be risk-neutral); Note, Liability of Parent Corporations for Hazardous Waste Cleanup and Damages, 99 Harv. L. Rev. 986, 995 (1986) (“Any loss the parent might suffer would be spread widely among its shareholders and customers . . . .: [moreover, the parent] is in a good position to insure against the risk of [injury or liability].”).

82 Even pension funds have become more risk-tolerant. See Board of Governors of the Federal Reserve System, Report to the Congress on the Availability of Credit to Small Businesses 44 (October 1997) (noting that pension funds have become major investors in comparatively risky businesses through venture capital partnerships).

aversion is a function of the proportion of her wealth that would be represented by the size of her loss from the injury. This in turn is a function of the loss attributable to the tort and whether there may be others, including insurers, that would bear a portion of the loss.

A shareholder that stands to lose all her wealth is likely to be more risk-averse than a shareholder that loses only a small portion of her wealth as a result of having to compensate a victim of a corporate tort.

Suppose the shareholder is a wealthy individual. In the event of extremely risky corporate activity, such a shareholder could risk a major dollar loss. While a wealthy individual could be risk-averse, especially if a loss would threaten most or all the individual’s wealth, the greater an individual’s wealth, the easier it is for him or her, as a general matter, to bear the risk of a given loss. In the very simple situation where a tort victim’s loss exceeds corporate assets and a single shareholder would bear the loss if forced to make up the difference, the wealthy shareholder likely will be better able to tolerate the loss than the (on average less wealthy) individual tort victim. Consequently, limited liability likely would reduce total social utility by shifting risks to a party less able to bear them. In the case of a less wealthy individual shareholder, it seems difficult, at best,
to draw a conclusion that such an individual is relatively more or less risk-averse than the potential tort victim of his or her business.

Now consider the individual shareholder that is one of many shareholders, and the tort victim that is one of many injured by corporate activity. Assume that the loss from the tort exceeds corporate assets. The more companions the shareholder has to share the loss, the less risk-averse the shareholder will be. This will depend on insurance availability, the liability rule, and the number of other shareholders. Further, the greater the individual shareholder’s wealth, the smaller the fraction of wealth that will be consumed by the loss (and the less risk-averse the shareholder will be).

Similarly, the fraction of the tort victim’s wealth at risk from an injury will depend on the victim’s total wealth, insurance, and whether the loss is shared with others. Again, it is extremely difficult to conclude that tort victims generally will be better able to bear the loss of excessively risky corporate activity.

Because of variations in individual circumstances, the goal of efficient risk-bearing cannot be assumed to justify limited liability. When the shareholder is an institution or is wealthy, the shareholder is likely to be able to tolerate the risk of a given loss better than the average individual tort victim. To the extent the shareholder is an individual and is relatively less wealthy, so that she could lose her entire portfolio to a claim for corporate

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88 For example, under current limited liability rules, if a court “pierces the corporate veil” to hold a shareholder responsible for corporate liability, the shareholder normally is jointly and severally liable with the corporation and with other shareholders held liable under a veil-piercing rule.

89 For example, insurance may be readily available for health consequences and unavailable for injury to shared environmental resources.

90 The total loss resulting from risky corporate activity could be a sum of a number of individual losses (as in the case of personal injuries resulting from a defective product), or it could be the loss of a public good whose value to each affected person is equal (as in the case of an aesthetic resource). Cf. NOAA Natural Resource Damage Assessment Rule under Oil Pollution Act (contaminated natural resources valued at the cost of restoration, replacement or acquisition of the equivalent).
losses in excess of corporate assets, such a shareholder could be risk-averse.\(^91\) However, it remains far from clear that such a shareholder would be relatively more risk-averse than the corporate victim. Victims of the corporate activity also might include less wealthy individuals whose wealth would be wiped out by tort costs.

The risk-aversion justification for shifting risks from a shareholder to a tort victim is strongest when the shareholder holds only a small share of equity, thus reducing the shareholder’s ability to monitor or to influence corporate activity, and (probably) when the shareholder is a less wealthy individual, so that the shareholder is more likely to be risk-averse relative to the tort victim.\(^92\)

Both the information-costs justification and risk-aversion justification assume as “typical” a particular kind of individual shareholder. This shareholder possesses only a small share of ownership in a large corporation – and thus cannot easily gain access to corporate information or participate in corporate management. To the extent the shareholder is an individual that possesses a portfolio that would be threatened (absent limited liability) if the corporation faces a large tort liability, the shareholder also may be risk-averse, and even more risk-averse than the victim of a corporate tort. This is the shareholder, so the argument goes, that would forego a socially beneficial investment (i.e.: one where the investment’s social utility exceeds its social cost) either because the costs of monitoring are too high or because the investor is unwilling to bear a small risk of a

\(^91\) Cf. Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. Law 573, 576 (1986) (most of limited liability’s “theoretical advantages, however, are valid only when limited liability is interposed for the protection of the ultimate investors in the enterprise”). Of 69.3 million individual investors holding common stock in 1995, 75% had total stock portfolios of $50,000 or less. Shares held by these investors, however, accounted for little more than 10% of all shares owned by individuals. See New York Stock Exchange, Shareownership 1998, at 18.

\(^92\) This statement assumes that both the tort victim and the shareholder will bear equivalent fractions of the loss attributable to risky corporate activity. A wealthier individual also might be relatively more risk-averse than the potential tort victims. This might happen if the individual, say, bore the risk of hazardous corporate activity alone, while the potential tort victims were in a class of 20,000.
significant corporate liability, given the investor’s small portfolio.

The reality, however, is that the shareholder portrayed may not be “typical” at all. There certainly are many shareholders that resemble the sympathetic picture of the risk-averse small individual investor in a stock traded on the New York Stock Exchange. Several pieces of evidence, however, strongly suggest that most corporate shareholders do not fit the image of the “typical” small, less wealthy risk-averse shareholder facing significant information costs. Most shareholders fall in other categories.

First, most corporate equity is not held by individuals. Individual investors overall hold directly less than 40% of all corporate equity, whether publicly-traded or private corporate equity.93 The remainder is held by institutional investors, including other corporations.94 Moreover, institutional investors often hold significant shares of the companies in which they invest.95 Thus, the majority of corporate equity in America is not

93 See New York Stock Exchange Fact Book: 1998 Data 55, 60 (1999) (based on Federal Reserve Board, Flow of Funds Accounts of the United States (Dec. 1998)). That statistic includes not only publicly-traded corporate equities, but estimates of closely held shares (equity issued by private corporations that is not publicly traded). See Federal Reserve Board, Flow of Funds Accounts of the United States 1 (Dec. 15, 1999) (discussing table L.213) (available on the internet at www.bog.frb.fed.us). Mutual funds, which own approximately 15% of all corporate equities, are considered institutional investors in these statistics. For purposes of this discussion, that seems appropriate in view of mutual funds’ superior access to corporate information and superior ability generally to diversify holdings. Even if mutual fund shares held by individuals were treated as “individually-held” corporate equity, total individual holdings of US corporate equity still amounts to less than half of the total equity. Of the corporate equities held by mutual funds, a little over half of the investment in mutual funds is contributed by individuals; the remainder of the equity is held by institutional investors apart from mutual funds. See Investment Company Institute, Institutional Investors and Mutual Funds, Fundamentals 1 (July/August 1995) at 1 (available on the Internet at www.ici.org/economy/institutional_investors.html).

94 Institutional investors hold 49.6% of all outstanding corporate equities. See New York Stock Exchange Fact Book: 1998 Data 59 (“U.S. institutional investors, who owned only 6.1% of all equities in 1950, now hold a total of $6.3 trillion, or 49.6% of outstanding equities.”). “At year end 1989, the 50 largest institutions owned . . . 27% of the entire U.S. stock market. The thirteen largest institutions held over half this amount – an average of over 1% of the U.S. market each.” See Bernard Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 567-68 (1990).

95 See Bernard Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 568 (1990) (“Legal obstacles notwithstanding, institutions are talking about, and occasionally moving toward, owning
The individual shareholders of large, publicly-traded corporations listed on one of the three major stock exchanges (the NYSE, AMEX, or NASDAQ),—like the holder of 200 shares of General Electric—would seem most likely to conform to the image of the small, not especially wealthy, risk-averse stockholder with no control over the corporation. As noted, however, individual equity holdings are a minority of all corporate equity. And only about half of individual equity holdings, either directly or through the intermediary of a mutual fund, are in publicly traded equities. In 1992, for example, households held directly, at most, $1.4 trillion in publicly traded stocks and approximately $2 trillion including mutual fund investments. By comparison, the total market capitalization of the New York Stock Exchange alone at the time was over $4 trillion.

Thus, a considerable proportion both of publicly-traded corporate equity and of corporate equity overall is held not by individuals, but by institutional investors or other corporations. Institutional investors are more likely to be risk-neutral than risk-averse.

96 See NASDAQ in Black and White at 4-4 (1999).

97 An analysis of the 1998 Survey of Consumer Finance, a triennial survey conducted for a time by the University of Michigan Survey Research Center and currently by the University of Chicago National Opinion Research Center, see Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances, 83 Federal Reserve Bulletin 1, 22 (1997), indicates that approximately half of household corporate equity holdings consist of stock in publicly-traded corporations, held either directly or through mutual funds. The remainder constitutes equity in all types of privately-owned businesses. See Carol Bertaut and Martha Starr-McCluer, Household Portfolios in the United States, Federal Reserve Board of Governors working paper, April 2000, at 26-27.

98 The 1992 Survey of Consumer Finance estimated that households held just over $1 trillion in publicly-traded corporate equity; the 1992 Flow of Funds Report of the Federal Reserve Board estimated approximately $1.4 trillion. If mutual fund investments are included, total household holdings in publicly traded corporate equities approximated $2 trillion. But see supra note 93 (arguing that mutual fund investments are more akin to institutional investments than individual investments).

They also can more easily obtain and analyze corporate information, placing them in a position to anticipate and potentially influence hazardous corporate activity.\textsuperscript{100}

The characteristics of individual corporate equity holders also bear closer examination. Consider first those that hold small amounts of publicly-traded stock. These investors fit the picture of the “typical” shareholder that is implicit in justifications of limited liability. To the extent they are small shareholders, individual shareholders might indeed face significant costs of gathering and analyzing corporate information.

Regarding the risk-aversion justification, we do not possess information regarding many of the factors that may bear on the risk-averse tendencies of these shareholders, relative to victims. However, at least one characteristic of this group suggests that they may not tend to be risk-averse relative to potential victims of corporate tort and statutory violations. The vast majority of corporate stock held by individuals is held by wealthy individuals. In 1995, shares on any of the major stock exchanges held by individual investors, either directly or through mutual funds, with total stock portfolios of $50,000 or less accounted for little more than 10% of all shares traded on any listed exchange owned by individuals.\textsuperscript{101} Eighty-two percent of these shares held by individuals, either directly or through mutual funds, were held by individuals with stock portfolios exceeding $100,000.\textsuperscript{102} This is not to say that an individual with a portfolio of $100,000 on the stock market might not be risk-averse — a retiree, for example, is likely to be quite risk-

\textsuperscript{100} See supra Section III(B). Even pension funds, which some might consider risk-averse, are free, within Department of Labor rulings, to invest in securities issued by small or new companies and venture capital partnerships, provided they do not endanger an entire portfolio. See Board of Governors of the Federal Reserve System, Report to the Congress on the Availability of Credit to Small Businesses 44 (October 1997).

\textsuperscript{101} See New York Stock Exchange, Shareownership 1998, at 18.

\textsuperscript{102} See New York Stock Exchange, Shareownership 1998 18. The statistic probably underestimates these individuals' total wealth, since it does not take into account wealth other than holdings of common stock.
averse – and someone evaluating an activity that would risk the entire portfolio also could be risk-averse. However, shifting a given risk only increases social utility when the shifting is to a person that is relatively less risk-averse. The data on wealth does suggest that it may be questionable to assume that these individuals should be presumed more risk-averse, for a given risk, than a corporate tort victim, regarding whose wealth we cannot generalize.

The risk-aversion assumption may be questionable for another reason: 75% of households with investments in the stock market polled in a broad-based Federal Reserve Board-sponsored study\(^\text{103}\) viewed themselves as willing to tolerate an average, above-average, or substantial amount of risk.\(^\text{104}\) (25% viewed themselves as tolerating an above-average or substantial amount of risk.) Although it could be argued that the responses were made against the backdrop of limited liability and thus do not represent the levels of risk-aversion that would be present in the absence of limited liability (and furthermore that survey results do not always reliably predict actual behavior), the survey results at least raise questions regarding whether individual investors can be assumed to be risk-averse.\(^\text{105}\)

For privately-held corporations, the profile of the passive, uninvolved “small individual investor” facing significant information costs also does not track reality. The S Corporation shareholder generally is one of a very few. S Corporation returns represent approximately half of the 3.9 million corporation income tax returns filed with the IRS, and

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\(^{103}\) This Survey of Consumer Finances was conducted by the University of Michigan Survey Research Center. See New York Stock Exchange: Shareownership 1998, at 8 (1999) (“There is a broad consensus that the Survey of Consumer Finances provides the best available information on household asset holdings.”).


\(^{105}\) This is, of course, distinct from the question whether an individual investor would accept an investment that presented risk of loss in excess of the individual’s entire portfolio.
somewhere between one-fifth and one-sixth of corporate economic activity.\footnote{See S. Wittman \& R. Grant, \textit{S Corporation Returns}, Internal Revenue Service, Statistics of Income Bulletin 40 (Spring 1999). Not surprisingly, perhaps, S Corporations are a “small though growing percentage” of corporate net income. For Tax Year 1996, S Corporation income represented 17.6% of corporate net income. \textit{Id.}} Over 90\% of S Corporations are owned by 3 or fewer shareholders.\footnote{Less than 10\% of S Corporations had 4 or more shareholders. 99\% had 10 or fewer shareholders. \textit{See S. Wittman \& R. Grant, S Corporation Returns, Internal Revenue Service, Statistics of Income Bulletin 42 (Spring 1999).}} For close corporations generally, 79\% have a shareholder with 50\% or more of the equity.\footnote{See Board of Governors of the Federal Reserve System, \textit{Report to the Congress on the Availability of Credit to Small Businesses} 41 (October 1997). In this report, the Board of Governors commented that the definition of “small business” used by the Small Business Administration included firms with fewer than 500 employees. More than 99\% of all businesses in the United States fit this definition. \textit{See id.} at 1-2. Small businesses in high technology are a recent and notable exception, as such firms apparently do attempt to raise equity from external sources. \textit{See id.} at 41.} Small uninvolved shareholders are apparently relatively rare. “Relatively few small businesses raise equity from external sources.”\footnote{See S. Wittman \& R. Grant, \textit{S Corporation Returns, Internal Revenue Service, Statistics of Income Bulletin} 40 (Spring 1999).} The information-costs justification would seem to have no application to these shareholders. An individual shareholder very often will be in a position of actual or potential control of a privately-held corporation, and, at a minimum, will have easy access to the information necessary to monitor the corporation.

Regarding the assumption of risk-aversion, we know that a shareholder in a privately-held corporation likely can minimize risk by monitoring a corporate investment closely and participating in corporate management. In view of the control likely possessed by such a shareholder, shifting the risk of corporate activity from close corporation owners to tort victims seems likely to generate more inefficiency, not less.\footnote{See Shavell.} Moreover, further analysis would appear to be required before it could be assumed that these shareholders
are more risk-averse than tort victims.\textsuperscript{111}

So what conclusions can be drawn from all of this? First, while many individuals do invest in corporate equity, a substantial portion of the market for publicly-traded corporate equity consists of investments from institutions and other corporations. At least half the market for corporate equity comes from institutional and corporate sources whose characteristics differ sharply from the profile of the less wealthy, risk-averse investor with only limited access to corporate information. Further, a substantial number of individual investors in small corporations likely can gain easy access to information and exercise some influence over the corporation. Meanwhile, limited liability is fully available not only to all small individual investors, but to these institutional investors, investment intermediaries, parent corporations, and controlling shareholders.

At a minimum, for these shareholders with characteristics divergent from those of the “typical” shareholders, limited liability seems overbroad and inefficient. Shifting the risks inherent in these investments to tort victims or victims of statutory violations does not increase social utility. For these shareholders, monitoring a corporation is cheap and easy. These shareholders are far better placed, relative to potential victims of corporate torts and statutory violations, to anticipate and influence potentially hazardous corporate activity. Finally, it cannot be said, especially as to institutional shareholders, that these shareholders will be more risk-averse than tort victims. Consequently, shifting the costs of excessively risky corporate behavior likely will not increase social utility, but will reduce it.

III. Excessive risk-taking under limited liability

Limited liability’s moral hazard is the incentive created for corporations to engage in excessively risky activity, shifting those costs to tort and environment victims. Much

\textsuperscript{111} See, e.g., page 32 (most individual corporate investors considered themselves willing to tolerate “average” to “substantial” levels of risk).
commentary has recognized the problem as a general matter. The following sections outline the basic problem and provide some additional comments on empirical evidence collected to date. Finally, these sections discuss the phenomenon of the corporation with a controlling shareholder. The corporate temptation to choose excessively risky activity will be especially pronounced when corporate equity is in the hands of a parent corporation or controlling shareholder.

A. The basic moral hazard problem

At least with respect to risky activities for which tort victims might seek to obtain legal recourse, limited liability presents an opportunity to avoid paying the "appropriately-sized" tort judgment. A corporation may be created or operated in a way that renders it "judgment-proof"– having only nominal assets available to pay a tort judgment. Or, a corporation simply may have inadequate assets available to fully cover its responsibility. And once the corporate assets are exhausted, the shareholder typically has no personal responsibility for the judgment except under limited circumstances – when the corporate veil can be pierced or when the shareholder's own conduct violates the law. Neither the corporation nor its shareholders are held fully responsible for the consequences of excessively risky corporate behavior.

Consequently, corporate managers may select overly risky projects more often than is socially optimal. As a matter of economic theory, a shareholder will favor

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112 Corporate veil-piercing rules imposing liability on a shareholder when a corporation has been undercapitalized provide little protection from this problem. See Section III(D).

113 See LoPucki (discussing “soft” judgment proofing).

114 As discussed below, the opinion in United States v. Bestfoods, 524 U.S. 51 (1998), has indicated that both such opportunities are very limited. See Section III(D).

115 See Easterbrook & Fischel, Economic Structure at 49-50 ("Because limited liability increases the probably that there will be insufficient assets to pay creditors' claims, shareholders of a firm reap all of the benefits of risky activities but do not bear all of the costs. These are borne in part by creditors."); Paul Halpern, Michael Trebilcock & Stuart Turnbull, An Economic Analysis of Limited
increases in risky activity as long as the anticipated marginal benefit to the shareholder from an increase in risky activity (present value of increase in expected dividends from corporate income) exceeds the anticipated marginal loss (present value of reduction in expected dividends from costs of the activity, liability judgments, and the like), up until the point where the marginal benefit and marginal loss from an incremental increase in risky activity are equal. Under limited liability rules, the shareholder’s total losses are capped at the value of the shareholder’s potential lost equity. Thus, such risky projects may appeal to the shareholder even though they may be socially costly.

Take a corporation with assets equal to X, facing a choice between two possible projects, P_1 and P_2. Each of the projects has expected benefit A, and expected cost equal to a 2% chance of a tort liability judgment equal to W_1 and W_2, respectively. Suppose W_1 is less than W_2, and both are smaller than the corporation’s assets (and smaller than A). The shareholder is likely to choose the more socially beneficial project, P_1.

Now suppose that W_1 is less than W_2, but both W_1 and W_2 are larger than the corporation’s assets. Suppose further that (.02)(W_1) and (.02)(W_2) exceed corporate assets. If their benefits are the same, the shareholder will be indifferent between the projects, even though P_1 will be less socially costly. Conceivably, if both (.02)(W_1) and (.02)(W_2) further exceed A (which exceeds corporate assets), the shareholder might select a project even though neither would increase social utility. Moreover, under the


This discussion assumes that the marginal benefit of a particular decision to shareholders and the marginal benefit to the firm are identical. The marginal benefits and costs that a particular decision may offer the firm’s managers, can diverge from the marginal benefits and costs that the shareholder faces. A considerable literature discusses the problems shareholders have in ensuring that firm’s managers serve the shareholder’s interests. As discussed below, however, any tendency by firm managers to select less risky opportunities than those favored by shareholders is not likely to offset the “moral hazard” of limited liability, especially when the shareholder is in a position of control. See Section III(C).
circumstances where the projects also have different expected benefits, the shareholder could be expected to prefer the one with a greater expected benefit even if it also has a greater expected social cost.

More generally, limited liability reduces the shareholder’s incentive to gather and process information regarding a subsidiary’s potentially hazardous activities\(^\text{117}\) – even when the shareholder is in a position of control and can cheaply acquire that information. Consequently, even a risk-averse shareholder may make fewer attempts to encourage management to obtain more insurance, take more precautions, or avoid the risky activity altogether.

The costs of excessively risky corporate decisions for which shareholders bear no responsibility (because corporate assets have been exhausted) are shifted to third parties, including tort victims, the environment, and the community, as well as other "involuntary creditors" to whom the corporation is liable.\(^\text{118}\)

This moral hazard has a number of consequences. Most importantly, perhaps, under limited liability, companies will select restructuring as a means of managing the risk presented by hazardous corporate activities. The easy availability and effectiveness of limited liability in protecting the corporation’s shareholders or parents will make


\(^{118}\) This paper will not address shareholder responsibility to contract creditors, who generally are in a better position to anticipate risk of corporate nonpayment and to negotiate an expected payment that would compensate for the risk. E.g., Halpern, Trebilcock, and Turnbull, 30 U. Toronto L.J. at 128 (“The voluntary creditor will consider the probabilities that these outcomes will occur and determine an expected yield at which funds will be lent to the corporation to compensate for the risk.”); see also id. at 135 (“for small companies with limited liability creditors often require personal guarantees. . . [converting] the limited liability company into one with unlimited liability....”); Easterbrook & Fischel, Economic Structure at 51-52 (voluntary creditor can, ex ante, charge premium to compensate for risk); Jonathan M. Landers, A Unified Approach to Parent, Subsidiary and Affiliated Questions in Bankruptcy, 42 U. Chi. L. Rev. 589, 623 (1975) (creditors may have opportunity to protect selves).
restructuring a favored risk-insulating strategy.119

This will encourage corporations to divert investment from other, more efficient risk-management strategies. Restructuring is essentially an investment in transaction costs—hiring lawyers to legally immunize a parent corporation or a controlling shareholder from liability. Obtaining legal immunity through restructuring will reduce the need for a corporation to purchase adequate insurance or otherwise allocate risk through contracts.120 Further, a corporation will be less likely to invest in directly reducing the risks of its hazardous activities—say, by changing technologies or adding additional safeguards.121 With respect to environmentally hazardous activities, for example, because application of limited liability could be as—or more—effective in reducing potential environmental liability as investing in pollution-reducing technology, corporations whose managers decide to engage in environmentally risky activities often will direct their resources to creating a new corporate layer.122

For example, in one case, a company engaged in oil transport incorporated separate subsidiaries, each of which owned a number of barges that transported oil on Lake Champlain. The companies had identical officers and directors, and the subsidiaries

119 Given the wide array and effectiveness of devices that have traditionally been available for insulating the corporation from liabilities, corporate lawyers have been able to discharge their responsibilities by focusing principally upon insulating techniques for minimizing a corporation’s exposure to environmental risks. Peter Menell, Legal Advising on Corporate Structure in the New Era of Environmental Liability, 1990 Colum. Bus. L. Rev. 399, 402-03 (1990). See also Hansmann & Kraakman, 100 Yale L.J. at 1881 (strong empirical evidence indicates that increasing exposure to tort liability has led to the widespread reorganization of business firms to exploit limited liability to evade damage claims”).

120 These latter methods are preferred ways of insulating the company from the effects of risk, since the risk-bearers are likely to monitor the companies to minimize the possibilities of risk-taking and encourage the company to take adequate precautions to avoid tort liability.

121 See Steven Shavell, Economic Analysis of Accident Law 168 (1987) (the incentive for an injurer to take adequate care to avoid a risk is significantly diluted if the injurer can shield assets).

remitted profits to the parent by way of dividends. The barges’ slack operation led to a number of spills on Lake Champlain, from actions like continuing to pump oil into the water after the employee should have known of a leak; employee failures to cap pipelines; and disregard of navigation agreements. The limited liability doctrine encouraged resources to be devoted to corporate restructuring as a way to minimize environmental liability. Instead, the parent should have invested in training barge employees regarding appropriate measures to avoid oil spills.

B. Preferred risks under limited liability

The tendency toward excess risk-taking under limited liability will be skewed toward risky activities that present the risk of large losses. For example, suppose a parent company with a subsidiary with $2 million in assets compares a choice of two risky projects for the subsidiary. One presents a 1% risk of a $10 million loss in the next year; the other presents a 25% risk of a $400,000 loss in the next year. With unlimited liability for a parent corporation, and assuming that the corporation is "risk-neutral," these choices might well be evaluated equally: expected loss would equal risk of loss times projected loss. With limited liability, however, the preferred project is clearly the first one -- the small risk of a large loss -- since the parent corporation will not bear the full costs in case the gamble fails. The company is simultaneously less likely to purchase adequate

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123 These facts are taken from United States v. Ira S. Bushey & Sons, 363 F. Supp. 110 (D. Vt. 1973). While, the district court did agree to issue an injunction against the parent company, the case’s decision, at the limits of veil-piercing, seems somewhat atypical. E.g. Walkovsky v. Carlton (refusing to pierce veil to shareholder in multiple subsidiary taxicab case). The strategy of investing in multiple subsidiaries to manage risk, however, is quite typical.

124 See Hansmann & Kraakman, 100 Yale L.J. at 1883 n. 9 (noting that small risk of large losses may encourage shareholders to overinvest in firm, especially if creating subsidiaries is easy); id. (noting that if creating subsidiaries is difficult, incentive may be to be to underinvest to reduce exposure of owners to tort damages)

125 Hansmann and Kraakman also discuss the possibility that a shareholder might overinvest or underinvest in a particular firm engaged in risky activities. Because limited liability partly externalizes the marginal increase in tort damages from expansion of the firm’s risky activities,
As among excessively risky projects, corporations will be more inclined to select those where the realization of expected costs are delayed, relative to the activity that generated the costs. Projects where the risky activity leads to a latent injury – one not immediately detectable, such as pollution or cancer – will be preferred. Projects with costs that cannot be imposed without a judgment in a court of law (e.g.: common law tort litigation) will be preferred to projects with costs that can immediately be imposed. This is so even if the delayed costs have the same present value as if they were imposed today (if, for example, a court judgment rendered later were to include interest). If there is delay, a corporation and its shareholders can more easily separate corporate assets from the risky corporate activity. For example, the corporation is more likely to have sufficient time to distribute dividends to shareholders. Once the payments are made, they generally cannot

126 Cf. Alan Schwartz, Toxic Substances and Remote Risk, 14 J. Legal Stud. 689, 709 (1985) (noting that a firm's incentives to insure against knowable risk dissipate when "its liability exposure greatly exceeds its wealth"). Schwartz also observes that the incentive to insure is reduced when the imposition of costs is delayed. 14 J. Legal Stud. at 714-15 (when harms from a firm's action "do not materialize for several years," "limited liability actually can create a pathological incentive for entrepreneurs to operate firms without full insurance and thereby to externalize risk"). While potential claimants also may have insurance, for, say, medical expenses and property damage, e.g. James J. White, Corporate Judgment Proofing, 107 Yale L.J. 1363, 1365 n. 16 (1998) ("victims of random and conventional negligence are usually covered by insurance"), such policies may not cover extraordinary losses. Further, the firm (and its insurers) remain in a better position to anticipate and to avert potential injuries.

shareholders may be encouraged to invest too much in the firm. On the other hand, an increase in the value of the firm may make more assets available to pay damages to all tort claimants. This would discourage shareholder investment. As Hansmann and Kraakman acknowledge, however, the second effect is likely only when the risk facing the firm is a relatively large probability of damages that do not substantially exceed the firm's value. In other word, underinvestment is likely only when the marginal investment increases the probability that a firm will actually be fully responsibility for its liabilities. Overinvestment in such firms is more likely when the activity presents a small risk of a large tort judgment and when it is easy for a firm to limit assets available for tort judgments by creating subsidiaries. See Hansmann & Kraakman, 100 Yale L.J. at 1883 & note 9.
be reached unless the corporate veil is pierced.\textsuperscript{127}

Judging from tort judgment statistics, these types of risks very likely can involve toxic substances, injuries from defective products, or environmental injuries.\textsuperscript{128} While some have argued that tort victims may be indirectly protected from excess corporate risk-taking by contractual creditors that will insist on showing that the corporation is maintaining adequate operating reserves,\textsuperscript{129} such victims are less likely to be protected simply because the size of the judgments is larger.

Environmental resources are especially at risk from this moral hazard because the combination of “small risk/large loss” and “delayed cost realization” is typical of activities threatening an environmental injury.\textsuperscript{130} First, environmental losses tend to be delayed because the injuries to human health and the environment of particular substances may take years to manifest themselves. Second, once an environmental injury has occurred, cleaning it up or restoring the natural environment can be very expensive due to technological difficulty.\textsuperscript{131} Third, the process of enforcing environmental liabilities --

\textsuperscript{127} On rare occasions, a court will permit a tort creditor to recover directly from shareholders on a fraudulent conveyance theory or if the corporation has been dissolved. See Section III(D).

\textsuperscript{128} In a survey of 1996 judgments in state court cases, plaintiffs in cases involving product liability claims or injury from toxic substances, had, together with medical malpractice claims, the highest median awards of any tort cases. In over 10\% of these cases, plaintiffs received awards of over $1 million (combined compensatory and punitive damages). See Bureau of Justice Statistics Bulletin, Civil Trial Cases and Verdicts in Large Counties, 1996, at 7 (Sept. 1999) (available at www.ojp.usdoj.gov/bjs/pub/pdf/ctcvlc96.pdf). By comparison, the median award in an auto accident case was $18,000; only 3.4\% of such cases involved awards of over $1 million.

\textsuperscript{129} See J.J. White at 1396; Schwarcz note 49.

\textsuperscript{130} See P. Menell, 1990 Colum. Bus. L. Rev. at 404 n. 20 (“Many environmental risks are remote, though of great potential magnitude.”).

\textsuperscript{131} For example, over 80\% of the approximately 1300 hazardous waste disposal sites on the Superfund National Priorities List involve groundwater contamination with hazardous substances. See Environmental Protection Agency, Groundwater Cleanup at Superfund Sites 1 (Dec. 1996). Groundwater extraction and treatment remedies run in the millions of dollars and “can take anywhere from several years to many decades,” if it is feasible to clean up the groundwater at all. Id. at 3. Generally, the Congressional Budget Office has estimated the average cost of cleaning up a National
especially large ones -- is likely to take place years after the original conduct that created the environmental injury. As a practical matter, legal action to address environmental harm faces significant obstacles. Lack of scientific knowledge often presents an obstacle to discovering environmental damage and then to documenting environmental damage in court.132 Fourth, the probability of liability is reduced because environmental enforcement is predominantly pursued by federal, state, or municipal government entities.133 Liabilities are frequently large, but many violations are not pursued. For example, in fiscal year 1997, EPA obtained, on average, a penalty of over $700,000 in Clean Water Act settlements, in addition to the costs of action to abate the violation, but there were only 35 such judicial

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133 Because environmental injuries so often involve shared resources such as water or air, private common law actions generally have been inadequate to address environmental harm. E.g. F. Grad et. al, Injuries and Damages from Hazardous Wastes – Analysis and Improvement of Legal Remedies, S. Rep. No. 12, 97th Cong. 2d Sess. 97-98, 101-102, 105-07, 110-12, 114-17 (1982). This was one reason for the enactment of the current array of state and environmental statutes, most of which are enforced primarily by governmental entities. E.g. Gwaltney of Smithfield v. Chesapeake Bay Foundation, 484 U.S. 49, 60-61 (1987) (government has primary Clean Water Act enforcement responsibility). A number of state and federal statutes do provide private rights of action, including citizen suits, but these often are available only to enforce prior government action or when the individual already has made a significant financial investment. For example, the citizen suit provisions of the Clean Water Act authorize citizen suits against polluters only for violation of effluent standards or limitations under the chapter or an order issued by the Administrator or a State. E.g. 33 U.S.C. 1365(a). Similarly, CERCLA's citizen suit provisions authorize suit against a polluter only if it is "alleged to be in violation of any standard, regulation, condition, requirement or order which has become effective pursuant to this chapter." See 42 U.S.C. 9659(a). CERCLA's liability provisions authorize a private suit only to recover "necessary costs of response" to a hazardous substance release. 42 U.S.C. 9607(a)(4)(B). Consequently, environmental enforcement is still dominated by federal, state, or municipal action.
settlements under the Clean Water Act.\textsuperscript{134} One estimate is that between 18 and 27\% of "major" facilities holding such permits (a total of 7000, at that time), were in significant noncompliance with their permits. In the hazardous waste context, as well, EPA has taken enforcement action at only a fraction of the hazardous waste sites that warrant cleanup under its standards.\textsuperscript{135}

As noted, the presence of large liabilities is also likely to be marked in areas such as new product development, pharmaceuticals, and other areas presenting health and environmental risks. For example, the cost of damages from asbestosis alone amounted to $1.2 billion by 1986 and is expected to exceed $31.7 billion.\textsuperscript{136} Current cases involving the separation of treads on Firestone tires used on Ford Explorers are expected

\textsuperscript{134} See U.S. Environmental Protection Agency, \textit{Enforcement and Compliance Assurance Accomplishments Report, FY 1997} A1-A2 (July, 1998). Over the same period, EPA noted that it reached administrative settlements for penalties in 205 cases of Clean Water Act violations (collecting a total of $4.2 million), and issued 815 administrative compliance orders. There is perceived to be underenforcement of minor violations. E.g. General Accounting Office, \textit{Water Pollution: Many Violations Have Not Received Appropriate Enforcement Attention} 2 (Letter Report, GAO/RCED-96-23, Mar. 20, 1996) (addressing violations of National Pollution Discharge Elimination System ("NPDES") permits); see also General Accounting Office, \textit{Environmental Enforcement: Penalties May Not Recover Economic Benefits Gained by Violators} (GAO/RCED 91-166, June 17, 1991). There may be some argument that generalized underenforcement will encourage regulated entities, including corporations, to take more minor risks. That does not dispel the point that limited liability also may encourage corporations to take major risks where liability, if imposed, would exceed corporate assets. Thus, strengthening enforcement to address minor violations as well as major violations would only partially address the problem. The preference for environmentally risky activities might be less pronounced, since the risk that a corporation actually might have to bear the costs associated with the risky activities might be greater. However, some environmentally risky activities would continue to present the small risk of a large liability. E.g. note 143 (cost of groundwater cleanups).

\textsuperscript{135} EPA has announced that in addition to the 1300 sites on the National Priorities List, where EPA is pursuing cleanup and cost recovery from responsible parties, there are between 1700 and 3000 "NPL-caliber" sites that meet the NPL-listing criteria of health and environmental threats, that are not included in the federal remedial action program. E.g. Testimony of James Coleman before the House Committee on Transportation & Infrastructure, Subcommittee on Water Resources & Environment (Nov. 2, 1995) ("U.S. EPA and State Waste Managers project that are potentially another 1700 NPL calibersites yet to be remediated in this country."). EPA is listing sites on the National Priorities List at the rate of 10-20 per year.

to exceed the hundreds of millions of dollars. Whether these risks can be seen as “excessive” depends in part on whether the liability costs will be paid. In some of the preceding examples, companies did pay liability costs. Nonetheless, the scale of these liabilities suggests that even large companies could take “excessive” risks (i.e., risks likely to be externalized).

As a general matter, there is little disagreement that limited liability encourages companies to engage in excessively risky activity. That “excessively risky activity” could be defined as the activity generating externalized social costs – those not, as a practical matter, collectible through tort liability judgments. Since we lack the “control set” of an industrialized regime without limited liability, the extent of the overinvestment in this type of excessively risky activity remains an empirical question that is difficult to answer precisely.  

Some commentators have suggested that bankruptcy cases or unpaid tort judgments of corporate subsidiaries might prove to be an indicator of excess risk-taking attributable to limited liability. However, even a systematic examination of reported cases in which tort or statutory plaintiffs attempted to obtain compensation from corporations or their controlling shareholders likely would seriously underestimate the association of limited liability with excess risk-taking. This is because claims are very often

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137 See, e.g., “Chief of Bridgestone Says He Will Resign,” New York Times, Jan. 12, 2001, at W1 (Firestone parent company to take $750,000,000 charge against earnings in light of lawsuits). While total revenue figures for Firestone, the subsidiary that actually manufactured and marketed the tires, are hard to come by, at least one press release suggests that Firestone’s net earnings may be significantly less than the liabilities expected by its parent. E.g., “Bridgestone Corporation Announces Decline in Consolidated Net Earnings and Sales Despite Strong Performance by Bridgestone/Firestone, Inc.,” (projecting total 1999 net earnings at $769 million for Bridgestone and its subsidiaries).


139 See supra note 151.
resolved out of court prior to judgment and outside of bankruptcy proceedings.\(^{140}\) Moreover, they frequently are resolved explicitly or implicitly, in the shadow of limited liability rules.

Again, environmentally risky activity presents a compelling example. Here, corporations clearly rely on limited liability as a means of minimizing liability exposure, but not in a way that lends itself to systematic documentation.\(^{141}\) As noted, this type of activity can present the small risk of a large liability likely to be favored under a limited liability regime. The federal government, for example, brings large claims under the Comprehensive Environmental Response, Compensation, and Liability Act,\(^ {142}\) for cleaning up hazardous substances releases. Claims under this statute are very often for amounts in the millions of dollars\(^ {143}\) and the statute authorizes courts to impose response costs on a

\(^{140}\) The extent of unpaid environmental liabilities, for example, is difficult to document. See Administrative Office of the US Courts, Judicial Business of the United States Courts: 1999 Annual Report of the Director, Supp. Table C-4.

\(^{141}\) Although the research is now somewhat outdated, Thompson notes that prior to 1986, arguments to pierce the corporate veil were made in only six environmental cases. (The veil was pierced in five of the cases.) Thompson, 76 Cornell L. Rev. at 1062 n. 135. Although he concluded that judges might be more likely to pierce the veil in environmental cases, he has since concluded based on later data that piercing in that category has a frequency “that [has] receded toward the mean of the entire sample.” See Robert Thompson, Piercing the Veil Within Corporate Groups: Corporate Shareholders as Mere Investors, 13 Conn. J. Int’l L. 379, 385 & n. 35 (1999).

\(^{142}\) 42 U.S.C. §§ 9601 et seq.

\(^{143}\) For example, over 80% of the approximately 1300 hazardous waste disposal sites on the Superfund National Priorities List involve groundwater contamination with hazardous substances. See Environmental Protection Agency, Groundwater Cleanup at Superfund Sites, 1 (Dec. 1996). Groundwater extraction and treatment remedies run in the millions of dollars and “can take anywhere from several years to many decades,” if it is feasible to clean up the groundwater at all. Id. at 3. Generally, the Congressional Budget Office has estimated the average cost of cleaning up a National Priorities List site, including both capital investments and operations and maintenance (Which can extend for decades), at over $20 million per site, in present day dollars. Probst and others have estimated an average cleanup cost for these sites of $29.1 million, and note that cleanup costs range widely by type of site, from $12.7 million, on average, to clean up an asbestos site, to $170.4 million, on average, to clean up a mining site. Kate Probst et al., Footing the Bill for Superfund Cleanup 36 (1994).
wide array of entities with some connection to the hazardous substance release.  

If corporations used subsidiaries for environmentally risky activities, one might expect to observe a significant number of subsidiary bankruptcies in response to government enforcement. However, the vast majority of government claims are settled, very often for less than the face value of the claim. The government guidelines for settlement expressly internalize limited liability rules as the backdrop to settlement. For example, the United States Environmental Protection Agency's settlement policies based on a defendant's "ability to pay" judge a company as "unable to pay" if paying would result in "undue financial hardship." "Undue hardship" means that a company would go out of business, have its viability jeopardized, or lack the ability to pay "ordinary and necessary business expenses." In determining "ability to pay," the settlement policies assume that parent company assets are unreachable: "A corporation's owners (i.e. shareholders) generally enjoy limited liability for any of the corporation's debts or legal claims . . . . In assessing the financial health of a corporation, only the financial resources of the corporation are relevant." Consequently, any count of the number of actual subsidiary bankruptcies in the face of large government claims would substantially undercount the number of companies that have tried to limit exposure to environmental claims by moving their hazardous activities to a subsidiary.

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144 See 42 U.S.C. § 9607(a) (imposing liability on "owners," "operators," "generators," and "transporters" of hazardous waste).

145 EPA General Policy on Superfund Ability to Pay Determinations ("EPA General Policy") 1, 2 (Sep. 30, 1997) (party's "ability to pay" Superfund cleanup costs judged against "undue financial hardship" standard); see also EPA Guidance on Determining a Violator's Ability to Pay a Civil Penalty 1 (Dec. 16, 1986) (civil penalties can be adjusted for "extreme financial hardship").

146 EPA General Policy 2.

147 EPA General Policy App. B. Assets of the corporation are deemed to exclude profits paid out to shareholders, although profits paid after notice of the environmental claim are viewed with considerably more suspicion.
The explicit government settlement policy for environmental claims simply codifies the more general calculation of a tort plaintiff that is considering settlement and attempting to determine expected returns from litigating. What a private plaintiff is likely to be able to obtain in court from a subsidiary also is constrained by current limited liability rules. Bankruptcy’s high transaction costs and low priority for unsecured creditors will discourage invoking the bankruptcy court’s protections. Thus, the general incentive for "tort victims suing under a regime of limited liability... to accept a settlement for less than the full value of the firm,"148 suggests that subsidiary bankruptcies in the face of tort or statutory claims are likely to understate the extent to which corporations externalize the costs of risky activities.

So what can be learned about the reality of excess risk-taking by corporations, especially corporations with a parent company or controlling shareholder? Several pieces of evidence suggest that such risk-taking is significant and that incorporating represents a strategy to reduce liability flowing from the risk-taking.

First, every attempt to pierce the corporate veil represents a case where the plaintiff, at least, believes that the liable corporate entity lacks sufficient assets to compensate the plaintiff and that a major shareholder has significant additional assets. Otherwise the plaintiff would have simply filed against the corporation alone and would not have spent the resources necessary to file a lawsuit against a shareholder. Of course, plaintiffs may try to pierce the corporate veil even when their underlying claim lacks merit. Nonetheless, it is worth considering the numbers of such cases.

In the 1970s and 1980s, for example, out of 2000 cases that mentioned veil-piercing or a similar phrase, approximately 1500 cases actually consisted of attempts by plaintiffs to pierce the corporate veil. In Robert Thompson's study of these cases, as well

148 Hansmann & Kraakman, 100 Yale L. J. at 1895 & n. 43 (1991) (tort victims will accept less than full value in order to avoid costs and delay of obtaining litigated judgment).
as the approximately 2100 veil-piercing cases between 1985 and 1995, a little over half of these involved tort claims or claims of statutory violations.  

Second, anecdotal evidence regarding bankruptcies and claims against subsidiaries supports the claim of excess risk-taking. Again, on an aggregate level, the most relevant information might be the extent to which judgments against a corporation that arise out of tort or statutory claims exceed the assets available to a corporation, even though shareholders have significant assets. Judgments against a close corporation or a wholly or largely-owned subsidiary would be of particular interest, since the shareholders more likely could have affected the corporation's ability to pay legal claims, by influencing dividend distribution policy or other operational decisions.

One also might expect to see "evidence" that corporate subsidiaries are unable to pay large tort claims, despite better-funded shareholders or parent corporations. As noted, such aggregate data is difficult to obtain and almost certainly understates the amount of excess risk-taking that takes place. However, subsidiary bankruptcies do occur. Litigation over injuries from the Dalkon Shield and asbestos resulted in A.H. Robins and Manville, respectively, filing in bankruptcy. Further, in 1992, an involuntary bankruptcy

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150 Other useful information might be the extent to which the creation of subsidiaries is more common in especially risky industries.

151 As an aggregate matter, however, bankruptcy filing data is at most suggestive of a broader corporate strategy to limit exposure to tort liability by forming subsidiaries. Drawing firm conclusions from bankruptcy filing data is extremely difficult. Compare James J. White, Corporate Judgment Proofing, 107 Yale L.J. at 1379-80 (arguing that aggregate trend downward in dividends to creditors in bankruptcy is attributable to higher rate of personal bankruptcy filings) with Lynn LoPucki, Virtual Judgment Proofing, 107 Yale L.J. at 1419-20 (arguing that “only remaining explanation” for trend downward in dividends to unsecured creditors is that debtors could encumber more assets, leaving fewer for unsecured creditors).

152 See Janet Cooper Alexander, 106 Harv. L. Rev. at 424.
petition was filed against Gulf USA Corp., for inability to pay $70 million in cleanup costs at a mining and smelting complex at Bunker Hill, Idaho. Gulf had been controlled by a series of individual shareholders that apparently had drained assets from its operations.\textsuperscript{153} After reorganization, the company paid only $17 million toward cleanup.\textsuperscript{154}

Although no bankruptcy filing took place, the Exxon Valdez oil spill is another example. Oil from that ship devastated Alaska’s Prince William Sound. The tanker was owned by a subsidiary of the Exxon Corporation, the Exxon Shipping Corporation. Had Exxon claimed limited liability – which public embarrassment deterred it from doing – the subsidiary could not possibly have paid the cleanup costs. The parent company, however, had relatively little trouble covering the costs.\textsuperscript{155}

In some ways, however, less visible examples are more telling. Although public pressure compelled Exxon to pay the judgment against the subsidiary that owned the tanker Exxon Valdez, public pressure may never come to bear in the case of smaller business enterprises. For example, in Humana, Inc., v. Kissun,\textsuperscript{156} a parent company, Humana, was not responsible for its subsidiary hospital’s medical malpractice liability, notwithstanding plaintiffs’ veil-piercing arguments. The subsidiary was wholly owned by Humana, and Humana hired the subsidiary’s attorneys, and hired and directly supervised

\textsuperscript{153} See “And forgive us our trespasses,” Forbes (May 24, 1993), at 42 (Gulf’s major shareholder at time of bankruptcy filing has made “bondholders and shareholders [in his various companies] upwards of $400 million poorer”).

\textsuperscript{154} See News Briefs, The Idaho Statesman (July 2, 1995), at 2B.

\textsuperscript{155} Apparently due to the high level of public indignation, Exxon “did not choose to contest its liability for the negligence of its subsidiary.” Phillip I. Blumberg, The Increasing Recognition of Enterprise Principles in Determining Parent & Subsidiary Corporation Liabilities, 28 Conn. L. Rev. 295, 334 (1996). Paying the liabilities associated with the spill injured, but did not disable, Exxon’s finances. E.g. “Most Players in the Big Spill Have Moved On,” Seattle Times, Mar. 20, 1994, at A16 (Exxon Corp.’s usual net earnings of “about $5 billion a year fell to $3.5 billion the year of the spill, but rebounded in succeeding years.”).

\textsuperscript{156} 471 S.E.2d 514 (Ga. App. 1996).
the hospital’s CEO. Although the subsidiary hospital apparently was insured, it had no separate banking account, and had no access to the money which it was paid. Apparently, Humana “‘always funded what was necessary in order to allow the hospital to maintain a position where it could pay its creditors, payroll, et cetera . . . .’”[157] but apparently was not willing to fund the particular tort liability. Despite the obvious foreseeability of medical malpractice claims in the hospital setting, and Humana’s ability to control the subsidiary’s bill-paying and likely ability to cover the tort claim, Humana had no responsibility.

And in the case Department of Env. Prot. v. Ventron Corp.,[158] a parent company known as Velsicol, incorporated a subsidiary, Wood Ridge, for the sole purpose of purchasing and continuing the operation of a mercury processing plant. The plant, which occupied 7 acres on a 40-acre tract of land, dumped mercury process waste into a tidal estuary of the Hackensack River in New Jersey, resulting in extraordinary contamination: “for a stretch of several thousand feet, the concentration of mercury . . . is the highest found in fresh water sediments in the world.”[159] The parent company had had “constant involvement” with the subsidiary’s day-to-day operations; the subsidiary’s board of directors were all officers of the parent, and the subsidiary’s board reviewed not only finances and public relations, but the details of daily operations, such as personnel practices and production. Seven years after its incorporation, the subsidiary subdivided its 40-acre parcel and declared a 33-acre land dividend – the land on which the factory did not sit and the subsidiary’s major asset apart from the factory – to the parent.[160] Nonetheless, the parent company did not voluntarily undertake responsibility for its subsidiary’s liability and

[157] 471 S.E.2d at 519 (Pope, P.J., dissenting) (quoting testimony of subsidiary’s chief executive officer).


[159] 94 N.J. at 484.

[160] 94 N.J. at 484.
was not held vicariously liable because the subsidiary had not been created to “perpetrate a fraud or injustice.”

Cleanup costs are expected to be several million dollars.

Further, in Craig v. Charter Consolidated, P.L.C., a parent company, Charter Consolidated, P.L.C., a industrial and mining conglomerate incorporated in the United Kingdom, which held 62.5% of a subsidiary known as Cape Industries, another U.K. company, was not responsible for its subsidiary’s asbestos tort liability. Cape mined asbestos fiber in South Africa, and through a wholly owned subsidiary, sold it in the United States. An individual injured as a result of his exposure to asbestos fibers brought suit against Charter, attempting to pierce the corporate veil and hold Charter responsible for Cape’s stipulated personal injury liability.

Cape had engaged in a number of maneuvers to reduce its own liability to asbestos suits, including reorganizing to conduct business in the U.S. market through a new, “seemingly independent” corporation. Cape later made a policy decision not to appear in any United States asbestos litigation; over $75 million in unpaid litigation judgments had

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161 94 N.J. at 501. See also State of New Jersey Dept. of Envt’l Protection v. Arky’s Auto Sales., 224 N.J. Super. 200, 539 A.2d 1280 (N.J. Super. A.D. 1988)(refusing to pierce corporate veil to two sole shareholders of site where drums full of hazardous contaminants were dumped, despite showing of extensive control). Although the parent company eventually was held responsible for cleaning up the mercury contamination under a state statute, the New Jersey Spill Act, such statutes now seem unlikely to provide a meaningful solution for the excess risk-taking occasioned by limited liability. See Section III(D).


163 843 F.2d 145 (3d Cir. 1988)

164 The parties to the case stipulated that corporate separateness between Cape and its wholly owned subsidiary would be disregarded for purpose of the litigation, and that the veil-piercing issue should be approached as through Cape had been found liable to plaintiff. See 1987 WL 10191, *2 (district court opinion), rev’d, 843 F.2d 145 (3d Cir. 1988).

been entered against it by the time the Craig case was tried.\textsuperscript{166} Meanwhile, evidence was presented in litigation that Charter, with nominees on Cape’s board of directors, was generally aware of Cape’s operational and financial decisions, and was specifically aware of the decision of Cape (and Cape’s subsidiary) to reduce warehouse inventory to “the lowest possible level,” following Cape’s loss in an asbestos personal injury suit.\textsuperscript{167}

Charter took a majority share in Cape in 1969, after the first asbestos personal injury suits had been filed.\textsuperscript{168} Charter’s purpose was to assure its control, so that Cape would serve as the “main channel for the expansion of Charter’s industrial activities of the [building and light engineering] type.”\textsuperscript{169} Charter had the authority to control the board of directors; its directors closely monitored Cape’s finances; and a Charter statement suggested that it would “maintain . . . close scrutiny of [Cape’s] new capital expenditure projects.”\textsuperscript{170} Among other things, Charter used its authority to make recommendations regarding Cape’s dividend payments. Charter clearly could influence Cape’s operational and financial decisions, probably including its decisions to take actions to minimize or avoid personal injury liability in United States courts. Nonetheless, the United States Court of Appeals for the Third Circuit declined to pierce the corporate veil and to hold Charter responsible for Cape’s liability for Craig’s personal injury.\textsuperscript{171}


\textsuperscript{168} E.g., Bill Sanderson, Former Asbestos Factory Workers Sue Over Illnesses, The [Bergen] Record, June 10, 1987, at D01 (available on Lexis, News library) (mentioning asbestos 1950’s suit and 1960’s and 1970’s asbestos litigation; noting that asbestos manufacturers have “apparently known for decades that asbestos fibers are dangerous”).


\textsuperscript{170} 1987 WL 10191, *14; 843 F.2d at 151-52.

\textsuperscript{171} 843 F.2d at 152.
Finally, anecdotal evidence suggests that corporations actively rely on limited liability devices as a strategy to minimize liability risk.¹⁷² The fact patterns in cases such as Bestfoods,¹⁷³ as well as cases such as Humana and Ventron, suggest that companies clearly choose to create subsidiaries for the sole purpose of operating the risky activity, while minimizing the risk to parent company assets.¹⁷⁴ Further, corporations contemplating entry into a risky industry are traditionally advised to create subsidiaries.¹⁷⁵ While companies may not attempt to become completely judgment proof, the creation of subsidiaries is a dominant strategy to reduce exposure to claims for environmental injury and other potentially large tort claims.¹⁷⁶

A corporation attempting to insulate itself from liability by moving hazardous activity to a subsidiary probably will not seek complete “judgment-proofing.”¹⁷⁷

¹⁷² Because much corporate data, including tax returns (at the election of the corporation) consolidates the parent and subsidiaries, the most readily available information on this topic, again, is anecdotal. E.g., James J. White, Corporate Judgment Proofing, 107 Yale L.J. 1363, 1388 (1998) (because of consolidated data, “reports on insurance and secured debt also fail to give any reliable information about the financial status of wholly owned subsidiaries”).


¹⁷⁴ See Ventron, 94 N.J. at 483 (Wood Ridge subsidiary created to purchase and operate mercury processing plant); e.g. Plaskon Electronic Materials v. Allied-Signal, 904 F. Supp. 644, 649 (N.D. Ohio 1995) (subsidiary formed “for the purposes of manufacturing semi-conductor-related products and ‘446’ polyester at the Site”).

¹⁷⁵ Menell, 1990 Colum. Bus. L. Rev. at 411 (“The principal risk-insulating strategy would be to set up the new production operation in a wholly-owned subsidiary corporation.”); Lynn LoPucki, Virtual Judgment Proofing, 107 Yale L.J. 1413, 1421 (1998); see also Hansmann & Kraakman, 100 Yale L.J. at 1881 (strong empirical evidence indicates that increasing exposure to tort liability has led to the widespread reorganization of business firms to exploit limited liability to evade damage claims”).

¹⁷⁶ E.g., Lynn LoPucki, The Death of Liability, 106 Yale L. J. 1, 21 (1996) (“This parent-subsidiary ownership strategy is in wide use among the largest companies in America.”); Hansmann & Kraakman, 100 Yale L. J. at 1881 nn. 3, 4 (noting efforts by tobacco and environmental services firms to use subsidiaries to evade tort liability).

¹⁷⁷ Lynn LoPucki has argued that in creating a subsidiary, a corporation’s goal is to completely insulate itself from an adverse legal judgment. He argues that the creation of a subsidiary is a convenient “judgment-proof structure,” because it can justify a transfer, to the parent, of excess
Corporations certainly have legitimate reasons to use subsidiaries, including managerial and organizational efficiencies and the need to comply with foreign and domestic rules that implicitly or explicitly require separation of functions. Further, should a corporation form a subsidiary as a means of reducing corporate exposure to tort liability all the way to zero, such a subsidiary would be less likely to assure contract creditors of satisfaction, something necessary for the subsidiary to do ordinary business. And the subsidiary more likely would be viewed negatively by the public.

However, the anecdotal evidence does seem to suggest that even if total judgment proofing is not the goal, corporations do use subsidiaries as a means of significantly reducing tort liability exposure. This seems especially likely for torts presenting some risk of a judgment substantially larger than, say, the size of contract debts that the subsidiary regularly incurs. For these types of tort liability, the corporation can limit its exposure while simultaneously providing adequate reassurance to contract creditors, should they seek it, that corporate contractual debts are likely to be paid.

C. The special case of the controlling shareholder

Every corporation does not face an equivalent moral hazard from limited liability.

178 See James J. White, Corporate Judgment Proofing: A Response to Lynn LoPucki’s The Death of Liability, 107 Yale L.J. 1363, 1389 (1998). White also notes that firms are highly unlikely to use subsidiaries to reduce their liability to zero in any event, because of public perception and the threat of veil-piercing, among other things. Id. at 1399. But see Section III(B) (arguing that neither veil-piercing nor public perception can substantially deter this strategy).

179 But see Lynn LoPucki, Virtual Judgment Proofing at 1422-25 (noting that contract creditors commonly rely on assurances of repayment other than presence of unencumbered corporate assets).

180 E.g. Lynn LoPucki, Virtual Judgment Proofing (noting use of “soft judgment proofing”).
Some have argued that a small, closely-held corporation may be more likely to select excessively risky activity than a big corporation, and that a wholly-owned subsidiary may face different incentives than a company owned by numerous individual corporate investors. A common thread may unite these observations: limited liability’s moral hazard appears to be different for differently-positioned shareholders. When a controlling shareholder, including a parent, is present, a corporation will be more likely to pick excessively risky, socially costly activity. When corporate ownership is dispersed, that tendency will be reduced.

This is likely for two reasons. First, when corporate ownership is dispersed, managerial risk-aversion is likely to temper any shareholder tendency to take excessive risks. By comparison, a controlling shareholder can more easily compel managers to carry out its profit-maximizing, risk-taking preferences. Second, a control shareholder will be better able to strategically time dividend payments or equity sales to assure that it vests benefits from risky corporate activity before lawsuits are filed against the corporation.

First, in a corporation with dispersed share ownership, the well-documented phenomenon of managerial risk aversion will more likely blunt a tendency to select excessively risky activity. Limited liability’s moral hazard is a temptation primarily for shareholders, not for managers. Limited liability subsidizes those costs from liability judgments that potentially exceed the corporation’s assets. Unless constrained to do so by shareholders, however, managers are relatively unlikely to select corporate activities that present a risk of just these types of costs. They will be unwilling to select activities that

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181 E.g., Paul Halpern, Michael Trebilcock, Stuart Turnbull, An Economic Analysis of Limited Liability in Corporation Law, 30 U. Toronto L. J. 117, 141 (1980) ("The moral hazard problem is likely to be more severe for small, tightly held companies than for larger companies.").

182 E.g., Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. 573, 630 (1987) ("If a subsidiary corporation constitutes only one of a number of components of a corporate group collectively conducting a fragmented unitary business, the very basis for the establishment of limited liability as a matter of general legal policy disappears.").
amount to a bet, even a pretty good bet, on the corporation’s existence, because that also means betting their (undiversified) jobs. Managers will seek to avoid activities involving risks of devastating losses (destroying the corporate entity and their employment) even if the risk is remote, and even if selecting the activities might be to the benefit of the corporation’s shareholders. Consequently, managers might not maximize profits in the strictest sense (which might involve selecting an activity whose downside costs could be subsidized by limited liability). Instead, managers might prefer to select corporate activities that achieve “target levels of profits,” or other goals that will satisfy stockholders enough to keep managers’ jobs, even if such an approach does not obtain for stockholders every possible profit dollar. Some have described this as operating at an “aspiration level” – one that protects managers from ouster, while avoiding high risks associated with activities for which a corporation may not be able to bear the full costs.

When shareholders are numerous and dispersed, this managerial tendency could significantly offset excess risk-taking. Consider the small “passive” corporate shareholder, 

\[183\text{ E.g. Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law 53 (1991) ("Human capital, for example, is notoriously difficult to diversify. Managers who have firm-specific investments of human capital cannot diversify the risk of business failure."); Zohar Goshen, Shareholder Dividend Options, 104 Yale L.J. 881, 887-88 & note 32 (1995) (discussing managerial tendency to retain earnings to avoid business failure and potential loss of human capital). Stock options may blunt, but are unlikely to eliminate, managers' concerns regarding their jobs.}

\[184\text{ E.g. Mark J. Roe, Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539, 5432 (2000) ("unconstrained managers often prefer to maximize the firm’s size, to avoid severe but potentially profitable risks, and to defer hard, disruptive actions"); David Leebron, 91 Colum. L. Rev. at 1606 n. 24; George Dent, Jr., Toward Unifying Ownership and Control in the Public Corporation, 1989 Wis. L. Rev. at 889 ("Managers fear risk more than shareholders do because managers cannot diversify their investment of human capital as shareholders can diversify their investments of money.").}

\[185\text{ E.g. Lipsey, Steiner, et al., Economics 320 (1990) (discussing “satisficing” behavior in firms); John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 29 (1986) (managers seek “that level of profits that will suffice to prevent external interventions by dissatisfied creditors or stockholders”).}

\[186\text{ See Steven L. Schwarcz, The Inherent Irrationality of Judgment Proofing, 52 Stan. L.R. 1, 26-27 (1999).}
one of thousands of stockholders in a large corporation, who favors a level of corporate activity up until the point where expected marginal benefit to the shareholder is equal to expected marginal cost. The shareholder’s calculation might well favor excessively risky activity, because, under limited liability, the shareholder will not fully bear the costs of such an activity. Agency costs, however, will prevent the shareholder from ensuring that managers fully maximize profits on the shareholder’s behalf.\textsuperscript{187} Small shareholders will face this agency problem for straightforward reasons. First, the small shareholder is unlikely to have easy or inexpensive access to information necessary to evaluate managerial quality. A small shareholder interested in monitoring and in participating in corporate management often faces significant information-gathering costs.\textsuperscript{188} Second, even if a small shareholder can acquire the information necessary to fully evaluate corporate management performance, influencing corporate management is difficult. Occasionally, takeovers and proxy fights can serve as avenues for groups of small shareholders to communicate preferences to corporate management or to ensure that they focus strictly on maximizing profits.\textsuperscript{189} However, small shareholders – especially those acting alone -- generally are unlikely to have any significant participation in month-to-month operations, or knowledge

\textsuperscript{187} The presence of limited liability’s distortion places us in the world of the “second-best.” E.g. P.R.G. Layard and A.A. Walters, Microeconomic Theory 181 (1978) (“If one of the standard efficiency conditions cannot be satisfied, the other efficiency conditions are no longer desirable.”) Were there no other efficiency problems (e.g.: no costs that a corporation could externalize), we undoubtedly would prefer that a shareholder be able to costlessly ensure that corporate managers fully maximize profits. Given the perverse incentives created by limited liability, though, the argument here is that we prefer the existence of the second distortion – the agency costs associated with shareholder monitoring of managers – because it tends to offset the distortion from limited liability. E.g. P.R.G. Layard and A.A. Walters, Microeconomic Theory 180 (“A first-best optimum is ruled out, and the problem is now to do the best we can, subject to the additional constraint . . . .”).

\textsuperscript{188} See Edward S. Herman, Corporate Control, Corporate Power 25 (1981).

\textsuperscript{189} But see Robert Ragazzi, 35 Ariz. L. Rev. 989, 1002 (1993) (“The market for corporate control no longer acts as a check on management’s decisionmaking.”).
of day-to-day details.\textsuperscript{190}

When the corporation’s ownership includes a controlling shareholder, however, the agency problem is reduced and the risk-taking dynamic consequently is more pronounced. The controlling shareholder’s agency costs are lower. The controlling shareholder generally has ready, low-cost access to information regarding operations or marketing plans.\textsuperscript{191} Depending on the jurisdiction, a parent corporation can, as part of "normal" operation, keep the books, approve the budgets, require that major capital expenditures be subject to approval, appoint the subsidiary's board of directors,\textsuperscript{192} and place its own employees in positions of control at the subsidiary.\textsuperscript{193} Further, managers

\textsuperscript{190} See Edward S. Herman, Corporate Control, Corporate Power 25 (1981) ("the small, absolute and relative size of their holdings, their impersonal and distant relationship to the organization, and the high cost of obtaining detailed knowledge about a company and communication among numerous stockholders normally limit the cohesion and power of ordinary owners").

\textsuperscript{191} Loftus C. Carson, II, The Liability of Controlling Persons Under the Federal Securities Acts, 72 Notre Dame L. Rev. 263, 315 (1997) ("[C]ontrolling shareholders may confer with directors and executive officers about a range of corporate matters from the selection of officers to various corporate policy and operational matters."); Edward S. Herman, Corporate Control, Corporate Power 25 (1981) ("These investors are knowledgeable, in close communication with one another, and interested in corporate affairs because of the size of their holdings . . . .").

\textsuperscript{192} Committee on Corporate Laws, Guidelines for the Unaffiliated Director of the Controlled Corporation, 44 Bus. Law. 211, 212 (1988) ("In a controlled corporation, all of the directors (including the unaffiliated directors) are usually voted into office with the support of the controlling shareholder.").

\textsuperscript{193} United States v. Bestfoods, 524 U.S. 51, 118 S. Ct. 1876, 1884-85 (1998). Majority shareholders of an enterprise have "authority to ratify and monitor with regard to certain organizational personnel and affairs because they have the legal right to select and remove directors and to veto significant proposed corporate changes of a structural nature." Loftus C. Carson, II, 72 Notre Dame L. Rev. at 281-82. A parent company can retain substantial "control and the other incidents of ownership" and possesses considerable access to information regarding the company's operation. See, e.g., Rev. Model Bus. Corp. Act § 11.01(a) (1984) (shareholder approval required for mergers); id. § 12.02(a) (a corporation’s sale of all or substantially all its assets conditioned on shareholder approval); Del. Code Ann. tit. 8, § 275(b) ("If a majority of the outstanding stock of the corporation entitled to vote thereon shall vote for [a] proposed dissolution, a certificate of dissolution shall be filed with the Secretary of State."). See also Anderson v. Abbott, 321 U.S. at 535 (owner of banking stock cannot escape liability by transferring shares to a holding company: "[F]or he retains control and the other benefits of ownership without substituting anyone in his stead any one who is responsible for the risks of the banking business.").
obviously will respond more readily to a controlling shareholder’s concerns than those of a shareholder with a small ownership stake. 194

Thus, the controlling shareholder can more easily detect managerial risk aversion. The controlling shareholder can compel managers to select the most profitable opportunities. To the extent a corporate opportunity appears profitable, taking into account limited liability’s subsidy of liability exposure, a controlling shareholder can strongly encourage management to pursue it.

Further, where the control shareholder is a parent corporation, the shareholder may be able to address managerial risk-aversion to excess risk-taking in other ways. For example, the parent may be able to find a position for a loyal, displaced manager that became the victim of an ultimately realized small risk. This possibility may comfort the manager considering whether to select an excessively risky corporate activity. 195

Second, many shareholders in positions of control will be better able than small shareholders to ensure that shareholders vest gains from the corporation’s risky activities. A parent corporation could, for example, compel the corporation to pay dividends promptly when the corporation is engaged in very risky activities, or the parent may simply sell the subsidiary. This might mean that the parent (as well as other shareholders) could lock in benefits from those activities before a tort or statutory claimant threatens or files a lawsuit — or, in some instances, such as activities involving health or environmental risks, before the risky activity has even created known social costs. The parent thereby redistributes corporate income to itself and away from the victims of corporate torts and

194 See The Liability of Controlling Persons under the Federal Securities Acts, 72 Notre Dame L. Rev. 263, 315 (1997) (“controlling shareholders have the power to select the board and they can and frequently do exert pressure on directorial decision making that may be dispositive”); ALI, Principles of Corporate Governance § 1.10 cmt. (1994) (person is a controlling shareholder if the person exercises control by virtue of position as a shareholder).

statutory violations.

LoPucki describes a generalized version of this phenomenon as separating the corporation’s risky business from the corporation’s assets -- even those generated by the risky business itself.\textsuperscript{196} The subsidiary can be capitalized appropriately, but then after its initial creation, the parent can encourage the subsidiary to distribute the proceeds of its business, beyond its immediate cash needs, as dividends. Once distributed to the parent, these dividends generally cannot be reached based on a subsidiary’s tort or statutory violation unless the corporate veil is pierced.\textsuperscript{197}

Dividend-paying behavior of this type is not unusual.\textsuperscript{198} For example, as discussed above in the \textit{Ventron} case, after a corporate subsidiary had operated a mercury processing plant for several years, the parent corporation took possession of 33 of the 40 acres previously held by the subsidiary as a "land dividend," leaving the subsidiary in possession only of the 7 acres on which the plant itself stood, and limiting the subsidiary’s ability to pay tort judgments based on nearby mercury contamination.\textsuperscript{199} Further, the famous case of \textit{Walkovsky v. Carlton} concerned the sole shareholder of several taxicab corporations, who arranged for constant dividend payments, thereby limiting corporate ability to pay tort judgments.\textsuperscript{200}

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\textsuperscript{196} See generally LoPucki, supra note 11.

\textsuperscript{197} Unless a shareholder has (or should have) knowledge of a likely lawsuit, fraudulent conveyance law generally will not preclude this type of transfer. Knowledge that the corporation is selecting risky activity is not likely to suffice. See Section III(D). When shareholders elect to dissolve a corporation, they may be responsible for corporate debts for a limited period of time after the corporation’s dissolution. \textit{Id.}

\textsuperscript{198} In general, the decision of corporate managers to pay or not to pay dividends is reviewable under the highly deferential business judgment rule. See \textit{Sinclair Oil v. Levien}, 280 A.2d 717, 723 (Del. 1971). Consequently, small shareholders are not in a position to compel dividend payments.

\textsuperscript{199} \textit{State Dept. of Env. Prot. v. Ventron Corp.}, 94 N.J. at 484.

\textsuperscript{200} See 223 N.E.2d at 11.
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A corporation whose equity is held in whole or in part by a shareholder with a capacity to control the corporation is more likely to select excessively risky activities, both because the shareholder can more effectively monitor corporate management’s conduct, so as to assure that management will maximize profits on the shareholder’s behalf, and because the shareholder is in a better position to ensure prompt reaping of the benefits of the activity through dividend payments. A controlling shareholder is more likely to find attractive and to be able to persuade corporate management to approve the choice of hazardous activities that present the small risk of a large loss. The corollary is that, under limited liability, there is a set of risky activities that a company with a dispersed share ownership would not select, but a company with a controlling shareholder would.201

D. Possible neutralizers

Some commentators have identified features either of the legal system or of corporate structure that might tend to blunt the effect of limited liability’s moral hazard. Five major possibilities have been identified: (1) current veil-piercing rules; (2) managerial risk-aversion; (3) new statutes purporting to bypass limited liability rules; (4) fraudulent conveyance rules; and (5) free transferability of shares in publicly traded corporations.202 However, none of these is likely to compensate adequately for this excess risk-taking, especially when a controlling shareholder or parent corporation is present.

1. Veil-piercing rules

Current equitable veil-piercing rules are not a significant deterrent for companies

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201 Arguably, a shareholder’s possession of additional control might reduce the value to the shareholder of a given excessively hazardous corporate activity because the control would increase the shareholder’s liability exposure under the veil-piercing doctrine. The risk of greater liability exposure under the veil-piercing doctrine, however, as discussed below, appears very small. See Section III(D).

202 A fifth suggestion – a judicial doctrine that corporate managers have a duty of some kind to creditors – is not available under current law. See Lynn LoPucki, The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwartz, 52 Stan. L. Rev. 55 (1999).
that want to rely on limited liability as a means of reducing liability exposure for hazardous activities. Although there are some limited exceptions, current law generally retains limited liability for a corporate shareholder even when the shareholder exerts a considerable degree of influence – or even direct control – over corporate action.

Both this analysis of limited liability’s problems and the scope of a control-based liability regime depend on examining the especial problems created by limited liability when a shareholder has some level of control over a corporation. Consequently, a relatively close examination of current law is appropriate.

Corporate shareholders, with or without some level of control, generally have limited liability unless they have liability arising directly from their own conduct, a statute imposes liability upon them or a court pierces the corporate veil. Since this paper focuses on vicarious shareholder liability, the first exception need not be discussed further. The second is relatively rare and looks to be unsuccessful, as discussed below. Veil-piercing is the primary means of holding shareholders vicariously responsible for corporate torts.

Limited liability protections are currently available equally to individual shareholders and to corporate shareholders, such as parent corporations. Veil-piercing doctrine does

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203 Of course, the shareholder may also agree to have liability.

204 The federal Superfund law, otherwise known as the Comprehensive Environmental Response, Compensation, and Liability Act, or CERCLA, 42 U.S.C. 9601 et seq., is a notable exception. See infra _ (cases imposing liability directly on shareholders as “operators”). However, as discussed below, the effectiveness of such attempts to address excessive-risk taking under limited liability rules has been undermined by decisions like United States v. Bestfoods. See Section III(D) (discussing “direct” parent corporation liability under the federal Comprehensive Environment Response, Compensation, and Liability Act). Further, a very few state laws expressly impose responsibilities directly on corporate shareholders. E.g., New York Corporation Law (imposing unlimited responsibility for workmans’ compensation claims on 10 largest shareholders); Wis. Stat. Ann. § 180.0622 (all shareholders personally liable for wage claims up to amount of consideration paid for shares). And, as noted above, shareholder may be “directly” liable under other statutes by virtue of his or her own conduct. E.g., Browning-Ferris Industries of Illinois, Inc. v. Ter Maat, 195 F.3d 953, 955 (7th Cir. 1999) (“[T]he status of being a shareholder does not immunize a person for liability for his, as distinct from the corporation’s, acts.”).
not distinguish explicitly between the shareholder that is an individual and the one that is a corporate entity. Nor does the doctrine focus expressly on shareholders that are in a position to control the corporation (even a parent corporation with 100% ownership of its corporate subsidiary). As discussed below, however, the extent of corporate ownership and actual influence over corporate decision making may be relevant to some of the equitable factors considered as part of the court’s decision to pierce a corporate veil.

Generally, a tort claimant may persuade a court to pierce the corporate veil when "the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime." Despite this seemingly broad language, which appears to encompass a host of circumstances, courts rarely "pierce the veil." The doctrine essentially applies when abuse of the corporate form or of the limited liability privilege is extreme.

While there is some variation among states, and between state common law doctrines and federal common law, the corporate entity generally is disregarded and a shareholder held liable for corporate obligations or torts only where "the subsidiary was a ‘mere instrumentality of the parent corporation’" and the corporate form has been used to accomplish "fraud, injustice or the like." To satisfy this "mere instrumentality"
requirement, also known as the "alter ego" requirement, a claimant typically must show that the owner so dominated the subsidiary that it "had no separate existence but was merely a conduit for the parent." This might be shown by the intertwining of checking accounts, the parent's use of the subsidiary to transact the parent's business, or the lack of corporate formalities such as subsidiary directors' or shareholders' meetings.

While showing that a shareholder holds a substantial ownership stake is relevant, and perhaps even necessary, for a judicial finding that a corporation serves as a shareholder's "conduit," the showing of a substantial stake is not sufficient, under present law, to hold a shareholder responsible for corporate torts. Even with a showing of dominance such as close intertwining of a parent and subsidiary management discussed above, "liability generally is imposed only when the parent [also] has . . . us[ed] the

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208 One example is the Supreme Court's decision in Chicago, M & St. P. Ry. Co. v. Minneapolis Civic & Commerce Ass'n, 247 U.S. 490 (1918), finding that a railway subsidiary was a "mere agency or instrumentality" of its two 50% shareholders. The subsidiary had no stations or freight depots, only two engines, and 20-30 employees; it was managed by a "managing committee" that consisted of the general manager of one shareholder and the general superintendent of the other. The shareholders selected the superintendent, and exercised approval over business agreements. shares could be issued; they selected the superintendent; and they required that their consent be sought for business agreements. Seven of the nine members of the subsidiary's board of directors were officers of one of the two parents.
subsidiary to perpetrate a fraud or injustice, or otherwise to circumvent the law."\(^{209}\)

Showing that the subsidiary has committed a tort (apart, in some circumstances, from torts involving fraudulent representation regarding the corporation’s owners\(^{210}\)), is not sufficient to satisfy this requirement.\(^{211}\)

Courts have also stated that veil-piercing may be warranted if the subsidiary is

\(^{209}\) Ventron, 94 N.J. at 501. Compare Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986) ("the separateness of the corporation has ceased"). The Castleberry court took a relatively liberal approach to "alter ego" veil-piercing, requiring no fraud or inequitable conduct, but instead holding that alter ego could be shown "from the total dealings of the corporation and the individual, including the degree to which corporate formalities have been followed and corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes." Id. at 272. Reacting to Castleberry, the Texas legislature amended its corporate code in 1989 to specifically overrule any suggestion in that opinion that a failure to observe corporate formalities could be a factor in proving an "alter ego" theory. See Western Horizontal Drilling, 11 F.3d at 68.

The federal common law standard is somewhat more flexible. See S. Presser, Piercing the Corporate Veil § 3.01 & n. 5 (1991 & Supp. 1998) ("several federal courts have developed a federal common law . . . that allows for more easy piercing") (citing Leddy v. Standard Drywall, Inc., 875 F.2d 383, 387 (2d Cir. 1989); Capital Tel. Co. v. FCC, 498 F.2d 734, 738-39 (D.C. Cir. 1974). Prior to Bestfoods, federal courts considered the following factors in addition to "convenience, fairness, and equity," none of which factors individually is necessary or sufficient for piercing the veil: "(1) inadequate capitalization in light of the purposes for which the corporation was organized; (2) extensive or pervasive control by the shareholder or shareholders; (3) intermingling of the corporation's properties or accounts with those of its owner; (4) failure to observe corporate formalities and separateness; (5) siphoning of funds from the corporation; (6) absence of corporate records; and (7) nonfunctioning officers or directors. See In re Acushnet River and New Bedford Harbor Proceed., 675 F. Supp. 22, 33 (D. Mass. 1987); see also Public Interest Research Group v. Top Notch Metal Finishing Co., 29 Env. Rept. Cas. 1022, 1988 WL 156725 (D.N.J. Dec. 23, 1988) (under Third Circuit rules, veil will be pierced based on alter ego considerations).

\(^{210}\) For example, a corporation “might lead potential creditors to think that it is more solvent” than it really is. See Browning-Ferris Industries of Illinois, Inc. v. Ter Maat, 195 F.3d 953, 959 (7th Cir. 1999).

\(^{211}\) Needless to say, perhaps, if proof of a corporate tort was sufficient to show that the corporate form had been used “to circumvent the law,” that prong of the veil-piercing test would be rendered extraneous in all tort cases. E.g., Aronson v. Price, 644 N.E.2d 864 (Indiana 1994) (despite body shop’s negligent damage of car, engaging in separate analysis of “injustice” in determining whether to pierce veil to shareholder), reh’g denied (1995). See also Huffman v. Poore, 6 Neb. App. 43, 569 N.W.2d 549 (Neb. App. 1997) (veil will be pierced “only where the corporation has been used to commit fraud, violate a legal duty, or perpetrate a dishonest or unjust act in contravention of the rights of another”)
undercapitalized at the time of its creation, in view of the reasonably expected costs of running the business.\textsuperscript{212} As a practical matter, undercapitalization must be egregious before a court will pierce the corporate veil.\textsuperscript{213} If the corporation has been properly capitalized at the outset, later operation with clearly insufficient assets to cover the corporation’s tort liabilities will not suffice to show undercapitalization.\textsuperscript{214} Even undercapitalization \textit{ex ante} generally has been insufficient by itself for a court to justify piercing the corporate veil.\textsuperscript{215} In cases where corporations have been found to be undercapitalized at the outset and the corporate veil is pierced, another factor, such as the lack of corporate formalities, almost always has been present.\textsuperscript{216}

In short, a shareholder may maintain limited liability despite a high degree of

\begin{footnotesize}
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\item \textit{In re Acushnet}, 675 F. Supp. at 33; \textit{Anderson v. Abbott}, 321 U.S. at 362.
\item See \textit{Thompson}, supra note 141 (discussing refusal to pierce in 25-30% of cases where undercapitalization present).
\item \textit{E.g. Walkovsky v. Carlton}.
\item The Seventh Circuit, applying Illinois law, recently interpreted adequate capitalization, for veil-piercing purposes, as maintaining merely the “minimum capitalization required by law.” \textit{Browning-Ferris Industries of Illinois, Inc. v. Ter Maat}, 195 F.3d 953, 961 (7th Cir. 1999). Minimum capitalization requirements are not likely to be a meaningful constraint.
\item “Undercapitalization is rarely if ever the sole factor in a decision to pierce the corporate veil.” \textit{Browning-Ferris Industries of Illinois, Inc. v. Ter Maat}, 195 F.3d 953, 960 (7th Cir. 1999). In his empirical study of 1600 judicial opinions through 1985 in which plaintiffs sought to pierce the corporate veil, Thompson notes that undercapitalization was discussed only in a "small minority of the cases," and that courts "refused to pierce in 25 to 30% of the cases even when undercapitalization was present." See Robert Thompson, \textit{Piercing the Corporate Veil: An Empirical Study}, 76 Cornell L. Rev. 1036, 1066 (1991). Thompson does not discuss whether undercapitalization was the sole factor in any case justifying piercing the corporate veil. See also S. Presser, \textit{Piercing the Corporate Veil} § 1.05(2), at 1-54-55.
\end{enumerate}
\end{footnotesize}
potential or actual control over a corporation’s activity. Extensive control of a corporation by a shareholder – including selection of the subsidiary’s board of directors and control over major financial decisions – is treated by courts as fairly run-of-the-mill and is unlikely to create a significant risk of veil-piercing.\footnote{E.g. United States v. Bestfoods, 524 U.S. 51, 118 S. Ct. 1876 (1998).} Controlling shareholders can ensure that their interests are fully represented on the subsidiary’s board of directors, or by commonly employed officers, and that they have influence over both large and small corporate decisions, either directly, for some decisions, or through the board.\footnote{E.g. Datron, Inc. v. CRA Holdings, Inc., 42 F. Supp. 2d 736, 747 (W.D. Mich. 1999) (parent and subsidiary’s employment of a common officer not beyond “the parameters of normal oversight by a parent corporation of its subsidiaries”); AT&T Global Information Solutions Company v. Union Tank Car Company, 29 F. Supp. 2d 857, 867 (S.D. Ohio 1998) (“Ohio law permits one corporation to own all of the stock of another corporation as well as to employ common officers and directors, as well as other personnel, without risking veil piercing.”).} Parent corporations can weigh in heavily on a subsidiary’s decision to take on debt, on management and operational decisions – in the case of corporate activity presenting environmental risks, the decision to purchase pollution control equipment, litigation decisions, and, of course, decisions on the timing and amount of corporate distributions.\footnote{E.g. Aron Bookman, Parent Corporation Liability Under CERCLA, 18 Virginia Envt’l L.J. 556, 600 (1999) (“A parent could be fully aware of an environmental disaster, contribute to its creation through general mandates, make a substantial profit, and not be liable, even though it is arguably responsible.”).} Under current doctrine none of these activities normally will justify a court “piercing the veil” to a shareholder responsible for a corporation’s liabilities.

Similarly, that a corporation lacks sufficient assets even to address liabilities likely to flow from its operations generally is insufficient to pierce the veil. A shareholder may even influence a corporation to divest itself of assets (through, for example, the payment of dividends) without endangering limited liability protections. Shareholders thereby can demand distributions from corporate activity, even if that may leave the corporation with
relatively insignificant operating reserves.\footnote{E.g., Walkovsky v. Carlton.}

A shareholder must work hard to dominate every aspect of a subsidiary’s operations and also disregard corporate formalities (such as board meetings or corporate minutes) or engage in fraud in order to run afoul of current veil-piercing rules. In most jurisdictions, the exercise of extensive control over corporate management, including influencing management to pay distributions and to operate the corporation with reserves inadequate to pay tort claims against the corporation, will not result in veil-piercing absent a showing of disregard of corporate formalities or fraud.\footnote{See Section III(D). White argues that veil-piercing is likely if a parent “routinely drain[s] the subsidiary of its assets while satisfying the subsidiary’s contract creditors.” See James J. White, Corporate Judgment Proofing, 107 Yale L.J. 1363, 1401 (1998). Such veil-piercing, however, is likely to be the rare exception. Even the example given by White, Eastridge Development Co. v. Halpert Associates, 853 F.2d 772 (10th Cir. 1988), involved corporate conduct significantly more egregious than a parent’s influencing of a corporation to make large distributions. The parent company in that case arranged for all the corporation’s revenues to be paid directly to the parent and asserted control over all the subsidiary’s expenses as well. Corporate formalities were disregarded; the two corporations lacked any separateness at all. See 853 F.2d at 779. As discussed above, see Section III(D), a parent corporation or controlling shareholder has plenty of room to control a corporation’s actions before it runs a significant risk of veil-piercing in most jurisdictions.}

2. Managerial risk-aversion

As discussed above, managerial risk-aversion generally tends to blunt limited liability’s incentive for excess corporate risk-taking. However, managers can express their risk-aversion preferences only to the extent that they are not tightly constrained by shareholders. The greater the degree of shareholder control, the less the degree of managerial risk-averseness, since managers will have reduced latitude to serve their own goals in preference to maximizing shareholder welfare. Thus, managerial risk-aversion will have greater play when shareholder control is relatively low – for example, when all shareholders hold less than 1% of stock, exercising control over management will be more difficult. Where a shareholder with control is present, however, managerial risk-aversion
is unlikely to prevent excessive risk-taking.\footnote{Easterbrook and Fischel also argue that managerial fear of job loss may encourage a firm to pay a premium in the form of additional insurance. Easterbrook & Fischel, Economic Structure 53-54. Certainly, managerial risk-aversion might lead a larger corporation to purchase insurance where a corporation with a single individual owner-manager would not. As Easterbrook & Fischel acknowledge, however, firms may find it cheaper simply to pay a premium directly to a risk-averse manager rather than to buy insurance, especially for large potential losses. Firms may even pay managers a premium while “simultaneously decreas[ing] their capitalization.” Id. at 54.}

3. **Statutory tort law changes**

Several commentators also have argued that state and federal statutes might succeed in impeding corporate attempts to use subsidiaries to limit liability for hazardous activities.\footnote{James J. White, Corporate Judgment Proofing, 107 Yale L.J. 1363, 1404 (1998) (“state and federal statutes that explicitly decline to recognize corporate separateness of parties might thwart judgment proofing through subsidiaries”); Cindy Schipani, Infiltration of Enterprise Theory into Environmental Jurisprudence, 22 J. Corp. L. 599 (1997) (“enterprise liability is making its debut in CERCLA jurisprudence”); Philip Blumberg, The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities, 28 Conn. L. Rev. 295, 323 & nn. 100-02 (1996); Lynda Oswald and Cindy Schipani, CERCLA and the “Erosion” of Traditional Corporate Law Doctrine, 86 NW. U. L. Rev. 259 (1992). See also Peter Menell, Legal Advising on Corporate Structure in the New Era of Environmental Liability, 1990 Colum. Bus. L. Rev. 399, 410-11 (1990) (noting some legal uncertainty regarding “liability of parent corporations for the environmental harms of their subsidiaries”) e.g. A T & T Global Information Solutions Co. v. Union Tank Car Co., 29 F. Supp. 2d 857, 863 (S.D. Ohio 1999)(holding “grandparent” company liable for subsidiary’s hazardous waste cleanup liability only on a showing that it exercised control over the subsidiary and owned all the relevant assets).} Shareholders are directly liable under the common law for torts they commit, even when the shareholder purports to act on the corporation’s behalf.\footnote{E.g. Bestfoods.} Statutes that impose tort-type liability on a broader range of conduct than at common law also impose that responsibility directly on shareholders. Consequently, shareholders might have statutory responsibility for corporate actions that, at common law, would not have exposed the shareholder to tort liability, either directly or vicariously. According to these commentators, the strongest such statute appears to be the Comprehensive Environmental
Response, Compensation, and Liability Act (CERCLA, or Superfund),\(^{225}\) which imposes liability for cleaning up hazardous substance releases on a wide array of parties connected with the release, including the entity that “arranged for disposal” of the hazardous substance, the transporter, and the owner and operator of the facility where the release occurred. CERCLA’s liability section is perceived as a fairly radical attempt to expand liability for cleanup costs, notwithstanding the restraints that might be imposed by a host of common law tort and corporations rules.\(^{226}\) Caselaw under CERCLA over the last fifteen years or so was perceived to be “eroding” traditional corporation law concepts, such as limited liability.\(^{227}\)

A few other federal environmental statutes, including the federal Clean Air Act and Clean Water Act, impose liability on polluting behavior with language similar to CERCLA’s.\(^{228}\) A number of state environmental cleanup statutes have similar language


\(^{226}\) E.g. White, 107 Yale L.J. at 1404 (“[T]he most notable of these is [CERCLA]...”); Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. at 549-50 (discussing CERCLA and securities laws).

\(^{227}\) E.g. Oswald & Schipani.

\(^{228}\) See 42 U.S.C. 7413(b) (under Clean Air Act, "owner or operator" of affected source not in compliance with permit liable for penalties); 42 U.S.C. 7412(a)(9) (Clean Air Act provision defining "owner or operator" to include one that "controls" stationary source); United States v. Dell’Aquila, Enterprises & Subsidiaries, 150 F.3d 329 (3d Cir. 1998) (Clean Air Act imposes strict liability on owners and operators); 33 U.S.C. 1321(b)(6), (f) (Clean Water Act provisions imposing penalties and removal costs liability on "owner [or] operator" of vessel or facility from which oil or hazardous substance is released into water). One court also has imposed liability directly on corporate shareholders and officers under the federal Rivers and Harbors Act. In re Pollution Abatement Services, 763 F.2d 133, 135 (2d Cir. 1985), two corporate officers who were "personally involved or directly responsible" for the discharge of refuse and storage of thousands of drums of chemicals on the banks of a creek were held directly liable. Compare United States v. Sexton Cove Estates, Inc., 526 F.2d 1293, 1300-01 (5th Cir. 1976) (corporate president with personal involvement in dredging decisions, was not liable under Rivers and Harbors Act, because Congress did not expressly impose liability on corporate officers).
as well.\textsuperscript{229} Another statute that arguably imposes responsibility for corporate statutory violations directly on shareholders is Section 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934, which imposes responsibility for securities fraud on a person that “controls” any liable person, although subject to a “good-faith” defense.\textsuperscript{230}

Indications appear to be, however, that such statutory efforts to hold shareholders directly liable for corporate torts, as they currently stand, are unlikely to substitute for directly revisiting vicarious liability rules. The purported “erosion” of traditional corporation law concepts under CERCLA, for example, was set back sharply in 1999. In United States v. Bestfoods,\textsuperscript{231} the Supreme Court interpreted CERCLA to include concepts drawn from limited liability, thereby creating a safe harbor from statutory liability for parent corporations.

Prior to Bestfoods, it was not clear that courts would apply CERCLA or other environmental law statutes to hold a parent company directly liable for environmental injury from a subsidiary’s operations when there would be no liability under traditional corporation law doctrines. Prior to Bestfoods the Courts of Appeals had split regarding whether a parent company could, based on control exercised over a subsidiary, be an “operator” of the subsidiary’s disposal facility, so that CERCLA would impose liability for


\textsuperscript{231} 524 U.S. 51 (1998).
cleanup costs on the parent company.\textsuperscript{232}

In \textit{Bestfoods}, the Court granted certiorari on a question of a parent corporation’s direct liability as a CERCLA “operator” for cleaning up the polluted chemical manufacturing facility of its subsidiary. The parent company, CPC International (later renamed Bestfoods), had purchased, through a wholly owned subsidiary, a chemical manufacturing company. Several individuals served simultaneously as managers at both the parent and the subsidiary, and the parent controlled the subsidiary’s finances and a parent company employee actively participated in environmental matters. The question was whether the parent company had “operated” the subsidiary’s facility within the meaning of CERCLA’s liability provisions.

The Court stated that it viewed limited liability for corporate shareholders, including parent companies, as a “bedrock principle,” to be rarely disrupted, and suggested that the corporate veil was appropriately pierced only on a showing of “alter ego” and the use of the corporate form to accomplish fraud or for other wrongful purposes.\textsuperscript{233}

Based on the limited availability of veil-piercing, the Court then reasoned that parent companies normally had a “safe harbor” for certain types of activities, including “the


\textsuperscript{233} 118 S. Ct. at 1884.
election of directors, the making of by-laws . . . and the doing of all other acts incident to the legal status of stockholders. Nor will a duplication of some or all of the directors or executive officers be fatal.\(^{234}\)

So what was the fate of the “direct” liability under this federal statute? The Court reasoned that it applied only to a parent corporation that engaged directly in “operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations.”\(^{235}\) A parent’s involvement and control over the subsidiary’s operations, even “significant control” over its “business and decisionmaking,” as the district court found, and even when, as in the Bestfoods case, the subsidiary’s operations consisted only of running the single chemical manufacturing facility, could not expose the parent to CERCLA liability because it would be inconsistent with “common law standards of limited liability.”\(^{236}\)

And, an extremely important addition: a parent company action that could be characterized as a “normal” part of the relationship with the subsidiary could not expose the parent to liability under CERCLA, even if that action qualified as directly involving the parent in a hazardous waste disposal decision or in compliance with the environmental laws. “Norms of corporate behavior,” in the words of the Court, were to continue to serve as “reference points,” notwithstanding this far-reaching environmental statute.\(^{237}\)

\(^{234}\) 118 S. Ct. at 1884 (ellipsis in original) (citing Douglas & Shanks, Insulation from Liability through Subsidiary Corporations, 39 Yale L.J. 1929)). In some ways, Bestfoods is even more protective of a parent company’s prerogatives than earlier Supreme Court rulings. E.g. Chicago, M. & St. P.R. Co. v. Minneapolis Civic and Commerce Ass’n, 247 U.S. 490, 501 (1918) (relying in part on duplication of directors and officers to justify veil-piercing).

\(^{235}\) 118 S. Ct. at 1887.

\(^{236}\) 118 S. Ct. at 1887.

\(^{237}\) 118 S. Ct. at 1887. The Court held that a parent company could be held to have “operated” a facility when it “depart[ed] so far from the norms of parental influence exercised through dual officeholding as to serve the parent, even when ostensibly acting on behalf of the subsidiary in operating the facility,” or when an “agent of the parent with no hat to wear but the parent’s hat might
Excluded from the “norms” of acceptable behavior are only the limited set of shareholder behaviors that might lead a court to pierce the corporate veil.

Thus, the Court re-interpreted CERCLA to create a safe harbor from federal statutory liability for parent corporations. That safe harbor was directly informed by current veil-piercing rules. If a parent could exercise control over a subsidiary without risking limited liability under current veil-piercing rules, that same behavior would provide a shield from statutory liability that otherwise would attach.

In view of its application of the federal statute most often identified as working a change in the rules of corporate shareholder liability, Bestfoods strongly suggests that statutory law imposing direct liability is unlikely to effectively broaden vicarious responsibility for corporate shareholders.238 These types of statutes consequently are unlikely to be a very effective substitute for a direct change to vicarious liability rules for corporate shareholders and parents.

4. Fraudulent conveyance law

Current fraudulent conveyance law also is unlikely to provide significant protection for tort victims injured by a corporate activity that presents excess risks. A corporation may know it is engaged in risky activity that could expose it, somewhere down the line, to a risk of a large tort liability. For example, a pharmaceutical manufacturing operation may know that one of its products could present a risk of serious side effects. A corporation

238 Lower court cases decided after Bestfoods have continued to find that parent corporation control “within the parameters of normal oversight” – short of the required showing of control to justify veil-piercing – also is immune from CERCLA liability. E.g. Schiavone v. Pearce, 77 F. Supp. 2d 284 (D. Conn. 1999) (intertwined management and parent company approval of capital budget expenditures, including on pollution control equipment, would not render parent company directly liable under CERCLA for cleanup of subsidiary’s creosote plant); Datron, Inc. v. CRA Holdings, Inc., 42 F. Supp. 2d 736, 747 (W.D. Mich. 1999).
may even have general knowledge, given the size of typical jury awards for defective products, that if it is held liable in tort for the side effects, the corporation and its shareholders may not fully bear the costs. Even with this information, a corporation may, for example, pay contract claims and distribute dividends to its shareholders if the corporation is still solvent afterwards -- even if the corporation ultimately may be left with insufficient assets to pay a particular plaintiff’s claim.

Until a corporation has knowledge that a specific lawsuit is threatened or pending, a plaintiff will have a difficult time showing that the transfer was made with knowledge that a lawsuit has been filed or threatened, and hence “with actual intent to hinder, delay, or defraud any creditor.”

Consider a corporate subsidiary that engages in environmentally risky activity (by, for example, discharging wastewater that contains small amounts of hazardous chemicals), but that also regularly pays substantial dividends to its parent and pays its contract claimants. A neighbor down river later discovers that the chemicals have affected her plant nursery business and that the subsidiary does not have sufficient assets to fully address the

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239 See Uniform Fraudulent Transfer Act § 4(2).

240 See Uniform Fraudulent Transfer Act § 4, reprinted in 7A Uniform Laws Annotated 266, 301 (1999). The UFTA has been adopted in 38 states and its predecessor, the Uniform Fraudulent Conveyance Act, has been adopted in 6 states. A plaintiff may also be able to show a fraudulent conveyance if the debtor was engaged in a business and had “unreasonably small assets” or reasonably should have believed that the business would incur debts beyond its ability to pay as it became due, if the debtor transferred the asset “without receiving a reasonably equivalent value in exchange for the transfer or obligation.” See id. §§ 4.5. A showing that a corporation satisfied a bona fide contract claim, for example, is unlikely to satisfy this latter element, since the corporation will have received “reasonable equivalent value” in the form of the services rendered in the contract. Similarly, the preference to pay a dividend rather than to retain earnings in anticipation of potential future liability from risky activity is highly unlikely to constitute a fraudulent conveyance, if the dividend payment does not render the corporation insolvent. E.g. Prairie Lakes Health Care System v. Wookey, 583 N.W.2d 405, 415 (S.D. 1998) (no fraudulent conveyance if claim did not arise before conveyance); Burke v. Marlboro Awning Corp., 330 Mass. 294 (1953) (in context of dividend payments, “a mere preference is not ordinarily a fraudulent conveyance”) As James J. White has noted, asset sales for “reasonable equivalent value” also are not voidable under section 4 of the Uniform Fraudulent Transfer Act. White, 107 Yale L.J. at 1405.
pollution.

Although the amounts the corporation has paid in dividends and to the contract claimants would help compensate the neighbor if they were made available to her, the neighbor would have to overcome several obstacles for recovery on a fraudulent conveyance theory. First, as a plaintiff, the tort victim would have difficulty proving that, at the time the transfer was made, the corporation had knowledge of or should have anticipated that her property or business would be injured by the effluent. The corporation’s knowledge that it was engaged in behavior that could present an environmental risk is unlikely to suffice. Second, the plaintiff may have an even more difficult time showing that the corporation knew or should have known the tort claimant’s identity. Finally, even if the plaintiff could show that the corporation should have known that its discharge of hazardous chemicals would harm her property leading to an actionable tort claim, courts generally will sustain a debtor’s ability to transfer assets to legitimate creditors even when the result is that the debtor lacks sufficient assets to fully satisfy the later tort judgment. In short, fraudulent conveyance law is unlikely to be of much assistance.

241 Dickinson v. Ronwin, 935 S.W.2d 358, 364 (Mo. App. 1996) (“Conveyances made for the purpose of defeating an anticipated judgment in a case pending or about to be commenced are in fraud of creditors and void as to such plaintiff;” transfer to close family friend made on eve of tort judgment invalidated), reh’g denied (1996).

242 See Wyzard v. Goller, 23 Cal. App. 4th 1183, 28 Cal. Rptr. 2d 608 (1994) (“A debtor may pay one creditor in preference to another, or may give to one creditor security for the payment of his demand in preference to another.”); Smith v. Whitman, 39 N.J. 397, 189 A.2d 151, 18 (1963) (same). In Wyzard, the debtor’s preferential transfer of assets to pay an attorney’s bill for representation in a lawsuit was not held to be a fraudulent conveyance, even though it was apparent that debtor likely would lose the lawsuit and that, if the judgment creditor executed on the judgment, the debtor might not have sufficient assets to pay the attorneys’ fee. See also Garton v. Garton, 533 N.W.2d 828 (1995) (depositor’s transfer of inheritance to pay debt to bank was not a fraudulent conveyance even though it rendered him unable to pay spousal support and child maintenance obligations).

State corporate laws restricting a corporation from paying dividends except out of its surplus or profits likely also will present little obstacle to a corporation’s payment of dividends out of its profits from excessively risky activity. E.g. Del. Code Ann. tit. 8, § 170 (1996).
5. Free transferability of shares in publicly-traded corporations

Other commentators have argued that the free transferability of public corporation shares serves as another disincentive to overly risky projects.243 Because shares can be freely transferred, so the argument goes, management teams selecting inappropriate projects can be replaced through corporate takeovers.244 A project that is socially inappropriate because of its expected cost, however, might well be favored by shareholders because limited liability may subsidize those costs. So shareholders may not be the ones that will wish to discourage such projects. This argument would have

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243 Shares generally are not freely transferable where the corporation is a close corporation, or where it is a wholly- or mostly-owned subsidiary. Even on the open market, control shares are typically purchased at a significant premium. See Frank Easterbrook & Daniel Fischel, Corporate Control Transactions, 91 Yale L. J. 698, 706 (1982) (sale of a control bloc of stock will be at a “premium over the market price”); see also Manne, Our Two Corporation Systems: Law and Economics, 53 Va. L. Rev. 259, 279 (1967) (in close corporations, “restrictions on share transferability are very common”); Edward Herman, Corporate Control, Corporate Power 29 (1981) (“control is valuable and will be sought and consolidated”). For example, cash tender offers made in 1977 for a controlling share included an average cash premium of 32% above the market price. See Michael Maher, An Objective Measure for a Discount for a Minority Interest and a Premium for a Controlling Interest, 57 Taxes 449, 454 (1979). More recently, premiums have ranged well over 40% and as high as 100% in tender offers such as IBM’s 1995 purchase of the Lotus Development Corporation and Vivendi’s purchase of the Seagram Company. E.g. Judith H. Dobrzynski, The Art of the Hostile Deal, New York Times, June 22, 1995, at D1 (100% premium paid); Geraldine Fabrikan and Andrew Sorkin, French Company Agrees to a Deal to Buy Seagram, New York Times, June 20, 2000, at A1 (44% premium paid). See generally 33 Mergers & Acquisitions 23 (Mar.-Apr. 1999) (in 1998, over two-thirds of tender offers for which control premium could be calculated involved substantial control premia ranging from 25% to 95% over target’s stock price). 75% of acquisitions involved a control premium of over 25%. See id. See also Stuart Elliott, The $1.9 billion Saatchi deal vaults Publicis to the top tier, New York Times, June 21, 2000, at C6 (Publicis Group purchases Saatchi & Saatchi at premium of over 50%); Seth Schiesel, Web Hardware Marker Buys Digital ‘Plumber’ for $41 Billion, New York Times, July 11, 2000, at C1 (JDS Uniphase Corp. purchases SDL Inc., giving company’s investors a “takeover premium of almost 50 percent”).

244 Frank Easterbrook & Daniel Fischel, 52 U. Chi. L. Rev. at 94; see Harold Demsetz, 26 J. L. & Econ. at 387 (shareholders may engage in “takeover, a rebellion by a group of cooperating shareholders, or the acquisition of large shareholdings” to “give proper guidance to, perhaps to ‘boot’ out, an ineffective management”). But see Zohar Goshen, Shareholder Dividend Policy, 104 Yale L.J. 881, 884 (1995) (noting that market for corporate control offers only “indirect and expensive” discipline of management).
significant force only if tort victims could help displace corporate managers.\footnote{On occasion, social activists will purchase shares of a corporation so that they can attempt to participate in its governance and urge it to select activities that are less socially costly. However, these efforts have been few and remain the exception rather than the rule. They generally have not succeeded in significantly budging management that is otherwise committed to a certain course of conduct. \textit{E.g. Watchdogs of Corporate Ethics}, New York Times, Mar. 5, 1981, at D1 (describing church group efforts to question Rockwell International’s nuclear weapons production, among other corporation policies); Elizabeth Kolbert, \textit{In PCB Fight, It’s the Nun vs. the CEO}, New York Times, May 25, 1998, at B1 (describing Sister Patricia Daly’s unsuccessful effort to pass General Electric shareholders’ resolution against various corporate efforts to resist cleaning up PCBs dumped into New York State’s Hudson River).}

\section*{IV. A Control-Based Shareholder Liability Regime}
\subsection*{A. The Capacity to Control Rule Proposed}

Other legal structures and rules generally fail to fully address the problems flowing from limited liability. Moreover, the justifications for limited liability are largely confined to the case of the small, passive shareholder with no ability to control corporate direction. Meanwhile, the advantages of limited liability can be substantial for controlling shareholders.

A control-based regime would respond to these concerns. Such a regime would impose liability for a corporation’s torts or statutory violations on a shareholder (including a corporate parent) when the shareholder has the “capacity to control” the corporation by virtue of ownership.\footnote{A corporate officer, such as the CEO, that also holds a small ownership stake in the company as a performance incentive, would not have the “capacity to control by virtue of ownership.” A similar standard is imposed under the “controlling persons” portions of the Securities Acts.} Such a change could be accomplished by a liberalization of the common law rule of veil-piercing or through a statutory modification of the rules of vicarious liability.\footnote{Whether such a step would best be taken at the state or federal level is beyond the scope of this paper. Aside from the difficulty of convincing all fifty states to change their laws, Janet Cooper Alexander convincingly argues that claimants attempting to invoke expanded vicarious liability under state law would be beset by countless procedural difficulties. \textit{See} Janet Cooper Alexander, \textit{Unlimited Shareholder Liability Through a Procedural Lens}, 106 Harv. L. Rev. 387, 389 (1992).}

The rule would not impose responsibility on the passive shareholder who holds
only a small percentage of shares. For the individual that purchased 200 shares of General Motors on the open market, limited liability would remain a feature of the investment.

However, a shareholder would have liability if it exercised “actual control” over a corporation’s activities by virtue of ownership. Exercise of “actual control” over corporate operations, even in some limited aspects, would be evidence of the “capacity to control” the risky activity, even if the actual control was unrelated to the operations that resulted in a tort or statutory violation. If such shareholders could exercise actual control by virtue of ownership, such shareholders implicitly could control the corporation in other respects, either through involvement in the selection of the corporation’s board of directors, exercising authority over significant asset sales, or making other major corporate decisions.248

For example, in In re Pollution Abatement Services,249 which dealt with a close corporation’s liability for discharging refuse into and storing thousands of drums of chemicals on the banks of a creek, the two (of the four) shareholders that ran the corporation’s day-to-day operations would have vicarious responsibility under a control-based regime for the costs of cleaning up the chemicals if the shareholders had possessed the potential control by virtue of their ownership. Such vicarious liability would be in addition to whatever responsibility the shareholders might have directly by virtue of their own actions.250 In Ventron, for example, where the subsidiary’s mercury processing operations substantially polluted a waterway, such a rule would have resulted in vicarious environmental liability for the parent company, which owned 100% of the subsidiary, and which elected its own officers to the subsidiary’s board of directors. The board met

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248 See Edward Herman, Corporate Control, Corporate Power 26 (1981) (“the dominant owners occupy the top offices themselves, or they select (and can readily displace) those who do”).

249 763 F.2d 133 (2d Cir. 1985).

250 In Pollution Abatement Services, for example, the court did impose direct liability on the shareholders under the Rivers and Harbors Act. 763 F.2d 133 (2d Cir. 1985).
monthly and knew the details of daily operations.

In addition to imposing liability on shareholders exercising actual control over a corporation by virtue of ownership, a “capacity to control” regime also would impose vicarious liability for a corporation’s torts and statutory violations on those possessing potential control by virtue of ownership in the corporation. Even if a potentially controlling shareholder attempted to maintain a more passive role regarding management of the particularly risky activity leading to liability – or a passive role in general – this regime would impose liability.

As a consequence, parent corporations and other shareholders in a controlling position would watch managers more closely to minimize the corporation’s exposure to tort liability. These controlling shareholders would be more likely to press the corporation to purchase adequate insurance to cover liability flowing from risky activities.

Parent corporations and controlling shareholders, for whom monitoring management is cheap and efficient, would have no incentive to close their eyes to a corporation’s risky business choices. A parent corporation with especial knowledge or

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251 See Christopher Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 Yale L. J. 1, 73 (1980)


253 Hansmann and Kraakman appear to argue that a reduction in control premia – which could result from a control-based liability regime – would be related to a “decrease in shareholder monitoring of the management of risky firms.” 100 Yale L.J. at 1904. If so, this would offset an increase in monitoring attributable to a control-based liability regime. However, the conclusion is debatable under either a pro rata regime or a capacity to control regime. Certainly there would be a reduced demand for shares of excessively risky firms, and perhaps especially so for control shares. If the goal is to reduce the extent to which businesses can externalize their costs, this seems entirely appropriate. However, shareholders with liability would have an increased incentive to monitor risky firms that remained in business. Hansmann and Kraakman appear to assume that the number of risky firms will stay the same, but that there will be less monitoring because fewer investors would accumulate a large shareholding. A more likely outcome is that there will be less investment in risky firms and fewer firms
technology would be more likely to make it available to a subsidiary as a means of minimizing risk from the subsidiary’s activities.\textsuperscript{254} A parent company could assist a subsidiary in locating liability insurance. Finally, a parent company would be more likely to direct its limited resources to reducing the risks presented by corporate activities, rather than attempting to avoid paying the costs of those risks through corporate restructuring.\textsuperscript{255} Corporations would thus be less likely to select excessively risky corporate activities.

How could one tell whether a particular shareholder possesses the “capacity to control”? A majority shareholder clearly would qualify. For shareholders holding less than a majority of the outstanding shares, whether the shareholder has the “capacity to control” the corporation would have to be decided based on the facts of the individual case. The American Law Institute takes the position that a controlling influence should be assumed where there is ownership and/or possession of the power to vote more than twenty-five percent of the corporation’s shares.\textsuperscript{256} The SEC has publicly noted the “widely held belief that the ownership of 20\% . . . voting power in a widely held company in most instances

\textsuperscript{254} Cf. Shell Oil Co. \textit{v.} Meyer, 684 N.E.2d 504, 516-17 (Ind. App. 1997) (holding franchiser responsible for underground storage tank in view of large oil marketer knowledge of steel underground storage tank problems and that "the solution to the problem required significant engineering knowledge and resources beyond the limits of most gas station owners"), \textit{transfer granted} 698 N.E.2d 1183 (1998)


\textsuperscript{256} See American Law Institute, \textit{Principles of Corporate Governance} \textsuperscript{\$} 1.10(b) (1994); see also Essex Universal Corp. \textit{v.} Yates, 305 F.2d 572, 579 (2d Cir. 1979) (a 28.3\% owner is "almost certain to have share control as a practical matter"); see also Investment Company Act \textsuperscript{\$} 2(a)(9), \textit{codified at 15 U.S.C. \textsuperscript{\$} 80a-2(9)} (2000) ("any person who owns beneficially . . . more than 25 per centum of the voting securities of a company shall be presumed to control such company").
constitutes control.” However, the question whether a particular shareholder has the capacity to “direct . . . the management and policies” of a corporation could in some cases be an issue requiring expert testimony.

Whether a particular minority shareholder has the capacity to control the corporation might depend on the total value of the corporation and consequently the value of the shareholder’s holdings; whether there is a majority shareholder; the relationship between the minority shareholder and that shareholder or other minority shareholders; or the relationship between that shareholder’s board representatives and those of the other shareholders. Evidence that the stockholder has asserted a significant role in corporate organization also might be relevant.

For example, in Chicago, M. & St. P. R. Co. v. Minneapolis Civic and Commerce Ass’n, 247 U.S. 490, 501 (1918), each of the two parent companies held exactly 50% of the subsidiary’s shares. Although neither held a majority, together they had a history of acting together to control the subsidiary’s operations. Given this history, the proposed rule

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257 Exchange Act Release No. 27,035, 54 Fed. Reg. 30,490, 30,492 n. 23 (July 14, 1989), cited in Bernard Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 549 n. 90 (1990). Although it is considered an aggressive position, the SEC staff apparently also has argued that a shareholder should be considered “controlling,” under some circumstances, with a 10% holding of equity. See Black, 89 Mich. L. Rev. at 549; see also Deborah A. DeMott, Down the Rabbit-Hole and Into the Nineties: Issues of Accountability in the Wake of Eighties-Style Transactions in Control, 61 Geo. Wash. L. Rev. 1130, 1137 (1993) (describing incidents at Datapoint, in which 15% stock ownership was apparently adequate to confer control); Victor Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Cal. L. Rev. 1072, 1072 n. 2 (1983) (“The owner of 5% or 10% of the outstanding voting power may possess control.”).

258 This formulation appears in the securities regulations, 17 C.F.R. § 230.405 (1995).

259 E.g., Edward Herman, Corporate Control, Corporate Power 63 (1981) (relevant criteria might include ability to select outside directors and establishment of “power position”).

260 E.g., Edward Herman, Corporate Control, Corporate Power (1981) (noting that in 1975, the market value of the median-sized 5% holding of the 200 largest corporations amounted to $38 million).

261 See Edward Herman, Corporate Control, Corporate Power 26 (1981).
would make them liable for a subsidiary’s tort or statutory violations. Similarly, where the three individual shareholders of a close corporation together composed 50% of the board of each of the corporation’s subsidiaries, so that no decision can be made without their approval, the individuals would have the “capacity to control.”

Judges would not find such a standard altogether novel. In the context of cases under the Employee Retirement Income Security Act of 1974 (“ERISA”), for example, courts must consider whether a pension fund fiduciary has purchased or sold certain assets for “fair market value.” In order to determine whether a control premium should have been paid when a corporate ownership stake is acquired or sold, judges will consider whether a controlling share was involved in the transaction.

And, as discussed above, a shareholder that can control a corporation is responsible for its securities law violations. The SEC has interpreted the statutory language as the “power to direct . . . the management and policies of a person. . . .”

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263 29 U.S.C. §§ 1001 et seq.

264 E.g. 29 U.S.C. 1108(b) (fiduciary may purchase ESOP securities for “adequate consideration”); 29 U.S.C. 1002(18)(b) (“adequate consideration” defined to mean fair market value).

265 E.g. Montgomery v. Aetna Plywood, Inc., 39 F. Supp. 2d 915 (N.D. Ill. 1998) (calculating control premium for sale of interest in privately held corporation). The Montgomery court relied on a proposed ERISA regulation, 53 Fed. Reg. 17632 (May 17, 1988), suggesting that “fair market value” should include the calculation of a control premium if such a premium would be paid by a third party with regard to the securities being valued, if control would pass with the equity being purchased and if it is reasonable to assume that the purchaser’s control will not be shortly dissipated. Id.

266 See 15 U.S.C. § 77o (“Every person who, by or through stock ownership . . . controls any person liable under [section 11 or section 12] shall also be liable jointly and severally with and to the same extent as such controlled person . . . .”); 15 U.S.C. § 78t(a) (“Every person who, directly or indirectly, controls any person liable . . . shall also be liable jointly and severally with [that person].”)

Several courts have taken similar positions.\(^{268}\)

Further, in the context of determining when a parent company might have CERCLA liability for “operating” the facility of a subsidiary where a hazardous substance had been released, a number of courts, prior to the Bestfoods ruling, had imposed liability when the entity had “authority to control” the operations of the contaminated facility or decisions involving hazardous substance disposal. For example, in *Nurad, Inc. v. William E. Hooper & Sons Co.*,\(^{269}\) the Fourth Circuit ruled that an entity’s “authority to control”
a contaminated facility or hazardous substance disposal decision would lead to “operator” liability under CERCLA. 270

Under a “capacity to control” regime of vicarious tort liability for corporate shareholders, a court’s conclusion that a parent company possessed the capacity to control the subsidiary would render the parent jointly and severally liable with the corporation and any other shareholders possessing the capacity to control. In holding a shareholder fully responsible, a “capacity to control” regime is similar to current veil piercing rules. Once a veil is pierced under current law, the defendant shareholder’s responsibility for the corporation’s obligations also is complete. 271

Finally, a question remains regarding the time when shareholder liability would be assessed. There are essentially three choices: an “occurrence” rule – imposing liability on a shareholder with the capacity to control the corporation at the time of the occurrence that leads to liability in excess of corporate assets; a “claims-made” rule, which attaches liability to persons who are control shareholders at the time they receive notice that a claim will be filed against the corporation, and a “judgment” rule - attaching liability to those that are shareholders at the time of judgment.

An “occurrence” rule would appropriately encourage those in positions of control to monitor and influence corporate decisionmaking. As among the three timing rules, it

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270 Nurad involved a tenant and two vice presidents of a company; the Fourth Circuit found them not liable because they lacked any “authority to control.” Although Nurad did not involve a parent corporation or majority shareholder, the holding has been interpreted to apply to them. E.g. United States v. Bestfoods, 524 U.S. 51, 60 n. 8 (citing Nurad for the proposition that “parent having authority to control subsidiary is liable as an operator, even if it did not exercise that authority”). See also 40 CFR 89.2 (defining a nonroad vehicle or equipment manufacturing entity to include “all nonroad vehicle or equipment manufacturing entities that are under the control of the same person”).

271 Multiple “controlling shareholders,” if they were present, would be jointly and severally liable for a single corporate tort. Cf. Restatement of Torts.
would best minimize the opportunity for a shareholder to evade liability by selling its shares immediately after the occurrence. In proposing a pro rata regime, Hansmann and Kraakman reject an occurrence-based rule in favor of a claims-made rule. They argue that when a corporate tort spans a period of time, determining when the tort has “happened” and which shareholders have liability will present significant administrative difficulties. Many shareholders could be involved, and many shares could have changed hands.

These administrative difficulties would be considerably less under a control-based regime, however, because fewer shareholders would be involved. Of course, some torts might take place over a long period of time (as they presently do), and control shares could change hands during that period. However, similar apportionment issues have proved manageable for courts. For example, courts have had to apportion liability among different corporate defendants when a manufacturing operation has been in continuing violation of a statute, and has changed hands during that time.

Another potential issue would be the conflict of interest between shareholders at the time a lawsuit is filed and “old” control shareholders that may have liability if a judgment exceeds corporate assets, but that no longer hold shares in the firm. New shareholders might be tempted, for example, to distribute or otherwise dissipate corporate assets to reduce the assets available to pay a judgment, shifting the liability costs to the old shareholders. This conflict of interest would be heightened under an occurrence-based rule, simply because the greater length of time between the occurrence of the tort and the issuance of a judgment will make it more likely that shares will have changed hands. To the extent fraudulent conveyance law does not address this concern, Hansmann and Kraakman correctly argue that any adequate regime of unlimited liability must include a “duty on management to avoid opportunism on the part of new shareholders.”

B. Comparison of a Control-Based Regime with Other Regimes

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272 Hansmann & Kraakman, 100 Yale L.J. at 899.
When they proposed a regime of unlimited pro rata liability, Hansmann and Kraakman argued that there were “no persuasive reasons” to prefer a regime of limited liability over the regime they proposed. Hansmann and Kraakman have argued that pro rata liability for all corporate shareholders is feasible, even for shares traded on public stock exchanges.\(^{273}\) Stone also proposes pro rata liability.\(^{274}\)

A definitive choice of the “best” shareholder liability regime depends at least somewhat on empirical issues, including the extent of insurance availability and the precise distribution of corporate ownership. Nonetheless, comparison of the limited liability regime, a pro rata liability regime, and a control-based liability regime suggests that a control-based regime is a strong contender as a solution to the problem of limited liability’s moral hazard – and depending on the results of empirical investigation, could indeed be superior.

The following analysis compares the regimes in several ways. First, in terms of ensuring that those benefitting from risky corporate activity internalize the costs of those activities, both a control-based regime and a pro rata regime are clearly superior to a limited liability regime. As between the last two, a control-based regime appears superior to a pro rata regime because control shareholders will face inadequate incentives to internalize costs under a pro rata regime. Second, compared to a control-based regime, a pro rata regime likely will impose greater litigation costs upon a plaintiff seeking compensation from risky corporate activity. This will reduce the ability of corporate tort victims to get compensation. To the extent plaintiffs do overcome the litigation costs barrier and seek compensation from, among others, very small corporate shareholders, a pro rata regime may encourage those shareholders to engage in relatively costly monitoring.


\(^{274}\) Christopher Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 Yale L. J. 1, 74 (1980) ("each would be liable only in proportion to his or her equity interest").
On the other hand, a control-based regime also has weaknesses. Some weaknesses of the regime are common to any regime that imposes greater liability on shareholders, including the pro rata liability regime. Assertions of weakness specific to a control-based regime include the prospect of increased costs from litigation over the meaning of the rule; the inability of a plaintiff to obtain compensation from excessively risky activity when a corporation has no shareholder with a capacity to control; overdeterrence of some socially beneficial activities when insurance is not available for the activity; and a change in equity ownership patterns.

1. Internalizing the costs of risky activities

Both the “capacity to control” regime and the pro rata regime purport to address limited liability’s critical problem - the corporate ability to externalize the costs of risky activities and the resulting incentive to overinvest in those activities. As discussed below, a control-based regime is likely to be more successful than a pro rata regime in addressing

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275 In a world without transaction costs, the efficient solution to the problem of internalizing costs probably would be to apportion the costs of a corporate activity in proportion to the shareholders’ expected benefit – that would mean adding a premium or discounting each shareholder’s right to receive dividends depending on their ability to control or lack of control of the corporation. If there were no transaction costs, shares would be tradable because investors could costlessly monitor each others’ holdings and wealth. Further, each shareholder would face incentives that, to the extent of current tort and statutory law, correctly internalize social costs and benefits.

However, because we live in a world with transaction costs, such a rule is unworkable. First, it would be more difficult to trade minority shares. Second, because of transaction costs, as Hansmann and Kraakman acknowledge, a tort victim would face difficulties in collecting from numerous minority shareholders of a corporation and thus would be unlikely to obtain compensation for injuries from risky corporate activity in many instances. Further, calling on the court to add a premium to or discount each shareholder’s responsibility depending on control considerations similarly would make judicial proceedings considerably more cumbersome.

Given the reality of transaction costs, the “capacity to control” regime proposed here would be more likely either than the “efficient rule” outlined above or a pro rata liability rule to ensure that a corporation and the shareholders that can control it more fully internalize costs of excessively risky operations. It is also more likely to assure compensation for tort victims and the environment. See supra note 187 (regarding theory of the second-best).
limited liability’s “moral hazard.”

Under a control-based liability regime, shareholders with the capacity to control likely would encourage corporate management to resist risky, socially costly activities and, more generally, to appropriately capitalize the corporation and to insure against the potential costs of risky activities. Firms are more likely to internalize their costs, rather than shifting excess costs to involuntary creditors such as tort victims. Tort and statutory claimants would more likely be compensated.

At an economy-wide level, one would expect to see an overall reduction in risky activities undertaken by corporations. Under any regime, control generally confers on the shareholder a greater expected benefit per share purchased, relative to other shareholders. Under a control-based liability regime, control also would confer greater responsibility. An entity that purchased a controlling share of ownership in a highly risky corporate activity could expect to face higher costs should the risky business result in a tort liability judgment exceeding the corporation’s assets. For corporations engaged in highly risky activity, especially activities presenting risks of extremely large injuries, one would expect to see a reduced demand for control shares and a decline in the premium paid for control.

Overall, corporations would be less likely to select risky activities, either because of the presence of a control shareholder that has responsibility for tort or statutory liability exceeding corporate assets or because, in the absence of such a shareholder, managers could more freely express their risk-aversion.

Because shareholders would have greater responsibility for tort liability that exceeds a corporation’s assets, a pro rata liability regime would also reduce corporate

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276 See infra text accompanying notes 280-301 (discussing particular benefits attributable to shareholder control).

277 With a rule of pro rata liability, a similar consequence is likely. See 100 Yale L.J. at 1904 (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” and takeover premia would decline).
While the following discussion examines particular benefits of control in a general way, there is no reason to think (leaving aside the possibility of vicarious liability) that a control shareholder would tend to benefit less overall from risky corporate activity than from other types of corporate activity.

278 See supra note 243.


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well.  

This paper will not attempt a detailed analysis of the precise manner in which a control shareholder realizes the benefits of control. However, even briefly explained, it seems clear that a shareholder’s possession of corporate control confers tangible and unique benefits on the shareholder.

A major reason for acquiring control, of course, is the ability to realize greater profits by improving or changing the corporation’s management. Minority shareholders also may benefit from this, since better management can be reflected in increased dividends, which are paid pro rata. However, a control shareholder also can obtain benefits not shared with minority shareholders.

First, a control shareholder can benefit from synergies between the corporation

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281 Telephone conversation with Bruce A. Gutenplan, Paul, Weiss, Rifkind, Wharton & Garrison (Sep. 28, 2000); e.g. Montgomery v. Aetna Plywood Inc., 39 F. Supp. 2d 915 (N.D. Ill. 1998) (calculating control premium for sale of interest in privately held corporation).

282 Some have argued that control buyers overpay for control. See Bernard Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597 (1989). However, it is hard to imagine that overpayment accounts systematically for the presence of the control premium.

283 A control shareholder may be willing to pay some premium per share for the possession of control in order to improve corporate profits, and hence the payment of dividends, even if minority shareholders benefit equally from the increased dividends payable per share. The control shareholder may find the prospect of improving management so attractive that it is willing to tolerate some free-riding by minority shareholders. Cf. Steven Croley, Theories of Regulation: Incorporating the Administrative Process, 98 Colum. L. Rev. 1 (1998). This phenomenon may be reflected in the observed increase in the value of minority shares in a company that is the target of an acquisition. Cf. Randall Morck, Andrei Schleifer & Robert Vishny, Management Ownership and Market Valuation, 20 J. Fin. Econ. 293, 306 (1988) (firms with significant percentage of equity held by board member have higher profits); Karen Wruck, Equity Ownership Concentration and Private Equity Sales, 23 J. Fin. Econ. 3, 12 (1989) (presence of controlling shareholder tends to increase firm’s value because of better management). However, the continuing presence of a substantial difference between the per share price of a minority share and the per share price of a control share strongly suggests that the prospect of improving management in a way that would benefit each shareholder pro rata explains only a little of the value a control shareholder expects to receive upon acquiring control.
and the shareholder’s other businesses.\textsuperscript{284} For example, Ford Motor Company’s ownership of Volvo, Mazda, and other car manufacturing entities presumably allows economies of scale in automobile design, manufacturing, and improved bargaining leverage in the purchasing of parts from suppliers. The shareholder may benefit not only as a result of investing in the acquired business, but the shareholder’s other businesses – in which minority shareholders likely have not invested – also may be more profitable as a result.

Second, possession of the control share may provide the shareholder with an opportunity for, using the term loosely, self-dealing.\textsuperscript{285} For example, suppose Ford exercised its control as a majority shareholder in Hertz to require it to buy Ford cars. Ford – but not the minority shareholders in Hertz – could capture the seller’s surplus from such transactions.\textsuperscript{286} While this type of self-dealing is constrained by its fiduciary duty to minority shareholders,\textsuperscript{287} a control shareholder nonetheless will have some latitude to influence the corporation to act in ways that benefit the shareholder while perhaps benefitting minority shareholders less. Consider \textit{Sinclair Oil v. Levien}.\textsuperscript{288} There, a 97% parent corporation systematically arranged for the payment of corporate dividends that exceeded, by 30%, the corporation’s earnings over the same time period, apparently because the parent corporation was short of cash. Although they received their pro rata share of dividends, the minority shareholders viewed these dividend payments as against

\begin{footnotesize}
\textsuperscript{284} See Bernard Black, \textit{Bidder Overpayment in Takeovers}, 41 Stan. L. Rev. 597, 608 (1989); telephone conversation with Sam Frieder, principal, Kohlberg & Company (Sep. 22, 2000).

\textsuperscript{285} True “self-dealing” could, of course, expose the shareholder to liability for violating a fiduciary duty to minority shareholders.

\textsuperscript{286} Majority shareholders also may have the opportunity to “expropriate” corporate assets.

\textsuperscript{287} E.g. Committee on Corporate Laws, \textit{Guidelines for the Unaffiliated Director of the Controlled Corporation}, 44 Bus. Law 211, 212 (1988) (controlling shareholders might seek to cause corporation to contract with the controlling shareholder; try to eliminate non-controlling shares through ‘cash-out merger;’ or cause controlled corporation to repurchase shares from controlling shareholder); Deborah A. DeMott, \textit{Down the Rabbit-Hole}, 61 Geo. Wash. L. Rev. 1130, 1137 (1993).

\textsuperscript{288} 280 A.2d 717, 721 (Del. 1971).
\end{footnotesize}
their interest, because it prevented the corporation from making capital investments that would improve its value over the long-term. Nonetheless, despite a legal challenge by minority shareholders, the Delaware Supreme Court upheld the dividend payments as a reasonable exercise of business judgment. Further, a control shareholder also can control the form of corporate distribution (for example, dividends as opposed to share repurchases), which may confer significant tax advantages on it, but not on other shareholders.

Third, a control share investment is a lower-risk investment, on a per-share basis, than an investment in shares that lack control. The control shareholder does not face the risk, faced by the minority shareholder, that the corporation will come under the control of others that may do a poor job managing the corporation, try to expropriate assets, or run it solely to benefit the business of others. The control shareholder thus is likely to value the control shares higher, relative to other shares.

Fourth, in addition to the form of corporate distribution advantage mentioned above, a control shareholder may be able to gain tax and accounting advantages

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289 Needless to say, perhaps, the assumption of this analysis is that two shareholders may not have the same view of the utility of an equivalent dollar payout in dividends. One may favor the payout; the other, as appeared to be the case for the minority shareholders in Sinclair, may perceive that the opportunity cost of the payout – foregoing an investment in capital that would increase firm size, say – outweighs the value of the payout.

290 280 A.2d at 721-22.

291 For example, individual shareholders would normally prefer sale or exchange distributions to dividends, because they could have gains taxed at capital gains rates, rather than ordinary rates (and only the portion of proceeds in excess of the basis is taxed). Corporate shareholders, however, may prefer dividends, because corporations, especially those with large control shares, can take the dividends-received deduction. See Scholes et al., Taxes & Business Strategy 311 (2002).


293 Cf. Hansmann & Kraakman, 100 Yale L.J. at 1890 (“Differences in risk aversion or in the form of investment (for example, human capital versus financial capital) inevitably lead shareholders to value a firm’s potential projects differently.”).
unavailable to a minority shareholder of the same corporation. For example, a corporation that holds 80% of a couple of subsidiaries will be able to write off the losses of one subsidiary against the income from another. Further, dividends are taxed at different rates; a corporation that receives dividends from another corporation that is a member of the same “affiliated group” will pay no taxes on the dividends at all; a corporation that owns 20% or more of a distributing corporation will be able to deduct 80% of the dividend before taxes are calculated. By comparison, a corporation that holds a minority interest can deduct 70% of the dividend, while an individual that owns a minority interest will pay tax on 100% on the dividends.\footnote{294}

Moreover, an 80% control shareholder will be able to file consolidated tax returns even if the shareholder does not own all the cash flow from the subsidiary. This might make the shareholder's cash flow look high and make it easier to get financing. In other words, a control shareholder might be able to reduce its overall cost of capital by virtue of control ownership in a corporation with positive cash flow.\footnote{295}

Fifth, the buyer of a control share can gain additional value because, depending on the size of the control share, the control shareholder may have the option of cheaply acquiring the shares held by minority shareholders.\footnote{296} Because a control shareholder often can control dividend payout schedules and the timing of earnings reports,\footnote{297} the buyer may

\footnote{294} See Douglas Kahn & Jeffrey Lehman, \textit{Corporate Income Taxation} 66-71 (5\textsuperscript{th} ed. 2001).

\footnote{295} Douglas Kahn & Jeffrey Lehman, \textit{Corporate Income Taxation} (5\textsuperscript{th} ed. 2001); telephone conversation with Bruce Gutenplan, Paul, Weiss, Rifkind, Wharton & Garrison (Sep. 29, 2000).

\footnote{296} Robert Ragazzi, 35 Ariz. L. Rev. 989, 1002 (1993). “Under Delaware law, a purchaser may acquire a block of stock from one shareholder at a premium, and thereafter may offer a lower price for the corporation’s remaining shares.” \textit{In re Sea-Land Corporation Shareholders Litigation}, 642 A.2d at 802.

be in a position to depress the value of the minority shares and gain additional value from the repurchase of the shares on terms favorable to the control shareholder.

Moreover, a control shareholder’s opportunities to obtain most, if not all, these control-based benefits likely will increase as a corporation takes on new projects and grows in size. For example, as a corporation grows in size, a control shareholder’s ability to obtain tax advantages, such as the deduction for dividends and the ability (in the case of an 80% shareholder) to write off losses of one subsidiary against income of another, clearly will increase. And a control shareholder’s opportunity to benefit by altering the form of corporate distribution also will increase as the corporation undertakes more projects. Thus, a control-based shareholder likely will benefit not only from corporate activity in general, but from a particular new project, risky or not, in excess of that shareholder’s pro rata share of ownership.

Finally, while not every control shareholder may be able to avail itself of each of these sources of additional per-share value, the control shareholder can sell the control block to a buyer that will value control for these reasons and will be willing to pay for it. In such a transaction, the control shareholder will capture some of the surplus attributable to these additional sources of value. This type of transaction is likely, because the vast majority of corporate acquisitions take place through transactions other than tender offers. In these transactions, a buyer seeking control is likely to approach a control shareholder rather than trying to assemble a control share from minority shareholders, since the buyer likely will more easily obtain control if it can purchase block ownership from a shareholder that already possesses control. The control shareholder is free to sell its controlling ownership interest at any price it can negotiate, even if that price is not available to shareholders, that duty is unlikely to constrain this type of activity. See Bebchuk; Ragazzi.

298 In 1998, tender offers accounted for only 2.2% of all 9,129 corporate acquisitions, although they accounted for 8.3% of the total dollar volume. See 33 Mergers & Acquisitions 23 (Mar.-Apr. 1999).
to minority shareholders. The premium paid represents an immediate gain for the controlling shareholder.\footnote{See Alfred Rappaport, Creating Shareholder Value 159 (1988).} Once the acquirer has paid a premium for control to a controlling shareholder and acquired control, the acquirer is unlikely to pay any premium to purchase the shares of minority shareholders.\footnote{See Robert Ragazzi, 35 Ariz. L. Rev. 989, 1002 (minority shareholders lack “opportunity to sell their stock at a premium in the future”); see also Lucien Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1693, 1696 (1985). A control shareholder could, of course, have already paid a premium for a control block that s/he later tries to sell at a premium, and could take a loss on the sale if, for example, s/he overpaid initially in purchasing the control block. The point, however, is that the control shareholder has an asset to sell – the ability to control the corporation and to profit from synergies and other opportunities – that does not belong to minority shareholders.} Further, the seller of a control share need not share the premium with other shareholders.\footnote{“Our law does not regard a control premium as a corporate asset that must be shared among all shareholders. A fortiori a shareholder without control, even if he is a director, and thus owes a duty of loyalty to the corporation and its shareholders, may qua shareholder negotiate the sale of his stock on whatever terms he is able to arrange.” Citron v. Steego Corp., 1988 WL 94738, *8 (Del. Ch. 1988) (citations omitted). See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 5.16 (1994) (A controlling shareholder has “right to dispose of [voting equity securities] for a price that is not made proportionally available to other shareholders . . . .”). Of course, to the extent a control buyer acquires control by making a tender offer, that price must be made available to all tendering shareholders. See Securities and Exchange Act § 14(d)(7).}

An analysis of the extra value attributable to control raises a number of further questions that are beyond the scope of this paper, such as the size of the unique benefit that control shareholders can gain. For example, while a control shareholder clearly can obtain value not shared with other shareholders, some of the premium such a shareholder is willing to pay for control certainly could include benefits shared \textit{pro rata} with other shareholders, such as increased dividends that would come with an improvement in management. Another such question is whether unique control benefits would tend to increase proportionately with the size of a company. In public corporations, for example, an increase in a company’s size might be correlated as well with greater marketplace monitoring. This might, for example, reduce the extent to which a control shareholder
might take “synergistic” opportunities. Finally, some of the benefits clearly vary with the size of the control share held. For example, some tax benefits are not available to a shareholder with less than an 80% share. The extent to which others (such as synergistic opportunities) also may vary with the size of the control share presents an additional empirical question beyond the scope of this paper.302

In general, though, the control shareholder or parent is in a position to realize a benefit from corporate activity in excess of a pro rata share – and, depending on the structure and operation of the corporation and the control shareholder’s other businesses, perhaps substantially in excess of the pro rata share.

Despite receiving control-specific benefits, however, such a shareholder or parent would, under the pro rata regime, bear responsibility for an excessively risky corporate activity only in proportion to the share of equity held. To the extent expected costs exceed corporate assets, the control shareholder thus would continue to receive some “discount” on expected liability from a risky corporate activity, although expected benefits would not be similarly “discounted.”303 The control shareholder thus likely still will encourage overinvestment in such activities, even for some activities for which the activity’s social cost exceeds its social benefit.

More subtly, perhaps, a control shareholder will have a reduced incentive to ensure that a corporation is appropriately capitalized or carries appropriate insurance in view of the expected costs of its activities. This is because under a pro rata regime, a control shareholder’s share of expected costs from a risky activity is likely to be higher if the corporation is fully insured or capitalized than if it is not. For example, the control shareholder will be likely to bear more than a pro rata share of, say, insurance premiums.

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302 For example, a shareholder with a bare majority seeking to take synergy opportunities could face a greater risk of a fiduciary duty suit filed by minority shareholders.

303 This conclusion depends on an assumption that for any given corporate activity, a control shareholder is likely to realize additional benefits, relative to a minority shareholder. This appears true for at least some, if not all, of the benefits of control discussed above. See page 93.
in the form of reduced dividends or other distributions. For example, the corporation’s total cash flow will be reduced, which might have the effect of increasing the cost of capital to the control shareholder.

However, if the corporation is underinsured, the control shareholder’s liability is limited to a pro rata share of the expected loss in excess of insurance and assets. While incentives to insure adequately are surely greater under the pro rata regime than under a limited liability regime, a control shareholder still might encourage a corporation to underinsure its risky operations.

Even if the argument could be made that control shareholders do not realize any additional value from holding control of a corporation or, on the margin, from a particular corporate activity, a pro rata rule still would be less successful than a capacity to control rule in compelling a corporation with a control shareholder to internalize its costs.

Take a corporation that has a 51% shareholder and numerous small shareholders. As among all corporations, such a corporation is more likely to select excessively risky activities because of the presence of the majority shareholder. Under the pro rata liability regime, however, chances are good that a tort victim injured by the risky corporate activity will recoup only 51% of a tort liability judgment to the extent it exceeds corporate assets. As discussed in more detail below, obtaining additional recovery from investors that each own a tiny fraction of the total shares will involve considerable difficulty and expense. Tort victims may well forego this effort. As discussed above, a considerable number of

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304 See supra text accompanying notes 280-300 (discussing control benefits).

305 Cf. Janet Cooper Alexander, Unlimited Shareholder Liability Through a Procedural Lens, 106 Harv. L. Rev. 387, 389 (1992) (“The feasibility and costs of implementing a substantive rule are critical to evaluating what it would actually accomplish, and whether it would be an improvement over existing laws or possible alternatives.”).

306 E.g. Stone, 90 Yale L.J. at 75 (“In the typical giant, publicly held enterprise . . . no ordinary investor's exposure would be more than nominal.”). See Section IV(B) (discussing litigation obstacles presented by pro rata liability rule). Of course, this problem will not be as severe for closely-held corporations, since they generally have many fewer total shareholders.
publicly-held corporations fit this model. Consequently, tort and statutory claimants will continue to bear some or all of those costs, rather than being fully compensated.

Again, even assuming that there is no particular benefit to control, control shareholders would still obtain some benefits from the corporation’s collective ability to externalize costs as a result of the transaction costs faced by plaintiffs. Again, assuming control per se is worthless, these benefits presumably would be distributed pro rata among all shareholders, including control shareholders. As a consequence, control shareholders still will have an incentive to encourage corporations to overinvest in risky activity.

Hansmann and Kraakman acknowledge that under their regime, the damages owed to tort victims from risky corporate activity likely would not be fully paid, despite adequate shareholder assets, because of difficulties in collection. They argue that public corporations nonetheless would bear the “bulk of their expected liability costs.”

This would seem to be true primarily when the parent company of a non-publicly-traded subsidiary or close corporation that is, say, 95% or more owned by the parent, because the shareholder or parent would be nearly completely responsible for judgments that exceeded assets of the corporation. When a significant part of a corporation’s equity is held by numerous small shareholders, a tort victim seeking compensation in excess of corporate assets under a pro rata liability regime is unlikely to recover the “bulk” of his or her damages. Such a firm still could externalize significant costs of its activities. This

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307 See text accompanying note 50 (Demsetz conclusion that approximately 50% of publicly-traded companies are “owner-controlled”).

308 See Hansmann & Kraakman, 100 Yale L.J. at 1901.

309 Hansmann & Kraakman, 100 Yale L.J. at 1901. For the privately-held corporation with a small number of shareholders, a plaintiff seeking to invoke a pro rata liability rule probably will face manageable transaction costs.

310 Under a pro rata regime, a well-capitalized public corporation will likely bear the bulk of its expected liability costs, just as it presently does. Once it decided it was willing to pay its subsidiary’s liabilities, the Exxon Corporation’s payment of liabilities arising out of the Exxon Valdez oil spill put a dent in revenues only for one year. See supra note 155.
problem would be most significant for a corporation characterized by the presence of a shareholder with capacity to control and a large number of additional shareholders. As discussed above, this may typify a significant percentage of publicly traded corporations. In the late 1980s, several hundred publicly-traded companies had majority shareholders, and one source has suggested that roughly half of large corporations are “owner-controlled.”311

By comparison, under a capacity to control regime, a tort victim could seek full recourse from the majority or controlling shareholder. The corporation and its shareholders would be more likely to internalize the costs of their risky activity and to compensate the tort or statutory claimant.

(2) Incentives to insure

As mentioned in the previous section, a control shareholder’s incentive, under a pro rata regime, may be to encourage a corporation engaged in risky activity to underinsure. A control shareholder is likely to bear a greater share of corporate investments in insurance or capital than the shareholder would bear if a court actually imposed liability in excess of what the corporation could pay.

By comparison, under a control-based regime, a control shareholder is more likely to make sure that the corporation has insured adequately, given the risks presented by a particular activity. If a corporation is adequately capitalized or adequately insured for the risky activities it does undertake, the control shareholder will share the expected costs of a particular activity with other shareholders proportionately to the way in which it shares the benefits of corporate activities. The control shareholder’s expected costs likely will consist of reduced dividends and other expected benefits of share ownership, such as reduced tax benefits or synergy opportunities. Failure to ensure that a corporation is adequately capitalized or insured will expose the control shareholder to a larger proportion

311 See text accompanying note 50 (1988 survey identifying 650 public corporations with majority owners); note 50 (Demsetz data).
of liability for costs exceeding corporate assets.\textsuperscript{312}

(3) \textit{Litigation and transaction costs}

Because fewer parties would be involved in litigation, a control-based liability regime also would tend to minimize litigation and transaction costs. Under the \textit{pro rata} regime, a tort plaintiff interested in full compensation must engage in the costly enterprise of naming all shareholders as defendants – including identifying, locating, and serving these defendants. Especially for a publicly-held corporation with a controlling shareholder holding substantially less than all the shares, the number of potential defendants could be numerous.\textsuperscript{313} By comparison, a tort plaintiff in a control-based liability regime could name many fewer shareholders to obtain recovery for an injury caused by corporate activity.

Small shareholders also could incur significant transaction costs under a \textit{pro rata} unlimited liability regime, relative to a capacity to control regime. Because a prospective plaintiff is likely to face substantial transaction costs, a shareholder could discount the likelihood of actually being named in a lawsuit. However, to the extent small shareholders believe they face a significant risk of suit, they will monitor the corporation to minimize a potential liability risk, or else they will simply choose not to invest.\textsuperscript{314} The smallest

\textsuperscript{312} Under some circumstances, a control shareholder may not be able to ensure adequate corporate capitalization or insurance - for example, some risks may be uninsurable. Under these circumstances, a control shareholder might elect to avoid a risky activity altogether. See pages 105-07 (discussing overdeterrence).

\textsuperscript{313} For the difficulties facing a plaintiff that wishes to pursue numerous corporate shareholders under a \textit{pro rata} liability rule, implemented through state tort law, see generally Janet Cooper Alexander, 106 Harv. L. Rev. at 421, 424 (“Thus, [pro rata] unlimited liability would not normally be implemented in a unified proceeding in a single court, but rather in many different proceedings in many courts, possibly occurring long after the initial tort suit or suits are filed.”).

\textsuperscript{314} E.g. Paul Halpern, Michael Trebilcock, and Stuart Turnbull, \textit{An Economic Analysis of Limited Liability in Corporation Law}, 30 U. Toronto L.J. 117, 125 (1980) (explaining theory that a “risk-minimizing response [to unlimited liability] might entail more detailed involvement by owners in managerial supervision, thus generating increased, and wasteful, transactions costs”). Insurance might provide a partial solution to this problem, but probably only a partial one. See Janet Cooper Alexander, 106 Harv. L. Rev. at 428 (insurers not likely to provide shareholders with unlimited liability
individual shareholders may lack ready access to information necessary to assess expected liability and, sometimes, the knowledge or skill necessary to evaluate the information. Effective monitoring thus may require significant transaction costs. Because there is no limit on a shareholder’s potential liability, diversification is likely to represent only a partial answer.\footnote{Hansmann and Kraakman imply that diversification is still useful under an unlimited liability regime based on an assumption that “even a catastrophic liability judgment would [not] impose costs exceeding a publicly-traded firm’s value by more than, say, a multiple of five,” and, consequently, a shareholder would rarely be forced into insolvency. See 100 Yale L.J. at 1900, 1904. The basis for the assumption is unclear, however, and it is worth noting that in the ten years since Hansmann and Kraakman wrote their article, tort liability awards have continued to increase. For example, the median jury award in defective products cases rose from $500,300 in 1993 to over $1.8 million in 1999. See “Jury Awards Soar as Lawsuits Decline on Defective Goods,” New York Times, Jan. 30, 2001, at A1.}

A control-based liability regime, however, would, permit the truly small shareholders to avoid their relatively high monitoring costs.\footnote{As under a pro rata standard, however, mutual funds and other investment intermediaries might face responsibility under a control-based liability scheme. See Hansmann & Kraakman, 100 Yale L.J. at 1904 (noting that a collection mechanism imposing greater liability on large shareholders would “discourage investment intermediaries such as mutual funds”). However, liability would not be automatic, but would depend on the size of the fund’s holdings and other factors. Individual mutual fund shareholder liability seems highly unlikely under a control-based regime.}

The liability of these shareholders would continue to be limited under a “capacity to control” regime. These shareholders could continue to minimize investment risks by diversifying, rather than by monitoring. The bulk of monitoring responsibility would be borne by shareholders with the

\footnote{Further, institutional investors likely are in a good position to obtain any available insurance against such liability, and can presumably can include in their contract with individual investors some additional charge for their willingness to bear the risk associated with investment. Individual investors likely will continue to pay, just as they do now, a premium above what they would pay to invest in individual stocks, for the convenience and superior informational access provided by mutual funds. Finally, to the extent investment intermediaries are discouraged under a control-based regime, the effect likely will be seen primarily in risky industries.}
capacity to control, who most likely face comparatively low monitoring costs.\footnote{317 See Section II(B). Finally, like the limited liability regime, a capacity to control regime would continue to make wealth-accumulation opportunities available more democratically. Less wealthy shareholders, who tend to hold small percentages of a corporation’s stock, would face greater costs under a pro rata regime than a capacity to control regime. Avoiding the “tax” of litigation and a pro rata judgment would require these shareholders to spend substantial sums on information to monitor their corporate investments. Under a capacity to control regime, less wealthy individuals could invest — as they do now — without risking their entire portfolio. See Stephen Presser. Of course, these opportunities also would be available to wealthy individuals that elected to buy only small shares of ownership of a corporation.}

4. Costs from litigation over the meaning of “capacity to control.”

A capacity to control regime could be criticized as generating litigation because it would not impose a detailed standard or “bright-line” rule, and instead would impose a rule in which detail would be developed through judicial application.\footnote{318 See generally Louis Kaplow, \textit{Rules v. Standards: An Economic Analysis}, 42 Duke L. J. 557 (1992).} In some instances, such as where a shareholder owns 35% of shares, or arguably is a member of a shareholder “block” that can control the corporation, application of a control-based rule could require a trial judge to evaluate factual evidence and hear expert testimony.\footnote{319 E.g. Hansmann & Kraakman, \textit{Toward Unlimited Shareholder Liability for Corporate Torts}, 100 Yale L.J. 1879, 1931 (1991) (“In short, it is very difficult to determine where to drive the piton into this particular slippery slope.”); Cf. Note, 99 Harv. L. Rev. at 996 (describing litigation reduction as advantage of limited liability).}

However, even for the case requiring the development of a factual record, courts are not wholly without experience in addressing the capacity to control issue. In the context of ERISA, securities law, and certain environmental statutes, courts may have had to evaluate whether a particular shareholder has actual or potential control over a corporate entity.\footnote{320 See pages 81-82.} While there might be more litigation over the presence of liability for a particular shareholder than under a pro rata rule, the question does not seem more difficult to answer than the current veil-piercing standard, which requires a court to evaluate whether the parent is the subsidiary’s "alter ego" or has fraudulently used the corporate
Perhaps more critically, the lack of a detailed standard might require a potential corporate shareholder to expend resources determining whether it would face potential “capacity to control” liability in the event of a tort or statutory judgment exceeding corporate assets. Only some shareholders would need to spend resources on determining possible exposure. For example, it is clear that a majority shareholder and a truly tiny shareholder in a public corporation would be vicariously responsible and not responsible, respectively. However, shareholders possessing or considering the acquisition of large non-majority shares of equity would face the costs of determining whether they have the “capacity to control.”

Nonetheless, permitting the detail of a control-based regime to be developed in the context of particular cases still seems the best approach for several reasons. First, assuming that courts do not regularly make legal errors, the cost for a private shareholder to determine whether it possesses the “capacity to control” the corporation is likely to be relatively low. The shareholder that must make this determination likely will hold a significant block of stock. Such a shareholder is likely to have control over or inexpensive access to the information necessary to determine whether it has the “capacity to control” within the meaning of the rule: the proportion of shares held by others, the shareholder’s ability to select directors, and whether the shareholder is viewed by the market as possessing “control.”

Second, a rule that ex ante is more detailed, with less room for adjustment in individual cases, is likely to create significant evasion opportunities. It may be overinclusive as well. For example, a more detailed rule that selects a precise level of stock ownership – such as 35% – as “control” – would impose no responsibility on the 34% shareholder that is the largest corporate shareholder, is strongly represented on the board of directors, and is the only shareholder to hold more than .5% of stock. However, it would mistakenly include the 36% shareholder in the corporation that is controlled by a 64% shareholder.
In other words, a proper determination of “capacity to control” will depend, at a minimum, not only on the shareholder’s absolute share of ownership, but the share of ownership compared with the shares held by others. The potential for dramatic case-by-case variation weighs in favor of not attempting, ex ante, a detailed definition of the shareholder with the capacity to control.\footnote{See generally Louis Kaplow, Rules v. Standards: An Economic Analysis, 42 Duke L.J. 557 (1992).}

It is worth noting, however, that a somewhat similar rule developed by a federal appeals court in the context of lender liability under the Comprehensive Environmental Response, Compensation, and Liability Act was subject to substantial criticism. In United States v. Fleet Factors,\footnote{901 F.2d 1550, reh'g denied en banc, 911 F.2d 742 (11th Cir. 1990), cert. denied, 498 U.S. 1046 (1991). I am grateful to Ronald Mann for pointing out the potential similarities between a control-based liability regime for shareholders and the Fleet Factors lender liability standard.} the Fifth Circuit held that a lender with the “capacity to influence” its borrower’s operations would have statutory cleanup liability in the event of improper waste disposal there. The criticism of Fleet Factors stemmed in part from lenders’ concerns about the uncertainty they would face about their potential liability, including the size of that liability.\footnote{E.g. G. Van Velsor Wolf, Jr., Lender Liability After Fleet Factors, Perceptions and Realities in Fourth Annual Advanced ALI-ABA Course of Study: The Impact of Environmental Law on Real Estate and Other Commercial Transactions (Sep. 26-27, 1991); Widespread Havoc Predicted by ABA [American Banking Ass’n], 55 Banking Rep. (BNA) 791 (Nov. 12, 1990); Dennis Connolly, Superfund Whacks the Banks, Wall St.J., Aug. 28, 1990, § A, at 10, col. 3; Fleet Factors Files in Supreme Court, Says Ruling Disrupts Commercial Lending, 55 Banking Rep. (BNA) 586 (Oct. 8, 1990). For some of the commentary on Fleet Factors, see George Anhang, Cleaning up the Lender Management Participation Standard Under CERCLA in the Aftermath of Fleet Factors, 15 Harv. Envt. L. Rev. 235 (1991); Michael B. Kupin, New Alterations of the Lender Liability Landscape: CERCLA After the Fleet Factors Decision, 19 Real Est. L.J. 191 (1991).}

Concededly, a control-based liability standard for shareholders would create some uncertainty, just as it did for lenders after Fleet Factors until the decision’s import was weakened by administrative guidance and ultimately reversed by a statutory
amendment. However, the Fleet Factors liability standard was perceived to be considerably broader than the shareholder liability standard discussed here. Some believed the Fleet Factors standard would impose liability on any lender with a secured interest because of standard monitoring provisions in commercial loan contracts. Further, a number of other criticisms led to Fleet Factors being judged an “infamous decision,” including that it would have imposed greater statutory liability on lenders than on parent companies, other shareholders, or managers of a company that had improperly disposed of hazardous waste. These types of criticisms were particular to the statutory regime at issue, and would not apply to a control-based shareholder liability regime.

5. Exclusion of companies without controlling shareholders.

The company without a single shareholder in a position of control presents a special case. Such a corporation might, for example, fit the Berle-Means profile, owned by numerous individual shareholders, none of which individually (or as a block) possesses the capacity to control the corporation. To the extent large tort liabilities exceed corporate assets, a control-based regime would authorize no additional recovery from the corporation’s shareholders. Consequently, the corporation would not fully internalize the costs of its risky behavior. By comparison, the proportional liability rule urged by Hansmann and Kraakman would, in theory, provide for a pro rata recovery from each shareholder.


325 E.g. George Freeman, Recent Case Law May Expand Lenders’ Risks Under Superfund, Nat’l L.J., Sep. 17, 1990 at 19 (“A ‘capacity to influence’ test may well make all secured creditors vulnerable on the grounds of some inherent power to affect their borrower behavior.”); Dennis Connolly, Superfund Whacks the Banks, Wall Street J., Aug. 28, 1990, § A, at 10, col. 3 (“Lenders may be reluctant to finance clients with any involvement in environmental clean-up . . . for fear that such financial arrangements, in and of themselves, might establish a sufficient level of control to trigger liability.”); Widespread Havoc Predicted by ABA [American Banking Ass’n], Others Supporting Fleet Factors Review, 55 Banking Report (BNA) 792 (Nov. 12, 1990).

326 See Michael Kupin, 19 Real Est. L.J. at 209-16.
Whether this situation would arise frequently depends on, among other things, the extent of excess risk-taking, that is in fact, attributable to these types of corporations. Even without further empirical investigation, several factors suggest that the theoretical difference in treatment may not create a substantial practical difference between the regimes. First, even of the largest corporations, a considerable number have a control shareholder. For public corporations, as discussed above, one economist has estimated that 50% of public corporations are owner-controlled. Close corporation ownership is generally highly concentrated. Given the state of current information, the best conclusion seems to be that a corporation lacking a shareholder with capacity to control is unlikely to occur in the universe of close corporations, and probably does not represent the majority of public corporations.

Second, such a corporation is relatively unlikely to select an action with an appreciable risk of liability in excess of assets. In the absence of a shareholder with the capacity to control, managerial risk-aversion will be relatively unhindered. Managers can better serve their own goals – like keeping their jobs – in preference to strictly maximizing shareholder profits. As discussed above, even in the absence of a new liability rule, managerial risk-aversion is likely to temper limited liability’s “moral hazard.”

Third, a pro rata rule is unlikely to offer significant practical advantages in the treatment of a corporation without a control shareholder. Under a pro rata rule, a plaintiff would face substantial difficulty in obtaining compensation due to transaction costs. In the case of a public corporation without a control shareholder, for example, a tort or statutory claimant would be compelled to pursue hundreds or thousands of small shareholders, each for only a small fraction of the tort victim’s total loss. Considerable transaction costs could consume much of the potential recovery. For example, a claimant with $50,000,000 in injuries faced with suing 5,000 individual shareholders, each for $10,000, could

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See supra note 50.
conceivably be deterred by litigation costs from embarking on the process at all.

6. **Overdeterrence of some socially beneficial activities.**

Another criticism of a control-based regime could be that it would overdeter certain risky, but socially beneficial activities, if they present a risk of tort or tort-like statutory liability in excess of corporate assets. Because a shareholder with capacity to control would bear all the excess costs if the corporation faced a tort judgment, the shareholder might find that the shareholder’s expected costs from a new risky project (the losses resulting from increased corporate costs of paying liability judgments, together with the stockholder’s share of the costs that exceed corporate assets) outweighed the expected benefit to the shareholder, even if, overall, expected benefits exceeded expected costs.³²⁸ A 60% parent corporation, for example, which possesses the capacity to control (and hence exposure to 100% of tort liability in excess of corporate assets), but has the right to receive significantly less than 100% of the marginal value of a new corporate activity, might oppose a corporate activity whose social benefit exceeds the social costs, if the activity presents the risk of tort or statutory liability in excess of corporate assets. The shareholder might attempt to deter corporate management from undertaking the project.

If a corporation is properly capitalized or insured, however, there will be no overdeterrence effect. As discussed above, the incentive for a control shareholder under a control-based liability regime will be to encourage the corporation to get insurance or to capitalize more appropriately. When insurance and capitalization are adequate, a control shareholder is likely to view a business opportunity as privately advantageous when it is

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³²⁸ Cf. Halpern, Trebilcock, and Turnbull, 30 U. Toronto L.J. at 130 (“If [under unlimited liability] the wealthy shareholder buys more shares, then the probability distribution of his end of period wealth becomes more symmetric, since he has more claims to the firm’s earnings in the event of profitable operations to match his large potential loss in the event of default and the insurance provided to other shareholders is reduced. This will result in the stock price of the wealthy investor’s holdings being less negative or even positive. Therefore, a capital market will exist, and wealthy shareholders will purchase equity claims of corporations.”).
socially advantageous. Only when insurance (or capitalization) is inadequate will a control shareholder face a risk of liability “disproportionate” to the shareholder’s expected gain from the activity. By comparison, under the pro rata regime, a control shareholder’s incentive to make sure a corporation is fully insured or well capitalized will be inadequate.³²⁹

Any overdeterrence effect from a control-based regime likely will be limited to the circumstance where a risky corporate activity is uninsurable. Which types of risks may be uninsurable presents an empirical question. Should a control shareholder be presented with uninsurable risks, however, such a shareholder might elect to avoid socially beneficial activities presenting these types of risks. The significance of such an overdeterrence effect would depend not only on the presence of uninsurable risks, but on several other factors. The larger the shareholder’s proportion of ownership and the value attached to control of the corporation, the less the overdeterrence effect. A parent corporation or controlling shareholder that owns all or nearly all a corporation’s shares, for example, will not likely be overdeterred because the shareholder can expect to receive nearly all the benefits as well as the costs distributed by the firm as a result of a particular activity. The evidence on the value of control discussed above suggests that it is quite valuable – control premia very often range upward of 30% to 40% of share prices. However, a shareholder with, say, a 60% share of corporate ownership, but with control assumed to be worth only an additional 10%, might choose to forego a socially beneficial project that presents significant uninsurable liability risks in excess of corporate assets.³³⁰

³²⁹ See Section IV(B).

³³⁰ With a set of very conservative and oversimplified assumptions, this can be expressed in the following way. Let the marginal benefit of a project be represented by \( x \), and the marginal cost (here, assume it is tort liability) be represented by \( y \). Assume that all the corporation’s benefits are passed through to shareholders in the form of dividends or a change in share value, with a market in which the share can be sold. Also assume, conservatively, that the corporation is considering a project that is uninsurable, and that the corporation has no assets with which to pay a tort judgment. Take a 60% shareholder, and assume that control is worth an additional 10%. Then, the shareholder’s expected
Control likely is fairly valuable, and shareholders often will have more control than assumed in this example. Moreover, the expected cost of a particular action generally is not completely exogenous. Depending on the activity, control shareholders very often can influence the corporation to invest in safeguards that will minimize the activity’s potential risk.

Ultimately, however, the precise scope of any “overdeterrence” of uninsurable activities – and how that would compare with the underdeterrence effect under a pro rata regime – depends on empirical questions, including the distribution of ownership in corporations, the value of control, and the availability of insurance for risky corporate activities.

7. Changes in equity ownership distribution

The capacity to control rule might be conceptualized as a tax on control, likely resulting in some change in the distribution of equity ownership. Because the acquisition of control would be accompanied by new potential liabilities, the price of acquiring a control share in a risky business is likely to decline. Under a control-based liability regime, however, the tax is “flat.” If a shareholder were to acquire the “capacity to control” by virtue of ownership, the shareholder’s decision to acquire further shares in the company would not be accompanied by any further increase in liability exposure. So, for a shareholder that would have held control in a corporation under a limited liability regime, one might expect, under a capacity to control regime, that the same shareholder either

\[\text{incremental benefit from the project will be } (.66)x \text{ and the shareholder’s expected incremental cost will be } y. \text{ For a project presenting uninsurable risks, the shareholder will oppose any project for which } x < y/.66.\]

\[331\] In the absence of a capacity to control rule, the marginal benefit to a controlling shareholder of, say, the share that gives it majority control (51% of the voting shares) is likely to be quite high. By comparison, the marginal benefit of the share that gives the controlling shareholder 98% control rather than 97% control is likely to be considerably less: the entitlement to receive additional dividends from an enterprise that the shareholder already controls. Of course, the value of the share still would be higher than the marginal benefit of a share to a shareholder that had no capacity to control the corporation.
would hold a greater percentage of shares than it would have under a limited liability regime or else would avoid altogether the acquisition of a control share.

While this could be said to be a “distortion,” numerous other “distortions” are present in the corporation as a profit-maximizing enterprise. These include the presence of agency costs, the variation in those costs for a shareholder depending on the size and sophistication of the shareholder, and, of course, the presence of limited liability. Consequently, the fact of a new “distortion” in ownership distribution alone cannot be assumed to reduce social welfare.\textsuperscript{311} Some studies have suggested that having a moderate-sized shareholder (as opposed, say, to one holding a bare majority of stock) might bode well for corporate performance, but the implications of such a change are at best unclear.\textsuperscript{312}

A second set of objections flows from the attempt to substitute limited shareholder liability rule with any rule that imposes greater shareholder liability, whether it is a pro rata rule or a capacity to control rule. Many of these objections have been effectively answered by Hansmann and Kraakman in their defense of the pro rata rule. Consequently, discussion of these objections is not a central focus of this paper. The following discussion is intentionally brief and contains only a few additional comments.

\textsuperscript{311} See note 187 (regarding theory of the second-best).

\textsuperscript{312} It has been suggested that in close corporations, diluted ownership firms and extremely concentrated ownership firms tend to perform less well than firms where the largest shareholder is medium-sized, because in the latter, a controlling shareholder can effectively monitor management performance, but the controlling shareholder’s interest in expropriating benefits from the corporation for private use will be checked. See Venky Nagar, Kathy Petroni, and Daniel Wolfenzon, \textit{Ownership Structure and Firm Performance in Closely Held Corporations} (June 2000) (available from Social Science Research Network, www.ssrn.com). The effect of ownership concentration in large corporations, however, is less clear. Cf. Lucien Bebchuk and Luigi Zingales, \textit{Ownership Structures and the Decision to Go Public}, in ____ 59 (going public and diluting control may reduce company’s value because of “agency costs thereby created”). In any event, while a capacity to control rule might encourage a shareholder seeking control to hold more shares, rather than fewer, it is far from clear that the shareholder would try to acquire the nearly complete control that would best facilitate expropriation opportunities.
(1) **Public stock markets:** Some commentators have argued that any change from limited liability would impair the tradability of shares on a public stock exchange. Such arguments are ill-founded. The argument had been that under a shareholder liability rule, the price of a particular share would depend not only on the wealth of the individual shareholder, but also on the wealth of every other shareholder. Shares would no longer be homogeneous.313 Hansmann and Kraakman, however, have persuasively argued that the public tradability of shares would be unaffected under a pro rata unlimited liability regime, because a share would have the same expected value for each shareholder.314

A “capacity to control” rule would, of course, affect the prices at which control shares were traded, since an ownership share conferring “capacity to control” on its owners would confer not only the higher expected benefits of control, but a greater component of responsibility for corporate risk-taking.315 Since they would be jointly liable

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313 See Easterbrook & Fischel.

314 See Hansmann & Kraakman, 100 Yale L.J. at 1903.

315 Some also might argue that unfairness is inherent in the capacity to control rule’s placement of 100% responsibility for tort liabilities in excess of corporate assets on, say, an 80% shareholder because such a shareholder does not have the right to collect 100% of the company’s dividends. However, as discussed elsewhere, the primary effect of a control-based regime likely will be that a control shareholder will want its corporation to be properly insured. In the case of losses exceeding a corporation’s assets, the capacity to control regime admittedly would not treat every shareholder alike. The goal of treating every shareholder alike, however, is a red herring, since they are alike only in that they all have the identical per share entitlement to receive dividends. See supra text accompanying notes 281-300 (discussing unique advantages of control).

In that sense, the capacity to control rule is no different from veil-piercing rules as presently applied, or from the “controlling persons” liability imposed by the securities law. Under current law, only those shareholders whose circumstances or conduct satisfy the veil-piercing standard are responsible for the corporation’s liability. For example, in *State ex rel. Celebrezze v. Specialized Finishers, Inc.*, 604 N.E.2d 842 (Ohio Com. Pl. 1991), after finding that veil-piercing was clearly appropriate, id, at 604 N.E.2d at 851, the court apportioned environmental liability unequally among a corporation’s four shareholders (each of which held one-fourth the shares), with the shares ranging from 10% to 48%. See supra note 27 (discussing Wisconsin and New York statutes holding only the largest shareholders responsible for unpaid wage claims). Cf *State of Vermont v. Staco*, 684 F. Supp. 822, 835 (D. Vt. 1988) (holding some, but not all, individual stockholders directly liable under RCRA based on “authority to control” corporation’s mercury releases); *United States v. Pollution Abatement Services of Oswego*, 763 F.2d 133, 135 (2d Cir. 1985) (holding two of four shareholders directly liable under Rivers and Harbors Act).
in the event of a liability exceeding corporate assets, owners of control blocks likely would wish to monitor each others’ wealth. However, control shares in publicly-traded corporations generally are not traded at published market prices, but are bought and sold at a negotiated premium above that price anyway. Further, shareholders with control probably already monitor each other to some degree to assess relative control. Finally, for any particular corporation, the group of shareholders that could be considered to have a “capacity to control” is likely to be small, so monitoring control shareholder wealth should not be excessively burdensome.

As discussed above, the market might perceive uncertainty in some circumstances about whether a court would deem a particular shareholder to have the “capacity to control” a corporation, and hence liable under a control-based regime. If this were true, that could impair the tradability of marginal shares that could give such a shareholder the capacity to control. Other than these shares, the tradability of other shares on public stock exchanges would be unaffected.

Placing greater requirements on control shareholders is appropriate for three reasons. First, the shareholder with the capacity to control is the one best placed to encourage corporate management to avoid the excessively risky activity, or to invest in precautions if such an activity is undertaken. A shareholder without the capacity to control is far less likely to be able to join with others to convince corporate management to avoid the excessively risky activity. Second, by ensuring that tort and statutory claimants are compensated, a capacity to control regime best prevents a corporation from externalizing the costs of excessively risky activities.

Finally, a control buyer’s preference regarding liability exposure simply will be reflected in the price that a control buyer is willing to pay for a control share. If such a buyer values a control share less as a result of the potential responsibility that accompanies it, the buyer will be willing to pay less for it. There could, of course, be some unfairness for current control shareholders in risky industries when a capacity to control rule is first implemented.

The only exception here would be the attempt to quietly assemble a block of corporate stock on the open market. However, this is a relatively rare form of acquisition, and once an acquirer has obtained 5% of a company’s stock, a report must be filed with the SEC.

E.g. Hansmann & Kraakman, 100 Yale L.J. at 1891-92 (arguing feasible to negotiate among close corporation shareholders under unlimited liability rule). Further, historical evidence suggests that even in the absence of homogeneous shares, individuals will invest in transferable shares in business enterprises. See Philip I. Blumberg, Limited Liability and Corporate Groups, 111 Corp. L. 573, 581 (1986) (discussing extensive individual investment in English joint stock associations).
(2) **Disinvestment in socially beneficial industries.** A second possible criticism is that a shareholder liability rule generally might reduce the incentive to invest in certain industries that are risky, but widely agreed to be socially beneficial, such as pharmaceutical research.

Under a control-based regime, however, the incentive, as discussed above, would be for a control shareholder to ensure that a corporation is adequately capitalized or insured in view of the risks of its activities. To the extent there is a social need for “uninsurable” risky activities, limited liability rules would seem to go considerably further than necessary to address it. These rules encourage all risky activities, without distinguishing those that are uninsurable or distinguishing between those that society might wish to subsidize and those that it does not. A preferable approach would be to selectively subsidize particular socially beneficial activities. For example, to the extent pharmaceutical research is difficult to insure – hence leading to control shareholders avoiding socially beneficial research opportunities – we might choose to offer tax credits for money spent on pharmaceutical research or to subsidize the research outright.

(3) **More “fly-by-night” corporations in risky industries.** A third potential criticism is that excessively risky activities will be undertaken more by “fly-by-night” corporations, which are poorly capitalized, owned by individuals with few assets, and financed with debt. 318 Hansmann and Kraakman term this the “high roller” problem. Under either a pro rata or “capacity to control” regime, these corporations would not fully bear the costs of their activities because their shareholders would be judgment proof once they are relieved of their few assets. These entities would effectively continue to have limited liability even in the presence of a shareholder liability rule. As a consequence, the investors in riskiest

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activities would be those with the smallest incentive to minimize the risks. This could not only undermine the effectiveness of a shareholder liability rule at eliminating limited liability’s moral hazard, but somehow make matters worse by putting “fly-by-nights” in charge of the riskiest activities.

“Fly-by-night” corporations might take fewer precautions or insure less; risky activity could be undertaken more by these corporations not because they are expert at managing such activities, but because the “fly-by-nights” would be more judgment-proof and hence more risk-preferring. Further, they would be likely to seek higher levels of debt financing, which in turn would impose “efficiency losses in the form of agency costs of risky debt.”

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The first consequence is equally likely under limited liability, since generally all shareholders are “judgment-proof” under limited liability, not just owners of “fly-by-nights.”

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As to the other consequences, they could potentially occur under either a pro rata regime or a control-based regime. Hansmann and Kraakman have reasoned that the second two consequences are unlikely because for most unusually hazardous activities, a significant investment in specialized plant and equipment is required. Consequently, a significant problem associated with “fly-by-night” corporations would only arise if there were a large number of very wealthy individual shareholders that also did not especially mind a prospect of personal bankruptcy. In view of the stigma and general discomfort associated with individual bankruptcy, this seems unlikely. Declaring personal

319  See 100 Yale L.J. at 1913.

320  See Hansmann & Kraakman, 100 Yale L.J. at 1913. See also Section III(D) (discussing shareholder liability under veil-piercing and statutory liability theories).

321  See 100 Yale L.J. at 1913.

bankruptcy is not likely to be appealing, whether an individual shareholder is wealthy or not.\footnote{One recent empirical paper concludes that the prospect of personal bankruptcy does indeed affect individual decisionmaking. The larger the size of a state’s bankruptcy exemptions, say, for personal residences, the more likely individuals were to use a noncorporate form for businesses they started. See Wei Fan and Michelle J. White, Personal Bankruptcy and the Level of Entrepreneurial Activity 21-22 (unpublished, July 2000) (on file with author). Interestingly, Fan and White also conclude that the presence of greater wealth was positively correlated with decisions to start a business, but do not mention it as a significant factor in the decision to choose a corporate or noncorporate form for that business. Id. at 19-21. These findings are far from conclusive on the issue, but they do suggest that less wealthy individuals are not necessarily more willing to risk all their assets than more wealthy individuals.}

Finally, even assuming a “fly-by-night” problem, a control-based regime still would be preferable to a limited liability regime.\footnote{The concern would remain that, to the extent they are drawn to risky industries, “high rollers” might not be the individuals most skilled in managing highly risky enterprises, resulting in efficiency losses. See Hansmann & Kraakman, 100 Yale L.J. at 1912. As noted, however, the distasteful prospect of personal bankruptcy that would be faced by the ultimate owners of risky enterprises is likely to deter many less wealthy individuals from selecting excessively risky activities. Further, the concern seems outweighed by the overall improvement in the incentives for businesses to take care when entering into these industries.} The “fly-by-night” strategy is already available under current law. Under control-based liability, a “fly-by-night” might have a comparative advantage in bearing the risks of excessively risky corporate activity and thus might be more likely to enter a relatively risky industry. Certainly a capacity to control rule will be less effective in compelling a corporation to internalize liability if its shareholders are largely judgment-proof.

Under the current system, however, all shareholders are, as a legal matter, judgment-proof. Even if some fly-by-night corporations move into risky industries under a capacity to control regime or other regime of expanded liability, the remainder of corporations, with wealthier shareholders, will be less able to externalize the costs of excessively risky activities. Second, even if fly-by-night corporations can externalize some of their costs under a capacity to control rule, they still will internalize more costs than
under a present regime.\textsuperscript{325} Under a control-based regime, all shareholders with a capacity to control, even less wealthy ones, would have their assets at stake. Shareholders of such corporations would have to be sufficiently risk-preferring to “incur a substantial chance of personal bankruptcy if tort damages should prove large.”\textsuperscript{326} Again, the stigma and discomfort that generally accompanies personal bankruptcy is likely to prove a deterrent.

In short, even though such corporations might be relatively more risk-preferring than well-capitalized corporations under a capacity to control rule, they are still likely to be less risk-preferring overall than under current law. Consequently, the undertaking of excessively risky activity by “fly-by-night” corporations is still likely to be lower, at an absolute level, under a control-based regime than under a limited liability regime.

(4). Disaggregation.

This is a different version of the “fly-by-night” problem. Large companies might seek to disaggregate their risky businesses and spin them off piecemeal to small, less well-capitalized firms, but then continue to do business with those firms.\textsuperscript{327} The large company would, through contract, continue to engage in the risky activity, but would shift the liability risk to a more risk-tolerating entity. Hansmann and Kraakman give the example of a large oil company, which, rather than continuing to ship its oil in tankers that it or a subsidiary owns, might sell the tankers to small companies and then contract with them to transport the oil.\textsuperscript{328} Besides the oil tanker example, another one might be a metal smelting operator that would have purchased a mine in order to guarantee a supply of ore to the smelter.

\textsuperscript{325} As discussed earlier, \textit{pro rata} liability rule will generally be less effective at ensuring that costs of corporate activity are borne by the corporate unit, rather than the tort victim or society at large.

\textsuperscript{326} While the stigma associated with corporate bankruptcy may or may not have lessened over the decades, it is unlikely that many individuals will happily tolerate a significant risk of personal bankruptcy. \textit{See} note 322.

\textsuperscript{327} 100 Yale L.J. at 1913.

\textsuperscript{328} \textit{See} 100 Yale L.J. at 1913-14.
Instead, under an expanded shareholder liability regime, the smelter operator elects instead to approach a mine operator and contract to supply ore. The disaggregation/contracting phenomenon is likely to be seen primarily in vertically integrated businesses, which are likely to be invested in risky businesses as a way of ensuring supply or distribution for other parts of the business.\footnote{E.g., Kenneth Arrow, Essays in the Theory of Risk-Bearing 140 (1971) (companies vertically integrate to minimize market risks that might lead to variations in supply).}

Imposing a shareholder liability rule might reduce a parent company’s incentive to integrate vertically. However, the incentive for a company to purchase those goods or services rather than to integrate them into the firm would be offset by the loss of the very features that make vertical integration attractive in the first place, such as economies of scale and quality of management, greater assurance that a product will be effectively marketed, and reducing the risk of a shortage of a critical material.\footnote{See Arrow, Essays in the Theory of Risk-Bearing at 140; Hansmann & Kraakman, 100 Yale L.J. at 1914. Knowledge-based considerations – the costs of acquiring the information needed for vertical integration, versus the cost of purchasing the service elsewhere and having those individuals acquire the information – might also create an incentive to integrate vertically. E.g., Harold Demsetz, “The Theory of the Firm Revisited,” in Oliver Williamson and Sidney Winter ed., The Nature of the Firm 172 (1991) (because information costs for new business are not significantly greater, steel manufacturing firm may find it worthwhile to set steel “into its structural producers” rather than to sell the steel unriveted to construction companies). For an example of the risk of relying on other companies to provide marketing services, see Candy Sagon, Frozen Out: How a Pint-Sized Company Learned a Giant Lesson, Washington Post, May 3, 1995, at E01 (describing how small company, Sharon’s Sorbet, lost its market because its distributor, Haagen Dazs, decided to end distribution contract and market its own sorbet). See generally Harold Demsetz, “The Theory of the Firm Revisited,” in Oliver Williamson and Sidney Winter ed., The Nature of the Firm 163-64 (1991) (discussing calculus for a firm’s choice of “in-house production” rather than “external procurement”).}

Anecdotal evidence suggests that disaggregation/contracting is not likely to be a dominant strategy. After the Exxon Valdez oil spill, in which Exxon elected to bear responsibility for the oil spill of its subsidiary’s tanker, some oil companies did divest themselves of their tankers. However, other oil companies believed the best practice was to own the tankers to ensure that they
were managed appropriately for safety.  

V. Conclusion

To date, writing on limited liability has not delved deeply into the different incentives that may be faced by particular shareholders. Among other things, control shareholders are in a position to monitor and control managers and to reap additional benefits, beyond their pro rata share of ownership, from corporate activity. Consequently, limited liability’s moral hazard likely is most severe when a corporation’s shareholders include one (or more) with the capacity to control. At the same time, the efficiency justifications for limited liability, which largely depend on a prediction that shareholders will face significant monitoring costs, are strongest in the case of the individual shareholder that holds a small percentage of stock and are quite weak in the case of the control shareholder. Empirical evidence suggests that for a substantial number of corporate shareholders, limited liability’s promise of transaction costs reductions enhances efficiency little, if at all, despite the potentially significant efficiency costs it imposes in the form of corporate opportunities to externalize costs.

Although it represents one solution to limited liability’s “moral hazard,” the pro rata liability regime alternative also does not fully address shareholder differences, especially the special position of control shareholders. As a consequence both of this and of the significant transaction costs facing a plaintiff trying to obtain compensation from shareholders, the pro rata liability regime may not ensure that corporations fully internalize the costs of risky activities.

The control-based liability regime focuses more particularly on the special position of control shareholders. By holding them fully responsible for tort liability costs that exceed a corporation’s assets or insurance, the regime seems likely to get corporations with

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331 E.g., “Oil Tankers Shed Tankers to Reduce Liability Risks,” Journal of Commerce, Feb. 28, 1995, at 1A (quoting ARCO executive, “‘If you want to control liabilities in large oil companies, you ought to bring it in-house . . . .’”).
control shareholders to internalize their costs. Further, control shareholders would be far more likely to insist that a corporation purchase insurance at an adequate level. To the extent a corporation has not done so (or an activity is uninsurable), plaintiffs will face many fewer transaction costs in bringing a suit for compensation. While it has its own shortcomings, a control-based liability regime seems a strong candidate as a solution to limited liability’s moral hazard.

A definitive comparative analysis of these regimes requires evaluating the varying empirical assumptions each makes regarding the location and significance of different types of transaction costs. Limited liability defenders presume that under a regime of expanded shareholder liability, shareholders would incur substantial information-gathering and monitoring costs, and that on balance, limited liability is justified by the need to minimize these costs. This assumption seems highly questionable in the case of control and institutional shareholders, but it deserves fuller empirical investigation as to other shareholders.

Proponents of pro rata shareholder liability also make implicit empirical assumptions regarding transaction costs: under a pro rata regime, small shareholders would not need to expend resources on monitoring because diversification would remain a viable strategy for minimizing risk, and further, that tort plaintiffs seeking compensation from multiple corporate shareholders under an expanded liability regime would be able to obtain compensation (and corporations would internalize their costs) because litigation costs would not prove a significant impediment. Both these assumptions also are open to question, and empirical investigation would be worthwhile here as well. Although the special situation of control shareholders is not an explicit focus of the writings on pro rata liability, the extent to which a control shareholder can obtain benefits from corporate activity, in excess of its pro rata ownership share, clearly bears on the likely success of the pro rata regime in preventing corporations from externalizing their costs.

Finally, a definitive comparative assessment of the control-based liability regime
with the pro rata regime and limited liability regimes also would require empirical investigation into the ownership composition of corporations. For example, if a significant proportion of public corporations have control shareholders that hold significantly less than 100% of shares, then likely a control-based regime would be more successful than the pro rata regime in compelling corporations to internalize their costs. However, if corporations generally are owned nearly 100% by a corporation or individual shareholder, or else have no control shareholder at all, then the advantages of the control-based liability regime over a pro rata regime would be reduced. Similarly, the advantages of the regime would be reduced if corporations attempt to externalize costs significantly despite the absence of a control shareholder. Finally, if many corporate activities are uninsurable, the possibility that a control-based liability regime would overdeter those activities would be more significant.

At base, however, a thorough consideration of shareholder liability issues cannot presume that all shareholders are identical. Developing an appropriate solution must include not only not only more detailed empirical investigation, but a consideration of the special position of the shareholder with the capacity to control.