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Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers

Timothy P. Glynn*

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I. INTRODUCTION

Debate continues to rage over limited shareholder liability and the social costs it imposes.1 While proposals flourish for imposing liability on shareholders to reduce these costs, little attention has been devoted to a more promising solution: vicarious tort liability for high-ranking corporate officers. Limited shareholder liability produces benefits, but it also inflicts costs, including encouraging excessively

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risky corporate activity. These costs are most pronounced in the tort context because potential tort victims rarely can protect themselves by monitoring corporate activities or bargaining with corporate actors. Commentators disagree on limited shareholder liability's net impact on social utility and what, if anything, should be done to change limited liability. Some defend the current regime as efficient or at least preferable to alternatives, even in the tort context. Others propose curtailing limited liability, arguing that vicarious liability for corporate torts ought to extend to some or all shareholders in closely held corporations, or that courts ought to "pierce the corporate veil" more often. Still others have gone much further, arguing that liability for corporate torts should extend to all shareholders. Few, however, have seriously considered extending vicarious liability to the firm's other primary stakeholders, corporate management.


3. See, e.g., Paul Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, 30 U. Toronto L.J. 117, 148-49 (1980) (arguing liability should extend to shareholders in closely held companies); Note, Should Shareholders Be Personally Liable for the Torts of Their Corporations?, 76 Yale L.J. 1190, 1190 (1967) (same); see also Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. Corp. L. 573, 630 (1986) (advocating the abolition of limited liability for wholly owned subsidiaries); Leebron, supra note 1, at 1618-19 (same); Robert B. Thompson, Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise, 47 Vand. L. Rev. 1, 4-6 (1994) (suggesting shareholder-managers should be vicariously liable for corporate torts).


6. Only a few scholars have offered a thorough critique of managerial liability. Cf. Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. Ill. L. Rev. 691, 691 (arguing that with respect to fraud on the market, vicarious entity liability "does not serve the goals of optimal deterrence or optimal risk
have addressed the idea have dismissed it with little analysis. In this post-Enron environment of concerns over corporate accountability and participant behavior, it is time to take seriously the option of holding top corporate officers responsible for the torts of their enterprises.

In a recent Columbia Law Review article, Professor Nina Mendelson offers the most thorough analysis to date of limited shareholder liability's moral hazard, i.e., its encouragement of excessively risky activities. Building on existing scholarship, she contends that the efficiency-based arguments in favor of limited shareholder liability fail to take into account qualitative differences among shareholders, that these arguments at most support limited liability only for small or passive investors, and that the limited liability of controlling shareholders for corporate torts harms social utility. She proposes that all shareholders with the capacity to control corporate activity be held liable for corporate torts and tort-like statutory violations. Professor Mendelson's critique of limited liability is compelling. She demonstrates that the current regime is socially costly and explains why imposing liability on controlling participants is the most efficient way to reduce excessively risky corporate behavior. Nevertheless, her prescription ultimately falls short because, like most previous reform proposals, it seeks to "unlimit" shareholder liability.

Despite scholarly criticisms, limited shareholder liability is an enduring feature of our economic landscape. Since the early twentieth century, state business corporation statutes have limited the liability of shareholders for corporate obligations to the amount of their investment (except in very rare circumstances). These statutes draw spreading" and should be supplanted by a regime of agent liability and criminal enforcement, but distinguishing liability for market fraud from other corporate liabilities in tort). See generally Thompson, supra note 3, at 1-41 (1994) (discussing both managerial and shareholder liability). Professor Kraakman offers a detailed exploration of managerial liability in an early article, suggesting its potential usefulness in some contexts. See Reiner H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 YALE L.J. 857 (1984). But, in a later article proposing pro rata shareholder liability, he rejects managerial liability in certain situations. See Hansmann & Kraakman, supra note 5, at 1928-29.

7. See, e.g., Easterbrook & Fischel, supra note 2, at 61-62 (rejecting managerial liability on overdeterrence grounds); Hansmann & Kraakman, supra note 5, at 1929 (same); see also Gregory Walker, The Personal Liability of Corporate Officers in Private Actions Under the Sherman Act: Murphy Tugboat in Distress, 55 FORDHAM L. REV. 909, 934 n.137 (1987) (noting that holding a corporate officer jointly liable for firm wrongdoing may lead to overdeterrence).

8. See Mendelson, supra note 1, at 1203.

9. See generally id. at 1203-71.

10. See id. at 1271-79.

11. Two minor exceptions are the New York and Wisconsin statutes, which impose liability on some shareholders for wage claims. See N.Y. BUS. CORP. LAW § 103 (McKinney 2003); Wis. STAT. ANN. § 180.0622 (West 2002).
no distinction between controlling and passive shareholders, between closely held and publicly traded firms, or between voluntary and involuntary creditors.12 Moreover, the trend in the last two decades has been towards expanding limited liability protections rather than curtailing them.13 Thus, as an initial matter, statutory reform in favor of unlimiting shareholder liability is a political nonstarter.14

In addition, although courts have utilized various “veil piercing” theories to extend liability to shareholders, such theories cannot serve as a vehicle for meaningful reform. Veil piercing jurisprudence is unpredictable, inconsistent, and largely unprincipled.15 This disarray is a symptom of a more fundamental flaw: courts use veil piercing to extend liability to select shareholders when, in fact, state legislatures have conferred on all shareholders the benefit of limited liability. Whether viewed as a conceptual problem or as a separation-of-powers problem, this dichotomy has led many courts to resist piercing even when extending liability might be efficient or equitable in a given case. For instance, courts almost never pierce based on shareholder control alone.16 Piercing therefore cannot serve as the means of implementing comprehensive reform.

Moreover, a shareholder-based liability regime would be ineffective and may have adverse downstream consequences for corporate governance. For example, under a capacity-to-control liability rule, investors would find ways to maintain control while evading liability or would reduce their equity stake in any one corporation to below the level at which they would face liability. A sophisticated, controlling investor can seek to remain judgment proof by restructuring the enterprise or by redefining its role within the firm.17 On the other hand, if long-term, institutional or fiduciary investors choose to avoid control-based liability by divesting or reducing their equity interests, publicly traded firms will lose a growing, important check against managerial abuse. Thus, although discussion of limited liability has produced many proposals to alter shareholder liability, these proposals are unpersuasive.
In this Article, I argue that there is a better way to link control with accountability in the corporate context and to reduce limited liability's social costs. The corporation's highest-ranking officers, rather than its controlling shareholders, should be vicariously liable for torts of the enterprise. This control-based approach, like Professor Mendelson's, creates a powerful incentive for primary corporate participants to compel the firm to internalize tort risk. It also leaves the beneficial aspects of limited shareholder liability undisturbed and provides an administratively simple enforcement mechanism. My proposal, in fact, offers greater efficiency than shareholder liability regimes. High-ranking corporate officers are the most efficient risk bearers within the corporate enterprise: they are in the best position to monitor and avoid risks, and to determine and bargain for efficient levels of risk spreading among customers, shareholders, and insurers. Furthermore, traditional claims that managerial risk aversion and overdeterrence render officer liability inefficient are no longer convincing. This is due, in part, to the recent emergence of a powerful, highly compensated, and highly mobile top managerial class. This class is less subject to human capital "job lock" than a generation ago, and, given their compensation structure, more risk preferring than their predecessors. Any remaining tendency towards overdeterrence will be constrained by their incentive-based compensation, the equities markets, controlling shareholder oversight, and other factors. Moreover, officer liability would be effective because, in every firm, there will be at least one natural person—a named highest-ranking officer or someone acting in an officer-like capacity—who cannot evade vicarious liability if the entity lacks the capital or insurance to satisfy tort claims.

In addition, holding high-ranking corporate officers vicariously liable for corporate torts is a more realistic proposal than unlimiting shareholder liability. It is consistent with norms and trends elsewhere in the law. For example, Congress, state legislatures, and courts have extended various forms of direct and vicarious liability to corporate controlling persons, a phenomenon reflected in post-Enron legislative and regulatory reforms. And high-ranking officer liability does not depend on statutory reform or on veil piercing. Courts can implement this regime through a natural extension of respondeat superior liability consistent with the predominant, contractarian or "nexus-of-contracts" conception of the firm. Respondeat superior extends vicarious liability to a principal for the tortious activities of
agents subject to the principal's direct control,18 thereby shifting the risk of loss to the person most able to prevent the tortious conduct and spread the risk. The contractarian view of the firm recognizes that the corporation is a hub of contractual relationships between its participants—including shareholders, officers, and creditors—rather than a single, independent actor.19 The law ought to account for the differing inputs and roles of these participants. Thus, when torts are committed within the enterprise, the law of respondeat superior should extend principal liability not only to the firm but also to its highest-ranking officers, since these participants exercise direct control over firm activities and are the firm's most efficient risk bearers. In this way, my proposal offers a realistic means of synthesizing modern tort and corporate law theory, and resolving the lingering conflict between limited liability and the aims of our tort regime.

In Part II, I begin by summarizing the history and parameters of limited liability for firm participants. I then critique corporate veil piercing, limited shareholder liability's most prominent exception, and demonstrate that veil piercing doctrine is inherently flawed. This Part ends with a discussion of recent extensions of controlling person liability, which collectively constitute another growing hole in limited liability's protective shield. Part III explores the potential benefits and costs of limited shareholder liability, focusing largely on efficiency concerns. It then reviews the existing debate between various proponents of reform and defenders of the current regime. This Part concludes with a discussion of why Professor Mendelson's critique of limited liability is the most persuasive to date, but also discusses why her proposed reform, like others, is both infeasible and inadequate. In Part IV, I propose highest-ranking officer liability as an alternative to both the current regime and to other suggested reforms. I begin by explaining why, contrary to the claims of other scholars, an officer-based approach is the most efficient mechanism for retaining the benefits of limited liability while reducing its social costs. I then discuss why highest-ranking officer liability would be more effective than alternatives at preventing judgment evasion. Finally, I establish that my proposal is realistic, demonstrating that it reflects prevailing social norms, can be implemented through an extension of tort principles, and is consistent with both tort and corporate theory.

18. A principal who asserts such direct control over agent activities is a "master" or "employer." An agent subject to such control is a servant or employee. See infra note 50 and accompanying text.

II. AN OVERVIEW OF LIMITED LIABILITY, VEIL PIERCING, AND CONTROLLING PERSON LIABILITY

A. Limited Liability

At the most general level, limited liability refers to the legal default rules that limit the personal liability of a firm's stakeholders and participants for the firm's obligations. Thus, if the firm fails, the stakeholders' or participants' losses are limited to their investments—labor, capital, opportunity costs, etc.—in the firm. Although most commentary focuses on limited liability for shareholders and the owners of other modern entities, theories of limited liability existed long before the modern corporation and extend today to other firm participants, including managers, agents, and creditors.

Methods for achieving limited liability for commercial activity have ancient roots. For example, under Roman law, the master or head of household could use the "peculium," a device that allowed the master or head of household to entrust assets to a slave or son who would then conduct trade with third parties, to invest in and profit from a commercial enterprise while limiting his risk of loss to the amount invested. Other ancient doctrines allowed participants to allocate liability in a variety of ways: the Byzantine "chreokoinonia" provided a means for passive investors to profit from sea ventures while limiting their exposure to the amount invested; conversely, the Digest of Justinian also explicitly provided for limited shareholder liability.

20. See, e.g., Leigh A. Bacon, "Freedom of" or "Freedom from"? The Enforceability of Contracts and the Integrity of the LLC, 50 DUKE L.J. 1087, 1109 (2001) ("[T]he idea of managers being liable without limit while inactive suppliers of capital risked only their capital is ancient." (quoting H.A.J. FORD & R.P. AUSTIN, FORD AND AUSTIN'S PRINCIPLES OF CORPORATIONS LAW 1.230 (7th ed. 1995))); Robert W. Hillman, Liability in Historical Perspective, 54 WASH. & LEE L. REV. 615, 615 (1997) ("[F]or as long as commerce has existed, merchants, financiers, and others associated in business activity have sought to eliminate, minimize, and shift their losses and liabilities.").

21. See, e.g., David Johnston, Limiting Liability: Roman Law and the Civil Law Tradition, 70 CHI.-KENT L. REV. 1515, 1515-16 (1995) (discussing limiting liability under Roman law, including the actio de peculio); David V. Snyder, The Case of Natural Obligations, 56 LA. L. REV. 423, 429 (1995) ("The existence of the peculium in this circumstance made slaves particularly useful for engaging in commerce because limited liability trading . . . was thus possible centuries before the creation of the corporation."). The Digest of Justinian also explicitly provided for limited shareholder liability. See DIG. 3.4.7.1 (Ulpian, Ad Edictum 10) (Alan Watson ed., 1988) ("A debt to a corporate body is not a debt to individuals and a debt of a corporate body is not a debt of individuals.").

22. See, e.g., ROBERT S. LOPEZ, BYZANTIUM AND THE WORLD AROUND IT: ECONOMIC AND INSTITUTIONAL RELATIONS 69-85 (1978); Hillman, supra note 20, at 619; Abraham L. Udovitch,
early Islamic law offered a technique by which a merchant could operate with limited liability while his (more passive) investing partner bore the liability risks. During medieval times, some European traders utilized the "commenda"—containing many of the attributes of the modern limited partnership, most importantly passive investor limited liability—to facilitate larger sea-based ventures. Thereafter, regimes in Continental Europe began to enact limited partnership statutes, and England and the United States followed.

The corporate form emerged in England and the American colonies in the late seventeenth century. Although limited shareholder liability is now the primary benefit of the corporate form, the earliest corporations in England and the United States served other purposes. In the early 1800s, for example, states

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23. See, e.g., Hillman, supra note 20, at 621; see also Daniel Klein, Comment, The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East, 23 Den. J. Int'l L. & Pol'y 535, 539 ("A mudaraba is a limited liability partnership in which one or more people provide 'a fixed amount of disposable money capital.'").

24. See, e.g., Harold J. Berman, Law and Revolution: The Formation of the Western Legal Tradition 353 (1983) (noting that, under the commenda, liability of partners was limited to the amount of their initial investment); Bacon, supra note 20, at 1109 (stating that, under the commenda, "suppliers of capital . . . risked only the amount of their capital"); Paul J. Mahoney, Preparing the Corporate Lawyer: Contract or Concession? An Essay on the History of Corporate Law, 34 Ga. L. Rev. 873, 880-81 (2000) (indicating that the commenda was similar to a limited partnership). Investors in land-based ventures during the same period had no such privileges. See, e.g., Adam B. Weissburg, Note, Reviewing the Law on Joint Ventures with an Eye Towards the Future, 63 S. Cal. L. Rev. 487, 506-07 (1990).

25. See, e.g., Ronald E. Seavoy, The Origins of the American Business Corporation, 1784-1855, at 97-98 (1982) (noting that in 1822, the New York legislature enacted a limited partnership statute that was based on the French commercial code); Blumberg, supra note 3, at 576-85 (discussing England's slow evolution in eliminating direct shareholder liability and the ultimate emergence of limited liability); Hillman, supra note 20, at 626-27. Today, limited partnerships consist of at least one general partner and one limited partner. Limited partners enjoyed limited liability as long as they did not exercise "control" over the affairs of the partnership's business. See Revised Unif. Ltd. P'Ship Act § 303 (2001). The general partner remains subject to personal liability. Id. § 404.

26. 1 Joseph S. Davis, Essays in the Earlier History of American Corporations 30-48, 50 (1965) (discussing colonial corporations chartered in England and mentioning that in 1641 "the first of the score or more incorporated boroughs and cities was chartered in Maine"); Seavoy, supra note 25, at 3-4 (stating that Massachusetts enacted "a general regulatory statute for towns as early as 1635"); Susan Pace Hamill, The Origins Behind the Limited Liability Company, 59 Ohio St. L.J. 1459, 1485 (1998) ("Corporations have existed in America since the earliest colonial days.").

27. See, e.g., I. Maurice Wormser, Disregard of the Corporate Fiction and Allied Corporation Problems 14 (1927); Thompson, supra note 3, at 6.

28. Mendelson, supra note 1, at 1209 n.15 (noting corporate features predating limited liability).
granted the privilege of incorporation for other reasons, such as facilitating building projects or other activities that enhanced the public welfare. These charters did not provide for limited liability, and some expressly provided for full shareholder liability. As states began to extend the privilege of incorporation more broadly, they did not necessarily provide limited liability as well. Indeed, many state statutes provided that shareholders were liable for amounts in excess of their investment.

By the end of the nineteenth century, however, most states had enacted corporation statutes that provided limited shareholder liability. There is some disagreement over why limited liability

29. See, e.g., HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 26 n.7 (3d ed. 1983) (noting that under special acts of state legislatures, incorporated businesses usually consisted of “public utility-type enterprises”); SEAVOY, supra note 25, at 5 (stating that the earliest method for creating a corporation was by individual charter and that such a mode “assumed that corporations were legally privileged organizations that had to be closely scrutinized by the legislature because their purposes had to be made consistent with public welfare”); see also Steven C. Bahl, Application of Corporate Common Law Doctrine to Limited Liability, 55 MONT. L. REV. 43, 55 (1994) (noting that in the early to mid-1800s, states placed substantial limitations on corporations and corporate activity).

30. Some charters did not provide for limited liability. See, e.g., Merrick Dodd, The Evolution of Limited Liability in American Industry: Massachusetts, 61 HARV. L. REV. 1351, 1356 (1948) (“Several of the early Massachusetts manufacturing corporation charters were completely silent with respect to what rights, if any, corporate creditors would have against individual shareholders.”); Morton J. Horwitz, Santa Clara Revisited: The Development of Corporate Theory, 88 W. VA. L. REV. 173, 208 (1985) (“[T]ruly limited shareholder liability was far from the norm in America even as late as 1900.”). But see Blumberg, supra note 3, at 588-89 (noting that there were some early examples of limited liability in New York). Other charters expressly provided for full shareholder liability. See, e.g., id. at 588 (discussing such charters in New England states and New York); William J. Carney, Limited Liability Companies: Origins and Antecedents, 66 U. COLO. L. REV. 855, 873 (1995) (stating that many incorporated companies lacked limited shareholder liability during this period); Stephen B. Presser, Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics, 87 NW. U. L. REV. 148, 155 (1992) (“In the beginning of the nineteenth century, state legislators tended to impose unlimited liability on corporate shareholders . . . .”).

31. See Blumberg, supra note 3, at 577 (“[Limited liability] arose in the wake of the acceptance of the entity concept but not as a necessary consequence.”); Leebron, supra note 1, at 1567 (stating that limited liability “gradually became a fixture of the law between the seventeenth and nineteenth centuries”).

32. See, e.g., J. William Callison, Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded, 26 J. CORP. L. 951, 972 n.153 (2001) (“In fact, throughout the nineteenth century, shareholders did not enjoy complete limited liability protection since state statutes made them liable to creditors of insolvent corporations for up to twice the value of their stock . . . .”); Carney, supra note 30, at 873 n.95 (“In New York, shareholders in manufacturing corporations bore double liability until all stated capital was paid until 1828.”).

33. Janet Cooper Alexander, Unlimited Shareholder Liability Through a Procedural Lens, 106 HARV. L. REV. 387, 415 (1992) (“By 1850, most states had enacted statutes providing for limited liability.”); Blumberg, supra note 3, at 593-94 (discussing the legislative development of limited liability in several industrial states). However, as recently as 1931, California law imposed personal liability on shareholders on a pro rata basis. See Amalia D. Kessler, Limited
became universally accepted. Some observers believe that politically powerful industrialists used their influence to extend limited liability; others argue that limited liability was the product of an ideological commitment to economic democracy and the corresponding belief in broad-based entrepreneurialism. Still others contend that legislators simply became convinced that limited liability would enhance capital formation and commercial activity. What does appear largely undisputed, however, is that early proponents of limited shareholder liability were primarily concerned with limiting investor exposure to the firm’s contract creditors.

Today, the vast majority of state corporation statutes expressly provide for limited shareholder liability and the remaining statutes clearly imply it. The Model Business Corporation Act, for example, provides that “[u]nless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become liable by reason of his own acts or conduct.” Similarly, the Delaware General Corporation Law provides that, as the default rule,
shareholders are not personally liable for corporate debts "except as they may be liable by reason of their own conduct or acts."^{40}

This statutory protection is both unqualified and universal. Absent circumstances giving rise to direct liability—e.g., tortious or criminal conduct or an independent statutory cause of action—a shareholder enjoys limited liability regardless of the firm's status as closely held or publicly traded, the size of the shareholder's stake in the firm, the level of the shareholder's involvement in the management of the firm's affairs, or the contractual, tortious, or statutory nature of the firm's liability.\textsuperscript{41} In other words, state corporation statutes plainly provide shareholders far-reaching protection against vicarious liability for firm obligations.

Statutorily sanctioned limited liability for equity stakeholders continues to expand. All states have recently enacted statutes extending the privilege of limited liability to equity stakeholders in firms other than corporations and limited partnerships. For example, all states now allow firms to organize as limited liability companies ("LLCs") and limited liability partnerships ("LLPs").\textsuperscript{42} Although there are some variations, LLC statutes generally treat the owners of the firm ("members") like corporate shareholders for purposes of limited liability.\textsuperscript{43} LLPs sometimes provide more qualified protection. LLP statutes usually shield partners from liability for firm contractual obligations, but some of these statutes require the purchase of a minimum level of malpractice insurance and provide that a partner remains liable for torts committed by an employee or agent within the partner's sphere of control.\textsuperscript{44}

Because these "hybrid" entities offer limited liability for equity stakeholders, allowing participation by professionals unable to incorporate and providing organizational flexibility and elective tax treatment, these hybrids have experienced explosive growth over the last decade. Indeed, while corporations remain dominant in terms of

\begin{footnotes}
\item[{40}] DEL. CODE ANN. tit. 8, § 102(b)(6) (2002).
\item[{41}] Again, the New York and Wisconsin statutes impose liability on some shareholders for wage claims. \textit{See supra} note 11.
\item[{42}] \textit{See, e.g.}, Larry E. Ribstein, \textit{Limited Liability Unlimited}, 24 DEL. J. CORP. L. 407, 407 (1999). Most state legislatures have also recognized limited liability limited partnerships ("LLLPs"), which provide, within certain limits, greater protection for the limited partnership's general partners.
\item[{43}] \textit{See Huss, supra} note 4, at 101-02.
\item[{44}] \textit{See id.} (citing jurisdictions that provide mandatory insurance requirements for LLPs and discussing how some jurisdictions extend liability to an LLP partner for tortious conduct committed by someone under the partner's direct supervision).
\end{footnotes}
total economic output, hybrid entities are now, in many contexts, the forms of choice for closely held firms.

Yet equity stakeholders are not the only firm participants that enjoy limited liability. Again, absent tortious conduct or statutory violations on their part, firm officers, employees, agents, and creditors generally need not account for firm obligations or losses. Thus, like equity stakeholders, these participants risk only their investment (e.g., capital, labor, loans, opportunity costs) in the firm.

Importantly, however, the limits on liability for these participants usually are not statutory, but rather derive from agency and tort principles. Once courts recognized the separate legal existence of the corporation, they extended this fiction—albeit somewhat mechanically—to the agency context. Thus, the entity itself, not the person(s) managing its affairs and/or benefiting from its existence, is the principal and master. Corporate officers and other agents are simply agents of the entity. Directors, although not formally agents because their role is to manage the affairs of the

45. Mendelson, supra note 1, at 1208 (citing statistics showing the overwhelming dominance of corporations in terms of economic output).
46. See Huss, supra note 4, at 97-98 (describing the growth in LLCs as “tremendous”).
47. Individuals committing torts or statutory violations are always individually liable. See, e.g., Thompson, supra note 3, at 7 (discussing agency principles).
48. See Easterbrook & Fischel, supra note 2, at 40 (noting that no one—shareholders, workers, or voluntary creditors—risks more than he invests).
49. Thompson, supra note 3, at 6-7. A few statutes limit director and officer liability, but the meaning of these statutes is at best unclear. Most likely, they codify the common-law rule that agents are not liable in contract for acts committed within the scope of their authority. For example, the Model Business Corporation Act states that an officer is not liable for actions taken as an officer, but, because this section contains a cross-reference to the officer’s “discretionary authority,” it appears to address contract claims. See MODEL BUS. CORP. ACT § 8.42(a), (d) (3d ed. Supp. 1997); see also Thompson, supra note 3, at 6 n.22 (stating that this section appears to have no impact on tort liability).
50. See, e.g., Meyer v. Holley, 537 U.S. 280, 282 (2003) (holding, in a unanimous opinion, that a corporate officer of a real estate company is not vicariously liable for the violations of the Fair Housing Act committed within the scope of the enterprise, because traditional tort principles provide that the corporate entity, not its officers or shareholders, is the “employer” for purposes of vicarious liability); Kinney Shoe Corp. v. Polan, 939 F.2d 209, 211 (4th Cir. 1991) (“We have long recognized that a corporation is an entity, separate and distinct from its officers and stockholders . . . .”); Dutton & Vaughan, Inc. v. Spurney, 600 So. 2d 693, 697 (La. Ct. App. 1992) (“Corporations are distinct legal entities, separate from the individuals who comprise them.”); see also Leonard v. McMorris, 63 P.3d 323, 330 (Colo. 2003) (“Corporate officers occupy the position of agents in relation to third persons dealing with the corporation. Therefore, personal liability of officers is governed by principles of agency law.”). Today, the master-servant relationship is often referred to as the employer-employee relationship. See generally RESTATEMENT (THIRD) OF AGENCY (Tentative Draft No. 2, 2001). Neither set of terms is particularly appropriate: for example, “employer-employee” can be misleading because, provided it exercises enough control, a corporation can be the “employer” of another corporation, subjecting it to respondent superior liability. See, e.g., infra note 106 (discussing cases).
51. See, e.g., Leonard, 63 P.3d at 330.
entity, likewise are not principals or co-principals. Similarly, absent the unusual circumstance in which a creditor exercises or bargains for the right to exercise principal or master-like control over the entity, a creditor is not the principal or master with regard to entity activities.

The entity's status as the principal/master limits liability for nonshareholder participants in both contract and tort settings. When a participant acting on behalf of the corporation enters into an authorized transaction with a third party, the transaction binds only the corporation. Thus, the transacting participant—officer, employee, or authorized agent—is not liable to the third party. In addition, although a participant is always personally liable for torts she commits within the scope of the corporate enterprise, the doctrine of respondeat superior extends vicarious tort liability only to the entity. Similarly, only the entity is liable for forms of enterprise liability in

52. Directors are sui generis. Acting in their capacity as members of the board of directors or a board committee, they are neither agents nor officers. See, e.g., First Valley Bank of Los Fresnos v. Martin, 55 S.W.3d 172, 183 (Tex.App. 2001) (“A director of a corporation is not, as such, an agent of the corporation.”) (citing to RESTATEMENT (SECOND) OF AGENCY § 14C (1958)); see also MODEL BUS. CORP. ACT § 1.40(8) (2002) (defining “employee” to include officer but not director).

53. On rare occasions, courts have held creditors exercising substantial control over corporate affairs liable as principals or masters of the entity. See, e.g., A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 293 (Minn. 1981) (holding that there was a master/servant relationship between the two parties, but noting that this was a “unique fabric” and varied from the normal debtor/creditor situation).

54. See, e.g., Leonard, 63 P.3d at 330 (“Generally, a corporate officer acting in his or her representative capacity and within his or her actual authority is not personally liable for such representative acts . . . .”); Winkler v. V.G. Reed & Sons, Inc., 638 N.E.2d 1228, 1231 (Ind. 1994) (“It is a matter of black-letter law that where the agent acted within the scope of the agent's authority in signing a contract on behalf of the principal, the remedy of one seeking to enforce the contract is against the principal and not the agent.”); Dutton & Vaughan, 600 So. 2d at 697 (stating that, absent his purporting to bind himself individually, an officer or director does not incur personal liability for the debts of the corporation). If an agent enters into a truly unauthorized transaction, the third party cannot hold the principal liable. See RESTATEMENT (SECOND) OF AGENCY § 140 (1958).

55. Under the doctrine of respondeat superior, a master is liable for the torts of his servants acting within the scope of employment. RESTATEMENT (SECOND) OF AGENCY § 219. A master “is a principal who employs an agent to perform service in his affairs and who controls or has the right to control the physical conduct of the other in the performance of the service.” See id. § 2. When the employee works for a corporation, the corporation is the principal/master. See, e.g., Bagsby v. Gehres, 195 F. Supp. 2d 957, 964 (E.D. Mich. 2002) (“Acts within the scope of the agent's employment are imputed to the principal corporation.”); see also Browning-Ferris Indus., Inc. v. Ter Maat, 195 F.3d 953, 956 (7th Cir. 1999) (stating that there is no doctrine of “superiors' liability” and that, under the doctrine of respondeat superior, only the employer is strictly liable); Wellborn v. Mountain Accessories Corp., 23 F. Supp. 2d 1321, 1327-28 (D. Wyo. 1998) (stating that an officer is only liable to a third party if he or she "directs or participates actively in the commission of a tortious act").
tort, such as liability arising from product defect claims. Thus, agency and tort principles, as currently applied in the corporate context, limit contract liability to the entity and tort liability to individual tortfeasors (if any) and the entity.

Taken together, these statutory and common-law doctrines form a fairly preclusive web of protection for corporate participants. In this country, the protection for equity stakeholders has expanded over time, from fairly restrictive forms such as limited partnerships, to general protection for corporate shareholders, to very recent recognition of hybrid limited liability entities. The common-law protections for other participants have, for the most part, held fast over the last century.

However, there are three important holes in this web. First, limited liability is merely the default rule. Thus, parties transacting business with the firm can and often do bargain for greater protection by requiring corporate participants personally to guarantee satisfaction of corporate obligations. Second, equity stakeholders may lose their limited liability protection via one or more "veil-piercing" or "disregard of the corporate form" theories. Third, Congress, state legislatures, and some courts recently have extended various forms of controlling person liability to firm participants who otherwise would enjoy limited liability. Because the latter two "exceptions" to limited liability are involuntary and the subject of much scholarly attention, they are worthy of further exploration.

B. Veil Piercing

When a firm is insolvent, the firm creditors often seek legal theories to hold firm participants liable. The most prominent of these approaches is veil piercing. Since the nineteenth century, courts have been willing in some circumstances to "pierce" the "veil" of limited liability or otherwise "disregard the corporate entity" to impose liability on shareholders. Although courts rely on similar underlying

56. See, e.g., Lobato v. Pay Less Drug Stores, Inc., 261 F.2d 406, 409 (10th Cir. 1958) (stating that officers and agents are not liable along with the corporation in a products liability action).

57. See Lumbermen's Mut. Cas. Co. v. Thornton, 92 S.W.3d 259, 270 (Mo. Ct. App. 2002) ("[N]ormally, the acts of a corporation's agent are imputable to its principal.").

58. See supra notes 38-40 and accompanying text.

59. Booth, supra note 4, at 143 (stating that contract creditors will often negotiate for personal guarantees in the closely held context).

60. See, e.g., I. Maurice Wormser, Piercing the Veil of Corporate Entity, 12 COLUM. L. REV. 496, 517 (1912) (discussing veil piercing in the late nineteenth and early twentieth centuries).
theories, there is great inconsistency between jurisdictions with respect to outcomes.\textsuperscript{61}

The dysfunctional nature of the doctrine has produced a steady stream of critical commentary, culminating in Professor Bainbridge's recent proposal to abolish veil piercing.\textsuperscript{62} Yet, importantly, many scholars and courts still view veil piercing as a vehicle for addressing limited liability's perceived inefficiencies or inequities. As I detail here, however, veil piercing cannot serve such ends.

Despite enormous variation in application, there are four basic common-law theories for piercing the corporate veil or disregarding the corporate entity: 1) fraud, 2) "alter ego" or "mere instrumentality," 3) enterprise entity, and 4) agency. Courts often are unclear as to which theory they are applying; some use these terms interchangeably, and others seem to combine different theories into a single analytical framework. Interestingly, the New York Court of Appeals mentioned each of these theories in its seminal \textit{Walkovszky v. Carlton} decision.\textsuperscript{63} Like many piercing decisions, however, \textit{Walkovszky}'s analysis is cursory and confusing, providing little guidance for future cases.

Briefly, the first and least controversial piercing theory is premised on shareholder fraud. Courts will pierce the veil when a shareholder uses the corporate entity to further a fraud, mislead creditors transacting business with the entity, fraudulently transfer funds out of the corporation, or otherwise engage in fraudulent or deceitful activity within the corporate enterprise.\textsuperscript{64}

The second theory, often labeled either the "alter ego" or "mere instrumentality" doctrine, premises shareholder liability on the "unity of interest" or lack of separation between the shareholder and the

\textsuperscript{61} Bainbridge, \textit{supra} note 1, at 554-55 (stating that the standards for veil piercing are vague and produce uncertainty and unpredictability).

\textsuperscript{62} \textit{Id.} at 521, 554-74. Professor Bainbridge advocates abolishing veil piercing. In its place, he proposes a direct liability regime for shareholders who engage in wrongful conduct such as fraud and an enterprise liability regime for certain parent-subsidiary groups. \textit{See id.} at 521-22, 554-74.

\textsuperscript{63} 223 N.E.2d 6 (N.Y. 1966). \textit{Walkovszky} was a struck by a cab operated by the Seon Cab Corp. \textit{Id.} at 7. Carlton owned Seon and nine other taxicab corporations, each owning only two cabs and carrying only the minimum liability insurance required by applicable law. \textit{Id.}

\textsuperscript{64} \textit{See} ALFRED A. CONRAD, \textit{CORPORATIONS IN PERSPECTIVE} 431 (1976) (discussing misleading creditors as a basis for piercing the corporate veil and citing \textit{Weisser v. Mursam Shoe Corp.}, 127 F.2d 344, 346 (2d Cir. 1942), as an example of this theory). Of course, as \textit{Walkovszky} makes clear, incorporation itself or dividing a single enterprise into multiple entities as a means of judgment proofing does not constitute fraud. \textit{See} 223 N.E.2d at 10. Some courts have held that structural changes to avoid an already existing liability may constitute fraud. \textit{See, e.g.}, \textit{Parker v. Bell Asbestos Mines, Ltd.}, 607 F. Supp. 1397, 1403-04 (M.D. Pa. 1985).
corporate entity. Courts have reasoned that when a shareholder fails to maintain or shows disrespect for the distinctiveness of the entity, the shareholder loses the benefit of asserting the legal separateness of the entity for purposes of limiting liability. Courts articulate varying tests and factors for determining whether to pierce under this type of theory. Yet, at minimum, there must be shareholder control of the entity and other circumstances—including undercapitalization, lapses in corporate formalities, or utter shareholder domination—suggesting a lack of distinction between the shareholder and the corporation. Some courts also impose an additional requirement that the shareholder misuse the corporate form, such as to perpetrate a fraud or illegal activity, or otherwise

65. See Sonora Diamond Corp. v. Superior Court, 99 Cal. Rptr. 2d 824, 836 (Ct. App. 2000) (noting that California piercing law requires a showing of “unity of interest” between the shareholder and the corporation). Courts do not always use the terms “alter ego” and “mere instrumentality” interchangeably. They sometimes articulate different tests based on the chosen label. For example, Mid-Century Insurance Co. v. Gardner, 11 Cal. Rptr. 2d 918, 922 (Ct. App. 1992), contains a common description of alter ego doctrine as embodying two elements: “(1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow” (citation and internal quotation marks omitted). Courts that expressly follow an instrumentality theory often apply a three-prong test:

(1) Control, not mere majority or complete stock control, but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own; and (2) Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of plaintiff’s legal rights; and (3) The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.

Glenn v. Wagner, 329 S.E.2d 326, 330 (N.C. 1985). I view these theories as essentially the same because, despite their differing articulations, they are premised on the lack of any de facto distinction between the shareholder and the corporation. Courts also have described this type of theory as holding a shareholder liable for acts of its corporate “dummy.” See, e.g., Walkovsky, 223 N.E.2d at 8.

66. See supra note 65 (setting forth the commonly articulated tests for piercing pursuant to this theory).

67. Bainbridge, supra note 1, at 547 (“[I]t seems clear that control is an essential prerequisite for holding a shareholder liable.”). Professor Bainbridge contends that courts applying the instrumentality rule often require shareholder control that is so complete as to “amount to total domination of finances, policy, and business practices such that the controlled corporation has no separate mind, will, or existence” and the use of such control to commit fraud, a violation of the plaintiff’s rights, or some other wrong. Id. at 547-48 (citing cases).

68. See, e.g., Carte Blanche (Sing.) Pte. v. Diners Club Int’l, Inc., 2 F.3d 24, 26 (2d Cir. 1993) (stating that the corporate veil can be pierced “‘when the corporation has been so dominated by an individual or another corporation . . ., and it [sic] separate identity so disregarded, that it primarily transacted the dominator’s business rather than its own and can be called the other’s alter ego’ ” (quoting Gartner v. Snyder, 607 F.2d 582, 586 (2d Cir. 1979))); Bainbridge, supra note 1, at 547-48.
engage in conduct that promotes injustice (beyond the mere inability of the plaintiff to receive complete relief). 69

The "enterprise entity" or "enterprise liability" doctrine provides a third theory for reaching shareholder assets. 70 This theory allows courts to extend liability within corporate groups, including parent-subsidiary relationships and other groups of aligned or affiliated entities. 71 Enterprise entity doctrine provides that when two or more firms are in fact conducting business as a single enterprise, a plaintiff ought to be able to collect a judgment out of the assets of all firms making up the enterprise. 72 Unlike the other piercing theories, it facilitates a horizontal form of liability—access to assets of aligned or affiliated entities that are not shareholders—as well as a vertical form of liability (to reach the assets of the parent-shareholder). 73 Although courts articulate a variety of grounds for imposing liability on a parent corporation under this theory, at minimum there must be such a unity of interest—including substantial parent control and overlapping

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69. See, e.g., Perpetual Real Estate Servs., Inc. v. Michaelson Props., Inc., 974 F.2d 545, 548 (4th Cir. 1992); Sea-Land Servs., Inc. v. Pepper Source, 941 F.2d 519, 524 (7th Cir. 1991); Minifie v. Rowley, 202 F. 673, 676 (Cal. 1921); see also Bainbridge, supra note 1, at 548-49 (noting that courts that require fraud or injustice require more than the absence of sufficient funds to satisfy the claim); cf. Hystro Prods., Inc. v. MNP Corp., 18 F.3d 1384, 1390 (7th Cir. 1994) (stating that to show injustice requires "something less than an affirmative showing of fraud"). But other courts do not require fraud. See, e.g., In re Silicone Gel Breast Implants Prod. Liab. Litig., 887 F. Supp. 1447, 1452-53 (N.D. Ala. 1995) ("Although the standards are not identical in each state, all jurisdictions require a showing of substantial domination .... Delaware courts... do not necessarily require a showing of fraud, if a subsidiary is found to be the mere instrumentality or alter ego of its sole stockholder.").

70. Some commentators do not consider the enterprise entity theory to be a "veil piercing" theory. Professor Bainbridge, for example, argues that enterprise entity theory is not a veil piercing doctrine because it is premised on holding an entire enterprise liable despite the presence of separately incorporated entities. See Bainbridge, supra note 1, at 566. In fact, he ultimately concludes that veil piercing in the parent-subsidiary context is, in substance, an aspect of enterprise liability. See id. at 568.


72. See, e.g., Bainbridge, supra note 1, at 566-67.

73. See, e.g., Gartner v. Snyder, 607 F.2d 582, 585 (2d Cir. 1979) (horizontal liability between three overlapping entities used to develop housing); Walkovszky, 223 N.E.2d at 7 (horizontal liability between the ten taxicab companies); see also Carte Blanche, 2 F.3d at 26 (vertical liability between parent and subsidiaries). Texas courts have analogized this form of liability to partnership liability. See N. Am. Van Lines, Inc. v. Emmons, 50 S.W.3d 103, 119 (Tex. App. 2001) ("The single business enterprise theory relies on equity analogies to partnership principles of liability."). The Emmons court also required a "common business purpose" among the constituent entities. Id. (citing Aluminum Chem. (Bol.), Inc. v. Bechtel Corp., 28 S.W.3d 64, 68 (Tex. App. 2000)).
operations—between the entities that they are in fact operating as a single enterprise.\textsuperscript{74}

The final doctrine is the "agency" theory. As its name suggests, this theory purports to apply agency principles to hold a shareholder personally liable as a "principal" when the shareholder treats or uses the corporate entity as its "agent."\textsuperscript{75} Courts have not articulated with precision a test for determining when a shareholder's actions create an agency relationship. In fact, most courts, including the \textit{Walkovszky} court, mention agency but apply an alter ego analysis.\textsuperscript{76} While shareholder control or domination of the entity is an essential element in this analysis, courts almost always require more than principal-like control or domination to pierce via the agency doctrine.\textsuperscript{77}

Although these four theories have gained widespread acceptance, application of these doctrines is uncertain, inconsistent, and shrouded in the "mists of metaphor."\textsuperscript{78} Courts applying these doctrines—in particular, the alter ego, enterprise entity, and agency theories—tend to make broad announcements of policies or offer unwieldy lists of factors, without providing much useful analysis or

\textsuperscript{74} See, e.g., Pan Pac. Sash & Door Co. v. Greendale Park, Inc., 333 P.2d 802, 806 (Cal. Dist. Ct. App. 1958). Courts are split on whether the enterprise entity theory requires some form of bad faith or fraud. \textit{Compare In re Sunstates Corp. S'holder Litig.}, 788 A.2d 530, 534 (Del. Ch. 2001) ("For the purposes of the corporation law, the act of one corporation is not regarded as the act of another merely because the first corporation is a subsidiary of the other, or because the two may be treated as part of a single economic enterprise for some other purpose. Rather, to pierce the corporate veil based on an agency or 'alter ego' theory, 'the corporation must be a sham and exist for no other purpose than as a vehicle for fraud.'") (quoting \textit{Wallace v. Wood}, 752 A.2d 1175, 1184 (Del. Ch. 1999)), \textit{with Emmons}, 50 S.W.3d at 119 ("To recover under a finding of a single business enterprise, no proof of fraud is required ... .")

\textsuperscript{75} See, e.g., \textit{Walkovszky}, 223 N.E.2d at 8 ("[W]henever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts 'upon the principle of respondeat superior applicable even when the agent is a natural person.'") (quoting \textit{Rapid Transit Subway Constr. Co. v. City of New York}, 259 N.Y. 472, 488 (1932)).

\textsuperscript{76} Id. at 10. Although courts generally do not distinguish the two theories, they are conceptually distinct. See, e.g., Sonora Diamond Corp. v. Superior Court, 99 Cal. Rptr. 2d 824, 837 (Ct. App. 2000) (noting that many courts have failed to distinguish between an agency analysis and an alter ego analysis). Indeed, if courts took the agency theory seriously, neither the lack of formalities nor shareholder misconduct would be required. Rather, courts would simply determine whether the shareholder exercised sufficient control—or had the right to exercise such control—to be considered a principal, or, in the tort context, a master. See \textit{Restatement (Second) of Agency} §§ 1-2 (1958). If so, then the shareholder would be strictly liable for authorized corporate transactions or torts committed within the corporate enterprise. See \textit{id.} § 219(1).

\textsuperscript{77} \textit{See In re Sunstates}, 788 A.2d at 534 ("[T]o pierce the corporate veil based on an agency or 'alter ego' theory, 'the corporation must be a sham and exist for no other purpose than as a vehicle for fraud.'") (quoting \textit{Wallace}, 752 A.2d at 1184))

\textsuperscript{78} Bainbridge, \textit{supra} note 1, at 546 (quoting Berkey v. Third Ave. Ry., 155 N.E. 58, 61 (N.Y. 1926)); see also Thompson, \textit{supra} note 3, at 9 (stating piercing is best described as "open-ended").
guidance. At the same time, they conflate the various theories; for example, courts utilize many of the same factors in determining whether to hold a shareholder liable under the three non-fraud theories. According to Professor Bainbridge, existing veil-piercing doctrine is so vague and unpredictable that it allows individual judges to "impose their own brand of rough justice without being overly concerned with precedent or appellate review."

There are, however, a few sensible trends in the application of piercing doctrine. First, it is largely beyond dispute that fraudulent conduct serves as a basis for finding shareholder liability in the contract setting. Of course, in many circumstances, shareholder fraud may support direct rather than vicarious shareholder liability. The broad acceptance of the fraud theory therefore may simply be a recognition that reliance-inducing shareholder misrepresentations and fraudulent transfers of assets create direct tort liability.

79. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 54-55 (stating that the standard formulations are "singularly unhelpful"); Bainbridge, supra note 1, at 553 ("Judicial opinions in this area tend to open with vague generalities and close with conclusory statements with little or no concrete analysis in between."). Professor Bainbridge argues, for example, that courts are sloppy in applying the instrumentality doctrine. Id. at 548. He also summarizes the unwieldy "laundry list" of factors many courts adopt. Id. at 549-51 (quoting and citing cases).

80. In Walkovszky, for example, the court essentially treated the agency and alter ego theories as a single theory. See 223 N.E.2d at 8-10; Bainbridge, supra note 1, at 568 ("The observant reader will note substantial overlap between the factors considered in enterprise liability cases... and the veil piercing cases.").

81. Bainbridge, supra note 1, at 555. To make matters worse, in some contexts it is not clear which jurisdiction's piercing law—state versus state or state versus federal—should apply. See, e.g., United States v. Bestfoods, 524 U.S. 51, 63-64 n.9 (1998) (noting that there is disagreement whether federal or state common law applies to CERCLA indirect liability, and declining to resolve the issue).

82. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 58 (arguing that fraud and misrepresentation justify piercing); Bainbridge, supra note 1, at 543 ("If the shareholder in some way deceived the creditor into believing that the corporation had adequate assets to cover its obligations and the creditor, relying on that misstatement, failed to demand a personal guarantee, the shareholder ought to end up being held liable."); Thompson, supra note 3, at 9.

83. See, e.g., Bainbridge, supra note 1, at 521-22; see also Thompson, supra note 3, at 10 ("When the shareholder behind the veil actively participated in the act leading to liability, there is no need to use piercing... .")

84. See, e.g., Bainbridge, supra note 1, at 521-22. Professor Bainbridge argues that in many piercing cases, the plaintiff could have brought a direct action because the shareholder-defendant either misled the creditor or was otherwise a joint tortfeasor. Id. at 556. He contends the fraud theory should be retained as a form of direct liability, at least when shareholder fraud leads creditors to forgo protections or fraudulently transfers funds out of the corporation. See id. at 556-57. Indeed, the less similar the allegedly wrongful shareholder conduct is to common-law fraud, the less likely that piercing will succeed. Although some courts do not require actual fraud, the language they use suggests that something close to common-law fraud is required. See, e.g., Hystr Prods. v. MPN Corp., 18 F.3d 1384, 1390 (7th Cir. 1994) (noting that the "promote injustice" test requires something less than an affirmative showing of fraud, but it requires something more than the mere prospect of an unsatisfied judgment); Sea-Land Servs.,
piercing occurs only in the closely held context.\textsuperscript{85} This distinction between closely and publicly held firms is consistent with some of the efficiency-based justifications for limited liability discussed in the next section.\textsuperscript{86} Third, more courts now require a misrepresentation or other deceptive conduct for piercing in the contract (voluntary creditor) context.\textsuperscript{87} This narrowing of the doctrine makes sense, given that contract creditors bargaining at arm's length are often able, absent fraud, to protect themselves from the risks of limited shareholder liability through a variety of means.\textsuperscript{88}

Yet other aspects of piercing doctrine make no sense and promote neither efficiency nor other normative aims.\textsuperscript{89} For example, in the closely held context, piercing occurs sporadically, and, again, absent fraud or statutory violations, it is difficult to predict when a court will pierce.\textsuperscript{90} Because piercing is both rare and unpredictable, it is unlikely to have any meaningful effect on internalizing risk or on increasing firm monitoring, and is unlikely to promote equitable

Inc. v. Pepper Source, 941 F.2d 519, 523 (7th Cir. 1991) ("Some element of unfairness, something akin to fraud or deception or the existence of a compelling public interest must be present in order to disregard the corporate fiction." (internal quotation marks omitted)); Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806, 813 (Ct. App. 1963) ("[W]hile the doctrine does not depend on the presence of actual fraud, it is designed to prevent what would be fraud or injustice if accomplished. Accordingly, bad faith in one form or another is an underlying consideration and will be found... in those cases wherein the trial court was justified in disregarding the corporate entity.").

85. See generally Robert Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036 (1991) (finding no piercing to reach shareholders in publicly traded corporations and, hence, piercing was limited to close corporations and corporate groups).

86. As discussed below, scholars contend that the externalization of risk onto creditors is more likely in the close corporate context because firm management and ownership tend to overlap, and shareholder-managers are more likely to engage in risky behavior than managers in publicly traded firms. See discussion infra Part III.B. This is also consistent with Professor Bainbridge's view that shareholders who are natural persons should be liable only for their direct acts. See Bainbridge, supra note 1, at 556-57 (noting that the focus on personal conduct of shareholders "effectively incorporates the important distinction between public and close corporations").

87. See, e.g., Perpetual Real Estate Servs., Inc. v. Michaelson Props., Inc., 974 F.2d 545, 550 (4th Cir. 1992) ("[I]n [contract] cases, courts have required proof of some form of misrepresentation to the creditor."; see also supra note 69.

88. See discussion infra Part III.A; see also EASTERBROOK & FISCHEL, supra note 2, at 55 n.8 ("There is no reason to disregard a 'shell' corporation in favor of a creditor that can negotiate for such protection as it desires. Courts routinely enforce limited liability in such cases... ."); Bainbridge, supra note 1, at 557-59 (arguing contract creditors should be able to hold shareholders liable only when the shareholders have defrauded the creditor or later siphoned away funds); Thompson, supra note 3, at 12-13 (noting that few question limited liability in the bargain setting for a variety of reasons).

89. Bainbridge, supra note 1, at 555.

90. See, e.g., id.; Easterbrook & Fischel, supra note 2, at 89.
outcomes across similarly situated firms and creditors.\textsuperscript{91} In addition, the most comprehensive empirical study suggests that piercing occurs no more frequently in the (non-fraud) tort context than in the contract context.\textsuperscript{92} This is particularly troubling, given that contract creditors are usually better able to protect themselves from the firm's externalization of costs—limited liability's moral hazard—than are tort creditors.\textsuperscript{93}

Moreover, regardless of the underlying theory, many courts cling to, as a prerequisite for piercing, the failure to maintain corporate formalities or "corporate separateness."\textsuperscript{94} This focus is a product of the antiquated notion that firms somehow exist and act independently from their primary participants, including their shareholders.\textsuperscript{95} Thus, the analysis is flawed from the start: shareholders necessarily seek to achieve their own preferences rather than hypothesized corporate ends, whether or not formalities are maintained.\textsuperscript{96} What is even more troubling, however, is that the inquiry into formalities and separateness is, as a matter of efficiency

\textsuperscript{91} See, e.g., Bainbridge, \textit{supra} note 1, at 564 (noting that the small number of piercings and seemingly arbitrary outcomes suggest that piercing may not have any effect on the internalization of risk).

\textsuperscript{92} In his extraordinary empirical study, Professor Thompson found more contract piercings than tort piercings, and a greater creditor success rate in contract cases than tort cases. Thompson, \textit{supra} note 85, at 1058 (finding 779 contract veil piercing cases and only 226 tort piercing cases, and finding a contract creditor success rate of 42 percent and a tort creditor success rate of 31 percent). Professor Thompson admits potential bias in the data based on settlements and other factors, and he notes that courts refused to pierce in a high percentage of the contract cases that did not involve some kind of misrepresentation. \textit{See id.} at 1046, 1063. Nevertheless, the low rate of success in non-fraud tort cases is troubling, as is the difference in the total number of tort and contract piercings.

\textsuperscript{93} \textit{See infra} notes 227-237 and accompanying text.

\textsuperscript{94} See Campbell, \textit{supra} note 71, at 43 ("The failure to maintain the requisite corporate formalities substantially increases the probability that the corporate existence will be disregarded."). In his study of piercing cases, Professor Thompson found that courts pierce in two-thirds of the cases in which they find that the defendant has failed to comply with corporate formalities, and decline to pierce in almost all (over 90 percent) of the cases in which they find that the defendant complied with formalities. \textit{See Thompson, supra} note 85, at 1063-65. Such formalities may include holding annual board of director meetings, maintaining separate bank accounts, recording all transactions in the corporate books, formalistically separating firm functions from those of related firms, and compliance with other traditional corporate practices. Sometimes, it also refers to undercapitalization.

\textsuperscript{95} See, e.g., Bainbridge, \textit{supra} note 1, at 524 (stating that the alter ego doctrine is flawed because it is premised on the "mindlessly formalistic notion that the corporation is a real entity distinct from its owners"); \textit{id.} at 547 (stating that it begs the question to describe a closely held corporation as the "dummy" for its individual shareholder since the corporation has no ends separate from that of the shareholder (citing Gevurtz, \textit{supra} note 4, at 864 ("No corporation in the world has a mind of its own; they are fictitious entities. People control corporations.")).

\textsuperscript{96} \textit{See supra} note 95.
or equity, usually irrelevant. Indeed, rigid adherence to a formalities inquiry promises arbitrary results since, all else being equal, shareholders and corporate affiliates who (wisely) make the nominal investment in maintaining corporate formalities will be immune from piercing, while those who (unwisely) do not may be subject to it.98

Although observers tend to agree that piercing doctrine is a mess, most proposed reforms predating Professor Bainbridge's critique sought to address the problem by "correcting" or adjusting one or more aspects of piercing doctrine, rather than confronting the problem holistically.99 Other scholars contend that piercing can be utilized broadly to address limited liability's social costs.100 What these commentators do not consider is that piercing doctrine is fundamentally flawed and therefore cannot serve as the means for enhancing efficiency or for other normative ends.101

Piercing doctrine is inherently problematic for two reasons. Professor Bainbridge discusses the first: as mentioned above, piercing is premised on an antiquated view of the corporation, rather than on the more realistic contractarian conception. The former view assumes a separation between the interests and preferences of the entity itself and those of its "owners," the shareholders.102 The contractarian approach abandons the artificial distinction between the firm and its

97. See, e.g., Bainbridge, supra note 1, at 551-53 (noting that although the failure to maintain formalities is often cited in opinions ordering veil piercing, such formalities are of dubious relevance and obscure the real issues). For example, with regard to voluntary creditors, whether or not the corporate participants have maintained formal distinctions between themselves and the corporation seems beside the point, unless the failure to do so misleads these creditors. As to tort creditors, formalities are rarely relevant: consideration of the lack of formalities or corporate distinctiveness in the tort context seems wholly unprincipled unless it serves as evidence of something else, such as the level of shareholder control or, in the products liability context, customer reliance or confusion.

98. Cf. Mendelson, supra note 1, at 1262-64 (discussing how a shareholder must "work hard" to dominate the corporation and disregard corporate formalities such that the shareholder will run afoul of current veil piercing rules).

99. See supra notes 3-4 (providing a sample of reform proposals).

100. See, e.g., Mendelson, supra note 1, at 1207.

101. See Bainbridge, supra note 1, at 555 ("[i]t may be doubted whether veil piercing contributes much to any plausible conception of either efficiency or equity."). Piercing also inflicts substantial transaction costs. Professor Bainbridge discusses the significant resources devoted to reducing the risk of veil piercing and the litigation costs in such an unwieldy doctrinal landscape. Id. at 564, 575.

102. Indeed, courts and commentators describe veil piercing as the means by which debts of the corporation are recast as debts of individual shareholders. See, e.g., Stephen B. Presser, Piercing the Corporate Veil § 1.01, at 1-6 (1998); Wormser, supra note 60, at 517 (stating that, once the veil is pierced, courts will "regard the corporate company as an association of live, up-and-doing men and women shareholders").
participants, and between shareholders and other participants. Rather, the firm is viewed as a nexus of consensual relationships between various participants—including shareholders, firm managers, and voluntary creditors—with their own sets of inputs, rights, and obligations. The antiquated view of the corporate fiction leads courts to focus on irrelevancies such as corporate formalities. It also emphasizes shareholder liability to the exclusion of other firm participants. Because shareholder liability dominates the discussion, piercing doctrine fails to offer a broader conception of accountability within the enterprise.

A second, even more fundamental problem with veil piercing, and disregard of the corporate entity is that courts use these theories to extend vicarious liability to select shareholders despite the fact that state legislatures have conferred upon all shareholders the benefit of unqualified limited liability, regardless of firm size, the level of shareholder participation and control, or the nature of the creditors' claims. In other words, piercing seeks to do precisely what limited liability statutes seemingly prohibit: it extends vicarious liability for firm obligations to select shareholders in select circumstances.

103. Other authors offer a detailed account of the contractarian view of the firm. See, e.g., Easterbrook & Fischel, supra note 2, at 1-39; Bainbridge, supra note 1, at 524-27. This view of the firm can be traced to Ronald Coase's work on the nature of the firm. See R.H. Coase, The Nature of the Firm, in The Firm, the Market, and the Law 33-55 (1988).

104. See, e.g., Easterbrook & Fischel, supra note 2, at 12; Bainbridge, supra note 1, at 525. Although some contractarians' claims—both positive and normative—about the nature of corporate law are subject to debate, their aforementioned descriptive claims about the nature of the firm and firm participants seem largely beyond dispute.

105. See Bainbridge, supra note 1, at 525.

106. There are a few exceptions. Again, enterprise entity theory provides a model for spreading liability to affiliated firms within corporate groups that are not shareholders. See supra notes 70-74 and accompanying text. And courts occasionally hold lenders and other third parties liable for firm obligations under various “agency” theories. See, e.g., Billops v. Magness Const. Co., 391 A.2d 196, 197-98 (Del. Super. Ct. 1978) (“If, in practical effect, the franchise agreement goes beyond the stage of setting standards, and allocates to the franchisor the right to exercise control over the daily operations of the franchise, an agency relationship exists.”); A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 291 (Minn. 1981) (“A creditor who assumes control of his debtor’s business may become liable as principal for the acts of the debtor in connection with the business.”); Humble Oil & Ref. Co. v. Martin, 222 S.W.2d 995, 998 (Tex. 1949) (holding that a Commission Agency Agreement between two independent contractors actually created a master-servant relationship). Yet horizontal enterprise entity and third-party claims are rarely successful and do not contemplate vicarious liability for other corporate constituencies, including directors, officers, and employees.

107. Although Professor Bainbridge recognizes this problem in his critique of the alter ego and agency theories, I contend it also precludes a coherent application of the enterprise entity theory in parent-subsidiary groups. He recognizes the drawbacks of enterprise entity analysis, yet, on balance, he advocates retaining this doctrine. Bainbridge, supra note 1, at 568-74. I agree that limited shareholder liability is less defensible in the parent-subsidiary context, and that, without a means for holding parents accountable for subsidiary torts, firms will have even
Obviously, this apparent conflict between veil piercing theories and statutory limited liability has separation-of-powers implications, as the Walkovszky court recognized. One can offer arguments why piercing does not violate separation-of-powers principles. Nevertheless, the co-existence of these legislative and judicial prerogatives is, at best, troublesome. Keenly aware of this tension, courts almost always state that piercing must be limited to "exceptional" circumstances. Yet the conflict between the unqualified and universal limited liability "rule" and the veil piercing "exception" creates enormous conceptual difficulties, and courts must perform analytical cartwheels to justify holding select shareholders liable for firm obligations. Except for shareholder fraud and statutory violations, the factors that emerge in the courts' analyses are singularly unhelpful: they are either irrelevant to any efficiency-based or normative conception of appropriate liability allocation, or, if dispositive, prove too much, because they would swallow limited shareholder liability.

For example, in order to justify defying corporate statutes, courts look to maintenance of corporate formalities as an indicator of greater incentives to separate their businesses into distinct entities to externalize risk. See id. at 569, 571-72; see also discussion infra Part III. My point, however, is that enterprise liability in the parent-subsidiary context is as conceptually problematic as the alter ego and agency theories, since corporate shareholders, like individual shareholders, enjoy unqualified limited liability. Also, I am persuaded by Professor LoPucki's more general conclusion that the search for the boundaries of the enterprise often will be futile. See LoPucki, supra note 17, at 157.

108. See Walkovszky v. Carlton, 223 N.E. 6, 10 (N.Y. 1966); see also Radaszewski v. Telecom Corp., 981 F.2d 305, 311 (8th Cir. 1992) (refusing to pierce in part because legislatures are the ones who have the right to decide such questions).

109. For example, the drafters of the limited liability provisions in modern corporation statutes may have been well aware of judicially crafted "equitable" exceptions at the time of enactment, and, thus, their failure to eliminate these exceptions implies intent to retain them. Indeed, a comment to section 6.22 of the Model Business Corporation Act suggests the legitimacy of common-law piercing doctrine. MODEL BUS. CORP. ACT § 6.22(b) (3d ed. Supp. 1997). Yet, as Professor Bainbridge notes, while the Model Act's drafters may have "wimped out" in the historical commentary, the Act itself makes no such provision for veil piercing. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 173 & n.10 (2002). On the other hand, a few enacted LLC and LLP statutes contain sections addressing veil piercing. See, e.g., Huss, supra note 4, at 116-19. Most such provisions are general, stating that existing corporate veil piercing principles ought to apply to LLCs or LLPs. See id.; see also MINN. STAT. ANN. § 332B.303 (West 2002) ("[C]ase law that states the conditions and circumstances under which the veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."). The Uniform Limited Liability Company Act explicitly provides, however, that the failure to observe the usual formalities is not a ground for imposing liability on LLC members or managers. See UNIF. LTD. LIAB. CO. ACT § 303(b) (1996).

110. See Bainbridge, supra note 1, at 521 n.8 (noting that the piercing could easily swallow the rule if courts are not careful to limit the doctrine to exceptional circumstances); see also DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 683 (4th Cir. 1976) (stating that courts pierce "reluctantly" and "cautiously").
whether a shareholder "respects" the corporate form and, hence, is entitled to the benefit of limited liability.\textsuperscript{111} As discussed above, however, this kind of analysis is antiquated and focuses the inquiry on easily avoided failings that are irrelevant to efficiency and equity concerns.\textsuperscript{112} And, of course, corporate statutes no longer require meticulously maintained formalities; on the contrary, modern statutes expressly allow closely held corporations and hybrid entities to structure and operate the firm with far greater informality than the traditional corporation.\textsuperscript{113}

In addition, courts often include "undercapitalization" or "gross undercapitalization" as a factor in determining whether to pierce. Obviously, when the corporation's lack of capital is the result of shareholder misconduct—such as a fraudulent transfer—producing direct liability, creditors should be able to hold the shareholder accountable.\textsuperscript{114} And, as I discuss below, greater firm capitalization may enhance efficiency.\textsuperscript{115} But undercapitalization, by itself, cannot justify piercing, because \textit{limited shareholder liability is a license to

\textsuperscript{111} See, e.g., United States v. Van Diviner, 822 F.2d 960, 965 (10th Cir. 1987) ("[C]onsiderable weight is attached to the respect given the corporate form by the corporation's officers and shareholders."); Note, supra note 3, at 1195 ("Despite the 'piercing' doctrines, then, shareholders are still virtually immune from the claims of tort victims so long as they treat the corporate entity with proper respect.").

\textsuperscript{112} See Bainbridge, supra note 1, at 553-54 (stating that a "single-minded emphasis on formalities tends to lead the adjudicator down the wrong path by obscuring the real issues" and that precautionary maintenance of formalities has little to do with "real policy concerns" in this area); see also supra notes 94-98 and accompanying text.

\textsuperscript{113} See, e.g., DEL. CODE ANN. tit. 8, § 351 (2002) (allowing shareholders to elect to manage the affairs of the firm directly); MODEL STATUTORY CLOSE CORP. SUPP. § 25, in MODEL BUS. CORP. ACT ANN. (3d ed. Supp. 1997) (stating that the failure to observe corporate formalities is not a ground for imposing personal liability on a shareholder); UNIF. LTD. LIAB. CO. ACT § 303(b) (1996) (providing that the failure to observe usual formalities is not a ground for imposing liability on LLC members or managers).

\textsuperscript{114} See Bainbridge, supra note 1, at 561-62 (discussing undercapitalization and fraudulent transfer).

\textsuperscript{115} See EASTERTROOK & FISCHEL, supra note 2, at 59 (suggesting that undercapitalization creates problematic incentives for shareholders). As I discuss below, a legal regime that induces greater firm capitalization or insurance will enhance efficiency in some circumstances. Thus, perhaps holding shareholders liable when they have failed to invest sufficient capital will create an efficiency-inducing incentive. Of course, this may justify piercing only up to the level of optimal capitalization. Moreover, piercing based on undercapitalization may not enhance efficiency in the context in which voluntary creditors could, upon reasonable investigation, determine the level of firm capitalization, since the creditor, as the cheapest cost avoider, can simply demand personal guarantees from the shareholders or take other steps to protect itself. See infra notes 227-230 and accompanying text; see also Lala v. Erin Homes, 352 S.E.2d 93, 100 (W. Va. 1986).
undercapitalize.116 This is why promoters and investors incorporate in the first place,117 and why corporations form most subsidiaries.118 In fact, with the exception of mandatory capital and insurance requirements in certain industries,119 modern corporate statutes either contain no capitalization requirement or require only nominal capital.120 The mutual exclusivity of limited shareholder liability and "undercapitalization" is why no court, to my knowledge, has pierced based on this factor alone.121

Finally, I argue below that firm control is a critical consideration in the efficient allocation of responsibility.122 Yet shareholder control of the entity, like undercapitalization, cannot be independently decisive in piercing analysis, because corporation statutes do not distinguish between controlling and passive shareholders and a control-based piercing doctrine would swallow limited shareholder liability, particularly in closely held firms. This may explain why agency theory rarely stands alone as a basis for shareholder liability and why courts require more than shareholder

116. See, e.g., Thompson, supra note 3, at 11-12; see also Bainbridge, supra note 1, at 521 n.8 ("The law permits incorporation of a business for the very purpose of avoiding personal liability.").

117. See, e.g., Bainbridge, supra note 1, at 543-44 ("[I]n the close corporation setting externalizing such risks likely is the very purpose of incorporating."). That is why the defendant in Walkowszky organized the business into ten different cab corporations. Walkovszky v. Carlton, 223 N.E.2d 6, 12 (N.Y. 1966) (Keating, J., dissenting).

118. Radaszewski v. Telecom Corp., 981 F.2d 305, 311 (8th Cir. 1992) ("The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine . . . ").

119. See, e.g., Huss, supra note 4, at 129 n.191 (discussing minimum capital requirements for financial institutions). In fact, in Walkowszky, Carlton incorporated separate firms partly to limit his exposure under New York's mandatory insurance regime. See 223 N.E.2d at 12. Also, in some states, professionals engaged in practice in LLPs or otherwise must maintain minimum levels of malpractice insurance. Bainbridge, supra note 1, at 565-66.


121. See, e.g., Fisser v. Int'l Bank, 282 F.2d 231, 240 (2d Cir. 1960) (refusing to pierce the corporate veil on undercapitalization alone). A Ninth Circuit opinion suggests that California courts will pierce based on undercapitalization alone. See Nilsson, Robbins, Dalgarn, Berlinger, Carson & Wurst v. La. Hydrolec, 854 F.2d 1538, 1544 (9th Cir. 1988) ("[T]he California Supreme Court has held that undercapitalization alone will justify piercing the corporate veil."). The California opinion the Ninth Circuit cites for that proposition, however, also discusses the lack of corporate formalities. See Minton v. Cavaney, 364 P.2d 473 (Cal. 1961). Thus, undercapitalization alone may not be sufficient. See, e.g., Browning-Ferris Indus., Inc. v. Ter Maat, 195 F.3d 955, 961 (7th Cir. 1999) ("Undercapitalization is rarely if ever the sole factor in a decision to pierce the corporate veil."); Bainbridge, supra note 1, at 561; Mendelson, supra note 1, at 1262.

122. And, of course, as I stated earlier, to this extent I agree with Professor Mendelson's control-based approach to liability allocation.
control or domination to pierce;\textsuperscript{123} indeed, control alone is almost never sufficient.\textsuperscript{124} In fact, upon closer inspection, some cases in which courts have purported to pierce based on control alone contain another element that otherwise justifies liability.\textsuperscript{125} Courts applying Ohio law have come closest to treating shareholder control as independently dispositive,\textsuperscript{126} but courts in other jurisdictions have not adopted this approach.

This judicial reticence to pierce based solely on shareholder-level control alone is apparent in the Supreme Court's unanimous decision in United States v. Bestfoods.\textsuperscript{127} In Bestfoods, the Court refused to extend "operator" liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")\textsuperscript{128} to a parent corporation whose subsidiary owned a polluted chemical manufacturing plant, although the parent's management substantially overlapped with the subsidiary's, and the parent otherwise exercised significant control.\textsuperscript{129} Referring to the limited liability of a shareholder as a "bedrock principle," the Court concluded that Congress did not intend to extend CERCLA operator liability to corporate parents based solely on the exercise of significant control over the subsidiary.\textsuperscript{130} Rather, the corporate veil can be pierced to extend derivative liability to a shareholder under CERCLA only when the shareholder used the corporate form for certain wrongful purposes, including fraud.\textsuperscript{131} Otherwise, the shareholder can be directly liable as an operator only when the shareholder directly operates the facility in question, not merely the subsidiary itself.\textsuperscript{132}

\begin{itemize}
\item \textsuperscript{123} See Bainbridge, \textit{supra} note 1, at 547 (stating that control is an essential prerequisite for holding a shareholder liable).
\item \textsuperscript{124} See Campbell, \textit{supra} note 71, at 34 ("[S]omething more than control is needed, . . . otherwise the corporate entity will stand." (quoting Brown v. Margrande Companie Naviera, S.A., 281 F. Supp. 1004, 1006 (E.D. Va. 1968))); see also Mendelson, \textit{supra} note 1, at 1263 (stating that extensive control is unlikely to create a risk of veil piercing); cf. Bainbridge, \textit{supra} note 1, at 547, 549 (stating that courts would pierce much more often if domination and control sufficed). \textsuperscript{125} For example, although the Sixth Circuit indicated in Carter-Jones Lumber Co. v. LTV Steel Co., 237 F.3d 745, 747 (6th Cir. 2001), that control alone is sufficient to pierce under Ohio law, in the case before it, the shareholder at issue was actually involved in the illegal scheme. \textsuperscript{126} See Janos v. Murduck, 672 N.E.2d 1021, 1023-24 (Ohio Ct. App. 1996) (piercing based solely on shareholder domination and the fact that the corporation filed for bankruptcy and therefore failed to honor the contract in question); see also Carter-Jones Lumber, 237 F.3d at 747 (citing Janos for the proposition that Ohio courts will pierce based on control alone).
\item \textsuperscript{127} 524 U.S. 51 (1998).
\item \textsuperscript{128} 42 U.S.C. §§ 9601-9675 (2000).
\item \textsuperscript{129} See Bestfoods, 524 U.S. at 61-64.
\item \textsuperscript{130} Id. at 62.
\item \textsuperscript{131} See id. at 62-63.
\item \textsuperscript{132} See id. at 66.
\end{itemize}
Thus, while veil piercing and disregard of the corporate entity have a long history, this history is deeply troubled. Except for theories premised on shareholder fraud or statutory violations, which appear to be forms of direct shareholder liability, piercing theory and jurisprudence offer little coherence. Indeed, the law is so confused and unpredictable that judges’ decisions in this area may be ad hoc, ensuring that indistinguishable cases will produce different outcomes in different courtrooms.\textsuperscript{133} The fact is, a principled piercing regime that enhances efficiency or otherwise results in consistent, socially beneficial outcomes cannot co-exist with statutorily mandated, unqualified, and universally limited shareholder liability. Absent statutory reform, this inherent conflict cannot be resolved. Solutions to the social costs limited shareholder liability may inflict must be found elsewhere.

C. Controlling Person Liability

The other, potentially significant hole in the preclusive web of limited liability is the growing collection of theories that hold controlling persons liable for corporate obligations. These theories tend to originate in regulatory statutes or from judicial gloss on statutory liability provisions. Controlling person liability theories vary greatly in scope and substance; for example, given their essential elements, many such theories do not impose true vicarious liability. Yet, each of these theories extends liability to controlling persons who would not otherwise be liable under traditional corporate, tort, or agency law principles. More importantly, they often extend criminal or civil liability without a demonstration of intent or negligence.

Federal securities laws are among the oldest examples of regulatory statutes that impose liability on controlling persons for corporate wrongdoing. Section 11 of the Securities Act of 1933, for instance, holds certain corporate individuals liable for any materially misleading registration statements, subject to a due diligence defense.\textsuperscript{134} Similarly, under Section 15 of the 1933 Act and Section 20 of the Securities Exchange Act of 1934, anyone who controls a liable corporation is also responsible for its securities violation, unless

\textsuperscript{133} See Thompson, \textit{supra} note 3, at 23 (“The legal doctrine of piercing the veil is so amorphous that it leaves a large area in which courts can impose liability based upon a ‘smell’ test of fairness.”). This incoherence also produces enormous transaction costs.

\textsuperscript{134} See 15 U.S.C. § 77k (2000). Potentially liable parties under Section 11 are the issuing corporation, anyone who signs the registration statement, anyone serving as a director at the time the registration statement is filed, and every person named in the registration statement as about to become a director. See \textit{id.}; PAT K. CHEW, DIRECTORS' AND OFFICERS' LIABILITY § 6:2.3 (2001).
the controlling person acted in good faith.\textsuperscript{135} And Section 16(b) of the 1934 Act holds controlling persons strictly liable for short-swing trading in equity securities.\textsuperscript{136}

Most recently, in response to a series of corporate disclosure scandals, both the Securities and Exchange Commission ("SEC") and Congress imposed new certification requirements on CEOs and CFOs. Previously, officers of a publicly traded company, and, in the case of annual reports, a majority of the company's directors, were required to sign periodic reports made pursuant to Sections 13(a) and 15(d) of the 1934 Act.\textsuperscript{137} However, the signing corporate officials were not subject to certification requirements regarding the completeness and accuracy of all aspects of these reports. Pursuant to an SEC investigative order issued on June 27, 2002,\textsuperscript{138} the CEOs and CFOs of the largest 947 companies whose securities are registered with the SEC were required to certify the validity and accuracy of their most recently filed reports by August 14, 2002.\textsuperscript{139} In the Sarbanes-Oxley Act of 2002, Congress, in addition to enhancing penalties for fraud, required CEOs and CFOs to certify the validity of certain matters disclosed in periodic reports filed with the SEC.\textsuperscript{140}

Federal and state environmental statutes are another significant source of controlling person liability. Again, CERCLA creates liability for the cleanup of hazardous substances released into the environment by certain parties, extending responsibility to the current owner and "operator" of a facility and to "any person who arranged for disposal or treatment."\textsuperscript{141} CERCLA therefore imposes liability on persons who traditionally have been shielded from liability for tortious or illegal corporate actions, including corporate officers

\textsuperscript{139} See, e.g., Duffey, supra note 137, at 410.
\textsuperscript{140} Pub. L. No. 107-204, §§ 302, 906, 116 Stat. 745, 777-78, 806 (2002); Duffey, supra note 137, at 411. Thus, the CEO and CFO bear the ultimate responsibility for the certifications. They cannot simply assert a "clean heart, empty head" defense. Rather, at the time the certifications are filed, they "must have had a good faith basis, based on their own personal due diligence, for their certification." Richard A. Rosen et al., Litigation Implications of the Sarbanes-Oxley Act: An Analysis of the Key Issues, SH097 ALI-ABA 115, 123 (2002).
and other persons exercising direct control over polluting facilities.\textsuperscript{142} Similarly, the Resource Conservation and Recovery Act ("RCRA"),\textsuperscript{143} which provides for the comprehensive management of solid and hazardous waste, imposes liability upon non-negligent waste generators and transporters, as well as on the owners of waste disposal sites, and thereby creates liability exposure for corporate officials.\textsuperscript{144} Other federal and state environmental statutes also extend liability to controlling persons.\textsuperscript{145}

Notably, in applying these kinds of public welfare statutes, some federal and state courts have adopted the responsible corporate officer ("RCO") doctrine.\textsuperscript{146} Under this theory, controlling persons may

\textsuperscript{142} See United States v. Bestfoods, 524 U.S. 51, 66-71 (1998); Tom McMahon & Katie Moertl, \textit{The Erosion of Traditional Corporate Law Doctrines in Environmental Cases}, 3 Nat. Resources \& Env't 29, 29 (1988) (noting that court decisions construing CERCLA have imposed direct liability on corporate officers and shareholders, thereby significantly eroding traditional corporate law protection accorded to such parties); see also Mendelson, \textit{supra} note 1, at 1265 ("Caselaw under CERCLA over the last fifteen years or so also has been perceived to be 'erosing' traditional corporation law concepts such as limited liability.").

\textsuperscript{143} 42 U.S.C. §§ 6901-6992k (2000).

\textsuperscript{144} See 1 \textsc{William E. Knepper \& Dan A. Bailey, Liability of Corporate Officers and Directors} § 10-3 (6th ed. 1998).

\textsuperscript{145} The Clean Water Act ("CWA"), 33 U.S.C. §§ 1251-1387 (2000), imposes strict civil liability for discharges into navigable waters and criminal penalties, which does not require fault, except in relation to the amount of the penalty. See \textsc{Knepper \& Bailey, supra} note 144, § 10-5. The Oil Pollution Act of 1990, 33 U.S.C. §§ 2701-2761, imposes strict liability for removal costs and damages on owners and operators of the source from which oil is discharged but only up to defined maximum limits. The Clean Air Act, 42 U.S.C. §§ 7401-7671k, controls the emissions of air pollutants from stationary sources and imposes penalties for noncompliance with permit on owners or operators. See Janet L. Woodka, \textit{Sentencing the CEO: Personal Liability of Corporate Executives for Environmental Crimes}, 5 Tul. Envtl. L.J. 635, 641 (1992). Some courts have also based controlling person liability on the federal Rivers and Harbors Act of 1899, 33 U.S.C. § 407. See Mendelson, \textit{supra} note 1, at 1265 n.261. In addition, some state environmental statutes have parallel liability regimes. For example, in \textit{Wisconsin v. Rolfink}, the court held a corporate officer personally liable for corporate violations of Wisconsin's solid and hazardous waste laws because the officer was responsible for overall operation of the corporation's facility which violated the law. 475 N.W.2d 378, 376-80 (Wis. 1991). In so holding, the court held that the officer's lack of personal authorization or participation in the waste disposal activity was immaterial. \textit{Id.} at 576-80; see also \textsc{Chew, supra} note 134, § 6:2.

\textsuperscript{146} See, e.g., United States v. Park, 421 U.S. 658, 673-74 (1975) (stating, in determining whether a controlling person is liable under the RCO doctrine, that the government may satisfy its burden of proof by introducing “evidence sufficient to warrant a finding by the trier of the facts that the defendant had, by reason of his position in the corporation, responsibility and authority either to prevent in the first instance, or promptly to correct, the violation complained of, and that he failed to do so”); United States v. Ming Hong, 242 F.3d 528, 531-32 (4th Cir. 2001) (applying RCO under the CWA); United States v. Kelley Tech. Coatings, Inc., 157 F.3d 432, 438-39 (6th Cir. 1998) (applying the RCO to RCRA); United States v. Brittain, 931 F.2d 1413, 1419 (10th Cir. 1991) ("[W]illfulness or negligence of the [corporate] actor would be imputed to him by virtue of his position of responsibility."); United States v. Northeastern Pharm. \& Chem. Co., 810 F.2d 726, 727 (8th Cir. 1986) (applying the RCO doctrine to CERCLA); BEC Corp. v. Dept' of Envtl. Prot., 775 A.2d 928 (Conn. 2001) (applying RCO doctrine under the Connecticut Clean Water Act); \textit{In re Dougherty}, 482 N.W.2d 485, 488-89 (Minn. Ct. App. 1992) (applying RCO.
be liable if they wield decision-making authority and control over the operations of the regulated facility or activity, but failed to take action that would have prevented the violation. Thus, the RCO doctrine exposes controlling persons to liability for corporate misconduct regardless of actual participation in or knowledge of any wrongdoing. In imposing liability based on the failure to prevent misconduct by subordinates, the doctrine imposes a form of liability on controlling persons that, in practice, is akin to vicarious liability.

There are a few controlling person liability provisions in other areas. And, as discussed previously, some jurisdictions extend vicarious liability to a partner in an LLP for torts committed by those acting under the partner's direct supervision. In most circumstances, controlling persons remain immune from liability for torts or tort-like statutory violations committed within the corporate enterprise, absent actual participation in the wrongful conduct. Nevertheless, the foregoing examples demonstrate some willingness on the part of legislatures and courts to impose supervisory or vicarious liability on controlling persons. The Supreme Court's opinion in Bestfoods evinces a continuing reluctance, even in the face of statutory reform, to impose vicarious liability on controlling shareholders, but there is less resistance to extending liability to persons exercising direct supervisory control over corporate affairs.

doctrine to Minnesota's hazardous waste laws); see also United States v. Hodges X-Ray, Inc., 759 F.2d 557, 558-59 (6th Cir. 1985) (holding an officer civilly liable under a federal health and safety statute). But see United States v. MacDonald Watson Co., 833 F.2d 35, 38 (1st Cir. 1991) (stating that because RCRA has an express knowledge requirement, a mere showing of official responsibility is insufficient).

147. See, e.g., Park, 421 U.S. at 673-74; Ming Hong, 242 F.3d at 531-32; Noël Wise, Personal Liability Promotes Responsible Conduct: Extending the Responsible Corporate Officer Doctrine to Federal Civil Environmental Enforcement Cases, 21 STAN. ENVTL. L.J. 283, 286-89 (2002).


149. For example, corporate officers have been held liable for violations of federal food and drug laws occurring under their watch. See Park, 421 U.S. at 672; United States v. Dotterweich, 320 U.S. 277, 279 (1943). In addition, officers of nonprofit organizations may be liable for organizational violations of federal tax law. See Celia Ready, Intermediate Sanctions, SH047 ALI-ABA 137, 140-41 (2002).

150. See supra note 44 and accompanying text.

151. See Thompson, supra note 3, at 27-28 (discussing the trend towards holding corporate managers accountable for the failure to monitor or supervise employees who commit torts or statutory violations).

152. Again, even in Bestfoods, the Court was willing to extend liability to natural or corporate persons exercising direct control over the polluting facility. See United States v. Bestfoods, 524 U.S. 51, 67-71 (1998).
III. LIMITED SHAREHOLDER LIABILITY: BENEFITS AND COSTS

As the preceding part demonstrates, limited liability for equity stakeholders has a long history and, in all likelihood, is here to stay, at least as the predominant default rule. Indeed, all states have recently enacted statutes expanding the privilege of limited liability to equity stakeholders in unincorporated firms. Although limited shareholder liability has always had its critics and skeptics who challenge it as just another benefit for our society's wealthiest members, it enjoys continuing and widespread support.

Whether limited shareholder liability produces a net social benefit is a more complex question. Contrary to popular belief, there is no convincing evidence that limited liability is essential for large-scale capital investment or economic growth. Yet limited shareholder liability produces some kinds of cost savings and market efficiencies. In so doing, it also may produce distributive benefits. On the other hand, even scholarly supporters of limited liability recognize that it potentially creates social costs—most notably, a moral hazard problem. It encourages excessively risky activities by allowing corporate actors to externalize some of their costs. The recent debate among scholars then, properly framed, is whether or how to alter the current limited liability regime to maintain or enhance its benefits while reducing the social costs it inflicts.

A. An Overview of Potential Benefits and Costs

In the nineteenth and much of the twentieth centuries, many hailed limited shareholder liability as a cornerstone of the American economic system. Some have gone as far as to suggest that the emergence of limited liability was essential for the ultimate success of the Industrial Revolution and, more generally, the American economy. A major premise underlying this argument is that limited shareholder liability is necessary to facilitate large-scale capital development: without limited liability, the argument goes, promoters—industrialists and others—could not attract sufficient capital to fund large-scale enterprises because potential passive

153. See, e.g., Halpern et al., supra note 3, at 117-18 (discussing the debate over limited liability in the nineteenth and early twentieth centuries).
154. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 49-50; Bainbridge, supra note 1, at 529.
155. WORMSER, supra note 27, at 14.
156. See, e.g., Dodd, supra note 30, at 1378-79 (quoting academics from the early twentieth century who suggested that limited liability was the most important factor leading to industrial growth in the nineteenth century); Hackney & Benson, supra note 120, at 841 (same).
investors would not invest if they could be subject to personal liability for firm obligations.\textsuperscript{157} A related premise offers the broader, more democratic conception that the protection limited liability affords is necessary to promote widespread entrepreneurialism.\textsuperscript{158} Furthermore, some have contended that limited shareholder liability is essential for corporate risk taking, and that such risk taking, in the aggregate, produces a net social benefit.\textsuperscript{159}

Although limited shareholder liability has always had its critics,\textsuperscript{160} the arguments favoring limited liability persuaded policy makers to adopt and retain it as the operative default rule.\textsuperscript{161} Moreover, once legislators in one state enacted protective legislation, lawmakers in other states had to follow to prevent capital from fleeing the jurisdiction.\textsuperscript{162} Today, many believe that, absent a compelling demonstration to the contrary, we ought to presume that limited shareholder liability is at least partially responsible for, if not essential to, our economic progress.\textsuperscript{163}

Yet, despite the popular appeal of limited shareholder liability and these claims regarding its role in our economic system, there is no empirical evidence that it is essential for capital development, entrepreneurialism, or economic growth.\textsuperscript{164} In fact, some historical indications are to the contrary. For example, Rhode Island did not

\textsuperscript{157} Bainbridge, supra note 1, at 535 ("Indeed, there is a widely shared view that limited liability was, and remains, essential to attracting the enormous amount of investment capital necessary for industrial corporations to arise and flourish.").

\textsuperscript{158} See, e.g., Presser, supra note 30, at 155.

\textsuperscript{159} See e.g., Bainbridge, supra note 1, at 539 (questioning whether sound social policy would require the complete internalization of tort risk); Jonathan R. Macey, The Limited Liability Company: Lessons For Corporate Law, 73 WASH. U. L.Q. 433, 448-52 (1995) (discussing the social benefits of limited liability and risk taking).

\textsuperscript{160} See, e.g., Halpern et al., supra note 3, at 117-18 (discussing the debate over limited liability in the nineteenth and early twentieth centuries).

\textsuperscript{161} See supra note 33 and accompanying text.

\textsuperscript{162} In the early 1800s, Massachusetts did not extend benefit of limited liability, but some neighboring states did. Bainbridge, supra note 1, at 532 n.59. During the 1820s, there was some debate over whether capital was fleeing those states for neighboring states. Id. (citing HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836-1937, at 50 (1991)).

\textsuperscript{163} See, e.g., Bainbridge, supra note 1, at 555 ("In my judgment, the case for limited liability seems unassailable."). Some, for example, may contend that the historical success and current pervasiveness of the corporate form provide strong evidence of the efficiency and/or social utility of limited liability.

\textsuperscript{164} See Hansmann & Kraakman, supra note 5, at 1920; Lawrence E. Mitchell, Close Corporations Reconsidered, 63 TUL. L. REV. 1143, 1155 (1989) ("Modern courts and commentators often speak of limited liability as having developed as an incentive to industrial growth.... Yet, although this rationale appears historically as one justification for limited liability, little evidence supports the view that it caused the adoption of that policy. At best, the rationale is only one of many reasons why limited liability became an accepted principle of corporate law. At worst, it is a rationalization of that principle.").
limit shareholder liability until 1847, yet before then, it retained its position as the second leading producer of textile products.\textsuperscript{165} Similarly, some states, including California, did not grant full limited shareholder liability protection to all corporations until deep into the twentieth century.\textsuperscript{166} Also, there is growing agreement in recent scholarship that large-scale enterprises and even public equities markets would exist without limited liability.\textsuperscript{167}

The economic democracy and entrepreneurialism arguments also prove too much since, in many circumstances, the owners of small businesses are personally liable for corporate obligations despite limited shareholder liability—as guarantor, tortfeasor, statutory violator, or the target of piercing.\textsuperscript{168} While the increased risk of personal liability in an unlimited liability regime might deter some entrepreneurs, the overall effect likely would be minimal. Given the risk of personal liability for small business owners even with limited shareholder liability, particularly risk-averse individuals would not operate their own firms anyway, while risk-neutral and risk-prefering individuals would still invest, given their ability to exercise control over the firm and firm risks.\textsuperscript{169} Indeed, I have seen no study suggesting that, prior to the recent extensions of limited liability protections to LLCs and LLPs, the inability to take advantage of

\begin{itemize}
\item \textsuperscript{165} See Dodd, supra note 30, at 1376.
\item \textsuperscript{166} See, e.g., Hansmann & Kraakman, supra note 5, at 1924 ("California imposed unlimited pro rata liability by statute on the shareholders of both domestic and foreign corporations . . . until 1931, evidently without crippling industrial and commercial development."); see also id. (discussing how most states imposed double liability on shareholders of banks until the 1930s).
\item \textsuperscript{167} See, e.g., Halpern et al., supra note 3, at 136-38 (discussing the alternative contractual arrangements that might emerge in the absence of limited liability); Thompson, supra note 3, at 19 (noting the lack of evidence that public markets would not exist without limited liability and discussing examples of liquid trading in contexts in which investors did not enjoy limited liability); see also Joseph Grundfest, The Limited Future of Unlimited Liability: A Capital Markets Perspective, 102 YALE L.J. 387, 392-405 (1992) (discussing ways in which the markets might respond to unlimited liability).
\item \textsuperscript{168} See Booth, supra note 4, at 143 (arguing that limited liability seldom insulates shareholders in small firms from liability because contract creditors usually require guarantees and tort creditors will almost always be able to show that shareholder-operators participated in the wrongful acts).
\item \textsuperscript{169} Indeed, in many closely held firms, the risks associated with contractual liability are more significant than the risks associated with tort liability. See Hansmann & Kraakman, supra note 5, at 1910.
\end{itemize}
stakeholder limited liability deterred professionals from practicing.\textsuperscript{170} Similarly, although limited shareholder liability facilitates firm risk taking in some contexts, no one has demonstrated persuasively that such risk taking produces a net social benefit or that equally or more optimal levels of firm risk taking would not otherwise occur.\textsuperscript{171}

At most, then, whether the American (or global) economy, capital investment, and economic growth—past, present, and future—depend on limited shareholder liability is an open question.\textsuperscript{172} Thus, I agree with Professor Bainbridge that “[b]y allowing the public corporation to develop, limited liability thus was in large measure responsible for the development of our modern economic system.”\textsuperscript{173} In the absence of empirical support, however, I question, as others have,\textsuperscript{174} whether limited shareholder liability is necessary for

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\item \textsuperscript{170} See Michelle M. Mello & Troyen A. Brennan, \textit{Deterrence of Medical Errors: Theory and Evidence for Malpractice Reform}, 80 Tex. L. Rev. 1595, 1606 (2002) (“[O]verdeterrence rhetoric has not been firmly grounded in fact. Most defensive-medicine studies have failed to demonstrate any real impacts on medical practice arising from higher malpractice premiums.”). I have no doubt that professionals have recently perceived growing risks of liability. See Robert W. Hamilton, \textit{Registered Limited Liability Partnerships: Present at the Birth (Nearly)}, 66 U. Colo. L. Rev. 1065, 1066, 1069 (1995) (noting that LLPs arose out of the swirl of litigation spawned by the collapse of Texas banks and savings and loans in the 1980s). This perception explains professionals’ desire for greater liability limits, and public choice analysis may explain their success in achieving some such limits. See Macey, supra note 159, at 451-52 (applying a public choice analysis to the emergence of LLCs and stating that the comparative political power of business people and entrepreneurs assured the extension of limited liability despite the debates over its benefits and costs in the tort context). Neither this perception nor recent legislative successes establish, however, that professionals would abandon their professions without these new protections.
\item \textsuperscript{171} See Mendelson, supra note 1, at 1217 n.52 (“Risk taking per se is not beneficial, however. It is warranted only if the risk taken is to engage in an activity whose expected social benefits, on the margin, outweigh its expected social costs. . . . [L]imited liability may encourage overinvestment in activities with excessive social costs.”). Professor Bainbridge questions whether sound social policy mandates internalization of tort risk. See Bainbridge, supra note 1, at 539. This is certainly a legitimate question, but one he implicitly concedes cannot be answered. See id. That is why the debate has focused—appropriately in my view—largely on the effects of limited liability. I agree with Professor Bainbridge, however, that, in addition to efficiency, political reality must play a role in the analysis. See id. n.97.
\item \textsuperscript{172} I have no doubt that the existing structure of the capital markets and, more generally, firm organization in the American—and now global—economy is closely tied to the corporate form and limited liability. Given that this “need” for limited shareholder liability is unverified, that the overall benefits of limited liability-induced risk taking are questionable, and that limited shareholder liability also inflicts social costs, whether the existing regime produces a net social benefit—and the extent of any such benefit—is unknown. In my view, historical success alone is not strong evidence of limited liability’s necessity or social utility. For example, “path dependence” theory demonstrates how history may lock in inefficient or otherwise socially harmful practices or norms. See generally Frederick W. Lambert, \textit{Path Dependent Inefficiency in the Corporate Contract: The Uncertain Case with Less Certain Implications}, 23 Del. J. Corp. L. 1077 (1998) (describing various theories of path dependency and providing an analysis of each).
\item \textsuperscript{173} Bainbridge, supra note 1, at 536.
\item \textsuperscript{174} See, e.g., supra note 164.
\end{itemize}
economic growth or that an alternative system of allocating risk of loss would not be equally or more socially beneficial. Therefore, it appears that the more grandiose claims regarding the benefits of limited shareholder liability lack support.

Rather than seeking to prove or disprove these kinds of claims, recent scholarship has focused on various efficiency-based justifications for limited shareholder liability. Commentators offer strong arguments as to why limited liability produces information cost savings and market efficiencies, and why some of these effects foster corresponding distributive benefits. Yet they also continue to recognize that limited liability may inflict social costs, most notably as a result of the moral hazard problem it produces.

1. Efficiency-Based Justifications

Limited shareholder liability corrects market imperfections and reduces the overall costs of investment in a number of related ways. First, and most fundamentally, limited liability facilitates specialization (the separation of ownership and control) within the firm. Potential capital investors may not possess the resources, time, or expertise to operate or closely monitor a business enterprise. If such investors faced the risk of unlimited personal liability for firm obligations—in other words, losses in excess of their initial investment—they might choose not to invest. If they did invest, they would face high information-gathering costs, such as the costs of acquiring greater expertise, gathering substantial information about firm operations and potential return, assessing potential firm liabilities in excess of assets, and monitoring the wealth of other investors. Limited shareholder liability limits investor risk to the amount initially invested, thereby reducing the need for, and the costs

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175. See, e.g., Mendelson, supra note 1, at 1213, 1217 (noting that efficiency-based justifications for limited liability now dominate).

176. Not everyone agrees that limited liability produces benefits, even in publicly traded firms. See, e.g., Booth, supra note 4, at 147-49. Yet most scholars believe that limited liability does produce some beneficial effects. The debate centers on the extent of these effects and whether they are worth their costs.

177. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 41-42.

178. See, e.g., Easterbrook & Fischel, supra note 2, at 94; Mendelson, supra note 1, at 1217.

179. See, e.g., EASTERBROOK & FISCHEL, supra note 1, at 41-42; Mendelson, supra note 1, at 1218. This is particularly true for the small investor. Bainbridge, supra note 1, at 530 (“A regime of unlimited personal liability thus would directly conflict with the efficient centralized decisionmaking apparatus that is the hallmark of modern corporations.” (footnotes omitted)).

180. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 41-42; Bainbridge, supra note 1, at 531; Halpern et al., supra note 3, at 136; Mendelson, supra note 1, at 1218.
of, monitoring the firm closely. Investors with limited liability can leave the task of managing the firm largely to agents and voluntary creditors, who, on balance, are better situated to monitor and control firm activities. Thus, limited shareholder liability facilitates low-cost and more passive capital investment, and decreases the overall costs of operating the firm by reducing the amount of investor monitoring needed.

Second, limited shareholder liability decreases the inefficiencies associated with excessive investor risk aversion. If shareholder liability were unlimited, the possibility of losing more than her initial investment would prompt a risk averse investor either to avoid investing in enterprises that otherwise provide positive net present values or to spend too many resources on managing and monitoring the risk. By limiting investor risk to the initial investment, limited shareholder liability reduces these effects.

Third, although perhaps not essential for the existence of equities markets, limited shareholder liability may enhance the efficiency of these markets. In an unlimited liability regime, or at least one that extends joint and several liability to shareholders, the price of shares would vary by the wealth and risk preferences of individual shareholders. Shareholders with greater wealth would face greater risk per share, since they would have more to lose and would more likely be "targets" of firm creditors. Moreover, the wealth and identity of other investors would be important in pricing

181. Easterbrook & Fischel, supra note 2, at 42.

182. Id. at 41-42. Professor Booth has argued that monitoring and information cost savings are not an argument for limited liability because if shareholders needed someone to monitor management, management would arrange for outside monitors—accountants, underwriters, bond rating agencies, etc.—to perform such services to promote investment. Booth, supra note 4, at 147. Today we know that such "outside" monitoring is not always reliable. But, more importantly, passive and risk averse shareholders facing personal liability in excess of their investment would still have to expend resources monitoring firm activities more closely or demand significantly greater and more costly outside monitor oversight, and they would have a greater incentive to monitor other investors. See, e.g., Leebron, supra note 1, at 1595-96, 1605.

183. See, e.g., Easterbrook & Fischel, supra note 2, at 94; Mendelson, supra note 1, at 1218.


185. See supra note 167 and accompanying text.

186. Several commentators have argued that this effect would be less pronounced under a pro rata shareholder liability regime. See, e.g., Hansmann & Kraakman, supra note 5, at 1903-04; Mendelson, supra note 1, at 1296-97. However, the markets would still offer less efficiency under such a regime, because investors would still have an incentive to monitor firm activities and the wealth of other shareholders more closely, and market insurance and other protective devices would have transaction costs. See infra notes 256-259 and accompanying text.

187. See, e.g., Easterbrook & Fischel, supra note 2, at 42-43; Halpern et al., supra note 3, at 130, 136. Indeed, wealthy investors would forego small investments. Id. at 136.
shares because the greater the wealth of other shareholders, the less likely a single shareholder's assets would be needed to satisfy judgments. As a result, shares might not be fungible, or the market might become illiquid. In a limited liability regime, because the risk of loss is limited to shareholders' investment, shareholder wealth is irrelevant. Therefore, shares are fungible and trade at one price in a liquid market. Because prices in a liquid market reflect all publicly available information about the firm, investors will not have to expend substantial resources to determine which price or trade is appropriate. And, the resulting free transfer of shares on liquid markets provides shareholders with the ability to exit and new investors to assemble controlling blocks, which may create incentives for management to operate efficiently in order to maintain share values.

Fourth, limited shareholder liability may facilitate cost-effective diversification. In a truly unlimited liability regime, diversification may increase rather than reduce investor risk, since a single investment could result in the loss of all of an investor's assets. Thus, unless an investor has sufficient wealth to absorb any loss, limited liability or a comparable substitute is needed for diversification. Yet, substitutes may impose additional costs. Diversification, in turn, allows investors to avoid the risk and monitoring costs of undiversified investments, and correspondingly

188. Easterbrook & Fischel, supra note 2, at 42.
189. Id.; Bainbridge, supra note 1, at 533 (arguing that joint and several shareholder liability would destroy share fungibility and, hence, the efficiency of the secondary trading markets); Halpern et al., supra note 3, at 131 (noting that a capital market would exist, but there would not be a single price for shares). But see Booth, supra note 4, at 147-48 (arguing that since the markets function well given disparate profit-side preferences, based on the marginal utility of investment returns, there is no reason to believe that these markets would not also function with disparate loss-side preferences).
190. Leebron, supra note 1, at 1609 (arguing that as the wealth effect becomes significant, the market would become thinner and eventually illiquid).
191. See, e.g., Easterbrook & Fischel, supra note 2, at 42-43. Wealthy purchasers, for example, no longer face the risk of becoming the "target" of creditors.
192. Id. at 43.
193. See id.
194. See Halpern et al., supra note 3, at 130 (noting that if each owner is liable for the full loss, the wealthier the investor the riskier his position).
195. See, e.g., Easterbrook & Fischel, supra note 2, at 42; Leebron, supra note 1, at 1595-96.
196. Market insurance, for example, may have loading costs and require the shareholder to engage in greater firm monitoring and information gathering. These costs may be prohibitive for smaller investors.
allows firms to raise capital at lower costs. Moreover, diversification facilitates firm investment in projects potentially offering positive net present values that otherwise would be too risky because such projects will not expose diversified investors to the risk of ruinous losses.

These effects of limited liability tend to occur in the publicly traded rather than the closely held context. Indeed, separation of ownership and control, efficient equities markets, and diversification tend to characterize investments in, and the structure of, publicly traded firms. Thus, scholars have questioned whether limited liability is justified in the closely held context. Judge Easterbrook and Professor Fischel ("Easterbrook and Fischel") have suggested that these differences may explain the sharp distinction in piercing doctrine between close corporations (which sometimes are pierced) and publicly traded firms (which are never pierced). Of course, limited liability may offer efficiencies in some circumstances in the closely held context; for example, some closely held firms have passive shareholders who, without limited liability, may face prohibitively high information costs.

Most recently, Professor Mendelson has argued that the potential benefits of limited shareholder liability depend not only on the nature of the firm—widely owned versus closely held—but also on the nature of the shareholder. She contends, for example, that information costs are an issue only for small, passive investors in

197. Easterbrook & Fischel, supra note 2, at 43; see also Bainbridge, supra note 1, at 531 (noting that unlimited liability would require greater monitoring, and, correspondingly, decrease shareholders' ability diversify, increasing the cost of capital and harming economic growth).

198. Easterbrook & Fischel, supra note 2, at 43-44. As Professor Bainbridge argues, unlimited liability would raise the cost to shareholders of investing:

With limited liability, shareholders are free to diversify and refrain from monitoring portfolio firms. This is desirable because most investors are rationally apathetic. Under conditions of limited liability and diversification, shareholder passivity is possible because the shareholder stands to lose only a small portion of his or her wealth in the event one of the portfolio firms goes bankrupt. Bainbridge, supra note 1, at 530-31 (footnotes omitted). I therefore disagree with Professor Booth's contention that diversification, rather than being an argument in favor of limited liability, renders it unnecessary. See Booth, supra note 4, at 148. Although diversification will offset some losses, a single, substantial loss—which is more likely in a diversified portfolio—may substantially harm or ruin some portfolios absent the protections of limited liability. See, e.g., Leebroon, supra note 1, at 1599-1600.

199. See Easterbrook & Fischel, supra note 2, at 55-56 (arguing that limited liability does not reduce monitoring costs in this context); Mendelson, supra note 1, at 1230-31 (arguing that the information costs justification for limited liability does not apply to most shareholders in closely held firms since they can monitor and control firm activities).

200. See, e.g., Easterbrook & Fischel, supra note 2, at 55-56; Mendelson, supra note 1, at 1230-31.

201. See Easterbrook & Fischel, supra note 2, at 55-56.

large enterprises.\(^{203}\) Larger corporate, institutional, or other wealthy shareholders, whether in publicly traded or closely held firms, have the capability to monitor corporate activities relatively cheaply and to force firm management to comply with their demands.\(^{204}\) Moreover, she notes that institutional and corporate investors tend to be risk neutral; therefore, limited liability serves no risk-aversion correction function with regard to these shareholders.\(^{205}\) Thus, while limited shareholder liability may produce certain benefits, its coverage is overbroad, since its benefits will be forthcoming, if at all, only with regard to small, passive investors.\(^{206}\)

Finally, it should be noted that these potentially beneficial effects, even if limited by Professor Mendelson's analysis, have related distributional benefits. By facilitating low-cost, passive investment, limited shareholder liability creates opportunities for broader participation in corporate ownership than would otherwise exist.\(^{207}\) Indeed, as discussed previously, although the claim that large-scale business enterprises would not exist without limited liability is dubious, limited liability probably has played a critical role in allowing small and passive investors to participate in and benefit from corporate activities and the equities markets.\(^{208}\)

2. Potential Social Costs

Although limited shareholder liability produces cost savings and corrects certain inefficiencies, it also inflicts costs, and therefore may not enhance social welfare. Limited liability produces the

\(^{203}\) See id. at 1206, 1230-31 ("A limited liability regime might indeed save significant costs for a shareholder with only a tiny proportion of a corporation's shares and limited access to information.").

\(^{204}\) See id. at 1219-20 (stating that for corporate shareholders and other shareholders with a significant ownership share, information about the business is "likely to be readily and cheaply available").

\(^{205}\) See id. at 1225-27. Professor Mendelson also argues convincingly that the risk-aversion justification is problematic given that tort victims as a class are less efficient risk bearers than institutional and corporate shareholders and perhaps other shareholders. See id.

\(^{206}\) See id. at 1231-32. She also notes that there are far more closely held and controlling-shareholder controlled firms than firms with dispersed ownership. See id. at 1215-18. She further argues that less wealthy, passive shareholders are rare. See id. at 1227-29.

\(^{207}\) See Bainbridge, supra note 1, at 537 (noting that, in a world without limited liability, there would be few people willing to be shareholders, and large-scale firms therefore would have few shareholders but great leverage).

\(^{208}\) Henry G. Manne, Our Two Corporation Systems: Law and Economics, 53 VA. L. REV. 259, 262 (1967) ("Limited liability is probably an essential aspect of a large corporate system with widespread public participation."); see Halpern et al., supra note 3, at 137 (stating that unlimited liability would concentrate the ownership of equity in the hands of wealthy shareholders and active trading would be unlikely).
aforementioned effects not by reducing the overall level of risk, but rather by allowing shareholders to externalize part of the cost of their investment onto corporate creditors and society at large.209 By capping shareholder liability at the level of the shareholder's investment, limited shareholder liability ensures that, if the enterprise suffers losses and ultimately becomes insolvent, someone else will bear those losses. By shifting the risk of loss to firm creditors, limited liability may increase the cost of credit capital, even though it reduces the investment costs for shareholders.210 In addition, if the creditor who ultimately bears the risk of loss under a limited shareholder liability regime is a less efficient risk bearer than the shareholder who is immune from liability, the regime has allocated risk inefficiently.211 Limited shareholder liability also raises distributional concerns if, by shifting losses, it serves as a social subsidy for one segment of society while transferring wealth away from another.212

Moreover, limited shareholder liability creates or, at a minimum, accentuates a moral hazard problem. As residual claimants, shareholders get compensated last in the corporate structure and therefore prefer projects with high rates of return.213 Such projects usually entail greater levels of risk than do those with lower rates of return.214 Yet, because limited liability caps

209. See, e.g., Mendelson, supra note 1, at 1220 (stating that limited liability addresses investor risk aversion by shifting rather than reducing risks, and that, in the tort and statutory context, these risks are shifted from shareholders to tort victims and the community at large); see also Bainbridge, supra note 1, at 528 (arguing that limited liability allows shareholders to externalize investment costs to society); Thompson, supra note 3, at 2.

210. See EASTERBROOK & FISCHEL, supra note 2, at 44-45 (acknowledging this potential increase but arguing, for various reasons, that the increase will be lower than the cost savings offered by limited liability); Leebron, supra note 1, at 1584-85.

211. See EASTERBROOK & FISCHEL, supra note 2, at 46 (indicating that the issue is whether limited liability is borne equally well by creditors and stockholders); SHAVELL, supra note 184, at 180-92 (discussing how loss bearing by risk averse parties harms social welfare); Alexander, supra note 33, at 390 ("Unlimited liability is said to produce a net gain to society because the rule shifts risk to better risk bearers."); Mendelson, supra note 1, at 1220-21 (arguing that risk shifting will improve social welfare—measured as total social utility—only if the risk-shifting party is not in a better position than the risk-receiving party to monitor and manage the risk and the receiving party is less risk averse than the risk-shifting party).

212. Cf. Mendelson, supra note 1, at 1219 n.63 ("The distributional concern is that individuals who benefit from corporate activity may be able to shift some of its costs to others who benefit little or not at all from the corporate activity.").

213. Bainbridge, supra note 1, at 529 ("Because creditors (such as a bank) have a prior claim on the firm's assets and earnings, they get paid first; shareholders get the residue (i.e., whatever is left over). Shareholders, thus, prefer projects offering potentially high rate of returns, so there will be something left over after the creditors get paid.").

214. See, e.g., HAL R. VARIAN, INTERMEDIATE MICROECONOMICS 233 (4th ed. 1996) ("[A] risk-averse investor would never hold the risky asset if it had a lower expected return than the risk-free asset. It follows that if you choose to devote a higher fraction of your wealth to the risky asset, you will get a higher expected return, but you will also incur higher risk.").
shareholders’ risk of loss at the level of their equity, shareholders will
not be concerned about risks in excess of this amount. So, from the
shareholders’ perspective, any risk of loss in excess of their equity, no
matter how large, simply equals the value of their equity. For
shareholders, this substantially increases the net present value of
highly risky projects.\textsuperscript{215} Limited liability therefore does not merely
shift risks from shareholders to creditors; it creates an incentive for
shareholders to press the firm to engage in higher risk projects.\textsuperscript{216}
Such projects, although favored by shareholders, may be excessively
risky and inflict large social costs.\textsuperscript{217}

At the same time, limited liability reduces or eliminates
shareholder incentives both to gather information about firm risk
taking and to encourage management to take precautions, whether or
not the shareholder is able to do so cheaply.\textsuperscript{218} Likewise, this regime
removes the incentive to maintain levels of capital or insurance
adequate to cover potential losses, or otherwise spread risk
efficiently.\textsuperscript{219} Indeed, limited liability creates the incentive for firms to
structure their operations and manage risk—such as by shifting risky

\textsuperscript{215} See Hansmann & Kraakman, \textit{supra} note 5, at 1883 (“[A] corporation engaged in highly
risky activities can have positive value for its shareholder, and thus can be an attractive
investment, even when its net present value to society as a whole is negative.”); Mendelson,
\textit{supra} note 1, at 1233 (“As a matter of economic theory, a shareholder will favor increases in
risky activity as long as the anticipated marginal benefit to the shareholder from an increase in
risky activity . . . exceeds the anticipated marginal loss . . . up until the point where the marginal
benefit and marginal loss from an incremental increase in risky activity are equal. Under
limited liability rules, the shareholder's total losses are capped at the value of the shareholder's
potential lost equity. Thus, such risky projects may appeal to the shareholder even though they
are socially costly.”). Because the amount of the loss in excess of firm assets is irrelevant, the
key variables are the potential return from the project and the likelihood of the loss. Limited
liability therefore creates a preference for projects presenting a small risk of a large liability.
Mendelson, \textit{supra} note 1, at 1235-36.

\textsuperscript{216} See Bainbridge, \textit{supra} note 1, at 529 (“Limited liability thus generates negative
externalities by creating incentives for shareholders to cause the company to invest in higher
risk projects than would the firm’s creditors. Because shareholders do not put their personal
assets in jeopardy, they effectively externalize some portion of the risk associated with such
investments to creditors.”) (footnotes omitted); Mendelson, \textit{supra} note 1, at 1233 (stating that,
because limited liability caps losses, shareholders will prefer the project with the greater
potential benefit even if the net social benefit, which accounts for the total potential loss, is
smaller); \textit{see also} Hansmann & Kraakman, \textit{supra} note 5, at 1883; Leebron, \textit{supra} note 1, at 1586;
Thompson, \textit{supra} note 3, at 14. Indeed, limited liability’s moral hazard will create an incentive
for the firm to engage in projects that have greater potential losses because those projects are
likely to offer a greater potential return. \textit{See} Mendelson, \textit{supra} note 1, at 1235-36.

\textsuperscript{217} Mendelson, \textit{supra} note 1, at 1233 (“Thus, such risky projects may appeal to the
shareholder even though they may be socially costly.”).

\textsuperscript{218} See SHAVELL, \textit{supra} note 184, at 168 (contending that the incentive to take care to avoid
risk is diluted if the potential injurer can shield assets); Hansmann & Kraakman, \textit{supra} note 5,
at 1882; Thompson, \textit{supra} note 3, at 14.

\textsuperscript{219} \textit{See}, e.g., Hansmann & Kraakman, \textit{supra} note 5, at 1889; Mendelson, \textit{supra} note 1, at
1233-34.
or hazardous activities to subsidiaries—in such a way as to reduce amounts available to satisfy judgments in favor of creditors.\textsuperscript{220} Correspondingly, firms enjoying limited shareholder liability will be inclined to select projects with delayed expected costs, so that the firm and its shareholders can separate assets and reap benefits (through, for example, the payment of dividends) before any judgment.\textsuperscript{221}

Going forward, the incentive to maximize and then distribute short-term gains may be enhanced by the recently enacted reduction in the dividend tax. Indeed, this shift in tax policy reduces an existing incentive—tax avoidance or deferral—to maintain or reinvest capital in the enterprise.\textsuperscript{222} Obviously, the overall effect of such reform on investor and firm behavior is unknown, but a case can be made that it will induce further excessive risk taking. The much-discussed elimination of such taxes might have an even more profound effect.

Commentators agree that limited shareholder liability encourages excessively risky activities.\textsuperscript{223} Indeed, there is some evidence that corporations actually engage in such activities.\textsuperscript{224} And there is no doubt that shareholders and firms structure their operations to avoid foreseeable tort liabilities, thereby reducing the costs of monitoring, capitalization, and insurance—the firm

\textsuperscript{220} See, e.g., Mendelson, supra note 1, at 1234.

\textsuperscript{221} See Hansmann & Kraakman, supra note 5, at 1884 (discussing the shareholders' option to liquidate the firm before tort liability attaches); see also Mendelson, supra note 1, at 1236 (noting that delayed judgments allow shareholders greater opportunities to separate corporate assets from risky activities). Delayed judgments resulting from delayed injuries or latent defects are typical in cases involving defective product and environmental injuries. See Mendelson, supra note 1, at 1237.

\textsuperscript{222} See Andrew Leckey, Once Snubbed, Dividends Are Regaining Favor, CHI. TRIB., June 10, 2003, at C5 (noting that the new tax rate on dividends received after January 1, 2003, is 15 percent, or 5 percent for certain investors in lower tax brackets); see also Ken Brown, Tax-Cut Plans Spark a Rally—Can It Last?—Dividend Proposal Won't Quickly Solve Market's Problems, WALL ST. J., Jan. 7, 2003, at C1 (noting that a dividend tax cut could pressure companies to pay a dividend, which could reduce available cash for beneficial corporate undertakings).

\textsuperscript{223} See supra notes 213-217 and accompanying text. Even limited liability's staunchest defenders recognize that limited shareholder liability creates an incentive to engage in excessively risky activities. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 49-50; Bainbridge, supra note 1, at 529.

\textsuperscript{224} See Mendelson, supra note 1, at 1239-47 (arguing that veil piercing cases, subsidiary bankruptcies, and the purposeful utilization of limited liability devices to minimize liability risk suggest that corporations engage in excessively risky activities); see also Hansmann & Kraakman, supra note 5, at 1881 (discussing empirical evidence of strategies to avoiding tort risk in high risk industries and incomplete insurance). Hansmann and Kraakman also argue that the small number of bankruptcies in publicly traded firms may underrepresent the frequency with which such firms cause tort damages exceeding their net worth, since tort victims have strong incentives to accept a settlement for less than the full value of the firm. Id. at 1895.
disaggregation in Walkovszky offers but one example. However, the aggregate costs of these activities, like the aggregate benefits of limited liability, remain empirically unquantified and perhaps unquantifiable.

Yet certainly, the potential social costs of limited liability and the corresponding distributional concerns vary by creditor type. These costs and concerns are reduced in the context of voluntary creditors, or at least sophisticated contracting parties such as commercial lenders. While limited shareholder liability increases the risk, and therefore the cost, of credit capital, this increase may be lower than the information costs savings to many shareholders. Sophisticated voluntary creditors often have the knowledge and ability to monitor firm activities more cheaply than shareholders can, and, to lower risk premiums, firm managers have an incentive to facilitate such creditor oversight. In addition, voluntary creditors are in a position to forego much of this monitoring: to the extent they are concerned about the risk of firm insolvency and nonpayment, they can take steps ex ante—including demanding shareholder guarantees, securing the debt with collateral, charging appropriate premiums, and diversifying their debt investments—to insure against nonpayment ex post. The moral hazard problem will remain, but these types of creditors often are well positioned to manage that risk or to forgo the investment. They are thus likely to be efficient risk bearers relative to...
Moreover, shifting the risk of loss to these types of creditors raises few distributional concerns.

Although some observers have suggested that, in the closely held context, limited liability should not be the default rule, even for voluntary creditors, prevailing thought is to the contrary. Indeed, the notion that voluntary creditors ought to bear the burden of hedging against or bargaining around limited shareholder liability is consistent with the courts’ increasing reluctance to pierce in contract cases absent shareholder fraud or illegal conduct. Thus, there is growing agreement that limited shareholder liability is an efficient default rule in the voluntary creditor context.

Nevertheless, in the involuntary creditor context—the focus of this Article—limited liability’s potential costs and distributive concerns are paramount. To begin with, tort victims and the victims of tort-like statutory violations, the quintessential involuntary creditors, rarely have the ability to avoid losses caused by corporate activities because they face prohibitively high information and monitoring costs. Moreover, they rarely are able to bargain with the firm ex ante for protection against firm-created risks and losses. In addition to their inability to avoid firm-created risks, tort victims are less likely than many shareholders to be able to insure adequately.

230. See Bainbridge, supra note 1, at 542 (arguing that voluntary creditors are the “cheapest cost avoiders”); see also Easterbrook & Fischel, supra note 2, at 48 (noting the plausible assumption that creditors are often the most efficient risk bearers). Also, unlimited liability may produce no net benefit for voluntary creditors, since their information costs, including monitoring the wealth of shareholders, might be higher than under limited liability. See Halpern et al., supra note 3, at 135.


232. See, e.g., Easterbrook & Fischel, supra note 2, at 45-46, 55 n.8, 58; Bainbridge, supra note 1, at 534; Booth, supra note 4, at 157-58; Hansmann & Kraakman, supra note 5, at 1919-20; Leebrom, supra note 1, at 1589; Richard Posner, The Rights of Creditors of Affiliated Corporations, 43 U. Chi. L. Rev. 499 (1976); Thompson, supra note 3, at 13.

233. See supra note 84-88 and accompanying text.


235. See Mendelson, supra note 1, at 1222. There may be some limited exceptions, including the purchase of products with obvious defects or when the tort victim is a business or other institution. See id. at 1222 nn. 75-76. But the vast majority of tort cases are brought by individual plaintiffs. Id. at 1222 n.76. Small, passive investors likewise may find information and monitoring costs to be prohibitive. See id. Yet, shareholders still have some advantage in acquiring firm information over tort victims.

236. See Hansmann & Kraakman, supra note 5, at 1920; Mendelson, supra note 1, at 1222. Small shareholders usually do not have de facto bargaining power either, but they can sell their shares to avoid risk. Id.
against losses or otherwise spread risk efficiently. And some common consequences of tortious activity, including physical injuries and death, cannot be diversified. Obviously, generalizations are difficult, but, for all of these reasons, tort victims often are inefficient risk bearers. Indeed, Professor Mendelson and other scholars make a compelling argument that tort victims are, as a class, less efficient risk bearers than many shareholders.

Limited shareholder liability therefore produces social costs in the tort context when shareholders—regardless of their particular risk characteristics—shift some of their risk of loss to a class of more inefficient risk bearers. The moral hazard problem enhances these inefficiencies: shareholders enjoying limited liability have an incentive to engage in excessively risky activities and to externalize these risks onto potential tort victims. And, accordingly, limited liability and its moral hazard may impair the aims of our tort system—deterrence, adequate compensation, and the efficient allocation of risk. This shift of the risk of loss from one segment of society to another also

237. See Mendelson, supra note 1, at 1224-25. Tort victims generally are individuals and, using the most conservative assumptions, are likely to be randomly distributed by income. See id. at 1224. Thus, they are likely to be more risk averse than institutional and other wealthy individuals.

238. See id. at 1221-27; see also Leebron, supra note 1, at 1602-03 n.116 (stating that tort injuries are often nondiversifiable).

239. See Mendelson, supra note 1, at 1221-27. The ability of a tort victim to bear the loss efficiently may depend on a number of factors, including the size of injury, the nature of the injury, and the victim's wealth. Id. at 1223; see SHAVELL, supra note 184, at 189 (noting that risk aversion will depend on the size of the risk). Nevertheless, a tort victim's inability to monitor firm activities and bargain for protection, combined with the potential for undiversifiable risks, insufficient insurance, and relatively low wealth, makes this assumption a defensible one. But see Leebron, supra note 1, at 1630 (arguing that shareholders in closely held firms may not be efficient risk bearers relative to tort victims, particularly when injuries are small and widespread).

240. Mendelson, supra note 1, at 1221-27 (arguing that tort victims are likely to be less efficient risk bearers than at least institutional and other wealthy shareholders, and perhaps all shareholders); id. at 1230-32 (discussing individual investors in closely held firms). Indeed, Professor Mendelson argues that the vast majority of shareholders are either institutional investors or wealthy individuals. See id. at 1227-29 (citing various statistics regarding shareholder characteristics).

241. Risk shifting in this context therefore harms social utility. See SHAVELL, supra note 184, at 207 ("In the case where victims are risk averse and injurers are risk neutral, it will be optimal... for injurers to bear the risk of victims' losses."); Mendelson, supra note 1, at 1225 (stating that risk shifting in this context would harm social utility).

242. See, e.g., Thompson, supra note 3, at 14.

243. See infra notes 480-484 (discussing the aims of our tort regime); see also Halpern et al., supra note 3, at 145 ("Limited liability here may undermine the deterrent objectives of the tort system because of moral hazard problems. In addition, there is no incentive for the owner to carry adequate insurance since, in the event of default, there is no cost to the owner."). This impairment is enhanced by the fact that tort victims, as unsecured creditors, are paid off last in bankruptcy.
raises distributional concerns, particularly since tort victims, as a class, are likely to be less wealthy than shareholders.\footnote{244} In sum, while limited shareholder liability produces some beneficial effects, it can inflict social costs. Commentators agree that these costs, including the moral hazard problem, are most pronounced in the context of tort creditors. But that is where their agreement ends. The debate over whether and how to alter the current limited liability regime focuses largely on the extent of these costs. Scholars disagree on the size and scope of the moral hazard problem, whether an alternative regime would maintain the beneficial effects of limited liability while lowering its costs, and the extent to which such alternatives would produce other costs that may exceed the costs inflicted under the current regime.

B. Parsing the Arguments to Reform or Retain the Existing Regime

Scholarly responses to the social costs limited shareholder liability inflicts in the tort context vary widely. Some commentators have offered fairly targeted proposals; for example, some have proposed statutory reforms or modifications to piercing doctrine in specific contexts and others have proposed minimum insurance or capitalization requirements in particular industries.\footnote{245} These kinds of proposals, however, tend to ignore resulting inefficiencies, larger conceptual issues, and application problems. Statutory insurance or capitalization requirements, for example, are likely to be inefficient and ineffective since legislatures rarely will be able to set these requirements at optimal levels, much less make necessary adjustments to account for variables such as firm size and structure, market conditions, changing risk factors, and inflation.\footnote{246} In

\footnote{244. Mendelson, supra note 1, at 1224 n.86 (noting that tort victims may not be randomly distributed and may in fact tend to be low income, given that some kinds of hazards, such as environmental harms, tend to be concentrated in low-income areas and wealthier individuals are more able to take steps to avoid certain risks); \textit{id.} at 1227 n.95 (suggesting that distributional concerns might weigh against shifting losses from shareholders to tort victims). The various normative bases for these distributional concerns are beyond the scope of this Article. However, I suggest that my proposal ultimately may be consistent with various normative analyses of the proper allocation of responsibility in the tort context.}

\footnote{245. See, e.g., Grundfest, supra note 167, at 421 (discussing various alternatives to shareholder liability, including minimum capitalization requirements). Professor Leebroon has suggested that subordinating all lenders to tort claimants in bankruptcy might create efficiencies. \textit{See Leebroon, supra note 1, at 1648-49. However, changing bankruptcy priorities may have a limited effect on limited liability's moral hazard. \textit{See Hansmann & Kraakman, supra note 5, at 1929-30 (likewise rejecting the bankruptcy approach to reform).}}

\footnote{246. \textit{See, e.g.,} Easterbrook \& Fischel, supra note 2, at 60-61 (discussing the problems with these proposals including inefficiencies, administrative costs, and resulting barriers to entry); Hansmann \& Kraakman, \textit{supra} note 5, at 1928-29; Mendelson, \textit{supra} note 1, at 1205-06 n.7}
Walkovszky, there were minimum insurance requirements in place, but the statutory amount was set far too low to cover foreseeable tort judgments and failed to address judgment avoidance techniques, such as dividing the enterprise into separate corporations. Also, as discussed previously, proposals to alter various aspects of piercing doctrine fail to consider the larger conceptual problems with piercing.

More comprehensive proposals fall roughly into three groups. The first group of commentators seeks to end the externalization of risk onto tort creditors by extending vicarious liability for corporate torts to all shareholders. Professors Hansmann and Kraakman ("Hansmann and Kraakman") offer the most well known of these proposals, advocating pro rata shareholder liability for corporate torts. The second group, conversely, largely defends limited liability, even in the tort context, arguing that it avoids transaction costs and that, at least in the publicly traded context, its moral hazard is checked by managerial risk aversion and other factors. These commentators tend to acknowledge, however, that limited liability's costs are greater—and its benefits fewer—in the closely held context, and thus they are more willing to support vicarious shareholder liability in some closely held firms. The third group similarly argues that limited liability is socially costly in the closely held context, yet they advocate the extension of vicarious liability for corporate torts to one or more controlling stakeholders in publicly traded firms as well.

As I discuss below, although the Hansmann and Kraakman proposal has generated enormous scholarly interest, it is widely viewed as an unattractive approach to addressing limited liability's social costs. The second and third groups agree that at least some shareholders should retain the benefit of limited liability, but differ over whether and when to hold other corporate stakeholders liable for corporate torts. The third group's parsing of the justifications for and costs of limited shareholder liability—and, in particular, Professor Mendelson's control-based analysis—is more persuasive. Nevertheless, much is missing in the current proposals, including a thorough analysis of the role of limited managerial liability and the

(noting that these kinds of proposals would require the government to anticipate risks and set levels accordingly, despite inferior information).

247. Walkovszky v. Carlton, 223 N.E.2d 6, 7 (N.Y. 1966); see supra note 63.
248. See generally supra Part II.B.
249. See infra Part III.B.1.a.
250. See infra Part III.B.1.b.
251. See infra Part III.B.1.c.
feasibility of significant reform in the current shareholder liability regime. Indeed, by taking aim at limited shareholder liability, Professor Mendelson's proposal, like many that preceded it, would prove to be both unrealistic and ineffective.

1. Existing Responses to Limited Shareholder Liability

As a threshold issue, various sides in the debate over limitations on shareholder liability have sought to define its starting point. Some of the defenders of limited liability caution against upsetting the current regime absent a compelling, perhaps empirically supported demonstration that an alternative would reduce the social costs of limited liability. At the same time, the alternative must not inflict even greater costs, such as increasing transaction costs and deterring socially beneficial corporate risk taking.²⁵² Hansmann and Kraakman contend that the burden is on proponents of limited liability to justify its continued existence.²⁵³ Although I agree that careful consideration should precede any reform, there should be no presumption one way or the other. As discussed previously, there is evidence of excessive corporate risk taking, but the aggregate marginal benefit or cost of limited shareholder liability and its alternative regimes has not been and cannot be quantified.²⁵⁴

a. Pro Rata Liability

In recent years, few commentators have advocated joint and several shareholder liability for corporate torts.²⁵⁵ Such a regime, it is largely agreed, would destroy many of the beneficial effects of limited liability. Others have argued, however, that all shareholders should be subject to pro rata liability for corporate torts.²⁵⁶ Most notably, Hansmann and Kraakman contend that a pro rata regime, which would limit a shareholder's exposure for tort losses to the shareholder's proportionate share of ownership, would retain the

²⁵². See, e.g., Bainbridge, supra note 1, at 555-56 (arguing that the status quo deserves to be the null hypothesis); see also Easterbrook & Fischel, supra note 2, at 49-50 (stating that whether limited liability ought to be retained for torts is an empirical question and then suggesting that, given the survival of the current regime, a preferable regime seems unlikely).
²⁵³. Hansmann & Kraakman, supra note 5, at 1880 ("[W]e conclude that the burden is now on the proponents of limited liability to justify the prevailing rule.").
²⁵⁴. Like other scholars, I question whether existing levels of corporate risk taking are either beneficial or necessary. And, even if some current risk taking is socially beneficial, and therefore should be subsidized, blanket limited liability protection is still too broad. See, e.g., Leebron, supra note 1, at 1574-78.
²⁵⁵. Cf. Gabaldon, supra note 5, at 1440 (suggesting limited liability is unjustified).
²⁵⁶. See supra note 5.
benefits of limited liability, including information costs savings, diversification, and share fungibility. At the same time, such unlimited shareholder liability would force the firm to internalize the risks created by its activities, thereby inducing socially efficient levels of monitoring to avoid risk as well as capitalization and insurance to cover unavoidable risks. Hansmann and Kraakman further contend that the new transaction and administrative costs that this regime would create would not be serious and, in all likelihood, would be offset easily by the social costs it would prevent.

So thorough and provocative is their critique of limited liability that Hansmann and Kraakman have all but defined the debate in the last decade. Yet such a pro rata regime, while preferable to joint and several liability, might prove more costly and less effective than Hansmann and Kraakman acknowledge. They concede that this regime would induce some additional shareholder monitoring of the firm and each other, inflicting some costs. But others argue that passive and certain other shareholders may be poorly suited to assume the risk of corporate activities, even on a pro rata basis, which might result in inefficient levels of monitoring or a reduction in investment by shareholders unable to control corporate affairs. In addition, a pro rata regime might reduce beneficial monitoring of agency costs because it would discourage investors from assembling controlling blocks of shares and thereby becoming visible targets of tort plaintiffs. Conversely, if investors do become controlling shareholders, Professor Mendelson argues that pro rata liability is insufficient to deter them from engaging in excessively risky activities.

257. Hansmann & Kraakman, supra note 5, at 1892-93, 1903-06.
258. See id. at 1904.
259. Id. at 1896-1901. Rather than adopt an occurrence-based regime, which they contend would be difficult to administer, Hansmann and Kraakman propose a modified claims-made rule, attaching liability at the time the claims are filed or when management becomes aware of a high probability of such a claim, whichever comes first. Id. at 1897.
260. For example, both Professors Bainbridge and Mendelson treat Hansmann and Kraakman’s pro rata proposal as the major alternative to limited shareholder liability. See Bainbridge, supra note 1, at 536-40 (critiquing pro rata liability); Mendelson, supra note 1, at 1280-96 (comparing her proposal to the current regime and a pro rata regime).
261. Hansmann & Kraakman, supra note 5, at 1906.
262. See Bainbridge, supra note 1, at 539-40; Leebron, supra note 1, at 1600 (“[U]nlimited liability in either of its forms might significantly deter from equity investments those investors seeking to diversify their investments, which would include most passive and fiduciary investors.”).
263. See Bainbridge, supra note 1, at 539-40; Leebron, supra note 1, at 1610; Thompson, supra note 3, at 18 (noting that mutual funds would decline because they would become a target of tort plaintiffs and therefore offer lower rates of return). Hansmann and Kraakman acknowledge this risk, but downplay its significance in a pro rata regime. See Hansmann & Kraakman, supra note 5, at 1905.
since they could use their control to extract greater than a pro rata share of benefits from the firm. 264 And, according to Professor Grundfest, capital market participants would respond to this regime by engaging in various forms of risk arbitrage, thereby evading liability. 265

Moreover, a number of scholars have argued that this kind of regime would be costly and ineffective because of the enormous collection costs it would inflict ex post. 266 For example, Professor Alexander has detailed the enormous procedural and other hurdles tort plaintiffs would have to overcome to hold large numbers of shareholders accountable. 267 Other commentators have noted, given the constantly changing ownership of publicly traded firms, the high cost of utilizing litigation to determine which shareholders in such firms are accountable. 268 In turn, Professor Mendelson argues that the excessive costs of seeking to hold numerous small shareholders liable on a pro rata basis would preclude tort victims from receiving full compensation, and thereby would only partially address the externalization of risk. 269 These significant transaction costs and collection difficulties, combined with the potential costs described above, render pro rata liability an unattractive alternative.

b. Retaining Limited Shareholder Liability

The most ardent efficiency-based defenders of limited shareholder liability for corporate torts recognize that limited liability potentially inflicts social costs and creates a moral hazard problem. Nevertheless, these commentators reject broad reform for a number of reasons. As discussed above, this group warns that alternative regimes, such as pro rata shareholder liability, will inflict significant transaction costs and may deter socially beneficial corporate

264. See Mendelson, supra note 1, at 1283-84 (concluding that a pro rata regime would tend to underdeter controlling shareholders from influencing the corporation to engage in excessively risky activity and would create an insufficient incentive to capitalize or insure appropriately).
265. See generally Grundfest, supra note 167, at 392-405.
266. See, e.g., Bainbridge, supra note 1, at 536-37 (discussing the significant procedural hurdles—choice of law, personal jurisdiction—tort creditors would face in seeking to hold shareholders liable); Leebron, supra note 1, at 1610-11 (discussing the substantial collection costs associated with pro rata liability).
267. See Alexander, supra note 33, at 398-99; see also Bainbridge, supra note 1, at 536-37.
268. See Bainbridge, supra note 1, at 537. This would be true even under Hansmann and Kraakman’s claims-made rule. See id.
269. See Mendelson, supra note 1, at 1284-85; id. at 1292 ("Considerable transaction costs could consume much of the potential recovery.").
activity. But, they also question the extent to which the current regime actually inflicts social costs.

A core argument of this group is that there are other corporate constituencies, more risk averse than shareholders, who will compel the firm to reduce risks and insure against firm losses, thereby blunting the effects of limited liability's moral hazard. Primary among these constituencies are firm managers. Because managers have firm-specific investments of human capital, the argument goes, they cannot diversify away the risk of business failure. Managers, who possess the authority to make risk-bearing decisions on behalf of the firm, are unlikely to select activities that create a threat to the existence of the firm and, hence, to their jobs and livelihood. Management therefore may prefer a strategy of achieving profits at a level sufficient to satisfy shareholders and to receive performance-based compensation, rather than a strategy of unrestrained profit maximization. Correspondingly, management, unlike shareholders, will have an incentive to maintain sufficient levels of capital to protect against business failure or to insure corporate activities in excess of capital. And, to reduce insurance premiums, managers will have a further incentive to avoid risks. At the same time, agency costs may prevent

270. See supra notes 252, 261-265 and accompanying text. Easterbrook and Fischel also argue, for example, that managerial liability will cause overdeterrence. See EASTERBROOK & FISCHEL, supra note 2, at 61-62.

271. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 53 ("Human capital, for example, is notoriously difficult to diversify. Managers who have firm-specific investments of human capital cannot diversify the risk of business failure."); Larry E. Ribstein, Limited Liability and Theories of the Corporation, 50 MD. L. REV. 80, 128 (1991) (making an assertion similar to that of Easterbrook and Fischel); see also Kraakman, supra note 6, at 863-66 (discussing managerial risk aversion).

272. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 53; Bainbridge, supra note 1, at 573-74; Thompson, supra note 3, at 19-20.

273. See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 MICH. L. REV. 1, 29 (1986) (stating that managers seek profits at a level sufficient to prevent external intervention by dissatisfied creditors or stockholders); see also Mendelson, supra note 1, at 1248 ("[M]anagers might prefer to select corporate activities . . . that will satisfy stockholders enough to keep managers' jobs, even if such an approach does not obtain every possible profit dollar for stockholders.").

274. EASTERBROOK & FISCHEL, supra note 2, at 53. This does not mean that management always takes sufficient care or will avoid all overly risky activities. If management feels that the firm is adequately insured against losses, another moral hazard problem emerges, since the insurer, rather than the firm, will bear much of the risk of loss. Id. at 54. However, insurer monitoring and premiums provide some check against such behavior. See id.

275. See Bainbridge, supra note 1, at 573-74 (summarizing this argument); see also EASTERBROOK & FISCHEL, supra note 2, at 53-54 (stating that the purchase of insurance creates a contract creditor where none existed before and the firm therefore faces costs if it engages in risky activities).
In addition to management, a corporation's voluntary creditors have incentives to prevent business failure. Voluntary creditors face the risk of nonpayment or incomplete payment if the firm fails. Thus, voluntary creditors may bargain for protections that reduce their repayment risk, such as access to firm information, veto power over certain decisions, premium rates that reflect the level of risk of firm activities, or maintenance of insurance or minimum levels of capital. Firms may have corresponding incentives to reduce risk and adequately insure to lower risk premiums. Creditor bargaining and corresponding monitoring provide imperfect protection, however, since many creditors may forgo the costs of monitoring and seek to reduce nonpayment risk in other ways, such as charging higher premiums ex ante and diversification. Yet, voluntary creditors may provide a check against excessive risk taking in some circumstances.

But even the defenders of limited liability recognize that the offsetting effects of managerial and creditor risk aversion do not apply equally in every context and can be avoided through judgment-proofing techniques. First, managerial risk aversion is reduced and perhaps extinguished in the closely held context because small firms tend to be shareholder managed and, as shareholders, these managers are likely to prefer risky projects that offer greater returns. Second, the nature of closely held corporations—for

276. See Mendelson, supra note 1, at 1248-49.
277. EASTERBROOK & FISCHEL, supra note 2, at 50.
278. See, e.g., Bainbridge, supra note 1, at 544; Ribstein, supra note 271, at 128; Thompson, supra note 3, at 36-37.
279. EASTERBROOK & FISCHEL, supra note 2, at 52.
280. See, e.g., id. (noting that voluntary creditors may have imperfect information about firm risk or insufficient incentives to monitor risks); id. at 51 (suggesting that there may be an externality at the point at which the firm no longer must raise new capital); Thompson, supra note 3, at 37 (“This protection for tort creditors from the existence of contract creditors would decrease or disappear, however, if a corporation never enters the credit market, if it does not plan to go back to the credit market (a 'final period' problem), or if its only creditors cannot effectively learn of the risks so as to charge an appropriate premium . . . .”). Voluntary creditor insistence on the maintenance of adequate operating reserves also will provide insufficient protection since tort judgments may greatly exceed such operating levels. See Mendelson, supra note 1, at 1236-37. Moreover, a high ratio of debt to equity may accentuate limited shareholder liability’s moral hazard. See Hansmann & Kraakman, supra note 5, at 1884.
281. See, e.g., Bainbridge, supra note 1, at 533 (“To the extent that the creditor is concerned about the corporation's creditworthiness it can simply raise the interest rate it charges to reflect the risk that the firm will not repay the obligation.”).
282. EASTERBROOK & FISCHEL, supra note 2, at 56; Bainbridge, supra note 1, at 541.
283. EASTERBROOK & FISCHEL, supra note 2, at 56; Bainbridge, supra note 1, at 541; see Halpern et al., supra note 3, at 141 (arguing that the moral hazard problem is particularly
example, their relative informality and exemption from public disclosure requirements—may make creditor oversight less effective.\textsuperscript{284} Thus, rather than seeking to control the activities of closely held firms, voluntary creditors of such firms may simply bargain for personal guarantees, higher premiums, or other security, which, in turn, will not curb shareholder tendencies toward risky behavior.\textsuperscript{285} These differing incentives, combined with the fact that the beneficial effects of limited liability are less pronounced in closely held firms, have led even some otherwise ardent defenders of limited liability to question the efficiency of limited shareholder liability for the torts of close corporations.\textsuperscript{286}

Moreover, defenders of limited liability acknowledge that neither managerial risk aversion nor voluntary creditor oversight is likely to offset limited liability's moral hazard if the firm can structure its operations to protect the firm, its management, and its voluntary creditors from tort judgments. Most often, firms seek to externalize this risk by forming wholly owned subsidiaries.\textsuperscript{287} Firms that would otherwise operate within the constraints of risk aversion can engage in excessively risky activities—to seek maximum returns—by assigning those activities to separately incorporated subsidiaries that maintain capital and insurance far below expected liabilities.\textsuperscript{288} Limited shareholder liability prevents tort victims from collecting judgments from the parent, and, thus, the parent's managers and creditors will not face the risk of business failure. Managers of the subsidiary likewise will not be risk averse as long as they are also managers of the parent, since the failure of the subsidiary will not cause them to lose their investment of firm-specific human capital. Relatedly, such judgment proofing does not produce the beneficial

\textsuperscript{284} See, e.g., Halpern et al., supra note 3, at 143-45 (discussing the incentives for firms to take risks unanticipated by creditors and the heightened moral hazard problem in the closely held context).

\textsuperscript{285} Cf. Bainbridge, supra note 1, at 533 (noting that creditors need not worry about firm creditworthiness since they can simply raise the interest rate to reflect the risk of nonpayment).

\textsuperscript{286} See, e.g., EASTERBROOK \& FISCHEL, supra note 2, at 56 (stating that piercing in favor of tort and trade creditors unable to negotiate with the firm reduces the externalization of costs).

\textsuperscript{287} See id. at 56-57 (stating that the moral hazard problem is probably greater in the parent-subsidiary context because the parent can reap the benefits of subsidiary activities but there are fewer risk aversion effects and incentives to monitor and insure); Bainbridge, supra note 1, at 569 ("The ability to allocate business activities between a parent and various subsidiaries facilitates the externalization of risk.").

\textsuperscript{288} See EASTERBROOK \& FISCHEL, supra note 2, at 56-57.
efficiency-based or distributive effects limited shareholder liability offers in other contexts. 289

Thus, scholars in this group generally defend limited liability for shareholders in publicly traded firms, but recognize that the arguments in favor of limited liability for closely held corporations and parent-subsidiary groups are weaker. 290 Yet some still question whether, on balance, shareholder liability should be unlimited in these contexts. Professor Bainbridge, for example, argues that other factors, including reputational considerations and demands by voluntary creditors, may create sufficient incentives for shareholders in closely held corporations to take precautions and insure. 291 Scholars have noted that substitutes for limited liability, including market insurance and veil piercing, would not eliminate moral hazard entirely and would impose additional transaction costs. 292 For example, Professor Bainbridge contends that veil-piercing doctrine—which, given the current statutory framework, would be the primary means of imposing shareholder liability—imposes costs in the form of ex ante uncertainty and unpredictability, and ex post collection costs. 293 In addition,

289. See Blumberg, supra note 3, at 630 ("If a subsidiary corporation constitutes only one of a number of components of a corporate group collectively conducting a fragmented unitary business, the very basis for the establishment of limited liability as a matter of general legal policy disappears.").

290. See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 55-56. Professor Bainbridge notes that concerns about diversification and excessive monitoring are far less significant in this context. Bainbridge, supra note 1, at 543. He also points out that the collection costs of unlimited liability are greatly reduced in the closely held context, given the small number of potential defendants. See id. at 541. And, he discusses why holding a parent liable for a subsidiary's conduct will not discourage investor diversification or cause the parent's shareholders to invest excessively in firm monitoring. See id. at 569.

291. See Bainbridge, supra note 1, at 544. Professor Bainbridge and others also argue that some owners of closely held firms will avoid the risk of insolvency because the venture may be his or her livelihood. Id.; Booth, supra note 4, at 156 (arguing that small business owners tend to have a substantial portion of their wealth tied up in the firm, and thus, are unlikely to "bet the farm" on risky projects); Leebron, supra note 1, at 1628 (arguing that owners of small firms often are undiversified); Thompson, supra note 3, at 33 (noting that the inability of participants to diversify their human or financial capital may lead to overdeterrence). This is true in some circumstances, although Professor Bainbridge concedes that it will not be true in others. See Bainbridge, supra note 1, at 544 n.120. Indeed, where the perceived risks of bankrupting losses resulting from an activity are low, but the potential return is high, it would make economic sense under a limited liability regime for such an owner to have the firm engage in such a project. Cf. Booth, supra note 4, at 156 (conceding that this bet may make economic sense).

292. See EASTERBROOK & FISCHEL, supra note 2, at 50 (suggesting the moral hazard problem will remain even without limited liability); Halpern et al., supra note 3, at 140-43 (discussing how the moral hazard problem will remain even with insurance); Hansmann & Kraakman, supra note 5, at 1889-90 (noting the transaction costs associated with insurance). For example, if a firm is fully insured against tort losses, and therefore judgment proof, the firm's participants would have incentives to engage in risky activities since they would not bear the cost of those activities. See Halpern et al., supra note 3, at 140-41.

293. Bainbridge, supra note 1, at 554-55, 575.
Easterbrook and Fischel argue that holding corporate parents and/or affiliates liable for the obligations of subsidiaries would have the perverse effect of giving the smallest, independent firms a competitive advantage over larger firms.\textsuperscript{294} Thus, Easterbrook and Fischel, along with Professor Bainbridge, support parent liability for subsidiary torts only when the overall risk level from that corporate structure exceeds the level that would result if the subsidiary were organized as a separate venture.\textsuperscript{295}

However, these arguments against extending vicarious liability to shareholders in the closely held firms may be overstated. As I discussed previously and will revisit below, Professor Bainbridge's practical concerns regarding piercing doctrine are warranted. Yet, some other kind of alternative liability regime that is conceptually sound, contains clear standards, and targets a discrete subset of stakeholders need not inflict the transaction costs he discusses. Also, while reputational factors and voluntary creditor demands may occasionally neutralize limited liability's moral hazard, they are not a sufficient proxy for shareholder liability. These supposed neutralizers will have no effect on some shareholders and a limited effect on others,\textsuperscript{296} while shareholders enjoying limited liability will always have a strong, countervailing incentive to externalize risk. Moreover, market insurance is not a perfect check against moral hazard, and is not free of transaction costs. But such insurance does preclude the costless externalization of risk onto involuntary creditors and provide compensation for some creditors that may not otherwise exist, and, relatively speaking, its transaction costs are not serious.\textsuperscript{297}

\textsuperscript{294} EASTERBROOK \& FISCHEL, supra note 2, at 57. They argue that if all affiliated entities were liable for the losses of the entire enterprise, this would require greater (group-wide) monitoring by voluntary creditors, and hence, greater costs. See id. Moreover, corporate groups responding to managerial and creditor risk aversion would have to retain greater capital or insurance to protect against these losses. Small, independent firms would not have to carry the same level of insurance. See id. Such a rule would promote corporate disintegration, harming potential tort victims, since smaller firms may be less likely to carry adequate insurance. Id.

\textsuperscript{295} EASTERBROOK \& FISCHEL, supra note 2, at 57; Bainbridge, supra note 1, at 574 (stating his proposal for a restricted form of enterprise entity liability, which would focus on whether the firm has split up a single enterprise into multiple corporations with the goal of externalizing specific risks).

\textsuperscript{296} Again, monitoring by voluntary creditors is an imperfect check against externalization, particularly in the closely held context. See Halpern et al., supra note 3, at 144-45; see also supra notes 280-281 and accompanying text. And, reputational concerns cut both ways since higher returns offer reputational advantages.

\textsuperscript{297} See Halpern et al., supra note 3, at 145-46; Hansmann \& Kraakman, supra note 5, at 1889-90 (discussing transaction costs). Although imperfect, insurer monitoring and premiums would provide some check against this moral hazard. See, e.g., Halpern et al., supra note 3, at 138-41, 145-46; Hansmann \& Kraakman, supra note 5, at 1890. Since the premium will depend on the behavior of the firm, shareholders will have an interest to undertake some cost-justified,
Furthermore, I question whether subsidiaries usually are better insured for foreseeable risks than are small, independent firms. Even if they are, parent or affiliate liability would create a competitive advantage for small, independent firms only if the individual shareholders of those firms were not likewise subject to liability for corporate torts. Larger corporate groups would retain greater capital and insurance, but at levels commensurate with their greater overall levels of risk. Indeed, under a regime in which all shareholders of closely held corporations—both individuals and corporate parents—were liable for corporate torts, the more likely effect would be a barrier to entry for firms too new or too small to secure adequate insurance, maintain sufficient capital, or otherwise spread risk efficiently. This cost of reduced competition should not be ignored, but it would have the opposite effect of that described above: although there might be fewer firms engaging in some risky activities or industries, the participating firms would be more likely to satisfy tort judgments.

c. Control-Based Approaches

The final group of commentators agree that limited shareholder liability produces certain beneficial effects. They also agree that limited liability is less justified in the closely held context, although they are less hesitant about extending liability for corporate torts to some or all shareholders in closely held firms. But, unlike the previous group, these scholars argue that certain controlling
stakeholders in both closely held and more widely traded firms should be liable for corporate torts.

For example, a number of years ago, Professor Halpern and his coauthors argued that shareholders in closely held firms should be liable for corporate torts—for reasons similar to those discussed above—and that vicarious liability should also extend to directors of publicly traded corporations.\(^{302}\) In proposing director liability, they reasoned that such a rule would minimize the monitoring costs for shareholders, reduce enforcement costs for tort creditors, and create incentives to adopt avoidance precautions.\(^{303}\)

Although much of their economic analysis of limited liability has proven influential, the proposal by Halpern and his coauthors to hold directors vicariously liable for corporate torts has not gained adherents. Critics of director liability argue that the risk of potentially catastrophic tort liability would be socially costly by, for example, deterring otherwise qualified persons from becoming directors.\(^{304}\) It also would overdeter corporate risk taking, inducing directors to select only activities offering sub-optimal levels of risk to avoid potential tort losses.\(^{305}\) For these reasons, few others have seriously considered extending vicarious liability to (nonshareholder) directors or other managers of publicly traded corporations.\(^{306}\)

In a later article, Professor Thompson offers the most thorough discussion of managerial liability. In addition to advocating greater veil piercing in the parent-subsidiary context,\(^{307}\) he approves the trend towards holding corporate managers accountable for the failure to monitor or supervise employees who commit torts or statutory

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303. See id. at 148-49. Their proposal rejects extending liability to employees of the firm, contending that employees often cannot diversify against business failure and are relatively less able to bear losses. Id. at 149-50.
304. See, e.g., Hansmann & Kraakman, supra note 5, at 1929 (arguing that managerial liability is most likely to lead to resignations).
305. See id.
306. Professor Kraakman discussed the potential benefits and costs of managerial and other forms of “gatekeeper” liability in his 1984 article, suggesting that managerial liability may be socially beneficial in some circumstances where enterprise liability fails as a legal control. See generally Kraakman, supra note 6, at 868-98. However, he and Professor Hansmann later dismiss managerial liability as inefficient. See Hansmann & Kraakman, supra note 5, at 1929. Also, although Professor Mendelson’s critique of limited liability is otherwise thorough, she only contrasts her controlling shareholder regime with the current limited liability regime and a pro rata shareholder liability regime. See generally Mendelson, supra note 1, at 1279-96 (comparing these regimes). She does not consider liability for firm managers.
307. Thompson, supra note 3, at 37-38 (arguing that parent liability is appropriate when the parent corporation so controls the subsidiary as to leave the usual incentives to reduce risk and insure ineffective).
violations. Professor Thompson also suggests that limited liability is least justified for individuals who are both managers and shareholders, since shareholder-managers have an incentive to externalize risk that may offset managerial risk aversion. He stops short, however, of offering a more specific proposal for modifying the current regime.

Recently, Professor Mendelson has offered the most comprehensive critique to date of limited liability's potential benefits and costs, including its moral hazard. She begins by emphasizing the qualitative differences between shareholders. As discussed previously, she demonstrates convincingly that the efficiency-based justifications for limited liability—information costs savings, facilitating diversification, and risk-aversion correction—apply only to small, passive investors. She also argues compellingly that there is no reason to believe that externalization of risk by institutional or other wealthy shareholders is efficient, given that these investors are, as a class, more efficient risk bearers than the tort victims upon whom limited liability shifts risk.

Building on these distinctions between shareholders, she next argues that a shareholder with the capacity to control the corporation—whether closely held or widely owned—is more likely to select excessively risky activities. These shareholders have a greater ability than passive investors to benefit from excessively risky activities, including the ability to control the timing and size of distributions, the greater capacity to sell and shift assets strategically, and the means of achieving taxation and operational synergies. Indeed, she details how these benefits will be disproportionate to the

308. Id. at 27-28, 40.
309. See id. at 41 ("Liability for those who combine both functions presents the easiest case for departing from limited liability, but even in this context, nonlegal constraints temper application of the legal rule."). Professor Thompson also states that "[l]iability for managers can be extended if appropriate consideration is given to possible overdeterrence." Id. In their recent article, Professors Gulati, Klein, and Zolt suggest that directors, officers, and employees might be "fair game" for liability for corporate obligations, but they do not advocate such liability. See G. Mitu Gulati et al., Connected Contracts, 47 UCLA L. REV. 887, 930 (2000).
310. See Mendelson, supra note 1, at 1203.
311. Id. at 1219-32.
312. Mendelson, supra note 1, at 1231-32 ("Consequently, shifting the costs of excessively risky corporate behavior likely will not increase social utility, but will reduce it."); see supra notes 202-206 and accompanying text.
313. Mendelson, supra note 1, at 1247.
314. Id. at 1250-56.
controlling shareholder's equity stake. Moreover, faced with fewer information costs, and armed with the ability to replace managers or relocate displaced ones, controlling shareholders, unlike passive ones, can compel managerial compliance with their interests and otherwise avoid the effects of risk aversion. Likewise, voluntary creditor oversight and insistence on the maintenance of adequate operating reserves may provide insufficient protection, since tort judgments may greatly exceed such operating levels. Furthermore, Professor Mendelson notes that other potential neutralizers, including current veil piercing rules and new statutory impositions of controlling person liability, apply rarely and therefore are unlikely to deter most risk taking.

Thus, she concludes, the presence of a controlling shareholder enhances limited liability's moral hazard problem. Corporations with controlling or potentially controlling shareholders—which includes virtually all closely held corporations and many publicly traded firms—therefore are more likely than corporations with widely dispersed ownership to engage in excessively risky activity.

Based on this analysis, Professor Mendelson advocates a regime in which all shareholders with the capacity to control corporate activity would be vicariously liable for corporate torts and tort-like statutory violations. When there is more than one shareholder with

315. Id. For all of these reasons, combined with disproportionate voting power, controlling shareholders are positioned to benefit in excess of their pro rata share of corporate equity. Id. at 1252.

316. See id.

317. Id. at 1236-37.

318. See id. at 1259-71, 1291-92.

319. Id. at 1258. Professor Mendelson then adds a corollary: "[U]nder limited liability, there is a set of risky activities that a company with a dispersed share ownership would not select, but a company with a controlling shareholder would." Id. And, again, a shareholder's ability to benefit from risky activities may be enhanced if the dividend tax is eliminated. See supra note 222 and accompanying text.

320. See Mendelson, supra note 1, at 1271-74. She states that her "capacity to control" regime would include shareholders that actually exercise control by involvement or selection of the board of directors, control over major activities such as asset sales, or participation in other major decisions. Id. at 1272. It would also include shareholders who have significant potential control. Id. at 1273. This would certainly include majority shareholders. Id. It may also include some minority shareholders, depending on a number of factors such as whether there is a majority shareholder, the relationships between shareholders, and the relationship between a shareholder's board representatives and other shareholders. Id. at 1273-74. Professor Mendelson would hold accountable shareholders with the capacity to control at the time the tortious conduct occurred. Id. at 1278. She argues that an occurrence-based rule is superior to the other choices because it would encourage those in control to monitor and influence decision making, and would be easy to administer. See id. at 1278-79 (arguing that a modified claims-made rule, as proposed by Hansmann and Kraakman, is unnecessary in a control-based regime because there would be few administrative difficulties). Some years earlier, Professor Leebron
the capacity to control, all such shareholders would be jointly and severally liable with the right to contribution.\textsuperscript{321} Such a regime, she argues, would force those most likely to engage in excessively risky activity to internalize the costs of such activity, neutralizing the effect of limited liability's moral hazard.\textsuperscript{322} Controlling shareholders therefore would have an incentive to monitor and avoid risk and to secure insurance or maintain capital adequate to cover foreseeable tort judgments.\textsuperscript{323} While determining who is a controlling shareholder will inflict litigation costs, she contends that, in most circumstances, this determination will not be difficult.\textsuperscript{324} She then defends this regime against other potential criticisms, arguing that it is not likely to overdeter corporate risk taking,\textsuperscript{325} preclude investment in risky industries,\textsuperscript{326} or adversely affect securities markets.\textsuperscript{327} She further details why such a regime is likely to be less socially costly than the current regime and more effective than a pro rata liability regime.\textsuperscript{328} Finally, she argues that in the special case of a corporation without even a single shareholder with the capacity to control, shareholder liability is unnecessary because managerial risk aversion combined with agency costs will neutralize limited liability's moral hazard.\textsuperscript{329}

Professor Mendelson's careful analysis of the effects of limited liability and shareholder control in any corporation offers a powerful rebuttal to those who generally defend limited shareholder liability in larger corporations, including those that are publicly traded. Indeed, she shows why the widely accepted critique of limited liability in closely held corporations and parent-wholly owned subsidiary groups applies with equal force in many larger, publicly traded corporations.

\textsuperscript{321} Mendelson, supra note 1, at 1271.

\textsuperscript{322} See id. at 1281 ("Firms would more likely internalize their costs, rather than shift excess costs to involuntary creditors such as tort victims. Tort and statutory claimants would more likely be compensated.").

\textsuperscript{323} See id.

\textsuperscript{324} See id. at 1288-89.

\textsuperscript{325} Id. at 1294-96.

\textsuperscript{326} Id. at 1297-98.

\textsuperscript{327} Id. at 1296-97.

\textsuperscript{328} See id. at 1280-96; see also supra notes 261, 265 and accompanying text. For example, she argues that a pro rata regime is less likely to deter risky conduct by controlling shareholders who receive proportionately more benefits from such activities than other shareholders. Mendelson, supra note 1, at 1281-85. She also argues that tort victims facing excessively high collection costs would not be able to receive full compensation whenever the firm has dispersed ownership. Id. Controlling shareholder liability avoids these problems. Id.

\textsuperscript{329} Id. at 1291-92.
2. The Problems with "Unlimiting" Shareholder Liability

The previous section outlines the various scholarly attempts to assess and enhance the efficiency of limited shareholder liability. Although I disagree with a few aspects of Professor Mendelson's analysis, her critique is compelling. She demonstrates why the current regime extends the protective shield beyond what is needed to produce beneficial effects and why such protection for controlling shareholders in all types of firms is socially costly. Yet, like most previous attempts to address limited liability's social costs in the tort context, her proposed reform is inadequate because it depends on "unlimiting" shareholder liability. Reform that unlimits the liability of some or all shareholders is unrealistic, would be ineffective, and may have adverse downstream consequences for corporate governance.

For example, Professor Mendelson contends that her controlling shareholder-based liability regime can be implemented through either statutory reform or an overhaul of the veil-piercing doctrine. Yet, as I discussed earlier, limited shareholder liability is an enduring and ever expanding feature of our economic landscape, despite scholarly criticisms. Business corporation statutes draw no distinction between controlling and passive shareholders, between closely held and publicly traded firms, or between voluntary and involuntary creditors. Plus, the trend in the last two decades has been towards extending limited liability protections to various hybrid entities. Again, this expansion is particularly telling because these hybrid firms usually are closely held, the context in which limited liability is least justified. And, although the historically successful arguments in favor of shareholder liability—economic democracy, entrepreneurialism, economic growth—are overstated at best, such arguments retain their political appeal. Thus, widespread statutory reform in favor of unlimiting shareholder liability, including controlling shareholder liability, is simply not going to happen.

330. Id. at 1207 (suggesting that implementation of a controlling shareholder regime can be achieved through statutory reform or extension of common-law piercing rules).
331. See supra Part II.A.
332. See supra notes 42-46 and accompanying text.
333. Bainbridge, supra note 1, at 540 (noting that since Hansmann and Kraakman's article was published, no state has repealed limited liability, and that, indeed, "states have been busily expanding the scope of limited liability through the creation of such new enterprise forms as limited liability companies and limited liability partnerships"); id. at 571 (stating that shareholder liability is almost certainly a political nonstarter); Leebron, supra note 1, at 1567-68
Moreover, without statutory reform, veil piercing is a dead end. As I outlined, except for theories premised on shareholder fraud or statutory violations, which are essentially forms of direct shareholder liability, piercing theory and jurisprudence offer little coherence. Given this disarray and uncertainty, the transaction costs of utilizing piercing doctrine to achieve significant reform would be substantial, as Professor Bainbridge details. But that is just the beginning. As discussed, a principled piercing regime—one that enhances efficiency by extending liability to a class of shareholders—cannot coexist coherently with statutorily mandated, unqualified and universal limited shareholder liability. Indeed, because piercing is supposed to be an “exception” to limited liability, courts almost never pierce based on shareholder control alone. Although Professor Mendelson acknowledges the judicial reluctance to extending liability to controlling shareholders in her discussion of current veil piercing doctrine and the Supreme Court’s Bestfoods decision, she offers no way to overcome it. Absent statutory reform, linking control and accountability in the tort context cannot be achieved through piercing.

Furthermore, even if a shareholder-based liability regime were implemented via statute or common law, it would be likely to be ineffective and to raise serious corporate governance concerns. For example, under Professor Mendelson’s “capacity to control” regime, investors at risk of being deemed controlling shareholders would find ways to maintain control while evading liability or would reduce their equity stake in any one corporation to below the level at which they would have the capacity to control the entity.

(noting the unlikelihood of such reform). Professor Mendelson concedes that statutes that purport to apply liability to controlling shareholders are, in the wake of Bestfoods, unlikely to broaden liability for shareholders. See Mendelson, supra note 1, at 1266-69.

334. See supra Part II.B.

335. See Bainbridge, supra note 1, at 554-55; see also supra notes 78-81 and accompanying text.

336. See supra notes 123-124 and accompanying text.

337. See Mendelson, supra note 1, at 1263 (“In short, a shareholder may maintain limited liability despite a high degree of potential or actual control over a corporation’s activity. Extensive control of a corporation by a shareholder—including selection of the subsidiary’s board of directors and control over major financial decisions—is treated by courts as fairly run-of-the-mill and is unlikely to create a significant risk of veil piercing.”).

338. See id. at 1266-69 (“Indications are, however, that such statutory efforts to hold shareholders directly liable for corporate torts, as they currently stand, are unlikely to substitute for directly revisiting vicarious liability rules. The purported ‘erosion’ of traditional corporation law concepts under CERCLA, for example, was set back sharply in 1999.”).
Evasion imposes a major impediment to preventing the externalization of risk through shareholder liability. As Professor LoPucki has demonstrated, a sophisticated or institutional investor can reap the benefits of an enterprise while remaining judgment proof through restructuring the enterprise with symbiotic contracts. In the current regime, an easy and obvious example of such judgment proofing is the allocation of risky activities to a subsidiary. Although that technique would no longer be available in a controlling shareholder liability regime, there are other, low-transaction-cost alternatives for facilitating the externalization of risk. Highly sophisticated investors—today's controlling shareholders in large firms—may abandon their direct, shareholder relationship with the firm and seek control-level benefits through other types of relationships. For example, they could convert from equity to various forms of debt financing and bargain with management for concessions to ensure adequate control. With relatively few transaction costs, and with agency costs preventing passive shareholder interference, the investor could structure the repayment and its relationship with firm management in such a way as to have controlling shareholder-like incentives (including the incentive to engage in excessively risky activities) and influence. In addition, former controlling shareholders might seek to participate and exercise control through multiple intermediaries or subsidiaries. They also could contract out risky activities to firms with no controlling shareholder or to firms with a single "high roller" with limited assets, but bargain to retain significant control and shareholder-like returns.

339. See Hansmann & Kraakman, supra note 5, at 1895 (suggesting that without a uniform rule, covering both closely held and publicly traded entities, firms will find ways to alter their equity structure to avoid liability); Thompson, supra note 3, at 20 (discussing the likelihood of evasion after liability is unlimited for some participants).

340. See generally LoPucki, supra note 17, at 147-50.

341. See supra notes 287-289 and accompanying text.

342. See Thompson, supra note 3, at 20 (noting the likelihood of evasion strategies such as the transfer of assets to judgment-proof investors or managers); see also Hansmann & Kraakman, supra note 5, at 1911-12 (discussing the high-roller strategy and coining the term). Professor Mendelson recognizes the possibility of such judgment-proofing techniques, although she suggests they may be infrequent. See Mendelson, supra note 1, at 1301. She acknowledges that controlling shareholders might have an incentive to establish contractual relationships with risk-bearing firms rather than vertically integrate, but she argues that this incentive would be offset by the loss of the advantages of integration. See id. I disagree. As Professor LoPucki's analysis of judgment-proofing demonstrates, through contractual arrangements, firms can bargain for and exert an enormous amount of control over affiliated firms—debtors, trading partners, franchisees, etc.—and remain judgment-proof. LoPucki, supra note 17, at 151-55. Indeed, lenders and other creditors can, among other things, utilize this control to exact shareholder-like returns, take advantage of synergies, hedge against market risks, and gain
The point is that any reform that leaves classes of shareholders or firms free from vicarious liability will create opportunities for judgment proofing. Although some courts have been willing to extend tort liability through several levels of ownership or to lenders and other voluntary creditors, such an equitable extension of the control-based approach is likely to be rare, unpredictable, and—like piercing doctrine—internally problematic. While this does not mean that a pro rata shareholder liability regime would be preferable, it does mean that more limited reform may be largely ineffective in reducing the moral hazard problem.

On the other hand, a “capacity to control” liability rule may inflict unintended costs by driving certain institutional investors from the equities markets. These investors—including pension funds, mutual funds and other fiduciaries—may have longer-term objectives or lower tolerances for risk, and, thus, may be uninterested in reaping short-term gains or controlling shareholder-like benefits, despite holding large equity stakes in a firm. And some of these investors, seeking steady returns through substantial but diversified portfolios, simply could not tolerate the risk of vicarious liability for a single investment. To this extent, a “capacity to control” rule is overbroad.

other benefits. In essence then, sophisticated investors can exact benefits similar to those of a controlling-shareholder through other kinds of relationships, while remaining judgment proof.

343. Hansmann & Kraakman, supra note 5, at 1894, 1931-32 (discussing the advantages of promulgating a single rule for all corporations). Again, this is consistent with Professor LoPucki’s core thesis. Indeed, his examples of judgment evasion through restructuring the enterprise depend on limits on the liability of shareholders, lenders, or other contracting parties. See generally LoPucki, supra note 17, at 147-55.

344. Indeed, Professor LoPucki argues that, while courts will search for the boundaries of the “enterprise,” such boundaries are “ethereal”—the enterprise has “no sharp boundaries” in the shifting web of relationships between firms and participants engaged in commercial activity. LoPucki, supra note 17, at 157-58. Thus, “[t]he search for the boundaries of the ‘enterprise’ will fail.” Id. at 158.

345. Besides the costs of this regime discussed previously, pro rata shareholder liability is subject to some of the same evasion techniques. And I question whether an amorphous “constructive equity” doctrine would be useful in preventing evasion. Cf. Hansmann & Kraakman, supra note 5, at 1913 (discussing this notion). Again, Professor LoPucki argues that the search for principled distinctions between contracting firms will fail. See supra note 344.

346. Professor Mendelson acknowledges that a capacity-to-control rule, which places a tax on control, might affect equity ownership patterns. Mendelson, supra note 1, at 1293-94. However, she contends that it will not deter many from retaining control level equity stakes because of the disproportionate benefits of control. See id. Yet I believe she underestimates the potential effect of such a regime on certain kinds of large investors. For example, suppose a large pension fund owns 5 to 10 percent of the outstanding shares of a smaller publicly traded firm. Such an ownership stake, in and of itself, might be viewed as creating the capacity to control, particularly in firms without a larger shareholder or cumulative voting, and with otherwise widely dispersed ownership (many, rationally apathetic small investors). Add a few more facts—such as the fund’s offering a successful shareholder proposal in the past, making a few recommendations to the board of directors, or assisting in the appointment of a new director to the audit committee—
These types of institutional investors, therefore, would choose to eliminate the risk of vicarious tort liability by divesting or drastically reducing their equity interests and avoiding direct involvement in corporate governance. Yet, if these institutions reduce their participation in the equities markets or in corporate governance, publicly traded firms will lose an important check against managerial abuse. Indeed, particularly in the wake of Enron and other corporate scandals, long-term institutional investors are widely regarded as the most effective, internal check against the agency problem. Ironically then, a “capacity to control” regime may move more publicly traded firms toward the Berle and Means model, a model Professor Mendelson suggests is now atypical. Perhaps this concern can be addressed by adjusting the test for determining who is a controlling shareholder, but, as it stands, a “capacity to control” rule and the fund would be even more likely to be found to have the “capacity to control.” Yet this type of fund, which invests widely in the market, may not have interest in investing in greater firm monitoring and, correspondingly, seeking disproportionate, controlling shareholder-type benefits. The fund therefore will have an incentive to reduce its stake in the corporation and reduce its participation in corporate governance.

347. Similarly, institutional investors likely to become the target of tort victims may reduce their equity interests in any one corporation. See Leebro, supra note 1, at 1611 (discussing how sophisticated investors would reduce their investment in any one firm in a pro rata regime); see also Thompson, supra note 3, at 31 (arguing that pro rata shareholder liability would “discourage mutual funds from holding large blocks of stock, since a large, well-financed shareholder would be a much more attractive defendant than would many dispersed shareholders”).

348. Cf. Bainbridge, supra note 1, at 540 (suggesting that a liability regime that discouraged the assembling of controlling blocks of shares would reduce oversight of corporate management).

349. See, e.g., Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6,563, 6,564-65 (Feb. 7, 2003) (noting that in September 2002 mutual funds held $2 trillion of corporate equity, representing 18 percent of U.S. market capitalization, and discussing “the enormous influence of mutual funds in the capital markets and their huge impact on the financial fortunes of American investors”); Proxy Voting by Investment Advisors, 68 Fed. Reg. 6,585, 6,586 (Feb. 7, 2003) (noting that equity advisors registered with the SEC have discretion in the management of over $19 trillion in assets, often on the behalf of institutional investors); see also Kate Kelly et al., Behind Chief’s Departure, A Profit Squeeze, Governance Questions, WALL ST. J., Sept. 18, 2003, at A1 (describing Richard Grasso’s departure from the New York Stock Exchange and pressures brought to bear by large institutional investors); Joann S. Lublin, Proxy Voting Is a Fiduciary Duty, SEC Chief Says in Letter to Group, WALL ST. J., Mar. 21, 2002, at C20 (describing a letter from Harvey Pitt to an investment firm in which he urges money managers to vote proxies consistent with fiduciary duty to clients and describing the recent trend for pension funds to exercise voting power); Martin Peers & Julia Angwin, Steve Case Quits as AOL Chairman Under Pressure, WALL ST. J., Jan. 13, 2003, at A1 (describing the role a long-term institutional investor played in forcing Steve Case to step down as Chairman of AOL Time Warner).


351. Mendelson, supra note 1, at 1216.
may have unintended effects that have troubling consequences for corporate governance.  

In conclusion, scholars who seek to reform the current regime usually propose unlimiting shareholder liability in one way or another. But such reform is unrealistic. In addition, shareholder liability proposals fail to grasp a broader conception of accountability within the firm and therefore are vulnerable to a wide variety of evasion techniques. Lastly, targeting shareholders may have other adverse effects on corporate governance. Thus, the challenge of finding a way to retain the beneficial effects of limited shareholder liability while reducing its costs remains.

IV. A NEW APPROACH: EXTENDING VICARIOUS TORT LIABILITY TO HIGHEST-RANKING CORPORATE OFFICERS

Several scholars recently have questioned why, given the now predominant contractarian view of the firm, so few reform proponents have sought to apply the arguments for personal shareholder liability to other firm participants. Although these commentators do not offer such proposals, I will take the bait.

I propose that the highest-ranking corporate officers, rather than controlling shareholders, be subject to vicarious liability for torts and tort-like statutory violations committed within the corporate enterprise. In seeking to reduce limited shareholder liability's social costs, including its moral hazard, Professor Mendelson appropriately focuses on the implications of corporate control. Like many before her, however, she largely confines her discussion to shareholder liability. But shareholders are not the only potentially controlling participants within the firm; by definition, management also exercises control. In particular, high-ranking officers, who exercise control over the daily and ongoing operations of the firm, wield the most significant and direct control over many firm activities. And, as discussed earlier,

352. Professor Bainbridge offers a similar assessment of seeking to hold controlling shareholders liable. See Bainbridge, supra note 1, at 571.

353. See id. at 538-39 ("[W]hy should not other corporate constituents—such as creditors, employees, and managers—be liable for the corporation's torts as well?"); Gulati et al., supra note 309, at 930 ("From the perspective of the connected contracts model, it is interesting and surprising that no one seems to have considered the possibility of applying the arguments for shareholder personal liability to other participants such as creditors, suppliers, customers, directors, officers, and employees.").

354. Professor Bainbridge, for example, is a leading proponent of the contractarian view of the firm, but, again, he also is largely a defender of limited liability.

355. Officers of a corporation are selected by the board of directors and carry out their decisions. ROBERT W. HAMILTON, BUSINESS ORGANIZATIONS: UNINCORPORATED BUSINESSES AND CLOSELY HELD CORPORATIONS: ESSENTIAL TERMS AND CONCEPTS 200 (1996). They also have
firm managers, like shareholders, usually enjoy limited liability for corporate torts under the current regime.\textsuperscript{356} While most other commentators have dismissed unlimiting managerial liability, often on risk aversion and overdeterrence grounds,\textsuperscript{357} I argue that imposing vicarious tort liability on this discrete subset of corporate management is the most efficient, most effective, and most realistic means of retaining limited shareholder liability's social benefits while reducing its social costs.

By "highest-ranking corporate officers," I refer to a limited subgroup of corporate management exercising control at the time the tortious activity occurs. My proposed regime would extend vicarious tort liability to the highest named officer in the firm; for example, the CEO or president in a corporation, or the top "manager" in an LLC.\textsuperscript{358} It also would extend liability to any other officer—perhaps a CFO or division head—who exercises ultimate executive authority over certain firm activities either because the officer does not report to the highest named officer, or because there is no highest named officer, or because, as a practical matter, the structure of the firm provides that officer with such authority. However, vicarious liability for the latter set of officers would extend only to torts committed within their area of ultimate control. Finally, liability would extend to any other natural person or entity actually exercising high-ranking officer-like control in addition to or instead of firm officers. To the extent there is more than one highest-ranking officer, each would be jointly and severally liable.\textsuperscript{359}

This liability regime therefore excludes directors acting only, for example, in their oversight and decision-making capacities as members of the board or board committee. It also does not include other officers, lower-level managers, or employees. Finally, it does not extend liability to shareholders in their capacity as shareholders. Of
course, directors or shareholders may be held liable if they also serve in a high-ranking officer capacity.

The advantages of my "highest-ranking corporate officers" liability proposal require a fairly detailed explanation. Below, I begin by outlining why my alternative control-based approach preserves the beneficial effects of limited shareholder liability while neutralizing its moral hazard. I demonstrate why, contrary to the views of other scholars, high-ranking corporate officers are more efficient risk bearers than other firm participants, and, hence, why they should bear this burden in all firms. I then show why judgment evasion is less likely under my approach; indeed, given that every enterprise will contain at least one natural person subject to liability for firm torts, there will always be a firm participant with the strong incentive to reduce risks and maintain adequate insurance or capitalization. Next, I discuss why high-ranking officer liability is a realistic alternative to the (highly unrealistic) shareholder liability proposals. I recount how long-existing legal norms and recent reforms, including Sarbanes-Oxley, link officer-like control and accountability. I further explain how courts can easily implement this regime through a natural extension of respondeat superior and enterprise liability principles. I conclude by arguing that my proposal is the only one to date that successfully synthesizes tort law and the contractarian view of the firm, and resolves the lingering conflict between limited liability and the aims of our tort regime.

A. Retaining Beneficial Effects and Reducing Social Costs

My control-based approach preserves the beneficial effects of limited shareholder liability. By extending liability only to high-ranking officers, my proposal threatens none of the efficiency-based justifications for limited shareholder liability discussed earlier, including specialization, correcting investor risk aversion, enhancing equity market efficiency, and facilitating diversification. Indeed, these effects largely or exclusively accrue in the context of passive investment, and officer liability, by definition, will never extend to these passive participants. Thus, unlike pro rata shareholder liability, for example, my proposal does not threaten to increase shareholder-to-shareholder monitoring costs. And, by limiting officer liability to firm torts and tort-like statutory violations, my proposal, like most others, retains the limited liability default rule in the voluntary creditor

360. See supra Part III.A.1.
context, which most agree is efficient. Moreover, since the distributive benefits of limited shareholder liability are a product of facilitating participation in firm ownership by small, passive investors, these benefits likewise will remain unaffected.

In addition, high-ranking officer liability avoids most of the new transaction costs unlimiting shareholder liability would inflict. For example, because my proposal extends liability to a clearly defined and numerically small set of corporate participants, it would not produce the potentially enormous collection and litigation costs of a pro rata regime. Indeed, the definition of “highest-ranking officers” discussed above seeks to limit the universe of potential defendants as much as possible while ensuring the internalization of risk and preventing evasion. Likewise, by extending liability to those who were highest-ranking officers at the time the tortious conduct occurred, this regime avoids the costs associated with determining who ought to be liable given firm personnel and organizational changes over time. Also, it undoubtedly avoids the existing veil-piercing quagmire and the enormous transaction costs of seeking to implement a shareholder liability regime through that doctrine.

Similarly, my officer-based approach avoids the costs of a “capacity-to-control” shareholder liability regime. Of course, internalization of risk will reduce the need for plaintiffs to resort to vicarious tort liability in either regime, assuming no evasion. Nevertheless, determining whether a shareholder has the capacity to control the firm will be a highly fact-intensive inquiry in many larger firms. A capacity-to-control regime therefore will produce both ex ante uncertainty and ex post litigation costs, and, as discussed previously, may have adverse consequences for corporate governance. The highest-ranking corporate officer or officers, on the contrary, are usually apparent in both publicly traded and closely held firms. In the rare circumstance in which a tort plaintiff claims another, less visible

361. See supra notes 227-228 and accompanying text.
362. Cf. Bainbridge, supra note 1, at 533, 541 (discussing the enormous transaction costs a pro rata regime would inflict in the publicly traded context but noting the minimal costs of litigation and collection when the potential universe of defendants is small).
363. Cf. Mendelson, supra note 1, at 1278-79 (arguing an occurrence-based rule is workable and efficient).
364. Cf. id. at 1282-83 (arguing that a control-based regime that forces internalization of firm risks will produce an overall reduction in risky activities undertaken by corporations).
365. Professor Mendelson acknowledges that a capacity-to-control regime would inflict some of these costs, although she argues that, on balance, these costs would be lower than its benefits and would avoid the problems of seeking to define and implement a bright-line rule. Id. at 1288-91. Again, however, she does not consider the advantages of holding high-ranking officers liable, which provides the same benefits and comes closer to offering a bright-line rule.
person actually exercised ultimate officer-like control, the inquiry will be far more limited: the plaintiff must demonstrate that the unnamed person or entity actually (rather than potentially) wielded direct supervisory control of the day-to-day operations of the business.\textsuperscript{366} While such inquiry will be fact intensive and sometimes costly, the focus on actual, direct control, rather than on the capacity to control, will substantially reduce doctrinal unwieldiness and corresponding costs.

Most importantly, highest-ranking officer liability reduces the social costs of limited shareholder liability by counteracting its moral hazard. Everyone agrees that an unlimited liability regime would neither eliminate all corporate torts or tort-like statutory violations nor eradicate moral hazard.\textsuperscript{367} And no regime guarantees that all tort victims will receive full compensation for their injuries. But, like other proposals, my approach reduces the externalization of firm risk onto tort creditors by forcing one or more of the firm participants to internalize such risk. Although officer-based liability does not reduce shareholders' incentives to engage in excessive risk taking, this regime reduces or neutralizes limited liability's moral hazard by imposing vicarious liability on corporate officers. As a result, these officers will seek to avoid risk and spread the cost of unavoidable risk across firm participants. And, like other occurrence-based proposals, this regime reduces the incentive to engage in activities with short-term returns but long-term risks, such as activities that create a substantial risk of latent injuries or temporally distant environmental damage.

Yet my proposal offers greater efficiency than other proposed reforms because, contrary to the claims of other scholars, high-ranking corporate officers are the most efficient initial risk bearers within the corporate enterprise.\textsuperscript{368} Officers are in a better position than

\textsuperscript{366} This kind of actual and direct oversight of day-to-day operations would be rare. One example of usurpation of officer functions is State Department of Environmental Protection v. Ventron Corp., 468 A.2d 150, 155 (N.J. 1983), in which the parent's employees took over control of the day-to-day operations of the polluting subsidiary. Another example, this time in the lender context, may be found in A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 293 (Minn. 1981), in which a lender essentially took over its debtor's operations.

\textsuperscript{367} Again, insurance carries with it its own moral hazard, although one that is less serious than limited liability. See supra note 274 and accompanying text.

\textsuperscript{368} By "most efficient initial risk bearer," I mean the person who can avoid or reduce preventable harms most cost effectively and spread the risk of loss across firm constituencies in such a way that these losses are born most efficiently. See Howard C. Klemme, The Enterprise Liability Theory of Torts, 47 U. COLO. L. REV. 153, 179-84 (1976) (stating that the criteria for determining the superior risk bearer—the one who ought to have the initial burden—are who is in the most effective position to cause preventative action to be taken and to cause the costs of such preventative action or insurance to be spread most efficiently); see also Guido Calabresi,
shareholders—even controlling shareholders—to monitor corporate activity and control risks. Although I agree with Professor Mendelson that controlling shareholders encounter fewer information costs in monitoring firm affairs than do other shareholders, and that these shareholders by definition have the ability to exercise significant control over firm conduct, they still must expend more resources than officers to monitor firm activities closely. Indeed, controlling shareholders cannot effectively monitor and alter firm activities without resort to officers, because officers have direct access to firm-specific information and are responsible for the day-to-day operations of the business. In much the same way, directors, who perform monitoring and decision-making functions to protect the interests of shareholders, lack the expertise and access to information that officers possess. Moreover, ensuring officer compliance with directives constitutes an additional agency cost for directors. Because officers (or those assuming officer-like functions) are the firm participants best able to observe and alter firm activities, placing the burden of risk avoidance on them, rather than on shareholders or directors, reduces costs.

Similarly, because high-ranking officers have more direct access to information and expertise regarding firm activities than shareholders or directors, they are in the best position to determine both the nature and size of potential, unavoided risks and to spread


370. See supra notes 203, 316 and accompanying text.

371. See Mendelson, supra note 1, at 1213 (discussing controlling shareholders' ability to exercise significant control over firm activities and ways in which they can benefit from those activities).

372. Controlling shareholders have the ability to exercise great control over the firm, and, as Professor Mendelson argues, they can substantially influence the firm's risk preferences to gain unique benefits from its activities. See Mendelson, supra note 1, at 1213, 1249-58; see also supra notes 313-316 and accompanying text. But, to achieve enhanced benefits, or conversely, to implement greater risk avoidance and risk spreading, they must resort to the firm's officers or usurp direct, officer-like control. Only officers (as opposed to directors) have direct access to firm operations, record keeping, and expertise, and only officers can alter and monitor firm activities directly. The point is not that controlling shareholders are unable to appoint officers who will do their bidding; rather, they need to appoint officers to do this bidding. Cf. Mendelson, supra note 1, at 1249-50 (discussing the ability of parent corporations to place their own employees in "positions of control" in the subsidiary). Indeed, in Professor Mendelson's discussion of why controlling shareholders are in a better position than other shareholders to benefit from risk externalization, she often refers to the use of corporate managers to achieve these ends. Id. at 1253, 1258, 1294.
those risks efficiently. For example, these officers are in the best position to determine where to set the price of firm goods and services to take into account the cost of the risk of tort liability that a particular product or service creates. Similarly, officers are best able to calculate the optimal level of retained capital or insurance to cover potential losses while otherwise maximizing returns. Thus, officers are in the best position both to monitor and avoid risks and to determine how to spread excess risk efficiently among customers, shareholders, and insurers. 373

The efficiency of high-ranking officer liability may face a number of challenges. First, some may contend that corporate officers are risk averse because potential tort losses may exceed their wealth. Such risk aversion, it may be suggested, will lead to overdeterrence—overinvestment in risk prevention and risk spreading or underinvestment in projects that pose some, but not socially excessive, risk—particularly given imperfect information and insurance. 374 Second, many scholars have argued that managers are inherently risk averse because of their firm-specific investments of human capital. 375 If this is true, then imposing on officers the risk of tort liability is unnecessary, since they will take steps to reduce or cover risks anyway, 376 and expanding the potential number of defendants in a tort

373. See Klemme, supra note 368, at 213 (discussing the criteria for determining the most efficient cost distributor, including a sophisticated understanding of business practices, an ability to calculate risks accurately, and the ability to add insurance and other costs to the price of goods and services).

374. Easterbrook and Fischel elaborate on the flaws of managerial liability:

   The problem with managerial liability is that risk shifting may not work perfectly. It is unlikely, for example, that managers who are liable for mass torts, with mammoth but uncertain expected liabilities, could shift all of this risk. . . . To the extent that risk is not completely shifted, a legal rule of managerial liability creates risk for a group with a comparative disadvantage in bearing that risk. This inefficiency leads to both an increase in the competitive wage for managers and a shift away from risky activities. And there is no guarantee that the social costs of this shift away from risky activities will not exceed the social costs of the excessively risky activities in the absence of managerial liability.

EASTERBROOK & FISCHEL, supra note 2, at 62; see Hansmann & Kraakman, supra note 5, at 1929 ("In the absence of insurance, imposing personal liability for the firm's entire tort losses on its managers would create a powerful incentive to overinvest in safety measures or, what is more likely, to resign."); Kraakman, supra note 6, at 876, 887 (suggesting that managerial liability is justifiable only if firm risk shifting is relatively costless, adequate insurance coverage is available, and legal rules are relatively clear cut).

375. See supra notes 271-272 and accompanying text.

376. See Thompson, supra note 3, at 19-20 (suggesting that risk aversion may induce managers to overinvest in safety); see also SHAVELL, supra note 184, at 189 ("The attitude toward risk of firms will reflect the attitudes towards risk of their managers, employees, and shareholders. To the extent that the managers and employees of a firm are risk averse and that their rewards (or positions) are tied to the firm's performance, they will want the firm to behave
action would cause overdeterrence and inflict unneeded costs. Third, even if they are not particularly risk averse, officers might still respond to potential liability by overinvesting in risk prevention and risk spreading if they do not bear all of the costs of such overinvestment. Finally, there may be inherently hazardous or risky activities that are uninsurable but socially desirable. If highest-ranking officer liability eliminates such activities, there may be social loss.

1. Risk Bearing and Overdeterrence

In response to the first argument, it is important to begin by distinguishing between initial risk bearing and ultimate loss bearing. Some high-ranking corporate officers may not be able to bear losses as efficiently as some wealthy shareholders, such as large, institutional investors. But initial risk bearing and ultimate loss bearing are not the same. High-ranking officers, unlike lower-level managers, have the means to protect themselves from most such losses through risk avoidance and risk spreading. In many small, closely held firms, the highest-ranking officers own the firm and therefore can avoid and spread risk by investing in monitoring, retaining capital, and purchasing insurance. They also can compensate themselves for the risk they bear. In firms in which

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377. Voluntary creditors may also serve as a check against the firm's engaging in excessive risk. Yet, as discussed previously, voluntary creditors provide an imperfect check in some circumstances and no check in others. See supra notes 277-281, 317 and accompanying text.

378. See, e.g., Calabresi, supra note 368, at 543-44 (discussing primary risk spreading); Klemme, supra note 368, at 179-80.

379. Professor Shavell describes an individual's risk aversion as largely depending on the size of the risk in relation to his or her assets and needs (the marginal utility of wealth). SHAVELL, supra note 184, at 186-89. An individual who may lose all of his or her wealth therefore will be more risk averse than an institutional or other more wealthy investor. See id. at 19; Mendelson, supra note 1, at 1224. Risk-averse parties dislike the uncertainty of large losses, and requiring such parties to bear such losses will harm social welfare, deterring them from engaging in socially desirable, risky activities. See SHAVELL, supra note 184, at 190-91.

380. Obviously, social welfare can be enhanced by the avoidance of activities that harm social utility. But it can also be enhanced by shifting risks from the more to the less risk averse, or by the sharing of risks among risk averse parties. See SHAVELL, supra note 184, at 189-91 (discussing how the sharing of risks or shifting risks to the less risk averse enhances social welfare); Klemme, supra note 368, at 179-89 (discussing efficient risk bearing); cf. EASTERBROOK & FISCHEL, supra note 2, at 61-62 (although ultimately arguing managerial liability is inefficient, acknowledging that if managers are potentially liable they will have incentives to monitor the firm's capital and insurance).

381. Where the high-ranking officer is one of a number of shareholders in a small firm, the officer can bargain for such compensation, and such bargaining will entail relatively few
management and ownership are separated, the highest-ranking officers can bargain with shareholders or directors for protection. In exchange for their services, high-ranking officers can bargain for the resources needed to monitor risk, for the retention of firm capital to support indemnification, for indemnification from controlling shareholders, for the purchase of liability insurance in excess of retained capital or shareholder indemnification, and for additional compensation for the excess risk they bear. In this way, although high-ranking officers may not be the most efficient ultimate loss bearers in the enterprise, they are the most efficient initial risk bearers: if given the incentive to do so, they will reduce risks and spread the risk of loss across firm constituencies.

Nevertheless, despite the greater care that firms will take in reducing risks by maintaining adequate capital and/or insurance, imperfect information and insurance leave open the possibility that high-ranking officers will still face significant personal liability for tort transaction costs. Cf. Hansmann & Kraakman, supra note 5, at 1891-92 (discussing how heterogeneous shareholders in small firms can bargain with limited transaction costs for compensation for the risk they bear).

382. Transaction costs for such bargaining, which will involve relatively few participants, will not be substantial. Indeed, over time, standard contracts for indemnification and other terms are likely to emerge.

383. Hansmann and Kraakman suggest that if potential tort losses were large relative to a manager's assets, managerial liability might generate an incentive for a manager to take a very high salary (rather than seeking to properly capitalize or insure the firm) in exchange for undertaking risky activities on behalf of shareholders, because the manager would be judgment proof. Hansmann & Kraakman, supra note 5, at 1929. I find this to be highly improbable. In small firms, officers and shareholders usually are the same people. In larger firms, officers would quickly acquire sufficient wealth that they would have a significant amount to lose. It is doubtful that rational, wealthy individuals would accept such risks, even if they have a risk-prefering outlook. In addition, as discussed below, this is really just a variation on the "high roller" evasion technique Hansmann and Kraakman discuss in their article, except the high roller is a manager rather than a shareholder. Yet they contend high-rolling shareholders will be rare, and I argue that high-rolling officers—those who have sufficient sophistication, expertise, and business acumen to run the firm—will be even rarer. See discussion infra notes 442-443 and accompanying text. Moreover, because my officer-based proposal extends to other persons who exercise officer-like control, shareholders will not be able to recruit a stand-in to serve as a highest-ranking officer only in name. See discussion infra notes 440-441 and accompanying text. While high-ranking officers may demand some premium to compensate them for the risk of liability, they also will bargain with the firm for the resources to avoid and spread risk.

384. Indeed, as discussed below, after taking these steps, officers often will bear no losses. And, if an officer is indemnified by a controlling shareholder, then the shareholder will be the ultimate loss bearer, as Professor Mendelson wishes. Moreover, to address tort claims with "long tails," officers can bargain for protection over time, including the long-term provision of adequate insurance and personal guarantees by incoming officers or controlling shareholders for amounts up to a point of reasonable indemnification.
losses.\textsuperscript{385} This risk alone—even if slight—appears to be enough for some commentators to question whether officer liability is efficient, or rather, will lead to overdeterrence.\textsuperscript{386} In my view, this residual risk of liability does not render this regime inefficient.

Again, limited shareholder liability facilitates risk-creating behavior and then shifts losses to tort victims, who, as a class, are inefficient risk bearers.\textsuperscript{387} The possibility—and, hence, occasional imposition—of personal liability is necessary to induce officers to undertake the aforementioned risk avoidance and risk spreading that significantly reduce this externality. At the same time, an officer who compels (or bargains with) the firm to implement these measures substantially reduces the probability of personal liability. Some residual liability for an officer or indemnifying shareholder will have an additional efficiency-enhancing effect: this risk will create an ongoing incentive—after risk spreading—for officers to monitor and avoid risks.\textsuperscript{388}

In addition, after risk avoidance and spreading, actual imposition of personal liability is most likely in small, individually held firms, although it may be infrequent even in this context.\textsuperscript{389} Sometimes officers in small firms may not be able to foresee or insure

\textsuperscript{385} For example, the firm may be bankrupted by market conditions or significant or unforeseeable liabilities. Also, not all risks are insurable and insurance may not cover maximum foreseeable losses. \textit{See, e.g., Easterbrook & Fischel, supra} note 2, at 54 (“Even when offered, the insurance will exclude very large losses.”). Plus, there is no guarantee that insurers and insurance markets will not fail.

\textsuperscript{386} \textit{See, e.g., id.; Hansmann & Kraakman, supra} note 5, at 1929.

\textsuperscript{387} As discussed above, Professor Mendelson argues convincingly that tort victims are often less efficient risk bearers than shareholders. \textit{See supra} notes 235-240, 312 and accompanying text. As I have discussed above, high-ranking corporate officers are, as a class, even more efficient initial risk bearers than shareholders. And, although officers may be less capable of bearing losses than some institutional shareholders, officers can seek indemnity from these shareholders. Moreover, although officers are less wealthy than some shareholders, they undoubtedly are, as a class, wealthier than tort victims and more capable of protecting their assets through insurance and other means. They also have the ability to bargain for firm level risk avoidance and risk spreading. This does not mean that they would bear losses more efficiently than tort victims in every circumstance, as, for example, when tort losses are massive but widely dispersed among victims. But I contend that, for all of the foregoing reasons, highest-ranking officer liability will allocate risk efficiently in the vast majority of circumstances.

\textsuperscript{388} \textit{Shavell, supra} note 184, at 197 (“[T]he expected utility maximizing level of coverage will be the greatest level that will still leave the insured bearing enough risk to induce him to take the risk-reducing action.”). Risk spreading through insurance may create its own moral hazard since someone besides officers and shareholders—insurers—often will bear part or all of the risk of firm activities. \textit{See supra} note 274 and accompanying text. Insurer monitoring and premiums blunt this moral hazard to some extent, \textit{see supra} note 274, but a low risk of officer liability in excess of insurance will ensure that the incentive to avoid risks remains.

\textsuperscript{389} \textit{See, e.g., Hansmann & Kraakman, supra} note 5, at 1890 (arguing that unlimited liability in the small firm context will lead to the purchase of adequate insurance in most contexts).
against all potential losses, yet these officers are still in the best position to bear the risk. They usually are the controlling shareholders, and, as such, are able to compensate themselves for the risk they bear. In addition, they may not be particularly risk averse as a class anyways, given that even in today's regime, they are likely to be personally liable for many corporate obligations—as guarantor, tortfeasor, statutory violator, or the target of piercing. And, as a class, they are likely to be better risk bearers than tort victims. Furthermore, limited liability for officer-shareholders produces few countervailing benefits worth preserving. Indeed, because officers and shareholders in these firms are one and the same, the effect of my proposal differs little from the intended effect of the many other proposals that, for similar reasons, seek to unlimit shareholder liability in close corporations. It is, however, simpler to administer. Finally, to the extent some firms with officer-shareholders exit certain industries or markets because they either cannot adequately insure against tort risks or are risk averse, their absence may have positive net social value since, among other things, their participation would

390. See, e.g., Shavell, supra note 184, at 197-98. Adequate insurance is likely to be available in many contexts. Hansmann & Kraakman, supra note 5, at 1888; see infra note 400 (discussing the stability of comprehensive general liability insurance). Yet there will be some contexts in which insurance adequate to cover all losses is not available, or information is sufficiently imperfect that individuals or firms will miscalculate the appropriate level of insurance.

391. See supra note 282 and accompanying text.

392. See supra notes 168-169 and accompanying text. Indeed, in many closely held firms, the risks associated with contractual liability are more significant than the risks associated with tort liability. Hansmann & Kraakman, supra note 5, at 1910. Moreover, excessive risk aversion seems unlikely since, even in today's regime, people engage in risky behavior—such as driving automobiles—all the time, and the empirical evidence suggests that few individuals purchase exceptionally high levels of insurance for such activities. See id. at 1904 n.72 (discussing this evidence); Leebron, supra note 1, at 1574-75 (stating that the impact of unlimited liability is likely to be less than many commentators suggest, given that “we constantly take risks far more drastic than those posed by unlimited liability”).

393. Mendelson, supra note 1, at 1231; supra notes 234-244 and accompanying text (discussing why tort victims are likely to be inefficient risk bearers and why shareholders in closely held firms are likely to be more efficient risk bearers). Also, if the shareholder-manager is a particularly poor risk bearer because the person's wealth is dwarfed by the potential liability, the plaintiff(s) may not find it worthwhile to pursue the matter against the shareholder/manager. And, the plaintiff(s) may prefer to settle than drive the shareholder/manager into bankruptcy. See infra note 404 and accompanying text.

394. See supra notes 199-201 and accompanying text (discussing the limited benefits of limited liability in the closely held context).

395. See supra notes 3, 298-300 and accompanying text. Of course, a regime that imposes pro rata liability on all shareholders or liability on all shareholder-managers also would extend liability to this group. See Hansmann & Kraakman, supra note 5, at 1907, 1928-29. And, again, support for limited liability, even by its defenders, is not particularly strong in this context. See supra notes 287-288 and accompanying text.
otherwise lead to the externalization of risk onto tort victims and society as a whole.\textsuperscript{396}

In larger firms, the actual enforcement of tort judgments against high-ranking corporate officers will be very rare. These officers will have sought to reduce risk. They also will have bargained for indemnification for unavoidable risks, which will be available absent firm insolvency.\textsuperscript{397} Larger firms, including those that are publicly traded, go bankrupt,\textsuperscript{398} but they do so less often than small, closely held firms.\textsuperscript{399} If a larger firm becomes insolvent, and unpaid tort judgments remain, the officer may have bargainned for indemnification by a controlling shareholder. If there is no controlling shareholder able to indemnify the officer, the insurance for which the officer also bargained will often cover these losses. And, although insurers and insurance markets can fail, comprehensive general liability insurance, unlike other types of insurance, enjoys a long history, sophisticated markets, and relative stability.\textsuperscript{400} If the firm's insurance is

\textsuperscript{396} Hansmann & Kraakman, supra note 5, at 1888 ("[T]here is no reason to assume that such small firms should exist—that is, that they have positive net social value. In fact, an important advantage of unlimited liability is precisely that it would force such firms—which are effectively being subsidized by their tort victims—out of business."); Mendelson, supra note 1, at 1295-96. The reduction in competition might inflict a social cost in the form of super-optimal pricing. But the remaining competitors will be more likely to compensate tort victims, which will reduce the social costs of the activity.

\textsuperscript{397} Again, officers will be liable for torts even after they leave the firm, as long as the tortious conduct occurred during the officer's tenure. Once they leave, they cannot ensure that the firm will retain sufficient capital. Yet, officers can bargain with incoming officers for indemnification to ensure that the incoming officers bargain with directors or shareholders for sufficient retained capital, and incoming officers will have an incentive to maintain such capital anyway, since they may be subject to liability for firm losses.

\textsuperscript{398} See, e.g., Booth, supra note 4, at 154 (stating that small and closely held corporations are much more likely to become bankrupt). Sometimes these firms go bankrupt because of tort liability, such as environmental and mass tort liability. See, e.g., Bainbridge, supra note 1, at 534. However, high-ranking officer liability will reduce the number of tort-induced bankruptcies. Increases in such bankruptcies would be only indirect—the result of plaintiffs' willingness to push the firm into bankruptcy knowing that high-ranking officers may also be liable. Cf. Hansmann & Kraakman, supra note 5, at 1909 (making this argument with regard to unlimited shareholder liability). But this regime's more direct effect will be to reduce such bankruptcies. High-ranking officers will force firms to internalize the risk of tort losses ex ante, thereby reducing risks and ensuring greater capital and insurance to cover losses ex post.

\textsuperscript{399} In fact, large, wholly owned subsidiaries go bankrupt because corporate parents can drain the subsidiary of cash or assets. See Mendelson, supra note 1, at 1214 (discussing the depletion of Pacific Gas and Electric Company's cash reserves by its parent prior to its bankruptcy and subsidiary bankruptcies). Other subsidiaries would go bankrupt if creditors were not willing to settle for lesser amounts to avoid bankruptcy. See, e.g., Mendelson, supra note 1, at 1241-42. At least in the subsidiary context, tort-induced bankruptcies are likely to decline under a high-ranking officer regime.

\textsuperscript{400} See Robert A. Buhlman, Comprehensive and Commercial General Liability Policies, in MASSACHUSETTS LIABILITY INSURANCE MANUAL § 4.1 (2000) ("Broadly defined, a liability insurance policy is an insurance policy purchased to provide insurance protection against
The officer likely will have purchased individual liability insurance. After all of this, if the officer still faces liability, he or she may be sufficiently wealthy to absorb the uncollected portion of the judgment. If not, the threat of personal bankruptcy is likely to induce tort creditors, even those seeking damages for catastrophic losses, to settle for an amount less than the total value of the officer’s assets. Thus, there is a small risk of personal liability in the liability to third persons for covered losses. It is one of the oldest forms of insurance in the United States.” (citing Employers’ Liab. Assurance Corp. v. Merrill, 29 N.E. 529 (Mass. 1892)); Eugene R. Anderson et al., Policyholder Claims for Insurance Coverage Because of Environmental Damage, C427 ALI-ABA 427, 434 (1989) (“Liability insurance is one of the oldest and most common forms of insurance purchased by American businesses. . . . Liability insurance policy forms are standardized and prepared by insurance industry-wide organizations.”); Thomas M. Reiter & John K. Baillie, Better Late Than Never: Holding Liability Insurers to Their Bargain Regarding Coverage for Unforeseen, Gradual Pollution Under Pennsylvania Law, 5 DICK. J. ENVTL. L. & POL’Y 1, 8 (1996) (stating that business liability insurance became widely available in the 1880s); Timothy Stanton, Comment, Now You See It, Now You Don’t: Defective Products, the Question of Incorporation and Liability Insurance, 25 LOY. U. CHI. L.J. 109, 111-13 (1993) (“Insurance companies have long tried to implement standard CGL terms and conditions. They have largely succeeded. Standard language promotes price competition and fosters useful legal precedent.” (internal citations omitted)); Susan Warren, Plaintiffs Target Companies Whose Premises Contained Any Form of Deadly Material, WALL ST. J., Jan. 27, 2003, at B1 (stating that many corporate asbestos defendants that have exhausted their products liability coverage may still have sufficient insurance to pay claims falling under their general liability coverage); see also Hansmann & Kraakman, supra note 5, at 1888 (stating general liability insurance is available for most businesses). But see Thompson, supra note 3, at 22 (stating that some evidence exists that insurance is unavailable or inadequate for many environmental liabilities). Although there have been recent discussions of insurance market problems in the terrorism and medical malpractice contexts, there has been no suggestion that comprehensive general liability insurance is at risk.

401. See, e.g., Easterbrook & Fischel, supra note 2, at 48-49 (noting that insurance will not necessarily cover all claims in bankruptcy). But see Warren, supra note 400 (stating that many asbestos defendants still have ample insurance to pay claims falling under their general liability coverage).

402. Officers of large corporations are, as a class, among the wealthiest segments of our society. They therefore have greater access to risk spreading—such as insurance—than other segments of society.

403. Again, officers of large corporations are among the wealthiest segments of our society. They therefore are more likely to be able to absorb excess tort liabilities than other segments. Of course, they will not be able to absorb the kinds of catastrophic losses that may result in the mass tort, environmental, and defective product areas. But, these kinds of catastrophic losses, although much discussed, are not common. See, e.g., Hansmann & Kraakman, supra note 5, at 1903. These losses would be even less common under a regime that requires firms to internalize the costs of risky activities. See id.

404. Indeed, no one really faces absolute unlimited liability: the availability of bankruptcy protection and other evasion techniques ensures that some assets will be judgment proof. Tort creditors often will seek to avoid the transaction costs and risks associated with pressing for a greater recovery in bankruptcy. Mendelson, supra note 1, at 1241-42 (noting that many potential subsidiary bankruptcies are averted because claimants—tort victims or the government—settle for lesser amounts to avoid bankruptcy); see Hansmann & Kraakman, supra note 5, at 1895 (noting that tort victims have strong incentives to accept a settlement for less than the full value of the firm).
context. But, as long as the officer has taken appropriate steps to avoid and spread losses, that risk is sufficiently remote, and the risk of personal-bankruptcy-inducing liability is so improbable, that, absent other circumstances, it is not likely to lead to overdeterrence.\textsuperscript{405}

2. Managerial Risk Aversion

Managerial risk aversion arising from the firm-specific investment of human capital also does not render high-ranking officer liability unnecessary or inefficient. Even the defenders of limited liability concede that managerial risk aversion does not neutralize limited shareholder liability's moral hazard in the closely held context.\textsuperscript{406} But I reject the contention that managerial risk aversion neutralizes the moral hazard problem in firms in which management and share ownership are separated, most notably in larger corporations.

\textsuperscript{405} I recognize that there are influences on risk preferences besides wealth and risk of loss, including psychological and social influences; for example, there is a growing body of behavioral law and economics literature that suggests that decision makers sometimes assign greater weight to potential losses than potential gains. See, e.g., Chris Guthrie, Prospect Theory, Risk Preference, and the Law, 97 NW. U. L. REV. 1115 (2003) (describing prospect theory and summarizing the scholarship in this area); Henry T.C. Hu, Risk, Time, and Fiduciary Principles in Corporate Investment, 38 UCLA L. REV. 277, 331 (1990) (noting that the individual psychology of managers often defies precise characterization in economic models and that "prospect theory" holds that decision makers tend to overweight small probabilities and underweight large probabilities). While a thorough examination of behavioral psychology is beyond the scope of this Article, these psychological influences will not necessarily lead to overdeterrence. Assuming corporate officers take the aforementioned steps to reduce the risk of personal liability, they would have to overvalue dramatically their probability of liability to conclude that the risk is too great to justify their compensation. And again, the impact of such residual risk may be less than many commentators suggest. See Leebron, \textit{supra} note 1, at 1574-75; \textit{supra} note 392. For example, even in today's regime, there are real risks of criminal or civil liability for high-ranking officers under federal securities laws, federal and state environmental statutes, and various public welfare regulations. See \textit{supra} Part II.C. Yet there is no convincing evidence of substantial overdeterrence. See infra note 423 and accompanying text. My proposed regime would increase the risk of personal liability, but this increase will be slight if officers convince the firm to take steps to avoid and spread the risk. And this country's history of entrepreneurialism belies the contention that individuals—wealthy or otherwise—are unwilling to accept substantial investment and liability risks, particularly when presented with a far greater likelihood of significant gains. See \textit{supra} notes 168-169 (discussing why entrepreneurs face substantial risks of personal liability despite limited shareholder liability). Indeed, aspects of prospect theory itself arguably suggest that officers may be willing to overlook small chances of significant liability where the potential for gain is more certain. See, e.g., Guthrie, \textit{supra}, at 1119 (quoting James D. Cox, Private Litigation and the Deterrence of Corporate Misconduct, 60 LAW & CONTEMP. PROBS. 1, 5 (1997)). Thus, there is much that casts doubt on dire predictions of officers and entrepreneurs heading for the exits; and, as discussed below, there will be substantial, additional checks against other forms of firm overdeterrence, including overinsurance and underinvestment in socially beneficial activities.

\textsuperscript{406} See, e.g., EASTERBROOK & FISCHEL, \textit{supra} note 2, at 56.
As an initial matter, as Professor Mendelson has argued, controlling shareholders can overcome such risk aversion through a variety of means.  These shareholders, owners of controlling blocks of shares and corporate parents, will be present in many larger firms.

Furthermore, to date, the discussion of managerial risk aversion largely has failed to take into account the qualitative differences among firm managers, except for recognizing the special category of shareholder-managers. Certainly, lower-level officers and employees—who have firm-specific investments of human capital, limited bargaining power, and limited wealth—are risk averse. But strategic decisions about risk management often are made at higher levels. On the other end of the spectrum, directors have the authority to manage the affairs of the corporation, but face high information costs and receive relatively low compensation. Thus, if outside directors were subject to vicarious liability for corporate torts, they would most likely head for the exits, or, if not, would demand far greater compensation and excessive levels of monitoring, insurance, and capitalization. This may be why the proposal for director liability offered by Professor Halpern and his coauthors has received no scholarly support.

High-ranking corporate officers, however, differ from both lower-level managers and directors. With regard to their incentives to externalize risk, they may be more like shareholder-managers or controlling shareholders. Although it is true that their investment of human capital is undiversified at a given point in time, this does not necessarily alter their risk preferences. High-ranking officers are able to bargain for compensation that aligns their incentives much more

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407. See Mendelson, supra note 1, at 1247-50; id. at 1264 ("The greater the degree of shareholder control, the less the degree of expressed managerial risk aversion, since managers will have reduced latitude to serve their own goals in preference to maximizing shareholder welfare.").

408. See id. at 1215-18, 1227-30 (detailing how, in the last couple of decades, corporate ownership has moved toward greater concentration and away from the Berle-Means corporate model).

409. Outside directors are highly dependent upon officers. Corporate law recognizes this informational disadvantage by allowing outside directors to rely in good faith upon the information provided by officers and experts. See DEL. CODE ANN. tit. 8, § 141(e) (2002). I therefore disagree with Professor Halpern and his coauthors that directors are best situated within the firm to respond to risk avoidance incentives. See supra notes 302-303.

410. Deterring otherwise qualified candidates from becoming outside directors also would have negative consequences for corporate governance.

411. See Kraakman, supra note 6, at 871 (discussing some qualitative differences, including informational and other advantages, between high corporate officials and lower-level corporate agents).
with those of shareholders than with those of other managers or employees. In fact, high-ranking officers may even have greater incentives than shareholders to engage in excessively risky activities, since they are able to demand performance-based compensation that both enhances their returns relative to shareholders and allows them to reap the benefits from the activities sooner than shareholders.\textsuperscript{412} Certainly, to the extent high-ranking officers are compensated faster (or sooner) than shareholders, like controlling shareholders are, they can compel the firm to engage in activities with risks that do not mature until after they have received enhanced returns, giving them a tremendous incentive to externalize risk.\textsuperscript{413} Furthermore, given the relative size and speed of their compensation, high-ranking officers can quickly reallocate their portfolios to diversify away some of the risk of their undiversified investment of human capital.\textsuperscript{414}

Indeed, there is a growing body of literature suggesting that the investment outlook of high-level officers in large firms is not particularly long term nor firm specific, and that such officers, as a group, may be risk preferring.\textsuperscript{415} For instance, many commentators have observed that stock option-based compensation, which enjoyed

\textsuperscript{412} See EASTERBROOK & FISCHER, supra note 2, at 54 (noting firms may pay managers a premium for the firm-specific risk they face); see also Hansmann & Kraakman, supra note 5, at 1909 ("[M]anagerial decision making is commonly shaped in important part by market-based performance incentives that work to align management's interests with those of shareholders.").

\textsuperscript{413} See, e.g., Hansmann & Kraakman, supra note 5, at 1908-09 ("Many important classes of torts which create a risk of catastrophic loss that might bankrupt the firm ten or twenty years in the future seem unlikely to carry any weight in management's incentive calculus today beyond their effect on share prices. Consequently, even if managerial risk aversion might overdeter projects with volatile near-term payouts, it is unlikely to overdeter distant harms that may remain undiscovered until well after management's tenure is over.").

\textsuperscript{414} See, e.g., Mendelson, supra note 1, at 1223 n.80 (stating that wealthy individuals are generally in a better position to diversify risks (citing Blumberg, supra note 3, at 613)).

\textsuperscript{415} See, e.g., Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L. REV. 1233, 1233 (2002) ("[M]anagers with a rich load of options have incentives to get the stock price high by any means necessary, fraud included. In particular, they have incentives to increase the riskiness of the firm .... Managers become risk-preferring"); Hu, supra note 405, at 325 (noting that when managerial compensation depends on perceived corporate performance and actual corporate performance is difficult to measure, a manager "will be sorely tempted to take large, unrecognized risks"); Michael Maccoby, Narcissistic Leaders, HARV. BUS. REV., Jan.-Feb. 2000, at 68, 77 (providing a psychological profile of the so-termed "narcissistic leader," whose "sometimes flagrant risk-taking ... can lead to catastrophe"); suggesting that many corporate leaders of the 1990s exhibited this trait); see also Christopher Avery et al., Why Do Managers Undertake Acquisitions? An Analysis of Internal and External Rewards for Acquisitiveness, 14 J.L. ECON. & ORG. 24 (1998) (reporting the results of a study of 346 CEOs which found that those who undertook corporate acquisitions gained more seats on boards than did non-acquisitive CEOs and suggesting this may give CEOs an incentive to "build empires" rather than maximize shareholder wealth).
rapid growth in the 1990s,\textsuperscript{416} may encourage officer risk taking.\textsuperscript{417} There is also evidence that high-ranking officers, as a class, are becoming more likely to move quickly between firms.\textsuperscript{418} To the extent their expected firm-specific tenure is short, officers, like some controlling shareholders, may seek to enhance short-term returns and to exit prior to potential tort exposure.\textsuperscript{419} And, again, the incentive to produce and distribute short-term gains may be enhanced by the newly lowered dividend tax.\textsuperscript{420}

Obviously, to the extent high-ranking officers are risk neutral or risk preferring, the concern is not risk aversion or overdeterrence, but, rather, limiting shareholder-like excessive risk taking. I therefore question the assumption that excessive risk taking is not a concern in widely held firms without a controlling shareholder.\textsuperscript{421} The conventional wisdom regarding managerial risk aversion may apply to lower-level management and to directors, but it does not necessarily apply to high-level officers in either closely or widely held firms. Thus,
managerial risk aversion is not a compelling argument against vicarious tort liability for these officers.

3. The Costs of Overdeterrence

High-ranking officer liability may still produce overdeterrence if these officers do not bear their relative share of the costs of both overinvestment in risk avoidance and spreading, and underinvestment in socially beneficial projects. However, I suggest these kinds of concerns are overstated. As an initial matter, in areas in which controlling person liability—civil or criminal—currently exists for high-level managers, including the antitrust and environmental areas, we have not experienced the overdeterrence effects some initially feared.

And, again, overdeterrence is unlikely in small firms in which high-ranking officers are also substantial shareholders. These officer-shareholders will bear the full costs of firm monitoring and insurance, and therefore will seek to avoid and spread risks as efficiently as possible. Overdeterrence likewise will not be a significant problem in larger firms with controlling shareholders. Because they will be immune from liability, such shareholders will still prefer risky projects offering high returns. Given their greater access to firm information and their strong bargaining position compared to non-controlling shareholders, such shareholders will be able to bargain with high-level officers to strike the right balance. Indeed, optimal

422. EASTERBROOK & FISCHEL, supra note 2, at 61-62; see supra note 374 and accompanying text.

423. See George E. Garvey, Study of Antitrust Treble Damage Remedy, 46 ANTITRUST & TRADE REG. REP. (BNA) 356, 367 (Mar. 1, 1984) (arguing that the lack of evidence of overdeterrence of pro-competitive conduct despite concerns to the contrary weakened “the logical and intuitive support for the overdeterrence argument”). A major criticism of environmental crime prosecution is that “civil liability provides a sufficient deterrence and criminal laws ‘overdeter.’” Robert G. Kondrat, Punishing and Preventing Pollution in Japan: Is American-Style Criminal Enforcement the Solution?, 9 PAC. RIM L. & POL’Y J. 379, 408-09 (2000). Yet, despite a high rate of imprisonment in the United States for those convicted of environmental crimes, there is little evidence to suggest that criminal sanctions have deterred beneficial activities. Id. at 409-10 (noting that criminal enforcement has had largely positive effects on pollution reduction). For instance, since passage of the Oil Pollution Act of 1990, which provides for criminal sanctions, oil spilled in United States waters has decreased by 81 percent. Id. at 410 & n.225. At the same time, oil imports have continued to grow. See Jeffrey Sachs, America’s Disastrous Energy Plan, FIN. TIMES, Dec. 23, 2003, at 15 (describing growing United States dependence on imported petroleum).

424. See SHAVELL, supra note 184, at 189-90 (“[S]hareholders will often wish firms to be operated in an approximately risk-neutral manner, and firms will be operated in that way insofar as shareholders exercise control over managers and employees.”); supra notes 310-329 and accompanying text (outlining Professor Mendelson’s discussion of controlling shareholder monitoring and oversight capabilities).
risk taking is most likely to occur in circumstances in which participants have significant information, conflicting incentives, and equal bargaining power.

In large or publicly traded firms without a controlling shareholder, overdeterrence may be more likely. Shareholders in these firms may prefer risky projects offering high returns, but agency costs will make it more difficult for them to compel high-ranking officers to internalize their preferences.\(^{426}\) Likewise, agency costs will make it harder for shareholders to prevent officers from exacting an excessively high risk premium.\(^{426}\)

Yet, even in this context, there are checks against overdeterrence. First, as Professor Mendelson argues, as long as the corporation is adequately capitalized and insured, overdeterrence in the form of underinvestment in socially beneficial projects is unlikely.\(^{427}\) Second, the equities markets will provide some check against both underinvestment in projects with net positive values and overinvestment in monitoring and insurance: the value of a firm that consistently underperforms will be reduced and the firm may be taken over by shareholders who will remove the incumbent officers.\(^{428}\) Third, appropriately structured incentive-based compensation, which aligns officer returns with those of shareholders, will force high-ranking officers to internalize some of the costs of overdeterrence.\(^{429}\) Fourth, outside directors and institutional investors, acting on behalf of shareholder interests, will provide some counterbalance, particularly given post-Enron board reforms and enhanced institutional investor oversight.\(^{430}\) Finally, the aforementioned checks combined with the

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\(^{425}\) Cf. Mendelson, supra note 1, at 1248-49 (arguing that when shareholders are numerous and dispersed they face agency costs—greater information costs and greater difficulty in compelling managerial compliance—in seeking to get management to conform to their wishes).

\(^{426}\) Cf. id.

\(^{427}\) See id. at 1294-95.

\(^{428}\) Cf. EASTERBROOK & FISCHEL, supra note 2, at 42 (stating the equities markets provide a check against firm underperformance and that underperforming firms will have discounted share prices, subjecting them to takeover); Hansmann & Kraakman, supra note 5, at 1907 (discussing market mechanisms for holding managers in check).

\(^{429}\) See, e.g., Hansmann & Kraakman, supra note 5, at 1908.

\(^{430}\) See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6,563 (Feb. 7, 2003) (requiring registered management investment companies, such as mutual funds, publicly to disclose their proxy voting policies and how they voted); Proxy Voting by Investment Advisors, 68 Fed. Reg. 6,585 (Feb. 7, 2003) (requiring investment advisors publicly to disclose their proxy voting policies and how they voted); see also New York Stock Exchange Corporate Accountability and Listing Standards Committee, Untitled Report 2 (June 6, 2002) (proposing that "[i]ndependent directors must comprise a majority of a [NYSE member] company's board"). The NYSE board of directors voted to approve the proposed rules on August 1, 2002. Press Release, New York Stock Exchange, NYSE Approves Measure to Strengthen Corporate Accountability (Aug. 1, 2002),
market constraints on the price of firm goods and services will restrain officers from charging customers an excessive risk premium. These checks are not perfect, but, in combination, reduce the risk of overdeterrence, even in firms more closely resembling the Berle and Means model.

4. Uninsurable Activities

Finally, some may argue that any regime that imposes liability on one or more corporate participants—officers or shareholders—that cannot be evaded raises the specter of social loss because there may be some corporate activities that, although socially beneficial, create risks too great to insure against or otherwise spread efficiently. This is a possibility.\(^4\)\(^3\)\(^1\) However, as Professor Mendelson contends, the existing regime may be socially costly because it draws no distinction between insurable and uninsurable risks, allowing both to be externalized.\(^4\)\(^3\)\(^2\) Moreover, the universe of truly uninsurable, undiversifiable risks that produce net social benefits may not be significant. For example, in some contexts, smaller firms that cannot obtain insurance will abandon such high risk activities, while larger firms more capable of reducing and spreading the risk will remain.\(^4\)\(^3\)\(^3\)
Reduced competition may inflict social costs, but it seems doubtful these costs will exceed the social and distributive costs highest-ranking officer liability avoids. And, to the extent the loss of certain corporate activities or competition is viewed as socially harmful, that harm can be addressed by legislation subsidizing such activities or capping potential damages in discrete areas, while maintaining the remainder of the otherwise socially beneficial highest-ranking officer liability regime.  

5. Conclusion

Highest-ranking officer liability is more efficient than proposed reforms that seek to unlimit shareholder liability. Of course, like other proposals, mine would not eliminate corporate torts, completely eradicate moral hazard, or ensure that all tort victims receive full compensation. But my regime both retains the beneficial effects of limited shareholder liability and reduces its social costs, while only inflicting minimal transaction costs. Most importantly, it allocates the risk of liability to the firm's most efficient initial risk bearers: high-ranking officers are best situated to monitor and reduce risk cost effectively; to determine appropriate levels of risk taking, capital retention, and insurance; and to spread risk efficiently among firm customers, shareholders, and insurers. These efficiencies usually will not be offset by risk aversion. And, while high-level officers are capable of bargaining with other firm constituencies for protection, they face counterbalancing interests and checks that prevent both overinvesting in monitoring and risk spreading and underinvesting in projects with socially beneficial levels of risk.

434. See Leebron, supra note 1, at 1578 (stating that an approach whereby particular enterprises must seek a subsidy to engage in certain uninsurable activities is superior to more general limited liability).

435. See supra note 367 and accompanying text.

436. Although I do not analyze limited shareholder liability from a "corporate social responsibility" perspective, I note that my proposal would further some of the same ends. Indeed, my approach may be more effective in some circumstances. For example, Professor Green has argued that, given the social harm limited liability and the corresponding lack of corporate responsibility may inflict, corporate managers ought to be able to consider the impact of their decisions on nonshareholder constituencies. See Ronald M. Green, Shareholders as Stakeholders: Changing Metaphors of Corporate Governance, 50 WASH. & LEE L. REV. 1409, 1414-15 (1993). My proposal would not just give high-ranking officers the ability to consider the welfare of potential tort victims; it would force them to internalize the risk of loss.
B. An Effective Response to Judgment Evasion

Under my proposal, it will be more difficult for firms to externalize all of the risks of tort liability through restructuring the enterprise. Thus, in addition to its initial efficiency advantages, highest-ranking officer liability is more effective than shareholder liability regimes, and particularly than those that extend liability to only some shareholders.

No regime can eradicate judgment proofing, nor should it attempt to do so. Judgment proofing that does not externalize the risk of tort losses is not a concern. For example, firms can always avoid tort judgments by ceasing involvement in risky activities or by contracting out those activities to others in exchange for a lower return. Similarly, firm participants are also “judgment proof” if their personal assets are not at stake because the firm or the firm’s insurers are able to cover the judgment. The challenge, therefore, is to ensure that someone within an enterprise initially internalizes the risk of tort losses, thereby preventing the inexpensive externalization of risk onto tort victims and the moral hazard that accompanies such externalization. Under the current regime, the most obvious example of such an evasion technique to avoid risk internalization is a parent’s relegating risky activities to a wholly-owned subsidiary.437

Because limited shareholder liability itself is a license to externalize risk, no proposal to reform the current regime that unlimits shareholder liability for only limited types of shareholders will be an effective check against the externalization of risk. Similarly, any regime that allows other firm constituencies, such as lenders or third-party contractors, to exercise direct control over an enterprise and seek shareholder-like returns without having to pay for their corresponding risk will be subject to evasion.438 Thus, as discussed in the last section, a sophisticated investor can avoid controlling shareholder liability while retaining controlling shareholder-like control and returns. Such an investor can achieve these results by converting from equity in a publicly traded firm to various forms of debt financing, by investing and participating through multiple intermediaries, or by contracting out risky activities to firms with either no controlling shareholder or a single “high roller” with limited assets. This is consistent with Professor LoPucki's

437. See, e.g., Bainbridge, supra note 1, at 569 (discussing the externalization of risk through subsidiaries).

438. This goes to the essence of Professor LoPucki's critique of judgment proofing. See supra notes 340, 342.
assertion that an owner can structure the enterprise and its operations to externalize risk with relatively few transaction costs.\textsuperscript{439}

The characteristics of highest-ranking officer liability are different, however. In every firm—closely held, wholly owned, or publicly traded—there will be at least one \textit{natural person} who cannot evade vicarious liability if the corporate entity lacks adequate assets or insurance to satisfy a tort judgment.\textsuperscript{440} The highest-ranking named officer will always be vicariously liable. If the firm has no named highest-ranking officer, or other officers in fact wield ultimate authority over some or all firm activities, then these officers also will be liable.

Highest-ranking officers, like corporate entities, may seek to evade liability, but, as Hansmann and Kraakman suggest, evasion techniques for individuals are limited, and courts can more easily prevent the opportunistic shielding of personal assets.\textsuperscript{441} Unable to evade such liabilities in their entirety and unwilling to forgo most of their wealth (and reputations) in personal bankruptcy, highest-ranking officers will be forced to internalize the risk of corporate activities. In response, these officers will bargain for various protections—resources for monitoring, indemnification, the purchase of insurance, and greater compensation—regardless of whether the participant seeking to retain the benefits of risky activities while externalizing the risk is a board of directors, a corporate parent, a lender, or a third-party contractor. In the parent-wholly owned subsidiary context, for example, although the parent will enjoy limited liability for the subsidiary’s torts, the subsidiary’s highest-ranking officers’ preferences will offset those of the parent, and the officers will make sure the parent invests in risk prevention and loss coverage. This is true whether or not the subsidiary’s highest-ranking officers are also the parent’s officers. Either way, the officers will demand indemnification and insurance from the parent. Thus, high-ranking officers of a risk-taking entity will compel the larger enterprise, regardless of its structure, to internalize the risk of tort losses.

Perhaps a board of directors, controlling shareholder, lender, or third-party contractor might seek to avoid this result by installing a

\textsuperscript{439} LoPucki, \textit{supra} note 17, at 147-55; \textit{supra} note 338 and accompanying text.

\textsuperscript{440} See, e.g., Grundfest, \textit{supra} note 167, at 422 (suggesting that no market arbitrage can hedge away an individual executive’s exposure to liability). Of course, individuals also can seek to evade tort judgments through a number of techniques, and personal bankruptcy provides the ultimate limit on personal liability. See Hansmann & Kraakman, \textit{supra} note 5, at 1885, 1911-12. However, as Hansmann and Kraakman argue, these evasion techniques are themselves limited, and courts may prevent individuals from engaging in an opportunistic shielding of assets. \textit{Id.} at 1910-11.

\textsuperscript{441} Hansmann & Kraakman, \textit{supra} note 5, at 1885, 1910-12.
highest-ranking officer who will not bargain for such protection. Professors Hansmann and Kraakman discuss the possibility of a similar evasion technique—the shareholder who is a “high roller”—in their discussion of pro rata shareholder liability. They suggest that this approach to judgment proofing will be infrequent, but it is even more unlikely under my proposed regime. An officer who is in direct control of the business is less likely to be a “high roller” than a person who is simply a shareholder or other, more passive corporate participant. Although officers who truly wield such authority may be risk preferring, they are likely to be both sophisticated and rational.

In addition, if one of these other corporate constituencies installs a stand-in—a highest-ranking officer only in name—or otherwise takes over officer functions, a tort plaintiff can seek recovery from the person(s) exercising actual, direct control. As I have previously discussed, my definition of “highest-ranking officers” includes other natural persons who actually exercise high-ranking officer-like control in addition to or instead of named officers. This is not a “capacity-to-control” analysis since it requires the actual exercise of officer-like control over firm activities. Directors, controlling shareholders, lenders, and third-party contractors ordinarily exercise control without displacing officers or usurping officer-like control. They often, for example, perform monitoring functions, reserve the power to approve or veto important financial and other decisions, and participate in control on a strategic level.

My definition seeks to limit the extension of liability to these other persons to only those circumstances in which they take direct supervisory control over the firm activities: executive decision making and direct control over the operations or day-to-day affairs of the business. When non-officers exercise this kind of direct control over firm activities, they are able to alter the firm’s risk characteristics without substantial interference. And, given how atypical such direct control is for a non-officer, it suggests that, when it occurs, the named officer(s) lack de facto bargaining power and that the firm is being utilized as a means to externalize excessive risk.

Similarly, high-ranking officer liability avoids the quest to define a larger enterprise, a search that may be in vain. Nor does it rely on vague and problematic veil piercing or constructive equity

443. Id. at 1912-13.
444. See supra notes 415-420 and accompanying text.
445. See supra notes 358-359.
446. See supra note 372 and accompanying text.
447. See LoPucki, supra note 17, at 156-58.
My proposal avoids these problems because it is neither a veil piercing theory nor a larger attempt to allocate liability between firms in commercial relationships. It ensures internalization of risk by focusing on persons who are in fact acting as an operating firm's highest-ranking officers. Application to persons not named as officers is likely to be rare; indeed, as long as there are named highest-ranking officers who actually exercise real authority over firm-wide activities, there can be no liability for other persons.

Thus, given the reach of highest-ranking officer liability, it is unlikely that firms will be able to evade the costs of risky activities by planting a “stand-in” in a subsidiary or affiliate. Nevertheless, some may still argue that firms will seek to externalize risk by contracting out risky activities to small firms operated by individuals who, given

448. Courts have, on occasion, extended vicarious tort liability to those who actually exercise officer-like control in both the parent-subsidiary and voluntary creditor contexts. See, e.g., supra note 106 and accompanying text (discussing cases). To date, however, such extensions are unpredictable at best, and the underlying reasoning, whether premised on veil-piercing or agency principles, is vague and problematic. Again, I am skeptical that a “capacity to control” test could be applied coherently and predictably. For similar reasons, I question whether Hansmann & Kraakman’s “constructive equity” doctrine would be useful in preventing evasion. See supra notes 346-347 and accompanying text.

449. There may be additional theories that appropriately allocate risk among commercially affiliated firms. For example, aspects of enterprise liability theory in tort seeks the efficient allocation of responsibility among firms engaged in commerce of defective products. See infra note 492. Likewise, even if my regime were adopted, there may be reasons for extending vicarious tort liability to firms that make assurances of control or quality to the market or create customer confusion or reliance. Nevertheless, the utility of theories that seek to allocate responsibility among commercial affiliates—other than unlimiting shareholder liability—is beyond the scope of this Article.

450. This inquiry is both narrower and broader than other approaches to preventing judgment evasion. It is narrower because it focuses on actual control of firm activities or operations; it is broader because it is not limited to persons within the particular firm or a firm’s parent.

451. The distinction I draw between more indirect forms of control and officer-like control is quite similar to the Supreme Court’s discussion of CERCLA operator liability in United States v. Bestfoods. 524 U.S. 51, 64-71 (1998). The Court emphasizes the difference between a shareholder’s normal exercise of (significant) control over a subsidiary and the shareholder’s direct control of the polluting facility, drawing on corporate law norms:

[The acts of direct operation that give rise to parental liability must necessarily be distinguished from the interference that stems from the normal relationship between parent and subsidiary. Again norms of corporate behavior (undisturbed by any CERCLA provision) are crucial reference points.... So here we may refer to [corporate norms] in distinguishing a parental officer’s oversight of a subsidiary from such an officer’s control over the operation of the subsidiary’s facility. “Activities that involve the facility but which are consistent with the parent’s investor status, such as monitoring of the subsidiary’s performance, supervision of the subsidiary’s finance and capital budget decisions, and articulation of general policies and procedures, should not give rise to direct liability.” The critical question is whether, in degree and detail, actions directed to the facility by an agent of the parent alone are eccentric under accepted norms of parental oversight of a subsidiary’s facility.]

Id. at 71-72 (citation omitted).
their limited wealth and relative immunity to tort judgments, are willing to take uninsured or underinsured risks.452 This kind of outsourcing is possible under a highest-ranking officer liability regime, but complete judgment evasion through outsourcing is likely to be rare. First, not all risky activities can be contracted out to small firms.453 Second, there may be a limited universe of such limited-wealth, high-rolling operators.454 Finally, because the risk-exporting firm will not be able to maintain direct control over the activities of the risk-importing firm and remain judgment proof under my proposal, the exporting firm will face information costs and the risk of lower returns.455 The risk-importing firm also may charge some premium for bearing the risk, even if the premium is lower than that which full risk-internalizing firms may charge. These costs, in combination, may well exceed the costs—the investment in risk avoidance and risk spreading—of keeping the risky activity in house.456

452. Professor Mendelson refers to these as the "fly-by-night" corporations. Mendelson, supra note 1, at 1298-99. Like firm disintegration, such outsourcing might make tort victims worse off because they would be likely to recover less from such firms than from larger firms that retain such activities. See id.

453. See Hansmann & Kraakman, supra note 5, at 1912-13 (arguing that many hazardous activities—such as the manufacture of chemicals and pharmaceuticals—require significant investments in specialized equipment and that individuals with limited assets will not be able to secure debt financing).

454. See id. Obviously, outsourcing is an important externalization strategy in the current regime. See LoPucki, supra note 17, at 157. Yet the current regime facilitates judgment proofing through outsourcing by allowing the participants in small firms to avoid vicarious tort liability and by rarely holding accountable risk-exporting firms that exercise significant control of outsourced activities. Under my proposal, most officers of small risk-importing firms, seeking to retain the benefits of their labor, will attempt to avoid personal liability through risk reduction and insurance. These operators will then charge the risk-exporting firm a premium to cover the cost of risk reduction activities and insurance.

455. Professor Mendelson makes a similar argument, contending that controlling shareholders might have an incentive to purchase goods and services rather than vertically integrate, but this incentive would be offset by the loss of the advantages of integration, such as economies of scale, oversight capabilities, and assurances of product quality. See Mendelson, supra note 1, at 1301. However, as discussed previously, many of the benefits of integration, including controlling-shareholder-like control, can be achieved through symbiotic contracts, as Professor LoPucki has argued. See supra notes 340-342 and accompanying text. My proposal, which extends liability to anyone (shareholder, lender, contractor) who actually exercises officer-like control, avoids this problem.

456. Firm disintegration also is unlikely because operators of small firms, like officers of larger firms, will face vicarious liability for firm torts and may, in fact, face proportionately greater costs of avoiding risks because of higher insurance premiums, the inability otherwise to spread risk efficiently, and economies of scale. See, e.g., Hansmann & Kraakman, supra note 5, at 1913-14 (arguing that disaggregation is unlikely for these reasons and that larger, parent firms are likely to retain ownership); Leebron, supra note 1, at 1615-16 (discussing the enhanced efficiencies of firm integration). And, as discussed previously, such operators, although likely less wealthy, will have strong incentives to retain the fruits of their labor.
The point is that, while firms always will seek to achieve high returns by engaging in risky activities while externalizing the costs of these risks, a highest-ranking officer liability regime makes such externalization difficult. Because officer liability ensures that there will be at least one natural person within the enterprise who is vicariously liable, complete evasion of liability through restructuring is nearly impossible. And the extension of liability to persons who take over officer-like functions ensures that formalistic distinctions between firms and firm participants will not serve as a loophole. As a result, there is almost always going to be someone who has both the capability and the incentive to compel the enterprise to internalize the risk of tort liability.

C. A Realistic Approach to Synthesizing Tort and Corporate Law

If, as I have argued, highest-ranking officer liability is both more efficient and more effective than unlimiting shareholder liability, the question remains whether such a regime is more realistic. As discussed earlier, unlimiting shareholder liability—in whole or in part—is simply not going to happen. Limited shareholder liability remains politically popular, the legislative trend is towards expanding the limited liability to non-corporate forms, and, as a conceptual and practical matter, veil piercing cannot serve as a vehicle for implementing such a regime. Again, highest-ranking officer liability is different. Holding these participants vicariously liable for corporate wrongs is more consistent with long-existing legal norms and recent reforms. Moreover, unlike unlimiting shareholder liability, courts can implement this regime through an extension of common-law tort and agency principles. Finally, highest-ranking officer liability is preferable to and more realistic than unlimiting shareholder liability because it synthesizes the modern view of the corporation and the aims of our tort system.

There remains a risk that some firms may seek to externalize risk through shifting risky activities to foreign subsidiaries operating in foreign jurisdictions in which enforcement of tort judgments against firms or firm officers are unlikely. This kind of cross-national externalization is exemplified by the Bhopal disaster. See Green, supra note 431, at 1419-20 (discussing Union Carbide's use of an Indian affiliate). International risk arbitrage raises important issues beyond the scope of this Article. Tentatively, however, I would suggest that this may be a circumstance in which a domestic court might extend highest-ranking officer liability to officers of the domestic parent, since such officers are in the best position of anyone within the reach of a domestic judgment to ensure the subsidiary avoids and covers risks.

457. See supra Part III.B.2.
1. The Normative Appeal of Highest-Ranking Officer Liability

Holding high-ranking corporate officers vicariously liable for corporate torts is more socially and politically acceptable than unlimited shareholder liability. As discussed previously, firm control and accountability have long been linked. The ancient forms of limited liability usually protected more passive participants while imposing liability on the controlling participant in the enterprise. Until recently, limited partnership law drew the same distinction between controlling and passive participation. Likewise, partners in a general partnership are jointly and severally liable for firm obligations because all general partners presumptively exercise control over firm activities. In each of these contexts, which historically have involved relatively small organizations, the law placed the risk of liability on the party or parties exercising the most direct control over the enterprise.

Limited liability’s expansion to the modern corporation seemingly severs this link between control and accountability. Corporate statutes grant unqualified and universal limited liability to shareholders, and courts traditionally have recognized that the corporate entity itself, rather than its controlling participants, is the principal/master under tort and agency law. Limited shareholder liability has held fast and has, indeed, recently expanded to include equity stakeholders in other types of “hybrid” entities. At the same time, piercing doctrine generally leads nowhere.

458. See supra notes 20-25 and accompanying text. The exception, of course, was the “mudaraba” under Islamic law. See supra note 23 and accompanying text.

459. See, e.g., Pear v. Grand Forks Motel Assocs., 553 N.W.2d 774, 780 n.2 (N.D. 1996) (“In sum, in a limited partnership, general partners, with unlimited liability, manage the business; limited partners contribute only investment capital without participating in the business and without liability beyond capital contributed.”); REVISED UNIF. LTD. P’SHIP ACT §§ 303, 404 (2001). With the advent of LLCs, and LLPs, limited partnerships are utilized only in rare circumstances—for example, when the enterprise is beyond the scope of these other business forms—and most such limited partnerships are LLPs or convertible to LLPs (in which both controlling and passive participants enjoy limited liability). See, e.g., UNIF. LTD. P’SHIP ACT Prefatory Note (2001).

460. See UNIF. P’SHIP ACT §§ 6, 9, 15 (1914) (sections six and nine provide that partners are co-owners and have the ability to bind the partnership, and section fifteen provides for joint and several liability for each partner for acts chargeable to the partnership). Again, virtually all general partnerships—except those formed unintentionally—are now organized as LLPs or LLCs.

461. See, e.g., Thompson, supra note 3, at 31 (“In partnership law, investors are liable for the acts of others, but such extended liability occurs in a context in which the partners will be able to monitor closely the conduct of those for whom they would be liable.”).

462. Indeed, control is an essential element of piercing, but, as discussed supra Part II.B, control alone is almost never sufficient.
Yet, importantly, the limited liability shield for other controlling participants has fared less well. For example, although LLPs are among the new “hybrid” entities, some LLP statutes retain partner liability for torts committed by persons acting under the partner’s direct supervision. In addition, since the mid-twentieth century, Congress, state legislatures, and courts have extended various forms of civil and criminal liability to corporate controlling persons. Some of these forms of liability extend to controlling shareholders as well as to other participants, but, as evidenced by Bestfoods, courts resist imposition of liability on controlling shareholders absent direct participation or the presence of other factors. There is less resistance to imposing liability on other controlling participants.

I am not trying to overstate the breadth of the various forms of controlling person liability. In most circumstances, absent negligence or intentional misconduct, corporate officers and other participants are not personally liable for firm torts or tort-like statutory violations, and many forms of controlling person liability do not impose pure vicarious liability. But recent legislative and judicial extensions of liability to controlling participants in some circumstances, contrasted with the reluctance to unlimit shareholder liability, suggest that the linkage of direct control and accountability has not been lost to the ages. On the contrary, consistent with long-existing legal norms, legal decision makers remain willing to link direct control and accountability for wrongs committed within that sphere of control.

In the smaller business organizations, such as the ancient forms and small partnerships, types of control—more direct versus more indirect—are not dispersed among firm participants; thus, historically, the link between direct control and accountability was achieved by holding any controlling person liable. In modern, complex organizations, however, some participants, including controlling shareholders, directors, and principal lenders, typically exercise significant and perhaps ultimate control, but not direct control. While some believe that these corporate participants ought to be liable for

463. See supra note 44 and accompanying text.
464. See supra Part II.C (discussing various forms of controlling person liability).
465. See supra notes 127-132 and accompanying text; see also United States v. Bestfoods, 524 U.S. 51, 64-71 (1998) (drawing the distinction between shareholder control and direct participation); Mendelson, supra note 1, at 1268-69 (concluding, after discussing Bestfoods, that “statutory law imposing direct liability is unlikely to substantially broaden responsibility for corporate shareholders”).
466. See supra Part II.C; see also Thompson, supra note 3, at 27-29 (concluding that many of these regulatory reforms impose an enhanced duty to monitor, rather than pure vicarious liability).
corporate wrongs, more widespread sentiment holds responsible only those who exercise direct, executive control over firm activities. For example, both the public at large and the markets give high-ranking officers the credit for firm successes and the blame for firm failures, acknowledging that these officers are best situated to influence and alter participant behavior throughout the firm. Legal norms often reflect this view, most recently illustrated by the new certification requirements for CEOs and CFOs. CEOs and CFOs must answer to controlling shareholders and boards of directors, but they may not be in the best position to verify the accuracy of financial statements—accountants, division heads, and experts may have even more direct access to some information and more expertise. Nevertheless, because CEOs and CFOs are a clearly identifiable set of firm participants who combine both significant firm-wide control and direct access to its activities, Congress and the markets view them as the participants most capable of ensuring immediate compliance and instilling confidence. Thus, for many of the same reasons why these officers are the firm’s most efficient risk bearers, they are widely viewed as the participants who ought to be accountable for firm activities.

Of course, history and popular sentiment do not necessarily translate into legislation. Indeed, public choice analysis would suggest that legislation imposing vicarious liability on highest-ranking officers is unlikely, given that corporate officers are a discrete and powerful interest group. Yet, as evidenced by recent expansions of controlling person liability, this kind of reform, as opposed to unlimited


468. Joseph Nocera, Of Fame and Fortune, FORTUNE, Nov. 18, 2002, at 28, 29 (“It is true, certainly, that just as Presidents get more credit than they deserve for the state of the economy, so too do CEOs get more credit—or blame—for the state of their particular company. There are a lot of things, after all, that are outside a CEO’s control. But there are a lot of things CEOs do control—and a company’s success or failure is almost always at least some reflection of the skill of the man or woman at top.”); Thomson, supra note 418, at 32 (discussing a Booz Allen Hamilton study finding an increasing executive turnover due to firings during the market downturn); Margarethe Wiersema, Holes at the Top: Why CEO Firings Backfire, HARV. BUS. REV., Dec. 2002, at 70, 70, 72 (discussing the increasing rate of CEO firings); see Deborah Ball et al., Supermarket Giant Ahold Ousts CEO in Big Accounting Scandal, WALL ST. J., Feb. 25, 2003, at A1.

469. See supra notes 137-140 and accompanying text.

470. See, e.g., Humbled, ECONOMIST, Dec. 20, 2003, at 91, 92 (discussing the tarnished public reputation of corporate executives in general as a result of the Enron and Tyco scandals).

471. See, e.g., Macey, supra note 159, at 451-52 (applying a public choice analysis to the emergence of LLCs and stating that the comparative political power of business people and entrepreneurs assured the extension of limited liability despite the debates over its benefits and costs in the tort context).
shareholder liability, is not a complete political nonstarter. Legislative enactment of highest-ranking officer liability is a possibility, although it is most likely to be achieved piecemeal, if at all, through continued legislative attempts to reduce certain kinds of tort losses or social harms associated with certain industries.

2. Tort and Agency Law Through a Contractarian Lens

The probability of comprehensive legislative reform is, however, largely beside the point, because highest-ranking officer liability can and should be implemented without legislation. Unlike unlimiting shareholder liability, courts can implement my proposal through a natural extension of common-law tort and agency principles. Once one abandons the antiquated notion that the corporate entity controls firm activities, highest-ranking officer liability is simply the appropriate application of respondeat superior (and related forms of enterprise liability) within the corporate structure.

This analysis begins with the predominant contractarian or nexus-of-contracts conception of the firm. Again, this conception rejects adherence to the fiction that the corporate entity has its own preferences and acts separately from its various constituencies.\textsuperscript{472} Rather, under the contractarian view, the firm is simply a nexus of consensual relationships—governed by explicit and implicit contracts—between various participants, including, inter alia, shareholders, directors, officers, and voluntary creditors.\textsuperscript{473} Each of these participants either bargains for various rights and protections, or agrees to accept a standard set of terms.\textsuperscript{474} Thus, for example, shareholders agree to invest capital in exchange for voting rights (e.g., to elect directors) and residual claims on firm cash flows; officers agree to manage the operations of the firm and, in exchange, bargain with directors or controlling shareholders for compensation and protection. Importantly then, legal rules or doctrines as applied to corporations should be consistent with this conception of the firm, rather than with the antiquated, entity-centered view.\textsuperscript{475}

\textsuperscript{472} See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 12 ("The 'personhood' of a corporation is a matter of convenience rather than reality ... ").

\textsuperscript{473} See, e.g., id. at 12; Bainbridge, supra note 1, at 525.

\textsuperscript{474} See, e.g., EASTERBROOK & FISCHEL, supra note 2, at 14.

\textsuperscript{475} See, e.g., Gulati et al., supra note 309, at 891.
The doctrine of respondeat superior is a fundamental risk and loss-allocation vehicle in tort and agency law.\textsuperscript{476} It provides that, when an agent/servant commits a tort within the scope of the agency/servancy, the principal/master is vicariously liable for the tort (along with the agent/servant).\textsuperscript{477} In allocating the burden of vicarious liability in tort, the doctrine draws a critical distinction between master and non-master principals: the former group is subject to vicarious liability while the latter is not.\textsuperscript{478} The test for determining whether a principal is also a master is based on the level of control. A master is a principal who exercises (or has the capacity to exercise) control over the physical conduct of her agents; a principal who is not a master by definition exercises control, but not direct control, over the conduct of her agents.\textsuperscript{479}

Historically, the respondeat superior doctrine has been based primarily on the notion—very much reflecting sentiments described above—that a party capable of directly controlling the conduct of those acting on her behalf is best able to reduce or avoid tortious conduct within the sphere of her control, and, thus, ought to be accountable for such torts.\textsuperscript{480} In so doing, respondeat superior serves the tort system's
traditional goal of deterrence. In addition, extending liability to the principal/master may have the additional effect of facilitating adequate compensation. More recently, economic theorists have defended respondeat superior liability on efficiency grounds: the doctrine allocates losses efficiently by placing the initial loss burden on the party (the principal/master) who can most efficiently bear the risk. That is, it places the initial risk-bearing burden on the party who not only is in the best position to prevent the loss, but who also can most efficiently bear or spread the loss. Of course, this risk-bearing analysis is familiar, since it parallels the analysis of risk bearing within the firm addressed earlier in this Part.

So, if we seek to synthesize the contractarian view of the firm with respondeat superior, who ought to be vicariously liable for torts committed within the scope of the corporate enterprise? The traditional answer has been that the entity itself is the only principal/master, and courts continue to cling to this fiction. But

481. Bennis v. Michigan, 516 U.S. 442, 469 (1996) (Stevens, J., dissenting) (stating that respondeat superior serves as a deterrent by encouraging employers to closely supervise employees and is limited in situations where no deterrent function is served); Schwartz, supra note 476, at 1754; Bryant Smith, Cumulative Reasons and Legal Method, 27 TEX. L. REV. 454, 455 (1949).

482. The adequate compensation justification is not inherently linked to control, and it may not stand on its own as an independent basis for vicarious liability. But it often is listed among the factors supporting respondeat superior liability. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 204 cmt. b (Tentative Draft No. 2, 2002) (“Respondeat superior also reflects the likelihood that an employer will be more likely to satisfy a judgment.”). Some have suggested that respondeat superior liability is based on the fact that the master benefits from the activities of employees. But because both master and non-master principals benefit from the actions of agents, respondeat superior cannot be based solely on such benefits.

483. See, e.g., SHAVELL, supra note 184, at 170-71 (demonstrating that "where the principal can observe and control the [employee's] level of care the actor will take optimal care whether the principal is vicariously liable for full losses or only for the balance not paid by the actor and whether the principal or actor initially bears the cost of care"); see also WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 121 (1987) (stating that respondeat superior enlists the employer as an enforcer of tort law where tort liability against the tortfeasor is unworkable or insufficient).

484. See, e.g., P.S. ATIYAH, VICARIOUS LIABILITY IN THE LAW OF TORTS 23 (1967) (arguing that risk spreading among stockholders, employees, and customers is the most rational justification for vicarious liability); Calabresi, supra note 368, at 543-44 (arguing that the employer is "the best primary risk spreader"); Klemme, supra note 368, at 177-78.

485. See supra notes 50-57 and accompanying text; see also Meyer v. Holley, 537 U.S. 280, 282 (2003) (holding, in a unanimous opinion, that a corporate officer of a real estate company is not vicariously liable for the violations of the Fair Housing Act committed within the scope of the enterprise). In Meyer, the Supreme Court refused to extend vicarious liability for Fair Housing Act violations to a corporate officer and sole shareholder, holding instead that only the entity (as "employer") is vicariously liable under the Fair Housing Act for discriminatory practices of lower-level employees. See id. at 289. In deciding that Congress did not intend to extend vicarious liability to corporate officers under the Act, the Court inferred that, absent a contrary expression, Congress intended ordinary background tort principles to apply. See id. at 289-91. In so doing,
this conception is clearly inconsistent with the contractarian view, which recognizes that the corporate entity has neither the capacity to control nor the ability to allocate risk. Only the firm's participants have preferences and the ability to act on them.486

The participants within the firm who wield master-like control—direct control over firm activities and employees—are corporate officers.487 Controlling shareholders, directors, and lenders may also have the right to exercise control over firm activities, but they usually exercise indirect control akin to that of non-master principals.488 In reality, they do not have the capacity to control conduct within the firm directly unless they assume officer-like functions. And, given that these constituencies both must act through officers and face information costs, they are not the firm's most efficient initial risk bearers.489 Likewise, managers and employees down the chain of command may have very direct access to some firm activities, but they likely do not have the authority to make strategic decisions about risk and are not otherwise efficient risk bearers. High-ranking corporate officers are the firm's most efficient initial risk bearers, and, correspondingly, extending vicarious liability to these participants furthers the goals of deterrence and compensation.

Thus, if courts apply the doctrine of respondeat superior in light of the contractarian view of the firm, they should extend vicarious liability for firm torts and tort-like statutory violations to highest-ranking officers.490 Such an extension of respondeat superior

the Court found that, absent special circumstances, ordinary vicarious liability rules extend liability to the corporate entity only, not to corporate officers or shareholders. See id. Although I argue courts should extend such liability to corporate officers, the Meyer Court correctly describes the traditional and prevailing view. And, consistent with other decisions regarding vicarious officer liability, Meyer simply echoes the standard fiction that employees work for corporate entities, not the people who actually control these entities. See id.

486. See, e.g., SHAVELL, supra note 184, at 189 (“The attitude toward risk of firms will reflect the attitudes toward risk of their managers, employees, and shareholders.”); Gulati et al., supra note 309, at 891 (“[I]t is dangerous to ignore the reality that firms can transact only through individuals, whose motivations may be different from those imputed to the abstraction.”).

487. Again, corporate officers exercise control over the daily and ongoing operations of the firm. See supra note 355 and accompanying text; see also Glanville Williams, Vicarious Liability and the Master's Indemnity, 20 MOD. L. REV. 220, 230 n.29 (1957) (noting that the control-based justification for respondeat superior ignores the fact that corporate officers and managers exert greater control over employees than the corporate employer).

488. See supra notes 372, 446 and accompanying text.

489. See supra notes 368-373 and accompanying text. Indeed, Professor Shavell has argued that vicarious liability is more effective as the principal's ability to observe and control the actor increases. SHAVELL, supra note 184, at 171-72. Lower-level officers and employees have direct involvement in firm activities—indeed, they may be the tortfeasors—but they are not otherwise efficient risk bearers. See supra Part IV.A.2.

490. This is consistent with the view of Professor Gulati and his co-authors that the appropriate analysis of which firm participant ought to be liable for corporate debts "would be to
liability is consistent with both its traditional and efficiency-based justifications.

This does not mean, however, that the entity should be free from liability. The firm represents a bargain between its participants, and each of these participants is aware that his or her particular investment—capital, labor, opportunity costs—in the firm is at risk, including the risk of liability for tort claims. It does mean, instead, that high-ranking corporate officers should be vicariously liable along with the entity, thereby ensuring that the firm internalizes the risk.

Moreover, my proposed regime not only is consistent with the traditional and economic justifications for respondeat superior, but also furthers the goals of enterprise liability theory. Enterprise liability theorists are concerned with the efficient allocation of risk for injuries resulting from enterprise activities. They advocate the extension of liability to the party best able both to prevent injuries and to spread losses efficiently. Enterprise liability theorists therefore tend to favor respondeat superior and other, more controversial forms of "faultless" liability, such as strict products liability. Yet enterprise liability theory generally does not address the allocation of

examine each of the most proximate participants to determine which one, or which combination of them, would most likely respond to incentives to take the optimal level of care." Gulati et al., supra note 309, at 930-31.

Thus, to the extent corporate officers or others bargain for protection and compel the firm to retain capital and insurance to protect against tort losses, the law will enforce that bargain.

Enterprise liability theory also seeks to allocate risk to various firms engaged in commerce for a particular good, assigning the ultimate economic burden of defect avoidance and insurance to the manufacturer. See Klemme, supra note 368, at 188. Without high-ranking officer liability, however, shareholders and managers of manufacturers may have insufficient incentives to prevent product defects, particularly latent defects, or to retain sufficient capital and insurance to indemnify downstream distributors and retailers. And, although risk avoidance is more difficult for downstream firms, regardless of whether there is highest-ranking officer liability or not, officers of downstream firms faced with potential liability will have a greater incentive spread the risk of loss efficiently than under today's regime. Indeed, standard contracts may emerge whereby officers of upstream firms agree to indemnify officers of downstream firms.


See generally Guido Calabresi & Jon T. Hirschoff, Toward a Test for Strict Liability in Torts, 81 YALE L.J. 1055, 1056-61 (1972); Klemme, supra note 368, at 174-78, 222-23.
vicarious responsibility within the firm. Correspondingly, it offers no mechanism for ensuring that someone within the firm internalizes the risk of firm activities and compels the firm to take steps to avoid and spread risk. Although high-ranking officer liability does not address whether or when tort liability ought to arise for firm activities, it does provide the otherwise absent, risk-internalizing mechanism for those liabilities that do attach. Of course, many criticize the existing tort regime and argue that tort law imposes excessive liability in some contexts. If such normative claims are accurate, they justify modifying those aspects of the tort regime. They do not justify retention of so ill adapted a tool as limited liability, which allows corporate participants to externalize the cost of many risks that are undisputedly appropriate subjects for tort and tort-like statutory liability. Limited liability, therefore, is overbroad as a check against expansive tort liability and, correspondingly, is a rough and inefficient substitute for appropriate tort reform. Thus, my proposal, which focuses on correcting limited liability's inefficiencies, neither embodies nor should be rejected based on normative assumptions about whether or when tort liability ought to attach for firm activities.

Finally, because my proposal simply extends the doctrine of respondeat superior, a creature of common-law tort and agency principles, it offers a further implementation advantage over unlimiting shareholder liability. By merely modifying an existing common-law doctrine, my regime avoids the inter-jurisdictional constraints of corporate law reform. Unlimiting shareholder liability most likely would have to be achieved through amendments to state business corporation statutes. Yet, faced with such statutory reform in one jurisdiction, firms would incorporate elsewhere to prevent shareholder liability. This potential exodus, in turn, will deter

496. Cf. Thompson, supra note 3, at 15 (stating that earlier enterprise liability scholarship did not seek to extend these principles beyond the firm). These theorists tend to discuss only the tortfeasor (if there is one), and the firm or employer.

497. See id. ("The recent flurry of proposals to extend liability beyond the enterprise builds on the now-mature legal doctrine making the enterprise liable for acts of those within the firm without applying strict causation or agency principles found in earlier law. The extension of liability beyond the enterprise rests on similar efforts to make the enterprise internalize costs and to spread costs to better risk-bearers.").

498. See Hansmann & Kraakman, supra note 5, at 1887-88, 1918 (making this argument in support of their proposal to extend pro rata liability to shareholders).

499. Hansmann and Kraakman argue that their proposal should be viewed as one of tort law and subject to traditional choice-of-law analysis in tort. Id. at 1921-22. I find this argument unconvincing since the limitations on shareholder liability are contained in state business corporation statutes.

500. See, e.g., Easterbrook & Fischel, supra note 2, at 5-6 ("The managers who pick the state of incorporation that is most desirable from the perspective of investors will attract the
Highest-ranking officer liability, on the contrary, would not produce this deterrent effect. Because highest-ranking officer liability would be an extension of vicarious liability in tort, courts would apply their normal choice-of-law principles for tort actions, which usually point to the law of the jurisdiction in which the tort occurred. The state of incorporation therefore would not be dispositive. In fact, even if only a few jurisdictions adopt this approach, its efficiency-enhancing effects may be widespread, since officers in firms engaged in nationwide commerce would have to consider the risk of vicarious tort liability in these jurisdictions.

V. CONCLUSION

Limited shareholder liability continues to generate controversy. It should, since, as Professor Mendelson and others persuasively demonstrate, it inflicts social costs. Proposals for reform have largely focused on unlimiting shareholder liability, but, realistically, the existing protections for shareholders are not going to be dismantled through statutory reform or veil piercing. In addition, some proposed alternatives—such as pro rata liability—threaten the benefits of shareholder liability and would be administratively costly. And all forms of shareholder liability are vulnerable to evasion techniques and may have negative downstream consequences for corporate governance. The challenge, then, is to find a realistic and effective alternative approach to reducing the social costs of limited shareholder liability.

The best solution is vicarious tort liability for highest-ranking corporate officers. Contrary to prevailing thought, given their role within the firm and risk characteristics, high-ranking officers are the most efficient risk bearers in the corporate enterprise. By placing the burden of liability on them, my proposed regime retains the beneficial
effects of limited shareholder liability and counteracts its moral hazard, and does so with minimal administrative costs. And officer liability, unlike shareholder liability, is not easily evaded through restructuring the enterprise. Finally, an officer-centered liability regime can be implemented through judicial application of ordinary tort doctrines consistent with the contractarian view of the firm. This will synthesize tort and corporate law theory like no other previous proposal, and will resolve the lingering conflict between limited liability and the tort system’s deterrence and compensation goals.