A FEDERALISM-BASED RATIONALE FOR LIMITED LIABILITY

Douglas G. Smith,
George Mason University School of Law

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In recent years, there has been a vigorous debate regarding the costs and benefits of limited liability and its proper scope.[1] Critics of limited liability have claimed that it imposes unwarranted externalities and improperly shifts costs from corporate shareholders to innocent third parties.[2] As a result, they argue, it exacerbates a moral hazard problem

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[*]Associate Professor, George Mason University School of Law. J.D., Northwestern University School of Law; M.B.A., The University of Chicago; B.S./B.A., State University of New York at Buffalo.

[1] *See, e.g.*, Stephen B. Presser, *The Bogalusa Explosion, "Single Business Enterprise," "Alter Ego," and Other Errors: Academics, Economics, Democracy, and Shareholder Limited Liability: Back Towards A Unitary "Abuse" Theory of Piercing The Corporate Veil*, 100 NW. U. L. REV. 405, 411 (2006); Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 J. CORP. L. 1063, 1065 (2006); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 81 (1991); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 7 (1997).

[2] *See, e.g.*, PHILIP I. BLUMBERG ET AL., BLUMBERG ON CORPORATE GROUPS (2005) (hereinafter "BLUMBERG ON CORPORATE GROUPS"); Henry Hansmann & Renier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J.

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by eroding the incentives corporate managers have to engage in responsible conduct. The proponents of a continued vigorous doctrine of limited liability respond to these criticisms with a variety of economic arguments, contending that limited liability has played an important role in the development of the United States economy and that, indeed, advanced securities markets would not be possible without the doctrine.[3] They argue that limited liability lowers the cost of capital formation and allows the free transfer of corporate shares, which would otherwise be impeded by a variety of costs were shareholders held personally liable for the debts of the corporation.

However, there are important aspects of both the historical development of the limited liability doctrine and its economic underpinnings that have gone largely unaddressed. In particular, the federal system has been an important and under-analyzed factor in the development of limited liability. There are strong economic arguments for limited liability that arise from that structure, which have not been given adequate attention. Moreover, the doctrine has historical significance. The federal nature of our governmental system influenced the development of limited liability as an important bulwark against state encroachment on the rights and sovereign prerogatives of other states within the federal system.

This article attempts to supplement current scholarship by exploring both the historical and economic interplay between limited liability and our federal system. Part I begins by discussing the traditional arguments in favor of limited liability and recent critiques of the doctrine. Academics have developed a number of creative theories supporting limited liability. Equally creative have been the critiques of these arguments. The law across the states has traditionally recognized a strong presumption in favor of preserving limited liability precisely because of its significant economic benefits. Accordingly, parties seeking to pierce the corporate veil and impose liability upon corporate shareholders often face significant hurdles. Courts typically require that the party seeking to pierce the corporate veil demonstrate that there is significant shareholder domination and control over the corporation whose veil is to be pierced, that there is an element of fraud in the use of the corporate entity that warrants dispensing with limited liability, and that the fraudulent use of the corporate form has caused the party seeking to pierce the corporate veil some injury. While courts have articulated a variety of factors that may be analyzed in determining whether these fundamental elements are present and the test is often less than clear cut, nonetheless most commentators agree that the test is generally a stringent

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1879, 1880, 1920 (1991); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996).

[3] *See, e.g.*, Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 481 (2001) ("limited liability was, and remains, essential to attracting the enormous amount of investment capital necessary for industrial corporations to arise and flourish."); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 90-98 (1985); Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 154 (1992).

one. Limited liability will not be abandoned absent unusual circumstances.

Nonetheless, some commentators have argued in favor of relaxing these standards and thereby broadening shareholder liability. These commentators maintain that the doctrine of limited liability leads to undesirable allocations of liability by shifting costs away from responsible corporate entities. At the same time, other commentators have urged what might be termed an absolute rule of limited liability and that veil piercing be eliminated altogether because the standards for piercing the corporate veil are so vague that they are unworkable or because the economic benefits of limited liability clearly outweigh any associated costs.

Part II analyzes the historical development of corporate law in the United States and, in particular, the limited liability doctrine. Because corporate law was traditionally a matter within the control of the state governments, corporations enjoyed a unique status in the United States. Corporations were viewed as artificial creatures of the state. Moreover, because they often undertook public functions, the state governments that created them had significant interest in their regulation. In this context, the state of incorporation supplied the law of limited liability and other internal corporate matters, which served as an important tool that had significant extraterritorial effects.

Finally, Part III analyzes the economic aspects of the federal system that support limited liability. Limited liability remains an important tool for minimizing extraterritorial regulation. It allows each state to bar other states from imposing liability on corporations created in their respective states in a manner that deviates from the policy of the state of incorporation. Moreover, it allows states to compete as centers of corporate creation: for example, certain states have developed particularly stringent doctrines of limited liability and it is arguably no accident that such states are favorites for those seeking to incorporate. Likewise, the doctrine of limited liability allows states to shield their corporations from differing standards of tort liability found in other states to some extent. States with stringent doctrines of limited liability may protect their corporations from the application of relaxed standards of tort liability found in other jurisdictions or procedural standards that threaten to impose significant and arguably unwarranted liability upon the corporate entity. Plaintiffs under such circumstances will find themselves limited to the assets of the corporation even though they may be able to establish entitlement to far greater sums under the laws of their own jurisdictions. This aspect of limited liability has become even more important given the recent increase in forum shopping and the recognition of certain jurisdictions as magnets for claims that would not succeed elsewhere. Moreover, it explains the continuing vitality of limited liability in the context of involuntary tort creditors, which has been the focus of much of the academic criticism. Thus, the federal structure leads to unique economic arguments in favor of the continued vitality of the limited liability doctrine.

I. PROPOSED JUSTIFICATIONS FOR LIMITED LIABILITY

The general rule in most jurisdictions is that the shareholders of a corporation are not responsible for its liabilities but rather are treated as separate and distinct legal entities.[4] Indeed, "[s]hareholder protection through the corporate form is 'ingrained in our economic and legal systems'"[5] and has been described as a "fundamental principle of corporate law."[6] As the Supreme Court famously stated in *Anderson v. Abbott*, "[l]imited liability is the rule not the exception; and on that assumption large undertakings are rested, vast enterprises are launched, and huge sums of capital attracted."[7]

The argument in favor of the limited liability doctrine is not merely historical or based on principles of *stare decisis* and longstanding reliance. Rather, the doctrine has been long accepted precisely because it has a strong economic rationale. Accordingly, it is widely recognized that the limited liability doctrine has played a fundamental role "'in the expansion of industry and in the growth of trade and commerce.'"[8] Moreover, limited liability for corporate shareholders is consistent with broader legal principles. Limited liability "is not unique to corporations," but rather is a rule that applies in many different contexts in which investors' risk is typically limited to the amount of their investments.[9]

Given the critical importance of limited liability in our economic and legal systems, the burden on a party seeking to pierce the corporate veil is severe.[10] "Courts will pierce the corporate veil only in exceptional circumstances."[11] Accordingly, disregarding the corporate form and imposing liability on affiliated corporate entities is an "extreme remedy,

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[4] *See* 1 FLETCHER CYCLOPEDIA OF PRIVATE CORP. § 43 (Nov. 2004) ("As a general rule, two separate corporations are regarded as distinct legal entities even if the stock of one is owned wholly or partly by the other. . . . Thus, under ordinary circumstances, a parent corporation will not be liable for the obligations of its subsidiary."); *see also* Hickman v. Rawls, 638 S.W.2d 100, 102 (Tex. Ct. App. 1982) ("The general rule is that a corporate entity may not be ignored."); In re Hillsborough Holdings Corp. v. Celotex Corp., 166 B.R. 461, 468 (Bankr. M.D. Fla. 1994) ("Delaware courts disregard the corporate entity in only the most extraordinary cases.").

[5] Hambleton Bros. Lumber Co. v. Balkin Enters., Inc., 397 F.3d 1217, 1227 (9th Cir. 2005).

[6] Easterbrook & Fischel, *supra* note 3, at 89.

[7] Anderson v. Abbott, 321 U.S. 349, 362 (1944).

[8] *Hambleton Bros.*, 397 F.3d at 1227.

[9] *See* Easterbrook & Fischel, *supra* note 3, at 90.

[10] *See, e.g.*, Mid-Century Ins. Co. v. Gardner, 9 Cal. App. 4th 1205-1212 (1992) ("It is the plaintiffs' burden to overcome the presumption of the separate existence of the corporate entity."); 1 FLETCHER, *supra* note 4, § 41.10 ("Courts apply the alter ego rule with great caution and reluctance. In fact, many courts require exceptional circumstances before disregarding the corporate form.").

[11] Calvert v. Huckins, 875 F. Supp. 674, 678 (E.D. Cal. 1995).

sparingly used."[12] Nonetheless, there are exceptions to the doctrine of limited liability and a significant debate among courts and commentators regarding their proper scope.

A. The Economic Basis Of Limited Liability

The traditional rule of limited liability for corporate shareholders may be justified on several grounds. First, limited liability reduces the economic costs of equity investment.[13] The less likely it is that shareholders will be personally liable for the debts of the corporation, the greater the value shareholders will place on corporate equities and the lower the costs associated with holding such investments. Commentators have argued that limited liability also reduces the costs associated with shareholders' "need to monitor" the corporation.[14] The less likely it is that shareholders will be responsible for the liabilities of the corporation, the less time and effort they will have to expend in ensuring that the corporation does not incur unwarranted liabilities. These costs reductions, in turn, encourage economic investment and the growth of organized markets.

In addition, if limited liability were abandoned or eroded, there would be an increased risk of shareholder freeriding. In a world in which shareholders were held responsible for the liabilities of the corporation and thus had an incentive to engage in greater monitoring of corporate activities, "only a fraction of the gains expected from effective monitoring will go to the monitor."[15] Accordingly, shareholders (particularly shareholders with limited stakes in the corporation) would have an incentive to freeride off of other shareholders' monitoring activities.

Second, commentators have suggested that limited liability facilitates the "free transfer of shares" and thus "gives managers incentives to act efficiently."[16] If shareholders cannot be held liable for the debts of the corporation, the wealth of individual shareholders is irrelevant in valuing those shares. As a result, each share of the corporation may be valued equally and all shares are fungible.[17] Without limited liability, the value of shares in the corporation would not be determined by cash flows of the

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[12] Sonora Diamond Corp. v. Superior Ct., 83 Cal. App. 4th 523, 539 (Cal. Ct. App. 2000).

[13] *See* Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387, 390 (1992); Bainbridge, *supra* note 3, at 499; David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1573 (1991); Presser, *supra* note 1, at 408.

[14] Easterbrook & Fischel, *supra* note 3, at 94; Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 18 (1994) ("Unlimited liability can . . . affect the market indirectly to the extent that it impacts on the amount of monitoring.").

[15] Bainbridge, *supra* note 3, at 492. *See also* Ribstein, *supra* note 1, at 103.

[16] Easterbrook & Fischel, *supra* note 3, at 95.

[17] *Id.*

corporation, but rather would be dependent in part on the wealth of the shareholder that happens to hold the particular share.

Moreover, because the value of each share is based on the cash flows of the corporation as opposed to individual shareholder wealth, the share price embodies information about the actual "value of firms" and, as a result, investors need not do their own research before purchasing a particular share of stock, but rather can rely with confidence on the market's valuation.[18] Without limited liability, there would be a significant danger that organized markets could not function efficiently or at all given the barriers shareholder liability may impose on the free transfer of shares.

Third, it is widely recognized that limited liability facilitates diversification. Without limited liability, shareholders would be unlikely to hold a wide array of stocks. Because their personal holdings would be put at risk with each corporate investment, shareholders would not want to expose themselves to additional risk of liability by investing in a wide range of corporations. Rather, they would seek to confine their investments to companies with which they are familiar or that are less costly to monitor, thereby preventing them from taking advantage of an important mechanism for reducing risk.[19] "The greater the degree of monitoring of each investment required, the fewer investments that will be made."[20]

Critics have argued that a rule of proportional liability would eliminate the need for limited liability to ensure diversification.[21] If an individual shareholder's liability were limited in proportion to the amount of shares they owned in a corporation, then the risk to shareholders of holding stock in a wide range of corporations would be reduced. Nonetheless, to the extent limited liability has been eroded, it has not been replaced with a rule of proportional liability, and commentators continue to argue that this is a powerful reason for vigorous adherence to the doctrine.

Fourth, in the absence of limited liability, corporate managers may reject projects that have a positive net present value because they are overly risk averse. According to Easterbrook and Fischel, this is "the real benefit of limited liability."[22] Projects may not be undertaken solely because managers fear that the risk of potential shareholder liability for a particular project will outweigh the benefits. Under such circumstances, it is conceivable that projects may be rejected even though the benefits might otherwise outweigh the costs.

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[18] *Id.* at 96.

[19] *Id.* ("limited liability allows more efficient diversification"); Thompson, *supra* note 14, at 32 ("[E]xtended liability will have a significant negative effect on the ability of shareholders to diversify, which in turn removes their risk-bearing advantage and more generally will remove the standardized pricing of shares that has contributed significantly to the growth and development of liquid financial markets for shares.").

[20] Bainbridge, *supra* note 3, at 491.

[21] *See generally* Hansmann & Kraakman, *supra* note 2.

[22] Easterbrook & Fischel, *supra* note 3, at 97.

Fifth, some commentators have suggested that without limited liability, shareholders would be forced to incur the costs of "monitoring other shareholders."[23] Because the holdings of all shareholders are potentially available to satisfy any judgments against the corporation in the absence of limited liability, shareholders have an incentive to monitor the wealth of all the other shareholders to ensure that adequate funds will be available to satisfy any judgments. While the strength of this incentive may be questioned, it represents a potential factor that could further add to the costs of owning equities in the absence of limited liability.

Finally, commentators have argued that bringing suit against numerous shareholders spread across the country (and in foreign jurisdictions)—which would be required if limited liability were abandoned—would result in large, and in many instances prohibitively large, transaction costs.[24] If shareholder liability were the rule, rather than the exception, as a practical matter it might be difficult for plaintiffs to obtain the additional relief authorized under the law. Moreover, even before liability arises, potential or actual creditors of the corporation may find the costs of monitoring numerous shareholders in order to ensure that they have sufficient assets to satisfy potential claims prohibitive.[25] Accordingly, even if limited liability were eroded or abolished, as a practical matter it might be difficult or costly for potential plaintiffs to take advantage of the relief the law authorized.

B. Exceptions to Limited Liability

Although there are significant benefits associated with limited liability, the doctrine is not absolute. There are exceptions to limited liability under certain exceptional circumstances in which the potential economic benefits are outweighed by the costs. Thus, the corporate veil may be pierced and shareholder liability imposed where a plaintiff demonstrates that there is domination or control of the corporation by the shareholder, that the corporate form is used to perpetrate fraud or injustice, and that the misuse of the corporate form has caused plaintiff

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[23] *Id.* at 95; Thompson, *supra* note 14, at 32-33 ("[L]arge transaction costs are likely to be incurred in a move to extended liability; these costs include excessive monitoring and evasion strategies exceeding what now occurs."). Easterbrook and Fischel also argue that limited liability reduces the cost of monitoring management because creditors may "possess a comparative advantage in monitoring particular managerial actions." Easterbrook & Fischel, *supra* note 3, at 100.

[24] Bainbridge, *supra* note 3, at 492 (arguing that "it would be prohibitively costly for the creditor of a corporation to bring individual suits against thousands of geographically diverse investors"); *see also* Leebron, *supra* note 13, at 1610-11 ("The transaction costs of collecting the pro rata shares against typical individual shareholders would in almost every case be so high that it would not be worth it. The uncertain application of the rule would create substantial uncertainty.").

[25] Bainbridge, *supra* note 3, at 492-93.

some injury.[26] While courts often consider a laundry list of factors in making these determinations, [27] at bottom these basic elements generally must be satisfied.

1. General Principles Governing The Veil Piercing Analysis

The cases construing these requirements have made clear that the exceptions to limited liability apply only in exceptional circumstances. Thus, for example, the "domination control" that is required to pierce the corporate veil is more than the ordinary control exercised by shareholders. "[I]t is hornbook law that 'the exercise of the "control" which stock ownership gives to the stockholders . . . will not create liability beyond the assets of the subsidiary."[28] Likewise, a parent corporation "may be directly involved in financing and macro-management of its subsidiaries . . . without exposing itself to a charge that each subsidiary is merely its alter ego."[29] In fact, "[p]arents and dominant shareholders are almost always 'active participants' in the affairs of an owned corporation. And, in the usual case, the exercise of such control over a subsidiary's actions is entirely permissible and does not result in the owner's personal liability."[30] Thus, limited liability will be maintained unless a party seeking to pierce the corporate veil demonstrates an unusual and all-encompassing level of shareholder control over the corporation.

These requirements have been explored in depth in situations where a party seeks to pierce the corporate veil to reach the assets of a parent corporation. In order to overcome the general rule imposing limited liability, a party must demonstrate that the parent corporation exercised "exclusive domination and control to the point that the subsidiary no longer has legal or independent significance of its own."[31] "The parent's

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[26] *See* 1 FLETCHER, *supra* note 4, § 41.10 (summarizing these fundamental requirements, including "complete domination," use of the corporation to "commit fraud or wrong," and that "the aforesaid control and breach of duty must proximately cause the injury or unjust loss"); Thompson, *supra* note 14, at 9.

[27] *See, e.g.*, W. Passalacqua Builders v. Resnick Developers South, Inc., 933 F.2d 131, 139 (2d Cir. 1991) (listing factors); Associated Vendors, Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 838-40 (1962) (same).

[28] United States v. Bestfoods, 524 U.S. 51, 62 (1998).

[29] Doe v. Unocal Corp., 248 F.3d 915, 927 (9th Cir. 2001).

[30] Esmark, Inc. v. NLRB, 887 F.2d 739, 759 (7th Cir. 1989). *See also Doe*, 248 F.3d at 926 ("Appropriate parental involvement includes: 'monitoring of the subsidiary's performance, supervision of the subsidiary's finance and capital budget decisions, and articulation of general policies and procedures.'").

[31] Outokumpu Eng'g Enters. v. Kvaerner Enviropower, 685 A.2d 724, 729 n.2 (Del. Super. Ct. 1996). *See also* Wallace v. Wood, 752 A.2d 1175, 1184-85 (Del. Ch. 1999) ("Plaintiffs must allege facts that, if taken as true, demonstrate the Officers' and/or Parents' complete domination or control of the [subsidiary]."); Bainbridge, *supra* note 3, at 507 ("Control is the common (if sometimes implicit) feature of all the concepts used to describe cases in which veil piercing is appropriate.").

general executive control over the subsidiary is not enough; rather, there must be a strong showing beyond simply facts evidencing 'the broad oversight typically indicated by [the] common ownership and common directorship' present in a normal parent-subsidiary relationship."[32] "As a practical matter, the parent must be shown to have moved beyond the establishment of general policy and direction for the subsidiary and in effect taken over performance of the subsidiary's *day-to-day* operations in carrying out that policy."[33] As a result, even "widespread involvement" in financial and management decisions may be insufficient to justify piercing the corporate veil and reaching the assets of the parent corporation.[34]

The criteria for establishing that there was a misuse of the corporate form constituting fraud or injustice are equally stringent.[35] Only specific types of fraud or misrepresentation are sufficient to establish liability. "[T]he act of one corporation is not regarded as the act of another merely because the first corporation is a subsidiary of the other, or because the two may be treated as part of a single economic enterprise for some other purpose. Rather, to pierce the corporate veil based on an agency or 'alter ego' theory, 'the corporation must be a sham and exist for no other purpose than as a vehicle for fraud.'"[36] A corporation is not a "sham" or "vehicle for fraud" if it "engaged in substantial business operations."[37] Thus, limited liability will be abandoned in only the most extreme cases.

"The underlying cause of action does not supply the necessary fraud or injustice. To hold otherwise would render the fraud or injustice element meaningless, and would sanction bootstrapping."[38] Likewise, "[m]ere use of the corporate form to avoid liability is insufficient to warrant piercing the veil."[39] The party seeking to pierce the corporate

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[32] *Sonora*, 83 Cal. App. 4th at 542.

[33] *Id.* (emphasis in original). *See also* Allen v. Oberdorfer Foundries, Inc., 595 N.Y.S.2d 995, 996 (N.Y. App. 1993) ("The parent corporation must exercise complete domination and control of the subsidiary's everyday operations.").

[34] Craig v. Lake Asbestos of Quebec, Ltd., 843 F.2d 145, 151 (3d Cir. 1988).

[35] *See* Resolution Trust Corp. v. Latham & Watkins, 909 F. Supp. 923, 927, 930-31 (S.D.N.Y. 1995) ("Absent proof of intentionally fraudulent conduct, courts simply do not pierce the corporate veil . . . ."); Mobil Oil Corp. v. Linear Films, 718 F. Supp. 260, 268 (D. Del. 1989); 1 FLETCHER, *supra* note 4, § 41.32 ("Some courts have referred to a requirement of intentional misconduct, while others reiterate the more general requirement that there must be some form of deception, injustice, defeat of public policy, or fraudulent, improper or criminal purpose.").

[36] In re Sunstates Corp. Shareholder Litig., 788 A.2d 530, 534 (Del. Ch. 2001) (quoting *Wallace*, 752 A.2d at 1184). *See also* Kaplin v. First Options of Chicago, Inc., 19 F.3d 1503 (3d Cir. 1994) (same).

[37] *Sunstates Corp.*, 788 A.2d at 534.

[38] *See, e.g.*, *Mobil Oil Corp.*, 718 F. Supp. at 268; *see also* 1 FLETCHER, *supra* note 4, § 41.32 ("A fraud or injustice which relates to ancillary activity is not a sufficient basis for piercing the corporate veil.").

[39] Itel Containers Intern. Corp. v. Atlanttrafik Exp. Serv. Ltd., 909 F.2d 698, 704 (2d Cir. 1990). *See also* Radeszewski v. Telecom Corp., 981 F.2d 305, 311 (8th Cir. 1992) ("The

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veil must demonstrate that the misuse of the corporate form was the instrumentality used to perpetrate a fraud on the plaintiffs.[40]

Finally, courts generally require that the fraud or wrong result in an actual injury to the plaintiff.[41] It is not enough that there was fraud or misuse of the corporate form: that fraud or misuse must lead to a tangible injury to the plaintiffs.[42] For example, where misuse of the corporate form leads to undercapitalization which leaves plaintiffs without an adequate monetary remedy, there may be grounds for piercing the corporate veil.[43] However, if undercapitalization causes no injury, then the plaintiff has nothing about which to complain and no basis for piercing the corporate veil. The law will not provide a remedy where there has been no injury.

These requirements ensure that the long-recognized economic and legal benefits of limited liability will be preserved so long as there has been no abuse of the corporate form.[44] Limited liability may not be abandoned based solely on "the mere prospect of an unsatisfied judgment."[45] If that were the test, limited liability would exist only in theory. Rather, the various requirements for piercing the corporate veil

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doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke."); Zubik v. Zubik, 384 F.2d 267 (3d Cir. 1967) ("Limiting one's personal liability is a traditional reason for a corporation."); Oriental Commercial and Shipping Co. v. Rosseel, N.V., 702 F. Supp. 1005, 1019 (S.D.N.Y. 1988) ("[T]he mere fact that an entity may or may not have the capital to respond to a potential large award against it does not justify piercing the corporate veil.").

[40] *See, e.g.*, *Mobil Oil Corp.*, 718 F. Supp. at 269 ("The law requires that fraud or injustice be found in the defendants' use of the corporate form."); Resolution Trust Corp. v. Latham & Watkins, 909 F. Supp. 923, 927, 930-31 (S.D.N.Y. 1995) (courts generally "pierce the corporate veil only upon 'proof of deliberate misuse of the corporate form—tantamount to fraud"); 1 FLETCHER, *supra* note 4, § 43 ("There is a presumption of separateness the plaintiff must overcome to establish liability by showing that the parent is employing the subsidiary to perpetrate a fraud or commit wrongdoing and that this was the proximate cause of the plaintiff's injury. Merely showing control, in the absence of an intent to defraud or escape liability, is insufficient to overcome that presumption.").

[41] *See, e.g.*, *W. Passalacqua Builders*, 933 F.2d at 138; Morris v. Dep't of Taxation & Finance, 623 N.E.2d 1157, 1160-61 (N.Y. App. 1993) (plaintiffs must show that "(1) the owner[] exercised complete domination of the corporation in respect to the transaction attacked and that (2) such domination was used to commit fraud or wrong against the plaintiff which resulted in plaintiff's injury"); Irwin & Leighton, Inc. v. W.M. Anderson Co., 532 A.2d 983, 987 (Del. Ch. 1987).

[42] *See, e.g.*, Radaszewski v. Telecom Corp., 981 F.2d 305, 307 (8th Cir. 1992) (there is no harm without liability); Lucas v. Texas Ind., 696 S.W.2d 372, 375 (Tex. 1985) ("If the corporation responsible for the plaintiffs' injury is capable of paying a judgment upon proof of liability, then no reason would exist to attempt to pierce the corporate veil and have shareholders pay for the injury."); *see also* Arch v. American Tobacco Co., 984 F. Supp. 830, 839 (E.D. Pa. 1997) ("Courts do not pierce the corporate veil unless the 'corporation is so undercapitalized that it is unable to meet debts that may reasonably be expected to arise in the normal course of business.'").

[43] *See, e.g.*, *Zubik*, 384 F.2d at 273.

[44] Easterbrook & Fischel, *supra* note 3, at 89.

[45] Hystro Prods., Inc. v. MNP Corp., 18 F.3d 1384, 1390 (7th Cir. 1994).

are designed to attempt to identify those rare situations in which limited liability is not economically beneficial.

2. Instances In Which Veil Piercing Is More Common

Examining the cases in which the corporate veil has been pierced and limited liability abandoned, some general categories may be identified. For example, a number of commentators have observed that veil piercing occurs more frequently where the corporation at issue is a closely-held corporation as opposed to a large, publicly-owned corporate entity.[46] This makes sense given that in closely-held corporations the degree of direct shareholder control is likely to be greater and the potential for utilizing the corporate entity as a "sham" is increased. The dangers of misuse of the corporate form are magnified where a handful of shareholders (rather than numerous, dispersed shareholders with much smaller holdings) may influence corporate activities.

Likewise, while there is some dispute regarding the data,[47] a number of courts and commentators have suggested that veil piercing is more common in the context of tort creditors.[48] Unlike contract creditors, tort creditors do not make a conscious decision to enter into a relationship with the corporation.[49] Rather, they have been injured in some way by

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[46] *Cf.* Bainbridge, *supra* note 3, at 503 ("the tort creditor of the close corporation" is "the hardest case in which to justify limited liability" because "the shareholders of a close corporation frequently are actively engaged in the business on a full-time basis"); Easterbrook & Fischel, *supra* note 3, at 109 ("Almost every case in which a court has allowed creditors to reach the assets of shareholders has involved a close corporation."); Thompson, *supra* note 14, at 9 (empirical study of 1600 veil-piercing cases "found no case in which shareholders in a public corporation were held liable"); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1047 (1991); *but see* Leebron, *supra* note 13, at 1649 (arguing that "the case for limited liability of closely held corporations has been understated").

[47] *Compare* Thompson, *supra* note 46, at 1058, 1068 (empirical study finding that the veil was more likely to be pierced in contract cases than in tort cases) *with* Presser, *supra* note 3, at 167-68 (concluding based on a review of leading cases that "the veil is more likely to be pierced in tort than in contract cases").

[48] *See, e.g.*, Cambridge Electronics Corp. v. MGA Electronics, Inc., 227 F.R.D. 313, 331 n.50 (C.D. Cal. 2004) ("Courts are less likely to apply the alter ego doctrine where the party seeking to invoke it . . . voluntarily transacted business with the corporate entity.") (citing Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990)); Carte Blanche (Singapore) PTE., Ltd. v. Diners Club Int'l, Inc., 758 F. Supp. 908, 913 (S.D.N.Y. 1991) (the "presumption [of limited liability] is particularly strong in contract cases, in which plaintiff has chosen the party with which it has contracted, and may negotiate guarantees or other security arrangements"); Lucas v. Texas Ind., 696 S.W.2d 372, 375 (Tex. 1985) ("Courts have generally been less reluctant to disregard the corporate entity in tort cases than in breach of contract cases."); 1 FLETCHER, *supra* note 4, § 41.85 ("[C]ourts usually apply more stringent standards to piercing the corporate veil in a contract case than they do in tort cases.").

[49] *See* 1 FLETCHER, *supra* note 4, § 41.85 ("[C]ourts are more likely to disregard the corporate entity in tort cases than in cases of contract because the injured party in contract cases had the opportunity to select the entity with whom he or she contracted; in a tort case, no such selection is made by a plaintiff."); Easterbrook & Fischel, *supra* note 3, at

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the corporation's unilateral conduct. Under such circumstances, the case for piercing the corporate veil is arguably greater given that contract creditors voluntarily enter into a relationship with the corporation and are therefore in a position to avoid injury occasioned by a misuse of the corporate form.[50]

Finally, commentators have observed that the veil piercing doctrines are most often applied where shareholders are active participants in the alleged wrongdoing.[51] In such circumstances, the actions of the shareholders directly contribute to the creditors' loss and there is a stronger case for liability. This phenomenon is closely tied to the greater incidence of veil piercing in the context of closely-held corporations. Where corporations are closely held, there is a greater opportunity for shareholders to interject themselves in the conduct of corporate affairs, in contrast to the typically passive shareholders in most publicly-traded corporations.[52]

C. The Traditional Case For Strengthening the Doctrine of Limited Liability

Not all commentators believe that these exceptions to limited liability are beneficial or are justified based on economic principles. The significant economic benefits associated with limited liability have led some commentators to advocate further limits on these exceptions or even that they should be abandoned altogether. Among other things, these commentators reason that "[t]he standards by which veil piercing is effected are vague, leaving judges great discretion," that, as a result, there is "uncertainty and lack of predictability, increasing transaction costs for small businesses," and that there is "no evidence that veil piercing has been rigorously applied to effect socially beneficial policy outcomes."[53]

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102 ("Courts are more willing to disregard the corporate veil in tort than in contract cases. The rationale for this distinction follows directly from the economics of moral hazard—where corporations must pay for the risk faced by creditors as a result of limited liability, they are less likely to engage in activities with social costs that exceed their social benefits.").

[50] As Justice Easterbrook explained in *Secon Service System, Inc. v. St. Joseph Bank and Trust Co.*, courts generally require "more than control to pierce the corporate veil for the benefit of contract creditors" because, "unless the corporation engaged in some practice that might have misled its contract creditors into thinking they were dealing with another entity, there simply is no need to 'protect' them." 855 F.2d 406, 415-16 (7th Cir. 1988) "Unlike tort claimants, they chose to deal with the corporation; to allow them access to shareholders or parent corporations when the deal goes sour is to give them more than the benefit of their bargain." *Id.* at 416.

[51] *See, e.g.*, Bainbridge, *supra* note 3, at 507 ("Minority shareholders who do not actively participate in the corporation's business or management are rarely held liable on a veil piercing theory."); Thompson, *supra* note 14, at 9 (observing that empirical study of 1600 veil-piercing cases "found . . . no civil case in which individual shareholders identified as passive in corporations of any size were held liable"); Thompson, *supra* note 1, at 10.

[52] *See supra* note 46 and accompanying text.

[53] Bainbridge, *supra* note 3, at 481. *Cf.* Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. U. L. REV. 140, 162 (1994) ("The law has never

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This asserted uncertainty in the application of these exceptions, they maintain, results in "substantial costs" because "parties can be deterred from engaging in socially desirable activities or, at the least, will take excessive (and costly) precautions."[54]

There are several potential substitutes that have been proposed for these exceptions to limited liability. One possibility is to replace the veil piercing doctrines with nothing and allow an absolute and immutable form of limited liability for corporate shareholders. This would ensure that all of the benefits associated with limited liability are steadfastly maintained. However, it would also impose some costs assuming (as the traditional exceptions to limited liability appear to do) that there are times when it makes economic sense to pierce the corporate veil and impose liability on corporate shareholders. Accordingly, this approach may not prove completely satisfying.

Another alternative that has been proposed is to substitute direct liability for shareholders who actively engage in wrongdoing.[55] Under this proposal, which commentators argue is already largely authorized under existing law, shareholders would be liable if they personally engage in some form of unlawful conduct. Absent such direct activity, however, shareholders would not be subjected to liability. This approach would have the beneficial effect of eliminating the asserted uncertainty associated with veil-piercing determinations. No longer would courts be free to apply a laundry list of potentially malleable factors. Instead, traditional notions of liability would be applied directly to shareholders. Nonetheless, it might not result in liability in all situations in which it makes economic sense to impose liability. Depending on the rules for imposing direct shareholder liability, there may be instances in which shareholders are not held liable under a direct liability regime but would be held liable under the exceptions to limited liability. Moreover, in situations where a corporation has multiple shareholders, as a practical matter it may be difficult for a party seeking to impose shareholder liability to join all shareholders and prove their individual liability.

D. The Traditional Case For Eroding The Doctrine of Limited Liability

Other commentators have criticized the doctrine of limited liability as improperly shifting costs that should be incurred by shareholders onto the backs of innocent creditors. Moreover, they have argued that limited liability gives managers an incentive to undertake business activities that are harmful to society because they are able to externalize the risk of

been very clear about what is the standard for piercing the corporate veil."); Easterbrook & Fischel, *supra* note 3, at 109 ("The arbitrariness of the[] nominal tests [for piercing the corporate veil] casts further doubt on the utility of the doctrine.").

[54] Bainbridge, *supra* note 3, at 514.

[55] *See id.* at 481-82.

such projects, resulting in a moral hazard problem.[56] These costs, such commentators assert, outweigh the benefits of limited liability.

Accordingly, several academics have advocated that the doctrine of limited liability be revised or abandoned entirely. Some proponents of such views argue that the requirements for piercing the corporate veil should be eroded or reduced such that the inquiry focuses on the "control" element of the veil-piercing analysis. Under such "enterprise" theories of liability, courts would determine whether the shareholders were merely passive or exercised some form of control over the corporation, and if the latter, they would be subject to the corporate liabilities.[57] Moreover, the advocates of this view often seek to erode the traditional control element itself. Instead of the "extraordinary" level of control that is currently required in most jurisdictions today, they would substitute something approaching the ordinary control that a parent corporation typically exercises over its subsidiary.[58] Thus, enterprise liability would function in practice as a form of strict liability for corporate parents for the actions of their subsidiaries.

Other commentators have gone even further, advocating the complete elimination of limited liability or at least the elimination of limited liability with respect to tort creditors.[59] These commentators focus on the argument that limited liability imposes externalities and maintain that "[p]ermitting an enterprise to avoid the full costs of its activities creates incentives for excessive risk-taking."[60] In particular, they observe that, while contract creditors may have some ability to prevent the imposition of externalities because they may negotiate with or monitor the corporate entity, "limited liability in tort permits the firm's owners to determine unilaterally how much of their property will be exposed to potential tort claims, thereby inviting opportunism and inefficiency."[61] In addition, some argue that limited liability should be abandoned because shareholders are superior risk-bearers given that they are able to diversify against firm-specific risks.[62]

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[56] *Id.* at 494 ("[a] number of commentators have complained that limited liability permits investors to externalize the risks of modern industrial enterprise").

[57] *See* 1 BLUMBERG ON CORPORATE GROUPS, *supra* note 2, § 10.03[E], at 10-11 (these doctrines "focus[] on the common business, control, and extensive integration of operations and management of the enterprise"); Phillip I. Blumberg, *Control and the Partly Owned Corporation: A Preliminary Inquiry Into Shared Control*, 10 FLA. J. INT'L L. 419, 425 (1996) ("Control plays a crucial role in the application of enterprise principles wherever they have been adopted in U.S. law.").

[58] *See* Blumberg, *supra* note 57, at 426.

[59] *See, e.g.*, Hansmann & Kraakman, *supra* note 2, at 1880; *see also* Leebron, *supra* note 13, at 1605 ("the case for limited liability with respect to tort victims is far more tenuous" than for contract creditors).

[60] Thompson, *supra* note 14, at 14.

[61] Hansmann & Kraakman, *supra* note 2, at 1880, 1920.

[62] Thompson, *supra* note 14, at 17 ("A dominant argument for extending liability to shareholders rests on the superior risk-bearing ability of dispersed shareholders of public corporations.").

The traditional response to these arguments is premised largely on the lack of any showing that the potential risks of limited liability outweigh its many benefits. As one commentator has observed, "[f]or all the academic controversy, the evidence is hardly overwhelming that limited liability causes a significant increase in a corporation's willingness to engage in risky behavior."[63] As a threshold matter, the proponents of limited liability note that, as the critics generally concede, "there is no externality with respect to voluntary creditors."[64] Accordingly, there is no argument for abandoning limited liability in the context of contract creditors. All of the benefits of limited liability and none of the costs identified by the critics exist under such circumstances because contract creditors have control over their dealings with the corporation.[65]

Moreover, even with respect to involuntary creditors such as tort victims, the proponents of limited liability observe that "modifying limited liability has its costs," which critics often ignore, and that "moral hazard would exist without limited liability."[66] Accordingly, it is not clear that the critics of limited liability have demonstrated in any convincing fashion that the costs associated with limited liability in such circumstances outweigh its many recognized benefits or that the costs of an alternative rule do not outweigh those of limited liability.

II. THE HISTORICAL DEVELOPMENT OF CORPORATE LAW IN THE UNITED STATES: A FEDERALIST PERSPECTIVE

There may be additional potential responses to the critics of limited liability, however. The traditional economic arguments in favor of limited liability may ignore certain potential benefits of limited liability as the doctrine exists in the United States. The legal structure in the United States is somewhat unique in that from the outset, our legal system has been federal in nature, with strong state governments that share power not only with the federal government, but with each other. It is this interaction among the state governments and their respective jurisdictions that provides the basis for another potential argument in favor of limited liability.

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[63] Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 421 (1992). *See also* Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. ILL. L. REV. 77, 96 (contending that "there is no reason to believe that veil piercing causes equity claimants to internalize the risks associated with their business' operations" and that because of its vagueness, "[i]t seems unlikely that veil piercing even inadvertently addresses concerns over negative externalities"); Presser, *supra* note 1, at 410 (it is "far from clear" that "by externalizing the costs of tortious behavior through limited liability, we will encourage corporations to engage in more hazardous behavior"); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 439 (1992) ("the potential for externalities may be less than has been supposed").

[64] Easterbrook & Fischel, *supra* note 3, at 104.

[65] *Id.*

[66] *Id.*

Perhaps it is a quirk of history, but the states have had the primary role in defining and implementing basic corporate law in the United States.[67] Thus, for example, corporations were originally conceived of as artificial persons created by the states. The Supreme Court described the common conception of the corporation in *Dartmouth College v. Woodward*, where it stated that "[a] corporation is an artificial being, invisible, intangible, and existing only in contemplation of law."[68] "Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."[69]

Accordingly, corporations evolved as pure creatures of the state. They were chartered by the state governments, and their internal affairs were governed by the states' laws. This unique aspect of corporate law in the United States gives rise to certain economic arguments in favor of limited liability that may not exist in other legal systems. But before we address those arguments, it is worthwhile to briefly describe the evolution of this legal system and the development of corporate law in the United States.

Originally, corporations were created by the states pursuant to special corporate charters and "existed solely at the pleasure of the state legislature" because their charters were subject to revocation.[70] These early corporations were distinguishable from modern corporations in that they often were created for special purposes, such as building roads or bridges, and often were invested with special privileges that conferred monopoly-like powers to exclude competitors.[71] The corporation functioned almost as an extension of the state in that, in many instances,

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[67] *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1438 (1992) ("The American legal system accords primary responsibility for regulating corporate affairs to states."); Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 83-84 (1999) ("Although federal law plays a very important role in regulating corporate conduct, the foundation of U.S. corporate law started, and currently resides, in the state, rather than the federal, domain.").

[68] 17 U.S. (4 Wheat.) 518, 636 (1819).

[69] *Id.*

[70] Hamill, *supra* note 67, at 140; *see also* RONALD E. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855, at 5 (1982) ("The earliest method of creating a corporation was by granting an individual charter. This mode of creation assumed that corporations were legally privileged organizations that had to be closely scrutinized by the legislature because their purposes had to be made consistent with public welfare.").

[71] Hamill, *supra* note 67, at 84 ("The special charter, essentially a private bill creating the particular corporation, outlined the corporation's terms and conditions . . . and in certain instances granted special privileges such as monopoly and eminent domain rights."); Joseph H. Sommer, *The Birth of the American Business Corporation: Of Banks, Corporate Governance, and Social Responsibility*, 49 BUFF. L. REV. 1011, 1031 (2001) ("Like today's public utilities, the post-Revolutionary corporations were deemed 'natural' regional monopolies by many.").

it was created for a public purpose that might otherwise be carried out by the state government.[72]

During the late nineteenth century there was a progression away from this mechanism as a means of establishing corporations toward general incorporation statutes that eliminated the requirement that the state government individually consider and approve each corporate charter.[73] This development was coupled with, and largely the result of, public opposition to the monopoly-like powers that were given to corporations created under special charters.[74] The power to establish corporations became more democratized as did their role and function. No longer were corporations solely dedicated to public affairs or public functions. Rather, they typically engaged in a much wider range of economic activities. Nonetheless, they remained fundamentally creatures of the state, dependent upon state law and the state legislatures for their existence.

As a result of these origins, the corporation's activities and powers were established and regulated by the law of the state responsible for its creation. Since corporations were initially founded on what amounted to a contract with the state governments, it is not surprising that the law of the state in which that contract was entered and to which the state was a party should govern. While the corporation ceased exercising government-like monopoly powers, it nonetheless was still subject to state direction and regulation. Each state determined the legal principles

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[72] *See* GEORGE HEBERTON EVANS, JR., BUSINESS INCORPORATIONS IN THE UNITED STATES 1800-1943, at 21 (1948) ("The character of the early corporations may reflect a contemporary belief that the corporate form should not be resorted to unless the public interest was involved."); SEAVOY, *supra* note 70, at 50 ("In the beginning almost all business corporations had some degree of franchise relationship to the state."); Simeon E. Baldwin, *History of the Law of Private Corporations in the Colonies and States*, *in* 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 236, 250 (1909) ("Of the charters granted prior to 1800 for moneyed corporations, two-thirds were of a quasi-public character . . . ."); Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, at 22 (1945) (corporations functioned as "an agency of government, endowed with public attributes, exclusive privileges, and political power, and designed to serve a social function for the state"); Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1594, 1595 (1988) ("Within the preclassical, mercantilist model, the corporation was a unique entity created by the state for a special purpose and enjoying a privileged relationship with the sovereign.").

[73] *See* EVANS, *supra* note 72, at 10 ("[N]ot until about 1875 had constitutional provisions requiring incorporation under general laws become so numerous that special charters might be considered a thing of the past for most fields of enterprise in most states of the Union."); SEAVOY, *supra* note 70, at 3 ("most states" had adopted general incorporation statutes by 1855); Hamill, *supra* note 67, at 104-05 ("[b]y 1875, America reached a point of uniform availability of incorporation under general laws"); *id.* at 122 ("Most states chose to end the practice of issuing special charters by passing a constitutional amendment forbidding the legislature from issuing special charters.").

[74] *See* Theodore H. Davis, Jr., Note, *Corporate Privileges for the Public Benefit: The Progressive Federal Incorporation Movement and the Modern Regulatory State*, 77 VA. L. REV. 603, 605 (1991) ("Americans embraced the English 'tradition of statutory and common law hostility' toward the granting of special privileges to companies carrying on particular trades."); Sommer, *supra* note 71, at 1051-52.

that would govern the internal affairs of corporations created within their jurisdictions.

Indeed, this was a necessary outgrowth of leaving such issues to the individual states. Were the states to share regulatory authority over each corporation, no matter what the state of original incorporation, there would be no coherent and established set of rules to govern each corporate entity. A corporation created in New York might be subject to New York law when it did business within that state and subject to Massachusetts law when it did business there. While such a result might be feasible with respect to some matters, subjecting the internal affairs of a single corporate entity to different states' laws was untenable. Each corporate action might have effects in different states. Subjecting those actions to different standards depending on the jurisdiction in which suit was filed would be arbitrary and would cause corporate managers great uncertainty in determining their legal duties and obligations.

Accordingly, application of the law of the state of incorporation became the dominant rule.[75] As a result of this rule, the federal system allowed the development of a diversity of legal principles applicable to corporations. Each state remained free to develop a distinct body of law governing corporations created within their respective jurisdictions. And, as one might expect, each state deviated to some extent in the legal rules that developed. Here, as in other matters, the states remained free to serve as "laboratories" for experimentation to ascertain which legal principles better served their interests and those of the public at large.[76] And each therefore was potentially in competition with the other states to develop optimal bodies of corporate law.

These dynamics extended to the doctrine of limited liability. While some commentators have argued that it was not originally the primary motivation behind incorporation and was at some times the subject of public criticism, one of the defining characteristics of the early corporation was limited liability—the bar against holding the corporation's shareholders liable for the debts of the corporation.[77] The

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[75] United States v. Funds Held in the Name or for the Benefit of Wetterer, 210 F.3d 96, 106 (2d Cir. 2000) ("Questions relating to the internal affairs of corporations . . . are generally decided in accordance with the law of the place of incorporation."); Fletcher v. Atex, Inc., 68 F.3d 1451, 1456 (2d Cir. 1995); Bebchuk, *supra* note 67, at 1442-43 ("A corporation is governed for corporate law purposes by the law of its state of incorporation, regardless of where it conducts its business operations."); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters*, 112 YALE L.J. 553, 553 (2002) ("In the United States, most corporate law issues are left for state law, and corporations are free to choose where to incorporate and thus which state's corporate law system will govern their affairs.").

[76] *See* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. REG. 209, 210 (2006) ("Corporate law, the legal rules governing relations between managers and shareholders of for-profit corporations, is an arena in which the advantage of our political system of federalism—encapsulated in the metaphor of the 'states as a laboratory'—describes actual practice.").

[77] SEAVOY, *supra* note 70, at 5 ("Franchise corporations such as turnpikes required special powers, like eminent domain, limited liability, and the right to collect a public

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state of incorporation thus had an important role in defining the scope of the exceptions, if any, that were available to this long-established principle of corporate law. A state could strongly shield corporate shareholders from potential liability imposed by other states by making clear that the exceptions to limited liability were narrow and should apply only in exceptional circumstances or by eliminating them altogether. Likewise, a state could subject shareholders in its corporations to greater potential liability by eroding the doctrine of limited liability and expanding the exceptions under which potential plaintiffs might reach the assets of corporate shareholders.

Thus, historically, the states have had a significant interest, and predominant role, in regulating corporations that were incorporated within their jurisdictions. This is an important and longstanding role of the state governments. The power to regulate the internal affairs of corporations was not traditionally exercised by the federal government. Nor was exercised by the governments of other states whenever a corporation that happened to be incorporated in one state did business in another. Consistency and efficiency required that one state's laws govern the internal affairs of each corporation and that the law not differ depending on where the particular transactions at issue occurred.[78] Moreover, the historical conception of the corporation as essentially an artificial person created by the state, in many instances originally created to carry out state functions, further added to the necessity that the law of the state of incorporation should govern.

In sum, the history of corporate law in the United States has had a profound effect on the development of the doctrine of limited liability. While many of the functions of the corporation may have been localized within the state, to the extent the corporation could act extraterritorially, the seeds were sown for a powerful economic engine that could give stability to investors by limiting their potential liability to the assets of the corporation. Not only does this history explain the development of the doctrine of limited liability, but it arguably presents an argument in favor of its continuing vitality.

The states' strong interest in regulating their corporations' internal affairs underscores the necessity of faithfully adhering to home state courts' and legislatures' articulation of the doctrine of limited liability. If the home state has made a conscious decision to provide strong guarantees in favor of limited liability, courts in other states should not erode those guarantees unilaterally. Conversely, to the extent states have

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toll, before they could begin operations."); Hamill, *supra* note 67, at 91 n.42 ("The assumption that limited liability protection automatically resulted when operating in the corporate form began to develop in the early nineteenth century and proceeded at an uneven pace across the states."); Hovenkamp, *supra* note 72, at 1651 ("Limited liability has been recognized in the United States at least since the eighteenth century." (citing JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 349 (1832))).

[78] *See* Romano, *supra* note 76, at 210 (observing that alternative potential conflict rules might "subject firms operating across state lines to multiple legal regimes in the absence of federal regulation").

made a conscious decision to broaden the exceptions to limited liability, courts in other states, should comply with those directives. The rules governing limited liability and its scope have played an important role in regulating the conduct of corporations acting outside their home states, and thus there are strong historical reasons for faithfully adhering to the doctrines that have been established by home state courts and legislatures regarding limited liability and its exceptions. To erode these protections would be to seriously erode the comity that is a fundamental feature of our federal system, particularly in matters of corporate law where there is a long and particularly well-developed history of respect for other states' laws with respect to the regulation of the internal affairs of their home-state corporations.

III. CORPORATE FEDERALISM AND LIMITED LIABILITY

This historical analysis also provides potential grounds for important and under-recognized economic benefits of limited liability. Because the law of the jurisdiction of incorporation typically governs the internal affairs of the corporate entity, including the conditions under which the corporate veil may be pierced, the state of incorporation may exercise significant power in determining the extent to which limited liability will be maintained. The exercise of this power may have several important consequences, which can have both potentially negative and beneficial economic effects. However, on balance, there are reasons to believe that the effects of limited liability that relate to the interplay among states in the federal system will be positive. Accordingly, the influence of the federal system in shaping the effects of limited liability as that doctrine is applied in the United States are likely to represent an additional benefit of the doctrine that counsels in favor of its retention.

First, as noted above,[79] the exercise of the power to set the terms on which limited liability applies and the scope of the exceptions, if any, may serve as a basis for competition among the states. The decision with respect to the state of incorporation may be determined, in part, by the body of law that will govern the new corporation. Managers may seek out states that have favorable legal structures and may eschew those that do not. Accordingly, the power of the states to set the scope of the limited liability doctrine provides a basis for competition among the states seeking to attract incorporators to their states to obtain the financial and other benefits associated with incorporation.[80]

Second, this power to dictate the scope of limited liability is an important tool that maintains balance within the federal system. To the

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[79] *See supra* note 76 and accompanying text.

[80] *See* Bebchuk, *supra* note 67, at 1453 ("States clearly derive benefits from in-state incorporations. Incorporations bring with them franchise tax and fee revenues as well as patronage for in-state law firms, corporation service companies, and other businesses."); *see also* Romano, *supra* note 76, at 212 ("A substantial portion of Delaware's tax revenue—an average of 17% over the past several decades—is derived from incorporation fees.").

extent some states relax the traditional rules of liability governing, tort, contract or other causes of action, the power of other states to determine the scope of liability for corporate shareholders provides an important counterbalance. As some jurisdictions have increasingly established laws either through legislative or judicial action that deviate from the norm in eroding traditional standards for establishing civil liability, this mechanism has only become more important. A significant and under-recognized benefit of limited liability is its function as a check on the sometimes socially undesirable expansion of liability in other areas that may be found in some jurisdictions.

As a result of these potential benefits, one would expect that jurisdictions that successfully attract incorporators to their states would also have laws that ensure limited liability. To the extent limited liability is preserved, so is shareholder wealth. And thus, all other things being equal, one would expect that shareholders and corporate managers would be attracted to states with strong doctrines of limited liability. There is some evidence that this is the case. The most successful jurisdiction in terms of attracting incorporators, Delaware, has a particularly strong doctrine of limited liability and stringent requirements for piercing the corporate veil. Not only are there substantive barriers to imposing liability on shareholders for the actions of the corporation, but there are also procedural barriers that make it a desirable jurisdiction for both corporate shareholders and managers.

A. Inter-Jurisdictional Competition

The implications of the federal system for corporate law have been addressed by many commentators, primarily with respect to the effects different states' laws have on corporate governance issues and the balance of power between managers and shareholders.[81] Commentators have argued that the federal system has both positive and negative effects in shaping corporate law. The traditional view has been that the federal system encourages a "race to the bottom" where managers seek out jurisdictions that have corporate laws that will benefit managers, potentially at the expense of shareholders or other third parties.[82] The primary focus of this scholarship has been on matters of internal

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[81] *See, e.g.*, Bebchuk, *supra* note 67; Lucian Arye Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793 (2006); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporate Law*, 76 NW. U. L. REV. 913 (1982); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

[82] *See, e.g.*, Cary, *supra* note 81, at 663 ("Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards"); *id.* at 705 ("The absurdity of this race to the bottom, with Delaware in the lead—tolerated and indeed fostered by corporate counsel—should arrest the conscience of the American bar when its current reputation is in low estate.").

corporate governance. However, other aspects of corporate law have received some treatment as well.

More recent scholarship has maintained that the federal system may have beneficial effects on the development of corporate law. Commentators publishing such work have argued that there may be a "race to the top" where competition among jurisdictions results in socially-beneficial results.[83] The theory is that the market will punish those corporate managers who select the jurisdiction of incorporation based on their own self interest at the expense of shareholders.[84] Conversely, it will reward those who select jurisdictions that are the most beneficial to corporate shareholders.

Some scholars have taken an intermediate position, arguing that depending on the issue, and the constituencies that are impacted, state competition may have adverse or positive social effects.[85] Thus, for example, while managers may be disciplined by the market to avoid jurisdictions that favor managers over shareholders, where managers and shareholders can benefit at the expense of third parties, they will do so by selecting the jurisdiction with the corporate laws that they deem most favorable. Accordingly, the effects of inter-jurisdictional competition may not be clear cut.

Other scholars have gone even further. While they recognize that there is inter-jurisdictional competition among the states, they argue that the extent of this competition is limited.[86] This muted effect is the result of the dominance of Delaware as the primary state of incorporation. They maintain that Delaware's significant incumbency advantages mean that other states will have less ability and less incentive to undertake

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[83] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 458 (5th ed. 1998) ("Competition among states to attract corporations should result in optimal rules of corporate law."); Fischel, *supra* note 81, at 922 (the states "striv[e] to create an attractive climate for private parties to maximize their joint welfare"); Romano, *supra* note 76, at 211 (concluding that "[t]he output of this competition [among states] has been, for the most part, welfare-enhancing"); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977).

[84] *See* Fischel, *supra* note 81, at 917 (arguing that the "race to the bottom" theories are "based on a model of shareholder irrationality" under which "shareholders voluntarily entrust their money to managers who have no incentive to maximize their welfare"); *id.* at 919 ("market mechanisms exist to minimize the divergence of managers' interests from those of the shareholders").

[85] *See* Bebchuk, *supra* note 67, at 1440-41 ("To be sure, because the interests of managers and shareholders are somewhat aligned, there are many corporate issues with respect to which managers seek, and states in turn have an incentive to provide, rules that enhance shareholder value," but there are other "issues with respect to which managers' opportunism may well lead to undesirable state law rules.").

[86] *See, e.g.*, Bebchuk & Hamdani, *supra* note 75, at 609 ("The competitive pressure on states, including the dominant state of Delaware, is actually much weaker than has been previously recognized. States, we have seen, are hardly compelled by competition to provide optimal rules, and Delaware has market power with respect to firms that seek out-of-state incorporation."); Bebchuk & Hamdani, *supra* note 81, at 1795; Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

changes in their corporate laws to compete with Delaware.[87] Delaware will simply match these changes, they maintain, and retain its role as the primary state of incorporation in the United States.

Finally, some commentators have argued that state competition does not have a significant effect on the development of corporate law.[88] These commentators maintain that in areas where inter-jurisdictional competition may have a significant effect, the federal government has stepped in to preempt state law and, moreover, that the threat of federal action has tempered the states' conduct in developing corporate laws.[89] However, absent the effects of inter-jurisdictional competition, it is difficult to explain the success of certain jurisdictions such as Delaware, which have managed to attract the vast majority of corporations. And, in fact, as many commentators have demonstrated, there are significant differences among the states' corporate laws. Given these differences, the relatively low barriers to mobility among jurisdictions, and the incentives to the states, there will inevitably be some inter-jurisdictional competition among the states.

While the general effects of the federal system on corporate law have received much attention, the specific effects of the federal system on the rules governing limited liability *per se* have not received much commentary. To the extent there has been commentary on the potential effects of state competition on third parties, it has been decidedly negative, suggesting that managers will seek to disadvantage potential creditors of the corporation and other third parties when selecting the jurisdiction of incorporation.[90] Thus, for example, Professor Bebchuk has argued that states may seek to tailor their regulation of corporate dividend policy to potentially disadvantage corporate creditors. He argues that states have enacted regulations that do not prohibit corporations from paying dividends to their shareholders even in situations where they may not have sufficient funds to satisfy their creditors. As a result, assets of the corporation may be depleted to the

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[87] *See* Bebchuk & Hamdani, *supra* note 75, at 585-95.

[88] *See* Roe, *supra* note 81, at 635 ("Absent a constitutional bar to federal involvement in corporate affairs, the federal government can determine, has determined, and will determine many critical elements of corporate governance."); *see also* Bebchuk & Hamdani, *supra* note 75, at 558 ("the greatest threat confronting Delaware is not competition from other states but the possibility that the federal government will intervene in a way that would undermine Delaware's position"); *but see* Kahan & Rock, *supra* note 81, at 1576 (arguing that the threat of federal regulation is intermittent).

[89] *See* Bebchuk & Hamdani, *supra* note 75, at 604-605. As Professor Roe has argued: "The reality of American corporate lawmaking is that the United States has never had a pure interstate race. If the issue is important, federal authorities act on it immediately, take it away from Delaware, or threaten to do so. Delaware players have reason to fear that if they misstep, federal authorities (Congress, the courts, or the SEC) will enter the picture." Roe, *supra* note 81, at 644.

[90] *See* Bebchuk, *supra* note 67, at 1489 ("[T]o the extent that rules affecting creditors are left to state law, the concern arises that state competition will produce inefficient rules that diverge systematically from the socially desirable ones in ways that are unfavorable to creditors.").

disadvantage of corporate creditors.[91] Presumably, the same reasoning would apply to limited liability, which commentators have likewise argued has the potential to impose externalities on innocent creditors by forcing them to shoulder liability that should properly be assessed against corporate shareholders.[92]

However, to the extent one believes that limited liability has positive economic benefits, the federal system will only magnify these effects. Inter-jurisdictional competition will lead to strengthened protections in favor of limited liability. Incorporators will seek out those states with the strongest guarantees, and corporations will be able to take advantage of the strongest guarantees available by seeking out those states with the most favorable laws. Corporations will not be stuck with laws that only weakly guarantee limited liability or that have eroded the exceptions to limited liability recognized under the veil-piercing doctrines. Rather, they can seek to re-incorporate in more favorable jurisdictions in order to maintain or increase the benefits they receive.

Despite the critiques, there are strong reasons to believe that inter-jurisdictional competition will have positive effects. The fact that each state's laws may have an effect on its own citizens should they hold stock in, or interact with, corporations that are incorporated within the jurisdiction provides state actors with an incentive to protect the interests of these constituencies, or at least not to disadvantage them where it does not make economic sense to do so. The fear that third-party corporate creditors will automatically be disadvantaged by state governments that do not fully recognize the costs of limited liability is overblown. Moreover, to the extent one concludes that the benefits of limited liability outweigh its costs, preserving the doctrine will have beneficial social effects in general. Indeed, if anything, there seems to be a danger of such parochial concerns unduly eroding the doctrine of limited liability, as courts in some states seemingly have expanded the exceptions to limited liability without any real analysis of the costs associated with such action.

Finally, the competitive effects with respect to limited liability are likely to be significant. If, for example, Delaware were to announce that it was abandoning limited liability in favor of a theory of enterprise liability, one would promptly see a change in the rate of incorporation. Indeed, given the importance of limited liability, one might expect to see an exodus of corporations from the state. Not only does limited liability have historical significance as one of the defining features of the corporation and an important way in which states protected their interests extraterritorially, but it has profound economic benefits for shareholders and managers alike. Were limited liability abandoned, there would be powerful incentives to seek out other jurisdictions whose laws provide a shield against liability for corporate shareholders. Indeed, while some courts have seemingly eroded the doctrine of limited liability in recent

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[91] *See id.* at 1490 (arguing that "the limits on dividends established by state law are generally so weak and ineffectual as to have virtually no practical significance").

[92] *See supra* note 56 and accompanying text.

years, the powerful incentive corporations have to seek out jurisdictions that strongly adhere to the doctrine may present a barrier to further significant erosion. At a minimum, the federal system provides a safety valve for corporations that want to preserve the benefits of limited liability. Should significant erosion occur in an entity's state of corporation, it may preserve the benefits of limited liability by simply re-incorporating in another jurisdiction.

B. Extraterritorial Effects And The Federal System

Moreover, the critiques of limited liability may miss important dynamics at work in the federal system. There are important inter-jurisdictional forces that create additional benefits of limited liability that have not been considered to date. The doctrine of limited liability may have important extraterritorial consequences. For example, not only will a Delaware corporation enjoy limited liability when it is sued in Delaware, but also when it is sued in other states. Accordingly, policies established in Delaware may have far-ranging effects. Even though a state may have determined that limited liability is not fully beneficial and that the exceptions to limited liability should be expanded, a foreign corporation doing business in the state may be shielded from liability that would otherwise be required under the policies of that state because the law of the incorporating state governs whether the corporate veil should be pierced.[93]

This extraterritorial impact of limited liability may have important consequences. Not only does it serve to potentially defeat the policies of other jurisdictions requiring the proper scope of limited liability, but it also may counterbalance other policies of those jurisdictions. For example, some jurisdictions have expanded the traditional doctrines of tort and contract liability far beyond the prevailing norms. To the extent a corporation's shareholders may be shielded from liability that would otherwise be applied under the tort law of a jurisdiction in which the corporation does business, the extraterritorial application of limited liability may defeat to some extent the policies underlying the tort law doctrines of the other state. The extraterritorial impact of the doctrine of limited liability may therefore not only counterbalance, and indeed supplant, other states' policies regarding the proper scope of liability for corporate shareholders, but also other states' policies regarding the proper extent of tort or contract liability. This extraterritorial effect can have additional positive or negative effects, depending upon one's view of the tort or contract doctrines of a particular state. Nonetheless, it will indisputably have such effects. Moreover, on balance it may serve as an important check on the policy-making authority of each individual state. No state can unilaterally impose its doctrine of limited liability on all corporations doing business within its state. Nor can any state fully ensure that its policies regarding tort or contract law will have full effect—other states have the power to defeat their full application

[93] *See supra* note 75 and accompanying text.

through their doctrines of limited liability. These counterbalancing effects may become particularly important as the policies of certain states deviate more significantly from the norm among the states.

In recent years, there has been much commentary regarding the expansion of liability in areas such as mass torts, where claims are often asserted and paid with little regard to the actual merits. Mass tort litigation has been described as being in a state of "crisis" in some jurisdictions.[94] Litigation regarding the health effects of asbestos, for example, has been the subject of "intense criticism"[95] as an "unsatisfactory system"[96] for resolving such mass tort claims. The "avalanche of litigation"[97] has been characterized again and again as a "serious problem,"[98] a "dilemma,"[99] and a "disaster."[100] As the Supreme Court has recognized, the tort system is besieged by an "elephantine mass of asbestos cases" that "defies customary judicial administration."[101]

Many of the problems associated with the litigation can be traced to the filing of scores of claims with little or no merit.[102] "In recent years, caseloads have burgeoned—not because of an increase in the numbers of the seriously ill—but rather because of the enormous incentives for plaintiffs to enter the lottery and the far more enormous incentives for plaintiffs' lawyers to obtain ever increasing numbers of claimants."[103]

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[94] *See, e.g.*, Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 597 (1997) (noting that there is "an asbestos-litigation crisis"); Alan N. Resnick, *Bankruptcy As a Vehicle For Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, 2045 (2000) ("A difficult challenge facing the American judicial system is providing for the fair and efficient resolution of litigation arising from mass tort liability."); W. Kip Viscusi, *The Dimensions of the Product Liability Crisis*, 20 J. LEGAL STUD. 147 (1991).

[95] *See* Howard M. Erichson, *Mass Tort Litigation and Inquisitorial Justice*, 87 GEO. L.J. 1983, 2017 (1999) ("No mass tort litigation . . . has received more intense criticism than the litigation concerning exposure to asbestos.").

[96] *See* Peter H. Schuck, *The Worst Should Go First: Deferral Registries in Asbestos Litigation*, 15 HARV. J.L. & PUB. POL'Y 541, 541 (1992) ("Most commentators agree that tort litigation today is a highly unsatisfactory system for resolving claims arising out of workers' exposure to asbestos.").

[97] Jenkins v. Raymark Indus., 782 F.2d 468, 470 (5th Cir. 1986).

[98] In re Asbestos Litig., 829 F.2d 1233, 1235 (3d Cir. 1987).

[99] *Jenkins*, 782 F.2d at 470.

[100] REPORT OF THE JUDICIAL CONFERENCE AD HOC COMMITTEE ON ASBESTOS LITIGATION 2 (Mar. 1991).

[101] Ortiz v. Fibreboard Corp., 527 U.S. 815, 821 (1999).

[102] *See* Lester Brickman, *The Asbestos Litigation Crisis: Is There A Need For An Administrative Alternative?*, 13 CARDOZO L. REV. 1819, 1826-27 (1992) ("The more successful courts became in devising ways to more quickly and assuredly compensate the meritorious, the larger the number of unmeritorious claims that were able to enter the system."); Christopher F. Edley, Jr. & Paul C. Weiler, *Asbestos: A Multi-Billion-Dollar Crisis*, 30 HARV. J. LEGIS. 384 (1993) ("Tens of thousands of [asbestos] claims have been made, many successfully, by individuals who are understandably worried about their exposure to asbestos but who are not now and never will be afflicted with disease.").

[103] Brickman, *supra* note 102, at 1834.

As Justice Breyer has observed, "'up to one-half of asbestos claims are now being filed by people who have little or no physical impairment. Many of these claims produce substantial payments (and substantial costs) even though individual litigants will never become impaired.'"[104]

Other mass torts have exhibited similar phenomena. Litigation over exposure to silica, for example, has seen the filing of large numbers of claims, often based on dubious scientific and medical evidence.[105] As the district court presiding over the federal multidistrict litigation found, "[i]n the majority of cases, . . . diagnoses [of disease] are more the creation of lawyers than of doctors."[106] The weak standards of proof found in some jurisdictions have only encouraged the filing of large numbers of claims that in most jurisdictions would not merit compensation.

This phenomenon exists because plaintiffs generally can choose the forum in which they file suit. As a result, it is no surprise that such claims have been drawn to certain jurisdictions that plaintiffs believe are more favorable.[107] As a result, in the asbestos litigation for example, "a small number of jurisdictions have accounted for the bulk of the litigation, but the areas of concentration have changed over time."[108] While there are some legal barriers to forum shopping and state legislatures have attempted in recent years to strengthen them, nonetheless plaintiffs' ability to choose the forum in which litigation will occur largely has been persevered. As a result, the policies of certain jurisdictions—those that have relaxed traditional standards of liability or whose juries are deemed more favorable to plaintiffs—have gained prominence at the expense of other jurisdictions that have deemed it proper to retain these traditional requirements.

The extraterritorial effect of limited liability presents a potential check on the aberrational policies adopted by some jurisdictions and the ability of plaintiffs to utilize forum shopping to take advantage of them. It is only a partial check because it comes into effect only with respect to the assets of corporate shareholders. Because the rules governing corporate shareholder liability apply extraterritorially, they may apply in jurisdictions that have adopted extremely lax rules with respect to tort or contract liability. In such situations, the assets of corporate shareholders

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[104] *Amchem*, 521 U.S. at 629 (Breyer, J., concurring in part and dissenting in part).

[105] *See* In re Silica Prods. Liab. Litig., 398 F. Supp. 2d 563, 629, 635 (S.D. Tex. 2005) (the "unreliability of the B-reads performed for this MDL is matched by evidence of unreliability of B-reads in asbestos litigation" and holding them inadmissible under Rule 702).

[106] *Id.* at 635.

[107] Brickman, *supra* note 102, at 1827 n.34 ("Forum shopping is widespread in asbestos litigation."); Francis E. McGovern, *Resolving Mature Mass Tort Litigation*, 69 B.U. L. REV. 659, 664 (1989); Francis E. McGovern, *The Tragedy of the Asbestos Commons*, 88 VA. L. REV. 1721, 1747 (2002) ("[T]here has been a gross disparity in jury verdicts among states, usually with the largest verdicts coming from the same counties that allow large mass filings.").

[108] RAND INSTITUTE, ASBESTOS LITIGATION 61 (2005).

may be shielded from the effects of the home jurisdiction's policies. To the extent one views these policies as undesirable because they allow plaintiffs with little or no injury to recover limited funds that may be used to compensate more meritorious claims, limited liability—and, in particular, its extraterritorial effects—have beneficial consequences that have gone largely unrecognized.

These extraterritorial effects of limited liability are not the only potential checks on the erosion of traditional principles of liability. Ultimately, federal law provides additional limitations through the bankruptcy system. Thus, for example, the major asbestos manufacturers have long since entered bankruptcy and reorganized under Chapter 11.[109] Nonetheless, the extraterritorial effects of limited liability provide an important barrier that exists long before the provisions of the bankruptcy system are invoked. Just as plaintiffs may shop for a favorable forum to bring their lawsuits, so too corporations may "shop" for a favorable "forum" regarding the rules governing shareholder liability. Thus, the rules regarding limited liability provide an important counterbalance among the states with respect to the scope of potential liability.

C. An Explanation For The Continuing Vitality Of Limited Liability In The Context of Tort Creditors

This benefit of limited liability helps explain its continuing vitality in the context of involuntary creditors, such as tort victims.[110] As noted above,[111] this has been the area in which limited liability has received its greatest criticism. Voluntary creditors, such as contract creditors, are able to negotiate with the corporation to ensure that their interests are protected. To the extent they decide to contract with the corporation anyway, they voluntarily assume the risk that they will not be able to recover from the corporation's shareholders. In contrast, involuntary creditors such as tort creditors do not choose to deal with the corporation and thus some commentators have argued that barring them from recovering from corporate shareholders imposes an element of unfairness. While courts typically recognize that a tort creditor seeking to pierce the corporate veil has a lower burden than a contract creditor seeking to do so,[112] nonetheless they do not dispense with limited liability altogether. The stringent standards for piercing the corporate veil still apply.

This result makes sense if there are benefits in addition to the economic benefits typically attributed to limited liability. As this article

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[109] *See* 1 REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 315 (Oct. 20, 1997) (discussing asbestos manufacturers that have entered Chapter 11).

[110] *See* Alexander, *supra* note 13, at 391 (arguing that limited liability "threatens the animating principles of tort law"); Thompson, *supra* note 14, at 40 ("The continuing puzzle is why courts remain so willing to provide limited liability to parent corporations in tort cases.").

[111] *See supra* notes 59-62 and accompanying text.

[112] *See supra* notes 47-50 and accompanying text.

has sought to demonstrate, one such potential benefit is the offsetting effect of the extraterritorial application of limited liability against the relaxed tort liability standards adopted in some jurisdictions. This benefit of limited liability is particularly critical in the context of tort claims today, given the "crisis" such claims are imposing on the litigation system and the unfairness that has resulted where claims that lack merit have received compensation at the expense of those with merit, thereby injuring not only corporate shareholders and employees, but also potential plaintiffs whose claims have merit but who may receive less compensation as limited funds are depleted paying claims that lack merit. Moreover, this is a benefit of limited liability that has only become more significant over time. The crisis with respect to resolution of tort claims is only becoming worse, not ameliorating. Accordingly, this important function of limited liability within our federal system is only increasing in significance.

Managers have an increasing incentive to seek out states that will shield them from the effects of sub-optimal tort rules in a minority of jurisdictions. They may do so by incorporating or re-incorporating in states with strong doctrines of limited liability. Moreover, the states themselves have an interest in utilizing their laws regarding limited liability as a counterbalance to the effects of these sub-optimal tort rules on home-state corporations. This interest extends beyond merely attracting corporations to their home states by enacting corporate laws that are favorable to managers and shareholders.

D. Limited Liability And The Preeminence of Delaware

If there are, in fact, such benefits of limited liability, one would expect that jurisdictions with strong doctrines of limited liability would be more successful in attracting incorporators. That does, indeed, appear to be the case. The leading jurisdiction for incorporation, Delaware,[113] has a particularly strong doctrine of limited liability. The standard for piercing the corporate veil under Delaware law is a stringent one.[114]

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[113] *See* Bebchuk, *supra* note 67, at 1438 ("The widely recognized leader in the state charter competition is Delaware."); Bebchuk & Hamdani, *supra* note 75, at 553 ("The dominant state in attracting the incorporations of publicly traded companies is, and for a long time has been, the small state of Delaware."); Romano, *supra* note 76, at 212 ("About half of the largest corporations are incorporated in Delaware, the majority of firms going public for the first time are incorporated in Delaware, and the overwhelming majority of firms that change their domicile mid-stream re-incorporate in Delaware.").

[114] HMG/Courtland Properties, Inc. v. Gray, 729 A.2d 300, 309 (Del. Ch. 1999) ("Delaware courts have been very cautious about imputing even the acts of wholly-owned Delaware subsidiaries to parent corporations without an analysis of whether the corporate veil should be pierced or whether the parent corporation actively employed the subsidiary as its mere agent or instrumentality."); *id.* at 307 (Delaware courts "appl[y] the alter ego theory rather strictly, using an analysis similar to those used in determining whether to pierce the corporate veil"); Greene v. New Dana Perfumes Corp., 287 B.R. 328, 342-43 (D. Del. 2002) ("Delaware courts apply the alter ego strictly and analyze and employ a similar analysis to that of deciding whether it is appropriate to pierce the corporate veil."); In re iPCS, Inc., 297 B.R. 283, 292 (Bankr. N.D. Ga. 2003) ("As Delaware courts are reluctant to ignore the corporate form, a party seeking to pierce the corporate veil must

(Continued…)

"'Persuading a Delaware court to disregard the corporate entity is a difficult task.'"[115] "Delaware courts disregard the corporate entity in only the most extraordinary cases."[116] This stringency begins with the standard for piercing the corporate veil. Courts require proof that is "greater than merely a preponderance of the evidence standard"—if not "clear and convincing" evidence—before they will disregard the corporate form.[117]

Stringent proof of each element of the veil-piercing test likewise is required. The standards for piercing the corporate veil have not been eroded as they have in some jurisdictions. Thus, for example, there is a strict requirement that a party seeking to pierce the corporate veil demonstrate shareholder "domination and control" over the corporation to the extent that it has no "legal or independent significance of its own."[118] Likewise, "the fraud or similar injustice that must be demonstrated in order to pierce the corporate veil under Delaware law must, in particular, be found in the defendant's use of the corporate form."[119] In sum, the party seeking to pierce the corporate veil must demonstrate that the corporation was nothing but a "sham".[120] Fraud that is unrelated to the use of the corporate form or that does not meet this high standard is insufficient.

Moreover, there are also procedural features of Delaware law that make piercing the corporate veil more difficult. Under Delaware law, whether limited liability will be abandoned is a question that is reserved

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meet a high burden," citing Harco Nat'l Ins. Co. v. Green Farms, Inc. 1989 WL 110537, at *4 (Del. Ch. 1989)); Dana M. Muir, *The Intersection of State Corporation Law and Employee Compensation Programs: Is It Curtains for Veil Piercing,"* 1996 U. ILL. L. REV. 1059, 1086 (1996) ("it is relatively difficult to pierce the corporate veil in Delaware").

[115] *Wood*, 752 A.2d at 1183. *See also* Fletcher v. Atex, Inc., 68 F.3d 1451, 1458 (2d Cir. 1995) (same); LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 294 (D. Del. 2000).

[116] In re Hillsborough Holdings Corp. v. Celotex Corp., 166 B.R. 461, 468 (Bankr. M.D. Fla. 1994). *See also* Mobil Oil Corp. v. Linear Films, Inc., 718 F. Supp. 260, 270 (D. Del. 1989) ("[u]nder ordinary circumstances, a parent corporation will not be held liable for the obligations of its subsidiary").

[117] In re Foxmeyer Corp., 290 B.R. 229, 237 (Bankr. D. Del. 2003). *See also* Kaplan v. First Options of Chicago, 19 F.3d 1503, 1522 (3d Cir. 1994) ("Because alter ego is akin to and has elements of fraud, . . . it . . . must be shown by clear and convincing evidence.").

[118] Outokumpu Eng'g Enters. v. Kvaerner Enviropower, 685 A.2d 724, 729 n.2 (Del. Super. Ct. 1996).

[119] *In re Foxmeyer*, 290 B.R. at 236.

[120] In re Sunstates Corp. Shareholder Litig., 788 A.2d 530, 534 (Del. Ch. 2001) ("[T]o pierce the corporate veil based on an agency or 'alter ego' theory, the corporation must be a sham and exist for no other purpose than as a vehicle for fraud."); Crosse v. BCBSD, Inc., 836 A.2d 492, 497 (Del. 2003) ("To state a 'veil-piercing claim,' the plaintiff must plead facts supporting an inference that the corporation, through its alter-ego, has created a sham entity designed to defraud investors and creditors."); *Wood*, 752 A.2d at 1184 ("Effectively, the corporation must be a sham and exist for no other purpose than as a vehicle for fraud.").

for courts, not juries.[121] Accordingly, Delaware law dispenses with the possibility that jury sympathy for a party seeking to pierce the corporate veil will replace a rigid application of the stringent standards under Delaware law. Rather, a body of law developed by a highly professional and experienced judiciary governs such determinations.[122]

Taken together, these factors would suggest that corporate managers incorporating in Delaware can be confident that limited liability will be preserved. Empirical data seem to support the conclusion that limited liability is rigorously enforced under Delaware law. Some surveys have found no instances of veil piercing under Delaware law during the survey period.[123] Others have been unable to find an example of the corporate veil being pierced by a contract creditor.[124] Thus, while some courts have suggested that the standards for piercing the corporate veil in Delaware are "similar" to those in other jurisdictions,[125] the data suggest that the Delaware courts' professed rigid defense of the limited liability doctrine is borne out in practice.

This is exactly what we would expect given the theory articulated in this article. If inter-jurisdictional competition is an important mechanism shaping the rules governing limited liability and if the standards for abandoning limited liability are both an important determinant of a state's success in competing with other jurisdictions and an important mechanism by which the state enforces and protects the prerogatives of corporate entities created in its jurisdiction, then one would expect that the most successful jurisdiction in terms of the rate of incorporation would have particularly stringent standards governing limited liability.

That is exactly what we find where Delaware is by far the most successful jurisdiction in terms of the rate of incorporation and at the same time courts around the country recognize that its standards for piercing the corporate veil are particularly stringent and faithfully enforce

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[121] United States v. Golden Acres, Inc., 684 F. Supp. 96, 103 (D. Del. 1988) ("[u]nder the law of Delaware, a state which staunchly maintains the division of law and equity," veil piercing issues are decided by courts, not a jury) (citing Sonne v. Sacks, 314 A.2d 194, 197 (Del. Super. Ct. 1973)); John Julian Constr. Co. v. Monarch Builders, Inc., 324 A.2d 208, 210 n.1 (Del. 1974); Retzler v. Pratt and Whitney Co., 723 N.E.2d 345, 354 (Ill. App. 1999) ("In Delaware, piercing the corporate veil is an equitable remedy and is considered only in the court of chancery, Delaware's court of equity.").

[122] *See* Kahan & Rock, *supra* note 81, at 1602 ("both on the trial and the appeals court level, corporate cases [in Delaware] are decided by a specialized judiciary"); Roe, *supra* note 81, at 594 ("Delaware . . . has a specialized, highly regarded judiciary, acting without a jury. The judges take pride in keeping up with business trends, having good business sense, knowing their own limits, and reacting quickly as professionals.").

[123] *See* Thompson, *supra* note 46, at 1036 (finding no instances of a Delaware court piercing the corporate veil during survey period).

[124] *See* Vincent M. Roche, *"Bashing the Corporate Shield": The Untenable Evisceration of Freedom of Contract in the Corporate Context*, 28 J. CORP. L. 289, 302 n.86 (2003) ("Delaware, for example, has never pierced the veil in a contract case (according to most recent data).").

[125] *See, e.g.*, Harrison v. NBD Inc., 990 F. Supp. 179, 183 (E.D.N.Y. 1998) (noting similarity in standards for piercing corporate veil in New York and Delaware).

those standards in disputes involving Delaware corporations arising in their jurisdictions.[126] Both the analysis undertaken by the courts as well as the existing data suggest that the rate of veil piercing is comparatively low under Delaware law, which is widely recognized as strongly protecting corporate shareholders through its vigorous doctrine of limited liability.

IV. CONCLUSION

This article has attempted to demonstrate the significant effects of the federal system in the development of limited liability as well as the economic arguments in support of limited liability arising from our federal structure. The traditional arguments in favor of limited liability may thus be supplemented by considering the corporation not in the abstract, but as it exists in practice, functioning in a multi-jurisdictional system governed by overlapping and competing systems of laws.

While the laws in most states traditionally recognize a strong presumption in favor of preserving limited liability because of its significant economic benefits, not all states recognize and protect limited liability to the same extent. This is particularly true in recent years as courts in certain states have eroded the traditionally stringent requirements for piercing the corporate veil to impose liability on corporate shareholders.

Historically, the doctrine of limited liability was not only an important means of fostering economic development through the creation of corporate entities, but also served as a means by which states could protect the corporations they created from what they may consider potentially excessive liability imposed by courts in other states. Because the law of the state of incorporation governs the veil piercing inquiry, the state of incorporation may exercise important powers extraterritorially. By setting the terms upon which limited liability may be abandoned, the state may exercise its own judgment in determining the scope of limited liability. Those states that seek to preserve the doctrine and safeguard its widely recognized economic benefits can impose high standards for piercing the corporate veil that must be observed in other jurisdictions that may have made different policy determinations with respect to the scope of limited liability for their own corporate shareholders and who may also have made dramatically different judgments regarding the appropriate scope of liability for ordinary tort or contract disputes.

This important power of the state of incorporation is even more important now where there are often dramatic differences among jurisdictions in the scope of liability that may be imposed on corporate entities. For example, both courts and commentators have recognized that mass tort litigation has led to a "crisis" in the judicial system in certain jurisdictions that have served as a magnet for such claims given their more generous standards of tort liability. States that wish to mitigate the effects of these doctrines created by the courts and

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[126] *See supra* at __.

legislatures of their sister states may do so at least in part by maintaining stringent standards for abandoning limited liability. Any judgment will thus be limited to the assets of the corporation, even if the law of these other states would impose far greater liability.

Such considerations are important when assessing both the benefits and costs of limited liability. There are indubitably benefits to the state of incorporation and corporate shareholders in general who may search out a jurisdiction with favorable rules regarding veil piercing in which to incorporate. Conversely, there may be costs for other states that have made a judgment to relax traditional principles of tort or contract liability and whose policy determinations may be frustrated if out-of-state corporations are allowed to shield the assets of shareholders based on laws that were passed extraterritorially. On balance, these competing concerns allow for some mitigation of some of the excesses of the federal system. Incorporators' ability to shop for a favorable forum in which to incorporate serves to mitigate the ability of plaintiffs to shop for a favorable forum in which to bring a tort lawsuit against the corporation. Moreover, it explains the continuing vitality of the limited liability doctrine in the context of involuntary tort creditors. On balance, this phenomenon represents a significant benefit of limited liability as it functions within our federal system.