Piercing All the Veils: Applying an Established Doctrine to a New Business Order

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Who wins and who loses as a result of . . . limited liability? “The controversy over this issue among legal historians is one of the hottest topics in historiography and intriguingly enough, the debate over the justice of shareholder limited liability has recently become an important contemporary topic as well.”

Stephen B. Presser and James S. Zainaldin

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* This Article is dedicated to the memory of my nephew Bill Zarling (1978-2006) and to his loving parents Jamie and Ed. The author would like to thank his colleague Professor Michael McClintock for helpful suggestion to this piece. He would also like to acknowledge the help of student assistant Emily Bushaw.

I. INTRODUCTION

“Piercing the corporate veil” (piercing) has a long, if controversial, history in the law of business.² It allows creditors of such an entity to disregard the limited liability normally given its shareholders and hold them personally answerable for the debts of the enterprise.³ The remedy arose as a counterbalance to the asset shield normally afforded corporate investors, and it is closely tied to important issues involving the accountability and social responsibility of business.⁴

² See infra notes 83-110 and accompanying text. No less a jurist than Benjamin Cardozo observed that the doctrine of veil piercing is “enveloped in the mists of metaphor” and went on to warn that such legal figures of speech “are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.” Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926). A more recent legal pundit has noted that veil piercing is still “regularly criticized as confused and unprincipled.” Robert B. Thompson, Piercing the Veil: Is the Common Law the Problem?, 37 CONN. L. REV. 619, 619 (2005).

³ See generally ROBERT CLARK, CORPORATE LAW 71-74 (1986); FRANKLIN A. GEVURTZ, CORPORATION LAW 69-70 (2000).

⁴ Public sentiment for socially responsible corporate activity has existed for some time and continues to
In the last decade, this special protection—at first only given to corporate shareholders\(^5\)—has been extended to investors in two new business entities, the limited liability company (LLC) and the limited liability partnership ( LLP). Consequently, concerns have been expressed about whether the piercing doctrine should be applied to those companies and, if so, how it should affect their liability shields.\(^6\)

The principle of limited liability has long safeguarded the personal assets of corporate stockholders. It developed from the concept that corporations have a separate legal existence from their shareholder owners.\(^7\) Limited liability was hailed as a crucial innovation that both fostered entrepreneurship and encouraged widespread equity investment in commercial ventures.\(^8\) In more recent times, economic theorists have shown how the principle also promotes the efficient allocation of investment capital.\(^9\)

In the early part of the last century, no other business organization afforded owner/operators such protection for their personal property. The general partnership had existed at common law and was given statutory authorization about that time. While it entailed no organizational formalities\(^10\) and empowered all the co-owners of a business with managerial control,\(^11\) each partner remained personally liable for the debts of the enterprise.\(^12\)

Also around the turn of the last century, limited partnerships became authorized by statute. Unlike general partners but like shareholders, investors there were afforded a shield against personal liability. Limited partners, however, risked losing it if they became involved in the operation of their businesses.\(^13\) Corporate shareholders, by contrast, could become active in that way without forfeiting their protected status, so long as they did so in the separate roles of either directors or officers.\(^14\)

In the latter part of the last century, as tax considerations became a more important factor in business planning, the “flow through” treatment for profits and losses that partnerships offered investors proved more attractive than the corporate model.\(^15\) Tax law usually mandated double taxation of a corporation’s profits and allowed shareholders no direct attribution of its losses which could be used to shelter other income from build. For a good review of this movement and its various permutations since the late 1960s, see Douglas M. Branson, Corporate Social Responsibility Redux, 76 Tul. L. Rev. 1207 (2002); see also Kellye Y. Testy, Linking Progressive Corporate Law with Progressive Social Movements, 76 Tul. L. Rev. 1227 (2002). The author weighed in on this topic some years ago in Daniel J. Morrissey, Toward a New/Old Theory of Corporate Social Responsibility, 40 Syracuse L. Rev. 1005 (1989). For a religious perspective, see Mark A. Sargent, Competing Visions of the Corporation in Catholic Social Thought, 1 J. Cath. Soc. Thought 561, 568 (2004).

5. GEVURTZ, supra note 3, at 5-8.
6. See infra notes 232-96 and accompanying text.
7. See infra notes 47-54 and accompanying text.
8. See infra notes 35-40 and accompanying text.
9. See infra notes 55-58 and accompanying text.
10. UNIF. P'SHIP ACT (UPA) § 6 (1914) defined a partnership as “an association of two or more persons to carry on as co-owners of a business for profit.” Accord REVISED UNIF. P'SHIP ACT (RUPA) § 202(a) (1997).
11. UPA section 9 provided that every partner is an agent of the partnership for the purpose of the business. Accord RUPA § 301.
12. UPA § 14 (1914); RUPA § 306 (1997).
15. See infra note 169 and accompanying text.
taxation. However, both general and limited partnerships were imperfect instruments for investors because, as has been said, the former raised the specter of personal liability for its owners, and the latter could likewise result in such unpleasant consequences for any limited partners who became active in management.

Legal innovators went through several intermediate steps to remedy that unsatisfactory choice and finally hit upon a new entity, the LLC. It could provide its members with partnership-like flexibility in its operation, while at the same time giving them full limited liability protection regardless of how active they became in the business. When the IRS ruled that the LLC was entitled to flow-through tax treatment, it seemed that the ideal structure for a non-publicly-held business had now been created.

The LLC thus became quite popular during the last decade and now appears to be the preferred legal entity for closely held firms. However, it still entails some organizational and operational formalities that have the potential for being costly, cumbersome, and/or inconvenient for its members. Better still, particularly for businesses with just a few owners, would be the general partnership, if all its owners could be afforded the protection of limited liability. Just such a legal entity, the limited liability partnership, was authorized in the early 1990s with professional associations—like legal and accounting firms—in mind. The LLP may be organized and operated just like an uncomplicated general partnership, requiring only a simple public filing to guarantee its owners the protected status once reserved for shareholders and limited partners. It now appears to be the best legal organization for small businesses with just a few owners who work closely together.

But what about the legal shield that purports to safeguard LLC members and LLP partners from personal liability? Should its protection be absolute? It is promised to them by statute, but in the corporate context courts for some time have disregarded that shield when its application would cause injustice. That jurisprudence, although longstanding, is somewhat disjointed, and has therefore led one commentator to argue that it should have no applicability to LLCs and LLPs—particularly when the statutes that authorize those new legal entities make no mention of such relief. The existing corporate remedy has been undisciplined, he says, and has led to costly and unpredictable results. Why carry it over to new entities whose laudable purpose is to encourage the capital formation and commercial risk-taking that are so beneficial to our economy?

16. See HAMILTON & MACEY, supra note 14, at 140-43.
17. See infra text accompanying note 167.
18. See infra text accompanying note 168.
19. See infra notes 166-70 and accompanying text.
20. See infra notes 174-82 and accompanying text.
21. See infra note 190 and accompanying text.
22. See infra notes 175-190.
23. See infra notes 200-15 and accompanying text. The LLC, however, is not restricted to those groups and there is no reason why it cannot be used by any commercial enterprise.
24. See infra note 219 and accompanying text.
25. See infra notes 93-110 and accompanying text.
This Article, however, will argue the opposite. While limiting entrepreneurial liability serves a valid goal, it ought not to be upheld in situations where fraud or injustice would occur. In those cases, contract or tort creditors should be able to secure relief from those who own the business. And since LLCs and LLPs offer their members and partners more direct management power than usually afforded shareholders, there may be even greater justification to hold them personally accountable for the obligations of their businesses than the stockholder/owners of a corporation.

Before it presents that theory in full, however, this Article will first give a brief description of limited liability itself—how it arose in the corporate context and was then applied to other entities. It will examine the initial reasons for the liability shield and the justification for carrying it over to other forms of business organizations. It will then discuss some recent support and criticism of it and evaluate the merits and shortcomings of those comments.

The Article will next focus more fully on the theories that allow for piercing the corporate veil. As has been mentioned, some commentators have noted that this area of law is something less than a seamless web. That inconsistency appears most glaring in cases that indicate a judicial proclivity to pierce more often when the person seeking redress is a contract creditor rather than a tort plaintiff.

What the piercing doctrine may lack in conceptual clarity, however, may be remedied through close scrutiny of the typical situations where it appears. They usually involve one or a very few shareholders who have a dominant and controlling interest in a corporation and use it to defraud or otherwise deal unfairly with those affected by the business.

The Article will then examine several theories that have been advanced to justify piercing either LLCs or LLPs. Since by business law standards both those entities are still quite new, there are limited cases to review here. But the LLC is one of the most important developments in business law in some time and it may take several decades for judicial opinions to flesh out all its doctrinal implications.

The Article will conclude with some guidelines on applying veil piercing to those new entities. Courts of course should respect the basic legislative judgment that owners of LLCs and LLPs are entitled to shield their personal assets from the obligations of their firms.

Yet the equitable remedy of piercing the corporate veil has grown up to deal with egregious situations where business owners have conducted their operations in a fraudulent, unjust, or socially irresponsible manner. This Article will argue that it should be extended to cover similar states of affairs involving LLCs or LLPs—particularly since the owners of those enterprises are usually able to exercise control over their operations in a more direct, hands-on manner than stockholders of corporations.

28. See supra note 25 and accompanying text.
29. See infra notes 139-47 and accompanying text.
II. LIMITED LIABILITY

A. Origins

The earliest corporations in British legal history were ecclesiastical and other privileged organizations chartered by the sovereign and allowed perpetual existence beyond the lifetime of their individual members. In the new American Republic, incorporation continued to require individual acts by legislatures, which were most often granted for special projects such as creating canals, banks, or roads. As the industrial revolution began in earnest in the U.S. around 1825, businesses began to need capital from widespread investors. At that time, corporate statutes first started providing limited liability for shareholders and state legislatures created general laws allowing businesses to incorporate by merely filing certain documents with designated government officials. Parliament passed the first Limited Liability Act in 1855 and by then limited liability had also become a standard feature in the corporate codes of American States.

By the turn of the last century that privilege was extended to corporations that had only a single shareholder. As befit the democratic traditions of our country, small business owners were then afforded equal standing with large-scale enterprises in sheltering their household assets from liability. Likewise, corporations were allowed to own controlling interests in subsidiary entities, thus making it possible for a “parent” company to insulate itself from the obligations of a related firm.

That liability shield was actively celebrated by civic leaders of the day, like the renowned president of Columbia University, Nicholas Murray Butler, who said at a chamber of commerce banquet: “In my judgment the limited liability corporation is the

30. Thompson, supra note 2, at 620. The corporation was recognized under Roman law and through the Canon Law of the Catholic Church it was received into the laws of Europe. See Presser & Zainaldin, supra note 1, at 357.
32. See, e.g., McCulloch v. Maryland, 17 U.S. 316 (1819).
34. See also Thompson, supra note 2, at 620. See generally G Evurtz, supra note 3, at 20-26. Through the later half of the 19th century various restrictions on corporate activity including their size, capital requirements, and permissible lines of business fell away as states actively competed with one another for the revenue that incorporation would bring. Louis K. Liggett Co. v. Lee, 288 U.S. 517, 548-65 (1933) (Brandeis, J., dissenting).
35. G Evurtz, supra note 3, at 27.
36. Blumberg, supra note 33, at 587-95; see also infra note 40 and accompanying text.
37. Thompson, supra note 2, at 620.
38. See Presser & Zainaldin, supra note 1, at 359 (discussing how this trend was supported by antimonopolistic sentiment beginning in the presidency of Andrew Jackson that grew up as a reaction against the granting of corporate charters only to the privileged few. Professor Stephen Bainbridge echoes that tradition in arguing for the abolition of the piercing doctrine in corporations and other entities because it “undermines a valuable democratic contribution . . . of small business and entrepreneurship.” Bainbridge, supra note 26, at 106.
39. Thompson, supra note 2, at 620.
greatest single discovery of modern times . . . even the steam engine and electricity are far less important than the limited liability corporation and they would be reduced to comparative impotence without it.\textsuperscript{40}

Such innovations were not without cost. When the assets of a particular corporation were insufficient to satisfy outside claimants, those parties bore the economic risks of the business, not the owners, who stood to garner its profits.\textsuperscript{41} Society was making a trade-off. To encourage economic expansion, the laws of incorporation were lessening the risks entrepreneurs and investors would have to shoulder and passing them on to outside parties that dealt with their businesses.\textsuperscript{42}

\begin{itemize}
  \item \textsuperscript{40} William M. Fletcher, I Cyclopaedia of the Law of Private Corporation § 21 (1917).
  \item \textsuperscript{41} Commenting on the remarks made by President Butler and others lauding limited liability, Professor Gabaldon said: “It was left to later, and more cynical, commentators to remind us what some of the early legislators feared: in modern terms, a ‘moral hazard’ arises whenever one group may capture the benefits of an enterprise without being wholly responsible for its risks.”
  \item \textsuperscript{42} Elsewhere, Professor Gabaldon puts that point concisely: “Limited liability is about imposing risks that someone else must bear.”
\end{itemize}
Limited liability is considered the most important aspect of a corporation and is given explicit recognition in corporate statutes. For instance, the Model Business Corporations Act provides: “[A] shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct.” One distinguished commentator succinctly noted that the agents or employees of a corporation can run up sizeable tort and contract liabilities, but stockholders, as passive investors, will only stand to lose their initial investments in the business. The rest of their personal assets will be safe.

Shareholders, unlike traditional general partners, will not be liable for contractual obligations of their corporations unless they act as joint obligors or otherwise personally guarantee those debts. In the tort area, stockholders are likewise protected from losing more than they have put into the business unless they have committed a tort in their personal capacity. For instance, if a lawyer who is a shareholder of her professional corporation commits malpractice, she is going to be liable for that tort herself. But if her corporation is sued vicariously for her tortuous activity, the personal assets of the other owners will remain secure.

C. The Conceptual Justifications for Limited Liability

As one distinguished commentator has pointed out, since limited liability is seen as the natural state for those who invest in the debt of a business, one would normally presume that equity investors, as the owners of the firm, would then have unlimited responsibility for that and all the other obligations of the business. General partnership principles preserve that distinction, but in the corporate context it is overturned, at least implicitly, by the recognition of a corporation as an entity separate and apart from its shareholders. As such, the corporation is conceptually a distinct legal unit and the assets of those who have invested in the business are only deemed part of the firm’s

45. Clark, supra note 3, at 7.
46. Professor Gevurtz puts it this way: “limited liability] means that stockholders have no liability for the corporation’s debts by virtue of being stockholders. Hence, all they stand to lose by virtue of being stockholders if the corporation goes under is whatever they paid to purchase their stock.” Gevurtz, supra note 3, at 7.
47. See Robert B. Thompson, The Limits of Liability in New Limited Liability Companies, 32 Wake Forest L. Rev. 1 (1997). This agency liability is a well-established proposition citing the Restatement (Second) of Agency § 343 (1958) and other sources. He adds that it has been reemphasized recently in legislation like the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601-9675 (1994) that imposed additional liability for those who act for a corporation in the environmental area. Id.
48. Gevurtz, supra note 3, at 7 (giving examples of when an individual’s tort within a corporate context will extend liability to the individual).
50. See supra note 12 and accompanying text (noting the personal liabilities extant in partnerships).
51. This “separate and apart” formulation has an ancient lineage. See I. Maurice Wormser, Piercing the Veil of Corporate Entity, 12 Colum. L. Rev. 496 (1912) (tracing the origination of the notion of corporations as entities to the early 1800s). At that time, Chief Justice Marshall had called a corporation an “artificial being.” Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819).
property to the extent that they have been paid or promised to it. The passive role of shareholders also supports the notion that they should have no responsibility for the corporation’s debt. Stockholders typically have the power to elect directors, and it is the board that runs the corporation’s business. Without any direct control over the corporation’s policy, it would seem unfair to hold shareholders accountable for its obligations beyond the amounts they have invested. They are out of the firm’s management loop and thus cannot be said to be principals directing its undertakings.

D. The Economic Arguments

1. The General Theory

Limited liability is also validated by economic considerations. In that approach, a corporation is seen as solely a “nexus of contracts,” organizing the relationship between various actors in an enterprise so that it can thrive under an appropriate division of labor. Shareholders, for their part, agree to simply supply the firm’s capital and are eligible to share in its profits.

Stockholder/investors, particularly if they are wealthy, would be reluctant to provide

52. See Thompson, supra note 2, at 621 (noting that the assets of a corporation that creditors can reach are limited). In reality, it took the better part of the first half of the 19th century to establish limited liability as we know it today in most American jurisdictions. The matter was only firmly settled by statute. California law even provided for pro rata shareholder liability for corporate debt until the 1930s. Gevurtz, supra note 3, at 27-28.

53. Gabaldon, supra note 41, at 1400-01. Otherwise put: “Corporate law, while securing limited liability, provides that corporate power must be exercised along certain mandatory rules . . . .” Those require a “representative, as opposed to a democratic, governance structure.” Shareholders elect directors, but directors manage the company. John H. Matheson & Raymond B. Eby, The Doctrine of Piercing the Veil in an Era of Multiple Limited Liability Entities: An Opportunity to Codify the Test for Waiving Owners’ Limited-Liability Protection, 75 WASH. L. REV. 147, 156 (2000).

54. MODEL BUS. CORP. ACT § 7.28(a) (1985).

55. MODEL BUS. CORP. ACT § 8.01(b). Officer and director liability is beyond the scope of this Article. In short, they are generally protected by the business judgment rule unless they have performed their corporate responsibilities with “gross negligence.” Smith v. Van Gorkom, 488 A.2d 858, 888 (Del. 1985).

56. This of course does not apply to majority shareholders of closely held firms. As Professor Gabaldon notes, many times they are liable by virtue of having guaranteed corporate debt or actively participated in its tortious conduct. And only those shareholders are likely to be found liable under a veil-piercing theory. Gabaldon, supra note 41, at 1402; see also infra note 113 and accompanying text.

57. A recent observer summed it up in this fashion: “The key economic justification for limited liability is based on the premise that apart from the simple shifting of loss from interest holders to creditors, there is a change in behavior due to the limited liability status of interest holders.” Jeffrey K. Vandervoort, Piercing the Veil of Limited Liability Companies: The Need for Better Standards, 3 DEPAUL BUS. & COM. L.J. 51, 54-55 (2004).


59. Easterbrook & Fischel, supra note 27, at 94 (noting the advantages derived from publicly held corporations’ use of division of labor).
such funding if the rest of their personal holdings would be at risk for corporate obligations. They couldn’t make small capital contributions to diverse firms without exposing themselves to such liability. Instead, to protect their fortunes, they would have to select just a few companies for investment where they could actively monitor management.\textsuperscript{60}

In the last several decades, that approach has been refined to differentiate between the virtues that limited liability offers to publicly held firms and those it affords closely-held ones. And it has also focused separately on the justice of such a policy when applied to voluntary and involuntary creditors of the corporation, otherwise known respectively as contract claimants and tort victims.

2. Limited Liability and Creditors of a Public Firm

One might first ask whether it is efficient to create a legal preference for limited liability, particularly in the publicly held company. Couldn’t the law just take a neutral stance and let investors who want to be free from personal liability bargain for a provision that voluntary creditors of the corporation will have no recourse against them? In theory that is possible, but for several reasons limited liability provides a cost-effective general rule, especially in a public firm.

First, it would obviously be difficult and expensive for the corporation to arrange hundreds of such non-recourse arrangements for all of its shareholders.\textsuperscript{61} Such contracts might be further complicated by the risk tolerance of each shareholder, which would depend, at least in part, on his or her individual net worth. If limited liability is intuitively appealing to shareholders, why not just provide it as a matter of practice in all cases?

Second, while major creditors, such as banks, do bear the risk of loss in a limited liability regime, they are generally better at assessing it than individual shareholders.\textsuperscript{62} Additionally, a creditor’s transaction costs of trying to recover a portion of such losses from each shareholder would be tremendous.\textsuperscript{63} In practice, voluntary creditors must concede the futility of such a strategy and seek compensation for their risk ex ante in the bargaining process.\textsuperscript{64} That can be done by getting a higher interest rate on loans or charging more for goods or services supplied to the firm.

Involuntary creditors of public firms have some advantages over such claimants of closely held ones. Chief among them are the bigger capitalizations of widely held companies giving them more resources with which to compensate claimants.\textsuperscript{65} They can also be expected to have purchased substantial liability policies to protect against tort claims.\textsuperscript{66} Such victims will also have a better chance of recovering in a direct suit against


\textsuperscript{61}. See CLARK, supra note 3, at 9 (stating that it would be expensive and cumbersome to assess the credit of thousands of investors).

\textsuperscript{62}. See id. at 8.

\textsuperscript{63}. GEVURTZ, supra note 3, at 31.

\textsuperscript{64}. See CLARK, supra note 3, at 8 (explaining that banks may charge higher interest rates on loans to more risky entities).

\textsuperscript{65}. See GEVURTZ, supra note 3, at 35 (“Because such firms aggregate together large amounts of capital, they may be better able to pay tort claimants . . . .”).

\textsuperscript{66}. See Easterbrook & Fischel, supra note 27, at 108 (arguing that this is likely because management does
the corporation than by pursuing far-flung shareholders who may have limited personal wealth. 67

With mass torts, however, even large amounts of capitalization or insurance may not be enough to compensate victims. And it is thus unlikely that tort liability by a company or its management will ever be an effective deterrent against such horrible events. Union Carbide and the tragedy of Bopal come to mind. 68 Government regulation (and ultimately the possibility of criminal prosecution) may be the only meaningful way to deter undue risk-taking in such hazardous businesses. 69

3. Limited Liability as Enhancing Share Value in Public Firms

For other reasons, limited liability seems like an almost unqualified good for a public company. First, it facilitates an active trading market for the firm’s shares. 70 Without it, stockholders would have different amounts of exposure to liability because of their personal wealth causing their share holdings to be valued differently. Before investing, a careful stockholder would then have the burdensome task of assessing the value of her potential shares vis-à-vis those of every other stockholder. But if all shareholders have limited liability, there is no such value differential and all shares are fungible as “homogenous commodities.” 71 That liquidity makes stocks a much more attractive investment and thus lowers the cost of capital for businesses. 72

Stockholders protected by limited liability are also free from the costly task of monitoring management because all of their personal wealth is not at stake in just one enterprise. 73 As such they can spread their investments around in different companies. 74 That too lowers a firm’s cost of capital because equity holdings then are more attractive to investors, allowing them to diversify their risks. 75 Small scale shareholders can then leave the work of management oversight to others with more at stake in the enterprise—like large creditors, 76 or to those with more to gain (like potential hostile bidders). 77

67. Id.
68. It is no longer just corporations that have such holdings. “LLCs now own professional sports franchises, operate electric utilities, nuclear power plants, manage hospitals, and operate child care facilities.” HAMILTON & MACEY, CASES AND MATERIALS ON CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 203 (8th ed. 2005).
69. Easterbrook & Fischel, supra note 27, at 115.
71. Easterbrook & Fischel, supra note 27, at 96-98.
72. Id. at 97.
73. See supra note 60 and accompanying text.
74. Easterbrook & Fischel, supra note 27, at 96-97; Gabaldon, supra note 41, at 1406; see also supra note 60 and accompanying text.
75. Easterbrook & Fischel, supra note 27, at 97.
76. CLARK, supra note 3, at 8 (explaining that large creditors may be better risk bearers because they are “better at assessing and monitoring risk”).
77. Easterbrook & Fischel, supra note 27, at 98-99. Such takeover bids also benefit shareholders by typically offering them a premium over the price their shares are traded on the market. They can also arguably benefit society by causing a firm’s resources to be put to more efficient use. See Edgar v. Mite Corp., 457 U.S. 624, 643 (1982) (observing that blocking a tender offer hinders reallocating “resources to their highest valued use”); see also Daniel J. Morrissey, Defensive Tactics in Tender Offers—Does Anything Go?, 53 TENN. L. REV.
They can also freely place their money in speculative enterprises, like technology companies, without fear that they will lose more than their original investments. That, in turn, benefits society at large by encouraging the type of risky innovations that ultimately improve the general standard of living.78

4. Claims in Close Corporations

However, it may make no real difference to contract creditors of a closely held corporation whether or not its shareholders have limited liability. Sophisticated creditors dealing with such an entity will know the ramifications of that doctrine and will bargain to compensate themselves for it by demanding a greater price for their goods or services or higher interest on their loan.79 As an alternative, they may demand additional assurance of payment—such as a personal guarantee from a leading shareholder with a substantial net worth.80

Such astuteness, however, may not be present when small trade creditors deal with a closely held firm. The possibilities of forfeiture and injustice then arise and that can be exacerbated if any deception or overreaching is involved.81 That problem will be discussed in the following section, which examines situations where the law disregards a corporation’s separate existence and holds shareholders personally liable for its obligations.82

Tort claims against the dominant shareholders in closely held corporations present similar problems, particularly if those firms are run in a socially irresponsible manner. That can occur when a company has inadequate liability insurance or is undercapitalized vis-à-vis the risks of its business. Enforcing a regime of limited liability there can allow the owners to unfairly externalize the costs of their enterprise. Those issues will also be discussed further in this Article.83

5. Differentiating between Closed and Public Firms

Since limited liability occurs in practice as a matter of course in public firms but is often contracted around in closely-held firms, perhaps the law should only afford that benefit to the former?84 Despite the theoretical appeal of such an approach, a complicated set of legal distinctions would have to be formulated to make it work. Thus, there appears to be some virtue in the current system uniformly granting all corporations

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78. See Gabaldon, supra note 41, at 1407 (explaining that “high risk strategies may produce significant technological and other innovations”).
79. CLARK, supra note 3, at 8; GEVURTZ, supra note 3, at 29.
80. “Indeed this is so commonly done when large creditors deal with small business borrowers that it significantly undercuts the supposed advantage of doing business in the corporate form.” GEVURTZ, supra note 3, at 29.
81. One commentator called this “a kind of ‘soft core’ fraud.” CLARK, supra note 3, at 76.
82. See infra notes 128-38 and accompanying text.
83. See infra notes 156-59 and accompanying text.
84. See GEVURTZ, supra note 3, at 33 (raising that possibility).
limited liability and allowing voluntary creditors of small firms to abrogate it with special arrangements.

III. THE LIMITS OF LIMITED LIABILITY

A. The Piercing Doctrine

Despite what one commentator has called the “gross social benefits” of limited liability, the law has never recognized the separate existence of a corporation when that would work injustice. After all, the result of limited liability is to leave creditors of failed corporations unpaid, and the law seeks to avoid such forfeitures whenever possible. The judicial antidote in those situations is to “pierce the corporate veil,” an equitable remedy embraced by the common law. As a leading authority has concisely put it, “[b]asically the piercing issue only involves the question whether a specific shareholder is personally liable for a specific corporate obligation, and the court’s conclusion uses ‘piercing the corporate veil’ as a justification to impose or refuse to impose liability.” And although conventional explanations of piercing describe it as “the rare exception,” the doctrine has the distinction of being the most litigated issue in

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85. Gabaldon, supra note 41, at 1413.
86. Wormser, supra note 51, at 497 (citing Chief Justice Marshall in Bank of United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809)). Elsewhere Dean Wormser, in summarizing early twentieth century attitudes toward limited liability, said:

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

Id. at 517.
87. G EVURTZ, supra note 3, at 69.
88. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 229 (1981) (providing that contract law will excuse the occurrence of a condition to avoid a disproportionate forfeiture).
90. Wormser, supra note 51, at 497.
91. HAMILTON & MACEY, supra note 14, at 261. As a legal encyclopedia puts it, “The doctrine of disregarding a corporation’s separate and independent existence is commonly referred to as ‘piercing the corporate veil.’” 18 AM. JUR. 2D Corporations § 47 (LexisNexis 2006); see also 18 AM. JUR. Pleading and Practice Forms, Corporations §§ 55, 56 (2005).
92. 18 AM. JUR. Pleading and Practice Forms, Corporations §§ 55, 56 (2005). “[I]n all jurisdictions veil piercing is the exception rather than the rule.” Bendremer, supra note 89, at 390. A typical judicial remark in that regard is: “A court will disregard the corporate structure and pierce the corporate veil, only under exceptional circumstances such as where the corporation is a mere shell, severing no legitimate purpose, and used primarily as an intermediary to perpetuate fraud or promote injustice.” SFA Folio Collections, Inc. v. Bannon, 585 A.2d 666, 672 (Conn. 1991) (quoting Angelo Tomasso, Inc. v. Armor Constr. & Paving Inc., 447
corporate law. It is said to be applied only “in the case of fraud or certain other exceptional circumstances, and is usually determined on a case-by-case basis.”

B. A Jumbled Jurisprudence?

Despite its long-standing acceptance and importance in corporate law, the piercing doctrine has been widely disparaged as a confusing anomaly. State statutes typically provide limited liability for shareholders unqualified by any reference to such a policy. Legislatures grant that concession to encourage the formation of new businesses by specifically allowing owners of a corporation to avoid personal liability for its debts.

In light of that, some have called the justification for piercing “obscure,” although it seems “fair enough” that courts of equity should do so to avoid injustice. The most persistent complaint is that the rule is “long on rhetoric, and contradictory on general principles but short on reasoning,” and constitutes “jurisprudence by metaphor or epithet.” As a result of this undisciplined approach, said to be overly-reliant on “broad generality,” the piercing doctrine has been famously derided as “happen(ing) freakishly.”

If that is the case, there may be unpredictability inherent in piercing that works against the generally accepted purposes of limited liability. Lawyers will then have difficulty advising clients about the types of activities to avoid to preserve their liability shields. One authority has thus commented that “courts apply this doctrine (piercing) with such frequency and freakishness that shareholders of closely held corporations can

A.2d 406, 412 (Conn. 1982)).
94. AM. JUR. Pleading and Practice Forms, supra note 91.
95. One leading treatise spends over forty pages on it. See GEVURTZ, supra note 3, at 69-111.
96. E.g., Shu, supra note 89, at 1017 (calling it “one of the most confusing issues in corporate law”).
97. See supra note 44 and accompanying text; see also Easterbrook & Fischel, supra note 27, at 109.
98. See supra note 42 and accompanying text.
100. Easterbrook & Fischel, supra note 27, at 109.
101. GEVURTZ, supra note 3, at 70.
102. HAMILTON & MACEY, supra note 14, at 261.
103. PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS 8 (1983). In this “reason by pejorative,” “id., “alter ego,” “instrumentality,” “sham,” “subterfuge,” and “tool,” are a few of the commonly used disparaging terms that Professor Hamilton notes in the recent edition of his casebook. HAMILTON & MACEY, supra note 14, at 261. “Shell” is another. GEVURTZ, supra note 3, at 70. Cardozo even lamented that the doctrine was “enveloped in the midst of metaphor.” See supra note 2 and accompanying text.
104. GEVURTZ, supra note 3, at 70.
105. See, supra note 27 and accompanying text. In his most recent casebook Professor Hamilton observes, with regard to piercing, “the rules are not getting any clearer.” HAMILTON & MACEY, supra note 14, at 261.
106. See Stephen M. Bainbridge, Abolishing Veil Piercing, 26 J. CORP. L. 479, 481 (2001) (noting that this uncertainty both increases transaction costs and is wasteful). Professor Hamilton places that concern in the context of a lawyer’s professional responsibility. “The vagueness of the articulated legal standards for piercing the corporate veil presents significant challenges for corporate lawyers required to advise clients in an area of understandably great personal concern to them since personal liability may well be involved.” HAMILTON & MACEY, supra note 14, at 261.
never really consider themselves safe.”

Such criticisms have been made for centuries about the discretion necessarily inherent in equitable jurisprudence. But the need for some legal flexibility is certainly warranted here. A set of fixed rules might only constitute a “road map for fraud” that unscrupulous business people could use to guide them in their improper activity. Even such persistent critics of the piercing doctrine as Easterbrook and Fischel acknowledge the correctness of most decisions in this area. They find that the cases, “at least roughly,” strike the appropriate balance between the benefits of limited liability and its costs. In that, the courts have recognized the need for flexibility. As one put it, a “guiding concept behind veil piercing cases is the need for the court to avoid an over-rigid preoccupation with questions of structure and apply the preexisting and overarching principle that liability is imposed to reach an equitable result.”

C. The Current Standards

1. Some General Points

Finding a uniform test for piercing is a frustrating quest. At minimum, it can be said that courts have never held shareholders of public corporations so liable. That is as it


109. Thompson, supra note 2, at 625. As an example of the need for broad rules in this area, Professor Thompson, in a footnote, refers to the well-known vagueness of Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (LexisNexis 2007). It has been hailed as a needed and effective “catch-all” for securities fraud. Grace v. Rosenstock, 228 F.3d 40, 45-46 (2d Cir. 2000).

110. “We conclude, however, that the doctrine of piercing the corporate veil, and the distinctions drawn by the courts, may make more sense than at first appears.” Easterbrook & Fischel, supra note 27, at 109; accord Thompson, supra note 2, at 627-28 (commenting that “[n]otwithstanding the conclusory labels used by the courts and the metaphors that do not bring clarity, courts are by and large are getting the cases right . . . .”).


113. Thompson, supra note 93, at 1036. Professor Thompson re-emphasized that finding in a later article, The Limited Liability of the New Limited Liability Entities, 32 WAKE FOREST L. REV. 1, 9-10 (2005) [hereinafter New Limited Liability Entities], where he said: “Those who are only passive investors, as the shareholders of a large corporation, will be insulated from the liability of the enterprise, while those who take a more active role in the business are subject to liability.” Id. at 10 (citing Robert B. Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise, 47 VAND. L. REV. 1, 11 (1994)).
should be, not only because of the lack of control that such stockholders have, but also because of the benefits that such an arrangement furnishes to the general economy. It is also sometimes said that courts are more willing to disregard the corporate form in the case of parent-subsidiary companies. After all, in those situations, the fortunes of individual shareholders are still protected from business creditors. Yet, counter-intuitively, one scholar has compiled empirical evidence showing that courts are more likely to pierce against individuals than corporations.

2. A Multiplicity of Approaches

Without a unified criterion for piercing, courts have relied on what one commentator called, “a number of overlapping lists of factors that are passed off as a test.” For instance, in a leading case where the majority shareholder blatantly misappropriated corporate funds owed to its creditors, the court went to some lengths to list a number of reasons when it would pierce. Chief among them were undercapitalization, the failure to observe corporate formalities (including the commingling of corporate and personal monies), siphoning of corporate funds by the dominant shareholder (without the payment of dividends), corporate insolvency, and the absence of corporate records. But after reciting those criteria, the court seemed to lessen their significance by concluding that ultimately, the case “must present an element of injustice or fundamental unfairness.” Such lists have been called a “template” that offers no real analysis and carries with it much “indeterminacy.” They are also criticized as “offering little real guidance” and their relevance has been called “questionable and at times completely unexplored.” The factor that comes under fire most frequently in that index is the corporation’s failure to follow appropriate formalities. In its grossest application, courts seem to be saying, if you fail to act like a corporation (for example, by not holding regular board and shareholder meetings or not distributing income to stockholders by way of properly declared dividends) we won’t afford your owners limited liability, which is

114. New Limited Liability Entities, supra note 113, at 10; see also GEVURTZ, supra note 3, at 78-79.
115. See supra notes 55-81 and accompanying text.
117. Easterbrook & Fischel, supra note 27; see also GEVURTZ, supra note 3, at 103.
118. Thompson, supra note 93, at 1038.
119. Matheson & Eby, supra note 53, at 173.
121. Id. at 686-87.
122. Id. at 687.
123. GEVURTZ, supra note 3, at 72, (citing Secon Service System, Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406, 414 (7th Cir. 1988), where the court said such multi-part tests require it “to balance many imponderables, all important but none determinative”). Judge Richard Posner also criticized multi-factor tests as being non-directive, with no indication of how to weigh the various factors which “invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb.” Exacto Spring Corp. v. Comm’r, 196 F.3d 833, 835 (7th Cir. 1999).
124. BLUMBERG, supra note 103, at 8.
125. Matheson & Eby, supra note 53, at 173.
126. It has been called the legal equivalent of “an old wives tale” and at best a “make-weight” argument. GEVURTZ, supra note 3, at 79.
the principle privilege of such an artificial existence.\textsuperscript{127}

That reasoning has been said to have as much logic as “holding a driver liable for an accident that occurred in broad daylight because the headlights were not in proper working conditions.”\textsuperscript{128} One state of affairs where such negligent behavior might theoretically have a legitimate impact on piercing liability is when creditors could be misled by a business owner who gives them no reason to believe he is operating in the corporate form. But it is hard to see how such a signal would be sent when creditors generally have no reason to inquire into the inner workings of a business.\textsuperscript{129}

But the law’s failure to articulate a concise test for piercing does not mean that the remedy should be abandoned. Nor, for that matter, does it indicate that courts are not doing the right thing here or that closer inspection will not reveal core principles that can be fashioned into serviceable standards for this relief. To make such an analysis, piercing claims should be divided into those based on contract and those resulting from torts.

\section*{3. Contract Claims}

Absent fraud, a number of commentators have little sympathy for contract claimants who ask courts to disregard the corporate shield. Those who voluntarily deal with a limited liability entity, commentators say, should and will most likely compensate for it—either by gaining an appropriate concession in the bargaining process, or by securing a personal guarantee.\textsuperscript{130} So scholars in this area have tended to focus on what might constitute deception or some other type of unfairness that would give a court a legitimate reason to disregard the corporation’s separate status.

Those situations, in turn, break down into a controlling shareholder’s dealings with either creditors or corporate property.\textsuperscript{131} In the former category are false assurances a controlling stockholder might make about either the entity’s financial status or future performance to lull creditors into false beliefs about the solvency of the business as well as statements that might mislead them about personal guarantees made by the shareholder or others.\textsuperscript{132}

In the latter class involving fraud with corporate property are various methods that a shareholder might use to remove funds from the entity.\textsuperscript{133} Many times these are the same activities that would bring the law of fraudulent conveyances into play.\textsuperscript{134} They may also involve preferential transfers on the eve of bankruptcy. Then the doctrine of equitable subordination should control to return such property to the bankrupt’s estate and then to rank shareholder claims below those of other creditors so that those outsiders will have first access.\textsuperscript{135}

\textsuperscript{127} Id. at 81 (citing Victoria Elevator Co. v. Meriden Grain Co., 283 N.W.2d 509 (Minn. 1979)).

\textsuperscript{128} Matheson & Eby, supra note 53, at 176.

\textsuperscript{129} G EVURTZ, supra note 3, at 80-82. But see infra notes 138 & 154 and accompanying text (discussing cases where courts cited the following of corporate formalities as a reason not to pierce).

\textsuperscript{130} See supra notes 79-80 and accompanying text.

\textsuperscript{131} G EVURTZ, supra note 3, at 82-91.

\textsuperscript{132} Vandervoot, supra note 57, at 59.

\textsuperscript{133} Bainbridge, supra note 106, at 517.

\textsuperscript{134} CLARK, supra note 3, at 72; see also HAMILTON & MACEY, supra note 14, at 285.

\textsuperscript{135} See, e.g., Pepper v. Litton, 308 U.S. 295 (1939) (disallowing a stockholder’s “alleged salary claim” on the bankrupt corporation).
This inquiry about unfairness should be sharpened when the plaintiff is an unsophisticated and/or small trade creditor who might be unaware of the ramifications of limited liability. In those cases, it is also unrealistic to expect the claimants to have investigated the corporation’s resources before dealing with it. Depending on the circumstances, some form of fraud by nondisclosure should be sufficient there to justify piercing. Bartle v. Homeowners Coop., Inc. should have been such a case. There a parent corporation did business through a wholly-owned subsidiary that built homes for members of the parent at cost and thus was never allowed to make a profit. What little capital the sub initially had was quickly exhausted. Over a strong dissent, however, the court’s majority refused to pierce its veil to allow creditors of the subsidiary corporation to hold the parent liable.

One presumes that such an odd arrangement was never revealed to the plaintiffs as they were supplying their goods or services to the sub. The court nevertheless found that the creditors were not misled because “the outward indicia of these two separate corporations was at all times maintained . . . .” The court failed to explain, however, in what way the observance of those formalities made any difference to the plaintiffs.

4. Tort Claims and Undercapitalization

In the tort context, legal observers have long been troubled by an anomaly. Victims there have not dealt voluntarily with the corporation and therefore cannot be said to have knowingly entered into a relationship with an entity without individuals standing behind its debts. They have likewise had no opportunity to seek personal guarantees or bargain for extra compensation to balance off that disability.

When a corporation is thinly capitalized or carries insurance incommensurate to the risks of its business, one would think that courts would be most ready to pierce in favor of a victim of its tortious conduct. Not to do so would be to allow the business to

136. See supra note 81 and accompanying text. One court used the term “something like fraud” to describe the type of showing that the common law required to pierce a corporate veil. Mobil Oil Corp. v. Linear Films, Inc., 718 F. Supp. 260, 268 (D. Del. 1989). In that case, however, the court refused to disregard the separate existence of a subsidiary corporation. Id. In Castleberry v. Branscum, 721 S.W.2d 270 (Tex. 1986) the Supreme Court of Texas allowed piercing to take place in instances of “constructive fraud.” Id. It defined that in distinction to actual fraud, which required some intent to deceive. Id. Constructive fraud, on the other hand, “is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.” Id. at 273. The court said it would allow such issues to go to the jury. The Texas legislature responded by narrowing the definition of piercing to disallow it on that theory. TEXAS BUS. CORP. ACT ANN. art. 2.21 (Vernon 2003); see HAMILTON & MACEY, supra note 14, at 279-80.

137. As one commentator put it, “[s]omeone who sells the firm a chair on thirty days credit is not going to engage in detailed negotiations about risk and security.” Easterbrook & Fischel, supra note 27, at 113.

138. GEVURTZ, supra note 3, at 93-94.

139. 309 N.Y. 103 (1955).

140. Id. at 106.

141. See HAMILTON & MACEY, supra note 14, at 266-67 (“Tort cases involving the ‘piercing’ doctrine have a different flavor than contract cases. . . . It is astonishing to find that this fundamental distinction is only dimly perceived by many courts, which indiscriminately cite and purport to apply, tort precedents in contract cases and vice versa.”).

142. GEVURTZ, supra note 3, at 34.

143. Easterbrook & Fischel presumed that was the case in their 1985 article. See supra note 27, at 112.
externalize those costs on innocent strangers. Yet, surprisingly, a leading study shows that courts are less willing to disregard the corporate shield in tort than in contract.

The author of those troubling findings has recently speculated that they may be attributable to “a type of judicial nullification.” Tort claims against corporations most often result from some type of vicarious or strict liability, many times involving defects in the firm’s products. And the author surmised that some courts may have been uncomfortable with those theories. As a consequence, they might have been reluctant to pierce, “using the separate corporate entity as a brake on [their] application.” In other words, by refusing to disregard the corporate shield, those courts may have been doing their own backdoor tort reform.

Meisel v. M & N Modern Hydraulic Press Co. may be an example of such “judicial legislation.” The court refused to pierce the corporate veil in a matter involving strict product liability. The plaintiff was injured by a defective trim press manufactured by an insolvent corporation. She attempted to hold an alleged successor corporation liable for her damages. The court held that it would only permit veil piercing under a two-pronged test, which required not only injustice, but also the intentional use of the corporate form to violate or evade a duty. Setting the state-of-mind standard so high, however, undercuts modern tort principles that make corporate owners responsible for the goods they produce.

Some courts unfortunately have also declined to pierce when corporations have blatantly failed to provide satisfactory arrangements to compensate their tort victims. In those situations, neither the corporation’s assets nor its liability insurance were sufficient for that purpose, but the courts justified their rulings by accepting what the legislature

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144. Two leading scholars have even proposed that limited liability be abolished in the tort context, with each shareholder pro rata responsible for a share of the recovery necessary to compensate the victim. Henry Hansmann & Reinier H. Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 YALE L.J. 1879 (1991). Whatever the theoretical value of that argument, it would be quite difficult to make it work when corporations can move freely from state to state seeking more favorable treatment under the Internal Affairs Doctrine in a new jurisdiction of incorporation. HAMILTON & MACEY, supra note 68, at 340.

145. Professor Robert Thompson, supra note 93, found such in his exhaustive 1991 study.

146. See Thompson, supra note 2, at 632 (stating that courts “are refusing to apply strict liability or other broad principles of tort law where such result does not seem appropriate”).

147. G EVURTZ, supra note 3, at 34.

148. G EVURTZ, supra note 2, at 632.

149. See Larry E. Ribstein, The Evolving Partnership, 26 J. CORP. L. 819, 836 (2001) (arguing that shareholder limited liability for corporate torts may be efficient, in light of widespread acceptance by states).

150. Meisel, 645 P.2d 689 (Wash. 1982). Before addressing the piercing question however, the Meisel court found that the defendant was not liable as a successor corporation. Id. The new corporation was a bona fide purchaser/lessee of the original corporation’s plant and equipment and those transactions were not done to avoid liability. Id. The case can therefore be read narrowly to only apply to “attempts to integrate a theory of corporate disregard with [a] successor liability claim.” Id. at 692. However, commentators have read the Meisel case broadly as creating a restrictive standard for veil piercing “when the corporation has intentionally been used to violate or evade a duty owed to another.” STEWART LANDEFELD, BARRY KAPLAN & STEVEN YENTZER, WASHINGTON CORPORATE LAW: CORPORATIONS AND LLCS § 17.2(b) (2002) (citing Meisel, 645 P.2d at 692). One law review note on the case states that it “creates a nearly impenetrable corporate shield.” Carole L. Hollon & Jo Lynne Pitts, Corporate Disregard in Washington After Meisel: An Analysis, 18 GONZ. L. REV. 341, 343 (1982).

151. Meisel, 645 P.2d at 692.

152. G EVURTZ, supra note 3, at 34.
had set in the way of minimum capitalization or adequate coverage. One such notorious case involved the owner of a taxi cab business in New York City who set up his operations in a number of corporations that each owned two cabs. He maintained the minimum liability insurance required by statute on each: $10,000. A pedestrian hit by one of those negligently driven vehicles was not allowed to pierce the corporate veil, but instead was limited to the $10,000 policy—with the New York Courts of Appeals deferring to the legislature that had apparently established that amount as legally sufficient.

The court also refused to consolidate the corporations so that plaintiff could reach their total assets. Even though little cash remained in each of the corporate treasuries, the court noted with approval that the owner had carefully observed the requisite corporate formalities, duly declaring dividends to himself.

In a more recent case, the plaintiffs were severely injured in an automobile accident caused by an intoxicated patron of an incorporated bar. The bartender had knowingly served the customer in that drunken state and allowed him to leave the establishment inebriated. Even though the bar carried no dram shop liability insurance, the court would not hold its dominant shareholders liable because they had contributed some capital to the business at its inception, which the court found was adequate for its operation.

Some courts, however, have issued more expansive rulings that allow the corporate shield to be set aside in instances of inadequate capitalization. One such case from the California Supreme Court permitted piercing on behalf of the estate of a girl drowned in a swimming pool. The facility was run by a corporation that had issued no stock and had no paid-in capital. To support its holding, the court cited this statement from a leading treatise of the time, “If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege.”

153. Most states have abandoned any attempt to require that corporations have a certain amount of paid-in capital before they may begin business. See HAMILTON & MACEY, supra note 14, at 215-16 (suggesting that corporations should have a certain amount of paid-in capital before they may begin business).


155. Walkowsky, 296 N.Y.S.2d at 362. Professor Gabaldon ridicules the notion that patrons of such poorly insured cabs have supposedly entered into some type of implied bargain, accepting the risk of an uncompensated injury for lower fares. Gabaldon, supra note 41, at 1410-12. Even so, that far-fetched logic would not apply to the instant case because the plaintiff in Walkowsky was a pedestrian. Walkowsky, 296 N.Y.S.2d 362.

156. Bartle v. Home Owners Coop., 127 N.E.2d 832, 833 (N.Y. 1955), was another case where the New York Court of Appeals cited the maintenance of corporate formalities as a reason not to allow piercing. See supra note 140 and accompanying text.


158. Id.

159. Id.


161. HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 303 (rev. ed. 1946). Dean Clark, criticizing the Minton case, has called that quote, “a wishful reading of prior cases.” CLARK, supra note 3, at 81 n.10. Along the same lines, he also states that “a court with anything less than a wildly activist vision of its role
Despite such expansive rulings, an overriding unfairness remains here in the case of many tort victims. As a leading authority cogently put it, “Inadequate capitalization externalizes the costs of accidents.”\textsuperscript{162} That cost should be paid by the corporation, preferably in some form of liability insurance sufficient to cover foreseeable risks of the business.\textsuperscript{163} Absent such a provision, the dominant shareholders should be held liable for injuries wrongfully caused by corporate conduct.

IV. THE RISE OF LLCs AND LLPs

A. Earlier Business Forms

When the American Industrial Revolution got into full swing in the latter part of the 19th century, there were just two legal forms in most jurisdictions that a multi-owner business could assume. One was the corporation, a creature of statute, which afforded its shareholders limited liability\textsuperscript{164} at the expense of some cumbersome formalities.\textsuperscript{165} The other was the general partnership that had existed at common law. Unlike the corporation, it offered its members a flexible mode of operation,\textsuperscript{166} but provided personal liability for all partners similar to that of a sole proprietor.\textsuperscript{167} In the early part of the twentieth century, limited partnerships were created by statute as a hybrid between the two existing forms, offering the corporate-like liability shield to investors, so long as they did not participate in control of the business.\textsuperscript{168}

In the 1930s, legislation imposed a higher separate income tax on corporate profits that was justified because those organizations were distinct legal entities. It therefore

\textsuperscript{162} See supra note 36 and accompanying text.
\textsuperscript{163} See supra notes 10-11 and accompanying text.
\textsuperscript{164} See supra note 12 and accompanying text.
\textsuperscript{165} See supra note 13 and accompanying text.
resulted in the double taxation of corporate income if it was paid out to shareholders as dividends. For that reason, the corporate form became even less attractive, particularly for small companies. But because of its liability shield, business lawyers and sympathetic congressional innovators devised a number of ways to mitigate that extra tax burden. The most prominent of those were the “zeroing out” tactic, the “accumulations and bailout” strategy, and the “S” corporation.

The quest to find the ideal all-purpose legal form for a business continued with the creation of close corporation statutes that allow shareholders, in certain situations, to dispense with boards and run the business directly. And when sheltering income became an important consideration in the 1970s, limited partnerships gained acceptance as a preferred mode for certain types of businesses because they would allow their losses to “flow through” to investors. A corporation would often serve as the entity’s general partner, so that all its partners would have limited liability. That, in turn, gave rise to the phenomenon of the so-called master limited partnership, whose interests were widely held and publicly traded. It flourished briefly and then died off when its favorable tax treatment was disallowed by new laws.

B. The Creation of Limited Liability Companies

Despite all those innovations, no one legal form seemed the perfect fit for a small business that wanted to avoid double taxation of its profits yet maintain a simple, flexible operating structure that at the same time would afford its owners limited liability. Yet one had existed under various guises on the “unfamiliar terrain” of the civil law tradition for almost a century.

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170. There the goal of a regular “C” corporation is to minimize the tax on its revenue by “zeroing out” its income. If such firms pay as much of their receipts to leading shareholders as employee compensation, rent, or interest on loans, they can turn corporate earnings into deductible expenses, eliminating much or all of the corporation’s taxable income. The recipient-shareholders will still have to pay tax on the earnings of the business, but because they are not paid to them as dividends, they do not bear the burden of double taxation. This has been a tactic traditionally favored by closely held corporations. HAMILTON & MACEY, supra note 14, at 142.

171. This presupposes that there will be a buyer for the corporation’s shares. A corporation’s earnings will then be retained in its treasury or used to expand the enterprise. Such activity theoretically will cause the firm’s shares to appreciate, and stockholders can realize that extra value whenever they choose by selling them. Such proceeds have normally been classified as long-term capital gains which, until 2003, were taxed at a lower rate than dividends. Id. at 141.

172. Under subchapter S of the Internal Revenue Code, a corporation structured in a certain fashion can have its income pass directly through to its shareholders, as if they were partners. Id. at 138-39.

173. Id. at 430-32.


175. As one commentator has aptly described that unsatisfactory situation, “Given this ‘pass-through’ taxation/limited liability trade-off, it was only a matter of time before business owners wanted to have their cake and eat it too.” Douglas K. Moll, Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History, 40 WAKE FOREST L. REV. 883, 921 (2005).

176. This descriptive metaphor is borrowed from John Morey Maurice, Operational Overview of the Washington Limited Liability Act, 30 GONZ. L. REV. 183 (1995).

177. Professor Maurice aptly describes how various forms of the LLC have existed in Western European
The break-through came in the 1970s by way of a client’s suggestion to its lawyers. An American oil company had been conducting its exploration in Panama, in one of that country’s legal forms, the limitada. That organization offered the firm’s U.S. investors not only limited liability, but also tax treatment as a partnership. The company asked its lawyers to see if such a business structure could be permitted under U.S. laws, and after some legislative forum shopping, counsel persuaded Wyoming to enact the first Limited Liability statute in 1977. Then began what one commentator has called “an eight-year struggle” with the IRS to allow LLCs to be taxed as partnerships. The Service finally agreed to that in 1988, and by 1995 all states had passed legislation authorizing some version of the LLC. The battle wasn’t fully won, however, until 1997, when the IRS replaced its earlier multi-part standard on taxation of businesses with a simpler one that allowed entrepreneurs to select their own tax treatment. Those so-called “Check the Box” regulations permitted even one-member LLCs to avoid double taxation by electing partnership-like taxation. Legislatures amended their statutes accordingly and the LLC became an idea whose time had come.

The LLC now appeared to offer small businesses the best of all possible legal worlds. It provided them with a partnership’s ease of operation, limited liability for all members, regardless of their activity in the business, and complete flow-through tax treatment for all profits and losses. In other words, the LLC afforded its members/owners a corporate-like liability shield with neither the draw-backs of cumbersome formalities nor concerns about double taxation.

At first there was some reluctance to choose that new business form over the tried-and-true corporate structure. One study in the late 1990s found that new incorporations were still outnumbering LLC formations by margins of 2:1, 3:1, or even greater.

and South American jurisprudence for years. Id. at 185-86; see also Steven C. Bahls, Application of Corporate Common Law Doctrines to Limited Liability Companies, 55 MONT. L. REV. 43, 46 (1994) (“Today limited liability company-type organizations are common throughout Europe and Latin America.”).


179. Id. at 1465.


182. HAMILTON & MACEY, supra note 14, at 163.

183. Id. at 154-55.

184. Friedman, supra note 180, at 48-49. (“In the period immediately after 1988, lawyers were so obsessed with assuring that LLCs would get partnership tax treatment that some states adopted so-called ‘bullet proof’ LLC statutes . . . .”). All this happened, according to one scholar, in “stealth developments . . . with virtually no debate over the policy implications of limiting partner liability.” Robert W. Hillman, Law, Culture, and the Lore of Partnership: Of Entrepreneurs, Accountability, and the Evolving Status of Partners, 40 WAKE FOREST L. REV. 793, 793 (2005).

185. See Friedman, supra note 180, at 49; Moll, supra note 175, at 917. But see Susan Pace Hamill, The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question, 95 MICH. L. REV. 393, 446 (1996) (discussing the “underlying and often unarticulated concerns hidden in the shadows of the LLC euphoria”); see also supra note 178 and accompanying text.

186. See Friedman, supra note 180, at 49-55 (discussing the LLCs “tax and non-tax advantages over the alternative business forms”).

187. See John W. Lee, A Populist Political Perspective of the Business Tax Entities Universe: “Hey, the
Commentators attributed that to fears by practitioners that LLC formation would “require numerous choices and decisions” or that its liability shield would be more easily penetrated than that of the well-established corporate form. Yet, half a decade later, that trend seems to have been reversed with LLCs now constituting about 50% of all business formations nationwide.

C. The Structure of LLCs

However, some of those early concerns about the complexity of LLCs had some basis in fact. It is often described as a hybrid between the corporate and partnership forms, but, except for its benefit of limited liability, it most strongly resembles the traditional general partnership, particularly when it is managed directly by all of its members. And the LLC is an entity that gives its organizers much more freedom in its design than the standard form corporation.

An LLC comes into existence by the filing of a relatively simple document, usually called the “articles of organization” that contains basic information about the company. Prior to that, members must decide whether to have the firm “member-managed” where each owner, as in a general partnership, has decision making power or “manager-managed,” where control is centralized in one or a group of individuals.

If the LLC is “manager-managed,” its members cannot bind the company, and the members have authority only on major matters. A limited liability company, to be “manager-managed,” must designate itself so in the company’s articles of organization.
In default of that arrangement, each member has the power, as in a general partnership, to bind the company. The LLC’s members also have broad discretion to define their rights in the allocation of profits and losses by including such provisions in the operating agreement.

In addition to the possibility of centralized management, the LLC also can differ from a partnership in the exit rights of its members. Unlike partners who can freely disassociate themselves from a business by voluntarily withdrawing, causing a dissolution, LLC members, like shareholders, must bargain for those rights in advance, most often by securing “buy/sell agreements.” Careful planning is, therefore, necessary in an LLC to assure that salary and profit-sharing arrangements are acceptable to all parties, particularly to minority members who lack disassociation rights and are locked into their investments.

D. The LLP Alternative

If business planners think they have created the perfect, all-purpose legal structure for a commercial enterprise in the LLC, the LLP should make them think again. Limited liability partnerships started in Texas in the early 1990s as a protection from the enormous potential liability faced by legal and accounting firms from the savings and loan debacle in that state. Its immediate focus was to safeguard innocent partners from malpractice or other negligence claims resulting from legal work done by others in their firms. The form quickly spread to other states, and its impact was broadened substantially in many of those jurisdictions from the original “narrow shields” designed only for protection from negligence claims to “full shields” against all legal actions. Now, the Uniform Partnership Act makes that complete protective feature available to all partnerships if they simply file a statement qualifying themselves as such. In whatever form it takes, however, LLP partners, like corporate shareholders and officials, are

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198. See, e.g., id. § 101(11).
199. Stover & Hamill, supra note 192, at 817; ULLCA § 301(a).
200. Bendremer, supra note 89, at 386.
201. RUPA, supra note 10, §§ 601, 801. Other issues, like sleeping-dogs, may be lurking in the LLC such as matters of fiduciary duty and basic questions of authority. Professor Friedman has called for more academic engagement there. See Friedman, supra note 180, at 76-86. It may be many years before such questions are fully settled.
202. Stover & Hamill, supra note 192, at 829. For a good discussion of this and the possible oppression that may result to minority members of LLCs, see Moll, supra note 175, at 925-40.
203. See Dennis S. Karjala, Planning Problems in the Limited Liability Company, 73 WASH. U. L.Q. 455, 467 (1995) (discussing different statutory methods for withdrawal of LLC members). Such planning, of course, can be expensive, particularly when it requires the retaining of multiple counsel to represent the rights of a number of parties.
205. Rutledge, supra note 190, at 149.
206. Id. at 150.
207. RUPA, supra note 10, § 1001.
208. See supra notes 47-48 and accompanying text.
liable for their own misconduct.209

The LLP remains then a traditional general partnership, with the provision of limited liability added on.210 In essence, it is just two or more persons operating as co-owners of a business for profit,211 but who are no longer jointly and severally liable for the debts of their business.212 It has the same ease of formation and flexible operating structure as a conventional general partnership along with pass-through tax treatment for its profits and losses.213

Scholars have debated whether this change, as it has particularly occurred in law firms, has altered the traditional notion of partnerships214 or sent signals that such groups may be altering the quality of their services.215 Nevertheless, business lawyers who fail to advise their clients about such protection may be inviting a malpractice claim.216 At this time, the LLP appears to be in wide use by legal and accounting firms, but has not caught on with general commercial enterprises.217 Yet there is no reason why that has to be so because “statutes in most states do not” limit the LLP’s use to just certain businesses.218 Any partnership can easily avail itself of the LLP’s liability protection by an uncomplicated public filing.219

E. Selecting Between LLCs and LLPs

Nevertheless, some advocates of the LLC regard the LLP as an “intermediate form,”220 still best suited to professional firms (like legal or accounting) where procedures for centralized decision making are well established by their own traditions and enforced by their own sanctions.221 The LLC has a specific mechanism to unify management222 and also allows for many of its sticky profit and loss issues to be settled up front in a written operating agreement.223 It also locks in investor capital, like a corporation, which is a valuable provision for estate and gift taxation,224 although it may

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209. HAMILTON & MACEY, supra note 14, at 9.
210. Stover & Hamill, supra note 192, at 817.
212. RUPA section 306 states that traditional default rule of joint and several liability controls if the partners have not elected LLP status. RUPA § 306.
214. Hillman, supra note 184; see, e.g., Poonam Puri, Judgment Proofing the Profession, 15 GEO. J. LEGAL ETHICS 1 (2001).
216. Rutledge, supra note 190, at 155.
217. HAMILTON & MACEY, supra note 14, at 9.
218. Cane & Franco, supra note 213, at 1304-05 n.27.
219. See supra note 207 and accompanying text.
220. Friedman, supra note 180, at 42.
221. Stover & Hamill, supra note 192, at 840.
222. See supra notes 194-195 and accompanying text.
223. Under Section 103 of the ULLCA, this agreement need not be in writing. However, many state LLC statutes require that the operating agreement be in writing. See, e.g., WIS. STAT. ANN. § 183.0102 (West 2006); Stover & Hamill, supra note 192, at 820.
224. Stover & Hamill, supra note 192, at 839.
prove troublesome to minority investors.\textsuperscript{225} Thus, for larger businesses that need a regularized system of decision making with permanently committed resources, the LLC is preferable.\textsuperscript{226} Notably, since most states require that LLC operating agreements be in writing, members there who rely on oral promises about profit sharing and other matters may find their expectations frustrated.\textsuperscript{227} By contrast, in the case of smaller firms (especially those that can’t afford the transaction costs necessitated by LLC agreements),\textsuperscript{228} the LLP is preferable.

LLPs also allow the “free exit” prerogatives that are typical in general partnerships.\textsuperscript{229} The corresponding lack of stability is balanced by the likelihood that minority investors will not be frozen-out or otherwise oppressed. That is a distinct possibility in an LLC, which in that regard more nearly resembles a closely held corporation than a partnership.\textsuperscript{230} Also, in partnership law, there is a well-established body of law on fiduciary duties to protect against such unfairness while many of those issues are unresolved in LLCs.\textsuperscript{231}

V. THE LIMITED LIABILITY OF LLCS AND LLPs

A. Extending the Shield

LLCs and LLPs now appear to be the medium of choice for small firms,\textsuperscript{232} guaranteeing their owners will not be deprived of limited liability while also granting the benefits of operational flexibility and flow-through tax treatment.\textsuperscript{233} The long-time justification for such a privilege in the corporate form was that it encouraged entrepreneurship and capital formation, creating productive and well-financed firms that, in turn, contributed to the overall wealth of society.\textsuperscript{234} According to that theory, if persons of limited means might stand to lose all their assets if their businesses failed, the only people who would undertake commercial activity would be those with substantial personal resources.\textsuperscript{235} Absent limited liability, the number of start-up firms would be much smaller, and industrial output and employment would suffer accordingly.

Such arguments are made even more forcefully today by those who promote a strict view of the limited liability given to LLCs and LLPs. They claim that the purpose of those new organizations is to encourage the creation of small businesses, not only to enhance the product capacity of our nation,\textsuperscript{236} but also to allow individuals from modest

\begin{footnotes}
\item[225] See supra notes 201-203 and accompanying text.
\item[226] See supra notes 196-99 and accompanying text.
\item[227] Stover & Hamill, supra note 192, at 846.
\item[228] See supra note 203 and accompanying text.
\item[229] RUPA supra note 10, § 601(1).
\item[230] Stover & Hamill, supra note 192, at 841.
\item[231] Friedman, supra note 180, at 79-82; see also Moll, supra note 175, at 888-95 (discussing that issue in the context of closely held corporations and citing Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975) (applying the fiduciary duties of partnership law to protect minority shareholders)).
\item[232] See supra note 190 and accompanying text.
\item[233] See supra note 186 and accompanying text.
\item[234] See supra notes 40-42 and accompanying text.
\item[235] See supra note 38 and accompanying text.
\item[236] Matheson & Eby, supra note 53, at 170-71, makes this argument:
\end{footnotes}
economic backgrounds to participate in the American dream of entrepreneurship.\textsuperscript{237} Another commentator has also suggested that the spread of limited liability to those unincorporated entities has been a backdoor way of achieving tort reform,\textsuperscript{238} relieving small business owners of the potential burden of such costly liability. In that way, limited liability provides an indirect subsidy to those enterprises, albeit one paid by uncompensated victims of their malfeasance.\textsuperscript{239}

\textbf{B. Statutory Provisions for Limited Liability}

\textit{1. LLC Statutes}

Professor Robert Thompson’s review of LLC statutes found that they have more ways of prescribing limited liability than comparable corporate statutes.\textsuperscript{240} In the first instance, LLC statutes contain varying language about whom they clothe in limited liability. Such differences, however, are not significant because all the statutes furnish such protection to both passive investors and active officials.

Thompson’s second category differentiates the statutes according to the breadth of their coverage.\textsuperscript{241} Some absolve certain individual participants from personal responsibility while providing that they can still be held legally accountable for their own actions.\textsuperscript{242} Others, however, contain qualifying language that LLC members and managers cannot be liable “solely” by virtue of their positions.\textsuperscript{243} Professor Thompson points out that the use of the word “solely” there leaves room for courts to hold members and managers of LLCs personally liable for reasons other than their mere status. Those findings could be predicated on traditional corporate piercing theories.\textsuperscript{244}

The almost universal adoption of the limited liability company and the limited liability partnership makes clear the states’ desire to expand upon this important policy decision (encouraging newcomers to invest capital and to participate in business). State legislatures around the country, having considered the underlying arguments both for and against limited liability, elected to encourage commercial activity at the possible expense of creditors and others to whom a particular business may have incurred obligations.

Likewise, it is argued that an iron-clad liability shield for LLCs will promote venture capital investment. Shu, \textit{supra} note 89, at 1009.\textsuperscript{237} Bainbridge, \textit{supra} note 26, at 106.\textsuperscript{238} See \textit{supra} notes 146-149 and accompanying text.\textsuperscript{239} Ironically, at about the same time as academic interest in removing limited liability on behalf of tort victims was surging, legislatures were expanding limited liability by creating LLCs and LLPs. Friedman, \textit{supra} note 180, at 44-45.\textsuperscript{240} Thompson, \textit{New Limited Liability Entities, supra} note 113, at 14-15; see also Vandervoort, \textit{supra} note 57, at 65-67.\textsuperscript{241} Thompson, \textit{supra} note 113, at 11.\textsuperscript{242} Id.\textsuperscript{243} See, e.g., ULLCA § 303(a).\textsuperscript{244} Thompson, \textit{New Limited Liability Entities, supra} note 113, at 20. A Connecticut court has issued just such a ruling, justifying the piercing of an LLC’s veil under that state’s statute which provides that liability will not be imposed on members or managers “solely” by virtue of such status. Bastan v. RJM & Assoc., LLC, No. CV99-0593189-S, 2001 WL 1006661, at *1 (Conn. Super. Ct. 2001). Professor Bainbridge concedes that the statute may be read that way, but argues that it can also be interpreted as allowing liability on other grounds—
Professor Thompson’s third grouping focuses on whether LLC piercing statutes refer to such provisions under corporate law. A number of statutes do,\(^{245}\) while others provide the same by clear implication.\(^{246}\) Even in states where LLC codes are silent, however, courts have refused to allow such legislative inaction to promote injustice. The leading case to that effect is appropriately from Wyoming, home of the LLC.\(^{247}\)

Wyoming’s first-in-the-nation LLC statute had no provision allowing that entity’s separate legal status to be disregarded. Yet the plaintiff in *Kaycee Land & Livestock v. Flahive*\(^{248}\) asked the Court to pierce an LLC’s veil and hold its managing-member liable for environmental damage caused by the company. While noting that the reasons for piercing an LLC veil might be different than those in the corporate area, the court nonetheless held that the doctrine should apply to both situations. “If the members and officers of an LLC fail to treat it as a separate entity as contemplated by statute, they should not enjoy immunity from individual liability for the LLC’s acts that cause damage to third parties.”\(^{249}\)

### 2. LLP Statutes

The statutes for limited liability partnerships, as noted earlier, started out providing only a “narrow shield” safeguarding partners from claims arising from the negligence of their colleagues.\(^{250}\) Now, at least seventeen states have expanded that protection to include contractual obligations of the firm.\(^{251}\) Many, however, specifically provide that there shall be no exemptions from liability for individual partners on account of their own negligence or for the misfeasance of those working under them.\(^{252}\)

The Uniform Partnership Act has no provision directly applying piercing principles to LLPs. Like many LLC statutes, however, it does qualify the immunity it grants partners by stating that they will not be liable “*solely* by reason of being or acting as a partner.”\(^{253}\) Logically, the same line of analysis may be applied to similarly worded LLC provisions to find LLP partners personally liable on grounds other than their status. Such findings, furthermore, would resemble traditional corporate piercing theories.\(^{254}\)

Professor Thompson asserts that common law piercing standards should apply to LLPs.\(^{255}\) That form can be used in the same way as corporations and LLCs to improperly externalize costs. He convincingly argues, therefore, that any restrictions on the

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\(^{245}\) Vandervoot, *supra* note 57, at 66 (citing, in that regard, Illinois’s and Maine’s provisions).

\(^{246}\) Vandervoot, *supra* note 57, at 66.

\(^{247}\) See *supra* note 179 and accompanying text.

\(^{248}\) 46 P.3d 323 (Wyo. 2002).

\(^{249}\) Id. at 327.

\(^{250}\) See *supra* note 206 and accompanying text.


\(^{253}\) RUPA § 306(c) (emphasis added).

\(^{254}\) See *supra* notes 84-94 and accompanying text.

application of the piercing doctrine to LLPs should come from legislatures, not courts.  

C. The Grounds for Disregarding the Liability Shield of LLCs and LLPs

1. The Appropriateness of Piercing

At the extreme are the views of Professor Stephen Bainbridge, who has called for the outright elimination of the piercing doctrine—not only as it has historically been applied to corporations, but also as it might pertain to LLCs (and presumably LLPs). At least in the corporate context, he has thus parted company with some of his colleagues in the law and economics school. Professor Bainbridge’s reasons for doing away with that doctrine and advocating an absolute protection against personal liability are twofold. First, he says that the grounds for piercing are “hopelessly dysfunctional.” Second, he argues that remedy contravenes the explicit purpose of LLC statutes, which is to encourage small business owners to engage in entrepreneurial activity.

Professor Bainbridge’s latter claim is directly refuted by a number of states that have enacted LLC statutes, which specifically provide that such protection should be tempered by the piercing doctrine. In another state where no particular statutory mention was made of piercing, a judicial decision has found it appropriate.

Such an approach is most appropriate under rudimentary principles of distributive justice and should be part of any legal system that espouses the social responsibility of business. The piercing doctrine has a long and distinguished history in the corporate area, protecting contract claimants there from being cheated and refusing to allow profit-making companies to externalize their costs on tort victims. It is most fitting that those same considerations now carry over to LLCs and LLPs.

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256. Id. at 25.
257. Bainbridge, supra note 106, at 480.
259. See supra notes 109-110 and accompanying text.
260. Bainbridge, supra note 26, at 106.
261. Id. at 132.
262. See supra note 245 and accompanying text.
263. See supra notes 247 and accompanying text.
264. See supra notes 131-36 and accompanying text. As Professor Thompson put it, “formation of this new corporation usually means that additional risk relating to the enterprise moves from the insiders of the venture to creditors. American law has long recognized such use of separate corporations and has trusted exceptions to that rule to be developed by courts applying a common law process.” Thompson, supra note 2, at 635.
265. See supra notes 159160 and accompanying text.
266. One commentator aptly summed up the needed balance provided by the piercing doctrine in this fashion:

The history of the firm illustrates the tension between the conflicting goals that American society set for corporations. On the one hand, Americans wished to promote efficient wealth maximization by as broad a range of people as possible. On the other, Americans wanted to regulate the firm in order to protect those who lost out on that wealth creation.

2. The Effect of Statutory Language and Non-Corporate Status

But what about Professor Bainbridge’s first criticism that piercing jurisprudence is “hopelessly dysfunctional?” Is it possible to fashion appropriate standards that bring the rule of law to that area? Two questions appear at the threshold of such an inquiry concerning LLC and LLP piercing.

One concerns the diverse language used by various statutes. The other raises an even more fundamental issue pertaining to the different structure of those two new entities from the corporation. Should piercing theories that were developed to deal with that long-established business form carry over to LLCs and LLPs? If so, must they be tailored in some way to meet the special concerns of those new organizations?

On the first point, Professor Thompson has pointed out that courts should focus their efforts on developing unified standards for piercing and “not seek to distinguish particular meanings of individual statutes on tangential points . . . .” LLC and LLP statutes are essentially alike on matters that are germane to piercing questions, with many specifically providing for it and none excluding it. On the second matter relating to the applicability of the piercing theories as developed in the corporate context, many statutes specifically refer to such standards in their LLC and LLP statutes, explicitly signaling their relevance. For instance, some of those provisions use language prescribing that LLC and LLP shields may be disregarded under “analogous circumstances” as they would be in the corporate context. Other states put the matter more directly, specifically mandating that corporate-piercing standards be applied to LLCs.

One leading case in that area noted, however, that some factors relevant to the issue of corporate piercing would not apply “for the obvious reason that many of the organizational formalities applicable to corporations do not apply to LLCs.” Although the court failed to elaborate on that comment, one obvious difference is that corporate statutes mandate centralized management by a board, but LLCs are member-managed, like partnerships, unless their operating agreements provide for a more unified form of management. On the other hand, that much maligned reason for corporate piercing, i.e. the failing to follow appropriate formalities, is specifically excluded in a number of LLC statutes from being grounds to disregard liability shields. That seems appropriate because such improprieties do not mislead creditors.

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267. See supra notes 240-41 and accompanying text.
269. See supra note 245 and accompanying text.
270. WASH. REV. CODE § 25.15.060 (LexisNexis 2006), see also CAL. CORP. CODE § 17101 (Deering 2006); IOWA CODE § 490A.603 (2005).
271. See COLO. REV. STAT. § 7-80-107 (2005) (“In any case in which a party seeks to hold members of a limited liability company personally responsible . . . the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced.”); see also FLA. STAT. § 608.701 (2006); MINN. STAT. § 322B.303 (2005).
273. See supra note 198 and accompanying text.
274. See supra notes 125-26 and accompanying text.
275. See, e.g., ULLCA § 303(b) (2001).
Courts also do not pierce to hold uninvolved shareholders liable, but only those that are active in the business—such as those in direct control of a closely held corporation. Under similar logic, a court might be willing to pierce against a member-manager of an LLC analogizing to the situation of dominant shareholders of closed corporations who face liability under “alter ego” or “instrumentality” theories.\textsuperscript{277} Other considerations for corporate veil piercing are likely to be relevant to that issue in LLCs and LLPs.\textsuperscript{278}

3. Defining the Standards for LLC and LLP Veil Piercing

While case law has been developing slowly, with courts in general following corporate piercing theories,\textsuperscript{279} there has been no shortage of academic writings on the appropriate reasons to disregard the liability shields of LLCs and LLPs. Like the judicial decisions, several of the initial proposals there focused on traditional themes in the corporate area, fraud and undercapitalization—with the former applying to contract claims and the latter to tort actions.\textsuperscript{280}

One such commentator came up with an elaborate six-step standard of review.\textsuperscript{281} In summary, its factors were: (1) whether the LLC was publicly traded; (2) whether it was member or manager managed; (3) whether it was undercapitalized or underinsured for its risks; (4) whether its creditors had dealt with it voluntarily or involuntarily; (5) whether it had been operated fraudulently or in bad faith; and (6) whether it was run as a separate entity. All those criteria were familiar carry-overs from corporate law and, except possibly for the last one, should be relevant to a piercing inquiry for any limited liability entity.

That proposal, however, suffered a customary problem that plagues multi-factor

\textsuperscript{277} Bahls, \textit{supra} note 177, at 62.
\textsuperscript{279} Bendremer, \textit{supra} note 89, at 396. Professor Elizabeth S. Miller has surveyed case law in this field and has published her findings. She states:

Predictably, courts tend to analogize to corporations and partnerships when faced with LLC issues, and the results in the cases are generally not too surprising . . . . The development of a clear, well-reasoned body of case law dealing with the new types of unincorporated entities will depend in large part on how effectively litigants educate courts as these cases arise.

Elizabeth S. Miller, \textit{More than a Decade of LLP and LLC Case Law: A Survey of Cases Dealing with Limited Liability Partnerships and Limited Liability Companies}, (2006), available at http://law.baylor.edu/faculty/profiles/Miller.htm (click on CLE Materials). A good example of some judicial confusion in this area is \textit{Skidmore Energy, Inc. v. KPMG}, 2004 U.S. Dist. LEXIS 28396, at *14 (N.D. Tex, Dec. 28, 2004), where the court refused to apply the alter-ego theory of piercing to an LLP, relying on a case as precedent that had found that theory unnecessary in a general partnership situation. The flaw in the court’s application of that principal is that, unlike partners in an LLP, general partners are always personally liable for the debts of their business so the piercing theory is superfluous there. But such is not the case in an LLP because limited liability is essential to the nature of that entity.

\textsuperscript{281} Cohen, \textit{supra} note 266, at 490-91.
tests. It failed to rank the criteria by analytical import. And its proponent even acknowledged that it had a principal shortcoming of such a detailed approach—it might invite a businessperson to abuse the limited liability privilege by skillfully navigating around its various factors.

More recently, an article co-written by a corporate professor and a practicing lawyer put forth a model statute on piercing that purports to cover all limited liability entities (corporations as well as LLCs and LLPs). The test would focus on the culpability of the firm’s insiders and apply to insolvent companies. It would come into play in three situations: (1) when there was fraudulent misrepresentation of the firm’s assets; (2) when the company’s property was transferred to its owners in a way that conflicted with their duty of loyalty to the company; and (3) when assets were distributed to the owners that caused insolvency. The authors specifically omitted undercapitalization as a factor leaving that to legislative determination.

Another observer urged that this test should be broadened to include wrongful conduct and constructive fraud. Those categories would include purposeful underfunding of a company that left those injured without any relief. Such a situation could arise when the company had either inadequate capital or carried insufficient liability insurance.

Theories to pierce the liability shield in LLPs are equally plentiful. According to Professor Hamilton, they include "misrepresentation, . . . fraudulent transfers, and breach of . . . duties of full and fair disclosure required by ethical principles." He also notes that many lawyers believe the LLP shield is more "porous" than that provided by either the corporate or LLC form. For instance, since the existence of such firms is fragile and may end with the withdrawal of any partner, the limited liability of a defunct partnership might not transfer over to a newly formed one without another filing. Hamilton also points to questions about whether the limited liability of a partnership in one state will be recognized by other jurisdictions.

4. The Benefits of a Flexible Approach

Professor Thompson suggests that the most appropriate policies on veil piercing for those new entities can come from the common law methodology. Courts should develop a fact-rooted jurisprudence on a case-by-case basis. In other words, let lines continue to be “drawn by judges after the fact.” Such a supple jurisprudence has much to recommend it, particularly against the backdrop of well-framed corporate guidelines

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282. See supra note 123 and accompanying text.
283. Cohen, supra note 266, at 491. “Also such a test would encourage firms to adjust their actions in such a way as to still engage in ‘bad’ behavior but simultaneously to avoid the ‘bright lines’ that will result in piercing.” Id.
284. Matheson & Eby, supra note 53.
286. HAMILTON & MACEY, supra note 14, at 54.
287. Id.
288. Id.
289. Thompson, supra, note 2, at 627-35.
290. Id.
291. Id. at 623.
that guard against a charge of excessive vagueness. Perhaps the best all-purpose standard is one drawn from a leading corporate treatise. After an exhaustive review of piercing standards, Professor Gevurtz predicates personal liability on a two-part test, emphasizing control by the business owner and some type of improper conduct.\(^{292}\) Otherwise put, this standard would mean a unity of interest between the individual owner and the limited liability business coupled with some type of fraud or injustice.\(^{293}\)

In addressing the needs of involuntary tort victims, Professor Gevurtz recognizes that initial capital requirements have become fairly meaningless.\(^{294}\) Instead, he would substitute a test that focuses on whether the business maintained sufficient resources, either in capitalization or by way of liability insurance, for any tort liability that might be reasonably foreseeable.\(^{295}\) To that end, such standards set by statutory or regulatory law\(^{296}\) would have evidentiary force, but would not necessarily be dispositive.

### VI. Conclusion

LLCs and LLPs may be the most important developments in business law during the last century. As with any significant legal innovation, it will probably take some time for our system to flesh out decisive rules to cover all of the issues that will arise from these new forms. But the piercing question has been the most litigated matter in corporate law, and it is easy to foresee that trend continuing in the context of LLCs and LLPs.

So far, both statutory and case law have found it convenient to borrow piercing standards from the corporate area to adjudicate piercing in LLCs. But both LLCs and LLPs are new and different creatures that resemble the classic general partnership more closely than the traditional corporation with its multiple layers of authority. As one commentator has therefore put it, “[t]he development of a clear, well-reasoned body of case law dealing with the newer types of unincorporated entities will depend in large part on how effectively litigants educate courts as these cases arise.”\(^{297}\)

To that end, courts should respect the legislative decision that gives a basic liability shield to those who form LLCs and LLPs. But they certainly do not have to accept the argument by conservative commentators that this immunity ought to be absolute. Principles of simple justice and important concerns about the social responsibility of businesses are relevant here. Firms should not be allowed to completely externalize their costs on legitimate contract claimants and tort victims.

In developing this new piercing doctrine, it is entirely appropriate for courts of equity to proceed on a case-by-case basis, examining the facts of each situation carefully. In doing so, they should keep in mind two elemental questions that form the crux of corporate piercing jurisprudence: first, have the individual defendants so dominated this business that there is really no distinct entity here? And second, are these defendants

\(^{292}\) Gevurtz, supra note 3, at 76.

\(^{293}\) Id.

\(^{294}\) See supra note 34 and accompanying text; see also supra note 151 and accompanying text.

\(^{295}\) Gevurtz, supra note 3, at 96.

\(^{296}\) See, e.g., Washington statutes, which set financial responsibility standards for LLCs offering professional services and for professional LLPs. WASH. REV. CODE §§ 25.05.125(4), 25.15.045(2) (2006).

\(^{297}\) See Miller, supra note 279.
using this purportedly separate organization to perpetrate a fraud or injustice?

In the context of an LLC or an LLP, the first criteria should be relatively easy to satisfy. Both those forms are, in essence, general partnerships with limited liability tacked on. All partners or members, at least conceptually, have hands-on control of the company. This is particularly true for manager-members of an LLC.

In extending the shield of limited liability to small businesses by allowing them to be formed as LLPs and LLCs, the legislatures have deferred to entrepreneurship and economic democracy. But courts should never forget that the potential of liability exists to make people treat others fairly and to exercise due care in their dealings with them. 298 If our legal system now allows business owners free reign to walk away from the injuries they create, it will be a sorry time for the rule of law and the role of justice in society.

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298. Reflecting on limited liability in the corporate context, Professor Gevurtz notes that it is qualified by the piercing doctrine, so that “shareholders of closely-held corporations can never really consider themselves entirely safe.” GEVURTZ, supra note 3, at 7. Given the possibility that businesses may unjustly inflict damage on outsiders, that may be a good thing.